A Two-Handed Economist's Presentation on The Treaty

Professor Karl Whelan
University College Dublin
Presentation for Labour Party
April 28, 2012

The Fiscal Compact Treaty: Two Angles, Four Questions

- A European angle:
  - Are the fiscal requirements right for Europe? (My answer: No)
  - Is some kind of fiscal pact part of solving the Euro's problems? (My answer: Yes but a lot more required)
- An Irish angle:
  - Does it mean more austerity in the coming years than we already will need? (My answer: No)
  - Will we need to access ESM to avoid a severe disruption? (My answer: Yes)

Balanced Budgets = Common Sense?

- Even people who are against the Treaty often say they favour balanced budgets after some period of time.
- In fact, with economic growth, prudent fiscal management means low and stable Debt / GDP ratios, not the elimination of deficits.
- If GDP grows, then debt can grow.
- This means that economies can run deficits on average over time.

How Tight Are the Fiscal Rules?

- Key restriction is so-called "golden rule":
  - Maximum cyclically-adjusted deficit of 0.5% of GDP when debt/GDP above 60%.
  - Maximum cyclically-adjusted deficit of 1% of GDP when debt/GDP below 60%.
- If you borrow 1% of GDP and your nominal GDP grows at X%, you tend towards a debt ratio of 1/X.
- Nominal GDP growth of 4% means following rules leads to maximum debt-GDP ratio of 25%. No need for a level of public debt that is this low.

Implications for Growth in Europe

- Peripheral countries have serious public and private debt problems.
- Need to be solved by earning more than we spend, (i.e. current account surpluses) which requires strong growth in exports.
- With fiscal tightening even in countries that don’t need to (Germany, Netherlands) European economy will be too weak to deal with debt problems.
- If we pass the Treaty, we should support amending it to be less restrictive.

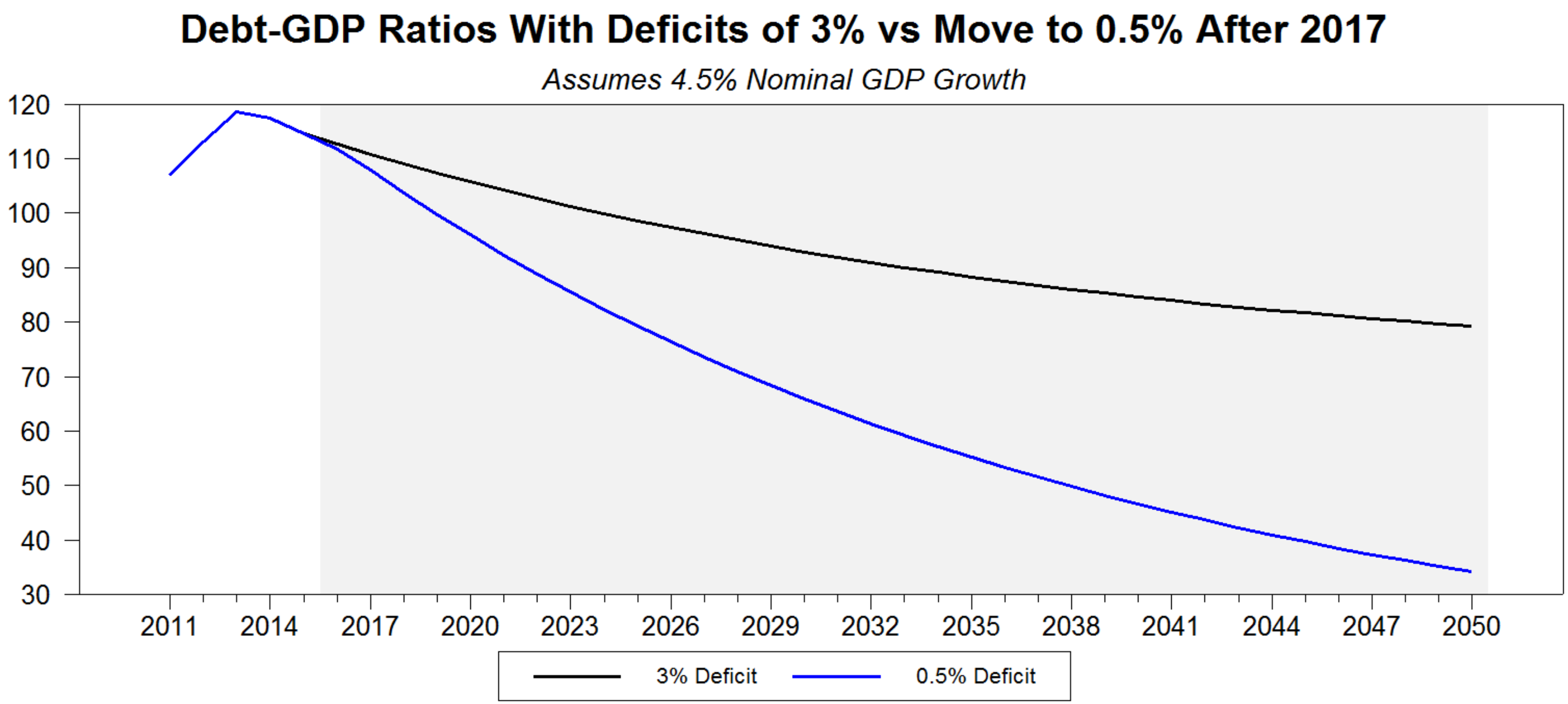
But Some Kind of Pact Is Required

- I'm not keen on how the Fiscal Compact has been specified.
- But the Euro is in crisis and major changes are required if it is going to stay intact:
  - Sovereign lender of last resort, e.g. Eurobonds or (my preferred option) providing EFSF with a banking license.
  - Common deposit insurance and pooling of losses for failed banks.
- Binding commitments to fiscal discipline are required for core states to be willing to sign up for these.

Does the Treaty Imply More Austerity for Ireland?

- We have already agreed fiscal targets out to 2015 with Europe: Deficit projected at 3% in 2015.
- Does need to move to 0.5% require more austerity from 2016 onwards than would happen otherwise?
- Probably not: Sustaining a 3% deficit would leave Irish debt ratios very high – and the country in danger of another crisis – for a long period.
- A slow move to a period of surpluses is desirable before debt stabilisation allows sustainable deficits.

Two Scenarios for Debt Ratios



Will Ireland Need a Second Bailout?

- My answer is YES.
  - Growth has fallen short of projections.
  - Housing market still contracting.
  - Bank losses heading for “stress scenario”.
  - Private sovereign debt investors worried about potential “haircuts” after Greek precedent.
  - Plans to refinance promissory notes and move trackers require large amounts of new funding.
- But access to ESM provides “safety net” and raises chances of market access.

Access to Funding After a No Vote

- ESM Treaty now includes a requirement to sign pact.
  - Refuse to sign ESM Treaty? ESM will be delayed but then most likely introduced in an inter-governmental fashion.
  - There is no “leverage” in relation to ESM.
- What about EFSF? It’s still around to mid-2013.
  - Requires unanimous approval by Eurogroup finance ministers.
  - Germany will not approve a loan to a country that votes No. From their perspective, linking bailouts with fiscal discipline is the point of the Treaty.

Isn’t it a Bluff from EU?

- “No” advocates claim “It’s all a bluff. Europe won’t let Ireland fail.”
- Are they right?
  - People used to say “Europe won’t let Greece default” but it happened.
  - People used to say “Sovereign default in any Euro area country would cause chaos everywhere.” It didn’t.
  - People used to say “No country could leave the Euro” Now German politicians openly talk about Greek exit.
- A good time to play poker over economic stability?

What About the IMF?

- IMF lending capacity smaller than most realise.
- The first Irish programme was very big one for IMF. They said it “entailed substantial risks” for them.
- A second programme without EU involvement would be even bigger.
- Most likely, the only type of programme IMF would agree to would involve:
  - A significant sovereign default
  - Very fast reduction in budget deficit
  - Austerity critics would find this mixture worse.

Yes for Ireland
But Europe Can Do Better

- For Ireland:
  - Passing Treaty will not mean more fiscal adjustment for Ireland over the next ten years.
  - Failing to pass it presents serious uncertainties for future funding and claims of “leverage with EU” are wrong.
  - Arguments favour a Yes vote.
- For Europe
  - Some kind of fiscal pact makes sense but we should lobby with like-minded partners for a less restrictive pact.
  - Need to play our role in pushing for systemic solutions (e.g. EFSF banking licence)