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22 Queen Anne's Gate, London SW1H 9AA
Email: press@politeia.co.uk Telephone: 0207 799 5034
www.politeia.co.uk

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Balancing the Books should be Priority for Growth, says Politeia's new study. ECB economists say Keynesian pessimism on deficit reduction is wrong.

As low growth figures cast their shadow over the Budget, many critics remain concerned about the approach to public spending cuts and the fragility of the economic recovery.

But in Politeia's next study, ***More Gain Than Pain: Consolidating the public finances***, three distinguished economists at the ECB explain that the case is strong for cutting the deficit and debt without delay. The authors, Philipp Rother, Ludger Schuknecht and Jürgen Stark*:

- Explain that the public finances in most advanced economies are unsustainable, taking into account government deficits, debt and other liabilities for the budget (e.g. financial sector or population).
- Show that the benefits of balancing the books, rapidly, are substantial in the short- as well as long-term.
- Set out the principles for an immediate course of debt and deficit reduction. The long-term goal must be to reduce levels of public spending to support growth with lower taxes and fewer distortions in the economy.

The authors explain that:

First, the problem is grave. The level of debt in the system – nationally and cross border – is high, and globally unprecedented. Private debt has seeped into the government accounts (e.g. that of the banking sector) and governments also face liabilities from other countries they have underwritten. Given the uncertainty about the public finances, it is not clear when markets will perceive them to be unsustainable.

- Deficits in the euro area are expected to average 6 per cent in 2010 and 10 per cent in the US and UK.
- Debt ratios have risen rapidly. Those for the UK and US have risen as rapidly as those in the euro area, and the lower starting position means the underlying story is worse.
- To bring the public finances back on to a sustainable footing, the figure for the euro area is 6 per cent of GDP, but the UK and US would need 10 per cent of GDP, and this implies a reduction in expenditure of 10-20 per cent.

Second, the gains from consolidation are significant. Consolidation reduces the savings used by the public sector, leaving resources for private investment. It strengthens fiscal sustainability and contributes to macroeconomic stability. This allows stable growth by smoothing out the shocks, reducing distortive tax rates and improving the quality of the public finances. Meanwhile the - adverse - short term effects on domestic demand are compensated by positive effects on confidence and expectations.

The most positive effect on the economy and demand is reduced concern about financial stability. The consequences of such concern include, for example, increases in interest rates, which feed back into the economy, lowering the value of government bonds, downgrading ratings and limiting access to external funding. Given the strong – and fast – links between the fiscal-financial sector and the problems which arise when fiscal plans are inadequate, consolidation brings significant fiscal-financial gains.

The authors conclude by outlining the principles for consolidation. Governments should:

- Implement immediately plans to return to positive primary balances over the next few years.
- Base consolidation generally on expenditure reduction, reducing expenditure ratios to below the pre-crisis levels but aiming for further reductions to support long-term growth via lower taxes and reduced distortions in the economy.
- Set out sizeable and well-targeted cuts early in consolidation in order to increase confidence.
- Make the medium- term reforms needed to address future burdens such as pensions and health- care systems.
- Couple fiscal reforms with structural reforms in order to maximise growth and sustainability. Meanwhile the labour and product market need to be flexible, with financial sector regulation ensuring sound incentives and early detection of emerging risks.

More Gain Than Pain: Consolidating the public finances is published by Politeia, 22 Queen Anne's Gate, London SW1H 9AA.

Enquiries to:
Matt Trahair, Press Officer, Politeia: Email: press@politeia.co.uk Tel: +44 (0)7800 519277
The European Central Bank Press Office: General Enquiries: info@ecb.europa.eu
Journalist enquiries: media@ecb.europa.eu Tel: +49 69 1344 7455

*Philipp Rother is Head of the Fiscal Surveillance Section in the European Central Bank (ECB).
Ludger Schuknecht is Senior Adviser in the Economics Directorate General of the ECB.
Jürgen Stark is a member of the Executive Board and the Governing council of the ECB.