FT.com
FINANCIAL TIMES

Lack of fiscal credibility hurts sterling

By Willem Buiter
Published: March 2 2010 02:00 | Last updated: March 2 2010 02:00

Sterling has been weak and jittery recently, falling below $1.50 yesterday. Even with the euro weakening amid the sovereign debt tsunami about to engulf Greece - barring a rescue - the pound has dropped against the single currency.

There are good reasons for the weakness and volatility of sterling. Among industrial countries, Britain's economic fundamentals are uniquely awful. As regards public debt and deficits, Britain's true fiscal circumstances are about as bad as Greece's reported situation, once we allow for the understatement of UK public debt through the off-balance-sheet accounting tricks of the past decade (the private finance initiative, unfunded pensions, student loans and other Enron-like constructs).

The fiscal weakness of the UK is largely government-inflicted, rather than a result of the financial crisis and global contraction. During the long boom preceding the crisis, fiscal policy was relentlessly pro-cyclical, with public spending rising steadily as a share of gross domestic product. The size of the bank bail-out reflected failures of UK regulation that permitted the financial system's balance sheet to pass 400 per cent of GDP.

Britain has four, inconsistent, features. It is a small, open economy, with a large, internationally-exposed financial sector, its own minor-league currency and limited fiscal spare capacity. This makes it uniquely vulnerable. Its central bank is limited in the liquidity support it can give banks with short-term foreign-currency liabilities. Its fiscal authorities may discover that major banks are not just too big to fail but also too big to save. The markets have recognised this, become nervous and started testing it.

When a government has credibility - its promises and commitments are believed by its citizens and by the markets - the best policy is not an immediate fiscal tightening. A credible government would implement an immediate fiscal stimulus of, say, 2 per cent of GDP and commit itself to sufficient future tightening to restore fiscal sustainability.

Unfortunately, thanks to a decade of fiscal mismanagement, the British government has little credibility. Public finances during the last boom are the obvious guide to expectations about the likely future fiscal behaviour of a Labour government. The cynical manipulation of Gordon Brown's "golden rule" (over the economic cycle borrowing only to invest) and the decision to jettison it and the sustainable investment rule (net debt not to exceed 40 per cent of GDP) as soon as they threatened to become binding constraints will cause the markets to act like St Thomas towards promises of future fiscal tightening: seeing is believing.

The Conservatives are untried and untested. So the markets will also demand their pound of flesh in the form of immediate fiscal tightening if the Tories form the next government.

The crucial difference between Britain and Greece is in the political economy of fiscal tightening. Both need 8 to 9 per cent of GDP-worth of permanent fiscal tightening. Greece cannot deliver that without external support because its society and polity are deeply divided; its institutions of governance are weak and its government incapable of swift, dramatic actions.

The UK authorities, by contrast, should be capable of imposing a timely burden-sharing solution. This is an advantage of the UK's "elected dictatorship" constitution: with a powerless second chamber, a first-past-the-post electoral system and no tradition of judiciary interference in economic affairs, there are no checks and balances constraining the executive when a single party has a parliamentary majority. Without a hung parliament, it is all but certain that the next government will impose early spending cuts and tax increases of sufficient size to calm the markets.

All bets are off, however, should there be a hung parliament. The British political class would have to learn the art of coalition politics. Fiscal tightening could be postponed. The markets would attack both sterling and gilts, threatening the triple A rating. Even this should be survivable, although it could cause Britain to relapse into recession.

A commitment now to a three-party government of national unity could stabilise matters immediately. Failing that, all three parties could agree the size of post-election tightening now, with only the mix of tax rises and spending cuts to be decided after the election. I am not holding my breath.

The writer is Citigroup chief economist