Ireland's Adjustment through the Crisis

Lunchtalk, 2 December 2011, Bruegel

On the 2nd of December, Bruegel hosted a talk on Ireland's adjustment during the past three years and its current prospects. The discussion was chaired by Alan Ahearne, research fellow at Bruegel. The panel of discussants included István Székely, Director, Directorate General for Economic and Financial Affairs of the European Commission, Sven Langedijk, from the Economic and Financial Affairs of the European Commission and Philip Lane, Professor of International Macroeconomics and Head of the Economics Department at Trinity College Dublin.

Following the burst of the credit and housing bubble, Ireland has undergone remarkable adjustments. Productivity has increased at the fastest pace among EU countries. Economic growth has resumed and fiscal targets have been met. An EU-IMF programme is currently operating in the country. The programme has three main pillars: reforming the banking system, restoring healthy public finances and enabling growth enhancing structural reforms. In terms of funding, of the €85 billion total the Irish government provided €17.5 billion, the IMF €22.5 billion and European partners the remaining €45 billion. €35 billion are devoted to the recapitalization of banks and €50 billion to budget financing.

The programme was a result of several negative economic developments, which included an overall highly leveraged economy, particularly in the financial, corporate and household sectors and high loans to deficit ratios.

Mr. Ahearne introduced the discussion by remarking on the strong Irish export growth, the overall GDP growth, which is due to turn positive this year, and the achievement of fiscal targets. Nonetheless, challenges remain. Public debt is projected to reach 120 per cent of GDP and unemployment is still high, at 14.5 per cent. The timing of the talk is optimal, Mr. Ahearne argued. This is due to the fact that the problems of the euro area are likely to have a strong impact on a small open economy, such as Ireland, which is heavily dependent on trade.

Mr. Székely then took the floor and argued that the case of Ireland is different from that of many other countries, in that it is a highly competitive economy, as shown by the Global Competitiveness Report of the World Economic Forum. Furthermore, Ireland began its adjustment before the start of the programme. Price level adjustment in fact started in 2007-2008 and is now almost complete. The current account is also back in surplus, mainly owing to strong export growth. The highly leveraged economy is still problematic.

Mr. Langedijk continued the presentation and argued that the challenges on the fiscal front have recently taken a back seat and that focus should be re-shifted towards them. The fiscal deterioration in Ireland was significant. Nominal GDP increased between 2000 and 2007 by 80 per cent, compared to 30 per cent in the euro area. Nominal expenditure increased by 130 per cent from 2000 to 2008, resulting in an 11 per cent increase per annum, much higher than in Germany, which recorded a rate of 1.5 per cent. As GDP collapsed, expenditures stabilized, leaving a gap behind. Large parts of the revenues were unsustainable, 5 per cent GDP in 2006 came from housing and construction related activities. This number has now fallen to a mere 0.5 per cent, leaving a fiscal deficit of more than 10 per cent of GDP. A lot of adjustment has happened and the underlying fiscal weaknesses have been exposed.

Growth remains crucial for the programme, Mr.Langedijk argued, and the growth path the economy is currently on, mainly owing to exports, is promising. Nonetheless, significant risks remain for 2012. Domestic demand is still weak and projections in this area are modest. This is mainly owing to deleveraging and fiscal consolidation, which are likely to have a negative impact on domestic demand.

Mr. Lane focused his presentation on a comparison between the situation of Ireland now and that from a year before. The outlook at the moment is much more optimistic than in the previous year and the Irish system is committed to delivering the required adjustment. Before the July summit, there was a sharp increase in the interest rate on sovereign debt. That trend however has been reversed. The lowering of the interest rate on European funding was a big part of this. Since July, there has been a return of real private sector investors. This includes equity investment in the bank of Ireland without any government guarantee. There are also some major private sector bond investors who became involved, which Mr. lane argued is a sign of the fact the Europe is committed to Ireland.

There are still threats at work. One of them is given by the downgraded forecast for euro-area and global GDP. The Irish trade path is less cyclically sensitive than that of other countries, nonetheless, the slowdown may have negative implications for Ireland. There also remains the question of whether financial markets will reopen to Ireland, the uncertainty about the euro itself and the role of private sector involvement.

Many risk factors are also present at the local level. There is uncertainty regarding whether the default rate of mortgages will be a function of income levels, i.e. driven by unemployment and disposable income, or whether a strategic default is likely to take place, whereby large negative equities encourage strategic defaulting. Big questions also dominate the labour market: Are labour costs going to fall? Will fatigue set in after three years of adjustment? All these are relevant topics, particularly with the upcoming budget next week.

Mr. Lane then addressed a question to the Commission. He thus wondered whether, on hindsight, the Commission would alter any aspects of the original programme. Some key issues, which may be reassessed, include the role of loss guarantees in restructuring the bank system, the speed of bank deleveraging and the pace of fiscal adjustment. The political equilibrium seems to operate according to the motto "meet the terms of the deal, no more, no less," Mr. Lane argued. There may be a bias now towards doing too little.

One thing remains clear, Mr. Lane concluded, there is a long road ahead. Even though Ireland has increased its competitiveness, there is still a lot of downward wage stickiness. Unemployment is a key variable that requires the attention of policymakers. As long it remains high, there is a competitiveness problem, implying that labour is too expensive.

Mr. Székely reiterated his firm belief in the programme and argued that even if one could go back in time, the programme would still be roughly the same.

Addressing the speed of fiscal adjustment, Mr. Székely highlighted the fact that ideally one can fine-tune the fiscal fence if one knows everything about the economy, however since this is not the case, the degree of precision for predictions about the economy is low. As a result, the strategy is to "fly through this fog with a simple rule, that may not be robust, but hoping that credibility will be built up to an extent that the room for policy manoeuvre will increase." Mr. Székely once more applauded the Irish achievement in implementing changes and increasing the credibility of the programme. One illustration of this was the small number of industrial actions that took place in the past year in Ireland, relative to other countries.

On the discussion of the pace of deleveraging, Mr.Langedijk argued that deleveraging has two components: the asset sales that may be going too fast and may lead to excessive losses and the amortization of the loan portfolio, which has a core and a non-core component. While the non-core part can run down fast, it is worrying if the core component gathers a significant speed of deleveraging.

Jean Pisani-Ferry, director of Bruegel, raised a question regarding the measurement of structural deficits. He asked what the amount of tax revenue that was dependent on real estate development can tell us about the measurement of structural deficits and about the possibility of having automatic sanctions, which are based on the imprecise measure of structural deficit.

Mr. Székely argued that policymakers need to go back to the start, in what the measurement of these deficits is concerned. "We are completely lost on this issue conceptually. There are difficulties regarding the measurement of potential output and of the output gap. We have to start from scratch", he argued, "in the meantime, we're stuck with existing legislation."

Mr. Pisani-Ferry went on to argue that this highlights a need to be cautious when it comes to putting things in the automatic machine. Mr. Székely responded by suggesting that the key issue at stake in this matter is credibility. If one is credible, one can be flexible. Lacking credibility, strict rules become necessary. And these rules sometimes do not make sense: "The automatism is there to overcome this unholy alliance problem that we had in the past, but institutions' credibility is not created by rules, but by intelligent behaviour," he concluded.

Mr. Ahearne expressed some concern about the general optimistic outlook echoed by his colleagues. He reminisced about the time of the Asian financial crisis, when he was doing forecasting for emerging Asian economies. When growth figures looked excessively optimistic, his superior jokingly suggested the figures would be correct if he put a minus sign in front of them. Along the same lines, he asked his colleagues to hypothesize about what would happen if instead of positive growth, a contraction, for instance of 1 per cent magnitude, were to hit the Irish economy. He particularly expressed an interest in what that would mean for the current programme.

Mr. Langedijk argued that it is highly unlikely for Ireland not to have positive growth in the medium term, especially once world trade enters a stronger growth track after 2012. According to him, not the long term is of concern, but the more immediate future, particularly what will happen in 2012 on the fiscal side. Lower revenues may occur and some slippage from target may also be the case, unless corrections are applied.

Another issue raised by the audience targeted the topic of surveillance on the part of the Commission and the extent to which the Commission should give early warning signs when it believes something is not going in the right direction. Mr. Lane argued that risks accumulate over time, however even if fiscal policy is too loose, the economy as a whole may be doing fine. Should the European Commission do something in this case? He argued that countries which are not on a programme will be less likely to listen to Commission recommendations. This remains a contentious topic.

Zsolt Darvas, research fellow at Bruegel, asked the panel what would have happened, had Irish banks been left to fail. Mr. Darvas also highlighted the change of course in the decision of the Irish government, in what the involvement of senior bond holders was concerned. A strong resistance from the ECB and the UK, in particular, was expressed towards such involvement. Mr. Darvas then asked whether there would be a case for an ex-post burden sharing of the losses on the grounds that the lack of involvement of senior bond holders was a result of outside pressure.

Mr. Székely argued that two waves of guarantee schemes were already in place at the start of the programme. Also, Irish banks received huge amount of loans from the European Central Bank at an interest rate of about one percent – which is well below the earlier borrowing cost of these banks. The value of this cut in bank borrowing cost relative to a baseline of the market rate was about €12 billion. "That seems a fair deal", he argued. "This seems substantial burden sharing and no one can argue that putting a zero margin on Irish debt is a massive transfer from the European tax payer, because the price of that kind of risk is clearly not zero, even if the market gets back to normal," he concluded.

Mr. Darvas also addressed the issue of the Irish labour market, commenting in particular on the large fall in employment, working hours and output. He asked how unemployment could be reduced and the problem of wage stickiness resolved.

Mr. Lane argued that it is interesting to think of wage adjustment as a substitute for devaluation. It can be seen that public sector wages have come down. If a firm is about to fail, unions are pragmatic and wages will fall to make the business survive. In such cases, "micro dominates macro", he argued. Wage cuts however will not be accepted unless really necessary. If wages are not reduced, higher wage costs will translate into higher prices. Macro considerations are so external to the firm, that there will be no downward wage pressure. A centralized system may help internalize these macro aspects.

Mr. Langedijk commented on the lack of wage adjustment and attributed this in part to the fact that the labour force is part of sectoral wage agreements. Some of these are even perceived to be unconstitutional, and are in need of review and renegotiation.

Finally, the possibility that Ireland would not be able to return to the market was also raised. Mr.Székely argued that if for some reason Ireland will not return by the deadline set in the programme, funding will still be provided. "We can't be prepared for everything, but at least the path is clearly laid out. Another year of similarly strongly implemented reforms and meeting of fiscal targets, then the market sentiment will change," he concluded.