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Macroeconomic Context for a Sustainable Recovery

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Introduction

This note summarises the preliminary results of research under way at the ESRI examining the current macro-economic problems facing the Irish economy and the possible policy responses. The full analysis and results of this research will be published in the next ESRI Quarterly Economic Commentary.

Background

The Irish economy today suffers from three major challenges which have to be addressed effectively to return the economy to a sustainable growth path. These are:

- the serious loss of competitiveness, which the economy experienced between 2003 and 2008, reflected in the burgeoning balance of payments deficit,
- the structural imbalance in the government accounts and
- the restoration of order to the banking system.

The origin of these problems lies partly with bad policy mistakes over the course of the current decade and partly with bad luck.

The combination of the domestic housing bubble unwinding and a world financial crisis has particularly unpleasant consequences for the Irish economy. However, while the bursting of the property bubble makes things much worse in Ireland than they would otherwise be, up to a half of Ireland's current problems with the public finances and in the labour market arise from the global financial and economic crisis – they would have happened anyway no matter how appropriate fiscal policy had been over the last decade. This diagnosis of the current Irish economic crisis has important implications for how best to tackle the problems.

The serious problems that are a legacy of past policy mistakes culminating with the building and construction bubble have to be tackled by tough fiscal policy measures. The element of Ireland's economic difficulties which derives from the world recession should await a world recovery for an effective cure. The need to restore competitiveness will be reflected in the response of the labour market to the rising toll of unemployment, producing a fall in nominal wage rates.

The Structural Deficit

Before taking account of measures to be announced in the budget on the 7th of April, the general government deficit in 2009 is likely to substantially exceed 10 per cent of GDP. This represents a substantial deterioration over the last three months in the prospective deficit for this year. Much of this deterioration is due to the dramatic fall in output that is now expected in the major world economies. Forecasts for economic growth in our key neighbours remain highly uncertain. This makes the targeting of a specific borrowing figure for 2009 exceptionally difficult.

The appropriate target for public policy in the forthcoming budget is the structural deficit, i.e., the deficit that is due to permanent changes in the economy. The rest of the deficit, namely the cyclical element, should not be targeted by public policy; it will disappear when the world economy recovers pulling the Irish economy with it.

The structural deficit is relatively invariant to short term fluctuations in the outside world and is, thus, a more certain and appropriate target for fiscal policy. Our research suggests that the structural deficit this year is of the order of 6 per cent to 8 per cent of GDP. By contrast the deterioration in the cyclical deficit reflects the fall in tax revenue that will not return without an economic recovery. If Ireland did not currently face a structural deficit, then the appropriate public policy response would have been to let the “automatic stabilisers” work. The fall in tax revenue and the rise in unemployment benefit payments would have seen a cyclical rise in the deficit, albeit of major proportions since this is a severe world recession. In turn, this would have provided some offsetting stimulus to the recession and the deficit would have eventually unwound when the world economy and the Irish economy had recovered.

However, we do have a serious structural deficit, which became apparent early last year. This problem, together with the severity of the recession and uncertainty about when a recovery can be expected, means that there is no option but to take severe action to substantially reduce that structural deficit.

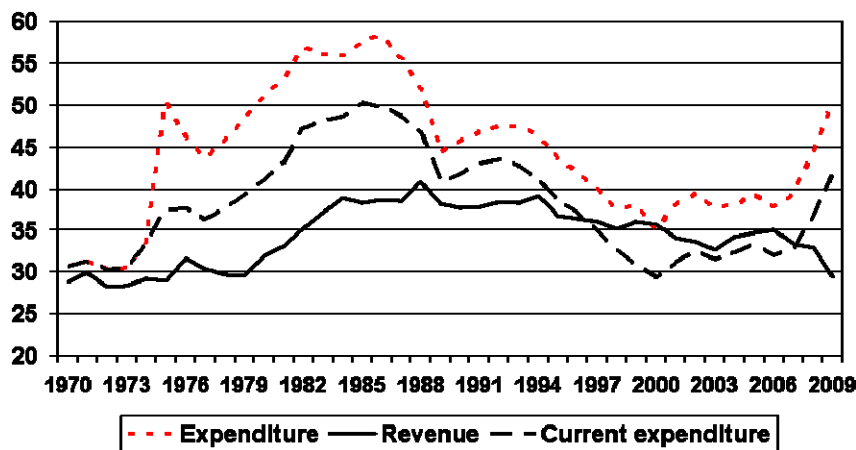
Under these circumstances, and because the earlier actions taken in July, in October (Budget 2009) and in the February package (including the pension levy) proved inadequate, it is necessary to take further action to reduce substantially the structural

deficit in the April budget. It would probably be appropriate for fiscal policy this year and next year to work to roughly halve the structural deficit by the end of 2010. As the economy recovers in 2011 and in subsequent years, further action of a less draconian nature would be needed to reduce the structural deficit to below 3 per cent of GDP by 2013 and to eliminate it by around 2015.

Budgetary Action

As shown in Figure 1 the share of tax revenue in GNP in 2009 may prove to be the lowest since the 1970s. This reflects the dramatic fall in property related taxes and the growing dependence of the government's finances on such taxes since 2000. The rapid increase in the share of expenditure in GNP reflects the fall in nominal GNP as well as a substantial increase in debt interest payments and in welfare payments, which are partly due to the rise in unemployment.

Figure 1: Tax Revenue and Current expenditure as a % of GNP



On the basis of the pattern of behaviour observed over the last two decades, it seems likely that the public would wish to preserve the existing standard of health care and education in the long run. This would make it undesirable to make those providing such services redundant given that they would have to be rehired once the economy recovered. In making cuts in expenditure, priority should be given to areas where services are inefficient or of low value. Already the government has achieved a significant reduction in expenditure through the pension levy, which effectively reduced its labour costs. A reduction in capital expenditure will be facilitated by the large drop in the cost of such investment. However, the Irish economy will continue

to need a relatively high level of public investment in infrastructure over the coming decade.

If the public wishes to preserve the current level of public services, then revenues will have to be raised to between 35 per cent and 40 per cent of GNP. Under these circumstances it seems likely that a substantial increase in tax revenue, combined perhaps with more user charges, will be required to restore the public finances to a sustainable growth path. In choosing the mix of sources of additional revenue it will be important to take account of the likely effects of higher taxes on the labour market. This would argue for developing new sources of revenue such as taxes on carbon and on property.

So far, in considering the government's borrowing and the likely increase in the debt we have not made allowance for the need to recapitalise the banking system. The uncertainty about the necessary provision makes this difficult to do. However, the necessary provisions are likely to be limited when viewed against the likely continuing borrowing for normal budgetary purposes over the period to 2015 and the resulting increase in the debt.

Competitiveness

The deterioration in the competitiveness of the economy in recent years is primarily a result of the labour market pressures exerted by the growing bubble in the property market and the building sector of the economy. (However, other inefficiencies, including a lack of competition in key areas of the economy have also contributed to the problem.) The exceptionally tight labour market saw wage rates and other prices rise very rapidly over the period since 2001. To undo the consequences of this loss of competitiveness will require a substantial reduction in wage rates and other prices in Ireland relative to its trading partners within the Euro area. Within EMU this can only take place through changes in nominal wage rates in Ireland relative to the rest of the Euro area. Because nominal wage rates are only rising very slowly in the Euro area such an improvement in competitiveness can only be achieved quickly by a reduction in nominal wage rates.

Private sector wage rates are not a policy tool available to the government as they are set on the market. Research suggests that the partnership process has not had a long-term impact on the outcome for wage rates. However, it is possible that the partnership process may impact on the rise in nominal wage rates over a limited period. A renegotiation of the agreement to reflect the dramatic fall in prices that is underway and the deterioration in labour market prospects since September could prove helpful and it would be in the spirit of the partnership process.

While previous research on the labour market would suggest that wage rates are relatively flexible, we have no experience of such flexibility where falling prices would warrant cuts in nominal wage rates. In addition, it normally takes a number of years for wages to adjust to a new equilibrium. Thus while instantaneous adjustment to the appropriate level of wage rates would be very desirable to minimise the cost of the recession, it is likely to take some time. The longer that the adjustment is delayed, the higher will be the eventual cost in terms of lost output and higher unemployment. There are signs that wage rates are falling in some parts of the private sector but it will be some time before the pace of change becomes clear.

Finally, the substantial fall in the price level expected this year, across a wide range of imported and domestic goods and services, ranging from rent to energy, will play an important role in improving the long-term competitiveness of the Irish economy.

Medium-term scenario

The current financial crisis and the resulting economic recession has taken a heavy toll on the world economy. It is not just that there has been a collapse in world output but the nature of the recession and the change in the cost of capital may have longer-term consequences. It is likely that there has been some reduction in the potential growth rate of the world economy. As a result, even when there is a recovery it is likely that the level of output will not bounce back to **where it would otherwise have been** – in other words there will be a permanent loss of output. However, as with all recessions, the rate of growth in the recovery phase will rise above the potential output of the world economy recovering some of the loss ground.

For Ireland we estimate that potential growth rate of the economy over the period 2005-2020 will average around 3 per cent a year. This estimate is derived from research undertaken using the HERMES macro-economic model. This estimate of the potential growth rate is substantially lower than the 3.6 per cent that was estimated as recently as last year in the *Medium-Term Review*.

The reduction in the potential output growth of the Irish economy derives from four main sources:

- the reduction in the potential growth of the EU and the US;
- the reduction in the expected capital stock in Ireland as a result of the current period of very low investment;
- the expected higher long-run cost of capital; and
- the burden of higher government debt that will result from the recession.

While we estimate that the financial crisis has brought about a significant reduction in the potential long-term growth rate of the Irish economy, this must be set against the dramatic fall in output which we are currently experiencing. Over the period 2008-2010 the cumulative fall in output could exceed 10 per cent. Even with a potential output growth rate of 3 per cent a year, this would result in a large output gap – the gap between the potential output of the Irish economy and the actual output.¹ This means that when the world economy recovers the Irish economy would be expected to grow well above its potential for several years.

Once the world recovery has picked up momentum it will begin to impact on Ireland. Current international forecasts suggest that this could happen in 2011. In this recovery phase growth rates of 5 to 6 per cent would be likely.² However, this would not be a return to the heady days of the 1990s but would reflect a restoration of only some of the losses sustained over the period 2008-10. It would still leave the long-term loss of output as a result of the recession at over 10 per cent.

¹ Account is taken of the fact that there was a large negative output gap in Ireland before the recession began – i.e. output was above potential.

² A similar pattern of above average growth rates in the recovery phase can be expected in the US, the EU and the rest of the world economy.

A recovery beginning in 2011 would see the cyclical component of the government deficit eliminated by 2015. It would also see a major reduction in unemployment from a peak of around 15 per cent. With a rapid restoration of competitiveness in 2009-10 a return to near full employment by the middle of the next decade would be possible. This rapid growth in the recovery period will reflect the fact that in the very many businesses that survive the recession, there will be very considerable spare capacity. Without any further investment they will be able to ramp up output in the recovery phase once world demand begins to recover.

While current forecasts suggest that the world recovery will begin next year, bringing rapid growth in Ireland in 2011, there is no certainty that this will happen. If the world recovery were to be delayed by a year so that the Irish recovery began in 2012 rather than 2011, this would cause some further long-term damage to the economy. It would probably add a limited amount to the structural deficit and reduce the long-term potential growth rate of the economy further. However, it would not invalidate the basic analysis set out in this note.

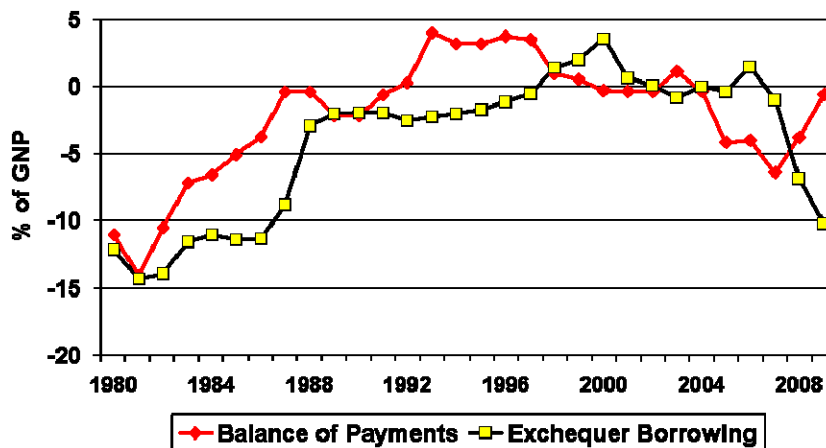
Nevertheless, the possibility that such a delay in the recovery might occur argues for caution in formulating fiscal policy. Because a delayed recovery would increase the public finance problem such a possibility reinforces the argument for taking significant action to reduce the structural deficit in 2009 and 2010.

Financial Sustainability and the Balance of Payments

In considering the financial sustainability of the Irish economy, and of the public finances in particular, there are a number of important considerations. Firstly, the government sector began this year with a very low debt / GDP ratio. When allowance is made for financial assets held at the NTMA, it amounted to only 20 per cent of GDP, an exceptionally low level by international standards. Secondly, the current account of the balance of payments is likely to move into surplus and remain in surplus over the period to 2015. The counterpart to the surplus on the current account will be an outflow on the capital account as Ireland reduces its net foreign liabilities over that period. While government foreign liabilities will rise, the net liabilities of the private sector, including the banking system, will fall by even more.

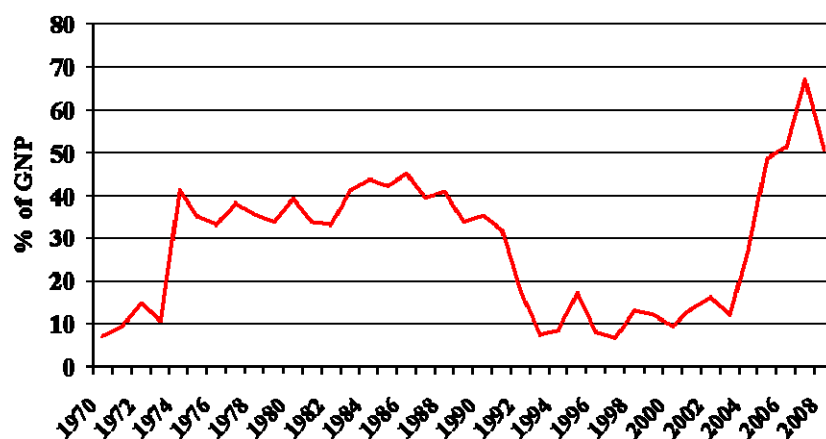
Since the advent of the Euro relatively little attention has been given to the current account of the balance of payments in Ireland. Up to 2004 it was broadly in balance. However, it deteriorated rapidly in subsequent years with the deficit reaching a peak in 2007 of 6.4 per cent of GDP (Figure 2). This deterioration, while very rapid, was little remarked upon at the time. The lack of attention to the balance of payments may have been partly due to the false sense of security arising from the government's apparently strong net borrowing position up to 2007.

Figure 2: Balance of Payments and Government Borrowing



Under monetary union private debts by Irish citizens or companies were not considered as having major national implications. If an Irish citizen or company were to have difficulty repaying its foreign debts that was considered to be a problem for the private sector creditors and private sector debtors so affected. However, the deterioration in the current account masked a major change affecting the banking system. While the government's accounts were broadly in balance up to 2007, the massive expansion in activity in the building and construction sector, especially in housing, ran well ahead of personal sector savings. As a result the household sector had very extensive recourse to the banking sector to finance its investment boom.

Figure 3: Net Foreign Liabilities of Banking System as a % of GNP



In turn the banking sector financed this boom by borrowing extensively abroad. Figure 3 shows the net foreign liabilities of the banking system over the last three decades. While under normal circumstances this increase in net foreign liabilities was easily fundable, over the last year it proved very difficult to do so in a normal manner because of the dislocation in the world financial system. While the ECB stepped in to provide liquidity, the deep-rooted problems in the banking system, specifically the problems in Anglo-Irish Bank, forced major government intervention. As a result the liabilities of the Irish banking system have become the contingent liabilities of the government (largely counterbalanced by the associated banking sector assets).

There is a major difference between the current situation in Ireland and that of Ireland in the early 1980s (or Spain, Greece or Estonia today). As shown in Figure 2, whereas the government borrowing requirement may exceed 10 per cent of GDP this year, the balance of payments deficit may disappear by the end of next year. This contrasts with the crisis in the early 1980s when they were both over 10 per cent, which meant that Ireland as a whole was increasing its net foreign liabilities at a rapid rate in a manner which was clearly unsustainable in the long run.

As discussed earlier it seems likely that this year the government borrowing requirement will exceed 10 per cent of GDP. In turn, this borrowing is substantially funded by borrowing abroad. The household and the company sectors have reacted to the economic crisis by dramatically reducing their levels of investment and raising

their savings rate.³ The result is that they have a very large surplus of funds which they are using to reduce their borrowing. In the medium term it seems likely that the bulk of this reduction in the net financial liability of the private sector will be reflected in increased deposits and reduced lending by the domestic banking system. Signs of this turnaround can be seen in Figure 3 for 2008 where the banking system's net foreign liabilities fell very significantly over the course of the year.

If fiscal policy delivers a major reduction in the government's structural deficit this year and next, that will also lead to a major improvement in the current account.⁴ This will result in the current account moving into surplus at the latest by the end of 2010. This means that the external borrowing by the government sector of 10 per cent or more of GDP will be counterbalanced by a reduction in the banking sector's net foreign liabilities. With the liabilities of the Irish banking sector being guaranteed by the Irish government, this will mean that the government's contingent liabilities will remain roughly unchanged in 2009 and 2010.

Looking beyond 2010, any recovery in the Irish economy is likely to occur through a recovery in world demand that increases the demand for Irish exports. Consequently, the next few years are likely to see an increasing surplus on the balance of payments counterbalanced by a gradual fall in government borrowing. This is likely to mean a continuing reduction in the net foreign liabilities of the banking system.

The Irish economy is today operating within a global financial system. The bulk of the funding for the government is likely to come from abroad while the bulk of the debt repayment by the banking system will be to its external creditors. Viewed in this light, the prospect of a surplus on the current account balance means that the current fiscal crisis, while obviously undesirable because of the loss of productive capital that it involves and the prospect of future distortions that it holds out, is sustainable.

When one compares the position of the Irish economy, with its balance of payments current account heading towards balance, with that of other countries such as Greece

³ See Box on pages 27-29 of the ESRI's *Winter 2008 Quarterly Economic Commentary*.

⁴ Generally every one percentage point reduction in the structural deficit is accompanied by a one percentage point improvement in the current account of the balance of payments.

and Spain with substantial continuing deficits, the risk premium currently exacted on borrowing to the Irish government relative to those countries seems surprising. With the burden of the government's contingent liabilities unchanging or even falling, the overall financial sustainability of the government sector and of the economy as a whole should not be in doubt. With effective fiscal action to tackle the structural deficit in the April budget and again in the budget for 2010, a significant fall in the current risk premium could be anticipated.

Conclusions

The structural deficit of the government is in the range 6 to 8 per cent of GDP. It is important that the government in its April budget moves to substantially reduce this deficit. If such action is followed up with a further significant reduction in the budget deficit for next year, it could move to halve the deficit by the end of 2010. This would leave a quite manageable task of eliminating the remaining structural deficit by 2015. It would also provide room for manoeuvre if the world recovery occurred later than current forecasts would suggest.

While fiscal policy action this year and next year must substantially reduce the structural deficit, the total deficit could nevertheless be 10 per cent or more of GDP this year and next year because of the exceptional nature of the world recession and the resulting cyclical increase in the deficit. However, with rapid growth in the recovery period (2011-15) the cyclical element of the deficit would be eliminated by natural buoyancy in revenue and the reduction in unemployment consequent on a restoration of employment growth.

If such a coherent strategy is embarked upon in April, it should provide reassurance to Irish citizens and to foreign lenders that the Irish economy is in a strong position to ride out the current storm. The high levels of private sector savings, reflected in the current account of the balance of payments, will mean that the current high level of borrowing will be only temporary and will be easily sustained by what is by international standards a public sector which has entered this crisis with a very low level of net indebtedness.