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austerity?**

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Is Ireland really the role model for austerity?

Stephen Kinsella¹

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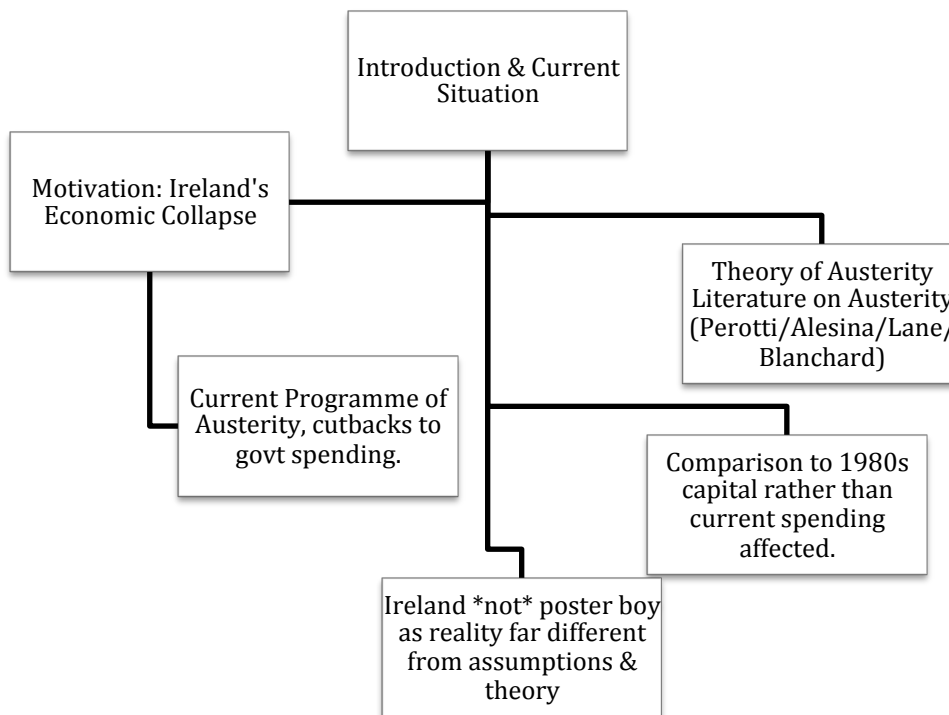
Abstract

This paper describes the causes and consequences of Ireland's economic crisis in the context of the policy solution implemented to contain that crisis: protracted fiscal austerity. I describe the causes of the recent crisis in Ireland, and look at the logic of austerity with a simple model. I compare the current crisis to the crisis of the 1980s, when fiscal austerity was touted as the trigger for the Celtic Tiger. I discuss the measures implemented to date in the current crisis, tracing their effects on sectors of Ireland's macroeconomy, and, finally, ask whether Ireland is, indeed, the role model for fiscal austerity in the Eurozone and beyond.

JEL Codes: E00; E30; E62; E63.

Keywords: Ireland; Austerity; Fiscal Policy; Monetary Policy.

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Introduction

Speaking at the European Parliament on March 24, 2010, former European Central Bank President Jean Claude Trichet held up Ireland as the poster child for fiscal austerity in 2010 and 2011. While trying to push through similar austerity measures in Greece and Portugal, Mr. Trichet endorsed Ireland's approach to austerity, saying: "Greece has a role model and that role model is Ireland" (Trichet, 2011).

When the ratings agency Moody's downgraded Ireland's credit rating to junk status in July 2011, they explained what was needed to change the ratings again: "upward pressure on the rating could develop if the government's continued success in achieving its fiscal consolidation targets, supported by a resumption of sustained economic growth, is able to reverse the current debt

dynamics, thereby sustainably improving the Irish government's financial strength" (Moody's, 2011).

This paper looks at the logic, theory, and evidence for the two statements above, and asks whether Ireland's approach to austerity really *is* a role model for small countries experiencing fiscal imbalances, balance sheet crises, and banking crises.

The goal of the paper is to answer this question by looking at the theory surrounding austerity measures in the Irish case, examining the empirical evidence for those claims, and making a historical comparison to the last Irish experience of austerity in the 1980s.

First, I give a general overview of the current macroeconomic situation and the genesis of the current crisis that necessitates (at least in the eyes of Ireland's policy makers) the austerity measures Ireland has introduced. Then a brief discussion of austerity theory, including an illustrative model and recent literature is explored. I describe Ireland's experience of austerity in the 1980s, and conclude with a discussion of whether Ireland is indeed a role model for austerity, as Mr. Trichet believes.

Ireland's current situation

Ireland has experienced a cumulative nominal gross domestic product (GDP) decline of 21 percent from Q4 2007 to Q3 2010, while its primary fiscal balance shifted to baseline deficits of 11-12 percent of GDP in 2009 and 2010. The Irish economy experienced the largest compound decline in gross national product (GNP) of any industrialised economy over the 2007-2010 period.

Ireland's general government debt (GGD) has increased by 320% over the same period. The level of national debt has increased rapidly as a result of successive bank bailouts, allied to the budget deficits associated with running a pro-cyclical taxation and expenditure mix.

Bank bailouts alone accounted for 14.5% of nominal GDP in 2009 and 32% of nominal GDP in 2010 (Kinsella and Lyons, 2011). In the most optimistic scenario, Ireland's general government debt is projected to stabilize at 108% of GDP by 2014.

Unemployment has grown from 4.6% in 2007 to 14.2% in June 2011. Over 55% of those unemployed are long term unemployed (greater than 12 months). Domestic price levels have fallen for 9 successive quarters, especially in the private sector.

There has been a collapse of private credit into the economy. Banks are deleveraging, suddenly unable to access interbank funding, and dependent on liquidity from the ECB to remain nominally solvent. Figure 1 below shows the contraction of credit in Ireland quite starkly.

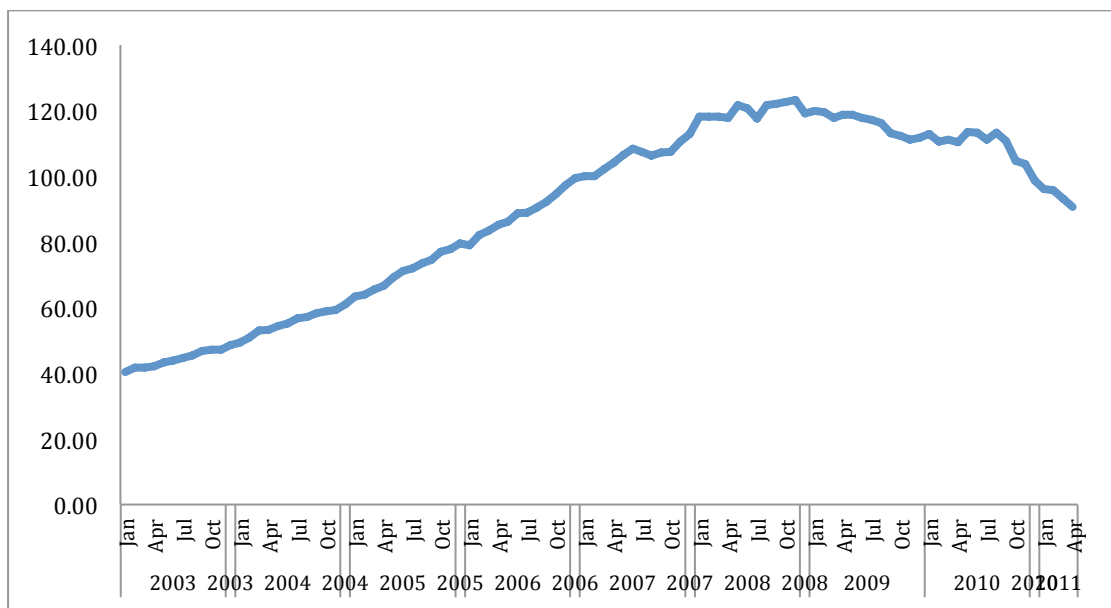


Figure 1: Outstanding domestic loans in Ireland, January 2007=100. Source: Central Bank of Ireland.

Private savings rates have increased from 1.6% of disposable income in 2007 to 14.6% in 2010 as households pay down debt and move to cope with increased uncertainty. Figure 2 shows the net savings ratios of Ireland, Germany, and Estonia from 2005 and forecasted for 2011 and 2012. Clearly precautionary savings as well as deleveraging are taking place.

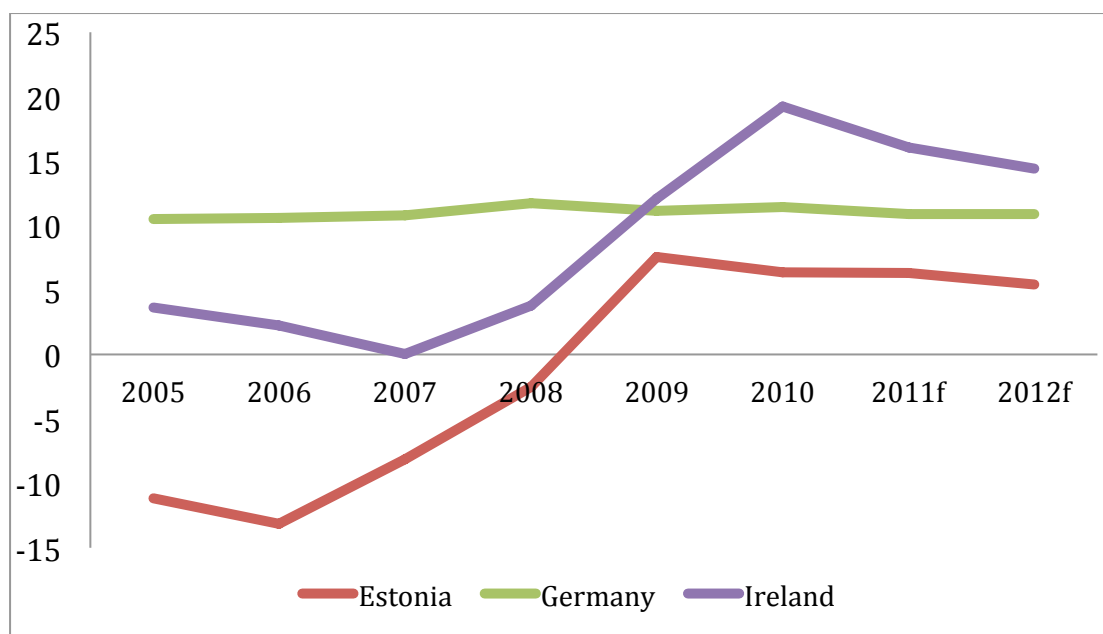


Figure 2: Household (and non-profit institutions serving households) net saving ratio. Source: OECD Economic Outlook June 2011.

The drop in consumption and investment following the bursting of the property bubble in late 2007, allied to drops in capital spending by the government, and the ramping up of national debt, both private and public, has resulted in the Irish economy's highly fragile state.

Table 1 shows the deterioration the components of gross domestic product and gross national product from 2005 to 2009. (Please note the large difference in GNP and GDP due to net factor income from abroad: Ireland has a large multinational sector and a particular taxation system which encourages the declaration of profits in Ireland rather than elsewhere, hence the large distortion).

	2005 ($\Delta\%$)	2006 ($\Delta\%$)	2007 ($\Delta\%$)	2008 ($\Delta\%$)	2009 ($\Delta\%$)	'05-'09 Average ($\Delta\%$)
Consumption	6.9	6.7	6.4	-1.5	-7	2.3
Government Expenditure	3.9	5.1	6.9	2.2	-4.4	2.7
Investment	14.90	4.6	2.8	-14.3	-31	-4.60
Exports	4.80	4.8	8.2	-0.8	-4.1	2.60
Imports	8.30	6.4	7.8	-2.9	-9.7	2.00
GDP	6.00	5.3	5.6	-3.5	-7.6	1.20
<i>Value, €m</i>	<i>162,314</i>	<i>177342</i>	<i>189374</i>	<i>179988</i>	<i>159647</i>	
GNP	6.00	6.5	4.5	-3.5	-10.7	0.60

<i>Value, €m</i>	<i>138,053</i>	<i>154078</i>	<i>162853</i>	<i>154671</i>	<i>131242</i>
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Table 1: Year on Year percentage change in components of GDP and GNP, and values of GNP and GDP, 2005-2009. Source: Irish Department of Finance.

Table 1 contains some striking statistics. Private investment in Ireland has collapsed, recording a drop of 31% in 2009. Consumption has also dropped, but government expenditure only began to drop (by 4.4%) in 2009 after an emergency budget was introduced to curb spending. Only exports have retained any degree of growth, and all recovery plans are predicated on an export-led recovery.

Three separate reports into the Irish banking crisis have established that macro prudential regulation of banking was lax, that fiscal policy, and in particular Ireland’s fiscal stance, was inappropriate given its membership of the Eurozone during a period of low real interest rates, and finally, that Ireland’s political elite was inappropriately enmeshed with property developers, whose interests were served before those of the national interest. Each report has noted with dismay the failure of macroeconomic models used by Ireland’s Department of Finance and the European Central Bank to accurately predict the crisis (Honohan, 2010; Regling and Watson, 2010; Nyberg, 2011).

Balance sheet effects on Irish banks and the State

In some sense, the balance sheet is the fundamental object in economics. As Minsky (1975, p. 118) has written, “an ultimate reality in a capitalist economy is the set of interrelated balance sheets among the various units, so that one way every economic unit can be characterized is by its portfolio: the set of tangible and financial assets it owns and the financial liabilities on which it owes”.

As indicated above, Ireland’s households and firms are saving and paying down debt for precautionary reasons, as uncertainty about the economy has increased, but also because the supply of loanable funds has diminished markedly over the period as banks’ balance sheets have become impaired with bad loans run up over the construction boom.

The scale of the boom is worth reporting here: the value of output of the construction industry was 80% higher in 2006 than it had been in 2000. Over the period, the structure of the Irish economy became increasingly dependent on the

construction sector, and by 2006 construction output represented 24% of total GNP, as compared with an average ratio of 12% in Western Europe. By the second quarter of 2007, construction accounted for over 13% of all employment (almost 19% when those indirectly employed are included), and generated 18% of tax revenues (Gurdgiev et al, 2011). Ireland's construction boom and bust is a classic asset price boom described by a Minsky cycle (Kelly 2007, Kinsella, 2010). When the unstable investment process eventually collapsed, Ireland's banks' balance sheets were where the damage was most obvious.

The first

Figure 3 shows the year on year percentage change in the numbers of customer loans of three of Ireland's largest (and most wayward) banks. Clearly credit constraints are and will be a problem for a small economy whose banks are deleveraging as a result of mandated austerity measures. It should also be noted that the simple austerity logic described above also breaks down in the presence of a credit constraint.

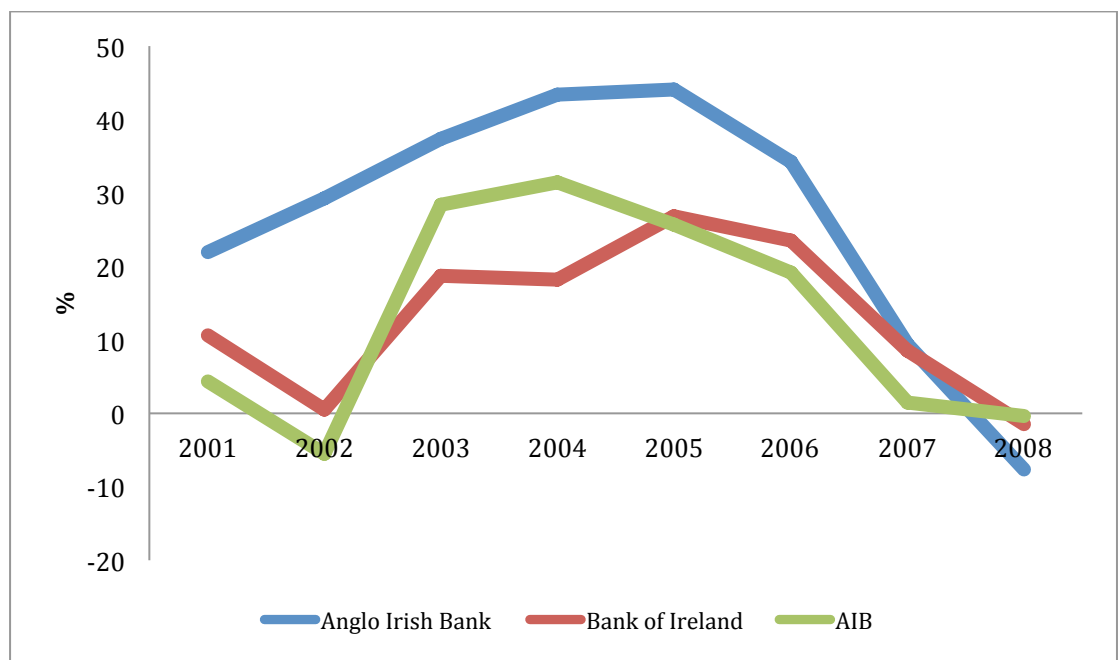


Figure 3: year on year percentage change in the numbers of customer loans of Anglo Irish Bank, Bank of Ireland, and Allied Irish Bank (AIB). Source: Central Bank of Ireland.

In April 2009, the Irish government established the National Asset Management Agency (NAMA), to purchase the universe of development-related loans (above a certain value) from the banks. As a result of guaranteeing the assets and liabilities of the banking system in September 2008 and injecting

almost €70billion into its banking system, the balance sheet of the Irish state is in rough repair. By guaranteeing existing senior bonds and some types of subordinated debt, the capacity to allocate some part of the ultimate loan losses to bondholders was compromised, raising the ultimate cost to the taxpayer of resolving the banking crisis and contaminating the public balance sheet with private assets and liabilities.

Table 2 shows the latest consolidated balance sheet for the year ending 2010. Please note that the general government deficit (GGD) does not include the €30.7 billion of loans for NAMA.

Assets	€bn	Liabilities	€bn
A. Cash	16.2	E. Government securities/borrowings	116.5
B. Non-bank NPRF	15	F. Provisory notes	30.9
C. Non-bank fin. Assets	31.2	Anglo Irish bank	25.3
D. NPRF investment in banks	9.4	Irish Nationwide	5.3
Total financial assets (C+D)	9.4	EBS	0.3
		G. Special investment shares EBS/INBS	0.7
		GGD (E+F+G)	148.1
		Net government debt (GGD)-non. Financial assets, (C).	116.9
Loan assets of NAMA	30.7	Bonds issued by NAMA	30.7

Table 2. Ireland's Assets and Liabilities at the end of 2010. Source: NTMA.

Ireland cannot borrow from the international debt markets. From 2010 to 2014, Ireland is reliant on liquidity transfers from the European Central Bank to fund its banking system, totalling 157 billion euros at the end of 2010, and loans from the European Union, the United Kingdom, Sweden, and the International Monetary Fund to fund a rescue package of €67.5 billion. The Irish state will use €17.5 billion of its own reserves in the rescue. €35 billion from this €85 billion fund have been apportioned to recapitalising Ireland's banks, with the remainder plugging the gap between government revenues and expenditures.

This emergency funding is contingent on a series of austerity measures, detailed below, designed to correct the primary fiscal imbalance, cleanse wayward bank's balance sheets, repay senior and subordinated bondholders in these banks, and finally, introduce a series of supply-side measures designed to improve relative wage competitiveness in the economy (Kinsella and Leddin, 2010; Lane, 2011; Lucey et al, 2011).

Summary of Irish austerity measures

The conditionality surrounding Ireland's loan agreement from the EU and IMF entailed a series of austerity measures over a four-year period. The International Monetary Fund's Memorandum of Understanding (IMF, 2010) sets out, in detail, the austerity measures the Irish will undertake until 2014. Briefly, they fall under the following categories and sub-categories.

1. Fiscal consolidation.
 - a. Taxes are to be raised. Carbon, property, and water taxes are to be introduced, a lowering of personal income tax bands and credits is to be pursued.
 - b. Government expenditure, including social protection expenditure and numbers of public sector workers is to be reduced.
2. Financial Sector Reforms
 - a. A further deleveraging of Irish banks by €72 billion over 3 years.

- b. There will be a reorganisation of the banking sector.
Smaller banks are being merged with larger 'pillar' banks.
 - c. Increases in Tier 1 capital ratios of 'pillar' banks.
 - d. Burden sharing by holders of subordinated (not senior) bond debt.
3. Structural reforms to the labour market
- a. The IMF proposed a reduction of the minimum wage.
 - b. Increase workplace training and internship positions.
 - c. Government will introduce legislative changes to remove restrictions to trade and competition in sheltered sectors including the legal and medical professions.

It is clear from the list above that the proposed and implemented solution to the problem of fiscal imbalances in particular is a range of austerity measures across the real and financial sectors of the economy.

In particular, government receipts are to be increased through a range of new taxes and higher rates of existing taxes on income particularly, and government expenditures on goods and services are to be reined in through cuts to current and capital expenditure. The fiscal imbalance is of primary concern.

Figure 4 below shows the effects of fiscal measures implemented in recent years, as well as the divergence in government receipts and expenditures since 2007. The series begins in 1983, and we can see a rough correlation between receipts and expenditures up until recent times, even though expenditure was less and receipts in only 4 instances in 27 years.

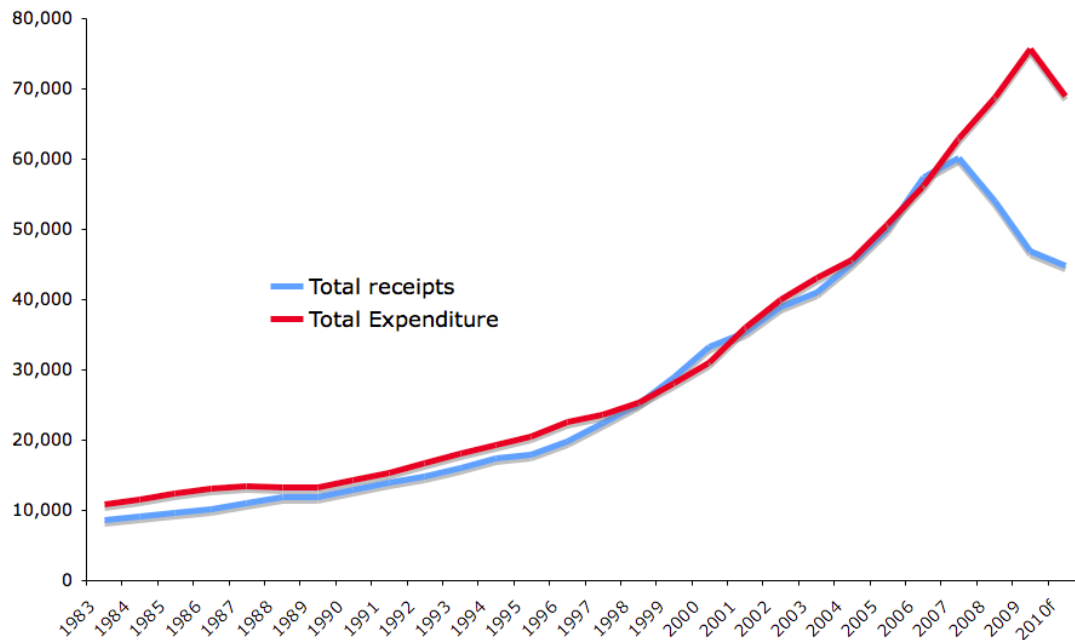


Figure 4. Government receipts and expenditures, 1983-2010f. Source: Irish Department of Finance.

The logic of austerity measures has always been built around this figure, or allusions to it, as well as a series of references to the gains enjoyed during the boom years of 2000-2008. In terms of unemployment and wage adjustments, most of this has taken place in the private sector. Self-employed pension coverage was down to 36% in 2009 and is likely much lower in 2010 and 2011.

Proponents of the ‘we all partied’ view point out that there was no growth in jobs numbers in the internationally trade-able goods and services sectors in 1998-2008 as the workforce expanded by 25%; exports increased in nominal terms by 50% in 2000-2008 as the consumer price index rose 35%. Of course additional output from the MNC sector is not permanent wealth. In 2000-2008, GNP increased by 74%; welfare spending increased by 160%; health care expenditure increased by 186%; expenditure on education increased by 128%. They also point out that the absolute level of government expenditure has risen even during the crisis: In 2010, current public spending was €61 billion. It was €52.5 billion in 2007. In 2010, gross government revenue was at €47bn. It was €61bn in 2007, as Figure 4 shows. The implication here is that any decrease in expenditure through austerity measures merely cuts the fat from government services. As in any economic debate, of course, multiple perspectives are brought to bear on Ireland’s approach to austerity.

The next section examines the theory driving this debate using a simple model.

Theory of austerity

The simple macroeconomic logic underpinning this logic stems from the postulates of Sayers' law—that supply creates its own demand. Imagine an economy operating below its 'natural' or 'warranted' rate of output, with a government running a budget deficit. The government reduces spending from G to G' , and increases taxes from T to T' .

The decrease in government spending lowers aggregate demand, of course, and output decreases. The aggregate supply curve also shifts backwards, reducing the prices of inputs and lowering the level of inflation. In the medium term, due to the economy-wide deflation, productive resources become more attractive as investment options, and so investment increases.

The deficit reduction leads *pari passu* to an increase in investment. There are multiplier effects on this increase in investment in the long run, of which more in a moment. In the long run, standard macroeconomic theory holds that output is dependent on the rate of capital accumulation. If the lower budget deficit leads to an increase in investment, then it will lead to a higher capital stock, and hence to a higher rate of output. It is worth spending some time writing down a simple model of this theory, because this model drives the policy propositions that follow.

A simple exposition of Irish austerity logic

There is a simple linear model following any introductory macroeconomics textbook, but based on Hansen (1951), used to convince the reader that reducing the discretionary budget deficit is the only path to fiscal sustainability. The deficit D is given as the gap between government expenditures, G and taxes, T . The government wishes to control the ratio of the deficit as a percentage of GDP, defined as (D/Y) . If the deficit reduction has an effect on the economy, it must be through an automatic stabilizer. Consider the following model:

$$Y = Y_0 + xD \quad (1)$$

$$D = D_0 - yY; \quad (2)$$

The first equation describes output as a function of the value of output in a given year and the value of the deficit. The relationship between the value of output and the deficit is captured in the multiplier x .

The second equation relates the deficit in the first year (0) to the level of output through an automatic stabilizer x , which depends negatively on output. Solving this model by combining the two equations yields:

$$Y^* = (Y_0 + xD_0) \frac{1}{1 + xy} \quad (3)$$

$$D^* = (-yY_0 + D_0) \frac{1}{1 + xy} \quad (4)$$

We can easily see the effect of a change in the deficit via the equation below. We would like to see what happens when we increase the deficit by some amount so:

$$\frac{\partial D}{\partial D_0} = \frac{1}{1 + xy} \geq 0 \quad (5)$$

It is easiest to see the effects when the model is in equilibrium. The equilibrium deficit-to-output ratio is

$$\frac{D^*}{Y^*} = \frac{D_0 - xY_0}{(Y_0 + yD_0)^2} \geq 0 \quad (6)$$

By partially differentiating with respect to the deficit level, we can see the effect of increasing the deficit relative to output.

$$\frac{\partial \frac{D^*}{Y^*}}{\partial D_0} = \frac{(1 + xy)Y_0}{(Y_0 + xD_0)^2} \geq 0 \quad (7)$$

Equation (7) states that any increase in the deficit will tend to increase the overall level of the deficit, as well as the rate of accumulation of the deficit, for any non-negative choice of multiplier/stabilizer parameter. Conversely, any reduction of the deficit will reduce the overall level of the deficit and its share as

a percentage of output. Following on from this, the logic of austerity holds that deficit reduction is both a necessary and sufficient condition for growth.

This simple presentation holds the values of the taxation and government spending multipliers equal to one another, ignores non-linearities, ignores interest servicing on the debt, and, crucially, ignores credit constraints.

We can see that once any debt threshold \bar{D} is introduced (perhaps due to funding constraints, as we have experienced in Ireland), the properties of the model break down quite quickly. The model is however robust to other challenges, such as changes in parameter values for x and y , particularly.

The Keynesian logic for fiscal expansion during a protracted downturn can also be applied to this model, but are only effective in their medium-term or long-term guises. When policy makers raise unemployment initially via austerity cuts in government spending, some of that increased unemployment becomes structural unemployment. Call the share of unemployment that does so s . When the economy is far from its equilibrium position, an austerity program today worsens the long-run debt-and-deficit picture if the following inequality holds:

$$x.y > \frac{(r - g)}{r - g + s} \quad (7)$$

where x is the multiplier as above, y is the marginal effect of a change in government debt serving on output (the automatic stabilizer from equation 1 above), s is the share of the cyclical recession rise in unemployment becomes a permanent rise in unemployment, r is the real interest rate on government debt, and g is the real growth rate of output. If, for example, $x.y$ were 0.7, and r was less than 1.25% per year, as we have in the Eurozone at the moment, this means that fiscal contraction is bad for the long-run debt-and-deficit right now as long as $s + g > 1.5\%$.

As long as the sum of the economy's long-term growth rate, and the share of a rise in unemployment that becomes structural is greater than 1.5%, fiscal contraction is of questionable benefit to the economy.

The theoretical underpinnings described above find their way quickly to policy prescriptions in the form of an `expansionary fiscal contraction`.

Proponents of this theory propose that fiscal contraction, rather than leading to a decline in output, as might be expected, will result in higher output due to its medium term effects on private sector expectations - consumers and investors anticipate long-run tax reductions because of cuts in expenditure, then they may increase expenditure now and so off-set the demand-side effects of the scale of the contraction.

A modern exposition of this proposition can be found in Alesina, Perotti, and Tavares (1998, pg. 200)

“Empirical work on the effects and sustainability of fiscal adjustments has consistently reached two conclusions. First, long-lasting adjustments rely mostly (or exclusively) on spending cuts, in particular, in government wages and social security and welfare; by contrast, short-lived adjustments rely mostly on revenue increases. Second, fiscal adjustments are not always associated with reduced growth, or with deterioration in the macroeconomic environment in general.”

They continue on page 213:

“Fiscal adjustments that rely on cuts in government transfers and wages and are implemented in periods of fiscal stress are long lasting and not contractionary. On the demand side, the expansionary aspect of such fiscal adjustments works through an expectation effect, which is stronger the worse are initial fiscal conditions. On the supply side, the interaction of certain types of adjustment — those without tax increases but with cuts in government employment and wages — lead to wage moderation, reduced unit labor costs, and increases in profitability, business investment, and production.”

Similar findings are expressed in Alesina and Ardagana (1998), though they become nuanced in Perotti (2011). That Alesina et. al slightly hedge their bets in the quote above (“not always associated with reduced growth”) should give us pause, especially when other authors are even more hesitant.

In a large panel study, Hogan (2004, pg. 647) claims that, while there is evidence that private consumption rises, it is usually not sufficient to offset the reduction on output: “. . . fiscal contractions are not literally expansionary”.

Prammer (2004, pg. 50) also finds contradictions and lack of support “The empirical evidence surveyed . . . provides no clear support for the existence of expansionary fiscal consolidations.”

Finally, Alfonso (2006, pg. 30) warns us to be “cautious to welcome into conventional wisdom the idea of expansionary fiscal consolidations ... it is far from clear whether one can use the positive expansionary fiscal consolidations experiences that occurred in the past in a few countries as a rationale for similar policy prescriptions in other EU countries.”

In Ireland, the rhetoric has become ‘the country is broke’. Fiscal contraction has morphed into public expenditure contraction following Alesina, et. al. That said, even underpinned by a theory of fiscal contraction, Ireland’s policy makers could point to a recent episode in Irish history when fiscal contraction appeared to work: the late 1980s, which gave birth to the ‘Celtic Tiger’ era.

Historical context for austerity: it worked in the 1980s, didn’t it?

Even though the logical underpinnings for Ireland’s austerity measures might be questionable, Ireland’s policy makers could always point to the moment the government ‘got its house in order’. Figure 5 shows Ireland’s exchequer borrowings as a percentage of GNP over the decade of the 1980s. Clearly there was a case to be made for fiscal consolidation in this decade. Ireland had achieved considerable success in reducing overall debt levels from a peak of 112% in 1986 to 25% by 2007. It seems natural, then, to point to the previous fiscal consolidation as a blueprint for austerity measures in the current crisis.

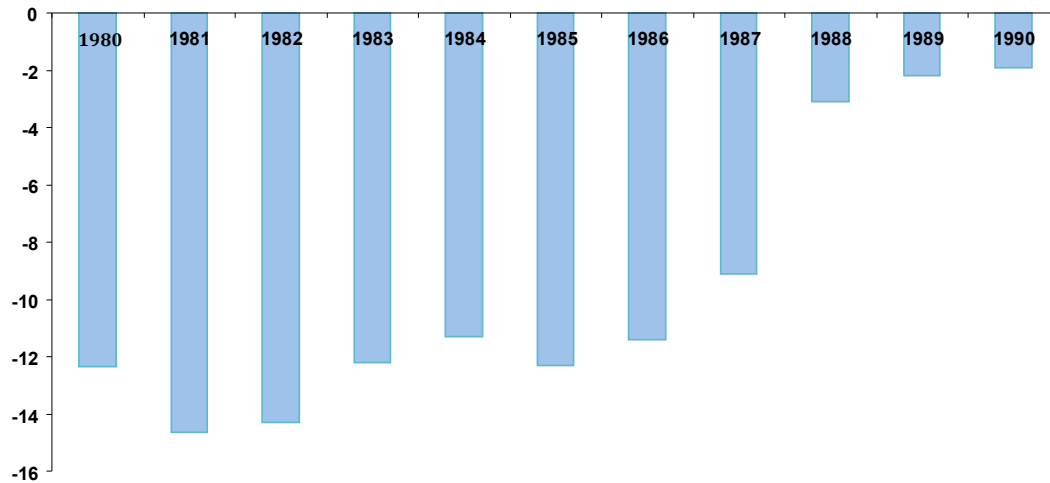


Figure 5: Exchequer borrowing as a percentage of gross national product, 1980-1990. Source: Department of Finance,

Parallels with the Irish fiscal crisis and austerity measures in the 1980s are of limited value given the different circumstances the Irish economy finds itself in in 2011 and 2012. The 1987 to 1990 consolidation did not coincide with a banking collapse, nor did it coincide with a worldwide credit crunch and a rapid world trade contraction (Ferriter 2005). In the 1987 to 1990 consolidation, only capital expenditure was reduced as a percentage of GNP, current expenditure went largely untouched, and in fact rose in one year. Yet within three budgets, the government managed to reduce the deficit from -11.4% to -2.2%, a considerable feat.

What accounted for this deficit-reduction from -€2.7 billion in 1986 to -€636 million in 1989? The 1987 to 1990 fiscal consolidation coincided with a period of growth in the international economy, with the presence of fiscal transfers from the European Union, the opening up of the single market, and a well-timed devaluation in August 1986. An income tax amnesty introduced in the January 1988 budget also contributed, yielding at least 2% of GNP more than expected (Kinsella and Leddin, 2010).

Finally, the average industrial wage rose by over 14% in the period 1986-1989, or an annual average of 4.6%. Public sector pay rose by a similar level. These wage increases had a two-fold effect: they boosted government revenue, and increased economic activity through increased private consumption. Rather than being a role model of expansionary fiscal contraction, the 1986-1990 period looks more like a proto-Keynesian story, where a laggard country converges

rapidly to OECD averages of per capita consumption, output, and (real) growth (Honohan and Walsh 2002, Honohan and Leddin 2006).

Ireland cannot devalue its currency in 2011 or 2012. There will be no windfalls in taxation revenue or opening up of new markets, and both current and capital expenditures are to be reduced over a five to ten year period to achieve a positive primary balance. With the cost of debt servicing rising over time, and with increasing pressure on social transfers, austerity policies will concentrate on large cuts to pay and pensions and social welfare transfers. Unlike the 1980s, it will not be enough just to halt the rise in real non-interest spending.

The Bank for International Settlements (2010) estimate that the average primary balance required to stabilise the public debt/GDP ratio at the 2007 level is 5.4% annually for 10 years. The high levels of post-crisis absolute public and private debt will exacerbate any desired fiscal correction. This debt will be difficult to reduce because the permanent loss of potential output means that government revenue may have to be permanently lowered.

Ireland: role model for austerity or not?

Is Ireland the role model for austerity? The logic and empirical foundation of expansionary fiscal contractions is shaky, at best. The experience of the 1980s in Ireland shows that it is possible to reduce fiscal expenditure in a small open economy openly courting foreign direct investment with friendly taxation rates when the rest of the world is growing and one is receiving transfers from other states whilst reducing costly unemployment through emigration.

It is hard to see Ireland recovering in the short term as a result of austerity measures alone. Their short term deflationary impact can be absorbed. It is the long run effects alluded to in the BIS study that are cause for concern. Following a debt-financed asset price bubble however, with firm, household, and bank deleveraging, credit constraints on non-autonomous private investment and a government committed to austerity policies, sluggish growth seems to be the most likely outcome for the Irish economy. We are not a role model, but a cautionary tale.

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