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"The Macroeconomic Challenges Facing Ireland"

Philip R. Lane
Trinity College Dublin

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The Macroeconomic Challenges Facing Ireland

Professor Philip R. Lane, Trinity College Dublin

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In line with the theme of this session, my goal in this contribution is to provide an assessment of the macroeconomic challenges facing Ireland over the next five years. Although the general agenda is well known and is closely monitored through the quarterly Troika reviews, last week's European Summit has sharply changed the external financial environment facing the Irish government and it is timely to consider the macroeconomic strategy in the light of the new situation.

Over the last eight months, the most pressing challenge has been to restructure and recapitalize the Irish banking sector. Through the PCAR/PCAR processes that concluded at the end of March, new capital requirements were imposed on the Irish banks, together with commitments to shrink the size of their balance sheets through deleveraging programmes over the 2011-2013 period. In addition, the banking system is going through a reorganization process around the two pillar banks, with Anglo Irish and Irish Nationwide in shutdown mode. The extra capital required by the banking system is being partly financed through new private-sector investment in Bank of Ireland and aggressive writedowns of subordinated debt across the system, but with the taxpayer acting as the major source of funds. The recapitalization process should be completed very soon, with an end July target.

However, the vitality of the banking system ultimately rests on the fiscal health of the government. Accordingly, the main challenge now facing the government is to restore Ireland to long-term fiscal sustainability. The intensification and spread of the European sovereign debt crisis over the last several months has resulted in very high market interest rates on Irish sovereign debt, such that the projection of a near-term return to market funding that was embedded in last November's agreement with the Troika has turned out to be excessively optimistic. It is for this reason that last week's new European agreement on official funding is so important.

The new European bailout framework provides important benefits to Ireland. In particular, an interest rate on EFSF funds of around 3.5 percent is much more conducive to fiscal sustainability than the previous deal that included a large penalty premium. However, the lower cost of official funds relative to the market interest rates faced by countries such as Italy and Spain means that policy conditionality is bound to be even stricter on programme countries, in order to make sure that the duration of official support is no longer than strictly necessary. Moreover, the burden sharing with private investors in sovereign debt that is a feature of the new Greek deal means that it will be more difficult for Ireland to re-enter the private market until and unless it has much more sharply proven the sustainability of its fiscal position, with the 'safe' level of public debt now lower than before. Finally, the assurance of ongoing official support means that that negative feedback loop between the market perception of the sovereign position and the funding position of the banking system is attenuated.

For these reasons, the optimal response for Ireland is to move more quickly on fiscal adjustment. One basic step is to commit that the savings from the lower debt servicing cost should be fully passed through into a lower fiscal deficit, rather than seeking to increase spending or cut taxes.

In addition, in terms of the non-interest component of the fiscal balance, Ireland should increase the pace of consolidation. In particular, the cumulative €15 billion target that was agreed last November reflected the environment Ireland faced at that time. First, the relatively benign market conditions for non-crisis countries suggested that Ireland could soon return to private funding, even at a very high level of public debt. Second, there was a very high degree of uncertainty about the prospective level of losses in the banking system and the potential for GDP growth in Ireland. While the projected bank losses are indeed horrendous and the domestic component of GDP continues to shrink, the PCAR/PLAR exercise showed that the likely range of losses for the banks were not as severe as envisaged last November and the extreme downside risks to GDP have not materialised.

Accordingly, while the ongoing risk profile continues to justify a gradualist approach to fiscal adjustment, the reduction in uncertainty and the altered European financial environment calls for a partial shift in fiscal strategy. For instance, in terms of near-term fiscal policy, the current target is a €3.6 billion discretionary adjustment in the 2012 Budget, which corresponds to 2.3 percent of projected 2011 GDP. A revised target of €4.4 billion would correspond to 3.0 percent of GDP, which is a sufficiently large difference to demonstrate to Ireland's European partners and the markets that Ireland recognizes the change in its financial environment, while not being so large to pose an excessive risk to the recovery in GDP. Moreover, a pre-emptive adoption of such a more ambitious target would reinforce the reputation of the new government in showing leadership in "getting ahead of the curve" in responding to Ireland's deep fiscal and economic crisis.

In terms of the expenditure and revenue decisions that lie behind the overall fiscal targets, the in-train spending review that will be published in September can provide a basis for a "smart" approach to expenditure reductions. A multi-year strategy that makes clear choices between higher-priority and lower-priority expenditure lines is superior to a blunt approach that seeks to impose uniform reductions, regardless of the relative value or effectiveness of different programmes. In relation to public investment, the government may well have scope to achieve further reductions in nominal spending with little efficiency loss, through a combination of further reductions in tender prices and a more rigorous approach to cost-benefit analysis of individual projects.

In relation to the revenue side, the uncertainty facing households and firms would be alleviated by more information concerning the tax strategy of the government. The more quickly the government can decide the relative contributions of different elements to the required overall increase in tax revenues, the greater the boost to consumption and investment through the reduction in planning uncertainty. Just as there is no reason to delay the publication of the spending review until the budget, so there is no strong rationale for the government to delay providing greater clarity over its multi-year tax strategy.

A broad-based tax/welfare system that is as employment-friendly as possible should be the target. Most taxes are distortionary in their own right (and there is a corresponding lobby group focused on the evil of each individual tax): the challenge is to find the combination of taxes that strikes a balance between efficiency and equity concerns. The desirability of collecting revenues from a property tax, water charges, other user fees and the elimination of many types of tax expenditures has been well ventilated in the Irish debate. In addition, the capacity to collect more income tax through reducing bands and allowances is also well understood.

However, the scope for collecting more VAT revenue has been underplayed in the Irish debate. The tax base for VAT in Ireland is excessively narrow. Moreover, an increase in general VAT rates can alleviate pressure on other types of tax rates that might have a more negative impact in terms of reducing employment. Moreover, the announcement today of a schedule of substantial future increases in VAT rates can help to bring forward consumption, boosting current levels of demand. Finally, the increase in VAT rates need not be uniform – it is possible that a lower VAT rate may indeed be warranted for tourism- and leisure-related sectors that are quite labour intensive.

The final part of the Troika agreement is to boost growth in Ireland and, in particular, take measures to bring down the high rate of unemployment. In relation to Ireland's productive capacity, the determinants of productivity growth are poorly understood. Moreover, reforms to boost productivity may only bear fruit with a long lag and may actually have a negative initial impact on employment levels, since adjustment costs and a stagnant level of aggregate demand mean that workers released from sectors undergoing reform find it difficult to quickly obtain new positions. Still, the high prices and inefficiencies that characterize the 'sheltered' sectors in Ireland provide ample justification for an aggressive programme of liberalization. Furthermore by reducing the local cost base and increasing the range of service providers, such sheltered-sector reforms provide additional support for a faster rate of expansion in the export sector and an improvement in investor confidence.

Public sector reform is a special case, in view of the limited role played by market forces. The first review of the Croke Park agreement documents a range of productivity-enhancing reforms that have been agreed and implemented. In some areas, reforms mean that the level of public services will not decline proportionately to the scale of reduction in public sector employment that is taking place. In other areas, the quality of public service provision is improving (which should be captured in ideally-measured gross domestic product). In still others, reform means that savings are being made on the purchase of supplies by public service providers. However, in terms of the overall level of public services, such reforms only partially offset the impact of the reduction in the numbers of public sector workers, in view of the labour-intensive nature of many types of public services.

Turning to the labour market, the government can do much to tackle the high rate of unemployment. There is increasing concern about the rising incidence of long-term unemployment among low-skilled workers. Accordingly, the May announcement of the jobs initiative was welcome, in that it provides extra training places and tilts the taxation system to favour labour-intensive sectors and employers of low-skilled workers. However, the scale of this initiative is limited by the overall budgetary situation. The more resources that can be released from other expenditure lines or obtained through extra taxation, the more can be done to address labour market frictions.

However, a general issue across the euro area is how to reduce relative wage levels in countries that need to net exports. There are no simple "hard and fast" rules, in view of the array of other factors that interact with earnings levels (such as the levels of social welfare benefits and the scale of household indebtedness). However, as a general principle, a capacity to achieve downward wage adjustment is essential for successful membership of a monetary union. Otherwise, the required wage adjustment will only take place over a sustained period of excessively-high unemployment that results in stagnant nominal wages, with cumulative inflation ultimately eroding the level of inflation-adjusted real wages over a long period.

Relative to some other peripheral countries, Ireland does have a relatively-flexible labour market. In the public sector, sizeable wage reductions have been imposed by fiat. In the private sector, troubled firms battling for survival have been able to negotiate wage reductions with pragmatic unions and workers. In both sectors, entry-level wages have undergone especially large reductions, which is the single most important component in encouraging new hiring.

However, it remains the case that the aggregate scale of wage adjustment has not replicated what would be achievable under a traditional mix of a nominal currency devaluation plus an economy-wide incomes policy to ensure that devaluation is not simply offset by faster wage growth. In particular, earnings levels are not under the same level of pressure in the many sectors in which incumbent firms remain profitable. The partial nature of the wage response keeps cost levels higher than necessary across the economy, inhibiting investment, the entry of new firms and export competitiveness. In addition, in the public sector, the cost of ruling out further pay reductions for existing workers is a greater reduction in the level of public sector employment, notwithstanding the partial offset provided by the public sector reform initiatives discussed earlier.

While there is no magic bullet, finding solutions that can help reduce labour costs across the economy remains a central challenge in boosting employment growth in Ireland. While labour costs are just one element in the wider matrix of factors that determine the overall level of economic activity, the wage levels that emerged during the 2003-2007 boom are clearly not appropriate under current conditions. More generally, a twin-track strategy that seeks to boost employment both through reductions in labour costs and positive shifts in labour demand is a more complete response than working only one dimension of the problem.

Finally, it is important to emphasise that Ireland should continue to press for further changes in the European bailout framework. Beyond the desirability of expanding the financial capacity of the EFSF, an issue that is especially important to Ireland is that last week's deal still leaves the full financial burden of publicly-funded bank recapitalizations with national governments. As has been repeatedly emphasized by Governor Honohan, financial stability would be more quickly restored if there were greater risk sharing among European governments in respect of the tail risks in domestic banking systems.