"The economy: how to manage the recovery now and into the future?"

Rossa White, MacGill summer school, July 22nd 2015

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Introduction

Four years ago, almost to the day, Ireland hit rock bottom in the eyes of global investors. Bond market prices suggested that Ireland would restructure its debts and that our private creditors would get back about half of what they were owed. Ireland could have been where Greece is today. The country's recovery since then has been extraordinary, which is often underestimated.

The Government and the Irish authorities fought hard to avoid default. Some help to ease the debt burden was needed and gratefully accepted along the way. Events of the last few weeks in Greece have brought into focus that the counterfactual would have been a nightmare: who would fancy Government default leading to a halt of commerce, €60 limits to cash withdrawals, the potential departure of critical foreign direct investment and the high-value jobs that go with them? Ultimately, forced euro area exit could not have been ruled out. The destruction of wealth would have set Ireland back a generation.

Instead, we are now borrowing money for ten years at a repayment rate of 1.5% per annum. Unemployment is below 10% from the peak above 15% and declining steadily at a rate of about a tenth of a percentage point a month. Employment has increased by 110,000 from the trough of 2012 and the increase in net jobs over the last year was solely due to full-time employment. Real wages are starting to grow and workers are getting more hours per week. In short, the immediate future looks bright. Yet we have been here before.

I often say that if only we could have stopped the clock in 2001, Ireland was in good shape. There were no excesses; private and public debt was low; the credit bubble was yet to blow.

Perhaps, Ireland has a second chance. If I can doctor the well-worn Oscar Wilde line by one word: "To lose one *chance* may be regarded as misfortune, to lose both looks like carelessness". It may not be 2001 again – the position is not quite so promising. Debt levels are much higher, albeit falling. And for structural reasons, which I will allude to later, growth in the developed world is likely to be lower than in the 2000s. Yet Ireland is as competitive as it has been since 2001; we are now finally compliant with European fiscal rules and income per capita is growing by around 4% compared with less than 1% in the euro area.

There are three questions I would like to pose, the answers to which may determine whether we seize our second chance to take the economy in the right direction. First, what is our economic model and how do we protect it? Second, have we learned our lessons?

And third, do Irish economists look at the economy through the correct lens: will we read the warning signs next time?

1. Ireland's economic model: how do we protect it?

Ireland's economic growth and development model is export-led. It is hard to see any other option for a country of 4.6 million people. Moreover, it is an export model led by foreign multinational companies. In the 2000s, we accidentally tried something different: domestic construction-led growth. This priced out our export sector by driving up costs, wages and property prices, although it is difficult to disentangle which led which.

Crucially, the export model was not broken. Once our price level fell by 5%, wages by nearly as much, commercial rents and property prices by more than 50%, exporters were able to breathe again. We have attracted a new wave of FDI: the new internet service and social media companies. Tourism and agri-business were already recovering, only for the recent depreciation of the euro to provide a huge competitive boost.

It is a fact that Ireland is more competitive than at any time since about 2001. We have to protect that, because the underlying picture is that we are no longer gaining ground versus our peers as we did between 2008 and 2013.

We cannot rely on transitory currency gains. To keep our competitive edge, there are at least two vital levers over which the State has some cost control apart from public pay policy. One is prices that are influenced by Government policy – administered prices - the other is the price of housing.

Much of our goods price inflation is generated outside Ireland – particularly energy and consumer products. Service prices are largely domestically-influenced, the primary drivers being how close our non-traded sector is to full capacity; the other key variables are changes in administered prices and rents. Administered (or public sector) prices are up more than a quarter in the last five years (an annual rate of almost 5%), while private sector prices are down almost 10% in that period (deflation of -2%). Understandably, fiscal consolidation and health policy was responsible for some inflation - hikes in excise on tobacco, motor fuel and alcohol, for example. But there were other culprits: large price increases for education (for third-level mainly), public transport, health insurance, the TV licence and motor tax.

We should aim for growth of no more than 2% for administered prices (that's the ECB's inflation target after all), but these prices are rarely looked at in aggregate. Greater competition in sheltered sectors would help too. In contrast in retail, where competition is still intense, prices are down 4% in the first half of this year.

We also need to think differently about property prices in this country. They may well be the biggest swing variable for our competitive position, apart from fluctuations in the value of the euro. Stable property prices – growing no faster than consumer prices – should be a public policy goal. Many are exercised by rising rents. Yet few seem to link rents to prices: buying a property is the same as paying for a discounted stream of rents into the future. Where rents go, property prices go in the medium to long run.

What can be done in practice? The State can influence both supply and demand. We need to make it cheaper to build houses by freeing up land, speeding up the planning process and reducing burdensome regulation. The experts will discuss these supply issues in depth here on Friday at the summer school. On the demand side, the Central Bank's new mortgage rules already seem to have helped to cool house price inflation: this should be cheered.

In the end, it is time for a shift in culture and attitudes: property price rises above the rate of inflation are a bad thing. Let's make that public policy in itself and implement the required actions to achieve it.

The property bubble of the mid-2000s compensated briefly for the loss of export competitiveness it caused. We can't bank on striking oil like Norway. If Ireland is to lift living standards in the long run, there is no alternative to remaining fighting fit.

2. Lessons learned?

Have we learned our lessons from the crisis? If the goal is to avoid going from boom to bust and back again, it is far too early to say. Certain actions are meritorious. We have passed a Fiscal Responsibility Bill and the Fiscal Advisory Council is up-and-running on a statutory basis. Statistical fiscal transparency has improved and is now towards the top end of the class in Europe. The Central Bank's macroprudential rules were brave and necessary.[1] Regulation of the financial system has been beefed up.

Yet have we really thought strategically, rather than tactically, about economic stabilisation policy – particularly fiscal policy? Our record since independence is one of pro-cyclical budgetary policy: spending and cutting taxes when flush and then slamming on the brakes in dark times out of necessity, when neutral or looser policy would have been preferable. The ratio of Government debt to economic output rose from 46% in 1975 to 100% in 1988 back down to 24% in 2006 and then all the way up 123% at the recent peak in 2013.

Cultural change is required: higher structural deficits mean spend now, pay later. The next generation pays more in tax or receives fewer public services, to service interest payments to creditors. I don't want to shift that burden onto my daughters to have a better standard of living temporarily. We rarely speak this simple truth.

Why can't Ireland behave like Finland – a similar-sized exporting nation – did after its crisis of the 1990s? It ran a primary budget surplus (which is the budget balance excluding annual interest payment on government debt) in every year after its crisis until 2009; and even in

[1] See: http://www.centralbank.ie/press-area/press-releases/Pages/CentralBankannouncesnewregulationsonresidentialmortgagelending.aspx

the crisis years the primary deficit never exceeded 1.5% of GDP. Belgium, to which bond market investors now compare Ireland, has a 30-year record of fiscal prudence.

Investors, who lend us the money to finance our deficit, constantly ask us about medium-term budgetary plans. The Fiscal Advisory Council and overseas authorities have also pushed for rigorous detail out to 2020.[2] Such plans, along with the aim to keep the primary budget in surplus, would go a long way to cementing market participants' tentative assessment that Ireland is a new paragon of fiscal virtue.

However, I'm not sure we can do away with pro-cyclical policy without changing our political system. To behave strategically means not having to fear immediate consequences. In Ireland's type of Proportional Representation (PR) system, this is difficult given its competitive nature. If we are to attract politicians focused on the long-term future of the economy, we may need to adapt our system. The single constituency list of the Netherlands could provide a template. Dutch politicians represent the whole country without losing proportionality of the election result. It is likely that there are policy experts or business people who would consider devoting a period of their career to politics, but who don't want to run the risk of being a career politician with local responsibilities.

National pride was hurt by the arrival of the Troika in 2010. Once the initial shock subsided, it gradually became clear that its stay would prove beneficial. I saw first-hand how the Troika introduced best practice in certain areas; and in others provided the vital nudge. There was no spurious correlation between increased spreadsheet use and our overseas friends' period in situ! Information sharing, collaboration, and contingency planning – the lack of which was highlighted by the banking inquiry as failings of the 2000s – have also improved. Fiscal transparency has increased sharply, primarily through the publication of the Government Finance Statistics by the Central Statistics Office.[3] All of the other financial arms of the State publish many times more data in downloadable format than pre-crisis, although even more could be done. This modernisation process may help limit the damage from future "tail risk" shocks, as long as complacency does not creep back.

As for the banking system, we will hopefully never take our eyes off it again. Our banks are much more secure. Loans are in line with deposits for Allied Irish Bank and Bank of Ireland, instead of being almost twice the size of the deposit base ten years ago. Equity buffers against losses are significant and set to rise further as loan loss provisions shrink.

There is another insurance policy in place too. The deleveraging and refinancing of our banking system has seen risk shift from Irish-owned banks to foreign providers of capital. Overseas funds and other shadow banks have bought up billions of loans or properties outright. The good news is that if something goes wrong in the property market, the Irish taxpayer will not be on the hook – leaving aside the question of the new bank resolution

[2] See: http://www.fiscalcouncil.ie/wp-content/uploads/2015/06/Summary-Assessment.pdf
[3] See: http://www.cso.ie/en/releasesandpublications/nationalaccounts/governmentfinancestatistics/

mechanism in the EU. We must avoid reabsorbing those risks at all costs. How about this hypothetical scenario: our currently risk averse banks perk up in two to three years and want to re-finance the loans sold to foreigners or issue new ones to fund development at a time of much higher property prices than today. Ireland's new bank regulatory regime won't be fully tested unless such a scenario unfolds – the danger increases the more the crisis memories fade.

3. How to spot impending danger: are old models of the world redundant for now?

After the last devastating crisis, we have to be better prepared next time. Can we spot trouble in advance? I will argue that the tools which economists still use to anticipate recessions are faulty and some are possibly redundant. It is a more dangerous world of high debt, low growth and cycles dominated by financial mal-investment rather than the business investment of the past.

In the old days, recessions were typically caused by businesses investing too much in capital, labour or stocks (inventories as the Americans call them). Recessions tended to be shallower. Since the US recessions of the early 1980s, which was the price paid in the drive by Chairman Paul Volcker of the US Federal Reserve to tame inflation, economic downturns have had at least some roots in finance and the reactions of central banks in the aftermath of the preceding one. The more that inflation fell and productivity growth slowed, the more the global debt load grew. We have reached the point where the financial cycle is at least as important as what we remember as the "business cycle". This means that we have to watch asset prices as closely as consumer prices. Our dependence on the actions of central bankers has become disturbing.

Yet economists' models have not really changed. Believe it or not: no mainstream models of the economy fully incorporated the banking sector pre-crisis. Some did not even include credit growth. Now the game has changed again: non-banks (or "shadow banks" as they are also known) have turned central bank money creation into potential fuel for the next crisis since 2009. Large scale macro-economic (DSGE) models, already an imperfect guide to reality, might be powerless to predict the next global shock to hit Ireland.

Central banks have created trillions of dollars, euro and yen from the push of a button in the last six years. The majority of it has gone into bank reserves (when they buy Government bonds from banks) or into fund managers pockets - to be recycled into global assets.

Ireland has benefited enormously from abundant global liquidity. Our reliance on overseas – particularly US - capital has snowballed in three ways. US funds sparked the rally in our Government bonds in 2011 that priced out the expectation of default: they have largely gone to be replaced by other more passive foreign investors. US private equity funds and hedge funds have also poured capital into our property market since 2012. Lastly, US multinationals have invested heavily, led by internet service and software companies locating in Dublin.

I mentioned earlier the danger, albeit seemingly remote, of Irish-owned banks buying back the loans recently sold to foreign funds down the track. The risk is greater that there is a future shock in some part of the global financial system, leading to a flight of foreign capital and associated jobs from Ireland.

Central bank money creation has pushed asset prices – shares, Government and corporate bonds - to high levels in most of the developed world. Meanwhile, businesses and governments in certain emerging market countries have been borrowing heavily in dollars. The US Federal Reserve sets the price of global capital: it is time for Ireland's policymakers, economists and media to start watching closely as the American central bank inches towards its first interest rate increase since 2006.

It is a myth that nobody warned about financial risks prior to the last crisis. The Bank for International Settlements (BIS) – known as the central bank of central banks – was vocal for many years but was ignored. And its warning bell is chiming again. The BIS is worried that the QE programmes and 0% interest rates implemented by central banks have underwritten risk-taking and sowed the seeds of the next bust. It feels that the Fed has waited too long to raise rates. In its Annual Report at the end of June, the BIS wrote:[4]

"Domestic policy regimes have been too narrowly concerned with stabilising short-term output and inflation and have lost sight of slower-moving but more costly financial booms and busts. And the international monetary and financial system has spread easy monetary and financial conditions in the core economies to other economies through exchange rate and capital flow pressures, furthering the build-up of financial vulnerabilities. Short-term gain risks being bought at the cost of long-term pain".

Conclusion

To conclude, I want to again acknowledge Ireland's remarkable turnaround. Only four years, when Ireland was at rock bottom, I was sitting with one of my colleagues across the table from emerging market investors in New York who said forcefully: "our question is not if, but when are you going to default?" It seems like an age ago. Today, in the Government bond market, we're viewed as closer to the well-behaved northern European countries than the southerners who got into trouble in the crisis.

I am proud of the work the Government and all of us that were involved from the State's authorities put in to claw our way back. It makes the sense of needing to seize our second chance even more acute.

[4] See: http://www.bis.org/publ/arpdf/ar2015e.htm

Ireland has lots in its favour at the moment: an already competitive economy bolstered by a cheap currency, low interest rates, the collapse in commodity prices and billions of foreign capital seeking to invest here. Dr. Pete Lunn of the Economic and Social Research Institute (ESRI) outlined that the human behavioural flaw of extrapolation was an important cause of the Irish banking crisis. We know the current sweet spot won't last forever, but we are hardwired to think it will.

Therefore, we must do everything in our power to stay lean to support our exporters; and never again become overweight like a decade ago. That means aiming to keep property prices close to their current fair value level and avoiding hikes in State-influenced costs.

Fiscal policy has to become strategic and lean against the cycle rather than pushing it forward. Ireland should aim to build a long track record; I hope this year's primary surplus is the first of an extended unbroken run.

Finally, be aware that the risk of another major shock from financial markets is not far-fetched.

Ireland has the opportunity to protect itself this time around. Let's not waste it.

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