Post-bailout Ireland as the Poster Child for Austerity

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Surely Ireland in 2014 is the poster child for austerity?

This article is an update to Kinsella (2012), which argued Ireland was not the poster child for austerity because of the remarkable degree of openness of its economy. For the avoidance of confusion, let us follow Blyth (2013) in defining austerity as a policy of, cutting the state's budget to stabilise public finances, restore competitiveness through wage cuts, and create better investment expectations by lowering future tax burdens.

Kinsella (2012) argued policies that would work in Ireland could not be transplanted to other economies with any confidence in their success given Ireland's institutional specificities. Ireland's previous experience of austerity in the 1980s took place in the context of a confluence of positive and growth-enhancing internal and external factors like real wage increases, an income tax amnesty, the opening up of the single market, and a currency devaluation in 1986 detailed by Lee (1989), and Honohan and Walsh (2002). Rather than presenting Ireland as a case study for expansionary fiscal contraction as Alesina and Ardagna (2013) and others have argued, a close reading of Ireland's economic history reads in a rather Keynesian light today.

Unhelpfully for today's policy makers, the experience of the 1980s in Ireland shows 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 and devaluing one's currency.

But if Ireland is not the poster child for austerity, then what explains Ireland's remarkable performance from 2010 to 2014 in terms of fiscal consolidation, structural reform, and relative normalisation of a bloated banking system? This article attempts to answer this question.

Figure 1 traces out the details of the recent boom and bust cycle in levels for GDP, unemployment, and debt to GDP. What is remarkable are the sheer increases in the levels of debt to GDP and unemployment, but also the drop in the level of GDP to 2005 levels in 2013 and 2014, and the fall in unemployment after 2011, driven mostly, it seems, by emigration.

With unemployment dropping since 2011 from a high of 15.1 percent to 12.1 percent in February 2014, a return to a positive primary balance in the government finances is on the cards. Combined with a net debt position of 99 percent of GDP once cash balances and other holdings have been taken into account, and a series of successful bond auctions completed, Ireland's

Figure 1

Unemployment, GDP and Debt to GDP for Ireland
Quarterly levels

Q1, 2007 = 100

- GDP
- Unemployment rate
- Debt/GDP

Source: Central Statistics Office.
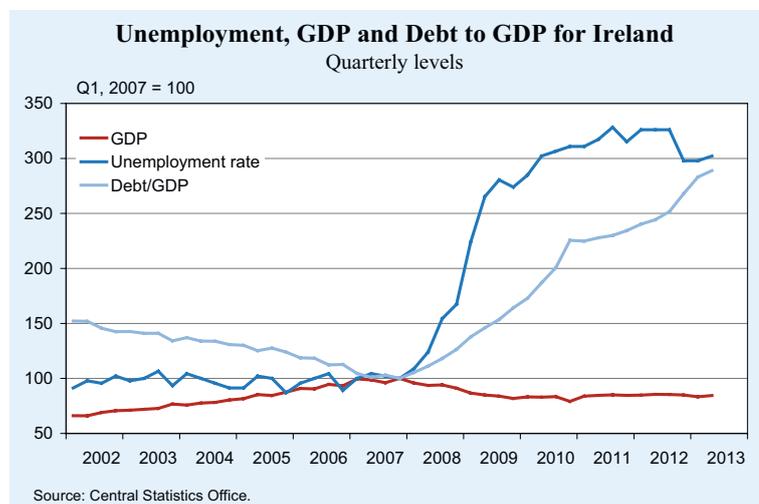
fiscal sustainability seems assured. Modest growth in domestic demand, as well as in overall GDP, is forecast for the next two years by all major institutions.

In the present day, Ireland is presented as a success story based on a number of outstanding achievements. The first is a remarkable degree of fiscal consolidation over a short space of time. Ireland has consolidated almost 20 percent of its GDP over an 8 year period, with no significant industrial or social upheaval. With a 'clean' exit from the EU/IMF bailout programme, recent quarterly increases in domestic demand and employment, as well as the favourable borrowing costs mentioned above, Ireland aims to give the impression is on its way to resuming business as usual from a macroeconomic standpoint.

Ireland's sectoral balances

Ireland's sectoral balances tell a slightly different story. Figure 2 shows three sectoral balances for Ireland.

Recall the fundamental macroeconomic accounting identity equating national income (Y) to consumption, (C) government expenditure (G), investment (I), and net exports ($X - M$). It is always true that

$$(1) \quad Y = C + I + G + X - M.$$

Following Godley and Cripps (1983), taking taxes (T) from both sides, and redefining $Y - T$ as disposable income YD, we have

$$(2) \quad YD = C + I + (G - T) + (X - M).$$

Subtracting C from both sides, defining saving as $S = YD - C$ and then subtracting I from both sides we have the sectoral balance identity relating the private sector balance to the public and rest of the world's sectoral balances:

$$(3) \quad \overbrace{(S - I)}^{\text{Private}} = \underbrace{(G - T)}_{\text{Public}} + \overbrace{(X - M)}^{\text{World}}.$$

Figure 2

Sectoral balances for Ireland
Seasonally adjusted

billion euros

Private
Public
Rest of world

Source: Central Bank of Ireland.
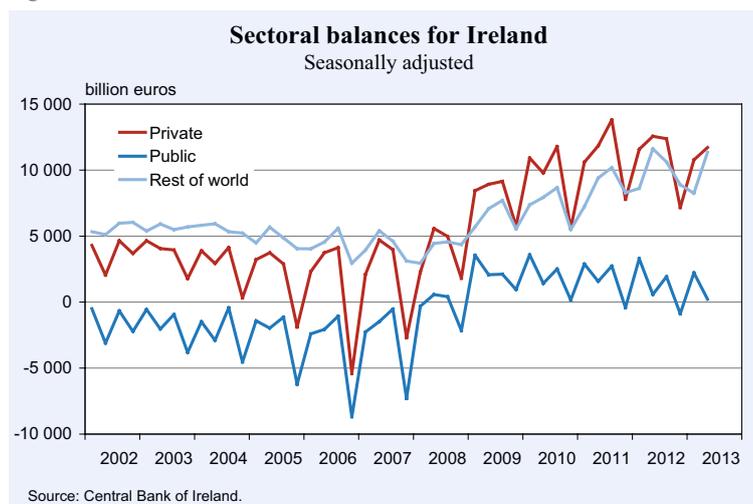
In the Irish case in 2014, we might say equation (3) represents the identity of the private sector surplus equalling Ireland's deficit spending plus our current account surplus. In particular for Ireland it is important to note the private sector surplus is a net position, made up of the change in foreign ownership of domestic assets minus the change in domestic ownership of foreign assets.

Figure 2 shows how these three balances have evolved since 2002. The 'public' sectoral balance was in clearly in rude health before 2007, with $G < T$ and the private sector investing large amounts while savings remained relatively low. From 2008 onwards, the deterioration in the public finances caused by the collapse of the asset bubble caused the public sector to run a large and persistent deficit financed through borrowing, first from the markets, and then from the EU and IMF once private sources of funding the state were no longer accessible. The movement by the authorities towards a positive primary balance at the end of 2013 is clear, with G almost equalling T before interest payments are accounted for.

From an examination of gross flows into and out of Ireland, it is clear Ireland's expansion was built on using a foreign surplus as deposits and equity. Post 2007, the relationship has changed, with the foreign surplus being used as loans and equity.

Post 2007 the expansion of saving, largely of a precautionary nature, combined with a drop in investment caused by a constriction of credit, forced the private ($S - I$) relation up, matched in this case by an expansion of holdings from the rest of the world ($X - M$) as Ireland's trade balance improved. These two lines are

almost equal as of the time of writing as Figure 2 shows.

In answer to the question posed by this volume, looking to the future using the sectoral balances, post-bail-out Ireland has a choice to make. Given the Irish authorities' commitment to drive $G < T$ for some time to come in order to pay down debts in particular, only two things can happen to the relation between $S - I$ and $X - M$. Either the private sector begins to invest more and save less, driving the 'private' line down somewhat, or if this does not happen, the 'world' sector must agree to hold ever more in terms of Irish exports. The following section examines the dynamics of Ireland's trade balance to investigate whether this reliance on export-led growth is an option moving into the future.

Digging into trade flows

Figure 3 picks out a startling relation between exports and imports pre- and post- the 2007 crisis. Pre-2007, the two series move in lock step, with a correlation co-efficient of 0.95. Post-2007 the series diverge dramatically, the correlation between the two series dropping to 0.71, with both series dropping from 2007 to 2009 as a result of the deterioration caused by the world-wide Great Recession.

Exports improve after 2009 almost to their pre-crisis trend. The same improvement does not take place for imports. The collapse in domestic demand caused by the popping of the asset bubble, combined with the imposition of austerity policies by the Irish authorities weakened Ireland's propensity to import, with the resultant improvement in Ireland's trade balance.
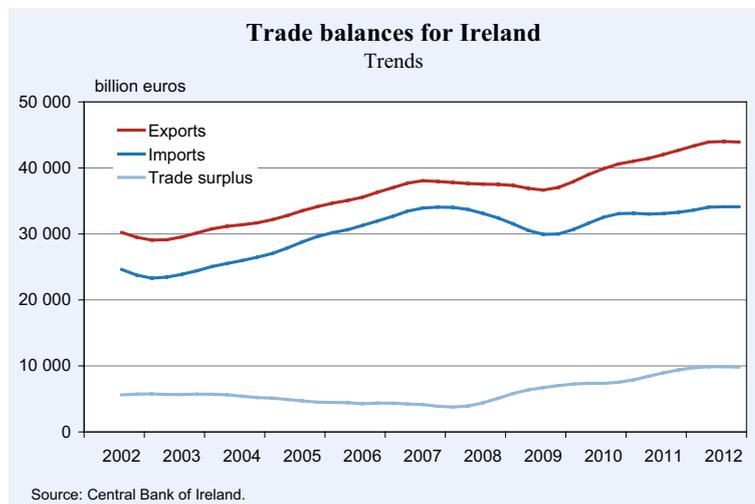
Austerity was, in this balance sheet sense, made more possible because of Ireland's openness, and its status as a multinational export hub. Much of the export base can, in a sense, be considered as exogenous to the Irish economy-proper.

Rather than collapsing imports and exports by deflating the entire economy, by only acting on one 'side' of the import-export relationship, and relying on export led growth, so long the mainstay of Irish economic policy, the Irish authorities accomplished what few other economies could: to engineer a deflation in Ireland's fiscal space, while leaving exports, and hence revenues from exports, relatively untouched.

Ireland's export sector has an almost unique institutional feature when compared to other EU countries: much of its exports are from multinationals, with the largest share, approximately half of all merchandise exports, coming from pharmaceutical companies. Nine of the top ten pharmaceutical companies on Earth are located in Ireland.

Sapir *et al.* (2014) have produced a review of all four EU/IMF programmes within the eurozone to date: Greece, Ireland, Portugal and Cyprus. The authors of the report subtitle Ireland's section of the report 'a success with costs'. The authors show the EU and IMFs forecasts for the increase in debt to national output and for the gap between government spending and taxation were almost perfect, while their forecasts for unemployment were substantially wrong, as were their forecasts for the effect of the fiscal consolidation on the domestic economy. The austerity measures affected the domestic economy much more than the EU/IMF planned, but they (and we) were saved by a better than expected export performance. Ireland could take a lot of austerity because of its openness and flexibility.

This feature of the Irish economy is unlikely to be present in other economies, meaning Ireland's usefulness as a poster child for austerity must still be questioned.

Figure 3

Trade balances for Ireland
Trends

billion euros

- Exports
- Imports
- Trade surplus

Source: Central Bank of Ireland.

A digression for regression

I estimate the evolution of the employment level of the labour force in logs (EMP) as

$$(4) \quad \text{EMP} = \alpha_0 + \alpha_1 \text{Real GDP}_{t-1} + \alpha_2 \text{Nominal Wages} + \alpha_3 \text{Time} + \alpha_4 \text{Taxes}.$$

Results are shown in Table 1 for employment and household disposable income (HH). Clearly, and unsurprisingly, employment depends positively on income, output and nominal wages. What is striking is how negatively taxes affect the log of household disposable income over this period (-0.410, significant at $p < 0.05$). Looking past the bailout, once the State's finances have been stabilised, tax decreases should help increase employment significantly.

When these data are broken into sub samples, pre- and post-2007, the findings are broadly similar, meaning the stimulative effects of tax cuts can't be ruled out as a means to increase the economic activity of post-bailout Ireland.

Turning to the financial side of the economy, we estimate relationships between financial corporate securities and a range of other assets, non-financial loans and a range of other assets, and household deposit and a range of other assets (see Table 2).

In model 1 shown in Table 2, it is clear financial corporates holdings of securities altered, moving from government loans (-0.397) towards loans and currency from the rest of the world.

In model 2, the effect of the collapse on non-financial loans was negative, both in terms of currency outflow (-0.538, significant at $p < 0.05$) but also in terms of a movement towards government loans (0.536, significant at $p < 0.05$). Running these regressions in sub-samples, one sees two distinct loan regimes – pre 2007 and post 2007, but the overall trend is similar. Looking at the influence of government securities issued on non-financial loans it is clear the credit contraction affected the economy in large and uncertain ways, and the portfolio effects described by Brainard and Tobin (1968) and Tobin (1969) are clearly in evidence as households and firms switched away from government loans (-0.397) towards loans from the rest of the world (0.426, significant at $p < 0.05$).

Household deposits were relatively unaffected during the crisis, showing us the effects on gross flows into and out of the economy, as well as portfolio reallocations, took place in the corporate and financial sectors.

The regressions are simple, but so is their message: portfolio allocations pre and post crisis differ mainly on the size and composition of their holdings, and appear to have taken place within the corporate and financial sectors.

Conclusion: post-bailout debt dynamics

One way to tell Ireland's post bailout story is to look at the likely evolution of the stock of debt and the flow of debt repayments, and their effects on the real economy when growth is sluggish. Following Godley and Rowthorn (1994), to reinforce the point of this short chapter, let us assume exports are exoge-

Table 1

OLS Regressions for the real economy

	Employment (1)	HH Gross Disposable Income (2)
	Dependent variable	
Lagged Real GDP	0.897***	
	(0.112)	
Real Wage	0.298***	
	(0.079)	
Time	−0.065***	
	(0.007)	
Nominal Wages		0.544***
		(0.029)
Taxes		−0.410**
		(0.188)
Constant	−4.842***	4,389.200***
	(0.773)	(1,125.892)
Observations	46	46
R^2	0.888	0.898
Adjusted R^2	0.880	0.894
Residual Std. Error	0.022 (df = 42)	846.761 (df = 43)
F Statistic	111.496*** (df = 3; 42)	189.885*** (df = 2; 43)
Note: *p<0.1; **p<0.05; ***p<0.01		

Source: Central Statistics Office.

Table 2

	FC Securities (1)	NFC Loans (2)	HH Deposits (3)
	Dependent variable		
HH Loans	− 0.487 (0.377)		
FC Deposits		− 0.538** (0.264)	
FC Securities		0.198*** (0.024)	
FC Loans			0.067*** (0.007)
Govt Loans	− 0.397 (0.401)	0.536*** (0.151)	
Govt Securities		0.254** (0.101)	
ROW Deposits	1.077*** (0.099)		
ROW Loans	0.426*** (0.146)		
ROW Securities	0.411*** (0.063)		0.084*** (0.006)
Cons.	21,803.940 (15,024.500)	− 83,217.430*** (9,716.771)	46,793.680*** (2,217.848)
Observations	46	46	46
R^2	0.974	0.892	0.994
Adjusted R^2	0.970	0.879	0.993
Residual Std. Error	18,161.470 (df = 39)	10,848.910 (df = 40)	1,651.373 (df = 41)
F Statistic	244.063*** (df = 6; 39)	66.104*** (df = 5; 40)	1,600.900*** (df = 4; 41)

A look at the financial side of the economy

Note: *p<0.1; **p<0.05; ***p<0.01.
FC: Financial corporates; ROW: Rest of world; HH: Households; Govt: Government

Source: Central Bank of Ireland.

nous, and the net stock of both foreign and domestic bonds hold by residents is *B*. Imports make up a fixed share *m* of income and the real exchange rate is fixed. Assuming a target wealth of *W*, and an autoregressive wealth accumulation process $W = \beta W_{-1} + \gamma(G + X)$, where wealth accumulates according to a country's export profile, we can define a stability condition in government expenditure and changes in government debt such that $\Delta B = 0$. In the steady state, Godley and Rowthorn (1994) show that government expenditures evolve (relative to exports) according to:

$$(5) \quad G^* = \frac{m(1 - \omega z) - (1 - \theta)(1 - \omega \theta)}{m(1 - \omega z) - (1 - \theta)\omega \theta} X,$$

where θ is the tax rate, m is the import propensity, *z* is average real post tax rate of return on net wealth, and ω is the target wealth-income ratio.

Equation (5) simply says a small open economy's 'warranted' level of government expenditure is commensurate with its trade performance. Whenever $G > G^*$, and the government must borrow to finance itself, the government can always finance itself through higher taxes.

Austerity fundamentally consists of a deflation, and, crucially, in the Irish case, a reduction of *m* while maintaining *X* at its highest level, because then the fiscal stance G / θ can take higher and higher values such that $\delta G^* / \delta \theta > 0$.

Ireland's post bailout performance in terms of debt dynamics will hinge upon its ability to trade off its trade performance and tax rates. Given that the composition of Ireland's fiscal adjustment from 2011 to 2014 was approximately $2/3$ expenditure reduction and $1/3$ taxation increase, it may be that Alesina and Ardagna (2013) have a point regarding taxation measures.

Ireland's openness is the reason austerity was able to succeed. Other countries without Ireland's institutional peculiarities, such as Spain, Portugal, Greece, and Italy, will not be able to, in a sense, play the same trick.

The portfolio switching observed in the regressions shown in Table 2 above also point to a degree of financial openness these economies do not share with Ireland, making the kind of macro-financial reversal Ireland has experienced also unique in both its scale and speed of adjustment.

All of the above should not be taken to mean Irish exports are all simply multinational transfers. However, given the austerity-induced reduction in wages it would be interesting to estimate how much of a terms of trade improvement this has given Ireland and how much of the rise in exports is therefore 'non-multinational' throughput. That would give us a better handle on the supply side of possible export growth, and is the focus of future work. The demand side is still constrained by the considerable risk of Europe (and in particular the eurozone, which accounts for 40 percent of Ireland's exports) experiencing a stagnation episode over the medium term.

Ireland is still not the poster child for austerity, but, against the odds, as it were, a lucky child. Given the simple fact that as a nation Ireland has been bankrupted three times in 50 years, Ireland's peaceful exit from its bailout programme is all the more remarkable. The post-bailout landscape is fraught with risks to the nascent recovery, but stable debt dynamics and the openness of the economy should be enough to keep Ireland from requiring another bailout in the medium term.

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