The Real Lesson About Ireland’s Austerity Plan

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For commentators like Paul Krugman and Joseph Stiglitz, it’s become an article of faith that credit markets will punish some of the governments that are pursing austerity plans or bold reductions in public spending. Their case study is Ireland. Krugman has asserted that Irish credit spreads have widened in spite of the austerity measures; Stiglitz has said “the belief that markets will get new confidence [from austerity] has been shown wrong” by Ireland’s budget cuts. Should Ireland seek a bailout from the International Monetary Fund (IMF) or European Financial Stability Facility (EFSF) – as now seems increasingly likely – look for Krugman and Stiglitz to blame it on fiscal consolidation.

This argument reflects a fundamental misunderstanding of the scale of the problems facing Ireland. It also badly mischaracterizes the policy steps taken by the Irish government. The problems facing Ireland are far greater than the solutions the government has proposed to date. It should be no surprise that market confidence has not returned because there is no reason for Irish creditors to be confident that they will be repaid in full.

To appreciate Ireland’s plight, it’s helpful to compare it to America’s financial turmoil. From the end of 2006 to the first quarter of 2009, more than $7.25 trillion of U.S. household wealth evaporated due to the collapse of the housing bubble. The economic consequences of this wealth destruction were two-fold: household consumption growth stalled as less wealthy households saved more and borrowed less to fund additional consumption (cash-out refi

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Although the problem was global in scope, national authorities were responsible for stabilizing their domestic financial sectors on a piecemeal basis. For the U.S., there was never any question about whether the federal government had the capacity to arrest the panic. At its peak, the liabilities of the U.S. financial system were $17.1 trillion (D.3), or about 118% of GDP. Even if one assumed that assets were worth 20% less than liabilities – a highly aggressive and unlikely assumption – the cost of guaranteeing all of the financial system’s liabilities would only be 23% of GDP, or equal to a one-time 50% increase in the debt-to-GDP ratio. Therefore, the implied guarantee of all financial system liabilities after TARP was highly credible.
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For other countries with larger (relative) financial sectors, the arithmetic was much different. The most obvious example was Iceland, whose banking system’s liabilities reached nearly 1,100% of GDP in 2007. When its banks could not access wholesale funding markets, the government lacked the fiscal capacity to intervene credibly. The result was economic collapse. For other nations, it was less cut and dry whether the government could backstop its banking system’s liabilities without incident (see chart above). The United Kingdom and Switzerland’s banking system liabilities exceeded 400% of GDP. Both nations took actions to recapitalize banks and provide implicit guarantees of their liabilities – TARP-like programs to stand behind banks and assuage concerns of creditors without legally obligating the government to ensure no bank creditor suffered any loss. Conversely, Ireland, whose banking system’s liabilities were also near 400% of GDP, decided to formally guarantee its banking system’s liabilities.

While the Swiss and UK guarantees seem to have succeeded thanks to their banking system’s international activity and broad diversification, the Irish guarantee has not been as successful, largely because of its banks concentrated exposure to a bursting domestic real estate bubble. The result has been a deeply insolvent banking system that some believe will ultimately push the Irish government itself bankruptcy. Barclays was the latest to warn that the government will likely have to renege on its guarantee and seek concessions from bank creditors if it is to avoid sovereign bankruptcy. As of August, the Irish banking system owed €95 billion to the European Central Bank (ECB), which means about 12% of all Irish bank assets are now financed through official liquidity facilities. This is only slightly below the 17% of Greek assets funded through official channels and a sign that the private sector is no longer willing to fund Irish banks.

The problem for Ireland is that the tax revenue that could otherwise be pledged to cover its banks’ debts has plunged for the same reason its banks are in such trouble: the collapse of the real estate bubble. Irish house prices have fallen by 34% from the peak and have yet to stabilize. Irish wealth fell by about €150 billion in 2009, which would be roughly equivalent to an $8 trillion decline for U.S. households. Unemployment has spiked in the very sectors most responsible for growth in the recent past – real estate construction and finance. The same factors driving the banks’ insolvency are simultaneously depressing employment, household spending, and tax revenue. The deficit stands at 14% of GDP, due largely to an economic contraction that sliced 10% off of the size of the Irish economy since 2008. The government’s gross debt has nearly tripled as a share of GDP, rising from 25.8% in 2006 to 64% at the end of last year and could exceed 75% by the end of the fiscal year.

There are no signs that any of this is temporary or that adjustments made to date are sufficient to maintain access to credit. The initial austerity measures taken by the Irish government – tax increases and large cuts to public employee wages – seemed ambitious, but they turned out to be a drop in the bucket relative to the cost of the bank rescue. The Irish government created the National Asset Management Agency (NAMA) to acquire property development and commercial real estate assets from
banks at a sizeable discount to par. As with similar schemes, this government-sponsored fund faces a catch-22: overpay for assets and transfer losses directly to taxpayers or drive a tough bargain and further expose the banks’ insolvency. To date, NAMA has recorded €30 billion of losses, or more than 10% of GDP. S&P estimates that ultimate losses will be between 29% and 32% of GDP. To put this figure in perspective, this would be equivalent to U.S. taxpayer losses on Fannie Mae and Freddie Mac of $4.2 trillion, or about 11-times the CBO estimate of $380 billion.

While some think Ireland could be saved through export growth given the number of international corporations that moved to Ireland to take advantage of the low corporate tax rate, the potential for export growth is limited by what the IMF suggests was a bubble in wages similar to the one in property prices. At the end of 2007, Ireland was proudly boasting that it had more Mercedes Benz per capita than Germany. The rise in wages brought about by a booming economy reduced competitiveness. Deflation has set in with prices falling by nearly 2% last year. Export growth will likely first require a period of prolonged deflation, which would result in a dramatic increase in the real cost of the large amounts of newly incurred debt. In short, the Irish economy is still reeling from a financial collapse that is several times worse than that of the U.S. Even the Spanish problems are mild by comparison, as only 4% of Spanish banking system assets are funded by the ECB and Spanish banks are more diversified and better capitalized.

Analysts on the political left are using the implosion of the Irish economy to advance their mistaken narrative about the supposed dangers of reductions in public expenditures. This overlooks that any savings generated by spending cuts were more than offset by outlays associated with the €90 billion NAMA to acquire bad loans in the banking system. While Ireland has made additional pledges to reduce the deficit to 3% of GDP in the medium term, its “consolidation plan would benefit from greater specificity,” as the IMF diplomatically puts it. In other words, Ireland has no credible plan to bring spending and revenues in line and has not done what is necessary to “reduce the uncertainties associated with the consolidation process.”

Large spending cuts can only succeed when they remove uncertainty and change private sector expectations about future disposable income growth and the cost of government. Ireland’s cuts failed to do that because they were dwarfed by the growth in the expected cost of the bank bailout. This means that the government’s implied cost to households and businesses has continued to grow despite the fiscal tightening. Implied government spending continues to grow.

The U.S. is in a very different situation. The TARP has largely been paid back. The losses from Fannie Mae and Freddie Mac are running at about 1% of GDP. The U.S. is not suffering from large increases in implied spending associated with an ongoing bailout. Over half of the increase in the budget deficit is attributable to discretionary outlays, which have pushed the government’s share of GDP to new records. Indeed, the reason the U.S. is likely to benefit so greatly from large reductions in federal spending is because of the growth in private sector investment likely to occur from taking the potential for confiscatory levels of taxation or an Irish-like debt spiral off of the table. Policymakers should not be misled by the Irish crisis. It is debt-financed government expenditures arising from a banking crisis that’s bringing down Ireland, not austerity.