Patrick Honohan: Making Ireland's public finances sustainable again

Opening address by Mr Patrick Honohan, Governor of the Central Bank and Financial Services Authority of Ireland, at the ESRI / Foundation for Fiscal Studies Budget Perspectives Conference, Dublin, 13 October 2009.

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Thanks to the Institute and the Foundation – both organisations with which I have had a long association – for giving me the opportunity to open this year's Budget Perspectives Conference. Always an important event in the calendar, the potential usefulness of this year's pre-budget conference, at which options and strategies can be discussed among experts in a very practical way, hardly needs emphasis. So I am glad that it is here that I can make my first public address as Governor of the Central Bank.

Naturally, my theme today is adapted to the focus of the Conference. Thus today I want to talk mainly about bringing the public finances back to a sustainable position. I will also touch on two central tasks of my new role, namely price developments and the reform of the banking system, though mainly insofar as they interact with the budgetary situation.

Actually, it is banking that chiefly preoccupies me at present, but this is not the place for a detailed discussion of it. For the moment, let me just briefly remind you that our banking situation has called for clear and decisive action on a number of fronts. These include restoration of the liquidity of the system to robust levels, dealing directly with the problem property loans, replenishing the cushion of risk capital that allows banks to expand lending again, and renewing bank senior management (ensuring that the lending decisions are better in the future). Strengthening the regulatory capacity to detect and forestall any recurrence of imprudent banking is also crucial, and this has both international and domestic dimensions. Of course, the ongoing investigations into certain alleged wrongdoings are also important. Current and recent policy measures are addressing all of these issues (and others besides). Optimising the design and implementation of each of these measures is a key priority and one on which I will speak further over the coming weeks.

For today, though, I want to concentrate on how we can help bring the public finances back to a sustainable position. This can be done, and it does not require reinventing the economy. Instead, the goal of policy should be to regain, as far as possible, many of the structures and relativities of just a short number of years ago. Replicating the past is not fully possible, but we can come close, especially if the global recovery strengthens. A sense of proportion as to the scale of the adjustments that will be called for – relative to the living standards of just a few years ago – will help restore confidence and build a consensus for the needed measures.

It is necessary to rebalance public spending and taxation through setting both of them at levels that are sustainable over time and not sensitive to cyclical economic conditions. This could be done by restoring the shares of taxation and spending in GNP to the levels which prevailed in the years running up to the turn of the millennium when the economy was growing along a sustainable path. More generally, restoring the structure of the broader economy to that which prevailed around the start of this decade would help bring about a return to sustainable employment-generating growth.

Falling prices are also threatening the budgetary situation, both through adversely affecting the tax take if they result in higher real wages (thereby choking-off the recovery of employment), and generating an unintended increase in the real value of payments which are fixed in monetary amounts. Wage discussions need to recognise the increased purchasing power of money in an environment where inflation is falling; if not then our wage structures will move out of line with competitors. Retaining wage competitiveness to sustain and increase employment is a key priority, even if it means cuts in nominal wages.

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It was just last year at this conference that I first proposed that the fiscal crisis – then emerging into full view – could best be addressed by looking back a few years to where we had been around the turn of the millennium in terms of the shares of taxation and spending in GNP. Those years define the end of the thoroughly healthy and sustainable path of aggregate activity. Getting back to those shares seemed like an appropriate target.

I believe that this approach to repositioning the budget remains a useful one. Indeed the need for such a way of framing budgetary planning was reinforced by the sharp decline in global trade and in economic activity in many of our major trading partners, a decline which for several months had no evident bottom. As we will see, though, the numbers need to change a bit to take account of all that has happened over the past year. Now by general consensus the bottom to the international recession seems to have been reached. Although global growth is projected to be weak, the upward movement offers some buoyancy to help stabilize Irish economic activity too, and provide a platform on which a recovery to future growth from 2010 can be built.

I would go further to assert that a wider rebalancing of the structure of the economy (going beyond just tax and spending) to something much closer to that of the year 2000 would leave us best-placed for a resumption of employment-generating growth on a sustainable basis.

When external observers ask me whether the Irish economy has to be reinvented, this therefore is my answer: not reinvented, merely restored to where it was just a short while ago.

Let me stay first, though, with those budgetary aggregates. Compared with this time last year there have, of course, been some unexpectedly severe adverse developments.

We have seen a collapse in total revenues as a share of GDP. Unlike the deliberate decline in this ratio in the latter part of the 1990s, this collapse was an unplanned consequence of, first, the collapse in housing activity and, then, the rest of the downturn. Especially important, as has been widely discussed, was the role of those evanescent taxes whose receipts were highly contingent on a booming economy generating large profits, capital gains, and – notably – stamp duty from property transactions. We had become highly dependent on these as the steady expansion in revenue from these sources during recent years came to be taken for granted and rates elsewhere in the tax code were lowered.

Thus the income tax increases of 2008-9 represent – broadly speaking – no more than a return to rates that prevailed within the past decade or so and over a period when the economy was growing strongly. While high marginal tax rates are distorting to economic performance, this comparison with recent history is needed to put the tax increases in context (Admittedly tax rates also need to be assessed in terms of international competitiveness, but the contemporary income tax increases in the UK dulls some of the impact of this caveat).

With the economy underperforming by so much, it will be some time before tax as a share of GDP gets back to its medium-term target value.

What of spending? Here there has been a huge expansion of what we are again calling automatic stabilisers, the largest of which are payments related to the very sharp increase in unemployment. (And of course the higher rates on these payments also amplify this effect.)

There has been a tendency by some commentators to bemoan spending cuts, but spending has, in the past year, jumped substantially as a result of this automatic stabilizer effect. This time last year we knew there would be an element of this type – though the scale of the increase was not anticipated because the rise in unemployment has been much larger than was expected before the global downturn kicked-in.

In the background, though, if we are to get back to that millennial share of spending in GNP, there have to be other cutbacks reversing the expansion of the mid-2000s. That of course is where the report of the McCarthy group comes in.

But there is something else new, namely the sharp fall in consumer prices since last year. This has raised the value of real transfer payments and other contractual amounts fixed in nominal terms and worsens the budget deficit, while giving an uncovenanted bonus to some.

We have never seen price falls on such a scale. The illusion that money cannot gain in value is something that must be seriously addressed if the budget is to be brought back into line, especially because of its tendency to result in higher real wages, thereby threatening employment. I'm sorry to touch on such a sensitive issue, but I think we need to be quite unambiguous about this. In previous times, whenever real wages moved as far ahead of our trading partners as they have since 2000 (abstracting from a gradual trend in differential average productivity in Ireland and abroad) an inevitable sequence followed. Sooner or later unemployment rose, as producers were forced by lack of profitability to shrink or close. But then, the real value of wages was eventually eroded by inflation and depreciation. In the euro zone the second, corrective step, is not going to happen. It is crucially important to recognise that the old automatic stabilizer of real wages – depreciation of the exchange rate – has been put out of action (and for good reason).

There's no point in getting distracted in this discussion by pointing out inequities in the current structure of wages and salaries or remuneration generally: attempts to fix such inequities and anomalies do not need to get in the way of ensuring that the average real wage structure does not move out of line with that of the indirect competitors for workers in Ireland, namely workers abroad.

In this context, the trend in Irish wage competitiveness over the years is worrying. If average wages in Ireland do not get back reasonably close to where they were *relative to competitors* earlier in this decade, then a reduction in unemployment will owe more to migration than to a return to job growth.

This does not, of course, mean a return to earlier living standards, because there has been quite a bit of productivity growth in the meantime. Besides, Irish wages were arguably super-competitive around 2000. The main point, though, is that here too reference to the millennial benchmark helps avoid a serious error in policy discussions.

By the way, some sectors are more affected than others, for example those which compete with UK producers. One of the reasons why consumer prices are falling further in Ireland than elsewhere in the euro area (where on average prices have dipped only a fraction of one per cent in the past 12 months) relates to the continued extent of our reliance on trade with the UK, whose currency has been very weak over the past couple of years. One dramatic expression of this weakness will resonate with the older members of the audience: the current exchange rate for sterling against the euro translates into IR£1=£1.18 sterling – a high level never approached during the twenty-year independent life of the Irish pound.

Retaining wage competitiveness to ensure maximum employment in these difficult times is surely a key priority, even if it means cuts in nominal wages. If all prices had fallen by another 10 per cent, would the old nominal wages be "just right"? Of course not. This reduction ad absurdum shows how important it is to shake-off the fetish of no nominal cuts.

I indicated at the start that the medium term targets for the spending and tax ratios to GNP could not be quite the same as appeared last year. The reason is that this unexpectedly deep recession will result in a very large increase in net public debt even before making allowance for the recapitalization of the banks. The deficit/borrowing requirement which has opened up will be closed over time, and the government have embarked on a credible convergence path for doing so, the commitment to which I am glad to see is reconfirmed in the newly agreed Programme for Government. Even with this, however, a large debt will have to be serviced. This will add to interest payments and mean that the gap between noninterest spending and tax revenue must be wider in the long-run (since debt ratios cannot spiral away to infinity). This is a drag, and the higher the debt level reached, the bigger the drag it is. That's an important reason for minimizing that accumulated debt, for example by sticking to the announced convergence path.

The recapitalisation of the banking system is also now sure to be a costly exercise, adding to net debt and impeding the possibility of getting back to 2000. For the same reason of avoiding the drag imposed by heavy debt in the long-run, this argues for a recapitalisation strategy that minimises the state's net long-term financial outlay. At the same time, though, it is crucial for sustaining the growth that will generate tax revenues in the long run that the banks move forward with adequate capital. Therefore it is not wise to skimp on the restructuring.

In conclusion, although I cannot strike quite as optimistic a tone as I offered last year, it remains true that the Irish economy is a productive one capable of delivering both high living standards and financing a good level of public services on a sustainable basis. Correcting some of the drift in wage competitiveness (notably by recognizing the implications of falling prices and the strength of the currency) will help ensure that employment can pick up again on a medium-term basis on the back of the global recovery. The sooner we can correct the structural elements of the budget deficit, the less public debt will be accumulated during the adjustment and hence the closer we will be able to return to the healthy and achievable living standards of just a few years ago. That perspective should help put what may seem to be large needed adjustments in context.