Patrick Honohan: Good times and bad for a globalised economy – macroeconomic policy lessons from Ireland

Address by Mr Patrick Honohan, Governor of the Central Bank of Ireland, to The Gilman Rutihinda Memorial Lecture, Bank of Tanzania, Dar es Salaam, 12 August 2011.

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The global crisis has left no part of the world unaffected. Tanzania may have weathered the crisis better than many, but even here an externally-driven credit crunch resulted in a temporary growth set-back in the period 2008–9. Market turbulence has increased again, but I do not want to discuss those very current matters today. After all, it is not only the immediate and direct impact that needs to be considered Arguably more important is to reflect on the lessons that are to be learnt in terms of how a relatively small economy should be positioned in regard to global trade and finance in order to survive well from that experience. In order to learn those lessons, there is no more instructive example than that of Ireland, albeit a country in a very different state of development to that of Tanzania.

After all, Ireland is one of the most globalized economies in the world, and it consolidated this position in the period 1986–2007, during which aggregate living standards rapidly converged to those of the world's leading economies. During that apparently highly successful period – dubbed the "Celtic Tiger" commentators – ambitious countries at lower levels of per capita income, such as Tanzania, began more and more to look to Ireland as a potential model against which to evaluate their own growth strategies.

But Ireland's navigation through the hazards of the emergent global economy hit severe shoals in 2007–8, since when an acute economic contraction has seen per capita GNP fall – faster than almost anywhere else – back to the levels of 2000, a return to high net emigration reflecting job losses and high unemployment, and a loss of access to financial market access reflecting international financial market concern at the extent of bank losses and the sustained jump also in other government borrowing.

In the end, while Ireland's engagement with globalization over the past quarter century cannot be counted a failure, its earlier characterization as a success must now be at least very heavily qualified. What then are the macroeconomic policy lessons for countries whose growth ambitions have also been based on a embracing globalization?

In this lecture, I will suggest that policymakers in small open economies need to be especially alert to the fact that globalization can act to accentuate, accelerate and prolong macroeconomic trends both in the upswing and the downturn. It's as if globalization acts as a *turbocharger* for the small open economy.

Just when things seem to be going very well in many dimensions, you can get into trouble very quickly and at a time when some of the conventional warning indicators are not flashing. Rapid and quite protracted growth spurts are possible, based not only on expanding exports to the vast global market for goods and services, but also on the availability from neighboring countries or further afield of additional factors of production, whether material inputs, labour or capital.

I will illustrate the turbocharging phenomenon drawing on the experience of Ireland in the past two cycles, in both of which serious policy errors were made, allowing an unsustainable boom to get out of hand. Recovery from the first cycle (in the 1980s) was at first slow, but then accelerated at an astonishing pace which sowed the seeds of the construction bubble of the 2000s from the aftermath of which the economy is only now consolidating the early recovery phase. The lessons are clear: macroeconomic policy in the globalized economy needs to be even more alert to the dangers of an unsustainable turbocharged boom. However enjoyable it is while it is in process, the bust – potentially also turbocharged – is even more painful.

I will also touch on another, not unrelated, globalization-related theme, likely to be even more relevant to Tanzania, namely the tendency for globalized economies to be structurally *incomplete* or "hollowed-out" both in productive capacity (concentration on a limited range of economic sectors[1]) and in the repertoire of macro-fiscal and prudential policy tools (as reliance is increasingly placed on (i) external markets for components or factors of production and on (ii) external institutions and analyses for the design and in some cases delivery of policy.) This tendency can feed the turbocharger and restrict the capacity for policy response to emerging problems.

1. International aspects of the fiscal crisis and recovery of the 1980s

In trade, migration and finance, Ireland had of course been an exceptionally open economy for a very long time. The large migration flows, especially to the UK and the New World, and the currency and banking links go back to the early 19th Century at least, with scarcely any overall interruption. Irish banks parked their excess resources in the London money market right up to the 1960s – a pattern familiar to many African countries today.

Nor is the current crisis the first (O Grada, 2011) – indeed the potentially turbocharged nature of the globalized economy is well-illustrated by the rapid recovery from the previous severe crisis of less than a generation ago, whose onset coincided with the decoupling – for the first time since just after the Napoleonic Wars – of Ireland's currency from sterling.

The earlier of the two macroeconomic cycles we look at happened at a point where global capital markets were still just beginning to move into the high gear that we see today. We may think of this as *Turbocharger Mark 1*. It allowed the Irish Government to access foreign capital to some extent without much by way of credit risk premium, but the fear of a sudden stop of this capital flow brought expansion to an end and resulted in a painful and protracted recession through the 1980s.

That crisis had its origin in the turbulent macroeconomic years of the 1970s which themselves saw Ireland make several severe demand management errors which stifled its capacity to benefit fully from the opportunities offered by EU (EC) membership from 1973. New opportunities there were, and especially the higher prices for agricultural produce under the Common Agricultural Policy. But that was not all: EU membership became a major channel for transmitting globalization to Ireland.

But the expansionist fiscal response to the stagnation of the 1970s created a huge and spiralling Government and balance of payment deficit which proved difficult to reverse in the early 1980s. By this stage, membership of the ERM of the European Monetary System had broken the currency link with sterling, and the Irish pound was prone to being realigned against the stronger ERM currencies – something that happened about once a year for the first 8 years of the system.

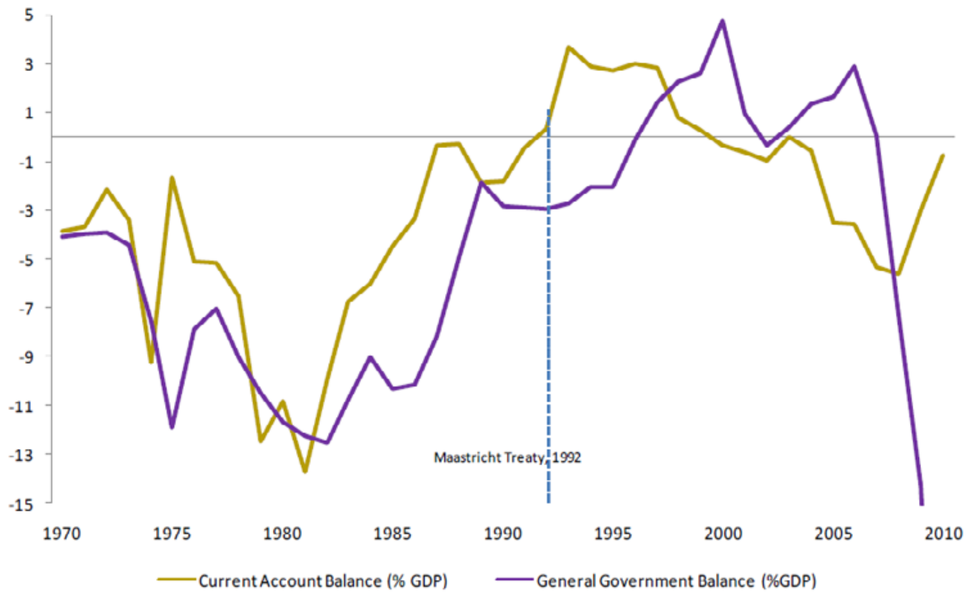
It is interesting therefore to contemplate how international factors influenced the fiscal correction of the 1980s. Although exchange controls still existed and indeed had been

[1] As with many African countries, the tendency for comparative advantage in trade to lead to heavy concentration in exports on just a few commodities is a familiar one to Tanzania – think of gold now, cashew even more so in times gone by, pyrethrum at a certain moment – and memorably, the vision of some of a vast groundnut industry many decades ago.

applied with respect to the UK for the first time in anticipation of ERM membership and the end of the sterling link, the borrowing needs of Government began to exceed domestic financing capacity (as reflected also in the swelling current account balance of payments deficit Figure 1). With the domestic market being perceived as almost tapped out – with Irish pound denominated debt having reached 60 per cent of GNP in 1979 – incremental debt in the early 1980s was increasingly borrowed from abroad to the point where foreign currency debt rapidly approached 50 per cent of GNP (Figure 2). Holdings by non-residents of Irish pound-denominated government paper also grew after the devaluation of 1986, reaching 16 per cent of GNP by the end of the decade. By this stage, international market conditions and the attitude of international investors to the Irish sovereign as well as to the prospects for the Irish pound were central influences on interest rates and borrowing conditions.

Figure 1: *Ireland: Current Account Balance and Fiscal Balance as a percentage of GDP.*

Source: Department of Finance Budget Statistics, various years and Central Statistics Office.



Soaring Irish pound interest rates in the early 1980s reflected each of these uncertainties. Irish pound interbank interest rates (three-months maturity) returned on average 2½ percentage points over corresponding German rates in the last ten years of the narrow bank ERM before the ERM crisis. Credit risk at such maturities was arguably very low in those years, so that most if not all could be accounted for by devaluation risk. For yields at longer-term the gap was even higher – a regression approach suggests a spread of about 6–7% in the mid-1980s (Figure 3): but the influence of credit risk over the longer term would not be negligible. Interestingly, in those days interest rate spreads reflected devaluation risks more than credit risks.[2]

[2] Unfortunately, the data that exists – which is not fully comprehensive or exactly comparable as between country issuers – does not yield very tight estimates of default risk insofar as, for example, the spreads on DM and Swiss franc-denominated debt for comparable maturities are rather different. Still, with yield spreads at issue over Swiss franc long-term bonds varying from about 2¼ per cent in 1983 to about 1¼ per cent by 1986, and lower spreads relative to German bonds, the data shown in Figure 3 suggest that the bulk of the raw spread perhaps as much as 5–6% relative to German bonds – should be thought of as a credit/default spread, the remainder being devaluation risk.

The figure shows two sets of data, shown with triangles and squares respectively. The triangles can be thought of as measuring credit risk; it is the spread of primary market yield on Irish Government DEM and CHF foreign currency denominated bonds over similar-maturity Sovereign bonds of Germany and Switzerland respectively (but terms and conditions of the debt of different issuers may not be fully comparable – possibly explaining the negative data points). The squares can be thought of as combining credit and currency risk; it is the secondary market spread on Irish pound Sovereign debt over German and Swiss Sovereign issues of similar maturity. The regression lines link these spreads to currency dummies, liquidity (size of issue) and date (linear time trend). (Source: Peter Dunne, unpublished note).

Figure 2: *Ireland: National Debt: Foreign and Domestic 1970-2010*

Source: NTMA website and Central Bank Bulletins. Note that the first five data points refer to March, the remainder to end-year. National debt does not correspond to General Government debt.

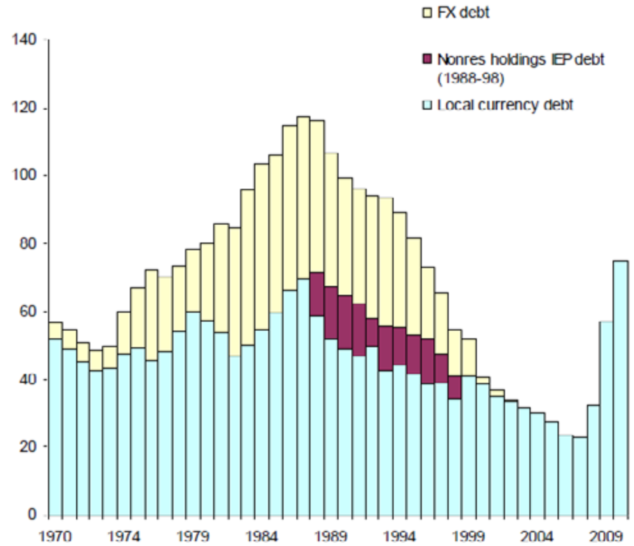
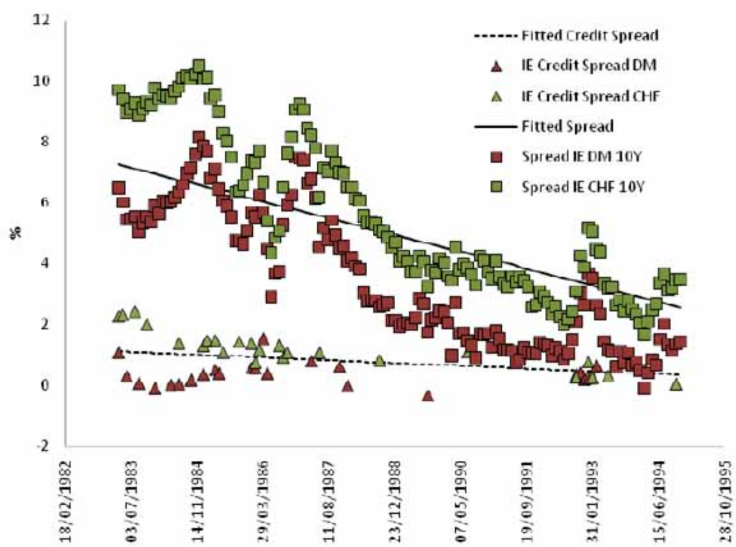


Figure 3: *Ireland yield spreads 1982-95*



Nevertheless, that the country was “living beyond its means” was universally acknowledged. With the surge in global interest rates following the Volcker anti-inflation policy initiatives of 1979–80, and the subsequent surge in the spread of Irish interest rates above those abroad, the interest cost of servicing the growing debt provided useful dramatizations of the problem (cf. Figure 4 showing the share of income tax revenue going simply to pay the national debt interest.) Turbocharger Mark 1 had reached its limit and the tough process of fiscal and competitiveness adjustment had to be ground out.

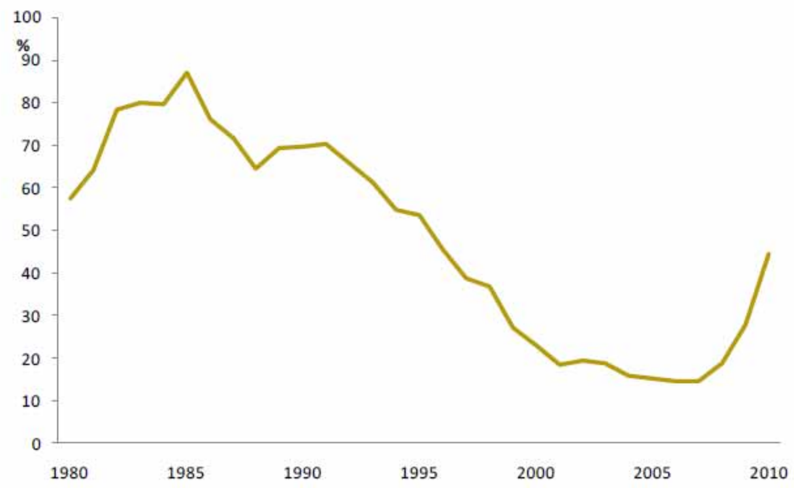


Figure 4: *National Debt Interest Payments as a % of Income Tax Revenue*

Source: Department of Finance Budget Statistics, various years

Ireland would have done well to resist the temptations of offered foreign loans on the scale offered, and adhered to conventional rules of thumb for sustainable fiscal policy. By establish a pattern of spending that required external financing on a scale that would inevitably become unsustainable, macro policy generated almost a decade of high unemployment, emigration and rising tax rates.

Descriptions of the Irish fiscal correction often give credit to the adoption of the Maastricht treaty’s deficit and debt criteria for entry into the euro. But this is wrong. Those criteria were designed and developed too late to have been decisive in this regard. As shown in Figures 1 and 5, the fiscal indicators had come back onto a clearly convergent path long before these externally-imposed constraints had been adopted in 1992. Even if they may, however, have continued to provide a new quantitative reference point for fiscal discipline, they were so far exceeded in the subsequent run-up to euro entry as to make this point of negligible significance.

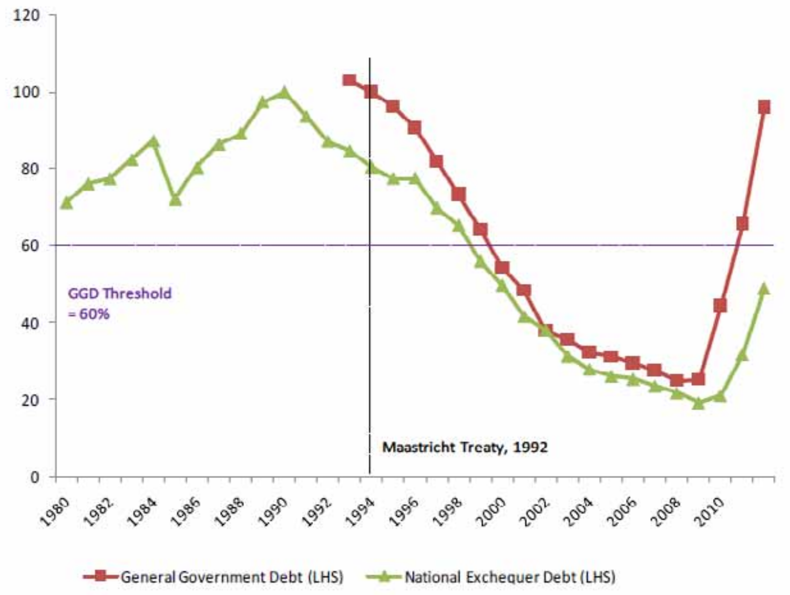


Figure 5: *Ireland: Government Debt as % GDP*

(Data on General Government Debt, used to evaluate performance relative to the Maastricht 60% criterion, are not available prior to 1991 so Exchequer figures are also shown).[4]

Source: Department of Finance: Budget Statistics, various years and Maastricht Returns, March 2011.

[4] General Government measures include local authorities, non-commercial state sponsored bodies, the National Pensions Reserve Fund (NPRF) and the Social Insurance Fund, whereas the Exchequer Balance only includes Central Government transactions. The General Government measure also includes elements of accrual accounting while the Exchequer Balance is a cash-based measure.

2. The Irish economy's golden age: meeting global demand in the 1990s

The near miraculous turnaround of the Irish fiscal and growth environment in the late 1980s has been the subject of a considerable amount of research.[3] From the present perspective, what is clear is that it depended heavily on Ireland's globalized status. Without the potential and actual surge in exports and export-oriented investment, the turbocharged surge of trend-following foreign investment in Irish government paper driving down long-term interest rates and the easy availability of labour not only from the pool of the unemployed but from the pool of returnees and other potential migrants from abroad, the Irish economy could not have moved into the Celtic Tiger phase with barely a hesitation related to the 1992–3 ERM currency crisis.

In retrospect the mid 1990s can be seen as a macroeconomic "Golden Age" for Ireland (Honohan and Walsh, 2002). Yet it must not be thought of as an era to which the economy could even expect to return, or even to have sustained. This was Turbocharging 2.0. The rapid growth rates represented a catch-up as the economy finally approached the production frontier by achieving essentially full employment (and with the traditional farming sector no

[3] Among others being the battleground of debates about the possibility of an expansionary fiscal contraction (see Barry and Devereux (1995), Bradley and Whelan (1997), Giavazzi and Pagano (1990), Honohan (1992) and McAleese (1990).

longer quantitatively significant). The important continuing role played by inward FDI in this period confirms the ability of the globalization links of the economy to generate a powerful turbocharging effect. Indeed, the FDI boom helped suck in migrants from non-traditional sources for the first time, with the share of non-nationals in the total population eventually reaching a relatively high 13.8% by 2007 – from a position where Ireland had had one of the mo re ethnically homogeneous societies in Europe (Figure 6).

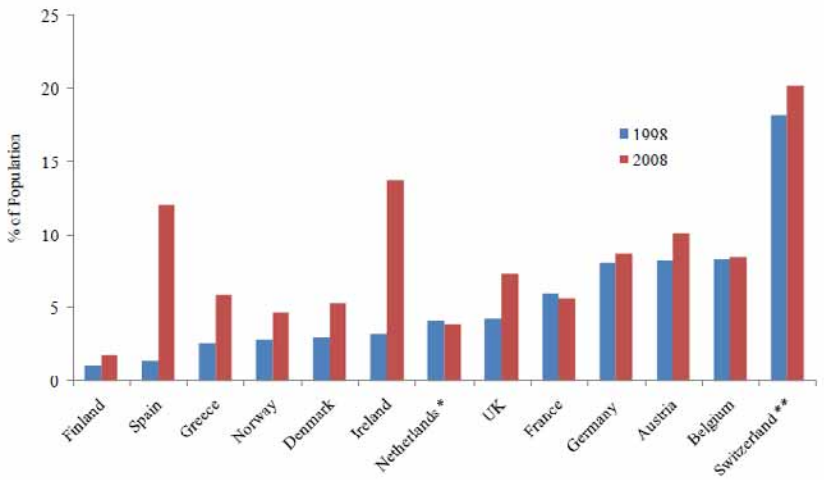


Figure 6: *Foreign Nationals as a Percentage of Total Adult Population.*

Source: CSO and Eurostat

Note: * Earlier figures for the Netherlands are for 1999.

** Later Figures for Switzerland are for 2007.

The heavy reliance in this period on inward FDI provides some evidence of the monocultural tendencies of the globalized economy. The sectors contributing by far the largest part of the growing exports and manufacturing output were highly concentrated in a small number of SITC codes corresponding to subsectors of pharmaceuticals and IT assembly and others well positioned to take advantage of the special tax environment. This concentration had the potential to create concentration risks, though these do not seem to have materialized to date.[4]

Such was the success of the Irish economy in this period of the 1990s that the former currency weakness which had characterized the Irish pound in its first 14 years of independence vanished. Instead, despite the +/–15% margins adopted against other ERM countries and despite the absence of any explicit or implicit indication of a policy stance, the Irish pound displayed a degree of nominal and real average exchange rate stability during the 1993–99 period, with a small *appreciation* against the DM in preparation for euro membership in 1998. In contrast to the later period, and to many other country experiences of rapid growth, currency fluctuations for the Irish pound did not generate a loss of competitiveness in this period.

[4] The Dublin International Financial Services Centre represented another subsector which, thanks to energetic promotion and the considerable profits tax sensitivity of relevant parts of the internationally traded financial services centre, began to make a noteworthy contribution to tax revenue and employment (Honohan, 2006). European union and euro area membership of course considerably turbocharged this sector, of course, giving it a growth potential that would simply not have been otherwise available.

By the late 1990s, though, the economy began to slip out of balance, in a way which was largely home-grown, though some foreign shock factors did continue. Fiscal policy became rather more procyclical; the dependence on volatile or insecure taxes increased, as centralized wage settlements continued to be bought by income tax concessions. The external shock of euro membership lowered nominal and real interest rates by removing the exchange risk premium which had persisted since the early 1980s – albeit on a reduced scale. The sense that lower interest rates could be projected for the indefinite future rationalized a willingness to pay more for one's home. The seeds of the property bubble had been sown.

3. The economy over-inflated by foreign credit 2000–2007

As Ireland joined the monetary union in 1999, its status among the most globalized economies in the world was confirmed. In the following years, its finances would be submerged in those of the euro area – with international flows often not even being separately measured and assessed as attention focussed on the euro area as a whole. The idea that much of macro policy had been largely outsourced to the European Central Bank took hold in policy circles. A sizable fragmentation of policy thereby occurred: domestic policymakers no longer took full ownership of macro issues. Finance Minister McCreevy's stated views about fiscal policy ("when I have it I spend it") disavowed any stabilization role for fiscal policy.[5]

Interest rates were now fully imported from the rest of the euro area (as had been the case with sterling before 1979). After years of relatively high nominal and real interest rates, the new regime lowered the cost and enhanced the availability of credit to Irish borrowers. Not surprisingly, the change resulted in an expansion of the most credit-dependent sector, house-building and property development.

The story of the property price and construction boom that ensued (it began around 1997 in anticipation of the monetary changes) has been often told (cf. for example Honohan, 2009; Whelan, 2011). Here it is most relevant to emphasize the globalization dimension. Not only did Ireland import a huge volume of funds through the banking system, but it also imported a newly relaxed approach to the prudential supervision of mortgage lending. The scale to which the Irish credit bubble eventually grew was also certainly facilitated by the absence of exchange rate risk. Together with another key element of globalization: the absence of any fear of exchange controls, this ensured the fuel for a turbocharged monocultural expansion of the Irish economy (call it *Turbocharger 3.0*) at a time when its previous, somewhat more broadly-based and certainly more sustainable, export driven growth was naturally slowing.

The result was a world-beating construction and property price bubble – barely interrupted by the global downturn of 2001–2 (see Figure 7). Economic growth became dominated by the new monoculture of construction, growing as it did to employ directly in construction over 13 per cent of those at work.

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[5] However, the 1999 establishment of the National Pension Reserve Fund as a way of institutionalizing the need for countercyclical fiscal restraint shows implied that fiscal policy had not become entirely rudderless.

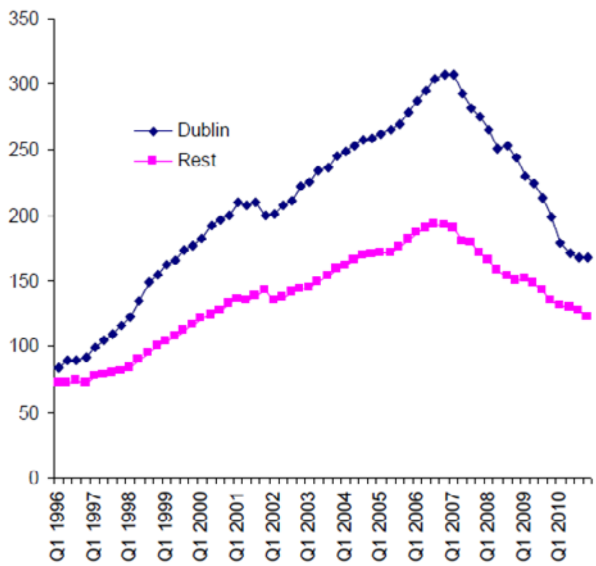

Figure 7 *Ireland: Real House Prices, 1996-2010*

(Source: ESRI-TSB index deflated by Consumer Price Index)

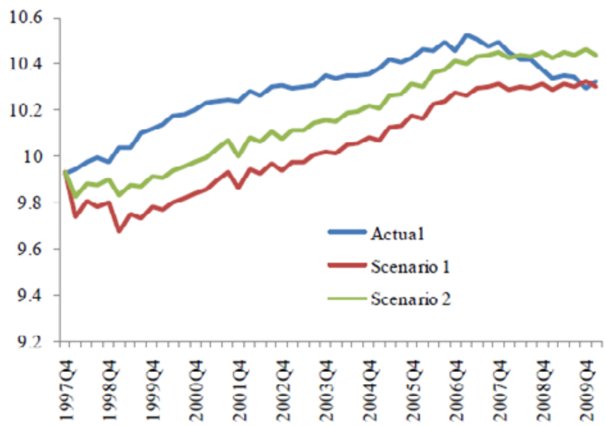

Figure 8: *Ireland: Actual and Scenario Real GDP Levels (in logarithms): 1997–2010*

Source: Based on the model in Kelly, McQuinn and Stuart (2011).[8]

[8] Kelly, McQuinn and Stuart (2011) present a simple model estimating the link between private sector credit and GDP, which can be used to assess how the economy might have grown had credit growth had been constrained to be more in line with bank deposit level growth over this period. Using this model two counterfactual scenarios for credit can be imagined

(i) Credit constrained to the level of deposits (Scenario 1) and

(ii) Credit running at 20 per cent above deposits (Scenario 2).

Thus, in the case of the first scenario, lending in the domestic Irish banking system would have been funded entirely through domestic deposit levels; banks would not have had recourse to wholesale funding. (It is worth bearing in mind that the recent EU-IMF program sets out specific targets for the loan-to-deposit ratio of each of the banks.) The actual track of GDP and the computed data under the two counterfactual scenarios are plotted in Figure 8. Because the hypothetical starting point involves a contraction of credit, both hypothetical scenarios begin with a severe recession induced by a credit crunch, nevertheless, by 2010, actual GDP has slumped to no better than the weaker of the two scenarios. More plausible models can no doubt be contructed; they would doubtless all display the pattern where a higher actual output path in the 2000s is followed by underperformance thereafter.

Although Ireland could expect to import medium term inflation rates in line with the rest of the euro area, the external weakness of the euro in its early years, combined with the booming national economy meant that inflation in Ireland soared to an annual rate as high as 7 per cent briefly. Once again, the outsourcing of anti-inflation policy meant that such an outturn did not result in an aggressive domestic policy response, and in 2004 the EU Commission launched an excessive deficit procedure against Ireland, reflecting the fact that budgetary policy had even relaxed in the face of booming domestic demand conditions.

The current account of the balance of payments remained surprisingly moderate during the boom. This reflected in part the continued strong export performance of the remainder of the economy, and the fact that a large segment of the funds borrowed from abroad by the banks was ploughed back into foreign property investment by the banks' borrowers, large and small.

Without the construction boom fuelled by credit sourced from abroad by the banks, the economy would doubtless have grown more slowly in the 2000s. But the underperformance after 2007 more than offsets the gains of the property bubble-driven growth. The 2008–9 recession would have been less severe, and the recovery from 2010 would not have been weighed down by the overhang of indebtedness.

The post-Lehmans global contraction certainly provided a dramatic illustration of exposure to external shocks. By that time, however, the globalization turbocharger was already working in reverse as Anglo and other banks struggled to refinance their foreign borrowings. Indeed, a partial decoupling of the globalized economy was under way as money markets began to fragment and the limitations of the monetary integration in Europe became evident.

4. Concluding remarks

Ireland's increasing globalization in the 1980s and 1990s both helped lift the economy from decades of under-performance and demonstrated its new ability to generate full employment and compete effectively at the production frontier. One aspect of this was the intimate engagement with the European Union since membership in 1973 had helped enrich administrative and political capacity as well as resulting in a vital flow of development funding through the structural funds especially from the late-1980s to the end of the millennium. By then the wider forces of globalization had begun to act as a kind of turbo-charger for the economy, amplifying the competitive, export-led growth period and the subsequent residential construction and property price boom. This helped achieve rapid living standards convergence through the attainment of full employment, but also fuelled an overshoot which could not be managed down given the debt vulnerabilities which had accumulated and which proved unsustainable through the global crisis.

International convergence of economic and regulatory policies towards liberalization and light-touch, unfortunately embraced also by Ireland (Honohan et al., 2011), and ridiculously easy availability of credit from abroad (eventually helped by the removal of exchange rate risk across the euro area) were key factors in the international environment that masked the vulnerabilities associated with the emergence of evident imbalances in the trend towards a construction monoculture: extreme house price inflation, a skewed revenue base for the Government accounts and a seemingly inexorable erosion of wage competitiveness.

A score-card on the role of globalization in the latest downturn shows a more mixed picture. Despite the fact that international trade was badly hit worldwide in the macro-shock of late 2008, Irish exports held up well and provided a stabilizing force in the evolution of aggregate demand both in that downturn and in the subsequent couple of years. The severe contraction in the numbers at work was somewhat mitigated by the continued availability of jobs abroad, both for recent immigrants who wished to return to their place of origin and others who sadly resumed the historical pattern of seeking employment opportunities abroad when few were available at home.

The eurosystem has also picked up the pieces on the downside: stepping-in to fund the liquidity deficit as the excessive bank borrowings from the global financial system drained out when markets lost confidence in the Irish Government's capacity to both bring its regular deficit under control and pay for the mounting losses of the banking system.

Globalization is a powerful transmitter of economic conditions and know-how, facilitating convergence of living standards. It can also act as a buffer against specific national shocks. But, amplified by globalization, the danger of the anonymous market overshooting is considerable. National governments can be powerless against consequences of such overshooting. Greater explicit mechanisms of external discipline and co-insurance at the supranational level can help cope with these risks. For Ireland, the European Union already goes some distance in this direction, but more is needed. Regional initiatives in Africa, including the NEPAD of the African Union and the East African Community are presumably best positioned to perform this function in relation to Tanzania.

Like Ireland, Tanzania too has the potential to reap the macroeconomic advantages of globalization to speed convergence towards better living standards and poverty reduction. But policymakers will want to be on their guard against the risks of being turbocharged into unsustainable spending patterns.