ANNUAL ST PATRICK'S DAY BUSINESS LUNCH

IRELAND & GREECE - FROM SHOCK TO RECOVERY

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GUEST SPEAKER

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THE IRISH AND GREEK CRISES

Introduction

I shall speak at first of Irish economic experience, from which you will readily observe that there are great differences between the ways in which our two countries got themselves into what have turned out to be equally severe economic difficulties. Then I shall turn to the Greek situation with a view to seeing to what extent we both need to adopt rather similar measures to enable us to get out of the rather different kinds of holes that we have dug for ourselves. But first of all I need to spend a couple of minutes to explain the Irish historical background.

Irish Historical Background

Like Greece, Ireland had to escape from the domination of a neighbouring power: in your case the Ottoman Empire: in Ireland's case the British Empire. Of course you won your independence almost a century before Ireland did.

After many centuries of conflict, the colonisation of Ireland by Britain was completed in the 17th century, after which an Anglican minority from Britain, constituting 15% of the Irish population, applied Penal Laws against the native Roman Catholic population so as to secure the transfer of land to Anglican ownership. By 1775 95% of the land was in the hands of that small minority, and almost all of the impoverished native population had become tenants at will of Anglican landlords.

Until 1782 the only schools permitted by law were Anglican schools, and the native population, which remained Roman Catholic, had to teach their children out of doors, in what were therefore called “hedge schools”. In the early nineteenth century these multiplied in number and found accommodation mainly in what a British parliamentary survey described as “miserable hovels”, cowsheds etc.

The colonists’ Parliament was abolished in 1801 - Ireland being then incorporated in the UK.

In 1845-1847 there was a major Famine: Over 1 mn. out of 8.5 mn died and or immediately after the Famine. in or immediately after the Famine. 1 mn. emigrated, mainly to the Unite4 States. For 120 years thereafter, there was continued massive emigration, which reduced the population of the island by one half, to 4.25 million people by the 1960’s. Moreover much poorer Ireland was required to subsidise Britain until the end of the 19th century.

Agitation for autonomy within the UK was resisted by Britain, which, after an abortive Rising in 1916, eventually led to a guerrilla War of Independence between 1919 and 1921. This was followed by a civil war, as partisans of a Republic rejected Irish independence as a Dominion within the British Commonwealth.

At the time of the foundation of the state in 1922, the north-east of the island, where descendants of the mainly Calvinist colonists of that area enjoyed a local majority, opted out of the new Irish state, in order to remain in the UK.

The Government of this area discriminated in employment, housing, and in the local electoral system against the Roman Catholic minority, Failure to reform that area led in the 1960’s to civil unrest, and eventually to violence.

Meanwhile until 1973, when Ireland and Britain both joined the EU, the new Irish state, despite its political independence, remained economically dependent on Great Britain, which continued to operate a neo-colonialist cheap food policy that left the Irish state - at that stage still predominantly agricultural - severely disadvantaged.

1973 - EU Membership:

All that changed totally when Ireland and Britain joined the EC in 1973, opening new Continental markets to Irish farmers, and forcing Britain for the first time to pay remunerative prices for Irish food which greatly boosted Irish GNP.

Furthermore Ireland, by far the poorest country in Northern Europe, benefited both from EC Structural funds and also from a Common Agricultural Policy that had been designed to benefit mainly Northern European farmers. The Irish public service, efficient and free from corruption, proved highly skilful at maximising benefits from both forms of EC transfers, and when the Greek public service sometimes failed to present viable projects for EU Structural Fund support, the funds in question were transferred to Ireland with its more efficient public service.

But, more important in the long run then either of these aspects of EU membership was the removal of continental EU barriers to goods manufactured in Ireland. In the 1990's the greatly expanded Irish educational system, (the high standards of which were maintained despite the rapidity of its growth), together with low Irish taxation of companies, started to attract to Ireland a high proportion of new high tech US investment in Europe. By the late 1990's as much as 25% of all such US investment in western Europe was coming to Ireland - with only 1% the EU population. This created the "Celtic Tiger" effect, achieving an annual 8.5% growth of GNP between 1993 and the year 2000.

(Some 15% of Irish GDP is now remitted abroad by mainly US multi-nationals - so only 85% is available as GNP for domestic purposes, so for most purposes GNP is a more relevant measure of Irish output than GDP).

First Economic Crisis - The 1980's

However the Irish political system remained clientelist and localist, and economically unsophisticated. In the past thirty years this has to two major economic crises - one in the late 1970's and the other in the current decade.

The Government in whìch I had been Minister for Foreign Affairs was defeated in 1977, and, following the resignation of Prime Minister Liam Cosgrave as Leader of the Fine Gael Party I was unanimously elected Leader of the Party, and thus of the Opposition in Parliament.

Unhappily the incoming government in 1977 decided to pursue a high spending policy: I am afraid that, like many Greek politicians they did not understand not understand that Keyensian policies cannot work in a small and very open economy. Between 1977 and 1981 current public spending was boosted by almost 25 per cent a year - increasing it within four years two and one-third times, from €2.4 bn to €5.6 bn. In the single year 1979 the public pay bill was increased by 34 per cent and by 1981 current spending was raised to 40-41% of GNP.

In mid-1981, after the defeat of that high spending Government in a General Election, the minority Coalition Government that I then formed with the Labour Party faced a horrifying financial situation. Before I could even announce my Cabinet in Parliament I was told that the current deficit looked like exceeding 20 per cent of GDP in the following year.

After three general elections within eighteen months, in coalition with the smaller labour party, I secured a term of office which lasted four and a quarter years.

In the years that followed our Government reduced inflation from over 20 per cent to 3 per cent; eliminated a 15 per cent external payments deficit - and cut capital spending - much of which was unproductive. We managed to hold current spending at the level to which it had been raised by our predecessors in office, but did not succeed in reducing it.

In 1987 the Labour Party's inability to agree to long overdue cuts in current spending, resigned from the Government, precipitating an election. Freed from the constraints of Coalition, my party then presented a tough Budget to the electorate - one that would have greatly reduced the current deficit - but a new Right-wing party took almost one-third of my party's votes, opening the way for our main opponents to return to power.

However, by fighting a deliberately long election campaign on the issue of budgetary policy, we forced our opponents to face the need for tough budgetary measures, about which they had previously been in denial. Within two years they balanced the budget but Ireland has lost eight years of possible economic growth.

The Celtic Tiger

Between 1993 and 2000 prudent budgetary policies undertaken by three successive Governments of quite different compositions held the rate of growth of current spending to 8% a year at a time when GNP was rising by an annual 14%. As a result, the share of current spending in GNP dropped from 36% to 27.5%.

However, after the year 2000 the rate of growth of GNP fell back to under 9% whereas public spending rose by 11.5% a year, thus raising the ratio of current spending to GNP by five percentage points, from 27.5% to 32.5%.

In the three years 1999 to 2002 current public spending actually rose by 15% per annum. Between 1996 and 2003 Irish inflation rose by 4.5% per annum as against less than 2% a year in the rest of the Eurozone. (In those years inflation in Greece was being reduced from 7.5% to 3%) In the years 1997 to 2000 the large differential between Irish and Eurozone inflation rates reflected the fact that rapid economic growth was in the process of creating full employment in Ireland. By the year 2001 unemployment had been reduced to 3.6%.

Thus, after the year 2000 a combination of full employment, with exceptional increases in public spending, boosted the Irish inflation rate to 5% - substantially higher than in Greece - at a time when the Euro zone inflation rate was only marginally above 2%.

Loss of Competitiveness

With Irish inflation rising well over twice as fast as in the rst of the Euro zone, Irish cost competitiveness was severely hit, with pay increases rising two and a half times more rapidly than in the Euro zone.

A consequence of this was a major loss of ground by Irish exports of goods - which had hugely increased during the 1990s. Since the year 2000 Ireland’s share of exports to developed countries has fallen by 20% - although during the recent crisis years since 2007 continual growth of pharmaceutical and chemical exports has temporarily and partially offset a fall in other exports.

However, this poor export performance was partially offset be a rapid increase of Irish exports of **services**, and an equally rapid growth of credit from abroad, the latter of which had the effect of artificially sustaining economic growth in the years up to

2007. As a result GNP rose by over 45% between 2000 and 2007, at a rate of 5.5% per annum, but in the three years 2007 - 2010 it will have fallen back by almost 15%. Thus the average growth rate for the whole period from 2000 to 2010 will have been less than 2.5% - a measure of the real change in the Irish economy since the end of the Celtic Tiger period of the 1990s.

The Construction Bubble:

Meanwhile, in the years from 2003 onwards a major building boom was being generated and by 2007 Ireland was building six times as many houses per thousand of the population as Britain and four or five times as many as in the main European continental countries. The bursting of this extraordinary housing bubble in and after 2007 has be the major factor in the sharp decline in GNP after 2007.

Furthermore, during the years up to 2007 competition between domestic and foreign banks, each seeking to maintain or increase their share of lending to developers and builders, undermined the banking system which is currently being rescued by the Irish State at huge cost. On September 29th 2008 a threatened collapse of the Irish banking system forced the Government overnight to guarantee all bank deposits for two years ahead.

The Irish State has now had to create a 'bad bank', NAMA, to take over almost €80 billion of bank borrowing at a discount that now looks like being well over 30% - with the hope of recovering this money over a period of possibly a decade.

Coming on top of the inflation generated in the years to 2003 by the combination of exceptional increase in public spending and the emergence of full employment in the year 2000, this banking crisis created by the building bubble has left the Irish economy in extremely bad shape.

Faced with this situation, the Government last year initiated a process of fiscal adjustment designed to stabilise the Budget deficit at 12% of GDP this year and to bring this figure down to 3% by the year 2014 - the scale of the required cuts having led the EU Commission last October to extend the initial 2013 deadline by an extra year.

Revenue Shortfall

This fiscal crisis has been due primarily due to the collapse of State revenue rather than excessive increases in public spending. Thus whilst the outcome of the 2009 budget has shown only a marginal increase in expenditure for that year as forecast two year earlier, in late 2006, there has been a €21 billon shortfall in revenue in 2009 by comparison with the Government's late 2006 forecast!

Accordingly in its April 2009 emergency Budget the Government proposed that half of the fiscal adjustment in the year 2010 would take the form of increases in taxation. However, this decision was reconsidered some months later when it was decided that virtually all of the 2010 fiscal adjustment would be achieved by €4 billion cuts in public spending - postponing any tax increases until 2011.

These spending cuts have included a 15% reduction in Public Service pay which has aroused intense opposition from the Trade Union Movement. The trade unions have mounted a campaign against the Government's decisions, which has included measures to disrupt the operation of the public service.

The negative reaction of the trade unions was aggravated in December last year by a confused negotiation which led the Unions to believe that a 'soft option' would be available to them. This possibility however was closed off by a back-bench revolt in the Government Party leading to tougher measures being taken.

As the trade unions had by then convinced themselves that their soft option would be accepted, this policy reversal greatly increased the anger of trade union leaders and their members vis-à-vis the Governments measures.

The resultant crisis in the public service has yet to be resolved, with the Unions still demanding a retraction of pay cuts effected in this year's Budget - which the Government are unable to agree because these pay cuts are an integral part of the €4 billion fiscal adjustment that won the support of the European Commission and the European Central Bank, and that partially restored the credit-worthiness of the Irish State.

The Government's popularity has been greatly reduced by these developments. The governing Fianna Fail Party which in the 2007 Election secured 42% of the national vote, currently enjoys support of only 27% in recent public opinion polls. By contrast support for the leading Opposition Party has jumped from 27% to 34%, and the second Opposition Party has also almost doubled its support of 10% in the 2007 Election. As a result there is a general expectation that in the next General Election not due until mid 2012 but capable of being precipitated earlier than that - the present Government would be replaced by a Coalition of the two Opposition Parties.

The huge fall in support for the principal Government Party, Fianna Fail, has transformed the Irish political scene because since 1932 that party has dominated Irish politics and has been in office for almost 80% of the intervening eighty years.

Despite the trade union opposition to the public service pay cuts, and despite the very large drop in support for the leading Government Party, the €4 bn. cuts to be achieved this year has considerable public support. This scale of fiscal adjustment was supported by the two main Opposition Parties - support which, although these parties disagreed with its specific composition, was important in securing general public support for - or any rate tolerance of -– this austerity programme.

The unresolved conflict between the trade unions and the Government has recently been a major source of uncertainty in the Irish economic situation today but last Friday agreement was reached on the resumption of negotiations - without the Government conceding a restoration of public pay cuts, for which, however, the trade unions continue to press.

Ireland And Greece

It will be seen from this account of the origins of the Irish crisis that my country's problems have come from wide oscillations in policy over the years, whereas the Greek crisis arises from consistent over-spending over many years combined with a failure to collect tax revenue appropriate to the size of the real Greek economy, including the grey economy, which, I have been told, may account for as much as 30% of the total.

Ireland has also had a grey economy, but on a very much smaller scale, and since the mid-1990s more effective tax gathering has greatly reduced its size, bringing in something like €4 billion in unpaid taxes and penalties - a possible indication of what might be collected in the case of Greece, with its much larger grey economy.

I note that the Greek government's expectations of gains from clamping down on tax evasion are very modest, at only €1.2 billion in the current year, but presumably much more can be expected in 2011 and immediately subsequent years.

It is, moreover, significant that in the Irish case the government's decision to make expenditure cuts of €4 billion in the current year has had a very positive impact on the interest it is having to pay on the very large borrowings currently required to bridge the remaining fiscal gap.

The day before yesterday the Irish government was able to announce the issue of a ten-year bond with a spread over a comparable German bond rate of 1.26% - as against the spread of about 3% on comparable bond issued on behalf of the Irish state just twelve months ago.

This, I believe, is a useful indication of what Greece can hope to achieve if it can convince the markets that the measures now proposed by the Greek government will be effective as the Irish government's measures are now seen to have been, for this Irish bond rate premium is now one third of the rate currently being paid by Greece. Moreover, the bids for this new Irish bond were 3.3 times higher than the amount on offer –a substantially higher ratio than one month ago.

If the markets can be convinced of the effectiveness of the measures now being taken by the Greek government, the need for a European back-up to reduce interest rates on Greek borrowing rates would be reduced or perhaps eliminated.

This would be important for despite discussions on Monday at the Eurogroup and at Ecofin on Tuesday the German finance ministry does not feel that next week's European Council will necessarily make a decision on a support mechanism for Greece. Germany has, of course, potential constitutional difficulties on this matter, which do not seem to be understood by Greek public opinion.

These difficulties arise from the terms on which the German Constitutional Court approved the Maastricht Treaty two decades ago, which excluded "bail-outs". The German Government cannot reasonably be expected to risk a constitutional challenge on this issue.

Certainly the scale of measures proposed by the Greek government and the time scale for reducing the Greek borrowing rate to 3% of GDP are both very severe. In my view the important thing is that the markets become convinced within the next three to four months that the measures being taken by the Greek government are having an immediate impact on its fiscal situation. If this happens, European political pressures could ease dramatically. On the other hand, if there were to be any sign by the summer that these measures were not being effectively implemented, this could have a very negative impact on Greece's situation.

In all this one cannot underestimate the importance of the fact that the Greek government has the support in principle for its actions of the main Opposition party - as also happened in the Irish case.

Finally I cannot sufficiently stress the importance of securing the independence from political pressures of the Greek state's Statistical Office - an advantage that we in Ireland have always enjoyed, and which in government in the late 1980's I took steps to reinforce.

Finally the economic and financial problems that have arisen in Ireland and Greece, (which have been accompanied by similar, but, thus far, less dramatic difficulties in Portugal, Spain and Italy), have raised serious questions about the Stability and Growth Pact agreed in the 1990s as a basis for the creation of the common currency, the Euro.

When the Euro zone was established it was assumed that the provisions of the Stability and Growth Pact would be sufficient to ensure that all members of this monetary area would pursue policies designed to ensure its success. The fact that in Southern Europe and in Ireland this expectation has not been fulfilled, combined with the discovery that the Euro can be vulnerable to policy errors in quite small States containing as little as 1% or 2% of the population of the area, has raised serious questions as to how a repetition of the current crisis can be avoided in the future.

Much more stringent EU monitoring and indeed control, of the national budgetary polices of Euro zone member states will clearly be required in the future. Is Europe ready for this?