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Talk at McGill Summer School Session: With Huge Debt And Resulting Austerity, Is Serious Economic Growth Possible?

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When Joe asked me to speak at a session titled "With Huge Debt and Resulting Austerity, Is Serious Economic Growth Possible?" I worried about whether this invitation was what soccer fans would call a bit of a "hospital pass". I wasn't sure I could figure out what the answer to the question was. And if I could figure it out, I might have to risk making everyone very depressed.

Anyway, I'll give it a go and I'll try not to be too depressing. Following orders, I'll first talk about debt and its relationship to austerity and then focus on the outlook for growth.

Ireland's Debt Problems

The first part of the title of this session "With Huge Debt and Resulting Austerity …" implicitly expresses a view that is common today: That the debts incurred in recent years (in particular bailing out the banks) are the root cause of austerity in Ireland. The truth is more complex.

At one level, there is a clear link between debt and austerity: If a country had no public debt at all, then it would likely be able to run large deficits for quite some time. But even if Ireland had incurred no banking debts, we would still have a public debt ratio approaching 80 percent today. This is partly because we started the recession with some public debt outstanding but it's mainly because public spending has been running well ahead of taxation for years now.

Even a country with an 80 percent debt ratio could not expect sovereign bond investors (or the EU or the IMF) to loan it the money to continue running deficits of almost ten percent of GDP on an ongoing basis.

So, maddening as the burden of banking debt may be, directly linking this issue to the current austerity ignores a crucial issue: Bank debt or no bank debt, Ireland simply can't continue to run large budget deficits. "I'm not paying my property tax so the money can be used to pay off bankers' gambling debts" has become a common refrain and the sentiment is understandable but, at this point, there is a strong onus on the Irish government to emphasise that people will be paying property taxes to fund public services and welfare benefits.

The flip side of this argument is that people need to be careful not to expect too much from any potential future deal with Europe to reduce the bank-related debt. Even if such a deal is struck, it would not change the need to continue raising taxes and cutting spending over the next few years.

Looking beyond Ireland's well known problems with public debt, there is also a significant problem with private debt. Individuals and businesses up and down the country are still on the hook for loans they took out during the boom that they are now having difficulty coping with. It will likely take years before this private debt burden returns to more normal levels via increased saving and the necessary resolution of unsustainable debts via defaults and restructuring.

Ireland's banks are also down-sizing so people who had previously were able to purchase homes or furniture or cars or whatever on credit, are now having to save to make these purchases on their own or to come up with larger downpayments. Taken together, the problems of private debt and tight credit are probably weighing as heavily on the Irish economy as the fiscal austerity.

The Belt-Tightening Analogy

The picture I'm painting of an economy with both public and private sector struggling to live within their means is no doubt familiar to people in Ireland. However, this picture can be repeated to varying degrees across Europe's periphery as private debt problems in countries like Spain and Portugal exist alongside the problems with their public finances.

To the citizens of Germany and other core members of the Eurozone, the solution to these problems is very simple. If the government is living beyond its means, then it must tighten its belt and spend less than it is taking in as tax. Similarly, a private household with debt problems needs to follow the example of the well-known Swabian housewife and learn how to balance its books.

This seemingly simple prescription turns out to be less simple when you examine it from a macroeconomic perspective. In the world economy as a whole, spending equals income. So if governments around the world are building up debt by running deficits, that means the private sector is building up assets by purchasing government bonds. The moralising attitude towards debt thus neglects that one man's debts are another man's assets.

Within an individual country, it is possible to have spending be lower than income. This occurs when a country imports less than it exports, meaning it has a trade surplus. The problem for the global economy right now is that there are too many countries in which both the private sector and the public sector are attempting to cut back. It isn't going to be possible for all these countries to run trade surpluses unless we quickly develop trade links with Mars. And in the meantime, the global economy is suffering from a rash of cuts to public and private spending, which in turn cut income, leaving us chasing our tail.

Against this background, the growth prospects for Europe's periphery aren't too good. Spain, Portugal and Greece are all running sizable current account deficits. The EU recommendation to these countries is that they introduce "reforms" to become more competitive. Translated, this means large wage cuts that would boost export growth. As inspiration, German politicians regularly point their own successful labour market reforms under Gerhard Schroeder, when their economy was transformed from the so-called "sick man of Europe" to an exporting powerhouse running huge current account surpluses.

My own view is that Germany's leaders have perhaps read a bit too much into this particular exercise. Their reforms were undertaken during a period of strong economic growth for their trading partners which facilitated export growth. This is not the case for struggling peripheral economies today. In addition, Germany's improved competitiveness occurred due to a long period of low levels of wage growth. Most of today's peripheral economies need much sharper wage reductions to restore competiveness and there are huge social barriers to these kinds of wage cuts, including in Germany.

An alternative approach to adjustment in the Euro area could feature countries that have a bit more room for manoeuvre, such as Germany, choosing to adopt a more expansive policy approach via fiscal stimulus and a faster pace of wage increases. This could provide the "carrot" for crisis countries to go along with the "stick" of wage cuts and structural reforms. Unfortunately, German economic policy makers are dead set against any such policies. The message from a recent speech by Bundesbank President Jens Weidmann was that it was up to the countries with debt problems to do all the adjusting. Time will tell whether a "stick only" approach is sufficient to save the euro.

Prospects for Ireland

Against this somewhat depressing background, what are the prospects for Ireland? Well, domestic demand is going to be restrained for years by fiscal adjustment, private sector debt problems and tight credit. So, as with the other peripheral economies, if economic growth returns to Ireland, it will have to be generated by exports.

And here, I think the news is better than many people think. Looking beyond the ravages of debt and recession, you might be surprised how good Ireland's underlying economy is.

Ireland has seen the largest adjustment to its wage costs of any of the European crisis countries and our current account is now in balance. Our European partners may give us quarterly lectures about the need for so-called reforms. However, the World Bank reports that Ireland is the 10th best country in the world in which to do business. For the record, Germany places 19th and France 29th.

Productivity levels in Ireland are still very high by international standards. And with wages and rents far cheaper than before and with other advantages such as a low corporate tax rate still in place, Ireland is in many ways a far more attractive place for multinational firms to use as a base for exporting activity. Indeed, the pipeline of FDI projects seems to be quite strong.

A return to the growth rates of Celtic Tiger period is not on the cards. Much of the growth of that period reflected adjustments to the dependency rate, to labour force participation and to productivity that are best seen as once-off events. However, with fifteen percent of the labour force unemployed, there is no doubt that the economy has plenty of "expansion room" to allow it to grow strongly in the years ahead.

In the short-term, however, we only control so much. As long as the global economy remains in a slump and the euro area fails to sort out its structural problems, it is hard to see a quick return to the kind of export-led growth that we need so badly. Indeed, only a fool could now rule out the possibilities of serious crisis such as a break-up of the euro, nor can we say for sure that a sovereign debt restructuring in Ireland is something will definitely be avoided.

Still, I'm tempted to finish by concluding that in the long-run, Ireland will get back on track. Tempted, but then I remember that whenever economists mention the long-run, people remind us of Keynes's remark that "in the long-run we're all dead." So let me just conclude by saying that while the next few years are bound to be rough, Ireland will pull through this crisis and when it does, I believe we will be able to put our economy on a more sustainable path than the one seen before the crash.