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Recovery Scenarios for the Two Irish Economies

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When the Economic and Social Research Institute (ESRI) were presenting our forecast for Ireland in December 2003 for the following 5 years, we began the press conference with a reproduction of a Chagall painting, that of Icarus. We felt that the Republic of Ireland (heretofore referred to as 'Ireland') was like Icarus, in that it was flying too close to the sun. Unfortunately Icarus, like Ireland, continued on his way and went too close to the sun; and the sun melted the wax and the wings with lethal consequences. The lesson I would draw from this is that, actually, this recession, as it is being played out in Ireland, is not as the bad as the fate that Icarus suffered. While he crashed into the sea with fatal consequences, there is likely to be a recovery in Ireland. With some new wax and feathers, Ireland will take off again; though future "flight" will be much less exuberant than in the past.

The problems facing the two economies of the island of Ireland today are the result of serious mismanagement, resulting in:

- A housing bubble in Ireland, squeezing out the tradable sector; and
- A financial sector bubble in the U.K. doing rather similar damage to the rest of the economy.

Returning our focus to the Irish economy, it has undergone a traumatic two years. The fact that much of this pain was self-inflicted, through unwise policy choices in the past, has not made it any easier to deal with. However, a path to recovery is now becoming clearer. It is probable that the worst of the pain is now over and that, from 2011 onwards, the economy will begin to recover. A key part of this recovery will be the repricing of the Irish economy as input prices, including the price of labour, adjust downwards. The faster this real depreciation of the currency occurs the more rapid will be the recovery[1].

The Northern Ireland economy, on the other hand, has had a much less traumatic experience over the last two years. The boom had not been as vigorous and, hence, in the bust, the economy had less far to fall. However, the very serious problems in the U.K. economy give major cause for concern for Northern Ireland. The U.K. faces a structural problem in its public finances of a similar order of magnitude to that in Ireland. And while a very serious adjustment has already been made in Ireland, putting the public finances on a sustainable path to recovery, the U.K. postponed all such action till after the general election of May 2010. While the interim Budget introduced by the incoming Conservative / Liberal Democrat government has begun the adjustment process, there remains a huge task to be undertaken. Thus, the Northern Ireland economy faces a number of years of very tough fiscal action, particularly in the period 2011-15; albeit superimposed on a world economic recovery.

The one area where there has probably been significant economic integration on the island of Ireland has been in the labour market. The boom in the building industry in Ireland had carryover effects, through the labour market, into Northern Ireland. Either directly or indirectly, significant numbers of people living in Northern Ireland benefitted through employment related to the Irish building boom. As a result, the inevitable collapse in this bubble has had significant negative consequences for many in Northern Ireland. As there is no prospect of a return of this bubble in Ireland, many of those North and South,

[1] Details of the latest analysis for Ireland are given in Bergin, A., T. Conefrey, J. FitzGerald, and I. Kearney (2010). "Recovery Scenarios for Ireland: An Update", special article in Barrett, A., and I. Kearney (eds.), *Quarterly Economic Commentary,* Dublin: The Economic and Social Research Institute, Summer 2010.

previously dependent on the building sector, will have to find employment elsewhere. This poses a challenge for the individuals concerned, and for the training and educational institutions in both jurisdictions.

Therefore, all aspects of policy ***should*** focus on the unemployed if we are to rapidly reverse the growth in numbers in consistent poverty. While an economic recovery will eventually see a recovery in employment, this is still some distance off. As such, further labour market policy action will be needed to ensure that the recovery brings a return to full employment.

In undertaking the necessary fiscal adjustment in Ireland, and the related increase in taxation, it will be important to choose tax instruments that are as 'job friendly' as possible. This means taking measures that broaden the base, rather than increase tax rates. It means avoiding, in so far as possible, taxes that directly impact on employment. It will also be important to choose taxes that have desirable properties for other reasons, such as discouraging damaging environmental behaviour, and taxes that are unlikely to be too volatile in the future.

It remains to be seen what approach is taken in the U.K. The increase in the VAT rate (from 17.5% to 20% as of 1 January 2011) is probably not very job friendly, relative to the adoption of possible new environmental taxes. Also, in the Northern Ireland context, water charges would form a more job friendly way of raising revenue than increases in other tax rates, and they would also have the desirable environmental properties.

Experience in the 1980s and early 1990s showed that when the Irish economy recovered and there was a return to employment growth, poverty traps seriously hampered a return to work by the long-term unemployed. It is essential that we begin work now to ensure that this will not be an issue hindering the impact of the recovery on unemployment, especially long-term unemployment.

Work by my colleagues suggests that, in preparation for an economic recovery, there is a need to put in place more effective activation measures in Ireland. Those who are unemployed must be helped to find jobs when they become available in the future. There is also a trade-off between activation measures and high replacement rates. Denmark, for example, manages to keep generous welfare payments with relatively low unemployment rates through attention to activation policies.

The experience of the 1980s and 1990s was that those with good education did not become the long-term unemployed of the future. That looks like being the case in this recession also. Many of those who are unemployed have limited education and training – they are the people who will need support over the longer-term.

While in the future we will eventually see a moderate increase in employment in areas like the building industry, we will never see anything like the levels of employment experienced at the height of the boom. Thus, many of those who have lost their jobs in such sectors need education and training support to prepare for the new Irish economy. This will not be easy, but training and education for the unemployed can make a difference. A similar issue applies in Northern Ireland. The relatively low proportion of the population completing High School (A levels) needs to be reconsidered. There needs to be an adaptation of policy in Northern Ireland to take account of the fact that future employment growth is likely to come in jobs requiring people with high levels of education.

One small good sign in Ireland in the current recession is that participation in education is rising. In particular there are signs that more boys are remaining on in school to complete their Leaving Certificate (currently, many more girls than boys complete their Leaving Cert examinations.). This will better equip them for the economy of the future.

The Northern economy is very dependent on the public sector as an engine of economic activity. With dramatic cuts in public expenditure in prospect in the coming years, in order to restore the UK economy to a sustainable growth path, this could have a disproportionate effect in Northern Ireland relative to the rest of the U.K. However, the weakness of sterling will provide a very important offset for the U.K., reducing the inevitable deflationary effect of fiscal action. What will be crucial will be the exploitation by the U.K. generally, and by Northern Ireland in particular, of its current competitive advantage to rebuild its economy. Unless there is an immediate major reorientation of the Northern Ireland economy towards an expansion in private sector activity, especially for export, there will be no offset to the inevitable consequences for the public sector of the coming fiscal deflation.

For Ireland, what is now crucial is to reduce the cost base to bring about a recovery in private sector activity. The stimulus to recovery in 2011 can only come from exports, not from domestic demand. For this to happen there needs to be both a recovery in external markets, and an improvement in competitiveness. Given the tight fiscal situation, this reduction in the cost base can not be supported by government subsidies. Rather, it is for the private sector to seek and produce a reduction in its own cost base through tough negotiation with suppliers and through a realistic approach to its labour costs. Provided that the fiscal adjustment in Ireland plays out as currently envisaged, my assessment is that the Irish economy will return to reasonably robust growth in the period 2012-2015. A consequence of this robust growth would be that a significant part of the current government deficit would prove to have been cyclical, and would be eliminated by the recovery. On the basis of this assessment, provided that the cuts currently planned for 2011 are implemented, the fiscal adjustment to be undertaken in subsequent years would be manageable without huge further pain.

However, the uncertainty surrounding all forecasts, including this forecast, must be acknowledged. The Department of Finance have a more pessimistic view of the likely Irish growth rate over the period 2012-15, and the EU Commission have an even more pessimistic view of the Irish potential growth rate. There remains the possibility that they could be right. A "no regrets" policy will involve planning for the tougher adjustment that slower medium-term growth would require, while being prepared for a pleasant "surprise" in 2011 or 2012 if the more optimistic forecasts prove correct.

For the Northern Ireland economy, there remain weaknesses in the availability of skilled labour at a realistic price. This poses challenges for policy in Northern Ireland. There needs to be both educational reform, and a repositioning of the economy to attract back skilled labour that has previously left. In the case of the Irish economy attention needs to be paid to the quality, as well as the quantity, of education.

For the future, especially in the Irish economy, growth will be driven by competitive private sector firms employing highly skilled labour supplying foreign markets for goods and, especially, for services. This has implications for the location of the new jobs. Generally skilled jobs working in services are found in major urban areas. This is for two reasons. Firstly, these activities have to be located close to a range of other services; services only available in major urban areas. Secondly, skilled individuals, like the animals in Noah's ark, tend to come two-by-two. There must be suitable jobs locally for the spouses and partners of those working in an enterprise providing highly skilled goods or services for exports. It is only in major urban areas that such a diversity of skilled jobs can be found, so that the social needs and expectations of skilled employees can adequately be met.

While there was a significant convergence in living standards between Dublin and the rest of the economy over the last decade, the next decade will see rather different trends driven by market forces. Many of the jobs in rural Ireland over the last decade were based on agriculture or, especially, on building. With prospects for building being much weaker over the coming decade, the growth in employment will tend to be concentrated in major urban areas.

This changed economic environment needs to be recognised and new policies developed to provide some offset to the likely direction of market forces. However, these policies will not be able to rely on any significant increase in resources from the government. Instead, it will be essential that any new policy focuses on developing sustainable economic activity in successful private sector firms. The best opportunities for such development will be available in the immediate hinterland of vigorous and substantial growth centres. The original spatial strategy, that is the *National Spatial Strategy* (NSS), developed a decade ago, needs to be revisited to take account of these new realities.

A final precondition for a recovery is the restoration of a banking system which is fit for purpose in both jurisdictions. After some very serious mistakes, action is now being taken in Ireland to crystallise the banks' losses and to develop a banking system that can fund a recovery. The National Asset Management Agency (NAMA) seems likely to pay the banks something approaching the true value for their impaired loans. As a result, they are forcing the banks to come clean on the likely losses on these loans, and to acknowledge this in their accounts. This will result in the banks which have some future (such as AIB and Bank of Ireland) being seriously undercapitalised. If they are to provide the credit for recovery, they will have to be recapitalised; as required by the regulator. The probability is that this will see them becoming largely owned by the state. This needs to happen very soon. Once they are recapitalised they will then have the wherewithal, and the incentive, to offer credit to a recovering Irish economy.

However, there must be a concern about what will happen in Northern Ireland. While attention in Northern Ireland has focused on NAMA, this is a side issue for Northern Ireland. It is likely that the best interests of NAMA, acting on behalf of the tax-payer in Ireland, will also serve the best interests of Northern Ireland – obtaining maximum value from its loan portfolio in both jurisdictions. However, it is not clear that there is a similar alignment of interests on the recapitalisation of the banking system. The Chancellor of the Exchequer, speaking after an EU Finance Council in January 2009, indicated a reluctance to recapitalise Ulster Bank; while already having had to recapitalise its parent RBS. Since then, in spite of the then Chancellor's doubts, the U.K. taxpayer has provided some additional capital for Ulster Bank through RBS. In the case of the Northern Bank, there also seems to be a reluctance to recapitalise it by its parent, the Danish-based Danske Bank Group. This leaves AIB and Bank of Ireland. There is much discussion as to whether their shareholders, the Irish government, or the EU Commission will force a sell off of significant assets outside Ireland (including U.K. assets, and Northern Ireland assets in particular). Should this happen it would reduce the amount of Irish taxpayers funds needed to recapitalise these banks. However, it would also mean that these banks would not be in a position to fund new loans in Northern Ireland; this would be an issue for any new owners.

Responsibility for ensuring an adequate flow of credit in Northern Ireland ultimately rests with the UK Treasury and the Bank of England. To date they have not shown obvious concern for Northern Ireland's potential credit problems. It will be important that they take their responsibilities seriously in the immediate future, especially if the Irish authorities decide on a course of action that would reduce their banking exposure in the U.K., including in Northern Ireland, and in other jurisdictions.