DOC. N.º 47

The New York Times

Irish Miracle — or Mirage?

By Peter Boone and Simon Johnson May 20, 2010 6:00 am

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With the European Central Bank announcing that it has bought more than $20 billion of mostly high-risk euro-zone government debt in one week, its new strategy is crystal clear: We will take the risk from bank balance sheets and give it to the central bank, and we expect Portugal-Ireland-Italy-Greece-Spain to cut fiscal spending sharply and pull themselves out of this mess through austerity.

But the bank's head, Jean-Claude Trichet, faces a potential major issue: the task assigned to the profligate nations could be impossible. Some of these nations may be stuck in a downward debt spiral that makes greater economic decline ever more likely.

Prime Minister George Papandreou said this week that Greece needs to see strong investment in order for the austerity program to work. While the government cuts fiscal spending, he said, it needs new private business to employ the dismissed workers so that they are productive, can pay taxes and do not need unemployment benefits.

The problems are strikingly reminiscent of Latin America in the 1980s. Those nations borrowed too heavily in the 1970s (also, by the way, from big international banks) and then — in the face of tougher macroeconomic conditions in the United States — lost access to capital markets. For 10 years they were stuck

with debt overhangs, just like the weak euro-zone countries, which made it virtually impossible to grow.

Debt overhangs hurt growth for many reasons: business is nervous that taxes will go up in the near future, the cost of credit is high throughout society, and social turmoil looms because continued austere policies are needed to reduce the debt. Some Latin America countries lingered in limbo for a decade or more.

Mr. Trichet and Mr. Papandreou can look more closely at home to see what might soon be going wrong. Ireland was one of the first nations to introduce tough fiscal austerity in this cycle — in spring 2009 the government slashed public-sector spending and raised taxes. Despite the cuts, the European Commission forecasts that Ireland will have one of the highest budget deficits in the world at 11.7 percent of gross domestic product in 2010. The problem is clear: when you cut spending you also lose tax revenues from people who earned incomes from that money. Further, the newly unemployed seek benefits, so Ireland's spending cuts in one category are partly offset by more spending in another. Without growth, the budget deficit still looms large.

Ireland's problems are, sadly, far deeper than the need for simple fiscal austerity. The Celtic Tiger's impressive reported growth over the past decades was in part based on its aggressive attempts to help major corporations in the United States reduce their tax bills. The Irish government set corporate taxes at just 12.5 percent of profits, thus attracting all sorts of businesses — from computer services like Google and Yahoo, to drug companies like Forest Labs — that set up corporate bases and washed profits through Ireland to keep them out of the hands of the Internal Revenue Service.

The remarkable success of this tax haven means that roughly 20 percent of Irish gross domestic product is actually "profit transfers" that raise little tax for Ireland and are owned by foreign companies. Since most of these profits are subject to the tax code, they are accounted for in Ireland where they are lightly taxed; they should not be counted as part of Ireland's potential tax base. A more robust cross-country comparison would be to examine Ireland's financial condition ignoring these transfers. This is easy to do: a nation's gross national product excludes the profits of foreign residents. For most nations, gross national product and G.D.P. are nearly identical, but in Ireland they are not.

When we adjust Ireland's figures accordingly, the situation is dire. The budget deficit was about 17.9 percent of G.N.P. in 2009, and based on European Commission projections (and assuming the G.N.P.-G.D.P. gap remains the same) it will be roughly 14.6 percent in 2010 and 15.1 percent in 2011, while the debt-to-G.N.P. ratio at the end of this year is expected — by our calculation — to be 97 percent, and 109 percent at the end of 2011. These numbers make Ireland look similarly troubled to Greece, with a much higher budget deficit but lower levels of public debt.

Ireland's politicians, rather than facing up to their problems, are making things ever worse. Simply put, the Irish miracle was a mirage driven by clever use of tax-haven rules and a huge credit boom that permitted real estate prices and construction to grow quickly before declining ever more rapidly. The biggest banks grew to have assets twice the size of official G.D.P. when they essentially failed in 2008. The government has now made a fateful choice: rather than make creditors pay some part of the losses, it is taking the bank debt onto the national balance sheet, effectively ballooning its already large sovereign debt. Irish taxpayers are set to be left with the risk of very large payments to make on someone else's real estate deals gone bad.

There is no simple escape, but if the government hopes to avoid a sovereign default, the one overriding priority should be to stop bailing out the banks. Instead, the government should wind down existing banks in a "bad bank," while moving their deposit base and profitable businesses into new, well-capitalized banks that can function without a taxpayer burden. This will be messy, but it is far better than a sovereign default.

Second, the Irish must take the tough fiscal steps that will be required under any circumstances. The International Monetary Fund and the European Union have made clear that funding is available to Ireland — so the government should use this to bridge the tough journey of fiscal cuts ahead.

Finally, the Irish need to consider seriously whether being in the euro zone is worth the cost. The adjustment to this awful situation would be far easier outside the euro zone — even though leaving the zone might have adverse repercussions for other nations. Once again, a comprehensive program with European Union and I.M.F. support might make this the least worse option.

Given the depths of Ireland's problems, it is no wonder the markets are looking with skepticism at the announced bailout package for the entire euro zone provided by the European Union and the International Monetary Fund. Policy makers are still not dealing with the core problems of each nation in the euro zone. With the debt hangovers remaining, who will want to invest in Europe's periphery, and so how can Greece, let alone Ireland, grow? One thing we can be sure of: Europe's political leaders are doomed to be spending much more time at emergency meetings in Brussels over the coming months and years.

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