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Ireland’s unexpected economic comeback

By David Vines and Max Watson

Markets and rating agencies, not to mention academics, often make egregious errors in judging country risk. All too often this is by failing to notice a change in macroeconomic fundamentals that really does matter. As the crisis moves through its nadir, one major error is almost certainly the market assessment of Ireland’s public debt.

As a group, the troubled periphery economies have faced three challenges: achieving a leap in competitiveness that will restore growth; convincing markets that public debt is on a sustainable track; and normalising the access of banking systems to market funding. These three challenges have become inextricably linked. In Greece, deep-rooted fiscal problems have infected the financial system. In Ireland a banking debacle has swollen public debt. And without strong competitiveness to relaunch growth, this aggregate debt dynamics story can have no happy ending at all.

So the first and most important thing about Ireland is that it is swiftly restoring its competitive edge. Indeed it is moving rapidly towards a sizeable current account surplus – in a range of 3 to 4 per cent of gross domestic product. Of course, recession has also played a role in turning external accounts around, but a steady uptrend in exports has been underway for some time.

The second element is that Ireland’s net public debt will probably peak at somewhere around 110 per cent of GDP. This is a steep challenge; but it is a magnitude that Ireland, among other advanced countries, has shown to be entirely scalable in the past. It is increasingly clear, too, that Ireland does not need to borrow from markets until 2014: that is the sort of borrower that markets can relearn to love.

The third issue is Ireland’s banking saga. The Achilles heel of the economy lay in bad bank governance and supervision, and a subsequent hard landing that neither the authorities nor the International Monetary Fund saw coming. But today there is a growing recognition that this corner has been turned. Steps were finally taken at the end of March to cauterise the problem with recapitalisation based on a tough set of stress tests; and a sharp division of core from non-core assets in the two “pillar” banks that are left. The recent success in keeping Bank of Ireland in private hands is also a major psychological boost.

Fundamentally, Ireland is also displaying an admirable social resilience. It takes little knowledge of history to place this in a perspective that has already seen the economy weather four dreadful economic crises in less than a century. It matters too that emigration has yet again helped to contain unemployment to some degree – even though, at 14 per cent, it is worryingly high.

As a result of all this growth is starting to re-emerge, even though domestic demand is still contracting. As expansion accelerates, it will generate jobs only slowly. But with the speed and slope of correction in competitiveness that is under way, the feed-through to domestic demand and job creation will come. And over the next few years a socially more sustainable balance to the recovery will also end up swelling the tax base more strongly than the present pattern of export-led growth. For the pressured taxpayer, there is a glimmer at the end of the tunnel.

We are highly conscious of the contagion risks posed to Ireland by further bond market or banking shocks elsewhere in the eurozone, or by any setback in world trade. And no one can ignore the political challenge of keeping Ireland ahead of the Troika's targets. It also has to be stressed that we are assuming firm persistence in the course of fiscal consolidation. This said, we do believe that Ireland's macroeconomic fundamentals provide the most important defence there can be against all forms of shock.

Perhaps most important of all, an Irish success story of the kind we think is underway will come to be seen as a precious and crucial trump card for the eurozone debt strategy. It gives the lie to fears about a generalised transfer union. And it illustrates that adjustment in the eurozone is feasible, just as currency board countries in the Baltics have wrongfooted the diehard pessimists.

In short, when we look at Ireland against sovereign spreads in the eurozone, we see a mismatch. Either markets are persuaded that economic policies can never defeat contagion, or understandably – given pervasive crisis fatigue – they have dropped off to sleep at the wheel.

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