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Appraisal of the Irish Economy through a Review of Relevant Literature

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Contents:

Appraisal of the Irish Economy through a Review of Relevant Literature.....	1
Introduction.....	3
'Economic & Social Research Institute (ESRI) Medium-Term Review 2005– 2012.....	3
Details of the Medium-Term Forecast	6
Review of Outcomes, June 2010.....	9
Literature Review on the Recession of 2008	12
'The Return of Depression Economics and the Crisis of 2008' by Paul Krugman	12
'The Shock Doctrine' by Naomi Klein	12
'The Big Short – Inside the Domsday Machine' by Michael Lewis.....	12
'The New Paradigm for Financial Markets – the Credit Crisis of 2008' George Soros	13



Introduction

In the first half of the decade 2000 – 2010 the Irish economy grew at an annual average rate of 5.4%. The Economic & Social Research Institute (ESRI) produced their 'Middle Term Review 2005 – 2012' in December 2005 in which they made predictions for the Irish economy out to 2012. These predictions, for the most part, were positive. Circumstances, however, changed in the second half of the decade and things went terribly wrong, with the foundations for much of the economic disaster being laid in the first half of the decade.

This Appraisal attempts to capture the developments of the time through:

1. A review of the ESRI study 'Medium Term Review 2005 – 2012', as well as using references from 'The Pope's Children'¹ and published articles from David McWilliams, a popular author and journalist who, at the time, antagonised Government officials by his incessant warnings of the consequences of their expansionist policies;
2. A brief review of the actual economic outcomes in Ireland using economic data;
3. Reviews of some of the international literature that followed the bursting of the Supper Bubble that triggered the economic crisis in 2008.

'Economic & Social Research Institute (ESRI) Medium-Term Review 2005– 2012

The ESRI "Medium-Term Review 2005 – 2012" was the tenth in a series of such reviews that commenced in 1986. These Reviews provide the most authoritative forecast of the parameters that underpin the Irish economy and are immensely influential with Government and business decision makers.

Overview of the Irish economy – Favourable Influences (2005 – 2012)

There was an alignment of influences that indicated that the fundamentals driving the Irish economy at that time were mainly favourable. There were also threats that were examined separately.

The **favourable influences** were:

- A fortunate set of demographic circumstances,
- The increasing importance of service exports,
- The large investment in construction and housing,
- The openness of the Irish labour market.

Fortunate Demographics

The fortunate demographics were elaborated at some length in David McWilliams's book "The Pope's Children".

¹ 'The Pope's Children – Ireland's New Elite' by David McWilliams (Gill & Macmillan 2005)



- Ireland had a baby-boom in the period mid-seventies to the mid-eighties that peaked shortly after Pope John Paul's visit in 1979. McWilliams refers to these baby-boomers as "the Pope's Children". He said of them –
 - “Today, the youngest Pope's Children are 25, the oldest are 35. There are close to 620,000 of them and they constitute the key generation in this country for their effect on our economy, attitudes, politics, art and literature. They are the creative dynamo of Ireland”.
- Augmenting the 'baby-boomers' that had matured into highly productive young adults, Ireland was benefiting enormously from immigrants from the Accession States, described by McWilliams as "the last fire sale of white Christian immigrants that the world is likely to see".
- A third fortunate demographic factor that was given considerable prominence in the MTR study was Ireland's low dependency ratio. It was approaching 1:1, that is, there was approximately one dependent for every person working. This was due to a combination of factors:
 - a. Very high emigration in the 1950's reduced the number of dependent elderly,
 - b. High participation rate of females in the labour force,
 - c. Large inflows of young immigrants, together with a young indigenous labour force,
 - d. Low net unemployment rate at the time,
 - e. A much reduced birth rate from the baby-boomer period.

It concluded that "Ireland faces an unusual demographic window of opportunity over the next fifteen years when dependency will be at an exceptional low level".

Increasing Importance of Service Exports

Service exports accounted for about one third of all Irish exports at that time and were expected to increase to approximately 40% by 2012. The attractive features of service exports are:

- They have a relatively low import content and are more beneficial to the Irish economy than an equivalent value of exported goods,
- The terms of trade were moving continuously against the price of goods, to the extent that merchandise export prices were increasing much more slowly than the prices of export services, making services increasingly important in Irish external trade.

Investments in Housing

Investments in Ireland amounted to a very high share of national income and expenditure, and approximately half of this was accounted for by investments in housing. Housing has a low leakage through imported inputs and, accordingly, has a major favourable impact on the economy.

The savings ratio in Ireland had traditionally been approximately 10% of disposable income. With large private investment in housing at the time, the net savings ratio had flipped to a net indebtedness of approximately 10%. The MTR study said of this situation:



“While this is not sustainable indefinitely, it is clearly sustainable (if not desirable) for some time to come”.

McWilliams, at the time, waxed eloquently on the Irish building boom. He reckoned that it was fuelled by:

- a. The young population that required high-standard housing,
- b. The ready supply of affordable credit – with cash emanating from German savings, and low interest rates that were determined by the sluggish European economy rather than by Irish exuberance,
- c. Greed, driven by escalating house prices that increased home-owners' wealth.

He reckoned that Ireland had moved into the bubble phase of a property boom, where

“all value, sense of proportion, etiquette and monetary decorum are thrown out the window”.

He warned that a bubble phase can last for a considerable time and can be pricked by such events as increased interest rates, or reappraisal of house values elsewhere in the world or a fall in confidence.

Openness of the Irish Labour Market

The Irish labour market has always been one of the most open in Europe, with the labour supply being very elastic – responsive to real after tax wage rates and to unemployment rates. In the past when the economy was performing poorly, this resulted in sustained emigration from Ireland and a falling population. At the time the reverse had occurred. There was a return migration of well-educated Irish people, remarkable levels of immigration of highly educated non-nationals and substantial investment in human capital (education) within Ireland.

Increasing participation in second and third level education

Increasing participation in second and third level education has a treble beneficial effect. It increases the productivity of the workforce, it increases labour force participation rates and increases flexibility / reduces the chances of unemployment. The MTR study referred to previous research when stating that:

“Had Ireland failed to invest in human capital over the past years, GNP per capita would be over 20 percentage points lower.”

The educational attainment levels in Ireland were expected to increase rapidly over the following decade. It is interesting to note that at that time the percentage of Irish people that had third level qualifications – degree or non-degree – was approximately 27%, whereas the percentage of foreign nationals in Ireland with similar qualifications was 54%.

Overview of the Irish economy – Threats

The principal threats overhanging the Irish economy were deemed to be:

- a. The large on-going imbalances in the US economy, in particular the current account deficit in the balance of payments,
- b. The high level of dependence on the continuing success of the Irish building industry,



- c. A gradual loss of competitiveness of the Irish economy that would, if it continued as it was going, bring the high-growth period to an end of its own accord.

Large Imbalances in the US Economy

The overhang of the US indebtedness caused the MTR to adopt a dual approach in its projections:

- o A high-growth approach, extending out to 2010,
- o A low-growth approach thereafter.

It was emphasised that the timing of the correction to the US finances was uncertain. It was reckoned that the process could commence in 2007 or later and that it could be gradual or sharp-and-shocking.

Euphoria associated with House Building

Not unrelated to the uncertainty regarding the US economy, was the threat posed by the euphoria associated with house building in Ireland. Even the 'dogs-in-the-street' knew that the levels of investment in building could not be sustained indefinitely and that an adjustment, when it occurred, would be painful. And yet it continued without abatement. It is appropriate to paraphrase the prayer of St. Augustan on the matter:

"Lord, make me prudent and wise, but not today, while house prices are increasing at 12% per annum".

Loss of Competitiveness

The MTR authors reckoned that high prices for houses and the high indirect costs associated with infrastructural constraints were both passed on to the business sector through the labour market. The associated deterioration in competitiveness would eventually reduce Ireland's potential growth over the following decade. The reduction in competitiveness was likely to progress independently of a correction to the US economy. It indicated that the high-growth projection up to 2010 would most likely switch to low-growth, with considerable uncertainty overhanging the timing and the severity of the adjustment.

Details of the Medium-Term Forecast

The MTR, like any economic study, argued its points at considerable length and one could agree or disagree with many of the points raised. However, its forte was its detailed quantitative summaries of relevant indicators of the Irish economy out to 2012. Projections were given for a high-growth scenario and a low-growth scenario that was most likely to kick in at some stage. It repeatedly emphasised that the timing and impact of the changeover were uncertain. In the detailed economic projections, the following indicators were used, all in millions of euro:

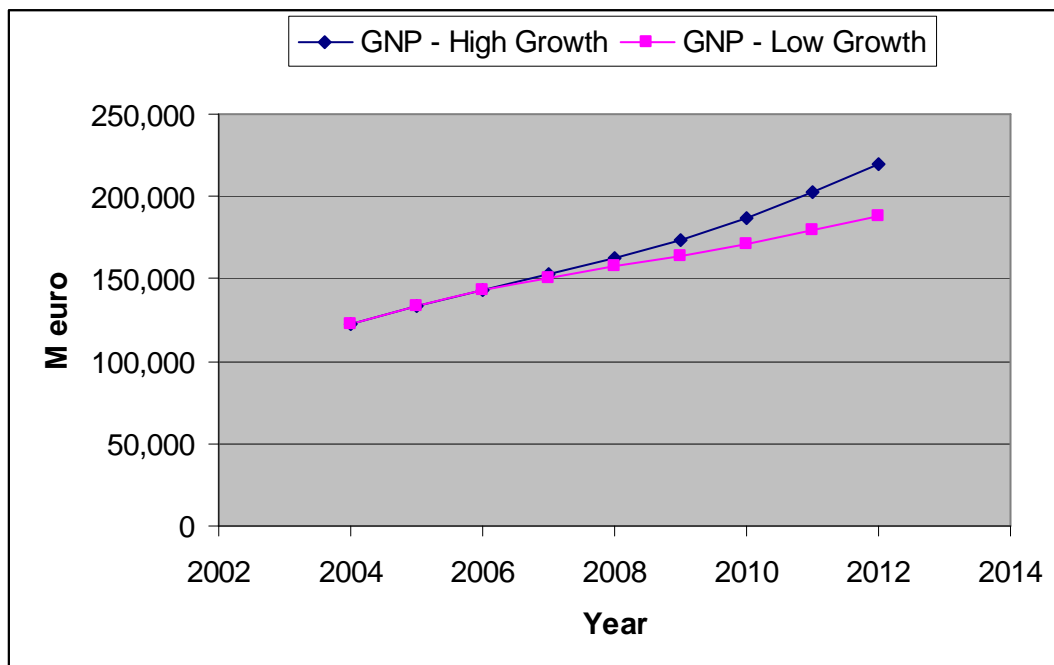
Merchandise Exports, Service Exports, Total Exports, Total Imports, GDP and GNP.



Comparison between GNPs for Low-Growth & High-Growth Projections

Year	GNP - High Growth (M euro)	GNP - Low Growth (M euro)
2004	122,315	122,316
2005	133,423	133,423
2006	142,968	142,968
2007	152,912	150,235
2008	162,704	157,228
2009	173,095	163,255
2010	186,961	171,226
2011	202,540	179,537
2012	219,480	188,225

GNP is the preferred indicator of Irish wealth generation, as it excludes repatriated profits by international firms. It was assumed that divergence from the high-growth scenario to low-growth would commence in 2007. In the projected figures, the changeover was shown to be smooth and orderly, but it was emphasised that it could be quite painful – if and when it occurred.

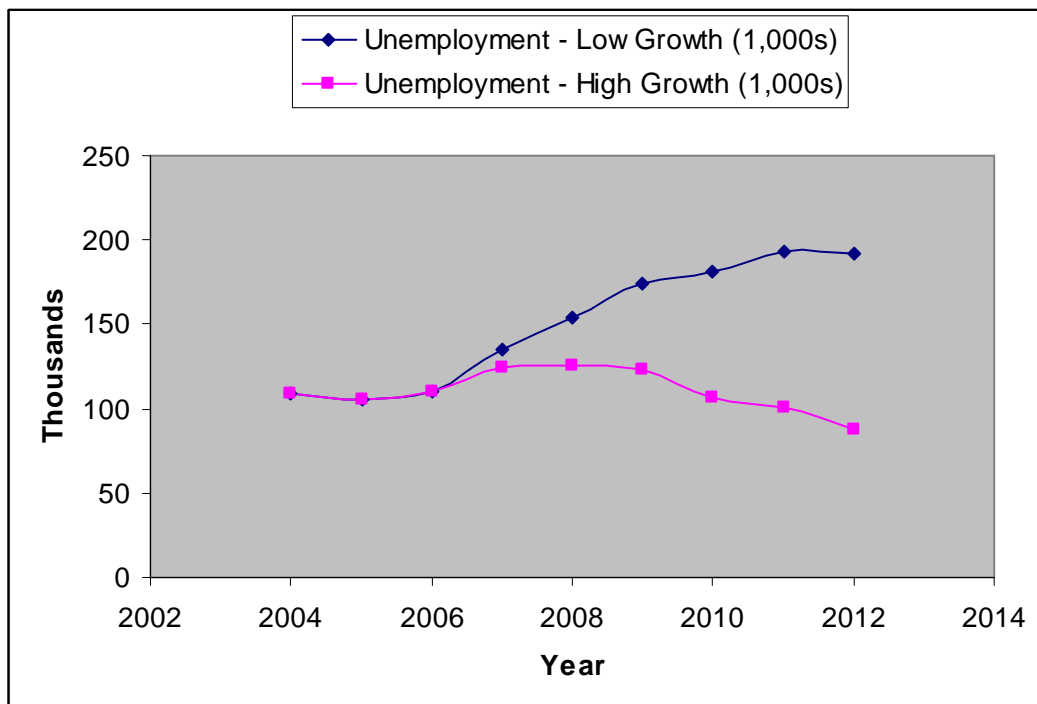




Comparison between Unemployment Numbers for Low-Growth & High-Growth Projections

Year	Unemployment - Low Growth (1,000s)	Unemployment - High Growth (1,000s)
2004	109	109
2005	105	105
2006	110	110
2007	135	124
2008	154	126
2009	174	123
2010	181	107
2011	193	101
2012	192	88

The human consequences of a switch to low growth are evident in the projected unemployment figures – deterioration in employment prospects and a near-doubling of the number unemployed in a few years.





Review of Outcomes, June 2010

The Authors of the Medium Term Review (MTR) of 2005 had clearly warned of the dangers associated with:

- a. The massive financial imbalances in the US economy,
- b. The bubble that was developing in building activities in Ireland,
- c. The damage that was being done to Irish competitiveness due to inflationary costs and wages in the Irish building industry.

What they failed to detect, possibly because it was not within their brief, were:

1. The out-of-control lending practices of Irish banks to developers, builders and property buyers. Control of these practices was really the province of the Financial Regulator's office, which is a subsidiary of the Central Bank.
2. The progressive ratcheting up of expenditures on Public Services in the boom years in a most un-Keynesian manner, with those expenditures being difficult to claw back in a recession.
3. The riotous financial practices in the US, into which European and World financial institutions were drawn with calamitous consequences.

As it transpired, the resulting financial outcomes for the Irish economy can be gleaned from the following table:

	2004	2005	2006	2007	2008	2009
GDP (€ million)	158,223	167,742	176,669	186,609	179,989	166,345
GDP Year-on-Year Change (%)		6.0%	5.3%	5.6%	-3.5%	-7.6%
GNP (€ million)	135,918	144,030	153,398	160,299	154,672	138,161
GNP Year on Year Change (%)		6.0%	6.5%	4.5%	-3.5%	-10.7%

Labour Force (000's)	1,980	2,072	2,155	2,240	2,223	2,155
No. unemployed (000's)	85.6	91.3	88.7	101.0	170.6	267.4

Immigration (000's)	58.5	84.6	107.8	109.5	83.8	57.3
Emigration (000's)	26.5	29.4	36	42.2	45.3	65.1
Net Immigration (000's)	32.0	55.2	71.8	67.3	38.5	-7.8

Exports (€ million)	84	87	87	89	86	84
Imports (€ million)	51	57	61	63	58	45
Trade Surplus (€ million)	33	29	26	26	29	39

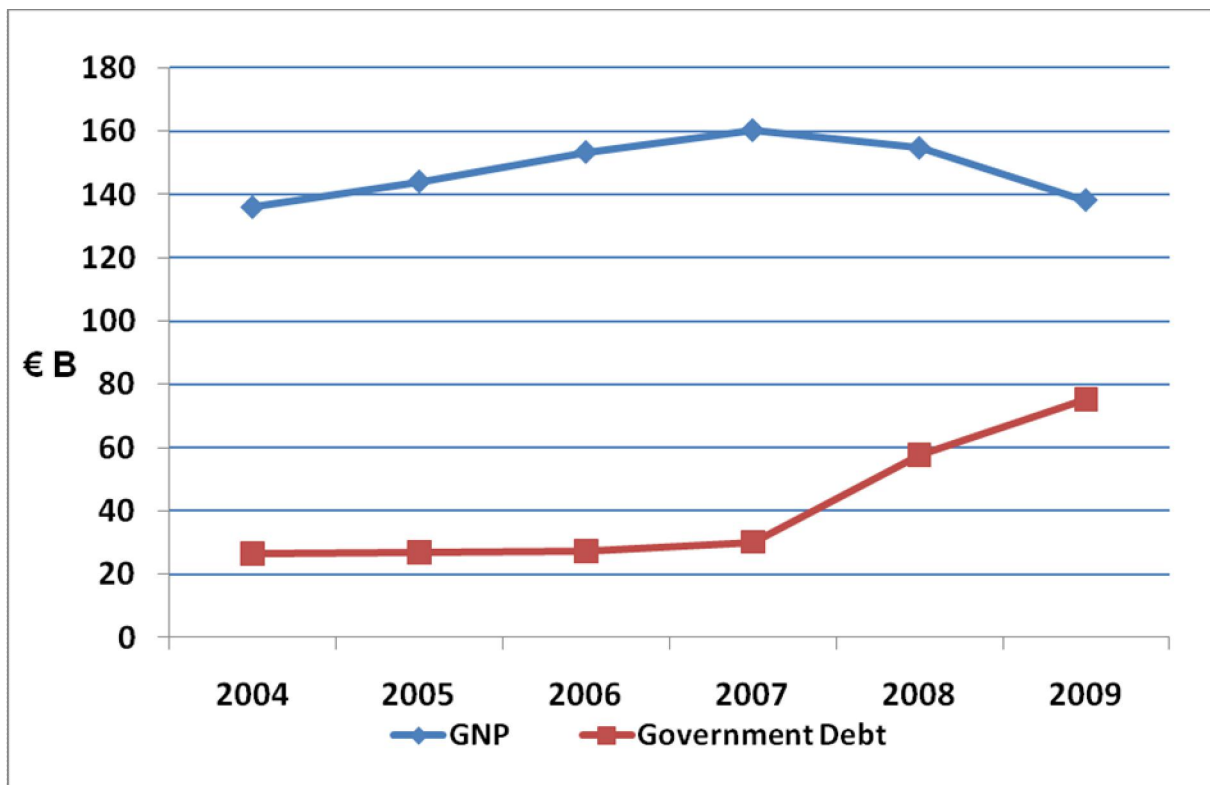
Government Debt (€ Million)	26,495	26,987	27,278	30,156	57,734	75,178
Debt to GNP (%)	19.5%	18.7%	17.8%	18.8%	37.3%	54.4%



From the above table it is apparent that:

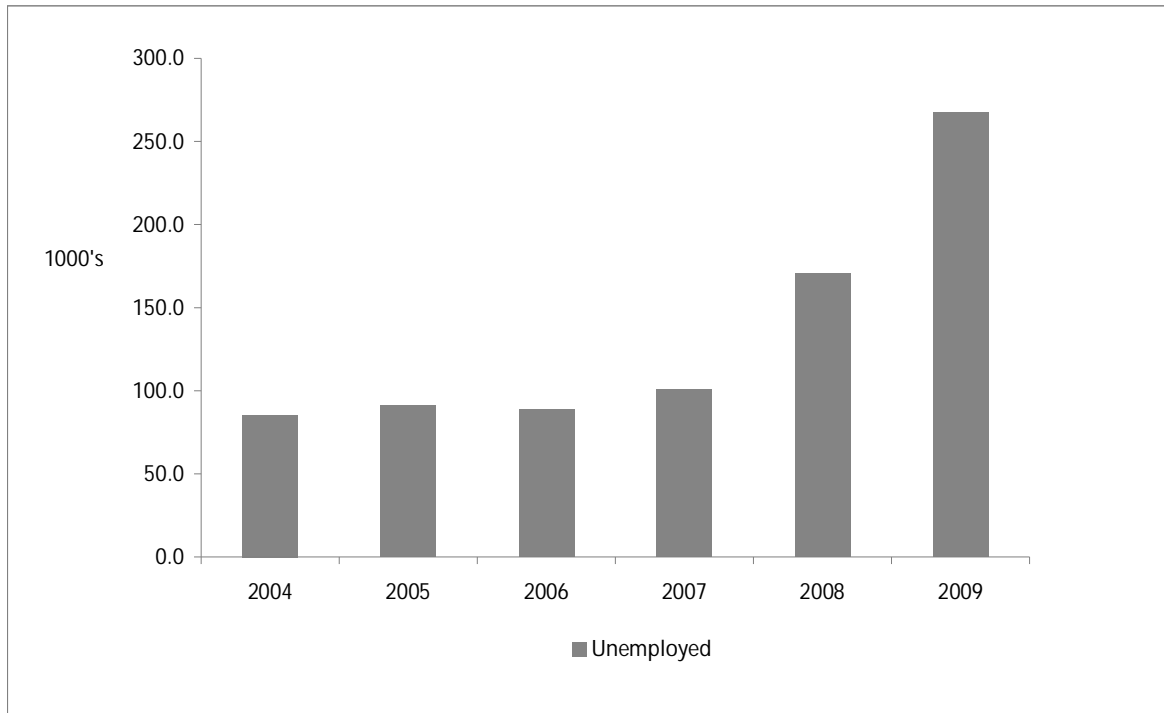
- The Irish GNP fell from a high € 160B in 2007 to € 138B in 2009, a fall of 14% in two years.
- The Irish Government debt in the same period, 2007 to 2009, rose from € 30B to € 75B, an increase of € 45B in two years.
- If the GNP were to continue to fall and the Government debt continue to rise, both at these rates, then the debt would equal the GNP in 2011 / 2012.
- The number of people unemployed rose from 88,700 in 2006 to 267,400 in 2009; that is, from 4% of the labour force to 12.4% in three years.
- The only encouraging aspect of the Irish economic indicators is that exports only declined slightly during the recession, while imports fell by approximately 30% between 2007 and 2009, giving an increase in the trade surplus in these two years of 50%.

Irish GNP & Government Debt (€ Billions)

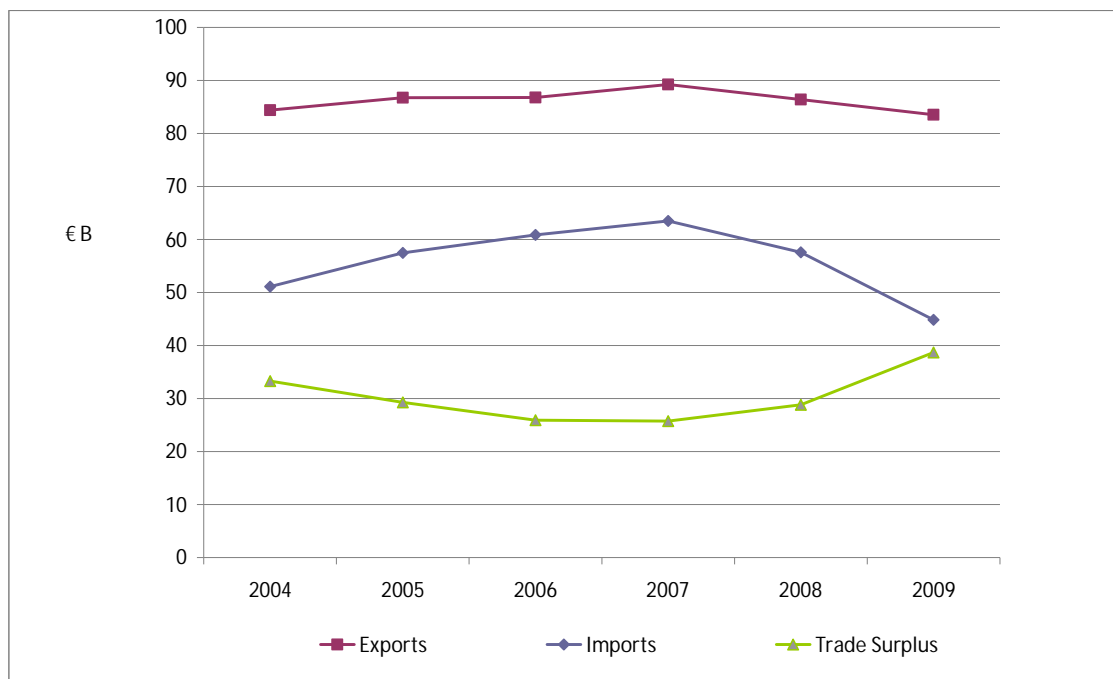




Unemployment Levels in Ireland (thousands)



Value of Irish Exports, Imports and Trade Surpluses (€Billions)





Literature Review on the Recession of 2008

The world recession of 2008 spawned a plethora of books that analysed and explained the origins of the recession and pronounced on remedies for recovery. Many of these are stimulating and very readable and they are all critical of the 'Masters of the Universe' and how they seriously erred in managing the world's finances. The following are brief reviews of a few of the books.

'The Return of Depression Economics and the Crisis of 2008' by Paul Krugman

(Penguin 1999 & 2008)

Paul Krugman's book is authoritative, beautifully written and comprehensible by anybody that chooses to read it. He sketches out the successes of capitalism, technological developments and globalisation. He describes and explains the relatively recent financial crises in Latin America, Argentina, Mexico, Japan, Southeast Asia, the failed attack on Hong Kong's currency and the financial crisis in Russia, before addressing the mismanagement of financial affairs in the United States.

'The Shock Doctrine' by Naomi Klein

(Penguin 2007)

Naomi Klein's book is well researched, intensely written and constitutes a savage attack on the dictates of Milton Friedman and the Chicago School of Economics, which she reckons pray for financial crises around the world the way that drought-struck farmers pray for rain and that when disaster strikes they know that their time has come.

They apply a simple remedy to such crises through their influence with the US Administration and the International Monetary Fund (IMF): the elimination of the public sphere, total liberation of corporations and skeletal social spending. The characteristic outcomes are huge transfers of public wealth to private hands, an ever-widening chasm between the dazzling rich and the disposable poor and an aggressive nationalism that justifies bottomless spending on security. She sketches the application of these tenets to various financial crises around the world and elaborates on the horrors that accompanied their application.

In summary, Naomi Klein's book is excessively long, is rather depressing but it does highlight the ravages that can accompany a relentless application of economic fundamentalism.

'The Big Short – Inside the Doomsday Machine' by Michael Lewis

(Penguin Group 2010)

Michael Lewis is a populist author with an expert knowledge of financial markets. In 'The Big Short' he tells the story of a number of financial traders in the US who understood they were in the middle of a massive financial bubble and who could not believe that so many large financial houses, traders and risk assessors could be so delusional about the situation. The story is really about life inside a bubble



from the perspective of people who perceived they were in a bubble, while all around them was unmitigated euphoria. The heroes of the story serviced the costs of their short positions in an ever-rising market and had to withstand considerable aggravation before the bubble eventually burst and they reaped their rewards.

'The New Paradigm for Financial Markets – the Credit Crisis of 2008' George Soros
(Perseus Books Group 2008)

George Soros's book is relatively small, slim and packed with thoughtful insights and personal experiences. It is an authoritative interpretation of the credit crisis that convulsed the world, with strong views on flaws in classical economics that have played a major part in causing the crisis.

The following summary is a brief interpretation of Soros's book. For a more detailed account the reader is referred to the original for an enjoyable and informative account of Soros's views & experiences relating to the current Supper Bubble, which he reckons had its genesis in economic fundamentalism – the misplaced belief in self-regulating markets.

Reflexivity

People interact with reality in two ways:

1. They seek to understand the particular set of circumstances with which they are contending. This is the assessment process.
2. They may wish to react to the set of circumstances as they see them in order to gain personal advantage. This is the participative process.

In normal circumstances people or organisations act independently of each other and the assessment process is exercised by individual entities acting independent of others. In these circumstances, any participative action arising from an individually exercised assessment only affects the individual involved, and the assessment process can be viewed as an independent variable and the participative process as the resulting dependent variable.

Circumstances, however, may arise where people or organisations do not act independently of each other. Their individually exercised assessments lead to the same participative processes and their combined actions may change the initial conditions. In these situations, the resulting accumulative action may be flawed. George Soros calls these circumstances **reflexive**, where collective participation affects the underlying circumstances.

The following are some examples of reflexive circumstances:

- a. People may be gripped by a collective fear, as happened in the United States when the 'War on Terror' was declared. For these and similar circumstances, Soros renames the participative process the 'manipulative process', as a collective fear can be instilled in a whole nation and used to modify the individual assessment processes, with manipulated information fed into the system at strategic points to sustain the collective fear. The resulting actions were accepted by a manipulated United States public, with disastrous effects on world events.



- b. At different times and at different locations throughout the world sets of circumstances have arisen to help create property bubbles. The circumstances are usually sustained low interest rates, ready access to credit and inflationary increases in property prices. The publicised success of early pioneers acts as a greed-induced narcotic on the masses who collectively inflate the bubble with predictably disastrous results. The recent bubble in Ireland was exacerbated by hallucinated behaviour on the part of bankers who lent what they did not have on property prices that were illusory in a regulatory environment that effectively was non-existent.
- c. Two-way reflexive action is much more common in financial markets than in boom / bust bubbles. The assessment process is well served in financial markets with a welter of information and knowledge sources that comprise an industry in themselves. The successes of early investors that detect disequilibrium in a market can result in a posse of followers that are alerted through efficient information channels. To that extent, the actions of participants are bound to affect the assessment process, resulting in reflexivity (i.e. positive feedback) being the norm rather than the exception in financial markets.

Reflexivity and Economic Fundamentalism

Soros uses the term 'economic fundamentalism' in a derogatory sense to denote an adherence to ill-founded economic beliefs. He is unambiguous in his career-long mistrust of classical economics in which economic tenets and models are used to make predictions based on an analysis of prevailing circumstances. Because of the possibility of reflexive action (positive feedback) in all social sciences, including economics, "events follow a one-directional path and are not determined in advance by universally valid laws, but emerge out of the interplay between participants' views & actions and the actual state of affairs".

Soros is particularly incensed by economists who advocate that the unrestrained pursuit of self-interest leads to market equilibrium and the optimum allocation of resources. He reckons that this flawed assertion was the basis for the laissez-faire policies of the nineteenth century, as well as the belief in the 'magic of the marketplace' that gained widespread acceptance during Ronald Reagan's presidency. This, he reckons, underpinned the flawed policies that culminated in the super-bubble that became evident in 2007. In contrast, he claims that "all human constructs are flawed; financial markets do not necessarily tend towards equilibrium; left to their own devices they are liable to go to extremes of euphoria and despair".

The Philosophical Implications of Reflexivity

Soros explores at some length the philosophical implications of his theories, probably because of his fascination with philosophy or perhaps because all great movements have philosophical underpinnings. He reckons that the classical philosophers concentrated excessively on theoretical reason i.e. on the assessment process, and did not pay adequate attention to the participative / manipulative function, nor did they grasp that the positive feedback that can occur between the two can have history-changing consequences.



Susanne Langer, in her book 'Philosophy in a New Key'², argues that the power of understanding symbols (i.e. modelling) is the most characteristic mental trait of mankind. In all sciences people try to understand and model key variables in defined situations and to use the models to help predict future outcomes. Natural phenomena are predictive in their outcomes, but social sciences are susceptible to feedback from participants actions and are intrinsically indeterminate. This highlights a basic weakness or perhaps a basic truth in economics – it is not at present amenable to modelling that is credible. This may change with time, but for the present social / economic models are only applicable in clearly defined and limited circumstances, ideally with the physical aspects of any situation separated from those aspects that are subject to human intervention.

² Susanne K. Langer 'Philosophy in a New Key' Harvard University Press