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In recent weeks a determined effort has been made to limit debate to the spending cuts and tax increases necessary to remove somewhere between €3bn and €7.5bn from the economy in the budget. This, I think, is the wrong starting point.

I do not think the key issue is about the parameters of tax and public expenditure. I do not think it is even about economics. What it should be about is political economy and the deeper question of whether the economy is embedded in society or the other way around.

So, like the Kerry man asked for directions I too have to say that I wouldn't start from here in the first place. By this I mean that I do not subscribe to the accepted orthodoxy that the budget deficit must be reduced by 3 per cent of GDP by 2014. I do accept that we cannot sustain the high level of borrowing and the cost associated with it indefinitely. But the target date of 2014 and the figure of 3 per cent are quite arbitrary. More importantly they cannot be attained without doing permanent damage to our economy and to the fabric of our society. I shall try to explain why this is so.

Growth is the key. Fiscal retrenchment cannot be achieved through austerity alone. Some months ago it was being confidently asserted that the 'Green Shoots of Recovery' would shortly be in evidence. It was not to be. The CSO data for the second quarter of the year revealed that GDP had in fact declined further by 1.2 per cent.

The truth is that Government is delusional about the effects of the fiscal crisis on growth. But markets can assess the reality. That is why after three brutal budgets the cost of borrowing has risen rather than fallen. *The Financial Times* put it succinctly when it said:

> "The problem for Ireland is no longer a question of profligacy, but whether the country has been too austere in its efforts to reduce debt at the expense of growth"[1].

Similarly, Adam Posen, a member of the Monetary Policy Committee of the Bank of England, has pointed out that low growth, if it persists, can cause people to drift into long term unemployment and machinery and plant which is temporarily mothballed to be taken out of commission entirely. The combined effect of these two factors is to permanently reduce the productive capacity of the economy.[2]

While external observers could see the fallacy at the heart of the Irish Government's strategy it was for a long time a lonely furrow to be trying to plough with a domestic audience. Happily – if one could apply that word to any aspect of this matter – the position has begun to shift in our direction. The publication of the ESRI *Quarterly Economic Commentary* on Thursday has added a significant new dimension. As they put it:

> "…..it is important to note that we have grave doubts over the wisdom of the parameters of an austerity programme where such high levels of savings will be sough in such a tight timeframe….the problem arises because an austerity package of €15bn within four years could damage the potential of the economy to grow its way out of recession".[3]

But why you might ask would any Government persist with policies which are so obviously failing. The answer lies in the difference between a political economy

[1] Oakley, David and Hughes Jennifer (2010) 'Is Ireland Restaging Greek Tragedy?' *The Financial Times*. September 29, 2010: P. 36.
[2] Posen, Adam S. (2010). *The Case for Doing More'*. Speech to Hull and Humber Chamber of Commerce, 28 September, 2010.

[3] ESRI *Quarterly Economic Commentary*. Autumn, 2010: 63-64.

approach and one guided by classical economics. The latter is based on models and precepts which assume certain things which do not occur in the real world.

It is very interesting to observe the way so many establishment figures have been deployed to press the case for austerity. For example, speaking at a dinner of the Dublin Chamber of Commerce Peter Sutherland addressed himself to some of the arguments we have been making. In particular he made the case that in the late Eighties fiscal contraction had in fact brought economic expansion. This is, I believe, known to economists as the expansionary-fiscal-contraction hypothesis.[4]

The problem is that conditions are not anything like they were in the late Eighties. At that time Ireland had the benefit of two currency devaluations and the implementation in 1986 of the Single European Act which provided us with a magnet for American foreign direct investment. Moreover, we were not then experiencing a synchronised global downturn. I do not think we can again expect growth from fiscal contraction.

In any event this hypothesis has been undermined in the last week by no less a source than the IMF.[5] [6] They argue that a fiscal consolidation equivalent to 1 per cent of GDP leads on average to a 0.5 per cent decline in GDP after two years, and to a 0.3 per cent increase in unemployment. Moreover, simulations carried out by the fund show that slashing spending in an environment where interest rates have no more room to fall doubles the contractionary effect of such cuts compared with a situation where the Central Bank still has scope to cut rates. In such a situation, GDP can be expected to decline by 1 per cent rather than the historic average of 0.5 per cent. If, in addition, everyone else is cutting, the effect of a fiscal contraction is further magnified.

A second argument sometimes deployed, although not by Mr Sutherland, is that the certainty generated by austerity will give people the confidence to spend money and

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[4] As reported in *The Irish Times* of October, 8, 2010.
[5] IMF (2010) '*Will It Hurt:* Macroeconomic Effects of Fiscal Consolidation' World Economic Outlook. Chapter 3. October, 2010.
[6] 'Does Fiscal Austerity Boost Short-Term Growth? A New IMF Paper Thinks Not' *The Economist.* October 2nd, 2010. P. 76.

reduce savings – which are now at a very high level. This is known as ‘Ricardian Equivalence’ but it is all neo-classical guff as far as I can see. I certainly don’t know anybody who thinks like this but I do know a lot of people who are saving all they can in case they loose their jobs in six months time.

It seems to be generally believed too that we can compensate for the effect of a deflationary strategy on the domestic demand side of the economy by growing exports. Now domestic demand accounts for 60 per cent of all economic activity so it is very important. Exports are important too of course and they have held up very well during the course of the recession. At a time when every country is trying to pull itself out of recession by increasing exports it seems improbable that we can greatly increase our market share. It is worth reflecting that this singular emphasis on exports is why we are having currency wars. So unless we can find a way to run a balance of payments surplus with Mars I doubt that exports will be our salvation. If this is indeed the case then it makes no sense to sacrifice the domestic side of the economy. That is the only possible source of significant new employment.

But, I hear you say, what choices have we. If we do not show firm intent to get our borrowing below 3 per cent of GDP by 2014 the bond vigilantes will get us. We have to ask what is the evidence for this. We assume a disposition on the part of the bond markets that they have never stated.

To the contrary Mr Hans Bloomstein, Head of Bond Markets and Public Debt Management at the OECD, is quoted in *The Financial Times* of 11th October as saying that there was a danger that some Governments might go too far with austerity measurers as they sought to reassure investors that they were tackling their deficit problems. That in turn could jeopardise their economic recovery.[7]

[7] Oakley, David (2010) ‘Eurozone Bond Investors Accused of Overreacting to Sovereign Risk’ *The Financial Times*. October 10th, 2010. P. 1.

More recently the case for a four year austerity programme has been presented in terms of being necessary because of our obligations to the EU.

I cannot see how this is the case. We do not yet have economic Government in Europe. Monetary policy is made in Frankfurt but fiscal policy is still a national Government competence.

What though of the Stability & Growth Pact? For all practical purposes that disappeared in a puff of smoke in 2003, when it became clear that neither France or Germany was willing to accept the rule that they should be fined by the EU for running budget deficits larger than 3 per cent of GDP.[8] What moral authority would the deficit hawks of Germany now have in seeking to impose fines on small countries struggling to reduce their deficit while trying to avoid ruining their economies at the same time?

Consider too that the logic of this argument is that if the EU does indeed have power to compel Ireland to stick with a four year austerity programme then it also has the power to make us change our stance on corporation tax.

A variation of this theme is that we have to start off with a four year programme and if things get sticky the EU might agree to change it. [9] What person in their right mind would buy such a proposition? The whole purpose of a longer adjustment period is to give growth a chance to get a foothold.

Remember too that if things go very badly wrong we don't even have the safety blanket of monetary policy to stimulate economic activity that Britain has.

In any event it seems to me that the European Commission has itself a more nuanced approach. In a presentation to the European Parliament on 14 January 2010 the Director General of the Economic and Financial Affairs Directorate, Mr Marco Buti, told MEPs

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[8] Rachman, Gideon (2010) 'Defiant France Ignores the Abyss'. *The Financial Times*. October 19, 2010: P.15

[9] 'The Politics of 2014 V 2016' *Irish Times* Editorial. October 22nd, 2010.

that the pace of consolidation should be conditional on a self sustaining recovery. No recovery will be self sustaining without growth.[10]

Growth can both do the heavy lifting of adjustment and diminish the scale of the problem by increasing the size of the economy. Growth needs time to get a foothold and it needs investment. That is why we believe the adjustment cannot be accomplished in four years and should be stretched to seven years. There is nothing scientific about four years. It is purely arbitrary.

Last week we had the pleasure of hosting a public lecture by Lord Robert Skidelsky, the biographer of John Maynard Keynes. He made the point that there is no remedy in accepting the economics of the cutters and seeking only to ease the pain of the axe. To promise to cut a little less than the Government and over a longer timeframe is less than a complete alternative economic strategy.[11]

That is why investment in the domestic economy is a necessary complementary action.

When we publish our pre-budget submission in about a week’s time we intend to deal comprehensively with how best to achieve this investment. There are are some technical problems to be overcome.

For instance, it seems crazy to allow the National Pension Reserve Fund to invest everywhere in the world except Ireland. The issue appears to be that direct expenditure from the fund is recorded on the balance sheet. We believe there is a way of talking it off the balance sheet and leveraging the amount involved by using either the state holding company concept or a special purpose vehicle.

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[10] Buti, Marco (2010) *The Spread of the Crisis: Effect of the Crisis on Public Finances.* Address to European Parliament on 14 January, 2010.
[11] Skidelsky, Robert (2010) ‘Our Austerity Apostles Duck the Real Debate’. *The Financial Times.* October 14th, 2010: P. 13.

A case where this approach could work in practise is in respect of water conservation. By establishing a national water company and having local authorities transfer their water assets to it, NPRF could be used to capitalise that company provided a way can be found to remunerate the investment. There is a huge job of work to be done in conserving and metering water.

There are many infrastructural projects – broadband is another obvious one – which if advanced could improve competitiveness, provide employment and a stimulus to domestic demand.

Another avenue of approach that we have been working on actively for some time is to find a way for private pension funds to invest in less ambitious projects like hospitals and schools by bundling funds together.

Every €1m invested in infrastructure generates between 8 ad 12 jobs and also enhances the productive capacity of a country. By focussing on infrastructure the impact of the investment is less likely to leak out to imports – often a problem in a small open economy.

Some say we have no right to bequeath debt to future generations. But it is hardly wise to bequeath them a smaller economy either. In other words sustained low growth can become a self fulfilling prophecy. If so we risk a deflationary spiral in which austerity kills growth and jobs leading to higher welfare costs and less tax revenue necessitating even more severe austerity. Is that not the experience of fiscal retrenchment to date? It is certainly the experience of Japan in the 1990s and we too are threatened with a lost decade if we do not change course.

The citizens of our country are confronted by a dark Hobbesian vista – an austerity plan which is nasty, mean, brutish and short.

To stay on course is not only economically dangerous it is politically unwise too. The distributional unfairness inherent in this policy may induce a societal reaction which could undermine our long-run stability and prosperity.[12] [13]

In conclusion I would make this point. Just as in 1987 the crisis that faces the Irish state has two major components – a very high rate of unemployment and a very large national debt. The difference is that external conditions were much more benign then. But even with an export-led growth rate in GNP of four per cent, both the volume of personal consumer expenditure and the numbers at work declined. Then, as now, decision making was centralised in the hands of the Department of Finance. Then, as now, the instrument of choice for dealing with the deficit was large scale expenditure cuts.[14] We are still living with the consequences of those cuts in our health service.

My point is that adopting the same approach in the much more challenging international environment of today is doomed to failure. We need to allow for thinking about the problem in a different way and foreclosing on all options other than a four year austerity plan is not a good start.

[12] Munchau, Wolfgang (2010) 'Ireland's Taxpayers Have Shouldered Too Much'. *The Financial Times*. October 4, 2010: P. 17.
[13] Posen, Adam S (2010) *The Case For Doing More*. Speech to Hull and Humber Chamber of Commerce. September 28, 2010. P. 3.
[14] Breen, Richard et al (1990) *Understanding Contemporary Ireland: State, Class and Developments in the Republic of Ireland*. London. The MacMillian Press Ltd.