IIF RESEARCH NOTE

Ireland and Greece: A Tale of Two Fiscal Adjustments

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- **Ireland and Greece have been led down two different adjustment paths**
- **The underlying fiscal adjustment in Ireland averaged just 1.7% of GDP a year during 2010-2012**
- **By contrast, underlying fiscal tightening in Greece averaged 5.2% of GDP a year over this same period**
- **Renewed growth has stabilized Irish debt/GDP ratios despite large fiscal deficits**
- **Falling GDP has hiked Greek debt ratios despite unprecedented principal reductions**
- **Large FDI inflows, competitiveness gains and exports have driven Ireland's recovery**
- **Economic recovery in Greece will be difficult to secure without more moderate fiscal adjustment going forward**

Divergent assessments about the creditworthiness of Ireland and Greece owe much to differences in their respective growth performances

Three years into Europe's crisis, and with worrisome output contractions ongoing in Italy, Spain and Portugal, the different experiences of Ireland and Greece offer useful lessons. A more tempered fiscal consolidation has helped Ireland succeed in restarting the growth needed to underpin debt sustainability and renew bond issuance. Few doubt, as a result, that Ireland's official creditors will be repaid in full and on time. With a much larger initial debt, a larger initial deficit and little saved from the strong growth registered before 2008, the far harsher fiscal adjustment required of Greece has had a much more negative effect on GDP. This has elevated debt ratios and reinforced doubts about creditworthiness despite fiscal adjustment and principal reductions from private creditors of unprecedented magnitudes. Applying the Irish example in Greece to help restart growth would require some additional funding. The final cost, however, would be much less than might eventually be needed if output continues to fall and doubts about debt sustainability remain entrenched.

Chart 1
Real GDP Level
2000 = 100

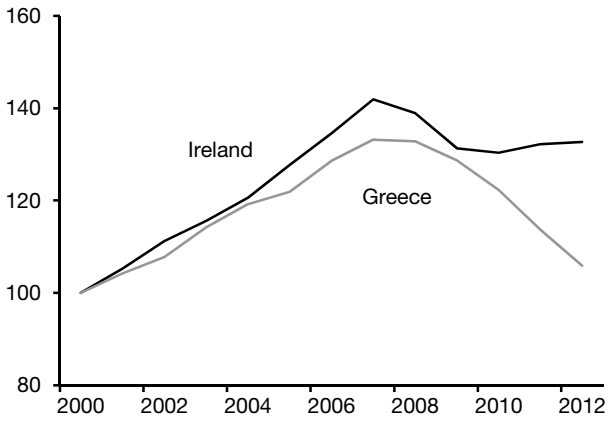
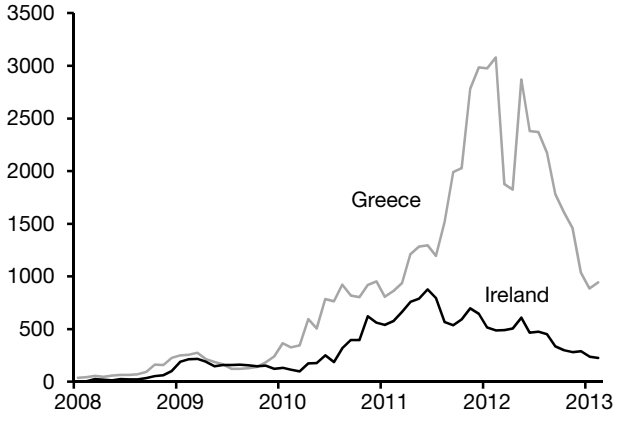


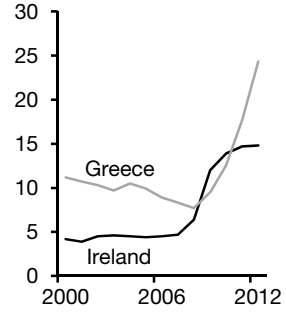
Chart 2
10-year Government Bond Spreads vs. German Bund
bps



A TALE OF TWO ADJUSTMENTS

Greece and Ireland are generally judged to represent opposite ends of the spectrum when assessing adjustment efforts made necessary by the European sovereign debt crisis. Bond markets have responded favorably to Ireland's relative success, with perceptions of renewed creditworthiness underpinned by the resumption of growth already in 2011, the first year of its EU-IMF program (Chart 1, previous page). Renewed bond issuance and greatly reduced bond yields – down to less than 4% in secondary markets on most outstanding issues – point to strong odds that Ireland will exit its reliance on official financing successfully – and with ample liquidity reserves – when its program expires in December 2013 (Chart 2, previous page).

Chart 3
Unemployment Rate
percent



Greece, on the other hand, has seen its economy contract by 20% since 2008, causing unemployment to surge to 26% (Chart 3). Even though bondholders acquiesced to massive, unprecedented principal reduction via a debt exchange in early 2012 and a sizable debt buyback nine months later, doubts linger about the sustainability of Greek debt. Renewed market access remains a long way off. Divergent assessments about the creditworthiness of Ireland and Greece owe much to differences in their respective growth performances.

DEFICITS AND DEBT DIFFER, BUT NOT AS MANY MIGHT THINK

Greek government debt has remained larger than Irish government debt, but Ireland's deficit has been larger since 2010

Greek government debt has remained larger than Irish government debt. But Ireland's deficit has been larger since 2010, net of bank restructuring costs, and will remain so through 2015, according to program targets. As a result, Irish government debt, while lower than that of its Greek counterpart, would have increased nearly as much during 2010-2012 had Greek debt not been reduced as much as it was in 2012 by the March debt exchange and the December buyback.[1]

Large fiscal deficits and heavy bank recapitalization costs caused the debt/GDP ratio of the Irish government to rise by 53 percentage points during 2010-2012 (Table 1, next page). More than half of this increase was in 2010, when bank recapitalization outlays amounting to 20% of GDP were covered by borrowing. The increase in debt since 2010, 26 percentage points, would have been larger had the government not drawn down assets to cover another 12% of GDP in bank recapitalization.

Had these assets not been available and used, Ireland's debt/GDP ratio would have risen by 69 percentage points during 2010-2012. Ireland's debt ratio would then have risen to 130% of GDP, the level with which Greece began its program in 2010. Drawing these assets down, Ireland's debt ratio still nearly doubled from 2009 to 118% of GDP at the end of 2012. This was a bit above what Greece reported when its program began, before Eurostat required the inclusion in the general government of loss-making transport companies owned by the state – in Greece and other countries.

[1] The March exchange and the December buyback together reduced Greek debt by 58% of GDP. Factoring in borrowing to cover recapitalization costs for Greek banks that were triggered by haircuts taken on Greek debt, the effective reduction in debt thanks to the March exchange and December buyback equaled 41% of GDP.

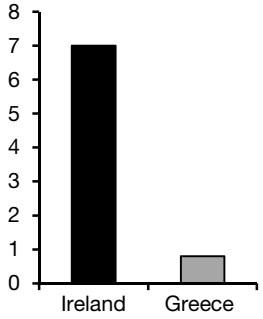
Table 1
General Government Developments, 2007-2015: Ireland and Greece
% GDP

	2007	2008	2009	2010	2011	2012	2013e	2014p	2015p
Ireland									
General government balance[1]	0.1	-7.3	-11.5	-10.7	-9.1	-8.3	-7.5	-5.0	-2.9
Interest payments	1.0	1.3	2.0	3.1	3.2	3.9	5.7	5.6	5.6
Primary balance	1.1	-6.0	-9.5	-7.6	-5.9	-4.4	-1.8	0.6	2.7
Cyclical effects	2.7	1.4	-1.0	-1.3	-0.8	-0.8	-0.8	-0.5	-0.2
Cyclically-adjusted primary balance	-1.6	-7.4	-8.5	-6.3	-5.1	-3.6	-1.0	1.1	2.9
change		-5.8	-1.1	*2.2*	*1.2*	*1.5*	2.5	2.1	1.8
General government debt	25.1	44.5	64.9	92.2	106.4	118.3	122.5	121.7	118.0
Nominal GDP (€ bn)	188.7	178.9	161.3	156.5	159.0	162.3	166.2	172.3	179.9
Real GDP % change	5.4	-2.1	-5.5	-0.8	1.4	0.4	1.1	2.2	2.8
Deflator % change		-3.2	-4.6	-2.2	0.2	1.7	1.3	1.4	1.6
Output gap	6.8	3.5	-2.4	-3.2	-2.0	-2.1	-1.9	-1.2	-0.4
Greece									
General government balance[1]	-6.8	-9.9	-15.6	-10.7	-8.2	-6.6	-4.6	-3.5	-2.1
Interest payments	4.8	5.1	5.2	5.8	7.1	5.1	4.6	5.0	5.1
Primary balance	-2.0	-4.8	-10.4	-4.9	-1.1	-1.5	0.0	1.5	3.0
Cyclical effects	4.3	4.3	3.1	1.4	-1.1	-3.3	-4.6	-4.1	-2.9
Cyclically-adjusted primary balance	-6.3	-9.1	-13.5	-6.3	0.0	1.8	4.6	5.6	5.9
change		-2.8	-4.5	*7.2*	*6.3*	*1.8*	2.7	1.0	0.3
General government debt	107.4	112.9	129.7	148.3	170.6	161.9	175.5	169.7	161.6
Nominal GDP (€ bn)	223.2	233.2	231.1	222.2	208.5	195.0	184.5	185.0	191.1
Real GDP % change	3.5	-0.2	-3.1	-4.9	-7.1	-6.4	-4.2	0.6	2.9
Deflator % change		4.7	2.3	1.1	1.0	-0.7	-1.2	-0.3	0.4
Output gap	10.0	9.9	7.3	3.3	-2.6	-7.7	-10.6	-9.4	-6.7

[1] Net of bank recapitalization outlays and debt assumption
e = IIF estimates; p = program
Source: Eurostat, European Commission, IMF

Greek government debt rose much less during 2010-2012, with the debt/GDP ratio increasing 32 percentage points. The increment would have been much larger, of course, equal to 73 percentage points, had it not been for the March debt exchange and the December buyback. Borrowing needs were buoyed by bank recapitalization costs beyond those triggered by the haircuts taken in March and December on Greek government debt holdings. These amounted to another €17 billion, or 9% of GDP, almost all of it incurred in 2012. Unlike Ireland, Greece had no assets to draw on for bank recapitalization.

Chart 4
Inward FDI, 2000-2011
percent GDP

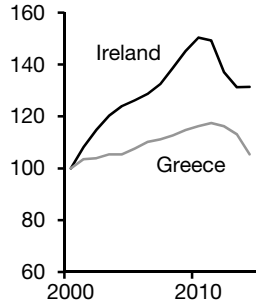


STRONG UPWARD PRESSURE ON GREEK DEBT RATIOS DUE TO FALLING GDP

Three years of output contraction have added more than 30 percentage points to the Greek government's debt/GDP ratio. At least six points of this increase reflected cyclical revenue declines; the remainder derives from the effects on the ratio of a decreasing denominator.

Greece's higher debt level, of course, has meant that the effects of decreases in GDP have been larger on the debt/GDP ratio than would have been the case in Ireland, had Irish GDP fallen by the same magnitude over the same period. Irish GDP, however, rose marginally over the period. The modest recovery in real activity in Ireland that began in 2011 suggests that Irish government debt should peak this year not far from last year's level, assuming fiscal targets continue to be met. Underpinned by renewed growth, these debt dynamics are more positive than in the rest of the Euro Area periphery. They are also a key reason Irish bond yields have declined so much and help explain why bond market access has begun to be restored.

Chart 5
Employment
2000 = 100



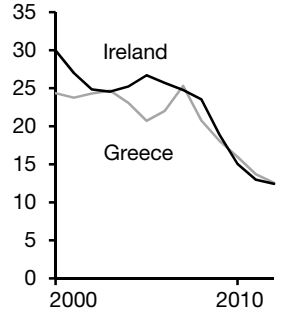
GROWTH HAS DIFFERED, TOO

Why has Ireland returned to growth so much faster than Greece? And what accounts for the harshness of Greece's output contraction? Ireland's better growth performance is often attributed to the fact that it started out with far fewer of the structural rigidities that characterize the Greek economy. Added to this is a low corporate income tax rate. This makes Ireland attractive to inward foreign direct investment, which has averaged 7.0% of GDP a year from 2000-2011, compared with 0.8% in Greece (Chart 4, previous page). These strong inflows in FDI helped Ireland grow at an annual average rate of 6.6% in the 10 years prior to the bursting of its property bubble in 2007.

But in terms of growth performance prior to the crisis, Greece did not lag behind very much, despite much smaller inflows of FDI. Growth in the Greek economy averaged 4.0% a year from 1997 through 2007.

The main difference between the two economies during this period was in the availability and utilization of labor. Employment grew 4.2% a year in Ireland, partly reflecting immigration and further increases in participation among women. Employment in Greece grew by 1.5% a year over the same period (Chart 5). Labor productivity gains were marginally higher in Greece at 2.5% a year (versus 2.3% in Ireland). The same was true of total factor productivity, which on average grew 1.8% a year in Greece over this period, compared with 1.7% a year in Ireland. Despite much larger inflows of FDI, fixed capital formation in Ireland was not much higher than in Greece, averaging 24% of GDP during 2000-2007 versus 23% (Chart 6).

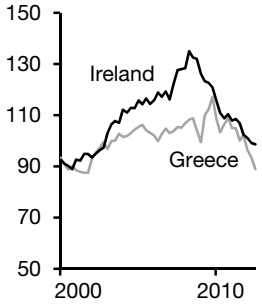
Chart 6
Fixed Capital Formation
percent GDP



EXPORTS HAVE BEEN KEY

Improvements in external competitiveness have played an important role in Ireland's recent recovery, as has its greater dependence on foreign as opposed to domestic demand. Relative unit labor costs declined by 19% in Ireland and by 20% in Greece between 2009 and the third quarter of 2012 because of nominal wage declines, labor shedding and the depreciation of the euro versus trading partner currencies (Chart 7). Exports matter more in Ireland, where domestic value-added in exports averaged around 55% of GDP during 2010-2012, based on recently published OECD estimates. The comparable figure in Greece was 15%.

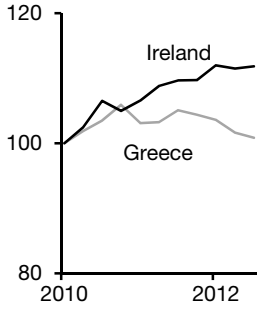
Chart 7
Relative Unit Labor Costs
1999Q1 = 100



The greater relative dependence of the Greek economy on domestic spending reflects in part a weak export performance since the crisis began

The greater relative dependence of the Greek economy on domestic spending reflects in part a weak export performance since the crisis began. Despite substantial improvements in its competitiveness and significant growth in export market demand, Greek exports of goods and services managed an average real increase of only about 1% during 2010-2012 (Chart 8). Two factors specific to Greece have constrained exports: decreases in tourism (because of widely-reported demonstrations and travel disruptions) and sharply diminished access to credit, especially normal trade financing, for exporters of goods and services. Diminished access to credit, in turn, reflected both the severe liquidity pressures faced by Greek banks and insistence on cash payments by trading partners because of elevated global aversion to Greek risk.

Chart 8
Export Volume
2010Q1 =100



Ireland, by contrast, saw export volume gains averaging roughly 5% during the same period, thanks to greater dependence on the U.S. market, where recovery has been stronger, increases in export capacity financed by strong inflows of FDI and somewhat stronger improvements in competitiveness. Among export-oriented firms, these improvements are likely to have been larger than the differences cited above in changes in economy-wide relative unit labor costs. In Ireland, these have been centered in the private sector, as public sector wages were left little changed because of agreements with unions signed prior to the start of the program. In Greece, by contrast, wages have been cut in the public sector as much or more than in the private sector.

Using OECD estimates of the share of domestic value-added in exports, Ireland's relatively larger dependence on exports suggests that export gains boosted Irish GDP by 2.5% a year during 2010-2012 (Table 2). Other factors, therefore, combined to reduce real GDP by 2.2% a year, leaving overall growth slightly positive. On the other hand, minimal export growth and the small relative share of exports suggest that factors other than exports caused real GDP in Greece to contract by 6.3% a year during 2010-2012.

Table 2
Relative Effects of Fiscal Consolidation
%, annual average

	2010-2012		
	Ireland	Greece	Difference
Real GDP Growth	0.3	-6.0	-6.3
Export Effects	2.5	0.3	-2.4
Other	-2.2	-6.3	-3.9
Fiscal Headwind Effects	-0.9	-5.2	-4.3
Other	-1.3	-1.1	+0.2
Memoranda:		% GDP	
Fiscal Consolidation Measures	3.6	7.8	4.3
Change in Cyclically-Adjusted Primary Balance	1.7	5.2	3.5
Effect of Fiscal Headwinds on Debt/GDP Ratio	1.1	9.9	8.8
On Denominator	0.8	7.8	6.8
On Numerator Via Revenues and Interest	0.3	2.3	2.0

Source: Eurostat, European Commission and IIF estimates

BUT DIFFERING FISCAL HEADWINDS HAVE MATTERED MORE

The most important factor explaining the difference in growth performance has arguably been the more marked pace of fiscal adjustment in Greece

Influences other than exports, therefore, are likely to have accounted for about two-thirds of the difference in growth performance between Ireland and Greece during 2010-2012. The most important single factor explaining this difference has arguably been the more marked pace of fiscal adjustment in Greece. Measured as the reduction in the primary fiscal deficit, net of cyclical effects and one-offs such as bank recapitalization, debt assumption and contributions to the ESM, this averaged 5.2% of GDP a year during 2010-2012. The comparable figure for Ireland, 1.7% of GDP, was less than one-third as much.

The negative effects of this sharper pace on growth were intensified in Greece because of a large fiscal multiplier

The negative effects of this sharper pace on growth were intensified in Greece because of a large fiscal multiplier, which is likely to have been more than double that experienced in Ireland. A range of academic studies, some based on econometric models of each economy, suggest an aggregate fiscal multiplier in Greece of 1-1.5, compared with one of no more than 0.5 in Ireland.

A larger multiplier would be consistent with the smaller share of imports in Greece, which would argue that changes in domestic spending should have a proportionately larger effect on domestic activity. A larger multiplier would also be consistent with the greater degree of economic slack. This should have been the case in Greece, given the sharper decline of real GDP and more marked jump in unemployment. Both these factors figure prominently in the larger negative output gaps which the IMF and the European Commission estimate for Greece, compared with Ireland (Charts 9 and 10). The marked widening of Greece's negative output gaps suggests, moreover, that the fiscal multiplier operating there has increased over time.

Neither country has been able to benefit from an easing of monetary policy or monetary conditions in response to fiscal consolidation

As members of the Euro Area, neither country has been able to benefit from an easing of monetary policy or monetary conditions, as would have been expected in countries with their own central banks, in response to fiscal consolidation. Lower Euro Area interest rates might have offset some of the fiscal adjustment carried out by both countries, but wider sovereign risk premia (compared with prior to the crisis) and additional charges passed along to borrowers are likely to have more than offset the effects of ECB easing since 2009.

Chart 9
Greece: Output Gap
percent

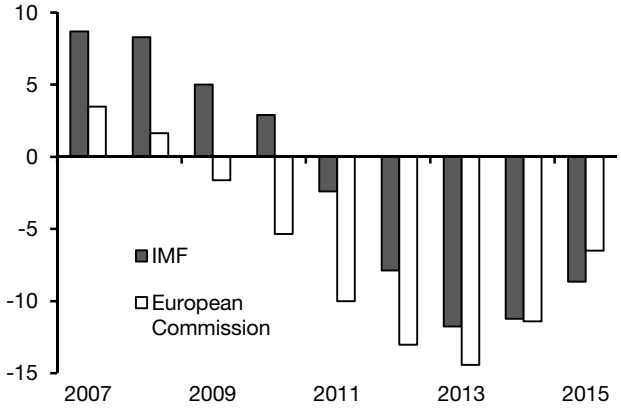
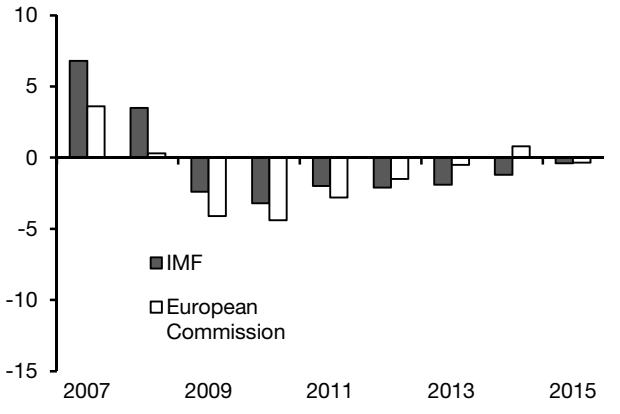


Chart 10
Ireland: Output Gap
percent



In Ireland, these additional charges were from the government for bank liability guarantees. In Greece, they were from the government and the central bank in connection with access to and guarantees of Exceptional Liquidity Assistance from the Greek central bank. The effects of these additional charges have been reinforced by higher costs for market funding. In Greece, where bank liquidity has been under intense pressure from deposit withdrawals and stringent criteria limiting ECB funding, bank credit has contracted more sharply, reinforcing the effects of fiscal consolidation on domestic demand and activity.

Irish households may have been more "credit constrained", given much higher levels of mortgage debt. Stepped-up saving out of current income, however, has enabled a substantial portion of this debt to be repaid and combined with stable or increasing deposits to leave Irish banks under much less liquidity pressure than their Greek peers. Irish banks, as a result, have been able to make significant repayments to the ECB since the Irish program began in late 2010.

FISCAL HEADWINDS IN GREECE HAVE BEEN FEROCIOUS

The milder pace of Irish fiscal adjustment suggests that "fiscal headwinds" have reduced real GDP by almost 1% a year during 2010-2012

Using aggregate multipliers of 0.4 for Ireland and 1.0 for Greece, the milder pace of Irish fiscal adjustment suggests that consolidation measures have reduced real GDP by almost 1% a year during 2010-2012. Other factors, mainly exports, have added 1¼% a year to real GDP. In Greece, a multiplier of 1.0 would suggest that fiscal consolidation efforts have caused real GDP to contract by 5¼% a year, while other factors – besides exports– have caused real GDP to decrease another 1% a year.

The consequences of these fiscal headwinds for debt/GDP ratios are worth noting

The consequences of these fiscal headwinds for debt/GDP ratios are worth noting. While the smaller deficits that result from fiscal consolidation efforts have done much to slow the increase in the numerator, the effects on the denominator in the case of Greece has been to add 10 percentage points a year to the debt/GDP ratio. This takes into account both the reduction in nominal GDP and the effects of lower domestic spending and incomes on taxes. This is 9 percentage points more than the impact of fiscal consolidation on the debt/GDP ratio in Ireland.

Steady program implementation and renewed growth have been key in reviving demand for Irish government debt

Because financing pressures were less severe than in Greece (bond maturities to be refinanced were much smaller), and cash reserves and other assets much higher, Ireland was at the outset able to secure the agreement of its official creditors to a more gradual pace of fiscal consolidation than in Greece. The important result for Ireland has been slower progress in reducing its deficit, leaving Ireland's debt/GDP ratio on an upward path through 2013. The steepness of that path has been tempered, however, by the renewal of Irish growth, which should also begin to narrow the deficit, as cyclical effects boost revenues. The more manageable pace of fiscal adjustment has helped support an earlier return to growth. Undoubtedly, consolidation measures have been painful but more manageable politically and socially, preserving support for fiscal program targets. These targets were achievable; those set for Greece, by contrast, were not. Steady program implementation and the renewed growth that the more manageable pace of fiscal adjustment has made possible have been key in reviving demand for Irish government debt. Stronger bond demand has

lowered bond yields, setting the stage for the government to restart bond issues. This policy strategy, it now seems increasingly clear, will enable Ireland's official creditors, and the taxpayers of the Euro Area, to be repaid on time and in full.

A USEFUL EXAMPLE FROM IRELAND FOR GREECE'S DIFFICULT CIRCUMSTANCES

Greece remains in very different, difficult circumstances. Another 7.4% of GDP of fiscal consolidation measures are required under its program in 2013-2014, two-thirds of which have been enacted for this year (Table 3, next page). Real GDP, as a result, will decline another 4-5% in 2013, adding another 9-10 percentage points to the government's debt/GDP ratio, mostly because of a further decline in the denominator. Whether things change significantly in 2014, when a smaller volume of additional fiscal consolidation is envisaged, will depend on whether further revenue weakness causes headline deficit targets to be missed once again, triggering troika demands for still further consolidation measures.

Real GDP in Greece will decline another 4-5% in 2013, adding another 9-10 percentage points to the debt/GDP ratio, mostly because of a decline in the denominator

Making Greece's debt dynamics more positive will require restarting growth. Doing so is likely to require not only the further advance of overdue essential reforms, especially product market liberalization and privatization, but the readjustment of Greece's program fiscal targets to incorporate the lessons of Ireland's useful example. Using the fiscal space gained from spreading out the remaining adjustment needed over a longer period of time should do much to stem the downward course of economic activity and renew growth. Using that space, along with stepped-up drawings on unused EU structural funds, to boost public investment might then convert a vicious spiral into a virtuous circle. With high multipliers, increases in public investment would help stabilize output and renew growth, helping to mitigate the adverse consequences of cuts in the government wage bill and pension benefits, softening the macroeconomic impact of those necessary measures.

Stretching out the fiscal adjustment timetable once again to eliminate the present front-loading may necessitate additional financing in the form of further reductions in interest rates on official credit to bring them closer still to historically low short-term funding costs. Additional financing might only be needed, however, until growth gets going again, boosting tax revenues. In the meantime, less emphasis would need to be given to projected levels of the debt/GDP ratio at the end of decade. Declines in the debt/GDP ratio will come but will be easier to accomplish when growth causes them to be driven more by increases in the denominator than costly and partly counterproductive efforts to reduce increases in the numerator.

Stretching out the fiscal adjustment timetable once again may necessitate additional financing, but only until growth gets going again

Table 3
Fiscal Consolidation Measures
% GDP

	2009	2010	2011	2012	2013	2014p	2015p
Ireland[1]							
Revenue	2.3	1.6	1.0	1.3	0.8	0.6	0.4
Personal Income	1.6	1.3	0.7	0.8	0.3	- -	- -
Corporate Income	0.1	0.1	0.0	0.0	0.0	- -	- -
Indirect Taxes	0.6	0.1	0.1	0.4	0.3	- -	- -
Social Contributions	0.0	0.0	0.2	0.2	0.3	- -	- -
Expenditure	2.7	3.0	2.6	1.3	1.4	1.2	0.7
Consumption	1.6	1.6	0.4	0.5	0.6	- -	- -
Transfer payments	0.0	0.8	1.0	0.3	0.5	- -	- -
Investment	1.1	0.6	1.2	0.5	0.3	- -	- -
Total	5.0	4.6	3.5	2.6	2.2	1.8	1.1
Greece							
Revenue	1.1	4.2	3.3	3.3	1.0	1.2	- -
Personal Income		1.3	1.0	2.5	0.3	0.5	- -
Corporate Income	0.0	0.5	0.6	0.1	0.0	0.2	- -
Indirect Taxes	0.2	2.4	1.4	0.6	0.4	0.1	- -
Social Contributions	0.0	0.0	0.3	0.1	0.3	0.4	- -
Expenditure	-3.0	4.4	4.7	3.5	4.1	1.1	- -
Consumption	-2.4	2.9	1.8	2.1	1.3	0.7	- -
Transfer payments	-1.2	1.0	2.0	1.0	2.7	0.4	- -
Investment	0.6	0.5	0.9	0.4	0.1	0.1	- -
Total	-1.9	8.6	8.0	6.8	5.1	2.3	1.5

[1] As announced and estimated in annual budgets
p = program

