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THE IRISH RECOVERY 1987-90: AN ECONOMIC MIRACLE?

BY

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The Irish Recovery 1987-90: An Economic Miracle?

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October 1991

1. Introduction

The details of Ireland’s recent economic recovery are well known. GNP growth increased dramatically from 1987, the unemployment rate fell by 3 percentage points between 1987 and 1990, the balance of payments on current account went from deficit into surplus, inflation remained low, investment and private-sector consumption boomed, and interest rates swung well below British levels while two-thirds of the differential against the Deutschmark rate disappeared.

That the recovery occurred during a period of severe fiscal contraction has led a number of commentators to argue that the cutbacks were a major force behind the recovery. This view, known as the "expansionary fiscal contraction" hypothesis, has been espoused in particular by Giavazzi and Pagano (1990) and by Dermot McAleese (1990a,1990b), and seems to have gained

* An earlier version of this paper was presented at a seminar at the Economic and Social Research Institute. The helpful comments of seminar participants are gratefully acknowledged, as is the invaluable assistance of Dr Anthony Leddin of the University of Limerick who provided much of the data. The author alone however is responsible for the opinions expressed in the paper.
widespread acceptance. It has been referred to in one business magazine, for example, as providing "the definitive account" of the period.

The present paper argues that this view is contradicted by the behaviour of almost every key macroeconomic variable.

2. The hypothesis of "expansionary fiscal contraction".

The cornerstone of this hypothesis is the (reasonable) belief that a reduction in the government budget deficit creates the expectation that future tax liabilities will be lower than the private sector had been assuming. This increase in expected future wealth raises consumer spending, while investment is stimulated both by the anticipation of more buoyant private sector spending in the future and by the reduction in interest rates to which fiscal stabilisation gives rise.

If this were as far as the hypothesis went, it would be uncontroversial; it would merely add another form of demand-side "crowding out" (whereby changes in government spending bring into play processes which impact in the opposite direction on private sector spending) to the ones everyone has known about since the Keynesian-Monetarist debates of the 1960s and early 70s. This would change the quantitative but not the qualitative effects of government spending.
The "expansionary fiscal contraction" hypothesis goes much further however. It implies that there is more than 100% crowding out, i.e. that the expansion in private sector spending due to a more optimistic assessment of the future dominates the contraction in government spending; fiscal contraction is therefore argued to raise aggregate demand, employment and output.

It is worth citing the evidence that the proponents of "expansionary fiscal contraction" (henceforth EFC) mean it to imply that more than 100% crowding out occurs, because this is the case that the present paper sets out to combat. Giavazzi and Pagano, for example, state their aim as to determine whether or not "the contractionary Keynesian effect of a spending cut prevails on its expansionary expectational effect", and conclude that the view that it does not "has a serious claim to empirical relevance".

McAleese (1990a) argues that "the adjustment process did not halt growth: it made it happen! The sequence of events was the direct opposite of that predicted by the standard Keynesian model which many of us learned as undergraduates. Fiscal retrenchment led not to recession but to recovery" and, in a later paper on the same topic, he explains that EFC "states that fiscal contraction, instead of leading to deflation, can actually result in an expansion of economic activity", concluding that "there is

1 The emphasis on domestic aggregate demand in this literature strikes the author as somewhat perversely Keynesian!
considerable evidence that EFC has been at work in the Irish economy in recent years."

Before reevaluating this evidence, I will attempt to reconstruct from the two McAleese papers and the article by Giavazzi and Pagano a unified story of the Irish recovery, which can be subjected in following sections to a critical scrutiny in regard to its logical coherence and to the timing of key events.

The authors accept that the initial spur to growth was strong export performance in 1987, that this was followed by a jump in private sector consumption in 1988 and by a strong return to positive levels of private sector investment in 1989. Giavazzi and Pagano however point out that Irish export growth was as strong in the years they classify as the earlier "failed" stabilisation period, 1982-84, as it was in the later more successful period, so that the boost to consumption and investment between 1987 and 1990 must have been due, not to the export performance, but rather to the "improved expectations" effect which was absent in the earlier period.

They therefore leave us with the impression that external conditions in the 1982-84 and 1987-90 periods were similar, and cannot therefore be accepted as the driving force behind the recovery.

Furthermore, they argue, the downward pressure on interest rates stemming from fiscal contraction and the commitment to exchange
rate stability was similar in the two periods, so the expectations effect is required to explain the success of the later stabilisation.

Having developed an alternative explanation of the recovery, I will return in a later section to discuss whether external factors were similar in the 1982-84 and 1987-90 periods, since it is this argument that allows the EFC school to dismiss the external environment as the major cause of the recovery.

3. An Analysis of the Recovery

In this section I wish to argue that the behaviour of key variables is inconsistent with a domestic-demand driven boom.

(i) Unemployment, Employment Growth and Emigration

Let us explore the extent of the recovery in terms of the unemployment rate first of all. Figure 1 shows that unemployment peaked in 1987 and fell for the remainder of the period under discussion. That this coincided with a period of very contractionary fiscal policy has been taken to indicate that the latter caused the former; the difficulty with this interpretation is that a similar fall in unemployment occurred from the mid to late 1970’s - a period of strong fiscal expansion!

2 Their view is that the fiscal stabilisation bolstered confidence in the government’s ability to maintain a fixed exchange rate against the DM. This, through interest rate parity, brought nominal rates down towards German levels and, with inflation inertia, real interest rates followed.
More revealing is the graph of the difference between the Irish and UK unemployment rates, also shown in Figure 1. We see that the gap between the two fell during the period of Irish fiscal expansion; Walsh (1987) and Barry and Bradley (1991) have presented econometric evidence on this relationship. It is clear that the recent period of fiscal contraction has not been associated with any such narrowing of the gap, at least until 1990³. Indeed if one measures fiscal stance in terms of changes in the cyclically-adjusted budget deficit, a measure with a stronger foundation in economic theory, the contraction is seen to have begun in 1982 and to have been associated with a sustained widening of the gap; cf. Barry (1991)⁴.

Further skepticism as to the strength and causes of the recovery is induced by noting that employment growth has not been particularly strong during the recovery, relative to that in the UK and the European Community (see Figure 2).

If employment growth has been poor, one is led to suspect that emigration has played a key role in keeping the Irish-UK unemployment gap lower than it would otherwise have been.

³ It is too early to isolate the factors accounting for the 1990 experience because fluctuations in the international environment affect the Irish economy with a lag, as can be seen in Figures 1 and 2 of Barry (1991) which compare the Irish and OECD inflation and unemployment experiences.

⁴ This is not to suggest however that there is no difference between a fiscal contraction brought about through tax increases, as occurred in the early 1980s, and one which is engineered through reductions in government spending, as the post-87 contraction has been.
Figures for net emigration are shown below:

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<td>Average 1980-85</td>
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Even during the recovery, then, emigration continued to increase. There is little doubt that the unemployment rate, in the short term at least, would have been higher were this "safety valve" not in operation.

(ii) The Manufacturing Sector

A closer look at the sectors in which the growth in manufacturing employment took place in recent years will shed further light on the importance of domestic- and external-demand factors in driving the Irish recovery.

IDA data, charted in Figure 3, reveal that of the total increase in manufacturing employment in the 1987-90 period, 11534 net jobs were created in the foreign sector while the net increase in the indigenous sector was 8070. The implication would seem to be that the recovery has been more strongly influenced by the kinds of factors that drive multinational investment than by those upon which indigenous manufacturing is based. Since the first sector

5 This point should not be overemphasised however, since the indigenous sector has been performing poorly relative to the multinational sector for decades; see e.g. O'Malley (1989).
has a much stronger orientation to export markets than the second, while the supply of multinational investment is also strongly determined by world market conditions, the buoyant world economy would appear to have been a stronger driving force in lifting the Irish economy out of the doldrums than domestic demand conditions have been.

That the world economy was booming during the period of the Irish recovery is not of course in dispute. As McAleese (1990a, p.22) himself points out: "(the) volume of EC imports of goods and services increased by 8% p.a. during the period 1986-89 compared with 2% p.a. 1981-85. More important, UK imports grew by 8.7% per annum 1986-89 compared with 4.2% p.a. 1981-85". What is in dispute is whether conventional factors such as this were sufficient to overcome the contractionary effects of fiscal contraction, or whether one needs to posit an expansionary fiscal contraction to explain the recovery.

(iii) Inflation

Maintenance of a low inflation rate has been read in some quarters as another indication of the strength of the economy in recent years. In fact it need represent no such thing; it can indicate a strong or a weak economy.

Bruno and Sachs (1985) present evidence that the sharp bursts of

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6 The Survey of Current Business published by the US Department of Commerce in March 1991 argues that the major factor behind the recent increase in US investment in Europe has been the move towards the Single Market.
inflation in the world economy in the late 1960s and the 1970s were the result of various expansionary demand-side policies and negative supply-side shocks. In the absence of major supply-side shocks over the last few years, the creep upwards in OECD inflation can be ascribed to buoyant aggregate demand.

To the extent to which a small and open economy like ours has an influence over its inflation rate, one would therefore presume that a "good" inflation performance relative to our trading partners indicates that the domestic economy has been relatively weak, as the unemployment experience also indicates.\(^7\)

This hypothesis is supported by evidence presented in OECD reports on Ireland in the 1980s indicating that of all OECD countries Ireland had experienced the largest reduction in inflation and the largest increase in unemployment. The situation has not changed markedly since then, and the lesson to be drawn is surely that our very low inflation rate has been purchased at the expense (in the short term at least) of unemployment – both these effects (when measured relative to our trading partners) being associated with weak domestic demand.

The maintenance of a low inflation rate offers no support for the theory of expansionary fiscal contraction. If more than 100% crowding out had occurred, the fiscal contraction should have

\(^7\) This is not to suggest that inflation and unemployment cannot jointly be reduced through supply-side measures (such as increasing competition in the non-traded sector, for example); merely that the maintenance of our low inflation rate in recent years has had other causes.
been reflected instead in a domestic-demand-driven boom, leading to some worsening of our relative inflation rate.

Indeed there is further evidence that the fiscal contraction must have reduced aggregate demand. The 1986 devaluation, according to the econometric evidence to date on this topic, should have been completely offset by higher inflation within about two years, but, as Leddin (1991) notes, "such an increase in inflation is not evident from a simple inspection of the trends...Irish inflation continued to converge, without any noticeable blip, on the German rate"; see Figure 4.

Why was the inflation experience in the wake of the 1986 devaluation so different from what it had been up to then? The answer has to be that the upward pressure on inflation exerted by the devaluation was offset by downward pressure from some other quarter — i.e. from the contractionary fiscal contraction!

(iv) The Balance of Payments

The evidence furnished by the performance of the current account

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8 Figure 6 shows that while the devaluation simply readjusted the Irish pound back in line with sterling, it represented a real adjustment against the DM. The econometric evidence in Callan and Fitz Gerald (1989) suggests that this would have raised the Irish-German inflation differential in terms of the wholesale prices of manufactured goods. Figure 4 shows that it did not do so in terms of consumer prices; indeed Irish prices began to converge more rapidly. The implication then is that the fiscal contraction reduced the price of non-traded goods (which are included in the CPI but not in Callan and Fitz Gerald’s wholesale price index), thereby preventing the wholesale-price inflation from feeding through into the CPI.
of the balance of payments in recent years tells a similar story to that suggested by the inflation experience. The balance switched from a deficit of 3% of GNP in 1986 to a surplus of 1.3% in 1987 and has remained positive since then. If we focus on the demand side, as the EFC school does, would this provide evidence of buoyant or of weak domestic demand relative to that in our trading partners? The answer must be the latter, since a more buoyant domestic economy would raise imports more rapidly than exports.

Besides weak domestic demand and the coming on stream of multinational investment, there was another factor behind the balance of payments turnaround, as Leddin (1991) emphasises; this was the economy’s relative competitiveness gain since 1986, shown in Figures 5 and 6. These competitiveness effects on the current account complement the demand-effects focussed upon here, but work in the opposite direction to the effects that would arise were the EFC argument valid.

(v) Interest Rates

Investment and consumption decisions are affected by real interest rates, i.e. by nominal interest rates less the expected rate of inflation. To see how fiscal policy affected real rates we need to look at its impact on both these variables.

Under interest rate parity, the nominal rate is driven by foreign rates adjusted for expected changes in the exchange rate. Inflation seems to adjust sluggishly – i.e. over a period of
several years - towards the levels prevailing in our trading partners. A fiscal contraction, then, it could be argued, might reduce the real interest rate by raising the confidence of financial markets in the credibility of the fixed exchange rate commitment within the EMS. This would allow the nominal interest rate to fall, which in conjunction with inflation inertia would translate into an expansionary fall in real interest rates.

Is this the whole story behind the movement of real interest rates towards German levels in the post-1987 period? (Figure 7). Leddin (1991) points out that there is a problem with this, since "real interest rates started to decline before the government introduced a deflationary budget in 1987. It will be recalled that the government which introduced the 1987 budget had been elected a short time earlier on the promise of introducing an expansionary fiscal policy and only changed the policy stance immediately before the budget. This means that some ... factor (other than the expectation of fiscal contraction) must have caused the decline in real interest rates in the first instance".

A clear candidate is the devaluation of the Irish pound in August 1986, which was followed by a sharp rise in our international competitiveness, whether measured in terms of the real exchange rate (Figure 6) or in terms of wage costs in a common currency (Figure 5). The competitiveness gain could have increased

\[9\] In the Barry-Bradley (1991) analysis, which relies on simulations of the ESRI macromodel, this mechanism does not have room to come into play. Recognising its possible importance however, we commented in a report to the NESC that "if a devaluation of the Irish pound happens to occur at a time of very
market confidence in the stability of the new exchange rate and put downward pressure on nominal rates.

If expectations were in any way rational, furthermore, the devaluation would also have led to the expectation of higher inflation; (as mentioned earlier, the econometric evidence suggests that the competitive gains of a devaluation would generally be offset by higher inflation within two years). The real interest rate, then, measured correctly with respect to expected inflation, would have fallen.

What about the phase of fiscal contraction that began with the January 1987 budget? It clearly strengthened market confidence in the exchange rate, and brought nominal interest rates down. Its effect on the real interest rate would be less clear, though, since the fiscal contraction would not only reduce inflation directly through contractionary demand-side effects already established, but would also, by enhancing confidence in the new exchange rate, facilitate the fall in the inflation rate of traded goods towards German levels.

As Giavazzi and Pagano accept, the devaluation therefore seems to play an important role in combination with the fiscal contraction in explaining the convergence of real interest rates to German levels in recent years.

high unemployment, as happened in 1986, it may speed up the Phillips Curve effect of unemployment on real wages". 

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Even if the fall in real interest rates were solely due to the fiscal contraction from 1987 onwards, however, could it be concluded that this sequence of events is "the direct opposite of that predicted by the standard Keynesian model"? Hardly - in fact, the reduction in real interest rates that a fiscal contraction induces in a model with inflation inertia is recognised in the most common textbook Keynesian model; it is the downward shift of the IS curve along the LM curve!

(vi) Differences between the first and second stabilisations

As mentioned earlier, Giavazzi and Pagano compare two periods of fiscal contraction, 1982–84\(^{10}\) and 1987–90. According to them, the impact of the stabilisation programmes on nominal and real interest rates were similar, while export growth was the same in both periods. Therefore, they suggest, the confidence factor stemming from the second stabilisation must explain the difference in outcomes.

There are several weaknesses in this argument. First of all, Irish competitiveness was moving in different directions in the two periods (Figures 5 and 6), so business expectations even if for that reason alone would have been more positive towards the end of the 1980s. More importantly though, the world economy was booming during the second period, and in recession during the first. The expectational effects stemming from the external

\(^{10}\) They do not explain why 1984 is chosen as the cut-off point.
environment and from movements in cost competitiveness were therefore much more positive in the second period, and these would have an impact on consumption and investment regardless of any changes in fiscal policy.

In any case, Giavazzi and Pagano seem much less convinced of the applicability of EFC to Ireland than to Denmark. They place more emphasis on the 1986 devaluation than on fiscal policies, and stress the importance of liquidity constraints in the Irish consumption function; these hinder credibility and expectational effects from manifesting themselves through increased borrowing and a consumer boom.

That EFC is proposed almost as an afterthought is evident from their summing-up, when they say that "it is tempting to relate the large forecast error of the Irish consumption function in 1988 with these two factors (i.e. that the second stabilisation was associated with a reduction in marginal tax rates, and that the liberalisation of credit markets had reduced liquidity constraints), and to conclude that the "German view" (i.e. EFC) may have had something to say also for the second Irish stabilisation".

4. Conclusions

The "expansionary fiscal contraction" hypothesis proposes that government cutbacks since 1987 induced a private-sector boom of such magnitude that the net effect on aggregate demand was positive. This expansion in domestic demand is then posited to
be the major force behind the recent economic recovery.

The argument presented in this paper is that this theory is belied by the behaviour of virtually every important macroeconomic aggregate.

If EFC had occurred Irish aggregate demand would have expanded more rapidly than elsewhere. This would have been reflected in a faster relative fall in unemployment; this did not occur. It would have been reflected in a relative deterioration in our inflation rate; this did not occur. It would have been reflected in a worsening of our balance of payments position; this did not occur.

In other words, if the recovery were primarily driven by a boom in domestic demand, it would have generated all the short-term effects that did show up when domestic demand was expanded relative to our trading partners (with such disastrous long-term consequences) in the mid- to late-1970s.

One is led to conclude that the factors which were working in the direction of recovery—buoyant world demand, improvements in cost competitiveness and an inflow of foreign investment in the lead-up to 1992—are more than outweighed the short-run contractionary effects of fiscal contraction. The lesson to be drawn from this, as from the debacle of policy-making in the 1970s, is a very old one: that counter-cyclical fiscal policies are vastly superior to pro-cyclical ones.
References


Read it again
Figure 1
Gap between Irish and UK Unemployment

Figure 2
Employment Growth (%) Total Economy

Source: OECD Employment Outlook
Figure 3
Manufacturing Employment (ooo's)

Figure 4
Inflation in Ireland, UK and Germany 1979-90
Figure 7

Differences in real interest rates
1979-90

Ireland - UK

Ireland - Germany

1979 q1 1980 q1 1981 q1 1982 q1 1983 q1 1984 q1 1985 q1 1986 q1 1987 q1 1988 q1 1989 q1 1990 q1