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Is Morgan Kelly right?

Compiled by LAURA SLATTERY and SUZANNE LYNCH

Fri, May 13, 2011

A compelling case for default and swift balancing of the national budget or a lethal injection for our economy and citizens? Twelve economists discuss

SEÁN BARRETT

Senior lecturer in economics Trinity College Dublin

IRELAND'S CHANGE from a full employment economy and solvency to 14 per cent unemployment and a bailout invites a contrarian response so well led by Morgan Kelly. Widespread institutional failure caused the twin crises in banking and the public finances. These then spread their contagion over the entire economy.

Regulatory capture and institutional malaise have dominated our responses to date. We need the provocative advice of Morgan Kelly to walk away from the bank crisis and tackle the public finances quickly rather than over several years.

With so many of the institutions and personnel who caused the twin crises largely exempt from its consequences, and likely to remain exempt, we need Kelly to remind them and us how much they have harmed this country.

Under "measures to prevent a recurrence" Kelly merits the tag of "required reading".

ALAN McQUAID

Chief economist Bloxham Stockbrokers

THE UNDERLYING theme of the Morgan Kelly article, apart from criticising individuals, is not saying anything new. What Joe Durkan and the ESRI are talking about is similar, in a way, to Kelly – they're both talking about speeding up the budget correction. Enda Kenny has dismissed the idea and I'd be with Kenny on this. The economy is too fragile.

The [Kelly/Durkan] argument is that it's the ECB's problem: a lot of the money was lent to us by European banks that should have known better. I wouldn't disagree with that. I think the ECB has to do a lot more before this crisis is over.

These are unprecedented times and my gut feeling is that I don't think anybody did anything deliberately to mess the State up, I think it was all in good faith. It does look like it was the wrong thing to do. Patrick Honohan is obviously in a difficult position given he is on the ECB. I'm not sure anyone could have done any better.

RAY KINSELLA

Economist UCD Michael Smurfit Graduate School of Business

IRELAND SHOULD withdraw from the euro zone and inform the next finance council of its decision. This will require pegging either to the UK's sterling, our largest trading partner, or to the "Deutsche" euro. Either way it will involve devaluation.

The transmission of the effects across the economy will involve negative, as well as positive, consequences. What can be said with near certainty is that it is the least worst option.

Domestic economic indicators and financial market data point to a terminal lack of credibility in the terms, scope and time-frame set out in the bailout. There is simply no way back from prevailing Irish bond yields and associated CBF spreads.

The recent euro zone policies have flown in the face of the markets' dispassionate analysis of the adjustment policies imposed on the Irish economy. The EU's €750 billion "shock and awe" initiative cobbled together in May 2010 singularly failed to firewall the periphery from contagion.

Recent proposals for a stabilisation mechanism by 2013(!) defy belief.

PAUL SWEENEY

Chief economist Irish Congress of Trade Unions

MORGAN KELLY'S article hit a real chord. He said it as it is. But his solutions would lead to chaos and impoverishment. He is correct about the immense stupidity of the bank guarantee and of the government continuing to repay these socialised private debts.

His most dangerous solution is to "bring the budget into balance immediately".

This would mean that the deflationary path currently being pursued by government – where one quarter of domestic demand was wiped out in just three years – would look positively benign. It would eviscerate the economy and wipe out too many businesses and citizens. Besides, few governments run balanced budgets.

This idea smacks of that most dangerous tendency in academic economics – to deliver prescriptions with little thought as to their impact on people. Fine in theory, appalling in practice. Interestingly, in its latest report, it is a weakness to which the ESRI has also succumbed as it does a volte face on previous recommendations and demands huge and immediate cuts.

Kelly is right on "disengaging from the banks" but it has to be done with EU agreement. Call it a "managed default".

TOM O'CONNOR

Lecturer in economics and public policy Cork Institute of Technology

I BELIEVE Morgan Kelly is correct in his assertion that Patrick Honohan was badly mistaken in going public on November 18th last, stating the Ireland would need a bailout. He is also totally correct that the bailout cannot be repaid and will have to be abandoned. Bondholder haircuts were rejected by the ECB also and the Irish negotiating team essentially rolled over for the ECB team subsequently.

The selfish motivations of the US and ECB, who were not concerned at all with the economic interest of Ireland, should alert policymakers immediately that the deal was never well intentioned and should never have been agreed.

Kelly's solutions are not the ones I would favour, however. His assertion that we eliminate an €18 billion Government deficit immediately is neither possible nor socially acceptable.

I do think that his way of dealing with the banks and the ECB is somewhat ingenious: the Government leaves the bailout and leaves the banks by default to be supported by the ECB, who ultimately will have to swap their debt for share capital. The ECB picks up the €160 billion tab. However, this could create huge uncertainty and frighten international investors.

BRIAN LUCEY

Associate professor in finance Trinity College Dublin

PATRICK HONOHAN couldn't change the guarantee – that's a political decision. I'd be amazed if he didn't argue strenuously for some change. In his previous existence, he had argued that we should be cautious with guarantees. Clearly, he lost the argument.

I don't think Honohan could have said anything much more than what he said – he is constrained by his position. It's important to remember that he is not the representative for Ireland on the ECB, he's the representative from Ireland.

I do think the Government could do well to accelerate balancing the budget. But I would lean more towards the ESRI than Kelly .

I think it's absolutely clear we have got to make our move very quickly. I don't know why we are waiting. I'd be astonished if the governments of Greece, Portugal and Ireland weren't working together in their common interest.

It’s very easy for politicians to be dismissive of articles by academics, but they should prove or dismiss those analyses on their own logic. What we really need to do is dig into the views of the Department of Finance.

FERGAL O’BRIEN

Chief economist Ibec

WE WOULD agree with some of what Morgan Kelly says and disagree with some of it. Overall there is considerable merit in doing a relatively fast fiscal balance. The quicker we do it, the stronger position we will be in in terms of our debt management options.

But it is not an exact science and, obviously, it cannot be done in a year.

Doing it in a single year would be far too brutal; there would be far too much damage to the economy and it would be far too much of a social challenge.

I think there’s no question but for Ireland to remain an attractive location for investment, we must work within the loan arrangements that are in place. If we isolate ourselves, we will be undermined. Europe hasn’t yet fully acknowledged the interconnectedness of sovereign and banking debt.

As it does so over the next few years, it will work in our favour.

There is a big difference between being a player with full information and being an observer and having partial information. There are certain people who have much more information than the rest of us.

STEPHEN KINSELLA

Lecturer in economics University of Limerick

MORGAN KELLY is a true social scientist. He takes data, looks at the economic and political realities in the economy, and makes a judgement which he communicates clearly. He has been spot on in his analysis to date, and while I was initially sceptical of his views, I’m now converted to the notion that Ireland has nothing but drastic options left to it.

I’ve tried to cost Kelly’s latest plan myself, and it isn’t pretty. Kelly’s views should be engaged with by policymakers, not because they are always right, but because they represent a challenge to the status quo that we need in a policy space filled with sycophants.

MOORE McDOWELL

Senior lecturer University College Dublin

MORGAN KELLY is definitely not a master of understatement and let's just say his colourful way of expressing himself doesn't do him any favours. Nonetheless I agree with about 80 per cent of what he says. He rightly says the decision to introduce the guarantee in 2008 was the wrong decision. But it's very unfair to accuse Patrick Honohan of making the "costliest mistake ever made by an Irish person". Messrs Cowen and Lenihan did that.

What Kelly is saying is that, while we have failed to burn the bondholders – the horse has bolted, as it were – we should now burn the ECB. The key problem in Kelly's argument is the conclusion he reaches. Putting the entire budget deficit right this year would involve a 30 per cent cut in Government spending, which equates to 10-12 per cent of GDP. The effect that would have on aggregate demand and employment would be colossal.

Kelly's figure of €250 billion in national debt is very much in the top-range estimates. Even the most pessimistic commentators say €230 billion. However, the question of whether the national debt is sustainable is the key issue.

TONY FOLEY

Senior lecturer in economics Dublin City University

I DO not agree that we are heading for economic ruin, although one could argue that large decline in GNP, 15 per cent unemployment and the likelihood that it will be 2017 or so before 2007 levels of economic activity will be resumed is already economic ruin.

I agree the Central Bank got its assessment of the scale of the bank bailout wrong and we only seemed to face reality when the EU-IMF required the involvement of the independent Blackrock assessment. Maybe if we had known much earlier the final scale, we would have had a stronger basis for an alternative approach.

In 2013, we will still be unacceptable to financial markets and there will have to be "Bailout Two" or a continuation of paying interest without repaying capital, with whatever additional money is needed to pay market bonds that are due. You could call this a default but it would be an agreed restructuring with the EU and IMF.

I do not agree we can walk away from the banks and presume the ECB will continue to operate them for our benefit as the new owners. It would be nice if the ECB did so.

JOHN McHALE

Professor of economics NUI Galway - Speaking on RTÉ's *Morning Ireland* , May 9th:

CERTAINLY, EARLY in the crisis Morgan Kelly was very much ahead of everybody else in seeing it coming and I think his early analysis was incredibly valuable.

But I think in his recent articles, and particularly this one, he is really going off in the wrong direction.

I think he has been quite unfair to Patrick Honohan. Honohan wasn't the one that gave the original blanket guarantee, but he inherited it.

Morgan puts a lot of emphasis on protecting Ireland's reputation and says we shouldn't default to protect that reputation, but reneging on the guarantee, which is what he calls on Patrick [Honohan] to have done, would have been reneging on a sovereign obligation and it would have done incredible reputational damage, and it would have really created a hornet's nest of legal issues, so I think it's just completely wrong to put the problems that have resulted from the guarantee on Patrick's shoulders.

The proposals that Morgan Kelly is putting forward, which are essentially to wash our hands of the banking system and also to cut our borrowing to zero immediately, would actually have devastating effects for the economy.

It would essentially destroy the banking system, and would not only require cuts of about a third in public spending but it would put us into another very deep recession.

JOE DURKAN

Economist Economic and Social Research Institute - Speaking on RTÉ's *Morning Ireland* , May 11th:

IF WE went bust, then banks in Europe would go bust. That means we are interdependent, and if that interdependence exists, then the right thing to do is to take an interdependent approach to it, which really means doing it at euro level.

Like everything else, you need to do it quickly, because the truth of the matter is while the debt is sustainable in a purely technical sense, it is by no means optimal.

If they don't help us, then it impacts on others and there's a possibility that we could just fail.

If you look at what's happening in the other countries, it is stop-gap measures you have all the time, and I don't think we need stop-gap measures, I think we need something new and innovative.

I don't agree with debt figure of €250 billion. The most I can see is five to six years' time is €195 billion, maybe €200 billion.

The second thing is, he had a point about when the debt goes over 100 per cent, you're in trouble. In fact, that's not strictly true.

Technically, we know that it's possible. The real issue is whether you can get a primary budget surplus, which is your budget surplus excluding your interest payments, above a certain level. It's a purely technical relationship, that the real interest rate minus the real growth rate times your debt-GDP ratio has to be less than your primary budget deficit.

WHAT THEY SAID: KELLY'S ARTICLE, HONOHAN'S RESPONSE

Quotes from Morgan Kelly's original article published in *The Irish Times* last Saturday:

"With the Irish Government on track to owe a quarter of a trillion euro by 2014, a prolonged and chaotic national bankruptcy is becoming inevitable . . . While most people would trace our ruin to to the bank guarantee of September 2008, the real error was in sticking with the guarantee long after it had become clear that the bank losses were insupportable . . .

"The ideal time to have reversed the bank guarantee was a few months later when Patrick Honohan was appointed governor of the Central Bank and assumed de facto control of Irish economic policy . . . Honohan's miscalculation of the bank losses has turned out to be the costliest mistake ever made by an Irish person . . .

"National survival requires that Ireland walk away from the bailout. This in turn requires the Government to do two things: disengage from the banks, and bring its budget into balance immediately."

Excerpts from Central Bank governor Patrick Honohan's response to the article on RTÉ radio last Sunday:

"I took a lot of legal advice on this. There was no way of the Government walking away from that very formal guarantee, endorsed by the Oireachtas. The Government would have been treated as a bankrupt right away . . . The fact that we did not have precise numbers did not affect the honouring of the guarantee . . . All it would have done would have been to bring forward and accelerate the EU-IMF programme probably to May or June of last year . . .

"Everything was done by me and by colleagues on behalf of Ireland . . . It was not a final solution. I would regard it as a holding operation, something to offer a window of time in which to get what could be sorted out within our own competence in Ireland . . . It's not the end of the story. Negotiations, discussions will continue with Europe for a long time to come as we know there are already discussions about the interest rate and so forth."