

THE MEGA- CRISIS



by Brendan Halligan

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Introduction

At the present time, Ireland is in the middle of a Mega-Crisis which will continue unabated up to the next election and dominate the life of the new government. It consists of ten interdependent crises, which have become interlocked through a process of circular causation.

The process began with the meltdown of the banking system as a direct result of a prolonged property bubble caused by the classic formula of abundant credit, low interest rates, lax supervision and managerial mania.

The banking failure led to an abrupt decline in output and demand, which, in turn, precipitated an immediate drop in tax revenues and a rapid increase in unemployment.

Phase One of the Mega-Crisis

The result was an escalating deficit in the public finances which threatened to get out of control and endanger Ireland's ability to borrow on the capital markets.

At that point, there were four economic crises: banking, public finances, unemployment and public debt. These, in effect, combined to throw the economy into reverse. Government reaction was ad hoc and dictated by necessity rather than by strategy. The first priority was to save the banks.

The focus was on solvency to the neglect of liquidity, thereby adding to cash flow problems in the real economy. The resulting business failures accentuated the widening budget deficit. Public finances began to be a concern and belatedly became a priority.

This series of events constituted Phase One of the Mega-Crisis.

Additional Crises

Government action in pursuit of its priorities created two additional crises: the first was the spiralling cost of the public debt and the second a massive reduction in public expenditure, which affected the level of services. These served to add a political crisis to the list.

It came as a result of public revulsion at the failure of the government and regulatory authorities either to prevent the banking crisis or to subsequently deal with it in an equitable and expeditious manner. Public anger was intensified by the failure to punish the guilty. As a result, there was a breakdown in social solidarity.

The situation was worsened by the psychological effect of the crisis on the higher reaches of the civil service. Senior public servants are demoralised by what has happened and are either incapable or unwilling to initiate remedial measures. The collapse in morale has extended to the lower grades, who believe they are being unfairly punished for a crisis they did not create.

That makes a total of four more crises on the list: public debt financing, cutbacks, breakdown in social cohesion and a collapse in public service morale.

Their emergence has constituted Phase Two of the crisis.

Nature of the Mega-Crisis

Ominously, the Mega-Crisis has revealed a lack of capacity both within government and the public administration with respect to economic governance, policy formation and strategic planning. To this must be added wholesale regulatory failure.

This adds two systemic crises to the list, bringing the total to ten. In short, the banking crisis has had a domino effect on the economy, politics and society.

In addition to the crises outlined above there are, of course, additional challenges which have been around for some time but which can only get worse due to cut-backs and political inertia. These include the drugs epidemic, organised crime, a dysfunctional health system and inadequate support services for the disadvantaged.

It can also be said that that there had been an ominous failure to refresh or replace the development model that had worked reasonably well for the past half century on the basis of FDI. It is now out-dated and has been undermined by a systematic loss of competitiveness. It's clear that present policies cannot replace the jobs that have been shed and are ill suited for the new low carbon economy ahead.

This is a crisis in its own right which has been made worse by the fallout from the banking crisis and also by the failure to recognise, or admit, its existence.

10 Separate Crises
Banking
Public Finances
Unemployment
Public Debt
State Borrowing
Cut-backs
Social solidarity breakdown
Civil Service Morale
Civil Service Capacity Failure
Regulatory Failure
Ongoing challenges
Drugs
Crime
Health Service
Support Services
Employment

Lack of Consensus

Previously, when society was under threat, such as in the mid 80s, the public service and state institutions provided leadership and came up with agreed solutions, primarily based on social partnership. The general reaction in the face of adversity was to pull together and share the pain equitably.

There is no possibility of a similar response for the foreseeable future. Trust has broken down between the government and unions and will not be restored during the lifetime of the current Dáil. The social partnership model is broken for the present and cannot be restored under the present government. It leaves a vacuum in policy formation, because at its best, the partnership was

a problem-solving mechanism based on common analysis and agreed solutions. These desirable ingredients are now missing from the political mix.

As a consequence, there is no consensus on either the causes of the mega-crisis or the means of curing it. For its part, the government is in denial about the role it played in causing the catastrophe. The public service is bereft of ideas. The unions are in denial about the measures which are needed to solve the resulting economic crisis, especially the deficit in the public finances, while business, generally speaking, denies any responsibility for the financial and economic collapse or for the tough corrective measures society will have to bear.

The media, with some few exceptions, are either confused, angry or negative, and equally in denial about their own culpability in promoting the worst excesses of the property boom.

The interaction of the different individual crises creates an overarching crisis that is bigger than the sum of the parts and has a life of its own. That creates what has been described here as a "Mega-Crisis".

Given the speed at which it unfolded and its inherent complexity, it is no wonder that there is little real understanding of how it originated or how it can be cured. There has been a failure of both analysis and prescription. The result is a lack of consensus about the way forward allied to wilful self-delusion in some quarters that there is an easy way out, if only we could find it.

Threats to Economic Independence

There is a widespread temptation, for example, to believe that the situation can be saved by buoyant export markets. But neither the European nor the global economy will provide the necessary external stimulus to turn the economy around within the next two years. On the contrary, there are fears that things could worsen globally, with a depressing effect on Irish exports and, hence, on the economy as a whole.

The overriding fear remains that due to its complexity nobody actually has an intellectually credible or politically feasible solution to the overall Mega-Crisis. It must be both, for this crisis is one of political economy, and not just economics.

The international markets began to sense the absence of a composite strategy some months back and hence the spread between Irish and German banks began to widen appreciably. Further downgrades by the credit agencies can be expected and will further widen the spreads, thereby increasing the cost of borrowing to record levels. They may go so high as to be unaffordable.

If this process of circular causation continues then the debt burden will become insupportable in terms of the state's capacity to raise taxation, even with reduced levels of public services and public sector pay. This is the threat to the state's independence which has begun to impinge on the public consciousness.

Task of the Next Government

Left to themselves, these crises will not be resolved. In particular, the debt crisis will progressively worsen and will intensify the severity of the others. On the assumption that the present government runs for its full term, then the next two years would not just be more of the same but worse. Ireland runs the risk of being branded as a failed state.

In those circumstances, the new government would inherit the worst set of political and economic conditions since the first Cumann na nGael government established the state in the teeth of a civil war.

The process leading to this threat to our independence constituted Phase Three of the Mega-Crisis and how it is resolved will determine the character and outcome of the next and final phase.

The final phase has begun with the widening of the spread to crisis dimensions. We are heading towards the point where we can no longer borrow.

Outline of a Response

Given the interlocking nature of the Mega-Crisis the key policy question is where and how to break out of the vicious circle.

Logic suggests it should begin where the process itself began, i.e. with the banking system. This would appear necessary for two reasons. Firstly, the cost of “rescuing” the banks is currently open-ended and the markets fear that it could swamp the state’s ability to fund itself, if it hasn’t already done so. Secondly, liquidity needs to be injected into the economy to get business moving again.

Putting a cap on the cost of the “rescue” plan is an essential first step but would mean winding down Anglo and Nationwide as rapidly as possible and nationalising the banks by transforming the loans to AIB and Bank of Ireland into equity. Having their balance sheets restored would help resolve their liquidity problem, and hence their ability to inject credit into the economy.

Economic growth might then pick up, with beneficial knock-on effects on jobs, tax revenues and welfare payments.

It is inescapable that the loss of competitiveness will impede, if not block, economic recovery and will have to be tackled via the equivalent of a devaluation. This can be achieved within the Euro by cutting incomes and prices by fiat, just as in wartime.

Given that the situation in which we find ourselves is analogous to a war, then we should adopt wartime measures, such as income and price controls. In this way we can have a virtual devaluation, restore competitiveness and stimulate growth.

If the two primary aims of national policy are to sustain jobs and protect the level of public services, which admittedly is not certain, then the burden of a virtual devaluation would have to fall on incomes. On the one hand, reduced public

sector pay would cut the budget deficit while, on the other, reduced private sector pay would increase competitiveness, the key determinant of economic growth.

Stabilising the public debt and producing growth will have to be pursued in tandem. One without the other is self-defeating.

But there is no consensus on what the overriding national priority should be. It is self-evident that reducing nominal incomes, even in the context of price controls, is not remotely feasible without widespread social support, notably from the trade unions. In order to win that support, however, at least three psychological pre-conditions will have to be met.

Firstly, the pain of real income reductions must be borne equitably across the board, especially by the professions, self employed, higher public servants and, of course, politicians. There can be no exceptions. Everybody is in the frontline.

Secondly, the economic consequences of the Mega-Crisis will have to be explained in full to the public, without any equivocation. While this should be done by the government which caused the catastrophe it will almost certainly have to be carried out by the current opposition. Preferably, this should be done before the election rather than afterwards. Otherwise, the message will lack conviction.

Thirdly, there has to be some ritual cleansing of society which puts a definitive end to the past and ushers in a new era. This will involve the punishment of the guilty and the dismissal of the incompetent. Arguably this is the most vital of the three pre-conditions, but in reality each is indispensable to the success of the virtual devaluation strategy.

If these three preconditions are met then a virtual devaluation has some chance of working. The alternative is wide-scale redundancies, massive cutbacks in services and the arrival of the ECB and IMF.

Critical Role of the Unions

A virtual devaluation will prove a political impossibility, of course, if the unions withhold their support. For unions read, of course, their members. And to sharpen the focus, for unions read public sector unions or public sector employees.

Winning their consent beforehand to accept and endure the unpalatable is an unavoidable precondition for the success of the recovery phase. There can be no equivocation on the measures to be taken; no *quid pro quo* in return for reduced incomes; and no pretence that the measures are either short-term or reversible. They are neither. In sum, the Croke Park agreement has been made redundant by the logic of events.

Consent to change and to reduced living standards invariably depends on an understanding of context which, in this case, is the scale of the dangers that threaten us. In essence, the economic literacy of the civil service, and wider public service, such as nurses, teachers and Gardaí, will determine whether Phase Four is marked by either recovery or ruin.

Growth

While the stabilisation of the public finances and the restoration of competitiveness are the *sine qua non* for survival it is equally true that economic growth above four per cent is just as essential. The model that served us so well for half a century is outmoded and needs replacement - but there is no alternative in sight.

Dependence on FDI should give way to reliance on domestic entrepreneurs and the exploitation of indigenous resources with the aim of future-proofing the economy by basing it on green enterprise and exports, especially in energy. The vibrancy of Irish entrepreneurs, especially within the green sector, has gone unnoticed in the general gloom caused by the catastrophe, but is a reality on which we can build.

The state apparatus is, however, by and large

caught in a time warp and has failed to recognise not just the need for change but the change that is happening underneath its nose.

The root and branch reform of the public service now accepted by the political class will have to be at its most vigorous in the government departments and agencies responsible for growth.

This is not to be interpreted as support for the slash and burn philosophy being promoted by a McCarthyite persecution of the public service. Instead, it is an affirmation of the role it can play if appropriately structured, effectively lead and properly motivated. Our renaissance began a half century ago with dedicated - and intelligent - public servants showing the way. We need another Whitaker to chart a fresh path to economic development. Without question, his successors are waiting in the wings.

Conclusion

This is the first time Ireland has had to confront a Mega-Crisis and there is no guarantee that it can be overcome. Indeed, there are growing international concerns that Ireland will fail and will have to be bailed out. This concern is gathering pace and threatens to engulf us.

It would seem that the primary task now is give people the sense that the crooks, chancers and incompetents have been expelled and that they themselves are again back in control once again of their own country. A sense of the people being masters of their own destiny would be the first step towards recovery.

Recovery will be long, slow and painful, calling for exceptional leadership and a profound sense of common purpose. The scale of the catastrophe is such that the Republic will literally have to be rebuilt from the ashes.

“Regaining the Republic” should be the theme of the first phase of recovery. “Rebuilding the Republic” should be the motto of the long haul towards economic independence and self-respect.



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