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PERSPECTIVE

Contrary To Keynesians, Cuts Help Default-Prone

By ALAN REYNOLDS

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A wise person once explained that good judgment can only be attained through experience, and experience often comes from bad judgment. There was a profusion of bad judgment behind the latest European debt crises. What did we learn?

One thing we should have learned is that a credible plan for deficit reduction requires action, not words. Overly indebted countries that have actually done something to restrain government spending faced much lower long-term interest rates than those that dissembled and delayed.

On the other hand, long-term interest rates can double quite suddenly if such countries reverse course and rack up so much debt that bondholders fear partial or total default. As it happens, Ireland illustrated both experiences last year, switching from good to bad judgment within a few months.

Ireland was the first of the debt-plagued European countries to cut government consumption significantly in 2009, mainly by reducing government paychecks from 12.3% of GDP in 2009 to 11.8% in 2010.

While such gestures toward fiscal frugality lasted, the country was rewarded with a tolerable risk premium on government bonds. The yield on 10-year Irish government bonds was still 5.3% as recently as last August, compared with 10.7% in Greece. This May, the interest on Irish bonds reached 17.6%. What went wrong?

Back in June 9, 2010, I wrote that "unlike Greece, the Irish economy is showing encouraging signs of recovery." Ireland's real GDP had increased by 1.7% in the first quarter, with an 11.7% quarterly rise in industrial production. Manufacturing output increased 29% from November 2009 to July 2010, thanks to growing exports.

Within fewer than four months, however, a terrifying series of fiscal blunders began to unfold. The Wall Street Journal reported last Sept. 24 that, "in recent weeks, some investors have begun to fear a Greece-style bailout for Ireland, though most observers say it is unlikely for now."

Such fears intensified on "Black Thursday," Sept. 30, when the BBC reported, "The cost of bailing out the Republic of Ireland's stricken banks ... will see the government run a budget deficit equivalent to 32% of GDP this year." There were mass protests against the bank bailouts in the streets of Dublin that day, and the risk spread between interest rates on Irish and German bonds jumped above 4 percentage points for the first time.

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The Irish government had suddenly opted to lift the expected budget deficit from an expected 12% of GDP to 32%. The national debt quadrupled from 25% of GDP in 2007 to 100%-125% in 2011. Why? To bail out foolhardy Irish banks that had bankrolled the world's looniest housing bubble. That really meant bailing out foreign banks that loaned nearly $700 billion to the troubled Irish banks.

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Posted By: MavenDog(1220) on 6/10/2011 | 6:38 AM ET

Krugman is my bet for Obama's next choice for economics adviser. It would follow the same logic as appointing Chu to energy. They are both Nobel Prize winners and both unqualified for the jobs.

Posted By: InCincy(3475) on 6/9/2011 | 8:50 PM ET

Keynesian economic theory was known as being flawed from the beginning but it has been advanced by the banking community because it supports the creation of debt from which interest is earned. This is why Wall Street supplies the government officials and the government policy drives the colleges to advance the flawed theory to greater acceptance. Follow the money.

Posted By: jpdwn(2255) on 6/9/2011 | 8:00 PM ET

Great, but who listens to bad news? We all want "Hope and Change", don't we? Sarcasm aside, Alan Reynolds knows his stuff and backs it up. If only the general public were as informed as IBD readers....

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