

## **WHAT WENT WRONG IN IRELAND?**

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### *Abstract*

With its fiscal, competitiveness and banking crisis, Ireland is among the most severely affected countries in the global crisis. Yet its sustained growth achievement for almost two decades has been widely admired. This note explains how and why Ireland has entered the recession so poorly positioned. Until about 2000, the growth had been on a secure export-led basis, underpinned by wage restraint. However, from about 2000 the character of the growth changed: a property price and construction bubble took hold. This boom sustained employment and output growth until 2007 despite a loss of wage competitiveness. The banks fuelled the boom, especially from 2003, exposing themselves both to funding and solvency pressures. Successive Governments had bought industrial peace (and at first wage restraint), with tax reductions, relying increasingly on volatile sources of revenue, thereby making the tax base increasingly vulnerable to a downturn. Among the triggers for the property bubble was the sharp fall in interest rates following euro membership: within the euro zone also the disciplines of the market which had traditionally served as warning signs of excess were muted. Lacking these prompts, Irish policymakers neglected the basics of public finance, wage policy and bank regulation.

## WHAT WENT WRONG IN IRELAND?

### 1. Introduction and overview

During the 1990s, Ireland emerged from a lengthy period of economic stagnation marked by high unemployment, emigration, and crippling public debt despite high tax levels (Ó Gráda and O'Rourke, 1996, Honohan and Walsh, 2002). From 1988 to 2007 real GDP expanded by 6 per cent per annum on average (reaching double digits on average during 1995-2000). Even more astonishing, the unemployment rate shrank from 16 per cent (on the ILO basis) in 1994 to 4 per cent in 2000 – essentially full employment for the first time in modern history. Non-agricultural employment jumped from 33 per cent of the population in 1993 to 41 per cent in 2000 and 46 per cent by 2007. With Ireland at the frontier of economic prosperity, surely this was an economic miracle to be studied and replicated.

But, after almost two decades of rapid growth, Ireland's economy has collapsed more severely than almost all others in the current economic downturn. Real GDP fell by over 2 per cent in 2008 and is expected to fall 8 per cent in 2009 and a further 3 per cent in 2010. The downturn in the real economy has been reflected in the sudden emergence of a twin crisis in the banking sector and in the public finances. These in turn have fed back negatively into credit availability and rising tax rates deepening the output loss.

What went wrong? It is an interesting boom and bust story, which combines hubris formed during the years of solid growth (before about 2000), the unprecedented experience on inward migration and the demonstration effect of financial excess in neighbouring countries. EMU membership plays a subtle role in the story in the way in which it lulled policy makers into a false sense of security. At the same time, having the euro has equally protected Ireland from an even worse financial collapse today.

#### *Overview*

It was always to be expected that Ireland would be particularly exposure to a global downturn, considering the exceptionally large contribution of exports to GDP and its vertical integration of much of Ireland's manufacturing sector into the global production chains of major multinational firms. These were characteristics which, when combined with the sustained growth in World Trade contributed to a sustained output boom for over 15 years. Now they had gone into reverse.

Moreover, by mid-2008, the Irish export sector had to cope with a sharp slide in the value of Sterling – the currency of neighboring Britain, still a major trading partner. Indeed, the sudden fall in sterling left even the domestic retail sector exposed as households crossed the border into Northern Ireland to take advantage of suddenly lower prices.

But the Irish crisis from 2007 on was not merely an aspect of international pressures. Ireland was relatively poorly positioned heading into the global recession for three distinct but related domestic reasons: a home-grown banking crisis, a trend loss in wage competitiveness that had been underway since 2000 and a tax structure whose yield was far too heavily dependent on a continuation of the boom.

### *Two distinct growth phases*

To understand what went wrong it is essential to distinguish between two different growth phases. Up to 2000 there was the true “Celtic Tiger” period of exceptional export-led growth with moderate wage and price inflation and healthy public finances. This began back in the late 1980s when, after several false starts, Government finally tackled its over-indebtedness with tough spending restraint, and managed to negotiate a series of centralized social partnership agreements which seem to have bought wage rate moderation in return for income tax concessions. This confidence-restoring policy package, given a competitiveness boost by the successful devaluation of 1986, launched the economy on a belated convergence in living standards towards the highest in Europe. An expanded flow of European Union structural funds amounting to as much as 3 per cent of GDP also helped fund sufficient public infrastructure in those years. The historic pattern of net emigration was dramatically reversed.

By 2000, the convergence phase was over, but rapid growth continued in Ireland – though now the sources of growth shifted sharply. An unsustainable decade-long property price and construction boom, which began before that of the US and UK and went further than these both in price and quantity, had taken over from exports as the main driver of Irish growth. Initially prompted by the increased household formation (related to unprecedented levels of net immigration) and by the sharp fall in interest rates that accompanied the transition to EMU membership, the property boom was increasingly financed after 2003 with foreign borrowing by the banks.

At the same time, the negotiated wage-restraint-for-income-tax-concessions bargain continued to be renewed. Government could afford to offer these concessions because of the buoyant revenue from the construction boom and from corporate profits, on which they became increasingly reliant, insouciant of the increasing vulnerability of the tax base to a downturn. But the apparent restraint in negotiated base wages began to lose relevance as workers negotiated supplementary wage increases. Although international competitiveness began to be eroded, the effects were not yet felt in aggregate unemployment while the domestic boom continued.

### *Poorly positioned for the global crash*

Thus, the international pressures on the Irish economy since early 2008 have been strongly exacerbated by the unwinding of the property price and construction boom, and by the tax collapse and uncompetitive wage structures it has left in its wake.

Real residential property prices peaked in late-2006 and a strong reversal set in both in prices and in activity. The collapse of the construction and property bubble, has brought banking difficulties in its wake. This would all have resulted in a recession even without the global crisis, though the banks would have been better placed to survive without exceptional intervention, and the government would have been able to take offsetting fiscal action had it not been for the collapse in construction-related tax revenues.

The remainder of this note reviews these three elements in turn, starting with the fiscal problems, and touching on the loss of wage competitiveness before proceeding

to the bubble and its aftermath. A concluding section looks at the ambiguous role of euro membership.

## **2. Fiscal crisis**

The fiscal crisis has been driven partly by an autonomous surge in the share of spending in GDP (after 2004), but more spectacularly by a remarkable collapse in tax revenues in 2008-9. While tax revenue has shrunk in many countries in the recent economic downturn, the revenue collapse in Ireland has been much more pronounced.

Much of the reason for the revenue collapse lies in the systematic shift over the past two decades away from stable and reliable sources such as personal income tax, VAT and excises and towards cyclically sensitive taxes. There has been more and more dependence on corporation tax, stamp duties and capital gains tax (in that order). These three saw their share in total tax revenues rise steadily from about 8 per cent in 1987 to 30 per cent in 2006 before falling to 27 per cent in 2007 and just 20 per cent as soon as the economy turned down in 2008 (Figure 1).

Although corporation tax is charged at a very low rate (currently 12½ per cent), revenue from this source grew from little over 1 per cent of GDP in the late 1980s to almost 4 per cent a decade later. A large fraction of this has come from multinational corporations in financial and non-financial sectors. Indeed, Ireland became quite a location of choice for firms seeking to shelter sizable profits from higher tax rates elsewhere. The surge on corporation tax was due not only to the property boom of the 2000s, but benefited significantly from internationally -oriented manufacturing and services, and from the high profitability of the domestic private service sector.

Stamp duties are payable especially on transfer of property and the boom in this revenue source reflects the real estate and equity bubbles; revenue from this source exceeded 2 per cent of GDP in 2002

To an extent, the growing reliance on these “fair weather” taxes has been an almost automatic albeit unintended consequence of the combination of the Social Partnership process combined with an almost unbroken period of rapid growth. From 1987, the former process of triennial tripartite national pay agreements was resuscitated with a view to achieving economic recovery. In each negotiation, in order to obtain or cement agreement of the unions to moderate basic pay trends, Government offered policy concessions, generally including an explicit or implicit understanding that income tax would be reduced. These tax reductions did help to buy wage restraint in the 1980s and 1990s, but left the government accounts exposed to a downturn. The sustained output, profit and asset price boom which extended for two decades from 1988 – with only two brief hesitations in 1993 and 2001/2 – lulled policymakers into a false sense of security as to the sustainability of the revenues from cyclically sensitive taxes, and induced them to take advantage of the extra revenues by narrowing the base of the personal income tax and lowering rates. To be sure, lower tax rates were in the air of international policy discussions from the 1980s, and this thinking also influenced policymakers in Ireland, but Ireland brought them further than most. Thus, at pay rounds, Government negotiators could offer concessions in those taxes that are felt by the working person — especially income tax but also some expenditure taxes. These concessions could be afforded because of the steadily

soaring revenues in the cyclically sensitive taxes. But each notch in this ratchet made the tax system more vulnerable to an economic downturn.

In 2008, tax revenue fell by almost 14 per cent (Figure 2<sup>1</sup>) — but the percentage fall in the cyclically sensitive taxes was much larger, at 36 per cent. The differential fall-off in revenue continued and even intensified into the first two months of 2009

Had Ireland's tax structure been less cyclically sensitive, the fall in revenue would have been much lower. Indeed, if cyclically sensitive taxes had been back at their 1987 share of total revenue, the fall in revenue in 2008 would have been much lower: 8 per cent instead of 14 per cent.

Figure 2 reveals the sudden collapse in taxation. It also shows the way in which Government spending had a strong upward momentum. It doubled in real terms between 1995 and 2007 for a real growth rate of 6 per cent per annum. With GDP and GNP growing even faster, this made for a generally falling or stable ratio until 2003, but thereafter the ratio grew, especially as soon as this started to slow in 2007.

Actually, spending grew by over 11 per cent real in both 2007 and 2008, reflecting an unfortunate late relaxation of spending which has worsened the deficit in the crisis just when it began to matter.

It is clear, then, that a return to budgetary stability requires not only a tax adjustment but also a reining in and rollback of spending; such a policy has been announced by the Government in the supplementary budget of April 2009.

### **3. The property bubble and the banking crisis<sup>2</sup>**

Even if the lower real and nominal interest rates from 1998 meant that any given income could support the servicing of much higher loans, the three-fold increase in average real property prices from 1994 to 2006 was the highest boom in any advanced economy in recent times. Long before it peaked, it looked unsustainable to most commentary.<sup>3</sup> Nevertheless, from 2003 on, banks continued to ease loan conditions such as maximum loan-to-value ratios. These continued to fall right through 2006 despite the increasingly evident vulnerability of the bubble.

Competitive pressure on the leading banks to protect market share came especially from reckless expansion by one bank, Anglo-Irish (whose market share among Irish-controlled retail banks jumped from 3 per cent to 18 per cent in a decade, as it grew its total portfolio by an average of 36 per cent real). Foreign controlled banks, especially the local subsidiary of HBOS also contributed.

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<sup>1</sup> This figure uses the 2007 NIE and the data in the October 2008 budget book, together with the ESRI's latest GDP forecast. The corresponding data updated to reflect the supplementary budget of April 2009 is not yet available. (nie2007tables1995-2007.xls).

<sup>2</sup> For a more detailed account, see Honohan (2009)

<sup>3</sup> There was plenty of evidence, even if not fully conclusive. For instance house price to rental ratios had been declining gently for two decades jumped about 70 per cent from their 1995 level by 2001, and then, after a pause, resumed their upward movement reaching 220% of their 1995 by 2006 (Kelly, 2007). For optimists, this was not too worrying, though, as real interest rates had fallen sharply with the adoption of the euro (discussed below). However, econometric studies of equilibrium house prices pointed to strong overvaluation by 2003-4. For a more detailed account of the evolution of the property bubble and banking crisis, see Honohan (2009) and references therein.

Bank regulation, although on the surface compliant with international standards (IMF, 2006), was complacent and permissive. Certainly it should have impeded the growth of Anglo-Irish bank. And it should have acted more vigorously to restrain the relaxation of lending standards: by 2006, fully two-thirds of loans to first time buyers had loan-to-value in excess of 90 per cent; one-third were getting 100 per cent loans. Regulatory stress tests were too timid (for example employing only a 20 per cent fall in house prices). Undue regulatory reliance was placed on banks' internal risk models, without apparent exercise of supervisory discretion, even when the most reckless loans were being made to property developers in blocks of up to several hundred million euros for prime land.

Banks funded the surging loan demand by huge foreign borrowings. By early 2008, net foreign borrowing by Irish banks had jumped to over 60 per cent of GDP from 10 per cent in 2003. Irish-controlled banks, long active in the retail market in Northern Ireland and in Britain, were also vigorous lenders in these and other property markets in Europe and North America during these years.

More or less simultaneously with Britain and the US, real residential property prices in Ireland peaked in late 2006. Loan demand slowed and construction – which had employed over 13 per cent of the workforce – began to contract.

At first, the banks were relatively unconcerned, their share prices peaked in February 2007, but remained high through the remainder of that year. Although they had become highly dependent on property-related lending (which now accounted for over 60 per cent of their total lending, up from less than 40 per cent only four years before), the perception was that most household mortgages would continue to be serviced even if house prices fell back by 20-30 per cent. The growing international banking crisis cast doubt on such complacency, and especially after the rescue of Bear Stearns, the liquidity of Anglo Irish bank came under repeated pressure. After the collapse of Lehman Brothers in mid-September 2008, Anglo was unable to secure funding and effectively failed, requiring a government rescue.

Fearing a contagious reaction on confidence in the other banks, the authorities decided not to put Anglo into a government-controlled winding-up,<sup>4</sup> but instead, extended a systemwide bank guarantee on, and with effect from end-September 2008.

The prospective budgetary cost if this guarantee (should it have to be called), together with the dramatic collapse in tax revenue which was becoming increasingly evident, began to put upward pressure on the secondary market yields of Irish Government securities. The spread over German Federal Government bonds at 10 years maturity jumped from about 30 basis points in September reaching 284 basis points in March 2009 before falling back.

Although all of the banks are currently reporting a healthy capital position, bolstered in the case of the two biggest ones by the Government's injection in the form of preference shares of a total of €7 billion (or over 2 per cent of their aggregate balance sheet), there is a large discrepancy between these reported figures and the market's

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<sup>4</sup> Subsequently, following revelation of governance problems at Anglo Irish Bank, it was nationalized in January 2009

assessment of the true value of equity shares in the banks, considering the likely scale of future loan losses beyond those currently acknowledged by the banks. The banks' share prices have fallen to as low as 1 per cent of their peak value of just two years ago. Since neither the regulator nor bank management have been able to convince the market that losses will not be high, it is clear that further financial restructuring will be necessary.

The Government announced in April 2009 that a National Asset Management Agency would be created to acquire the development property portfolio of the banks at a written-down value. The book value of the loans to be purchased was put at €80-90 billion, or about 50 per cent of GDP. If (as seemed likely) the valuation process for the loans resulted in write-downs bringing capital below regulatory levels, the Government will inject common equity, likely taking a substantial majority stake in the banks, though they have indicated reluctance to become outright owners,

#### **4. Loss of wage competitiveness**

From 1986 to 2000, wage restraint, generally attributed in part to the effect of the centralized pay negotiations, but owing something also to the high initial level of unemployment and the dampening impact of immigration (econometric work is inconclusive on these points), helped generate and sustain an era of full employment.

But after 2000, wage competitiveness deteriorated (Figure 3). By 2008, hourly wage rates had raced ahead of those in competitor counties, when measured in a common currency, by as much as 36 per cent.

Sooner or later, this loss of wage competitiveness was sure to affect employment expansion, but this was masked and delayed by the construction boom. Employment in the construction sector itself grew strongly from about 6-7 per cent of total employment in the early and mid-1990s to over 13 per cent in 2007 (Figure 4). This is what sustained overall employment levels despite the loss of wage competitiveness.

An interesting feature of this pay process was that public sector workers were able to maintain a significant average wage premium relative to private sector workers during the Celtic Tiger period. Boyle et al. (2004), using detailed microeconomic data and controlling both for job and personal characteristics, estimated a premium of between 8 and 15 per cent each year 1994-2001. Subsequently, the public sector premium seems to have grown rapidly. Kelly et al. (2008), using even more detailed data, found that the public sector wage premium increased from about 8 per cent in 2003 to 24 per cent in 2006.

#### **5. The subtle role of EMU membership**

Although growth remained strong for most of the first decade of Ireland's membership of the eurozone, the analysis we have presented suggests that the seeds of the crisis were sown around the time the single currency began at the beginning of 1999. But was this a causal factor or a coincidence?

Elements of eurozone membership certainly contributed to the property boom, and to the deteriorating drift in wage competitiveness. Low interest rates and the removal of exchange rate risk facilitated the boom; the insensitivity of the exchange rate and of interest rates to domestic developments removed a traditional external constraint or at

least warning sign. The enlargement of the EU also meant that the boom could continue longer than otherwise, fuelled as it was by strong inward migration.

Specifically, real interest rates 1998-2007 averaged *minus* 1 per cent, compared with over 7 per cent in the ERM period (even excluding the crisis of 1992-3) and 3¾ in the floating rate period between the two. The fall in nominal interest rates was even steeper. No wonder long-lived assets like residential property, capitalized at permanently lower discount factors, seemed and were appropriately valued more highly than before. The problem was to determine just how much higher. EMU introduced that element of uncertainty.

Up to 2003, the property boom was financed without significant recourse to foreign borrowing, but after then the banks started to borrow heavily from abroad. This was an effortless undertaking thanks to the removal of currency risk and went essentially unnoticed by analysts, the focus of policy attention having shifted away entirely from balance of payments concerns. Unlike imbalances of the past, overborrowing did not lead to interest rate increases, again because currency risk had been altogether removed. Only when credit risk became an issue after September 2008 did the financial markets belatedly sound a warning sign.

Much the same could be said of wage rates. As shown by Honohan and Leddin (2006), the former tendency for deviations in wage competitiveness to correct themselves (error correction model), detectable in previous data, was no longer evident after EMU began. The regime once again tolerated a larger movement away from equilibrium before warning signals sounded.

To be sure, all of these imbalances and misalignments could have happened outside of EMU – indeed, similar problems were experienced in other non-euro countries in the EU and the EEA. But the policy antennae had not been re-tuned in Ireland, and corrective action that could and should have been taken (fiscal policy, bank regulation, centralized wage negotiations) were neglected as a result. A costly error that will not be repeated in Ireland and should not be repeated elsewhere..

## **6. Concluding remarks: Lessons**

The Celtic Tiger period represented a solid convergence of Ireland to the frontier. But it ended in 2000, to be succeeded by an old-fashioned property bubble. The lengthy period of success lulled policy makers into a false sense of security, not to say invulnerability. Captured by hubris, they neglected to ensure the basics: a robust tax system, a mechanism for ensuring wage rates—especially those in the public sector and as such under government control—did not get out of line internationally, and above all, they largely ignored the need for conventional prudential regulation of the main banks, allowing a rogue bank's reckless expansionism to destabilize the whole sector.

For the future, recovery will depend on the economic and political system's ability to adapt flexibly, lowering the effective cost of public services and retaining labour market flexibility as the public finances and international wage competitiveness are brought back into a sustainable configuration.



Macro-modellers simulating possible recovery paths have concluded that the future path of GDP in Ireland will be lower than had been projected before the crisis by at least 10 per cent, and that, while recovery could begin by 2011, the economy will not have return fully to its equilibrium growth path before 2015 (Bergin et al., 2009). It should thereafter be possible to maintain the fundamental conditions that allowed the Irish Economy to reach the high levels of output and productivity attained by 2000, including the quality of education, social and physical infrastructure. The main domestic threats to this (that is, apart from the risk of a more prolonged global recession, especially if accompanied by protectionist policies abroad), would be the danger that policy is insufficiently decisive in correcting the public finances and cleaning-up the banks, and that wage determination processes are insufficiently flexible to deliver the declines in real wages now needed at a time when prices are falling.

On these matters, government, employers and trade unions are currently feeling their way towards politically and socially acceptable solutions.

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## Figures

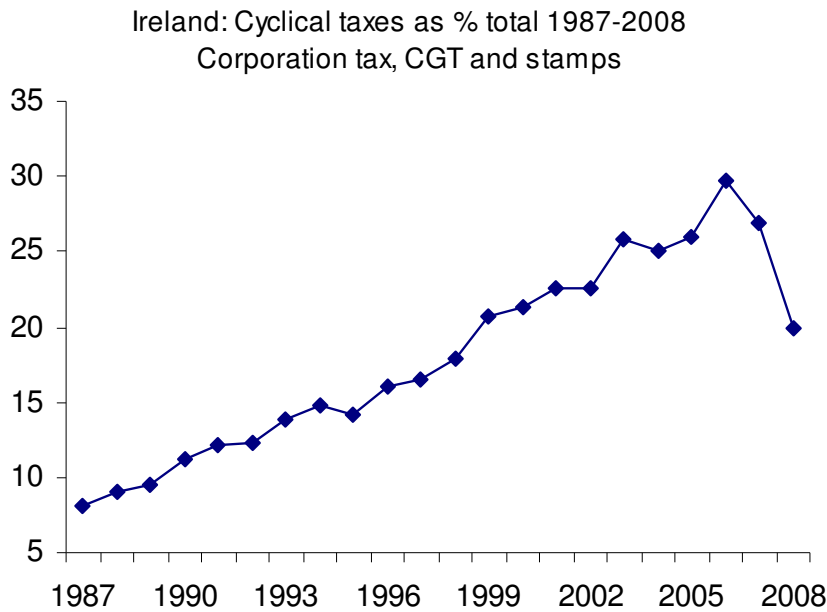


Figure 1: Ireland: Percentage Share of tax revenue coming from Corporation Tax, Capital Gains Tax and Stamps.

Source: Calculated from Department of Finance: Budget Statistics, various years.

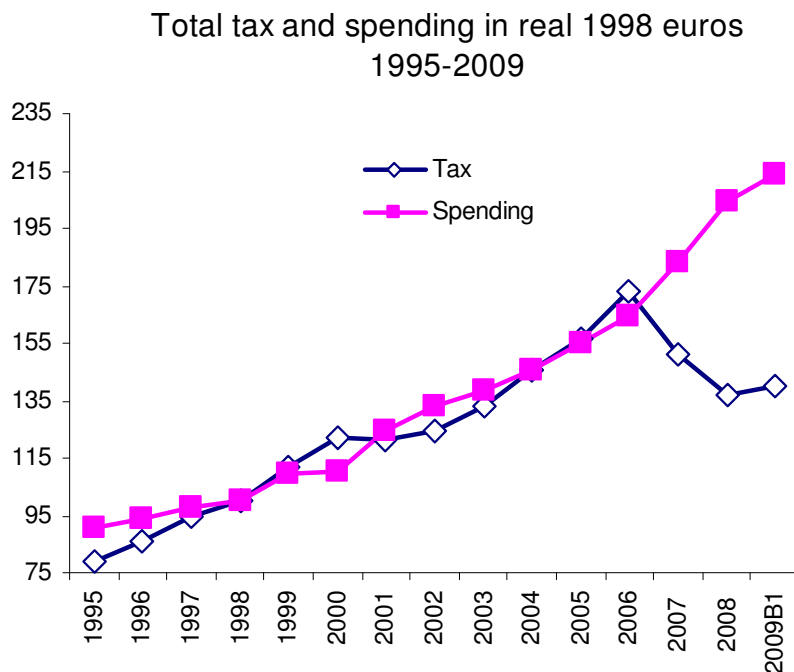


Figure 2: Ireland: Total tax and Government Spending in Real Terms, 1995-2009 (NB: 2009 is the forecast provided in the October 2008 budget statement)

Source: CSO: National Income and Expenditure, 2007 and Budget Statement, October 2008.

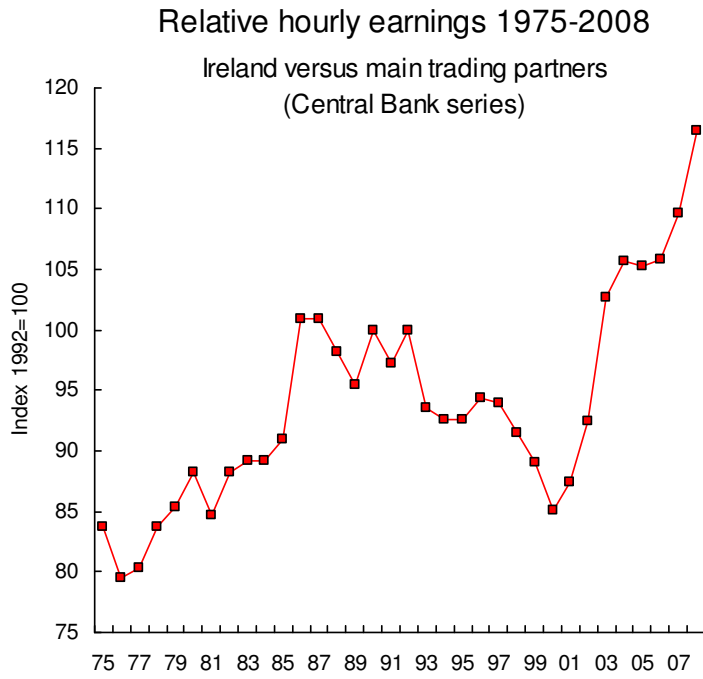


Figure 3: Ireland: Relative Hourly Earnings 1975-2008.  
Source: Central Bank of Ireland.

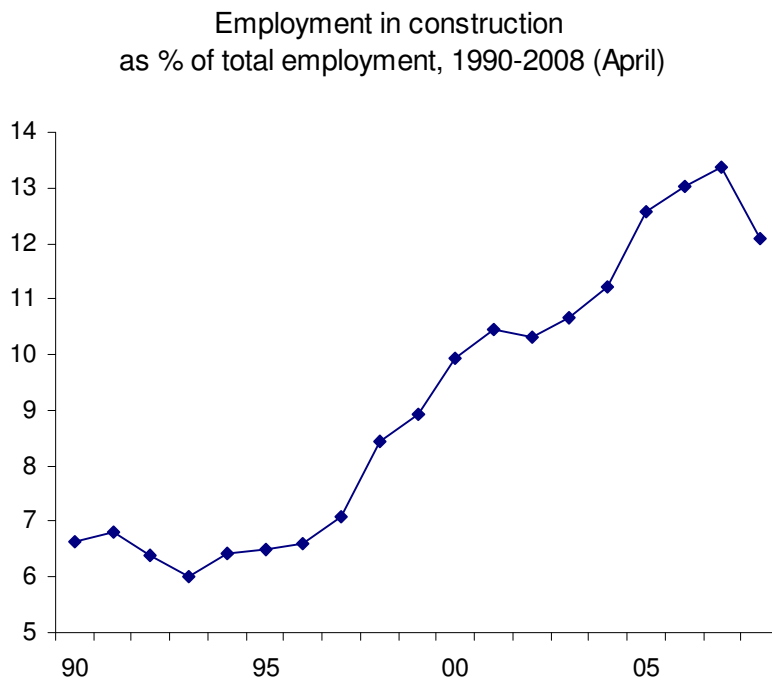


Figure 4: *Employment in Construction 1990-2008*  
Source: CSO.