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## Abstract

This paper has three goals. First, it seeks to explain the origins of the Irish crisis. Second, it provides an interim assessment of the Irish government's management of the crisis. Third, it evaluates the lessons from Ireland for the macroeconomics of monetary unions.

* This is a revised version of a paper prepared for the conference on 'The euro area and the financial crisis' (Bratislava, September 7th 2010), organised by the National Bank of Slovakia. It is forthcoming in ***The Euro Area and the Financial Crisis*** (edited by Miroslav Beblavy, David Cobham and Ludovit Odor), Cambridge University Press. I thank my discussant Wendy Carlin and conference participants for helpful feedback. I am grateful to Niamh Devitt, Peter McQuade and Donal Mullins for helpful research assistance. This paper is part of an IRCHSS-sponsored research project on 'An Analysis of the Impact of European Monetary Union on Irish Macroeconomic Policy'. Email: plane at tcd.ie.

# 1 Introduction

Ireland is in the midst of a severe crisis. While the global financial crisis has affected all economies to varying degrees, it has been especially severe in Ireland with a cumulative nominal GDP decline of 21 percent from Q4 2007 to Q3 2010. This ranks Ireland among the worst-affected countries in terms of output performance during this period (Lane and Milesi-Ferretti 2010).

Allied to this economic shock, Ireland has also experienced a severe fiscal deterioration. After a long period of running surpluses, the fiscal balance shifted from positive territory in 2007 to baseline deficits of 11-12 percent of GDP in 2009 and 2010. Much of this fiscal deficit is structural in nature, such that the resumption of economic growth on its own is not sufficient to restore fiscal sustainability. In addition, the one-off cost of recapitalising the banking system pushed the overall general government deficit to 14.5 percent of GDP in 2009 and 32 percent of GDP in 2010, leading to rapid growth in the overall level of public debt.

The main factor behind these developments has been the devastating boom-bust cycle in the Irish property market. Since the property boom was financed through aggressive lending by the Irish banking system, the decline in property prices and the collapse in construction activity has resulted in severe losses in the Irish banking system. In turn, this has contributed to the economic crisis through a credit squeeze

and the fiscal crisis, both directly through the costs of recapitalising the banking system and indirectly through the loss of asset-driven revenues.

The scale of these problems meant that the sovereign spread on Irish debt rose sharply in 2010, with doubts concerning whether the government could achieve the triple play of restoring economic growth, fiscal sustainability and a healthy banking system. In the end, this resulted in a shift to official sources of funding in November 2010, with a three-year deal agreed with the IMF and the European Union.

The primary goal of this paper is to describe what went wrong in Ireland, which is covered in Section 2. In addition, I review the Irish government's management of the crisis since 2007 in Section 3. Next, I reflect on the role of Ireland's membership of EMU during this episode in Section 4. Section 5 concludes.

## 2 The boom and bust in Ireland

It is important to appreciate that there was a genuine Irish economic miracle, with very rapid output, employment and productivity growth during the 1994-2000 period. This period can be interpreted as an accelerated convergence phase, with Ireland catching up with the European frontier after a long period of underperformance (Honohan and Walsh 2002). In particular, major policy mistakes in the late 1970s had led to an unstable macroeconomic situation that resulted in a sustained phase of economic stagnation.

This period of stagnation came to an end with a sharp fiscal correction which was launched in 1987 with the agreement of the main political parties and accompanied by

a new social partnership approach that provided a strong social consensus behind a cooperative approach to rebuilding the economy on a pro-business platform (see also Lane 2000). While the economy performed well in the late 1980s (supported by the boom in major export markets such as the UK and the US), this was temporarily halted by the 1992-1993 European recession and currency crisis. Accordingly, the sustained period of uninterrupted economic growth really only began in 1994.

The remarkable economic performance during the 1990s was underpinned by multiple factors. The 1987 fiscal adjustment had delivered a stable fiscal situation, while the stagnation during the mid-1980s had eliminated the high inflation that had plagued Ireland in the late 1970s and early 1980s. Participation rates in second-level and third-level education had sharply increased throughout the 1970s and 1980s, such that new entrants into the labour force had far higher human capital levels than those leaving the labour force through retirement.

These positive domestic trends were accompanied by a favourable shift in the nature of world production and world trade. In particular, the rise of the 'weightless' economy, in which 'high-value, low-weight' sectors such as computers and pharmaceuticals were increasingly important, meant that Ireland's peripheral geographic status became less of a barrier to export-oriented production. The result was a boom in inward foreign direct investment, primarily from American multinational firms. In part, these firms selected Ireland as a platform for exporting to the newly-unified European single market. However, a substantial proportion of the exports were also directed towards other regions, including exports back to the US home market.

With FDI providing an engine for productivity growth, domestic components of domestic demand also picked up, such that the economic expansion was very broad in its nature. Employment grew quickly with little pressure on wage rates, since there was an overhang of high unemployment, a very low initial level of female participation in the labour force and a large stock of Irish workers overseas that were ready to return home.

While house prices began to grow strongly from around 1994, much of the initial growth in house prices could be justified by low initial property values (in the wake of the 1992/1993 currency crisis) and the rapid growth in income levels. Moreover, credit expansion during the 1990s was also relatively restrained (Kelly 2010).

The rapid pace of economic growth was reinforced during 1999-2000 by the sharp devaluation of the euro against the dollar, which boosted Irish exports. In addition, interest rates fell in Ireland once entry into EMU was confirmed in 1997. While Ireland undertook a revaluation in spring 1998 prior to the formation of EMU, this was very small in scale. Moreover, Ireland had attained full employment by this stage and strong upward pressure on wage rates became evident.

There was also substantial fiscal expansion during 2000-2001, with a rapid increase in public spending and substantial cuts in taxation. While the ratio of public spending to GDP declined considerably during the rapid growth of the late 1980s, the timing of the fiscal expansion was procyclical. Accordingly, the initial years of EMU saw rapid growth but also a big surge in inflation, with Ireland appreciating against its fellow

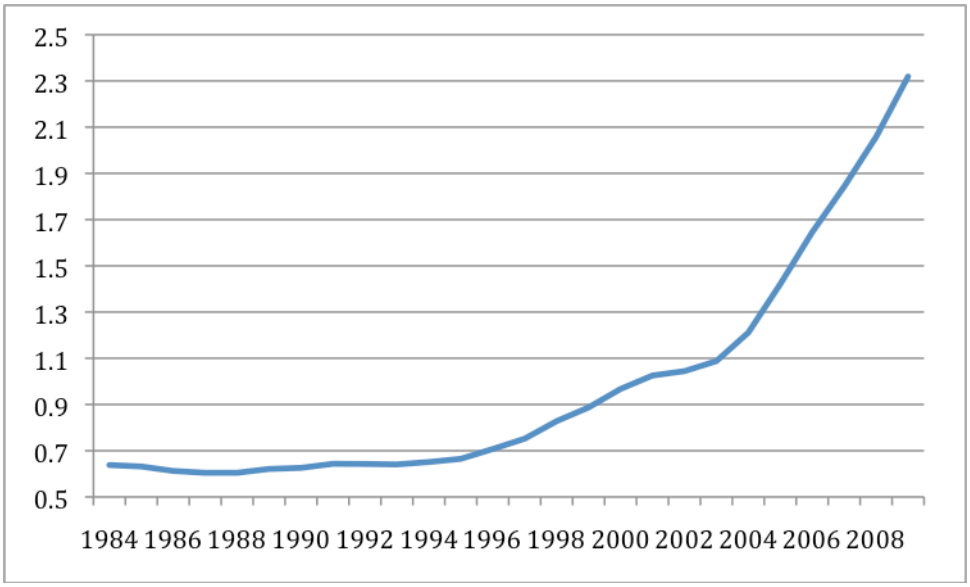
member states (Honohan and Lane 2003).

The international recession in 2001 marked a turning point for the Irish economy. The expectation at the time was that Ireland would return to a more 'normal' European growth path, since the spare capacity in the labour force had been eliminated and the real appreciation meant that the marginal gains to foreign investors were diminishing (at least in labour-intensive sectors such as assembly or call centres).

This projection was wrong. Rapid economic growth resumed in 2003 and was maintained through 2007. However, the flavour of this boom was very different to the 'Celtic Tiger' years. In particular, it was dominated by a surge in construction activity, with the economy driven by a boom in investment in housing and commercial property. In turn, the positive wealth effect from rising property prices fed into strong growth in private consumption. With tax revenues from asset-related sources very strong, the government was also able to fund a strong pace of public expenditure growth, while maintaining a budget surplus and enjoying a rapid decline in the debt/GDP ratio.

The result was strong growth in employment but with little productivity growth. While FDI still grew, it was increasingly targeted at higher-value activities that required relatively little by way of unskilled labour, even if this sector was an important source of demand for higher-skilled workers.

Figure 1. Ratio of Private Credit to GDP.

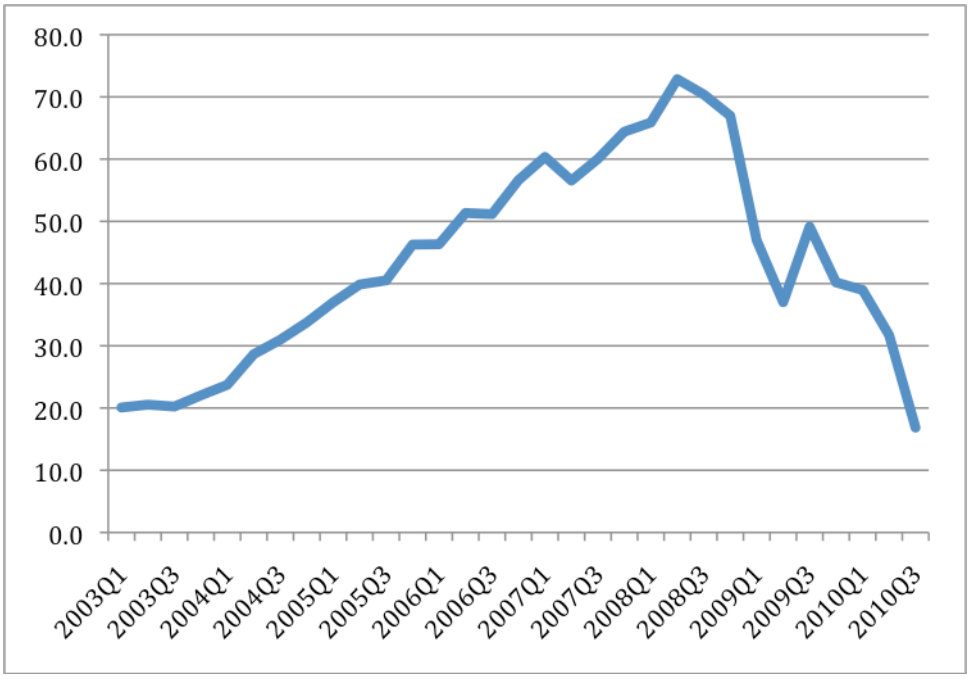



Note: Ratio of private credit by deposit money banks and other financial institutions to GDP. Source: World Bank Financial Development Database.

The expansion in property investment was fuelled by rapid credit expansion, with the ratio of private credit to GDP sharply increasing during 2003-2007 (see also Kelly 2010). Figure 1 shows the acceleration in credit expansion during this period.

This expansion encompassed an increase in credit provision to the household sector but also to a small group of property developers. These property magnates acquired large and complex portfolios that included the building of new housing estates, retail outlets and office buildings. There was also intense competition to redevelop prime sites in Dublin, looking to replace existing structures with higher-density complexes. At the peak of the boom, such sites were acquired at astronomical values.

Figure 2. Net Foreign Liabilities of Irish Banking System



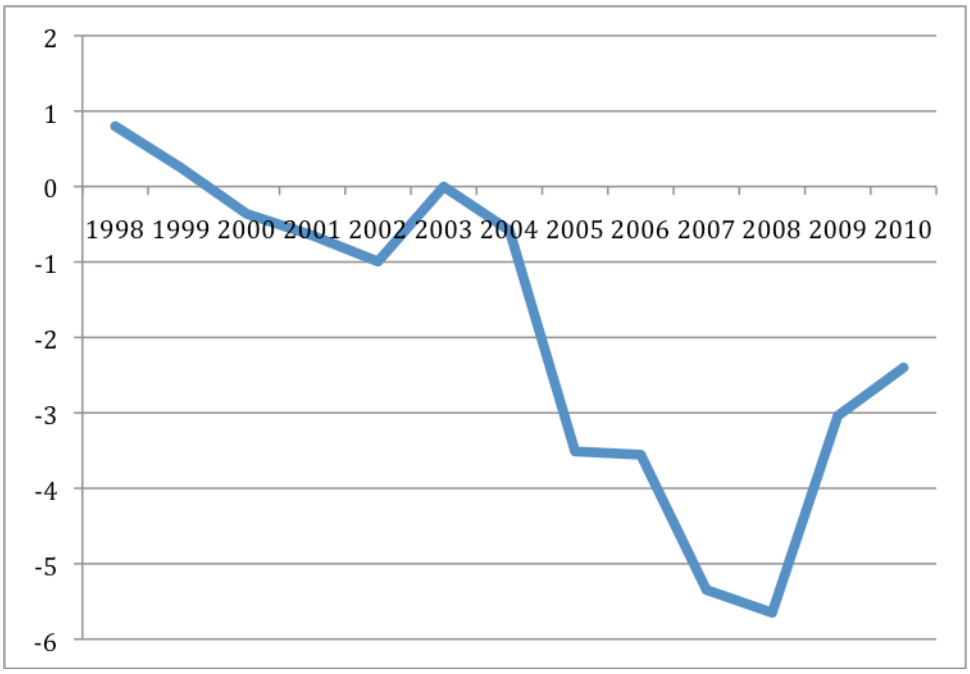

Note: Net foreign liabilities of domestic banking sector, expressed as a ratio to GDP.
Source: Author's calculations, based on data from Central Bank of Ireland.

In addition to these domestic activities, many of these developers were also aggressive in international acquisitions, in the London prime real estate sector, the United States and emerging Europe. (Irish households were also highly active in foreign property purchases, both holiday homes and buy-to-let properties.)

Much of the credit growth was provided by local banks. In turn, these banks relied increasingly on international wholesale markets for funding, with a mix of short-term interbank funds and international bond issues. However, there was also significant expansion by the local affiliates of UK-headquartered funds. The increased competition in the market contributed to very low loan spreads and a loosening of loan documentation standards. Figure 2 illustrates the extraordinary expansion in the

net foreign liabilities of the core Irish banks during this period.

Figure 3 Current Account Balance




Note: Ratio of current account to GDP. Source: Author's calculations based on data from Ireland's Central Statistics Office.

Some standard feedback mechanisms amplified the boom. The collateral cycle played an important role with rising property prices improving the net worth of domestic investors, which in turn enabled extra leverage and a further impetus to the property market. In related fashion, the high profitability of the domestic banking system enabled an expansion in the balance sheets of these institutions, with a major increase in net external liabilities. The overall current account balance shifted from near zero in 2003 to a deficit close to 6 percent of GDP in 2007, as is shown in Figure 3.

The boost to tax revenues from asset-related sources enabled the government to add to domestic demand, including via a heavy programme of public investment. A new

twist was the role played by inward migration from the new member states from 2004 onwards. Inward migration helped to limit labour cost pressures in the construction sector, while the boost to population growth also added to investor confidence that the underlying demand for housing would continue to grow.

Finally, the demand-led nature of the boom also contributed to a high rate of domestic inflation. Since this meant that the short-term real interest rate was low, it boosted borrowing and investment demand. In addition, it also boosted tax revenues due to the non-indexation of the tax system.

There were clear signs that the property sector had passed its peak by autumn 2006. However, the hope was that there would be a soft landing by which the decline in property prices and construction-related activity would be gradual in nature and could be offset by expansion in other areas. Indeed, economic activity continued to be strong during 2007 such that the risk of a sharp crash did not seem immediate, even if the historical cross-country evidence signalled that the likelihood of a large decline in house prices was substantial (Kelly 2007).

As it turned out, the final trigger for the economic collapse was the shift in international financial markets during 2007 and 2008. By early 2008, the Irish banks found it more difficult to maintain funding in the international wholesale markets and, at the same time, there was a more rapid pull back by domestic investors from the property market. This period of stress culminated in a full-scale crisis in September 2008, with commercial funding for the Irish banks drying up in the wake of the disruption of international credit markets after the collapse of Lehman Brothers. Since

then, Ireland has grappled with a triple crisis, with a severe decline in economic activity, massive losses in the banking system and rapid deterioration in the fiscal position.[1] We turn to the management of the crisis in the next section.

## 3 Crisis management

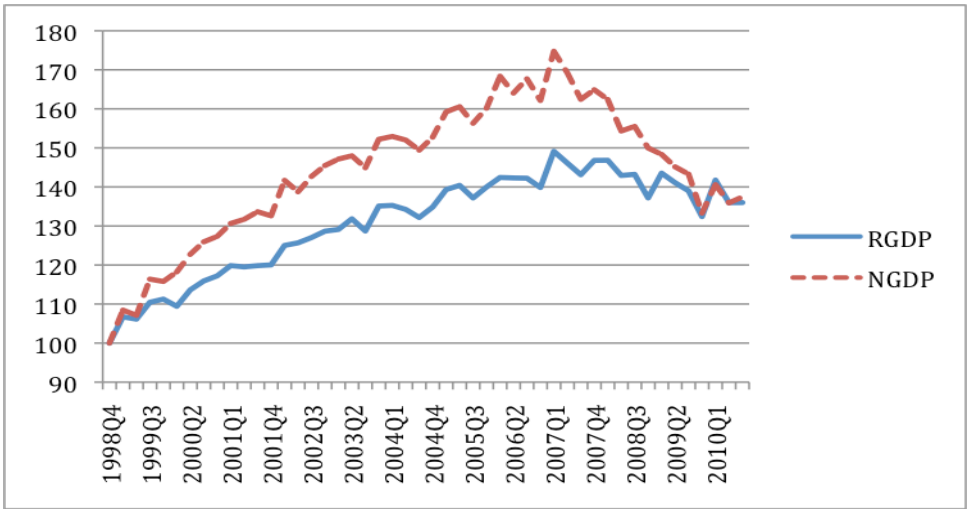
*The economic crisis*

In relation to the real economy, the recession in Ireland in 2008-2009 was driven by a dramatic decline in construction investment, with the sudden reversal in Ireland's fortunes also inducing a pull back in domestic consumption. In contrast to many other advanced economies, the export sector was a stabilising factor, with the decline in output concentrated in the domestically-oriented sectors of the economy. In a mirror image to the boom period, negative feedback mechanisms kicked in. Banks pulled in lending, which in turn amplified the downturn in the property sector. The increase in bad loans further curtailed the supply of credit by Irish banks.

The decline in domestic demand also put downward pressure on the price level, with deflation contributing to the decline in tax revenues and an increase in the real burden of debt. Deflation was also partly driven by the sharp depreciation of sterling against the euro, in view of the importance of imports from the UK in Irish consumption, which constituted a terms of trade gain for Ireland. Between September 2008 and November 2010, the cumulative decline in the CPI was 6.2 percent. Figure 4 charts the dynamics of real GDP and nominal GDP over 1998.4 to 2010.3, expressed relative to aggregate EMU-16 performance. The data clearly show illustrates the greater amplitude of nominal GDP relative to real GDP, with strong relative output growth in the first decade of EMU accompanied by above-average relative inflation and the

subsequent relative decline in output matched by a strong relative decline in inflation.

Figure 1. Real GDP and Nominal GDP, 1998.4 to 2010.3.




Note: Real GDP and Nominal GDP each expressed relative to aggregate EMU16 values, normalised to 100 in 1998.4. Source: Author's calculations based on data from Ireland's Central Statistics Office and European Central Bank.

The recession has led to a sharp increase in unemployment, which climbed from 4.6 percent in 2007 to 13.3 percent in 2010. In addition, participation rates dropped and net emigration resumed, so that the total fall in employment was about 12 percent. With the decline in domestic demand, the current account has sharply improved, from 5.6 percent of GDP in 2008 to 2.4 percent of GDP in 2010.

*The fiscal crisis*

The downturn in domestic spending and the decline in transactions in the property market meant that tax revenues fell very quickly, to the extent that the government had to introduce a series of measures to obtain other sources of tax revenue and limit public expenditure growth.

This included the introduction of graduated income levies, which had the effect of sharply increasing the marginal income tax rate for middle and high earners. For public sector workers, pay levels were de facto reduced by the introduction of a public sector pension levy, while a recruitment freeze was also implemented. Further measures were taken in the 2010 budget (announced in December 2009), including further sizeable reductions in public sector pay levels, a reduction in social benefit levels and a contraction in spending commitments.

These measures limited the scale of the decline in the fiscal situation. Even so, the underlying weak state of the economy and the collapse of the tax base meant that the baseline fiscal deficits in 2009 and 2010 were still extraordinarily large at 11-12 percent of GDP, even before taking into account the one-off costs of recapitalising the banking system.

A sizeable proportion of the deficit is structural in nature. A key problem is that elevated revenues from asset-related sources during the boom were in part deployed to reduce more stable types of tax revenue (see also Lane 2007). In particular, the direct tax burden on low and middle earners was significantly reduced during this period. In addition, the Irish tax base is quite narrow, with no significant role for sources such as annual property taxes or local-level taxes. Accordingly, a major challenge is to expand the tax base.

On the spending side, public pay levels and social benefit payments had been increased quite sharply during the good years. The initial phase of fiscal adjustment

has already rolled back some of these gains. However, a 2010 agreement with public sector unions means that nominal levels of public sector pay will not be further reduced (barring exceptional circumstances), with savings to be obtained from a combination of a recruitment freeze and productivity reforms in the delivery of public services. A saving grace is that the decline in the construction sector means that the cost of public investment projects has greatly declined, allowing cuts in nominal investment spending far in excess of the decline in real spending.

The fiscal tightening measures are certainly a procyclical force that has contributed to the scale of the recession. It would have been better to have run larger surpluses during the good years and even accumulated a liquid rainy-day fund that might have been deployed as a buffer against the impact of the severe negative economic shock (Lane 1997, Lane 1998a, Lane 2010).

Taken together, the cumulative size of the discretionary fiscal tightening over 2008-2010 amounts to €14.6 billion, which is 9.3 percent of 2010 GDP. In November 2010, the government announced a four-year fiscal plan for 2011-2014 which would involve a further €15 billion in discretionary fiscal tightening. In turn, this four-year plan forms the basis for the fiscal component of the EU/IMF deal, which is further discussed below. Under current IMF forecasts, this fiscal austerity package is projected to stabilise the debt/GDP ratio by 2014 at 124 percent of GDP.

*The banking crisis*

In addition to the baseline fiscal problem, the sovereign balance sheet in Ireland has been further strained by the government's role in resolving the crisis in the banking

sector. At the end of September 2008, the most immediate concern was to stabilise the banking system. At the time, the belief was that the main problem was the loss of market liquidity. Accordingly, the Irish government sought to improve the funding situation by guaranteeing the vast bulk of its liabilities for a two-year period (deposits, senior debt and dated subordinated debt). This was followed later in 2008 by the provision of extra capital for the banking system, as it became clear that losses on property-related loans would be greater than previously calculated. (However, these initial capital injections would prove small relative to subsequent estimates of the underlying scale of potential losses.) In April 2009, the Irish government also established the National Asset Management Agency (NAMA), with the mandate to purchase the universe of development-related loans (above a certain value) from the banks.

This triple-track strategy had an internal coherence, even if the execution of the strategy turned out to be quite problematic in several respects.[2] One basic problem was that the initial guarantee of liabilities was too broad (Honohan 2010a). By guaranteeing existing senior bonds and some types of subordinated debt, the capacity to allocate some part of the ultimate loan losses to bondholders was compromised, raising the taxpayer cost of resolving the banking crisis.

In relation to asset transfers, the aim was to cleanse bank balance sheets by transferring development-related loans to NAMA, since this category was the main source of uncertainty concerning total loan losses. During 2009-2010, NAMA purchased most of these loans at a steep average discount, such that the transfer also forced the banks to crystallise the losses on these loans. Under the guidance of EU

rules, the discount has been applied on a loan-by-loan basis. Accordingly, there were substantial transaction costs involved, since each individual loan had to be individually assessed. Moreover, the cumbersome nature of this approach meant that the transfer of loans took place slowly, which inhibited the goal of a rapid cleansing of bank balance sheets. (Under the EU/IMF deal, the remaining transfers to NAMA do not require loan-by-loan appraisal.)

While the asset transfer approach had the virtue of transparency, it also meant that the banks required substantial upfront recapitalisation programmes. Only one bank (Bank of Ireland) was able to raise significant new private capital, such that the State has ended up with extensive control of the Irish banking system. In turn, the high recapitalisation costs led to a sharp increase in gross government debt and increased the riskiness of the sovereign debt profile, in view of the ongoing uncertainties regarding ultimate losses in the banking sector.

While all banks have suffered considerable losses, the most extreme losses (relative to the size of loan books) were incurred by two marginal banks that have been revealed to have had very weak corporate governance. The biggest offender has been Anglo-Irish Bank, which was nationalised in early 2009. While it had little presence in the retail deposit market, this bank had grown very rapidly through aggressive property-related lending which was largely funded on wholesale markets. The losses at this bank have been by far the largest contributor to the overall losses in the Irish banking system. In addition, a smaller mutual bank (Irish Nationwide Building Society or INBS) has also incurred catastrophic property-related losses. However, the losses at the two main commercial banks (Bank of Ireland and AIB) and the tail-risk exposures

of these banks to further deterioration in the economy has meant that the entire banking system has been compromised.

While the public capital injections into Bank of Ireland and AIB may be viewed as financial investments that may ultimately yield a return, the capital poured into Anglo-Irish Bank and INBS is effectively a write-off. The capital transfers to Anglo-Irish Bank and INBS pushed the overall 2009 general government balance to 14.5 percent of GDP and the 2010 balance to 32 percent of GDP.

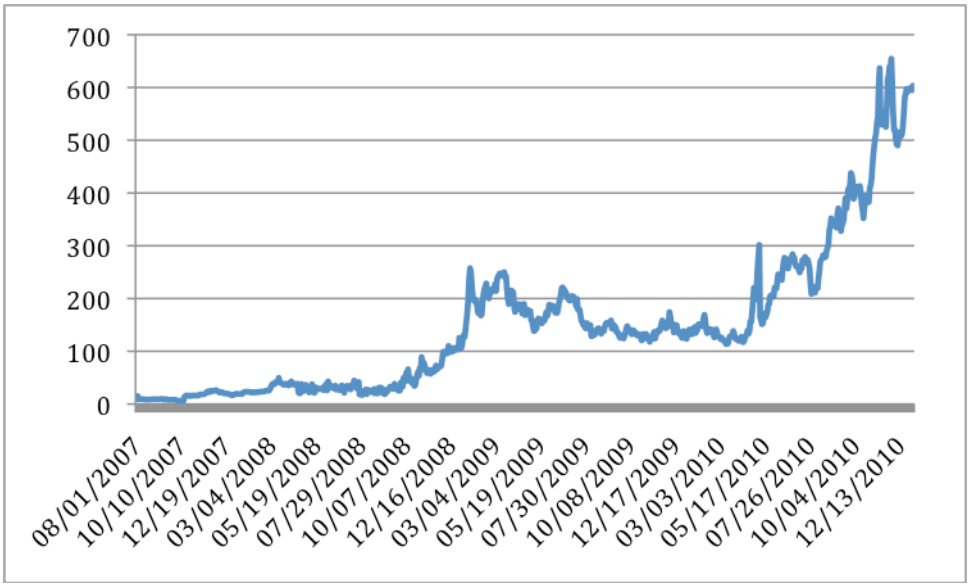
*The EU/IMF deal*

The Irish government ultimately requested assistance from the EU and IMF in November 2010. There were several triggers for this decision. In relation to the banking system, the expiry of the State guarantee in September 2010 led to an exit of private-sector funders that had committed funding under the guarantee. In turn, this resulted in a marked increase in the reliance of the Irish banks on liquidity support from the ECB and the extraordinary liquidity assistance facility of the Irish central bank. Apparently, the view from the ECB was that this liquidity support could only be maintained if the process of downsizing the Irish banking system were accelerated and the capital ratios of the Irish banks further improved as a buffer against tail-risk losses.

In addition, the projected level of property-related losses had increased over summer 2010, with the discounts on the second tranche of loan transfers to NAMA greater than expected. In addition, the new management team at Anglo-Irish Bank decided to make extra provisions on non-NAMA loans, requiring further capital injections into

Anglo-Irish Bank.

Figure 5 Spread between Ten-Year Bonds: Ireland over Germany.




Note: Yield spread on ten-year government bonds. Source: Author's calculations based on data from Global Financial Data.

These extra capital requirements contributed to increased market concerns about the sustainability of the fiscal position. More generally, the surprise nature of the extra provisions underlined the extent of the uncertainty surrounding estimates of total loan losses in the Irish banking system and this tail risk pushed up the spread on Irish sovereign debt (Figure 5).

Furthermore, a downward revision to the 2009 GDP data was announced in June 2010 and the publication of lower growth forecasts in the IMF Article IV report in July 2010 led to a re-assessment of the scale of the adjustment that would be needed to achieve a sustainable fiscal position. In part, these lower GDP forecasts related to a more pessimistic view of the impact of the financial crisis on the medium-term trend

growth rate for the economy. However, an additional factor was a greater recognition that the adjustment process would involve a sustained real depreciation, in which the growth in the GDP deflator would be negative in the short-term and only increase slowly over the medium term, such that the five-year projection for nominal GDP was much lower than previously estimated.

The total financial package under the EU-IMF deal is valued at €85 billion, which is about 54 percent of 2010 GDP for Ireland. However, €17.5 billion of the total is domestically sourced, from the assets held by Ireland's sovereign wealth fund (the National Pension Reserve Fund) and the cash balances held by the agency responsible for managing the national debt (the National Treasury Management Agency). The external component of €67.5 billion is evenly split with €22.5 billion from the European Commission's European Financial Stability Mechanism (EFSM); €22.5 billion from the International Monetary Fund (IMF); and €22.5 billion from the European Financial Stability Fund (EFSF) and bilateral loans (from the UK, Sweden and Denmark).

In terms of composition, the intention is that €50 billion can provide funding to the Irish State, such that Ireland need not primarily rely on the bond markets to fund its fiscal deficit or roll over existing debt over the next three years. (Although the programme does require Ireland to have partial access to market funding from 2012 onwards.) In relation to the banking system, €10 billion is to be drawn down to provide extra capital to the Irish banking system (€8 billion) and fund credit enhancements that are intended to allow the Irish banks to sell packages of risky loans to private investors (€2 billion). The final €25 billion is contingent funding that can be

drawn down if its turns out that the Irish banking system requires yet further capital in the coming years.

The agreed programme involves discretionary fiscal tightening of €15 billion over 2011-2014, with €6 billion of this total to take place in 2011. Under an optimistic growth scenario, this might deliver a budget deficit to GDP ratio in 2014 that is just under the 3 percent limit. However, the programme recognises that a lower growth path would not see the 3 percent target achieved by 2014. Under that scenario, the programme envisages that further tightening will be required in 2015, in order to achieve the 3 percent target.

The combined interest rate across the different funding lines is of the order of 5.8 percent per annum for a 7.5 year loan. While this is in line with standard IMF funding conditions, it is arguable that the European component of the funds could have been priced at a lower rate. While it is certainly important that such official funding contains a premium to discourage moral hazard, the 300 basis point premium built into this funding rate makes it more difficult to achieve fiscal sustainability. This limits the degree of solidarity across EU partners, while also increasing the risk facing other European governments in view of the potential contagion from doubts about the sustainability of the Irish sovereign position.

Although the context is quite different, it is striking that the December 2010 agreement between Iceland and the UK and Dutch governments on the Icesave debt specifies an interest rate of 3.2 percent over a long repayment period, with the interest rate calculated to approximate the cost of funds for the creditor governments.

Similarly, the balance of payments support provided by the European Commission to EU member countries outside the euro area (Hungary, Latvia) does not carry a similar penalty premium.

In terms of structural reforms, the main objective under the deal is to de-risk the banking system (see also Honohan 2010c, Honohan 2011). This involves several elements. First, the extra capital injections are intended to increase in core Tier 1 capital ratios to 12 percent. Second, the level of risky loans held by the banks are to be reduced through the transfer of extra property loan tranches to NAMA and the sale of loan packages to private investors. (As indicated above, the sale of loan packages to private investors will be supported by €2 billion in credit enhancements to limit the risk exposure that would otherwise deter private investors.) Third, the banks will be further downsized through the disposal of affiliates and other non-core assets. Fourth, the winding down of the main disaster banks (Anglo-Irish Bank and Irish Nationwide Building Society) will be accelerated. Fifth, the €25 billion in contingent funding provides an additional buffer in the event of extra loan losses.

Finally, these financial measures will be accompanied by a more extensive third-party assessment of the quality of the loan books. While the Irish central bank published a prudential capital assessment review (PCAR) in March 2010 that set out conservative provisions for loan losses (this was updated in September 2010), the level of uncertainty about loan quality means that further information disclosure is necessary in order to improve market understanding of the likely distribution of loan losses. Furthermore, the role of third-party assessors in examination of the loan books is seen as important in guaranteeing the rigour of the 2011 PCAR exercise. If it turns out that

the review signals that extra bank capital is advisable, this is allowed for under the terms of the EU/IMF funding.

Taken together, the goal is that these banking sector reforms will result in a smaller, less-risky and better-capitalised banking system. In turn, these changes improve the sustainability of the ECB liquidity provisions and also increase the likelihood that the Irish banks can return to the private wholesale funding markets.

An important issue in the negotiation of the deal was the appropriate scale of burden sharing by bank bondholders in the recapitalisation of the Irish banking system. If the holders of bonds issued by the Irish banks absorbed some of the losses, the fiscal burden would be lightened. It seems that there were about €32 billion of non-guaranteed bank bonds outstanding at the time of the EU-IMF deal, consisting of €12 billion of subordinated debt and €20 billion of senior debt. These are bonds that were issued before the introduction of the September 2008 guarantee (which has now expired) but have not yet reached their maturity dates. In addition, about €25 billion of guaranteed senior bonds have been issued under the 2009 Eligible Liabilities Guarantee scheme for new debt issuance.[3] (A small amount of new non-guaranteed bonds has also been issued.)

The EU-IMF deal envisages that holders of subordinated debt will not be repaid in full. There is currently a bond exchange programme for the Anglo-Irish subordinated debt which offers the bond holders 20 cents on the euro. Over the last two years, there have been other voluntary exchange programmes for subordinated debt holders in several banks, with an estimated €7 billion obtained in discounts. (It is arguable that

these earlier exchange programmes were premature in that the appropriate level of discount could not be properly determined before the full systemic evaluation of prospective loan losses had taken place.)

However, it also seems that there was serious discussion of writing down the value of some non-guaranteed senior bonds as part of the IMF/EU negotiations. While the legal tradition in Ireland has been to view senior bonds as pari passu with depositors, it seems that there may be legal options to break that link. For instance, in situations in which the scale of State capital injections exceeds the pre-crisis level of capital, it may be possible to argue that senior bondholders should have no legitimate expectation of full repayment.

However, no agreement was reached for restructuring the non-guaranteed senior bonds. Media reports indicate that European policymakers took the view that the restructuring of senior debt would create a new precedent in European banking that could severely disrupt bank funding markets. However, the counter-argument is that a set of objective criteria could be developed that would clearly delimit the scenarios under which some types of senior debt should be written down, thereby limiting the scope for contagion.

Indeed, the working document of European Commission (2011) identifies a range of possible criteria, even if the scope of the European Commission report is restricted to the design of future bank bond contracts, rather than to altering the payoffs on existing bank debt. Moreover, to the extent that the restructuring of senior bank bonds improves the sovereign fiscal position, it might even be a calming influence on

sovereign debt markets. The ultimate treatment of the non-guaranteed senior bank bonds remains an unresolved issue and is set to feature in the political debate surrounding the upcoming general election in Ireland.

In terms of other structural reforms, the main priority is to improve the operation of the labour market in order to facilitate a reversal in the sharp increase in unemployment (much of it now long-term) since the onset of the crisis. The minimum wage (set at the peak of the boom) has been reduced by 12 percent, while there has been a further 4 percent decline in unemployment benefits. In addition, more vigorous labour market activation policies are envisaged under the plan and other types of rigidities in the wage setting system will be targeted. In relation to product markets, there are aspirations to reduce monopoly rents in sheltered sectors (such as the legal and medical professions) and boost productivity in the public sector.

However, the growth payoff from such reforms may occur with a long lag and cannot be relied on to improve growth substantially within the period of the deal. Similarly, public sector reform has the potential to boost efficiency considerably, but the overall growth payoff will only occur over a long period. Accordingly, it is not realistic to expect a sizeable direct short-term growth payoff.

Overall, the EU/IMF deal provides an environment in which Ireland can make progress in resolving its crisis. However, there are considerable implementation challenges in delivering the planned fiscal adjustment (see also Beetsma et al 2009). In addition, the cost of restructuring the banking system remains uncertain and depends on the ability to sell bank assets at prices above fire sale values.

Both the debt dynamics and the health of the banking sector are dependent on the rate of nominal GDP growth in the coming years. In this regard, there is considerable uncertainty about the path for GDP. The Irish finance ministry and the main local economic forecaster (the ESRI) are relatively optimistic about the speed of output growth, pointing to the capacity for a small open economy to rely on export-driven growth and the high current levels of precautionary savings that should decline once uncertainty declines and consumer confidence recovers. Against that view, the cross-country historical evidence is that output growth is typically very slow after major banking crises, even if these historical examples do not precisely match the current Irish conditions (Reinhart and Reinhart 2010).

Having reviewed the course of events in Ireland, we now turn to asking some general questions about the lessons to be drawn from the Irish experience in relation to the impact of EMU on member countries.

## 4 Ireland and EMU

At a surface level, it is possible to argue that membership of EMU has directly contributed to the boom-bust cycle in Ireland.[4] First, Ireland entered EMU at the peak of the Celtic Tiger output boom, with full employment only recently achieved and the emergence of shortages in the labour market. Accordingly, the initial conditions for Ireland were quite different than for the aggregate euro area economy.

A standard prescription in this case is to revalue the exchange rate prior to entering the monetary union, such that price level pressures in the economy are diverted into

nominal exchange rate appreciation rather than a differential post-entry inflation rate. While Ireland undertook a small revaluation in spring 1998, this was inadequate given the scale of the boom.[5] Accordingly, the undervalued conversion rate between the Irish pound and the euro contributed to the inflationary pressures in Ireland in the early years of EMU.

Second, the creation of EMU itself represented an asymmetric shock. In particular, while the core member countries had experienced a convergence in interest rates long before the formation of EMU, there was a substantial decline in interest rates for peripheral member countries such as Ireland, Portugal, Spain and Greece in the late 1990s. For these countries, a history of devaluations meant that there was a substantial country risk premium in interest rates. Moreover, the smaller countries suffered from a low level of liquidity in their money and currency markets, such that a liquidity premium was also incorporated into the level of interest rates in these countries. Accordingly, EMU represented a major economic shock for them, since devaluation risk and currency liquidity risk were eliminated. As such, holding fixed other factors, households, firms and governments in these countries now faced a permanent reduction in the cost of capital. In turn, this triggered an expenditure boom in these countries (see also Fagan and Gaspar 2007).

Third, by virtue of its greater involvement in extra-EMU trade, Ireland was more affected by shifts in the external value of the euro than was the case for other member countries. In particular, the sharp depreciation of the euro against the dollar during 1999-2002 represented a positive differential shock for Ireland vis-à-vis the rest of the euro area, since the strong economic linkages between Ireland and the United States

meant that Irish competitiveness was boosted by more than in other countries. This contributed to the already-strong aggregate demand conditions in Ireland during that period and the positive inflation differential between Ireland and the rest of the euro area (Honohan and Lane 2003). More recently, the rapid depreciation of sterling against the euro during autumn 2008 has affected the Irish economy more than other regions in the euro area.

Fourth, the effective segmentation of national banking systems that remained even after the formation of EMU meant that shifts in market structure in the Irish banking system posed a challenge for the domestic financial regulator. In particular, aggregate credit growth in Ireland was boosted by the rise of Anglo-Irish Bank as an aggressive lender to property developers, which in turn induced a relaxation of lending standards by other participants in the Irish loans market (Honohan 2009, 2010a, 2010b). In similar fashion, greater competition from the affiliates of UK banks further contributed to rapid domestic credit growth. In turn, this domestic credit boom contributed to faster expansion in Irish aggregate demand relative to other members of the euro area and increased country-specific risks in the banking system.

Fifth, there have been major shifts in government spending and taxation in Ireland relative to other members of the euro area since 1999. Membership of a monetary union is perfectly consistent with a wide range of variation in terms of the ratios of government spending and tax revenues to GDP. However, the timing of the fiscal expansion was procyclical in nature, such that fiscal policy tended to amplify cyclical divergences between Ireland and the rest of the euro area economy.[6]

Sixth, the asymmetric liberalisation of EU labour markets to migrants from the new member states in 2004 represents a further idiosyncratic shock. In particular, Ireland was the only member of the euro area to open its labour market to workers from Central and Eastern Europe and only the United Kingdom and Sweden adopted a similar approach among the existing members of the EU. The scale of post-liberalisation migration far exceeded ex-ante expectations, acting as another structural shock for the Irish economy that was not shared by its fellow members of the euro area.

Taken together, these country-specific factors meant that macroeconomic stability in Ireland required effective national stabilisation policies. However, there was a failure to regulate the banking sector to guard against systemic risk factors. This was especially problematic under EMU, since access to the area-wide financial markets meant that the scope for Irish banks to take on too much risk was amplified. Moreover, the operation of fiscal policy was insufficiently counter-cyclical. These twin policy weaknesses both failed to curb the boom and exacerbated the scale of the crisis.

The weaknesses in banking regulation have been extensively analysed in two major reports that were commissioned by the Irish government (Honohan 2010a, Regling and Watson 2010). As a follow on to these reports, a banking inquiry has been established to further probe into these regulatory failures. This should prove helpful in establishing in more detail the factors that contributed to the banking crisis. However, major required reforms have already been implemented, with new senior appointments at the Central Bank and a reorganisation of the system of financial

regulation.

In relation to fiscal policy, there were both macroeconomic and microeconomic weaknesses (see also Lane 2010). While budget surpluses were run during the boom period, these were relatively small and the scale of the structural deficit was systematically underestimated (by both domestic and international agencies). On net, the fiscal position was fundamentally fragile, despite appealing headline numbers. In relation to microeconomics, the tax system during the boom period provided excessive incentives to invest in property - and these distortions amplified the cycle.

Accordingly, the lesson is that the fiscal system needs to be redesigned in order to be more robust in the event of future shocks. A broader tax base should help to provide a more stable platform for tax revenues, while the setting of tax rates should be counter-cyclical or at least acyclical. In relation to the fiscal balance, the crisis has illustrated that a small open economy such as Ireland should run much bigger surpluses during boom periods in order to provide fiscal space during downturns. An important current debate is whether formal fiscal rules and a role for an independent fiscal council can facilitate a more countercyclical pattern for fiscal policy (Lane 2010). Indeed, the EU/IMF deal includes a commitment to introduce a Fiscal Responsibility Law and a Budgetary Advisory Council in the first half of 2011.

The failure to implement appropriate national stabilisation problems meant that Ireland took excessive macroeconomic risks during the early years of EMU. In turn, membership of a currency union limits the range of options that can be pursued in emerging from the current crisis. However, along some dimensions, membership of

the euro area has also provided considerable stability during this crisis period. Most directly, the Irish banks have heavily relied on the liquidity provided by the European Central Bank as a substitute for the loss of access to private wholesale funders. In addition, highly-indebted Irish households have benefited from low ECB interest rates during the crisis.

Had Ireland not joined the euro, the foreign liabilities of the banking system would most likely have been in foreign currency and the banking crisis would have been amplified by a parallel currency crisis. Moreover, an independent currency would not have offered a guarantee against the onset of the mid-2000s credit boom. This credit boom affected many non-EMU economies in Europe (Iceland, Central and Eastern Europe) and many countries have experienced the problems associated with currency overshooting that can act to amplify the impact of credit booms, only to be followed by a deeper crash with currency depreciation exacerbating balance sheet problems. Moreover, even under an independent monetary policy, it is not clear that the central bank would have been able to neuter the housing boom solely through its interest rate policy, in view of the weak relation beween interest rates and housing prices and the potential output costs of targeting asset prices ahead of real indicators (Dokko et al 2011).

Of course, there are some attractions to an 'immaculate' devaluation by which a one-off realignment of the Irish real exchange rate could provide a boost to exports. However, as is exhaustively documented by Eichengreen (2010), there are considerable financial and logistical disruptions associated with seeking to exit the euro. In view of Ireland's very deep level of international financial and economic

integration, these transition costs might be especially high.

Moreover, the longer-term attractions of an independent currency remain open to question for the reasons given above. Such problems would be especially severe for a new currency created in the wake of exiting EMU, since the credibility of the new monetary regime and its anti-inflation commitment would be queried by the markets. Accordingly, the monetary regime for a new Irish currency would likely require an initial phase of relatively high interest rates.

In terms of the broader reform of the institutional framework for the euro area, the failures in domestic macroeconomic policy and financial regulation during the pre-crisis period mean that the proposals by the European Commission for tighter surveillance are welcome in terms of reducing the risk of future crisis episodes.

However, the absence of an EU-wide special resolution regime for failing banks has made it more difficult and more costly to resolve the Irish banking crisis. In relation to future crises, the types of proposals currently being developed by the European Commission should help (for instance, in allowing for the bailing in of senior unsecured bond holders in the event of severe bank losses) but these are too late to be helpful in resolving the current crisis. More broadly, the creation of the European Systemic Risk Board and the associated European Supervisory Authorities should help in monitoring European-wide risks in the financial system.

While the creation of the European Financial Stability Facility (EFSF) has facilitated the funding of the IMF/EU programme for Ireland, the size of the penalty premium

built into the interest cost is arguably too stiff for a fund that is built on the principles of solidarity and common financial interests among members of the euro area, since it is sufficiently high to non-trivially increase the risk that the sovereign will ultimately run into repayment difficulties.

Furthermore, the EFSF can only provide loans to member governments. In terms of promoting financial stability, a more flexible mechanism that could also offer tail-risk insurance might have been better suited to tackling the underlying fiscal exposure of the Irish government in relation to resolving the Irish banking crisis (see also Honohan 2011).

The current proposals for the permanent European Stabilisation Mechanism (ESM) that will replace the EFSF in 2013 do not extend the remit of the ESM to include this type of risk sharing mechanism. However, the greater clarity about the potential for burden sharing by bondholders under the ESM should prove helpful in providing greater market discipline in relation to future fiscal management. However, the uncertainty about the transition towards the ESM arrangements is a source of instability in dealing with the current sovereign debt crisis.

## 5 Conclusions

The 2003-2007 property-driven boom has proven to be very costly for Ireland, resulting in a deep recession, a severe fiscal crisis and the near-collapse of the banking system. While the frothy state of international financial markets and the under-pricing of risk certainly played a role in fuelling the boom, the primary responsibility for curbing excesses lay with domestic policymakers. In this regard,

there was a twin failure with the financial regulator losing control of systemic financial risk, while fiscal policy was insufficiently counter-cyclical.

By the same token, although the 2007-2008 international financial crisis was the proximate trigger for the hard landing in the domestic property market, the unwinding of the boom was bound to happen at some point, even if the nature of the inevitable adjustment might have been different under alternative realisations.

At a domestic level, a primary lesson from the Irish crisis is that it reaffirms the principle that rigorous discipline in fiscal policy and financial regulation is essential if membership of a currency union is to be compatible with macroeconomic and banking stability. At an EU level, the Irish crisis has highlighted the costs of the incomplete institutional design of the monetary union and the importance of deep-level reforms both to reduce the probability of future crises and to increase the resilience of the European banking system in the event of a crisis.

**Notes**

[1]The crisis in Ireland has other dimensions, including the damage to Ireland's international reputation and a loss of confidence among the domestic population in the

[2] Other approaches to resolving the banking crisis were also debated. For instance, the pre-emptive nationalisation of the banking system was advocated by many domestic economists and also raised by the 2009 IMF Article IV mission.

[3]The main focus of the debate is on the non-guaranteed bonds, since a restructuring of guaranteed bonds would have broader implications for sovereign debt.

[4]This section draws on Lane (2009).

[5]Lane (1998a) recommended that Ireland undertake a much larger revaluation. Slovakia revalued by 15 percent in 2008 before it joined EMU at the beginning of 2009.

[6]Lane (1998c) and Hunt (2005) analyse the long-standing procyclical pattern in Irish fiscal policy.

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