Ross Killion and Jess Delaney

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Econ 341

Current Status of Irish Economy

Long known as a country of poverty, famine and emigration, Ireland turned 180 degrees in the mid-1990's to become one of the strongest economies in Europe, boasting peak unemployment of 4.2 % and GDP growth of 6% (CIA). This economic miracle, often called the Celtic Tiger years, began in 1995 and ended along with the world financial crisis of 2008. GDP shrank by 3% in 2008 while average house prices fell by 47% (CIA). Legend has it that Irish policy makers convened at a trendy Irish pub, Doheny and Nesbitt, to discuss and eventually formulate the economic and government policies that kick-started the Celtic Tiger years. The policies embraced low-taxes, low import duties, invested in education and skills, improved infrastructure and welcomed foreign investment with open arms. Another important factor was Ireland's enthusiastic cooperation with the European Union.

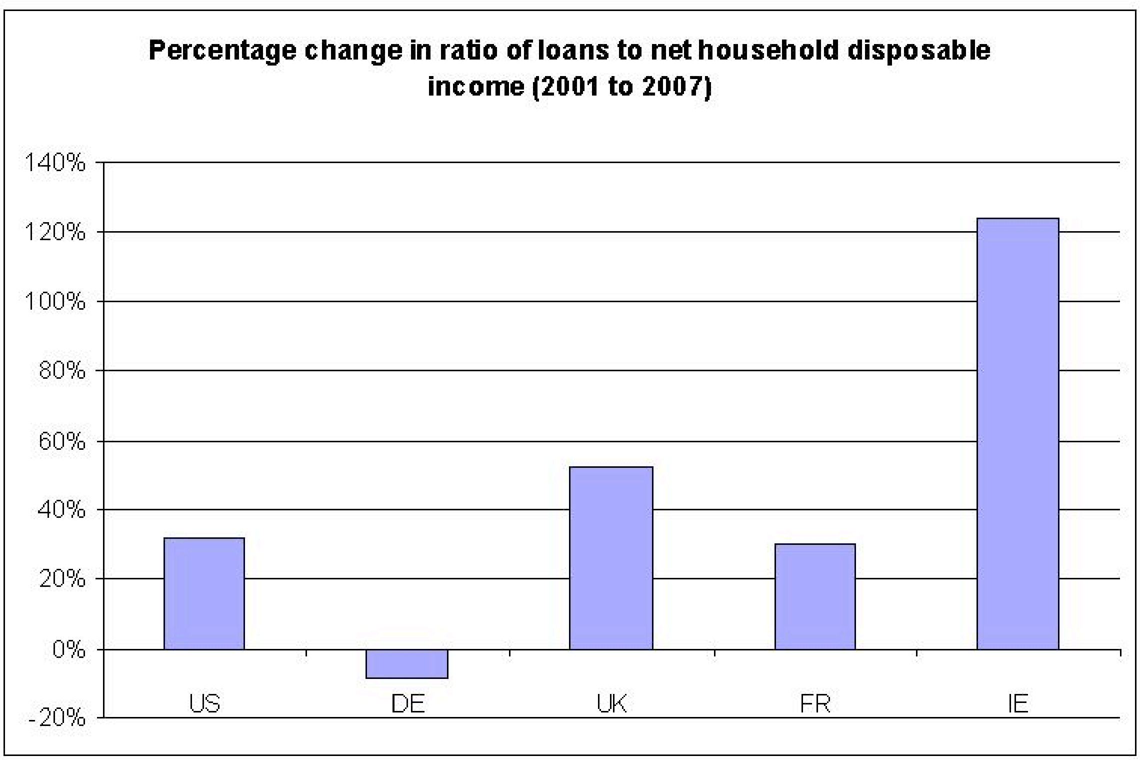
The roots of today's Irish economy can be traced to the early 20th century when the nation was known as the Irish Free State. This era was characterized by economic nationalism due to a retaliatory economic war with the United Kingdom in the 1930's. Import substitution and high tariffs resulted in economic stagnation while the rest of Europe enjoyed prosperous economic growth. It is estimated that 400,000 emigrants left Ireland in the 1950's. By the mid-1980's policy makers realized that economic nationalism was doing more harm than good and in 1987, Fianna Fail, a moderate Irish political party, introduced several capitalistic policies including lower taxes, reduced government spending and increasing foreign investment (Irish

Examiner). Intel, Microsoft and Google all jumped to Ireland to take advantage of relatively low wages and tax rates. The de-regulated atmosphere also opened the way for Irish entrepreneurship to prosper as shown by RyanAir and Elan. Importantly, and for the first time in history, Ireland became a land of opportunity, drawing in hundreds of thousands of immigrants from Eastern Europe.

The first part of the Irish economic miracle is often considered the ‘catching up’ portion as Irish standard of living reached the level enjoyed by Western Europe. The second part, after the mini-economic stagnation of 2001, is often blamed for the economic collapse of 2008. From 2002-2007, economic growth was largely based on short-term, high-risk money lending from abroad to satisfy the newly financially-empowered Irish borrowers which lead to a rapid expansion of credit as seen in Figure 1 where the rapid rise of lending in Ireland is compared to other advanced economies (European Commission). On top of this, the Irish economy became increasingly dependent on house building, causing a rapid increase in property taxes and the build up of a housing bubble. Additionally, overall competitiveness in the country dramatically decreased; this can be traced to an amplified nominal exchange rate resulting in a loss of price and cost competitiveness (DOF). The trade-weighted exchange rate, Ireland’s Harmonised Competitiveness Indicator (HCI), increased by 10% during the decade leading up to the financial crisis; this reflects an appreciation of the Euro which made Irish products more expensive beyond the Eurozone (DOF). This was compounded with a demand for higher pay by Irish workers, which further lowered cost competitiveness and retarded the export growth rate from 17.8% between 1995 and 2000 to 5.3% in the five years after (DOF). This decrease in exports shifted the economy towards domestic consumption, particularly the housing market. With 90,000 housing units completed in 2006, the residential investment rate in Ireland had reach 13%

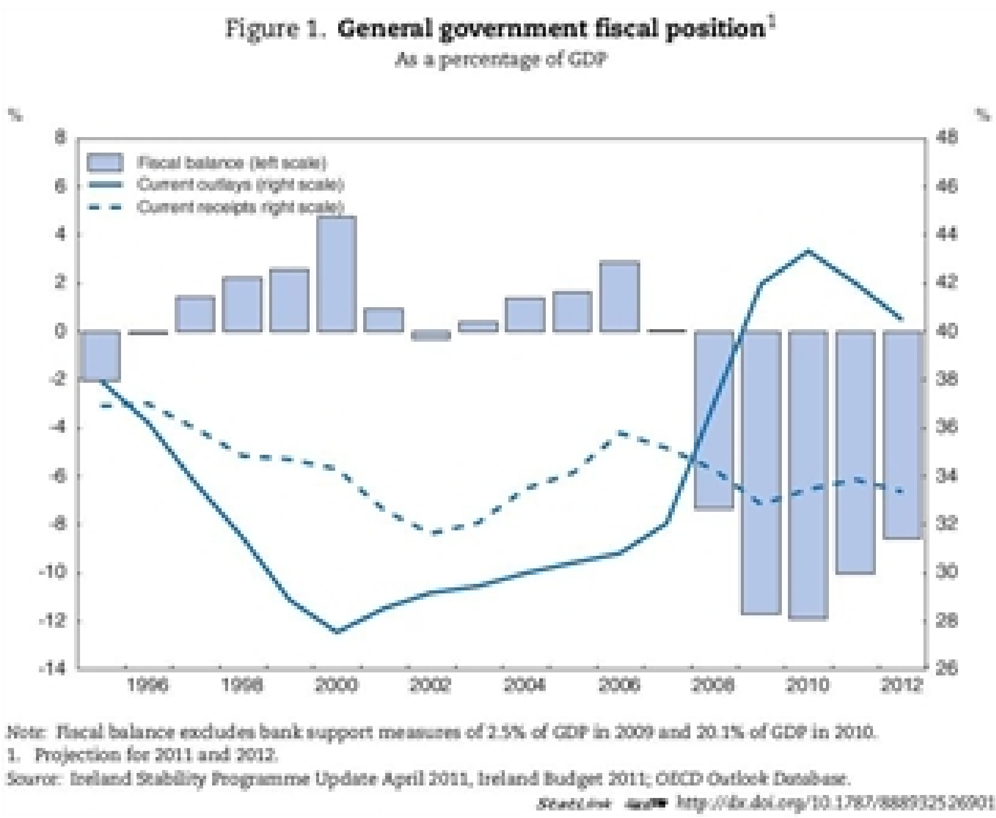
of GDP (DOF). Between 1997 and 2006, housing prices increased by an astronomical 240%, a boom fuelled by increased bank lending and borrowing from abroad which in turn were enabled by exceedingly low interest rates (DOF). Between 2005 and 2009, about 4.25% of national income was borrowed from abroad every year, dangerously cementing Ireland's vulnerability during the world financial crisis (DOF). Reduced fiscal confidence dwindled demand for personal items causing the housing market to collapse in addition to other markets such as cars and technology. The lowest point in the Irish recession was in the first quarter of 2010 when unemployment rose to 14.7% (New York Times) and GNP fell by 17%, although currently, the economy has been in a slight upswing.

Figure 1. (European Commission)



Similarly to the United States, Irish banks were overexposed to the housing bubble, and the decline in home values drained them of capital. In 2008, the Irish government responded to the banking crisis by guaranteeing bank deposits, recapitalizing the banks, and establishing partly-public venture capital funds. Toward the end of the following year, the government created the National Asset Management Agency (NAMA) to act as a bad bank. The agency absorbed the problematic property and development loans held by banks to reduce their liabilities. Although these efforts worked for a while, the government's exposure to the declining housing market had serious fiscal consequences. The government began running high deficits as banks took heavy losses. Figure 1 shows how the fiscal balance was predominately positive over the Celtic Tiger years until becoming hugely negative after rescuing the banking sector.

Figure 2: (Taken from OECD)



The government attempted to shore up the deficit in its 2009 budget plan by slashing spending across-the-board, including lowering wages for government employees. However, the new budget was not enough, and the deficit rose to 32.4% of GDP in 2010, becoming the world's largest deficit (as a percentage of GDP) (CIA). This caused financial markets to question the sustainability of Ireland's debt. The increased risk of sovereign default caused yield spreads on Irish bonds to skyrocket, and the country lost access to sovereign bond markets.

In late 2010, the government sought help from the European Central Bank, European Commission, and IMF (together known as Troika). The EU-IMF financial assistance program allotted EUR 50bn for the country's public finances and EUR 17.5bn to help recapitalize the banks for the 2011-2013 period (OECD). In addition, Ireland agreed to pledge EUR 17.5bn to help provide banking support. Table 1 shows the program broken down by the sources of loans along with respective interest rates.

Table 1: (Taken from OECD)

Table 2. **EU-IMF financial assistance programme**

	Amount	Indicative interest rates
	Billions of euro	Per cent
IMF[1]	22.5	4.8
EU	45	
of which: EFSM[2]	22.5	2.9
EFSF[3]	17.7	3.1
Bilateral loans[4]	4.8	
Total external support	67.5	
Ireland's own resources[5]	17.5	n.a.
Total package	85	

Note: The July 21 2011 EU summit and subsequent decisions lowered the interest rate on loans from the EFSF and EFSM to the borrowing costs of the EFSM and EFSF respectively. This lowered the interest rate charged on loans made through these facilities by around 290 basis points. The United Kingdom agreed to lower the interest rate charged on its bilateral loan to match the EFSF and EFSM rates.

1. Including hedging costs.
2. European Financial Stability Mechanism. Interest rate is indicative only and is the average borrowing cost of the EFSM in its bond issues in January and March 2011.
3. European Financial Stability Fund. Interest rate is indicative only and is the average borrowing cost of the EFSF in its bond issues in January and June 2011.
4. Funds from the United Kingdom (EUR 3.8 billion), Sweden (EUR 0.6 billion) and Denmark (EUR 0.4 billion).
5. EUR 7.5 billion in cash and the remainder from the National Pension Reserve Fund.

Note: European Commission (2011), Secretariat calculations and Department of Finance, Ireland.

Access to the EU-IMF loans is contingent upon Ireland taking immediate steps toward reforming its financial system and downsizing its public finances. It was determined that the banking system was larger than Ireland needed. Therefore, the banking sector will be consolidated around the solvent banks. Furthermore, capital requirements will be raised for all credit institutions (Economic Adjustment 2011). The Central Bank of Ireland created the Financial Measure Programmer (FMP) to perform stress tests on the financial system to determine necessary reforms. Under FMP, the annual Prudential Capital Assessment Review will calculate the capital requirements and costs necessary for the banking system under different stress scenarios. The Prudential Liquidity Assessment Review establishes “funding targets for banks to reduce the leverage of the banking system, reduce banks’ reliance on short-term, largely central bank funding, and ensure convergence to Basel III liquidity standards over time” (Central Bank of Ireland).

Ireland has set a deficit target of 3% of GDP for 2015. The country has highlighted spending cuts as its primary mechanism for fiscal consolidation. November, 2010 saw the announcement of the National Recovery Plan. The four year plan called for a reduction in public expenditure of EUR 10bn and a tax revenue increase of EUR 5bn up to 2014. Social welfare programs were to be cut by EUR 2.8bn over the four year period. The plan also called to reduce the minimum wage and cut wages and pensions for public servants. In addition, property taxes and domestic water charges would be put in place (RTE). Early in October 2012, the government announced that it would pass a law which would make it easier for people to declare bankruptcy and default on their mortgages. This is intended to give banks an incentive to reduce mortgages and absorb some homeowner debt rather than risk losing income from mass defaults (NY Times).

Although the economy is still in a recession, it has shown signs of improvement, and Ireland expects to be the first country to exist the EU-IMF bailout program. Ireland’s GDP grew

0.7% in 2011, and the government reduced its deficit to 10.1% of GDP (CIA).Ireland is set to regain access to sovereign bond markets in 2013 following the conclusion of EU-IMF assistance program.

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