The Irish Crisis

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Introduction

- Economic Crisis: GDP decline of 15 percent between 2007-2010
- Fiscal Crisis: Surplus in 2007; -11.5 percent in 2009 (-17 percent if no correction)
- Banking Crisis: Heavy losses of Irish banking system
The Celtic Tiger Years: 1994-2001

- Rapid productivity-driven output growth
- Long-delayed Catch Up Process
- Major expansion in inward FDI: European integration; the ‘weightless’ hi-tech sectors
- Little inflation: large over-hang of surplus labour
- Start of housing boom: rising incomes, lower interest rate under entry to EMU
- 1999-2001: very weak euro against $/£
- 1999-2001: big tax cuts
Temporary Deceleration 2001-2003

- Global recession in Hi-Tech Sector
- Post-election fiscal retrenchment in 2002
- Rapid euro appreciation against dollar in 2002
The 2003-2007 Bubble Period

- Rapid credit growth: land development; households; SMEs
- Rapid growth in property prices
- Major expansion in construction activity: large proportion of male workforce
- Tax breaks for property investment
- Substantial inward migration (New Member States etc)
- Associated revenue windfall and rapid growth in public spending
- Expansion in current account deficit
- Real exchange rate appreciation
- Relative contraction of tradables sector
- 2008/2009: Bursting of the bubble, compounded by the global crisis
The Economic Crisis

- Shuddering Halt in Construction Sector
- Approx 50% decline in housing prices; 90% for some development land
- Collapse in Investment
- Hike in private savings rate
- Jump in unemployment but also significant exit
- Fiscal tightening adding to demand slump
- Credit crunch for SMEs, households
- Inflation currently minus 5.7% (terms of trade gain from Sterling decline)
- Aggregate exports holding up but driven by FDI-dominated sectors (2009 GDP -7%; GNP -10.5%)
- Some level of downward pay flexibility in private sector
The Banking Crisis

- Traditional property-driven crisis
- Extensive guarantee: September 2008
- Preference Shares in AIB / Bank of Ireland
- Nationalisation of Anglo-Irish Bank (early 2009)
- Severe funding pressures in Q1 2009
- Heavy reliance on ECB liquidity
- National Asset Management Agency (NAMA) plan announced April 2009; legislation December 2009
- NAMA to acquire property development loan books (transfer value about 30% of GDP)
- Transfer values at a steep discount to face value of loans (average 30%): but 15% uplift relative to market value ('long-term economic value' concept)
- Also prospect of more bad debts (mortgages, HH, SMEs)
- Post-transfer: recapitalisation of banks
- Likely scenario: large government ownership stakes in the main banks
The Fiscal Crisis

- Summer 2008: brake applied
- October 2008: early announcement of 2009 budget; deficit mostly ‘structural’; significant tax increases (levies)
- Q1 2009: jump in sovereign spread; funding risk [interaction with bank funding]
- April 2009 ‘emergency’ budget
- 2009: ongoing decline in tax revenue; 2009-2014 fiscal adjustment schedule
- December 2009: tough budget for 2010, cuts of 2.5% of GDP in order to stabilise deficit at about 11 percent of GDP
Features of the 2008/2009 Fiscal Adjustment

- De facto 7.5 percent pay cut ['pension levy'] in public sector in January 2009
- Further 5%-12% cuts in public sector pay announced for 2010
- Major increase in top marginal tax rate: 45% to 54% (kicks in at €37K)
- Large fraction of workers pay no income tax
- Narrow tax base
- Further fiscal adjustment required over 2011-2014
- 2012 next election
Regrets

- Failure of macro-prudential banking regulation
  - Excellent new CB governor and bank regulator now appointed
- Failure to run large fiscal surpluses during good times
  - Exception: National Pension Reserve Fund
  - Counterexamples: Sweden/Finland; Chile
  - ‘Rainy Day’ Fund (Lane, 1998)
- Deficient Tax System
  - Over-reliance on asset-driven revenues
  - Unsustainable cuts in income taxes
  - Inappropriate tax incentives for property investment
  - Excessively narrow tax base
Ireland and the Euro

- Bubble period: not exclusive to euro area; limited role for interest rate mechanism
- High euro debt: in effect, ‘foreign-currency’ debt but with access to liquidity provider (ECB)
- Disciplinary impact of discriminating sovereign debt market
- Adjustment process
  - contrast to own-currency economies (different types, depending on reliance on foreign-currency debt and policy stability)
- Key issue: interplay between fiscal crisis and banking crisis
Lessons for Members of the Euro Area

- Importance of long-term fiscal anchor (SGP inadequate): new institutional arrangements
- Costs of banking crises inside a monetary union
- Costs of real over-valuation (limits to wage flexibility)
- Big gain: Liquidity support (but requires fiscal backstop to ensure bank solvency)
- Hypothetical alternative: no euro membership?
Future Prospects for the Irish Economy

- Shift in composition of economic activity: more tradables activity, less construction
- ‘Internal’ devaluation: slow adjustment process but faster in Ireland than in some other locations
- Overhang of high debt levels: tepid recovery in domestic spending
- Growth expected in 2010 H2; moderate pace for 2011 onwards
- Institutional reforms required: “never again”
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