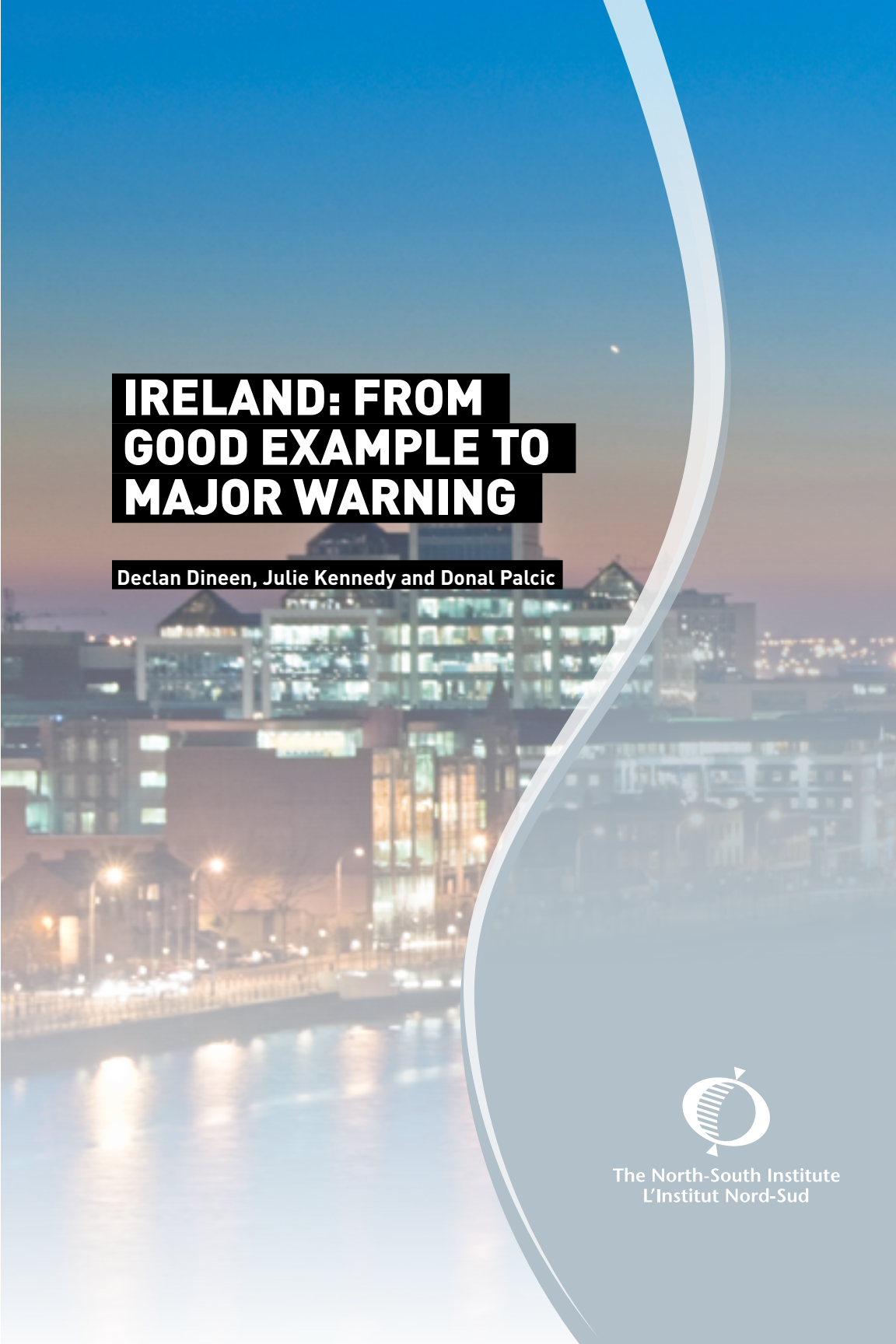

IRELAND: FROM GOOD EXAMPLE TO MAJOR WARNING

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INTRODUCTION

While it could not have been fully understood at the time, few countries entered the global recession as poorly positioned as Ireland. This was an economy where gross national product (GNP) grew at a rate in the range of 5–15 percent every year from 1991 to 2006 (Kelly, 2010), and this sustained growth achievement had been widely admired. Yet Ireland, once seen as a good example, now serves notice of a major warning. Kelly (2010) describes the Irish economic growth performance during the past two decades as a sequence of transitions "from basket case to superstar and back again – or almost". The story is certainly compelling, and is characterised by what appears to have been a remarkable economic transformation, followed by a very pronounced and ongoing contraction. This paper explains Ireland's economic rise and reversal.

The key to understanding what happened to Ireland lies in realising that the recorded surge in macroeconomic growth stemmed from two very different phases, and the transition between them attended a significant change in the structure of the Irish economy. Ireland is a textbook small open economy, where exports represent over 90 percent of gross domestic product (GDP),[1] and the move from boom to bubble mirrored the dynamic in the country's growth in exports. Ireland's huge exports to GDP ratio and privileged position in global supply chains helped it grow rapidly in the 1990s. This export-led boom gave way to an unsustainable credit-led property price bubble, financed by net external borrowing, after 2000. In the period from 2001 to 2006, new homebuilding disguised problems in the export sector. Indeed, if the construction sector is subtracted from national output, Ireland was in recession from 2001.

The current Irish debt crisis has resided, to a great extent, in property-related bad loans as a result of Irish banks' heavy loan losses on their development property portfolio acquired at the peak of the market. Easy access to consumer credit, funded by Irish banks' increasing reliance on wholesale external borrowing, and a sharp rise in construction lending fuelled a growing property bubble. Irish residential property prices declined continuously after 2007. The weaknesses of Irish banks were exposed after

1 "Exports of goods and services" (€144,782 million) as a percentage of "GDP at current market prices" (€159,646 million) in 2009 (CSO National Income and Expenditure, 2009).

the downturn in the domestic property market and the near-collapse of global debt markets in late 2008.

However, the causes of Ireland's current economic dislocation are wider than the solvency of its banking system. Domestic macroeconomic imbalances had built up during most of the second period of growth associated with the property bubble. The government's procyclical fiscal policy stance, budgetary measures aimed at boosting the construction sector and a relaxed approach to the growing reliance on property-related and other insecure sources of tax revenue were significant factors contributing to the unsustainable structure of spending in the Irish economy at this time (Honohan, 2010). While most of the causes of Ireland's economic malaise are home grown, additional important external influences included its membership of the eurozone in particular, and the added expansion of credit that attended the entry of foreign banks into the Irish market.

IRELAND'S ECONOMIC TRANSFORMATION AND GROWTH CONVERGENCE IN THE 1990s

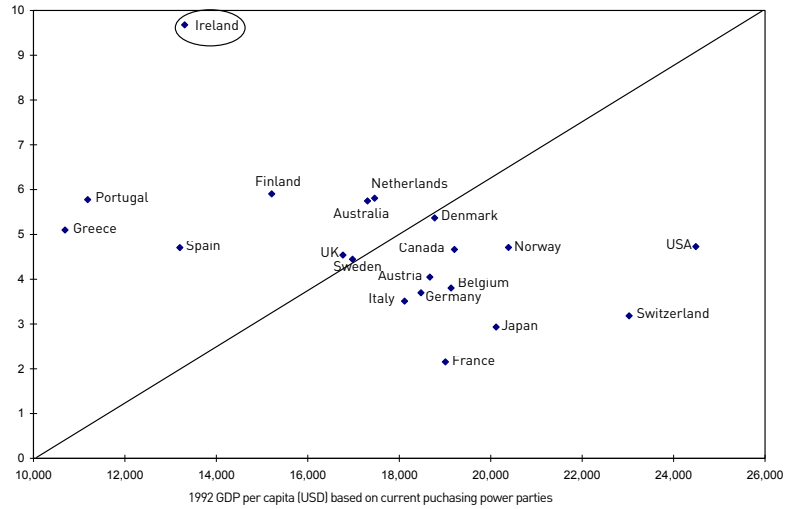
Before the onset of the current worldwide economic downturn, the turnaround in the performance of the Irish economy, especially during the 1990s, received considerable international attention. The focus of this was generally on how an economy with severe fiscal imbalances and endemic unemployment in the 1980s was transformed in the 1990s to exhibit remarkable economic growth and employment gains. 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 (Deegan and Dineen, 2003; Honohan and Walsh, 2002; Ó Gráda and O'Rourke, 1996).

Ireland's economic transformation during the 1990s constituted something of a macroeconomist's "vision of utopia", characterised as it was by high and sustained economic growth, low inflation, a current account balance of payments surplus, falling unemployment, net immigration and a growing budget surplus. Also, an expanded flow of European Union (EU) structural funds amounting to as much as 3 percent of GDP helped fund sufficient public infrastructure in those years (Honohan, 2009a).

IRELAND'S ECONOMIC GROWTH CONVERGENCE

Ireland's upsurge in economic growth during the 1990s was outstanding not only in terms of its own historical experience but also in an international comparative context. However, Ireland had been a laggard in terms of its

Figure 1: Average annual growth rates in Ireland, 1992–9, plotted against 1992 GDP per capita (purchasing power standards)



Source: IMF; OECD (2000).

performance during the European economy's "Golden Age", which spanned the period 1950–73. Hence, there are elements of delayed catch-up in its economic transformation (Barry and Crafts, 1999). Irish growth performance in the 1990s is a clear outlier, in terms of GDP per capita based on purchasing power parities, relative to the group of Organisation for Economic Co-operation and Development (OECD) countries considered in Figure 1, which presents initial income levels and subsequent growth. Ireland is located well above the trend line (not shown), illustrating the very robust annual average growth in income per head experienced between 1992 and 1999. It is clear that Ireland's belated catching-up was a comparatively rapid phenomenon. At the beginning of the 1990s, Ireland was grouped with the other peripheral EU countries (Greece, Portugal and Spain) in having among the poorest living standards in the OECD.

EXPORTS DURING THE 1990S BOOM

During Ireland's first growth period, the exceptionally large contribution of exports to GDP increased, and the vertical integration of much of the country's manufacturing sector into the global production chains of major

multinational firms deepened. These characteristics, when combined with the sustained growth in world trade, contributed to a sustained output boom during the 1990s.

Irish exports of goods and services amounted to the equivalent of 102 percent of GNP in 1999, and the combined share of exports and imports in GNP was almost 190 percent (CSO National Income and Expenditure, 1999).[2] The volume of Irish goods exports grew at the phenomenal rate of 16.5 percent per annum from 1993 to 2000—a rate that would lead to a doubling of exports every 4.5 years (Kennedy, 2001). Ireland experienced a rapid increase in its share of export markets during the Celtic Tiger period, but in accounting for the overall surge in Irish export performance, this effect was secondary to the growth of the export markets themselves. There were two important external dynamics that made for a resurgence in trade:

In the 1990s, the US returned to the rapid growth rates experienced during the "Golden Age" before the first oil crisis in 1973. High US economic growth translated into massive growth of US imports.

Despite continued low growth of European GDP, the import elasticity of demand with respect to GDP in the EU was substantially higher in this period than in the preceding 30 years.

The buoyancy of the US economy helped Ireland on both the supply and the demand side. On the supply side, Ireland secured an increased share of the flow of US foreign direct investment (FDI) to Europe; on the demand side, the strong growth in US imports underpinned the buoyancy of world trade, as well as providing a rapidly expanding market for Irish goods.

In 1992, the US was only the fourth most important market for Irish exports, corresponding to about one-third of Irish exports to the UK (Kennedy, 2001). By 2000, it was on the way to overtaking the UK as Ireland's most important export market. The growth in Irish exports to the US was heavily concentrated in high-productivity, labour-intensive industries. For example, by the year 2000, organic chemicals (SITC Division No. 51) accounted for nearly half of all Irish exports to the US. Even without any consideration of transfer pricing, this category has very high value-added relative to its employment.

The Irish growth rate would have been constrained, though, without a major acceleration in the growth of the volume of goods imports in the EU—the area receiving two-thirds of its exports. A wider consideration is why other EU countries, apart from Ireland, did not derive more benefit in

2 Exports and imports of goods and services exclude factor income flows.

Table 1: Average annual growth rates of real GDP, population and employment in Ireland, various periods since 1926 (%)

Period	Real GDP growth rate	Population growth rate	GDP/per capita growth rate	Employment growth rate	GDP/worker growth rate	Employment–population ratio growth rate
1926–47	0.9	0.0	0.9	0.0	0.9	0.0
1947–60	2.3	-0.4	2.7	-1.3	3.6	-0.9
1960–80	4.1	0.9	3.1	0.5	3.5	-0.4
1980–93	3.3	0.4	2.9	0.0	3.3	-0.4
1993–2000	8.3	0.8	7.4	4.7	3.5	3.8

Source: CSO National Income and Expenditure (various years); ESRI (2000).

terms of higher exports and GDP growth. US FDI was critical in enabling Ireland to realise the potential offered by the Single European Market.

Ireland during the 1990s was a case study of the effects on a small developing host economy of export-oriented FDI. The Single European Market provided the primary source of demand for these exports. Inflows of FDI to Ireland increased from an annual average of US$615 million during the period from 1987 to 1992 to US$838 million in 1994, US$2,618 million in 1996 and US$6,820 million in 1998 (O'Sullivan, 2000).[3] Increased investment by US enterprises accounted for more than 80 percent of overall flows into Ireland from 1994 to 1997, and the Irish share of US FDI stocks in Europe increased from 1.19 to 2.94 percent. Increased levels of direct investment by US firms in Ireland were especially important in chemicals and allied products and electric and electronic equipment. The output and exports of US enterprises operating in Ireland grew by annual average rates of 20.3 and 20 percent, respectively, from 1992 to 1997. US companies alone contributed nearly 47 percent of manufacturing gross output and 61 percent of manufacturing exports in the Irish economy in 1997, and provided about 25 percent of manufacturing jobs by 1999.[4]

ACCOUNTING FOR IRELAND'S GROWTH IN THE 1990S

The most remarkable feature of the first Irish economic boom during the 1990s was the economy's previously undiscovered capacity for creating employment on a rapid and sustained basis. In a short period, the extraordinary growth in employment transformed the economy from a situation of chronic labour surplus to one with labour scarcity.

Table 1 shows the growth rates of output volume, population and employment in Ireland over various periods since 1926. The period 1993–2000 is taken as the "first boom", or so-called "Celtic Tiger" phase. The remarkable acceleration in the growth of output (measured here as the total volume of GDP at constant factor cost) and GDP per capita distinguishes the 1990s from all previous phases of Irish economic history. Of particular note, however, was the absence of any increase in the rate of growth of overall labour productivity, as measured by GDP per worker. All of the acceleration in the growth in output, therefore, is accounted for by the acceleration in the growth of employment to an average annual rate of 4.75 percent per annum.

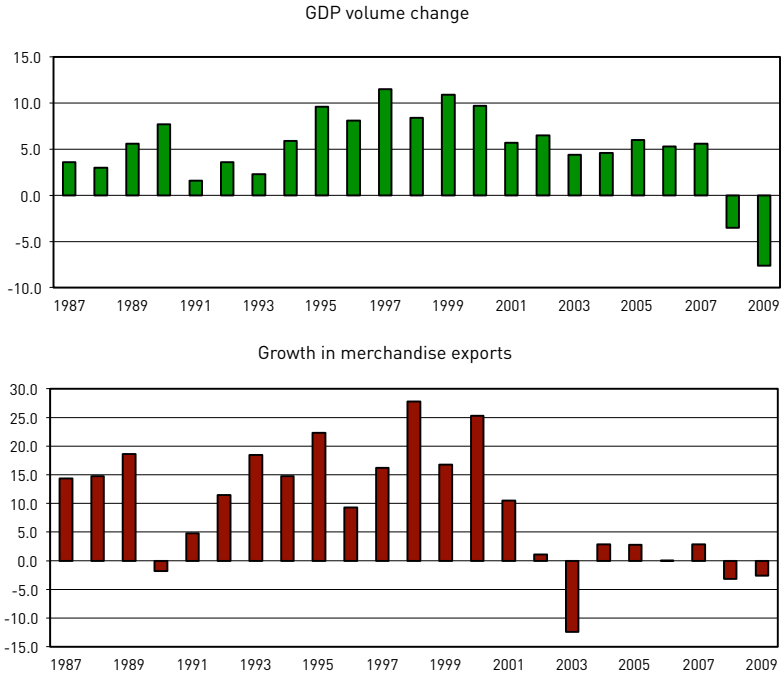
3 Ireland's share of FDI among OECD nations increased from an average of 0.06 percent for the 1986–90 to 0.66 percent for 1991–7.

4 For a wider discussion on Irish industrial development during the 1990s, see Bradley (2000) and O'Sullivan (2000).

THE SECOND GROWTH PERIOD: THE PROPERTY BUBBLE

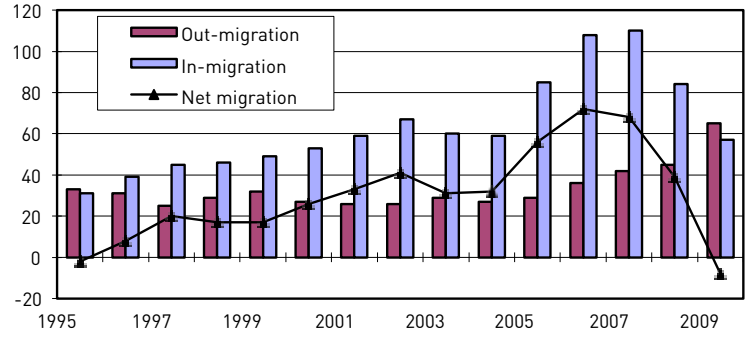
Ireland recorded prolonged and rapid economic growth even after the 1990s witnessed a belated convergence in living standards towards the highest in Europe. This growth also endured beyond the cyclical downturn in Irish export performance after 2001 (see Figure 2). From 2001, the sources of growth shifted sharply (Honohan, 2009a; Honohan and Lane, 2009). An unsustainable property price and construction boom 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—see Figure 3) and by the sharp fall in interest rates that accompanied the transition to Economic and Monetary Union (EMU) membership, the property bubble was increasingly financed after 2003 through foreign borrowing by the banks, which in turn lent to overleveraged households.

Figure 2: Year-on-year change in the volume of Irish GDP and goods exports (%)



Sources: CSO National Income and Expenditure and External Trade (assorted issues).

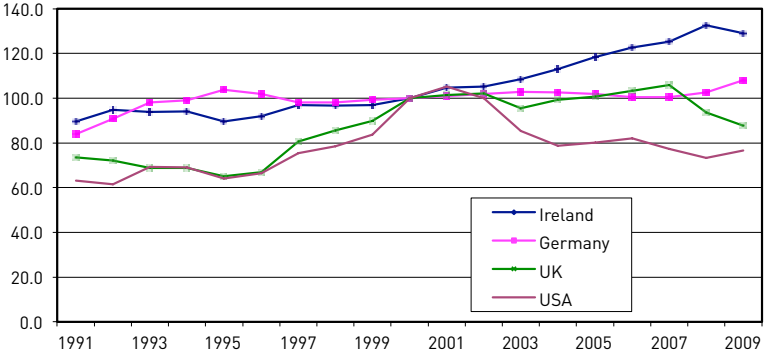
Figure 3: Irish net migration annual estimates, 1995–2009 (000s)



Source: CSO Annual Population and Migration Estimates (various years).

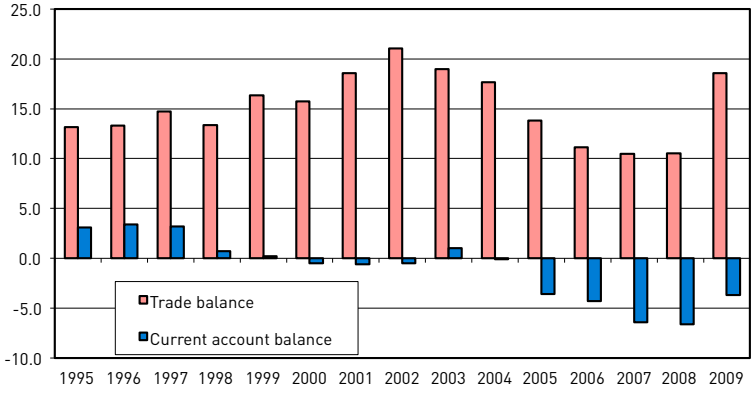
At the same time, Ireland experienced a sharp loss of competitiveness as domestic demand-led growth drove up prices and wages in the economy (Figure 4). In addition, the consumer boom increased imports, resulting in a deteriorating trade balance (Figure 5). The effects were not yet felt in aggregate unemployment while the domestic boom continued.

Figure 4: Nominal unit labour costs in the Irish total economy—common currency (€), 1991–2009 (2000=100)



Source: European Commission AMECO database (http://ec.europa.eu/economy_finance/ameco/user/serie/SelectSerie.cfm).

Figure 5: Trade and current account balances in Ireland, 1995–2009 (% of GNP)



Note: Trade balance relates to exports and imports of goods and services.
Sources: CSO Balance of International Payments, National Income and Expenditure and Quarterly National Accounts (various years).

The Irish economy continues to be afflicted by three problems: a retail banking solvency crisis that was initially (misre)presented by the banks themselves as a liquidity difficulty; a large budget deficit; and negative or very marginal economic growth. These issues are not independent of each other. The Irish government's commitment to absorb the losses of its banking system—calcified by the EU/International Monetary Fund (IMF) agreement—has heightened concerns in relation to a spiralling debt ratio and the solvency of the sovereign. In this sense, private banking debt has become public debt.

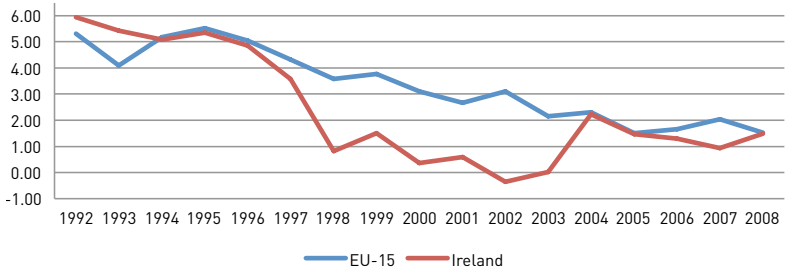
Even aside from the huge banking loan losses, the severe economic downturn had given rise to a large budget deficit. Although the Irish government ran annual budget surpluses until 2006, an increasing share of the revenue that supported these surpluses came from taxes on the value and volume of property asset transactions (see below). The tax base had narrowed during the housing price bubble years, and Ireland's overreliance on this source of revenue was sharply exposed by the collapse in the property market. In the Irish case, the combination of falling numbers of transactions and falling property prices has been acute. In addition, the deep recession in construction has had an indirect impact on the rest of the economy. Employment in service sectors linked to property and building has declined

rapidly. The economy-wide unemployment rate currently stands at over 14 percent—very far from the full employment of the Celtic Tiger period (the unemployment rate had shrunk from 15 percent, on the International Labour Organization (ILO) basis, in 1994 to 4 percent in 2000—CSO Labour Force Survey and Quarterly National Household Survey, various years). The automatic stabiliser effects for the exchequer are obvious. Also, lower employment leads to a decline in consumer spending with a multiplier effect on the rest of the economy. As a result, tax revenue from all sources has been falling.

THE EMERGENCE OF A PROPERTY BUBBLE: WHAT WENT WRONG IN IRELAND?

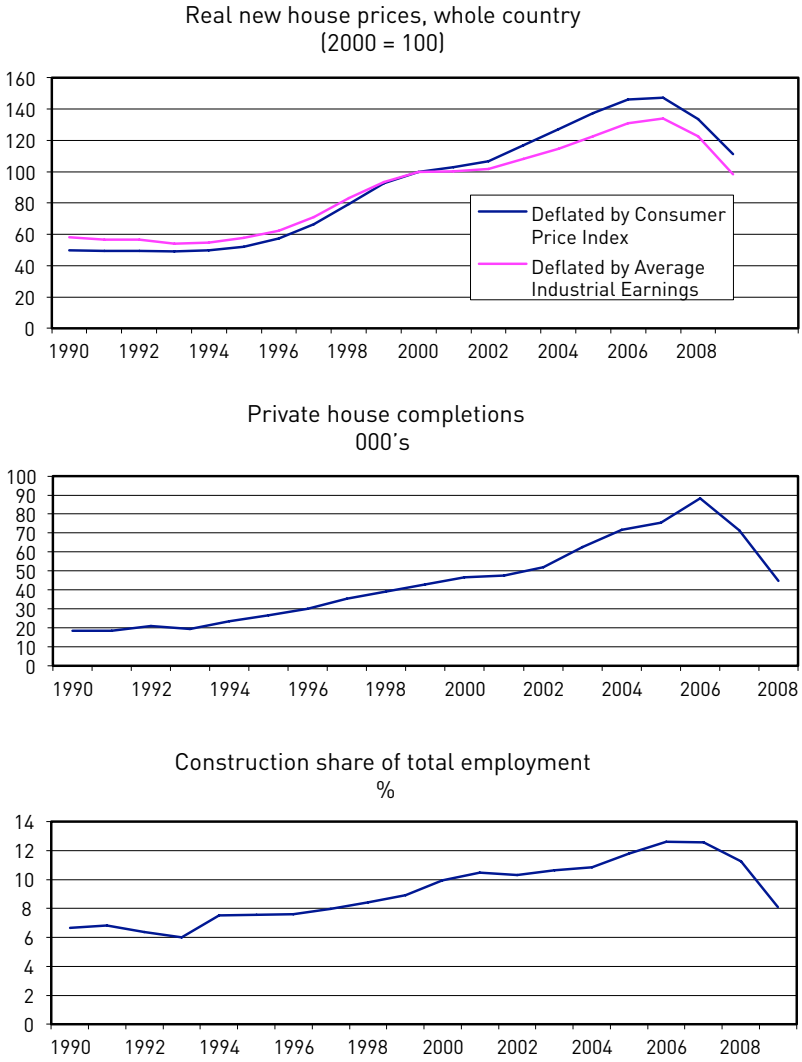
Even if the combination of lower interest rates from 1998 (see Figure 6) and higher income meant a sizeable increase in housing affordability, property prices overshot equilibrium levels. The threefold increase in average real new house prices from 1993 to 2007 was the highest in any advanced economy in recent times. Private house completions accelerated to a peak of over 88,000 in 2006 and the share of the (growing) workforce engaged in construction rose from 6–7 percent in the early 1990s to nearly 13 percent in 2006–7 (Figure 7).

Figure 6: Real interest rates—Ireland and EU-15, 1992–2008 (%)



Source: European Commission AMECO database (http://ec.europa.eu/economy_finance/ameco/user/serie/SelectSerie.cfm).

Figure 7: Real house prices, private house completions and construction's share of total employment in Ireland, 1990–2008



Sources: Department of the Environment, Heritage and Local Government data; CSO Consumer Price Index, Industrial Employment, Earnings and Labour Costs, Labour Force Survey, Quarterly National Household Survey (various years).

In 1995, the average first-time buyer took out a mortgage equal to three years' average industrial earnings, and the average house cost four years' earnings. By the bubble peak in late 2006, the average first-time buyer mortgage had risen to eight times average earnings, and the average new house now cost ten times average earnings. As the price of new houses rose faster than the cost of building them, investment in housing rose. By 2007, Ireland was building half as many houses as Britain, which has 14 times its population (Kelly, 2010).

The legacy of this second boom is that Ireland now has a large excess stock of housing, with the effect that this industry will not represent an area of significant economic activity in the medium term. In parallel with the property bubble, there was a sharp escalation in private debt. Overleveraged households are likely to spend quite some time repairing their balance sheets. Hence, it is clear that households are not in good shape to drive the economic recovery. Moreover, despite the fall in disposable incomes—owing to tax increases and public and private sector pay cuts—the savings rate has increased, as the drop in consumption has exceeded the decline in incomes.

The current difficulties of the Irish banks—whether in terms of liquidity or solvency—are directly attributable to their over-lending for land and property investment, much of it funded through heavy short-term wholesale foreign borrowing. Without the latter, the banks would not have been as vulnerable to the worldwide liquidity crisis which intensified throughout 2008 (Honohan, 2010).

Ireland in 2007 was relatively poorly positioned heading into the global crash, 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" (Honohan, 2009a: 1). The global recession influenced the timing and severity of the Irish economic crisis from 2007, but Ireland was not just an aspect of international pressures. Certainly, the global credit crisis brought the wholesale funding, risk management and capitalisation of the Irish banks into sharp focus. However, the collapse of the construction and property bubble has brought in its wake rapidly unwinding property prices, a near failure of the banking system, a very large fall-off in tax revenues and uncompetitive wage structures.

FISCAL CRISIS

Although the Irish government ran annual budget surpluses until 2006, an increasing share of the revenue that supported these came from taxes whose

yield was sensitive to high and increasing asset prices and asset transactions, including housing (capital gains taxes, capital acquisition taxes and stamp duties).[5] Once the asset markets turned, the volume of transactions dried up and the level of tax revenues plunged during 2008 exposing a structural deficit—exacerbated by a strong upturn in public expenditure in recent years.

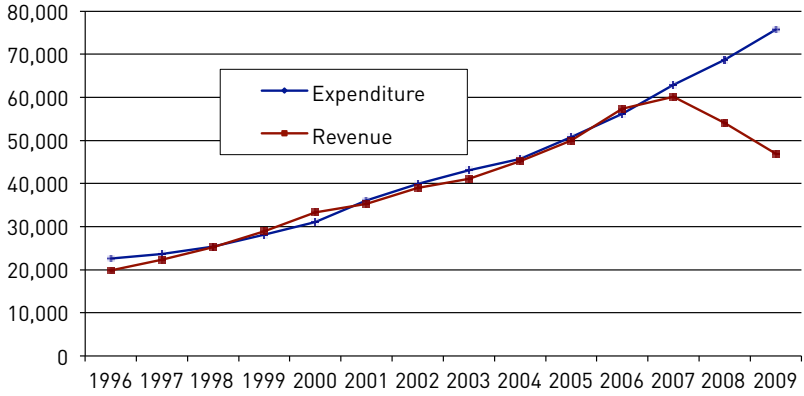
The Irish government had entered the crisis period with a healthy balance sheet—the gross government debt stood at only 24.8 percent of GDP at the end of 2007 and Ireland had a sizeable sovereign wealth fund in the form of the National Pension Reserve Fund (Honohan and Lane, 2009). The period of sustained economic growth allowed the Irish government to cut income taxes, increase spending and still run a budget surplus. During the four years from 2003 to 2006, the surge in tax revenue directly related to property transactions was another manifestation of the credit boom. The Irish property tax system was highly geared to activity and property prices: stamp duty is a straight transaction tax; value-added tax (VAT) is charged on the gross purchase price of a new home; and capital gains tax (CGT) liability is triggered, where it is applied, through the realisation of gains. Revenue from property jumped from 8 percent of total tax receipts in 2002 to 18 percent by 2006. However, after the collapse of the construction and property bubble, total direct revenue from property[6] dropped to €3.6 billion in 2008 from €8 billion in 2006 (McCarthy and White, 2008). Between 2007 and 2009, overall tax revenue fell by 20 percent, while expenditure rose by 9 percent, moving the state from a balanced budget to a deficit of 12 percent of GDP (Kelly, 2010). The dependence of the government on transitory property revenue is remarkable and should not have been seen as a platform for expenditure increases.

In combination with the collapse in tax revenues in 2008–9, the fiscal crisis was driven partly by an autonomous surge in total government expenditure (after 2004). Figure 8 presents data for *total government expenditur*e (*gross current expenditure* plus *exchequer capital expenditure*) and *gross current government revenue* for the period 1996–2009, and reveals the sudden collapse in taxation. It also shows the strong upward momentum of government spending.

5 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.

6 This excludes income tax from construction workers, VAT on furniture and electrical goods and corporation tax receipts from construction firms.

Figure 8: Total revenue and spending in Ireland, 1996–2009 (€ millions)



Sources: Department of Finance Revised Estimates for Public Services and Finance Accounts (various years); Public Capital Programme; CSO National Income and Expenditure (various years).

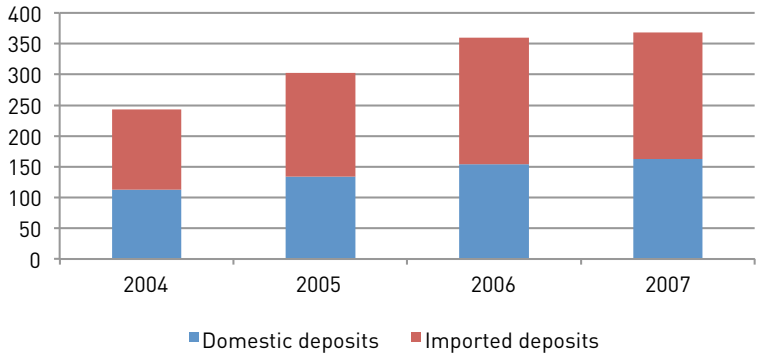
THE PROPERTY BUBBLE, THE BANKING CRISIS AND PUBLIC DEBT

Apart from the experience of Iceland, this has turned out to have been the poorest performance of any banking system during the current global downturn. Yet Irish banks had not indulged in the financing of US securitised mortgages, nor were they involved in aggressive international acquisitions—flaws that characterised weakened banks elsewhere (Honohan, 2010).

The economic fault-line in relation to the debt crisis in which Ireland finds itself runs from (delinquent) bank lending practices feeding an unsustainable property bubble, resulting in a banking crisis that required extraordinary intervention by the state with the manifestation that the enormous private debt of the Irish banking system has been loaded on the taxpayer.

At root cause, the property bubble was funded by the Irish banking system, which in turn relied heavily on the international inter-bank market and accumulated substantial net external liabilities. As credit growth began to exceed deposit growth, an increasing share of lending was funded mainly by borrowing from other financial institutions, with nearly half coming from UK banks. Figure 9 shows the growing reliance of the Irish banking system on wholesale external borrowing as opposed to the more traditional domestic deposit funding model. By early 2008, net foreign borrowing by Irish banks had jumped to over 60 percent of GDP, from 10 percent in 2003 (Honohan, 2009a).

Figure 9: Irish domestic banks' funding, 2004–7 (€ billions)



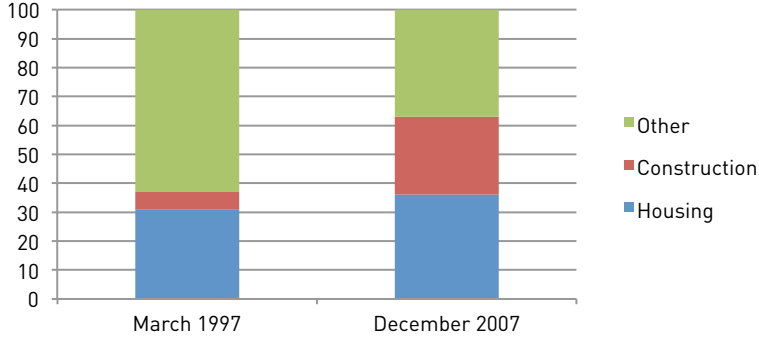
Source: Central Bank of Ireland data.

Moreover, the collapse of the construction and housing bubble, and the concentration of Irish banking loans in these sectors, has been central to the deterioration in financial health of the Irish banking system. By 2007, property-related lending (residential mortgages, commercial property and lending to construction companies) accounted for more than half the stock of bank lending (Figure 10). To the lack of diversification in loan assets we can add spiralling loan–deposit ratios (see Figure 11) and a pronounced deterioration in shareholder equity to assets and to risk weighted assets ratios. In a wider context, while Basel II was designed to improve prudential risk management, this was at a time when the general international application of Basel II risk weighting would have released capital for most banks. At a minimum, the internal risk management of the main Irish banks left much to be desired. This was compounded by what could euphemistically be described as "light-touch" regulatory oversight.[7,8]

7 Prior to the onset of the current global credit crisis, a light-touch regulatory orthodoxy held sway in many countries. Over the previous decade, the financial system had expanded hugely. This was encouraged by a general belief in laissez-faire regulation based on the assumption that financial innovation was spreading risk, not concentrating it. Ultimately, financial regulators were not equipped to see the risk concentrations and were not able to contain the risks resulting from rapid innovation and increased leverage, which had been building for years.

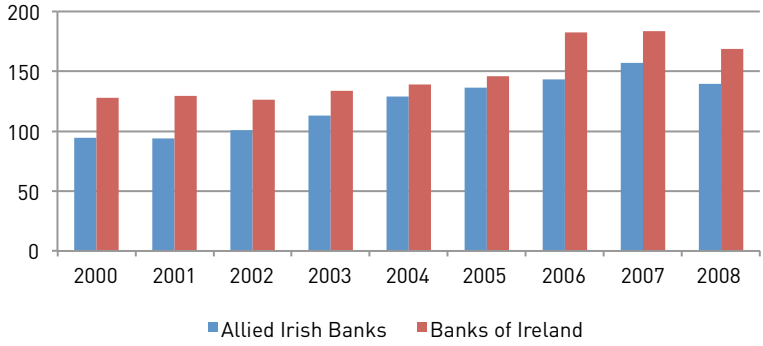
8 Private sector imbalances, such as excessive credit growth and large current account imbalances, were not at the core of the scrutiny framework used under the euro area's existing surveillance arrangement. Furthermore, the Stability and Growth Pact was created to ensure no country would pursue fiscal policy that would endanger the financial and economic stability of the other member states and the euro area as a whole. However, this mechanism was not broad enough in scope, as it left non-fiscal economic imbalances outside the scope of surveillance. Ireland is an unfortunate (though far from blameless) example of this.

Figure 10: Breakdown of lending of Irish commercial banks, March 1997 and December 2007 (%)



Source: Central Bank of Ireland data.

Figure 11: Loan-deposit ratios of Allied Irish Bank and Bank of Ireland, 2000-08



Sources: BankScope and AIB and BOI Annual Reports (various years).
Note: AIB and BOI are the two main retail banks in Ireland.

Elements of eurozone membership, including low interest rates and the removal of exchange rate risk, certainly contributed to the property bubble and to the deteriorating drift in wage competitiveness. The exchange rate and interest rates were no longer sensitive to domestic developments—the "one size fits all" low interest rates prevailing in the eurozone were orthogonal to Ireland's business cycle for virtually all of the period between the launch of the single currency and the onset of the global recession. During the period 1998–2007, real interest rates averaged *minus* 1 percent

(Honohan, 2009a). Furthermore, in sourcing loanable funds, the Irish banks borrowed heavily in eurozone inter-bank money markets from 2003. Unlike imbalances of the past, over-borrowing did not lead to interest rate increases because currency risk had been removed altogether.

In 1997, Irish banks' lending to the non-financial private sector was 60 percent of GNP. By 2008, this had grown to 200 percent of national income. Irish banks were lending 40 percent more in real terms to property developers alone in 2008 than they had been lending to everyone in Ireland in 2000, and 75 percent more to house buyers (Kelly, 2010). By 2006, two-thirds of loans to first-time buyers had loan-to-value in excess of 90 percent; one-third were getting 100 percent loans (Honohan, 2009a).

At the end of September 2008, the Irish government announced a blanket guarantee of the liabilities of the main Irish-controlled banks, including senior bondholders. As well as guaranteeing the deposits and most bonds of Irish banks, the government announced in April 2009 that a National Asset Management Agency (NAMA) would be created to buy the non-performing development property loan portfolio of the banks at a written-down value. NAMA acquires these loans at a discount ("haircut"), paying the banks with government-backed bonds, issued by a special purpose vehicle. The banks can then use these bonds as collateral against which they can borrow (access liquidity) from the European Central Bank. NAMA, however, does nothing about the Irish banks' losses for mortgages, personal lending and the small-to-medium enterprise sector.[9] The government has also had to inject unprecedented funds into the Irish banking system in order to recapitalise domestic banks and has consequently assumed ownership of a number of major banks.

REGULATORY FAILURES

Following in the wake of the newly established Financial Services Authority (FSA) in the UK, the Irish government decided in October 1998 to consolidate the prudential and customer protection regulation of all financial institutions under the umbrella of one institution, called the Irish Financial Services Regulatory Authority (IFSRA). In 2003, IFSRA initiated a move to a principles-led and risk-based approach to regulation with the aim of improving the quality and minimise the quantity, where possible, of regulation (Government of Ireland, 2004). This involved moving away from reliance

9 The NAMA process has left the banks with insufficient capital. As loan losses crystallise and get taken into account in a bank's balance sheet, its cushion of capital (essentially the difference between its assets and its non-risk-bearing liabilities) shrinks. Government injections of capital are more about protecting the depositors and other creditors against future risks than they are about making loanable funds available.

on detailed rules and to depend instead on high-level broadly stated rules or principles (Black et al., 2007). In this new "principles-led" environment, the board of directors of each supervised financial institution was responsible for setting its own standards in relation to tolerance of risk, etc. This approach relied on entities to act with their own integrity and placed a much greater emphasis on internal supervisory systems within banks.

The Irish retail banks' management took full advantage of the discretion that principles-based regulation allowed and began to expand their business models at an unprecedented pace. In the period from 2000 to 2005 alone, Irish domestic banks' lending doubled. The international credit boom saw an increase in bank lending across most eurozone economies and the UK, with loans increasing to 100 percent of GDP on average in 2008. In Ireland, Spain and Portugal (in descending order), bank lending to households and non-financial firms as a percentage of GDP exceeded 150 percent. In Ireland's case, this indicator had accelerated to almost 200 percent by 2008.

Since joining the EMU, Irish banks had been operating in a setting of greatly increased wholesale funding opportunities, and banks from abroad began to compete strongly in the Irish retail mortgage lending market. Competition intensified and "uncritical enthusiasm" (Regling and Watson, 2010: 35) within the Irish banking system resulted in an environment where prudent risk management was ignored. Financial sector compensation became based on short-term profits, as the Irish retail banks sought to generate returns via rapid expansion of their loan books. Short-term (wholesale) borrowing to fund long-term loans held sway. Against this backdrop, strongly risk-averse reactions from the Irish regulator would have been needed. However, in reality, there were serious failures regarding the supervision of credit institutions in Ireland, and bank governance and risk management were flawed.

By 2007, it had become evident that the Irish regulator had placed an unfounded reliance on principles-based regulation "based on a mistaken view of governance within banks" (Cowen, 2010) and had not backed this up with adequate supervision. As Honohan (2009b: 7) notes, the financial regulator "largely ignored the need for conventional prudential regulation of the main banks" and was inadequate in addressing the overexposure of the Irish banks to the accumulation of excess risk through their lending activities. However, the Irish regulator throughout the boom period was operating within an environment where excessive weight was placed on fears of upsetting the competitive position of domestic banks, even at the expense of prudential considerations (Honohan, 2010). Ultimately, IFSRA

had failed in its primary job of protecting and ensuring the credibility and solvency of the Irish banking system.

COST OF THE IRISH BANKING CRISIS

Estimating the net fiscal costs related to banking crises can be problematic. Even when assessing the fiscal costs of historical crises, where one would imagine that the passage of time would allow for a complete analysis, it is often difficult to source reliable data on the amounts paid out by the exchequer and the rate of recovery. It is even more difficult to examine the fiscal costs associated with ongoing crises, where the costs related to guarantees, recapitalisations, nationalisations and liquidity schemes will not become apparent for a number of years. Notwithstanding these difficulties, from the information available it is clear that the Irish banking crisis currently ranks as one of the costliest in history. The total gross cost of bank recapitalisations to the State as of March 2012 stood at €62.8 billion (equivalent to almost 40 per cent of 2011 GDP).[10] This figure does not include the cost of acquiring troubled loans from the covered domestic banks by the National Asset Management Agency (NAMA) between 2010 and 2011. NAMA was established at the end of 2009 as an asset management agency that would acquire troubled loans from five domestic banks (see Palcic and Reeves, 2011 for further detail on NAMA and the Irish banking crisis). By the end of 2011 NAMA had paid €31.7 billion to acquire loans with a book value of €74.2 billion at a discount.

A number of studies have attempted to estimate the direct fiscal outlays associated with systemic banking crises over the past number of decades. Caprio et al. (2005) provide estimates of the direct fiscal costs associated with 56 crises over a 50-year period. For systemic crises, they find that the median fiscal cost was 13.1 percent of GDP (mean 16.8). Laeven and Valenica (2008) find that the mean fiscal cost of 42 systemic crises in their database is 13.3 percent. Honohan (2008) extended the sample of Caprio et al. (2005) and found that the median fiscal cost for the 78 systemic crises in his sample was 15.5 percent (mean 19.1). Although the final fiscal cost of the Irish banking crisis will not become apparent for some time, the direct costs incurred by the Irish government to date would appear to be far in excess of those experienced historically.

While the Irish banking crisis has obviously resulted in significant direct fiscal costs, it is also important to note the considerable indirect cost of the crisis in terms of its impact on key variables such as output, unemployment

10 Written answer by Minister for Finance, Michael Noonan, Dáil Éireann Debate, Vol. 761, No. 5, 29 March 2012. Available at: http://debates.oireachtas.ie/dail/2012/03/29/00077.asp

and government debt. The peak-to-trough decline in real GDP, increase in unemployment, fiscal deterioration and explosion in national debt all rank among the worst experienced in the aftermath of a banking crisis on record (see Palcic and Reeves, 2011). The sheer scale of the crisis is put in stark perspective by Reinhart and Rogoff (2011), who show how the increase in public debt experienced in Ireland (and Iceland) between 2007 and 2010 already ranks as the worst in history. The authors state that the debt build-ups in both countries (which are projected to increase further) are "associated with not only the sheer magnitude of the recessions/depressions in those countries but also with the scale of the bank debt buildup prior to the crisis—which is, as far as these authors are aware—without parallel in the long history of financial crises" (11).

CONCLUSION

It is clear that Ireland's economy faces severe challenges. The twin crises in the banking sector and in public finances have fed back negatively into credit availability and rising tax rates, deepening the output loss. It follows from the above that the broad domestic policy response to the economic crisis has four key elements, with significant crossover effects between them:

- Correcting the fiscal imbalance;
- Addressing bad banking loans and capitalisation issues, and facilitating credit flow to enterprise;
- Reform of financial regulatory/supervisory instruments, resources and enforcement; and
- Providing for a stimulus to nudge the economy towards a stable natural growth path, as well as decisive labour market policy measures.

The rationale for a stimulus is obvious, especially in light of the recent, and necessary, budgetary adjustments. These "consolidations" have had a dampening effect on growth potential, and a jobs and growth package needs to be given effect in parallel with the ongoing process of fiscal correction. Ireland was one of the first countries to introduce tough budgetary austerity in this recessionary cycle. Despite the cuts, Ireland currently has one of the highest budget deficits in the EU. The problem is clear: when you cut spending you also lose tax revenues from people who earned an income from that money. Further, the newly unemployed seek benefits, so Ireland's spending cuts in one category are partly offset by more spending in another. Without growth, the budget deficit still looms large. Also, the growth rate is a key issue for the international investor community, which is trying to work out

whether the Irish economy will grow sufficiently quickly to make its public and private debt levels sustainable.

However, at an average interest rate of 5.8 percent, the EU/IMF loans are unlikely to improve Ireland's long-term debt situation. The interest rate is very likely to be higher than Ireland's nominal annual growth during the period of the loan, and that means the real value of the debt will increase.

Recent Irish industrial production data show promising signs in relation to export performance. Moreover, the balance of payments current account position displays continued improvement, and the fall in nominal wages has reduced unit labour costs. The downward adjustment of this competitiveness indicator could be given further effect through increased productivity fostered by policies that promote new products and innovation.

The Irish banking crisis has essential implications for how the design of regulatory and supervisory responsibilities will evolve. Robust regulatory leadership must set the trend for effective risk management and governance practices within the Irish banking system. Ireland has already embarked on the road to a much better resourced and independent financial regulatory enforcement with principle-based supervision only in conjunction with clear rules. If the financial regulator is to become a strategic agent for transparent and effective regulation in the post-crisis it must ensure that banks can no longer conceal or ignore risk. A reliance on banks' discretion in the management of risk has proven hugely costly in the Irish case. Reform of Ireland's financial regulatory architecture has included a new formal risk assessment framework, known as the Probability Risk and Impact System (PRISM) which should be given effect by the end of 2011. More prescribed and clear regulatory rules and instruments must be accompanied by sufficient powers—including manpower—to discharge the regulatory function effectively.

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