Ireland's Recovery from Crisis

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Introduction

The economic crisis that hit Ireland in 2008 stemmed from an uncontrolled real estate bubble that had developed over the previous five years, and the resulting collapse in the domestic financial system, which was heavily exposed to the property market. The collapse had an immediate and very severe impact on all aspects of the economy. The very large fiscal adjustment that was necessary to restore order to the public finances began in 2009 and it has continued to this day. However, there are clear signs that the economy began to grow again in 2012 and this recovery has continued through 2013 and into 2014.

This paper discusses the measures taken to turn the economy around: the domestic policy actions and their role in the adjustment. However, what is clear today is that the tradable sector of the economy was less damaged by the crisis than may have initially been thought and it has led a recovery. The growth of the tradable sector has occurred in spite of the fiscal adjustment that is still under way. While this recovery still has a long way to go, it is, by now, reasonably well established. Nonetheless there remain concerns about the robustness of the recovery elsewhere in Europe, which is crucial in underpinning the return to growth in Ireland, and there are also concerns about the ability of the domestic financial system to fund the ongoing recovery.

This paper first considers the nature of the crisis in Ireland since 2008 and the policy measures implemented to tackle it. It then considers the evidence of economic recovery, paying particular attention to the problems in interpreting data due to the exceptional openness of the economy. Finally, it considers how the recovery may proceed over the next few years.

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The nature of the crisis

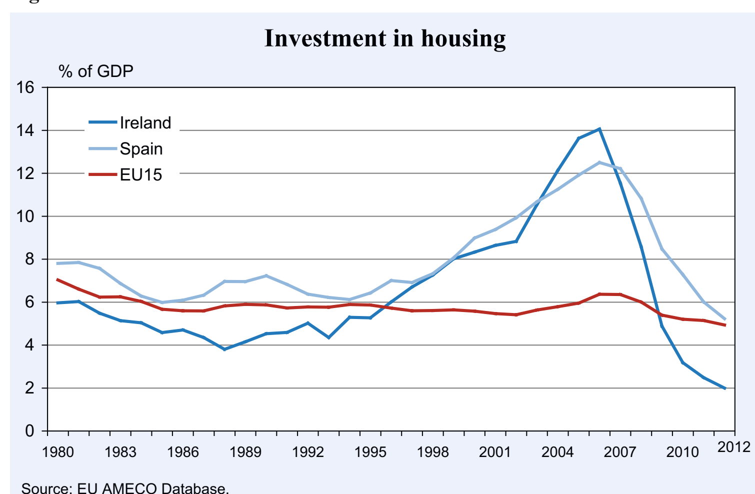
The crisis that broke in the Irish economy in 2008 was rather similar to that in Spain. A major property bubble had developed over the previous five years, which was financed by inflows of capital into the domestic banking system. The high expected returns from investment in housing in Ireland had evoked a huge supply response. The number of dwellings built in Ireland at the height of the boom was approximately 100,000. Today the number being built is less than 10,000. This meant that a very substantial part of the economy was devoted to building and construction in 2007 (Figure 1). To provide the necessary resources, including labour, the rest of the economy, especially the tradable sector, had to be squeezed through a high rate of wage inflation, which reduced competitiveness. In turn, this was reflected in a move into deficit on the current account of the balance of payments in 2003, a deficit which deteriorated rapidly thereafter.

When the crisis hit, the building and construction sector collapsed resulting in a fall in GDP from peak to trough of just under 10 percent and a fall in GNP of over 15 percent.[2] The unemployment rate rose very rapidly. Between 2007 and 2012 it had increased by 10 percentage points. As discussed in Fitzgerald (2012), the current account adjustment was particularly rapid in countries, such as Ireland, where there was a collapse in the construction sector, whereas in economies, such as Portugal and Greece, where there was no real estate bubble, the adjustment in the current account was slower, being driven by the fall in domestic consumption rather than the very rapid fall in domestic investment.

The real estate sector in Ireland was tax rich and employment rich so that its implosion had a very severe

[2] GNP is a better measure of living standards as it excludes profits of foreign firms and also national debt interest paid abroad. Here we have adjusted GNP, as described below, to exclude the additional income of some foreign owned firms that is not captured properly in the current account of the balance of payments.

Figure 1



Source: EU AMECO Database.

effect on the public finances. Having run a general government surplus in 2007, the deficit reached 11.3 percent of GDP by 2009 (in spite of significant cuts in the 2009 Budget). In addition, the crisis saw the government having to pump over 40 percent of GDP into the banking system to cover its losses and to recapitalise the remaining banks. The result was that the gross debt to GDP ratio, which was under 25 percent in 2007, peaked in 2013 at over 120 percent of GDP.

Policy response

Because the severity of the impending crisis was realised in the late autumn of 2008, urgent measures were taken to deal with the deterioration in the public finances in the Budget for 2009. However, these measures were only a beginning and they did not prevent the public finance from continuing to deteriorate. Table 1 summarises the *ex ante*[3] fiscal policy measures taken over the course of the crisis, including the measures pencilled in for 2015. Together, the cumulative *ex ante* adjustment amounts to just under 20 percent of GDP.

[3] This is the effect of the measures taken assuming no feedback from these measures to government revenue and expenditure.

When the adjustment began in 2009, the full gravity of the problem with the banking system was not realised. It was not till the autumn of 2010 that this became apparent. The revelation of these problems in 2010 saw Ireland's access to funding drying up and the result was the recourse to the support of the Troika in late November 2010. However, before assistance was sought from the Troika, the government had put in place an adjustment programme designed to bring government borrowing below 3 percent by 2015. The adjustment programme previously agreed with the EU Commission in 2009 had planned to reach this borrowing target by 2014 but, because of the additional burden of funding the banking sector losses, the time scale for meeting the borrowing target was extended to 2015.

The adjustment programme set out by the government in early November 2010 was accepted by the Troika in December 2010 without significant change. Thus it was the Irish government's plan, rather than a plan imposed from outside, that formed the basis for the ongoing fiscal adjustment. Up to that point the forecasts for the public finances in the government's programme had consistently proved to be pessimistic. However, in drawing up the programme in late 2010 the then government aimed to under-promise.

This policy stance by the outgoing government was unusual as they were facing into an election within three months. (It is more usual for governments to over-promise in a run up to an election.) However, in this case the outgoing government anticipated a disastrous election result and, instead, of over-promising,

Table 1

Summary of actual and planned austerity measures over period 2008–2015 (billion euros)

	2008–2010	2011	2012	2013	2014	2015	2008–2015
Revenue	5.6	1.4	1.6	1.3	0,9	0,7	11.5
Expenditure	9.2	3.9	2.2	2.3	1.6	1.3	20.5
of which Capital	1.6	1.9	0.8	0.6	0.1	0.0	5.0
Total	14.7	5.3	3.8	3.5	2.5	2.0	31.8
Share of GDP	9.2%	3.3%	2.3%	2.1%	1.5%	1.1%	19.5%

Source: Department of Finance Budgets. GDP figures revised based on CSO: National Income and Expenditure, 2011 and Duffy *et al.* (2012).

facilitated the incoming government by putting place an achievable set of fiscal targets.

The incoming government adopted the broad outlines of this plan. To the extent that they wanted limited modifications in the detailed measures, they received ready acceptance from the Troika. Because of the conservative nature of the original plan, even though the external environment proved less favourable than anticipated, with consequent negative consequences for domestic growth, the government has been able to outperform its fiscal targets each year. This helped restore external confidence in the Irish economy and it has also proved somewhat reassuring to the population suffering under the adjustment.

The broad composition of the large adjustments made over the period 2008–2015 is shown in Table 1. Roughly two thirds of the measures involved cuts in expenditure and one third involved increased taxation. This contrasts with the adjustment in the 1980s, when the initial measures were heavily weighted towards increased taxation and cuts in capital expenditure (Honohan 1999). Among the measures introduced were cuts in public sector pay[4] and cuts in welfare benefits.

This approach of under-promising and over-delivering in Ireland contrasted with that of Spain. The adjustment in the Spanish public finances planned in spring 2010 was more ambitious than that of Ireland (Table 2). While beginning with a deficit at a slightly lower level in 2010, the plan was to reduce the deficit to 3 percent of GDP by 2013. The outgoing government, in the spring of 2011, raised the bar for the incoming government, committing to reduce the deficit even more rapidly in 2011 and 2012. However, the incoming Spanish government in spring 2012 found that this time path of adjustment was not realistic and it had to dramatically alter the plan.

[4] Hourly rates of pay in the public service pay at the end of 2013 were 6.5 percent below the peak level in 2008 (CSO, CSO survey on Earnings Hours and Employment Costs).

Table 2

Stability programme updates – Ireland and Spain

Official plans	2010	2011	2012	2013
Plan of *Spain*				
Spring 2010	9.8	7.5	5.3	3.0
Spring 2011	9.2	6	4.4	3.0
Spring 2012	9.2	8.5	5.3	3.0
Latest	9.6	9.6	10.6	7.2
Plan of *Ireland*				
Winter 2009	11.6	10	7.2	4.9
Winter 2010		10.6	8.6	7.5
Latest	10.6	8.9	8.1	7.1

Source: Stability Programme Updates for Spain and Ireland. Latest data for Spain from EU AMECO database; for Ireland Duffy *et al.* (2013).

Because of a failure to meet the more ambitious targets, the financial markets temporarily lost faith in the ability of the new Spanish government to deliver and Spanish bond yields rose above bond yields for Ireland. By contrast, in the case of Ireland, sure but steady progress was rewarded with a steady fall in bond yields. While difficult to achieve politically, the lesson from these two examples of adjustment programmes seems to be that it is better to under-promise and over-deliver.

In addition, to dealing with the public finance crisis the Irish authorities also had to tackle the crisis in the domestic banking system. The first lesson from this crisis is that having domestically owned banks can be exceptionally costly. The very rapid rebound in the Baltic countries, in spite of a massive bubble bursting, owes something to the fact that the banking system in those countries was foreign owned. In Ireland, by contrast, the banking system was largely domestic and the domestic banks had a very high share of their business in Ireland. Thus a collapse in the domestic housing market led to the collapse in the domestic banking system. This has proved to be an albatross round the neck of the economy.

Honohan (2012) has drawn some lessons from the Irish experience of tackling the banking crisis saying that, once a problem has occurred, “prompt, transparent over-capitalisation in a systemic crisis should remain the preferred option for dealing with failing banks that it is deemed necessary to save”. While the Irish process was quite transparent the lack of information on the size of the problem resulted in regulators’ initial action being inadequate. Once the size of the funding needed began to become clear it was obvious that it could put the sovereign at risk. This made it difficult to over-capitalise the banks – too big an over-capitalisation would in turn put at risk the sovereign – a lose-lose situation. In the Irish case the funding needs of the banking system placed the sovereign under such severe pressure that, without

the support of its EU partners and the IMF, Ireland would not have been able to deal with the situation in the way it did.

The banking system has been very slow to deal with the problem of the debts that had been recognised in the 2011 stress tests and for which provision had been made in the recapitalisation. As a result, as a recovery in the wider economy is under-way, there are concerns whether the banking system will be able to fund a prospective significant increase in investment (Duffy *et al.* 2013). While the evidence to date is that finance has not been a constraint on growth (O'Toole 2013), it could well prove to be a greater obstacle in late 2014 and 2015.

The recovery

While economists are not good at identifying economic turning points in real time, after the event it is more straightforward to use national accounting data to date recessions and recoveries. However, in the current Irish case, because of the extreme openness of the economy, it is difficult to interpret standard economic data to assess trends in the recent past. While it is reasonably clear from the data for GDP that the economy peaked in 2007 and that output (and employment) levels fell precipitously in 2009, it is much less clear when the recovery actually began.

There are two obvious problems in interpreting the data: one problem relates to the effects on the data of the ending of pharmaceutical patents and the second relates to the operation of some investment vehicles located in Ireland.

Because of the major importance of the pharmaceuticals sector in Ireland, the ending of patents on certain key drugs has had a major impact on national accounting aggregates in recent years. For example, one particular drug manufactured in Ireland, Lipitor, dropped out of patent in the United States at the end of 2011 and in Europe in 2012 (Fitzgerald 2013a; Dalton and Enright 2013). The effect of this change was a loss of revenue for the owner of the drug, Pfizer, of 5.5 billion US dollars in 2012.[5] Even though the pharmaceutical compound continued to be manufactured in Ireland after the end of the patent, all of this loss of revenue is classified as a fall in volume of exports and of industrial output. To the extent that this fall in revenue resulted in a fall in profits earned in Ireland, it also represented a fall in the volume of GDP.

However, it had only a minimal impact on GNP. As this was only one of a number of drugs produced in Ireland that are falling out of patent, and because the precise accounting treatment used by individual companies is confidential, it is difficult to unravel the full effects of these developments on GDP.

In an economy, such as Ireland's, a better measure of real activity, in so far as it affects the domestic economy, is the development of GNP. This is because of the very large and profitable multinational sector in Ireland. The large profits that these firms earn are remitted to the firms' owners and this outflow is included in net factor income paid abroad; this is subtracted from GDP to arrive at GNP. Thus GNP is largely unaffected by the loss of patent revenue as that loss of revenue only affects the profits of the multi nationals.[6]

However, even with GNP there have been significant distortions arising from unusual behaviour by foreign firms located in Ireland, which affect the interpretation of the data. Between 2009 and 2012 approximately a dozen financial firms, largely UK in origin, relocated to Ireland. These firms, referred to as 'redomiciled plcs.', are liable for tax in Britain and have no domestic presence in Ireland (no employees) (Fitzgerald 2013b). They earn investment income in Ireland, which is credited as a net factor inflow, raising GNP and the measured current account surplus. However, because they do not pay dividends, their income does not flow back out to the beneficiaries on the current account. As a result, it increases GNP and Gross National Income (GNI)[7] and the current account surplus of the balance of payments by a significant amount. The increase in the value of the firms' assets arising from the inflow of dividends shows up in the Net Foreign Liabilities of the state. Clearly this addition to GNP, which properly belongs to the foreign owners of the investment funds, does not represent an increase in Irish welfare. To deal with this problem we exclude these inflows from the published GNP figure shown in Figure 2.

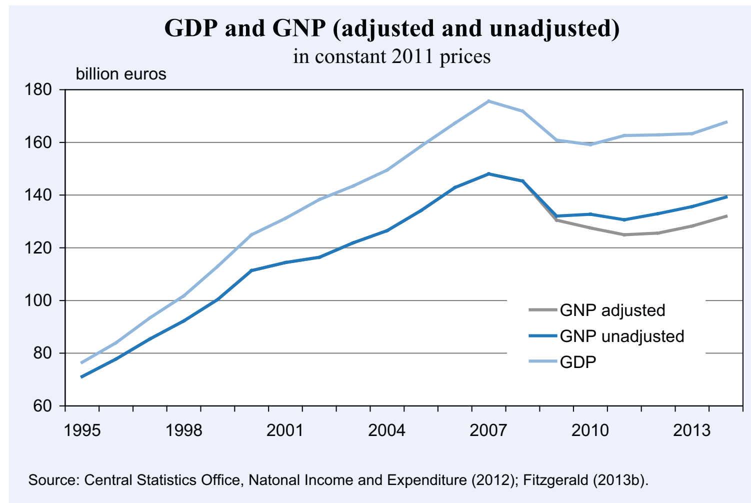
As shown in Figure 2, in the case of GDP the trough was in 2010 and there was very slow growth in 2012 and 2013. While GNP, unadjusted for redomiciled

[5] Over 2.5 percent of the value of exports and of GDP.

[6] To the extent that there is a loss of corporation tax as a result of the lower profits there would be an effect on GNP.

[7] The rise in GNI raises Ireland's contribution to the EU Budget in spite of the fact that there is no domestic value added arising from these firms' activities.

Figure 2



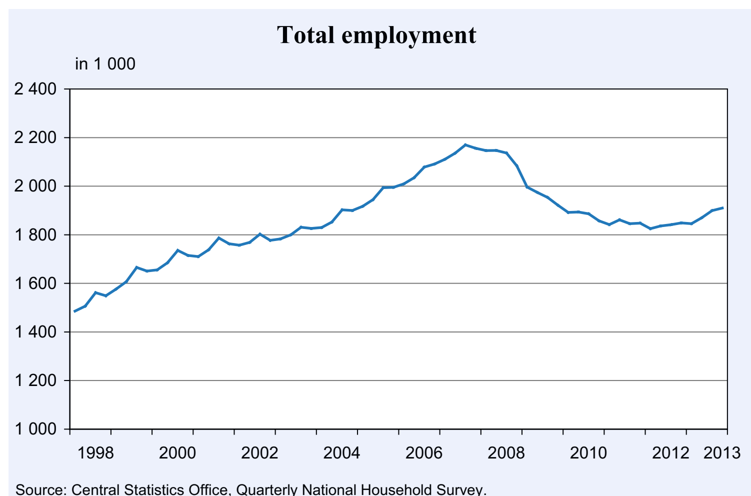
Source: Central Statistics Office, Natonal Income and Expenditure (2012); Fitzgerald (2013b).

plcs., stabilised in 2010, it only returned to significant growth in 2012. Probably the best measure of domestic welfare is GNP, adjusted to exclude the redomiciled plcs. This aggregate suggests that the recession in Ireland continued through 2010 and 2011, with recovery only beginning in 2012.

The clearest signal of what is happening in the economy is probably the growth in employment (Figure 3). Beginning with the last quarter of 2012, there have been five consecutive quarters where seasonally adjusted employment grew, quarter-on-quarter, by over 0.6 percent. This suggests a very similar turning point to the GNP data – some time in 2012. Since late 2012, there has also been a significant increase in hours worked.

When considering the impact of the crisis on the distribution of income, the single biggest driver of change was the dramatic rise in the numbers unemployed. However, there has also been a big impact on the incomes of a significant number of really high earners, many of whom were dependent on the property bubble for their livelihoods and the bursting of the bubble has seen a dramatic decline in their fortunes. Between 2007 and 2010 the numbers earning over 100,000 euros fell by almost 15 percent and, in addition, the average income of those who were still earning over 100,000 euros fell by around 8 percent.

Figure 3



Source: Central Statistics Office, Quarterly National Household Survey.

While the underlying driver of change in the distribution of income (and in the numbers at risk of poverty) has been the changes in economic fortunes, public policy has also played a mildly progressive role in modifying the impact of the crisis on households. Callan *et al.* (2013) show that the effects of changes in the tax and welfare systems over the period 2009–2014 have reduced the incomes of the richest 10 percent of the population by 15.5 percent, while the decline in the incomes of the poorest 10 percent of the population was 12.5 percent.

However, while changes in public policy did not have a major impact on the distribution of income, the operation of the existing welfare system, interacting with the wider changes in the economy, shielded an increasing number of people from the risk of falling into poverty. While the 'at risk of poverty' rate in 2011 was 16 percent, official data indicate that, without welfare transfers, it would have been close to 50 percent. By contrast, in the boom years it would have been under 30 percent without transfers. The resulting increase in welfare payments has contributed to the problems in the public finances.

The data for Ireland for 2011 suggest that the distribution of income was rather similar to what it was in 2007 and 2008. For 2009, the first full year of the crisis, the distribution of income, measured in this way, was the most equal that it has been since the 1980s. This contrasts with Spain where the Gini coefficient has risen significantly in recent years.

Conclusions

While the Irish economy suffered a very severe recession in recent years, the collapse in output was largely confined to sectors directly related to building and construction. The tradable sector had lost competitiveness during the bubble years but the deterioration had not reached the stage where wholesale closures were inevitable. Instead the tradable sector repriced itself over the course of the recession and today private sector hourly earnings are back at their 2008 level. The tradable sector of the economy has specialised in activities that require skilled labour and where demand is income elastic. This has resulted in a very rapid growth in exports of services, which now account for over half of all exports. As a result, in spite of the poor performance of the EU economy, exports of goods and services today are around 14 percent above their previous peak in 2007.

The labour market in Ireland is very elastic. Whereas in most other EU economies labour supply changes slowly over time, in Ireland it shows very rapid changes through migration. Having grown exceptionally rapidly through immigration in the period up to the crisis, peaking at over 2 percent of the population in 2007, there has been very substantial emigration in the last five years ranging up to 0.7 percent of the population. This safety valve of migration moderated the inflationary pressures of the boom and it has also moderated the rise in unemployment in the recession.

The return to rapid growth in employment since the end of 2012 has, so far, being concentrated in jobs for graduates. There has been little recovery in employment for those with lower levels of education. This reflects the nature of the recovery so far; it has been led by relatively high tech business in the tradable sector. Nonetheless, the unemployment rate fell from 14.2 percent of the labour force at the end of 2012 to 12.1 percent at the end of 2013.

The current account surplus has continued to increase, reflecting the continuing deleveraging by the private sector. However, the population is continuing to grow and, with rising employment and the exhaustion of the stock of vacant dwellings in the main cities, demographic pressures are beginning to arise in the housing market. In the main cities house prices and rents are rising. This reflects the fact that population growth alone would require 25,000 dwellings a year whereas currently under 10,000 are being built (Fitzgerald and Kearney 2013).

However, the deleveraging by households could continue for some considerable time if the incipient recovery stalled in the rest of the EU – resulting in a return to stagnation in Ireland. Also, even if the pressures for additional dwellings were to continue to grow, there might not be a supply response if the financial sector was unable to finance the new investment. Given the continuing high level of indebtedness a faltering recovery could result in renewed pressures on the government finances.

However, if the recovery continues to pick up pace in 2014 and 2015, with some increase in domestic investment, this could see a more rapid reduction in the numbers unemployed and a return of the public finances to a small surplus over the period 2017–2019.

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