The Irish Financial Crisis & Consequences for the UK

General Economic Background on Ireland
A summary of the current macroeconomic situation in Ireland:

- **GDP growth:** -4.1% in year to end of Q2, 2010. GNP (gross national product) is nearly twenty per cent lower than at the peak of the Irish economic cycle
- **Inflation**: +0.7% annual rate - but economy is close to experiencing persistent deflation
- **Unemployment** has doubled to over 290,000 in the last two years - now more than 12% of the labour force and a growing long-term unemployment problem
- **Construction** has suffered greatly during the downturn - because of the boom it grew to account for 12% of GDP (by value added) before the recession but many thousands of jobs have been lost and new housebuilding has collapsed.
- **Capital investment** spending is down 22% on the last year
- Combined value of government **guaranteed bank and public sector debt** is estimated at Euro 130billion - more than 230% of Irish GDP
- Ireland is running a huge **budget deficit**. And it appears that - after the bail-outs - annual interest payments on sovereign debt will be 20% of total tax revenues by 2014.
- For many years Ireland has had a **low rate of corporation tax** of 12.5% - a supply side policy designed to attract inward investment. There has been some pressure from Germany and other EU countries for Ireland to raise corporation tax as part of the 'price' of a bail-out.
- Ireland joined the **single currency** when it was established in 1999. Because Ireland is a member of the Euro Zone it's monetary policy is tied to decisions made by the European Central Bank. It cannot unilaterally cut interest rates or attempt to devalue their exchange rate in a bid to become more competitive.
- In the absence of currency flexibility Ireland can restore **competitiveness** only by cutting costs and wages (causing a real fall in living standards) - this has already happened but social unrest is being created by the need for further cutbacks in Irish government spending and a steep increase in the tax burden (including rising VAT and pension cuts)
- **Trade unions** opposed to the fiscal austerity programme introduced by Ireland argue that the European banks and American hedge funds should bear some responsibility for causing the

financial crisis by agreeing to take a **“hair-cut”** in other words, they accept a reduction in the amount of debt they expect to be repaid over time.

- Ireland’s main banks are
    - Bank of Ireland
    - Allied Irish Bank
    - Anglo Irish (already nationalised earlier this year)

Source: Irish Statistics Office

An unsustainable boom turns sour

Ireland is a small European country whose GDP is less than 2 per cent of total Euro Zone national output. The economy grew spectacularly quickly from the mid 1980s onwards and became known as the **Celtic Tiger economy**. As a result Ireland’s relative **GDP per capita** (PPP adjusted) surged from bottom of the EU league table to second top (behind Luxembourg) by the mid point of this decade.

But much of the extra wealth and funds flowing in their banking system was diverted into an **unsustainable property boom** affecting both commercial and residential property sectors. This **property bubble** burst in the fallout from the **global credit crunch** leaving **highly leveraged Irish banks** badly exposed to bad debts and certain to make huge losses. The Irish banks were deemed ‘**too big to fail’** by the government and so, to prevent a bank run, guarantees were made by the government to bank creditors. However, they offered too much and the bank problem quickly became a fiscal problem - Irish senior bank debt is estimated at 38% of its GDP! The bailout is certainly essential right now, but the worrying problem is, as the FT put today ‘Ireland is not the only country that let its banks become **too big to rescue**.’

For many countries a banking crisis turned quickly into an economic crisis and has now become a sovereign debt crisis. Ireland is no exception.

Ireland was one of the first European countries to go into recession in 2008 and the effect on unemployment and inflation was large. **Price deflation** has worsened the slump since the real value of debts has grown. Consumers, businesses, banks and now the Irish government have had to embark on a painful process of **de-leveraging** - reducing their borrowing and potentially leading to **social unrest**.

The Irish financial crisis of November/December 2010 is testing the viability of newly established **EU bail-out emergency funds (€700 billion)**. **A bail-out agreement of €85 billion** to cover Irish banks and its spiralling national debt has been made with the EU and the IMF as part of a national recovery plan, but there are doubts about whether Ireland can service interest payments on the emergency loans.

Macroeconomic instability across the Irish Sea

The unemployment rate has more than doubled since the start of the Irish economic crisis

Worries about the risks of an Irish partial default on their existing loans has contributed to a sharp upward spike in yields on ten-year Irish government bonds. This makes it more expensive for the Irish

state to finance existing and new debts.

Why is Britain helping Ireland?

British Chancellor George Osborne: "Ireland is our very closest economic neighbour so I judged it to be in our national interest to be part of the international efforts to help the Irish."

It is important to highlight that the UK is not gifting money to the Irish government; the UK's bilateral loan to Ireland of £3.2 billion is expected to be repaid. As such, the UK's involvement in the Irish rescue deal can help to stabilise the economy of a major trading partner , benefiting its economy in the short term at no cost in the long term (assuming that the Irish government is able to repay the debt at some point).

Sweden & Denmark Too!

It is not only the UK which is helping a 'friend in need.' Sweden and Denmark (neither are euro-zone countries) both have contributed €598m and €303m respectively. This is unsurprising as Sweden also played a crucial role in bailing out the banks of Iceland and Latvia (2008.) Anders Borg, Sweden's Finance minister, recently said, 'The financial stability of Europe is at risk so it is important to make a broader effort to try to stabilise the situation. For a country lie Sweden, that is so open and dependent on Europe, it is impossible to sit on the sidelines when this kind of risk occurs.'

Ways in which the Irish economic & financial crisis affects the UK:

1. **Trade**:
    a. There are close ties between Ireland and **Northern Ireland.** By some estimates, nearly 40 per cent of exports from the Northern Ireland region flow to the Irish Republic. For the UK as a whole exports to Ireland in 2009 were higher than the combined exports to the **BRIC countries** of Brazil, Russia, India and China combined!
    b. Exports to Ireland are worth about 2% of UK GDP and a fall in export sales would have negative multiplier effects unless alternative markets could be found.
2. **UK Banks and UK Savers:**
    a. Many UK commercial banks are heavily exposed to the Irish financial crisis having made loans during the property boom. According to the Bank for International Settlements, UK bank lending to Irish households and companies amounted to $131bn (£83bn) at the end of 2009.
    b. If UK banks suffer heavy **bad debts**, this could renew the credit crunch in the UK and make it harder for banks to lend out to UK consumers and businesses.
    c. Over two million British savers have billions of pounds on deposit in bonds and accounts with Ireland's banks
3. **Labour migration**: A sustained slump and falling living standards is likely to lead to a reversal of net inward migration into Ireland. Many younger Irish people may choose to leave and work in the UK or other countries inside the European Single Market. According to some estimates more than 100,000 people may leave Ireland in the next few years.
4. **The Pound**: Irish economic difficulties (and those in countries such as Portugal and Spain) have caused the Euro to weaken, forcing the pound higher. This makes it harder for UK

businesses to export to the Euro Zone.

Ireland and the Euro - A Single Currency in Crisis?

A statement made by the EU makes it clear that a financial bailout of Ireland is needed to protect the EU as a whole: “Ministers concur with the [European] Commission and the European Central Bank that providing assistance to Ireland is warranted to safeguard financial stability in the EU and in the euro area.” In a similar way, Swedish prime minister Fredrik Reinfeldt announced his plans to loan Ireland $1.5 billion not simply out of compassion. He argued that “if we don’t create a solution to this, we will also see the effect of the problems coming to us.”

This suggests a high level of **interdependency** between **trading partners** within the EU. When asked about the possibility of lending to Portugal, Reinfeldt stated that “I don’t think I want to speculate on any country that would follow.” Others in the markets, however, are less reticent, as Portuguese 10-year bond yields recently reached a 7.7% high (25/11/2010), and Spain’s spiked on Friday to a 260-basis point gap on Germany’s, amid fears that the “contagion” from Irish and Greek bond markets would spread to the other “PIIGS” economies whose debt has much foreign exposure. As both countries have recently approved harsh austerity budgets, however, (Portugal aims to curb its budget deficit from a 2010-projection of 7.3% to 4.6% next year) there are hopes that some jitters in the markets may be calmed - but also fears that, with few policy options left, the governments will be left at the mercy of speculation.

This **financial crisis in Ireland** also has serious implications for the single European currency. The crisis has caused the **external value of the Euro** to depreciate (fall) due to a decrease in speculative investment which has put many European stock markets under pressure. In addition to Ireland, the Euro is shared with 16 other countries and as all members of the EU are tightly connected via the Euro, any fluctuation in economic activity in one country affects all of the other members.

Given the Irish crisis and other pressures that the Euro is facing there is increasing case for it to split and for the countries to return to their original currencies. Indeed, it is highly debatable whether many Eurozone economies - particularly those on its preriphary with bad histories on budget responsibility and inflation - actually satisfied the **'Euro convergence criteria'** when they joined the European Monetary Union in 1998 anyway, (for a statistical account of how the PIIGS were unprepared to join the Euro, see http://www.voxeu.org/index.php?q=node/3454), or were capable of adjusting to the relatively low Eurozone-wide interest rate, and in hindsight one might say that the **motivation behind the Euro-project was largely political** - despite being based on an economic myth.

For Ireland, leaving the Euro could cause issues due to the high risk of **'capital flight'**. If Ireland were to convert all Euros into punts at an exchange rate of one to one the punt would almost certainly start to lose value against the Euro due to a lack of confidence. Speculators would not wait for this and so would sell for a trusted **reserve currency** such as the US dollar. This flight of money from the Irish economy could wreck their fragile banking system. Although a depreciation would make exports more competitive, the effect on the national debt would bring the country to its knees because existing corporate and public sector debts would remain in Euros while the punt depreciated in value in effect increasing the value of the debt. If one country leaves the Euro there are risks that speculative attacks could undermine the entire currency bloc and raise interest rates for many of the remaining member nations.

The **PIIGS** (Portugal, Ireland, Italy, Greece and Spain) account for a small % of total Euro Zone output but their economic and financial difficulties may eventually cause the break up of the single currency project.

Political Implications of the Crisis

The Irish crisis has created severe problems for Ireland's **coalition government,** dominated by the centrist Fianna Fail and the Green Party. Support for the party has plummeted in Ireland, and Fianna Fial has recently lost the Donegal South-West by-election to Sinn Fein, a move some pundits feel signals a leftward shift in Irish public opinion in the wake of the crisis. The government's majority in the 166-seat Dial now rests on two independents, which puts the critically important budget vote next month in peril.

With the Green Party coalition partners calling for an election, the Taoiseach, Brian Cowen, has announced his intent to seek the dissolution of the Dail. Fears of Ireland's political stability sped through Europe, but Prime Minister Cowen and his party urged the government to secure the proposed $100+ billion bail-out from the International Monetary Fund and the European Union. The bail-out will come as a result of the government's approval of deficit reduction plans. Michael Kennedy, a senior official in the governing Fianna Fail party, expects Cowen to "stand aside and a new leader come forward" after the crucial 2011 budget is passed in December.

BBC news video: Can the Euro survive the Irish financial crisis?

Key economic terms relevant to the Irish economic crisis

- Austerity
- Bad debts
- Bail Out
- Bond markets
- Brain-drain
- Budget deficit
- Capital flight
- Contagion effects
- Corporation Tax
- Credit default swaps
- Deflation
- De-leveraging
- Depreciation
- FDI flows
- Hair-cuts
- Housing bubble
- Moral Hazard
- Mortgage-backed securities
- Multiplier effects
- National income
- Recession
- Savings
- Single currency
- Sovereign debt
- Systemic risk
- Tax increases
- Trade relationships