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Irish Economy and the Recession

This paper will discuss the economy of The Republic of Ireland and how it has been affected by the current global recession. This story will be shown through data on the macroeconomic situation facing the country currently and in the recent past. It will also discuss policy recommendations for both recovery and more long-term issues. Note that while the proper name of the country is the Republic of Ireland to distinguish it from the island of Ireland, which also contains Northern Ireland, a member of the United Kingdom, I will refer to it largely as Ireland throughout the course of this paper for the sake of succinctness.

1. The Global Recession and Ireland

Like the rest of the world, Ireland has been affected by the global recession that started in 2008, often referred to as the "Great Recession". Very few countries were hit quite as hard as Ireland has been for a number of reasons that will be discussed further in this paper. Since the first quarter of 2008, Irish GDP has fallen in nine quarters while posting just four quarters of growth (the third quarter of 2008 was neutral, with a growth rate of zero percent.) It should be noted that 2007 also featured two quarters of negative growth albeit with the first and last quarters showing 3.4% and 5.4% growth respectively. This all came after a decade in which the Irish GDP rose from under 100 billion to a peak above 250 billion in US dollars (Trading Economics). This came with a thirty three percent growth in population and generally low

inflation, showing most of this growth corresponded to a rise in living standards (Ireland Population Growth). This rapid growth has caused many to nickname the country "The Celtic Tiger" referring to their Celtic ancestral background and drawing similarities to the Asian Tigers of the mid 1990s who also saw tremendous growth.

So, what caused this drastic downturn for a country following such rapid growth? Ireland is a very small country whose economy was largely dependent on growth occurring around the world. The Irish government had pushed low corporate taxation rates and little intervention, causing many corporations to set up some type of business in the country. Also, during this period Ireland received great deals of transfer payments from the rest of the European Union, which they used to subsidize domestic firms and entice international companies to move some operations to their country. Due to this, Irish exports exploded driving great deals of the economic growth.

While the country's growth had slowed prior to 2008, things did not fall apart until the global recession occurred. While there are many causes for this recession, the primary one was over leveraging by financial institutions, primarily in the United States. When housing prices dropped after a long bubble, many financial firms could not handle the losses and a global slowdown occurred. For Ireland, this meant a reduction in the amount of money foreigners were spending in the country, a large issue for a country that had tied itself so largely to economic fortunes outside of its own borders. The Irish also saw their own property prices collapse from the aforementioned bubble, falling forty three percent from their 2008 highs (Global Property Guide). This significantly harmed their domestic financial institutions.

Those domestic banking issues created a nationwide financial crisis that crippled Ireland. Their main three banks, Anglo Irish, Bank of Ireland, and Allied Irish Banks had posted losses

estimated at 106 billion, almost two thirds of the Irish GDP at the time. Anglo Irish Bank had lost 34 billion on investments of 72 billion, nearly half. The banks had been loaning great deals of money to property developers in Ireland and suffered greatly when prices collapsed. The Irish economy had become extremely tied up in property development, with one fifth of their workers employed in housing construction. A quarter of their GDP came from such activities. In 2008 twenty eight percent of bank loans went to construction or real estate compared to a European Union average of eight percent. Ireland in fact had the normal eight percent rates as recently as 2000. Not only was a great deal of employment tied up on credit, but the banking crisis became a huge problem for the government, who decided to guarantee bank bondholders their money. This was despite the fact that the combined bank losses equaled approximately three years of Irish government revenue (Lewis).

The slowdown in Ireland caused problems throughout the nation. Their unemployment rate ballooned from about five percent to a peak of over fourteen percent earlier this year. The stock market collapsed behind the plummeting values of the three large banks and the companies they supported. More troubling was the state of the Irish budget deficit. They had previously used the growth of the Celtic Tiger era to lower their debt levels to about twenty percent of GDP by 2008, but since then it has risen all the way to one hundred percent. Bond buyers lost confidence, and ten-year bond rates reached well over ten percent (Trading Economics). This compounded the previous problems they had with the deficit. In July their bonds were downgraded to junk status by Moody's Investors Service (Meichtry and Fidler). For a country with a budget deficit of approximately one third of GDP and the pledge to guarantee bank losses, losing the ability to cheaply borrow was extremely damaging. Along with Portugal, Greece, and Spain, the so-called PIGS countries, it was worried that Ireland would default soon, perhaps

leading to a domino effect amongst the rest of the three and perhaps even larger European countries such as Italy. Due to the support they were receiving from foreign countries, the Irish government was forced to pass an austerity budget, seemingly the last thing needed by a country that was experiencing such sharp negative growth.

2. Current Analysis

Despite all of these issues, the past few months have been encouraging for Ireland. The past two quarters both posted modest growth rates; the first time consecutive quarters had shown growth since 2006. Their bond yields have fallen into single digits and exports are up. Some have theorized that making a commitment to lowering deficits has increased confidence in the economy. Others counter that there has not been any increase in aggregate demand or decrease in the unemployment rate. This would mean that the recovery is all export driven and not likely to last.

One area that has tangential influence on the Irish economy and has been unmentioned so far is the large level of unrest that has been seen in the country before. Prior to the Good Friday Agreement of 1998, the island of Ireland had seen violence between Catholics and Protestants for years. While most of this was contained in Northern Ireland, some of it was in the Republic of Ireland itself. Since the agreement there has been less violence on the island. While one theory is that the Good Friday Agreement simply contained the measures needed to guarantee peace. However, it is possible to theorize that it has been the economic growth promoting peace. If this is the case, an economy that does not recover soon may lead to increased risk of Ireland falling into violence again. A violent country is much less likely to attract foreign investment meaning this could lead to the economic troubles spiraling. Of course it should be said that the economic significance of this potential violence is not as great as the threat from the violence itself.

3. Policy Recommendations

3.1 *The Short Run*

In the short term, Ireland is unable to enact the policies that usually would be suggested for a country in their state. As they are facing high unemployment and low growth, the usual move would be to attempt expansionary monetary and fiscal stimulus. However, they are unable to pursue these policies. The International Money Fund and European Union demanded significant budget cuts in return for loans that Ireland desperately needed. Due to this Ireland's fiscal policies resemble contractionary policies and it is slated to make similar cuts for each of the next four years.

Monetary stimulus would be perhaps the best policy for Ireland to attempt to revitalize the economy. Not only would this hopefully shift aggregate demand, but inflation could lower the real value of the large debts held by the Irish government and private citizens. Finally, increasing the money supply would lower the value of their currency in comparison to other currencies, helping to boost demand for Irish goods, leading to increased exports. However, Ireland is not free to adopt any of these suggestions. The Irish do not have their own currency and their central bank is not free to print Euros. The European Central Bank controls monetary policy and therefore Ireland needs them to perform the expansionary policies if they are to be done.

One possible solution to Ireland's short-term problems is to make an impassioned plea to the European Union and International Monetary Fund to allow them to undergo more expansionary policies. However, this is unlikely to work. The European Central Bank has a sole mandate to maintain low inflation unlike the Federal Reserve whose dual mandate also includes promoting maximum employment. For this reason they are unlikely to pursue policies that would

help Ireland. In regards to fiscal policy Ireland is dependent on outside organizations for credit still and a debtor is unlikely to be able to demand any concessions from creditors it desperately needs still. Simply, Ireland makes up just over one percent of the Eurozone's population and owes money to most of the others countries meaning it is unlikely that they will be able to convince these others to support them.

Unfortunately for Ireland, in the short term there are not a great deal of policy moves likely to help them. Due to the nature of their economy and their debt levels, they are extremely dependent on what happens with other economies. The best thing that could happen to Ireland would be successful expansionary policies being pursued by large economies such as the European Union and the United States. There are however, some policies that could help the economy. Acts of parliament could make strides to lower their future levels of spending. This could increase confidence in bond buyers, lowering their debt servicing rates, and gain them leeway with their creditors allowing them to avoid overcontractionary measures in the short run.

One idea that has been floated for Ireland is removing themselves from the Eurozone. By controlling their own currency, Ireland could easily engage in expansionary monetary policy. However, this line of action has a great deal of problems. For one, there are mechanical issues with changing a currency. Minting an entirely new currency while also retrofitting machines to accept the new currency would require money that Ireland does not have. Much more worryingly, this could cause a run on deposits in Irish banks. Depositors would expect their money to be changed from euros to a new currency that is certain to be inflated, lowering the real value of their deposits. These depositors would likely remove their money from Irish banks once they heard of this new currency. This issue could be fixed through freezing their ability to withdraw money by fiat, but doing something like that is not a good way to encourage anyone to

deposit money in their banks in the future. For these reasons, I do not recommend Ireland leaving the euro.

3.2 The Long Run

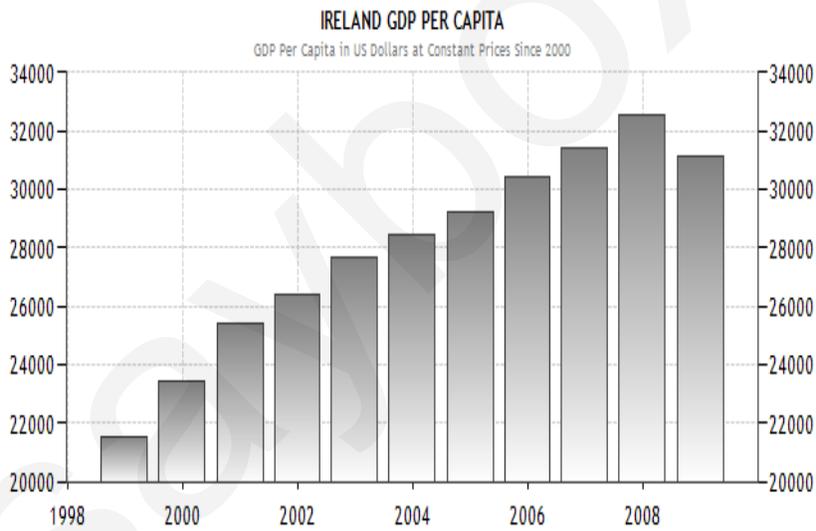
In the long run, Ireland needs to focus on decreasing its budget deficit. Ultimately, that needs to become a surplus so they can lower their debt levels. Someday in the future there will be another recession and when that comes it would be extremely advantageous for Ireland if they and not their creditors were the ones with the power to set fiscal policy. Although it has been strongly suggested by the European Union, raising the corporate tax rate seems like a bad way to accomplish this as Ireland's growth was so tied up in the positive effects that could be delivered by these low rates. One suggestion for increased revenue is to increase property taxes. Not only are wealth taxes usually the least distortive type, but a large part of the Irish economy's issue was fueled by overinvestment in property. Another area to improve revenue is through a broadening of the taxpaying base in the nation. In 2010, forty five percent of the Irish population was somehow exempt from paying income taxes. Widening this base could significantly increase revenue with little added distortions. I would also recommend a carbon tax, which raises revenue while also meaning Ireland is doing its part to combat global climate change. Despite all these ways to boost revenue through new taxation, it is likely that the best way to increase revenue for Ireland is to promote future growth.

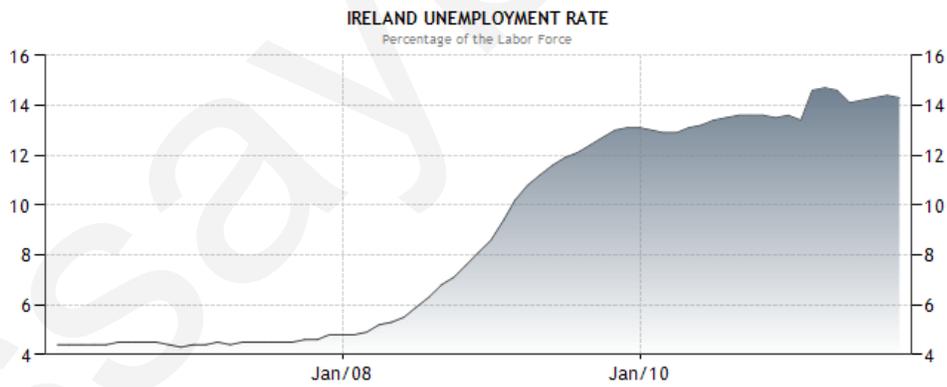
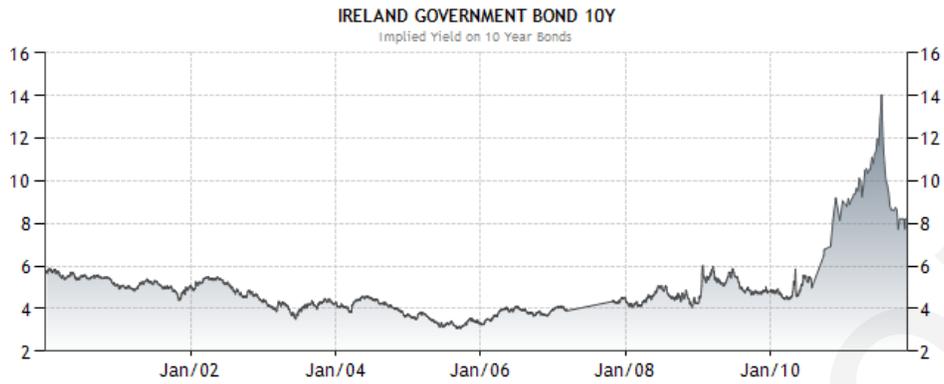
The Irish government also needs to cut expenditures. One area in which I would recommend cuts would be in industrial policy. Usually industrial policy is best used on infant industries, but the export levels of the nation before this recession shows that the Irish economy had passed that stage. Plus, with the benefits of their low taxation rates and low regulation it is unlikely that foreign companies need too much more to convince them to set up in Ireland.

Included in this would be tax expenditures, where they cut tax breaks for companies. Ireland already has a very pro business environment and applying it universally should be enough to promote investment in the country.

One area that should not be cut anymore than it has to in order to comply with the demands of their creditors is support for the Irish unemployed. Even the Irish government's official projections expect double-digit unemployment through 2014. This is obviously a significantly high level for long term that cannot be reduced through the traditional means of expansionary policy. Having already mentioned Ireland's troubled past; it is a remarkably bad idea to leave such a large part of their population without income and angry. Again, this would have significant economic affects, but they would certainly be insignificant compared to worst affects of returned violence in the country.

Appendix







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