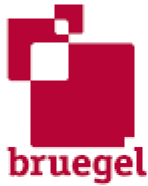

Bruegel lunchtalk

Coping with the crisis: What's next for Ireland

Alan Ahearne

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As part of Bruegel's lunch talk series, Alan Ahearne, economic advisor to the Prime Minister of Ireland, spoke on the causes and remedies of the economic crisis in Ireland, and its medium term growth prospects. He began by illustrating Ireland's economic situation, identifying three different phases.

The first, starting in the 1990s, characterized by sluggish growth, leading into a period of sustained growth, primarily driven by exports and structural changes in the economy, which lasted throughout the second half of the decade. In the following years, between 2001 and 2007, economic growth in Ireland slowed down, and it was more dependent on domestic demand, especially construction and consumption. Alan Ahearne then presented evidence of the growing dependence of Ireland on the construction sector, visible since 1997, but particularly marked in 2002 and 2003, thus forming an "old fashioned housing bubble."

In parallel, a loss in competitiveness was also taking place. The collapse of the housing bubble, in 2006, was a domestic shock, while the second global one, mainly affected the Irish economy through the fall in GDP of its main trading partners and the depreciation of the Sterling Pound. The result of these combined shocks pushed Ireland towards a deep recession, and a return to growth delayed until 2011. As for the remedies, Ahearne identifies three crucial elements: sustainable public finances, restoration of the banking system, and regaining competitiveness. Public finances were also affected by the housing bubble. In fact, a significant amount of the taxation revenues derived from asset transactions, and part of this additional revenue was used to reduce income taxes and increase public spending, thus creating a structural deficit. Further, the crisis has impacted extremely negatively on both unemployment and public debt, with both rising fast.

The speaker examined as well the situation of the Irish banking system before the crisis, emphasizing the high, and increasing, net foreign liabilities of the Irish banks since 2004, coinciding with a time of very low interest rates in the Euro Area. To avoid further problems in the banking sector, Ireland has undertaken a process of recapitalization and purchase of risky loans through the Asset Management Agency. Banks in return were given government debt that could be used for repo operations at the ECB. As for competitiveness, according to the European Commission, labor costs are likely to fall in Ireland, possibly reflecting a fall in productivity, but also the flexibility of the economy.

There is, however, a bright side. Ireland's exports are specialized in non-cyclical sectors (such as health and medical devices) and will contribute to balancing its current account. Other favorable factors are: demographics, with a young and educated population (second only to Sweden in the EU), the business culture, and the lowest tax wedge in the Euro Area. Ireland's potential for growth remains even in this dire situation.

Lastly, André Sapir presented a comparison with Spain, a country undergoing in many ways a similar crisis to that of Ireland, including the effects of a burst in its housing bubble, but that, in a medium term perspective, has less bright prospects than Ireland, a country that has shown much higher labor productivity growth and GDP convergence. However, this may not solve the root problem for Ireland, the possibility that its growth model may be exhausted. As the aid of EU Structural Funds decreases, and the imitation of Ireland's example by the New Member States is enacted, doubts over the Irish growth model start to arise. In a final note, Ahearne pointed out that belonging to the euro had been crucially important for Ireland during this global crisis.