Other articles

THE EU/IMF RESCUE PROGRAMME FOR IRELAND: 2010–13

Sean D. Barrett

The EU/IMF €85 billion rescue of the Irish economy required Ireland to address critical problems in banking and bank regulation, the public finances and structural reform. Ireland must also address weak expertise in economics in the public sector and in banking, rent-seeking, regulatory capture, moral hazard, lack of accountability and failures of corporate governance.

Keywords: Irish debt crisis, bailouts, IMF rescue.

The Memorandum of Understanding of December 2010

'Ireland faces an economic crisis without parallel in its recent history. The problems of low growth, doubts about fiscal sustainability, and a fragile banking sector are now feeding on each other, undermining confidence. . . . At the root of the problem is a domestic banking system, which at its peak, was five times the size of the economy and is now under severe pressure.' This is a key sentence from the text of a joint letter from Minister for Finance Brian Lenihan and Governor of the Central Bank of Ireland Patrick Honohan to the European Commission and the European Central Bank formally applying for support from the EU and IMF (1 December 2010). Ireland obtained a loan of €85 billion at an average interest rate of 5.82% with €35 billion allocated to the banking sector and €50 billion to the public finances. The sources of the loan finance included: eurozone plus United Kingdom, Sweden and Denmark (€45 billion); the IMF (€22.5 billion) and Irish internal resources, mostly the National Pension Reserve Fund (€17.5 billion).

The Memorandum of Understanding between Ireland and the EU and the IMF requires a programme of fiscal measures, financial sector reforms and structural reforms for each quarter between the beginning of 2011 and the end of 2013. The financial aid to Ireland is to be released on a quarterly basis if performance targets are met. Ireland is required to submit weekly data on the government's cash position, spending and receipts; the assets and liabilities of the Central Bank and the balance sheets of the larger banks. Ireland must report monthly on adherence to budget targets; debt due within 36 months; updated estimates of the banks' abilities to raise funds; the assets and liabilities of the Irish bank system; banks' debts due within 36 months; borrowings by the government from the banks and any guarantees given; financial stability indicators for the domestic banks; and estimates of the domestic banks' capital needs. The final set of information requirements on a quarterly basis is data on the public sector pay bill (number of employees and average wage) and data on debt falling due at state companies and local authorities over the next 36 months.

The fiscal measures required in 2011 include revenue increases of €1.4 billion; €2.1 billion in current expenditure reductions; and €1.8 billion in capital expenditure reductions. The targets for 2012 and 2013 include revenue measures of €1.5 billion and €1.1 billion respectively, while the expenditure reduction targets are €2.1 billion and €2.0 billion respectively. The financial sector reform section of the memorandum lacks detail but the general context is one in which both Bank of Ireland and Allied Irish Bank will be reduced in size with Anglo Irish Bank and Irish Nationwide facing closure. The structural reform section of the memorandum includes reducing the minimum wage; tackling unemployment and poverty traps; increasing the pension age to 66 in 2014, 67 in 2021 and 68 in 2028; basing public sector pensions on average instead of final pay;

removing barriers to competition in sheltered sectors such as the legal profession, medical services and the pharmacy profession; water charges; reform of bankruptcy laws; and reform of fiscal governance requirements.

The rescue measures have broad support among Irish economists because they address serious deficiencies in Irish economic governance which caused the three crises in the banking sector, bank regulation and the public finances. In addition, the reforms address the underlying problems such as regulatory capture, rent seeking, moral hazard, lack of accountability, lapses in corporate governance and weakness in economic policy formulation and appraisal.

Regulatory capture and rent seeking

The government was successfully lobbied by the banks in September 2008 to fully underwrite Ireland's entire banking network. The guarantee covered four banks: Bank of Ireland, Allied Irish Bank, Anglo Irish Bank, and Irish Life and Permanent and two building societies (Educational Building Society and Irish Nationwide). The lobbyists comprised the chairmen and chief executives of Allied Irish Bank and the Bank of Ireland. The government was represented by the Taoiseach, the Minister for Finance, the Attorney General, the Financial Regulator and the Governor of the Central Bank.

The bank guarantee has been heavily criticised because of the costs involved, the failure to address moral hazard, the failure to consult other members of the eurozone, and the failure to address the causes of the financial problems of Irish banks and their failed regulatory regime. There are also concerns that Irish public administration is dominated by clientelism and rent-seeking behaviour, notably in banking, construction and agriculture, and that taxpayers are not protected from delegations lobbying in government departments as the bankers did in this instance.

The Irish government will borrow 32% of GDP in 2011 in order to cover the bank guarantee and the deficit in the public finances. The 2012 borrowing is anticipated at 12% of GDP for the public finances only and assumes that the banking sector will not require further assistance.

The success of the banking lobby raised immediate concerns in Ireland and abroad. Murphy and Devlin (2009) wrote that: 'Guaranteeing the banks was an extraordinary step. It meant that if any bank discovered it had unmanageable bad loans, the taxpayer would be liable.' The unilateral guarantee also surprised other member states of the European Union.

The ease of access of senior bank officers to senior cabinet members in September 2008 reflected the smallness of the Irish economy and the informality of the public sector in dealing with lobbyists. Four months earlier Ireland had signed an EU-wide Memorandum of Understanding on Cooperation between the Financial Supervisory Authorities, Central Banks and Finance Ministries of the European Union on Cross Border Financial Stability. The signatories for Ireland were the Central Bank and Financial Services Authority and the Department of Finance. These bodies were represented at the meeting in September 2008. The memorandum of 1 June states that it applies in a crisis situation regardless of its origin, affecting the stability of the financial system in at least one member state with potential cross-border systemic impact in other member states and involving at least one financial group or affecting the financial infrastructure or the functioning of financial markets' (Section 1.1.2). 'A cross-border systemic crisis, having its origin in individual financial groups, is most likely to involve banks or banking groups, due to the specific features of banks' balance sheets.' (Section 1.1.3). In Section 1.1.4 it states: 'the parties commit themselves to open, full, constructive and timely cooperation to prepare and search for jointly acceptable solutions' (Commission of the European Communities, 2008).

Ignoring the June Memorandum of Understanding deprived Ireland of an agreed EU-wide approach to its banking crisis by nationalising the problem. Irish bank debt became sovereign debt. By contrast, proposals from Germany to require bank bondholders to bear part of the burden of bank failures will come into effect at the earliest in 2013.

The failure to address the causes of the financial problems of the Irish banks in September 2008 resulted in the government accepting the banks' contention that they had a liquidity problem whereas in fact they had a solvency problem. The Central Bank and Financial Services Authority and the Department of Finance had obviously failed in their regulation of the sector. Questions remain, more than two years later, about the standards of corporate governance in Irish banks and the reliability of their published accounts at the time of the guarantee. The former Taoiseach, Dr Garret FitzGerald (2003) states that, at the Department of Finance: 'there is now a most serious shortage of skills especially of economic skills at the Assistant Principal level where much research and policy analysis takes place'. The former chief economist at the Central Bank states that since the early 1970s 'there has been no serious attempt to formulate macroeconomic policy in a serious way' and that 'many top-flight economists left the Department in subsequent years and were never replaced. No other treasury in the world ever attempted to perform its duties with so little economic expertise' (Casey, 2010).

The December 2010 Memorandum of Understanding's rigid timetable for reform of the Irish public finances and its controls and information requirements indicate a lack of confidence by the IMF and EU in Irish economic governance and the failure of vital Irish economic institutions and policies. During the rescue period, economic policy will be controlled by the lending bodies. However, the rescue period affords Ireland an interval in which to secure reforms of the failed institutions and policies which caused the crisis.

The moral hazard aspect of the Irish crisis is indicated by reference to two earlier incidents of favourable treatment of Irish banks by the government. In 1985 Allied Irish Bank was rescued by the government in respect of losses in an insurance investment. There were also bogus non-resident accounts set up to avoid deposit interest retention tax on which Irish Banks paid £225 million in tax, interest and penalties, and schemes of tax evasion for senior executives through an investment company located in the Virgin Islands (Ross, 2009).

The role of the euro in the Irish crisis

Ireland joined the euro in 1999 but did not publish an economic evaluation of this choice as was carried out in the United Kingdom. In joining the euro Ireland abolished its ability to use exchange and interest rates as instruments of economic policy. The Irish pound was previously abolished in 1826, and until 1979 Ireland was an underperforming member of an economic and monetary union with Britain. In its brief period with an independent currency Ireland, in the decade 1987 to 1997, created 23% more jobs compared with 17% in the USA, 5% in the UK and 3% in the then 15 EU member states. Nonetheless, Ireland decided to join the eurozone in 1999.

The eurozone accounted for less than a third of Ireland's foreign trade. The eurozone brought low interest rates to Ireland which was already booming and a large capital inflow to a full employment economy. This large capital inflow caused asset price inflation and a loss of competitiveness in Ireland. It also relieved Irish financial institutions from the need to attract Irish domestic savings. Addressing an Irish audience, Friedman (2001) wrote that 'the euro was adopted really for political purposes, not economic purposes, as a step towards the myth of the United States of Europe. In fact I believe that its effect will be exactly the opposite. The need for different policies like tightening monetary policy in Ireland or a more flexible monetary policy in Italy will produce political tensions that will make it more difficult to get political unity.' In 2010 these tensions arose with the rescue of both Greece and Ireland and increasing German reluctance for further rescues. Friedman was also pessimistic about reversal of the decision to join the euro: 'Ireland is stuck with the euro. How would you break out, and start all over again to establish a new monetary system, the punt? You are not going to give it up. You have locked yourselves together and thrown away the key' (ibid.).

The implicit policy choice by Ireland in joining the euro was to adopt German monetary policies, thus aligning Irish policies with the lead currency in the eurozone. The OECD *Report on Public Management in Ireland* (2008) indicates that the public expenditure policies of Ireland and Germany were polar opposites. Real public annual expenditure growth in Ireland from 1995 to 2005 was 5% compared with minus 0.5% in Germany.

Central Bank of Ireland data show that Ireland was a full employment economy in 2000 with unemployment at 4% compared with 9.1% in Germany. Irish house prices and private sector credit were both rising by over 20% per year. After the launch of the euro on 1 January 1999 it depreciated by over 30% against the US dollar from a high of $1.17. In joining the euro Ireland conceded sovereignty in relation to interest and exchange rates and adopted policies appropriate to the German economy at an entirely different stage of the economic cycle. This remains the case in 2011 when higher interest rates are appropriate to an expanding German economy and low interest rates are appropriate to the declining Irish economy.

Institutional and regulatory policy failure

The Central Bank data indicate that private sector credit increased by over 20% in 2000 and by over 25% in each of the years 2004, 2005 and 2006. The Central Statistics Office data show a total increase of almost six-fold in advances by credit institutions from €66 billion in 1998, the last year before the adoption of the single currency policy, to €392 billion in 2008. Personal lending increased by €112 billion over the same period. In 2008 the pre-1997 position of a net balance of personal deposits in credit institutions was replaced by net advances of €57 billion. The largest sectoral increase was in real estate lending which increased from €4.8 billion to €97.5 billion, followed by lending for financial intermediation which increased from €18.3 billion to €97.5 billion, and construction which increased from €1.8 billion to €22.3 billion. By contrast the increases in advances to manufacturing and agriculture, at €4.8 billion and €2.6 billion respectively, amounted to only 1.9% of the total increase in advances by credit institutions.

This pattern of lending increases inevitably led to large increases in house prices. The Economist House Price Index 1997–2007 showed Ireland with the highest house price increase, at 251% or almost double the average for the 14 observations in the OECD countries included in the survey ('Houses Built On Sand', *The Economist*, 15 September 2007). The largest price increase in Ireland was for second-hand houses in Dublin from an average of €104,000 in 1997 to €512,000 in 2006. Former UK Chancellor of the Exchequer and Prime Minister Gordon Brown (2010) lists, *inter alia*, British house prices as a reason for remaining outside the eurozone: 'British house prices and market volatility had required interest rates higher than in other countries. . . . What I feared was that to restore lost British competitiveness following a period of higher inflation than that prevailing in the euro would require a period of British deflation.'

The requirement for bailouts of both the banks and the exchequer in December 2010 resulted from failures in banking and bank regulation. Cooper (2009) notes that, 'throughout 2008 and early 2009' both the then Central Bank governor and financial regulator 'publicly defended the lending policies of the Irish banks on many occasions, endorsed the strength of their balance sheets and decried suggestions that the banks might have walked themselves into trouble'. The banking sector achieved regulatory capture over the Central Bank and Financial Regulator and the Department of Finance.

The rapid growth in public spending in the expansionary years weakened the ability of the Department of Finance to control the spending departments and agencies. Project appraisal has been a weak area in the Department of Finance for some decades and the Department lacked economic expertise compared with the pre-boom era. Large spending departments such as health, welfare, education, transport, agriculture and energy had always lacked economic expertise. For example Transport 21, an investment of €34.4 billion in transport, contained no cost–benefit analysis of any of the investments or examination of large cost overruns in road and tram investments (Barrett, 2006). The spending departments were regularly captured by sectoral pressure groups, notoriously by the construction sector (McDonald and Sheridan, 2009).

The weaknesses of macroeconomic management in Ireland are illustrated by comparing the economy in 1999 and 2008. Ireland changed from a full employment economy with a government surplus, to over 13% unemployment and a borrowing requirement of 32% of GDP. The combination of weak macroeconomic management, Niskanen bureaucracy, and rent-seeking produced bizarre results across the economy. A campaign to market Ireland as a 'world leader' in science, technology and innovation contrasts with the report that 'only around 20 per cent of teachers of second level mathematics studied mathematics as a major subject beyond the first year of their primary degree' (Future Skills Needs, 2008). A vibrant tax lawyer and accounting sector secured tax expenditures costing the exchequer €11.5 billion, or 5.5% of GDP in 2006 (Collins and Walsh, 2010). State development agencies paid over €1 billion a year in grants but employment in these firms fell by 50,000 in the decade.

The social partnership system of involving employers and trade unions in wide areas of decision-making weakened the ability of the Department of Finance to control spending but gave unions and employer groups seats on boards such as the Central Bank, the state training agency FAS, and the health sector. Social partnership was operated through the department of the Taoiseach (prime minister), thus undermining the traditional role of the Department of Finance as controller of the public purse. Social partnership also undermined persons in spending departments who might have questioned the rapid increase of public spending without proper appraisals. A key part of social partnership was benchmarking, a closed system of public pay determination which raised public sector pay to levels which are uncompetitive by international standards, including, for example, senior politicians and central bank officers. The position of the exchequer was further weakened by the addition of some 850 quangos which quickly attained independence from the scrutiny of either their hollowed-out parent government department or parliament.

An economic reform agenda

The IMF/EU reform measures and their rigid timetable are necessary but not sufficient in the reform of Irish economic policy and institutions. A wider economic reform agenda is required to address the underlying problems which led to the need for the EU/IMF rescue.

Economic expertise

The economic expertise of the Department of Finance and the spending departments and agencies must be raised above the present minimal levels. An economist grade should be instituted and its staff trained to the highest international qualifications. A Council of Economic Advisers should be appointed.

Regulatory capture and rent seeking

A value for money perspective must replace lobbyist pressures as the determining factor in public expenditure policies. The current weak role of parliament in the Irish political system must be strengthened in order to combat the powers of pressure groups. The former Taoiseach, Mr John Bruton, has proposed the election of the Speaker by secret ballot of members of parliament in order to reduce control of parliament by the executive.

All representations, lobbying visits, delegations, requests, petitions etc. to a government department or agency should be reported to parliament within 24 hours. Ireland has engaged in considerable rent seeking in Brussels and this has reduced both the incentive and ability of many public bodies to live within Ireland's means.

Policy evaluation and transparency

All public expenditure proposals should be independently costed and evaluated. The evaluations should be published well in advance of any spending commitments. A Central Office of Project Evaluation should be established in the Department of Finance.

Accountability

Ireland needs far greater accountability in both the public and private sectors. Senior officials in banks, building, regulatory bodies, accountancy, the public service and board members have not, to date, paid the price for the recession in Ireland. There should be parliamentary scrutiny over appointments to public boards traditionally appointed from among supporters of the political parties in power. The lack of checks and balances among non-executive directors in the banking sector must also be addressed and taxpayers must not be allowed to bailout bank creditors except under very strictly defined circumstances (see also below).

Reform of banking and bank regulation

Regling and Watson (2010) find it 'particularly surprising that there was not a stronger reaction within banks themselves and among supervisors to lending trends that saw a progressive build-up of concentrated loan exposures to and within the commercial property sector. It would be valuable to establish the reasons for the absence of reaction, within banks and in the regulatory authority, since this was a critical factor that contributed to the overall level of risk exposure in the system.' The use of economic expertise in the banks for public relations purposes rather than project evaluation and in the Central Bank for macroeconomic commentary rather than bank regulation contributed to the malfunctioning of both. The September 2008 government intervention to save Irish banks is now seen as short term. The Irish banking sector on that date was too large for the country's needs and substantially insolvent. It is likely to become much smaller, based on utility banking and to pass mostly into foreign ownership. The burden of any future rescue will be borne by the home countries of foreign banks.

Reform of the public sector

Ireland's large public sector deficits will require shrinkage of the role of the state. There are likely to be considerable sales of public assets in areas such as airports, bus transport, the remaining state stake in Aer Lingus, horse- and dog-racing grounds, energy undertakings, land, health insurance, forests, banks, ghost housing estates, marketing bodies etc. While the restoration of the control of the Department of Finance is crucial to the restoration of order in the public finances, other departments could be closed in line with the reductions in state ownership in energy, transport and sport. The

Department of Health has already been hollowed out by the transfer of most of its budget to the Health Service Executive. Hospitals and educational bodies might compete for patients and students respectively with direct state finance and the departments of health and education could then be closed. Ireland's 800 quangos might either be returned to their parent departments or the departments abolished. The Taoiseach's department might revert to a small cabinet office rather than engage in micro-management of line departments as has happened under social partnership. Irish public sector pay at the top level exceeds that in the countries now supporting the rescue due to an offshoot of social partnership known as benchmarking. These heavily criticised exercises were, ironically, carried out by senior banking or legal figures. Future arrangements in this area should be linked to Ireland's international competitiveness.

Summary

Ireland's rescue by the EU and IMF has its roots in the widespread failure of policies and institutions in the banking sector, among bank regulators and in the management of public finances. The three-year rescue period affords Ireland the time to engage in widespread economic and institutional reforms rather than face the same underlying problems when the rescue period expires in 2013. Considerable inertia in the banking and bureaucratic sectors will make these reforms difficult. Transferring the costs of banker and bureaucrat failure elsewhere in the economy will postpone Ireland's recovery as will a focus on financing deficits rather than confronting them. The first three years since these problems arose in 2008 have hardly been auspicious. The external rescue agencies must insist on reforms in the Irish sectors which caused the crisis.

References

Barrett, S. D. (2006) *Evaluating Transport 21 – Some Economic Aspects*, Quarterly Economic Commentary, Winter, Dublin: Economic and Social Research Institute.
Brown, G. (2010) *Beyond the Crash*, London: Simon & Schuster.
Casey, M. (2010) *Ireland's Malaise*, Dublin: Liffey Press.
Collins, M. and M. Walsh (2010) *Expenditure Cuts: The Bell also Tolls for Tax Expenditures*, Kenmare Economic Policy conference, October.
Commission of the European Communities (2008) *Memorandum of Understanding between the Financial Supervisory Authorities, Central Banks and Finance Ministers of the European Union*, ECFIN/CEFCPE (2008) REP/53106, Brussels, 1 June.
Cooper, M. (2009) *Who Really Runs Ireland?*, Dublin: Penguin.
FitzGerald, G. (2003) *Reflections on the Irish State*, Dublin: Irish Academic Press.
Friedman, M. (2001) Interview in *Irish Times*, 5 September.
Future Skills Needs expert group (2008) *Statement on Raising National Mathematical Achievement*, Dublin, November.
McDonald, F. and K. Sheridan (2009) *The Builders*, Dublin: Penguin.
Murphy, D. and M. Devlin (2009) *Banksters*, Dublin: Machette Books.
Regling, K. and M. Watson (2010) *A Preliminary Report on the Sources of Ireland's Banking Crisis*, Dublin: Government Publications.
Ross, S. (2009) *The Bankers*, Dublin: Penguin.

Sean D. Barrett was a member of the National Economic and Social Council of Ireland from 2005 to 2010 on the nomination of the Government of Ireland. He is presently at the Economics Department, Trinity College, Dublin (sbarrett@tcd.ie).