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The debt crisis in Ireland

Colm Fitzgerald

Dublin City University, Ireland

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ABSTRACT

This paper takes a multidisciplinary approach to analyze the current debt crisis in Ireland. It briefly reviews Irish economic performance from 1980 to 2008 and in particular the Celtic Tiger years. The paper looks at changes in the Irish money supply and its contribution to the Irish housing bubble and the subsequent economic problems facing Ireland. An estimate of the negative wealth effect in Ireland since 2007 is made. Given that Ireland is a small open economy, a number of other factors which are both domestic and international are considered in an attempt to explain what has happened in Ireland, where might Ireland go from here and what lessons can be learnt. These factors include: the theory of political economics, the principal-agent problem, the theory of optimal currency areas, the Balassa Samuelson effect, the dynamics of a capitalist economy, neo-liberalism, European monetary integration, international bond markets and 'insurance' that was sold to cover a Eurozone breakup. The Irish culture is considered to differentiate Ireland from other EU countries, in particular, Portugal, Italy, Greece and Spain.

1. Introduction

Ireland experienced relatively unprecedented economic growth from the mid 1990s until 2007. Since then, Ireland has experienced a severe economic crisis which has seen it needing a bailout from the IMF/EU/ECB. This paper initially reviews the years of the 'Celtic Tiger' – highlighting some of the main factors that influenced Ireland's economic development during this time. The paper takes an alternative viewpoint to analyze the Irish debt crisis.[1] Significant emphasis is placed on the movements and the management of the Irish money supply. Political factors are considered, along with the dynamics of International Capital Markets and the Eurozone currency union. Several analogies are used to highlight the mistakes that were made which contributed to the debt crisis and to highlight flaws in existing economic theories and systems. Psychological and cultural factors are also considered. Possible future scenarios for Ireland are also discussed.

2. The Celtic Tiger

Irish GDP per capita increased from about 60% of German levels in 1980 to about 140% of German levels in 2007 (Source: Maddison, 2010 – Fig. 1). This was a remarkable success story.

Despite Ireland's current economic problems, income levels are still high. A number of factors played significant roles in this story. These include, albeit this is not an exhaustive list:

- EU transfers to improve infrastructure and to build roads.
- Lower interest rates: the yield spread between Irish and German ten-year government bonds was about 7% in 1987 and it converged quickly after that; and reductions in short term interest rates followed in the late 1990s. Irish mortgages are mainly linked to short term interest rates (unlike the US, but like the UK) so mortgage rates also fell sharply during the late 1990s.
- The Industrial Development Authority (IDA) was very successful at getting foreign direct investment into Ireland.
- The International Financial Services Centre (IFSC) in Dublin expanded rapidly, benefiting from some innovative, astute and possibly over 'friendly' regulation.
- Significant educational investment by the State in the 1970s and 1980s, along with more students staying on in education when

E-mail address: colm.fitzgerald@dcu.ie

[1] The author is a former derivatives trader (formerly Head of Quantitative Trading in Bank of Ireland Global Markets) who predicted and profited from both the boom and the bust in Ireland (allowing him to semi-retire in 2008, aged 32). The ideas expressed in the paper are some of the ideas and theories that were used in order to prospectively predict the boom and the subsequent bust.

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Table 1
Irish economic statistics.

	M M3 growth	*V* Velocity	*P* CPI inflation	*Q* GDP growth	$=M-P-Q$	House prices	Affordability index	Salary inflation	Stock market
1996	15.7%	?	1.7%	9.6%	4%	13%	n/a	4%	22%
1997	19.1%	?	1.4%	12.3%	5%	19%	n/a	4%	49%
1998	18.1%	?	2.4%	8.4%	7%	27%	n/a	4%	23%
1999	20%	?	1.6%	11.2%	7%	20%	n/a	4%	0%
2000	15%	?	5.6%	10.1%	−1%	15%	n/a	7%	14%
2001	17%	?	4.9%	6.8%	6%	8%	n/a	10%	0%
2002	9%	?	4.6%	6.4%	−2%	9%	n/a	4%	−30%
2003	6%	?	3.5%	4.9%	−2%	15%	n/a	4%	23%
2004	22%	?	2.2%	5.2%	15%	11%	n/a	6%	26%
2005	22%	?	2.5%	5.9%	14%	12%	21.60%	5%	19%
2006	29%	?	4.0%	6.4%	18%	12%	26.40%	6%	28%
2007	10%	?	4.9%	6.1%	−1%	3%	23.00%	4%	−26%
2008	−2%	?	4.1%	2.9%	−9%	−7%	18.20%	3%	−66%
2009	−3%	?	−4.5%			−25%	13.10%	−4%	27%
2010	−19%								
1996–2007	540%		47%	145%		360%		82%	210%

Sources: Central Bank of Ireland, Environ. i.e. CSO, Bloomberg, DKM/EBS.

there were few jobs prospects in the 1980s. This created a young skilled workforce which improved Irish competitiveness.
- Competitiveness was also helped by the 10% currency devaluation in 1993.
- Ireland's low corporation tax rate: this low corporation tax policy has been in place in Ireland since the 1960s and has been a cornerstone of Ireland's development policy since then.
- Ireland is the only English speaking country in the Eurozone.

It is said that great things happen, not because of great plans made by people at the top, but mainly because of the passion of the individuals implementing the plans at a more micro level. On this basis, it could be argued that it was some members of the Irish workforce, along with some of the foreign nationals working in Ireland, who played the most significant role in the Irish economic boom.

3. The Irish money supply bubble

This section looks at the relationship between the evolution of the money supply in Ireland and the Irish housing bubble. It is argued that the money supply played a significant role in the housing bubble.

From the Quantity Theory of Money we know that $MV = PQ$: where M is the money supply; V is the velocity of money; P is average prices; and Q the volume of all 'goods and services' (Sloman, 1997).

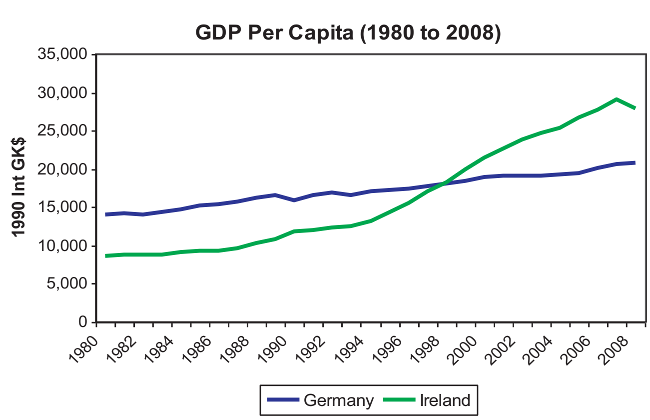

Fig. 1. Irish versus German GDP per capita.

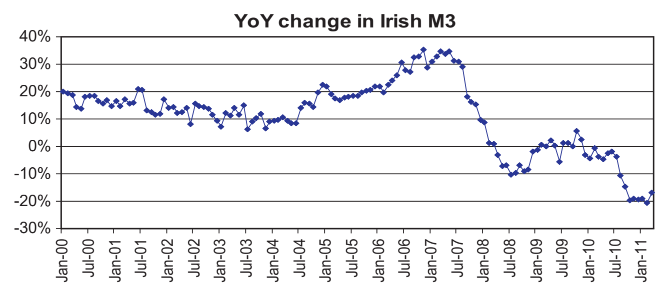

Fig. 2. Change in Irish M3.

From 1996 to 2007, Irish M3 increased by about 540%. M3 does not include the impact of derivatives which likely further increased the effective 'total amount of money' Ireland during this time (Table 1).[2]

From 1996 to 2007, Irish money supply was increasing about 20% p.a. (Fig. 2). The growth rate was moderated in the early 2000s by a highly tax incentivized government sponsored saving scheme (SSIAs). However, a lot of these savings came back into the economy after the scheme ended, which contributed to pushing the M3 growth rate above 30% p.a. (Fig. 2). GDP growth was about 8% p.a. and CPI inflation was about 3.5% p.a. Ignoring the velocity of money (which is could be argued was also increasing), one side of the Quantity Theory of Money equation was increasing at 20% p.a. and the other at about 12% p.a. ($\Delta M = 20\%$ plus $\Delta V \gg \Delta P = 3.5\%$ plus $\Delta Q = 8\%$).

Ireland is a small open economy so the prices of most of its goods and services are largely determined internationally rather than domestically. So the adjustment needed to balance the Quantity Theory of Money equation happened in the non-traded sector of the economy – particularly in Irish asset prices. This meant more expensive haircuts, higher restaurant prices, but mainly it resulted in massively higher house prices and a housing bubble. This is discussed further in Section 5.8.2.

[2] It could be argued that the main measures of the money supply (M1, M2, M3, etc) have become significantly outdated and redundant due to the exponential increase in off-balance sheet activities of banks and financial organizations and in particular the exponential increase in the size of derivatives markets – we need something like 'M8', 'M9' and 'M10' measures of money supply which calculate the effective impact on the quality of 'money' in an economy of the modern methods of the banking system to create money. However, this is not arguing for the old statistics to be no longer collected, as happened in the US with M3.