Ireland and the crisis[1].

Dr. Ciarán Mac an Bhaird, Fiontar, Dublin City University.

Abstract: The growth of the Irish economy in the years 1995-2007 was dramatic and unparalleled by Western economies, earning Ireland the moniker "The Celtic Tiger". Emerging from conditions of high unemployment, very high rates of emigration of graduates, and enormous government debt in the 1980s, the transformation of the Irish economy in two decades was remarkable and lauded by economists and commentators. High growth rates were facilitated by a number of factors, including the presence of a large number of multinationals producing goods for export, generally benign world economic conditions, low interest rates, a low taxation regime, and an expansionary government policy which embraced the tenets of the 'free market'. With the onset of the financial crisis, however, came another rapid transformation in the Irish economy. From being one of the fastest growing Western economies in the late 1990s, in 2009 Ireland suffered the greatest contraction of any OECD country since the second world war. The reasons for this dramatic reversal of fortune were attributable not only to the global financial crisis, but also to government policies and the structure of the Irish economy. In this chapter, the remarkable rise and fall of the Irish economy is described and analysed. Influences on the performance of the Irish economy in this period, including the benign world economy, government policy, and the structure of the Irish economy are analysed and examined. Proposals on how best to initiate recovery are also assessed, particularly the narrow focus of discourse which largely concentrates on attempts to 'fix' the current system, without considering alternative approaches.

[1] Figures quoted are sourced from Central Statistics Office and Economic and Social Research Council databases, unless otherwise indicated. I am grateful for comments and suggestions received from William Kelly.

This article considers the case of Ireland in the aftermath of the global financial crisis. As one of the most globalised, open economies in the world, Ireland benefited greatly from a worldwide economic expansion during the Celtic Tiger years. Increased demand from booming global economies, as well as a surge in supply of foreign direct investment (FDI), primarily from US multinationals, contributed to Ireland having the highest sustained growth rates in its history. Was it inevitable, therefore, that the Irish economy would suffer commensurately during the global financial crisis? Given that "….small states have a greater exposure to exogenous shocks than larger states because of their vulnerability to external economic, political, strategic and environmental shocks" (Read, 2004: 369), did it necessarily follow that the Irish economy would suffer a decline as dramatically low as growth during the Celtic Tiger years had been remarkably high? Did the liberalisation of the Irish financial sector facilitate and hasten contagion of the global financial crisis to Ireland? Were the effects of the crisis exacerbated by the actions of financial institutions and other actors in the Irish economy? Were policies enacted by the government effective in dealing with the crisis, or did they aggravate the problems even further?

The Irish circumstances present an interesting case study through which to view the financial crisis for a number of reasons: the performance of the Irish economy over the past two decades embodies the extremes of a boom / bust cycle which has been experienced by the majority of Western economies. In addition to being a salutary illustration of the boom / bust cycle, it is a small, open economy, and a member of the European Monetary Union (EMU), thus lacking autonomy over exchange rate and interest rate policy. Additionally, the Irish financial sector has experienced significant structural change and liberalisation over this period (Kelly and Everett, 2004). One would expect, therefore, that the Irish economy was particularly vulnerable to contagion from the financial crisis. This chapter explores elements of the Irish economy over recent decades, and examines contributory endogenous and exogenous factors for the current economic position. A primary conclusion is that, whatever the effects of the international financial crisis, the present predicament of Ireland's banking sector and fiscal position can, to a large extent, be attributed to endogenous policy decisions in government and private institutions.

This chapter proceeds as follows: firstly, the performance of the Irish economy over the past two decades is considered by employing commonly-used variables. A number of potential endogenous and exogenous contributing factors are considered, including policy decisions and the global economic environment. Secondly, the Irish property boom and related banking crisis are described, and policy responses to the crisis are detailed and examined. The chapter concludes by considering a number of salient long-standing deficiencies in bank-based systems which have been highlighted by the crisis. Policies and strategies that could be implemented to ensure that the economy is better prepared to cope with future exogenous shocks and to best build capacity for future development are briefly considered.

The geographical characteristics of the Republic of Ireland, an island nation of almost 4 million people on the periphery of Europe, have implications for its advancement and development. A lack of large deposits of natural resources, combined with a very small domestic market for goods and services offers few alternatives to seeking greater integration with the global economy. Ireland pursued a policy of import substitution and protectionism from the 1930s to the 1950s, resulting in stagnation of national income, balance of payments crises, and high rates of emigration (Bew and Patterson, 1982, Ó Gráda, 1997,). Policies pursued in subsequent decades were in marked contrast, as Ireland progressively became one of the most open economies in the world (Ireland was ranked as the world's most globalised economy from 2002 to 2004 in the Kearney/*Foreign Policy* index). An early endeavour in trade policy was characteristic of a desire for greater integration in the global economy, as the Industrial Development Agency (IDA) embarked on a policy of actively seeking FDI. Providing incentives in the form of grants, capital facilities and lower rates of taxation, the agency was particularly successful in attracting US multinationals over the following six decades. This aspect of trade policy has received much attention in media and academia (e.g. Burnham, 2003), and its beneficial effects in terms of economic growth and wealth generation are touted as incontrovertible evidence of the benefits of globalisation, liberalisation and *laissez-faire* economics. The success of this policy was not attributable to one single factor, but to a combination of policies, institutions, and a favourable external environment as explained in the following brief analysis.

1. Ireland's economic 'miracle'

Irish economic circumstances in the mid-1980s were extremely unenviable, characterised by high rates of unemployment (over 18 percent in 1985), high rates of emigration (including a large proportion of university graduates), substantial government debt (almost 130 percent of GNP in

1985), and high rates of inflation (over 17 percent in 1982). Indeed, Irish public finances were in such poor shape that the intervention of the International Monetary Fund (IMF) was considered as the solution. An extraordinary transformation occurred over the following two decades, as the Irish economy experienced a period of remarkably high, sustained growth rates as measured by growth in Gross National Product (GNP)[2]. This period of exceptional growth raised Ireland from being one of the poorest economies in the European Union to the second richest, receiving approval and acclaim from economists and commentators, earning Ireland the moniker 'The Celtic Tiger'. This economic 'miracle' has been the subject of many books and papers, and the common consensus is that the Irish economic boom can be categorised in two parts: by a period of export-led growth from the early 1990s to 2001, and secondly, by a huge expansion in the domestic property sector from 2002 to early 2007. Commentators have frequently examined the policies and conditions that laid the foundations for this phenomenon, with the aspiration of emulating and replicating it (Acs et al., 2007). Politicians were quick to claim credit for devising and implementing policies which brought about the economic boom, and whilst they were a contributory factor in creating the conditions for increased investment and economic activity, the simultaneous occurrence of advantageous external economic conditions were an essential element of the sudden increase in growth. Commonly cited endogenous factors in creating the underlying conditions for the economic boom include a young, well-educated English speaking population, membership of the European Union, a low corporate tax rate[3], grants and incentives provided by the IDA, wage moderation resulting from central wage bargaining, and a high rate of immigration. Whilst these factors undoubtedly contributed to economic growth by attracting FDI by exporting multinationals, Honohan and Walsh (2002) stress that the most important factor was an increase in the proportion of the population at work, particularly increased participation of females in the workforce. This, rather than increased productivity, was the primary reason for the growth in output and subsequently economic growth. Additionally, financial liberalisation and a decrease in restrictions in banks' activities contributed significantly to economic growth (Kelly

[2] Whilst this approach has been described by some commentators (e.g. Kirby, 2002) as a somewhat simplistic, one-dimensional approach adopted by neoclassical economists, it is beyond the scope of this chapter to address sociological factors, provision of and access to welfare, education and health, etc. It is, however, important to note that spending on welfare, education, and health increased dramatically during the economic boom.
[3] At 12.5 percent, the Irish corporate tax rate is one of the lowest in the OECD, and its effectiveness results from the double-taxation agreement with a number of countries, including the US.

and Everett, 2004), although Honohan (2006) finds little evidence that Irish finance made a leading contribution to this period of export-led growth.

Favourable exogenous factors also played an important part in the economic boom. Increased growth and demand in destination economies for Ireland's exports (Kennedy, 2001), sustained lower interest rates, a high immigration rate (Honohan and Walsh, 2002) and large inflows of FDI were significant factors in the expansion of the Irish economy during this period. Gallagher et al. (2002) state that the primary driver of growth in the Irish economy during the Celtic Tiger years was attributable to foreign owned firms in electronics, pharmaceuticals, and financial services. An indication of the success of this policy is that, by 2002 Ireland was the largest exporter of software in the world with a commercial software sector comprising 600 companies, many of them foreign, employing 15,000 people and generating €5 billion in export revenue. Whilst Irish growth rates were remarkably high in relation to OECD countries, the Irish economy was essentially converging with European norms (Honohan and Walsh, 2002, Ó Gráda, 2002), and by 2001 capacity for convergence was reduced. Furthermore, a diminishing supply of labour, combined with increased energy and wage costs meant that it was not possible to maintain the growth rates achieved during these years (Kennedy, 2001, Whelan, 2009), and before long a slowdown was inevitable.

The Irish economic boom did not end abruptly in 2001, and GNP continued to grow by an annual rate of 4.5 percent in the period 2001 to 2007. It was important to note, however, that the composition of GNP changed dramatically during this period. The most important component of this period of growth was expansion of the construction sector resulting from a domestic housing boom. Whilst the volume of exports fell from €93.6 billion in 2002 to €82 billion in 2003, the value of output from the construction industry was 80 percent higher in 2005 than it had been in 2000, increasing from €17.6 billion to €32 billion.

Table 1. Average annual growth rates, unemployment rate

	1987-1993	1994-2000	2001-2007	2008	2009 (forecast)	2010 (projected)
GNP[4]	3.4%	8.7%	4.5%	-2.8%	-10%	-1.5%
GDP	3.9%	9.5%	4.5%	-3%	-7.25%	-0.25%
Unemployment rate	15.3%	9.5%	4.2%	6.3%	11.75%	13.75%

Source: CSO and ESRI

2. Ireland's housing boom

By the year 2001 Irish incomes, as measured by GNP per capita, had increased significantly. Notwithstanding increased personal wealth, Irish housing stock was very low by European standards – the lowest in the EU (Somerville, 2007). Low interest rates, higher incomes, a greater number of people employed, as well as increased immigration resulted in a greater demand for housing. A supply side response resulted in an explosion in activity in the construction sector, and it became an increasingly significant component of the Irish economy. In 2006 construction output represented 24 percent of total GNP, compared with an average ratio of 12 percent in Western Europe. By the second quarter of 2007 construction accounted for over 13 percent of all employment (almost 19 percent when those indirectly employed are included), and generated 16 percent of tax revenues. This increase in construction activity resulted in a doubling of the number of house completions, from 46,500 units in 1999 to over 93,000 units in 2006. Despite the increase in supply, the average price of houses soared, increasing fourfold in the years 1996 to 2007. House price inflation was partly driven by low interest rates, but also by a considerable increase in bank lending. This led to a vicious circle – as house prices increased, banks were prepared to lend increased amounts secured on collateral which was regularly being valued upwards, continuously relaxing lending conditions and providing more attractive terms. Growth in lending by financial institutions in the Irish economy was inexorable[5]. Whilst the international credit boom saw an increase in bank lending to an average of 100 percent of GDP by 2008, in Ireland bank lending grew to 200 percent of national income (Kelly, 2009). This included an

[5] Michael Soden, ex chief-executive of Bank of Ireland remarked that, while it took Bank of Ireland over 100 years to grow its loan book to €100 billion in 2001, this was doubled to €200 billion by 2008.

increase, not only in mortgage lending, but also a large increase in lending to property developers. This is reflected in the growth rates of two institutions specialising in lending to the property sector: Irish Nationwide Building Society and Anglo Irish Bank had average annual growth rates of 20 percent and 35 percent respectively (Honohan, 2009a). Whilst growth in credit largely fuelled the huge increase in house prices (Kelly, 2009), government policy was also a contributory factor. Tax incentives were extended to entice investment in the property sector, and capital gains tax was cut from 40 percent to 20 percent. These measures remained in place, despite indications of oversupply.

Whilst the construction industry, the banking sector, the media and politicians were all of the view that growth in the housing market would continue apace, in early 2007 it became apparent that a slowdown was imminent with the accumulation in the number of unsold units[6]. Most interest groups insisted that a “soft landing” would cushion the blow. Few signalled the wider implications for the banking sector (apart from Kelly (2007), for example), although the dramatic fall in their share prices from early 2007 indicated that investors were nervous about the risk[7]. The risk to Irish banks stemmed from two sources: firstly, their assets were disproportionately concentrated in property development[8]; secondly, their liabilities were increasingly sourced in the interbank market. Up to the mid-1990s, Irish banks’ liabilities were largely comprised of deposits. The huge expansion in bank lending after 1997 was substantially funded through borrowing in the interbank market. Had Ireland an independent currency, the risk of large scale foreign borrowing to fund the property boom might have been signalled by adverse exchange rates. However, because of membership of the EMU, this warning sign (what Honohan (2006) referred to as ‘the canary in the mine’) was not signalled. This model of funding was facilitated by the global expansion of credit, ensuring adequate liquidity in the interbank market. Circumstances changed dramatically in the wake of the bankruptcy of Lehman Brothers. As institutions became increasingly nervous about advancing funds to the interbank market on which the Irish banks had become extremely dependent, problems arose for their funding model. In late

[6] The 2006 Census revealed that there were 266,000 empty housing units in the country.

[7] Between May 2007 and December 2008, the index of Irish bank shares fell by 94 percent, with shares in Anglo Irish Bank falling by 98 percent (Honohan, 2009). The fall in bank share prices comprised a two stage decline: from May 2007 to August 2008, the decline was relatively greater for Irish banks; from September 2008 to December 2008, the decline was universal, affecting bank share prices worldwide.

[8] By 2008 80 percent of the loan book of Anglo Irish Bank was secured against property in the UK and Ireland; 71 and 60 percent of the loan books of Bank of Ireland and Allied Irish Banks respectively were secured against property.

September 2008 one Irish bank was reportedly unable to roll over its foreign borrowings, and lacked adequate collateral to raise funds from the ECB. Worried about potential contagion effects, the chief executives of the two main Irish banks approached the Minister for Finance for assistance on the night of 29 September 2008. The following day the Irish government took the markets by surprise by moving to guarantee the liabilities of six banks and building societies. This initial guarantee exposed the state to a potential loss of €400 billion, and although it was unlikely that a liability of this amount would come to pass it attached the banks' financing problems to the state, raising concern about the Irish government general debt. It subsequently emerged that the Irish banks faced, not a short-term liquidity problem but a long-term solvency problem. Unable to raise funds on the financial markets, they turned to the government for assistance once more. Because of the wide-ranging nature of the initial guarantee, the Irish government had to make ever-increasing interventions to stabilise the banking sector. In January 2009 Anglo Irish Bank was nationalised, and Bank of Ireland and Allied Irish Banks were advanced €7 billion in return for preference shares. In April 2009, the government announced the establishment of the National Asset Management Agency (NAMA) to acquire the impaired property development loans of the banks. The underlying philosophy for the establishment of the agency is to remove impaired assets from the banks' balance sheets and facilitate access to funding[9], in the hope of restoring liquidity to the real economy. This plan has received much criticism, not least because bond holders and subordinated debtholders are secured at the expense of the taxpayer. Even with this cash injection, most commentators are of the view that the two main banks will require further recapitalisation over the course of 2010 (Honohan, 2009b). Economists opposed to the 'bad bank' model adopted by the state voiced concern that it would ultimately result in the state overpaying for impaired loans and that alternative mechanisms should be implemented by the government, such as temporary nationalisation or purchasing equity stakes for the taxpayer (Lucey et al., 2009a,b).

Whilst the unsustainability of the vast growth in bank lending, allied with a huge property bubble appears obvious in hindsight, why did this not seem apparent at the time, and why were steps not taken to rectify the situation? Just as the banking crisis can be partly explained by financial contagion, the property bubble can be explained by the social contagion of boom thinking

[9] NAMA is to acquire loans of €77 billion for a consideration of €57 billion, even though the estimated market value is €47 billion. (NAMA, 2009).

(Shiller, 2009). Additionally, it was in the short-term interests of a lot of sectors to perpetuate the bubble, even though it meant value destruction in the long-term. As property prices rose, almost all sectors of the economy were affected. The Irish economy was highly concentrated: a large portion of taxation revenue, employment and wealth was generated by the property sector; the increase in property related taxes facilitated reductions in income taxes and increases in government spending; the media, particularly newspapers, generated a significant proportion of advertising revenue from the property boom; a significant proportion of the Irish stock exchange was based on property values - furthermore, the valuation of companies whose main business had no connection to the property sector were valued on the speculative value of their sites (for example, Greencore, a food company). The Irish economy lacked diversification, and became increasingly dependent on the property bubble.

The role of the financial regulator came in for much scrutiny in the wake of the crisis. Commentators queried inaction by the regulator given the phenomenal rate of growth of the Irish banks and the concentration of growth in lending to the property sector. (Honohan (2009a) states that regulators employ an annual real growth rate of 20 per cent in the balance sheet as a warning sign of increased risk for a bank. Two Irish banks crossed this threshold on a number of occasions during this period). Whilst it appeared that the banks were growing too fast too quickly the financial regulator stated that "…Irish banks are resilient and have good shock absorption capacity to cope with the current situation" (Neary, 2008a). Claiming that banks had adequate capital to absorb losses on property loans, and that over-exposure to the property market was not a weakness of the Irish banking sector (Neary, 2008b), it appeared that whilst the regulator was applying capital adequacy rules, the systemic risks were not fully evaluated or appreciated. Additionally, stress testing conducted in 2006 was based on an overly optimistic estimation of the rate of default or non-performing loans (Honohan, 2009a). As the risk posed to the banking sector did not stem from Irish banks' use of exotic derivatives or hedging ('areas of significant ignorance' (Strange, 1997)), the problem did not arise from a lack of understanding of complex financial instruments and transactions. Rather, it was an inadequate appreciation of the increasing exposure of Irish banks to the property sector, in particular the large amount of loans advanced to the development sector, and the inadequacy of collateral provided. Whilst there were instances of irregular transactions in a number of cases, it appears that, by and large the crisis stemmed from an underappreciation of risk combined with inaction.

3. The Irish budgetary position

Rapid expansion of the property sector in 2002 resulted in a remarkable increase in government revenues from stamp duty and capital gains tax. Property-related taxes increased from 4 percent of total government revenue in 1995 to 16 percent in 2007. Enriched with windfall taxes from the construction boom, the government implemented a procyclical fiscal policy (Barry, 2009). In the period from 2002, increases in spending on social transfers and public pay far outpaced the rate of growth in GDP. The government also cut income tax rates repeatedly, with the result that income taxes as a percentage of total tax revenue declined from 37 percent in 1994 to 27 percent in 2006 (Lane, 2007). Additionally, the tax base was narrowed as rises in exemption levels were raised, placing those on low incomes, comprising almost 50 percent of PAYE workers, outside the tax net. Consequently, the income tax burden was exceptionally light - Whelan (2009: 8) estimates that the average tax rate for a single income married couple with two children on the average wage was 6.7 percent, compared with an EU-15 average of 23.7 percent and an OECD average of 21.1 percent. Whilst income tax cuts were popular, the transformation in composition of tax revenues was highly significant. By 2007 government revenues were greatly dependent on windfall taxes from the housing market. When activity in the sector came to a “shuddering halt” (Lenihan, 2008) tax revenues plummeted. The slowdown in the construction sector was accompanied by increased business closures in the traded sector, resulting in rising unemployment with consequent increased transfer payments and lower tax receipts. The deterioration in the budgetary position was immediate. After a decade of almost uninterrupted surpluses, the deficit in the general government balance soared to 7.5 percent of GDP in 2008 and 12.9 percent of GDP in 2009, levels not seen since the 1980s. The budgetary position was exacerbated by government policy in stabilising the banking sector. Re-financing the Irish banks entailed not only an increase in gross government debt, but also increased costs of raising finance on international debt markets. In March 2009, the yield premium over Germany which Ireland paid on its bonds rose to 3 percent in the wake of government assistance to the banks. (This spread has narrowed to 1.5 percent above German rates in recent months, as the perceived riskiness of Irish government debt recedes).

Steps taken in five successive budgetary measures since June 2008 have resulted in a stabilisation of the general government deficit[10], and whilst general government debt is projected to rise to 75 percent of GDP, it remains lower than that of many Eurozone countries[11]. Notwithstanding a number of contractionary budgets, competitiveness problems persist in the Irish economy. Combined with the imperative of restoring the general government balance and the general government debt within the limits of the Stability and Growth Pact (SGP), the fiscal 'correction' required remains substantial.

4. Discussion

The global financial crisis, similar to the economic boom that preceded it, had a significant impact on the Irish economy. Notwithstanding additional contributory factors, the financial crisis triggered an emergency in the Irish banks, exposing serious structural problems in an increasingly undiversified economy. Even more importantly, the global financial crisis highlighted a major deficiency in the way in which banks seek to overcome agency-related costs of adverse selection and moral hazard when advancing loans to firms and households. Whilst banks typically employ four main lending techniques in seeking to overcome these costs, including financial statement lending, business credit scoring, relationship lending, and asset-based lending (Baas and Schrooten, 2006), the latter is by far the most frequently employed technique. Empirical evidence highlights the pervasiveness in use of collateral-based methods in most bank-based economies (Coco, 2000, Bartholdy and Mateus, 2008). This approach leads to the inefficient allocation of resources as debt is advanced on the basis of collateral rather than profitability. This method of lending results in underinvestment, and is further exacerbated by the reluctance of firms and households to apply for debt finance because of a perception that they will be refused because of inadequate collateral (Kon and Storey, 2003). Some authors suggest that the introduction of stricter capital adequacy laws under the Basel II proposals will promote the use of asset-based

[10] The general government deficit is projected to stabilise at 12.8 percent in 2010.

[11] Ireland was well positioned at the onset of the crisis, as general government debt had been steadily decreasing since the early 1990s. In 2007, general government debt stood at 25 percent of GDP. Public liability is even lower when the assets of the National Pensions Reserve Fund are taken into account.

lending techniques even further (Tanaka, 2003), and increase the procyclicality in boom and bust cycles (Caprio et al., 2008). A related problem for institutions advancing debt finance secured by collateral is the valuation of collateralised assets. As revealed demonstrably in the Irish case, the procyclical nature of asset valuation amounts to a one-way bet, and in the absence of adequate appraisal of risk can lead to large-scale losses, amplified by the provision of high Loan To Value (LTV) mortgages.

A further disadvantage with the use of collateral-based lending techniques is that they favour investment in property, which is an unproductive use of capital. This is intensified in the Irish case, as property has long been a preferred investment for Irish investors. Concentration of investment in property resulted in a general lack of diversification in the Irish economy, and the neglect of alternative, wealth generating sectors. This was encouraged by government policies which rewarded investment in property (Rae and Van Den Noord, 2006). In order to encourage more productive use of private investment, the government should create a level playing field by reducing incentives to invest in the property market, and create additional incentives to invest in research and development and/or business enterprise. The requirement for greater expenditure on research and development is particularly applicable in the Irish case, which at 1.43 per cent of GDP is lower than the average for Eurozone countries, and considerably lower than Germany, France and the Scandanavian countries (Eurostat, 2009).

A related issue is the need for greater development of human capital and social cohesion, which is a source of comparative advantage and international competitiveness for small island states (Read, 2004). A widely-touted reason for the attraction of FDI to Ireland was the presence of a 'highly educated workforce'. This may no longer be true, however. At the Global Irish Economic Forum at Farmleigh in September 2009, Craig Barrett (ex CEO of Intel corporation) insisted that Ireland needed to invest in its education system; to spend more on research and development, and to place a greater emphasis on producing top-class science graduates. This is even more important in Ireland presently, because we cannot compete with more labour-intensive developing countries producing low-cost exports as we have in the past.

The primary obstacle to revitalising the real economy at present is the lack of liquidity in the financial system. NAMA was established to remove impaired loans from the balance sheets of Irish banks, encouraging them to resume lending, thereby stimulating activity in the real economy. There is an inherent difficulty in achieving this aim, however. Even if the banks emerge from NAMA adequately capitalised, and with balance sheets cleansed of non-performing loans, there is no guarantee that they will advance loans and credit facilities to business and personal customers. Banks are under no obligation to lend money, and it is both difficult and unwise to compel them to do so. Indeed, banks have a fiduciary duty to their shareholders to maximise their earnings. They must, therefore, seek to earn the highest return for their investment. If securities provide a higher return than commercial and domestic lending, then directors are duty-bound to invest in the former rather than the latter. Recent experience in Germany is salutary in this regard. The German finance minister, Peer Steinbruck, expressed disappointment that, despite assisting financial institutions to recapitalise, banks are investing capital in securities rather than lending to small businesses. Because of structural difficulties in their balance sheets, Irish banks have to either raise increased funding and/or significantly reduce their loan books. Failure to attract funds from institutional investors means that the banks are dependent on the state for badly-needed capital, and this source is limited. All evidence indicates that the main Irish banks will have to reduce their loan books, and this means even lower levels of lending. This outcome is potentially detrimental for the SME sector and the real economy. Surveys conducted by small firm organisations in the past six months reveal that SMEs are finding it increasingly difficult to secure debt funding from financial institutions. Firms are experiencing a ‘credit squeeze’ because of reduced lending facilities, which have been exacerbated by rising bad debts and by creditors taking longer to pay. This is not to suggest that banks should expand lending activity just to satisfy an increased volume of credit applications. Provision of finance to the real economy should be improved through the development of alternative means of financing, such as provision of sources of private equity and venture capital. This ensures, not alone a diversity of sources of capital, but also a source of knowledge, advice and investment expertise. Additionally, it promotes investment in intangible activities and sectors, which are typically not favoured by the banking sector.

5. The way forward?

Many commentators wish for a return to the halcyon days of the Celtic Tiger, which were characterised by extraordinary rates of growth, soaring incomes, ‘negative’ real interest rates, decreasing personal taxation, and ‘full’ employment. As Ireland has now converged with

Eurozone economies, we should beware of a return to high rates of growth vastly out of sync with our European partners. Most would welcome a return to positive, more sober growth rates. Economists contend that export-led growth is the means to achieve this aim and improve the present fiscal predicament. The main obstacle to this approach, however, is the lack of competitiveness of the Irish economy. The commonly-held view is that this should be achieved by reducing prices and wages by approximately 30 percent to promote growth in the traded sector, although this may involve significant job losses. An alternative view is that competitiveness may be achieved by leaving the EMU (Mc Williams, 2010), thus adopting a (vastly devalued) independent currency. Whilst this option is appealing for its immediate competitiveness benefits, it would have long-term economic costs and political implications. Firstly, it would likely cause a 'run' on bank assets, as depositors rushed to withdraw euro deposits. Secondly, it would significantly increase Irish foreign debt holdings, greatly indenturing future generations. Thirdly, it would create a myriad of political problems (Eichengreen, 2007). On balance, 'going it alone' is not a practicable or a wise course of action at present.

Ireland's vulnerability as a small open economy suggests that it will continue to experience disproportionately greater instability in its growth trajectory. Experience over the past two decades has shown that membership of a monetary union can amplify rather than reduce economic shocks. Whilst membership of EMU facilitated the Irish banking crisis through lower interest rates and enabling banks to borrow large amounts on the interbank markets, policies enacted by government and private institutions rendered the Irish economy vulnerable to the global financial crisis. It may be argued that the adoption of different policies or alternative systems would have resulted in different outcomes or have an ameliorating effect, although it is impossible to say. Recent experience highlights the consequences of short-term decisions in times of economic abundance. To achieve a more stable economic environment requires long-term strategic planning for sustainable development, and creation of a capacity to enable swift response to minimise the effects of negative external economic shocks.

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