

## GUEST EDITORIAL

# A Lesson from Ireland's Depression

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### A History of Economic Growth

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Private property requires laws for its protection, and laws require a state with enforcing powers. However, governors of states can become too powerful and subjugate individuals and expropriate property. So, as economic historians argue, there is a degree of power of the state, somewhere between all-powerful and completely powerless, that offers the individual just enough protection from both other individuals and the state itself. States with this intermediate degree of power encourage private wealth creation and hence economic growth (Olson, 1993).

States over the course of history have typically been too strong to sustain economic growth. Ever since the first civilisations allowed by the agricultural revolution, the power needed to protect the crops and livestock was usurped by those wheedling it to pursue their own ambitions over the ambitions of their populace – first by protecting their power from challenges within and without and then in vanity projects such as palaces, pyramids and plunder. So the consensual form of governance typical in the small hunter-gather tribes gave way after the agricultural revolution to states where very few held power over a great many.

Very untypical conditions of a stalemate of power amongst different groups, where neither could gain the upper-hand, developed in England after the Glorious Revolution of 1689 (De Long, 2000). This impasse led the parties to agree a stand-off: they enshrined mutual rights, appointed independent arbiters when in dispute and independent enforcers. So began the first and very limited form of democracy: a 'Bill of Rights' and institutions, such as a judiciary and police, to enforce it. These institutions, designed to protect an individual and his property, were also the institutions to protect the future accrual of wealth. Hence individuals were incentivised to grow their wealth for the first time since the agrarian revolution.

England after 1689 witnessed man's extraordinary ability to better his own circumstances when incentivised: the industrial revolution. Such early democratic ideas spread with the 'commonwealth', which proved to be formidably resilient against other warring states. However, these new states are always vulnerable at home: one group gaining too much power could subjugate the rights of others and bring back dictatorship. Or, to a lesser degree, some groups might not be granted equal rights, diminishing both total welfare and future welfare as the total growth capacity of the state is not harnessed.

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All this is well understood by economic historians. What is less understood, as Mancur Olson flagged in his seminal essay, are “the awesome difficulties in keeping narrow special interests from dominating economic policymaking in the long-stable democracy” (Olson, 1993, p. 574).

## Ireland, 29<sup>th</sup> September 2008

An extraordinary economic policy was hurriedly decided upon by Ireland’s Taoiseach (Prime Minister) and the Minister of Finance late in the night of 29<sup>th</sup> September 2008. The two government ministers, with several advisers, decided to nationalise the net debts of Irish banks. The banks liabilities were known to be of the order of €440 billion (280% of GNP in 2008 or about €100,000 for every man, woman and child in the state) but the value of its assets, largely in the form of loans secured on property, were the unknown. The euro interbank money market had been signalling concern for some time that the assets might not measure up to the liabilities and, with interbank rates charged to Irish banks soaring, was no longer prepared to take that risk at an affordable price. The small cabal betted that their guarantee to meet all the bank liabilities if the assets were insufficient would be ‘the cheapest bank bailout in history’ (as the bank guarantee was later described by the Minister of Finance) because the state guarantee would allay the fears of international banks which would resume providing liquidity to Irish banks when the markets opened in the morning.

It is over five years on and, unsurprisingly, we now know that the markets were better informed than the two executive politicians. Current estimates of the cost borne by the state vary, as it will take a decade or more to work itself out. However, the Irish state has recapitalised Irish banks with €64 billion (50% of GNP in 2012), which, taking this as the final figure, translates to a cost of €14,000 for every man, woman and child in Ireland. If the Government confiscated this quantum of private property to ensure bank bond-holders and large depositors were paid in full it would have prompted civil disobedience. However the Government got away with it because the expropriation (1) fell to future taxes and spending cuts, and, (2) was defended as a policy decision to improve economic growth prospects. In short, the expected future gains from the policy action would justify its cost and so, in fact, nobody would pay for the bail-out.

There have been numerous accounts from several different perspectives of Ireland’s boom to bust (see, for instance, Donovan & Murphy, 2013; Lane, 2014; Woods & O’Connell, 2012; Honohan, 2009a & b) and three official investigations (see Regling & Watson, 2010; Honohan, 2010) and the definitive official report to date, Report of the Commission of Investigation into the Banking Sector in Ireland, (2011). The last official report decided that the key of the crisis was to find the answer to the question:

*“Why did so many professionally adept Irish bankers and public servants (as well as politicians, entrepreneurs, experts, media and households) simultaneously come to make assessments and decisions that have later proven seriously unsound in a number of ways?” (1.4.1, p.5).*

So Charles MacKay’s 1841 classic, *Extraordinary Popular Delusions and the Madness of Crowd*, updated by Kindleberger (2011) and others, was used to ‘explain’ what happened in Ireland in terms of the irrationality of crowds<sup>1</sup>.

<sup>1</sup> *The Report of the Commission of Investigation into the Banking Sector in Ireland* (2011) characterises what happened in Ireland as a “national speculative mania”, following the classical development of manias. In its telling, buccaneering bankers engaged in new model ‘relationship lending’ show rapid growth and profitability and are widely admired in the media and then emulated by others. These new breed of banker gradually replace the old timers with their beliefs in traditional cautious lending criteria. Soon all bankers are competing to out

However, what happened in Ireland is fundamentally different from all those cautionary tales, because it has a different ending. In Ireland, the foolish do not pay for their folly. We can tell this modern Irish tale more convincingly as either (1) a case study of moral hazard (rewards privatised, losses socialised and the future less bright as irresponsible risk taking goes unpunished), or – and this is my contention – the moral hazard version can be developed as (2) the re-emergence of that old threat to economic growth: vested interests usurping the power of the state.

Maybe what is happening in Ireland is happening in other democracies, but to an extent that makes it less alarmingly obvious.

## The Extreme Case of Ireland

The Irish crisis, although it broke at roughly the same time as the international credit crunch in the autumn of 2008, was primarily a domestic crisis caused by many individuals and institutions blithely taking excessive financial risks, mostly linked to the domestic property market. In particular, economic activity and tax revenue became increasingly and overly dependent on the construction bubble in the years prior to 2008. The enlarged construction sector started contracting from the start of 2008, causing a slump in domestic demand just when the export sector struggled with the international downturn. Ignoring the banking crisis, Ireland was headed for a prolonged recession.

However, when it came to light that every major Irish bank and building society was insolvent, the recession was to turn into a depression. Ireland's financial problems effectively barred it from raising loans at repayable rates from the bond market, forcing it to accept a loan from the IMF, EU and ECB on terms and conditions that drastically limited its fiscal sovereignty. Ireland's GNP in 2012 is still 10% below its 2008 value at constant market prices (15% below its 2008 value at current market prices). As Laeven & Valencia (2012) demonstrate: "Ireland holds the undesirable position of being the only country currently undergoing a banking crisis that features among the top-ten of costliest banking crises along all three dimensions<sup>2</sup>, making it the costliest banking crisis in advanced economies since at least the Great Depression. And the crisis in Ireland is still ongoing" (pp. 19–20).

## Ireland: The Tale of Moral Hazard

The late evening of 29<sup>th</sup> September 2008 was clearly critical in developing Ireland's crisis into what it eventually became. But there were many midnight hours, and even better times, to have critical moments – moments that could have punctured the developing depression in Ireland into the more commonplace recession faced by the UK, US, and others. Why were all these moments allowed to slip by? It seems that the powers that be never missed an opportunity to miss an opportunity.

There was nothing subtle or complex about the property bubble in Ireland that developed from the early 2000s and peaked in 2007. It was the talk of the nation at the time and, even more tellingly, there is now a complete consensus amongst economists on its proximate causes. Demand was fuelled by bank lending and supply was restricted by not enough zoned land. The massive flow of cheap money was facilitated by the establishment of the euro, and flowed from richer euro buccaneer each other, and with no common sense input from outside (e.g., from the bank regulator), the lending and apparent profitability of banks grows and grows until the inevitable bust.

<sup>2</sup> The three dimensions are: fiscal cost as % of GDP, increase in debt as % of GDP, and output loss as % of GDP.

economies to poorer peripheral economies<sup>3</sup>, with nobody pricing the risk correctly in the interest rates charged. Irish banks were lent money short-term and cheaply on the interbank market and passed it on almost as cheaply as long-term mortgages – sometimes as 100% loan-to-value mortgages, and, materially, sometimes guaranteeing the interest rate spread relative to euribor. The constrained supply of rezoned land (especially rezoned land near employment) made sure that the cheap money would lead to high site costs and high property prices. High site and property prices translated into windfall profits for developers, who borrowed cheaply from banks to meet the demand for higher priced housing. The cycle continued as long as house prices rose, which was until 2007 when, coincidentally, Kelly (2007a)<sup>4</sup> in an analysis that was widely reported in the media estimated the dramatic decline that was needed to bring house prices back in line with fundamentals.

So who was acting irrationally? Well, with hindsight, we can say anyone who is going to lose money. So, by this criterion, it was not the core euro banks lending on the interbank market to Irish banks at such cheap rates – the state guarantee ensured they would not lose a cent. Nor was it the Irish banks, except to a very limited extent. Equity providers to Irish banks suffered but bank bonds and deposits were guaranteed and, oddly, few of those making the disastrous lending decisions lost their jobs. So the only losers amongst the central characters who created the bubble were the equity holders in Irish banks. The results from this overview are stark: many of those that took the risks managed to capture the rewards in the good years and, by and large, managed to pass the losses to others when things turned bad. The Irish crisis can thus be construed as a case study in moral hazard.

## The Underlying Forces

The above analysis is solely an analysis of the decision, and its outcome, made on that night of 29<sup>th</sup> September 2008, which effectively transferred much of the losses from one group to another. To understand why the bubble was allowed to develop in the first place, we must ask two key questions:

- (1) Why were site prices for property development allowed to jump dramatically when, by the simple political act of rezoning, supply could have more than kept pace with demand curtailing any rise in site value? There is no shortage of green fields in Ireland, even beside places of employment.
- (2) Why was the lending of Irish banks (to the property sector mostly) allowed to accelerate after, say, 2003 (see Figure 1)?

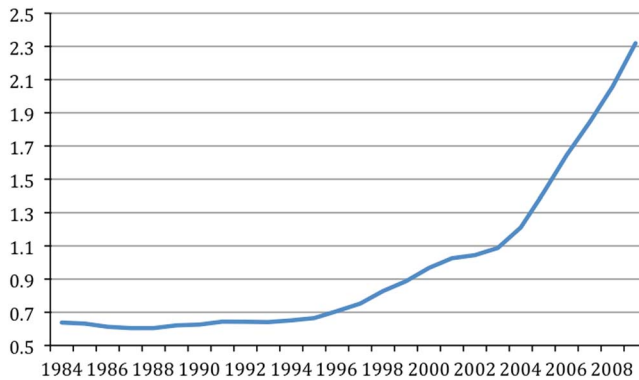
And, as information emerged after 29<sup>th</sup> September 2008, we can add another puzzle:

- (3) Why, when the ‘cheapest bailout in history’ was slowly mutating into the most expensive as the bad debts in Irish banks mounted, was nothing done to limit the extent of the guarantee?

These are altogether tougher questions to answer. It requires us to identify the forces at work that led to the crisis developing the way it did and not otherwise. Forces cannot, of course, be observed directly. However, the results of their actions can, and in reviewing who lost least and who

<sup>3</sup> As Honohan (2009b) points out real interest rates in Ireland in the euro period, 1998–2007, averaged minus 1 per cent, compared with over 7 per cent in the previous period of the Exchange Rate Mechanism (even excluding the crisis of 1992–3) (p. 8). Irish banks funded the exceptionally high lending in Ireland over the five years to 2008 by net foreign borrowing which increased from 10 per cent of GDP in 2003 to over 60 per cent of GDP at the start of 2008 (p.6).

<sup>4</sup> Kelly (2007b) went on to outline the possible impact of the property bubble bursting on the solvency of Irish banks.



**Figure 1.** Ratio of Private Credit (banks and other financial institutions) to GDP in Ireland. Source: Figure 1 in Lane (2014).

lost more, we can identify those who exercised greater control of events – a control or power that ensured that they suffered least in the downturn.

Let us consider what parts of the economy suffered most post-2008. Table 1 shows how employment numbers and average wages fared in each of the main divisions of labour in Ireland over the subsequent years.

This macro view of how the Irish labour market fared tells many stories. It highlights that the number employed shrank by 11% (as unemployment rose to 14%). It shows that most jobs were lost in construction, which halved in size. However, it makes an important point about the financial sector, where banks and building societies are dominant. The financial sector has not contracted nearly as much as the others – in fact it is one of the better performers. It also shows that wages as well as numbers held up better in the financial sector than in most others. Those employed in the financial sector enjoyed the highest average earnings of all sectors back in final quarter of 2008 when the crisis erupted, now it is the sector with the second highest average earnings.

If market discipline had been left to work, banks would have become insolvent and there would have been large employment losses in the financial sector of similar proportions to that seen in the construction sector with, likewise, pressure on wage levels. Yet the financial sector, arguably as bloated as the construction sector was in 2008, has fared considerably better than the average sector.

The financial sector seems powerful enough to resist bearing its share of the pain – a position once enjoyed by the armies of autocrats. Salaries in the nationalised banks were not capped, their jobs were more secure than the average sector, many retired with enhanced pensions and even bonuses, and their pensions are now more secure after their nationalisation. The Central Bank of Ireland (including the former Financial Services Authority) fared especially well, despite their spectacular failure to deliver on their mandate. The number of employees of the Central Bank of Ireland grew by more than a third in number (from 1,022.5 at the end of 2008 to 1,394 at the end of 2012) and, here too, key executives that retired, such as the Chief Executive of the Financial Regulator from 2006 to January 2009, were granted departing bonuses.

**Table 1.** Numbers in Employment and Average Wage, Q4 2008 to Q3 2012, by Principal Sector.

Principal Activity (NACE Classification)	Number, Q4 2008	Average Weekly Earnings Q4 2008	Number, Q3 2012	Average Weekly Earnings, Q4 2012	Changes in Earnings	Change in Numbers
Construction	127,700	789	60,800	702	-11%	-52%
Arts, entertainment, recreation and other	50,800	508	50,900	458	-10%	0%
Transportation and storage	68,800	796	62,200	728	-8%	-10%
Human health and social work	210,200	772	223,400	714	-7%	6%
Accommodation and food services	141,000	348	128,900	326	-6%	-9%
Professional, scientific and technical	80,000	823	71,500	772	-6%	-11%
Public administration and defence	119,600	983	110,900	932	-5%	-7%
Education	137,200	890	126,200	846	-5%	-8%
Financial, insurance and real estate	93,800	986	90,300	973	-1%	-4%
Wholesale and retail trade; repair of motors	318,100	519	279,000	522	+1%	-12%
Industry	221,100	819	190,100	829	+1%	-14%
Administrative and support services	86,200	497	78,200	512	+3%	-9%
Information and communication	58,600	960	57,300	1001	+4%	-2%
Total	1,713,100	721	1,529,700	696	-3.50%	-11%

Source: Central Statistics Office, Ireland (2013)

## The Role of the Central Bank of Ireland

There were trusted advisers in the room that night of 29<sup>th</sup> September 2008. Perhaps none was more relied upon than the representatives from the Central Bank of Ireland (then the Central Bank and Financial Services Authority of Ireland). This was their area of expertise – the solvency of Irish deposit takers, the functioning of the monetary system under different scenarios, and the impact that might have on the broader economy.

Both before and after the guarantee, reports published by the Central Bank and interviews given by their senior personnel confidently voiced the view that all would be right with the Irish banks and the system if only confidence was restored (see, for instance, the Financial Stability Report 2007 of the Central Bank & Financial Services Authority of Ireland, RTE Prime Time interview with Financial Regulator 2<sup>nd</sup> October 2008). Naturally, central bankers will be wrong in some judgements, and certainly in such a complex field as finance and economic growth. However, as advisers, they have a duty to communicate the risks. Did they materially underestimate the uncertainties and encourage the policymakers to place undue weight on their advice?

My contention, in brief, is that the Central Bank of Ireland is allowed far too much power and influence in Ireland. The reason why all those moments prior to and after the night of the guarantee

were allowed to slip by – despite widespread unease by many that something was amiss – was because the Central Bank kept reassuring everyone that they were in charge, that their experts had analysed the situation with more information than is publicly available and that all was okay. They continued to reassure that the bank losses were manageable for a couple of years after the guarantee was in place, until after large deposits had withdrawn and bond-holders were repaid<sup>5</sup>, even bond-holders not subject to the guarantee (Kelly, 2011).

The cost of the policy mistakes were largely borne by the household sector, with those with a smaller role in the economy suffering more. Costs were disproportionately borne by those losing jobs, reductions and restrictions on welfare payments, reductions in public expenditures such as on education and health, and generally on labour with wages falling and a higher retirement age (now Ireland has one of the highest state retirement ages in the world with phased increases from age 65 now to 68 from the year 2028). In short, the economically less powerful suffered disproportionately more in Ireland.

## The US Federal Reserve & Other Central Banks

A key lesson from Ireland's depression is that a central bank can be allowed too much influence. A central bank's primary directive is to protect the value of money and the functioning of the banking system. In this mandate, banks are obviously of more systemic importance than households and the economically powerful more important than the economically weak. Central banks have not signed up to a bill of rights that treats everyone as equal: in their worldview, some are less equal than others and, accordingly, so are their property rights.

Ireland is not unique in delegating important decisions on economic policy to its central bank. Many central banks are allowed in recent times to pursue extraordinary measures to safeguard economic growth. Consider the US Federal Reserve's experiment in quantitative easing, which now manipulates interest rates from overnight out to fifty years and longer, and affects the market value of all capital assets through the term structure of interest rates. This policy has, of course, been widely copied by central banks everywhere. Consider the ECB signalling to do all in its power to force interest rates in the euro area to converge despite the market's foreboding of the inherent risks. Like Ireland in 2008, we now appear to have more confidence in the advisers from the central banks than in the signals that market prices have been trying to give.

Central banks should not be cast or be allowed to cast themselves as the guardians of economic growth. They are not. They are primarily the guardians of the value of money and will attempt to deliver the sort of economic growth where monetary capital and the banking system are not threatened.

So, turning Mancur Olson's original observation into a question: have we inadvertently allowed narrow special interests dominate economic policymaking in long-stable democracies? The lesson from Ireland is that this small democracy devolved too much power and influence to its central bank, allowing the interests of capital to subvert the discipline of capitalism.

<sup>5</sup> In addition, it is a widely held view that the Governor of the Central Bank self-initiated interview on RTE 1 Radio show *Morning Ireland* on 18<sup>th</sup> November 2010 from Frankfurt, where he was attending a meeting of the Governing Council of the ECB, undermined the Minister of Finance's secret negotiations on the terms of the IMF/ECB/EU bailout.

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