III.2. Performance of the Irish financial assistance programme ([49])

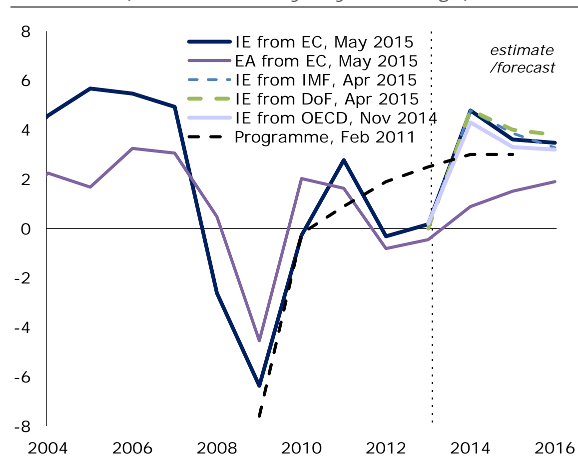
Ireland went into recession in 2008, after a decade of strong economic growth. Imprudent fiscal policies in the run-up to the crisis resulted in a large deficit when cyclical and asset-related revenues disappeared. At the same time, the banking sector was undergoing a severe crisis and needed significant support. A sovereign debt crisis started to unfold. As a result, Ireland requested financial assistance from the EU and the IMF. This was granted in December 2010, accompanied by an economic adjustment programme, the key objectives of which were to restore financial market confidence in the Irish banking sector and sovereign, and allow Ireland to make a sustained return to the markets. While the €85 billion financial envelope bought time, the programme was designed to restore the viability of the financial system and the sustainability of public finances, and introduce reforms that would support growth and stability over the medium term.

The European Commission has recently finalised an ex post evaluation of the economic adjustment programme. It found that the financial envelope had proven sufficient to meet Ireland's financing needs until it regained market access at sustainable rates. Measures to redress the financial sector, bring public finances back to a sustainable path and support growth were broadly appropriate and effective. The economy has returned to robust growth, unemployment is decreasing and productivity and cost-competitiveness have improved. While challenges remain in addressing the legacies of the crisis, the programme can be seen as a success.

The run-up to the programme

From the mid-1990s until the early 2000s, Ireland experienced a phase of healthy economic growth that enabled it to catch up with other euro-area countries. Economic reforms, favourable demographics, rising educational attainment and the deepening of the EU single market had a positive impact on labour-force participation, labour productivity, foreign direct investment (FDI) and exports. Productivity growth in the tradable sector exceeded the euro-area average.

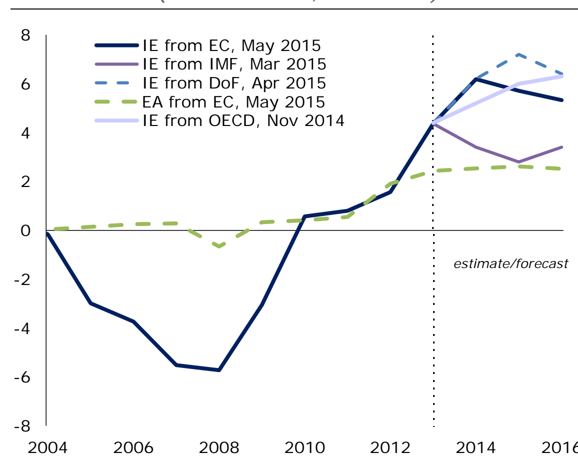
Graph III.2.1: **Real GDP growth**
(2004 — 2016, y-o-y % change)



Source: DG ECFIN, IMF, OECD, Department of Finance (DoF), Economic Adjustment Programme.

Although Ireland maintained high growth rates through the early 2000s until 2007 (Graph II.2.1), the underlying drivers of economic activity had changed. Productivity gains slackened and were outpaced by accelerating wage growth.

Graph III.2.2: **Current account balance**
(2004 — 2016, % of GDP)



Source: DG ECFIN, IMF, OECD, Department of Finance (DoF).

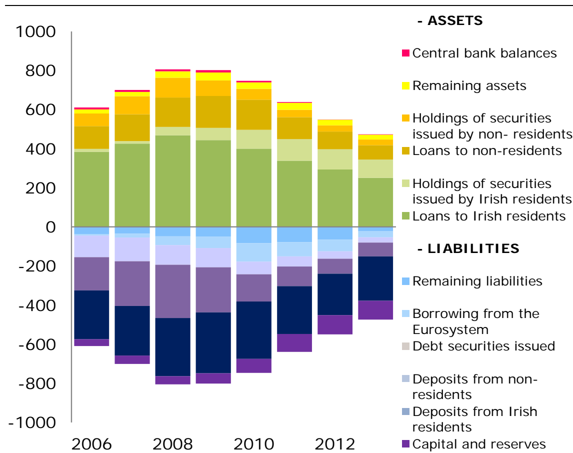
Consumer and producer prices rose much faster than in most other euro-area Member States. Unit labour costs rose and gradually eroded price-competitiveness. Ireland lost export market shares, imports grew rapidly and the current account went into deficit in 2005 (Graph II.2.2).

([49]) Section prepared by Alessandro Angelini on the basis of European Commission, DG ECFIN (2015): '*Ex post* evaluation of the economic adjustment programme for Ireland (2010-2013)', *Institutional Papers*, No 4.

On the back of low interest rates and lax credit standards, the risks taken by banks and the parallel increase of corporate and household indebtedness became excessive. The banking system became oversized and highly leveraged, increasingly relying on international money market funds. In 2008, the total assets of the domestic banking sector amounted to about €800 billion (Graph II.2.3).

Graph III.2.3: **Composition of assets and liabilities of the Irish domestic banking system**

(2006 — 2013, EUR billion)



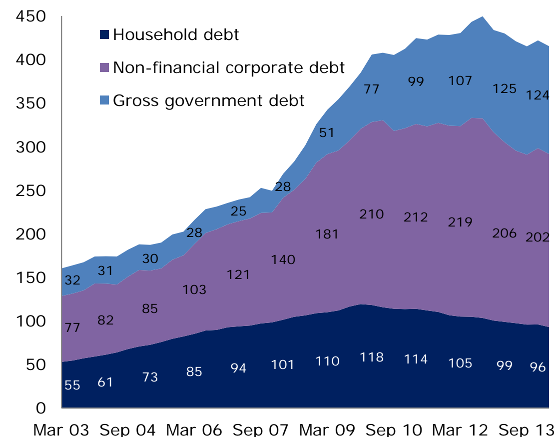
Source: Central Bank of Ireland

In 2008, the loan-to-deposit (LTD) ratio was exceeding 200 % ([50]). Rapid credit expansion led to over-investment and overheating in real estate, and accelerated consumer spending. By the end of 2008, private-sector debt had reached 282 % of GDP, up from 143 % five years earlier, while public debt was still relatively low (see Graph II.2.4). In the following two years, private debt continued to increase, accompanied by a surge in public debt, mainly due to the cost of supporting the banks. Financial regulation and prudential supervision proved inadequate and failed to rein in credit growth and bank balance-sheets.

High exposure to the property market and heavy reliance on inter-bank lending made the Irish banking sector particularly vulnerable to shifts in the housing market and to the global financial crisis. The housing market started to slow down in 2007 and then experienced sharp falls in new construction, transactions and prices. As a result, increasing losses on banks' loans were expected. Also, short-term inter-bank lending dried up as the global financial crisis intensified following the collapse of Lehman Brothers in September 2008.

Graph III.2.4: **Ireland, evolution of public and private debt (excluding financial sector)**

(2003 — 2014, % of GDP)



Source: ECB, National Accounts data (CBI).

From 2008, GDP began to fall and unemployment rose dramatically (Graphs II.2.1 and II.2.10). Ireland's main trading partners (the euro area, the United States and the UK) were going through a deep and sharp recession and this exacerbated the underlying vulnerabilities of the Irish economy. Irish GDP declined by 9 % in real terms and by 16.2 % in nominal terms in 2008-2010. By end-2010, the unemployment rate had risen to 13.9 %, up from 4.7 % at the end of 2007, with the construction sector accounting for half of the decline in total employment.

In order to overcome banks' funding problems and address potential capital shortfalls, the Irish authorities initially issued guarantees on banks' liabilities and provided substantial capital support. They also established an agency for the purchase, management and disposal of non-performing assets. Before the start of the programme, the Government had injected €46 billion (about 28 % of GDP) into five domestic financial institutions, but uncertainty about the value of impaired assets and the high cost of banking-sector support continued to undermine confidence in the Irish sovereign and banks. The solvency of the sovereign and that of the banking system became directly intertwined.

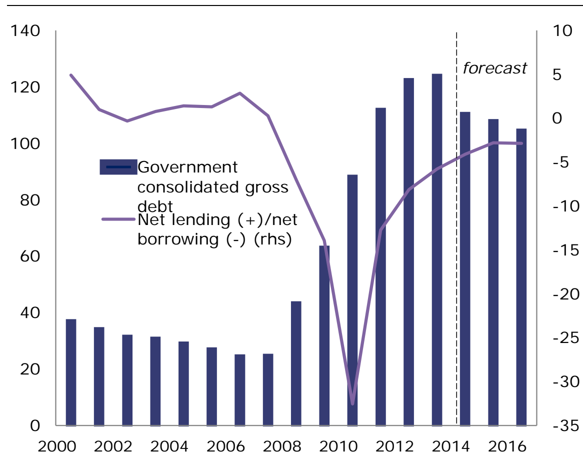
Liquidity support from the Eurosystem reached unprecedented levels (see Graph II.2.3). The

([50]) IMF, Ireland — third review under the extended arrangement, p. 28, August 2011.

Central Bank of Ireland (CBI) provided emergency liquidity assistance (ELA) to banks left with only a limited amount of eligible collateral for standard monetary policy operations with the European Central Bank (ECB). By November 2010, Eurosystem support to Irish banks (including ELA) amounted to €140 billion, or around 85 % of Irish GDP.

The crisis exposed significant weaknesses in public finances. Fiscal policy choices in Ireland's long boom years turned out to have been highly pro-cyclical; expenditure commitments and tax reductions were funded from cyclical and asset-based revenues that disappeared when the housing market crashed and the crisis hit.

Graph III.2.5: **Fiscal deficit and public debt**
(2000 — 2016, % of GDP)



Source: DG ECFIN.

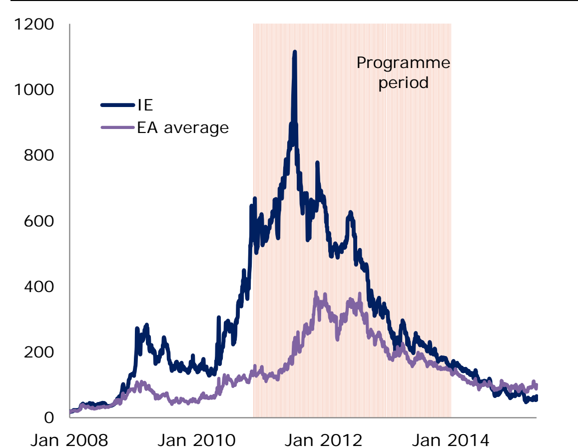
The combination of shrinking fiscal revenues and high banking-sector costs triggered a sovereign debt crisis. From mid-2008, five fiscal consolidation packages were implemented, with a total net deficit-reducing impact of 9 % of GDP in 2008-2010, but this was not enough to reverse the increases in public deficit and debt. In 2010, the total fiscal deficit amounted to 32.5 % of GDP, of which 11.1 % was underlying deficit, excluding one-off rescue measures for the financial sector. General government gross public debt soared from 24 % of GDP in 2007 to over 87.4 % in 2010 (Graph II.2.5).

The relative flexibility of the Irish economy was conducive to rapid adjustment. It was imperative to regain competitiveness, *inter alia* through internal devaluation. There was an abrupt fall in real unit labour costs, particularly in 2010, inflation plummeted between 2009 and 2010, and the real effective exchange rate started to improve as early as 2009. The current account deficit narrowed as a result of the improvement in cost-competitiveness and a contraction of domestic demand.

Overview of the programme

By November 2010, financial market concerns about the solvency of the Irish sovereign had pushed spreads of Irish sovereign bonds to record highs (Graph II.2.6). Given the overall context, such market interest rates were not sustainable. As a result, Ireland asked for financial assistance from the EU (through the European Financial Stabilisation Mechanism - EFSM), EU Member States (in the form of European Financial Stability Facility - EFSF - and bilateral loans) and the IMF, which was granted in December 2010. The Dáil (lower house of the Irish Parliament) approved a programme setting out policy reform commitments to be fulfilled in return for regular instalments of financial assistance.

Graph III.2.6: **10-year sovereign yield spread against euro-area average (1)**
(Jan 2008 — Apr 2014, bps)



(1) EA average includes AT, BE, FI, FR, IT, ES, NL, SI and SK.
Source: Bloomberg.

The involvement of the Irish authorities in the preparation of the programme was substantive, could build on existing credible national plans and aimed to ensure that Ireland retained the ownership of the related commitments. The fiscal and structural reforms set out in the programme were largely aligned with the Irish National Recovery Plan (NRP) for 2011-2014, a programme prepared by the Government in 2010.

The immediate priority was to ensure enough funding to break the financial-sovereign spiral of uncertainty and to buy the Irish authorities enough time to institute the necessary reforms. The programme provided €67.5 billion in funding to add to the €17.5 billion of Irish reserves, resulting in an overall package of €85 billion (about 50 % of GDP). At the time, there was great uncertainty as to the actual needs of the financial sector and whether the Exchequer would be able to absorb these costs. In a context of high financial market volatility and uncertainty as to the capital needs of the Irish banks, the choice was made to have a substantial financial envelope with sizeable contingency reserves. The financing package was intended to be a credible solution that would be sufficient also under adverse scenarios.

The key objective of the programme reforms was to restore financial market confidence in the Irish banking sector and sovereign and allow Ireland to make a sustained return to the markets. While the large envelope bought time, the programme was designed to address the immediate difficulties of the Irish economy by:

- restoring the viability of the financial system;
- consolidating public finances; and
- introducing reforms that would support medium-term growth and stability.

These three strands, which can be thought of as addressing immediate, short-term and medium-term challenges, were seen as mutually reinforcing.

While constrained by policies introduced since 2008, the financial-sector reforms aimed to draw a line under the immediate funding needs of the banking sector and gradually introduce the changes necessary to return it to a properly functioning state and to profitability. This was seen as crucial to breaking the vicious financial-sovereign loop that had proven so damaging to the Irish economy.

The programme included a financial-sector strategy involving a fundamental downsizing and reorganisation of the banking sector. The financial sector was to be stabilised and recapitalised, following an in-depth assessment of its needs, with non-viable banks being resolved or merged. The supervisory and resolution frameworks were also to be strengthened. Measures to clean up bank balance-sheets and return the sector to a viable state, in which it could lend to the economy and underpin growth, were of equal, although not as immediate importance, to ensure that the sector could survive without relying further on state support.

The fiscal consolidation and fiscal governance reforms were aimed ultimately at ensuring the sustainability of public finances. They sought to contain the continued increase in public debt due to a large underlying general government deficit. In doing so, the consolidation under the programme continued on from the substantial efforts made over the previous years and built on the existing fiscal priorities of the Irish authorities (which had already been taking shape within the framework of the Excessive Deficit Procedure that was ongoing since early 2009). The measures to be taken under the programme were front-loaded which could have risked further depressing growth while it was still vulnerable. However, the need to contain public debt was of primary interest in order to allow a sustainable return to the markets. With a view to establishing an appropriate budgetary policy for the future, the programme required the implementation of a strong set of measures to improve fiscal governance over the medium term.

The programme also contained structural reforms aimed at facilitating economic adjustment and boosting employment, competition and growth. The relatively limited scope of structural reform conditionality was justified by the strong fundamentals and flexibility of the Irish economy as a whole. Nevertheless, in view of high and rising long-term unemployment and significant skills mismatches, the programme included measures to tackle impediments to hiring on both the demand side (wage-setting) and the supply side (activation, skills and work incentives). The product market and sectoral reforms targeted the more longstanding economic inefficiencies holding back growth.

Overall results of the programme

The Commission has recently finalised its *ex post* evaluation of the economic adjustment

programme ([51]). As explained in detail below, it concludes that the programme was rightly focused on the main challenges faced by Ireland at the time and the measures were broadly appropriate and effective in achieving the objectives.

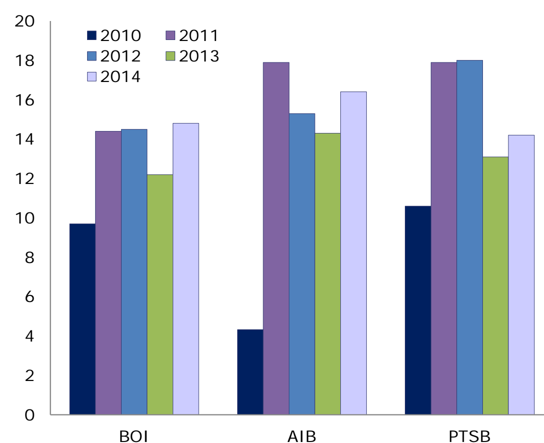
The €85 billion envelope proved sufficient to meet Ireland's financing needs until it regained market access at sustainable rates. Ireland received the full amount of external assistance, i.e. €67.5 billion, despite its financing needs proving less than initially envisaged. This allowed the Treasury to replenish the cash buffer and facilitated the full and sustained return of the Irish sovereign to financial markets before the end of the programme.

The programme was effective in restoring creditors' confidence in the financial system. The two pillar banks returned to the debt market by the end of 2012 and to profitability by the end of 2014. However, while the Government has already sold some of its stakes, a significant portion of the banking sector still relies on state-injected capital. The large upfront recapitalisation (covering rigorously assessed projected losses) significantly improved the banks' capital structure (Graph II.2.7) and was crucial in restoring confidence in their solvency, given the absence of well-established firewalls at the time ([52]).

Significant progress has been made in terms of downsizing the banking sector and addressing funding vulnerabilities, as indicated by the significant reduction in reliance on the Eurosystem and the improved LTD ratio (Graph II.2.8). Banking supervision has significantly improved.

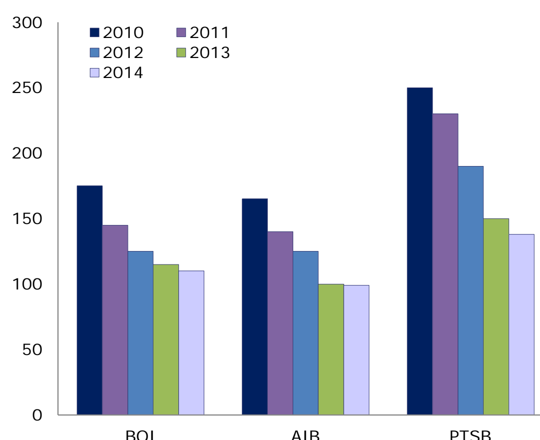
At the end of the programme, a decline in non-performing loans (NPLs) had yet to be seen, and this represented a continuing burden on banks' profitability; NPLs did start to decline in 2014, however. Financial-sector governance has a direct impact on balance-sheet repair in the banks and the real economy. While direct intervention in banks (e.g. recapitalisation, deleveraging and restructuring) was very front-loaded, reforms to broader financial-sector governance (e.g. the insolvency framework and credit registry) were scheduled relatively late in the programme.

Graph III.2.7: **Tier 1 capital ratio**
(2010 — 2014)



(1) 2014 data refer to CET1 capital (Basel III transitional).
Source: Irish banks' annual reports.

Graph III.2.8: **Loan-to-deposit ratio**
(2010 — 2014)



Source: Irish banks' annual reports.

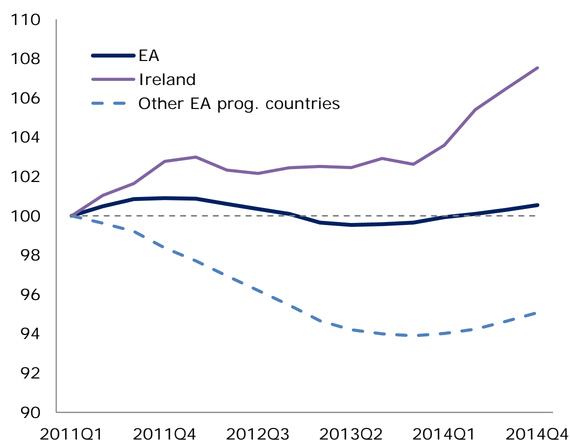
In the specific context of Ireland in 2010, not bailing-in unguaranteed and unsecured senior creditors of domestic banks was appropriate and reflecting complex considerations. In theory, a bail-in is preferable insofar as it limits the costs for the State and encourages proper risk pricing. Bail-in provisions are now enshrined in the new EU regime. However, a careful assessment concluded that the conditions for such a bail-in were not present in Ireland nor in the EU at the time. With no legal framework in place to manage such an exercise, the legal and economic risks were considered too great in light of the potential benefits. The risks of spill-overs to the Irish and

([51]) European Commission, DG ECFIN (2015), '*Ex post* evaluation of the economic adjustment programme for Ireland (2010-2013)', *Institutional Papers*, No 4.
([52]) At the time, there was no harmonised European resolution framework. This was introduced through the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM) in the course of 2014.

EU financial systems were highly uncertain and perceived to be very high, especially given the absence of a proper EU bank resolution framework.

Ireland achieved, with some margin, the fiscal targets in the programme. They had been realistic and Ireland benefited from a fiscal windfall due to the European Council's decision to reduce the interest rate on the EFSF and EFSM loans. The overachievement helped to foster a virtuous circle of good news and credibility for the programme. The changes on both the revenue and spending sides have made public finances more sustainable. Tax system reforms have broadened the tax base and should reduce its volatility. The public wage bill has been reduced and social support expenditure has been made more efficient, avoiding sharp across-the-board cuts. However, the sharp decrease in public investment might have negative repercussions for future growth.

Graph III.2.9: **Real GDP growth**
(2011Q1 – 2014Q4, Index: 2011Q1=100)

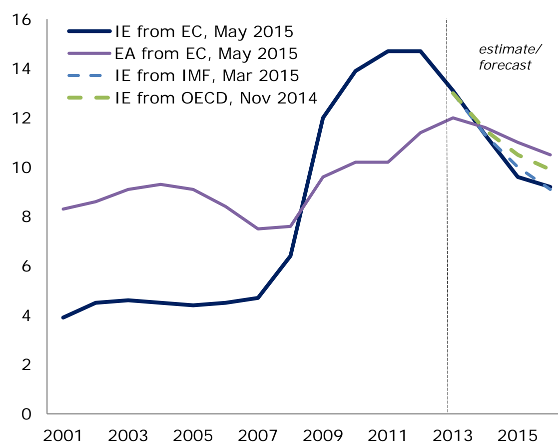


Source: Eurostat.

The fiscal governance measures taken over the programme years should in principle lay the ground for counter-cyclical fiscal policy in good times, which is necessary if debt is to be reduced quickly in the coming years. The programme contained a number of key reforms to enhance fiscal credibility and anchor long-term debt sustainability. The test of the institutional strength of the fiscal framework will come when economic expansion starts to produce revenue windfalls and political pressure for additional spending makes itself felt.

Overall, Ireland's recovery in the course of the programme was substantially stronger than that in peer countries (Graph II.2.9). Net exports bolstered growth, while domestic demand remained subdued owing to depressed disposable incomes, high unemployment, the large debt burden and continued deleveraging.

Graph III.2.10: **Unemployment rate**
(2001 — 2016, %)



Source: DG ECFIN, IMF, OECD.

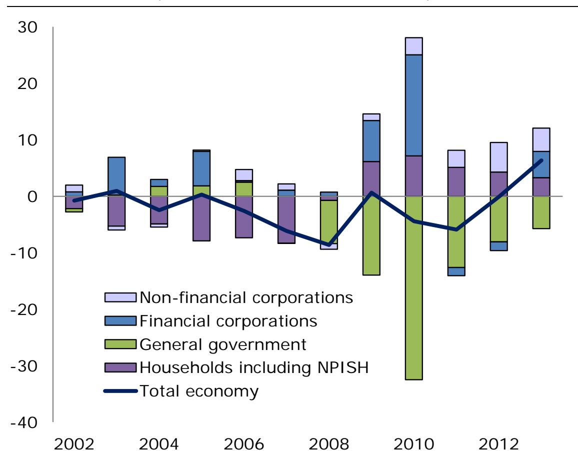
The economy has now returned to growth and is set to expand robustly until the end of the forecast horizon in 2016 (Graph II.2.1). Real output is forecast to exceed its pre-recession level in 2015. While net exports are still expected to contribute positively, domestic demand is taking over from net trade as the main driver of GDP growth, due to private consumption and investment. GNP has also returned to robust growth.

The unemployment rate continued to rise, reaching 14.7 % in 2011 and 2012. The dominant engine of growth, the export sector, tends to be less job-intensive, so could not quickly compensate for employment losses in other more labour-intensive sectors, such as construction. In 2013, the unemployment rate started to fall, however; in 2014, it dropped below the euro-area average and is now projected to decrease further (Graph II.2.10). Structural reforms introduced under the programme to tackle both demand- and supply-side impediments to hiring should support sustainable employment, but will take time to have an impact. The new active labour-market policies and reforms to address skills mismatches should help to raise the employment rate among young and lower-skilled workers over the medium term.

Productivity and cost-competitiveness continued to improve in the course of the programme. Hourly

labour-cost growth in Ireland has consistently lagged behind that in the euro area as a whole since the onset of the crisis. Real unit labour costs and the related real effective exchange rate have also fallen significantly. Following substantial price adjustment before the programme, consumer-price inflation remained muted in the face of subdued wage pressures and weak domestic demand. In the coming years, rising demand should keep inflation around the euro-area average.

Graph III.2.11: **Ireland, financial surplus (+) or deficit (-) by sector**
(2002 — 2013, % of GDP)



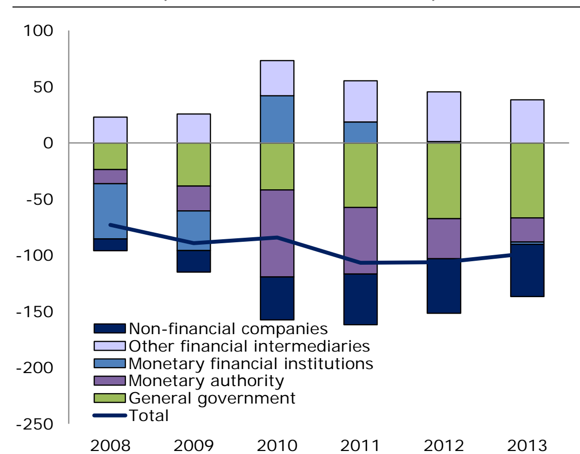
Source: DG ECFIN, Central Statistics Office (Ireland).

The current-account balance was positive throughout the programme period and reached 4.4 % of GDP in 2013. Net exports grew significantly in 2011 and continued to increase, albeit more slowly, in 2012 and 2013. This was despite the slowdown affecting Ireland's main trading partners and the 'patent cliff' in the pharmaceutical sector. In 2014, net exports accelerated again, but this was also on the back of rapid increases in contract manufacturing which may be mostly linked to the activities of multi-national corporations and could prove to be temporary, with a limited impact on long-term employment. In this context, strong export performance is also expected to generate significant surpluses in 2015-2016 (Graph II.2.2).

Deleveraging and balance-sheet adjustment have been substantial, but debt levels remain high (Graphs II.2.4, II.2.11 and II.2.12). The public sector managed to reduce its net borrowing, while the private sector moved into surplus. As a result, the Irish economy as a whole became a net lender to the rest of the world in 2013.

This is particularly true for private households and non-financial corporations, which have been aggregate net lenders since 2009. However, this favourable development in terms of flows is not yet reflected in stocks. Ireland's net international investment position still showed net liabilities of around 100 % of GDP in 2013.

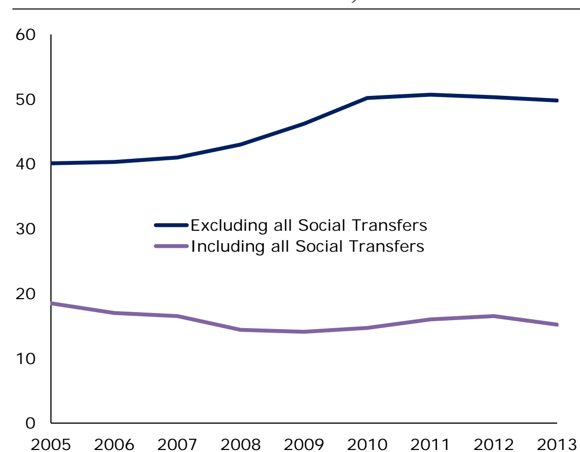
Graph III.2.12: **Ireland, net international investment position by sector**
(2008 — 2013, % of GDP)



Source: DG ECFIN, Central Statistics Office (Ireland).

While the CBI gradually reduced its liabilities *vis-à-vis* the Eurosystem, the Irish Government and non-financial corporations only stabilised their debt position with the rest of the world.

Graph III.2.13: **At-risk-of-poverty rate before and after social transfers**
(2005 — 2013, 60 % median income threshold, % of individuals)



Source: Central Statistics Office (Ireland), SILC 2014.

In the context of a sharp rise in unemployment, the economic crisis caused significant hardship in Irish society. The programme avoided sharp across-the-

board reductions in social support, so the comprehensive social safety-net that Ireland already had in place continued to function effectively and mitigated increases in relative poverty (Graph II.2.13). Indicators of enforced deprivation have risen, however.

Challenges remain in addressing the legacies from the crisis. High private and public indebtedness continue to weigh on domestic demand and growth. Banks continue to repair their balance-sheets by unwinding their still-large stock of NPLs and this also affects credit supply. Long-term and youth unemployment remain serious challenges and there is a risk of some cyclical unemployment becoming structural. The Irish economy depends on its capacity to attract FDI and remains vulnerable to changes in global patterns of product specialisation, shifts in the structure of value chains and losses in competitiveness. Continued progress on the structural reforms undertaken as part of the programme should allow future growth to be more sustainable.