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Eurozone (debt) crisis: Country Profile Ireland

Economic Comment
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To the Eurzone (debt) crisis overview page

- **The build-up of large private sector imbalances related to a housing boom and the financial sector were the prime cause of the crisis**
- **Ireland was a 'public finance posterchild' prior to the crisis**
- **Ireland has successfully reformed its banking sector and economic performance is strong, but bank balance sheets are still recovering and debt remains high**

Diagnosis

In Ireland, the build-up of large private sector imbalances related to a housing boom and the financial sector were the prime cause of the crisis. Rapidly increasing public debt was the consequence of the severe banking crisis and recession. In fact, Ireland was a 'public finance posterchild' prior to the crisis.

In the pre-crisis years, cheap access to foreign capital fuelled a huge housing and construction bubble. Consequently, bank balance sheets had become highly vulnerable to the housing and construction markets. The asset side of banks was heavily skewed towards (speculative) housing and construction loans and on the liability side they had become overly dependent on short-term euro area interbank funding. Ireland's recession and public debt crisis started with the burst of the real estate bubble in 2007 and was severely aggravated by the default of Lehman Brothers in the US end 2008 through its effect on the interbank borrowing market. After the bubble burst, domestic demand and housing prices fell considerably, bank balance sheets deteriorated rapidly, GDP contracted sharply and unemployment grew rapidly. GDP contracted further as a consequence of a banking crisis, which started end 2008. In order to prevent a complete collapse of its domestic banking sector, the Irish government introduced a blanket deposit guarantee scheme in 2008 and started providing large capital injections to its ailing financial institutions in 2009. As a result, government debt increased dramatically from its very prudent pre-crisis debt-to-GDP ratio (25% in 2007). Investors' confidence in the Irish economy and ability of the government to service its debt fell, credit became more expensive and aggravated the debt financing capacity of the government. After Greece ran into trouble, Ireland was also hit by contagion. Financial market unrest was fuelled even more by the proposal of Merkel and Sarkozy late 2010 to accompany future financial assistance from the European Stability Mechanism with private sector debt restructurings.

Crisis response

In the end, Dublin requested a bailout package as it could no longer finance itself in the financial markets. In November 2010, Ireland concluded a EUR 67.5bn loan agreement with multiple creditors: the IMF, the eurozone, the European Union, the United Kingdom, Denmark, and Sweden. In addition, the Treasury and National Pension Fund Reserve added another EUR 17.5bn to recapitalise the banking sector. As spreads had already started to fall before, Mario Draghi's promise in July 2012 to do "whatever it takes" was not the main turning point for government bond yields as in other countries. But, together with the subsequent announcement of Outright Monetary Transactions by the ECB it did certainly help to accommodate bond yield stress. In return for the financial assistance, Ireland implemented a thorough austerity and reform programme. Unemployment increased strongly. Ireland has created the bad bank NAMA and successfully reformed its banking sector. The combination of a relatively strong recovery of import demand in its major trading partners US and UK and to a lesser extent import contraction, has turned the current account deficit into a surplus. In 2015, Ireland is expected to be the fastest growing country in the eurozone. Admittedly, due to some statistical quirks in national accounts, GDP volume growth significantly overstates domestic strength and gross national product (GNP). A high share of economic activity is accounted for by foreign-owned firms, which tend to be much more productive than domestic-owned firms. Nevertheless, economic performance can be viewed as strong in recent years and the outlook is bright. That said, bank balance sheets are still in a recovery phase and the country is still very much (externally) indebted.

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