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Ireland: Success built on radical reforms

by Michael Heise

Ireland is back on track after a deep crisis. The savage cuts and reforms implemented since 2009 are working. The economy is enjoying an upswing, employment is rising and the country regained access to the capital markets some while back. All this despite the fact that Ireland was the country hardest hit by the banking crisis. In the boom years up to 2008 the banking system had become extremely bloated and in the financial crisis could only be rescued by large-scale nationalization. To avert a devastating bank run, the government even had to guarantee all deposits and liabilities in the Irish banking system. The upshot was a dramatic surge in government debt, which soared from just under 25% of gross national product in 2007 to more than 120% in 2013. Reining in this towering debt ratio will take years.

Ireland's performance is an outstanding example that, even in a dire situation, resolute consolidation in conjunction with reforms can quickly stabilize the economy and fuel new growth. It clearly gives the lie to the theory that government spending cuts – the much criticized austerity policy – only worsen the downturn in a crisis. Ireland implemented a whole range of tough consolidation measures: salaries and pensions in the public sector were cut, the retirement age raised to 68 by 2028, job protection relaxed, welfare benefits slashed and VAT increased. Ireland benefited from its highly flexible economy, with the job losses seen in the housing, construction and banking sectors being gradually offset by job gains in other sectors. The economy was also helped by the strong emphasis on exports and the close links to the relatively thriving economies in the UK and the US.

With its resolute reforms Ireland managed to swiftly regain the confidence of investors in Irish government bonds. The international bailout to the tune of EUR 67.5bn expired at the end of 2013. And the yield on 10yr Irish government bonds, which peaked at almost 15% in mid-2011, now stands at an all-time low below 1%, more than one percentage point below the yield on 10yr Treasuries. The fact that the recent drop in Irish bond yields was supported by the announcement of the ECB's bond-buying program does not detract from the Irish government's success in returning to the capital market without an EU safety net by building up a financial cushion (Portugal later followed Ireland's example). The strategy also includes the early repayment of EUR 12.5bn owed to the IMF. Financing conditions had become so favorable that the IMF assistance could be replaced with funds taken up on the market, thereby helping to reduce the interest bill.

The rebound in the real economy has also been impressive. Having shrunk by more than 6% in 2009, the bleakest year, in 2011 the Irish economy clearly outperformed the other bailout countries. At 4.8% last year, Ireland recorded by far the strongest growth in the eurozone and with 3% on the cards this year the economy is likely to grow by double the eurozone average. Apart from an increase in exports and investment, an additional fillip will also come from private consumption which, as elsewhere, is benefiting from the slide in oil prices.

In recent years Ireland has recorded very low, in 2009, 2010 and early 2015 even negative inflation rates. Apart from the recent drop in oil prices, this development is largely thanks to cost adjustments, which boost Ireland's competitiveness. The current account returned to surplus as early as 2010. Amid relatively favorable trends in productivity and labor costs the improvement on the labor market is particularly encouraging and has been under way much longer than in other crisis-torn member states. 2013 and 2014 saw major progress on the employment front and the Irish unemployment rate has fallen from a peak of around 15% to 10% most recently.

However, looking ahead, the recovery in the Irish economy is by no means ensured. Much still needs to be done on the economic policy front to overcome above all two major challenges. The main boil on the nose is the high level of debt in both the private and the public sector. Combined, this adds up to around 400% of economic output. Balance sheet adjustments in the private sector will curb growth for some time to come and the mountain of public debt will substantially limit the public sector's ability to act in the future. Secondly, emigration potentially poses a major problem for Ireland's future. Given the bleak outlook during the crisis years, many young, well-educated workers left the country. Incentives are needed to create new jobs and halt the brain drain and retain valuable human capital in the country or bring it back home. So, much still remains to be done and perseverance will be needed until the debt problem has been defused.

The resoluteness of Ireland's reform policy should act as an example for other countries. Certainly, conditions vary from member state to member state. But Ireland's experience should encourage other eurozone countries to push ahead with the necessary reforms and not keep putting off the overhaul of the public sector budget. Such a policy is in the countries' own interest and is not imposed from outside by the Troika or the EU, as the critics are keen to have us believe. Resolute action can help overcome even difficult problems. That is the clear message from the Irish success story.