ECONOMIC SOVEREIGNTY IN IRELAND: A THING OF THE PAST?

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Irish sovereignty was a central concern of the 1916 Proclamation which contended that "in every generation the Irish people have asserted their right to national freedom and sovereignty". The sentiments underlining this proclamation continue to resonate in post-Celtic Tiger Ireland today, and the notion of economic sovereignty has again been prominent in the national dialogue over recent years as politicians and commentators regularly refer to the loss of sovereignty associated with the country's EU/IMF programme that began in December 2010 and ended in December 2013 (Clifford). Early in its term, the new government elected in February 2011 set as a priority the "restoration of economic sovereignty" by 2014 (Gilmore). The political narrative was that by signing up to a programme of financial assistance, the previous government surrendered Ireland's economic and financial independence and handed over the management of the country to the ECB, the European Commission and the IMF, collectively known as the Troika.

Beyond the political rhetoric, however, how much was Ireland's economic independence really affected by entering and exiting a financial rescue programme? After all, the EU/IMF programme was largely designed in Dublin by Irish policymakers[1] and consists mostly of measures that are in the best long-term interest of the country's citizens.[2] Moreover, the Irish government would have had to implement a multi-annual economic plan very much along the lines of the EU/IMF programme even if the State had retained access to international debt markets. Ireland's room for manoeuvre in the policy sphere narrowed markedly as a result of the bursting of the real-estate bubble and the international financial crisis. The only question was whether financial markets would retain enough risk appetite to finance the plan or whether official funding would be needed instead.

Looking forward, policy choices for Irish policymakers will remain tightly constrained even though the State can again sell debt on private markets. As a small open trading economy, a high level of economic interdependence is an inescapable reality in a globalised world. As a member of the EU, strict fiscal rules and enhanced surveillance are part of the revised EU economic governance. As a member of the euro area,

1 See Cahill. This article notes that in a written reply to questions from the European Parliament, Minister for Finance Michael Noonan said that the programme reflected the previous government's National Recovery Plan published shortly before Ireland applied for a bailout.

2 Central Bank Governor Patrick Honohan noted: "Amid turbulent market conditions, [the programme] provided a safe harbour into which Ireland was able to retreat, in order to clarify its ability and determination to deal with the severe financial problems that had so destructively erupted during the global financial crisis in September 2008" (Honohan).

Ireland has no control over monetary policy or exchange rates, and banking union in Europe is well underway. For Ireland, the largest chunks of economic sovereignty were willingly ceded when the country joined the EU and especially when it adopted the single currency.

There is no doubt that the arrival of the Troika to Ireland's shores understandably shocked the national psyche. However, I will argue in this essay that what is being referred to here is a narrow and technical definition of sovereignty – a far cry from the meaning of sovereignty in the Proclamation. As former Minister for Finance Brian Lenihan pointed out, "Pearse and those who signed the 1916 proclamation certainly had no reservations about seeking external assistance from imperial Germany at the time. I am drawing attention to the fact that our sovereign republic from 1916 on has always required external assistance" (Lenihan).

In this essay, I will address the following questions: beyond the political rhetoric, how much has Ireland's economic independence really been affected by entering a financial rescue programme and how much autonomy do we now have since the ending of the programme on 15 December 2013? And what does economic and financial independence really mean for a small open economy that uses the euro as its currency?

From Bust to Boom, to Bust Again

Before addressing the questions outlined above, it is useful as a way of background to look at developments in the Irish economy, not over the last 100 years, but over the last few decades and particularly during the past few years and the events surrounding Ireland's application for financial assistance.

The Economist published a survey of Ireland in 1988 entitled "The poorest of the rich", in which the newspaper concluded that the country was heading for catastrophe, mainly because Ireland had tried to erect a welfare state on continental European lines in an economy that was too poor to support one (Cairncross). The survey featured a beggar on the front cover – a provocative image and one which I will return to later. Inside the survey was an even more offensive picture of a horse and cart.

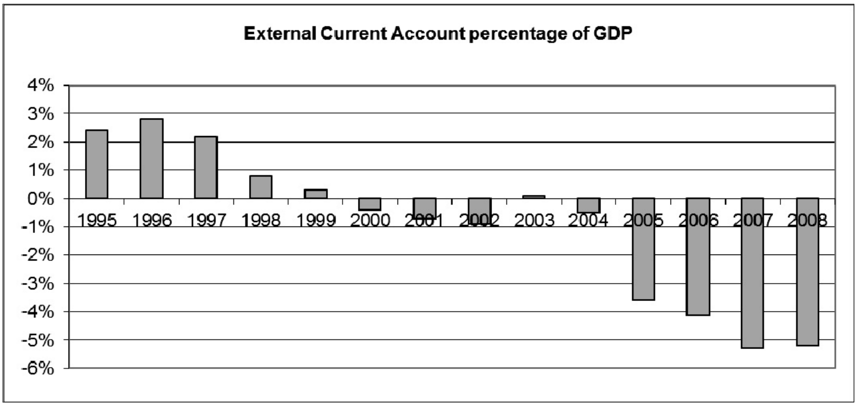
Yet less than a decade later, on 15 May 1997, *The Economist* had to eat humble pie. Amid rapid growth in its economy, Ireland featured on *The Economist*'s cover again though this time as "Europe's shining light". The newspaper marvelled that a sleepy European backwater had been transformed into a vibrant economy ("Ireland shines"). How did this transformation happen?

In a word: convergence. As Honohan and Walsh argue, the fundamentals of the Irish economy had been relatively strong for decades. Our convergence to rich-country levels of income per capita was delayed by the crisis in the public finances during the 1980s. When convergence came, it was telescoped in a short period of rapid growth. We began to reap the full benefits from the opening up of the economy that began in the era of Seán Lemass. Of course, the integration of the Irish economy with the global economy from the early 1960s was accompanied by a reduction in economic independence, but this loss of sovereignty was accepted. A key driver of our economy's convergence was inflows of foreign direct investment. Ireland became an export platform for U.S. multinational corporations selling products and services into European markets. Wage moderation and solid productivity growth in Ireland translated into large competiveness gains.

By the late 1990s, the Irish economy was, by and large, in great shape. Then things started to go wrong. Having joined the European Union in 1973, it seemed natural to go along with the next step in European integration – the adoption of a single currency, the euro. In the run-up to the introduction of the euro, economists had argued that membership of the single currency area would bring lower interest rates and therefore boost growth and employment. The Economic and Social Research Institute (ESRI), for example, argued in a 1996 report that under certain circumstances "the benefit to be obtained from EMU membership because of lower interest rates would average roughly 1.7 percentage points of GNP over the first five years of membership" (Baker, Fitzgerald & Honohan).

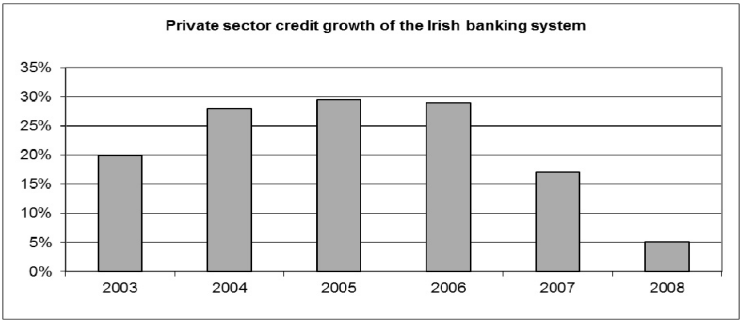
In the event, Ireland's adoption of the euro in 1999 led to a tidal wave of cheap money that flooded the Irish economy. These inflows of financial capital contributed to a dramatic swing in the external current account from a surplus of more than 2 per cent of GDP in 1997 to a deficit of 5 per cent of GDP in 2007 (fig. 1).

Figure 1: Central Statistics Office (<www.cso.ie>)



These capital inflows, mostly from European banks, were intermediated through the Irish banking system. Banking regulators around Europe relied on market signals to judge the riskiness of banking behaviour. As investors remained bullish about banks, this so-called "light touch" approach to regulation gave a green light for Irish banks to expand their loan books at a heady pace (fig. 2). Tax incentives for property investment added fuel to the property bubble.

Figure 2: Central Bank of Ireland (<www.centralbank.ie>)

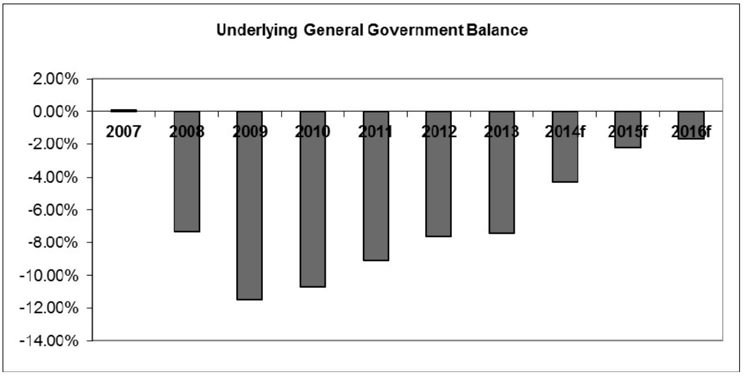


The property bubble was characterised by rapid increases in property prices (both for housing and commercial real estate), a huge expansion in construction activity, and a surge in purchases of houses and apartments. The bubble fuelled a jump in tax revenues for the government, including stamp duty, VAT, capital gains tax, and income tax. At the peak in 2007, about one-third of the government's tax revenues were being generated by the property bubble (Regling & Watson).

These windfall revenues from the bubble were mistakenly viewed as permanent. In reality, these receipts were more like the revenues that might accrue to the government if the State were to discover a gas field off the west coast of Ireland. These revenues are large, but time-limited; economic theory suggests that such temporary windfall revenues should be saved. Instead, the government used these receipts to increase public sector wages and welfare benefits, to expand public services as well as to reduce income tax rates and widen tax credits. The tax base shrunk alarmingly.

And then the bubble burst. The windfall tax receipts disappeared and welfare spending jumped as laid-off construction workers swelled the unemployment lines. As a result, the public finances plunged into an enormous deficit. As shown in fig. 3, the underlying budget balance (that is, the budget stripped of spending to rescue the banks) deteriorated into an eye-popping deficit of 11.2 per cent of GDP in 2009 (Department of Finance). The bulk of this balance was structural in nature and therefore the deficit would not shrink much even if the economy recovered to sustainable growth rates. The only way to restore order to the public finances was to broaden the tax base and reduce the cost of public services and social transfers.

Figure 3: Source: Department of Finance (<www.finance.gov.ie>)



The budget deficits registered over the past seven years had to be financed, as did the government debt that was scheduled to be repaid over that period. Over the course of 2008-2010, Ireland relied on stressed international money and bond markets to finance its borrowings. It should be obvious that, against a backdrop of increasingly risk-averse market investors, the set of policy options available to a government with a very wide gap between public expenditure and public receipts is extremely narrow. The reality is that the bubble had left Ireland dangerously exposed to a shift in conditions in financial markets.

From Market Financing to Official Financing

The Irish government had worked might and main to maintain access to borrowing on international markets at acceptable interest rates up until mid-2010. Conditions in government debt markets took a turn for the worse in the second half of that year. The deterioration reflected several factors:

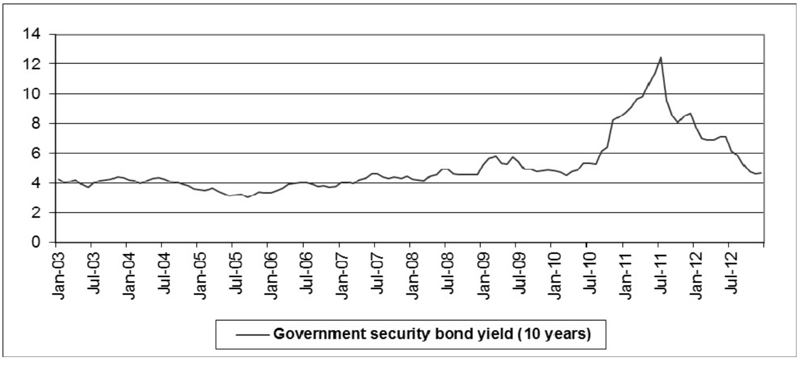
- Investors came to realise that the problems that had exploded in Greece earlier that year were not specific to that country, but rather reflected a fundamental malfunctioning of the euro area. The euro as a construct was deeply flawed.
- The global economy, which had shown some signs of recovery in the first half of 2010 following the slump in 2008/2009, began to weaken again.
- Investors became increasingly uncertain about the ultimate cost of the bank rescue, as banking losses continued to mount.
- The agreement at Deauville in October 2010 between Nicolas Sarkozy and Angela Merkel threatened potential investors in peripheral euro area sovereign debt with default.[3]

3 Angela Merkel and Nicolas Sarkozy agreed on 19 October 2010 that in future losses may be imposed on holders of government bonds of countries that apply for financial assistance from the European Stability Mechanism. Forelle *et al.* describe the events

- The European Central Bank gave strong signals to market investors that it was considering withdrawal of support to the Irish banking system (Ahearne). Ironically, less than two years later the ECB would introduce its Outright Monetary Transactions (OMT) programme to calm investors' fears as borrowing costs for Italy and Spain rose to unsustainable levels. Had OMT arrived in the autumn of 2010 instead, borrowing costs for the Irish government would have stayed low.

In the event, borrowing costs for Ireland on international markets hit unacceptably high levels and the Irish government was forced to apply for official financial assistance from the EU and the IMF. The cost of ten-year money for Ireland, for example, moved above 8 per cent in November (fig. 4).

Figure 4: Source: Central Bank of Ireland (<www.centralbank.ie/Pages/home.aspx>)



Having lost access to market financing, the government made the judgement that it would be better for the citizens of the country for the State to enter an official programme of assistance than the alternative. The alternative was for the government to instantly close the large budget deficit and default on its debts. Nonetheless, the application for official financing was greeted with dismay in the media.

In its editorial titled "Was it for this?" on 18 November 2010 *The Irish Times* lamented:

> whether this is what the men of 1916 died for: a bailout from the German chancellor with a few shillings of sympathy from the British chancellor on the side [...] Having obtained our political independence from Britain to be the masters of our own affairs, we have now surrendered our sovereignty to the European Commission, the European Central Bank, and the International Monetary Fund. ("Was it for this?").

The Irish Examiner on the same day was even more extreme:

> The founding fathers of the state are turning in their graves [...] because a major erosion of Ireland's economic sovereignty looks inevitable [...] People are right to be fearful of the punitive charges the ECB and the IMF will impose [...] the thorny issue of Ire-

leading up to the agreement at Deauville and the negative market reaction that followed. Mody offers a contrary perspective.

> land's generous corporation tax regime, the envy of other EU states, could be brought into play [...] For the man and woman in the street, the worry is that whatever loan package is put on the table by the enforcers of the ECB and IMF will have to be repaid – in full and with interest. ("Founding fathers")

The rhetoric about losing sovereignty was not confined to the media. The new government that came to power in March 2011 got in on the act also. In his national address in December that year, Taoiseach Enda Kenny declared: "I want to be a Taoiseach who retrieves Ireland's economic sovereignty" (Kenny). In August 2012, he stated: "Here at Béal na Bláth, as Taoiseach, I give you my word that I will not rest, our Government will not rest, until Ireland has reclaimed and restored its economic sovereignty" (Roche). Enda Kenny went on to say: "We will not cease in our painstaking, quiet but persuasive endeavours until Ireland has re-established the economic independence, so precious, so hard-won, which is its right and its due" (Roche).

The rhetoric about losing sovereignty ignored the fact that the EU/IMF programme was largely designed in Dublin by Irish policymakers. Most of the measures contained in the programme had appeared in the government's National Recovery Plan 2011-2014, which pre-dated the programme (Irish Government). The Irish government would have had to implement a multi-annual economic plan very much along the lines of the EU/IMF programme even if the State had retained access to international debt markets.

Restoring Economic Sovereignty?

When the EU/IMF programme ended in December 2013, how much more control of their own economy did Irish people regain that was not available to them during the period of the programme, 2011-2013? Three aspects of Ireland's economy suggest that the answer is: very little.

- Firstly, as a small open trading economy, a high level of economic interdependence is an inescapable reality in a globalised world.
- Secondly, as a member of the EU, strict fiscal rules and enhanced surveillance are parts of the revised EU economic governance.
- Thirdly, as a member of the euro area, Ireland has no control over monetary policy or exchange rates, and banking union in Europe is well underway.

It is well known that the original design of the euro was deeply flawed. European leaders have been forced back to the drawing board. The original Stability and Growth Pact (SGP) failed to prevent a major ongoing crisis in the euro area. The SGP rules were disregarded by larger member states, and in any event they wrongly focused almost exclusively on budgetary issues while ignoring excessive private capital flows which were the root cause of the crisis. European leaders have responded to past failures with a new regime of obligations and enhanced surveillance. This new regime goes beyond the focus on headline budget balances in the SGP.

This regime is built on a dizzying number of new rules and regulations. We now have a Six Pack and a Two Pack, economic partnership programmes and post-programme surveillance programmes, a European Semester, a Macroeconomic Imbalance Procedure, an Excessive Deficit Procedure including legal penalties and controls by the European Court of Justice, and macroeconomic scoreboards. Highly intrusive oversight of draft national budgets in the euro area by the European Commission is now a fact of life. The European Commission and Council now have significant powers in the European Semester, thanks to the Fiscal Treaty, which Ireland approved in a referendum in May 2012. What does economic independence mean in this context? These EU rules bind the Irish government to commitments towards sound fiscal policies and coordination by setting Ireland a medium-term budgetary target.

To conclude, none of this is to say that closer integration in Europe is unnecessary. I believe progress towards banking union and fiscal union is necessary if the euro is to survive. The point is that policy choices for Irish policymakers remain tightly constrained whether or not the State can sell debt on private markets. Ireland has chosen to share sovereignty and embrace globalisation with the aim of advancing economic welfare, consistent with the declaration in the 1916 Proclamation of “its resolve to pursue the happiness and prosperity of the whole nation.” The choice to share sovereignty and engage in world markets brings constraints. The idea that Irish policymakers can have full control of our economy is delusional. For Ireland, the largest chunks of economic sovereignty were willingly ceded when the country joined the EU and especially when it adopted the single currency.

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