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Financial Crisis in Economies with External Imbalances:

A Comparative Analysis of Ireland and Spain

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Abstract

The financial crisis of 2007-08 has had momentous consequences for most developed countries and triggered recession on the global financial markets. Consequently, economies with pre-existing deficiencies were hit in particular. In the European Union, especially two groups of member states with specific imbalances could be discerned. This thesis is intended to discuss the impacts on economies with external imbalances, where the crisis was not rooted in public finance profligacy. The main protagonists, Ireland and Spain, experienced resembling economic boom prior to the crisis, later accompanied by accumulation of foreign debt and real estate bubbles. Nonetheless, despite the strong similarities in their economic development their paths diverged after the bust, and Ireland has been given as an example for successful austerity. This thesis presents key determinative factors which differentiated Spain from Ireland in the reviving processes to discuss the hypothesis that the Irish recovery was generated solely by the implemented countermeasures and that it can therefore be considered a model for future crisis management. The objective of this thesis is to address this assertion and to evaluate its correctness using a detailed overview of structural specificities of the economies, as well as of the undertaken steps.

Abstrakt

Finanční krize z let 2007/08 měla závažné důsledky pro většinu zemí a způsobila ekonomickou recesi na světových finančních trzích. Především byly zasaženy země s již dříve existujícími nedostatky. V Evropské Unii byly zejména dvě skupiny členských států, které trpěly specifickými nerovnováhami. Tato bakalářská práce se zabývá dopady

na ekonomiky s nerovnováhami vnějšími, kde krize nebyla důsledkem špatného hospodaření s veřejnými financemi. Jejich hlavní představitelé, Irsko a Španělsko, zaznamenaly velice podobný ekonomický boom v letech předcházejících krizi, který začal být později doprovázen zvýšeným zahraničním dluhem a hypotečními bublinami. Po splasknutí bublin se však jejich cesty rozešly, navzdory silných podobnostem v ekonomickém vývoji a Irsko bylo dáváno za příklad úspěšných úsporných opatření. Tato bakalářská práce představuje rozhodující faktory, které odlišily Španělsko a Irsko v jejich rozdílných postupech pro ozdravení ekonomiky, aby mohla být zhodnocena hypotéza, že k irskému oživení došlo pouze na základě zavedených krizových protiopatření, a že Irsko tedy může být bráno jako model pro budoucí řešení krizí. Cílem práce je zaměřit se na toto tvrzení a zhodnotit jeho správnost pomocí detailního přehledu strukturálních rozdílů mezi oběma ekonomikami a jimi podniknutými kroky.

Keywords

austerity measures, banking sector, bubble, economic recovery, European Union, external imbalances, financial crisis, Ireland, public finances, Spain

Klíčová slova

úsporná opatření, bankovní sektor, bublina, ekonomické ozdravení, Evropská unie, vnější nerovnováhy, finanční krize, Irsko, veřejné finance, Španělsko

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Prague, 10 May, 2016 Ondřej Semerák

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Název práce: Financial Crisis in Economies with External Imbalances: Comparative Analysis of Ireland and Spain
Charakteristika tématu práce (max. 10 řádek): Finanční krize a následná dluhová krize Eurozóny představovaly jednu z největších výzev, kterým musela Evropská unie do té doby čelit a s jejichž následky se stále vyrovnává. Tato práce se zabývá krizí v ekonomikách s vnějšími nerovnováhami, které trpěly zvýšeným zahraničním dluhem. Jakožto komparativní analýza Irska a Španělska, tedy hlavních představitelů tohoto druhu nerovnováh v EU, srovnává práce dopady a následná protikrizová opatření v těchto zdánlivě velice podobných ekonomikách. Cílem je zhodnocení významu podniknutých kroků na celkovém ekonomickém ozdravení obou zemí a diskuse nad hypotézou, že Irsko může být díky svému řešení krize chápáno jako vzor pro úsporná opatření. Součástí práce je představení obou ekonomik, včetně jejich strukturálních rozdílů.
Zdůvodnění úprav a změn tématu od zadání projektu do odevzdání práce (max. 10 řádek): Oproti původnímu plánu, který počítal pouze se srovnáním dopadů a řešení v daných dvou zemích, byla přidána kontextualizační část. Krize v Irsku i Španělsku je tedy uvedena kapitolou, která shrnuje jejich moderní ekonomický vývoj s důrazem na strukturální aspekty a komparativní výhody/ nevýhody a která pokračuje stručným shrnutím hlavních faktorů ekonomik v předkrizovém období, zejména pak hypotečních bublin. Zařazení této části se ukázalo být klíčové pro kvalitní zhodnocení položené hypotézy a vysvětlení dosažených závěrů. Dále došlo ke zkrácení úvodní teoretické kapitoly, tak aby prezentovala pouze body bezprostředně relevatní pro tuto práci a nezahlcovala definicemi méně důležitého významu.
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Acronyms

AIB – Allied Irish Banks

AIReF – Autoridad Independiente de Responsabilidad Fiscal *(Independent Fiscal Responsibility Authority)*

Anglo – Anglo Irish Bank

BoI – Bank of Ireland

CORA – Comisión para la Reforma de las Administraciones Públicas *(Commission on the Reform of Public Administrations)*

EA – Euro Area

ECB – European Central Bank

EDP – Excessive Deficit Procedure

EFSF – European Financial Stability Facility

EFSM – European Financial Stabilisation Mechanism

ESM – European Stability Mechanism

EU – European Union

FDI – Foreign Direct Investment

FROB – Fondo de Reestructuración Ordenada Bancaria *(Fund for Orderly Bank Restructuring)*

FFPP – Fondo para la Financición de Pagos a Proveedores *(Fund for the Financing of Payments to Suppliers)*

GDP – Growth Domestic Product

GNI – Gross National Income

IFAC - Irish Fiscal Advisory Council

IMF – International Monetary Fund

INBS – Irish Nationwide Building Society

LVT – Loan-to-value (ratio)

MNCs – Multinational Corporations

NAMA – National Asset Management Agency

NRP – National Recovery Plan

OECD – Organisation for Economic Co-operation and Development

REDs – Real Estate Development loans

REITs – Real Estate Investment Trust

SAREB – Sociedad de Gestión de Activos procedentes de la Reestructuración Bancaria *(Company for the Management of Assets proceeding from Restructuring of the Banking System)*

SGP – Stability and Growth Pact

Introduction

The financial crisis that occurred in 2007/08 was unique because of its depth and global impacts in the sense that it broke the economic paradigm. The consequences, rivalled only by the Great Recession, elicited reaction of the national governments as well as resurgence of Keynesian economics. An overwhelming majority of developed countries had to implement countermeasures and the laissez-faire approach was relinquished. Following the overall difficulties with successful recovery, a universal solution became sought after.

Such was also the case in the European Union, where the implications of the fall were as blatant as in the United States and, moreover, still felt years after the American recovery. The acronym PIGS (PIIGS)[1] was used for the most affected countries, yet there were significant structural differences between them concerning notably the origins and nature of their troubles. Two groups can be distinguished in particular: countries with fiscal imbalances, i.e. Greece or Portugal, and countries with financial imbalances, represented namely by the Republic of Ireland (hereafter Ireland) and the Kingdom of Spain (hereafter Spain). While the first group was characterized by excessive spending, the second group was more closely related to the external imbalances of the EU, one of its greatest destabilizing factors.

Similar patterns could have been observed in the economic evolutions prior to and during the crisis within these groups. Ireland and Spain, above all, experienced analogous development from underdeveloped peripheral countries to booming economies with extraordinary levels of GDP growth. They both experienced some of the biggest housing bubbles in history, followed by an equally spectacular fall. Nonetheless, thereafter their paths diverged as Ireland achieved one of the most stunning recoveries while Spain continued to writhe in its predicament.

As diverse countries are clearly in need of different crisis management procedures, no universally applicable solution can be drawn for all. However, the striking similitude between Ireland and Spain raised the question of why Spain did not reach the same

[1] Jargonistic acronym for Portugal, Ireland, Greece and Spain (PIGS), sometimes including also Italy (PIIGS), a country with long-term structural deficiencies.

revitalization achievements as Ireland did, which became known as the role model for recovery and was branded by journalists a "poster child for austerity".[2]

The aim of this thesis is to present the aspects of the Irish recovery as compared to the Spanish case and distinguish its key contributing elements, outlaying not only the steps undertaken but also a historical overview of the boom and structural specificities of both economies. It is intended to discuss the hypothesis that the Irish recovery was based on implemented countermeasures and that it can therefore be considered a model for future crisis management. Its correctness will be assessed and potential modifications of this assumption will be offered. The final point of reference was set for December 2013, when both countries exited the foreign assistance programmes.

Methodology

The thesis is a case study of Ireland and Spain based on a comparative analysis of their economic evolutions. To achieve a complete evaluation of the discussed hypothesis, this paper is structured as follows: firstly, a theoretical framework is included to provide a complex understanding of the subject. The second and third chapter are dedicated to Ireland and Spain, respectively, examining the economic development prior to the crisis, as well as the emergence of the bubble. Structural aspects of the period of economic boom will be scrutinized to distinguish potential latent differences between the two countries. In its pursuance, the Spanish part is written in a semi-comparative manner, using Ireland as a benchmark to illuminate the distinct factors of their economies. The last chapter focuses on crisis management in Spain and Ireland and the distinctive elements of the countermeasures. Ultimately, a conclusion will be drawn concerning the aforementioned hypothesis. This thesis is equally based on analysis of primary data, using a number of

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[2] Larry Elliott, "Ireland becomes poster child for implementing austerity programmes," *The Guardian*, 27 November, 2011, accessed 27 April, 2016, http://www.theguardian.com/business/economics-blog/2011/nov/27/ireland-poster-child-for-austerity-programmes.
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figures to illustrate the discussed topics. The primary currency is the euro and, to a lesser extent, US dollars, used for comparative purposes in cases of better accessibility.

Literature Review

Since there are very few sources focusing on a qualitative evaluation of crisis management in various member states of the EU, and if so then mostly representing a non-comparative compilation (e.g. Conde-Ruiz's and Marín's contribution to "Austerity Measures in Crisis Countries - Results and Impact on Mid-term Development"), this paper structures its own comparison to offer a comprehensive analysis. Most of the sources are of an economic, financial and political nature. On the other hand, it is not the primary focus of this thesis to address social and socio-demographic consequences of the crisis, and even less so of the boom, which is why sociological sources are less common, even if related to the topic. Similarly, papers concerning measures undertaken by the EU/ECB other than bailout programmes for the two relevant countries (Covered Bonds Programme, Securities Markets Programme, LTROs, OMT Programme, European Semester etc.) are omitted, regardless of their abundance. Most of the sources used are in English, in the view of the economic subject, less so in Spanish and to a small extent also in French and in Czech.

Three main sources have been used during the elaboration of this thesis. Firstly, primary data are often used for elaborations of figures and interpretations of macroeconomic trends. They are accessed via databases of main international organisations in the field (OECD, Eurostat, IMF, World Bank), as well as of domestic authorities. The data are used throughout the paper and serve for illustration of the discussed aggregates.

Secondly, reports by international organizations and national authorities were a valuable contribution to this paper as they provided detailed analysis of their respective topics (IMF, OECD, Central banks, Research centres). The Report of the Commission of Investigation into the Banking Sector in Ireland "Misjudging Risk: Causes of the Systemic Banking Crisis in Ireland", or the so-called Nyberg Report, was crucial for the analysis of the second part of the Irish chapter: *The Bubble* and *Bust and its Impacts*. Commissioned by the government itself and published by Michael Noonan, the Minister of Finance, this is an extensive scrutiny lead by the Commission of Investigation, arguably the most trustworthy source available.

Three reports were particularly important for the last part. For Ireland, it was two reports by the Governor of the Central Bank of Ireland, Patrick Honohan: "Resolving Ireland's Banking Crisis" and "The Irish Banking Crisis Regulatory and Financial Stability Policy 2003-2008". While the first one was presented at a conference before his inauguration, the second one, which takes up some of the original arguments, is a report to the Minister for Finance from Honohan's position as a Governor. Both represent an extremely rich and detailed overview of the boom and the crisis management. A report by the International Monetary Fund entitled "Spain: Financial Sector Reform—Final Progress Report" was substantial for understanding the Spanish countermeasures. It provides an extensive analysis of the banking sector reform and steps undertaken by the Ministry of Economy and Competitiveness, the Bank of Spain and the European Commission.

Thirdly, specialized journal articles were used given the contemporary nature of the topic resulting in scarcity of published books related to the issue. The articles were accessed via a catalogue of the Sciences Po Paris Bibliothèque. "Spain after Franco: Lessons in Democratization" by Omar G. Encarnación, chair of political studies at Bard College, was a major source for the first part of the chapter on Spain, as it presents the roots of the economic boom. It entertains the steps leading to the successful transition and, published in 2002, it offers an unbiased critical evaluation. The most substantial source concerning the Spanish crisis was then "Boom and (deep) crisis in the Spanish economy: the role of the EU in its evolution" by Etxezarreta, Navarro, Ribera and Soldevila. This comprehensive communication, presented in 2011, bears high relevance to the subject, focusing not only on the impacts of the Spanish fall but also deciphering its genesis, preconditions and the role of the EU.

Ultimately, books, newspaper articles and official websites have also been used, although to a limited extent. *The end of Irish history? Critical reflections on the Celtic Tiger* by Coulter and Coleman is among key sources of the Irish historical overview. Written in 2003, it offers a critical assessment of the Irish boom and unravels its positive as well as negative aspects, unbiased by the successive blatant fallacies of the property bubble and its burst.

1 Theoretical Framework: Imbalances as a Cause of the Crisis in the Euro Area

The crisis in Europe, or the latter Eurozone debt crisis, deviates from the situation in the United States, namely in its origins. Most importantly, the US was responsible for the majority of the global derivatives trading, which played minor role in Europe and thus it is necessary to find the roots elsewhere. Some countries were struck solely by the global market trading deceleration; however, this concerned almost uniquely stable economies with long-term surpluses of both current accounts[3] and public finances. For the rest, two (three) major causes can be discerned - fiscal and financial/external imbalances.[4] The latter are closely connected and will be treated as such in this paper.

1.1 Fiscal Imbalances

At the beginning of the crisis in Europe, a false narrative was used that the origins of the Euro Area crisis lay solely in public finance profligacy. Such assertions were based on common neglect of the Stability and Growth Pact (SGP)[5], namely of two criteria concerning limits on the government budget deficit[6] and government debt-to-GDP ratio[7] mentioned in the preventive arm of the SGP.[8]

The criteria for the SGP were undeniably breached; however, it was not only the countries currently in distress which violated the fiscal responsibility criteria. Only five countries of the Euro Area (EA) have not breached the SGP since its introduction in 1999 (apart

[3] Current account is the difference between a nation's savings and its investment. A positive current account balance indicates that the nation is a net lender to the rest of the world, while a negative current account balance indicates that it is a net borrower from the rest of the world. (*Investopedia, accessed 20 April, 2016, http://www.investopedia.com/terms/c/currentaccount.asp*).

[4] International Monetary Fund, "Euro Area Imbalances," Annex to Umbrella Report for G-20 Mutual Assessment Process, *International Monetary Fund* (June 2012), 6, https://www.imf.org/external/np/g20/pdf/map2012/annex2.pdf.

[5] Stability and Growth Pact is a set of rules designed to ensure that countries in the European Union pursue sound public finances and coordinate their fiscal policies as part of preventive arm mechanism for the upcoming single currency in 1998 and 1999 *(European Commission, accessed 25 February, 2016, http://ec.europa.eu/economy_finance/economic_governance/sgp/index_en.htm).*

[6] Government deficit to gross domestic product must not exceed 3% at the end of the preceding fiscal year *(EUR-Lex, Accessed 25 February, 2016, http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=URISERV%3Al25014).*

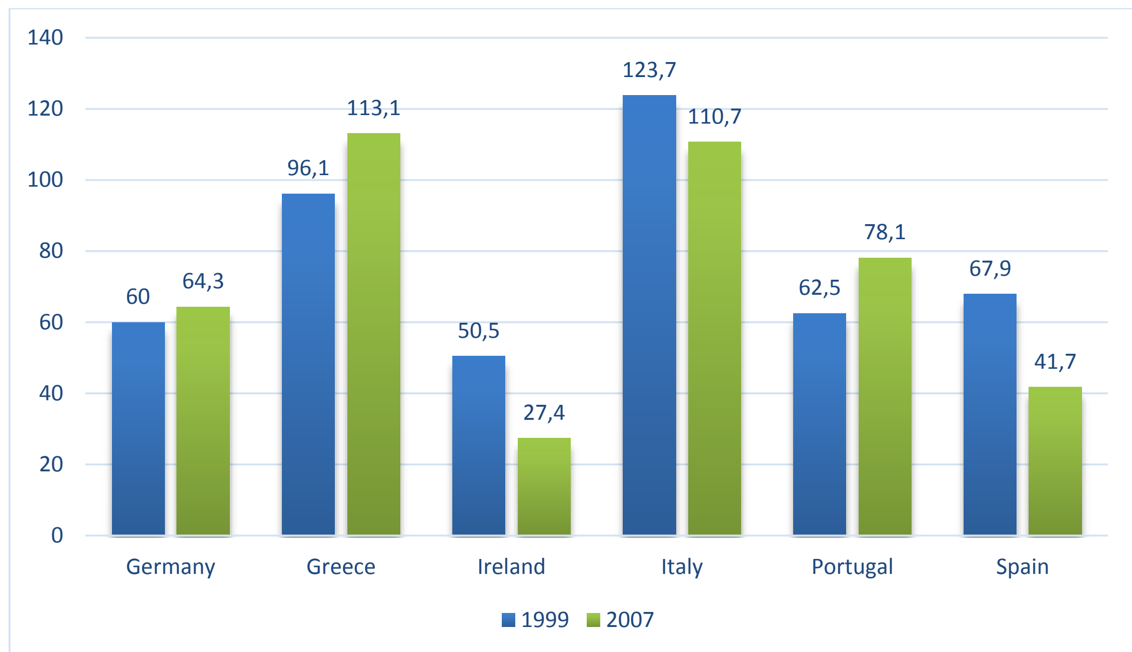
[7] Gross government debt relative to GDP must not exceed 60% at the end of the preceding fiscal year *(EUR-Lex, Accessed 25 February, 2016, http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=URISERV%3Al25014).*

[8] "COUNCIL REGULATION (EC) No 1466/97 of 7 July 1997 (OJ L 209, 2.8.1997, p.1)," Official Site of EUR-Lex, accessed 25 February, 2016, http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:01997R1466-20111213&from=EN.

from Ireland and Spain also Belgium, Finland and Luxembourg).[9] Thus it would be erroneous to label the state of public finances uniformly as the sole originator of all problems.

Figure 1 shows that many distressed countries saw a significant improvement in terms of public sector debt-to-GDP ratio. While some member states truly experienced exorbitant levels of public expenditure, e.g. Greece or Portugal, others went through a period of consolidation of public finances. Italy managed to reduce its long-term excessive debt by 13%. Similarly, the two countries key to this thesis, Ireland and Spain, had been virtuous in the pre-crisis period, reducing their debt-to-GDP ratio by more than a third and reaching levels deep below the given criteria limits.

Figure 1: General Government Debt of Selected EU Countries *(Total, % of GDP, change between 1999 and 2007)*



Source: Own elaborations based on OECD Data [10]

[9] "General Government Debt," Official Site of OECD Data, accessed 24 February, 2016,https://data.oecd.org/gga/general-government-debt.htm.
"General Government Deficit," Official Site of OECD Data, accessed 24 February, 2016, https://data.oecd.org/gga/general-government-deficit.htm.
[10] "General Government Debt," Official Site of OECD Data, accessed 24 February, 2016, https://data.oecd.org/gga/general-government-debt.htm.

1.2 Financial Imbalances

The explanation for the fall of these two countries therefore lies elsewhere. Although their public expenditure was improving, Ireland and Spain experienced a surge in private debt. While core countries as France, Belgium, or the Netherlands found themselves in economic downturn at the introduction of euro with annual GDP growth rates of around 1% (and Germany even with negative rates), peripheral countries were booming. From the introduction of the single currency, Spain maintained growth over 3%, and Greece and Ireland even over 5%. Ireland also benefited from extremely high rates from the end of millennium (over 10% annually).[11]

The boom attracted investors and further fuelled domestic bubbles.[12] Thus both households and non-financial corporations tried to profit from the growing bubble and these peripheral countries saw private debt boom. While Greece doubled its private debt, it did not represent such a threat thanks to its low pre-crisis levels deep below the Eurozone average, which was not the case for the rest of the periphery. Spain more than doubled its private debt, reaching a level of almost 200% of GDP. Ireland even exceeded it with 236% by the beginning of the crisis.[13]

As can be seen in figure 2, the trend of private debt was inverse to the public debt evolution in Ireland and Spain. The increase was colossal from the EU average towards the biggest debtors in the EU, caused by the inflow of foreign capital. While Greece and Italy experienced significant increases as well, they did not reach the unsustainable levels of Ireland or Spain. They rather equalled the rest of the EU and the primary deficiency of these countries remained public debt. For example, despite the fact that Portuguese private debt was reaching the same level as the Spanish in 2008, it was merely a continuation of the trend set before. The change raised far fewer concerns than in the Spanish case.

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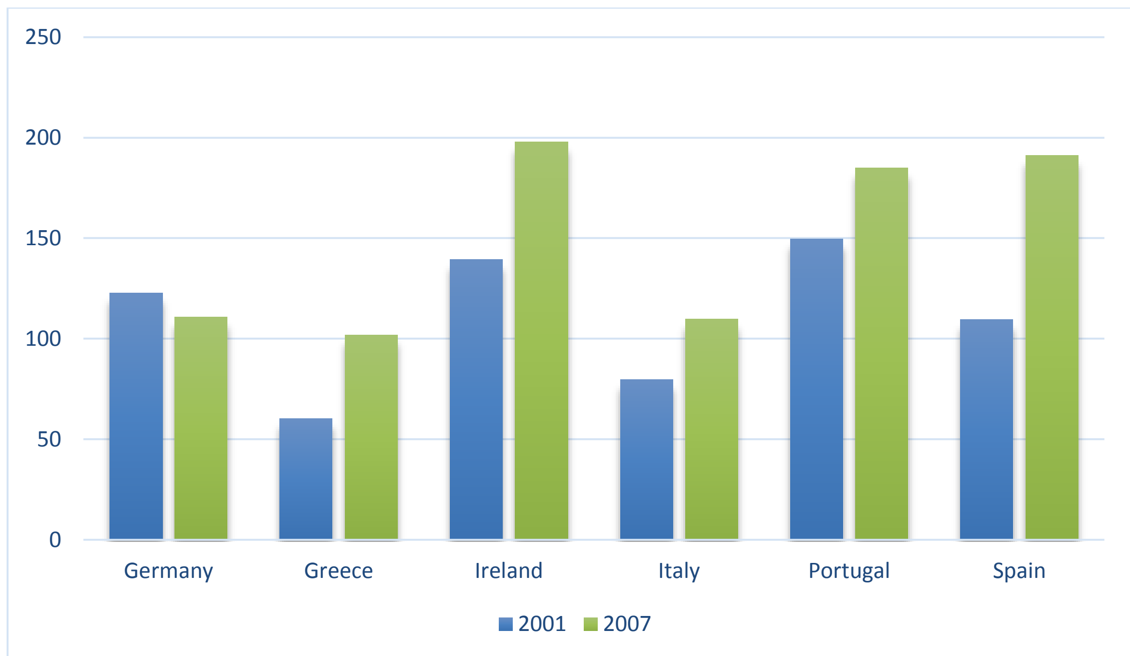
[11] "Real GDP Forecast," Official Site of OECD Data, accessed 28 February, 2016, https://data.oecd.org/gdp/real-gdp-forecast.htm.

[12] A bubble is a surge in equity prices, often more than warranted by the fundamentals and usually in a particular sector, followed by a drastic drop in prices as a massive selloff occurs. (*Investopedia, accessed 28 April, 2016, http://www.investopedia.com/terms/b/bubble.asp*).

[13] "Private Sector Debt, Consolidated % of GDP," Official Site of Eurostat, accessed 25 February, 2016, http://ec.europa.eu/eurostat/en/web/products-datasets/-/TIPSPD20.

Figure 2: Private Sector Debt of Selected EU Countries *(Consolidated - % of GDP, change between 1999 and 2007)*



Source: Own elaborations based on Eurostat Data [14]

1.3 External Imbalances

The financial imbalances were deeply rooted in an unfinished and imperfect pre-euro convergence process. In the context of globalized markets, they are closely tied to external imbalances. National financial institutions of these booming economies were not capable of satisfying the sharply increasing domestic demand. Thus, they resorted to foreign capital, originating primarily from northern countries (above all Germany and the Netherlands) that had long-term current account surpluses and were exporting capital to the peripheral countries (Spain, Ireland, Portugal, Greece or Italy).[15] The demand of the periphery, boosting the economy of the core countries, was thus financed by the capital from the core countries themselves through liberalized channels of the common market. Therefore, while Germany lent money for its own export expansion, Ireland's and Spain's increased consumption weighed on their private sector.[16]

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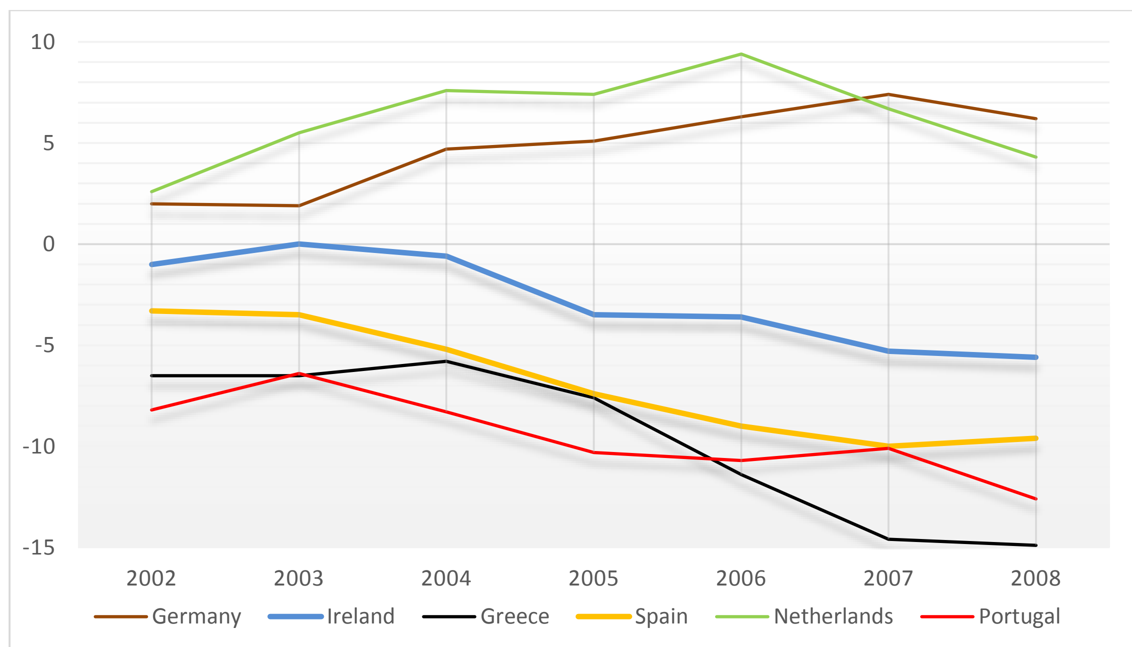
[14] "Private Sector Debt, Consolidated % of GDP," Official Site of Eurostat, accessed 25 February, 2016, http://ec.europa.eu/eurostat/en/web/products-datasets/-/TIPSPD20 .
[15] International Monetary Fund, "Euro Area Imbalances," 3.
[16] Etxezarreta, Miren, Navarro, Francisco, Ribera, Ramón, and Soldevila, Victòria, "Boom and (deep) crisis in the Spanish economy: the role of the EU in its evolution," (Communication presented at the 17th Workshop on Alternative Economic Policy in Europe, Vienna, September 2011): 5.

An aggravation mechanism occurred paradoxically in Germany, which underwent great reforms leading to reduced investment after the recession that followed the introduction of the euro. The German economy therefore substituted investment for savings that reached extremely high levels. Those savings were then used to fuel credit booms in peripheral countries.[17] Thus, two opposite and irrational behaviours could be observed - the exorbitant borrowing of the periphery during the financial bubble was as irrational as excessive German saving.

Figure 3 illustrates the external imbalances within Euro Area. Northern countries, above all Germany and the Netherlands, had high current account surpluses of over 5% of GDP, which was particularly significant in the German case given the size of its economy. In contradistinction, southern countries suffered from deep current account deficits, below -10% of GDP prior to the crisis. Irish deficits were partially mitigated by its successful focalisation on exports, as explained later.

Figure 3: Balance of the Current Account of Selected EU Countries *(% of GDP, 2002-08)*



Source: Own elaborations based on Eurostat data [18]

[17] Chen, Ruo, Milesi-Ferretti, Gian Maria, and Tressel, Thierry, "External Imbalances in the Euro Area," IMF Working Paper 12/236, *International Monetary Fund* (September 2012), 8, https://www.imf.org/external/pubs/ft/wp/2012/wp12236.pdf.
[18] "Balance of Current Account," Official Site of Eurostat, accessed 25 February, 2016, http://ec.europa.eu/eurostat/tgm/table.do?tab=table&language=en&pcode=tec00043.

2 Ireland

A historically underdeveloped country, Ireland never enjoyed a period of sustained economic growth and when it entered the European Communities in 1973, its GDP per capita was the lowest of all member states. In the mid-1980s, in the midst of a worldwide economic downturn, it saw its unemployment rate leap into historical levels - with youth exodus at rates unseen since the 1950s.[19] It wasn't until the end of the 1980s that Ireland emerged as a developed economy and experienced two decades of spectacular growth, earning the nickname "Celtic Tiger". Over this period, Ireland transformed from the poorest country in Western Europe to one of the wealthiest, profiting from a tremendous pace of economic growth of 6% per annum. It managed to achieve full employment for the first time in its history by 2000 and in mid-1990s it reached the average GDP per capita of the newly created European Union, only to surpass it by a half (148% of the EU average) by the outbreak of the crisis. The period between 1994 and 2000 is characterized especially by annual GDP growth of almost 10%.[20]

Nonetheless, two periods should be distinguished. The first one, from 1987 to 2000, can be named the "real" *Celtic Tiger* phase and was characterized by exceptional export-led growth, relying on Foreign direct investment (FDI) and American multinational corporations. The period of high competitiveness, moderate wages and price inflation, however, ended with the beginning of the new millennium when Ireland entered a second phase - the property bubble. The potential for growth at rates previously experienced no longer existed; nevertheless, high rates were further driven upwards by the housing bubble.[21] The following chapter addresses the *Celtic Tiger* phenomenon from its origins up to its fall, together with impacts of the bust.

2.1 Origins of the *Celtic Tiger*

There is no clear consensus on the origins of the exceptional boom; however, it is generally agreed that it was a consequence of epoch-making social changes that formed the *Celtic Tiger*. These changes include, namely, the introduction of free-schooling in the

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[19] Coulter, Colin, and Coleman, Steve, *The end of Irish history? Critical reflections on the Celtic Tiger*, (Manchester: Manchester University Press, 2003), 3.
[20] "Quarterly Growth Rates of Real GDP, Change over Previous Quarter," Official Site of OECD Stats, accessed 1 March, 2016, https://stats.oecd.org/index.aspx?queryid=350#.
[21] O'Callaghan, Cian, Kelly, Sinéad, Boyle, Mark and Kitchin, Rob, "Topologies and topographies of Ireland's neoliberal crisis," *Space and Polity* 19, No. 1 (2015): 35.

1960s and the implementation of fiscal prudence in the late 1980s, creating a stable macroeconomic environment and thus attracting major investors.[22] In 1987, the first of the *Social Partnership Agreements* was concluded between the government and representatives of labour unions, inducing tranquil relations and an investment-friendly background. The so-called *Programme for National Recovery* introduced the major principles of the *Celtic Tiger*: deregulation, low taxation and focus on foreign direct investment (FDI).[23] Such measures created a framework of stability and fiscal attractiveness for external factors, especially American investment, together contributing to the phenomenon of the *Celtic Tiger*.[24]

Likewise, Ireland benefited extensively from membership in the Euro Area. Besides the disappearance of exchange risk and free access to European capital markets, it could profit from European funds. Approximately €2bn per year aided considerably in attracting FDI by establishing a high-quality infrastructure, essential for future development.[25] Contrary to many other countries, Ireland achieved important convergence before the introduction of the common currency, owing notably to gains in competitiveness and a decrease in public debt, and therefore avoided most related negative effects.

Great responsibility for the previous underdevelopment of the Irish economy belonged to the government itself, which chose protectionist economic policies to defend its industry, namely against its newly separated neighbour, the United Kingdom. Among such measures was, above all, the *Manufactures Act* of 1933, enacting the obligation of domestic ownership of industrial companies, thus thwarting all major foreign investment in the country.[26] Ireland learnt from its mistakes, and while the world was struggling face to face with the challenge of globalization, Ireland used it to its advantage.

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[22] Coulter and Coleman, "The end of Irish history? Critical reflections on the Celtic Tiger," 11.
[23] Murphy, Mary P., "Ireland: Celtic Tiger in Austerity—Explaining Irish Path Dependency," *Journal of Contemporary European Studies* 22, No. 2 (2014): 132.
[24] Croke, James, "Chuaigh Ar La'-Debt of A Gaelsman: Ireland's Sovereign Debt Crisis, National and International Responses," Northwestern Journal of International Law & Business 32, No. 365 (2012): 370.
[25] Fitzgerald, Colm, "The debt crisis in Ireland," *The Quarterly Review of Economics and Finance* 53 (2013): 361.
[26] Croke, "Chuaigh Ar La' - Debt of A Gaelsman: Ireland's Sovereign Debt Crisis, National and International Responses," 369.

2.2 First Phase of the *Celtic Tiger*

The new epoch was characterized by multinational corporations (MNCs) seeking cross-border investment destinations. As a country with highly qualified, English-speaking work force and flexible labour market, Ireland was very alluring to investors, predominantly US firms.[27] Most importantly, Ireland differentiated itself from most economies with extensive deregulation and a neo-liberal economy, including wage restraints, low restrictions on business, and, above all, the lowest corporate tax of all members of the European Communities (12.5% as compared to 30-40% in the majority of remaining European countries). Such conditions attracted investment primarily in highly demanding manufacturing, especially pharmaceuticals and new technologies, to which Ireland was able to offer both a surplus of educated workers and flexible, cheap labour.[28] This liberalization was accompanied by extensive privatization that went well beyond the situation in other cradles of neo-liberalism, such as the US or the UK. Major transport companies were all commercialized while Public Private Partnerships[29] were engaged in all social services (schooling, housing for the socially disadvantaged, road and rail infrastructure or waste removal and recycling).[30]

2.2.1 IT and Pharmaceuticals Investment

Although minor IT investment could be spotted in the 1970s and 1980s, the year 1990 marked a crucial milestone in Irish economic history. At this time, Intel, one of the most important chip makers in the world, decided to settle in Ireland. They were followed by all major IT companies. Microsoft, Apple, Dell, Hewlett-Packard, Logitech, or IBM all decided to base their headquarters in either Dublin or Cork, and Ireland became responsible for 40% of US electronics investment in Europe. The magnitude of impact of MNCs on the *Celtic Tiger* phenomenon was immense, as they were responsible for 85% of its annual growth and their share on GDP rose from 14% in 1990 to more than 50% in

[27] Coulter and Coleman, “The end of Irish history? Critical reflections on the Celtic Tiger,” 19.
[28] Waldron, Richard, and Redmond, Declan, “POLICY REVIEW: The Extent of the Mortgage Crisis in Ireland and Policy Responses,” *Housing Studies* 29, No. 1 (2014): 150.
[29] Public-private partnerships are business relationships between a private-sector company and a government agency for the purpose of completing a project that will serve the public (*Investopedia, accessed 6 April, 2016, http://www.investopedia.com/terms/p/public-private-partnerships.asp*).
[30] O'Callaghan, Kelly, Boyle, and Kitchin, “Topologies and topographies of Ireland's neoliberal crisis,” 34.

1999.[31] Among other MNCs were primarily pharmaceuticals (above all Pfizer) and, later on, also Internet service companies (including Facebook, Twitter, Google, Yahoo, Linkedln, PayPal, Amazon, eBay, Dropbox, Airbnb and many others).[32]

2.2.2 Demographic Consequences of the Growth

As a result, Ireland experienced the biggest growth in job creation in its history, record numbers of integration of women in the labour force, and for the first time, significant inflow of migrants.[33] As opposed to demographic deficits in late 1980s, Ireland became net importer of people in 1992 and even more so from 1996 on, with immigration exceeding emigration more than tenfold by 2007.[34] Thus, the population saw a reverse curve and grew by 30% in two decades, while maintaining extremely low levels of unemployment (4% in the first half of 2000s).[35] Subsequently, average Irish wages rose from the second lowest to the second highest levels in the EU, only after Luxembourg. Figure 4 shows the evolution of annual wages in selected EU countries, and documents the astonishing increase in Ireland. While in 1990 Irish wages were still lower than French and Italian; by 2009 they surpassed their levels by over 138% and 154% respectively. For further understanding of this paper, it is important to take notice of development in Spain, which is almost non-existent.

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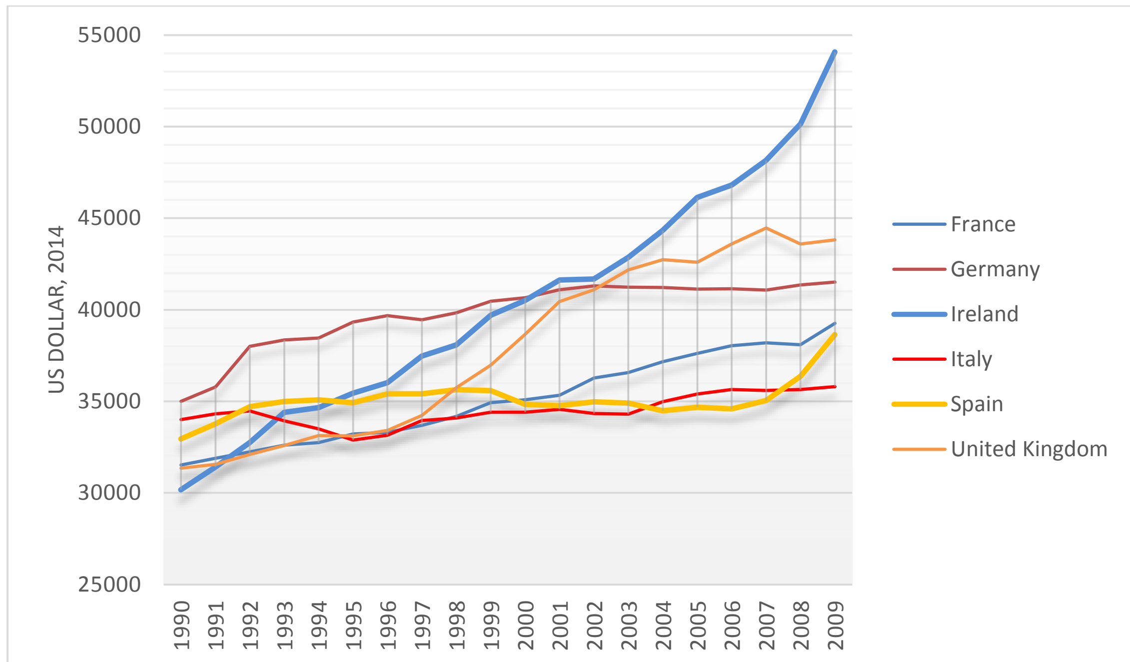
[31] Coulter and Coleman, "The end of Irish history? Critical reflections on the Celtic Tiger," 38.
[32] "Top 1000 Irish Industries," Official Site of the The Irish Times Guide to Business, accessed 3 March, 2016, http://www.top1000.ie/companies.
[33] Coulter and Coleman, "The end of Irish history? Critical reflections on the Celtic Tiger," 22.
[34] "Population and Migration Estimates," Official Site of Central Statistics Office, accessed 3 March, 2016, http://www.cso.ie/en/releasesandpublications/er/pme/populationandmigrationestimatesapril2015/.
[35] O'Callaghan, Kelly, Boyle, and Kitchin, "Topologies and topographies of Ireland's neoliberal crisis," 34.

Figure 4: Average Annual Wages in Selected EU Countries *(Constant Prices at 2014 USD PPPs, 1990 - 2009)*



Source: Own elaborations based on OECD Data [36]

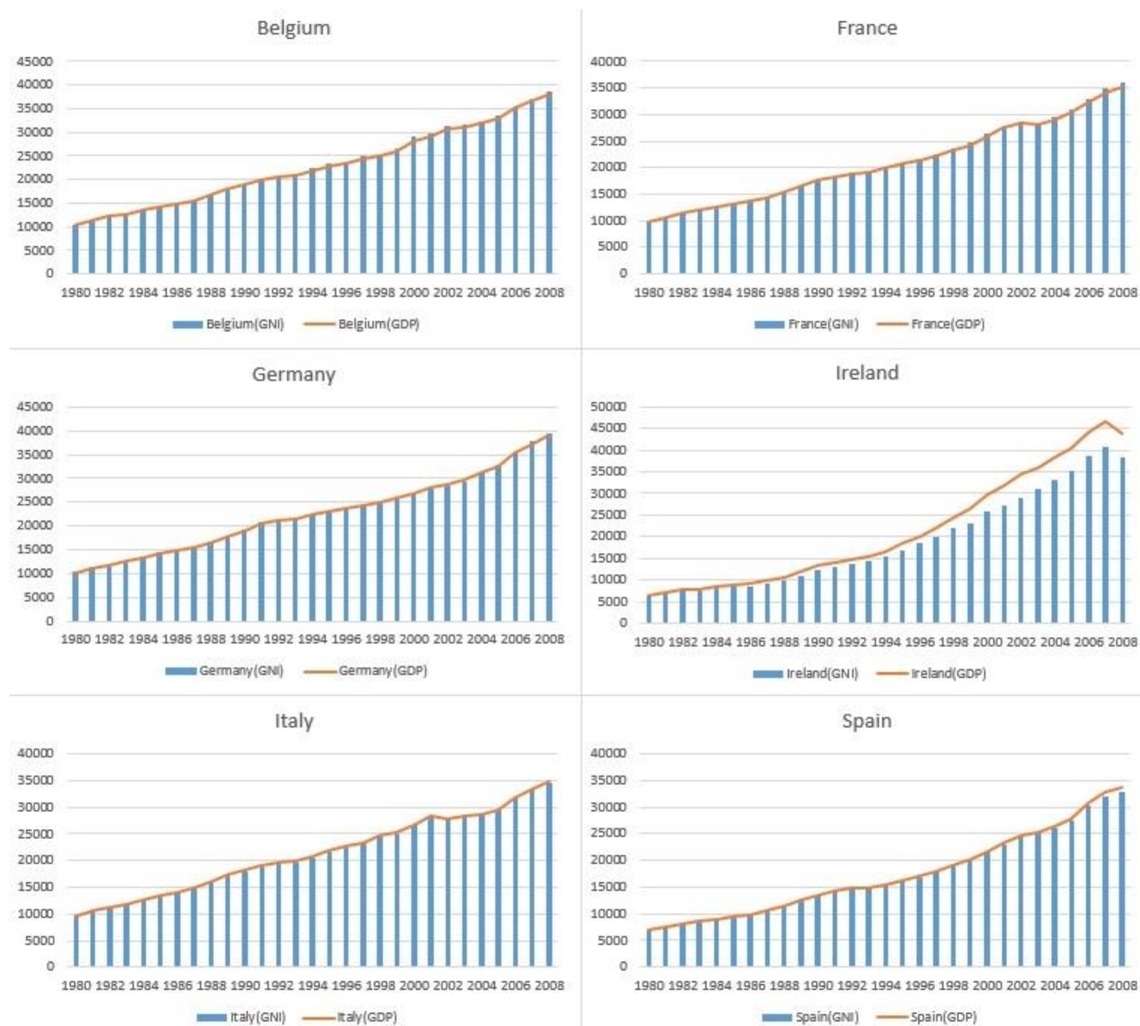
2.3 The Bubble

Nevertheless, foreign investment was both the motor and the inhibitor of the Irish boom. Closely related to the US entering recession, first assumptions about the fall of the *Celtic Tiger* appeared already in 2001.[37] A great comparison can be drawn using GDP[38] and GNI[39]. In a simplified way, GDP is the total value produced within a country while GNI represents the total value produced by all nationals, regardless of provenance. Figure 5 illustrates a comparison of selected Euro Area countries with Ireland. While in most developed economies the difference between GDP and GNI oscillates within several per cent, significant imbalances can be seen in the Irish case. The GDP-to-GNI spread started to show after the mid-1980s, and further expanded especially in the 2000s, illustrating the

[36] "Average Annual Wages," Official Site of OECD Stats, accessed 2 March, 2016, https://stats.oecd.org/Index.aspx?DataSetCode=AV_AN_WAGE#.
[37] Coulter and Coleman, "The end of Irish history? Critical reflections on the Celtic Tiger," 34.
[38] Gross domestic product is the standard measure of the value of final goods and services produced by a country during a period minus the value of imports (*OECD Data, accessed 5 March, 2016, https://data.oecd.org/gdp/gross-domestic-product-gdp.htm*)
[39] Gross national income is the total value of the primary incomes receivable within an economy less the total of the primary incomes payable by resident units (*OECD Data, accessed 5 March, 2016, https://data.oecd.org/natincome/gross-national-income.htm*).

share of foreign MNCs on its boom.[40] This gave a seeming image of great domestic development, which was, to a large extent, channelled abroad.

Figure 5: Comparison of GDP and GNI in Selected EU Countries *(Total, US dollars/capita, 1980 - 2014)*



Source: Own elaborations based on OECD Data [41]

Along with the American slowdown, Ireland suffered from loss of competitiveness as a result of a reverse in tendency when wages started to grow faster than GDP. Consequently, Ireland accounted only for approximately 5% of FDI of the Eurozone in 2007, compared to almost 15% in 2001. Yet the growth did not decrease accordingly. It

[40] Coulter and Coleman, "The end of Irish history? Critical reflections on the Celtic Tiger," 40.
[41] "Gross National Income," Official Site of OECD Data, accessed 5 March, 2016, https://data.oecd.org/natincome/gross-national-income.htm.
"Domestic Product," Official Site of OECD Data, accessed 5 March, 2016, https://data.oecd.org/gdp/real-gdp-forecast.htm.

was replaced by the real estate bubble, generated by increased wages and a demand for housing and mortgage services.[42] The following chapter offers a detailed look at the capital boom, lending and borrowing exuberance, and the real estate bubble.

2.3.1 Main Factors of the Bubble

Increasing deregulation was accompanied by a sharp reduction in Irish interest rates following entry to the Euro Area, which generated higher credit accessibility. A false sense of sustainability of fast growing peripheral economies, often powered by credit and/or housing bubbles, as well as of stability of the financial markets, gave rise to an unquestioning trust in high return. Unwillingness to accept warning signs about an overheated economy and herd behaviour of both institutions and investors marked the bubble inflation.[43] Its main factors consisted of a dual negative lending spiral, lack of regulatory oversight, occurrence of a money supply bubble and irrational exuberance[44].

Dual Negative Spiral of the Irish Lending

Ireland experienced a dual negative spiral - risk and volume loops. Firstly, riskier loans helped to fuel the bubble, widening the demand for less safe investment which resulted in increased profit for the banks. Bankers received bonuses for such bold moves and were thus encouraged to take even higher risks in the future. The negative volume spiral was nourished by both the banks and developers. Under the illusion of the seemingly stable and solid performance of the Irish economy, real estate demand grew exponentially. The developers, newly enriched by unheard-of profits, decided to invest more and also to raise prices. As banks competed in best offers for mortgages, house purchases, sometimes the second or even third, became not only affordable but also desirable. The ease of property

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[42] Croke, "Chuaigh Ar La' - Debt of A Gaelsman: Ireland's Sovereign Debt Crisis, National and International Responses," 375.
[43] Commission of Investigation into the Banking Sector in Ireland, "Misjudging Risk: Causes of the Systemic Banking Crisis in Ireland," Report of the *Commission of Investigation into the Banking Sector in Ireland* (March 2011), i, http://www.bankinginquiry.gov.ie/Documents/Misjuding%20Risk%20-%20Causes%20of%20the%20Systemic%20Banking%20Crisis%20in%20Ireland.pdf.
[44] Irrational Exuberance is a term coined by former Chairman of the Federal Reserve of the United States (Fed) meaning unsustainable investor enthusiasm that drives asset prices up to levels that aren't supported by fundamentals. (*Investopedia, accessed 5 March, 2016, http://www.investopedia.com/terms/b/bubble-theory.asp*).

purchase beyond one's means, but with high expectation of return, raised the demand even higher.[45]

It was especially the *Anglo-Irish Bank* (Anglo), and to lesser extent the *Irish Nationwide Building Society* (INBS), which saw significant increases in profits by issuing large amounts of loans for doubtful ventures. In order to maintain competitiveness against them, other banking institutions had to follow their example and reduce their credit standards, too.[46] Once again, there were two opposite irrational behaviours - banks were lending too much and with blind trust in their clients' solvency, while debtors were borrowing money regardless of their repayment capacity. Such investments into the property market nurtured the credit boom via a self-reinforcing spiral of high prices - increased demand - even higher prices.[47] Anglo and INBS were repeatedly reprimanded for suspicious and risky governance but the imposition of a raise on minimum capital ratios proved to be insufficient in the end. Banks both complied every time to these rules and continued imprudent investment, swiftly followed by other institutions. [48]

Lack of Regulatory Oversight

This was endorsed not only by a very lax approach of the evaluators but paradoxically also by the authorities. The government disregarded warnings of the Department of Finance to the benefit of high growth rates, as none of previous economic slowdowns brought about a significant property crash. Such disregard was caused both by indifference and lobbying, as construction-related donors accounted for 40% of all donations to the leading party, *Fianna Fáil*, between 1997 and 2007.[49] To give an illustration, authorities decided to ignore Anglo's breaches of the 20% limit on annual growth rate; instead, Anglo grew by an astonishing average of 35% for twelve years up to the bust.[50]

[45] Chari, Raj, and Bernhagen, Patrick, "Financial and Economic Crisis: Explaining the Sunset over the Celtic Tiger," *Irish Political Studies* 26, No. 4 (2011): 482.
[46] Report of the Commission of Investigation into the Banking Sector in Ireland, "Misjudging Risk: Causes of the Systemic Banking Crisis in Ireland," ii.
[47] Ibid. iii.
[48] Ibid., v.
[49] Chari and Bernhagen, "Financial and Economic Crisis: Explaining the Sunset over the Celtic Tiger," 482.
[50] Ibid., 477.

Similarly, the Central Bank of Ireland (CBI), vested with significant powers, took no measures to advise against such steps or to consider interruption of FDI despite clear signs of overheating of the Irish economy already in 2005/06.[51] This situation didn't change, even after the creation of a new regulator, the IFSRA[52]. It has been established to break the "golden circle", as *O'Flynn, Monaghan and Power* call it, i.e. the elite circle of bankers, developers, and members of the government; graduates especially from the University College Dublin. However, as a mere continuation of the Central Bank's regulation, it has failed not only to do so, but also to provide necessary regulatory guidance, especially property loan reduction and a threshold on bankers' salaries.[53] Unfortunately, no international organisation provided any major criticism of the Irish authorities.[54]

Deregulation and Money Supply Bubble

In times of economic boom, deregulation steps are conventionally applied. Its excess, however, proved to be fatal in the end, as in the US. Most importantly, the 2.5 earnings mortgage rule was removed and the exorbitant optimism about potential growth pushed the mortgages to irrational levels. Ultimately, they were issued at up to 9 times salaries, making it impossible for the borrowers to repay in case of even slight shock.[55] The high economic growth in late 1980s incurred disruption of the traditional oligarchic structure of the Irish mortgage market with high requirements and interest rates. In the context of liberalization, newly entering associated banks provided the market with highly competitive offers of gradually more leveraged loans.[56]

Irish money supply (M3)[57] increased annually by around 20% before 2001 and even though it was attenuated in the first half of the 2000s, monumental levels of over 30%

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[51] Report of the Commission of Investigation into the Banking Sector in Ireland, "Misjudging Risk: Causes of the Systemic Banking Crisis in Ireland," vii.
[52] Irish Financial Services Regulatory Authority
[53] Chari and Bernhagen, "Financial and Economic Crisis: Explaining the Sunset over the Celtic Tiger," 480.
[54] Report of the Commission of Investigation into the Banking Sector in Ireland, "Misjudging Risk: Causes of the Systemic Banking Crisis in Ireland," viii.
[55] Colm Fitzgerald, "The debt crisis in Ireland," 355.
[56] Waldron and Redmond, "POLICY REVIEW: The Extent of the Mortgage Crisis in Ireland and Policy Responses," 155.
[57] M3 is the broadest measure of an economy's money supply. It includes coins and notes in circulation (M0 and M1 = narrow money), short-term time deposits in banks, and 24-hour money market funds (M2) plus longer-term time deposits and money market funds with more than 24-hour maturity (*Financial Times Lexicon, accessed 5 March, 2016, http://lexicon.ft.com/Term?term=m0,-m1,-m2,-m3,-m4*).

were reached in 2006 and 2007. In total, the overall M3 grew by 540% between 1996 and the beginning of the crisis.[58] By loosening the fractional reserve system**,** the banks were given a chance to create even more money. Not only was the banking sector thus more prone to minor shocks, being covered only by 2% of deposits instead of the previous 10%, but the prodigious increase in money supply raised real estate prices to unsustainable levels.[59] Despite the increase in annual wages, Ireland faced an incoming challenge of housing unaffordability.[60] By implication, the pre-crisis house prices of approximately 2-3 annual salaries rose to around 12 by the beginning of the crisis.[61]

Irrational Exuberance

Mortgage interest rates fell to historic lows and as a result, the ratio of mortgage debt to GDP mounted from 29% to 92% between 1999 and 2009.[62] The sector saw significant increases in all kinds of loans, including the likes of interest-only mortgages[63], making them affordable and favourable for everyone. What proves that the Irish predicament was not caused that much by toxic assets but by sheer irrational exuberance is the volume of the subprime market. While in the United States it accounted for 20% by the outbreak of the crisis,[64] in Ireland it was as low as 1.5%.[65] Nonetheless, riskier investment could have been spotted. An illustration can be given using the loan-to-value (LVT) ratio[66], where a higher ratio stands for increased risk of default. While average LVT ratios were 60% in

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[58] Colm Fitzgerald, "The debt crisis in Ireland," 354.
[59] Ibid., 354.
[60] Honohan, Patrick, "The Irish Banking Crisis: Regulatory and Financial Stability Policy 2003-8," A Report to the Minister for Finance by the Governor of the Central Bank, *Central Bank of Ireland* (May 2010), 24, https://www.centralbank.ie/press-area/speeches/Pages/IntroductorystatementbyGovernorPatrickHonohanatOireachtasBankingInquiry.aspx.
[61] Waldron and Redmond, "POLICY REVIEW: The Extent of the Mortgage Crisis in Ireland and Policy Responses," 151.
[62] Ibid., 151.
[63] A type of mortgage in which the mortgagor is only required to pay off the interest that arises from the principal that is borrowed (*Investopedia, accessed 5 March, 2016, http://www.investopedia.com/terms/i/interestonlymortgage.asp*).
[64] Joint Center for Housing Studies of Harvard University, "The State of the Nation's Housing 2008," The State of the Nation's Housing Report, *Graduate School of Design and Harvard Kennedy School* (2008), 2, http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/son2008.pdf.
[65] Waldron and Redmond, "POLICY REVIEW: The Extent of the Mortgage Crisis in Ireland and Policy Responses," 151.
[66] The loan-to-value ratio (LTV Ratio) is a lending risk assessment ratio that financial institutions and others lenders examine before approving a mortgage. Typically, assessments with high LTV ratios are generally seen as higher risk and, therefore, if the mortgage is accepted, the loan will generally cost the borrower more to borrow or he or she will need to purchase mortgage insurance (*Investopedia, accessed 8 May, 2016, http://www.investopedia.com/terms/l/loantovalue.asp*).

the mid-1990s, ten years later banks offered mortgages to first time buyers of LVT ratios of over 95%, ultimately even 100%.[67]

2.3.2 Rise of the Speculative Bubble

The 1986 *Urban Renewal Act* instigated significant growth in the construction sector through a series of tax incentives. Apart from high export, the economy began to be fuelled by the property boom. 762,541 housing units were constructed between 1991 and 2006, which pushed prices up by 300%-400%. Housing ownership started shifting to the hands of individuals and its share of government revenue grew from 5% in 1998 to 17% in 2006.[68] While high-tech lending accounted only for 2.5%, property lending rose spectacularly by 400%, from 7% in 2000 to 28% in 2007.[69] This was primarily fuelled by bank lending that increased fivefold between 1998 and 2007, 67% of which was used in the property sector.[70]

The real estate bubble was instigated by the government itself by mechanisms to bolster home ownership rather than renting.[71] Subsequently, both housing prices and new construction grew rapidly. The threshold of sustainable usable construction, estimated at 50,000-60,000 completions per year, was surpassed in 2001 and in 2006 it reached almost 100,000.[72] Figure 6 shows the spectacular increase of both house completions and housing prices, especially from the mid 1990s.

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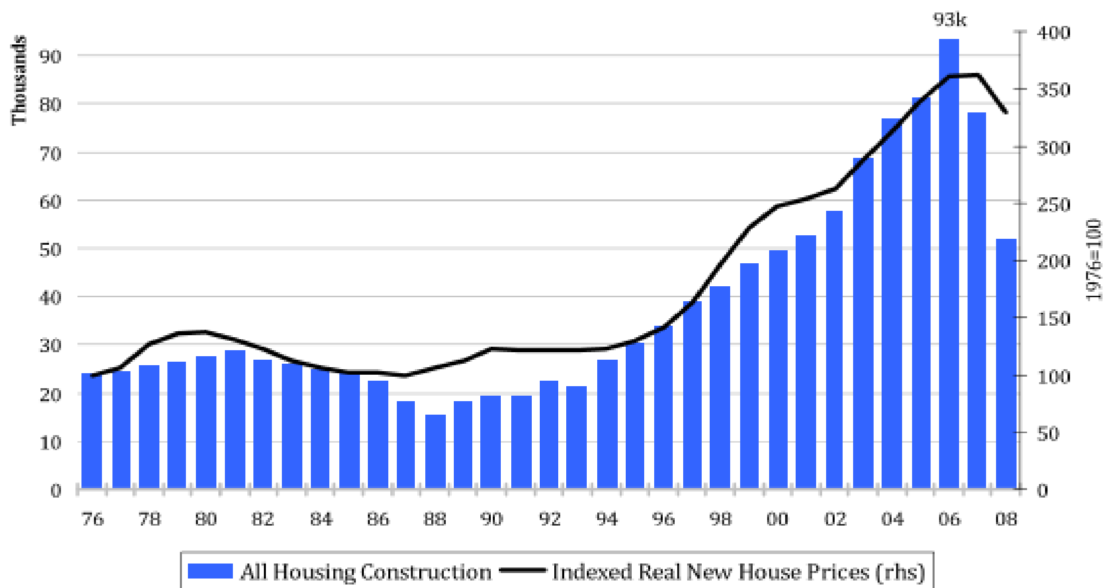
[67] Croke, "Chuaigh Ar La' - Debt of A Gaelsman: Ireland's Sovereign Debt Crisis, National and International Responses," 376.
[68] O'Callaghan, Kelly, Boyle, and Kitchin, "Topologies and topographies of Ireland's neoliberal crisis," 35.
[69] Ibid., 36.
[70] O'Flynn, Micheal, Monaghan, Lee F, and Power, Martin J, "Scapegoating during a Time of Crisis: A Critique of Post-Celtic Tiger Ireland," *Sociology* 48, No. 5 (2014): 926.
[71] Waldron and Redmond, "POLICY REVIEW: The Extent of the Mortgage Crisis in Ireland and Policy Responses," 152.
[72] Report of the Commission of Investigation into the Banking Sector in Ireland, "Misjudging Risk: Causes of the Systemic Banking Crisis in Ireland," 18.

Figure 6: House Completions and New House Prices in Ireland (Thousands, 1976-2008)

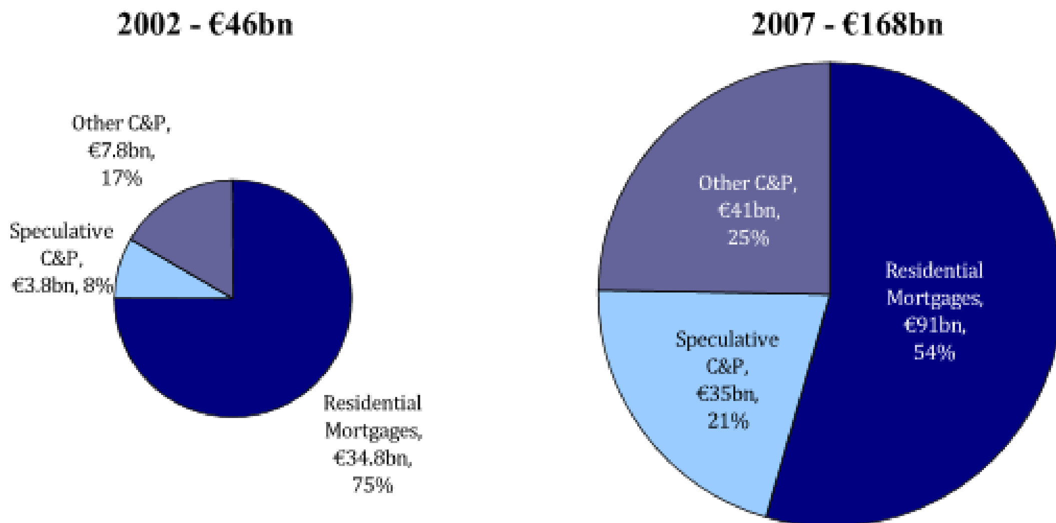


Source: Report of the Commission of Investigation into the Banking Sector in Ireland [73]

With rising prices, demand for additional funding grew as well. An increase in domestic lending to residents over deposits grew almost 5 times between 2002 and 2008.[74] Even though the number of residential mortgages more than doubled between 2002 and 2007, its share of aggregate domestic property lending decreased by more than 20%. As mentioned above, such a pace was unsustainable and well beyond demographic growth. As a consequence, thousands of newly constructed houses were left vacant every year. They were used for speculative lending, which experienced imposing growth of more than 900%, as illustrated by Figure 7. [75] While in 2002 its market share represented only 8%, five years later it increased to 21%, which reduced the share of mortgage lending from 75% to 54%.

[73] Ibid., 19.
[74] Ibid., 38.
[75] Ibid., 15.

*Figure 7: **Components of Domestic Property Lending to Irish Residents** by the Covered Banks (Change between 2002 and 2007)*



Source: Report of the Commission of Investigation into the Banking Sector in Ireland [76]

2.3.3 Macroeconomic Indicators during the Bubble

At the climax of the bubble, the Irish economy was in its best condition in history, or at least on paper. The AAA rating from all three major rating agencies, stable from 1998, respectively from 2002 at Standard & Poor's, was backed by all principal macroeconomic indicators. Ireland succeeded in reducing the government debt-to-GDP ratio from the highest in the European Communities at 107% in 1987 to only 27% in 2007, the third lowest level in the EU.[77] This resulted from high GDP growth rates and budgetary discipline. Ireland was one of only six pre-2004 admission countries, along with Luxembourg, Belgium, Finland, Denmark and Spain, with no breaches to the Stability and Growth Pact criteria since it entered into force on 1st July 1998. This is in comparison to the biggest leaders of the EU, Germany, France or the United Kingdom (see figure 8). Moreover, if we exclude the "satisfactory pace" formula[78], only Ireland, Finland and

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[76] Report of the Commission of Investigation into the Banking Sector in Ireland, "Misjudging Risk: Causes of the Systemic Banking Crisis in Ireland," 19.
[77] "Central Government Debt," Official Site of OECD Stats, accessed 14 March, 2016, https://stats.oecd.org/index.aspx?queryid=8089#.
"General Government Debt," Official Site of OECD Data, accessed 14 March, 2016, https://data.oecd.org/gga/general-government-debt.htm.
[78] A reduction of the gap between a country's debt ratio and the 60% of GDP reference value annually on average over three years (*European Commission, accessed 8 May, 2016, http://europa.eu/rapid/press-release_MEMO-12-385_en.htm*).

Luxembourg were able to achieve full compliance (see the far right column of figure 8). Ireland even managed to reach annual surpluses from 1997 to 2007, with a slight exception of marginal -0.32% in 2002.[79] Subsequently, per capita income rose to one of the highest levels in Europe at €43,500, average growth was 5.6% in 2000-2007, and the markets reflected the country's discipline with a 4.5% interest rate on government bonds.[80]

***Figure 8: Breaches to the SGP Criteria of EU-15 Countries** (1998 - 2007)*

	General government deficit	General government debt	Compliance	Debt excluding "satisfactory pace"	Compliance
Austria	2004	1998 - 2002; 2004 -	×	1998 -	×
Belgium			✓	1998 -	×
Denmark			✓	1998 - 2000	×
Finland			✓		✓
France	2002 - 2005	1998; 2002 - 2005	×	1998 -	×
Germany	2001 - 2005	1998 ; 2002 - 2005	×	1998; 2002 -	×
Greece	1998 -	1998 -	×	1998 -	×
Ireland			✓		✓
Italy	1998; 2001 - 2006		×	1998 -	×
Luxembourg			✓		✓
Netherlands	2003		×	1998 - 2000	×
Portugal	1998 - 2007	2001 -	×	1998 -	×
Spain			✓	1998 - 2001	×
Sweden		2001 - 2002; 2005	×	1998 - 2005	×
United Kingdom	2004 - 2005		×	1998 - 2005	×

Source: Own elaborations based on OECD Data [81]

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[79] "General Government Debt," Official Site of OECD Data, accessed 14 March, 2016, https://data.oecd.org/gga/general-government-debt.htm.

[80] Gärtner, Manfred, Griesbach, Björn, and Mennillo, Giulia, "The Near-Death Experience of the Celtic Tiger: A Model-Driven Narrative from the European Sovereign Debt Crisis," *Intereconomics* (2013): 360.

[81] "General Government Deficit," Official Site of OECD Data, accessed 14 March, 2016, https://data.oecd.org/gga/general-government-deficit.htm.
"General Government Debt," Official Site of OECD Data, accessed 14 March, 2016, https://data.oecd.org/gga/general-government-debt.htm.

2.4 Bust and its Impacts

Ireland experienced the first effects of the crisis in 2008, when its GDP contracted by 3% and its unemployment rose from 4.6% to 6.1%. Even though Ireland officially entered into recession in September 2008, as the first Euro Area country, it still enjoyed a merciful approach by the financial markets. Owing to the fall of German bond yields in 2007, Ireland was able to borrow at only 4.3% even after in September 2008, as compared to 4.5% the previous year.[82] On the other hand, foreign investors were much less lenient and regarded the Irish bank shares with suspicion already in 2007, as the economy heavily exposed to property sector bore strong marks of a bubble.[83]

2.4.1 Burst of the Bubble

When the situation deteriorated, the interruption of FDI was primarily detrimental to the construction sector. As property prices plummeted precipitously by 90% by 2010, the construction sector contracted by 58% by 2011 when the domestic demand for housing was hindered by an already disastrous situation. One eighth of households were in the longest arrears bracket (90 days+), and Ireland was left with tremendous amount of "ghost estates".[84] [85] The most severe impact could be observed in traditionally rural areas with a significant house construction boom following the governmental tax incentive scheme, as, for example, counties in Upper Shannon, which experienced a 50% increase between 2002 and 2009. To give an illustration, in Longford, one of the rural counties, 11.7% of the workforce was employed in construction. However, this number fell by more than 60% after the crisis and the county found itself with a grievous unemployment rate of almost 25%.[86] The fall was particularly painful for domestic banks. For example, Anglo

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[82] Gärtner, Griesbach, and Mennillo, "The Near-Death Experience of the Celtic Tiger: A Model-Driven Narrative from the European Sovereign Debt Crisis," 361.
[83] Chari and Bernhagen, "Financial and Economic Crisis: Explaining the Sunset over the Celtic Tiger," 477.
[84] O'Callaghan, Kelly, Boyle, and Kitchin, "Topologies and topographies of Ireland's neoliberal crisis," 38.
[85] Department of the Environment, Community and Local Government, "Quarterly House Prices Bulletin: Quarter 2 2010," *Department of the Environment, Community and Local Government* (November 2010), 1, http://www.environ.ie/sites/default/files/migrated-files/en/Publications/StatisticsandRegularPublications/HousingStatistics/FileDownLoad%2C25191%2Cen.pdf.
[86] O'Callaghan, Kelly, Boyle, and Kitchin, "Topologies and topographies of Ireland's neoliberal crisis," 39.

directed over 70% of its loans to construction and as a result, its shares fell to 1% of their value in May 2008 over 18 months.[87]

2.4.2 Macroeconomic Consequences of the Bust

The situation started to change rapidly with the exacerbation of Irish fundamentals, following the government guarantee for all bank deposits on 30th September 2008. The fundamentals concerned were primarily increased deficit, up to 6%, and an almost doubled debt ratio, which increased from 28.75% to 49.6%.[88] In total, the year of 2008 was marked by the weakest performance of the Irish economy in more than 25 years.[89] While Brian Lenihan, the then Minister of Finance, branded the guarantee scheme as *"the cheapest bailout in the world so far"*, repercussions of such measures weighed heavy on Irish economy henceforth. In the end, €64bn was needed to stabilize the banking system, bringing the country to the verge of collapse.[90]

Deterioration of GDP Performance and of Public Finances

The fall between 2007 and 2008 was sharp. From high GDP growth, Ireland experienced a fall of over -7 p.a. In 2009, it fell further by -5.5%, leaving serious consequences for the state of its public finances.[91] The government balance deteriorated precipitously from a surplus in 2006 to -32.3% in 2010, as a result of the poor performance of the economy in 2009 and worsening of the expenditure-to-revenue ratio.[92] In merely 4 years, Ireland lost all fruits from its two virtuous decades. The debt, successfully reduced to approximately 20% before the crisis, stood at 117.6% in 2011 after additional foreign borrowing to cover spending exceeding tax collection.[93]

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[87] Croke, "Chuaigh Ar La' - Debt of A Gaelsman: Ireland's Sovereign Debt Crisis, National and International Responses," 377.
[88] Gärtner, Griesbach, and Mennillo, "The Near-Death Experience of the Celtic Tiger: A Model-Driven Narrative from the European Sovereign Debt Crisis," 361.
[89] Robbins, Geraldine, and Lapsley, Irvine, "The success story of the Eurozone crisis? Ireland's austerity measures," *Public Money & Management* 34, No. 2 (2014): 91.
[90] O'Callaghan, Kelly, Boyle, and Kitchin, "Topologies and topographies of Ireland's neoliberal crisis," 38.
[91] "Real GDP Forecast," Official Site of OECD Data, https://data.oecd.org/gdp/real-gdp-forecast.htm
[92] "General Government Deficit," Official Site of OECD Data, accessed 15 March, 2016, https://data.oecd.org/gga/general-government-deficit.htm.
[93] Robbins and Lapsley, "The success story of the Eurozone crisis? Ireland's austerity measures," 93.

In total, the three years with negatives deficits left significant marks upon the remnants of the *Celtic Tiger*. The once virtuous public debt ratio surpassed the Maastricht 60% in 2009, and the following year the feared *Reinhard and Rugoff's* 90%[94]. The ratio stood at 123.7% in 2013, when Ireland officially exited the bailout programme.[95] The market reaction was embodied in an increase in government bond yields from a little over 4% in 2010 to almost 12% in summer 2011.[96]

Tax Collection and Impact on Government Revenue

Two aggravation mechanisms were experienced in particular: a €2.9bn increase in social welfare expense and a €6.4bn decrease in tax revenue. Concerning the latter, Ireland suffered notably the consequences of economy-stimulating measures taken in the wake of boom days. The most flagrant example was the shift from income-based taxes to asset-based taxes, which are not levied on property but stamped to purchase.[97] The focus was also put on sources depending on the economic cycle, as, for example, corporate tax or stamp duties, as opposed to traditionally reliable sources, like income tax or excise duties. While cyclical taxes accounted for 8% in the late 1980s, they rose to more than 30% in 2006.[98] In times of economic downturn, cyclical taxes decrease significantly more than non-cyclical; and as the property market collapsed, the country was left with minimal revenue from asset-based taxes.

As construction and banking were major sources of tax revenues, the government experienced a loss of 11-12% between 2009 and 2010 alone.[99] The reverse side of the low-tax burden coin was that since the second phase of *Celtic Tiger* and the related slowdown, Irish public expenditure growth surpassed the GDP growth. In 2007, social

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[94] Reinhard and Rogoff argue that when the level of public debt-to-GDP ratio exceeds 90%, the economic growth starts to decline sharply (*Investopedia, accessed 8 May, 2016, http://www.investopedia.com/terms/d/deficit.asp*).
[95] "General Government Gross Debt," Official Site of Eurostat, accessed 14 March, 2016, http://ec.europa.eu/eurostat/fr/web/government-finance-statistics/statistics-illustrated
[96] "Government Bond Yields: Ireland 1985-2016," Official Site of Trading Economics, accessed 14 March, 2016, http://www.tradingeconomics.com/ireland/government-bond-yield.
[97] Gärtner, Griesbach, and Mennillo, "The Near-Death Experience of the Celtic Tiger: A Model-Driven Narrative from the European Sovereign Debt Crisis," 361.
[98] Croke, "Chuaigh Ar La' - Debt of A Gaelsman: Ireland's Sovereign Debt Crisis, National and International Responses," 374.
[99] Waldron and Redmond, "POLICY REVIEW: The Extent of the Mortgage Crisis in Ireland and Policy Responses," 152.

welfare spending rose by €973 million, including redoubling of the mortgage interest rate deduction, while taxes were cut by €501 million.[100]

Irish Ratings

Because of the economy's performance in 2007, even a 1.4 notch downgrade in its sovereign debt rating by all rating agencies did not result in a loss of the AAA rating. This changed with the spread of the crisis in 2009. Quasi-doubling of the unemployment rate, from 6.1% to 11.8%, resulted in further decreasing tax revenue, pushing the debt-to-GDP ratio up. Subsequently, all rating agencies downgraded the Irish rating in 2009.[101]

The rescue of the banking sector left the most visible marks on the 2010 report. It was mostly the injection that, along with a slight contraction of growth (-0.4%) and increase in unemployment (+2%), resulted in a deficit surge of more than 30%. Subsequently, rating agencies further downgraded the Irish rating to BBB+ according to Fitch, while the theoretical prognoses bore estimates of about six notches higher - AA+. This overreacting nature of the financial markets therefore made the interest rates climb much higher than was presumed, up to 9.1%.[102]

Impacts on Population

The almost non-existent unemployment in 2007 rose to over 14% between 2009 and 2013. Subsequently, chronic emigration returned to the country and interrupted the period of very high inflow, peaking at 151,100 in 2007 (over +100,000 net migration). The much-acclaimed influx was lost and the net migration rate remained negative from 2010 on, at -27,000 and a further rise in 2012. More than a half of the emigrants were non-Irish residents, primarily economic migrants from Eastern Europe (Poles, Lithuanians and Latvians), and to a lesser extent from Africa (Nigerians above all).[103] Around 75,000 people were leaving the country annually from the beginning of the crisis, while immigration fell to levels three times lower than in 2007 (see figure 9). Most importantly,

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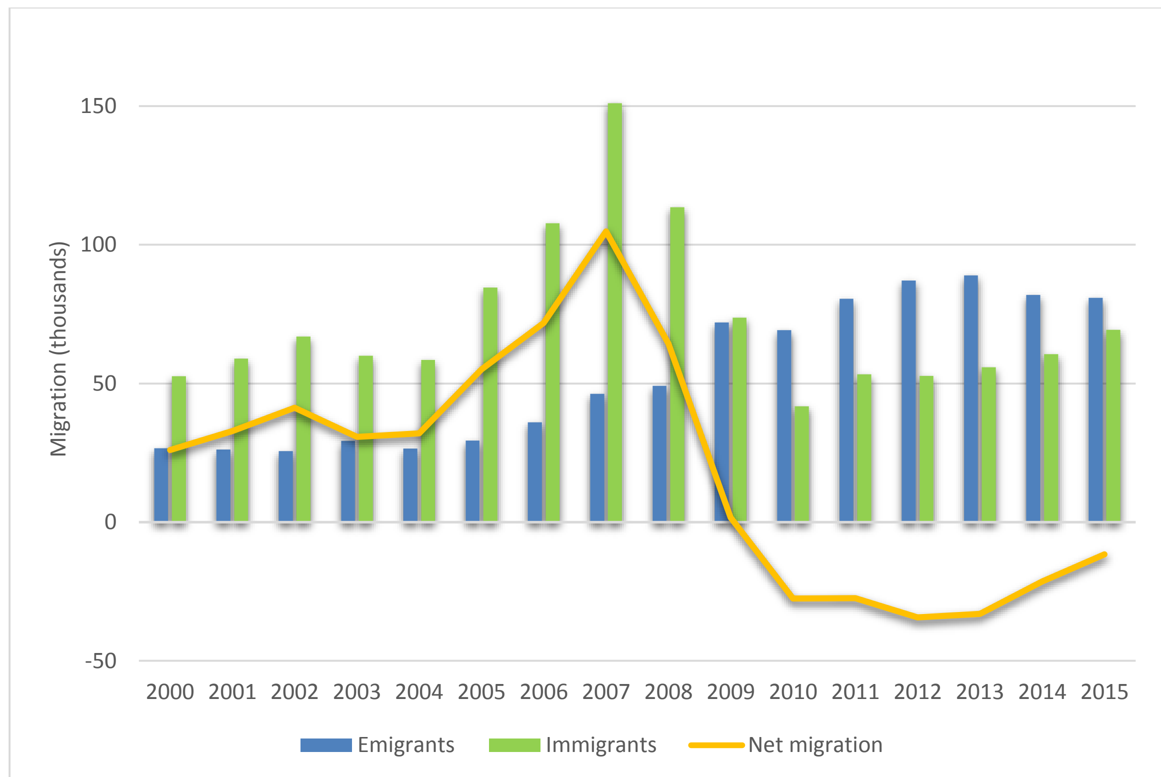
[100] Croke, "Chuaigh Ar La' - Debt of A Gaelsman: Ireland's Sovereign Debt Crisis, National and International Responses," 374.
[101] Gärtner, Griesbach, and Mennillo, "The Near-Death Experience of the Celtic Tiger: A Model-Driven Narrative from the European Sovereign Debt Crisis," 362.
[102] Ibid. 363.
[103] Robbins and Lapsley, "The success story of the Eurozone crisis? Ireland's austerity measures," 93.

an estimated half of the emigrants were young, educated people under 24, spelling grave consequences for the future of Ireland.[104] Likewise, approximately 230,000 houses were left vacant, creating a new phenomenon: the so-called ghost estates. While at its peak in 2009, Ireland constructed over 90,000 housing units per annum, in 2010 it was only a little over 14,000.[105]

Figure 9: Migration Flows in Ireland *(Thousands, 2000 - 2015)*



Source: Own elaborations based on European Migration Network Data [106]

The Irish case bears, however, an important specificity as compared to other, primarily peripheral countries most affected by the crisis. While a wave of antipathy against senior bankers and developers could have been spotted, the society was ready to accept its share of blame for the irresponsible market inflation to which it contributed. Be it based on the Irish culture, on lack of alternative, or even on fear that protests could make situation even

[104] Croke, "Chuaigh Ar La' - Debt of A Gaelsman: Ireland's Sovereign Debt Crisis, National and International Responses," 379.
[105] Department of the Environment, Community and Local Government, "Quarterly House Prices Bulletin: Quarter 2 2010," 2.
[106] "Population and Migration Estimates: Immigration, Emigration and Net Migration in Ireland, 2000-2015," Official Site of European Migration Network, accessed 15 March, 2016, http://emNo.ie/emn/statistics.

worse; Ireland, unlike Greece or Spain, experienced no major act of civil unrest.[107] This narrative was fed, of course, by the political elite, that used it as a relief from pressure. Brian Lenihan, the then Minister of Finance, reminded the nation that *"we decided as a people, collectively, to have this property boom"* and this [108] While senior bankers, social welfare benefiters or even the unions were all blamed for the situation at a point, "democratized discourse" remained the prevailing narrative.[109]

[107] Chari and Bernhagen, "Financial and Economic Crisis: Explaining the Sunset over the Celtic Tiger," 484.
[108] O'Flynn, Monaghan, and Power, "Scapegoating during a Time of Crisis: A Critique of Post-Celtic Tiger Ireland," 926.
[109] Ibid., 928.

3 Spain

After the climax of its power between the beginning of the 16th and mid-17th century, Spanish importance in the world started to decline. The country was ravaged by a train of wars following the death of the last Habsburg ruler and was unable to adapt to the new era of liberalized, industry-based trading. These aspects contributed to the fact that the once-feared superpower was considered a poor and underperforming country throughout the 20th century. However, the fall of the dictatorship brought about significant changes. Much like Ireland, the Spanish economy experienced impressive levels of GDP growth from the mid-1990s up to the crisis. Analogously to the Irish *Celtic Tiger*, it became known as the "Spanish Economic Miracle".[110]

However, the Spanish growth was not homogenous either. In contradistinction to the Irish, solely-economic liberalization, it also had to undergo political transition. Thereafter, their development was similar. The high growth rates propelled by FDI were replaced after the Dot-com crisis[111] by a property bubble of a historic magnitude. The evolution of the *Spanish Economic Miracle* up to the unsustainable inflation of the bubble is explained in the following chapter.

3.1 Origins of the *Spanish Economic Miracle*

The period of undeveloped economy came to an end with a shift towards capitalism in the 1960s that triggered the first wave of industrialization. From 1960 to the fall of the dictatorship in 1973, Spain was the second fastest (steadily) growing economy after Japan, and it became one of the ten biggest economies in the world.[112] The 1959 *Liberalisation and Stabilisation Plan* (PSL) was a major step towards sustainable economic growth, which provided necessary framework for the following economic reforms. Thereafter, Spain managed to keep inflation under 10% for more than a decade, an achievement unseen from the end of the civil war in 1936.[113] The period was

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[110] Etxezarreta, Navarro, Ribera, and Soldevila, "Boom and (deep) crisis in the Spanish economy: the role of the EU in its evolution," 2.
[111] Dot-com crisis followerd a speculative bubble in late 1990s concerning Internet sector and related technologies
[112] Encarnación, Omar G., "Spain after Franco: Lessons in Democratization," *World Policy Journal* 18, No. 4 (Winter, 2001/2002): 37.
[113] Prados de la Escosura, Leandro, Rosés, Joan R., and Sanz-Villarroya, Isabel, "Economic reforms and growth in Franco's Spain," *Revista de Historia Económica* 30, No. 01 (March 2012): 51.

characterized by average growth of 5.9% per capita up to the end of *Francoism*[114], while simultaneously experiencing significant labour productivity improvements (+6.4%).[115]

The economic growth rendered Spanish political institutions obsolete, which further hastened transition towards democracy under the programme of *continuismo* following Franco's death. Its success ultimately opened doors to the European Communities.[116] Membership was conditioned on liquidation of monopolies and liberalisation of the market, which resulted in gargantuan capital inflow and therefore worsening of the trade balance.[117] Nonetheless, Spain was able to benefit substantially from the full integration into the Common Market, thanks to its competitive export based on low wages and prices. Hence, Spain enjoyed high but unstable growth rates from the 1970s, owing not only to its labour cost but also to successfully developing industry, especially food and car manufacturing.[118]

3.2 First Phase of the *Spanish Economic Miracle*

After the emergence of Asian countries and primarily after the opening of Eastern European economies in the early 1990s, Spain underwent restructuring of industry, especially of manufacturing, construction and services, and also experienced major increases in tourism. A train of devaluations in 1992-94 instigated an unseen pace of recovery from the economic slowdown. In 1995, the primary balance reached a surplus, investment increased by 8.5%, and inflation, as low as 2.5%, reached its best condition in 28 years.[119] Owing to the four devaluations, Spain regained its competitiveness, boosting investment, exports and domestic demand. As compared to the three years of decline, industrial production rose by 7.3% and continued to grow further.[120] Figure 10 shows the evolution of value of the Spanish Peseta between 1994 and 1999, documenting effects of

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[114] Francoism is referring to the Spanish state under the dictatorship of General Franco, between the end of civil war in 1939 to his death in 1975.
[115] Prados de la Escosura, Rosés and Sanz-Villarroya, "Economic reforms and growth in Franco's Spain," 45.
[116] Encarnación, "Spain after Franco: Lessons in Democratization," 38.
[117] Cardesín Díaz, José María, and Araujo, Jesús Mirás, "Historic Urbanization Process in Spain (1746-2013): From the Fall of the American Empire to the Real Estate Bubble," *Journal of Urban History* (2015): 11.
[118] Etxezarreta, Navarro, Ribera, and Soldevila, "Boom and (deep) crisis in the Spanish economy: the role of the EU in its evolution," 3.
[119] Scobie, H. M., *The Spanish Economy in the 1990s* (London: Routledge, 1998), 10.
[120] Scobie, *The Spanish Economy in the 1990s*, 16.

devaluation up to early 1995 and a successive, sharp appreciation in 1997, as the Spanish economy started to regain its pace.

Figure 10: Peseta Exchange Rate *(Noon Buying Rates, 1994 - 1999)*

Source: Own elaborations based on NY Fed data [121]

3.2.1 Deregulation and Rise of Big Industries

In 1984, Spain entered a long period of shift towards deregulation and neo-liberalism. In its pursuance, it privatized most of the public companies held in state's hands under Franco's regime. Because it was able to achieve democratic transition before implementation of economic reforms, the deregulation happened in a gradual and orderly manner.[122] The size of these once monopolistic/oligopolistic enterprises gave them an unshakeable position on the market and promised bright prospects for the future. Ultimately, the new era of Spanish economic power was represented by strong, globally important companies generating billions of euros in annual profits. These new global players succeeded in various sectors, including telecommunications (*Telefónica*), banking (*BBVA* or *Banco Santader*), petroleum (*Repsol*), construction (*Sacyr*), civil engineering (*Ferrovial*) or fashion (*Zara* and *Mango*).

[121] "Foreign Exchange Rates," Official Site of Federal Reserve Bank of New York, accessed 8 April, 2016, https://apps.newyorkfed.org/markets/autorates/fxrates/external/home.
[122] Encarnación, "Spain after Franco: Lessons in Democratization," 41.

The dark side of such a trend was, however, the outflow of investment, as these companies focused on expansion in other regions, primarily Latin America.[123] Even thought they helped considerably in improving the reputation of Spanish business, the economy suffered from low productivity and the inability to adapt to modern, advanced technology manufacturing. Several of its firms managed to succeed in the international markets, but their numbers were scarce and the domestic market was dominated by foreign MNCs, leaving traditional small businesses exposed to a constant peril of bankruptcy.[124]

3.2.2 Structural changes

Spain underwent economic restructuring to allure more investment, primarily at the expense of traditional sectors such as agriculture and fishing. To a limited extent, Spain also managed to target highly competitive industry; for illustration, it became the third largest European producer of cars and the fifth largest in the world.[125] Tourism, another major sector of the Spanish economy, went through revitalization after the mid-1980s decline. In the mid-1990s, Spain enjoyed a record numbers of visitors, owing to a number of factors, including improved quality of facilities, use of EU Structural and Cohesion Funds in infrastructure, a re-elaborated publicity strategy, currency devaluation, and instability in other major destinations, primarily in former Yugoslavia, Algeria and Turkey. Hosting two global events in 1992, the Summer Olympics in Barcelona and Expo'92 in Seville, also helped significantly the Spanish cause.[126]

3.2.3 Underlying Deficiencies of the Spanish Economic Miracle

Unlike Ireland, Spain did not manage to reach necessary convergence levels. Although the gap was quickly narrowing leading up to the introduction of euro, the trend was only initiated in the mid 1990s. Still, in 1995, government bond yields were above 12% (as opposed to the Irish of less than 8%) and the changeover towards the replacement of the

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[123] Etxezarreta, Navarro, Ribera, and Soldevila, "Boom and (deep) crisis in the Spanish economy: the role of the EU in its evolution," 14.
[124] Ibid., 15.
[125] Scobie, *The Spanish Economy in the 1990s*, 15.
[126] Ibid., 18.

peseta was therefore very sharp (see figure 11).[127] Despite the improvements, Spain had a high inflation rate of 5% as well as other peripheral countries (as compared to the Irish 1-2%).[128] The situation was further exacerbated by different economic cycles of the core and of the periphery, whose boom, often propelled by real estate and mortgage bubbles, was subject to the economic slowdown in core countries. The spread of shocks caused by insufficient convergence had important consequences, notably for the Spanish trade balance. According to the estimates, they accounted for approximately -2.3% worsening of the national trade balance between the late 1990s and the beginning of the crisis.[129] With the introduction of the euro, Spain could no longer count on depreciation as means to boost competitiveness; however, such sacrifice was made to obtain globally used stable currency and low interest rates.[130]

***Figure 11: Government Bond Yields of Spain** (10Y, 1991 - 2016)*

Source: Trading economics [131]

[127] "Spain Government Bond 10Y," Official Site of Trading economics, accessed 19 March, 2016, http://www.tradingeconomics.com/spain/government-bond-yield.
[128] "Ireland Inflation Rate," Official Site of Trading economics, accessed 19 March, 2016, http://www.tradingeconomics.com/ireland/inflation-cpi.
"Spain Inflation Rate," Official Site of Trading economics, accessed 19 March, 2016, http://www.tradingeconomics.com/spain/inflation-cpi.
[129] in 't Veld, Jan, Kollmann, Robert, Pataracchia, Beatrice, Ratto, Marco, and Roeger, Werner, "International capital flows and the boom-bust cycle in Spain," *Journal of International Money and Finance* 48 (2014): 331.
[130] Etxezarreta, Navarro, Ribera, and Soldevila, "Boom and (deep) crisis in the Spanish economy: the role of the EU in its evolution," 4.
[131] "Spain Government Bond 10Y," Official Site of Trading economics, accessed 19 March, 2016, http://www.tradingeconomics.com/spain/government-bond-yield.

The economies of peripheral countries suffered greatly during the economic slowdown in the early 1990s. The FDI outflow was blatant and the periphery was forced to find other means of growth than the former low-wages competitiveness model. One solution was to focus on sophisticated manufacturing. That was the path chosen by Ireland, whose strong exports enabled it to have high levels of FDI, while maintaining a significantly better trade balance. Nonetheless, Spain was not able to attract major investment in high-tech sectors and instead, it became a net importer of goods and services and consequently experienced continuous falls in balance of payments. Because of the size of its economy, Spain became the biggest importer of capital in the Euro Area.[132] This was the beginning of external imbalances of the Spanish economy (see figure 3 in section 1.3).

3.3 The Bubble

Similar to Ireland, the Spanish economy was given as example for successful liberalization and a stunning pace of growth. The country achieved the lowest level of unemployment since the fall of Franco's dictatorship and attracted over 4 million immigrants in ten years. Spanish corporations became global players, such as *Banco Santader*, *Telefónica* or *Ferrovial*, and Spain was at the doors of the G8 while the predictions estimated it overcoming the French economy in the nearest future.[133] Nonetheless, a major role in this boom was played by the housing bubble that emerged especially at the beginning of the new millennium. In merely a decade before the crisis, land prices increased by 500% and the IMF branded the Spanish situation as the largest real estate bubble in the developed world (2010 Q4).[134]

3.3.1 Main Factors of the Bubble

The Spanish housing bubble started to inflate in the early 2000s, owing to a plenitude of free liquidity and very low interest rates after the introduction of euro. It was in the context of a globally booming construction sector, which doubled in the balance sheets after the Dot-com bubble bust. Even if some European countries did not experience increases that

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[132] Etxezarreta, Navarro, Ribera, and Soldevila, "Boom and (deep) crisis in the Spanish economy: the role of the EU in its evolution," 5.
[133] Ibid., 5.
[134] Quaglia, Lucia and Royo, Sebastián, "Banks and the political economy of the sovereign debt crisis in Italy and Spain," *Review of International Political Economy* 22. No. 3 (2015): 498.

high, particularly Germany or Belgium, its investors still engaged in the bubble elsewhere, for example in Spain. *Etxezarreta, Navarro, Ribera and Soldevila* distinguish several factors contributing to the spectacular growth in Spanish real estate.

Firstly, Spain could benefit from *increased availability of cheap foreign credit*. Apart from individuals and families who enjoyed the extremely low interest rates, it was the Spanish developers who, unlike in the US, accounted for almost 50% of all issued mortgages that they used for risky ventures leveraged up to 80%.[135] Spain also had at its disposal free domestic credit that was not used in manufacturing because of *lack of profitability and low productivity*, given the fact that the growth was not fuelled by improvements in manufacturing processes but rather correlated with employment evolution.[136] Thirdly, a *large building industry* was inherited from *Francoism* and subsequently, there were 5 Spanish firms among the 50 largest construction companies in the world. Moreover, the real estate boom was boosted by *deregulation and position of authorities* when municipalities supported the process on the newly liberalized land, as construction permits represented major source of revenue.[137] Ultimately, it was the socio-demographic aspect. The *Spanish people were covetous for better living* and demand was also increased by a large number of immigrants as well as summer houses of wealthy Europeans.[138] *López and Rodríguez* add another aspect - the *amelioration of public infrastructure*. Owing to the Cohesion funds of the European Union, Spain achieved the largest network of motorways and high-speed railways in Europe. Subsequently, a substantial real estate boom could thereafter occur also in distant regions lacking proper connection.[139]

As mentioned above, the bubble was fuelled by demographic surplus. The immigration rate rose from 1.4% in 1994 to 7% in a decade, which represented an increase of over 2.5 million.[140] They could enjoy 1.8 million jobs newly created by 2004, while that year Spain

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[135] Etxezarreta, Navarro, Ribera, and Soldevila, "Boom and (deep) crisis in the Spanish economy: the role of the EU in its evolution," 12.
[136] Muñoz de Bustillo Llorente, Rafael and Pérez, José-Ignacio Antón, "Low Wage Work in a High Employment Growth Economy: Spain, 1994-2004," *Investigación Económica* 66, No. 261 (July-September 2007): 125.
[137] Benito, Bernardino, Vicente, Cristina, and Bastida, Francisco, "The Impact of the Housing Bubble on the Growth of Municipal Debt: Evidence from Spain," *Local Government Studies* 41, No. 6 (2015): 998.
[138] Etxezarreta, Navarro, Ribera, and Soldevila, "Boom and (deep) crisis in the Spanish economy: the role of the EU in its evolution," 12.
[139] Díaz and Araujo, "Historic Urbanization Process in Spain (1746-2013): From the Fall of the American Empire to the Real Estate Bubble," 13.
[140] Muñoz de Bustillo Llorente and Pérez, "Low Wage Work in a High Employment Growth Economy: Spain, 1994-2004," 125.

accounted for 60% of all jobs created in Europe.[141] Immigration of unskilled workers both instigated and was instigated by the growth of undemanding labour-intensive sectors, such as construction. The average annual growth of foreign employment exceeded Spanish employment growth almost a dozen fold between 1996 and 2006 (+33.1% and 2.8% respectively), which corresponded to increases in the foreign and domestic population. Consequently, foreign labour accounted for 40% of GDP increase between 2001 and 2006.[142] Immigrants arriving in Spain often received welcome mortgages, but because of their very low position at the labour market, this resulted in growth of the subprime market and also increased domestic demand.[143]

Apart from demographics, the bubble may be explained also as a speculative bubble. There was a 200,000 dwellings surplus on average in 2001-07 between the construction (500,000) and increased households (300,000). These houses were used either as a second residence, which was a rather minor occurrence, or for speculation and safe investment. After the Dot-com bubble, steadily growing housing prices seemed to be a very convenient venture.[144] A noticeable contribution to the bubble was the Spanish black market. Illegal groups used the property sector as an inconspicuous way to hide money. It even intensified after the introduction of euro in 2002 that induced large volumes of counterfeit money, subsequently laundered in housing.[145]

3.3.2 Political and Administrative Framework of the Bubble

Both the authorities and the market created very a propitious environment for the emergence of the bubble. While loosened urban management provided developers with almost unlimited opportunities, deregulation and low interest rates contributed to a favourableness of real estate investment. Financial incentives from the mid-1990s resulted in a 600% increase in mortgage debt (from €100bn in 1999 to €600bn 9 years

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[141] Etxezarreta, Navarro, Ribera, and Soldevila, "Boom and (deep) crisis in the Spanish economy: the role of the EU in its evolution," 13.
[142] Domínguez-Mujica, Josefina, Guerra-Talavera, Raquel, and Parreño-Castellano, Juan Manuel, "Migration to Spain, Migration at a Time of Global Economic Crisis: The Situation in Spain," *International Migration* 52, No. 6 (2014): 115.
[143] Cano Fuentes, Gala, Etxezarreta Etxarri, Aitziber, Dol, Kees, and Hoekstra, Joris, "From Housing Bubble to Repossessions: Spain Compared to Other West European Countries," *Housing Studies* 28, No. 8 (2013): 1197-1202.
[144] Cano Fuentes, Etxezarreta Etxarri, Dol and Hoekstra, "From Housing Bubble to Repossessions: Spain Compared to Other West European Countries," 1210.
[145] Ibid., 1210.

later).[146] The following subchapters characterize the biggest culprits contributing to the bubble.

Government: Fiscal and Monetary Policies

As signs of a bubble began to appear, the government decided to adopt expansionary procyclical fiscal policy to artificially stimulate the economy, which contributed to overheating the economy. In 2008, Spain had already evinced a considerable deterioration of public finances of 6.4%, compared to 2007 when they reached a -4.5% deficit, although it stayed in a growth phase for the majority of the year.[147] Moreover, expansionary fiscal policies did not have the desired effect for the lack of coordination between national fiscal policy and monetary policy adopted by the ECB. While Spanish fiscal policy was procyclical in 2007-2008, the ECB monetary policy was countercyclical and therefore the effectiveness of the measures adopted by the Spanish government was minimal. Nonetheless, it had serious consequences during the recession, as Spain lacked the manoeuvring space and its capacity to successfully fight the crisis was very limited.[148]

Financial Institutions: Specificities of the Spanish Banking Sector

Important specificity was the Spanish dual banking system composed of private and public *(cajas)* banks. The *cajas* were closely related to regional and national authorities and the Central Bank had limited supervision over them, although they accounted for 50% of the assets in the Spanish financial sector.[149] The lack of regulation proved to be problematic in most countries with a multiple strata banking system. Germany, for example, even had a triple system, but even though its *Landesbanken* were seriously injured by the crisis, it had the capacity to save them. This was partially caused by different fundamentals of Spain and Germany, and to a large extent by the differences in current accounts and a surge of Spanish government bond yields.[150]

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[146] Ibid., 1211.
[147] Ferreiro, Jesús, Gómez, Carmen, and Serrano, Felipe, "Mistakes in the Fiscal Policy in Spain before the Crisis," *Panoeconomicus* 5 (2013): 585.
[148] Ferreiro, Gómez and Serrano, "Mistakes in the Fiscal Policy in Spain before the Crisis," 589.
[149] Ibid., 491.
[150] Quaglia and Royo, "Banks and the political economy of the sovereign debt crisis in Italy and Spain," 504.

The colossal increase of lending, especially since 2000, resulted in deficiencies in the balance sheets of Spanish banks. As they continuously lent more than was deposited, they needed to rely on other sources to counter the imbalance. Ultimately, only the United Kingdom had a larger securitization market and Spain became the third biggest issuer of covered bonds, after Germany and Denmark. This, however, only rendered the sector prone to capital inflow freezes as banks became more exposed to insolvency. Moreover, in most cases, banks were unwilling to lend to non-construction SMEs, which also hindered their increased productivity as they lacked funding for innovation. Thus, the Spanish financial market became extremely dependent on the real estate sector, which in the end represented 60% of all loans issued by Spanish banks.[151]

Politicians and Municipalities

Politicians were considered to be the biggest transgressors overall, despite their effort to externalize the blame (placing it on the EU, international markets etc.). A network of political and economic elites was established and dominated all major institutions, as well as most important lenders (the *cajas*). Nonetheless, the clientelism was not as serious as the lack of necessary education of the staffers. Less than a third of the *cajas* presidents had a postgraduate degree, and only half of them had previous banking experience. According to the estimates based on loan delinquency data, *cajas* could have saved €12bn euros had their managers had appropriate education and experience.[152]

The Spanish state is administratively divided into 17 autonomous regions and 2 autonomous cities. Apart from that, however, there are 8,116 municipalities. Among their functions are also decisions concerning land-use, most importantly whether a certain area is "developable" or "non-developable". Municipalities became particularly interested in urban development as taxes on building rights represent a significant share of their revenue. There was a clear political will of local authorities for a strong real estate sector, given the number of construction-related taxes.[153]

[151] Ibid., 500.
[152] Royo, Sebastián, "Institutional Degeneration and the Economic Crisis in Spain," *American Behavioral Scientist* 58, No. 12 (2014): 1580.
[153] Benito, Vicente and Bastida, "The Impact of the Housing Bubble on the Growth of Municipal Debt: Evidence from Spain," 1002.

3.3.3 Macroeconomic Indicators during the Bubble

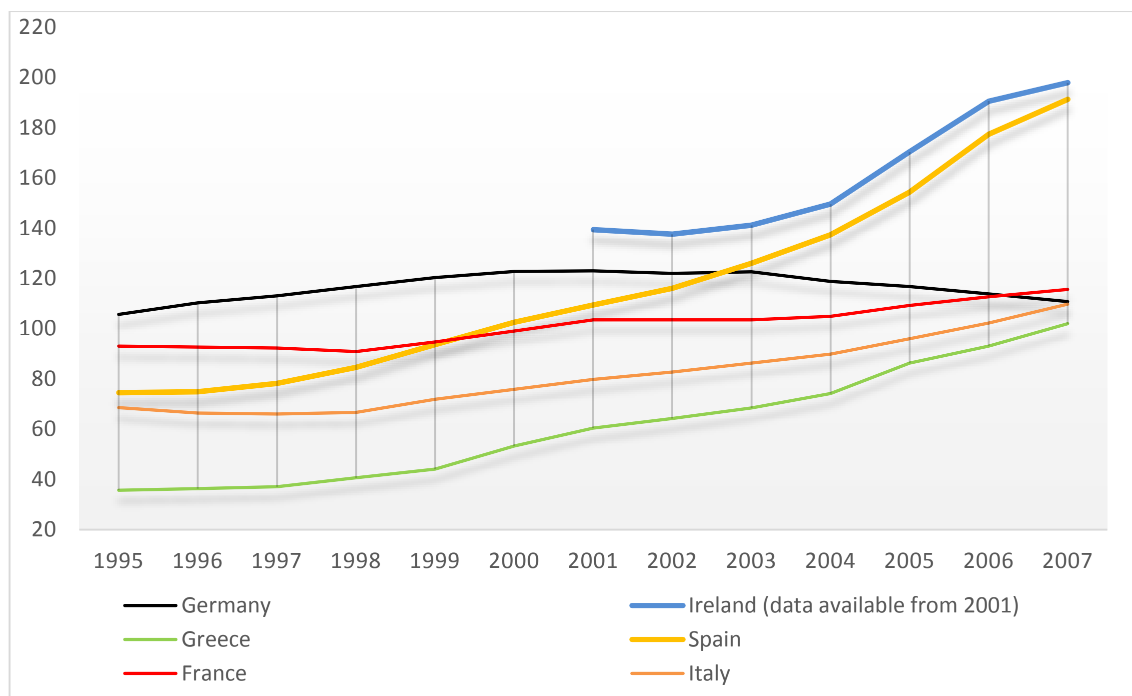
The bubble boosted most macroeconomic indicators. While core countries were suffering from an economic slowdown, Spain was growing by ca. 5% in the late 1990s/early 2000s and maintained approximately 3% on average afterwards, i.e. a very solid performance given the size of its economy. Similarly, the effect on public finances has been wholesome. Very low deficits within -1% of GDP margin and even surpluses in the last years before the crisis contributed to the fact that the public debt fell to 36.1%, one of the lowest levels in the EU.[154] Investment reached impressive numbers and the country seemed in its best overall conditions in years. Low productivity and high growth caused real exchange rate appreciation until 2009, while at the same time contributing to a sizeable decrease in interest rate spreads. Consequently, the domestic demand was increasing at a tremendous pace, further propelled by higher LVT ratios and lower housing risk premia[155].[156]

The private debt rose six fold between 1995 and 2007, representing an increase in private debt-to-GDP ratio from 74.5% to 191.2%. Figure 12 shows two important aspects in particular. Firstly, it shows that the Spanish economy experienced much bigger expansion during the years before the crisis than Ireland. Thus in 2007, Spain equalled the Irish private debt, which was more than 30% higher than the Spanish six years earlier. Secondly, difference between fiscal and external imbalances, mentioned in Chapter 1, can be observed. While Spain and Ireland maintained virtuous states of public finances, their private debt exceeded the GDP almost twofold, which accounted for most of their difficulties. On the other hand, Greece, and to a lesser extent Italy, had much lower private debt and their problems were caused by public finance deterioration.[157] By the outbreak of the crisis, Spain had a current account deficit of -10%,[158] which represented the second highest deficit in absolute numbers. For illustration, the third ranked was the United

[154] "General Government Deficit," Official Site of OECD Data, accessed 23 March, 2016, https://data.oecd.org/gga/general-government-deficit.htm.
[155] A risk premium is the return in excess of the risk-free rate of return that an investment is expected to yield. It is a form of compensation for investors who tolerate the extra risk - compared to that of a risk-free asset - in a given investment (*Investopedia, accessed 5 March, 2016, http://www.investopedia.com/terms/r/riskpremium.asp*).
[156] Veld, Kollmann, Pataracchia, Ratto and Roeger, "International capital flows and the boom-bust cycle in Spain," 332.
[157] "Private Sector Debt, Consolidated % of GDP," Official Site of Eurostat, accessed 23 March, 2016, http://ec.europa.eu/eurostat/en/web/products-datasets/-/TIPSPD20.
[158] "Balance of Current Account," Official Site of Eurostat, accessed 23 March, 2016, http://ec.europa.eu/eurostat/tgm/table.do?tab=table&language=en&pcode=tec00043.

Kingdom, whose deficit accounted only for 56% of the Spanish.[159] Apart from loss of competitiveness of the Spanish economy, a major role was played by the adoption of the euro, providing the country with low and stable interest rates but also no option for devaluing the currency.[160]

***Figure 12: Private Sector Debt of Selected EU Countries** (Consolidated, % of GDP, 1995 - 2007)*



Source: Own elaborations based on Eurostat Data [161]

3.3.4 Volume of the Real Estate Bubble

The low interest rates were accompanied by extremely long maturities, increasing from the common 12-15 years up to 40 years. Real estate purchase became a false means of certain profit as the prices were seemingly ever-growing. The construction sector reached unsustainable levels by 2005 when Spain built more houses than the three biggest economies of the EU combined, i.e. Germany, France and the United Kingdom.[162] The

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[159] "Current Account Balance (BoP, Current US$)," Official Site of World Bank, accessed 23 March, 2016, http://data.worldbank.org/indicator/BNO.CAB.XOKA.CD/countries?page=1&display=default.
[160] Etxezarreta, Navarro, Ribera, and Soldevila, "Boom and (deep) crisis in the Spanish economy: the role of the EU in its evolution," 10.
[161] "Private Sector Debt, Consolidated % of GDP," Official Site of Eurostat, accessed 23 March, 2016, http://ec.europa.eu/eurostat/en/web/products-datasets/-/TIPSPD20.
[162] Díaz and Araujo, "Historic Urbanization Process in Spain (1746-2013): From the Fall of the American Empire to the Real Estate Bubble," 12.

magnitude of the bubble can be illustrated by noting that the stock of real estate constructed in Spain was more than 1 per 2 inhabitants (23 million in a country of 45 million inhabitants).[163] At the beginning of 2008, the construction sector employed 13% of the active population and was one of the motors of the Spanish boom, alongside tourism and car manufacturing.[164]

3.3.5 Social Consequences as Reduced Automatic Stabilizers

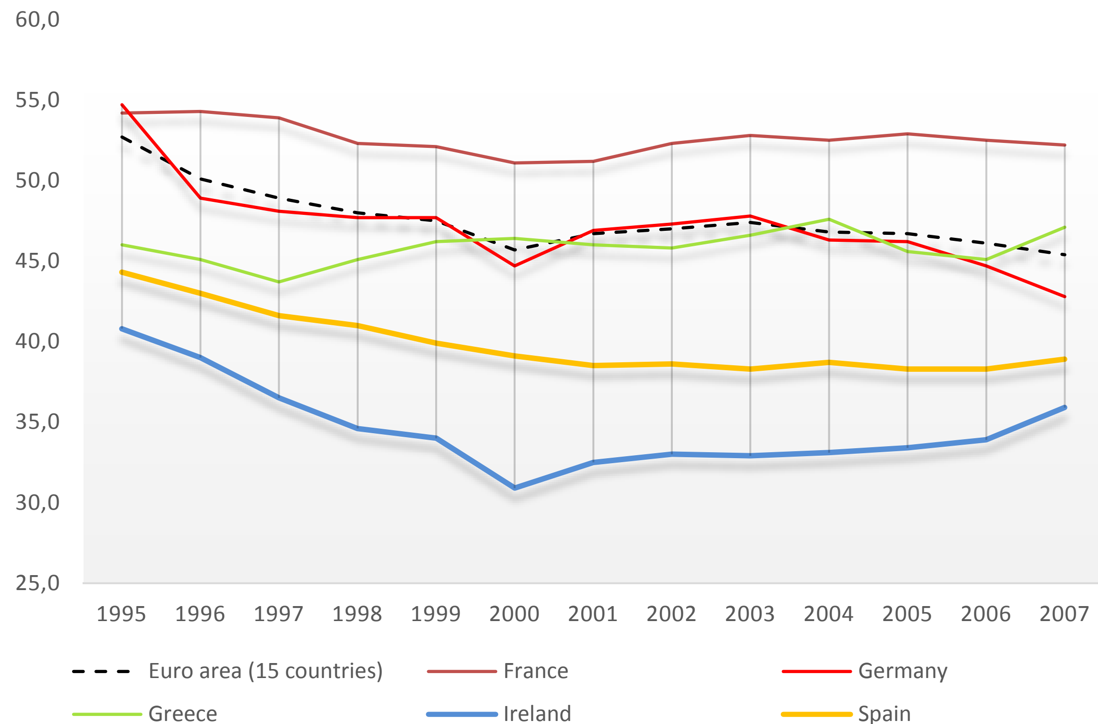
Meanwhile, further deterioration of the welfare state was taking place. Its unsatisfactory level, approximately 25% lower than the EU-15, remained as a legacy of the dictatorship.[165] Tax collection was lamentable, allowing a 10% GDP tax evasion, primarily from the largest corporations, while the population was burdened by a system focused on VAT. Social expenditure also remained incomparably lower than in the EU-15. It is no coincidence that Spain experienced one of the deepest gaps in life expectancy of the population, which was 6 years higher for the top 10% than for skilled workers.[166] The Bank of Spain estimates that the bubble improved conditions of less than 10% of households, since 60% of all wages remained stagnant in 1994 - 2006. The increase in housing prices was more than six fold the increase in nominal wages, which resulted in a sharply declining affordability.[167] Nevertheless, a decrease in real estate purchases did not occur owing to banking sector deregulation, government incentives and tax reliefs.

As opposed to common perception, such a situation was not only detrimental to the socio-demographic conditions of the population but also furtively pressed on the country's capacity to counter the crisis, as the public sector represents an important automatic stabilizer.[168] Figure 13 shows the evolution of the government expenditure of selected Euro Area countries between 1995 and 2007. Spain only reached ca. 83% of the Euro Area average, while its expenses were constantly decreasing. Spain cut spending much more fervently than other EU countries, decreasing it by 14% between 1995 and 2001.

[163] Etxezarreta, Navarro, Ribera, and Soldevila, "Boom and (deep) crisis in the Spanish economy: the role of the EU in its evolution," 13.
[164] Active Population by Nationality, Sex and Economic Sector," Official Site of Instituto Nacional de Estadística, accessed 24 March, 2016, http://www.ine.es/jaxiT3/Datos.htm?t=4075.
[165] Etxezarreta, Navarro, Ribera, and Soldevila, "Boom and (deep) crisis in the Spanish economy: the role of the EU in its evolution," 5.
[166] Díaz and Araujo, "Historic Urbanization Process in Spain (1746-2013): From the Fall of the American Empire to the Real Estate Bubble," 14.
[167] Ibid., 12.
[168] Ferreiro, Gómez and Serrano, "Mistakes in the Fiscal Policy in Spain before the Crisis," 581.

The level of approximately 38% of GDP was maintained throughout the 2000s and up to the crisis. As can be observed in figure 13, Spain had the second lowest expenditure out of EU-15, only after Ireland.

***Figure 13: Total General Government Expenditure of Selected EU Countries** (% of GDP, 1995 - 2007)*



Source: Own elaborations based on Eurostat data [169]

3.4 Bust and its Impacts

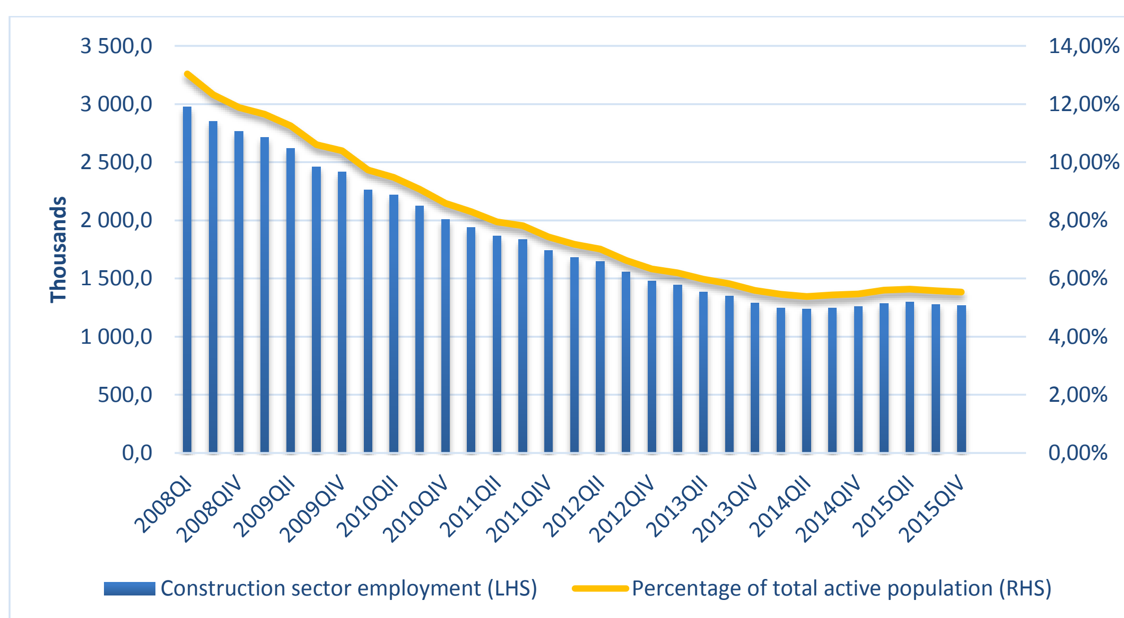
The Spanish economy started to evince overheating in late 2006. After the eruption of the crisis in the US and consequent international market freeze, the seemingly reliable performance of the economy proved to be spurious.[170] Nevertheless, Spain maintained a serene approach. There was a general perception that national fundamentals were stable, and that the banking sector was only mildly exposed to the American mortgage crisis, since financial institutions were under tight control after the 1980s banking crisis.[171] This chapter explains the gravity of such erroneous assumptions.

[169] "Government Finance Statistics," Official Site of Eurostat, accessed 23 March, 2016, http://ec.europa.eu/eurostat/web/government-finance-statistics/data/database.
[170] Etxezarreta, Navarro, Ribera, and Soldevila, "Boom and (deep) crisis in the Spanish economy: the role of the EU in its evolution," 14.
[171] Ibid., 16.

3.4.1 Burst of the Bubble

After the freeze in foreign lending, artificial inflation of housing prices became apparent, the real estate bubble burst and the construction sector went bankrupt. By 2011 the land prices had fallen by 30%, as compared to the pre-crisis situation and home prices by 22.5%. The worst situation, as in Ireland, was in the capital. In 2011 alone, housing prices in Madrid plummeted by 29.5%.[172] Not unlike Ireland, when the speculative bubble burst, Spain was left with 670 000 new vacant dwellings.[173]As the construction collapsed, so did the employment in the sector. It fell from almost three million at the beginning of 2008 to 1.2 million in 2014 Q2. In other words, one of the once-crucial sectors, which accounted for 13% of the total active population, fell to merely a 5.4% (see figure 14).

Figure 14: Construction Sector Employment in Spain: *Thousands Persons (Left Hand Scale) and Percent (Right Hand Scale), 2008 - 15*



Source: Own elaborations based on Instituto Nacional de Estadística data [174]

[172] Quaglia and Royo, "Banks and the political economy of the sovereign debt crisis in Italy and Spain," 500.
[173] Cano Fuentes, Etxezarreta Etxarri, Dol and Hoekstra, "From Housing Bubble to Repossessions: Spain Compared to Other West European Countries," 1211.
[174] "Active Population by Nationality, Sex and Economic Sector," Official Site of Instituto Nacional de Estadística, accessed 2 April, 2016, http://www.ine.es/jaxiT3/Datos.htm?t=4075.

3.4.2 Macroeconomic Consequences of the Bust

As the short term capital inflow suddenly stopped, the banking sector suffered mammoth losses and was unable to meet its liabilities. The *cajas* in particular had to resort to seeking financial assistance. The government, nevertheless, was unable to take over obligations to such an extent and had to borrow money from the Euro Area to save its banking sector. This resulted in a balance of payments crisis, the beginning of a sovereign debt crisis that emerged with the reluctance of the investors to finance Spanish debt in 20011/12.[175]

Fall of GDP performance

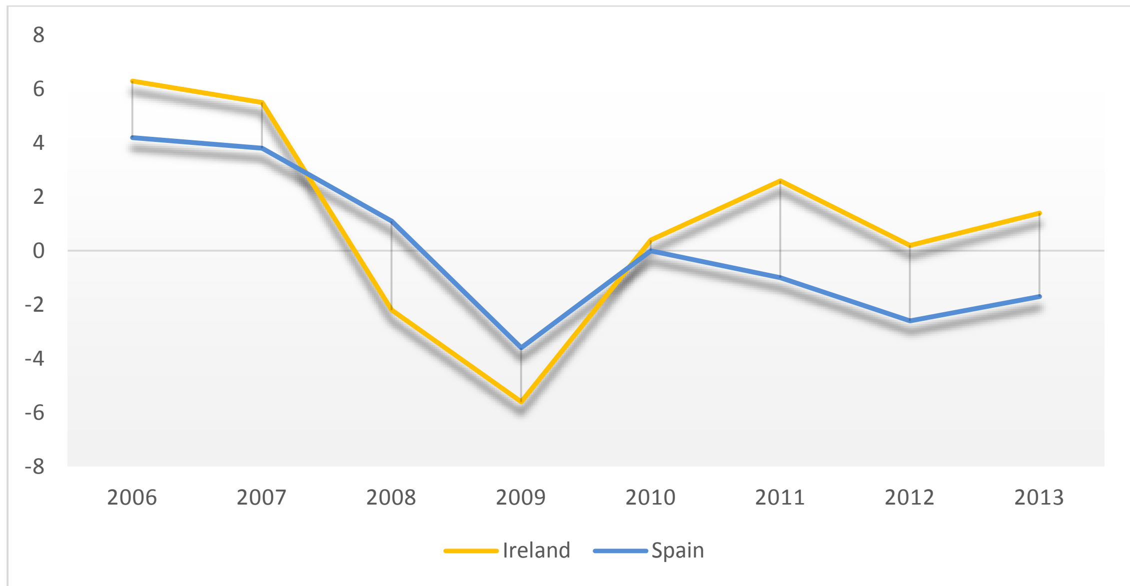
The size of the Spanish economy was important concerning three factors in particular. Firstly, although the levels of GDP growth were convincing, they were greatly inferior to the Irish. While Ireland enjoyed levels of approximately 10% in the late 1990s and around 6% throughout the 2000s, Spain only reached half of these values in the same periods (see figure 15). However, this also meant a shallower fall after the crisis.

Secondly, it contributed to graver consequences than was the case of the *Celtic Tiger*. When Ireland entered the recession in 2008, the European Union was shaken but stayed sure of its capacity to overcome most complications of the small Irish economy. At the time, Spain was evincing a slowdown but not yet a crisis, keeping a 1.1% growth. The fall to -3.6% the next year was what shocked the EU the most. The approximately ten times bigger economy, the fifth largest of the EU, represented a great menace, and all the more as Italy, the fourth largest, copied the same negative growth levels.

Ultimately, because of its size, the Spanish recovery was more painful and dragged on for much longer. Figure 15 depicts how the sharp Irish fall of -5.6% in 2009 also represented a rebound point followed by a period of smaller yet steady positive numbers. Spain, on the other hand, fell -3.6% a year later and experienced a double-dip recession in 2012 after a seeming improvement. The size of the economy therefore played a mitigating role - for GDP expansion, the fall and the effects of recovery mechanisms at the same time.

[175] Quaglia and Royo, "Banks and the political economy of the sovereign debt crisis in Italy and Spain," 503.

Figure 15: Growth Rates of Real GDP of Ireland and Spain (Change over Previous Quarter, % of GDP, 2006 - 13)



Source: Own elaborations based on OECD Data [176]

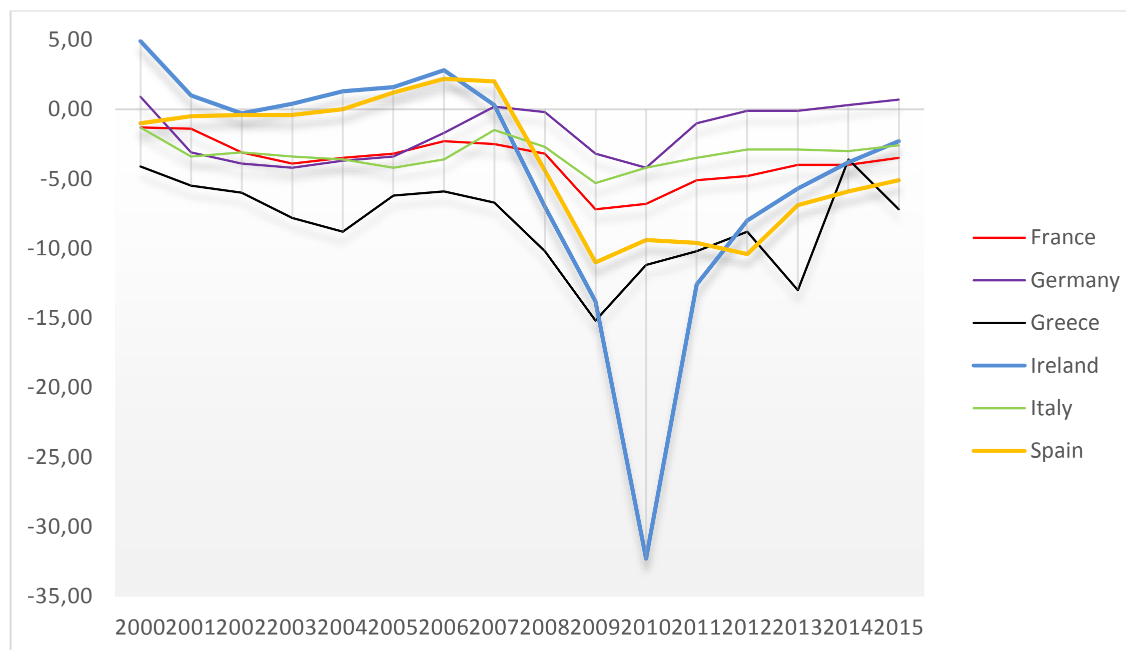
Deterioration of public finances

A similar situation could be observed for most macroeconomic indicators. Decreased investment and the almost bankrupt construction and banking sectors were pulling down the public finances. The most significant deterioration was recorded in 2009 when Spain suffered from a -11.1% deficit and colossal increase in public debt, from 39.8% to 53.3%. The public debt still was still low, as opposed to most EU countries, but Spain lost a significant proportion of its virtuous years.[177] While the fall in the government budget deficit was far inferior to the Irish -32.3%, the most disquieting aspect was the period of four continuous years of approx. -10% deficit. The impact was all the more serious given the country's budget record prior to the crisis. Figure 16 illustrates that while Germany, France and Italy experienced deterioration in budget balance, it was merely a continuation of the trend of approx. -3% deficits. Spain and Ireland, however suffered greatly following the previous surpluses. Three automatic factors contributed in particular to the deterioration of public finances, similarly to Ireland. Firstly, it was the increased expenditure on unemployment subsidies, by €27bn or 2.6% of GDP in 2013; secondly,

[176] "Quarterly Growth Rates of Real GDP, Change over Previous Quarter," Official Site of OECD Stats, accessed 2 April, 2016, https://stats.oecd.org/index.aspx?queryid=350#.
[177] Etxezarreta, Navarro, Ribera, and Soldevila, "Boom and (deep) crisis in the Spanish economy: the role of the EU in its evolution," 18.

high interest payments on the debt, €36.5bn in 2013.[178] The third point was decreased revenue, as Spain lost 17% in tax revenue in 2009 alone.[179]

***Figure 16: General Government Deficit of Selected EU Countries** (Total, % of GDP, 2000 - 15)*



Source: Own elaborations based on OECD Data [180]

Negative Effects of Lacking Welfare State

The predicament of the Spanish population was all the more troubling given the low levels of social protection. However, as mentioned in section 3.3.5, public expenditures only reached 38.7% of GDP before the crisis, as compared to 46.7% in the Euro area. Given the fact that the public sector works as an automatic stabilizer, the GDP contraction between 2008 and 2012 would have been 0.5% lower had Spain had the equivalent of the EA average according to the estimates. This would have meant a mere -0.3% average decrease instead of the average -0.8% fall.[181] Moreover, a similar situation would have likely occurred concerning most macroeconomic indicators, including fiscal deficit.

[178] Schwartz, Pedro, "The Welfare State as an Underlying Cause of Spain's Debt Crisis," *CATO Journal* 33, No. 2 (Spring/Summer2013), 281.
[179] Etxezarreta, Navarro, Ribera, and Soldevila, "Boom and (deep) crisis in the Spanish economy: the role of the EU in its evolution," 18.
[180] "General Government Deficit," Official Site of OECD Data, accessed 4 April, 2016, https://data.oecd.org/gga/general-government-deficit.htm.
[181] Ferreiro, Gómez and Serrano, "Mistakes in the Fiscal Policy in Spain before the Crisis," 582.

Under the condition of average EA public expenditure, Spain would have had a deficit of -5.6%, as opposed to the actual -10% deficit.[182]

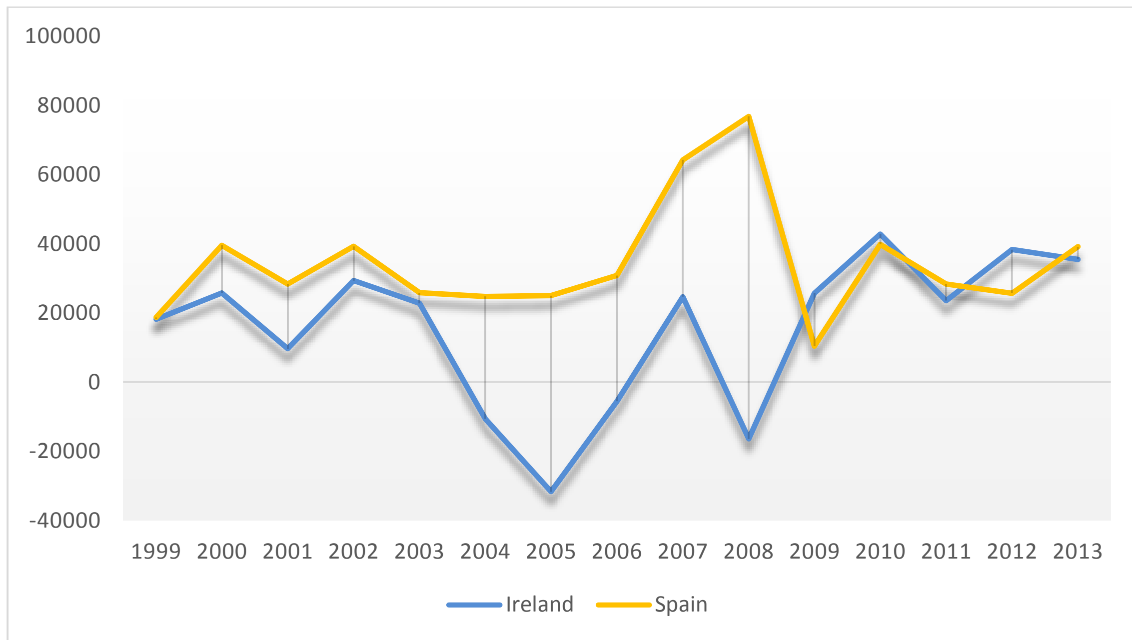
Fall in Investment

The bubble burst had a significant impact on investment in Spain. Sharp increases in risk premia and falls of LTV ratios halted especially FDI and ended the period of high growth rates. Also correlating with a global freeze in international capital flows, the Spanish trade balance improved in 2008 and continued to do so ever after.[183] Figure 17 shows the rise and fall of the FDI inflow to Spain. Spain already had an impressive inflow of foreign capital throughout the 2000s, but the peak housing prices in 2007 and 2008 drove investment up to towering heights.

The Minsky moment[184] occurred in late 2008 and the FDI plummeted to 14% of the 2008 level in a year. Figure 17 illustrates the development in Spain and Ireland. Both countries experienced the same process, quickly rising and attracting investors with a post-dot-com bust slowdown in 2001. Between 2002 and 2005 the levels stagnated, as a lot of potential had already been used up, with Ireland experiencing a much longer fall. Investment then grew exponentially following the respective peaks of national bubbles in 2007 or 2008. Even though Ireland, with a tenfold smaller economy than Spain, was able to attract similar numbers of FDI (especially up to 2002), the climax situation shows the sheer size of the Spanish bubble, surpassing FDI to Ireland by 2.5 times in 2007.[185]

[182] Ibid., 584.
[183] Veld, Kollmann, Pataracchia, Ratto and Roeger, "International capital flows and the boom-bust cycle in Spain," 332.
[184] Reverse in trend when a market fails or falls into crisis after an extended period of market speculation or unsustainable growth (*Investopedia, accessed 8 May, 2016, http://www.investopedia.com/terms/m/minskymoment.asp*).
[185] "FDI Flows, Outward, Million US Dollars," Official Site of OECD Data, accessed 8 April, 2016, https://data.oecd.org/fdi/fdi-flows.htm.

Figure 17: FDI flows in Ireland and Spain *(Inward, Million US Dollars, 1999 - 2013)*



Source: Own elaborations based on OECD Data [186]

Impacts on Population

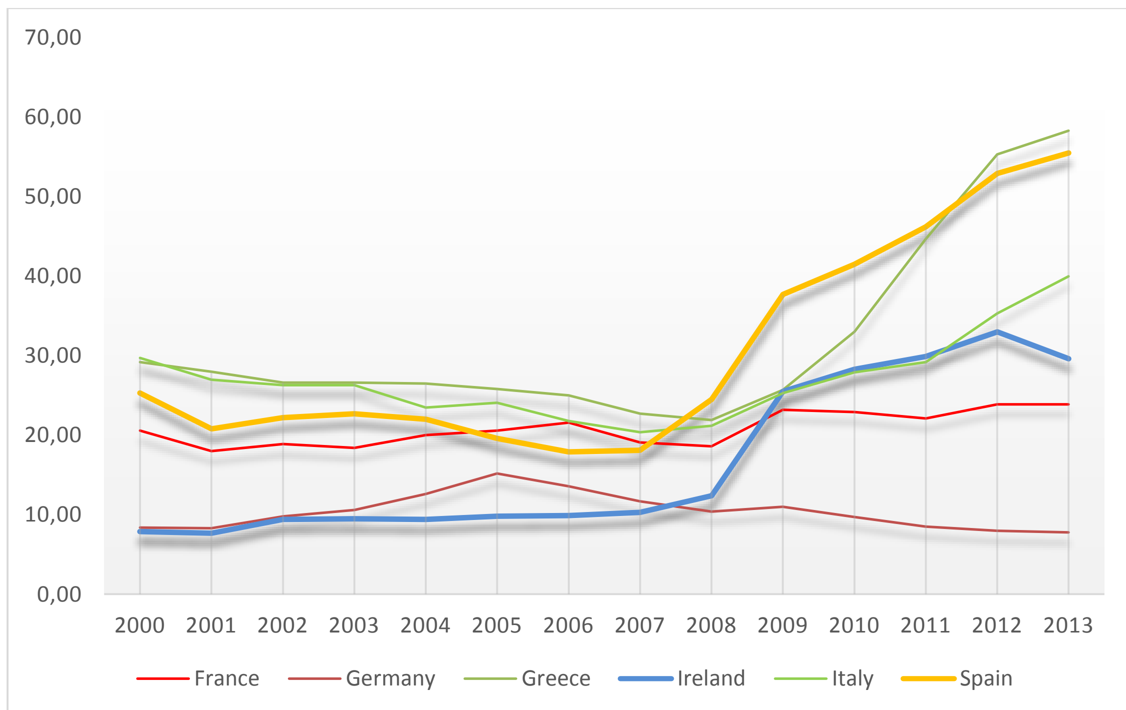
The impact on the Spanish population was among the most burdensome. While unemployment affected 5 million people, youth unemployment became the most menacing consequence for the future of the country. From a sound level of 18.1%, inferior to the French and Italian, it reached frightful level of 55.5%, while Ireland, hit severely as well, suffered a level of 33% (see figure 18). Spain experienced a grave youth exodus as more than every other youngster was unemployed, i.e. the worst situation of all EU and OECD countries, rivalling only the notable first place of Greece.

Job offer shrank, leaving space only for temporary contracts (which accounted for 94% all newly concluded contracts) while wages contracted.[187] Even for those who managed to keep a job, there was a still the ubiquitous spectre of uncertainty for both them and their children. Social expenditures were further limited and many families found themselves in a very precarious situation, especially the 1.3 million fully unemployed[188]

[186] "FDI Flows, Outward, Million US Dollars," Official Site of OECD Data, accessed 8 April, 2016, https://data.oecd.org/fdi/fdi-flows.htm.
[187] Etxezarreta, Navarro, Ribera, and Soldevila, "Boom and (deep) crisis in the Spanish economy: the role of the EU in its evolution," 16.
[188] Household where all members are unemployed.

households.[189] Ultimately, the overall unemployment more than doubled to 26.1% as compared to the level in 2008, representing once again the worst situation in the EU, alongside Greece. Figure 19 depicts the comparison of Ireland and Spain concerning the evolution of their Harmonised unemployment rates (HUR) and Youth unemployment rates. It gives a clear idea of the grave impact on the Spanish population.

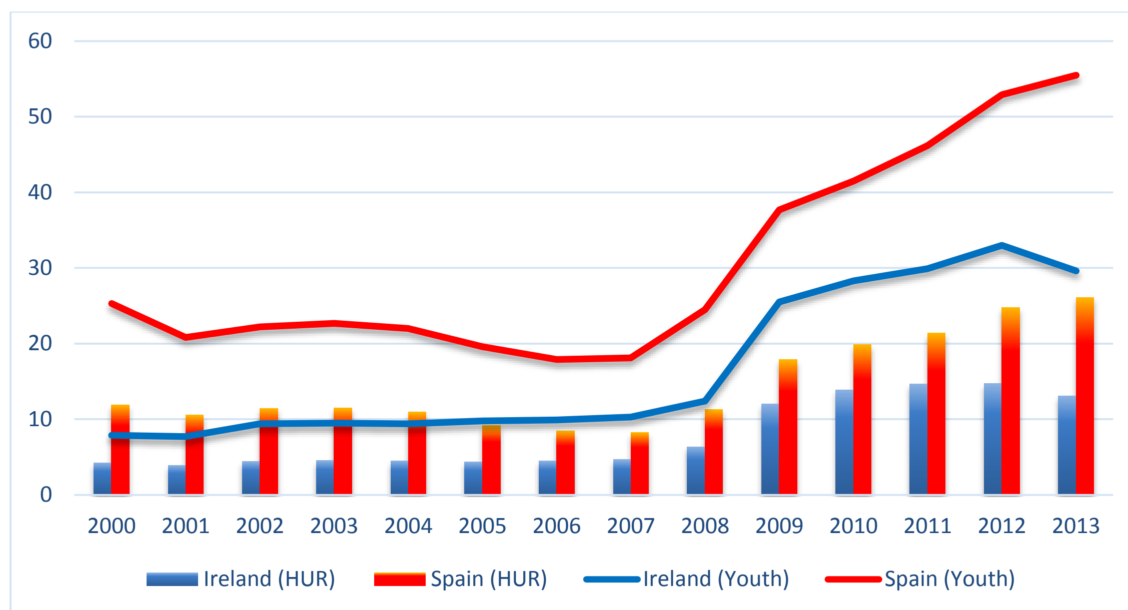
Figure 18: Youth Unemployment of Selected EU Countries *(Total % of Youth Labour Force between 15 and 24 y.o., 2000 - 2013)*



Source: Own elaborations based on OECD Data [190]

[189] Ibid., 15.
[190] "Youth Unemployment Rate, Total, % of Youth Labour Force," Official Site of OECD Data, accessed 9 April, 2016, https://data.oecd.org/unemp/youth-unemployment-rate.htm.

Figure 19: Harmonised Unemployment Rate (HUR) Compared to Youth Unemployment Rate of Selected EU Countries (% of Respective Labour Force)



Source: Own elaborations based on OECD Data [191] [192]

The diminutive growth of new contracts was also caused by labour obstacles such as high minimum wage and contributions to Social Security.[193] This forced many people to resort to the black market economy. At its peak, 4 million people were working under the table.[194] However, a paradoxical situation can be observed by comparing job contraction in the private and public sectors. While the private sector experienced almost 3 million dismissals, the public sector engaged 3,900 new employees.[195] By 2013 more than every fourth Spaniard was unemployed and 52,000 households had lost their homes.[196] As wages kept on falling, the external demand increased and exports started to grow but the domestic demand plummeted. For example, in 2010 the wages increased by 0.5% in a country with a 3% inflation rate. Such a situation promised very few prospects for a bright

[191] "Harmonised Unemployment Rate (HUR), Total, % of Labour Force," Official Site of OECD Data, accessed 9 April, 2016, https://data.oecd.org/unemp/harmonised-unemployment-rate-hur.htm.
[192] "Youth Unemployment Rate, Total, % of Youth Labour Force," Official Site of OECD Data, accessed 9 April, 2016,https://data.oecd.org/unemp/youth-unemployment-rate.htm.
[193] Schwartz, "The Welfare State as an Underlying Cause of Spain's Debt Crisis," 279.
[194] Etxezarreta, Navarro, Ribera, and Soldevila, "Boom and (deep) crisis in the Spanish economy: the role of the EU in its evolution," 27.
[195] Schwartz, "The Welfare State as an Underlying Cause of Spain's Debt Crisis," 280.
[196] Díaz and Araujo, "Historic Urbanization Process in Spain (1746-2013): From the Fall of the American Empire to the Real Estate Bubble," 14.

future for the Spaniards, all the less given the very low GDP growth rates.[197] The impact on households is documented by hundreds of thousands of repossessions between 2008 and 2011, a number incomparable to the rest of the Western Europe. An interesting comparison can be drawn with Ireland where, despite the bust of a bubble and high level of arrears, only several thousand dwellings were repossessed.[198]

The building sector was among the most affected by job contraction and foreign workers suffered accordingly. The unemployment of immigrants rose approximately twice as fast as that of Spaniards, and given the irregularity of their engagement, they had very limited means of protection.[199] The drop in foreign employment can be documented by a sharp decline of remittances of -21% between 2007 Q4 and 2008 Q4.[200] As opposed to Ireland, which suffered from relapse to chronic emigration, Spain decided to adopt measures limiting immigration to protect domestic labour market. The best comparison can be drawn using work permit quotas. While it was 27,112 in 2007, by 2009, only 901 work permits were issued.[201]

Consequently, immigration fell to a half from 13 to 6.5 million in 5 years.[202] Spain also experienced a rise of emigration. From a pre-crisis net migration flow rate of 17.2 per 1000 inhabitants, Spain fell to -5.4 in 2013 (see figure 20). Not only was immigration attenuated by both economic situation and restrictive measures adopted by the government, but significant numbers of Spaniards themselves decided to seek brighter futures elsewhere. The situation was better than in Ireland, which mostly reverted back to its previous tendency for the reasons explained above (see the early 1990s columns in figure 20).

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197 Etxezarreta, Navarro, Ribera, and Soldevila, "Boom and (deep) crisis in the Spanish economy: the role of the EU in its evolution," 25.

198 Cano Fuentes, Etxezarreta Etxarri, Dol and Hoekstra, "From Housing Bubble to Repossessions: Spain Compared to Other West European Countries," 1198.

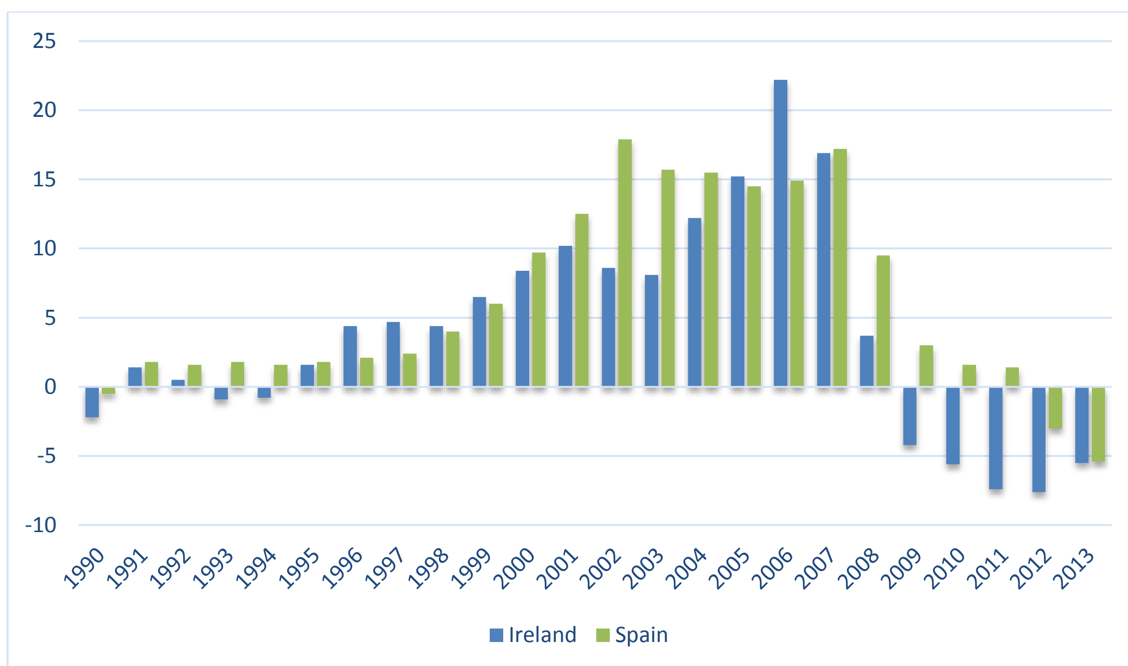
199 Domínguez-Mujica, Guerra-Talavera and Parreño-Castellano, "Migration to Spain, Migration at a Time of Global Economic Crisis: The Situation in Spain," 116.

200 Ibid., 117.

201 Ibid., 118.

202 "Gross Immigration Rate from abroad, Immigrations per 1,000 inhabitants," Official Site of Instituto Nacional de Estadística, accessed 2 April, 2016, http://www.ine.es/jaxiT3/Datos.htm?t=5841.

Figure 20: Crude Rate of Net Migration in Ireland and Spain *(Plus Adjustment, per 1 000 inhabitants, 1990 - 2013)*



Source: Own elaborations based on OECD Data [203]

[203] "Crude Rate of Net Migration plus Adjustment, per 1 000 Inhabitants," Official Site of Eurostat, accessed 9 April, 2016, http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&pcode=tsdde230&plugin=1.

4 Solutions and Crisis Management

This chapter analyses crisis management in Ireland and Spain. Different approaches to containment of the crisis at the financial markets, as well as public sector countermeasures, are explained, along with their extent and effects. Most important specificities of both economies are mentioned to elucidate the diverging paths of both economies, along with different reaction of domestic markets to the undertaken steps. Ultimately, the overall state of the Irish and Spanish economies by December 2013 is presented.

4.1 Ireland

The Irish government showed excellent reactivity to the crisis as it swiftly availed of 232 per cent of its GDP for crisis countermeasures. Nevertheless, the total cost of the measures amounted to 229.4% of its GDP and Ireland was forced to resort to EU funding, especially for its financial sector bailout.[204] [205] Ultimately, the Irish bailout was the most expensive in the European Union in terms of both absolute costs and percentage of GDP (37.5% of GDP).[206] Nonetheless, given the swift response and the size of the fiscal consolidation, Ireland became once again a role model, this time for austerity.

4.1.1 Financial Sector Reforms and Crisis Countermeasures

The consequences of the crisis were felt on the Irish financial markets much sooner than in Spain. Irish banks became increasingly less capable of rolling-over their debt, and the situation escalated primarily on the 29th September 2008 with a sharp fall in the bank share prices. This served notably as an important signal towards the investors about the soundness of the banks' balance sheets. The effect was so deep that the government decided to intervene the next day.[207]

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[204] Grossman, Emiliano, and Woll, Cornelia, "Saving the Banks: The Political Economy of Bailouts," *Comparative Political Studies* 47, No. 4 (2014): 584.
[205] OECD Policy Roundtables, "Exit Strategies," DAF/COMP(2010)32, *OECD* (2010), 35, http://www.oecd.org/daf/competition/46734277.pdf.
[206] Grossman and Woll, "Saving the Banks: The Political Economy of Bailouts," 585.
[207] Honohan, Patrick, "Resolving Ireland's Banking Crisis," Report presented at UCD-Dublin Economic Workshop Conference: Responding to the Crisis, Dublin, *Trinity College Dublin* (12 January 2009), 10, http://www.irisheconomy.ie/Crisis/HonohanCrisis.pdf.

Government Guarantee

The intervention happened in the context of a chain of government issued guarantees and injections all across Europe, following the steps of the United Kingdom, Benelux countries, Germany, France and even the ECB.[208] Compared to these milder solutions, Ireland decided on a more radical step. Most representatives involved in the preliminary talks preferred a four-bank guarantee, excluding, notably, Anglo and INBS, banks deemed to be in a malignant state. In the end, however, the Irish government issued a blanket guarantee of €440bn over all deposits and most liabilities, which ultimately rose to €485bn.[209] This decision met with severe criticism from other countries as it only covered domestic banks operating in Ireland, but was expanded afterwards. For example Denmark as Danske Bank, owner of the National Irish Bank, which was not covered by the guarantee, experienced significant losses and the country had to issue its own guarantee.[210]

The rationale behind this step was to assure depositors of the solvency and stability of the Irish banking sector. It was generally agreed that it was vital, lest there be repercussions alike to the Lehman fall.[211] Nonetheless, the effect on the mitigation of depositors' suspicion and alertness towards the Irish banks was unsatisfactory.[212] One of the most important defects of the intervention was the incapacity to discern the sources of crisis. Instead of critical analysis of the banks' imbalances and management, it was understood in the context of global financial downturn.[213] There was a general perception that the predicament was only a temporary liquidity crisis and after stabilization on the markets, it would only necessitate small financial outlays to revive the banking sector.[214] As a consequence, even though the banks were provided a guarantee, the gap between capital and risk-taking was abysmal and the banks stayed undercapitalized.[215]

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[208] Šlosarčík, Ivo, *Irsko a krize:Politika a ekonomika Irské republiky v letech 2008-2014 a její evropské souvislosti* (Praha: Karolinum, 2015), 23.
[209] O'Callaghan, Kelly, Boyle, and Kitchin, "Topologies and topographies of Ireland's neoliberal crisis," 38.
[210] Grossman and Woll, "Saving the Banks: The Political Economy of Bailouts," 586.
[211] Honohan, "The Irish Banking Crisis: Regulatory and Financial Stability Policy 2003-8," 14.
[212] Croke, "Chuaigh Ar La' - Debt of A Gaelsman: Ireland's Sovereign Debt Crisis, National and International Responses," 380.
[213] Honohan, "Resolving Ireland's Banking Crisis," 11.
[214] Šlosarčík, *Irsko a krize:Politika a ekonomika Irské republiky v letech 2008-2014 a její evropské souvislosti*, 24.
[215] Honohan, "Resolving Ireland's Banking Crisis," 12.

Recapitalization of the Financial Sector

To tackle not only trust but also liquidity and solvency, another step had to be taken in December 2008 when the Irish government decided to inject capital through preference shares[216] to three out of six largest nationally held banks, Bank of Ireland (BoI), Allied Irish Banks (AIB) and Anglo.[217] The initial proposition was equity funds recapitalization; however, after severe opposition from the banks, a public recapitalization was agreed.[218] While the guarantee was a preventive measure, the injection meant a palpable interference for the government expenditures. It consisted of an exchange of €5.5bn for a 25% preference share in BoI and AIB, and 75% in Anglo.[219] Nonetheless, this step had little impact on achieving higher confidence in the Irish banking sector after the circular transactions controversy[220]. Subsequently, Anglo was nationalized in January 2009, further injections were needed for BoI and AIB, and the government became the largest stockholder of all major banks.[221] Ultimately, €64bn of state funding was directly used to recapitalize the banking sector by 2013.[222] While some experts estimated the costs to be even higher, in retrospective we know that the cost dropped to €40bn owing to the fast recovery.[223]

Restructuring of the Financial System

The most important step towards restructuring the banking sector was undertaken in April 2009, when the government established the National Asset Management Agency

[216] Preference shares consist of a company stock with dividends that are paid to shareholders before common stock dividends are paid out. In the event of a company bankruptcy, preferred stock shareholders have a right to be paid company assets first. Preference shares typically pay a fixed dividend, whereas common stocks do not (*Investopedia, accessed 8 May, 2016, http://www.investopedia.com/terms/p/preference-shares.asp*).
[217] Honohan, "Resolving Ireland's Banking Crisis," 15.
[218] Grossman and Woll, "Saving the Banks: The Political Economy of Bailouts," 587.
[219] Croke, "Chuaigh Ar La' - Debt of A Gaelsman: Ireland's Sovereign Debt Crisis, National and International Responses," 380.
[220] Circular transactions controversy was a scandal in December 2008 after the then director of Anglo admitted having hidden €87 million from the bank. It lead to a series of resignations of the highest representatives of the involved actors, including the Anglo's CEO himself, Financial Regulator, CEO of INBS or director of the Irish stock exchange.
[221] Grossman and Woll, "Saving the Banks: The Political Economy of Bailouts," 587.
[222] Waldron and Redmond, "POLICY REVIEW: The Extent of the Mortgage Crisis in Ireland and Policy Responses," 152.
[223] BBC, "Irish banking inquiry: Bailout 'cost 40bn euros'", *BBC*, 15 January, 2015, accessed 26 April, 2016, http://www.bbc.co.uk/news/world-europe-30834738.

(NAMA). The agency used an SPV[224] owned by NAMA (from 49%) and by private investors, and it was vested with power to absorb bad debt from the six Irish financial houses up to €90bn with a single purpose: clearing the banks' balance sheets.[225] [226] NAMA had two areas of activities - purchases of risky property assets through trading with government guaranteed securities, also known as "NAMA bonds", accompanied by other government measures providing capital and liquidity to mitigate banks' losses, and asset management.[227]

This step was accompanied by a wave of criticism from both the public and experts. The most important difficulty concerned adequate valuation of bad loans to avoid overpricing and under-pricing at the same time, which could lead respectively either to significant losses of taxpayers' money or insolvency of banks.[228] In the end, NAMA opted for a 54% asset value write-down buying €74bn worth of assets for €32bn. The importance of this step could be evaluated already in mid-2012 when only one fifth of the NAMA assets were "performing". More than one third, €12.9bn, was directed to Anglo with a write-down of 62%. An even higher write-down, 64%, was used for INBS; however, its assets represented a much smaller proportion of "only" €3bn. [229]

However, the situation was further deteriorating even after the inauguration of NAMA and in 2010 Anglo, nick-named the "world's worst bank", experienced the biggest corporate loss recorded in Ireland - €17.6bn.[230] The Irish Central Bank announced exactly one year after the blanket guarantee that an additional €34bn were going to be needed, apart from the already received €23bn, to save Anglo. They also announced that an additional €3bn for AIB would be needed, atop the €7.4bn.[231] As the biggest culprits, Anglo and INBS ceased trading by 2011. EBS Building Society was demutualized and

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[224] Special purpose vehicle is a subsidiary company with an asset/liability structure and legal status that makes its obligations secure even if the parent company goes bankrupt. (*Investopedia, accessed 26 April 2016, http://www.investopedia.com/terms/s/spv.asp*).
[225] Croke, "Chuaigh Ar La' - Debt of A Gaelsman: Ireland's Sovereign Debt Crisis, National and International Responses," 380.
[226] Grossman and Woll, "Saving the Banks: The Political Economy of Bailouts," 585.
[227] Byrne, Michael, "Asset Price Urbanism' and Financialization after the Crisis: Ireland's National Asset Management Agency," *International Journal of Urban and Regional Research* (3 March, 2016): 7.
[228] Croke, "Chuaigh Ar La' - Debt of A Gaelsman: Ireland's Sovereign Debt Crisis, National and International Responses," 381.
[229] O'Callaghan, Kelly, Boyle, and Kitchin, "Topologies and topographies of Ireland's neoliberal crisis," 38.
[230] Croke, "Chuaigh Ar La' - Debt of A Gaelsman: Ireland's Sovereign Debt Crisis, National and International Responses," 381.
[231] Chari and Bernhagen, "Financial and Economic Crisis: Explaining the Sunset over the Celtic Tiger," 475.

became a subsidy of the AIB Group, thus leaving Ireland with only three domestic banks.[232]

Bad Asset Management and Incentives to Revive the Property Market

At the centre of the government lead responses was a revival of the property market. By fall 2012, Moody's estimated that half of all Irish mortgages were in negative equity, while others went even higher.[233] To mitigate the impacts, the government decided to reclassify some statistics definitions to artificially lower the number of vacant dwellings. Other dwellings judged non-commercializable were demolished. Thus, Ireland divested itself of the most blatant remnants of the once-faded boom, the *ghost estates*.[234] To avoid increases in vacant dwellings, the government issued a moratorium on possessions in 2010 that covered all borrowers, conditioned upon willing cooperation with their lenders. Even though 23% of all mortgages were in arrears, Ireland maintained an extremely low level of repossessions.[235] With its 0.25%, it represented but a fragment of the British 3% or the US 5% of home repossessions.[236] This was notably because of leniency and political will to protect the sector from further fall. The government firstly preferred short-term relief to borrowers in distress, primarily via forbearance by lenders. The focus was put namely on temporary measures such as interest-only payments. In the second phase, ca. from the beginning of 2013, the government resorted to debt write-downs through a new legislative framework and guidance for lenders.[237]

As mentioned above, NAMA's second task was asset management. With the newly acquired bad loans, it had at its disposal 60,000 property units, representing 47% of Irish GDP.[238] Since 2012, NAMA has focused on international markets, mostly private equity firms and hedge funds, using a number of strategies and activities. Firstly, by clustering discounted loan portfolios, NAMA managed to attract big foreign investors, protecting

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[232] O'Callaghan, Kelly, Boyle, and Kitchin, "Topologies and topographies of Ireland's neoliberal crisis," 38.
[233] Waldron and Redmond, "POLICY REVIEW: The Extent of the Mortgage Crisis in Ireland and Policy Responses," 153.
[234] O'Callaghan, Kelly, Boyle, and Kitchin, "Topologies and topographies of Ireland's neoliberal crisis," 41.
[235] Waldron and Redmond, "POLICY REVIEW: The Extent of the Mortgage Crisis in Ireland and Policy Responses," 153.
[236] Ibid., 162.
[237] Ibid., 157.
[238] Byrne, "Asset Price Urbanism' and Financialization after the Crisis: Ireland's National Asset Management Agency," 7.

them by spreading risk into pools and packages. Thus the risk-to-profit ratio shifted to the investors' advantage and they were quick to use it. Secondly, it tackled lacking liquidity on the markets by providing a vendor finance[239] of €2bn to assist investors in purchase of its distressed assets, and another €2bn to revive development in economically crucial sites.[240] Among them were, for example, Dublin Docklands, as Dublin itself represented 67% of NAMA's assets. Thirdly, NAMA moderated potential losses by partaking in joint ventures, thus bearing a proportion of the risk itself.[241]

Finally, REITs[242] were introduced in Ireland for the first time in its history by the Finance Bill of 2013. These aimed at alluring investors to vacant properties located especially in Dublin.[243] REITs procured a link between large capital reserves of the biggest global players and local real estate market, and thus provided the sector with an additional, and almost inexhaustible, pool of capital.[244] NAMA restructured its portfolio by bundling up to suit the needs and desires of investors, including REITs, and its results were highly satisfying. Ultimately, this proved that the Irish revival was going to be neo-liberal and market-driven, unlike in most countries.[245]

Ireland became one of Europe's most undervalued property markets which attracted significant numbers of new investors. Owing to the 2013 and 2014 budgets introducing capital-gains tax exemptions, NAMA managed to entice increasing earnings. By late 2013, NAMA had already sold €10.9bn out of the total €74bn worth in loans.[246] NAMA thus not only disposed banks of uncertainty by purchasing the toxic assets and protecting them from further fall in value, but it played a key role in providing liquidity to the

[239] Vendor financing is the lending of money by a company to one of its customers so that the customer can buy products from it (*Investopedia, accessed 8 May, 2016, http://www.investopedia.com/terms/v/vendorfinancing.asp*).
[240] O'Callaghan, Kelly, Boyle, and Kitchin, "Topologies and topographies of Ireland's neoliberal crisis," 41.
[241] Byrne, "Asset Price Urbanism' and Financialization after the Crisis: Ireland's National Asset Management Agency," 7.
[242] Real Estate Investment Trust is a type of security that invests in real estate through property or mortgages and often trades on major exchanges like a stock. REITs provide investors with an extremely liquid stake in real estate. They receive special tax considerations and typically offer high dividend yields (*Investopedia, accessed 8 May, 2016, http://www.investopedia.com/terms/r/reit.asp*).
[243] O'Callaghan, Kelly, Boyle, and Kitchin, "Topologies and topographies of Ireland's neoliberal crisis," 42.
[244] Byrne, "Asset Price Urbanism' and Financialization after the Crisis: Ireland's National Asset Management Agency," 10.
[245] O'Callaghan, Kelly, Boyle, and Kitchin, "Topologies and topographies of Ireland's neoliberal crisis," 42.
[246] Ibid., 42.

economy, all in correspondence with its goal: to use capital from assets sales to redeem its bonds, thus propelling transactions flows.[247]

4.1.2 Fiscal Consolidation

Given the massive financial injections to the banking sector and sharp decrease in tax revenues, the Irish budget saw a precipitous fall. While the revenue was €61bn in 2007, it dropped to €47bn in 2010. Contemporaneously, the expenditure increased significantly from €52.5bn to €61bn.[248] Thus, Ireland could not count on economic stimulus and it had to undertake severe expenditure cuts instead. Ultimately, it has undergone much more severe fiscal tightening than other countries in the EU, i.e. 18.5% of national income by late 2013, while Spain only underwent a 9% change.[249]

Public Sector Expenditure Reduction

Following the deterioration of government budget, Ireland opted for extensive expenditure cuts. Between March 2009 and January 2010 alone, civil servant salaries fell by 14% on average and did not increase until 2014. In July 2010 a national implementation body was established, responsible for introduction of the Public Service Agreement (Croke Park Agreement I), agreed between representatives of the government and labour unions in June 2010. The aim of this restructuring framework for 2010 - 2014 was to achieve higher flexibility and efficacy, and it was followed by the Croke Park II proposition in late 2013. The second agreement, which served to save €1bn by 2016 through further cuts in highest levels of public sector and other measures, was, however, rejected by the unions. To their great discontent, the government decided to impose further reforms itself, based on the principles of the Croke Park II.[250]

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[247] Byrne, "Asset Price Urbanism' and Financialization after the Crisis: Ireland's National Asset Management Agency," 8.
[248] Kinsella, Stephen, "Is Ireland really the role model for austerity?" *Cambridge Journal of Economics* 36 (2012): 230.
[249] Bozio, Antoine, Emmerson, Carl, Peichl, Andreas, and Tetlow, Gemma, "European Public Finances and the Great Recession: France, Germany, Ireland, Italy, Spain and the United Kingdom Compared," *Fiscal Studies* 36, No. 4 (2015): 416.
[250] Robbins and Lapsley, "The success story of the Eurozone crisis? Ireland's austerity measures," 94.

Structural Reforms of the Public Sector

In 2011, the Department of Public Expenditure and Reform of the Irish government was created, and its inaugural minister, Brendan Howlin, expressed urgent need for reform in parts of the public sector. In pursuance of the Croke Park agreements, the government started to issue Comprehensive Expenditure Reviews as a means to better control over the public finances. The focus was put on innovation, efficacy and customer service. Even though the Irish predicament was not rooted in fiscal imbalances, much of the austerity programme aimed at expenditure cuts.[251] Public services were primarily affected; however, education and healthcare cuts were to rather a minor extent. Most important reductions concerned justice (-13%) and other, smaller areas of the government.[252]

The *National Recovery Plan* (NRP) was introduced in November 2010, several days after the formal request for a bailout. The Plan had been discussed beforehand with representatives of the European Commission, and the bailout was conditioned upon several of its objectives. These included not only the primary focus on deficit reduction to -3%, as set by the Stability and Growth Pact, but also specific numbers concerning public sector restructuring. A €15bn budgetary adjustment was agreed for the 2011-14 horizon. A major part consisted of expenditure cuts, atop the €1.9bn savings achieved already in 2009 via the public sector wages and pension reductions channel, representing the first public sector cuts in salaries from 1933. The remaining €5bn was supposed to be earned from increased tax revenue, mostly from a broadened tax base, since in 2010, 45% of tax units still paid no income tax.[253]

The first NRP budget for 2011 was focused on reduction of wages, social protection and expenditure. The following budgets, however, already introduced some structural changes including new taxes and the establishment of an *Employment Control Framework*. It evaluated the needs of the public sector and realized further staff reductions. Unlike Greece, Spain or Portugal, Ireland succeeded in implementing important structural reforms, not only reducing its expenses. Expenditure cuts and staff dismissals, as unpleasant as they were, were directed at achieving maximum efficiency

[251] Ibid., 95.
[252] Bozio, Emmerson, Peichl and Tetlow, "European Public Finances and the Great Recession: France, Germany, Ireland, Italy,Spain and the United Kingdom Compared," 421.
[253] Robbins and Lapsley, "The success story of the Eurozone crisis? Ireland's austerity measures," 96.

with minimal costs and were thoughtfully elaborated under the frameworks issued by the newly created Department of Public Expenditure and Reform.[254]

Tax System Reform

Alongside Greece, Ireland introduced the largest fiscal consolidation package. It consisted primarily of spending cuts rather than tax increases, which represented a crucial point during the negotiations with Troika[255], as Ireland strictly opposed an primarily excessive corporate tax not to inhibit investment.[256] While most countries decided to make adjustments to their income tax systems focusing primarily on top marginal rates, Ireland was a unique exception. It introduced a large scale reform, increasing income tax rates for all individuals, including lower-income.[257] This was both in accordance with the highest level of crisis countermeasures and neo-liberal policies Ireland decided to pursue.

Apart from that, Ireland increased VAT from 21% to 23%. That was also the case of most European countries. However, in contrast to them, Ireland also decided to implement significant cuts in benefits.[258] Besides that, the government introduced new taxes, including new residential property tax and environmental taxes, namely carbon and water tax. Personal income tax bands were lowered, which also contributed to the broadening of the tax base.[259] Nevertheless, it protected its extremely low level of corporate tax.

4.1.3 External Aid

The European Commission played an important role during the first years of the Irish crisis. The assistance consisted mostly of "soft" steps, such as consulting on the austerity programme of 2010 and recommendations concerning expenditure cuts. It also approved Irish government guarantees, and the ECB provided important liquidity to the Irish Central Bank and the commercial banks through *ELA programme*[260]. On the other hand, Ireland strictly rejected a bail-out from the European Union, even after a pressure from

[254] Ibid., 96.
[255] Representatives of the European Commission, the ECB and the IMF.
[256] Bozio, Emmerson, Peichl and Tetlow, "European Public Finances and the Great Recession: France, Germany, Ireland, Italy,Spain and the United Kingdom Compared," 428.
[257] Ibid., 417.
[258] Ibid., 417.
[259] Kinsella, "Is Ireland really the role model for austerity?" 228.
[260] Emergency Liquidity Assistance was an exceptional measure of provision of ECB credit other than monetary operations provided to Euro Area banks that lack liquidity.

the Commission, which wanted to minimize losses of potential spreads, mostly to big economies such as Italy or Spain.[261]

Even though its conditions were far from as disastrous as the Greek ones, concerned about potential contagion, the ECB warned Ireland it might interrupt its access to emergency funding if it refused the Troika bailout.[262] Patrick Honohan, the governor of the Central Bank of Ireland, finally announced the Irish demand for bailout without prior consent of the Irish government, which further illustrates the Irish unwillingness to proceed to such measure. The demand was formally propounded on the 21st November 2010.[263]

This decision was far from consensual and the public greeted it with utmost reluctance. An aggravating fact was that the cost of the €85bn bailout from Troika in the form of interest payments was €5.6bn in 2011 alone.[264] It was understood as an imposed dictate that the country did not need and as a punishment for its unyielding tax policies, mostly the low corporate tax that the Irish were unwilling to harmonize.[265] This sentiment became rooted thereafter in the Irish population, and was periodically strengthened by various EU control steps. For instance, in November 2011, the German Bundestag pre-negotiated the Irish budget before it was submitted to the Irish government itself.[266]

Given the fact that the bailout was rather hard-won by the European institutions and that the Commission had already intensively cooperated with the Irish government, notably during the negotiations preceding the introduction of the austerity programme, things proceeded very quickly. It was finalized in less than a month on 16 December.[267] It was supposed to help Ireland to finish the restructuring of the banking sector and ultimately sell off the nationalized banks.[268]

The *Economic Adjustment Program for Ireland* was spaced between 2011 and 2013 and payments of the €85bn were realized quarterly to ensure Irish compliance with the bail-

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[261] Šlosarčík, *Irsko a krize:Politika a ekonomika Irské republiky v letech 2008-2014 a její evropské souvislosti*, 32.
[262] O'Callaghan, Kelly, Boyle, and Kitchin, "Topologies and topographies of Ireland's neoliberal crisis," 40.
[263] Šlosarčík, *Irsko a krize:Politika a ekonomika Irské republiky v letech 2008-2014 a její evropské souvislosti*, 33.
[264] Chari and Bernhagen, "Financial and Economic Crisis: Explaining the Sunset over the Celtic Tiger," 476.
[265] Šlosarčík, *Irsko a krize:Politika a ekonomika Irské republiky v letech 2008-2014 a její evropské souvislosti*, 37.
[266] Robbins and Lapsley, "The success story of the Eurozone crisis? Ireland's austerity measures," 96.
[267] Šlosarčík, *Irsko a krize:Politika a ekonomika Irské republiky v letech 2008-2014 a její evropské souvislosti*, 34.
[268] Grossman and Woll, "Saving the Banks: The Political Economy of Bailouts," 587.

out conditions. Apart from the €22.5bn from both EFSM and IMF and €17.5bn from EFSF, it also consisted of bilateral loans from three EU-15 member states outside the Euro Area – the United Kingdom (€3.8bn), Sweden (€0.6bn) and Denmark (€0.4bn). A contribution of €17.5bn was set for Ireland itself from its Treasury and National Pension Reserve Fund. For each actor there were different conditions, notably due dates and interest payments.[269]

The bailout was conditioned upon structural reforms of public sector and fiscal policy as well as a €10bn government budget correction (a reduction of expenditure and increase of tax revenue).[270] Domestic authorities also had to put forward quarterly reports concerning their implementation. In the end, results of all of the submitted reviews met with conditions from Troika.[271] The Irish bank bailout was of a gargantuan nature as it reached 38% of GDP, a number unrivalled by any other European bank bailout. Even Greece only rose to 28%.[272]

4.1.4 Specificities of the Irish Case

The Irish political elites quickly adopted a constructive narrative. They understood Ireland as a separate case with specific roots of the crisis and the necessity of distinct responses as compared to other countries. They did not resort to hiding behind a pan-European curtain of financial difficulties but rather sought to present austerity measures as crucial aspects of regaining competitiveness and hence financial independence. Given this neoliberal political will to rehabilitate the economy and the specificities of the Irish economy, Ireland was once again held up as an example to the entire EU, if not the world; this time as a "poster child for fiscal austerity".[273]

[269] Šlosarčík, *Irsko a krize:Politika a ekonomika Irské republiky v letech 2008-2014 a její evropské souvislosti*, 34.
[270] Ibid., 35.
[271] Robbins and Lapsley, "The success story of the Eurozone crisis? Ireland's austerity measures," 95.
[272] Chari and Bernhagen, "Financial and Economic Crisis: Explaining the Sunset over the Celtic Tiger," 476.
[273] O'Callaghan, Kelly, Boyle, and Kitchin, "Topologies and topographies of Ireland's neoliberal crisis," 41.

Political Environment

Apart from displeasure from the Irish public, only minor examples of civil unrest occurred and no major new party entered the political scene, as compared to the emergence of *Podemos* in Spain. The Minister of Finance, Brian Lenihan, struck a deal with the opposition to dissolve *Dáil Éireann*[274] in exchange for the 2011 budget, vital for the Troika bailout. Even though the Irish political scene experienced an unprecedented upheaval when the largest party since 1932, Fianna Fáil, lost 51 of its 71 seats, the transition was consensual and characterized by co-operation on greater challenges.[275]

The new coalition of Fine Gael and Labourists, under Enda Kenny, did not choose major discrediting of its predecessor's crisis countermeasures. As the new government had a significant majority, Ireland could enjoy stability. Important labour market flexibility and competitiveness reforms could have been successfully passed.[276] Even if the new government attempted repeatedly to achieve softening of the bailout conditions, it lead the country to a successful return to international markets financing as Ireland exited the programme in December 2013. Consequently, it became the fastest growing Euro Area country and decided to repay some of its loans in advance.[277]

Trade Balance Situation

Specificities of the Irish economy played a crucial role in its stunning recovery. Primarily, it was the level of openness achieved by years of neo-liberalism when Ireland became a global export hub. While the fall in domestic demand significantly hindered imports, the exports experienced only a minor slowdown and have quickly recovered. Already in 2010, they reached higher levels than in the pre-crisis period, also owing to increased competitiveness through wage cuts and low prices. Thus, the Irish trade balance improved. Through its thoughtful fiscal policy adjustments, Ireland managed, unlike most countries, to increase its tax revenues without hindering exports.[278]

[274] Lower chamber of the Irish Parliament.
[275] Gallagher, Michael, and Marsh, Michael, *How Ireland Voted 2011: The Full Story of Ireland's Earthquake Election* (New York: Palgrave Macmillan, 2011), 144.
[276] Robbins and Lapsley, "The success story of the Eurozone crisis? Ireland's austerity measures," 97.
[277] Šlosarčík, *Irsko a krize:Politika a ekonomika Irské republiky v letech 2008-2014 a její evropské souvislosti*, 39.
[278] Kinsella, Stephen, "Post-Bailout Ireland as the Poster Child for Austerity," *CESifo forum* 15, No. 2 (2014): 22.

Despite austerity, Ireland decided to continue in the previously successful path of neo-liberalism to attract domestic and foreign private capital. Apart from property-market stimulating neo-liberal plans, the main focus was put on exports.[279] In the Irish case, the government was able to take high expenditure cuts as well as high taxation at the same time, owing to reduction of imports and maintaining high levels of exports. This was, however, merely conditioned upon the level of openness of the Irish economy. Such levels of austerity would not have been otherwise able to bring the desired results.[280]

4.1.5 Irish Conditions upon Bailout Exit

Ireland managed to implement most impressive consolidation over a very short period of time without any major industrial or social upheaval. Even though the austerity measures had a much higher impact on the domestic economy than the EU/IMF predictions estimated, Ireland was able to overcome it thanks to its reinvigorated, export-led growth and the flexibility of its economy.[281] The government balance improved significantly from an abysmal -32.3% in 2010 to "only" -12.5% in 2011, and it maintained a steady amelioration progress towards the -3% level.[282] As lower deficits in principle lead to investment increases and consequent capital inflows, it creates favourable prerequisites for output to grow.[283] Already in 2010, the Irish GDP growth rate turned positive, and from late 2013 it became the fastest growing Euro Area country with almost 5% annual growth.[284]

Ireland achieved full compliance with the Troika set of conditions in all quarterly reports and the consequences of the bailout were also much more agreeable than in some other cases. No cuts for government bond holders or bank depositors occurred, as was the case in Greece and Cyprus respectively, and Ireland exited the programme as arranged.[285] It managed to assure the financial markets of its solvency and, more importantly, regain the

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[279] O'Callaghan, Kelly, Boyle, and Kitchin, "Topologies and topographies of Ireland's neoliberal crisis," 39.
[280] Kinsella, "Post-Bailout Ireland as the Poster Child for Austerity," 24.
[281] Ibid., 22.
[282] "General Government Deficit," Official Site of OECD Data, https://data.oecd.org/gga/general-government-deficit.htm.
[283] Kinsella, "Is Ireland really the role model for austerity?" 230.
[284] "Domestic Product," Official Site of OECD Data, https://data.oecd.org/gdp/real-gdp-forecast.htm.
[285] Šlosarčík, *Irsko a krize:Politika a ekonomika Irské republiky v letech 2008-2014 a její evropské souvislosti*, 41.

dynamics of its growth. Government bond yields, which reached a terrifying level of 14% in mid-2011, dropped to 3.67% by the end of 2013.[286]

[286] Robbins and Lapsley, "The success story of the Eurozone crisis? Ireland's austerity measures," 93.

4.2 Spain

Spain was much slower in its reaction to the crisis, especially on financial markets. Given the deficiencies of its economy, the fiscal consolidation programme was limited when compared to the Irish measures (as were its impacts). Structural reforms that Spain had needed for decades, including reforms of the labour market, pensions and product liberalization, were implemented either late or not at all, which left Spain with low prospects for a speedy recovery.[287] Other key aspects, explained in the following subchapters, played an equally important role in its insufficient recovery process.

4.2.1 Financial Sector Reforms and Crisis Countermeasures

In Spain, major financial sector countermeasures were introduced as late as in mid-2012. By that time, Spanish public finances were already in a dismal state, as were other macro-economic and social indicators. Unlike in Ireland, the financial sector measures followed rather than preceded high deficits, and were aimed at limiting the impact of the poor financial sector situation in the government budget.[288] The Spanish strategy was therefore an *ex post* measure using the restoration of the financial sector to boost the economy, while the objective of the Irish *ex ante* measures was to avoid deeper fall.

Deposit Guarantee Scheme

Guarantee steps undertaken in Spain were of much lesser importance than in Ireland. Spain did not introduce a blanket guarantee, nor even specific guarantees for chosen banks, as was the case in many other countries, including the joint Benelux guarantee for *Dexia*, Danish and French guarantees or various risk shields of the German government. In October 2008, Spain only increased the cap of its deposit guarantee from €20.000 to

[287] Conde-Ruiz, J. Ignacio, and Marín, Carmen, "The Fiscal Crisis in Spain," in "Austerity Measures in Crisis Countries-Results and Impact on Mid-term Development," *Intereconomics* 48, No. 1 (January 2013): 23.

[288] International Monetary Fund, "Spain: Financial Sector Reform—Final Progress Report," IMF Country Report No. 14/59, *International Monetary Fund* (February 2014), 3, http://www.imf.org/external/pubs/ft/scr/2014/cr1459.pdf.

€100.000 within F*ondo de Garantía de Depósitos*[289]. The aim of this measure was to ensure depositors of the soundness of the banking sector and avoid potential bank runs.[290]

Recapitalization and Restructuring of the Financial Sector

The *Fund for Orderly Bank Restructuring* (FROB)[291] was established in June 2009. This public entity was charged with the management and control of failing banks recapitalization and restructuring, with initial budget was €9bn, later increased by an additional €6bn. The interventions were divided into three rounds. The first one distributed €9.7bn in 2010, the second €4.8bn the next year. The third round of 2012 already required financial assistance from the EU as it provided much larger sums, i.e. €39bn. The majority of it was in the form of capital provision and €1.1bn in the form of CoCos[292]. Ultimately, it distributed €53.6bn to help recapitalize the banking sector and apart from that, it controlled restructuring and merges.[293]

By mid-2012, the falling property prices, tighter credit provision regulations and low domestic demand required stronger government reaction to help the undercapitalized sector. An extensive stress tests framework was launched in September to evaluate the situation of ten banks with presumed capital shortfalls, dividing them into three categories based on their ability to fill their liquidity needs. Banks in the two groups most exposed to losses in adverse scenarios were submitted either to restructuring plans or to resolution plans (in case their survival was judged impossible).[294]

In total, almost €56bn was needed to fill the capital shortfalls. The completion was achieved mostly in early 2013 and was composed of 70% of public capital injections, 23% of junior debt bail-in and 6% of private capital injections.[295] Consequently, the state

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[289] Deposit Guarantee Fund, Spanish deposit guarantee scheme.
[290] "State aid: Overview of national rescue measures and deposit guarantee schemes," Official Site of the European Commission, accessed 21 April, 2016, http://europa.eu/rapid/press-release_MEMO-08-619_en.htm?locale=en.
[291] Fondo de reestructuración ordenada bancaria.
[292] Contingent convertibles (CoCos) refer to a security similar to a traditional convertible bond in that there is a strike price (the cost of the stock when the bond converts into stock). What differs is that there is another price, even higher than the strike price, which the company's stock price must reach before an investor has the right to make that conversion (*Investopedia, accessed 8 May, 2016, http://www.investopedia.com/terms/c/contingentconvertible.asp*).
[293] "Naturaleza y régimen jurídico," Official Site of the FROB: Autoridad de Resolución Ejecutiva, accessed 21 April, 2016, http://www.frob.es/es/Sobre-el-FROB/Paginas/Naturaleza-y-regimen-juridico.aspx
[294] International Monetary Fund, "Spain: Financial Sector Reform—Final Progress Report," 8.
[295] Ibid., 8.

became an important actor in the banking system and held 18% of all loans.[296] This was, however, much less than in Ireland. In the end, three banks in particular have been restructured from FROB: *Bankia* (the fourth largest bank which received significantly more than any other bank, over €22bn), *Catalunya Bank* and *NCG Banco*. These three received €43.5bn combined, while the fourth largest share was injected into *Banco de Valencia*, bought from FROB for one euro by the third largest Spanish bank, *Caixabank*. Restructuring of these four banks was one of conditions of the EU accorded bailout.[297] [298]

Bad Asset Management

Similarly to Ireland, Spain opted for restructuring of the financial sector, notably of its bad debt via assets management agency. The Spanish SAREB[299] took over foreclosed assets and REDs[300] for €51bn from the four banks nationalized by FROB. The trade-off was also characterized by a significant write-down of 53% (as compared to 54% in Ireland). In total, 200,000 REDs were sold to SAREB in exchange for government-guaranteed bonds.[301]

SAREB positively influenced the Spanish financial sector through several channels. Firstly, by disposing banks of bad debt, it boosted confidence in their solvency in case of further market shocks. Secondly, it provided liquidity given high collateral of SAREB bonds as opposed to the illiquid foreclosed assets. Lastly, the toxic asset management, if done correctly under the state-owned bad bank, as was the case in Ireland, can propel revitalization of the property market.[302]

Concurrently, this measure exposed public finances to the risks of future market value evolution of these assets, as the government guarantee on SAREB bonds increased its

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[296] Ibid., 9.
[297] "Cuentas anuales," Official Site of the FROB: Autoridad de Resolución Ejecutiva, accessed 22 April, 2016, http://www.frob.es/es/Sobre-el-FROB/Paginas/Informes-de-cuentas-anuales.aspx.
[298] Davies, Nigel and de Miguel, Rodrigo, "Caixabank to buy nationalised Banco de Valencia for 1 euro-FROB," *Reuters*, 27 November, 2012, accessed 25 April, 2016, http://www.reuters.com/article/lacaixa-bancodevalencia-idUSE8E8IR00K20121127.
[299] Sociedad de Gestión de Activos procedentes de la Reestructuración Bancaria (Company for the Management of Assets proceeding from Restructuring of the Banking System).
[300] Real Estate Development loans.
[301] International Monetary Fund, "Spain: Financial Sector Reform—Final Progress Report," 10.
[302] Ibid., 10.

contingent liabilities[303]. Moreover, SAREB was not as successful as NAMA at incentivizing the property market regeneration for the lack of liquidity and low prices, and only slowly creates revival strategies. Thus, while SAREB managed to increase its sales in 2013, profit margins decreased because of further falling prices and a preference for less profitable wholesale deals. Nonetheless, SAREB had its positive impacts on the Spanish market. By late 2013, it had already achieved a transfer of assets, bonds issuance and due diligence on 80% of the assets, which showed that the actual price was not inferior to the purchasing value.[304]

Structural Reforms of the Banking Sector

Royal Decree Law of August 2012 introduced ground-breaking powers for authorities over the banking sector. It implemented new tools for intervention to successfully recapitalize and restructure the financial sector, to impose mandatory burden-sharing and to restore stability by vesting powers to FROB.[305] The savings banks reform aimed at resolving one of the most important flaws of the Spanish financial sector - the *cajas* controversy. *Cajas* were thereafter put under the authority of the BdE[306] and great effort was made to interrupt political ties within their management. They were also able to raise equity in contrast to the previous situation as they had no formal stockholders.[307] Apart from strengthened powers over all domestic banks, BdE also increased capital requirements and provision requirements for REDs and foreclosed assets.[308]

Another reform was passed in December 2013 including increased regulation of the last two remaining small banks and transformation of some savings banks into foundations. It was the case of *cajas* that were stockholders of commercial banks, raising concerns about their capacity to provide them with capital. Henceforth, as foundations they were subjected to other regulation criteria, which would ultimately lead to the separation of savings and commercial banks ties.[309]

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[303] A contingent liability is a potential obligation that may be incurred depending on the outcome of a future event that is uncertain (*Investopedia, accessed 8 May, 2016, http://www.investopedia.com/terms/c/contingentliability.asp*).
[304] International Monetary Fund, “Spain: Financial Sector Reform—Final Progress Report,” 11.
[305] Ibid., 13.
[306] Banco de Espagna, Central Bank of Spain.
[307] International Monetary Fund, “Spain: Financial Sector Reform—Final Progress Report,” 13.
[308] Ibid., 7.
[309] Ibid., 14.

4.2.2 Fiscal Consolidation

The beginning of the crisis had grave consequences for Spanish public finances. In 2008, the government budget worsened by 6.4%, falling to a deficit as a consequence of low revenue (-4.2% of GDP) and high expenditure (+2.2% of GDP).[310] In the first years of the crisis, Spain adopted countercyclical measures within expansionary fiscal policy. Tax cuts and liquidity support on one side and increased expenditure to stimulate activity on the other represented 4% of GDP.[311] Even though they might have mitigated some impacts on the economy, it mostly led to considerable fiscal balance deterioration. The situation was even aggravated by the income tax cutting reform, implemented before the crisis. Ultimately, the deficit reached -11% of GDP in 2009.[312]

Public Sector Expenditure Reduction

Given the growing finance difficulties, Spain decided to implement fiscal consolidation measures in 2010. Following the Greek, Irish and Portuguese bailout requests, increased alertness of investors and deteriorating public finances, Spanish sovereign spreads rose to the worst level in history in May 2010.[313] The government reacted swiftly by introducing an expenditure cuts package of 1.5% of GDP for 2010 and 2011. It consisted primarily of freezes of public sector wages and curbs of compensations and public sector investment. Further cuts and tax increases were covered in the 2011 budget, compliant with the EDP[314] plan which set deficit targets for Spain of 9.3% (2010), 6.0% (2011) and 4.4% (2012).[315]

While the effects were fast and the overview for 2010 was in accordance with the EDP, the next year's results came as an unpleasant surprise, exceeding the target by -3.5% and even slightly deteriorating from previous year.[316] The most important factor of the

[310] Martí, Francisco, and Pérez, Javier J., "Spanish Public Finances through the Financial Crisis," *Fiscal Studies* 36, No. 4 (2015): 536.
[311] Conde-Ruiz and Marín, "The Fiscal Crisis in Spain," 23.
[312] Martí and Pérez, "Spanish Public Finances through the Financial Crisis," 540.
[313] Conde-Ruiz and Marín, "The Fiscal Crisis in Spain," 23.
[314] Excessive Deficit Procedure was a European Council guideline set for distressed countries to gradually lower their government deficits.
[315] Martí and Pérez, "Spanish Public Finances through the Financial Crisis," 541.
[316] "General Government Deficit," Official Site of OECD Data, accessed 22 April, 2016, https://data.oecd.org/gga/general-government-deficit.htm.

"double-dip" recession, when Spain faced further worsening in 2012, was expenditure slippage of the regional governments that weighed down the central deficit. Transparency-enhancing and tax collection improving measures adopted by the central government did not, unfortunately, have the desired effect on regional authorities. A revision of the EDP for Spain was therefore necessary.[317]

The expenditure cuts had serious consequences for the Spanish population as minimum income and social protection were reduced. Spain fell even lower in the EU-wide comparative statistics concerning welfare state. In 2011, it reached only 51.3% of the EU-15 average for family and children per capita expenditure and even 39.6% for social exclusion. This also represented a rupture in the ameliorating trend from the previous decade, not only retrenchment as in many other countries.[318]

Comprehensive Fiscal Consolidation Measures

The insufficient effects of previous measures necessitated the implementation of a new comprehensive consolidation programme in late 2011. Apart from new taxes, it introduced extensive expenditure cuts at all levels of the government. Public sector wages were frozen and work hours increased, while a normalization of overemployment in public sector was achieved via recruitment freezes and restrictions on retiring employee replacements. Deep cuts afflicted, above all, education and healthcare, sectors left relatively untouched in Ireland.[319] [320]

These two domains are managed under the authority of the regional governments; however between 2012 and 2013 alone, the central government cut their budget for social expenditure by 40%. In healthcare, it was through significant personnel reduction and privatisation. For illustration, in Catalonia, one of the wealthiest regions, the government had to suspend grants for hospitals, eventides and centres for the handicapped.[321] The

[317] Martí and Pérez, "Spanish Public Finances through the Financial Crisis," 541.
[318] Pavolinia, Emmanuele, León, Margarita, Guillén, Ana M., and Ascoli, Ugo, "From austerity to permanent strain? The EU and welfare state reform in Italy and Spain," *Comparative European Politics* 13, No. 1 (2015): 71.
[319] Martí and Pérez, "Spanish Public Finances through the Financial Crisis," 543.
[320] Bozio, Emmerson, Peichl and Tetlow, "European Public Finances and the Great Recession: France, Germany, Ireland, Italy,Spain and the United Kingdom Compared," 429.
[321] Frotiée, Brigitte, "Transformation du modèle social: le cas de l'Espagne," *Informations sociales* No. 180 (June 2013): 126.

education budget was reduced by 14%, producing major complications especially for secondary education.[322] Consequently, it resulted in the doubling of tuition fees.[323]

The *Fund for the Financing of Payments to Suppliers* (FFPP)[324] was established in March 2012 to help the non-central governments finance their debt from local private providers. Despite augmentation of central debt and moral hazard controversies, FFPP and other fiscal funds providing liquidity to subordinate governments played imperative role in avoiding spread of contagion between regions.[325]

Structural Reforms of the Public Sector

Most structural reforms were implemented from 2010 on. Spain managed to introduce major improvements to its public finances via a new set of fiscal rules targeted at breaking spending slippage at lower levels of administration. Regions were spending 35% of total expenditure while they were only collecting 19% of total revenues. Moreover, the transfer of collected taxes to the regions is delayed and the discrepancies between estimates and actual revenues do not show until two years later. Given the lack of fiscal responsibility, the time lag is procyclical by delaying the fiscal adjustments, and thus the regional authorities were pulling the reputation of Spanish public finances down.[326] The constitution was amended in pursuance of improved budgetary stability. Subsequently, a new *Budgetary Stability Law* was passed in April 2012 redefining budgetary and spending criteria and introducing new mechanisms of evaluation of their fulfilment. Quarterly data were thereafter published and accessible to the public to improve transparency management of the governments.[327] It also introduced detailed restrictions on public spending in the future, including a 60% debt-to-GDP ratio from 2020 on and guideline to reduce the debt and deficit by then. Considerable power was given to the central government, which could thereafter withdraw authorisation from regional administrations in case of non-compliance.[328]

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[322] Pavolinia, León, Guillén, and Ascoli, "From austerity to permanent strain? The EU and welfare state reform in Italy and Spain," 69.
[323] Frotiée, "Transformation du modèle social: le cas de l'Espagne," 126.
[324] Fondo para la financición de pagos a proveedores.
[325] Martí and Pérez, "Spanish Public Finances through the Financial Crisis," 544.
[326] Conde-Ruiz and Marín, "The Fiscal Crisis in Spain," 25.
[327] Martí and Pérez, "Spanish Public Finances through the Financial Crisis," 550.
[328] OECD, "Spain: From Administrative Reform to Continuous Improvement," OECD Public Governance Reviews, *OECD* (2014), 45, http://www.oecd.org/spain/spain-from-administrative-reform-to-continuous-improvement.htm.

Concurrently to the Irish IFAC, *Independent Fiscal Responsibility Authority* (AIReF)[329] was established with the objective of fiscal analysis, budgetary stability surveillance and economic forecasts validation.[330] AIReF was acting as an independent body that would not only improve Spanish public finances but also their credibility among investors.[331]

Another agency was established to tackle the structural excesses of public spending. The *Commission on the Reform of Public Administrations* (CORA)[332] was charged with evaluation of duplicities and dispensable posts at various levels of administration and in public corporations.[333] The main goal was to achieve a simplification and increased efficiency of the public sector by overcoming the complicated framework of various tiers of public management. A similar problem was targeted by the *Law for the Unit of Market* of December 2013, which was supposed to unify the fragmented market principles in different regions, thus enhancing competitiveness and investment.[334] In retrospect, CORA played a cardinal role in restructuring public sector reform.

Tax System Reform

As in Ireland, the VAT was increased and the change was quite radical, from 16% to 21% between 2010 and 2012.[335] Thus, Spain followed the EU-wide focus on indirect tax increases and it implemented only limited changes to income tax rates, aiming primarily at the highest bracket.[336] Income tax therefore did not play as important a role as indirect taxation, including not only VAT but also new taxes, e.g. environmental. The first effect could be noticed already in 2010 when Spain experienced annual increase in taxes, as compared to previous precipitous falls. The most visible amelioration was recorded in 2013 when the tax revenue fully showed the fruits of the 2010-12 reforms.[337] Unlike Ireland, however, Spain was reluctant to implement benefit curbs.[338] Subsequently,

[329] Autoridad Independiente de Responsabilidad Fiscal.
[330] Bozio, Emmerson, Peichl and Tetlow, "European Public Finances and the Great Recession: France, Germany, Ireland, Italy,Spain and the United Kingdom Compared," 426.
[331] Martí and Pérez, "Spanish Public Finances through the Financial Crisis," 550.
[332] Comisión para la Reforma de las Administraciones Públicas.
[333] Ibid., 551.
[334] OECD, "Spain: From Administrative Reform to Continuous Improvement," 53.
[335] Martí and Pérez, "Spanish Public Finances through the Financial Crisis," 545.
[336] Bozio, Emmerson, Peichl and Tetlow, "European Public Finances and the Great Recession: France, Germany, Ireland, Italy,Spain and the United Kingdom Compared," 417.
[337] Martí and Pérez, "Spanish Public Finances through the Financial Crisis," 542.
[338] Bozio, Emmerson, Peichl and Tetlow, "European Public Finances and the Great Recession: France, Germany, Ireland, Italy,Spain and the United Kingdom Compared," 418.

unemployment benefits as percentage of GDP doubled in 2010-13 and pensions rose significantly as well.[339]

4.2.3 External Aid

In 2010, European Commission changed the nature of recommendations for the periphery. As the Euro Area entered the sovereign debt crisis, they became more precise and strict. Spain conformed to a deadline of 2 June 2010 to implement measures to reduce deficit already in May when it announced the biggest expenditure cuts since the fall of the dictatorship. The estimates, however, showed that this might not be sufficient and the Commission required further reforms of pensions and the labour market. They were adopted, even though to a limited extent, in August and September 2010, respectively.[340] Reforms of the labour market made it easier for employers to dismiss their employees while reducing the procedure as well as severance pays. Other aspects of the labour market were made more flexible, such as prolongation of trial periods, and representing measures strongly opposed by labour unions and the broader public.[341] The volume of countermeasures, as well as the achieved flexibility, was considerably lower than in Ireland and most of its problems persisted.

Given the peaking government bond yields, Spain was no longer able to finance itself while simultaneously recapitalizing its banking sector. The government thus had to request financial assistance from the EU in June 2012. The assistance was accorded in a rather inglorious manner as it was concluded on much different terms than the Spanish Prime Minister, Mariano Rajoy, desired. Spain was put under the surveillance of Troika, even though the IMF did not contribute to the funds. Similarly, financial assistance was provided from *European Stability Mechanism* (ESM)[342], instead of from the *European Financial Stability Facility* (EFSF)[343] as the Spanish would have preferred. Thus, Spain

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[339] Martí and Pérez, "Spanish Public Finances through the Financial Crisis," 545.
[340] Pavolinia, León, Guillén, and Ascoli, "From austerity to permanent strain? The EU and welfare state reform in Italy and Spain," 68.
[341] Frotiée, "Transformation du modèle social: le cas de l'Espagne," 126.
[342] The European Stability Mechanism started its operations on 8 October 2012 and it is currently the sole mechanism for responding to new requests for financial assistance by euro area Member States. It has provided loans to Spain, Cyprus and Greece. (*European Commission, accessed 9 May 2016, http://ec.europa.eu/economy_finance/eu_borrower/efsm/index_en.htm*).
[343] The European Financial Stability Facility was created as a temporary crisis resolution mechanism by the euro area Member States in June 2010 and has provided financial assistance to Ireland, Portugal and Greece. (*ESFS, accessed 8 May, 2016, http://www.efsf.europa.eu/about/index.htm*).

became the first beneficiary of the ESM which bore one distinctive difference as compared to the EFSF: preferred-creditor status. ESM debt is senior, meaning that it has preference over already existing sovereign debt, a fact that Rajoy feared might alarm financial markets.[344]

In December 2012, €100bn was made available for Spain, of which Spain chose to use €41.3bn, representing 4% of its GDP. As the money was primarily intended for banking sector recapitalization, its distribution was distributed via FROB.[345] It was conditioned upon the *Memorandum of Understanding*, a Council requirement concerning detailed monitoring of the banking sector, adopted in July 2012. It was supposed to provide not only surveillance but also guidelines to full restoration of the sector, in exchange for increased EU control with a high level of enforcement. As was the case in Ireland, quarterly evaluated compliance to the agreed terms was a prerequisite to the fund.[346]

4.2.4 Specificities of the Spanish Case

The Spanish general election of 2011 was similar to the Irish as it brought about a political earthquake. The incumbent socialist government of José Luis Rodríguez Zapatero suffered its biggest defeat since the end of *Francoism*. The new Prime Minister, Mariano Rajoy, could count on a majority in the Parliament, as could Enda Kenny; however, his position was constantly contested and destabilized by non-political powers.[347] Even King Juan Carlos, the enigmatic figure traditionally treated with the utmost respect, was affected by the discontent of the public following his elephant-hunting trip to Botswana.[348] Despite relative political stability, displays of civil unrest hindered the recovery process, all the more so given the structural deficiencies of the Spanish economy.

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[344] Weismann, Gerrit, "Troika to Supervise Spanish Bank Loan," *Financial Times*, 11 June, 2012, accessed 26 April, 2016, http://www.ft.com/intl/cms/s/0/5c1d283a-b3e2-11e1-8fea-00144feabdc0.html#axzz46rCoEP6f.
[345] Martí and Pérez, "Spanish Public Finances through the Financial Crisis," 543.
[346] Pavolinia, León, Guillén, and Ascoli, "From austerity to permanent strain? The EU and welfare state reform in Italy and Spain," 65.
[347] Plaza, Ana Martín, "Rajoy logra para el PP una mayoría histórica con 186 diputados y el PSOE se hunde con 110," *RTVE*, 20 November, 2011, accessed 26 April, 2016, http://www.rtve.es/noticias/20111120/rajoy-logra-historica-mayoria-absoluta-186-diputados-psoe-se-hunde-110/476868.shtml.
[348] Cano Fuentes, Etxezarreta Etxarri, Dol and Hoekstra, "From Housing Bubble to Repossessions: Spain Compared to Other West European Countries," 1200.

Civil Unrest

Spain demonstrated all attributes for a deep social crisis for the reasons discussed above, including sharp increase in unemployment, high levels of repossessions, declining housing prices, subprime lending and very low levels of welfare state protection.[349] The situation was all the more troubling given the fact that Spain has one of the most difficult systems to declare personal bankruptcy, and therefore negative equity can be a life-long strain.[350]

Unlike in Ireland, a very vocal opposition was created against the government-imposed austerity measures and the so-called European dictate. Even the employed started to feel oppressed by increased taxes and decreasing wages, and exposed to whichever will of the authorities as the two biggest labour unions, *CC. OO.* and *UGT*, were bargaining deals with the government, judged deleterious by the workers. Spontaneous reactions turned to movements of dissatisfaction, such as *Indignados*, *Democracia real ya* or *Jóvenes sin future*.[351]

The most important of all became the *M-15* movement, named after a massive anti-government demonstration on 15 May 2011. It maintained an opposition to the government held narrative that the society was collectively responsible for the crisis, blaming the financial industry for the impacts.[352] It was enriched by already-existing social movements, with increasingly elaborate structure and attendance. The local and district assemblies became very popular and liked by the general public with their pacifist but very clear expression of frustration about the situation.[353] Most of its supporters became voters of the new left-wing, anti-austerity party, *Podemos*.

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[349] Cano Fuentes, Etxezarreta Etxarri, Dol and Hoekstra, "From Housing Bubble to Repossessions: Spain Compared to Other West European Countries," 1207.
[350] Ibid., 1203.
[351] Etxezarreta, Navarro, Ribera, and Soldevila, "Boom and (deep) crisis in the Spanish economy: the role of the EU in its evolution," 28.
[352] Cano Fuentes, Etxezarreta Etxarri, Dol and Hoekstra, "From Housing Bubble to Repossessions: Spain Compared to Other West European Countries," 1214.
[353] Etxezarreta, Navarro, Ribera and Soldevila, "Boom and (deep) crisis in the Spanish economy: the role of the EU in its evolution," 28.

Insufficiency of the Adopted Measures

Although the measures adopted were seemingly sufficient, almost half of them were of a temporary nature and their effect on deficit reduction was therefore very limited. Above all, most of the structural reforms were belated and did not come into force until 2013, as was the case of the pension reform. Therefore, despite decreases of wages by -4% and of public investment by -75%, interest expenditure rose by +70% given the deteriorating conditions of the Spanish public finances.[354] Likewise, given the strong ties between tax revenue and the real estate sector, increases in VAT and income taxes could not make up for the losses followed by the bubble bursting. Spain had high marginal rates for both income taxes and VAT, while effective rates were low. The need for further reform was blatant, primarily for reduction of marginal rates and for elimination of deductions.[355]

In contradistinction to the Irish economy, Spain had another insufficiency. Irish deregulation was so thorough that it even exceeded the traditional models of liberalism, the US and the UK. The labour market in particular was highly flexible, which enabled it to adapt promptly to implemented measures. Spain, on the other hand, still had a rather Mediterranean type of economy, with important small businesses and focus on family, and the adaptation process was much longer and more painful than on the flexible Irish market.[356]

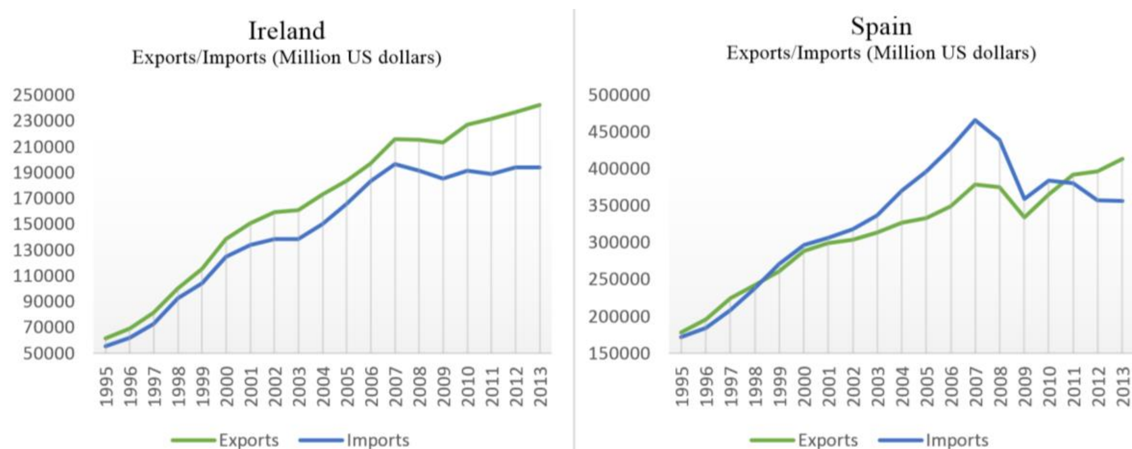
Trade Balance Situation

Contrary to Ireland, Spain, along with most peripheral countries, was not able to reach trade balance surpluses. While they were almost equal throughout the 1990s, imports started to rise incomparably to the lagging exports following the introduction of the euro. Figure 21 illustrates the difference in trade balance between Spain and Ireland. Apart from the automobile industry, Spanish foreign trade was ailing and was focused on low or medium-low technology industries with low profit ratios.[357] In contradistinction to the Irish exports dominated by IT and pharmaceutical/chemical products, Spain still focused

[354] Conde-Ruiz and Marín, "The Fiscal Crisis in Spain," 24.
[355] Ibid., 25.
[356] Cano Fuentes, Etxezarreta Etxarri, Dol and Hoekstra, "From Housing Bubble to Repossessions: Spain Compared to Other West European Countries," 1200.
[357] Oelgemöller, Jens, "Revealed Comparative Advantages in Greece, Ireland, Portugal and Spain," *Intereconomics* 48, No. 4 (September 2013): 246.

on low competitiveness sectors such as agricultural and food products.[358] It could not, therefore, afford to adopt fiscal consolidation measures to such an extent as was the case in Ireland without discouraging business activities in the country. Even the limited steps undertaken ultimately had a more serious impact on the Spanish society. The trade balance only improved in 2011, after falling domestic demand and lower prices, which could hardly be compared to the Irish situation.

Figure 21: Trade Balance of Ireland and Spain *(Exports/ Imports, Million US dollars, 1995 - 13)*



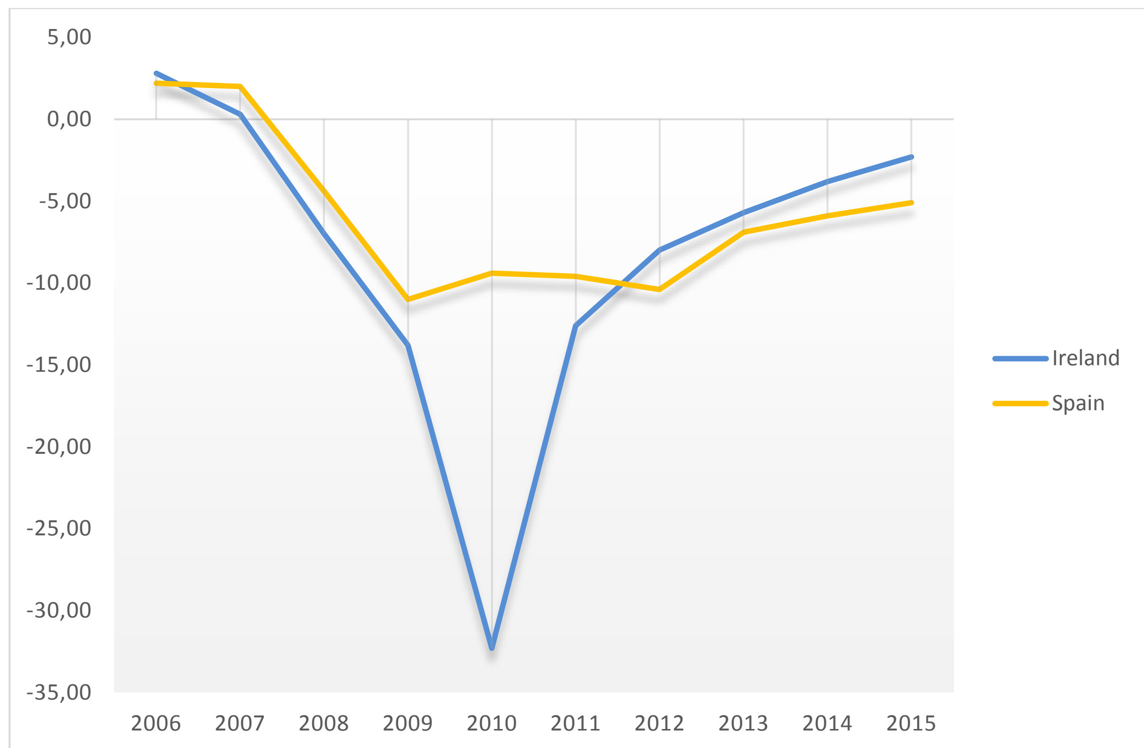
Source: Own elaborations based on OECD Data [359]

4.2.5 Spanish Conditions upon Bailout Exit

Spain exited the financial assistance programme as agreed on 31 December 2013 having used €41.3bn out of the €100bn made available by the ESM.[360] The exit was, however, less "clean" than in the Irish case, as its condition by the expiring period was far from optimal. While the country seemingly managed to intercept the fall in public finances at -11% in 2009, it could not count on export-led growth to drive up its economy. Ireland could continue in its foreign trade surpluses which enabled it to take severe austerity measures that ultimately guided the country from recession. Spain, on the other hand, did not possess such comparative advantages and experienced a double-dip recession in 2011. From that time on, its economic performance was more and more lagging compared to the Irish recovery (see figure 22).

[358] Oelgemöller, "Revealed Comparative Advantages in Greece, Ireland, Portugal and Spain," 252.
[359] "International Trade," Official Site of OECD Data, https://data.oecd.org/trade/trade-in-goods-and-services.htm.
[360] "ESM programme for Spain (concluded)," Official Site of the European Stability Mechanism (ESM), accessed 27 April, 2016, http://www.esm.europa.eu/assistance/spain/.

***Figure 22: General Government Deficit of Ireland and Spain** (Total, % of GDP, 2006 - 15)*



Source: Own elaboration based on OECD Data [361]

A similar situation could be observed concerning GDP growth. Spain exited the assistance programme still in red numbers at -1.7%, as compared to the Irish positive growth from 2010 on. Following the -3.6% in 2009 and slightly positive level in 2010, Spain suffered another fall in the recession in 2012 at -2.6%.[362]

The financial assistance programme along with measures undertaken by the government had, however, a positive effect on the economy. Bond yields decreased from 7.6% in mid-2012 to 4.2% in late 2013.[363] Consequently, the risk premia on external borrowing decreased by 75% during the programme.[364] The reforms set a trend in the unemployment curve that has been steadily decreasing from its highest point of 26.2% in mid-2013.[365] As can be seen, the Spanish conditions were clearly ameliorating. Nonetheless, it is clear

[361] "General Government Deficit," Official Site of OECD Data, accessed 27 April, 2016, https://data.oecd.org/gga/general-government-deficit.htm.
[362] "Domestic Product," Official Site of OECD Data, accessed 28 April, 2016, https://data.oecd.org/gdp/real-gdp-forecast.htm.
[363] "Spain Government Bond 10Y," Official Site of Trading economics, accessed 28 April, 2016, http://www.tradingeconomics.com/spain/government-bond-yield.
[364] International Monetary Fund, "Spain: Financial Sector Reform—Final Progress Report," 3.
[365] "Unemployment Rate," Official Site of OECD Data, accessed 28 April, 2016, https://data.oecd.org/unemp/unemployment-rate.htm.

that that the recovery was not as successful as in Ireland and that Spain was going to need much more time to solve the discrepancies in its public finances as well as deficiencies of its banking sector.

Conclusion

The economic evolution of Ireland and Spain bore strong resemblance up until the beginning of the financial crisis. These two peripheral countries with underperforming economies were considered undeveloped throughout the majority of the 20th century. Following a successful liberalization and transition period, the 1990s were characterized by the emergence of two phenomena: the *Celtic Tiger* and the *Spanish Economic Miracle*. Both countries went through substantial deregulation and privatisation, and implemented structural reforms that set them on the path of a neo-liberal boom. Impressive levels of economic growth could be observed notably in the second half of the 1990s, impelled by high levels of FDI. After the dot-com crisis at beginning of the new millennium, FDI-based growth was replaced by real estate bubbles. Irrational exuberance propelled high GDP growth levels as well as maintained seemingly sound public finances. Although the public debt stayed virtuous prior to the crisis, private debt reached unsustainable levels as external imbalances started to inflate.

Underneath the quasi-identical development, there were considerable deficiencies in the Spanish economy. Unlike Ireland, Spain was unable to attract sophisticated investment and its economy was based primarily on low profitability sectors. Irish competitive advantages, on the other hand, gave it a much better starting position. The growth was achieved also owing to the export-based economy built upon low corporate taxation and the flexible labour market with a cheap, educated workforce. As the only English-speaking member state of the EU (aside from the Republic of Malta), with access to the common market, it managed to entice extraordinary levels of (primarily US) investment. Moreover, the FDI was directed mostly at highly profitable sectors and Ireland became the seat of some of the most influential MNCs in the world. Meanwhile, Spain became a net importer of goods and services given the low competitiveness of its products.

Ireland was quicker in its responses to the crisis as the threat of the banking sector collapse was imminent. Its sovereign debt crisis was a crisis of expenditure following extensive measures to save its banks. The blanket guarantee was an extreme step, rarely seen in other countries, which, alongside a very successful bad asset management via NAMA and structural reforms, enabled Ireland to incentivize the recovery of its property market. Most importantly, owing to these considerate measures, not interfering with its export-oriented economy and low corporate taxation, Ireland was able to implement the biggest

fiscal consolidation package and achieve recovery by the end of the assistance programme.

After the bubble burst, the size of the Spanish economy acted as a decelerating factor. Spain was spared the abysmal fall experienced by Ireland but also found it more difficult to overcome the impacts of the recession. Its predicament consisted primarily of a revenue crisis as tax collection was even more connected to the property sector than in Ireland. Subsequently, it suffered the sharpest fall in revenues of all countries. Thus, most of the financial sector interventions happened in a situation of already enfeebled public finances and high deficits. The formal request for assistance therefore came much later than in Ireland. Spain suffered the consequences of structural deficiencies of its economy and banking system. The regional authorities not only played a vital role during the bubble, but their late implementation of fiscal consolidation hampered the recovery process.

In the end, Spain was not as successful at restructuring its banking sector and could not afford to implement austerity measures to the extent that Ireland did. It could not count on exports to boost its economy and its industry with low profit ratios was not enough to stimulate growth. The cuts therefore had to take into consideration the state of the macroeconomic and socio-demographic conditions. Apart from that, Spain was much slower in its reaction to the crisis and, especially, most of its much needed reforms were passed too late. Effects of the countermeasures on its financial market were therefore limited. Although both countries exited the bailout programme in time, Ireland managed full compliance with the Troika bailout package after much more impressive results and was re-branded the “Poster child for austerity”. As illustrated above, it was caused only partially by the implemented measures and to a great extent by specificities of the Irish economy, which played essential role in the magnitude of the austerity undertaken. As impressive as its recovery was, it is therefore clear the Irish case cannot be used as a universal model for crisis management.

Summary

The aim of this paper was to address a hypothesis that Ireland can be considered a role model for austerity owing to its elaborate crisis management. As documented above, the government showed excellent reactivity towards the evolution of the financial crisis and promptly introduced extensive measures on its financial markets. After the successful recapitalization and restructuring of the banking sector, Ireland managed to revive the property market via NAMA´s incentives. On the other hand, Spain was slower and the intervention on its financial sector came much later.

Even though the changes in the public finances were not as belated, most of the measures that the Spanish government implemented had limited effect, as the country lacked structural reforms of the public sector and the labour market. The recovery was being decelerated by deficiencies of the Spanish case, be it within the banking sector (ties between cajas, politicians and municipalities) or administrative framework (spending slippage of the local authorities). These problems had to be tackled before Spain could regain the economic growth.

On the contrary, it is clear that Ireland managed to achieve impressive recovery over a very short period. It implemented the biggest fiscal consolidation in the European Union and the effects arrived swiftly. Nonetheless, their success was based on specificities of the Irish economy. It had a unique position as the only English-speaking country in the Euro Area with low corporate taxation and young educated workforce. The undoubtedly fine crisis management was accompanied by extremely undervaluated property market in a country with strong tradition of high FDI levels.

In light of the above, Ireland truly was very successful at implementing the austerity measures; yet it cannot be understood as a model for future crisis management. A fiscal consolidation of such extent might result in complete interruption of investment activities in a different country without the Irish comparative advantages and strong exports to boost the economy. Specificities of different countries play important role in the nature and extent of countermeasures that can be undertaken and therefore the Irish case is not a universally applicable solution.

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