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# President Obama Visits the Irish Financial Crisis

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When President Obama visits Ireland on May 23–24, he is expected to visit Moneygall in County Offaly, the ancestral home of his mother's family. While finding Irish ancestors is a favorite electoral sport of American leaders, the President would be better advised to spend his time studying the Irish financial crisis, which has important lessons for America.

If this crisis continues to deepen, the U.S. may be compelled to consider the implications of an Irish default. If default becomes inevitable, then the U.S. should not simply take the side of European institutions if doing so would uselessly prolong the crisis.

**The Origins of the Irish Crisis.** In the 1980s and 1990s, Ireland grew rapidly, fuelled by a wide-ranging move toward a freer and more open economy. The resulting boom in employment and wages benefited the Irish people tremendously, but by the 2000s it had begun to seriously erode Ireland's international competitiveness. Then, like the U.S. and many other European countries, Ireland experienced a massive real estate property bubble. When that bubble burst in 2008, it exposed the leading Irish banks that had underwritten so much of the bubble to overwhelming losses.

In September 2008, Irish Finance Minister Brian Lenihan propped the banks up with a state guarantee. In 2009, Ireland nationalized the banks and created the National Asset Management Agency to purchase their bad loans. The costs of these interventions drove Ireland's budget into deep deficit in 2009 and, especially, for 2010, forcing crushing tax increases on an already shaky economy along with social welfare cuts and politically painful pay cuts for the public sector.

Unfortunately, like their U.S. counterparts two years earlier, Ireland badly miscalculated the size of the banking losses, and the banks were forced to resort to emergency borrowing from the European Central Bank (ECB). In November 2010, European finance ministers, hoping to stop a panic over Spain and Portugal, urged Ireland to accept a bailout. Lenihan denied that this was necessary, but the Governor of the Irish Central Bank, Patrick Honohan, almost immediately announced that it was. The result was an €85 billion financial assistance program between Ireland, the IMF, and the ECB, announced in late November 2010.

**Ireland's Solvency Crisis.** The premise of the European bailout program was that Ireland's taxpayers must fully repay all of Ireland's liabilities. Repeating a consistent pattern throughout the financial crisis in both the U.S. and Europe, once again creditors received rates of return reflecting the bearing of risk, and yet in the event of default, they were to be protected against loss.

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This was not what the IMF wanted: According to published reports, it initially proposed a plan for only partial repayment. But U.S. Treasury Secretary Timothy Geithner vetoed this plan, forcing both the IMF and Ireland itself to accept full repayment. Among other things, this raises the question as to just how welcoming President Obama may find his ancestral home.

In any event, the markets have given their verdict on the result: The spread on Irish government bonds has risen almost continuously since November and are now second in Europe only to those of Greece. The major credit rating agencies put Ireland's debt at one step above junk. The bailout, apparently, is understood—by Ireland's creditors if not by its Euromasters—to be a temporary band-aid, a prologue to default.

Ireland does have strengths on which to build and recover. Its exports are rising, and, in contrast to Greece, it has a functioning political and tax system. But the verdict of the markets is that the premise of the measures taken to date is mistaken: They have sought to solve Ireland's debt problem by inoculating past creditors while piling on more debt at a 5.8 percent interest rate. Further, as evidenced by the credit spread, these measures have not allowed Ireland to return to the markets to borrow money at an affordable rate.

Because of the steadily rising scale of its debts, Ireland has a solvency problem. Yet, like Greece and Portugal, it is being treated initially as though it has a liquidity problem. The relative size of Ireland's future national debt is to an extent unknowable, because the debts are offset by banking sector assets of uncertain value and future growth prospects are uncertain. But reasonable estimates reach €250 billion in 2014. Even with optimistic projections, Ireland's debt-to-GDP ratio, currently at an unbearable 94 percent, will reach an unsustainable 115 percent and could well top a disastrous 140 percent by 2014.

**The Dangers of a Europeanized Ireland.** Ireland could respond to its budget deficits by following Latvia's course: squeeze domestic consumption and government spending to bring the budget into balance. But that would only address Ireland's deficit, not its debts—the interest on which in 2010 consumed 11 percent of tax revenue, a figure that will only grow over the next several years.

Ireland could also seek to close its deficit by adopting much higher continental European tax rates. This approach would be applauded by the EU, but it would sharply reduce Ireland's competitiveness and the economic growth it needs to have the income needed to service its debt. And higher taxes, again, would do nothing to address Ireland's indebtedness.

To date, the ECB and the U.S. have concentrated on making Ireland pay in full. From the ECB's point of view, this approach has the merit of making Ireland an example for other indebted European nations—especially Spain—and ensuring that large, continental investors are shielded by the burdens that the Irish people would be forced to bear.

But the approach also has its problems. It may not work—indeed, failure is likely—and it has further increased the peril of the ECB's already overleveraged position. By Europeanizing the Irish crisis, Ireland, the ECB, and the U.S. may thus have achieved the worst of all possible worlds: no relief for Ireland and increased danger for the financial structure of Europe.

**Lessons from Ireland.** Ireland's peril holds three lessons for the U.S. and for the world. One is that the financial crisis that began in 2008 was truly global. It manifested itself first in the U.S. but was not of purely U.S. origin. Nations as diverse as France, Germany, and the United Kingdom made early contributions, and Ireland, Greece, and Portugal are continuing the saga.

The second is that Ireland has since 2002 been taking part in a great experiment called the euro. It is being conducted to determine if political will can outweigh economic reality. The Irish crisis, and the broader European one, implies that economic reality is likely to win out. The U.S. should therefore be cautious about policies (for example, in the realm of health care) that are deemed by some to be so politically desirable that their economic costs are not properly assessed.

Third, the U.S. should also remember that it historically supported European integration—and

continues to support it today—as a means to promoting prosperity and democracy in Europe. But if there comes a point when the U.S. or an EU member state finds that the institutions of an integrated Europe are irredeemably endangering its prosperity or democracy, the U.S. must not back the means of integration at the expense of the ends of its policy.

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