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Understanding Ireland's economic crisis and its aftermath

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Key points

- The narrative that Ireland has recovered is problematic. Employment is still far below peak levels and many other socio-economic indicators have deteriorated markedly since the start of the crisis.
- The recovery in GDP is associated mainly with exogenous factors, such as the fall in oil prices, a more supportive monetary policy, the fall in the value of the euro and distortive multinational activities.
- There is little evidence that recovery is related to the policies of 'austerity' and 'internal devaluation'.

1. Introduction

The Irish experience offers little succour for proponents of fiscal austerity and internal devaluation. Furthermore, using Ireland as a model for policy in the rest of Europe is misplaced.

The Irish economy fell into crisis in 2008. A widely reported and influential view at the time was that it had lost competitiveness due to a domestic building boom and increasing production costs. Ireland's current account deficit averaged 1.8 per cent of GDP in the eight years preceding the crisis and had deteriorated to 5.7 per cent of GDP by 2008. As nominal devaluation of the currency was not an option it was believed by many that competitiveness and economic recovery could be secured only by cutting prices and wages; in other words, by imposing internal devaluation. Fiscal austerity and internal devaluation became de facto government policy from late 2008 onwards.

Wages in the private sector have largely been stable since 2008. Even so, Ireland has shown a relatively strong improvement in exports and its current account has moved into surplus, despite a difficult international trading situation. This contradicts the internal devaluation narrative as Ireland improved its net export position rapidly without a general fall in wages. Falling disposable incomes and reduced demand for imports help explain some of the improvement in net exports. In addition, inflation has been lower than in the euro area for a number of non-labour categories, such as utilities, transport and communications. This has helped to push down costs.

There is no clear causal link between internal devaluation and the substantial movements in Irish employment since 2008. Nor is there

an obvious link between internal devaluation and the economy's recent partial recovery.

Experiences with internal devaluation policies have not been happy. Ireland is no exception. A nominal devaluation of the currency is likely to be a much more effective policy tool as it lowers export costs without inducing a decline in domestic demand. This option should have been considered by the ECB. The official preference for internal devaluation over internal revaluation in the more competitive core – that is, policies to increase domestic wages and prices – created a deflationary bias for the euro area and for the world economy and made the euro-area crisis much more damaging to the economy than it needed to be. A fundamental policy rethink is required at the European level.

2. The economic crash and its aftermath

The 2008 crisis was Ireland's longest and deepest recession in over a century and followed two decades of almost continuous strong growth in output and employment. Investment grew strongly for

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more than a decade prior to 2007 before collapsing in 2008–2010 as credit dried up, the banking system fell into crisis and construction activity and asset values plummeted. The Irish government decided it had no choice but to bail out its stricken banking sector to the tune of 40 per cent of GDP. Investment had become heavily skewed towards construction activity in the years leading up to 2008–2009; construction's contribution to gross value added was almost double the EU15 average by 2006.

Personal consumption and government consumption also grew strongly from 1998 to 2008 before falling sharply in 2009 as net wealth declined, confidence evaporated, investment went into reverse and the government began its programme of economic 'austerity' with the October 2008 budget. Economy-wide disposable household income came under immense pressure from 2008 onwards due to falling levels of employment, higher taxes and cuts to social transfers.

The economy stagnated between 2010 and 2013 as domestic demand continued to decline (CSO 2016a). By early 2012 the unemployment rate had trebled to 15.1 per cent as the financial crisis was transformed into a social crisis. Median individual disposable income fell by over 15 per cent in nominal terms between 2008 and 2013 (CSO 2015a). Even worse, the proportion of the population suffering deprivation increased from 13.7 per cent to 30.5 per cent between 2008 and 2013.

2.1 Where were the job losses between 2007 and 2015?

More than three out of every five construction jobs were lost between 2007 and 2012 and there were also large employment falls in industry and in wholesale and retail trade (Table 1).

The net job losses in the (non-tradable) construction sector (142,000) are equivalent to four-fifths of the economy-wide net job losses between 2007 and 2015. This lends strong support to the narrative of a construction boom and bust, with standard characteristics driving the overall fall in employment. However, the next largest job losses by sector (51,800) came in the largely tradable industry sector. This may support a narrative based on declining competitiveness.

On the other hand, the bulk of the job losses in industry came at the height of the economic crash, with net employment in industry declining by 39,800 between the third quarter of 2008 and the third quarter of 2009. The suddenness and timing of this decline is more suggestive of shock-induced decline associated with the global downturn than a decline associated with a gradual loss in competitiveness. Indeed, total employment in industry had broadly stabilised by 2010. Finally, the collapse in retail jobs is consistent with expectations, given the general collapse in domestic demand associated with the fall in disposable income.

Table 1 Employment shifts by sector (third quarter 2007 to third quarter 2015)

Economic sector	Q3 2007	Q3 2012	Q3 2015	Net change 2007–2015	Employment ratio Q3-2015/Q3-2007
Declining sectors					
Construction	268,200	100,100	126,200	-142,000	47.1%
Admin and support service	81,700	64,700	66,000	-15,700	80.8%
Industry	303,500	230,700	251,700	-51,800	82.9%
Wholesale and retail trade	308,700	271,000	273,300	-35,400	88.5%
Financial, insurance, real estate	105,700	101,200	98,800	-6,900	93.5%
Public admin and defence	106,900	99,300	100,400	-6,500	93.9%
Transportation and storage	92,100	90,200	90,700	-1,400	98.5%
Expanding sectors					
Agriculture, forestry and fishing	109,500	84,300	111,200	+1,700	101.6%
Accommodation and food	134,100	119,600	136,300	+2,200	101.6%
Professional, scientific and tech	115,300	101,300	120,800	+5,500	104.8%
Education	140,200	146,000	152,300	+12,100	108.6%
Other activities	95,400	100,600	103,800	+8,400	108.8%
Human health and social work	217,300	243,700	252,200	+34,900	116.1%
Information and communication	68,300	78,600	84,100	+15,800	123.1%
Total employment	2,146,900	1,831,300	1,967,800	-179,100	91.7%

Notes: Q3-2007 to Q3-2012 broadly equates to the peak to trough period. Net employment fell by 315,600 over this period with more than half of the job losses in the construction sector (168,100). In total, one out of every seven jobs were lost to the economy by mid-2012, with most losses happening close to the start of the crisis. By Q3-2015 the economy had recovered 136,500 jobs compared with Q3-2012. Even so, this was equivalent to just 43 per cent of the jobs lost in 2007–2012.

Source: CSO (2016b).

2.2 Has the patient recovered?

A more recent narrative suggests that the economy is now in full recovery and that this recovery is a direct consequence of austerity and internal devaluation policies. The economy has indeed been growing very strongly since mid-2014 and this is forecast to continue in 2016 and 2017. Officially GDP grew by 8.5 per cent in 2014 and by 26.3 per cent in 2015 (CSO 2016a), although these figures are grossly distorted by the tax planning activities of US multinationals. The unemployment rate fell to 8.4 per cent in the first quarter of 2016.

Even so, total employment remains well below its peak. Fully eight years after the start of the crisis less than half of the losses in total employment have been restored. Total employment in the final quarter of 2015 was down 8 per cent compared with the final quarter of 2007 (CSO 2016b), while the average employment rate in 2015 was six percentage points below the rate recorded for 2007. The number of people in long-term unemployment was three times higher in the first quarter of 2016 than in the first quarter of 2008. The associated loss of skills, confidence and experience is likely to have some permanent scarring effect on labour supply, equilibrium unemployment and potential output.

Almost one third (29 per cent) of households were experiencing deprivation in 2014, representing a doubling of the proportion of households (14 per cent) in 2006, while 8 per cent of households were in consistent poverty (CSO 2015). In this context, any discussion of Ireland as a success story for austerity and internal devaluation – or indeed as a model for the rest of Europe – appears misplaced.

3. Internal devaluation policies

Euro-area economies are unable to reverse lost competitiveness through nominal devaluation. Lost competitiveness can be reversed only internally, through relative gains in the efficiency of production, or through action to reduce individual domestic prices. In practice, direct action on domestic prices to induce so-called 'internal devaluation' usually refers to policies aimed at reducing wages and other labour costs. Internal devaluation is much harder to achieve than nominal devaluation because it involves changing thousands of prices and wages across the economy. The process is likely to be expensive, slow and uncertain.

Internal devaluation policies were usually framed as 'competitiveness reforms' in Ireland, although the term itself is rarely used (McDonnell and O'Farrell 2015). The idea is that falling labour costs will reduce export prices at constant exchange rates, while falling wages will reduce domestic demand for imports so that the overall effect will be to boost net exports. It is reasonable to anticipate gains in the form of higher net exports, but it is also reasonable to anticipate that deflating labour costs will reduce aggregate demand through lower household consumption and investment. Whether the *positive net export effect* on output and employment outweighs the *negative domestic demand effect* is an empirical matter.

Internal devaluation policies in Ireland

Policy has contributed to declining unit labour costs in Ireland in two main ways. Public spending cuts introduced in an effort to close the budget deficit included measures to reduce public sector pay rates. The direct competitiveness impact from these cuts is likely to have been marginal as they took place in non-traded sectors of the economy and there is no direct transmission from public sector pay to private sector pay in the traded sectors.

The second main way that policy sought to reduce unit labour costs was through changes to Ireland's wage-setting mechanisms. These cover some 23 per cent of total private sector employment. Ireland had a system of independent Joint Labour Committees (JLCs) to establish sectoral wages and terms and conditions of employment in certain industries, including hotels, retail and security. Pay, terms and conditions are set out in an Employment Regulation Order (ERO) and generally include matters such as breaks, holidays, overtime, sick pay and Sunday premiums. However, a 2011 court ruling declared the process of making EROs to be unconstitutional. All seventeen EROs in place at the time ceased to have statutory effect and could not be enforced. In effect, the sectoral minimum wages under the EROs were replaced by the lower national minimum wage. Ireland was a programme country in 2011 and the Troika¹ of lenders took an active interest in the new wage-setting legislation. The Troika and the Irish government were both keen to create a regime conducive to lower wage rates and more 'flexible' conditions (O'Farrell 2015).

Requirements related to wage-setting mechanisms were inserted in the Memoranda of Understanding between Ireland and the Troika. These were consistent with domestic policy preferences and included: (i) clauses to allow enterprises to derogate down to the minimum wage where the employer can show there is a risk to the sustainability of the enterprise; (ii) requiring that JLCs be reviewed every five years; (iii) requiring that wage setting take account of wages in other member states; and (iv) restrictions on the content of EROs, which are now limited to providing for a minimum hourly rate of remuneration and no more than two higher hourly rates. Other matters previously included – such as a rate for Sunday working, pay in lieu of notice, redundancy, breaks and holidays – are now specifically excluded by law. In addition, fewer sectors are covered by the EROs. The overall impact of the Troika's influence was to push the wage-setting legislation in an anti-worker direction.

The Troika also requested a cut in the national minimum wage in late 2010. The government complied by reducing the rate from 8.65 euros to 7.65 euros, although the cut was subsequently reversed in early 2011. Finally, various welfare rates were cut – for example, unemployment benefits for the under-25s – with the goal of forcing people into the workforce and reducing entry-level wage rates by increasing the overall supply of labour.

1 The troika is the European Central Bank (ECB), the European Commission and the International Monetary Fund.

4. Trends in competitiveness, earnings, prices and trade

The Harmonised Competitiveness Indicator (HCI) suggests that Ireland's competitiveness deteriorated between 2002 and 2005, and then again between 2006 and mid-2008 (NCC 2015). Since the onset of the crisis the real HCI has improved significantly compared with Ireland's trading partners, with most of the competitiveness gains coming during the height of the crisis between 2008 and 2012. Cost competitiveness in real terms (producer prices) deteriorated slowly between mid-2012 and mid-2014, partly as a consequence of an appreciating euro. Irish competitiveness began to improve again from March 2014 as a result of euro depreciation. Was there, then, an internal devaluation in Ireland, understood as a policy-driven general fall in wages and prices relative to the economy's main trading partners?

4.1 Wages, earnings and labour costs

There was only a general fall in wages in the public sector (CSO 2016c), although Irish wages are now relatively lower than in other EU countries compared with 2008. This is not primarily due to a coordinated policy, but is instead due to a relatively weaker Irish economy and to the absence of wage pressure in a post-crash environment characterised by high unemployment.

Earnings per week fell in absolute terms in 2010, 2011, and 2013. In 2010 a 1.9 per cent fall in average weekly earnings was somewhat mitigated by a reduction of 1.6 per cent in the rate of inflation. However, inflation was positive in 2011 and 2013, so the reduction in nominal earnings was compounded by the changes in prices to generate an even larger fall in real wages. Average hourly earnings increased marginally over the entire period, while average weekly wages declined.

Annual changes in real unit labour costs have been lower than in the euro area since 2009, with real unit labour costs declining sharply in 2010 and 2011 and then again, albeit more modestly, in 2012. The much faster growth in real unit labour costs in the euro area since 2009 suggests that Ireland did indeed undergo an internal devaluation vis-à-vis the rest of the euro area in the post-crash period.

However, a 'successful' internal devaluation may have been due more to chance than to design. Nominal unit labour costs represent the amount an employer must pay to hire someone to produce one unit of a good, and so account for changes in productivity. It may be that changes in the composition of the economy following the end of the construction bubble – that is, the loss of less productive construction and retail jobs – give an exaggerated sense of the improvement in nominal unit labour costs.

Some sectors of the economy are more labour intensive than others, and so have higher nominal unit labour costs. Even if such costs in each sector are constant, the *average* for the whole economy can change if jobs are lost in the more labour intensive sectors. We can treat the total of nominal unit labour costs over the economy as the weighted average of the cost for the individual economic sectors. The weights account for the importance of a particular sector in

contributing to nominal unit labour costs for a given year. Using the weights of a given year it is possible to control for changes in the composition of the workforce between 2008 and 2012. Using the sectoral weightings for 2008, nominal unit labour costs declined by 0.7 per cent between 2008 and 2012. Alternatively, keeping wages constant, but just altering the weights leads to a fall in nominal unit labour costs of 9.7 per cent (McDonnell and O'Farrell 2015). Clearly, the change in the sectoral *composition* of employment is the main cause of the improvement in nominal unit labour costs. The conclusion is that the decline in such costs in Ireland since 2008 is attributable mainly to compositional shifts in employment (notably the dramatic decline in construction) rather than to declining wages.

4.2 Prices

Prices (all items) increased just 0.5 per cent between 2008 and 2015, albeit with price fluctuations in the interim. Inflation was relatively stronger in the euro area at a cumulative 9.3 per cent between 2008 and 2015 (Eurostat 2016). Prices in Ireland also grew more slowly than in the United States and the United Kingdom. However, price changes in Ireland were driven mainly by market forces rather than by coordinated policy. While there were policies to reduce VAT in labour-intensive sectors linked to tourism, these were introduced only from 2011 onwards and were more than offset by an increase in the basic rate of VAT.

4.3 Trade

Ireland's current account has moved from deficit to surplus, reflecting improved cost competitiveness, allied to reduced consumer demand for imported goods. The current account moved from a deficit of 10 billion euros in 2007 and 2008 to surplus in 2013 and a surplus in excess of 9 billion euros by 2015 (4.4 per cent of GDP). The only substantial change in trends between 2008 and 2013 was the fall in goods imports. Goods exports remained stable. The fall in goods imports was very much in line with expectations, given the general fall in household disposable income, investment and aggregate demand. Service imports and exports continued to grow along broadly pre-crisis trends, with no obvious evidence on the services side of a trade impact directly attributable to internal devaluation. All of the headline trade components have been growing strongly since mid-2014 (CSO 2016d).

Ireland's share of world trade fell continuously year on year between 2002 and 2006 and again between 2009 and 2013. Specifically, Ireland's share of world trade, which peaked at 1.4 per cent in 2002, had fallen to 1 per cent by 2013 (NCC 2015). The share of merchandise trade fell even further, from 1.4 per cent in 2002 to 0.6 per cent in 2013. The decline suggests a loss of international competitiveness in merchandise production. On the other hand, Ireland actually increased its share of the global services market from 1 per cent in 2000 to 2.7 per cent in 2013. Ireland's share has been broadly unchanged since 2007, which suggests no fundamental improvement or decline in competitiveness in services provision in that time.

5. Final remarks: understanding the recent recovery

The current narrative about fiscal austerity and internal devaluation producing an Irish growth miracle is simplistic and misleading. The economy's strong growth performance since mid-2014 can be attributed to a confluence of internal and external factors that have cumulatively added strong tailwinds to growth.

Net exports have benefited from the weakness of the euro against a trade weighted basket of currencies. Ireland is a small open economy. Total exports were 113.8 per cent of GDP in 2014 (CSO 2015b) and Ireland is perhaps best placed within the euro area to benefit from the weakness of the euro owing to its high level of trade external to the euro area. The United States accounts for 23 per cent of exports, while the United Kingdom accounts for 16 per cent of exports (Trading Economics 2016). The euro was trading at USD 1.08 in March 2016, down from USD 1.30 in September 2014.

The reasonably strong growth performances of the United States and United Kingdom economies has contributed to growth in net exports because these are important export markets for Irish companies. The United Kingdom in particular is an important destination for indigenous small and medium-sized Irish exporters.

Ireland is a fuel importer, accounting for 15 per cent of total imports. The fall in oil prices in 2014 and 2015 increased the real income and purchasing power of Irish households. Analysis by the Central Bank of Ireland (CBI 2016a) suggests that the boost to real gross disposable income had accumulated to 1.5 percentage points by the end of 2015 and that the associated increase in purchasing power translated into an increase in the volume of personal consumption. The drop in energy costs has also reduced input costs for producers, thereby improving margins, increasing corporate profitability and facilitating higher subsequent investment levels.

The former drag on growth from fiscal austerity was replaced by a mild fiscal expansion (tax cuts and spending increases) in 2015 that boosted disposable income and domestic demand. Budget 2015 was the first Irish budget to loosen fiscal policy in seven years (Department of Finance 2014) and represents an end to the policy of fiscal austerity. The more expansionary fiscal stance continued with Budget 2016.

The ECB's policy mix of low interest rates and quantitative easing has helped push down financing costs. This policy mix is supportive of investment and has added stimulus to the economy. One effect of these policies has been the fall in the cost of sovereign borrowing – Irish 10-year bond yields have been below 2 per cent since August 2014 and reached a record low of 0.65 per cent in April 2015. This has helped ease the pressure on the public finances and increased confidence that fiscal policy will be somewhat more relaxed in the future.

The pent-up demand that built up in the economy post-2008 was gradually released as confidence has improved. Household debt as a proportion of disposable income has gradually been falling year-on-year since 2009, while household net worth has been rising since 2012 (CBI 2016b). Deleveraging was an important factor

driving the stagnation in personal consumption between 2008 and 2013 and the improving household debt and net wealth dynamics are likely to have supported the post-2013 increase in demand. In addition, with aggregate employment and prospects for domestic demand gradually improving, those households and firms that previously postponed consumption and investment decisions due to the uncertain outlook post-2008 will have been encouraged to increase their consumption and investment to more normal levels.

Business cycle dynamics have been providing a temporary fillip to growth. The upswing in the economic cycle as the economy approaches its potential output has been generating a positive multiplier effect, accelerating growth in the short run. This upswing growth effect is temporary and will dissipate as the economy reaches and exceeds its potential output.

Finally, Ireland's GDP growth figures are extremely volatile. The growth figures are, as always, distorted by the activities of a few large multinationals producing an outsize effect on the small Irish economy. These activities are often motivated by tax avoidance reasons or by international concerns and tend to be only marginally responsive to domestic considerations or trends. Such was the level of distortion in 2015 that the official real GDP growth figure came in at an implausible 26.3 per cent. The distortion is the result of large corporate inversions and the relocation of patents into Ireland – both motivated by tax planning reasons - as well as large increases in third party contract manufacturing and aircraft leasing. The actual rate of growth for the 'economy in Ireland' is most likely to have been somewhere between 4 per cent and 5 per cent.

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