5 The Irish Sovereign Debt Crisis

5.1 Introduction

From August 2010, financial markets’ concerns about the creditworthiness of the Irish sovereign increased significantly, due to large contingent liabilities from bank bail-outs and guarantees, as well as the direct impact on public finances of the real-estate collapse and deep economic recession. Market pressures intensified in late October; by mid-November, Ireland was requesting financial aid from the newly created EFSF as well as from the IMF. While Greece had received bilateral help from EMU countries, Ireland was the first country to receive multilateral assistance from EMU partners through a joint facility. During the crucial period running from mid-August to early December 2010, financial market attitudes towards the Irish sovereign deteriorated dramatically. The move was the culmination of a real-estate, banking and economic crisis that by 2010 had been three years in the making. Some re-pricing of sovereign bond yields had already occurred since the financial crisis hit: Ireland entered the crisis with one of the lowest risk premia in the EMU; by early 2009, they were the highest in the region. However, until then, the move had remained well contained and had little consequence in terms of Irish sovereign capacity to access external finance. Also, part of the move was reabsorbed later in 2009, coinciding with the decline in global risk aversion. However, in the space of a few weeks during the second half of 2010, the fundamental deterioration and the increasing burden of large actual and contingent liabilities related to bank rescues came to a head for the sovereign. In just a few weeks, markets not only moved Irish sovereign debt from the “good credit” to the “bad credit” category, but went so far as to place it on a par with some of the worst credits in the world, leaving the entity unable to raise finance in the private marketplace.

In the context of the Eurozone crisis, the Irish episode assumes particular importance in two respects. First, it is a textbook example of how a banking crisis can affect a sovereign as a consequence of credit risk transfer from the private to the public sector, reinforcing the case for looking beyond a few
public finance shortcuts when assessing the solidity of a country’s public finances. Banking sector issues were central to the emergence and evolution of the Irish sovereign debt crisis, interacting with and sometimes obscuring the role of other factors. Second, it can be considered as the first step in the contagion of the Eurozone crisis from the original Greek source, as well as the first test of the use of the EFSF, the regional rescue fund set up after the Greek bail-out. Not surprisingly in this light, the existing literature on the Irish crisis is mostly focused on the banking crisis and the “credit risk” transfer hypothesis as an explanation for the sovereign turmoil. The role of the banking crisis and the risk transfer from the banking sector to the sovereign is a recurring theme in the large-n analysis of Eurozone bond spreads (see, for example, Attinasi et al., 2009; Sgherri and Zoli, 2009). Single-country studies of the Irish crisis also tend to look at the banking and sovereign debt crisis as two elements of the same financial crisis. They identify the banking crisis, and the related boom–bust cycle in housing and private sector borrowing, as key drivers of the fiscal stresses through two main channels: the sovereign’s assumption of actual and contingent liabilities from the banking sector with the provision of extensive guarantees and recapitalisation funds, and the dampening effects of the crisis on activity, employment and fiscal revenues (Kelly, 2010; Lane, 2011). In contrast, here we focus on seeking to understand the influence that political economy factors had on the severity of the sovereign debt crisis. In doing so, we do not contest the importance of the credit risk transfer from the banking sector to the public sector, and the broader impact of the boom–bust cycle on private credit, housing and the real economy, as crucial sources of the crisis. We have the specific and complementary aim of highlighting how the domestic and international political economy factors identified in the theoretical framework impacted the evolution of bond spreads during the sovereign debt crisis. Importantly, we can base our judgement on an analytical framework that can be applied to other countries; we will, therefore, be able to judge the role of the factors mentioned not only in absolute terms, but in comparison with the Greek episode examined in Chapter 4. Indeed, the features of the domestic veto-player constellation identified in Chapter 3 suggest that these structural elements should overall have been more favourable for sovereign credibility during the crisis than was the case in Greece. Ireland has a more developed system of institutional checks and balances in the formal political system, combined with a much lower level of social polarisation on the left–right continuum, and a history of very little social contestation. Similarly, the external context appears a priori more favourable, as Ireland ranks as one of the most open economies in the world and had substantial trade and financial links with Germany, the UK and the US by the time the crisis started. Figure 5.1 maps Irish bond spreads with the key political, economic and financial events in the period under consideration. The remainder of this chapter (Sections 5.2 to 5.4) discusses