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Why Ireland's Luck Ran Out and What this Means for the Eurozone

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Abstract
Given its impressive economic performance over the past two decades, Ireland earned the title, the 'Celtic Tiger'. However, as the contagion from the subprime-induced global financial crisis spread, Ireland's boom went bust. In short order, Ireland (like Greece before it), had to seek financial assistance from the EU and the IMF to stave off sovereign default and national humiliation. How did Dublin and the eurozone respond to the crisis and what lessons can be learned from Ireland's experience? While Ireland grapples with its huge public debt, the EU needs to instill confidence in the markets before the current rolling debt crisis becomes a systemic threat to the eurozone.

The Republic of Ireland, long known affectionately as the Emerald Isle, had acquired another moniker in recent years – one that signified strength and respect: the 'Celtic Tiger'. With its economy notching an average growth rate of over 7 percent a year from 1997–2007 (the highest among the 30-member OECD countries), the new name was seen as most apt. Then it seems the proverbial luck of the Irish ran out. In short order, the Celtic Tiger became a whimpering house cat – forced to kneel down to the European Union (EU) and the International Monetary Fund (IMF) for more than USD 100 billion to stave off even greater humiliation – defaulting on its sovereign debt. What went so wrong? Was the Celtic Tiger just an over-hyped house cat all along or, to put it another way, was the Irish miracle just a mirage? What are the domestic, regional and global implications of the Irish meltdown? What options does Ireland have to make the best of a most unpalatable situation and what must the eurozone do, in the immediate, to prevent the contagion from spreading and, over the longer term, to mitigate Ireland-type crises? This article addresses these inter-related issues.

The rise and fall of the Celtic Tiger

First, the Irish miracle was authentic. The Celtic Tiger was no house cat and the Irish miracle no mirage. Numerous scholars as well as the IMF point out that Ireland's real GNP quadrupled during the Celtic Tiger period from 1990 to 2007.1 More specifically, Ireland's GNP grew from 5 percent to an unparalleled 15 percent every year from 1991 to 2006. However, Ireland's remarkable growth was rooted in two very different, yet inter-related economic booms. The first, beginning in the 1990s, was the sustained export-led boom.2 As Honohan notes, banks were not "central to the financing" of the export boom period.3 Rather, it was a combination of Ireland's unfettered openness to the global economy, one of the lowest corporate tax rates in Europe, a sophisticated human capital base and unique comparative advantage, in particular, dramatic improvements in productivity and

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competitiveness, and the adoption of the euro in 1999 that were the catalyst behind the export boom.4 Ireland became an attractive destination for blue-chip multinational corporations and high-tech businesses and experienced a flood of foreign direct investment (FDI). Almost overnight, a largely foreign-owned manufacturing sector with concentration on information and communications technology, particularly computer software and financial services, as well as pharmaceuticals took root and expanded, creating thousands of well-paid jobs and fueling exports.5 However, the dot.com crash of 2001 served to significantly undermine Ireland's export-led growth as the US information technology sector, including multinationals, sharply reduced both their investments and presence in the Irish republic.

However, this 'bust' was quickly filled by another boom that was not unique to Ireland, but shared by many OECD nations: a spectacular expansion in the real estate sector (both residential and commercial property) and domestic consumption. Also, as in other settings, Ireland's second boom was financed by the banks which supplemented their funds with massive foreign borrowings. In the process, the banks increased their assets in property-related lending – eventually to unsustainable levels.6 As in the United States, generous government subsidies and reckless bank lending fuelled a building frenzy and speculation in real estate, not only in major cities, but throughout the country. This, in turn, led to grossly inflated land and house prices. However, Ireland's membership in the eurozone meant that interest rates in the country remained low, allowing Irish banks to borrow heavily and cheaply from other eurozone banks to finance the real estate sector and domestic consumption.7 Kelly notes that "as Ireland converged to average levels of western European income around 2000 it might have been expected that growth would fall to normal European levels. Instead growth continued at high rates until 2007 despite falling competitiveness, driven by a second boom in construction."8

Why were such chronic excesses allowed to happen – or in Honohan's colourful words, why did Ireland's traditionally conservative banks, known for their fiscal prudence, engage in "bank lending decisions [that had] begun to lose touch with reality"?9 There were several inter-related reasons: low unemployment, rising wages, low mortgage interest rates, rapid growth in immigrant labour, and above all, the easy availability of 'cheap' capital due to the global savings glut and lack of exchange rate risk for euro borrowing. Left largely unregulated by policymakers, the banking sector, in cahoots with supplicant politicians and wealthy developers, poured billions into real estate, resulting soon in a property bubble.10 Whelan vividly captures the outcome:

> The total stock of dwellings – which had stood at 1.2 million homes in 1991 and had gradually increased to 1.4 million homes in 2000 – exploded to 1.9 million homes in 2008. As house completions went from 19,000 in 1990 to 50,000 in 2000 to a whopping 93,000 in 2006, construction became a dominant factor in the Irish economy. … By 2007, construction accounted for 13.3 per cent of all employment, the highest share in the OECD.11

As noted, massive bank lending underwrote this building frenzy. Kelly aptly notes,

> Ireland went from getting about 5% of its national income from house building in the 1990s

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> – the usual level for a developed economy – to 15% at the peak of the boom in 2006–2007, with another 6% coming from other construction. … Irish banks were lending 40% more in real terms to property developers alone in 2008 than they had been lending to everyone in Ireland in 2000, and 75% more to house buyers.12

The impact of the subprime crisis

The global credit crisis and the resultant tightening of global liquidity and collapse of the property market had serious ramifications for Ireland's overleveraged banking sector. Although, unlike their US counterparts, Irish banks had hardly issued complex mortgage or mortgage-related financial instruments, what they had issued generously and without much regulatory oversight were loans to property developers, who in turn invested in speculative real estate ventures. Even more shocking, two of the country's largest banks had financed much speculative real estate without asking for the requisite collateral. The banks now faced their moment of reckoning as the sharp drop in asset values depressed the balance sheets of the highly leveraged financial institutions. Put bluntly, as Ireland's real estate boom went bust, the country's banking sector now burdened with an unprecedented volume of bad loans saw their balance sheets deteriorate so rapidly that they faced simultaneously a solvency and a liquidity crisis.13 Following the collapse of Lehman Brothers and at the height of the global credit crisis, Ireland found itself confronting heightened investor panic and depositor runs, and mounting fears of a total banking collapse, not to mention, a potentially humiliating sovereign default.

In desperation, on 30 September 2008, Dublin approved a guarantee covering €400 billion (USD 530 billion) of liabilities of six of the largest Irish-owned banks, only to be further increased to €485 billion to cover foreign-owned banks with significant operations in Ireland. In addition, on 7 April 2009, the non-performing property-based loans were transferred to Ireland's 'bad bank', the National Asset Management Agency (NAMA). Yet, these enticements proved inadequate to quell market concerns. Arguably, with their backs to the wall, the Irish government tried to calm the jittery markets by doing the unprecedented: guaranteeing the private sector's liabilities by providing a blanket guarantee to the deposit base of the country's entire banking sector for two years. That is, in a last-ditch attempt to restore confidence in the nation's financial system, Dublin took the bold gamble of providing an explicit guarantee to all bank deposits for two years. With that, almost instantly, Ireland's essentially private sector debt (literally worth three times Ireland's annual GDP) was transformed into public or sovereign debt. Therefore, by nationalising private debts or taking over the private losses of the banking system, Ireland saw its public debt jump from about 7 percent of GDP to over 100 percent of GDP. Worse still, as a private debt problem was converted into a sovereign debt problem, private bondholders and other lenders who had 'skin in the game' got off the hook as they were allowed to withdraw their funds, leaving the taxpayers to pick up the huge tab.

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Nobel laureate Paul Krugman has provocatively captured this bitter irony by noting,

> …before the bank bust, Ireland had little public debt. But with taxpayers suddenly on the hook for gigantic bank losses, even as revenues plunged, the nation's creditworthiness was put in doubt. So Ireland tried to reassure the markets with a harsh program of spending cuts. Step back for a minute and think about that. These debts were incurred, not to pay for public programs, but by private wheeler-dealers seeking nothing but their own profit. Yet ordinary Irish citizens are now bearing the burden of those debts.14

Dublin's response

To be fair to Dublin and appreciate its predicaments, however, one has to ask what its options were and what constraints it faced. Simply walking away from the insolvent banks – and thereby preventing a banking crisis from morphing into a sovereign debt crisis – is easier said than done. Arguably, Dublin could have offered the holders of the senior debt of the major Irish banks more incentives (or read them the riot act for that matter) in order to reschedule or restructure their debts, even if this could have triggered a destructive sell-off in the banking sector in the eurozone, besides negatively affecting bank ratings. What the case of Ireland underscores is that if a country has a banking/financial sector that is 'systemic' or 'too big to fail', the country or the sovereign often has little choice but to defend that sector as their fates are inextricably and intimately tied.

Clearly the markets were cognizant of this. This partly explains why, contrary to expectations, the Irish government's gamble (and generosity) failed to satisfy the markets – especially the creditors (read bondholders).15 Given the massive volume of debt that Ireland was now holding, foreign creditors began to doubt Dublin's ability to meets its guarantee (that is, service its debt), and continued to flee (or more politely withdraw) their funds from the banks. By mid-2010, it was painfully clear not only that the yields and the prices of credit default swaps for Irish government bonds were still increasing, but also that investors were still dumping the bonds of several of the so-called peripheral eurozone members – namely Ireland, Greece, Ireland, Portugal and Spain, countries that had run up massive debts and deficits. Despite massive infusion of capital, including the Irish government's decision to nationalise or take major equity stakes in five of the six insured banks at an estimated cost of €50 billion (USD 65 billion), Ireland's state-backed banks were still struggling to raise funds and becoming ever more dependent on the short-term loans provided by the EU. To the already nervous markets, this served to further exacerbate their fears regarding the possibility of an eventual bailout, if not outright default.

Concerns about credit risk in Ireland (and other eurozone economies, including Portugal and Spain) re-emerged again in August 2010. This was most vividly reflected in the bonds issued by the Irish government which experienced a sharp widening (some 600 basis points) in the spread vis-à-vis the German Bunds – the widest margin since Ireland joined the eurozone. In turn, the bonds issued by the other so-called peripheral eurozone countries, and even Belgium and Italy, also faced strong

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pressure. Indeed, the widening sovereign yield spreads between Germany and the vulnerable countries, including the rise in the cost of insuring eurozone debt against default, underscored growing market concerns about the deteriorating state of public finances and banking problems in Ireland and weaker or peripheral members in the eurozone.16 Market sentiment turned menacingly more negative when the rating agency Standard & Poor's (S&P) further downgraded Ireland's sovereign debt in mid-August. Indeed, S&P's rather cold and unambiguous estimate that Ireland's blanket guarantee could potentially cost Dublin anywhere between €80 to €90 billion (or over 50 percent of Ireland's GDP), and that its public debt level would likely hover around 130 percent of GDP by 2012 (similar to Greece in 2010) profoundly unsettled the markets.

In this highly unpredictable and charged environment, it did not take much to spook the already nervous markets. The chastened creditors became panicked once again and began selling-off their peripheral euro bonds – thereby touching off the Irish crisis – when on 18 October, the French and German finance ministries, as well as Chancellor Merkel, proposed that private creditors (specifically bondholders) should be involved in any future 'crisis resolution mechanism' – meaning that creditors also needed to take a 'haircut' for their reckless, if not callous decisions. Although, the vast majority of Irish citizens (as well as German citizens paying for the profligacy of the peripheral eurozone countries like Ireland, Greece and Portugal) probably concurred with Merkel that foreign creditors who loaned billions to Ireland's banks without due diligence (or more charitably by mispricing credit risk) should share the cost of the bailout, such talk only served to further unnerve the jittery investors, sending shockwaves in the bond markets and pushing up yields in several eurozone countries. The spreads widened further after the European Council on 28 October stated that other EU governments had agreed to the proposals to establish a crisis resolution mechanism that could potentially impose losses on bondholders. Over the next two weeks, Irish spreads jumped by more than 200 basis points – despite adamant (if not obstinate) claims by the Irish Taoiseach or Prime Minister Brian Cowen and Finance Minister Brian Lenihan that Ireland was "no Greece" – meaning that Ireland did not need a sovereign bailout, but rather banking sector support.17

Ireland's becomes a eurozone problem

Yet, it seems the damage was already done. As the contagion began to spread again with renewed vigour, a visibly angry Greek Prime Minister George Papandreou accused Germany of spooking the bond markets as Greece's massive debt came under intense pressure and the borrowing costs of Ireland and Portugal shot up. It seems that even if Merkel was correct in principle, her timing could not have been worse, as her statement undermined the already eroding confidence in the European debt markets. Shut off from the international capital markets and faced with escalating borrowing costs, Irish banks were forced to seek assistance or 'emergency funding' from the European Central Bank (ECB) – further panicking investors and raising concerns in the other capitals of the eurozone.18 Eventually, this convinced Germany, France and other European governments to push

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the beleaguered Irish government to formally seek assistance, that is, accept a bailout package offered jointly by the EU and the IMF. On 28 November 2010, Dublin finally received approval of an €85 billion (USD 113 billion) emergency aid package of which some €45 billion would come from bilateral loans from the EU (in particular, the two EU rescue funds set up in spring 2010), €22.5 billion from the IMF, and €17.5 billion from its own pension reserves.

For its part, using the fund from its own pension reserves was just one of the bitter pills or 'conditionalities' Ireland had to swallow. Dublin, which in 2008 had already slashed spending and raised taxes to the tune of about €15 billion, had to agree to an austerity plan which will cut an additional €15 billion (made up of €10 billion in spending cuts and €5 billion in tax and other revenue-generating measures) over the next four years, including sharp reductions in public sector jobs, wages and benefits – and increased property taxes from the already besieged homeowners. However, even these Draconian cuts may not be enough to meet the government's (and the EU/IMF's) target to bring Ireland's budget deficit down to about 2.8 percent of GDP from the current 12 percent by 2014.19 What is certain is that for the residents of Ireland, the future will be defined by a massive fiscal retrenchment, which means living with painful austerity measures and hard times.20 Yet, adding insult to injury, the major banks of the other EU nations, including the UK, Germany and France, which have large exposures to the Irish economy and are the beneficiaries of the Irish's government's blanket guarantee, will hardly feel a commensurate pain. Similarly, the EU/IMF package exempted senior bondholders (although subordinated-debt holders were not spared), who lent money to Irish banks from suffering any losses – even though the EU agreed that private investors will be held accountable for losses in future crises.21 The EU did add an important caveat though to this controversial measure. Specifically, beginning in 2013, eurozone bonds will include clauses requiring bondholders to accept debt restructuring measures "on a case-by-case basis" – meaning that bondholders will be liable only if a country becomes 'insolvent' and about to default on its obligations (it is important to note that bondholders, including banks and hedge funds, were also protected in the Greek bailout).

On 15 December 2010, even as the Irish Parliament approved the EU/IMF bailout package, the opposition Fine Gael party threatened to renegotiate the agreement with the aim of forcing senior bondholders in Irish banks to take their share of losses. It should be noted that, if the threat comes to pass and Ireland unilaterally reneges on its responsibilities, the ramifications will be profoundly negative for Ireland's reputation and economy. However, even if it does not, the challenges for Ireland remain significant. Indeed, given the fact that the EU/IMF bailout package fails to strike an appropriate balance between revenue and spending measures, it is not clear how it will help Ireland reduce its public debt, estimated currently at around 130 percent of GDP.

What is clear is that in its current shape the package will add to Ireland's already high debt levels. In their seminal book, This Time is Different, Carmen Reinhart and Kenneth Rogoff argue that 90 percent of GDP is the highest sustainable level of public debt for a developed country.22 Yet, Ireland is predicted to accumulate a crippling 150 percent of GNP in debt by 2014 – even if it carries out

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substantial domestic fiscal cuts. This means that Ireland may no longer be able to raise funds on financial markets without paying prohibitive interest rates, raising questions about its long-term solvency. Not surprisingly, the markets know that a painful debt restructuring cannot be ruled out. Indeed, if the real task is to reduce the high debt ratios (rather than simply throwing more money at the problem), than giving some so-called haircuts or write-downs and restructurings sooner rather than later makes more sense. Of course, this will mean some pain for the bondholders.

The average annual interest rate for the IMF/EU loans to Ireland, set at 5.8 percent, is also rather high for a struggling economy. Ireland may not be able to service its debt. Under those circumstances, the interest and principal may well take more than chum change from the country's national income. As a result, Ireland (like Greece) could very well come to the point where it will need to devalue its currency if it hopes to restore competitiveness. Of course, that is not possible as long as Ireland remains in the eurozone.23 As noted, debt restructuring is also an option, but this could precipitate a wider European banking crisis. In turn, such a crisis would negatively impact US banks and the global financial markets in general because Ireland's economy has deep financial linkages with global markets. As a recent IMF report duly states, "disorderly eruption of financial pressures in Ireland could have wider implications through foreign banks' exposure to Ireland".24

Apparently, Ireland's rescue package was deliberately announced over the weekend (on 28 November) before financial markets opened on Monday in an effort to relieve pressure on Portugal and Spain, whose creditworthiness remains in doubt. Although the bailout for Ireland seems to be large enough, that is to provide cash flows to salvage the nation's beleaguered banks and keep the Irish government solvent, it remains to be seen if the financial rescue package will restore enough confidence in the markets and thereby prevent the 16-nation eurozone from further bailouts, including default.25 If the contagion spreads to Spain, or worse, spills over into countries like Italy and Belgium, the very future of the euro will hang in the balance. After all, Ireland and Greece have modest debt levels compared to Spain – whose public debt is estimated at over €1 trillion, not to mention that Spain also has €1 trillion in private foreign liabilities. While the EU's powerhouse, Germany, has repeatedly stated that it stands behind the euro, and while the EU does have a €750 billion (USD 992 billion) temporary rescue fund that can be used either to buy 'toxic' assets or as bailout loans, it may not be enough to ward off a virulent financial contagion.

Eurozone challenges

The EU needs to instill confidence in the markets quickly before the current rolling debt crisis becomes a systemic threat to the eurozone. This will require the European Commission to present a united and comprehensive response to deal with the crisis, instead of the current country-by-country approach. In addition, the eurozone must carry out a more meaningful review of its banking sector. In July 2010, when the EU stress-tested its banks, the results showed that only 7 of the 91 banks failed the test. Although, the markets felt that the tests were not rigorous enough, the exercise

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nevertheless calmed the markets. However, the fact that two of Ireland's major banks – the Bank of Ireland and the Anglo-Irish Bank – passed the tests, but have since received bailouts, have made markets more vigilant. Clearly half-hearted stress tests will no longer generate market confidence, but only greater mistrust of the EU. Hopefully, the EU will do much better in the new round of stress tests scheduled for 2011. At a minimum, the new stress tests must conduct more rigorous asset valuations to accurately determine the quality of banks' loan portfolios and a more comprehensive liquidity assessment, as well as require banks to have much higher capital standards.

What to make of Chancellor Merkel's staunch opposition to the idea of issuing a common eurobond (dubbed e-bond) on behalf of the entire eurozone? It seems that the issue will not go away. During the 16-17 December 2010 EU summit, two leading proponents of the e-bond, Jean-Claude Juncker, chairman of the Eurogroup of finance ministers, and Jean-Claude Trichet, governor of the European Central Bank, again raised the controversial topic, passionately arguing that issuance of a common eurozone bond would strengthen the European Union as it would allow the economically weak members to pool their credit standing with stronger economies like Germany, France and the Netherlands. On the other hand, the opposition of Germany (and also France, the Netherlands and Sweden) to the idea is prudent (at least for now) as the issuing of e-bonds would effectively mean that all of the 16 eurozone countries will have to finance a portion of their debt together, including sharing the same credit rating. For example, Germany, which is the benchmark issuer of debt in the eurozone and, because of its strong economic fundamentals, enjoys the lowest borrowing costs, would have to surrender some of its credit to the less creditworthy and riskier eurozone countries, such as Ireland and Greece, among others. While this would mean disproportionately higher borrowing cost for Germany, countries like Ireland and Greece would benefit from lower bond yields. Although it makes sense for the eurozone to speak and act together – and the e-bonds, by reducing risk by spreading it to one and all, will underscore the eurozone's commitment to the euro – a case could also be made that such an action would remove any real incentive for the profligate members to implement the necessary economic reforms. Clearly, without Germany's support, e-bonds are not in the cards, even though it is likely that the idea will gain more traction should the crisis in the eurozone not be mitigated.

A more prudent approach towards greater euro stability (argued for most compellingly by Jacob Funk Kirkegaard) is for the eurozone governments to set up a permanent sovereign bailout fund designed to provide insurance against future crises.26 The European Financial Stability Facility (EFSF) created in May 2010 serves as a temporary fund enabling governments cut off from market financing to borrow from the facility, but allowing creditworthy members to borrow on the markets backed by eurozone government guarantees. Kirkegaard believes that making the EFSF (which expires in 2013) permanent through the European Stability Mechanism, set up to provide financial support to eurozone countries suffering liquidity, but not solvency problems, can help instill greater market confidence. Even though Germany and France, the eurozone's largest economies, will have to pick up much of the tab, the fact that both agreed during the two-day summit of eurozone leaders

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in mid-December 2010 to amend the European Union Treaty to make it possible to establish a permanent European Stability Mechanism (ESM), underscores their commitment to the eurozone. Designed to come into effect in 2013, the ESM's aim is to help countries with short-term liquidity problems as well as to enable insolvent ones to engage in orderly debt restructuring.

The summit failed, however, to specify what the eurozone plans to do in the short term to assuage market fears, in particular, whether it has the resources and the will to bail out Portugal and Spain. This partly explains why, despite the eurozone's bold decision concerning the ESM, Moody's credit-rating agency formally downgraded Ireland's sovereign credit rating to a BAA1 rating from AA2 – just three steps above junk-bond status on 17 December 2010. The sad irony is that as ratings are reduced, countries like Ireland and Greece, which have enacted tough austerity measures to get their finances in order (in the case of Ireland, a wholesale restructuring of the country's banking system), will face even greater difficulty borrowing on international markets without paying the requisite higher interest rates.

To conclude on a more positive note, however, the new permanent facility will help mitigate the moral hazard problems (that is, excessive risk-taking by eurozone members as they know the fund will bail them out if they get into trouble), since the mechanism plans to put more stringent conditions into place, monitor that rules are followed, and impose sanctions on eurozone members that fail to exercise budget restraint. In addition, the fact that, with the permanent fund, private sector investors will have to absorb some of the losses in case of a sovereign debt restructuring will go a long way to reducing moral hazard problems. Equally important, eurozone governments have already committed themselves to including 'collective-action clauses' in any bonds issued after 2013. This will make defaults more orderly as it will enable a supermajority of creditors to agree to change the terms of bonds for all creditors and, thereby, avoid the protracted negotiations needed to get every last holdout creditor on board. 27 This should help the EU assuage market fears and allow it to cope more effectively with increased credit risk and market volatility.

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Notes

1 International Monetary Fund, IMF Country Report No. 06/2932006; and, among others, Honohan and Walsh, Catching Up With The Leaders; Nolan, O'Connell and Whelan, Bust to Boom; and O'Hagan, The Economy of Ireland.

2 MacSharry and White, Making of the Celtic Tiger; O'Riain, Politics of High Tech Growth.

3 Honohan, "Resolving Ireland's Banking Crisis", 209.

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4 Ireland's corporate tax structure at 12.5 percent is the lowest in the EU. In fact, Germany, France and many European countries have long complained that Ireland's low corporate taxes undermine open competition in the EU. For a good overview, see OECD, Recent Tax Policy Trends; Owens, "Fundamental Tax Reform".

5 It is estimated that "multinational corporations employ more than a quarter of a million people in Ireland. About 70 percent of the nation's exports and 70 percent of business spending on research and development comes from foreign direct investment." See L. Alderman, "In Ireland, Low Corporate Taxes go Untouched", New York Times, 25 November 2010. http://www.nytimes.com/2010/11/26/business/global/26tax.html?_r=1&pagewanted=all

6 Honohan notes that banks "began to increase the share of their assets in property-related lending from less than 40 % before 2002 to over 60 % by 2006". ("Resolving Ireland's Banking Crisis", 209).

7 Kirby, The Celtic Tiger in Distress.

8 M. Kelly, "Whatever Happened to Ireland?" Vox, 17 May 2010, http://www.voxeu.org/index.php?q=node/5040

9 Honohan, "Resolving Ireland's Banking Crisis", 216.

10 O'Toole, Ship of Fools.

11 Whelan, "Policy Lessons from Ireland's Depression", 233.

12 M. Kelly, "Whatever Happened to Ireland?" Vox, 17 May 2010, http://www.voxeu.org/index.php?q=node/5040

13 That is, Irish banks held assets which were not only worth far less than their liabilities, they were also so heavily leveraged that they lacked the ability to generate sufficient cash flows to service their creditors. "IMF Approves €22.5 Billion Loan For Ireland", IMF Survey Magazine, 16 December 2010, http://www.imf.org/external/pubs/ft/survey/so/2010/CAR121610A.htm

14 P. Krugman, "Eating the Irish", New York Times, 26 November 2010, http://www.nytimes.com/2010/11/26/opinion/26krugman.html?pagewanted=print

15 For example, on 30 March 2009, Standard and Poor's downgraded Ireland's credit rating from AAA to AA+, and on 8 April, Fitch downgraded Ireland from its AAA credit rating to AA-plus.

16 European Central Bank, Monthly Bulletin: December.

17 No doubt, Greece and Ireland are very different cases. Greece's problem is rooted in the nation's massive public debt. Also, unlike Ireland, the Greek economy is relatively closed and uncompetitive. Ireland's problem, on the other hand, is rooted in the country's highly indebted banking system. Hence the argument that the Irish banking sector could be made whole again via reorganisation (especially the imposition of a more robust supervisory system) and ample capitalisation.

18 A. Faiola, "Spain, Portugal Face Pressure for Bailouts," Washington Post, 27 November 2010, http://www.washingtonpost.com/wpdyn/content/article/2010/11/26/AR2010112605032_pf.html

19 Specifically, Dublin aims to reduce the deficit to 9.1 percent of GDP in 2011, 7 percent in 2012, 5.5 percent in 2013, and 2.8 percent by 2014. A recent IMF report notes the problems in meeting these targets: IMF, IMF Country Report No. 10/366.

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20 Rogoff has noted that "the so-called 'PIGS' (Portugal, Ireland, Greece, and Spain) face the prospect of a 'lost decade' much as Latin America experienced in the 1980's": K. Rogoff, "The Euro at Mid-Crisis", Project Syndicate, 2 December 2010, http://www.project-syndicate.org/commentary/rogoff75/English

21 Olli Rehn, the EU's commissioner for economic and monetary affairs defended his position of "no haircut on senior debt" because he wanted to show the markets that the EU was serious when it said that only future bailout recipients might be forced to reduce bondholder returns, once the permanent mechanism comes into force in 2013. See J. Chaffin, "Dublin Pays €17.5bn for Own Rescue", Financial Times, 29 November 2010, http://www.ft.com/cms/s/fbcb7732-fb3e-11df-b576-00144feab49a,dwp_uuid=bd2f85d2-8e90-11db-a7b2-0000779e2340,print=yes.html

22 Reinhart and Rogoff, This Time is Different.

23 As Eichengreen notes, "… the standard way to buffer the effects of austerity is to marry domestic cuts to devaluation of the currency. … But, since none of these countries has a national currency to devalue, they must substitute internal devaluation for external devaluation. They have to cut wages, pensions, and other costs in order to achieve the same gain in competitiveness needed to substitute external demand for internal demand." B. Eichengreen, "Europe's Inevitable Haircut", Project Syndicate, 2 December 2010, http://www.project-syndicate.org/commentary/eichengreen25/English

24 IMF, Country Report No. 10/366, 6–7. The same report notes that "German and UK banks have the largest exposure to Ireland (€113 billion and €107 billion, respectively), followed by US (€47 billion), French (€36 billion) and Belgian (€24 billion) banks. As a percent of home country banking system assets, banks from Belgium (2.2%), Germany (1.8%) and the UK (1.3%) are the most exposed. … Portfolio investments are another potential channel of financial contagion. The countries with the largest portfolio investments in Ireland are the UK (€134 billion), Germany (€112 billion), France (€95 billion), and the US (€83 billion). Relative to home country GDP, the most exposed countries are Portugal (18.8%), the UK (8.9%), Belgium (8.1%), the Netherlands (6.2%), Switzerland (5.9%), France (5.2%) and Germany (4.8%)."

25 On 1 January 2011, Estonia adopted the euro and became the 17th member of the eurozone.

26 Kirkegaard, "How Europe Can Muddle Through".

27 For an overview of collective action clauses as applied to developing nations, see Sharma, "Resolving Sovereign Debt", 627-46.

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