

## POLICY PAPER

# The European Context of Ireland's Economic Crisis

SEBASTIAN DELLEPIANE AVELLANEDA\*

*University of Antwerp*

NIAMH HARDIMAN\*\*

*University College Dublin*

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*Abstract:* The current economic crisis has hit all European countries hard, but some are more severely affected than others. The problems manifest in European peripheral countries that are also members of the Eurozone, that is, Ireland, Spain, and Greece, have roots in domestic policy mistakes. However, the European context of these policy profiles also needs to be taken into account. The creation of the Euro initially yielded large credibility gains for the weaker economies, extending low interest rates across the Eurozone. But it also introduced a set of perverse incentives toward fiscal expansion which were supposed to be managed at domestic level. Weak European coordinating capacity meant there were few effective external disciplines on national decision making. The sanctions built into the Stability and Growth Pact proved more controversial and, therefore, less constraining than originally envisaged. The problems accumulating in the weaker economies made them particularly exposed to crisis when the downturn came. The crisis is not merely one of peripheral economies' policy errors, but extends to the design of European decision making and the management of monetary union, and to the underlying structural differences in relative trade capabilities between Eurozone member states. These issues are explored with reference to the Irish case: the crisis of the Irish and other peripheral economies points to a number of unresolved difficulties at the heart of European politics.

\*sebasdellepiane@gmail.com

\*\*Niamh.Hardiman@ucd.ie

## I INTRODUCTION

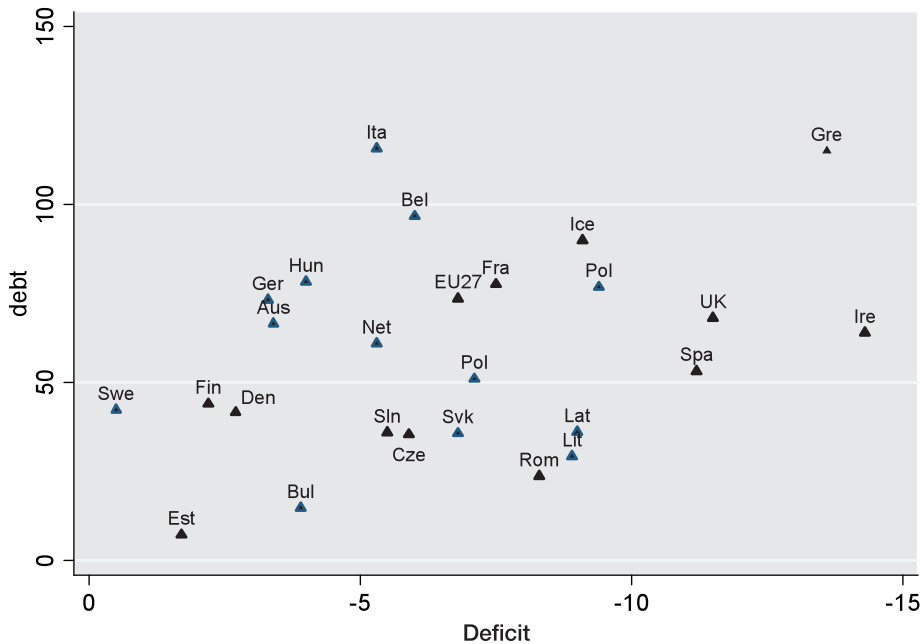
Ireland experienced one of the most severe economic contractions of the Eurozone countries, with a dramatic drop in growth and a sudden sharp increase in unemployment. It shares the experience of crisis with other European countries, but the trajectory and experience of crisis shows important variations. Each country experiences the crisis as a challenge to its domestic capacity to manage its own particular “problem load”; there are variations in the institutional and political resources each can draw on to deal with its own issues.

But in addition to viewing countries’ responses to crisis on a case-by-case basis, it may be useful to consider the wider political and institutional context within which domestic responsive capacity is situated. The creation of European Monetary Union (EMU) has played some part in creating the conditions for the domestic policy configurations that have intensified the experience of crisis in many countries. In the early years of EMU, the availability of a ready source of cheap credit created new growth opportunities. But as the economies of the Eurozone were at very different levels of development, the “one size fits all” central management of the Euro threw major challenges of domestic adaptation back onto national governments.

When the crisis began to unfold, national governments were similarly charged with responsibility for putting their own domestic houses in order. But once again, there is a European dimension to the management of the crisis that exposes not only the weaknesses of national decision making systems, but some systemic weaknesses in the institutional design of the Euro itself.

## II EUROPEAN EXPERIENCES OF CRISIS

From the perspective of the aftermath of the economic crash, it is now clear that some European countries were more vulnerable than others to economic downturn when it did come about. Yet why this should be so became clear only in retrospect. Although many analysts expected that the growing deregulation of financial markets since the 1980s and the trend toward securitisation of financial assets since the 1990s would induce a convergence in the role of national governments in economic policy, actual outcomes have been more varied than projected. Nation-states still displayed a good deal of diversity in the policies they adopted and had considerable room for manoeuvre (Busch, 2008). The near-collapse of the international financial system was the proximate cause of crisis. Underlying weaknesses in public finances were intensified by banking crises.

Figure 1: *Debt and Deficit as Percentage of GDP, 2010*

Source: General government deficit, general government debt, Eurostat.

As Figure 1 shows, the countries with the largest accumulated debts in 2010 were Belgium and Italy, along with Greece. These countries had long experienced the greatest political difficulties in controlling expenditure; qualification for Euro membership had been most problematic for them. But what presented the most pressing challenge for Eurozone members was the sudden deterioration in fiscal deficit. Ireland held the unenviable record on this measure, followed by Greece, Britain, Spain, Portugal, and Iceland. The concern that emerged during 2009/10 was that problems managing borrowing requirements would quickly result in greatly increased debt liabilities. Following the collapse of the Icelandic economy, sunk by the size of the financial industry and its extreme over-exposure to risk, the weakest links in the single European currency then seemed to be constituted by Portugal, Ireland, Italy, Greece, and Spain, the unappealingly named PIIGS, or perhaps GIIPS (Dadush, 2010).

However, the pathways by which countries had arrived at this point were rather different. On the face of things, the deficit problem is most readily explicable in the case of Greece, where as Figure 2 shows, fiscal deficits had persisted throughout the years of Euro membership.

Figure 2: *Revenue, Spending and Deficit Profiles for Four Countries, 1998-2009*



— Spending      — Revenue

Source: Eurostat.

Note: GDP dropped sharply in all four countries between 2007 and 2009, especially in Ireland, which exaggerates the impact in these graphs of the weaker tax revenues alongside with continuing spending obligations.

But Ireland and Spain did not run serious deficits during the 1990s, and indeed Ireland was running a small fiscal surplus during most years leading up to the crisis (O'Leary, 2010).<sup>1</sup> Britain, outside the Eurozone, began to experience fiscal deficits during the 2000s, especially in the run-up to political transition from the prime ministership of Tony Blair to his long-anticipated successor, Chancellor Gordon Brown. But the crash, when it came, placed the

<sup>1</sup> "By 1997, the Irish government was running a budget surplus and that outcome was repeated in all but one of the next ten years. Over the 1997-2007 period the budget surplus averaged 1.7 per cent of GDP and the debt-GDP ratio fell from 74 per cent to 25 per cent. In the five years prior to the onset of the current crisis the average budget surplus was somewhat less than this at 1.3 per cent of GDP"... "Finland and Luxembourg also achieved surpluses in 10 out of 11 of these years, Denmark in nine, Sweden in eight" (O'Leary, 2010, p. 3).

peripheral countries of the EU in the most vulnerable position, especially Greece, Ireland, and Spain.

Why this should be so has an international as well as a domestic aspect to it. The international dimension of problematic inter-state relationships within the single currency area has its origins in the terms on which the Euro itself was created (Marsh, 2009). Germany's preference for a strong and independent bank, based on the Bundesbank model, prevailed over the French desire to establish some mechanisms of democratic accountability for the bank's decision making. The Stability and Growth Pact vested responsibility for debt and deficit management in national governments. Each member state acquired new budget-framing and reporting responsibilities to the European Central Bank. The possibility of unmanageable unilateral fiscal problems was excluded from consideration on principle, to prevent the possibility of moral hazard.

What was created was a multi-level macroeconomic policy. At the centre, the ECB had quite light regulatory and liquidity responsibilities. And unlike federal states, the transnational monetary union had no counterpart in fiscal policy – the total EU budget is estimated at some 1 per cent of the GDP of the EU as a whole, and programmatic spending on targeted measures such as agricultural supports and regional cohesion policies accounts for most of this. The result was analogous to a federal state with a centralised monetary and exchange rate policy, but effectively no fiscal policy to counter the effects of regional shocks, and fiscal buffers available at the state level only.

When the Euro introduced a sustained period of low interest rates, this gave a fillip to the project of integrating the European market in financial services as well as in freeing up product markets. It was recognised in advance that the low interest rates that most benefited the largest economies would not necessarily be optimal across all regions. The principal controls available to governments to manage these surges in the peripheral economies were active fiscal policy to counteract spending, and active cost management to keep down relative cost structures and inflation.

The international context sets the scene for individual countries' adjustment challenges, in three respects. First, a trade imbalance is inherent in the diversity of the size of European economies and their level of economic development: Germany is the principal exporting economy in Europe, but domestic levels of demand had been held under control as part of the domestic cost-containment strategy, thus reducing the capacity of smaller countries to export their own goods and services. In Ireland, Spain, and Greece, "... current account deficits were mainly driven by private investment and capital inflows coupled with competitiveness lags" (European Commission, 2010, p. 215).

Second, the successful performance of German exports and sluggish domestic demand meant that bank assets exceeded domestic borrowing requirements, so German investments flowed outward into the more rapidly growing economies. This contributed to the greater availability of personal as well as corporate credit facilities, fuelling the surge in indebtedness in the peripheral economies. At a more global level, something similar had been happening in the USA relative to China. China's sudden emergence as a global manufacturer gave rise to trade imbalances with the USA; China's surpluses were not deployed to raise domestic living standards, but flowed back to the US in the form of purchase of government bonds and other investments. Public deficits had their counterpart in a sharp increase in private borrowing capacity. Across the developed world, the increase in household debt since the 1990s served to raise living standards (or to maintain them in the case of many US households) and boost demand, in what has been termed a form of "privatised Keynesianism" (Crouch, 2009).

Third, low interest rates and expanded availability of personal credit combined to generate conditions conducive to house-price inflation across Europe, especially in Ireland and Spain. Cheap credit conditions permitted the peripheral countries to engage in rapidly rising borrowing, facilitating domestic credit booms, which were in turn reflected in hugely intensified construction activity and house price inflation (Conefrey and Fitz Gerald, 2010).

These trends were transmitted through western economies by the surge of growth in the financial sector, as banks found innovative ways to create credit and sell new financial products. The scale of leveraging involved escalated sharply, and the market in various forms of hedges and derivatives grew so complex that the level of risk was, in effect, impossible to estimate. All this was made possible by the spread of support for bank deregulation, especially in the Anglo-American world (though the Canadian banks had to function within a tougher regulatory regime, and Australian banks faced "intrusive" regulation that may have helped forestall over-risky behaviour), and by the weaknesses of the international monitoring and bank regulation institutions. The rapid expansion of the financial sector across Europe far outstripped EU institutional capacities to oversee and regulate it (de la Rosiere, 2009; Lanchester, 2010). The nature as well as the extent of exposure to risk turned out to vary significantly across countries, depending on the extent to which banks bought into asset price bubbles in other countries, or engaged in intensified lending within their own countries that contributed to domestic asset bubbles. Icelandic banks suffered the first fate. Irish banks were mostly exposed to the second kind of risk, a traditional "plain vanilla" kind of over-

exposure to the domestic property market, and especially commercial property, but on a scale never before seen (Moghadam and Vinals, 2010; Regling and Watson, 2010).

Relative cost pressures in the overheated Irish and Spanish economies during the 2000s had to be managed through fiscal policy and wage-cost containment. However, the paradoxical effects of the credibility gains these countries achieved through monetary union had been to soften their budget constraints. EMU had facilitated pro-cyclical fiscal policies and the accumulation of deficits; domestic institutional buffers proved inadequate to resist. The point is not confined to the Euro. Ed Balls, then economic adviser to British Chancellor Gordon Brown, said of New Labour's early decision in 1997 to make the Bank of England independent of political influence, that "... central bank independence liberated us". That is, it assured the markets that Labour would not commit to a high-spending, high-tax strategy. The government gained in credibility, which helped keep interest rates low. Government was freed to increase spending and incur greater deficits without incurring "normal" retribution from the markets.

### III DOMESTIC POLITICAL INSTITUTIONS AND ECONOMIC POLICY

Membership of the Euro threw an unprecedented burden onto the adaptive capacity of the member states in two ways. First, on the demand side, fiscal policy acquired new significance as the principal means whereby inflationary pressures could be managed and deficits kept to a minimum, consistent with the terms of the Stability and Growth Pact. Second, the institutions of wage bargaining thus also became more important as a potential means of managing domestic economic performance in the context of EMU, for unless loss of competitiveness could be managed through relative cost adjustments internally, the cost would be borne otherwise in the form of a rise in unemployment.

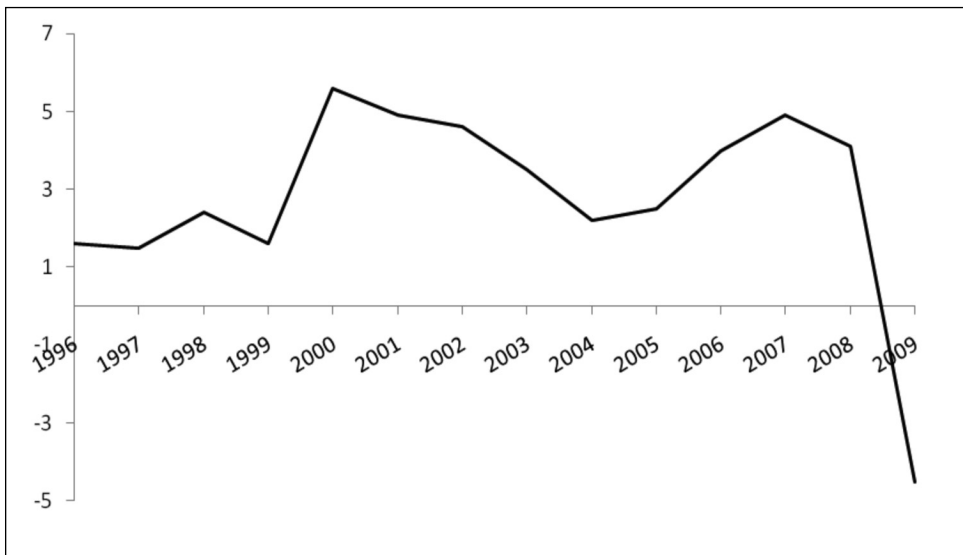
National processes through which budgets were approved and policy priorities established gained a new significance after 2000. As we have noted, Ireland did succeed in running fiscal surpluses for most of this time, though this generally came about through over-shoot of revenue projections rather than as a planned policy. The real problem lay in the fact that most of this buoyancy was attributable to frothy and cyclical property-related revenue source. While the overall ratio of tax to GDP changed relatively little, the composition of taxation changed a good deal, as the emphasis shifted away from personal income tax and toward taxes on activities to do with property transactions.

In view of the importance of fiscal policy as a stabilising instrument under EMU, the capacity to run counter-cyclical fiscal policy became an advantage to the smaller economies that were more vulnerable to fluctuations in the wider international economic environment. Ireland's pro-cyclical budgets were commented on by international monitoring bodies including the ECB, the IMF, and the OECD, and indeed in 2001 the ECB issued a formal criticism of Irish fiscal stance. Yet the conclusion of most of the reports was that, in view of the fiscal surpluses, Irish performance was acceptable (O'Leary, 2010).

Underlying trends in fiscal policy were problematic. Having adhered to publicly stated budget disciplines under the coalition government of 1994-1997, subsequent Fianna Fáil led governments explicitly stopped adopting constraints on government current spending in the early 2000s, just as the Euro was coming into being, and just as the boom was gathering pace (Regling and Watson, 2010). This contributed to the sharp upturn in inflation in 2000 and 2001, as seen in Figure 3 below.

The components of inflation during the 2000s included indirect taxation feeding through to price increases in goods and services. Southern European countries also experienced increased inflation, but with lower standard of living costs, and Ireland's competitiveness losses were greater. Moreover, during much of this period the value of the US dollar was weakening, which is

Figure 3: *Irish Consumer Price Index 1996-2009, Annual Percentage Change*



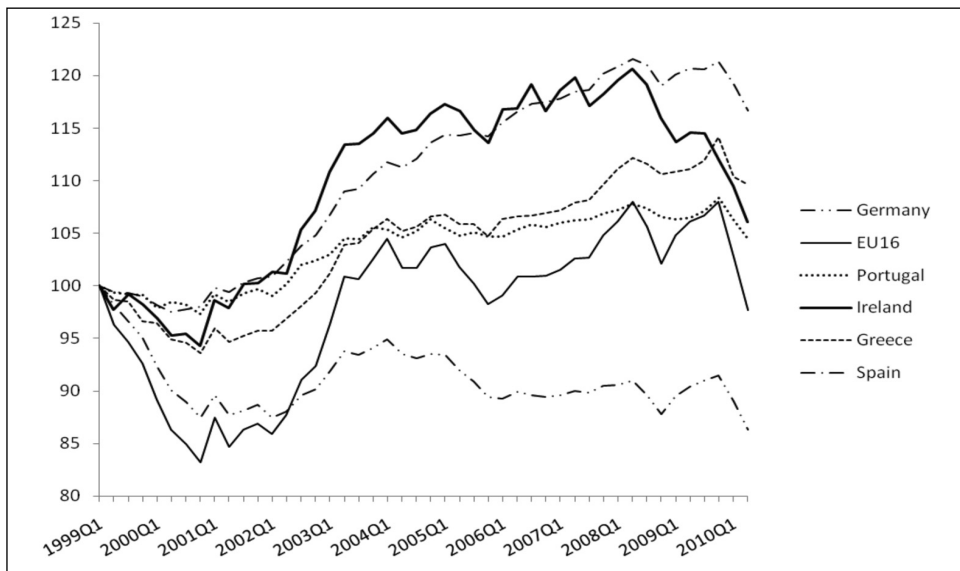
Source: Consumer Price Index, Central Statistics Office.



particularly onerous for a country as massively dependent on exports, and especially to the US, as Ireland. The loss of export share was therefore painful. The upturn in Irish shoppers going on weekend trips to New York and Boston not only dramatised the discretionary income available to many in the Celtic Tiger era, but more subtly pointed to the incipient hazards of macroeconomic mismanagement.

Ireland lost control of its cost base, but it was not alone in this. Figure 4 shows the extent of the loss of relative competitiveness, which compares the countries of the European periphery with the EU average and with German performance.

Figure 4: *Harmonised Competitiveness Indicators, 1999-2010*



*Note:* For the Euro Area, the real effective exchange rate of the Euro vis-à-vis 21 trading partners is displayed. For Euro Area countries, the table shows the harmonised competitiveness indicators calculated vis-à-vis the same 21 trading partners plus the other Euro Area countries. A positive change points to a decrease in price competitiveness.

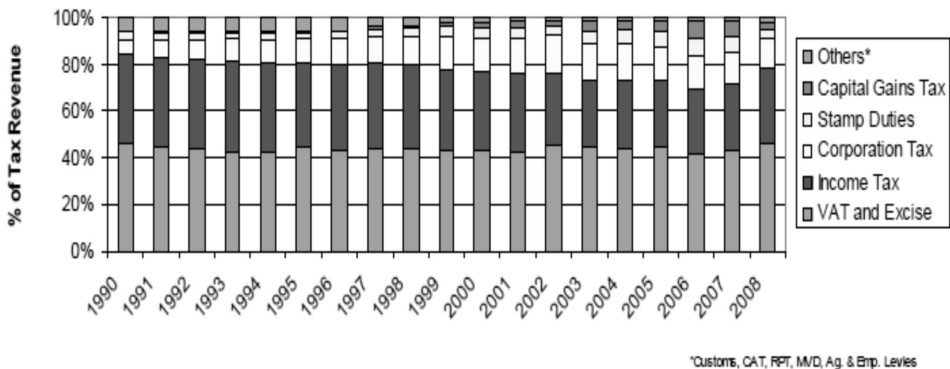
*Source:* Harmonised competitiveness indicators based on GDP deflators, percentage change, Q4 1998=100. European Central Bank.

What this figure captures is the real effective exchange rate obtaining between the member states of the Euro itself. Ireland and Spain lost competitiveness most dramatically vis-à-vis their principal European trading

partners, and Greece also experienced a worsening of its relative position. Ireland's was the worst performance by some margin: "... compensation per employee, which had grown more or less in line with the Euro Area on average until 1996, increased at two to three times the Euro Area average from 1997 to 2008" (Regling and Watson, 2010, pp. 21-2). Income costs were not the only contributory factor to competitiveness losses – non-income costs in energy, transportation, and other business costs were also pushing up costs (O'Farrell, 2010). In contrast, Germany maintained its relative domestic costs quite steadily over time, in part through geographical diversification of production across Eastern Europe (Marin, 2010).

One of the principal contributions to the scale of the fiscal collapse during the crisis was the distortion engineered in the revenue profile during the 2000s. Buoyant revenues hid a dramatic shift in the composition of taxation. As Figure 5 illustrates, personal income tax declined as a proportion of the total, while the revenues from the cyclical effects of the construction boom formed what is now clearly an unsustainably large proportion of the total.

Figure 5: *Composition of Taxation, 1990-2008*



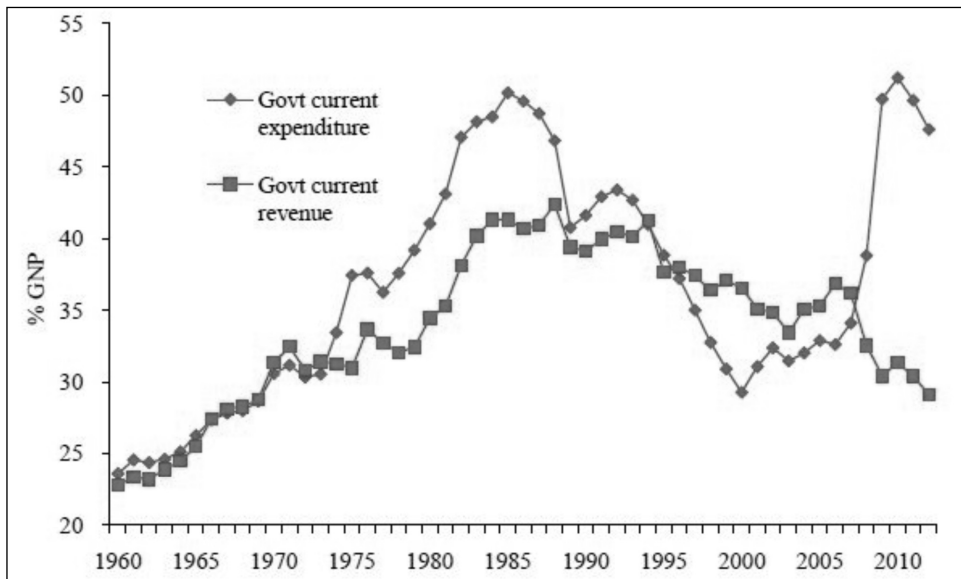
Source: Regling and Watson (2010), p. 27.

In addition, governments had come to use tax reliefs very freely indeed to incentivise behaviour: total reliefs amounted to more than the total income tax take in 2005, and reliefs ran at three times the European average (Regling and Watson, 2010, p. 27; Callan *et al.*, 2005). This is consistent with the prevailing sense that the Irish growth model depended on minimising the direct role of the state in the economy. Tax expenditures have real behavioural consequences and may prove to be an expensive policy tool. But they involve an indirect way of acting that recurs elsewhere: the Irish state typically prefers to let markets deal with major distributive issues rather than actively intervening on principles of fairness or redistribution. This is apparent, for

example, in the ways in which public funding is used to encourage and subsidise the accumulation of private benefits in areas such as education, health care provision, and pensions coverage. Indeed, the same may be noted of the way in which the eventual rescue of the banks was managed, when government preferred to create a Special Purchase Vehicle to buy up distressed assets at a discounted rate, rather than temporary nationalisation of the banks as happened in the earlier Swedish approach to bank rescue. Both strategies require the injection of massive amounts of public funding to recapitalise the banking sector. The political implications of each are clearly rather different, though their relative technical merits are contested.

Yet spending obligations once incurred cannot easily be reversed. Figure 6 shows the upward trend in government current spending after 2000 (with a slight corrective after the 2002 elections), that was all too dependent on a relatively soft revenue base.

Figure 6: *Government Current Expenditure and Revenue, Percentage of GNP, 1960-2010*



Source: Honohan (2010), Chart 2.9, p. 30.

The policy stance responsible for the weak management of the budget derives from several sources: we might identify the role of electoral and party-political considerations, the framework of policy advice, and the wider incentives and constraints embedded in what we might term the Irish growth model (Hardiman, 2010a).

Party political considerations are relevant here because the coalition of Fianna Fáil and the Progressive Democrats that held power between 1997 and 2007 led Ireland into Euro membership with a distinctive approach to the uses of public spending. Fianna Fáil Finance Minister Charlie McCreevy, now notorious for the pro-cyclical motto summarising his approach to budgetary policy, “When I have it, I spend it”, was also personally as well as politically close to the leader of the economically liberal Progressive Democrat party, Mary Harney. This is not unlike the British Labour Party observation noted above (“central bank independence liberated us”). Politicians, we may say, are less interested in discipline per se than in the economic and political benefits attached to the institutionalisation of discipline. The credibility gains won from Euro membership had very weak institutionalised domestic disciplines to restrain the surge in pro-cyclical fiscal policy that ensued.

The suspicion of big government and preference for low personal taxation tilted the Fianna Fáil government toward the right on these issues. Moreover, the traditionally close relationship between Fianna Fáil and the construction industry was intensified by an expansion in the tax breaks and incentive schemes available to the building industry – a useful boost to economic activity just as US-led FDI began to shrink. Construction employment almost doubled over a decade to almost 14 per cent of total employment in 2006. The close relationship between builders, developers, and the Fianna Fáil party carried on into party funding, although the extent of financial contributions has been difficult to probe.

Hallerberg and his colleagues have suggested that coalition governments tend to negotiate pre-commitment to budget outcomes (a “contract” model of fiscal policy), whereas single-party governments tend to privilege the decision making role of finance ministers (a “delegation” model) (Hallerberg *et al.*, 2009; Hallerberg *et al.*, 2007). The latter conditions are said to be conducive to budget stabilisation when there is little or no ideological conflict within the government, the former when ideological conflict is high. Governments also vary in the degree to which they were constrained by parliamentary deliberation to modify their policy proposals and adopt negotiated legislation (Döring, 2001, 2004; Strøm, 1998). Given the strongly autonomous role accorded to the Finance Minister in Ireland, and the low levels of ideological conflict in government, it should have been well suited to adopt strong targets on both spending and revenue and to make them stick. Yet this did not prove to be the case.

It might perhaps have been expected that the autonomous powers of the Irish Finance Minister would be guided by strong procedural rules and formalised policy advice. This was not so, however; and international commentators frequently noted the unusually weak formal rules governing Irish budgetary procedures. Furthermore, public administration reform had

lagged its Whitehall-model counterparts elsewhere in the English-speaking world, and the generalist model of recruitment had not been supplemented by recruitment of specialist professional expertise, especially in the area of economic competence (Hardiman, 2010c).

The dominant ideas within government and the senior civil service about what policy mix would be most appropriate were shaped by an acceptance of the low-tax, export-oriented model (even when not balanced by strong controls over public spending). The institutionalisation of the low-tax model supported the ongoing reduction in personal tax liabilities. As financial services grew in importance relative to GDP, free-market preferences extended also to the acceptance of a principles-based rather than a rules-based approach to bank regulation, and the institutional separation of central bank and financial regulator functions in a “light-touch” regulatory approach. The net effect was what has been termed a “timid” approach on the part of the financial regulator, and to what we now know to be a woefully misplaced assumption that the banks knew best and could be trusted to look after their own shareholders’ interests (Honohan, 2010).

If government fiscal strategy is one side of the cost management strategy required within the Eurozone, wage bargaining is the other. Here too we can see that the domestic institutional configuration was not well suited to taking on board the full compliance requirements of Eurozone membership. Government-led tripartite pay deals had expanded greatly from the agreement that started the series of social partnership agreements under crisis conditions in the mid to late 1980s. The range of issues had expanded by the early 2000s. The number of organisations that had some involvement in the negotiations had greatly increased, since all the civil society bodies that had previously been given separate forum representation for policy influence were now part of the National Economic and Social Council (NESC). But the core deal continued to centre on pay moderation in exchange for increased personal disposable income through tax cuts, mainly through extending tax credits rather than taking down rates.

Three problems with this strategy were not addressed throughout the 1990s. First, it is not clear that the changed policy framework and strategic priorities required by Eurozone membership really altered the bargaining priorities embedded in collective bargaining processes. Second, the uneven coverage of social partnership and the relative weight of the public sector unions came to be problematic. Third, the extent of competitiveness losses emanating from inflation-fuelled settlements and rising public sector costs were not subject to any institutionalised monetary disciplines or constraints.

The rationale for engaging in rounds of talks leading to a deal at approximately three-yearly intervals was not only to get a pay deal, but to situate this in the context of an agreed framework of macroeconomic

functioning. To this end, NESc published a strategy report prior to each round of negotiations. Social partnership was thus legitimated not only by its internal democratic accountability linkages, but by the notion that public interest considerations were built into its procedures. Indeed, some were led to argue that Ireland had evolved a new kind of social learning mechanism, a deliberative system that not only solved conflicting distributive interests but permitted an open-ended process of defining what these interests might be (O'Donnell and O'Reardon, 2002; O'Donnell, 2008, 2001). But it is far from clear that this was in fact what happened once the objective of securing Eurozone membership had been attained. Increased industrial conflict broke out over high inflation, and rising house prices further fuelled union members' demands for higher wage compensation. The processes of wage determination through social partnership were not well suited to negotiating internal deflation, whether through fiscal measures or cost-restraining settlements by employers and unions. The trade union movement stressed the desirability of particular kinds of changes to the tax system such as increasing credits to remove the low-paid from the tax net (though this weakened the income tax base overall), and extending bands, rather than cutting rates of tax (Irish Congress of Trade Unions, 2010). But the net effect of the government commitment to tax reduction resulted in a path-dependent route of sharing out growth through rising personal incomes rather than through improvements in public services and other forms of collective consumption, with all the inequalities this entails between households. As a consequence, Irish employees quickly came to be among the most lightly taxed in the OECD, outdone only by Korea and Mexico (OECD, 2009, p.51). The costs of this policy package did not become apparent until it was too late.

The trade union movement had a rather distinctive profile compared with other OECD member states though. Because the foreign-owned high-profit and export-oriented sector tended not to recognise unions at all, union membership was concentrated in less export-dependent enterprises and in the public sector. The risks of a union profile such as this for inflation-generating settlements under conditions of growth have been recognised elsewhere (Garrett and Way, 1999). Indeed, the fragmented nature of Irish public sector unions was recognised as a self-reinforcing source of upwardly competitive wage claims. The principal attempt to address this, through an exercise in 2003 in "benchmarking" public sector salaries, was a contentious exercise. Many considered this to have been too high a price to settle grievances, and it was only poorly linked into public sector reform priorities (O'Leary, 2002; Hardiman and MacCarthaigh, 2011, forthcoming). Relative wage differences between public and private sectors continued to be a source of disagreement and conflict (Kelly *et al.*, 2009).

Domestic institutions struggled with these issues against a backdrop of inflation that was higher than the EU average and a steady loss of cost-based competitiveness. The most direct corrective action to Ireland's over-heating economy – and Spain's – would have been an interest rate increase. In the German model on which the ECB was based, cost containment had been institutionalised by the interplay between industry-level collective bargaining and the signalling mechanism of Bundesbank interest rate increases. Translated to a Eurozone-wide level though, the ECB proved to be most attentive to the larger economies' slow growth and their need for a low interest rate stimulus (Franzese and Hall, 2000; Hall and Franzese, 1998; Crouch, 2002). Thus the actors in collective bargaining processes in fast-growing economies could not depend on an external monetary policy constraint on their deliberations. In Ireland, as in Spain and Italy, the Maastricht convergence criteria had been internalised in to the social partnership procedures (Pérez, 2002). But in an inflationary environment, the social partners had no further incentive to be self-binding. The Excessive Deficit Procedure was invoked against Portugal and Germany in 2002, France in 2003, the Netherlands and Greece in 2004 and Italy in 2005. But the sanctioning consequences of the Stability and Growth Pact proved weaker in their effects in the cases of Germany and France, when they in their turn breached the conditions even more egregiously than Ireland or Portugal (Hallerberg and Bridwell, 2008). The so-called punishment mechanisms, therefore, became largely ineffective once EMU was launched (Blavoukos and Pagoulatos, 2008). Moreover, prominent European leaders began to advocate more flexibility rather than more discipline, and Romano Prodi called the Stability and Growth Pact "stupid" (Hallerberg *et al.*, 2009, p.176). The credibility of the sanctions was called into question for other countries as a result. As the Irish parliamentary committee on European affairs noted:

By late 2003 it became clear that their deficits were continuing to rise and that neither France nor Germany would meet their targets. Neither Member State faced sanction due to this non compliance. These cases pointed to obvious credibility and enforcement problems for the SGP. If the two largest Euro Area economies fail to comply with the rules then why should smaller countries do so? (Houses of the Oireachtas Joint Committee on European Affairs, 2010, p.6)

In summary, the fiscal policy regime in Ireland was inappropriate to the conditions of monetary union. Although a fiscal surplus was often recorded, this was not a planned part of a counter-cyclical budgetary strategy, for which, under conditions of rapid growth, a very much larger surplus would have been appropriate. The underlying weaknesses in what may superficially seem to be a stable fiscal situation have recently begun to attract more notice

(O'Leary, 2010; de la Rosiere, 2009). Thus Ireland, with its extraordinarily high growth rates between the mid-1990s and mid-2000s, should have been running super-high fiscal surpluses (as Finland was). To the contrary though, fiscal policy was consistently pro-cyclical, and this was a recurring phenomenon in Irish public life, where spending booms tend to exacerbate economic upturns and recession is worsened by the need to address accumulated deficits (Lane, 1998). Small surpluses implied that the Irish public finances were highly vulnerable to a return even to moderate or sustainable rates of growth. There was little capacity for assessing the risk attached to weakening the revenue base or the capacity to withstand a downturn of any sort, let alone a major economic crisis on the scale that actually occurred. The institutional framework both for framing, monitoring, and implementing fiscal policy had many flaws. Correspondingly, the domestic institutional framework that was intended to make wage bargaining consonant with macroeconomic performance also proved to have many shortcomings, particularly in the foresight capabilities of the main actors.

But these domestic limitations also need to be placed in the wider context of European economic governance. The Euro was successful in bringing about low interest rates and freer cross-border mobility of financial assets. But the weight of adjustment accorded to national political systems proved to be too great. Among the perverse and unintended consequences of the Euro was the fact that an institutional design intended to bring about economic stability by ending currency volatility ended up by creating incentives for much greater instability in the form of very uneven growth, asset price inflation, and unsustainable credit expansion. Ireland, like the other European peripheral economies, fell victim to the politics of market-led indiscipline.

#### IV RESPONSES TO CRISIS: NATIONAL ADAPTATIONS AND EUROPEAN COORDINATING CAPACITY

The countries of the European periphery were more exposed than others to the effects of the financial crisis, and for members of the Eurozone, the conditions of the governance of the Euro itself made domestic adaptation more challenging. Similarly, once the economic crisis unfolded from 2008 on, the varying capacity of countries to devise a successful response has to be understood against the backdrop of the slow pace of response at the EU level, and the divided counsel about the most appropriate course of action that has prevented a coherent and coordinated strategy from being implemented. In this context, the smaller or weaker member states that had incurred the largest deficits have had little choice but to start vigorous programmes of



fiscal consolidation, while larger and more stable economies debated the relative merits of strong budget control measures at the risk of slowing recovery, or postponing consolidation measures in favour of maintaining a growth stimulus through continued spending (Alesina and Perotti, 2010; Giavazzi, 2010; Economics: Free Exchange, 2010). Yet the prospect that this would indeed stabilise their situation, let alone pave the way for economic recovery, remained uncertain. Greece continued to experience the greatest difficulties in 2010; but both Ireland and Spain, having undertaken fiscal austerity policies, still experienced lower levels of market confidence in their governments' bonds, and the prospect of a long period of economic hardship. The risk of a contagion effect, an unravelling of market confidence in Eurozone stability spreading from Greece to other countries, came to be a leading concern. The domestic institutions through which adjustments were managed first need to be considered; then we shall set these within the wider European setting.

We have noted that countries with strong executive autonomy from the legislature such as Ireland, Greece, and Britain, so far from using this to enforce a strong fiscal stance, were swayed by market incentives to take the brakes off and to permit a degree of fiscal laxity that would have been unconscionable in the preceding decade. (In the case of Britain, the capacity to allow its currency to depreciate against the Euro helped mitigate the damage this caused to its cost base, but at the expense of building up larger nominal deficits over the longer term.) But once the full impact of the crisis hit, precisely this executive strength could be deployed to impose fiscal stringency, even when it was electorally unpopular. Figure 7 below outlines an index of executive discretion, based on measures of the powers available to government and to committees in parliament in initiating, amending, and securing the passage of legislation. It shows that there is a broad pattern to the scale of executive power depending on the growth strategy and model of capitalism in place. The Anglo-American model, with its strong reliance on market signals, tends to be relatively unconstrained by obligations to institutionalised political stakeholders. The Scandinavian model tends toward a more decentralised and negotiated model of political decision making. Yet within each category there is also wide diversity, as for example between Greece and Spain within the "mixed" Mediterranean model of capitalism that features a strong state role in ownership and control of economic resources.

The strong executive autonomy available to the Irish government had contributed to creating the problem in the first place; but it also enabled it to commit successfully to fiscal consolidation once this seemed unavoidable. Something similar may be said of British governments, where the emergency budget of the newly formed British Conservative-Liberal Democrat coalition

Figure 7: *Index of Executive Autonomy and Varieties of Capitalism*

<i>Varieties of Capitalism</i>	<i>Index of Executive Autonomy</i>	
<i>Liberal</i>	Ireland	4
	UK	4
<i>Mixed</i>	Greece	5
	Portugal	1
	Spain	0.5
	Italy	-1
<i>Continental</i>	Germany	2
	France	1
	Netherlands	1
	Belgium	-1
<i>Social market</i>	Sweden	-4
	Iceland	-2
	Norway	-1
	Denmark	-1
	Finland	-1

*Note:* The data in the first column is derived from Döring 2001. Table 1 in that work itemised executive-enhancing legislative rules; we have allocated a sum of pluses and minuses to provide a single score. Table 2 itemised committee-strengthening parliamentary rules; a single score was similarly derived from this. The total from Table 2 was subtracted from Table 1 to give an index of executive dominance.

*Sources:* Döring (2001); Hall and Soskice (2001); Molina and Rhodes (2007); Pontusson (2005).

government in June 2010 was billed “the toughest in a generation” (*Economist*, 2010). In the Irish case, the commitment to a strong programme of spending cuts came relatively early, in a succession of budgets during 2008 and 2009, and most dramatically in a further sharp unilateral cut to public sector pay in Budget 2010 in December 2009. Both Spain and Greece implemented painful cuts and tax increases on a scale that has nowhere been apparent elsewhere in Europe.

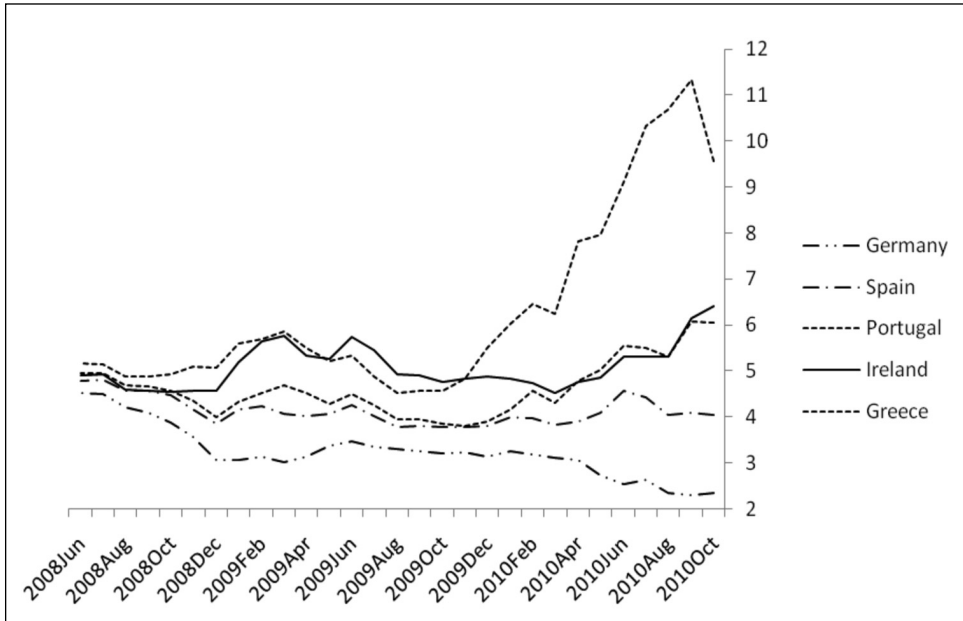
Governments’ capacity to gain acceptance of austerity measures from organised economic interests may also make a difference to the viability of their stabilisation strategy. In mid-2010, the Irish trade union movement voted to accept a deal that offered assurances that there would be no further pay cuts, in return for active implementation of public sector reform measures, the “Croke Park Agreement”. This acceptance of a form of “concession bargaining” in the intensive though ultimately abortive pay talks leading up to the unilaterally imposed December 2009 budget; some basis for agreement between government and unions (though not now employers) had been

reached which could be reactivated at this point. In Britain, the issues under discussion in the run-up to the election of May 2010 were about the timing and incidence of budget cuts, not the principle; and British trade unions are organisationally too weak either to organise resistance or to need to be involved as policy interlocutors (Merkel *et al.*, 2007; Hardiman, 2010b). In contrast, Spain and Greece have stronger and more contested left-right divisions in their party systems. Yet the differences between these two countries are striking too, notwithstanding street protests in both countries at austerity measures during 2010. Spain has a more strongly developed tradition of forming social pacts and more strongly institutionalised mechanisms for resolving political contestation. But Greece has been characterised as “une société bloquée”, in which the principal method for managing internal conflicts is through allocation of selective benefits (or clientelism), and in which lower levels of political institution-building mean that the communist Left can gain more traction through popular mobilisation than in other countries (Ongaro, 2010; Antoniadis, 2010; Featherstone, 2005).

The domestic institutional configuration of these countries helps to explain the variations in the profile of their responses to crisis. But once again, domestic institutional and political capacity is not the whole story, and the situation of each country in the international context, and the nature of its exposure to cross-national pressures, is also a critical part of the story. As of mid-2010 the trajectory of crisis is still unfolding, but the interplay between individual country responses and the coordination of response at the EU level brought out three key features of the governance of the Eurozone. The nature of Ireland's response can only be fully analysed once these background conditions are filled in. All three conditions have to do with the weaknesses in the implementation of the Stability and Growth Pact from an early stage, and for the failure to make any provision for the possibility of longer-term inability to comply on account of serious domestic fiscal crisis (Heipertz and Verdun, 2010; Dyson, 2008). First, the obligation to undertake policy adjustment exclusively at national level risked pushing the issue to the brink of the prospect of sovereign debt default. Second, once this prospect became conceivable, the coordinating capacity of the EU was revealed to be subject to fragmentation along lines of nationality. Third, the dearth of ideas about Europe-level macroeconomic priorities and growth strategy became evident. The orthodox view that rapid consolidation is desirable to secure a return to growth gained ground among the larger member states, including Germany, while a number of commentators pointed to the risk that this would further depress the prospects of recovery under conditions of a gravely impaired financial sector, no possibility of currency devaluation, and continuing structural trade imbalances.

Once it became clear that the peripheral economies were required to manage fiscal adjustments entirely within their own resources, the risk associated with sovereign debt on the international bond markets suddenly became much more differentiated, as Figure 8 illustrates.

Figure 8: *Interest Rates on Ten-Year Government Bonds*



Source: ECB Statistical Warehouse <http://sdw.ecb.europa.eu>

Because the possibility of fiscal crisis and the risk of sovereign debt default had been ruled out of account at the outset, there was no straightforward means of providing a credit line to the countries under greatest pressure – specifically to Greece, whose fiscal imbalances dated back some time. It took until late spring 2010 to provide supports in the form of a credit line to Greece from Eurozone member states, organised through the ECB. Alongside IMF intervention, this eventually stabilised Greece’s short to medium-term borrowing problems.

It remained unclear what the appropriate forum would be within which political mechanisms to prevent speculative attacks on individual countries could be worked out. The short-term issue centred on the urgency of a “Greek bail-out”, a difficult issue for German politicians facing important regional elections in May 2010. A combination of access to ECB loans on terms that were quickly drafted, and recourse to IMF loan facilities, defused the

immediate issue for Greece. The credit facilities were tied to a programme not only of immediate painful fiscal austerity but also of reform of social programme design and tax administration reform, intended to provide assurances that the medium to longer term fiscal trajectory would be stronger. But the scale of the fiscal problems it faced was clearly immense, and increasingly opening up the possibility of sovereign debt default. This in turn exposed the extent to which the peripheral countries' problems were in fact Europe-wide problems. French and German banks held much of the Greek government debts. The German financial regulator in 2009 produced a worst-case scenario of up to €800 billion in bad debts (Eurointelligence, 2010). Stress testing of European banks in mid-2010 allayed the worst of these fears (Balzi *et al.*, 2010). But the guarantees extended by governments across Europe to their banks meant that large volumes of private debt risked becoming a public debt liability. The issue for the Eurozone during 2010 slowly changed colour from a problem of sovereign debt in one country, Greece, to the risk of a contagion effect as nervousness spread, especially as it touched the much larger Spanish economy. Banking crises and fiscal crises had to be dealt with separately, but they were related problems.

European countries also faced a continuing problem about how best to create the conditions for the resumption of growth. The European periphery, particularly Ireland and Greece, but also Spain and Portugal, had very little choice in this: unless their governments embarked on austerity programmes, they would be unable to continue to raise the borrowing they needed to conduct their affairs. But these countries risked finding themselves in a double bind: having embarked on austerity measures, the growth potential would now be lower, the capacity to service debt correspondingly reduced, resulting in higher not lower interest rates. In the longer term, it is clear that market investors value growth and sustainable employment levels as much as fiscal orthodoxy.

Anticipatory austerity to appease the markets risked intensifying the negative European spiral, and a number of commentators warned of the risk of "double-dip recession" (Almunia *et al.*, 2009; Marzinotto *et al.*, 2010; Dadush, 2010; Wells and Krugman, 2010; Wolf, 2010). O'Rourke and others argued that in countries that had some leeway to create a stimulus, active demand-inducing measures would be preferable to a collective Europe-wide adoption of austerity policies (O'Rourke, 2010). If all were to engage in competitive internal devaluations by accepting domestic hardships, a "beggar my neighbour" effect could ensue, such that no country could provide the demand stimulus for the now increasingly competitive exports of the others. Yet the trend toward adopting orthodox austerity policies seemed widespread, extending to Germany and receiving the endorsement of the G20 in mid-2010 (Alesina and Perotti, 2010).

The slow pace of response at European level, and some tensions between the preferences of the ECB and different members of the European Commission over what should be done, revealed the difficulties of complex coordination in European economic governance. Three possible future lines of development may be outlined. The first would suggest that nothing short of a large-scale coordinated political re-engineering of the European political system itself was required. Hallerberg *et al.*, argued that "... it is important to centralise the budget process" (Hallerberg *et al.*, 2009). In fact at national level, a number of countries with centralised budgetary procedures also ended up in fiscal trouble, suggesting that fiscal disciplines are not only due to centralisation, but to some combination of monetary, fiscal and financial policies. Further centralising the European budget process at trans-national level would require a massive increase in centralised political competences. One commentator stated the prospect as follows: "... the Eurozone will need to commit itself to a full-blown fiscal union and proper political institutions that give binding macroeconomic instructions to member states for budgetary policy, financial policy and structural policies. The public and private sector imbalances are so immense that they are not self-correcting". In this view, European citizens face a stark choice, between "... reverting to dysfunctional and, as it transpires, insolvent nation states, or jumping to a political and economic union" (Münchau, 2010). However, this view suffers from political implausibility. European voters would be unlikely to approve increased transfers of powers to a federal centre; there is a marked lack of appetite among European leaders for any new constitutional initiatives; and the German Constitutional Court has ruled that any further moves in this direction would be impermissible under their existing constitution. Furthermore, as Rodrik argues, it is far from clear that it is even possible, let alone accepted as legitimate, to "domesticate" national polities and societies by delegating powers to supranational institutions (Rodrik, 2007a and b). In the absence of a common working language, Europe-wide representative parties, and discursive capabilities that transcend national borders, it is difficult to see how any such legitimisation could be achieved (McKay, 1999).

The second possibility would require European leaders and the ECB to shift the terms of the debate about EMU. The conventional position about the Euro is that no country can countenance sovereign debt default because this would undermine the viability of the single currency, and would even require the defaulting country to exit the single currency, with disruptive consequences all round. But the case could be made that a government defaulting on its debt need have no consequences for the currency regime at all: "... in the event of a Greek government default, the system could assure the stability of the Greek financial sector, and concern itself with any bank

runs or bank failures in the country, but not with the Greek government's difficulties", where "... its taxpayers and the creditors will bear the consequences" (Melitz, 2010). This would require reforms to provide the ECB with stronger supervisory powers over banks in the Eurozone, and power to act as lender of last resort. It would detach financial stability from fiscal stability, and avoid the moral hazard involved in underwriting bail-outs (however condition-bound). But while this position may be economically sound, since the argument that fiscal rectitude is required to guarantee the value of the currency may not be very strong, it is may be politically difficult to adhere to. Sovereign defaults are historically quite common, as Reinhart and Rogoff have documented, but they are painful for countries that have to endure their effects (Reinhart and Rogoff, 2009). "No bail-out" may still be an inviolable principle within the Eurozone. But there are also powerful underlying normative assumptions that the EU stands for more than a free market area; that inequality of living standards is a concern; and even that social stability itself may be threatened by extreme fiscal crises and that tolerating this would be inconsistent with the EU's self-professed values.

The third outcome is perhaps the most realistic and the most probable, and would involve more of the institutional bricolage through which institution-building within the EU has commonly taken place, with no grand design but rather multiple adjustments and fixes. This could happen alongside intensified bank supervision on the part of the ECB, and increased powers of scrutiny and even oversight of national budgets by the European Commission, as recommended in the first phase of the work of the Task Force on European Governance chaired by President of the European Council Hermann von Rompuy, (Van Rompuy, 2010). Divergent preferences would be inevitable, especially between French and German leaders, over the redesign of the sanctioning powers of the Stability and Growth Pact; but these kinds of tensions are, after all, also a familiar aspect of European politics.

## V CONCLUSION

The domestic origins of countries' experiences of economic crisis have to be taken seriously: Ireland was over-exposed to risk on a variety of fronts and suffered a correspondingly severe response to the international crisis when it came. The taxation system had been systematically weakened over time; political decision making was not firmly grounded in adequate risk assessment, whether of the stability of the financial system or the sustainability of fiscal policy; a massive asset price bubble was allowed to accumulate. As a small and very open economy committed to a strongly

market-conforming growth strategy, Ireland had fewer resources to counter an economic downturn. But governments also failed to plan for this contingency through active counter-cyclical budget management, and the design of banking sector regulation proved woefully inadequate. A low-tax discourse is embedded in the political system, and even the Labour Party and the Greens in Ireland find it difficult to make the case for rational and egalitarian tax reform, consistent with the need to keep productive assets priced low and encourage efficient use of scarce resources.

But in addition to these factors, it is useful also to recognise that there is an international dimension to Ireland's policy errors of the past decade. The politics of cheap money which lay behind the crisis depended on untested assumptions about nation-states' capacity to manage a policy mix consistent with ECB requirements. The under-institutionalisation of the nominal policy constraints at European level imposed the need for heroic levels of self-restraint on the part of peripheral economies. The new politics of the Euro, which was meant to constrain domestic policy, in fact ended up softening budget constraints: the ties did not bind (Hallerberg and Bridwell, 2008).

Similarly, there is a European dimension to the strategies adopted in response to crisis. Ireland adopted austerity policies relatively early, though the scale of the adjustment required grew even as the measures were being implemented. The policy community had no real experience of financial sector crisis, but had recent experience of fiscal crisis. Even if the precise policy mix of spending cuts and tax increases is contested, the belief that fiscal consolidation was evitable and would be effective remained widely shared, at least during 2008-2010. In the short to medium term, Ireland's policy options were tightly constrained. But in the medium to longer term, the conviction that this would restore Ireland's competitiveness conditions, and therefore growth prospects, depended on rescue coming from the international economy, as it had in the late 1980s. This remained far from clear in the context of a Europe-wide persistence with the politics of austerity (Krugman, 2010). The disagreements emerging between key European leaders were reminiscent of older divisions between "economists" and "monetarists" (Marsh, 2009, pp. 38-41), that is, between those who believed that currency unions are only possible when deep economic structures are fully aligned, and those who held that monetary union itself is an effective driver toward convergence in economic performance.

In summary therefore, Ireland has made many policy mistakes and is paying a high price for correcting them. The corrections are painful yet unavoidable. But the real dynamic for floating the Irish economy off the rocks of recession lies outside its control. The future for Irish growth prospects remains deeply tied into the terms of European debate.



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