The Fall of the Irish Tiger and the Spanish Bull

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Introduction

Before the global crisis that hit Ireland and Spain in 2007-2008 both countries had become two of Europe's most successful economies.[1] While other European countries had been stuck in the mud, Ireland and Spain performed much better at reforming their welfare systems and labor markets, as well as improving flexibility and lowering unemployment. Over the decade and a half that preceded the 2008 global financial crisis, the Irish and Spanish economies had been able to break with the historical pattern of boom and bust, and both countries' economic performance was nothing short of remarkable. Yet all this came to a halt when the global financial crisis hit them. As a result they have suffered one of the worst crises since the 1940s (see Table 1).

Following the transition to democracy in Spain, and both countries' European integration, Ireland and Spain were, prior to the 2007 crisis, model countries. But then the dream was shattered as their economies imploded. How did this happen? Policy choices and the structure of decision making; the role of organized interest; the structure of the state; and institutional degeneration all played an important role in explaining the severity of the economic crisis; as did the countries' membership under an incomplete monetary union. The countries are currently (as of 2014) exiting a quadruple crisis: financial, fiscal competitiveness, and institutional.

This paper seeks to explain their economic collapse after 2007, and it examines how domestic policy choices and existing institutional frameworks sharply influenced, both the impact and the responses, to the 2007 global financial crisis in Ireland and Spain. Indeed, domestic institutions and policy choices prior to the crisis stood in uneasy relationship with the requirements from monetary union membership. The paper shows how during the years that preceded the crisis, Irish and Spanish governments had options to determine their fiscal policies and to control relative costs, yet they failed to implement the appropriate policies needed to success in EMU, which may have limited the impact of the global financial crisis in their countries.

The first section of the paper outlines the main features of the Irish and Spanish growth models. Section two describes the scale of the shock it underwent from 2008 onward, and analyzes the triple crisis in financial, fiscal, and competitiveness performance. The paper concludes with some lessons from their experience.

Table 1: The Impact of The Crisis in Ireland and Spain (2005-2014)

Country	Subject Descriptor	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014*
Ireland	GDP, constant prices	5.7	5.5	4.9	-2.6	-6.4	-0.3	2.8	-0.3	0.2	3.6
Ireland	Output gap	3.6	6.4	9.4	5.0	-2.8	-4.0	-2.2	-3.5	-4.5	-2.5
Ireland	Inflation	2.2	2.7	2.9	3.1	-1.7	-1.6	1.2	1.9	0.5	0.6
Ireland	Exports of goods & services	4.6	5.2	8.8	-0.9	-4.0	6.2	5.5	4.7	1.1	6.3
Ireland	Unemployment rate	4.4	4.5	4.7	6.4	12.0	13.9	14.6	14.7	13.0	11.2
Ireland	Government structural balance	-3.6	-5.2	-9.3	-12.1	-9.5	-7.9	-6.5	-5.1	-4.1	-3.3
Ireland	General government gross debt	26.2	23.8	24.0	42.6	62.2	87.4	98.9	111.4	116.1	112.4
Ireland	Current account balance	-3.4	-3.6	-5.4	-5.7	-3.0	0.6	0.8	1.6	4.4	3.3
Spain	GDP, constant prices	3.6	4.1	3.5	0.9	-3.8	-0.2	0.1	-1.6	-1.2	1.3
Spain	Output gap	0.5	1.9	2.7	1.6	-2.9	-3.4	-3.4	-4.9	-5.9	-5.0
Spain	Inflation	3.4	3.6	2.8	4.1	-0.2	2.0	3.1	2.4	1.5	0.0
Spain	Exports of goods & services	2.5	6.7	6.7	-1.0	-10	11.7	7.6	2.1	4.9	4.1
Spain	Unemployment rate	9.2	8.5	8.2	11.3	17.9	19.9	21.4	24.8	26.1	24.6
Spain	Government structural balance	1.1	1.6	0.8	-5.3	-9.5	-7.8	-7.3	-4.9	-3.8	-3.4
Spain	Government gross debt	43.2	39.7	36.3	40.2	54.0	61.7	70.5	85.9	93.9	98.6
Spain	Current account balance	-7.4	-9.0	-10.0	-9.6	-4.8	-4.5	-3.7	-1.2	0.8	0.1

Source: IMF, *World Economic Outlook Database*, October 2014.
* Estimates

The Miraculous Decade

Spain[2]

European integration was instrumental in the modernization of Spain. Indeed, before the global crisis that hit the country in the spring of 2008 it had become one of Europe's most successful economies (see Table 2). Propped up by low interest rates and immigration, Spain was (in 2008) in its fourteenth year of uninterrupted growth and it was benefiting from the longest cycle of continuing expansion of the Spanish economy in modern history (only Ireland in the Euro zone has a better record), which contributed to the narrowing of per capita GDP with the EU. Indeed, in 20 years per capita income grew 20 points, one point per year, to reach close to 90 percent of the EU15 average. With the EU25 Spain already reached the average in 2008. The country grew on average 1.4 percentage points more than the EU since 1996 (see Table 2).

Table 2: The Boom Years, Spain (2000–08)

SPAIN	*Units*	*Scale*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*
GDP constant prices	National currency	Billions	546.9	566.8	582.2	600.2	619.8	642.2	668.0	691.8	697.7
GDP, constant prices	Annual percent change		5.1	3.7	2.7	3.1	3.3	3.6	4.0	3.6	0.9
GDP per capita, constant prices	National currency	Units	13,6	13,9	14,1	14,3	14,5	14,8	15,2	15,4	15,3
Output gap in percent of potential GDP	Percent of potential GDP		1.9	1.5	0.3	0.1	0.5	1.4	2.9	3.9	3.1
GDP based on purchasing-power-parity (PPP) share of world total	Percent		2.2	2.2	2.2	2.2	2.1	2.1	2.1	2.1	2.0
Inflation, average consumer prices	Annual percent change		3.5	2.8	3.6	3.1	3.1	3.4	3.6	2.8	4.1
Unemployment rate	Percent of total labor force		13.9	10.6	11.5	11.5	11.0	9.2	8.5	8.3	11.3
Employment	Persons	Millions	16.4	16.9	17.3	17.9	18.5	19.3	20.0	20.6	20.5
General government balance	National currency	Billions	-6.2	-4.4	-3.3	-1.6	-2.9	8.8	19.9	23.3	-41.9
General government balance	Percent of GDP		-1.0	-0.6	-0.5	-0.2	-0.3	1.0	2.0	2.2	-3.8
Current account balance	Percent of GDP		-4.0	-3.9	-3.3	-3.5	-5.3	-7.4	-9.0	-10.0	-9.6

Source: International Monetary Fund, *World Economic Outlook Database*, October 2009

Unemployment fell from 20 percent in the mid-1990s to 7.95 percent in the first half of 2007 (the lowest level since 1978), as Spain became the second country in the EU (after Germany with a much larger economy) creating the most jobs (an average of 600,000 per year over the last decade). In 2006 the Spanish economy grew a spectacular 3.9 percent, and 3.8 percent in 2007. As we have seen, economic growth contributed to per capita income growth and employment. Indeed, the performance of the labor market was impressive: between 1997 and 2007, 33 percent of all the total employment created in the EU-15 was created in Spain. In 2006 the active population increased by 3.5 percent, the highest in the EU (led by new immigrants and the incorporation of women in the labor market, which increased from 59 percent in 1995 to 72 percent in 2006); and 772,000 new jobs were created.

The economic success extended to Spanish companies, which expanded beyond their traditional frontiers (Guillén 2005). In 2006 they spent a total of €140 billion on domestic and overseas acquisitions, putting the countries third behind the United Kingdom and France in the EU. Of this, €80 billion were to buy companies abroad (compared with the €65 billion spent by German companies). In 2006 Spanish FDI abroad increased 113 percent, reaching €71.5 billion (or the equivalent of 7.3 percent of GDP, compared with 3.7 percent in 2005).[3] In 2006 *Iberdrola*, an electricity supplier purchased *Scottish Power* for $22.5 billion to create Europe's third largest utility; *Banco Santander*, Spain's largest bank, purchased Britain's *Abbey National Bank* for $24 billion, *Ferrovial*, a family construction group, concluded a takeover of the *British BAA* (which operates the three main airports of the United Kingdom) for £10 billion; and *Telefonica* bought *O2*, the U.K. mobile phone company. Indeed, 2006 was a banner year for Spanish firms: 72 percent of them increased their production and 75.1 percent their profits, 55.4 percent hired new employees, and 77.6 percent increased their investments.[4]

The country's transformation was not only economic but also social. The Spanish people became more optimistic and self-confident (i.e., a Harris poll showed that Spaniards were more confident of their economic future than their European and American counterparts, and a poll by the *Center for Sociological Analysis* showed that 80 percent are satisfied or very satisfied with their economic situation). Spain became 'different' again and according to public opinion polls it had become the most popular countries to work for Europeans.[5] Between 2000-2007, some 5 million immigrants (645,000 in 2004 and 500,000 in 2006) settled in Spain (8.7 percent of the population compared with 3.7 percent in the EU15), making the country the biggest recipient of immigrants in the EU (they represent 10 percent of the contributors to the Social Security system). This is a radical departure for a country that used to be a net exporter of people, and more so because it was able to absorb these immigrants without falling prey (at least so far) to the social tensions that have plagued other European countries (although there have been isolated incidents of racial violence).[6] These immigrants contributed significantly to the economic success of the

country in that decade because they boosted the aggregate performance of the economy: They raised the supply of labor, increased demand as they spent money, moderated wages, and put downward pressure on inflation, boosted output, allowed the labor market to avoid labor shortages, contributed to consumption, and increased more flexibility in the economy with their mobility and willingness to take on low-paid jobs in sectors such as construction and agriculture, in which the Spanish were no longer interested.[7]

Indeed, an important factor in Spain's per capita convergence surge after 2000 was the substantive revision of the Spanish GDP data as a result of changes in the National Accounts from 1995 to 2000. These changes represented an increase in GPD per capita of 4 percent in real terms (the equivalent of Slovakia's GDP). This dramatic change was the result of the significant growth of the Spanish population since 1998 as a result of the surge in immigration (for instance in 2003 population grew 2.1 percent). The key factor in this acceleration of convergence, given the negative behavior of productivity (if productivity had grown at the EU average Spain would have surpassed in 2007 the EU per capita average by 3 points), was the important increase in the participation rate, which was the result of the reduction in unemployment, and the increase in the activity rate (the proportion of people of working age who have a job or are actively seeking one) that followed the incorporation of female workers into the labor market and immigration growth. Indeed between 2000 and 2004, the immigrant population has multiplied by threefold.

As a matter of fact most of the 772,000 new jobs created in Spain in 2006 went to immigrants (about 60 percent). Their motivation to work hard also opened the way for productivity improvements (which in 2006 experienced the largest increase since 1997, with a 0.8 percent hike). It is estimated that the contribution of immigrants to GDP has been of 0.8 percentage points in the four years to 2007.[8] Immigration represented more than 50 percent of employment growth, and 78.6 percent of the demographic growth (as a result Spain has led the demographic growth of the European countries between 1995 and 2005 with a demographic advance of 10.7 percent compared with the EU15 average of 4.8 percent).[9] They also contributed to the huge increase in employment, which has been one of the key reasons for the impressive economic expansion. Indeed, between 1988 and 2006, employment contributed 3 percentage points to the 3.5 percent annual rise in Spain's potential GDP (see Table 1).[10]

The Basis for Success

What made this transformation possible? The modernization of the Spanish economy in the last two and half decades has been intimately connected to the country's integration in the European Union. Indeed, European integration was a catalyst for the final conversion of the Spanish economy into a modern Western-type economy. Yet, membership was not the only reason for this development. The economic liberalization, trade integration, and modernization of the Spanish economy started in the 1950s and

1960s and Spain became increasingly prosperous over the two decades prior to EU accession. However, one of the key consequences of its entry into Europe has been that it consolidated and deepened that development processes, and it has accelerated the modernization of the country's economy. EU membership facilitated the micro- and macroeconomic reforms that successive Spanish governments undertook throughout the 1980s and 1990s. Spain has also benefited extensively from European funds: approximately 150bn Euros from agricultural, regional development, training, and cohesion programs.

Moreover, European Monetary Union (EMU) membership has also been very positive for the countries: it has contributed to macroeconomic stability, it has imposed fiscal discipline and central bank independence, and it has lowered dramatically the cost of capital. One of the key benefits was the dramatic reduction in short-term and long-term nominal interest rates: from 13.3 per cent and 11.7 per cent in 1992, to 3.0 per cent and 4.7 per cent in 1999, and 2.2 per cent and 3.4 per cent in 2005. The lower costs of capital led to an important surge in investment from families (in housing and consumer goods) and businesses (in employment and capital goods). Indeed, EMU membership (and the Stability Pact) has provided the countries with unprecedented stability because it has forced successive governments to consolidate responsible economic policies, which have led to greater credibility and the improvement of the ratings of Spain's pubic debt (and consequently to lower financing costs).

Another important factor to account for the country's economic success was the remarkable economic policy stability that followed the economic crisis of 1992-93. Indeed, there have been few economic policy shifts throughout the 1990s and early 2000s, and this despite changes in government. Between 1993 and 2009 there were only two Ministers of Finance, Pedro Solbes (from 1993-96, and from 2004-2009) and Rodrigo Rato (from 1996-2004); and the countries only had three Prime Ministers (Felipe González, José María Aznar, and José Luís Rodríguez Zapatero). This pattern was further reinforced by the ideological cohesiveness of the political parties in government and the strong control that party leaders exercise over the members of the cabinet and the parliament deputies.

In addition, this stability was reinforced by the shared (and rare) agreement among Conservative and Socialist leaders regarding fiscal consolidation (the balance budget objective was established by law by the Popular Party), as well as the need to hold firm in the application of restrictive fiscal policies and the achievement of budgetary surpluses: As a result a seven per cent budget deficit in 1993 became a 2.2 percent surplus in 2007; and public debt decreased from 68 percent of GDP in 1998 to 36.2 percent in 2007.

Finally, other factors that contributed to this success include the limited corruption and the fact that politics are fairly clean and relatively open; that Spain has a flexible economy; and the success of Spanish multinationals: There were eight firms in the *Financial Times* list of the world's largest Multinationals in 2000, and 14 in 20008.[11]

The Challenges

However, this economic success was marred by some glaring deficiencies that came to the fore in 2008 when the global financial crisis hit the countries, because it was largely a “miracle” based on bricks and mortar.[12] The foundations of economic growth were fragile because the country has low productivity growth (productivity contributed only 0.5 percentage points to potential GDP between 1998 and 2006) and deteriorating external competitiveness.[13] Over the decade that preceded the 2008 crisis Spain did not address its fundamental challenge, its declining productivity, which only grew an average of 0.3 percent during that decade (0.7 percent in 2006), one whole point below the EU average, placing Spain at the bottom of the EU and ahead of only Italy and Greece (the productivity of a Spanish worker is the equivalent of 75 percent of a U.S. one). The most productive activities (energy, industry, and financial services) contribute only 11 percent of GDP growth.[14]

Moreover, growth was largely based on low-intensity economic sectors, such as services and construction, which are not exposed to international competition. In 2006 most of the new jobs were created in low-productivity sectors such as construction (33 percent), services associated with housing such as sales and rentals (15 percent), and tourism and domestic service (30 percent). These sectors represented 75 percent of all the new jobs created in Spain in 2006 (new manufacturing jobs, in contrast, represented only 5 percent). The labor temporary rate reached 33.3 percent in 2007, and inflation was a recurrent problem (it closed 2006 with a 2.7 percent increase, but the average for that year was 3.6 percent), thus the inflation differential with the EU (almost 1 point) has not decreased, which reduces the competitiveness of Spanish products abroad (and consequently Spanish companies are losing market share abroad).[15] May add a deep process of economic deindustrialization, low value added and complexity of exports, and low insertion in global value chains.

In addition, family indebtedness reached a record 115 percent of disposable income in 2006, and the construction and housing sectors accounted for 18.5 percent of GDP (twice the Eurozone average). House prices rose by 150 percent since 1998, and the average price of a square meter of residential property went up from 700 Euros in 1997 to 2,000 at the end of 2006, even though the housing stock had doubled. Many wondered whether this bubble was sustainable.[16]

The crisis that started in 2008 confirmed the worst fears, and the implosion of the housing bubble fuelled corruption and bad practices in the cajas sector of the financial system.

Between 40 and 60 percent of the benefits of the largest Spanish companies came from abroad. Yet, in the years prior to the crisis this figure has decreased by approximately 10 percentage points, and there has been a decline in direct foreign investment of all types in the countries, falling from a peak of 38.3 bn Euros in 2000 to 16.6 bn Euros in 2005.[17] The current account deficit reached 8.9 percent of GDP in 2006 and over 10 percent in 2007, which made Spain the countries with the largest deficit in absolute terms (86,026 mn Euros), behind only the United States; imports are 25 percent higher than exports and Spanish companies are losing market share in the world. And the prospects are not very bright. The trade deficit reached 9.5 percent in 2008.[18]

While there is overall consensus that the country needed to improve its education system and invest in research and development to lift productivity, as well as modernize the public sector, and make the labor market more stable (i.e., reduce the temporary rate) and flexible, the government did not take the necessary actions to address these problems. Spain spends only half of what the Organization of European Co-operation and Development (OECD) counties spend on average on education; it lags most of Europe on investment in Research and Development (R&D); and it is ranked 29th by the UNCTAD as an attractive location for research and development. Finally, other observers note that Spain is failing to do more to integrate its immigrant population, and social divisions are beginning to emerge.[19]

By the summer of 2008 the effects of the crisis were evident, and since then the countries has suffered one of the worst recession in history, with unemployment reaching over 27 percent in 2012, and more than 6 million people unemployed. This collapse was not wholly unexpected. The global liquidity freeze and the surge in commodities, food, and energy prices brought to the fore the unbalances in the Spanish economy: the record current account deficit, persisting inflation, low productivity growth, dwindling competitiveness, increasing unitary labor costs, excess consumption, and low savings, had all set the ground for the current devastating economic crisis.[20]

Ireland

Marked by the influence of Britain's Westminster-type political and administrative system, Ireland followed a developmental model that was quite distinctive from Spain. Prior to joining the

European Community in 1973, the country's economy was very dependent on the British one: almost half of Ireland's exports went to the United Kingdom, the country's currency was pegged to the British pound, wages were very influenced by British wages (Hardiman 2013, 3). This dependency was a driving force in the country's decision to apply for membership to the European Community. After the rejection of 1963, the country was finally admitted in 1973. This was a momentous development for Ireland.

Indeed, the Irish economy has been transformed since the country joined the EC. In 1973, 40% of the country's exports consisted of agricultural products. Before accession, as Spain, Ireland had been hampered by high tariff barriers, which hindered commerce with the rest of the European Community. Membership radically altered the economic and balance of payment outlook of the country. The combination of structural and cohesion funds, which contributed to improve the infrastructure and capital stock on the country; the improvement of the country's administrative capabilities; and the increasing opening of the Irish economy as well as access to European markets, drove this transformation.

This process accelerated in the 1980s and 1990s driven by several factors: first the fiscal consolidation that took place in the country in the 1980s; second, the inflow of funding from the EC/EU; third access to the Single Market; fourth the liberalization of financial markets, which increased the pool of investment capital available, and found a very attractive option under the Irish low-tax FDI model (particularly in the computer and financial services sectors); the liberalization and privatization of the Irish economy of the early 1990s (Hardiman 2013).

The first two decades of membership, however, were not as successful. Although Ireland received a larger transfer per head from the EC than the other 3 cohesion countries (Greece, Portugal and Spain), Ireland's GDP per head only grew from 52% of French levels to 60% in 1990. In contrast, Spain GDP per head grew from 1986 through 2001 from 62 to 74% of French levels. It took Ireland two decades to surpass France.

Ireland Foreign Direct Investment (FDI)-led strategy, a staple of the country's development model that intensified in the 1980s-90s, was instrumental in the convergence process. The FDI strategy was driven by investment in education (i.e. technical colleges), low corporate taxes, and flexible industrial relations. Henceforth during the two decades that preceded the 2007 crisis, Ireland experienced years of well above average economic growth, and the labor force grew rapidly (partly from the return of Irish immigrants) (see Table 3). While Ireland growth profile had been similar to Spain, the former took off in the 1990s: in the period between 19960-1998 only Japan outperformed Ireland (Dellepiane and Hardiman 2011, 4).

This growth was fostered by the transformation of Irish industry. Historically, the country's industrial sector was relatively small and based in low-skilled labor, low-value added, and lower-tech sectors. EC membership was very difficult for these companies, as it brought increasing competition. Consequently GDP per capita fell in the years following accession. EC membership, with open access to EC markets, made Ireland a very attractive base for FDI. Ireland's relative low labor costs, as well as its attractive corporate tax rate system combined with incentives and grants, were alluring for US and Japanese companies seeking to penetrate the European markets. The Industrial Development Authority (IDA) led this process.

As a result, in the last two decades the composition of exports became far more diversified, and Ireland's dependence on the British market sharply diminished. By the 1990s the country's principal export sectors were in manufacturing (particularly pharmaceuticals, chemicals, information and communications technology), and services (financial services and information systems), and most of the firms in these sectors were foreign-owned.

This spectacular combination of economic growth and virtual full employment came to a halt in 2007. Between 2007 and 2009 the Irish economy contracted very sharply, unemployment shot up, and the country's fiscal position deteriorated very rapidly (See Table 1). In November 2010 the Irish government was forced to request a bailout loan from the EU and the IMF. This outcome was the result of a traditional financial crisis and the loss of competitiveness that preceded the 2008 crisis, and it led to a huge fiscal crisis.

Table 3: Main Economic Indicators, Ireland (1999-2008)

Subject Descriptor	Units	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
Total investment	Percent of GDP	24.7	24.7	24.4	24.2	25.2	26.8	29.4	30.0	28.1	24.0
Gross national savings	Percent of GDP	25.0	24.4	23.8	23.2	25.0	26.2	26.0	26.5	22.8	18.3
Inflation	Percent change	2.5	5.3	4.0	4.7	4.0	2.3	2.2	2.7	2.9	3.1
Volume of exports of goods	Percent change	13.9	18.0	4.5	5.1	-4.0	8.8	2.7	1.2	8.6	-1.6
Unemployment rate	% of total labor force	5.6	4.3	3.9	4.4	4.6	4.5	4.4	4.5	4.7	6.4
General government structural balance	% of potential GDP	3.6	2.8	-1.5	-1.7	-0.8	-2.1	-3.6	-5.2	-9.3	-12.1
General government gross debt	Percent of GDP	46.7	36.3	33.4	30.7	30.1	28.3	26.2	23.8	24.0	42.6
Current account balance	Percent of GDP	0.2	-0.4	-0.6	-1.0	-0.2	-0.6	-3.4	-3.6	-5.4	-5.7

International Monetary Fund, *World Economic Outlook Database*, October 2014

After the Fiesta: The Global Crisis Hits Spain

The imbalances in the Spanish economy became obvious in 2007-08 when the real-estate market bubble burst and the international financial crisis hit Spain (see Table 4). In just a few months the 'debt-fired dream of endless consumption' turned into a nightmare. By the summer of 2013, Spain faced the worst economic recession in half a century. According to government statistics, 2009 was the worst year since there has been reliable data: GDP fell 3.7 percent, unemployment reached over four million people, and the public deficit reached a record 11.4 percent of GDP (up from 3.4 percent in 2008). Consumer confidence was shattered, the implosion of the housing sector reached historic proportions and threatened to extend for several years, and the manufacturing sector was also suffering.

Table 4: The Economic Crisis, Spain (2008-2013)

Subject Descriptor	*Units*	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*
Gross domestic product, constant prices	% change	3.5	0.9	-3.8	-0.3	0.4	-1.4	-1.6
Output gap in percent of potential GDP	% potential GDP	3.8	2.3	-2.8	-3.4	-3.2	-4.5	-5.4
Total investment	% GDP	31.0	29.1	24.0	22.8	21.5	19.6	18.1
Inflation, average consumer prices	% change	2.8	4.1	-0.2	2.0	3.1	2.4	1.9
Unemployment rate	% total labor force	8.3	11.3	18	20.1	21.7	25	27
General government structural balance	% potential GDP	-1.1	-5.4	-9.5	-8.0	-7.8	-5.7	-4.5
General government net debt	% GDP	26.7	30.8	42.5	49.8	57.5	71.9	79.1
Current account balance	% GDP	-1.0	-9.6	-4.8	-4.5	-3.7	-1.1	1.1

*Estimates
Source: International Monetary Fund, *World Economic Outlook Database*, April 2014

Initially, the Zapatero government was reluctant to recognize the crisis, which was becoming evident as early as the summer of 2007, because of electoral considerations: the countries had general elections in March 2008. And after the election, the Zapatero government was afraid to admit that it had not been entirely truthful during the campaign. While this pattern has been quite common in other European countries, in Spain the increasing evidence that the model based on construction was already showing symptoms of exhaustion in 2007 compounded it. Yet, the Spanish government not only refused to recognize that the international crisis was affecting the countries, but also that in Spain the crises would be aggravated by the very high levels of private indebtedness. As late as 17 August 2007, Finance Minister Solbes predicted that 'the crisis would have a relative small effect' in the Spanish economy.

When it became impossible to deny what was evident, the government's initial reluctance to recognize and address the crisis was replaced by frenetic activism. The Zapatero government introduced a succession of plans and measures to try to confront the economic crisis, and specifically to address the surge of unemployment.[21]

The sharp deterioration of the labor market was caused by the economic crisis and the collapse of the real estate sector, and it was aggravated by a demographic growth pattern based on migratory inflows of labor: in 2007 there were 3.1 million immigrants in the countries, of which 2.7 million were employed and 374,000 unemployed. In 2008 the number of immigrants increased by almost 400,000, to 3.5 million (representing 55 percent of the growth in the active population), but 580,000 of them were unemployed (and 2.9 million employed), an increase of 200,000. In the construction sector alone, unemployment increased 170 percent between the summer of 2007 and 2008. Meanwhile, the manufacturing and service sectors (also battered by the global crisis, lower consumption, and lack of international competitiveness) proved unable to incorporate these workers.

The pace of deterioration caught policymakers by surprise. The Zapatero government prepared budgets for 2008 and 2009 that were utterly unrealistic in the face of rapidly changing economic circumstances (as did all other advanced countries which in the G-20 agreed on a plan for fiscal stimulus that will later prove ineffective and dangerous for Spain as it increased debt) As a result, things continued to worsen over the new four years. The most significant decline was in consumer confidence, which was hammered by the financial convulsions, the dramatic increase in unemployment, and the scarcity of credit. As a result, household consumption, which represents 56 percent of GDP, fell one percent in the last quarter of 2009 for the first time in the last 15 years. According to the Bank of Spain, this decline in household consumption was even more important in contributing to the recession than the deceleration of residential investment, which had fallen 20 percent, driven down by worsening financial conditions, uncertainties, and the drop in residential prices. So far the government actions have had limited effect stemming this hemorrhage, and their efficacy has been inadequate.

The impact of the global economic crisis has been felt well beyond the economic and financial realms. The crisis also had severe political consequences. Spain followed in the path of many other European countries (including Ireland, Portugal, Greece, and France) that saw their governments suffer the wrath of their voters and have been voted out of office.

The Socialist Party (PSOE) was re-elected in a general election on March 9, 2008. Soon thereafter, economic conditions deteriorated sharply and the government's popularity declined rapidly. Between March 2008 and March 2012, there were a number of electoral contests in Spain at the local, regional, national, and European levels. At the national and European levels the one common pattern was the outcome: the defeat of the Socialist Party and the victory of the Popular Party (PP). And at the regional

and local levels the Socialists suffered historical losses, losing control of regional government that they ruled for decades (notably, Castilla-La Mancha and Extremadura), and even losing the election for the first time in one of its historical strongholds, Andalusia (although they were able to reach a coalition with a smaller leftist party to stay in power).

Spain's economic crisis was mainly due to a mismanaged financial sector, which by over lending freely to property developers and mortgages contributed to a real estate property bubble. This bubble contributed to hide the fundamental structural problems of the Spanish economy outlined in the previous section, and had an effect in policy choices because no government was willing to burst the bubble and risk suffering the wreath of voters. Furthermore, cheap credit also had inflationary effects that contributed to competitiveness losses and record balance of payment deficits. Therefore, three dimensions of the crisis (financial, fiscal and competitiveness) are interlinked in their origins. The crisis exposed the underbelly of the financial sector and showed that many banks (particularly the *cajas*) were not just suffering liquidity problems but risked insolvency, which led to the EU financial bailout of June 2012. The bailout had onerous conditions attached and it limited national economic autonomy.[22] Finally, the financial and fiscal crises were made worse by the incomplete institutional structure of EMU and by bad policy choices at the EU level (excess austerity and refusal to act as a lender of last resort for sovereigns by the ECB). Now we turn to the elements of domestic policy that underline the triple crisis in financial, fiscal and competitiveness performance.[23]

The Triple Crisis

The Fiscal Crises

One of the most common misinterpretations regarding the crisis in Southern Europe is attributing it to mismanaged public finances. Many policymakers across Europe, especially in the creditor countries (crucially Germany), still insist that irresponsible public borrowing caused the crisis, and this, in turn, has led to misguided solutions. In fact, with very few exceptions, notably Greece, that interpretation is incorrect. In Spain, the current crisis did not originate with mismanaged public finances. On the contrary, as late as 2011, Spain's debt ratio was still well below the average for countries that adopted the euro as a common currency: while Spain stood at less than 60 percent of GDP, Greece stood at 160.8 percent, Italy at 120 percent, Portugal at 106.8 percent, Ireland at 105 percent, Belgium at 98.5 percent, and France at 86 percent.

Prior to 2007, Spain seemed to be in an enviable fiscal position, even when compared with Germany.[24] Spain ran a budget surplus in 2005, 2006, and 2007. It was only when the crisis hit the countries and the real estate market collapsed that the fiscal position deteriorated markedly and the countries experienced huge deficits.

The problem in Spain was the giant inflow of capital from the rest of Europe; the consequence was rapid growth and significant inflation. In fact, the fiscal deficit was a result, not a cause, of Spain's problems: when the global financial crisis hit Spain and the real estate bubble burst, unemployment soared, and the budget went into deep deficit, caused partly by depressed revenues and partly by emergency spending to limit human costs. The government responded to the crisis with a massive €8 billion public works stimulus. This decision, combined with a dramatic fall in revenue, blew a hole in government accounts resulting in a large deficit.

The excessive lending and borrowing of the private sector rather than the government created the conditions for the crisis in Spain. In other words, the problem was private debt and not public debt. Spain experienced a problem of ever-growing private sector indebtedness, which was compounded by the reckless investments and loans of banks (including the overleveraged ones), and aggravated by competitiveness and current account imbalances. In Spain, the debt of private sector (households and nonfinancial corporations) was 227.3 percent of GDP at the end of 2010; total debt increased from 337 percent of GDP in 2008 to 363 percent in mid-2011.

Though Spain entered the crisis in a relatively sound fiscal position, that position was not sound enough to withstand the effects of the crisis, especially being a member of a dysfunctional monetary union with no lender of last resort. The countries' fiscal position deteriorated sharply—collapsing by more than 13 percent of GDP in just two years. Looking at the deficit figures with the benefit of hindsight, it could be argued that Spain's structural or cyclically adjusted deficit was much higher than its actual deficit. The fast pace of economic growth before the crisis inflated government revenues and lowered social expenditures in a way that masked the vulnerability hidden in Spanish fiscal accounts. The problem is that it is very difficult to know the structural position of a country. The only way in which Spain could have prevented the deficit disaster that followed would have been to run massive fiscal surpluses of 10 percent or higher during the years prior to the crisis in order to generate a positive net asset position of at least 20 percent of GDP.[25] This, for obvious reasons, would not have been politically feasible.

The Loss of Competitiveness

There is also another way to look at the problem. Many economists argue that the underlying problem in the euro area is the exchange rate system itself, namely, the fact that European countries locked themselves into an initial exchange rate. This decision meant, in fact, that they believed that their economies would converge in productivity (which would mean that the Spaniards would, in effect, become more like the Germans). If convergence was not possible, the alternative would be for people to move to higher productivity countries, thereby increasing their productivity levels by working in factories

and offices there (or to create a full fiscal union to provide for permanent transfers, as argued by OCA theory). Time has shown that both expectations were unrealistic and, in fact, the opposite happened. The gap between German and Spanish (including other peripheral countries) productivity increased, rather than decreasing, over the past decade and, as a result, Germany developed a large surplus on its current account; Spain and the other periphery countries had large current account deficits that were financed by capital inflows.[26] In this regard, one could argue that the incentives introduced by EMU worked exactly in the wrong way. Capital inflows in the south made the structural reforms that would have been required to promote convergence less necessary, thus increasing divergence in productivity levels.

Adoption of the euro as a common currency fostered a false sense of security among private investors. During the years of euphoria following start of Europe's economic and monetary union and prior to the onset of the financial crisis, private capital flowed freely into Spain and, as a result, the countries ran current account deficits of close to 10 percent of GDP. In turn, these deficits helped finance large excesses of spending over income in the private sector. The result did not have to be negative. These capital inflows could have helped Spain (and the other peripheral countries) invest, become more productive, and "catch up" with Germany. Unfortunately, in the case of Spain, they largely led to a massive bubble in the property market, consumption, and unsustainable levels of borrowing. The bursting of that bubble contracted the countries' real economy and it brought down the banks that gambled on loans to real estate developers and construction companies.

At the same time, the economic boom also generated large losses in external competitiveness that Spain failed to address. Successive Spanish governments also missed the opportunity to reform institutions in their labour and product markets. As a result, costs and prices increased, which in turn led to a loss of competitiveness and large trade deficits. This unsustainable situation came to the fore when the financial shocks that followed the collapse of Lehman Brothers in the fall of 2007 brought "sudden stops" in lending across the world, leading to a collapse in private borrowing and spending, and a wave of fiscal crisis.

The Financial Crises

A third problem has to do with the banks. This problem was slow to develop. Between 2008 and 2010 the Spanish financial system, despite all its problems, was still one of the least affected by the crisis in Europe. During that period, of the 40 financial institutions that received direct assistance from Brussels, none was from Spain. In December 2010 Moody's ranked the Spanish banking system as the third strongest of the Eurozone, only behind Finland and France, above the Netherlands and Germany, and well ahead of Portugal, Ireland, and Greece. Finally, Santander and BBVA had shown new strength with profits of €4.4 billion and €2.8 billion, respectively, during the first half of 2010. Spanish regulators had

put in place regulatory and supervisory frameworks, which initially shielded the Spanish financial system from the direct effects of the global financial crisis. Indeed, the Bank of Spain had imposed a regulatory framework that required higher provisioning, which provided cushions to Spanish banks to initially absorb the losses caused by the onset of the global financial crisis. And there were no toxic assets in bank´s balance sheets.

Nevertheless, this success proved short lived. In the summer of 2012, Spanish financial institutions seemed to be on the brink of collapse and the crisis of the sector forced the European Union in June (2012) to devise an emergency €100 billion rescue plan for the Spanish banking sector. When the crisis intensified, the financial system was not able to escape its dramatic effects. By September 2012, the problem with toxic real estate assets forced the government to intervene and nationalize eight financial institutions. Altogether, by May 9, 2012, the reorganization of the banking sector involved €115 billion in public resources, including guarantees.

There are a number of factors that help account for the deteriorating performance of the Spanish banks after 2009. The first is the direct effect of the economic crisis. The deterioration in economic conditions had a severe impact on the bank balance sheets. The deep recession and record-high unemployment triggering successive waves of loan losses in the Spanish mortgage market coupled with a rising share of non-performing loans. Like many other countries such as the United States, Spain had a huge property bubble that burst. Land prices increased 500 percent in Spain between 1997 and 2007, the largest increase among the OECD countries. As a result of the collapse of the real estate sector had a profound effect in banks: five years after the crisis started, the quality of Spanish banking assets continued to plummet. The Bank of Spain classified €180 billion euros as troubled assets at the end of 2011, and banks are sitting on €656 billion of mortgages of which 2.8 percent are classified as nonperforming.

A second factor is concern over the country's sovereign debt. As mentioned before the crisis in Spain did not originate with mismanaged public finances. The crisis has largely been a problem of ever-growing private sector debt, compounded by reckless bank investments and loans, particularly from the cajas, as well as aggravated by competitiveness and current account imbalances. To place the problem in perspective, the gross debt of household increased dramatically in the decade prior to the crisis, and by 2009 it was 20 percentage points higher than the Eurozone average (86 percent of GDP versus 66 percent). And the austerity policies implemented since May 2010 have aggravated the fiscal position of the countries. The ratio of Spain's debt to its economy was 36 percent before the crisis and is expected to reach 84 percent by 2013 (and this is even based on optimistic growth assumptions). In sum, Spain seems to have fallen into the "doom loop" that has already afflicted Greece or Portugal and led to their bailout. The sustainability of the Spanish government debt was affecting Spanish banks (including BBVA and

Santander) because they have been some of the biggest buyers of government debt in the wake of the ECB long-term refinancing operation liquidity infusions (the percentage of government bond owned by domestic banks reached 30 percent in mid-2012). Again, the doom loop is a result of EMU weakness, namely the lack of a banking union with a centralized EU funded mechanism to bail out banks.

Spanish banks are also suffering the consequences of their dependence on wholesale funding for liquidity since the crisis started, and, in particular, their dependence on international wholesale financing, as 40 percent of their balance depends on funding from international markets, particularly from the ECB. Borrowing from the ECB reached €82 billion in 2012, and Spanish banks have increased their ECB borrowings by more than six times since June 2011, to the highest level in absolute terms among Euro area banking systems as of April 2012.

The crisis also exposed weaknesses in the policy and regulatory framework. The most evident sign of failure has been the fact that the country had already adopted five financial reforms in three years, and it has implemented three rounds of bank mergers. The results of these reforms have been questionable at best. The fact that Spain has had five reforms in less than three years, instead of one that really fixed the problem, says it all. They have been largely perceived as "too little and too late," and they failed to sway investors' confidence in the Spanish financial sector.

Finally, the current financial crisis can also be blamed on the actions (and inactions) of the Bank of Spain. At the beginning of the crisis, the Bank of Spain's policies were all praised and were taken as model by other countries. Time, however, has tempered that praise and the Bank of Spain is now criticized for its actions and decisions (or lack thereof) during the crisis. Spanish central bankers chose the path of least resistance: alerting about the risks but failing to act decisively.

The Global Crisis Hits Ireland: The Fall of the Celtic Tiger

The Triple Crisis

Unlike Greece, in Ireland fiscal mismanagement and the risk of sovereign debt default were not the causes of the crisis. Ireland, like Spain, faced three economic crises: financial, competitiveness, and fiscal. The loss of competitiveness and the mismanagement of the banking sector were crucial to understand what happened in the country. The fiscal crisis was a consequence, although it had roots prior to the 2009 crisis.

The Fiscal Crises

Ireland's public debt and deficit had shrunk in the years that preceded the crisis (see Table 3). Between 1987 and 2006 the public sector debt ratio declined from 109% to 25% of GDP. Indeed, misunderstanding notwithstanding about the causes of the crisis, Ireland was prior to the crisis in an enviable position, far better than other EU countries like Greece, Italy or Belgium. By 2010, however, is fiscal position had deteriorated markedly.

A crucial element of Ireland's FDI-growth model has been a low corporate tax system that has been instrumental in attracting FDI to the country. Ireland's corporate taxes stand at 12% (compared with 35% in the US), making it one of the most attractive anywhere in Europe. In addition, the country developed a system of allowances and incentives that have helped companies reduce even further their tax bills. As a result, Ireland has been able to attract almost 1,100 international companies that employ over 161,000 workers all over the country, more than half of them in companies linked to computer services.

Loss in this history of success, however, has been the country's historical poor record in fiscal policy, which was compounded by the low corporate tax strategy. Even before the crisis, there were underlying weaknesses in Ireland's revenue raising and spending patterns. Indeed, Ireland had been unable to develop a broad and sustainable tax base, which had often led to budget deficits and higher debt. As in Spain, the Irish welfare state was relatively underdeveloped when it joined the EC. Its subsequent development was not accompanied by a parallel growth of the tax base, which was largely dependent on direct taxes to the self-employed and farmers, as well as a high reliance on indirect taxes. By the early 2000s there were clear signs that questioned the sustainability of the country's fiscal path, particularly its over reliance on housing which accounted for almost two thirds of Ireland's capital stock, making the tax system very exposed to property-related revenue (Hardiman 2013, 11; Dellepiane and Hardiman 2011, 12-13).

This problem was compounded by the unwillingness, largely driven by political considerations from coalitions of interest that sought tax exemptions, to run large surpluses during periods of growth to prepare the economy for periods of economic downturn. On the contrary, as Portugal, Ireland had a record of correcting budgetary imbalances during economic recessions, thus failing to implement the counter cyclical fiscal policies that have been so successful in other small and open economies, like the Scandinavian ones. Electoral competition was the driving force behind the country's damaging pattern of pro-cyclical fiscal stimulus and retrenchment that have characterized Ireland's fiscal policies during the decades that preceded the crisis. As a result, period of fiscal surplus were relatively short-lived, and they were particularly vulnerable during periods of economic growth and before elections, when the government was pressured to increase spending (Hardiman, 2013, 11; Donovan and Murphy 2013, 144-65). The government decided In the 1980s the country embarked in a process of fiscal consolidation,

marked by spending cuts and the retrenchment of the state from the economy, which has been credited with the onset of the so-called emergence of the *Celtic Tiger*. But in the 1990s public spending increased rapidly, particularly in the run up to elections, like the 2002 one.

During the boom years that preceded the crisis, the government decided to "spread the bounty" throughout the wide population and the consequence of this decision as a significant erosion of the tax base combined with an unsustainable increase in public expenditures. Tax rates were lowered at all income levels, while tax exemptions and incentives grew and proliferated (particularly in the property sector). In addition the government engaged in major public expenditures, including rises in public salaries, as well as growing spending in education and health services (with questionable outcomes, at least so far). These excesses remained largely hidden until the bubble burst, which exposed the underlying weakness of the fiscal system, and the fact that Irish people (like their Spanish counterparts) had been living beyond their means (Donovan and Murphy 2013, 102-15).

Moreover, in a context of low corporate taxes, a key feature of the Irish growth model, tax revenues were very reliant on income taxes, yet successive governments motivated by political and ideological reasons had pushed for the revenue from income taxes to decline. This problem was aggravated by the tendency to use tax incentives, and by the tax concessions and higher spending that governments had made to trade unions as part of the social bargaining process in exchange for wage moderation. These decisions were countered by new revenue sources from increases in indirect taxes (like the VAT) and public services fees (Dellepiane and Hardiman 2011, 14). This revenue, however, was not only regressive, but also contingent on consumption, and hence subject to decline when the consumption boom imploded after the crisis. In the end, Ireland, as Spain, sought lower taxes and increased spending, and this balance proved unsustainable.

Furthermore, the boom of the late 1990s and beginning of the 2000s would have demanded a countervailing fiscal policy, and the government should have been running very large fiscal surpluses. As in Spain, however, political and electoral consideration made it unfeasible (Royo 2013; Donovan and Murphy 2013, 144-70). On the contrary, governments in both countries decided that the dividends of the large growth should be available to their citizens in the form of increasing consumption and spending.

The government's decision to offer a blanket guarantee to the banking sector in October 2008 was the last nail in the coffin for Ireland's public finances. At that time the full scale of the banking losses were not known, and estimates have reached 50bn euros required to stabilize the sector. In addition, NAMA offered to swap bad loans for government-backed bonds, an extraordinarily expensive decision that further hampered the country's finances. The consequence of this controversial decision was a sharp increase in the country's budget deficit with reached an astonishing 32% of GDP in 2010, as well as the country's increased debt exposure.

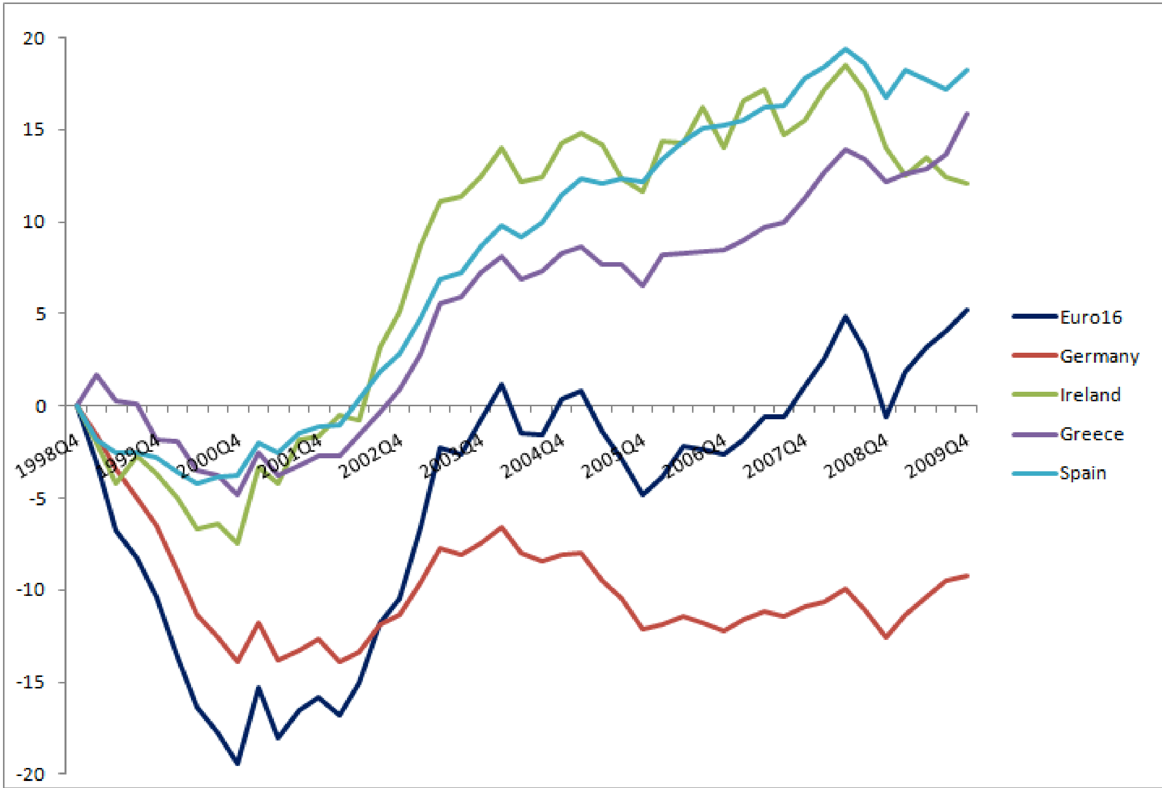
Finally, it is worth mentioning that although the social partnership model contributed to wage moderation (see section below), it also enabled the public sector to expand 35% between 2000 and 2008, and public servants were awarded public servants an average of 32% pay rise between 2003 and 2008. And during the boom years the public sector had become an engine of employment creation, even surpassing the industry and construction ones. This growth had a significant impact on public spending (Dellepiane and Hardiman 2011, 13; Donovan and Murphy 2013, 117-43).

The impact of the crisis was felt very rapidly as revenue shrank sharply (see Table 1). The government responded, yet again, with a pro-cyclical approach implementing fiscal adjustment largely through spending cuts, a decision that had a sharp contractionary effect.

The Competitiveness Crisis

In addition to the fiscal and the banking crisis, in the years that preceded the crisis, Ireland as Spain, also suffered a worsening in their terms of trade caused by the relative deterioration of their cost base vis-à-vis their European counterparts, particularly with Germany (see Figure 1):

Figure 1: Harmonized competitiveness indicator, % change, Q4 1998=100



Source: European Central Bank. [From Dellepiane and Hardiman 2011, p.32].

This loss of competitiveness was partly caused by the country's inability to control its cost base.[27] In the context of EMU, the main mechanism for countries to restore competitiveness would be through a decline in low wages. While other countries, notably Germany, had been very aggressive in holding their cost base under control to take full advantage of EMU membership, Ireland, however (as well as Spain), experienced a sharp deterioration in relative cost structures, and aggregate unit wage costs showed some relative deterioration. This failure was rooted in the structure of the wage bargaining system. Ireland's success during the boom years was also based in the establishment of a social partnership system in the mid-1980s (the first agreement, the *Programme for National Recovery*, was signed in 1987), which had led to wage coordination and wage moderation.

The system, however, proved to be too weak to withstand its own success (Dellepiane and Hardiman 2001, 17-18). A combination of very rapid economic growth, record low interest rates, excessive overleveraging, and a concentration of investment in the property market (rather than in productive investment), led to a sharp increase in living costs and, hence unsustainable growth in wages that eroded the competitive basis of the Irish economy. Indeed the boom of the late 1990s and beginning of the 2000s would have demanded very restrictive wage containment measures to sharply limit wage growth at a time in which other domestic costs were increasing sharply. As in Spain, however, political and electoral considerations made this unfeasible, and the Spanish and Irish wage bargaining systems lack the coercive mechanisms present in other countries to force onto employees the adjustment costs. By 2009 the crisis had hit the country and the government was unable to sustain the distributive trade-offs that had underpinned previous rounds of social bargaining (i.e. it did not have the resources to provide tax incentives and/or increase spending). Hence the social actors failed to reach an agreement that would have provided a deflationary pay deal, and pay determination was left to market mechanisms (Dellepiane and Hardiman 2011, 19).

Inflationary pressures derived from massive capital inflows and tax policies further hindered the country's competitiveness. The tax policy mix described above generated inflationary pressures through consumption and fees, as well as through the tax incentives to the construction sector. At the same time, the government's failure to adopt measures to control the property bubble and the escalating prices also contributed to push up the cost base of the Irish economy because it drove up wage demands (people wanted higher salaries to be able to afford their houses), thus injecting inflationary expectations into the system (Dellepiane and Hardiman 2011, 20). Finally, the erosion in competitiveness was also driven by supply side factors (educational and skill level attainment); as well low capital investment in infrastructure, transportation and energy costs; all areas in which Ireland (and Spain) have had weaknesses in the years that preceded the crisis, according to the World Economic Forum's *Global Competitiveness Report*.

The Financial Crisis

As in Spain, the original source of the crisis was the unchecked emergence of a property bubble largely funded by the reckless lending of banks. The international financial crisis that started in the United States exacerbated the financial crisis in Ireland, but it was not its cause. Indeed, Irish banks (like their Spanish counterparts) had not been affected by sub-prime lending. However, as in Spain, a central cause of the crisis was the mismanagement of the banking sector, which also lent irresponsibly to property developers and mortgage borrowers, and thus contributed to a classic property bubble. Between 1997 and 2007 housing prices increased in Ireland 240% (in comparison prices increase 180% in Spain, 175% in the US and 210% in the UK). This bubble, further driven by cheap credit, had inflationary effects that in turn contributed to competitiveness losses (Dellepiane and Hardiman 2011, 11).

In addition Irish banks were also very vulnerable to wholesale financial markets because of their over reliance on international lending, a problem compounded by the poor monitoring of loan collateral and the inadequate regulation of the sector (Donovan and Murphy 2013, 81-99). In many aspects the Irish banking sector is very similar to the British one. Both have been characterized by a "liberal regulatory model with light oversight" (Woll 2014, 141). The sector experienced rapid growth during the boom years of the 1990s and 2000s, as banks like the Allied Irish Bank and the Bank of Ireland pursued aggressive strategies to increase profits and markets share. In particular they focused in the mortgage market to take advantage of the property boom and the explosion in mortgage lending (as in Spain this explosion of lending was financed through cheap funding that Irish banks could obtain in international wholesale markets). They lent roughly two-thirds of GDP to property developers to fund property building and land purchases.

The deceleration of the Irish economy, which made it even more vulnerable to the real estate sector, had already started in 2001 as a result of three main factors: the 2001 *dot.com* collapse, the 9/11 shock, and the growing lack of global confidence. The government responded with additional fiscal concessions to the property market in the 2002 budget, which intensified the bubble. As we have seen, reckless bank lending further ignited the bubble, which intensified the concentration of lending in the property sector (Donovan and Murphy 2013, 59-80).

By 2006 there were increasing signs that the boom in the real estate sector was over and that the housing bubble was bursting. The crisis in this sector had dramatic consequences on Irish banks because they were severely exposed, and this happened at a time in wholesale commercial funding for Irish banks evaporated. Consequently banks' share prices dropped rapidly between 2007 and 2008. The hardest hit were the ones who had invested heavily in the property market like the Anglo Irish Bank and the Irish Nationwide Building Society, which had 75%(!) of their loans in the construction and property sectors in

2006. Not surprisingly the share price for Anglo Irish fell by 18% in one week in March 2008 over concerns about its real estate exposure.

By September of 2008 fearing a collapse of Anglo Irish, which could have had a systemic effect, Bank of Ireland and Allied Irish bank requested government intervention. The government, the Financial Regulator, and the Central Bank decided to issue a general guarantee on the deposits and most liabilities of Irish-owned banks for two years (Donovan and Murphy 2013, 197-218). The gross amount of liabilities was estimated at 375bn euros, more than twice the country's GDP. This decision was controversial, as Ireland failed to consult with its European counterparts, and its European partners reacted very negatively out of fear that such a guarantee may attract investment and funds from other troubled banks from other countries. Subsequently the Irish government followed through with some recapitalization measures, which had little success in reassuring investors, particularly as some scandals started to emerge from some of these banks, notably Anglo Irish, which forced the government to nationalize it on January 15 2009. At this time the focus shifted to containment to the resolution of insolvency (Woll 2014, 145-47).

The Irish banking crisis was caused by bad lending practices and poor regulation of the banking system. A 'principles approach' that avoided delving deeply into the activities of banks and focused on processes rather than substance, while trusting that banks would do the right thing, was largely to blame. The regulators failed to identify banks reckless practices, and in particular their risky concentration on property lending. And in those cases in which they identified irregularities, like with INBS, they failed to pursue them aggressively. The Financial Regulator and the Central Bank were responsible for this failure, which was compounded by the passive attitude of their European counterparts. The crisis has exposed the inadequacy of Irish banks' risk assessment processes, as well as their unsustainable overleverage asset base. But regulators were the ones that allowed banks to lend irresponsibly. The reasons for this can be traced back to the Irish development model that led to a significant liberalization and deregulation of the economy, and the banking sector, which historically had had a duopolistic commercial banking structure (Donovan and Murphy 2013, 81-99).[28]

As in Spain, the high rates of borrowing driven by record low interest rates, led to an unsustainable bubble in the property market, as well as sharp increase in private indebtedness. And as in Spain as well, successive governments failed to act to dampen the housing boom or to limit credit lending. On the contrary, the governments maintained the property tax incentives that continued fueling the bubble.

The problem was compounded, as in Spain, by the surge of inward capital flows that followed EMU membership. A significant part of this flow was in the form of lending to the banks, which in turn lent to the Irish economy. The sharp decline in interest rates the followed EMU membership further added fuel to the fire.

By 2008 it became clear that the banks were not only suffering liquidity problems, but that they risked insolvency. As we have seen, this led to the virtually unprecedented decision from the Irish government to guarantee not only all deposit-holders, but also most bondholders, in effect socializing the losses of the banking sector, which in turn resulted in an enormous increase in the deficit and the debt, and led to the 2010 bailout from the EU and the IMF. In the end the banking crisis blew a whole in the country's net external debt liabilities, a huge fiscal debt, and threw the country into a sovereign debt crisis, which in the case of Ireland was further aggravated by the government's decision to offer a blanket guarantee to the banking sector. On 21 November 2010 the Taoiseach Brian Cowen announced that the government had requested support from the EU and the IMF. On November 28 2010 the government, the EU and the IMF reached an agreement on a 85bn euros rescue package (Donovan and Murphy 2013, 221-49).

Rather than nationalizing all the banks, in 2009 the government created the National Asset Management Agency (NAMA), an 'special purpose vehicle'; charged with dealing with the depreciated assets from bankrupt developers, as well bad loans from banks. To this day the government decisions to rescue the banks and accept the 67.5m euro rescue package remains controversial.[29] Was the September 2008 blanket bank guarantee unavoidable? The argument has been that the government had no viable alternative. But it is not yet clear whether defaulting on its debt and imposing haircuts on senior bank bond holders was considered. Nor is it clear whether the dislocation and reputational damage would have been worse (see Donovan and Murphy 2013, 197-220).

Lessons From the Fall of the Irish Tiger and the Spanish Bull[30]

It Is Essential to Prepare for EMU

The crisis has also shown that countries need to undertake the necessary structural reforms to fully adapt to the demands of a single market and a monetary union. Somehow there was an expectation that membership on its own would force structural reforms, and this (naturally) did not happen. On the contrary, the crisis has shown the limits (and also adverse incentives) of EU/EMU membership in imposing institutional reforms in other areas (e.g., the labor market, the financial sector, or competition policy) and to balance domestic and external economic objectives.

EMU Membership Carries Risks

The Irish and Spanish experience also provides an interesting insight into the pitfalls of integration into an incomplete monetary union (one not backed by a political union): lower interest rates and the loosening of credit will likely lead to a credit boom, driven by potentially overoptimistic expectations of future

permanent income, which in turn may increase housing demand and household indebtedness, as well as lead to overestimations of potential output and expansionary fiscal policies. The boom will also lead to higher wage increases, caused by the tightening of the labor market, higher inflation, and losses in external competitiveness, together with a shift from the tradable to the nontradable sector of the economy, which would have a negative impact on productivity.

In order to avoid these risks, countries should develop stringent budgetary policies in the case of a boom in demand and/or strong credit expansion. At the same time, they should guard against potential overestimation of GDP, and measure carefully the weight of consumption on GDP, because they may inflate revenues in the short term and create an unrealistic perception of the budgetary accounts, as in the case of Ireland and Spain.

Furthermore, to avoid unsustainable external imbalances, countries should also carry out the necessary structural reforms to increase flexibility and productivity, as well as improve innovation in order to allow their productive sectors to respond to the increasing demand and to ensure that their economies can withstand the pressures of increasing competition. They should also set wages based on Eurozone conditions to ensure wage moderation, instead of on unrealistic domestic expectations and/or domestic inflation (Abreu 2006, 5–6). Countries should also take the opportunity presented by the boom to move into higher value-added and faster growth sectors toward a more outward-oriented production structure. Finally, the current global crisis illustrated the need for strict financial supervision to avoid excessive lending and misallocation of resources.

Fiscal Discipline Matters, but It Is Not Enough

Prior to the crisis, Ireland and Spain were perceived as two of the most fiscally disciplined countries in Europe. Initially, fiscal surpluses allowed the countries to use fiscal policy to be used in a countercyclical way to address the global financial crisis. However, although both entered the crisis in 2008 in an apparent excellent fiscal position, the countries' structurally or cyclically adjusted deficit turned out to be much higher than their actual deficit. As a result of the crisis, Spain fiscal performance collapsed by more than 13 percent of GDP in just two years. This shows that Ireland and Spain's structurally or cyclically adjusted deficit was much higher than its actual deficit, and illustrates how difficult it is to know the structural position of a country.

In order to avoid such a situation countries should further tighten budgetary policies in the case of a boom in demand and/or strong credit expansion. It is also important that they use fiscal policies in a countercyclical way to be prepared for recessions; finally, higher revenues, as in Ireland and Spain prior to the crisis, should not drive budget surpluses. On the contrary, governments need to address the

structural reasons for the deficits and avoid one-off measures that simply delay reforms but do not address the long-term budgetary implications.

Address Deficiencies in the Policymaking Process and Challenge the Dominant Paradigm

Prior to and during the crisis, there was strong consensus in Ireland and Spain among economic elites, as well as among main political parties, regarding fiscal consolidation and the balance budget objective. Indeed, prior to the crisis, they presented themselves as the model of countries applying the budget surplus policy mantra. This consensus may have worked well in the short term, contributed to the credibility of the government policies, and allowed them to become founding members of EMU, but a more accommodating policy would have positively contributed to upgrading their productive base, particularly in Spain, with investments in necessary infrastructure and human capital that may have contributed to a faster change in the model of economic growth, as well as reduced dependency on the construction sector.

Learn from Traditional Financial Crises

The financial crisis in Ireland and Spain did not involve subprime mortgages, collateralized debt obligations, structured investment vehicles, or even investment banks. In many ways, the financial crisis in both countries had strong similarities with traditional banking crisis: banks should not lend excessively to property developers; governments and central bankers should be proactive in bursting the bubbles before it is too late; bankers should recognize that retail banking is not a low-risk activity, and should avoid overconcentration in property loans; and finally, governments and central bankers should avoid any complacency (as it happened in in both countries), and instead need to be vigilant and proactive to avoid the mistakes of the past and to anticipate all possible scenarios, including the most negative ones. In Ireland and Spain, the misplaced and excessive confidence on the strength of the financial sector, and the almost unquestioned belief in the regulatory and oversight prowess of the BoS in the case of Spain, led to hubris.

Financial Regulation Matters

Regarding the experience of the financial sector from both countries during the crisis, there are also several lessons (Royo 2013). First, there is consensus that the stern regulations of the Bank of Spain played a key role in the initial positive performance of Spanish banks, because it forced banks to set aside during the good years "generic" bank provisions in addition to the general provisions for specific risks. In addition, it made it so expensive for them to establish off–balance sheet vehicles that Spanish banks stayed away from such toxic assets. Second, no model is perfect. Indeed, the experience of the Irish and

Spanish financial sectors shows that it is impossible for banks not to be affected from a collapsing bubble in real estate. Ireland and Spain are still suffering a property-linked banking crisis exacerbated by financing obstacles from the international crisis. The Bank of Spain announced in 2012 that bad loans on the books of the nations' commercial banks, mostly in the real estate sector, reached 7.4 percent of total lending.

Finally, the Irish and Spanish governments (and the ECB) failed to cope with the asset bubble and its imbalances. Hence, the Spanish experience shows that financial stability cannot be divorced from economic policy and macroprudential supervision; while regulation matters, macroeconomic factors do too. And they had options: the government should have eliminated housing tax breaks and/or establish higher stamp duty on property sales, or higher capital gains tax on second properties.

It Is the Politics, Stupid

Throughout the crisis the focus has been largely on the economic dimension of the crisis, as well as on its economic causes and consequences. It would be a mistake, however, to underplay the political dimensions of the crisis, and not just at the Irish and Spanish national level, but also at the European and global ones. This has been as much a political crisis as an economic one, and as much a failure of the markets, as a failure of politics. Political decisions have marked the course of the crisis.

Need to Address Current Account Deficits and Competitiveness

While the focus during the Eurozone crisis largely centered on the fiscal challenges, it is essential to note that we are also are dealing with a crisis of competitiveness. EMU membership fostered a false sense of security among private investors, which brought massive flows of capital to the periphery. As a result, costs and prices rose, which in turn led to a loss of competitiveness, particularly in Spain, and large trade deficits. Indeed, below the public debt and financial crisis there was a balance of payment crisis caused by the misalignment of internal real exchange rates. The crisis will largely be over when Spain regains its competitiveness.

Between 2000 and 2010 the loss of competitiveness vis-à-vis the Eurozone deteriorated in Spain: 4.3 percent if we take into account export prices and 12.4 percent if we take into account unitary labor costs in the manufacturing sector. The experience of Ireland and Spain within EMU also shows that there have been lasting performance differences across countries prior to the crisis. These differences can be explained at least in part by a lack of responsiveness of prices and wages, which have not adjusted smoothly across sectors, and which, in the case of Spain, have led to accumulated competitiveness losses and large external imbalances. While Germany (and other EMU countries) implemented supply-side reforms to bring labor costs down, through wage restraint, payroll tax cuts, and productivity increases,

making it the most competitive economy, with labor costs 13 percent below the Eurozone average, Spain continued with the tradition of indexing wage increases to domestic inflation rather than the European Central Bank target, and it became one of the most expensive ones with labor costs going up to 16 percent above average (Portugal leads with 23.5 percent, Greece with 14 percent, and Italy with 5 percent). [31] A lesson for EMU members has been that it is critical to set wages based on Eurozone conditions, and not on unrealistic domestic expectations, to ensure wage moderation (Abreu 2006, 5–6). Ireland faced similar challenges.

As we have seen crucial problem for Ireland and Spain has been the erosion of their comparative advantage. The emergence of major new players in world trade, like India and China, as well as the eastern enlargements of the European Union were somewhat damaging to the some European economies because those countries have lower labor costs and compete with some of our traditional exports (as exporters of relatively unsophisticated labor-intensive products), leading to losses in export market shares (aggravated by the appreciation of the euro and the increase of unit labor costs relative to those in its trading competitors). Yet while this was particularly true for Portugal, Italy and France, in Spain the problem has been that too few companies export, and that those that export have differentiated products because they are the large multinationals. That explains why the market share of Spanish products in world trade did not fall in the last 15 years. At the same time, Spain's attempt to specialize in medium- and higher-technology products was also hindered by the accession of the Eastern European countries into the EU, which were already moving into those sectors specializing in these products.

Moreover, in order to avoid unsustainable external imbalances, countries should also carry out the necessary structural reforms to increase flexibility (particularly internal flexibility which may be even more important for companies to allow them to deploy effectively their human capital, than the external one, despite the traditional fixation on dismissal costs) and improve productivity. This would be the most effective way to allow their productive sectors to respond to the increasing demand and to ensure that their economies can withstand the pressures of membership to a single market. Finally, countries should also take the opportunity presented by the boom to move into higher value-added and faster growth sectors, toward a more outward-oriented production structure.

Address EMU Institutional Constraints

The crisis has shown that the EMU is a flawed construction. Mario Draghi, president of the ECB acknowledged as much when he noted that it was like a "bumblebee" and declared "it was mystery of nature because it shouldn't fly but instead it does. So the euro was a bumblebee that flew well for several years." Lately it has not been flying well, and according to him, the solution should be "to graduate to a real bee." [32]

The crisis in Ireland and Spain has shown EMU's institutional shortcomings: Ireland and Spain had a huge bubble that crashed with the crisis. The "bumblebee" flew for a while and convinced investors that they could invest (and lend) massively to these countries, thus money poured into Ireland and Spain. However, when the crisis hit, these countries could not count on the EU to guarantee the solvency of its banks, or to provide automatic emergency support. And when unemployment soared and revenues plunged, the deficits ballooned. As a result, investors' flight followed and drove up massively borrowing costs. The government's austerity measures and structural reforms so far only contributed to deepen both countries' slump. They needed relief with their borrowing costs and hoped that the OMT ECB plan would help (but resisted the conditionality attached to it). They also need support with its exports. Europe has so far largely come short on both accounts. This crisis has shown the fragility of an institutional framework that tried to balance fiscal sovereignty with a monetary union. This model failed to combine flexibility, discipline, and solidarity. Fear is what is keeping it all together. But is fear enough to hold it together? If anything, the crisis exposed the shortcoming of EMU institutions. This is in many ways a repetition of the mistakes of the gold standard (Ahamed, 2009).

Discipline and Austerity Are Not Enough

Can an expansionary fiscal contraction work? The problem, particularly for Spain, is the feeble outlook for growth: the Spanish economy contracted by 1.7 in 2013, and is expected to grow a little over 1% in 2014 (way short to have a significant impact on unemployment); both countries still have high external indebtedness; and they both have a tremendous private and public sector debt. As a result, Ireland and Spain's sovereign debt was repeatedly downgraded throughout the crisis. Unemployment also reached record levels at over 24 percent in Spain (over 12% in Ireland) (and the unemployment problem is particularly acute among young people at over 50 percent). Furthermore, deep-seated structural weaknesses are still holding back growth and weighting on market assessment: overregulated product and labor markets, poor productivity, and low education achievement in international tests. And the effects of austerity are affecting not only Ireland and Spain: by the end of the 2014 summer the risk of deflation in the Eurozone were acute.

In this regard, the contrast with the United States is striking. Since 2007, the US Congress passed the equivalent of three stimulus bills:

a. A bipartisan $158 billion package of tax cuts signed by President George W. Bush in early 2008
b. A $787 billion bill pushed by President Obama as he took office in 2009 in the wake of the financial system's collapse

c. A tax cut and unemployment fund extension agreement reached by President Obama and Congressional Republicans in December 2010.

Many studies show that these measures are a key reason why the unemployment rate is not in double digits now in the United States.

<u>Need to address the inconsistency between institutions and policies at the European and domestic levels</u>

EMU membership constraints and the reliance, particularly in the case of Ireland, on foreign capital investment have been used as cover for political and economic decision under the guise that they leave very little domestic policy autonomy. Yet, both Ireland and Spain failed to recognize that in the absence of exchange rate adjustment (devaluations were no longer and option) and control over monetary policy, EMU membership placed significant emphasis on fiscal policy as a crucial policy instrument of domestic policy adjustment. Furthermore, they largely ignored the fact that relative costs of production (and in particular labor costs) had become under EMU the key variable in adapting to shifting terms of trade. Hence, it was paramount to contain labor costs to preserve competitiveness; otherwise there would be a loss of markets share, and consequently higher unemployment.

In addition, the Stability and Growth Pact did not force either country to accumulate large fiscal surpluses. On the contrary, Ireland and Spain both followed an expansionary fiscal policy in the years that preceded the crisis.

In both countries, however, the increase in domestic costs was largely exogenously determined and not driven by domestic institutions. Indeed, the massive inflow of capital that followed EMU membership, coupled with the dramatic decline in interest rates, fueled an unsustainable real estate property bubble, that inserted uncontainable upward pressure in domestic costs, and led to higher wages increases (particularly in Ireland), inflation, and loss of competitiveness.

The relative loss of competitiveness in both countries has to be placed in the context of the EMU flawed institutional design. The ECB interest rates 'on size fits all' model has proved to be unsuitable for countries that have a history of inflation and different rates of economic growth. Indeed, interest rate convergence was the last thing that Ireland and Spain needed in a context marked by booming growth and growing bubbles in the real estate sector. As we have seen, the sharp decline in interest rates combined with a surge in capital inflows, intensified inflationary pressures and further eroded the relative competitive position of both countries within EMU. This outcome was compounded by the unwillingness of the Irish and Spanish governments to impose the necessary fiscal discipline, and to take action to limit credit and control prices. Yet, it cannot be examined in isolation from a flawed European institutional design that limited the range of options available to domestic governments.

Conclusion

This paper has focused on the four dimensions of the crisis: financial, fiscal and competitiveness, governance/institutions. It shows the limits if domestic adjustment capacity and limits of EU to force change. In both Ireland and Spain the crisis has largely been a problem of ever-growing private sector debt, compounded by reckless bank investments and loans, (particularly in the case of Spain from the *cajas*), as well as aggravated by competitiveness and current account imbalances. In the end, the crisis has exposed the weaknesses of the countries' economic model. Indeed, despite the previous two decades' significant progress and achievements, the Irish and Spanish economies still face serious competitive and fiscal challenges. Unfortunately, the economic success of both countries prior to the crisis fostered a sense of complacency, which allowed for a delay in the adoption of the necessary structural reforms. And this was not a surprise; some economists had noted that these economies were living on borrowed time. Indeed, despite all the significant progress they still had considerable ground to cover to catch up with the richer EU countries and to improve the competitiveness of their economy. Given the existing income and productivity differentials with the richer EU countries Spain will have to continue and deepen the reform process.

The sudden collapse of the Irish and Spanish economy came as a shock. In retrospect, however, it should not have been such a surprise. The policies choices taken during the previous decade led to an unsustainable bubble in private sector borrowing that was bound to burst. Moreover, the institutional degeneration that led to systemic corruption and contributed to the implosion of parts of the financial sector made the crisis almost unavoidable.

Much of Spain growth during the 2000s was based on the domestic sector, and (as in Ireland) particularly on an unsustainable reliance on construction. In both countries tax incentives favored developers, property owners, and bankers. In addition, in Spain the particular regulation of the *cajas* proved fatally flawed, and led to a form of crony capitalism Spanish style, in which they invested massively in the construction sector in search of rapid growth and larger market share. These decisions proved fatal once the real estate bubble burst, and they led to the nationalization of several cajas, including *Bankia*, and the financial bailout from the European Union. In Ireland regulatory failures and lax oversight led to reckless lending and the eventual collapse of the Irish banking sector.

Membership in the European single currency was not the panacea that everyone expected it to be. Adoption of the euro led to a sharp reduction in real interest rates that contributed to the credit boom and the real estate bubble. However, it also altered economic governance decisions. Successive Irish and Spanish governments largely ignored the implications of EMU membership, and failed to implement the necessary structural reforms to ensure the sustainability of fiscal policies and to control unitary labor

costs. In Ireland and Spain these decisions led to a continuing erosion of competitiveness (and a record current account deficit); and a huge fiscal deficit when the countries was hit by the global financial crisis.

Indeed, the experience of both countries shows that EU and EMU membership have not led to the implementation of the structural reforms necessary to address these challenges. On the contrary, EMU contributed to the economic boom, thus facilitating the postponement of necessary economic reforms. This challenge however is not a problem of European institutions, but of national policies. Indeed, the process of economic reforms has to be a domestic process led by domestic actors willing to carry them out.

Both Ireland and Spain show the lack of institutional capacity, as well as the limits of a clientelistic approach encouraged by the political system and all parties under which everyone was paid off. Both countries relied on light-touch regulation (despite the fact that the Bank of Spain was more interventionist), which failed to prevent banks leveraging and led to the emergence of yet another form of crony capitalism.

In sum, in Ireland and Spain domestic policy choices and existing institutional frameworks sharply influenced, both the impact and the responses to the 2007 global financial crisis. Indeed, domestic institutions and policy choices prior to the crisis stood in uneasy relationship with the requirements from monetary union membership. The Irish and Spanish cases serve as an important reminder that in the context of a monetary union, countries only control fiscal policies and relative labor costs. They proved to be weak at both. They failed to develop an appropriate adjustment strategy to succeed within the single currency, and they ignored the imperative that domestic policy choices have to be consistent with the international constraints imposed by euro membership. On the contrary, in Ireland and Spain domestic policies and the imperatives of participating in a single currency union stood in uneasy relationship to one another. The crisis was the tipping point that brought this inconsistency to the fore, which led to the worst economic crisis in Irish and Spanish modern history.

In terms of future research agendas, this paper explains what happened, but it still necessary to develop further why it happened. Ireland and Spain had choices, why did it choose a particular path? Ireland and Spain moved away from a statist path. It was not just because of the SEM or EMU, there were domestic factors. It will be necessary to develop them further.

Indeed, the crucial cause of the crisis in both countries was a banking crisis caused by a property bubble. But blaming bankers and developers seems like a convenient excuse for politicians seeking aid from their European partners. The focus on the banking crisis conveniently underplays the depth of the fiscal crisis in which Ireland and Spain found themselves, regardless of the banking crisis. For instance, according to some estimates between 2008 and 2015 three quarters of the increase in Ireland's debt will

be accounted for by the budget deficit, as opposed to the capitalization of its banks. This seems to suggest that a bailout would have been required even if the banks had not collapsed. To this day Ireland's development stance has been based on FDI and consequently the rate of corporate taxes has been non-negotiable. As a consequence, as we have seen, the country relies on consumption and non-income based taxation. This had dramatic consequences for fiscal policy. Why isn't this strategy questioned today? Even as the Irish government announced in October 2014 the phasing out of the so-called "Double Irish," [33]the government is still unrelenting in its support for low corporate taxes with Taoiseach Enda stating, "We have nothing to be afraid of," and claiming that the tax system makes the "county more attractive for companies to invest here."[34] Is this sustainable? A lot of the focus is still on the banks, not on fiscal policy.

In this regard it is crucial to study further the political dimensions of the crisis. In both countries elections became auctions of electoral promises, and electoral considerations primed over longer term planning and sustainable policies. This was partly explained by the profile of the party system in both countries, with the leading parties having strong personal and financial connections to the construction and business sectors, which have led to widespread corruption in the years prior to the crises, corruption that is not finally coming to the surface. This led to a process of institutional divergence (Royo 2014). Why were the governments unable to resist such populist pressures? Why, despite the political autonomy of the minister for finance, which would have allowed for a coherent fiscal stance, did Ireland and Spain fail to accumulate large fiscal surpluses? Groupthink was also a problem among policymakers and regulators.

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Endnotes

[1] This article draws upon S. Royo, *Varieties of Capitalism in Spain*, (New York: Palgrave, 2008); S. Royo, *Lessons from the Economic Crises in Spain*, (New York: Palgrave, 2013). The Irish part owes an immense debt of gratitude to Niamh Hardiman and Sebastian Dellepiane. Our conversations about the crisis in both countries, as well as their own research, which is widely referenced throughout the paper, have been instrumental for the Irish section of the paper.

[2] This section borrows from S. Royo, *Varieties of Capitalism in Spain*, (New York: Palgrave, 2008).

[3] Emilio Ontiveros, "Redimensionamiento Transfronterizo," in *El País*, July 15, 2007.

[4] Deloitte's "Barometro de Empresas," from "Un año de grandes resultados," in *El País*, Sunday January 14, 2006.

[5] According to the *Financial Times*, 17 percent of those polled selected Spain as the countries where they would prefer to work ahead of the United Kingdom (15 percent) and France (11 percent). See "España vuelve a ser diferente," in *El País*, February 19, 2007, and *Financial Times*, February 19, 2007.

[6] Calativa provides a detailed analysis of the immigration experience in Spain and exposes the tensions associated with this development. She also highlights the shortcomings of governments' actions in regard to integration, and the impact of lack of integration on exclusion, criminalization, and radicalization. See K. Calavita, *Immigrants at the Margins*, (New York: Cambridge University Press, 2005).

[7] "Immigrants Boost British and Spanish Economies," in *Financial Times*, Tuesday, February 20, 2007, p. 3.

[8] Guillermo de la Dehesa, "La Próxima Recesión," in *El País*, January 21, 2007.

[9] "La Economía española creció en la última década gracias a la aportación de los inmigrantes," in *El País*, Monday, August 28, 2006.

[10] See Martin Wolf, "Pain Will Follow Years of Economic Gain," in *Financial Times*, March 29, 2007.

[11] According to the latest data (2007) from the *World Bank Governance Indicators* (http://info.worldbank.org/governance/wgi/sc_chart.asp), Spain is ranked in the 75-100th countries' percentile ranks in control of corruption, government effectiveness, regulatory quality, rule of law, and voice and accountability.

[12] According to Martinez-Mongay and Maza Lasierra, "The outstanding economic performance of Spain in EMU would be the result of a series of lucky shocks, including a large and persistent credit impulse and strong immigration, underpinned by some right policy choices. In the absence of new positive shocks, the resilience of the Spanish economy to the financial crisis might be weaker than that exhibited in the early 2000s. The credit impulse has ended, fiscal consolidation has stopped, and the competitiveness gains of the nineties have gone long ago." See C. Martinez-Mongay and L.A. Maza Lasierra, 'Competitiveness and growth in the EU.' *Economic Papers* 355 (January 2009), pp. 1-42.

[13] "Fears of Recession as Spain Basks in Economic Bonanza," in *Financial Times,* Thursday, June 8, 2006.

[14] "Los expertos piden cambios en la política de I+D," in *El País*, Monday, December 18, 2006.

[15] Angel Laborda, "El comercio en 2006," in *El País*, Sunday, March 11, 2007, p. 20.

[16] Wolfgang Munchau, "Spain, Ireland and Threats to the Property Boom," in *Financial Times*, Monday, March 19, 2007; "Spain Shudders as Ill Winds Batter US Mortgages," in *Financial Times*, Wednesday, March 21, 2007.

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[19] "Zapatero Accentuates Positives in Economy, but Spain Has Other Problems," in *Financial Times,* April 16, 2007, p. 4.

[20] See S. Royo, *Lessons from the Economic Crises in Spain*, (New York: Palgrave, 2013).

[21] See S. Royo, *Lessons from the Economic Crises in Spain*, (New York: Palgrave, 2013).

[22] S. Dellepiane and N. Hardiman, 'Governing the Irish Economy,' *UCD Geary Institute Discussion Series Papers,* Geary WP2011/03, (Dublin: University College Dublin, February 2011).

[23] This section borrows from S. Royo, *Lessons from the Economic Crises in Spain*, (New York: Palgrave, 2013).

[24] See Martin Wolf's blog: *"What Was Spain Supposed to Have Done?,"* June 25, 2012, http://blogs.ft.com/martin-wolf-exchange/2012/06/25/what-was-spain-supposed-to-have-done

[25] From Martin Wolf's blog: "What Was Spain Supposed to Have Done?," June 25, 2012.

[26] Simon Johnson's blog: "The End of the Euro: What's Austerity Got to Do With It?" June 21, 2012.

[27] Competitiveness is influenced by factors other than wage costs such as product markets, which may be more relevant to competitiveness than wage flexibility. Indeed, some have argued that product markets have a larger

impact that labor markets on changes in competitiveness. For instance, factors such as the capital intensity of production are affected by the extent of self-employment, which in turn has an impact on measures of productivity; and credit availability and fiscal policies can also affect the relative costs of factor inputs (Dellepiane and Hardiman 2011, 20).

[28] Similarly to Spain, the combination of a duopolistic commercial banking structure and poorly developed facilities for venture capital, hindered access to capital the development of a robust manufacturing sector (O'Malley 1989).

[29] The Irish press has published letters from the ECB threatening to cut off emergency support for Ireland's ailing banks unless the country applied for an international rescue. See: "Letters for ECB Suggest It Pushed Ireland Into a Paralyzing Bailout," in *The New York Times*, November 7th, 2014.

[30] From Royo 2013

[31] Stefan Collignon, "Germany Keeps Dancing as the iceberg looms," *Financial Times*, January 20, 2009, 13.

[32] Paul Krugman, "Crash of the Bumblebee," The *New York Times*, July 30, 2012.

[33] This system has allowed large tech companies operating in the country to reduce their tax bills by making royalty payments for intellectual property to a separate Irish-registered subsidiary incorporated in Ireland but with their home in a country with no corporate income tax, thus allowing companies to significantly reduce their tax burden.

[34] See: "Ireland Vies to Remain a Low Tax Magnet," in *The New York Times*, Monday November 10, 2014.