An Irish Mirror

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By Paul Krugman
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Everyone has a theory about the financial crisis. These theories range from the absurd to the plausible — from claims that liberal Democrats somehow forced banks to lend to the undeserving poor (even though Republicans controlled Congress) to the belief that exotic financial instruments fostered confusion and fraud. But what do we really know?

Well, in a way the sheer scale of the crisis — the way it affected much, though not all, of the world — is helpful, for research if nothing else. We can look at countries that avoided the worst, like Canada, and ask what they did right — such as limiting leverage, protecting consumers and, above all, avoiding getting caught up in an ideology that denies any need for regulation. We can also look at countries whose financial institutions and policies seemed very different from those in the United States, yet which cracked up just as badly, and try to discern common causes.

So let's talk about Ireland.

As a new research paper by the Irish economists Gregory Connor, Thomas Flavin and Brian O'Kelly points out, "Almost all the apparent causal factors of the U.S. crisis are missing in the Irish case," and vice versa. Yet the shape of Ireland's crisis was very similar: a huge real estate bubble — prices rose more in Dublin than in Los Angeles or Miami — followed by a severe banking bust that was contained only via an expensive bailout.

Ireland had none of the American right's favorite villains: there was no Community Reinvestment Act, no Fannie Mae or Freddie Mac. More surprising, perhaps, was the unimportance of exotic finance: Ireland's bust wasn't a tale of collateralized debt obligations and credit default swaps; it was an old-fashioned, plain-vanilla case of excess, in which banks made big loans to questionable borrowers, and taxpayers ended up holding the bag.

So what did we have in common? The authors of the new study suggest four " 'deep' causal factors."

First, there was irrational exuberance: in both countries buyers and lenders convinced themselves that real estate prices, although sky-high by historical standards, would continue to rise.

Second, there was a huge inflow of cheap money. In America's case, much of the cheap money came from China; in Ireland's case, it came mainly from the rest of the euro zone, where Germany became a gigantic capital exporter.

Third, key players had an incentive to take big risks, because it was heads they win, tails someone else loses. In Ireland this moral hazard was largely personal: "Rogue-bank heads retired with their large fortunes intact." There was a lot of this in the United States, too: as Harvard's Lucian Bebchuk and others have pointed out, top executives at failed U.S. financial companies received billions in "performance related" pay before their firms went belly-up.

But the most striking similarity between Ireland and America was “regulatory imprudence”: the people charged with keeping banks safe didn’t do their jobs. In Ireland, regulators looked the other way in part because the country was trying to attract foreign business, in part because of cronyism: bankers and property developers had close ties to the ruling party.

There was a lot of that here too, but the bigger issue was ideology. Actually, the authors of the Irish paper get this wrong, stressing the way U.S. politicians celebrated the ideal of homeownership; yes, they made speeches along those lines, but this didn’t have much effect on lenders’ incentives.

What really mattered was free-market fundamentalism. This is what led Ronald Reagan to declare that deregulation would solve the problems of thrift institutions — the actual result was huge losses, followed by a gigantic taxpayer bailout — and Alan Greenspan to insist that the proliferation of derivatives had actually strengthened the financial system. It was largely thanks to this ideology that regulators ignored the mounting risks.

So what can we learn from the way Ireland had a U.S.-type financial crisis with very different institutions? Mainly, that we have to focus as much on the regulators as on the regulations. By all means, let’s limit both leverage and the use of securitization — which were part of what Canada did right. But such measures won’t matter unless they’re enforced by people who see it as their duty to say no to powerful bankers.

That’s why we need an independent agency protecting financial consumers — again, something Canada did right — rather than leaving the job to agencies that have other priorities. And beyond that, we need a sea change in attitudes, a recognition that letting bankers do what they want is a recipe for disaster. If that doesn’t happen, we will have failed to learn from recent history — and we’ll be doomed to repeat it.