



# Perspectives by Ruth Lea

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### The Irish bailout and options for the Eurozone

#### *Introduction*

An IMF-EU bailout for Ireland is imminent. Indeed it may have been announced by the time this Perspective is released. At the time of writing expectations are for a bailout of less than €100bn. Perhaps half of this will be for recapitalising the ailing bank sector and half for the wider economy. Doubtless there will be conditions placed on the Irish Government, including the requirement to increase the 12.5% corporation tax rate which has long been a bone of contention with the French and the Germans as contrary to the spirit of the harmonised Single Market and “unfair”. An increase in the tax rate will inevitably damage Ireland’s international competitiveness and attractiveness to inward investors. It would *de facto* be a partial end of tax sovereignty. There may also be plans for an early exit from the generous bank guarantees. The package will be agreed against the background of another Irish austerity budget, expected on 7 December.

The funding for the bailout will come from the €750bn rescue package agreed in May which comprised the €500bn European Stabilization Mechanism<sup>1,2</sup> and €250bn from the IMF. The European Stabilisation Mechanism, in turn, comprised:

- The Eurozone’s €440bn European Financial Stability Facility (EFSF), a loan facility backed by the more creditworthy Eurozone members and operational until mid-2013.
- The EU27’s €60bn package of loans, of which the UK has a 13.6% commitment (€8.2bn or £7.0bn).

#### *Ireland’s predicament*

Ireland’s crisis is fundamentally a crisis over the insolvency of the Irish banking sector. In the early to mid-2000s the Irish economy, stimulated by low interest rates, experienced rocketing bank lending and an exploding property boom. The recession of 2008-2009 saw a vicious reverse. GNP fell by over 10% in 2009 after a fall of 3 ½% in 2008,<sup>3</sup> property prices are down by nearly half on some estimates, unemployment is currently little short of 14% and bad debts have mounted.

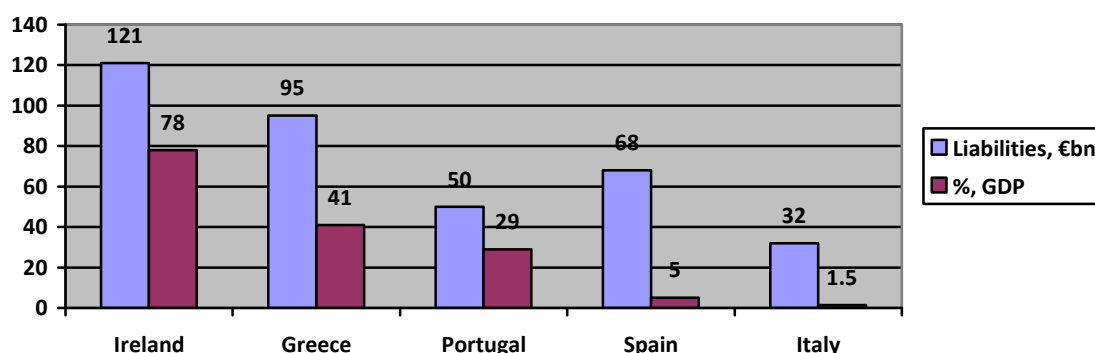
The bad debts problem has been exacerbated by the Irish government’s very generous guarantees to creditors. In September 2008 the Irish government guaranteed all retail and corporate deposits, interbank deposits, senior unsecured debt, asset-covered securities and dated subordinated debt.<sup>4,5</sup> In September 2009 the Irish Government announced that the bank guarantees could cost €50bn (equivalent to about one third of GDP) – which could be on the low side.<sup>6</sup> These costs have pushed the deficit to GDP ratio to 32% for 2010, undermining the solvency of the state.

The most urgent problem for Ireland and its rescuers is to recapitalise, maybe restructure, its banks. As already indicated, financial support for the banking sector is expected to be at the heart of the IMF/EU rescue package, which is likely to insist on the part-renegeing of the Irish Government's generous guarantees for bank creditors. It can therefore be expected that creditors will have to take bigger losses, whatever other decisions are made.

The markets confidence in Irish sovereign debt has nosedived in recent weeks reflecting the unpalatable truths about the banking sector and despite the fact that Ireland does not have to go to the capital markets to raise funds until July 2011.<sup>7</sup> The other market confidence wrecking factor was the report from the end-October EU Summit concerning the post-2013 permanent "crisis resolution mechanism". Even though the details of the crisis resolution mechanism have yet to be agreed, one thing was very clear. At Germany's insistence the losses/costs of future sovereign bail-outs would be shared between taxpayers and private bondholders however the losses/costs were incurred - whether by default (orderly or otherwise), debt restructuring or rescheduling or a combination of the three.<sup>8</sup> Chancellor Merkel's reiteration of support for loss-sharing on 11 November triggered more panic in the markets, perhaps under the impression that current bondholders would be suffer "haircuts" as well as post 2013 bondholders.<sup>9</sup>

Another aspect of Ireland's banking crisis is that the banks have *de facto* been locked out of the wholesale markets. This has left the banks increasingly reliant on short-term loans from the ECB. The ECB is not so much the lender of last resort for the Irish banks. It is the lender of only resort. The liabilities to the ECB, in €bn and as a percentage of GDP, for selected Eurozone countries are shown in chart 1.

**Chart 1 Liabilities to the ECB, in €bn and as a percentage of GDP, selected Eurozone countries**



Source: FT, "Vote for Trichet", Lex column, 17 November 2010. Data as at September 2010.

It can be argued that when liabilities are greater than 10% of GDP, this is a subsidy. But ECB liabilities are nearly 80% of GDP for Ireland. ECB funding is Ireland's life support. The Greek and Portuguese situations, though better, are clearly unsatisfactory.

#### *Importance of Ireland to Britain*

There is little doubt that Britain's banks have very large exposure to Ireland, as the table below shows.

### Consolidated foreign claims of reporting banks (\$bn), immediate borrower basis<sup>10</sup>

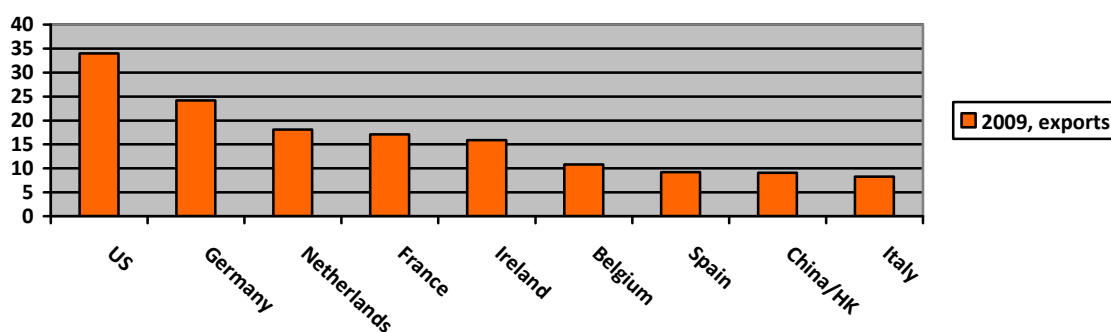
	Total foreign claims	European banks	Greece	Ireland	Portugal	Spain
Nationality of reporting bank:						
France	1,819.4	845.6	1.9	19.2	8.6	34.5
Germany	2,029.7	1,251.9	4.7	34.1	4.7	49.0
Italy	1,318.9	950.7	0.6	42.7	4.8	38.7
Netherlands	1,063.9	588.4	5.1	14.0	11.4	22.3
Spain	1,057.7	771.5	0.4	27.2	26.9	Na
UK	3,526.8	2,085.1	19.5	<b>211.4</b>	10.9	378.1
Japan	975.9	439.3	0	14.9	0	1.2
US	5,433.8	3,645.7	4.8	516.4	9.4	192.1

Source: Bank for International Settlements, *BIS Quarterly Review*, September 2010, table 9B. The data refer to amounts outstanding, end March 2010. The table shows the claims on individual countries by nationality of reporting banks.

The total exposure to Ireland amounts to \$211bn (£132bn), far higher than France, Germany or Italy – though less than half the US’s. Of the individual banks it has been reported that RBS (including its subsidiary Ulster Bank) has £53bn of exposure and the Lloyds Group £27bn.<sup>11,12</sup> Potential losses can only be speculated about at this stage, not least of all because of potential changes to the Irish Government’s banking guarantees to creditors.

Concerning trade, Ireland is an important trading partner. But it should be kept in perspective. Chart 2 shows the UK’s top destinations for the exports of goods. Ireland is number 5, accounting for 7% of total trade. But note that British exports to Ireland fell by £3bn in 2009 compared with 2008, because of Ireland’s steep recession.

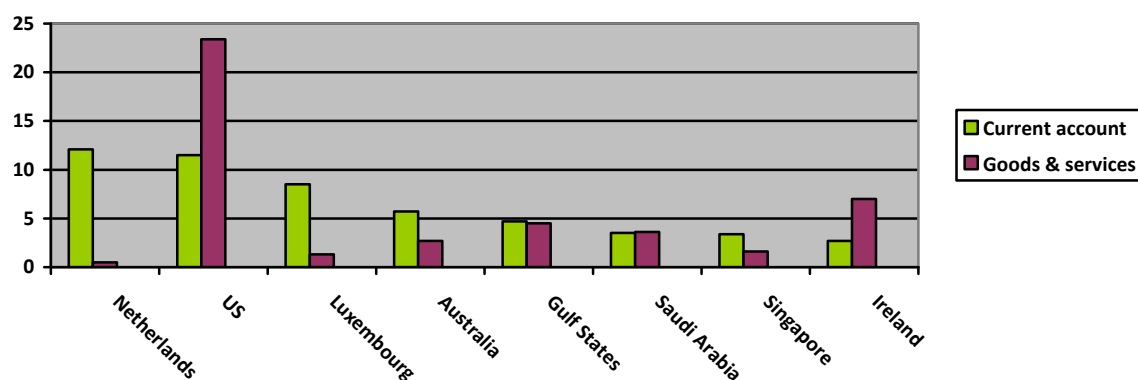
**Chart 2 Top destinations for UK exports of goods, £bn, 2009**



Source: ONS, *UK Balance of Payments, the Pink Book*, 2010 edition. It should be noted that the Dutch and Belgian data are distorted by the “Rotterdam and Antwerp effects”, whereby exports going to these ports are for third countries.

Chart 3 shows the relevant balances. Ireland makes a useful contribution to “goods and services”, which feed directly into GDP – though the £7bn balance amounts to just ½% of GDP. The contribution to the current account is less significant.

**Chart 3 Current account balance, balance on goods and services, £bn, 2009**



Source: ONS, *UK Balance of Payments, the Pink Book*, 2010 edition. The Dutch and Luxembourg data reflect the very high investment income credits.

#### *Contagion: the peripheral Eurozone economies*

Despite the initial reluctance of the Irish Government to accept a bailout, it will happen. There is no doubt that one of the main drivers behind the bailout is to control the Irish “contagion” in the sovereign bond markets to Portugal, as the next weakest economy, and also, crucially, to Spain.

The markets are clearly nervous about the sovereign debt of Portugal, Ireland, Greece and Spain - the peripheral “PIGS” countries - and have been for some time. Data recently available for the 2<sup>nd</sup> quarter (which included the May crisis and rescue packages) show that foreign investors were already shunning risky Eurozone bonds. Government debt held by foreign banks and institutions fell by 14% (for Greek bonds), 12% (for Portuguese), 8% (for Spanish) and 5% (for Irish). And foreign holdings of Portuguese and Irish bonds fell to 65% of total debt at the end of the 2<sup>nd</sup> quarter from 85% in 2009. They fell to 55% from 70% in Greece and to 38% from 43% in Spain during the same period. Increasingly bond auctions were depending on local buyers.<sup>13</sup>

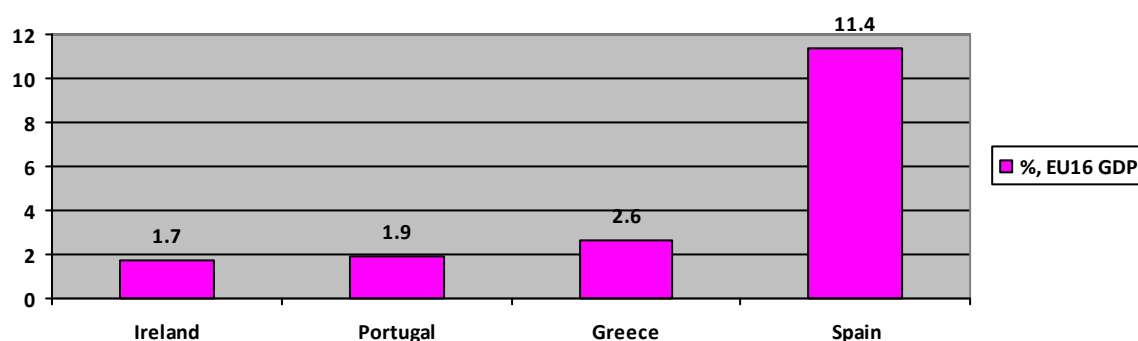
The PIGS are all in difficulties and face miserable growth prospects. They are stuck in the painful euro straightjacket and they are paying high costs for borrowing money. They are however weak for different reasons:

- Ireland: a collapsed property market has led to exploding bad debts coupled with an injudicious rescue of the banking sector that has undermined the solvency of the state. But the external sector is growing and austerity packages are being imposed. The banks are at the heart of Ireland’s problems.
- Greece: gross mismanagement of the public finances, an inadequate tax base, misleading official data and a basic lack of competitiveness. Eurostat recently revised the deficit to GDP ratio from 13.6% to 15.4% and debt as a % of GDP from 115.1% to 126.8% for 2009. Greece has a deficit target of 8.1% of GDP for 2010, but the outcome will be more like 9.4%. It is increasingly questioned whether Greece will be able to deliver the promised austerity measures in return for the €110bn rescue package. Austria has already suspended its contributions.
- Portugal: a creeping competitiveness problem and especially uncompetitive against China (a direct competitor in clothing and footwear), delayed austerity packages (proposing a budget squeeze as late as September) and political problems. But Portugal has no housing market collapse as in Ireland and Spain and the banks look solidly capitalised.
- Spain: sclerotic economy, 20% unemployment, inflexible labour markets and the same property bubble problem as Ireland.

There is increasing speculation that Portugal will need a rescue package. Bailing out Portugal would, however, be manageable.

The real concern is Spain. It may only be a matter of time before the bond markets turn their attention to Spain, given Spain's appalling fundamentals. But, as chart 4 below shows, Spain's GDP is nearly twice as large as the GDP of Ireland, Portugal and Greece combined. The €500bn "European Stabilization Mechanism", along with the IMF's €250bn, could be enough to bail them out. But it is not convincing and there is already unease in the markets that, unless the core EMU countries raise fresh funds to boost the collateral of the rescue fund, the EFSF would not have adequate firepower to support Spain. There is no guarantee that the "more creditworthy" Eurozone countries would be prepared to do this. Spain could be a rescue too far. And the notion of bailing out Italy, if the need arose, is simply out of the question with the current arrangements.

**Chart 4 Share (%) of Eurozone GDP: the peripheral Eurozone countries, 2010**



Source: FT, "Trouble on the periphery", 19 November 2010

#### *Where does the Eurozone go now?*

The rescue for Ireland can only be a temporary respite exercise. But the hope must be that it is enough (maybe with a Portuguese bailout) to stave off the current crisis, and give time for economic recovery to bed in and the proposed economic governance controls to bed in.<sup>14</sup> And the hope must be that all will be "ok" until mid-2013 when the proposed "crisis resolution mechanism", with its "orderly default" and loss-sharing proposals, is due to be introduced. This seems to be policy of hope over experience and reality.

The Eurozone is dysfunctional. The economics are tearing it apart, but the EU's politicians will give all appearances of holding it together. It is impossible to predict the Eurozone's future, but the following developments seem likely:

- There will be even more push from the Commission for central control over the Eurozone members economies (and possibly the EU27's). The likely call on Ireland to raise its corporation tax rate is symptomatic of the centralising and harmonising momentum.<sup>15</sup>
- Even though it has been argued many times that currency unions only endure if there is fiscal union, if not full political union, Germany will not agree to fiscal union. The notion that the German electorate is endlessly willing to see their taxes used to prop up profligate member states has been tested to destruction. It should be remembered that in the 19<sup>th</sup> century a series of European monetary unions, which were not backed by political union, failed.
- Highly indebted countries will probably have to restructure their debts. Mechanisms need to be devised before 2013.
- Economic imbalances will endure. Unless there is a major change of economic policy direction in the highly competitive, export-oriented Germany (which seems highly unlikely especially given its ageing population), other member states will struggle to remain competitive within the Eurozone. And they will include not only the PIGS but also Italy and possibly even France. Increasing economic divergence is much more likely than economic convergence.

- The markets will increasingly speculate that the Eurozone will break into a core and a periphery, or that the weaker currencies will unilaterally peel off. This speculation was considered “off limits” as recently as the beginning of this year. But the markets will increasingly see this outcome as the favoured and therefore the most likely option for the weaker countries, given the painful alternative. The chances that Greece, Ireland, Portugal and maybe Spain will leave within the next 3 years, maybe sooner, are increasing.

In the meantime the euro will struggle on, patched by the huge sums agreed in the rescue packages. Will the euro break up all together? Probably not in the next decade as the political stakes are too high. It would represent the failure of the European project.

## References

1. “The European Stabilization Mechanism”, memo/10/173, 10 May 2010, [www.europa.eu](http://www.europa.eu). The ECB was also given instructions to purchase the sovereign debt of the weaker Eurozone countries in May 2010.
2. Ruth Lea, “The eurozone’s rescue package: buying time and postponing the day of reckoning”, Arbuthnot Banking Group, 24 May 2010.
3. Data from the Irish Central Statistics Office, [www.cso.ie](http://www.cso.ie)
4. See [www.internationallawoffice.com](http://www.internationallawoffice.com), October 2008.
5. The tardiness of setting up the National Asset Management Agency (NAMA) for housing bad assets has also been widely criticised as adding to the severity of the banking crisis.
6. Ruth Lea, “Eurozone pain will continue: a lesson from Black Wednesday”, Arbuthnot Banking Group, 4 October 2010.
7. *FT*, “Plans for fiscal rescue mechanism move forward”, 10 November 2010
8. Ruth Lea, “Keep Britain’s cuts in perspective: it’s far worse in some eurozone countries”, Arbuthnot Banking Group, 8 November 2011.
9. *FT*, “A punt too far”, 20 November 2010
10. Note: while claims on an immediate borrower basis will indicate the direction of UK-owned banks’ lending to non-residents, this may not be where the risk ultimately lies (source, Bank of England).
11. *Times*, “Proud Ireland struggles to keep the lid on the begging bowl”, 18 November 2010.
12. Robert Peston, “Ireland: how much punishment for British & international banks”, *BBC website*, 17 November 2010, reported that the total lending of non-Irish banks to Irish banks was around \$170bn according to the BIS. The breakdown of the exposure was: British banks (\$42bn), German (\$46bn), US (\$25bn) and French (\$21bn).
13. *FT*, “Foreign investors shun risky eurozone bonds”, 9 November 2010.
14. Ruth Lea, “Eurozone pain will continue: a lesson from Black Wednesday”, Arbuthnot Banking Group, 4 October 2010.
15. *Daily Telegraph*, “IMF boss says give powers to Europe”, 20 November 2010, reported that IMF Managing Director Dominique Strauss-Kahn had called to move the responsibility for fiscal discipline & structural reform to a central body. There needed to be more tax harmonisation, a larger central budget and centralised labour market reforms.

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