Ireland’s European Crisis

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Ireland’s Current Position

- In a joint EU/IMF lending programme
- Banks and government unable to finance themselves
- 10-year sovereign bonds yield 8% in the secondary market
- Market re-entry planned for late 2012 or early 2013
- Infeasible under the current programme?
# Playing by the Fiscal Rules

Pre-crisis Debt and Deficit Ratios in Ireland since Eurozone Entry

<table>
<thead>
<tr>
<th>Year</th>
<th>Debt % GDP</th>
<th>Deficit % GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>48.0</td>
<td>2.7</td>
</tr>
<tr>
<td>2000</td>
<td>37.5</td>
<td>4.7</td>
</tr>
<tr>
<td>2001</td>
<td>35.2</td>
<td>0.9</td>
</tr>
<tr>
<td>2002</td>
<td>31.9</td>
<td>-0.4</td>
</tr>
<tr>
<td>2003</td>
<td>30.7</td>
<td>0.4</td>
</tr>
<tr>
<td>2004</td>
<td>29.4</td>
<td>1.4</td>
</tr>
<tr>
<td>2005</td>
<td>27.3</td>
<td>1.6</td>
</tr>
<tr>
<td>2006</td>
<td>24.8</td>
<td>3.0</td>
</tr>
<tr>
<td>2007</td>
<td>24.9</td>
<td>0.1</td>
</tr>
</tbody>
</table>

Boom and Bubble

- There was a genuine boom from 1993 to about 2001
- Since 2002, a credit-fuelled housing and property bubble
- Bank balance sheets exploded, funded through capital inflows
- Every single bank, including foreign-owned banks, needed rescue.
Policy Response

- The bubble flattered the budget numbers
- Bubble burst in 2007 and tax revenues collapsed
- Fiscal tightening commenced July 2008
- Banking crisis September 2008, post Lehman's.
- Government blanket guarantee, plus an asset management agency NAMA.
Wrong Diagnosis

- The Irish banks were not illiquid, they were bust.
- The guarantee and asset management agency were appropriate for an illiquid but solvent system
- Loan losses at the guaranteed banks so large, they brought down the sovereign
- Big NAMA discounts crystallised bank insolvencies.
Macroeconomic Black Hole

- Banking system rescue has enormous Exchequer costs, possibly 40 to 45% of GDP
- Competitiveness must be restored without devaluation…
- After three years of fiscal consolidation, budget deficit still c.10% of GDP in 2011
- Sovereign credit markets very sceptical…
Revenue Collapse....

Government spending and revenues

€ million

Year

2000 2001 2002 2003 2004 2005 2006 2007 2008 2009(f)

Revenues
Spending
Debt Service Rising Rapidly…

![Graph showing rising debt service](image)
Projected Debt Ratio % GDP

- 2011: 95%
- 2012: 110%
- 2013: 115%
- 2014: 120%
- 2015: 115%
Macroeconomic Prospects

- Sharp decline in activity seems to be over but no sign of recovery

- Fiscal stance highly deflationary, credit availability weak, banks, government and households all deleveraging

- Over 2012 to 2015, nominal GDP unlikely to grow quickly

- Clear debt sustainability problem
The Source of the Debt Crisis

- Government guaranteed €440 billion in bank liabilities while facing a deficit of €20 billion pa.

- Banks proved to be insolvent. Neither banks nor government can borrow in the market.

- The bank guarantee has exhausted the fiscal capacity of the state. Hence IMF/European programme

- The ECB has insisted on continued payouts to bondholders in bust banks, including banks closed and in resolution.

- But the budget gap, on its own, would have been manageable.
## Bank Rescue Cost, % of GDP

<table>
<thead>
<tr>
<th>Country</th>
<th>Start date of crisis</th>
<th>Gross cost</th>
<th>Net cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ireland</td>
<td>2008</td>
<td>40.0</td>
<td>n.a.</td>
</tr>
<tr>
<td>Indonesia</td>
<td>1997</td>
<td>37.3</td>
<td>37.3</td>
</tr>
<tr>
<td>Chile</td>
<td>1981</td>
<td>34.3</td>
<td>6.5</td>
</tr>
<tr>
<td>Turkey</td>
<td>2000</td>
<td>24.5</td>
<td>24.5</td>
</tr>
<tr>
<td>Korea</td>
<td>1997</td>
<td>19.3</td>
<td>15.8</td>
</tr>
<tr>
<td>Thailand</td>
<td>1997</td>
<td>18.8</td>
<td>18.8</td>
</tr>
</tbody>
</table>
## A Taleb Distribution

Profit before Tax, Anglo Irish 2001-2010, with Loan-Loss Provisions, €m.

<table>
<thead>
<tr>
<th>Year to Sept</th>
<th>Profit Before Tax</th>
<th>after Loan-Loss Provisions of</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>195</td>
<td>70</td>
</tr>
<tr>
<td>2002</td>
<td>261</td>
<td>66</td>
</tr>
<tr>
<td>2003</td>
<td>347</td>
<td>58</td>
</tr>
<tr>
<td>2004</td>
<td>504</td>
<td>19</td>
</tr>
<tr>
<td>2005</td>
<td>615</td>
<td>30</td>
</tr>
<tr>
<td>2006</td>
<td>850</td>
<td>66</td>
</tr>
<tr>
<td>2007</td>
<td>784</td>
<td>82</td>
</tr>
<tr>
<td>2008</td>
<td>1243</td>
<td>724</td>
</tr>
<tr>
<td>2009*</td>
<td>(12835)</td>
<td>15105</td>
</tr>
<tr>
<td>2010**</td>
<td>(17619)</td>
<td>19314</td>
</tr>
</tbody>
</table>

* 15 months to end-2009  
** 12 months to end-2010
Moral Hazard courtesy of the ECB

- Anglo-Irish was nationalised in 2009, closed in March 2011 and is in resolution.
- The ECB insisted, in November 2011, that holders of a maturing $1 billion bond be paid in full by the Irish government, which is in an IMF programme.
- The bond was ‘senior’, but *not* guaranteed by the government.
The Euro has Widened Spreads

Spreads above levels prevailing before the euro's birth

Euro area: Sovereign spreads vs. 10Y Bunds

Source: AA&MR, Datastream
Sovereigns versus Banks?

- Paying bank bondholders in full has subordinated sovereign debt.
- Countries without a currency are in any event at greater risk of default.
- The EU Commission and the ECB have been building in new short circuits, instead of circuit-breakers.
- Most European sovereign debt now potentially toxic.
Capital Mobility with Banks!

Bank Assets to GDP, Selected US States

Alaska  0.10  North Carolina  3.78

Arizona  0.05  Delaware  16.29
ECB on the Potomac

- Fifty central banks, one for each state.
- Each state governor responsible for supervision, and bank rescue, no limits.
- No bank resolution.
- No bank bondholder left behind.
- Who would buy bonds issued by states?
- Why would a prudent state governor license banks at all?
Re-Designing the Eurozone

- Centralised Bank Supervision
- Centralised Bank Resolution
- Common system of *ex ante* deposit protection
- No more seniority for bank creditors.
- The current structure in the Eurozone is like the USA before 1913.
- Afterthought: the Eurozone a single IMF member?