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After a Greek default - Restructuring by 2012 for the Irish economy

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The rescue package for Ireland negotiated with the Troika in November 2010 avoided for the time being default and escalating contagion. But despite the conditionality imposed, it did little to address the causes of Ireland's fiscal difficulties. To make matters worse, the Irish government has imposed fiscal austerity, which will limit the Irish economy's growth prospects into 2012.

Until about 2000, the so-called Celtic Tiger growth model was secured by strong exports and moderate wage demands. This then changed as property prices and the construction bubble gained momentum. That boom maintained employment and output growth until 2007 despite a loss of wage competitiveness. Irish and foreign banks fuelled the boom, especially from 2002. The Irish Department of Finance contributed to the financial implosion of the Irish economy by its lack of competence in economic management. The Irish Central Bank and the Regulator failed miserably, while the European Central Bank (ECB) presided over a financial sector operating under a lack of oversight with banks in the core lending recklessly to Irish banks. There are two likely scenarios for the Irish economy now - default and restructuring.

Morgan Kelly who had predicted in 2007 the Irish property crash wrote that Ireland's total government debt will top €190 billion by 2014, with another €45 billion in National Asset Management Agency (NAMA) and €35 billion in bank recapitalisation, for a total of €270 billion, plus whatever losses the Irish Central Bank has made on its emergency lending. Subtracting off the likely value of the banks and NAMA assets, final debt will be about €220 billion, possibly more like €250 billion, but those differences are immaterial: either way we are talking of a Government debt that is more than €120,000 per worker, or 60 per cent larger than Gross National Product. Ireland will need to restructure its debts. How soon and how completely it does this will have major implications for the EU/Eurozone. [1]

In Ireland, Fine Gael and Labour commitments made during the February 2011 general election campaign, impossible to meet because of the tight budgetary situation, are expected to add to voter anger ahead of a severe December 2011 budget. Government MPs see that their major problem will be a key election promise: to renegotiate the EU-IMF deal and to "burn the bondholders" as some of the more outspoken MPs pledged. The Irish public sees that this has not happened so far. Already the Roscommon accident & emergency unit has been closed in the West of Ireland. The further expected partial closures of accident & emergency units in early 2012 as a consequence of the cuts in the health budget will cause public opinion to turn against the Fine Gael/Labour coalition.

The Rise and fall of the Celtic Tiger

The problems in Ireland leading up to the crisis were twofold – linked to financial markets and politics. Two reports were commissioned by the Irish government to learn the lessons of what went wrong.

[1] Morgan Kelly, "Ireland's future depends on breaking free from bailout", Irish Times, May 7, 2011

As for the financial markets crisis, the "Misjudging Risk: Causes of the systemic banking crisis in Ireland"[2] report, was highly critical of the Irish banks, financial regulators and the Department of Finance during the emergence of the property bubble which collapsed during the US sub-prime crisis. The report of the Commission of Investigation into the Banking sector in Ireland carried out by Peter Nyberg; former Director General of the Financial Markets Department at the Finnish Ministry of Finance was completed in March 2011. As the Nyberg report points out, the roots of the Irish crisis were inadequate risk management practices of within Irish and foreign banks and the failures of the Irish financial regulator to supervise those practices effectively.

The successor Fine Fail/Green government also showed that it was unable to manage the country's financial affairs. The Irish Central Bank and the Regulator failed miserably, while the ECB presided over a financial sector operating under a lack of oversight with banks in the core lending recklessly to banks on the periphery such as Ireland.

With regards to the political causes of the crisis, the Irish government initiated an investigation into the financial crisis in 2010 under the leadership of Canadian expert Rob Wright called "Strengthening the capacity of the Department of Finance", a report of the independent review panel.[3] The result was severe criticism of the Fianna Fail/Progressive Democrat government and the Irish Department of Finance. The report was completed in December 2010 but not made public until after the Irish election in February 2011.

The Wright report blamed the 2002 Bertie Ahern Fianna Fail/Progressive Democrat government for causing most of the damage to the Irish economy, criticised the Irish Department of Finance for allowing tax breaks that encouraged the unsustainable property boom and further pointed at the Fianna Fail/Progressive Democrat policies in their 2002 election manifestos for sowing the seeds of the 2008 property market crash.

The Wright Report also criticised Department of Finance officials for not engaging in proper analysis of the implications of tax cuts and increased public spending the Fianna Fail/Progressive Democrats government were planning. The report blames the impact of the social partnership process as another key reason for Ireland's economic woes, highlighting high public sector wages compared with the private sector. It also questions the methods that were available to Department of Finance officials to raise those kinds of concerns with the then minister, Charlie McCreevy, and his successors, Brian Cowen and Brian Lenihan.

For Ireland, there are only two ways out of the crisis: default or large scale debt restructuring. Both options are discussed below.

[2] Misjudging Risk: Causes of the Systemic Banking Crisis in Ireland Report of the Commission of Investigation into the Banking Sector in Ireland, March 2011
[3] Strengthening the Capacity of the Department of Finance Report of the Independent Review Panel, December 2010

Scenario 1 Default

Following a possible Greek default Ireland could bargain away its bank debt burden if it exploits the threat of contagion from an Irish debt default, which would be vastly disruptive to the markets and the EU/Eurozone compared to the relatively minor cost to the EU/Eurozone as a whole of relieving Ireland's debt burden.

Following a default, Ireland would, according to experience, have no more access to external financing and should consequently, even in a monetary union, exclusively rely on its own resources to finance its expenditures; this could mean a drastic contraction of internal demand.

Default is unlikely only because investors would not benevolently accept the Irish government as being better off after default and the Irish government has no incentive to choose an even harder road.

Viewed with the interest of financial stability in the Eurozone in mind, organized default is definitely not an attractive option for European policymakers and would probably lead to chaos in the European banking sector with systemic risks to the global economy.

Ireland still faces a 10-year bond yield of between 7-8%. Unless this soon comes down, Ireland will be caught in an austerity trap for many years to come. Faced with year after year of economic pain, default looks more likely. Therefore the default scenario can’t be ruled out especially if Greece defaults.

Scenario 2 Restructuring

If an Irish default is to be avoided, debt restructuring needs to happen. The key question is over who should take the pain and shoulder the restructuring costs. The Fine Gael and Labour government have to address the deep anger that has led to the astonishing collapse in support for Fianna Fail during the February 2011 election.

A well thought out restructuring is legally feasible and economically necessary now. Debt restructuring would allow Ireland to reduce their debt. Debt restructuring also has to be accompanied by measures to avoid contagion. This is the issue that needs to be addressed immediately. Otherwise, there is something far worse than a debt restructure: the commencement of a successive elimination of countries from the Eurozone that will give rise to considerable levels of speculation in the money markets as to who comes next and when.

A debt restructuring plan for Ireland would need to be drawn up and implemented. A significant portion of the current debt would be written-off, to enable Ireland to have some chance of attaining solvency. All lenders, private sector banks and investors as well as official lenders, must bear the losses. Debt restructuring should entail lengthening the maturity of debt and renegotiating terms to try to ensure the ability to service the debt.

The debts incurred by German, UK and French banks because they gambled in the peripheral states like Ireland can only be paid by four sets of people or institutions.

They can be paid by (1) the ECB, (2) the bank creditors themselves – the bondholders, (3) the citizens of the peripheral countries where the banks who owe the money are located or (4) the citizens of the core countries where the banks who are owed the money are located. Now that the EU leadership has ruled out options (1) and (2), it means that only options (3) and (4) are possible.

They have forced Irish citizens to pay the debts of the core banks, which has already disposed of Fianna Fail as a major force in Irish politics for the time being and will cause severe difficulties for Fianna Gael and Labour Fail. The Irish citizens also now direct their anger at the EU/Eurozone policymakers. If the EU forces the citizens of the core countries like Germany to pay for their own banks they will also question the benefits of the EU and the Euro. Both outcomes would be bad for the EU/Eurozone project, so therefore only options (1) and (2) are good for EU taxpayers and citizens.

The optimal solution for the Eurozone crisis is that Ireland's debts would be reduced solely by the losses of private investors namely debt restructuring. The ECB and some banks would need assistance in this case.

While the European Central Bank and the European Financial Stability Facility are important in buying time for the Eurozone they lack the financial muscle required to safeguard the Euro's future. Germany will have to announce measures to support their banks, as required, to prevent losses on sovereign bond holdings from setting off a European banking crisis. Governments would stand ready to subscribe capital to banks or guarantee bank deposits and borrowing. The ECB itself, which is heavily exposed to the peripheral economies, may itself require recapitalisation and financial support. In the absence of decisive action there is a serious risk of rapid deterioration in financial conditions. This would create a domino effect on countries like Ireland making any recovery near impossible. It would also affect Spain and Italy and it would affect the stronger countries like Germany, France, UK and the Netherlands.

Ireland unfortunately has only indirectly been addressed through the interest rate reduction on loan packages decided on by the special Eurozone summit of July 21st, 2011. The Eurozone will need to move ahead with a better overall strategy for the long term. There is a deep seated scepticism among the financial market participants that the Eurozone policymakers will be able to move quickly with policy prescriptions for the ongoing crisis. They are seen as reactive, lacking a proactive approach to overcome the current difficulties.

If EU/Eurozone leaders are smart, they will understand that the turmoil they fear from an Irish restructuring will be much worse if that default is a unilateral one forced by a population that has taken to the streets. This crisis will also hit the US financial services firms who have sold European banks credit-default swaps (CDSs), which are essentially insurance policies against a default.

That leaves a Brady-like plan as the best policy. The original Brady plan in 1989 had Latin American countries undertake economic reforms in return for loans with which to buy US Treasuries. These were used as collateral for Brady bonds: securities offered in exchange for loans they could no longer service. The banks faced a choice of bonds, some with haircuts, and others with the principal intact but longer maturities. Debtors secured lighter payment schedules, while creditors were compensated with more liquid and secure assets than before. The European Union/Eurozone needs a plan with the same two objectives as the Brady Plan: 1) reduce the debt overhang of the periphery sovereigns; and 2) bolster the balance sheets of the banks and preserve their capital by controlling the form and magnitude of losses that they will have to realize.[4]

Another option would adopt a federal approach to all sovereign borrowing in the Eurozone under a joint guarantee from all Eurozone members. A more limited approach, first suggested by Daniel Gros at the Centre for European Policy Studies and Thomas Mayer at Deutsche Bank, would be to allow the EFSF to leverage its current resources and vastly expand its lending capacity by allowing it to borrow from the ECB. All these proposals imply new mechanisms to discipline the economic policy behaviour of individual member states and mitigate the moral hazard inherent in any pooled borrowing scheme.[5]

The recent German Constitutional Court ruling has added to the German government position that Eurobonds are not viable by warning that Germany should not assume other countries' liabilities. The German Constitutional Court also seems to suggest that joint debt in the Eurozone could be constitutionally allowed if it involved a stronger German say over other member states' fiscal policies. The full implications of the ruling, however, still remain unclear.

The Restructuring scenario is very likely especially if there is a Greek default and a continuing downturn in the global economy. There would be a need for a significant haircut of 40-60% before early 2012 to give a real chance of a sustainable recovery.

Conclusions

The Eurozone's problems are not merely the result of profligate borrowing by the peripheral nations. They also reflect earlier profligate lending by the core nations. Imposing austerity on Ireland or Greece cannot, on its own, solve the Eurozone's problems.

At heart, the "Eurozone crisis" is a battle over who will ultimately be liable for the billions actual and potential Euro losses by European financial institutions. The EU/ECB/IMF had initially decided that bank bondholders must be protected at all costs, preferring to impose losses on taxpayers instead – even if this stretches governments' solvency to breaking point. Because voters' tolerance for bank bailouts has worn thin,

[4] Financial Times Editorial, "A Brady plan to end Europe's crisis", 4 July 2011
[5] Daniel Gros and Thomas Mayer, "Disciplinary measures", Economist, 18 February 2010

governments are acting covertly: lending huge sums to Greece, Ireland and Portugal so that they can repay German, French and UK banks in full. The best solution economically would be a restructuring of debt of peripheral debt and a recapitalisation of the German, French and UK banks. The problem is the potential political fallout from such an action.

The EU/ECB/IMF policy is inviting a populist backlash which is already occurring in Greece. They weakened support for both the Euro and the EU. And by guaranteeing banks' debts, all EU governments risked their credibility and ultimately their solvency.

The ECB played a very obstructive role in preventing any effective restructuring of private creditors. This strengthened the "hostage taking" of the political authorities. At times, ECB board members gave the impression of being themselves captured by the financial elite of their home country. The ECB severely damaged its own reputation by siding so strongly with creditors and bankers rather than defending Europe's taxpayers and citizens. Private sector creditors must share the burden of sovereign debt restructuring without that it seems inconceivable their debt burdens can be lowered to solvency-consistent levels.[6]

On 8 September 2011 Jean-Claude Trichet vented his anger at German critics of the European Central Bank's handling of the Eurozone debt crisis, saying governments had failed to shoulder their own responsibilities and his bank deserved more praise for combating inflation. The following day Juergen Stark resigns as chief economist at the European Central Bank which clearly indicates that there is tension within the bank between traditionally Bundesbank views and current European Central Bank policy on bond purchases.

On top of the Eurozone crises, the US debt crisis will almost certainly be a serious issue for Ireland as the US is the largest Foreign Direct Investor. The shock caused by a possible worsening of the US debt crisis would have serious consequences for Ireland, Germany, the Eurozone and the global economy. A Greek default is unavoidable and there is a need for a plan for an orderly process towards a real private sector burden sharing plan which may be the best option to prevent further contagion.

The Eurozone prescription of austerity without restructuring debt has failed in Greece and will fail in Ireland and will only serve to plunge the Irish economy into recession. The road map for Ireland therefore is a significant haircut of 40-60% before early 2012 to give Ireland a real chance of recovery.

[6] Harald Hau, "Europe's €200 billion reverse wealth tax explained", 27 July 2011, VOXEU