

Coalition strategy may give us safety net we need

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OPINION: What should we take away from Morgan Kelly's article and Central Bank governor Patrick Honohan's response?

THERE ARE two parts to this debate. First, there is a dispute about the historical path by which Ireland has arrived at its current situation. Second, there is a forward-looking component about the correct strategy in dealing with Ireland's precarious financial situation.

In relation to the historical dimension, Morgan Kelly argues in his Irish Times piece (Ireland's future depends on breaking free from bailout, Opinion and Analysis, May 7th) that the last government should have rescinded the legal guarantee it provided for bank liabilities between October 2008 and September 2010, thereby allowing a much greater role for bank bondholders in absorbing losses before the majority of these bank bonds were redeemed. Furthermore, he postulates that the March 2010 underestimate by the Central Bank of projected bank losses was pivotal in persuading the government not to rescind the guarantee.

Are these points persuasive?

The fiscal commitment to the banking sector rose from €33 billion at the end of March 2010 to €45 billion at the end of September 2010 as a result of the upward revision of projected bank losses in summer 2010 following the second tranche of Nama transfers and the self-assessment by the new management team at Anglo Irish Bank of higher loss provisions on its non-Nama loan book.

In his Sunday radio interview on RTÉ, Central Bank governor Patrick Honohan argued that there would have been no change in strategy had the higher level of subsequent fiscal commitments been known at an earlier date (whether the €45 billion end-September number or the €65 billion number that emerged from the March 2011 stress tests), or had the Central Bank insisted in March 2010 on extra buffer capital to guard against downside risks. Rather, the main difference would have been that the EU-IMF bailout might have been triggered in spring 2010, rather than autumn 2010. Indeed, the relative merits of an earlier bailout (at that time, or even a pre-emptive move earlier in the crisis timeline) is sure to be hotly debated by future financial historians.

Was the upward revision in projected bank losses the pivotal event, either for the government's strategy or for market confidence in the Irish government and the Irish banks?

In relation to the sovereign bond market, the Irish-German spread on 10-year bonds actually fell in the first half of October after the end-September announcement of the extra bank provisions. Rather, the final upward spiral in the spread really began with the fateful Deauville meeting between German chancellor Angela Merkel and French president Nicolas Sarkozy on October 18th. The tougher line regarding post-2013 bondholders that emerged from that meeting shocked the sovereign debt markets and the spread climbed rapidly in the second half of October and early November, crossing the five-percentage-point mark on November 4th. The momentum for a bailout grew rapidly in the subsequent two weeks.

The upward revision in projected bank losses surely contributed to the lack of market confidence in the health of the Irish banking system, which resulted in the exit of private wholesale funding from the Irish banks upon the expiry of the guarantee at the end of September 2010.

However, even here, it is not clear that the upward revision in bank losses was the key factor in the loss of wholesale funding. Rather, the general deterioration in the economy and in the sovereign rating of the Irish government in the two years after September 2008 meant that many wholesale investors who had been willing to commit funding under the original sovereign guarantee would no longer have wished to maintain an exposure to the Irish banking system even at the level of losses projected in March 2010.

Finally, the gap between the March and September estimates seriously weakened the credibility of the Central Bank, which has now been partly restored by the broad similarity between the views of the external assessors and the domestic authorities in the March 2011 stress tests.

IN RELATION TO the banking system, the key event prompting the bailout was the replacement of exiting private bond investors by ECB liquidity funding. The scale of this liquidity support was of great concern to the ECB in view of the credit risk it faced in providing so much funding to a banking system that had many troubled assets, excessive reliance on non-deposit funding and was backed by a government with a vulnerable fiscal position.

Accordingly, Ireland faced a twin funding problem in November 2010. While the government may not have faced an immediate funding gap, there was no sign that the high sovereign spread would have gone into reverse by summer 2011 when its cash reserves would have been depleted. The more pressing problem was the total dependence of the banking system on ECB funding, which would only be maintained if the ECB could be satisfied that this dependency would diminish over time, through bank recapitalisation, deleveraging and restructuring and an improvement in the fiscal health of the Irish government that was the effective guarantor for so much of the collateral offered by the Irish banks under the various liquidity schemes.

It is certainly true that the financial health of the Irish banks and the Irish State could have been substantially improved if the unguaranteed senior bank bonds could have been written down without too many negative side effects. Moreover, the potential financial gain could have been far bigger again if the bank bond guarantee could have been unpicked in a way that successfully avoided a destabilising outcome.

It is on this set of issues that there is the greatest divergence of views across policymakers, academics and financial-sector economists. As indicated in recent work by the European Commission, there is an openness to imposing losses on senior bank bondholders in the context of future crises, with the terms of such bond contracts reworked to allow for this possibility. However, there is a reluctance at the ECB, some key national governments in Europe and, it seems, the US treasury to impose losses on senior bondholders during the current crisis, for fear that it could lead to a widespread disruption in global credit markets.

This hypothesis can be challenged. Many take the opposite view that the credit markets could absorb losses on senior bonds in the context of disaster banks that have losses far in excess of pre-crisis capital levels. Countries such as Ireland who bear the full cost of avoiding the risk of such widespread credit-market disruption have a strong interest in challenging this hypothesis.

SO, WHY HAVE the current and previous Irish governments ultimately accepted that losses on senior bondholders cannot be unilaterally imposed under prevailing conditions? Most important, the ongoing heavy reliance of the Irish banking system on ECB liquidity support means that the consent of the ECB and European governments is essentially required if the imposition of losses on senior bondholders is to be smoothly achieved.

It is certainly plausible that the ECB might continue funding the Irish banking system even if the Government were to impose unilaterally losses on senior bondholders. However, the terms of liquidity provision could be considerably more expensive than the current generous terms, which take into account the Government's limited fiscal capacity and its co-operation in preserving European financial stability. In turn, tighter liquidity conditions would considerably diminish the net financial gain from unilaterally imposing losses on senior bondholders.

As indicated, the savings from imposing losses on guaranteed bank bonds could be even greater. This would be even more true had this occurred before so many bonds were redeemed before September 2010.

In terms of a hierarchy, it is plausible that renegeing on sovereign-guaranteed bank bonds would be less costly than a direct default on government bonds and that this distinction would be recognised in any future debt restructuring.

However, this is a matter of degree and the economic disruptions associated with even this type of limited default could be substantial.

At the least, the closer connection between guaranteed senior bank bonds and sovereign debt than between unguaranteed senior bank bonds and sovereign debt is a reminder of the cost of the overly extensive nature of the blanket guarantee that was introduced in September 2008.

It is possible to take different views on the best strategy in managing the debt situation – there are many types of risks associated with each candidate strategy and judgments will differ as to the correct balance in risk management. In terms of the liabilities of the banking system, the Government has essentially opted to replace private bondholders with funding from the ECB.

Similarly, in relation to the sovereign debt, the bailout means that the European official sector will increasingly be the main creditor.

IN TERMS OF future sustainability, this strategy holds that it will be easier to design more flexible repayment terms with a set of official creditors that have a big stake in the recovery of the Irish economy and in preserving European financial stability rather than with a diffuse set of private bondholders.

Ireland's general standing with its European partners and its bargaining power in relation to both sovereign debt and bank liabilities would indeed be considerably improved if the Government no longer

needed to borrow to fund its activities and if the Irish banking system were sufficiently deleveraged that domestic deposits largely covered its loan book. The new banking plan is projected to get the Irish banks to low loan-deposit ratios by 2014, while the primary fiscal balance is also scheduled to be in surplus by 2014.

It is certainly arguable that the projected pace of fiscal consolidation is too slow. However, an immediate closing of the fiscal deficit would send Ireland into a new and deeper recession, while also having a dramatic impact on the banking system, in view of the high debt levels among households and small businesses. It is for these macroeconomic reasons (and not the protection of highly paid upper-level public sector workers) that the troika has agreed to a drawn-out fiscal adjustment process, in which steady expansion in the export sector offsets the negative fiscal drag on the domestic sector and private sector debt sustainability is supported by a gradual pace of adjustment.

In summary, Ireland is on a financial tightrope. The Government's strategy is to lobby for a more robust European safety net, in case negative shocks make it infeasible to deliver on projected targets. This approach is predicated on the commitment among our European partners to ensure that Ireland will successfully emerge from the current dire situation. This commitment is reinforced by the fact that the euro zone crisis is fundamentally different to previous sovereign and banking crises by virtue of the enhanced joint interest between creditors and debtors in preserving area-wide financial stability and in the capacity of the ECB to provide additional resolution mechanisms.

Morgan Kelly advocates a different approach, by which Ireland adopts a more unilateral approach to addressing the crisis. As currently presented, it seems to me that he understates the ultimate potential gains to the current official strategy, while also underestimating the potential costs of his alternative approach.

Still, the chronic nature of this crisis means this debate is sure to continue for several years.

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