

Ireland's future depends on breaking free from bailout

Sat, May 07, 2011

OPINION: Ireland is heading for bankruptcy, which would be catastrophic for a country that trades on its reputation as a safe place to do business, writes **MORGAN KELLY**

WITH THE Irish Government on track to owe a quarter of a trillion euro by 2014, a prolonged and chaotic national bankruptcy is becoming inevitable. By the time the dust settles, Ireland's last remaining asset, its reputation as a safe place from which to conduct business, will have been destroyed.

Ireland is facing economic ruin.

While most people would trace our ruin to to the bank guarantee of September 2008, the real error was in sticking with the guarantee long after it had become clear that the bank losses were insupportable. Brian Lenihan's original decision to guarantee most of the bonds of Irish banks was a mistake, but a mistake so obvious and so ridiculous that it could easily have been reversed. The ideal time to have reversed the bank guarantee was a few months later when Patrick Honohan was appointed governor of the Central Bank and assumed de facto control of Irish economic policy.

As a respected academic expert on banking crises, Honohan commanded the international authority to have announced that the guarantee had been made in haste and with poor information, and would be replaced by a restructuring where bonds in the banks would be swapped for shares.

Instead, Honohan seemed unperturbed by the possible scale of bank losses, repeatedly insisting that they were "manageable". Like most Irish economists of his generation, he appeared to believe that Ireland was still the export-driven powerhouse of the 1990s, rather than the credit-fuelled Ponzi scheme it had become since 2000; and the banking crisis no worse than the, largely manufactured, government budget crisis of the late 1980s.

Rising dismay at Honohan's judgment crystallised into outright scepticism after an extraordinary interview with Bloomberg business news on May 28th last year. Having overseen the Central Bank's "quite aggressive" stress tests of the Irish banks, he assured them that he would have "the two big banks, fixed by the end of the year. I think it's quite good news The banks are floating away from dependence on the State and will be free standing".

Honohan's miscalculation of the bank losses has turned out to be the costliest mistake ever made by an Irish person. Armed with Honohan's assurances that the bank losses were manageable, the Irish government confidently rode into the Little Bighorn and repaid the bank bondholders, even those who had not been guaranteed under the original scheme. This suicidal policy culminated in the repayment of most of the outstanding bonds last September.

Disaster followed within weeks. Nobody would lend to Irish banks, so that the maturing bonds were repaid largely by emergency borrowing from the European Central Bank: by November the Irish banks already owed more than €60 billion. Despite aggressive cuts in government spending, the certainty that bank losses would far exceed Honohan's estimates led financial markets to stop lending to Ireland.

On November 16th, European finance ministers urged Lenihan to accept a bailout to stop the panic spreading to Spain and Portugal, but he refused, arguing that the Irish government was funded until the following summer. Although attacked by the Irish media for this seemingly delusional behaviour, Lenihan, for once, was doing precisely the right thing. Behind Lenihan's refusal lay the thinly veiled threat that, unless given suitably generous terms, Ireland could hold happily its breath for long enough that Spain and Portugal, who needed to borrow every month, would drown.

At this stage, with Lenihan looking set to exploit his strong negotiating position to seek a bailout of the banks only, Honohan intervened. As well as being Ireland's chief economic adviser, he also plays for the opposing team as a member of the council of the European Central Bank, whose decisions he is bound to carry out. In Frankfurt for the monthly meeting of the ECB on November 18th, Honohan announced on RTÉ Radio 1's Morning Ireland that Ireland would need a bailout of "tens of billions".

Rarely has a finance minister been so deftly sliced off at the ankles by his central bank governor. And so the Honohan Doctrine that bank losses could and should be repaid by Irish taxpayers ran its predictable course with the financial collapse and international bailout of the Irish State.

Ireland's Last Stand began less shambolically than you might expect. The IMF, which believes that lenders should pay for their stupidity before it has to reach into its pocket, presented the Irish with a plan to haircut €30 billion of unguaranteed bonds by two-thirds on average. Lenihan was overjoyed, according to a source who was there, telling the IMF team: "You are Ireland's salvation."

The deal was torpedoed from an unexpected direction. At a conference call with the G7 finance ministers, the haircut was vetoed by US treasury secretary Timothy Geithner who, as his payment of \$13 billion from government-owned AIG to Goldman Sachs showed, believes that bankers take priority over taxpayers. The only one to speak up for the Irish was UK chancellor George Osborne, but Geithner, as always, got his way. An instructive, if painful, lesson in the extent of US soft power, and in who our friends really are.

The negotiations went downhill from there. On one side was the European Central Bank, unabashedly representing Ireland's creditors and insisting on full repayment of bank bonds. On

the other was the IMF, arguing that Irish taxpayers would be doing well to balance their government's books, let alone repay the losses of private banks. And the Irish? On the side of the ECB, naturally.

In the circumstances, the ECB walked away with everything it wanted. The IMF were scathing of the Irish performance, with one staffer describing the eagerness of some Irish negotiators to side with the ECB as displaying strong elements of Stockholm Syndrome.

The bailout represents almost as much of a scandal for the IMF as it does for Ireland. The IMF found itself outmanoeuvred by ECB negotiators, their low opinion of whom they are not at pains to conceal. More importantly, the IMF was forced by the obduracy of Geithner and the spinelessness, or worse, of the Irish to lend their imprimatur, and €30 billion of their capital, to a deal that its negotiators privately admit will end in Irish bankruptcy. Lending to an insolvent state, which has no hope of reducing its debt enough to borrow in markets again, breaches the most fundamental rule of the IMF, and a heated debate continues there over the legality of the Irish deal.

Six months on, and with Irish government debt rated one notch above junk and the run on Irish banks starting to spread to household deposits, it might appear that the Irish bailout of last November has already ended in abject failure. On the contrary, as far as its ECB architects are concerned, the bailout has turned out to be an unqualified success.

The one thing you need to understand about the Irish bailout is that it had nothing to do with repairing Ireland's finances enough to allow the Irish Government to start borrowing again in the bond markets at reasonable rates: what people ordinarily think of a bailout as doing.

The finances of the Irish Government are like a bucket with a large hole in the form of the banking system. While any half-serious rescue would have focused on plugging this hole, the agreed bailout ostentatiously ignored the banks, except for reiterating the ECB-Honohan view that their losses would be borne by Irish taxpayers. Try to imagine the Bank of England's insisting that Northern Rock be rescued by Newcastle City Council and you have some idea of how seriously the ECB expects the Irish bailout to work.

Instead, the sole purpose of the Irish bailout was to frighten the Spanish into line with a vivid demonstration that EU rescues are not for the faint-hearted. And the ECB plan, so far anyway, has worked. Given a choice between being strung up like Ireland – an object of international ridicule, paying exorbitant rates on bailout funds, its government ministers answerable to a Hungarian university lecturer – or mending their ways, the Spanish have understandably chosen the latter.

But why was it necessary, or at least expedient, for the EU to force an economic collapse on Ireland to frighten Spain? The answer goes back to a fundamental, and potentially fatal, flaw in the design of the euro zone: the lack of any means of dealing with large, insolvent banks.

Back when the euro was being planned in the mid-1990s, it never occurred to anyone that cautious, stodgy banks like AIB and Bank of Ireland, run by faintly dim former rugby players,

could ever borrow tens of billions overseas, and lose it all on dodgy property loans. Had the collapse been limited to Irish banks, some sort of rescue deal might have been cobbled together; but a suspicion lingers that many Spanish banks – which inflated a property bubble almost as exuberant as Ireland's, but in the world's ninth largest economy – are hiding losses as large as those that sank their Irish counterparts.

Uniquely in the world, the European Central Bank has no central government standing behind it that can levy taxes. To rescue a banking system as large as Spain's would require a massive commitment of resources by European countries to a European Monetary Fund: something so politically complex and financially costly that it will only be considered in extremis, to avert the collapse of the euro zone. It is easiest for now for the ECB to keep its fingers crossed that Spain pulls through by itself, encouraged by the example made of the Irish.

Irish insolvency is now less a matter of economics than of arithmetic. If everything goes according to plan, as it always does, Ireland's government debt will top €190 billion by 2014, with another €45 billion in 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, Namawinelake (by far the best source on the Irish economy) reckons our final debt will be about €220 billion, and I think it will be closer to €250 billion, but these 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 GNP.

Economists have a rule of thumb that once its national debt exceeds its national income, a small economy is in danger of default (large economies, like Japan, can go considerably higher). Ireland is so far into the red zone that marginal changes in the bailout terms can make no difference: we are going to be in the Hudson.

The ECB applauded and lent Ireland the money to ensure that the banks that lent to Anglo and Nationwide be repaid, and now finds itself in the situation where, as a consequence, the banks that lent to the Irish Government are at risk of losing most of what they lent. In other words, the Irish banking crisis has become part of the larger European sovereign debt crisis.

Given the political paralysis in the EU, and a European Central Bank that sees its main task as placating the editors of German tabloids, the most likely outcome of the European debt crisis is that, after two years or so to allow French and German banks to build up loss reserves, the insolvent economies will be forced into some sort of bankruptcy.

Make no mistake: while government defaults are almost the normal state of affairs in places like Greece and Argentina, for a country like Ireland that trades on its reputation as a safe place to do business, a bankruptcy would be catastrophic. Sovereign bankruptcies drag on for years as creditors hold out for better terms, or sell to so-called vulture funds that engage in endless litigation overseas to have national assets such as aircraft impounded in the hope that they can make a sufficient nuisance of themselves to be bought off.

Worse still, a bankruptcy can do nothing to repair Ireland's finances. Given the other commitments of the Irish State (to the banks, Nama, EU, ECB and IMF), for a bankruptcy to

return government debt to a sustainable level, the holders of regular government bonds will have to be more or less wiped out. Unfortunately, most Irish government bonds are held by Irish banks and insurance companies.

In other words, we have embarked on a futile game of passing the parcel of insolvency: first from the banks to the Irish State, and next from the State back to the banks and insurance companies. The eventual outcome will likely see Ireland as some sort of EU protectorate, Europe's answer to Puerto Rico.

Suppose that we did not want to follow our current path towards an ECB-directed bankruptcy and spiralling national ruin, is there anything we could do? While Prof Honohan sportingly threw away our best cards last September, there still is a way out that, while not painless, is considerably less painful than what Europe has in mind for us.

National survival requires that Ireland walk away from the bailout. This in turn requires the Government to do two things: disengage from the banks, and bring its budget into balance immediately.

First the banks. While the ECB does not want to rescue the Irish banks, it cannot let them collapse either and start a wave of panic that sweeps across Europe. So, every time one of you expresses your approval of the Irish banks by moving your savings to a foreign-owned bank, the Irish bank goes and replaces your money with emergency borrowing from the ECB or the Irish Central Bank. Their current borrowings are €160 billion.

The original bailout plan was that the loan portfolios of Irish banks would be sold off to repay these borrowings. However, foreign banks know that many of these loans, mortgages especially, will eventually default, and were not interested. As a result, the ECB finds itself with the Irish banks wedged uncomfortably far up its fundament, and no way of dislodging them.

This allows Ireland to walk away from the banking system by returning the Nama assets to the banks, and withdrawing its promissory notes in the banks. The ECB can then learn the basic economic truth that if you lend €160 billion to insolvent banks backed by an insolvent state, you are no longer a creditor: you are the owner. At some stage the ECB can take out an eraser and, where "Emergency Loan" is written in the accounts of Irish banks, write "Capital" instead. When it chooses to do so is its problem, not ours.

At a stroke, the Irish Government can halve its debt to a survivable €110 billion. The ECB can do nothing to the Irish banks in retaliation without triggering a catastrophic panic in Spain and across the rest of Europe. The only way Europe can respond is by cutting off funding to the Irish Government.

So the second strand of national survival is to bring the Government budget immediately into balance. The reason for governments to run deficits in recessions is to smooth out temporary dips in economic activity. However, our current slump is not temporary: Ireland bet everything that house prices would rise forever, and lost. To borrow so that senior civil servants like me can

continue to enjoy salaries twice as much as our European counterparts makes no sense, macroeconomic or otherwise.

Cutting Government borrowing to zero immediately is not painless but it is the only way of disentangling ourselves from the loan sharks who are intent on making an example of us. In contrast, the new Government's current policy of lying on the ground with a begging bowl and hoping that someone takes pity on us does not make for a particularly strong negotiating position. By bringing our budget immediately into balance, we focus attention on the fact that Ireland's problems stem almost entirely from the activities of six privately owned banks, while freeing ourselves to walk away from these poisonous institutions. Just as importantly, it sends a signal to the rest of the world that Ireland – which 20 years ago showed how a small country could drag itself out of poverty through the energy and hard work of its inhabitants, but has since fallen among thieves and their political fixers – is back and means business.

Of course, we all know that this will never happen. Irish politicians are too used to being rewarded by Brussels to start fighting against it, even if it is a matter of national survival. It is easier to be led along blindfold until the noose is slipped around our necks and we are kicked through the trapdoor into bankruptcy.

The destruction wrought by the bankruptcy will not just be economic but political. Just as the Lenihan bailout destroyed Fianna Fáil, so the Noonan bankruptcy will destroy Fine Gael and Labour, leaving them as reviled and mistrusted as their predecessors. And that will leave Ireland in the interesting situation where the economic crisis has chewed up and spat out all of the State's constitutional parties. The last election was reassuringly dull and predictable but the next, after the trauma and chaos of the bankruptcy, will be anything but.

Morgan Kelly is professor of economics at University College Dublin

© 2011 The Irish Times