Rescued?

The announcement that Ireland is accessing an EU-IMF “rescue plan” is a damning indictment of the government’s banking policies of recent years. In the space of just over two years, the government has shifted from claims that the banks were fully solvent and that the state guarantee was the world’s cheapest banking bailout to Brian Lenihan’s frank admission that the banks were too big a problem for the country to solve on its own.

We have also gone from a position where, only a few weeks ago, it was widely believed that the state had enough money to fund itself through until next summer to an agreement to use funds from the EU and IMF to fund the state over the next three years. How exactly this swift change of position came about has not been well explained to the Irish public.

The trigger mechanism for the bailout talks appears to have worked as follows. Because the original Irish liability guarantee ran out at the end of September, the Irish banks had a large amount of bond funding that matured in September as well as many corporate deposits with terms set to run up to the end of the guarantee. The banks failed to obtain new bond market funding and turned to borrowing from the ECB, and in some cases where banks had run out of eligible collateral for ECB loans, to the Irish Central Bank for emergency liquidity loans underwritten by the Irish state.

It appears that during November, the ECB decided that its exposure to the Irish banks had grown to an unsustainable level (€90 billion to the domestic banking group and about €30 billion in emergency liquidity assistance from the Irish Central Bank). At this point, the ECB directed the government to access a bailout in order to fix the Irish banks once and for all. With the banking system so reliant on ECB support, the government seem to have had little choice but to comply. And with the ECB still providing large amounts of liquidity to the banks, there has been a reluctance from the government to publicly complain about the ECB’s role in pushing Ireland towards seeking external assistance.

So, have we been rescued by this plan? There are plenty of reasons to believe that we have not.

On the banking side, the details of the plan released at the time of writing include a long list of vague statements about restructuring and deleveraging. However, despite the promise of an introduction of a special legislative regime to deal with distressed banks, there is little sign that there will be burden-sharing with senior bond holders of even grossly insolvent banks such as Anglo or Irish Nationwide.

The Taoiseach has said that this was a decision of the European arm of the rescue team but I have not seen anything legally binding in the agreement requiring the Irish government to continue bailing out bondholders at insolvent banks. Getting subordinated bondholders to accept their part in the losses is also being complicated by the apparent plan to first put in large amounts of state money in the form of equity to take losses ahead of bondholders.

If we are not going to get any sharing of losses with bank bondholders, then we should at least hope that the main Irish banks will be re-organised and sold to well-funded outsiders as quickly as possible.

This would most likely require our government to provide insurance on their loan books so that unforeseen losses still end up costing the Irish taxpayer, with funding provided by the EU and the IMF. But at least the economy would then be better served by having banks that make lending decisions on the basis of the commercial merits of borrowers, rather than restricting credit to raise capital ratios in the hope of avoiding nationalisation, as we have seen over the past two years. Of course, in light of the misguided and poorly-executed nature of the banking policies that we have seen thus far, hoping for a rapid and efficient solution of this sort may be wishful thinking.

What about fiscal policy? Here, we have even less reason to feel rescued. The average interest rate of 5.8% offered by our external rescuers is about the same as seen in the bond market in September and, at that time, there were serious concerns about the sustainability of borrowing at such an interest rate. That the rate is lower than what would be on offer now from the bond market is cold comfort.

The structure of the adjustment is also somewhat harsher than is necessary. I had argued in recent months for a sharply front-loaded adjustment to get the deficit below ten percent in a bid to restore access to the sovereign bond market. With this target now beyond us, there was a strong case for a smoother adjustment that would have been less disruptive to growth in 2011.

Finally, where do we stand in relation to the sustainability of our debt burden? Ireland seems likely to have a debt-GDP ratio of over 110% in 2014. By that time, Europe may have agreed on how to implement sovereign default procedures for Eurozone countries with Greece as the likely first test case. It is easy to imagine a scenario in which sovereign debt markets still refuse to lend to Ireland even if it has succeeded in reducing its deficit. The high yield on our sovereign bonds trading in the secondary markets suggests that eventual default is viewed as likely by those with money to invest.

We may have been rescued from the wolves. However, it is open for debate whether our rescuers are planning to feed us to the lions.