

Opening Remarks of Prof. Karl Whelan (University College Dublin) at Oireachtas Committee on Finance, Public Expenditure and Reform, February 15, 2012

There are a large number of technical issues relating to today's topic. I have circulated a detailed paper to the committee and will be happy to take questions on any of the issues covered. In my opening remarks, I want to focus on the key policy issues, which are not really so complicated. First, I want to briefly describe the balance sheet of the Irish Bank Resolution Corporation (IBRC). Second, I want to describe what ELA is and the role played by the ECB. Finally, I will discuss some ideas relating to restructuring the promissory notes.

It is well known that the Irish state has taken on huge debts by taking over the liabilities of the two institutions that make up the IBRC. Many of these debts were owed to unsecured bondholders and, for this reason a lot of commentary still focuses on the idea that the Irish government should change its policy in relation to payment of unsecured IBRC bondholders.

It is worth stressing, however, that the amount of unguaranteed unsecured IBRC bondholders remaining is small (less than €1 billion) when compared with the total debts of the organisation. Instead, I estimate that the vast majority of the IBRC's debt (about €42 billion as of a few months ago) take the form of so-called Exceptional Liquidity Assistance (ELA) loans provided by the Central Bank of Ireland. This is assistance provided to banks that need liquidity support but which do not have the type of collateral that is eligible for borrowing in regular Eurosystem operations.

The IBRC has two principal types of assets: Its loans to customers and its promissory notes from the Irish government which are currently scheduled to provide a series of payments over the next 20 years. It is important to stress that without the promissory notes, the IBRC would have sufficient assets to pay off all of its deposits, its bondholders, its Eurosystem borrowings and about one-third of its ELA debts. Effectively, one can say that the promissory notes only exist to pay off the ELA debts to the Central Bank of Ireland.

There have been two areas of confusion in relation to these ELA debts.

The first relates to the role of the ECB. I have provided a full description in my briefing of the mechanics of the issuance and repayment of ELA and would be happy to take questions on this later. However, for now I want to note that it is not the case, as has been reported in various media stories, that the ELA funds have been borrowed from the ECB. Rather, like all Eurosystem monetary operations, it is created by the relevant national country central bank.

The role played by the European authorities relates to the fact that central bank lending to insolvent institutions runs counter to the "monetary financing" prohibition in the European Treaty and also that the ECB Governing Council can stop the ELA programme if two thirds of its members vote that it interferes with the ECB's objectives.

In practice, this means that the ELA programme and all matters relating to the solvency of the IBRC are under constant review by the Governing Council. Indeed, the payment structure for the promissory note effectively represents an implicit long-term timetable for ELA repayment

The second area of confusion relates to what happens when ELA is repaid. Because ELA repayment goes from one public body, the IBRC, to another, the Central Bank of Ireland, some have concluded

that these transactions are completely circular and have no net cost to the state. The reality is less attractive. When the IBRC repays its ELA debts, the money that was created when the ELA loans were made is simply taken out of circulation. Effectively, it is as if it is being burned: There is no hidden benefit to the Irish state from these repayments.

For these reasons, the promissory note payments of €3.1 billion, or two percent of GDP, per year represent a heavy financing burden for the Irish state in coming years and any restructuring of these notes to lighten the payment structure would be welcome.

Most of the public discussion of the idea of restructuring the notes has focused on the high average interest rate that the notes carry: Many have noted that the total amount of payments on the notes out to 2031 run to €48 billion, which is €17 billion more than the original principal.

In fact, reducing this interest rate will have little impact on the long-run cost of the IBRC to the Irish public. Once the IBRC has repaid its ELA debts, it can be wound down and the notes cancelled. By my estimates, the current schedule would see the IBRC wound down in 2022 after €37 billion in payments had been made. And much of the gap between this €37 billion and the initial €31 billion principal will represent profits for the Central Bank of Ireland that can be returned to the Exchequer.

That said, while reducing the interest rate on the notes is of little longer-term benefit, there is a shorter-term benefit because the current structure of the notes sees Eurostat counting €1.8 billion on the general government deficit in 2014. I believe the high interest rate on the note—which effectively involves marking the notes to market—is unnecessary for maintaining the technical solvency of the IBRC and that the notes should be restructured with a low interest rate, held to maturity and recorded at face value. This would avoid having to make unnecessary spending cuts and tax increases to keep this official level of the deficit on target.

A more effective way to restructure the notes is to simply defer all payments for some number of years. For instance, payments could be delayed until nominal GDP has recovered its pre-crisis peak. Alternatively, payments could be deferred until the IBRC has used up all its non-promissory assets. Thus, IBRC could continue to repay ELA out of its other assets, with promissory note payments only commencing when these are exhausted.

It is likely that some members of the ECB Governing Council will object to any proposal to defer these payments, seeing it as setting a bad precedent so that other countries will also wish to use ELA and then defer its repayment. They also likely see the slow repayment of the ELA money that was created as a weakening of their commitment to low inflation. In truth, there is no slippery slope here: The ECB supported the Irish ELA programme but has no need to support any programmes that it does not see as supporting financial stability. And Eurozone money growth remains very low: There is no inflationary genie about to get out of the bottle.

Any steps that can be taken to hasten Ireland's departure from the EU-IMF programme are in the interests of both the Eurozone member states and the Irish people. A reduction in the funding burden associated with the promissory notes represents a relatively simple way to take such a step. This argument needs to be made strongly by Irish politicians to their peers in Europe as, without strong lobbying, I suspect we are unlikely to make much progress on this issue.