

One Letter and Six Months? Ireland and Iceland Three Years On

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Presentation at The Debt Crisis in the Eurozone,

Reykjavik University

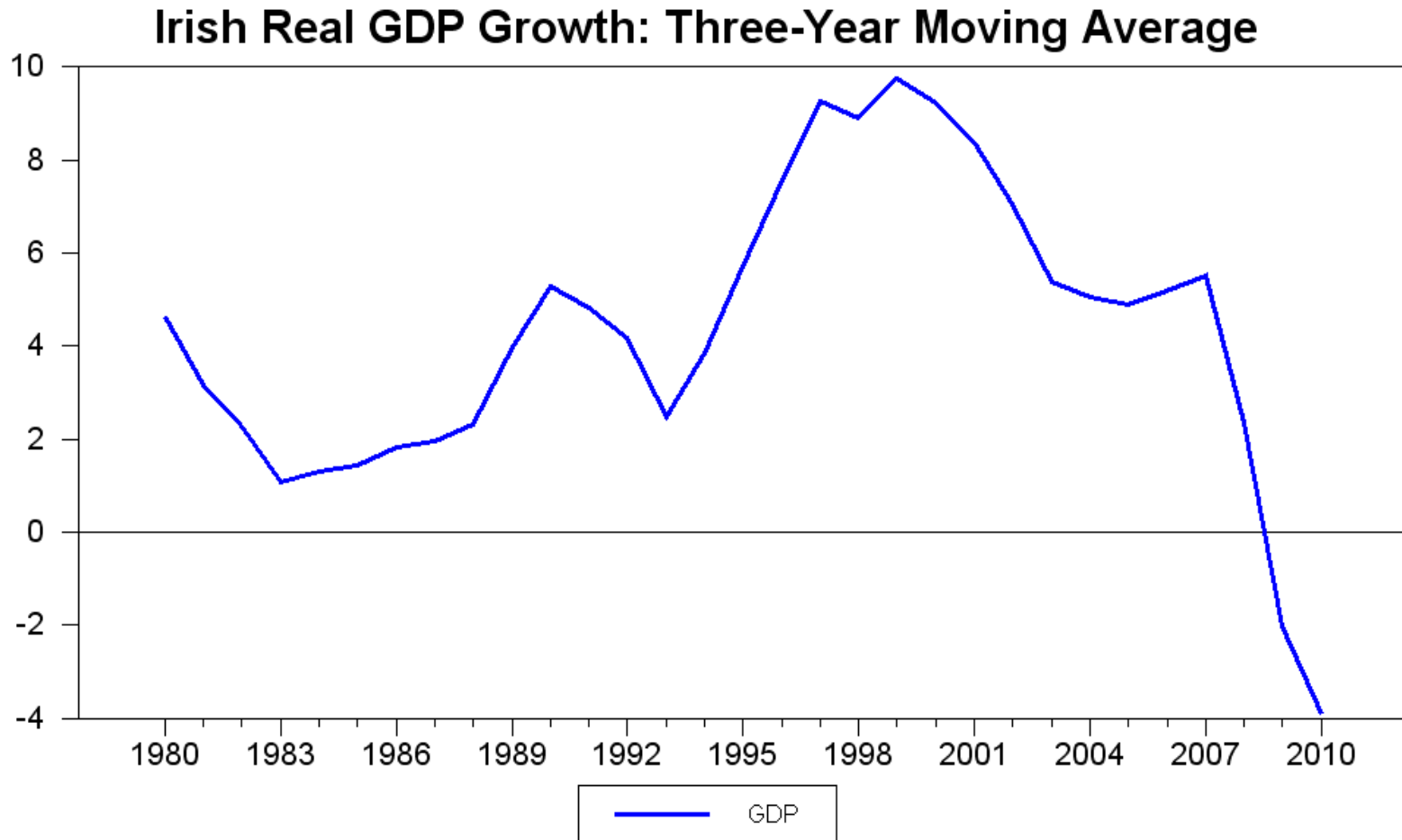
October 7, 2011

Plan for the Talk

- Review Ireland's boom and bust.
- Ireland's policy approach and contrast with Iceland's.
- Benefits and costs of Euro membership.
- Prospects for Ireland.

IRELAND'S BANKING BOOM AND BUST

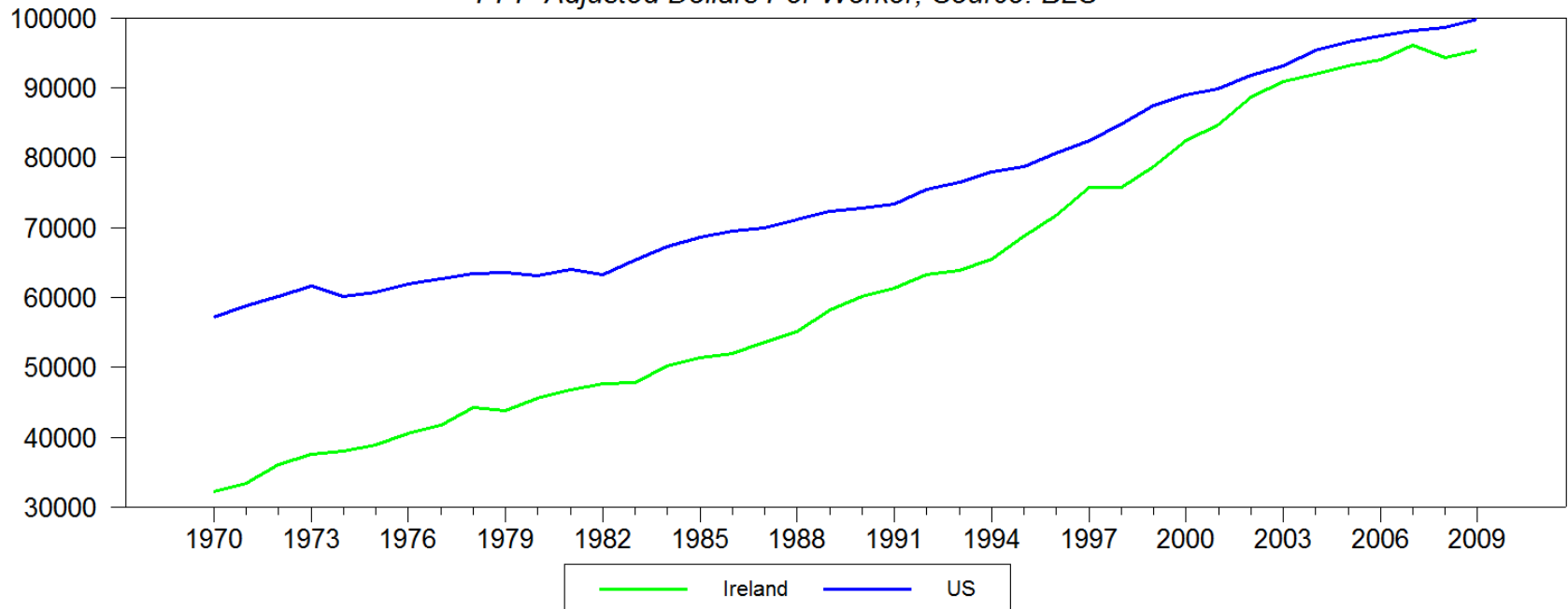
Banking Boom Occurred During Second Half of a Long Period of High Growth



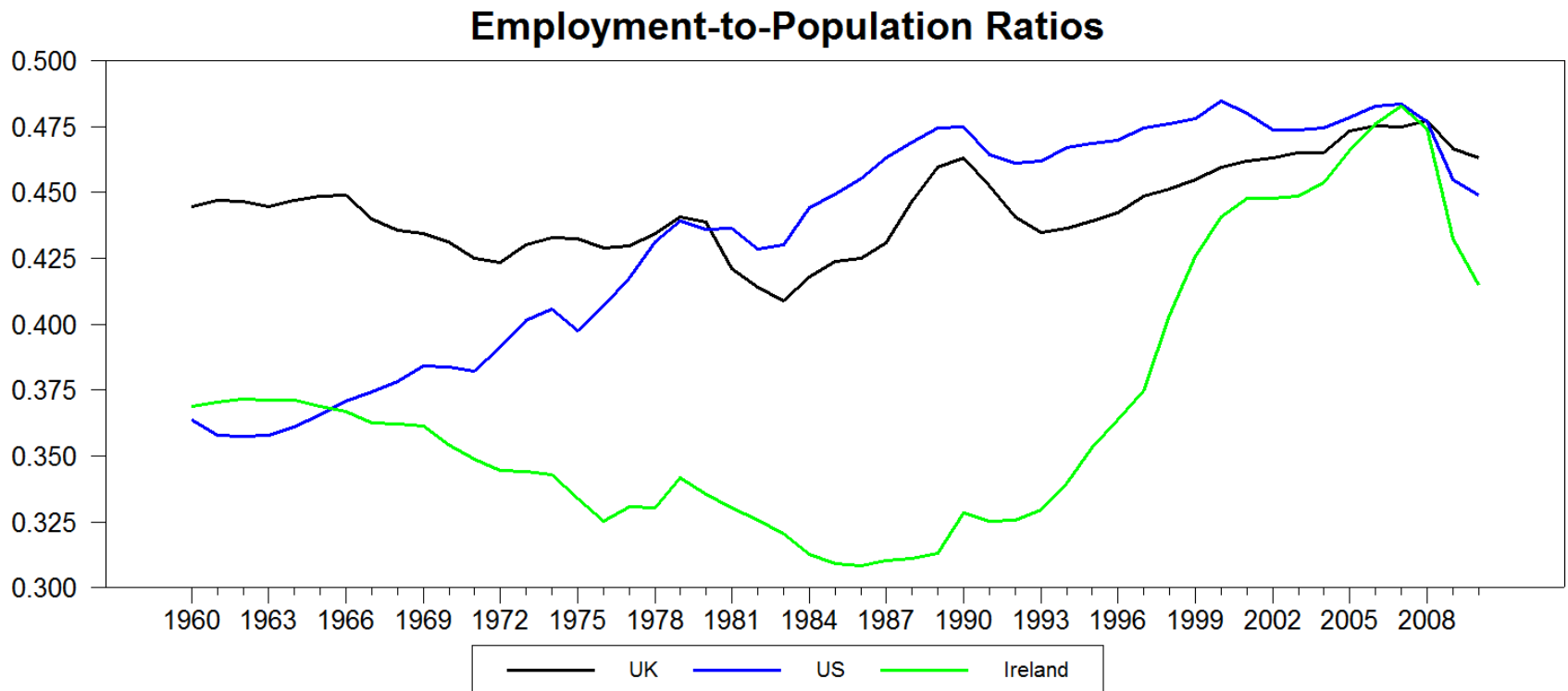
Driven by Rising Productivity

Labour Productivity in Ireland and the US

PPP-Adjusted Dollars Per Worker, Source: BLS



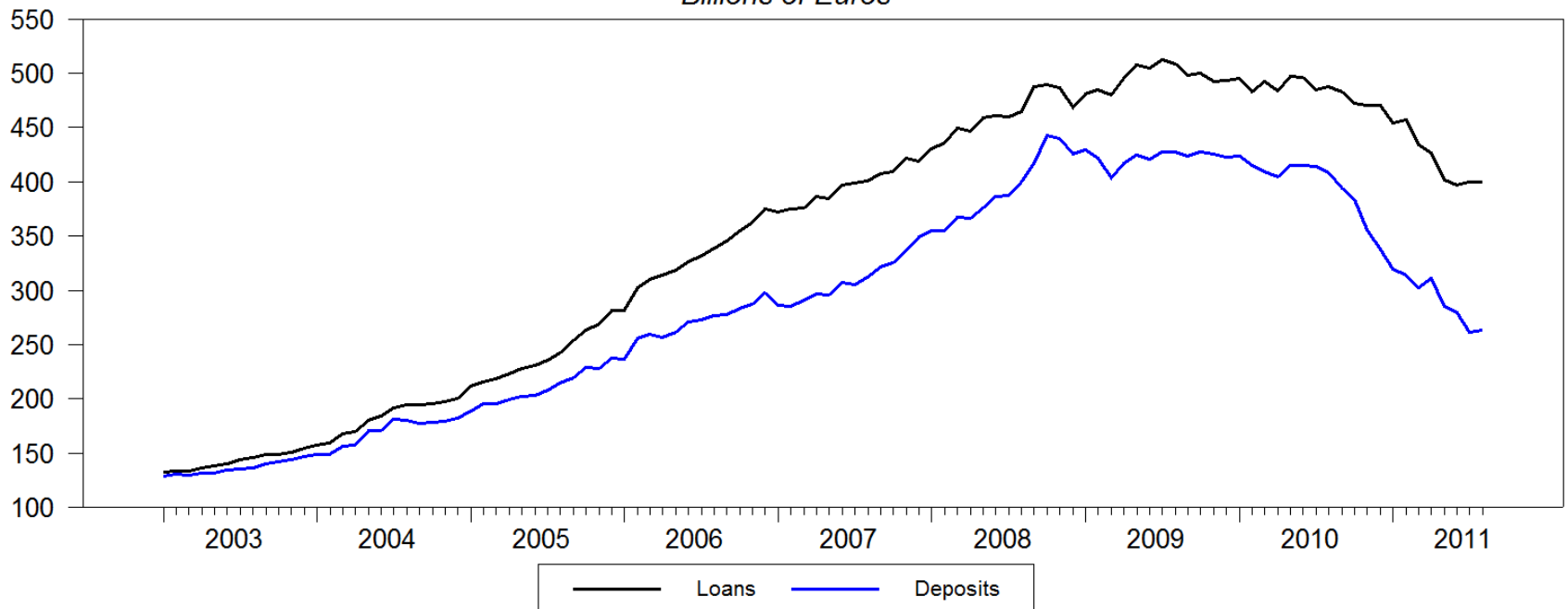
And an Employment Boom



Loans Outgrew Deposits: Funded by International Bond Market

Loans and Deposits at Guaranteed Banks

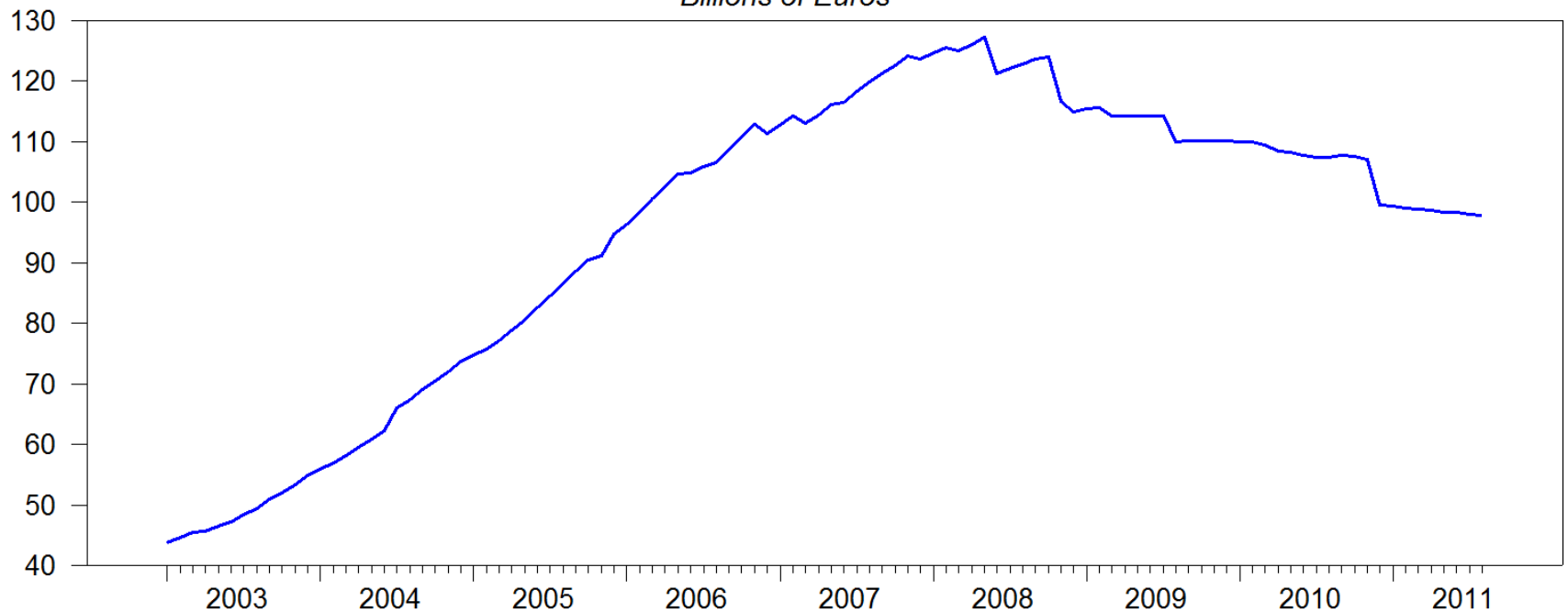
Billions of Euros



Huge Increase in Mortgage Lending

Stock of Irish Household Mortgage Debt

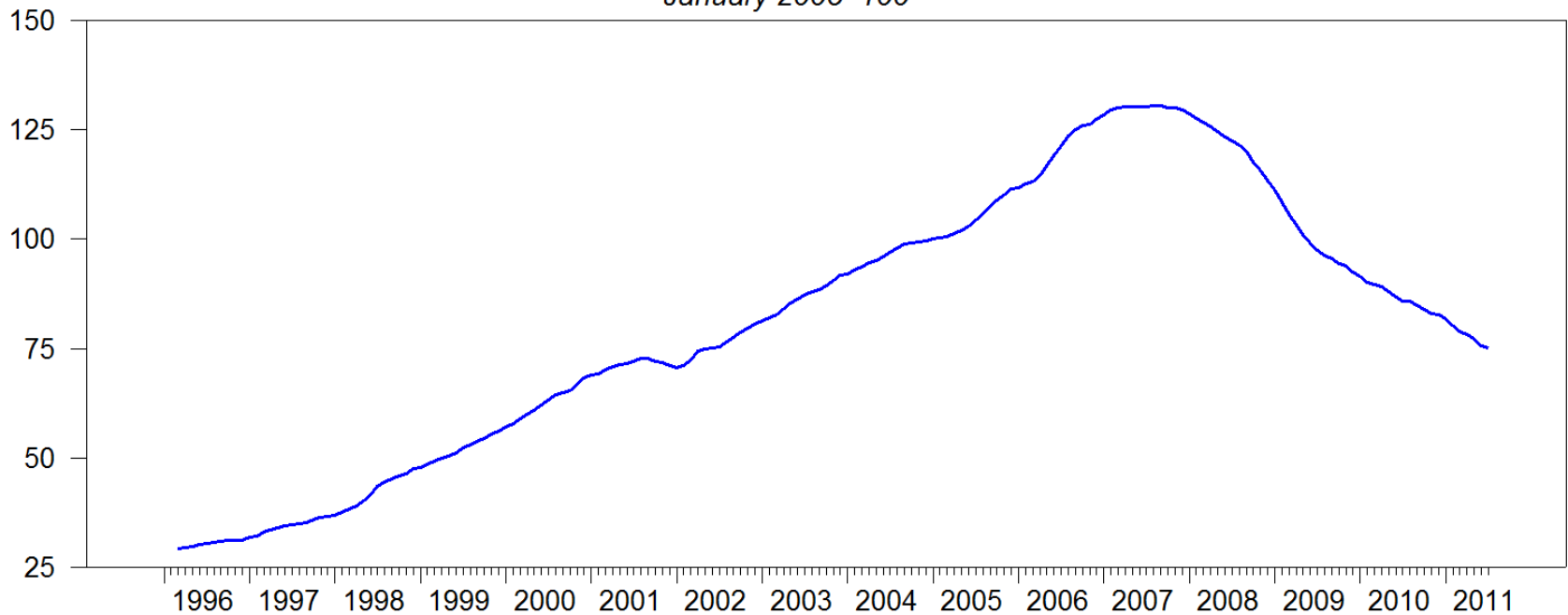
Billions of Euros



Which Fuelled House Prices

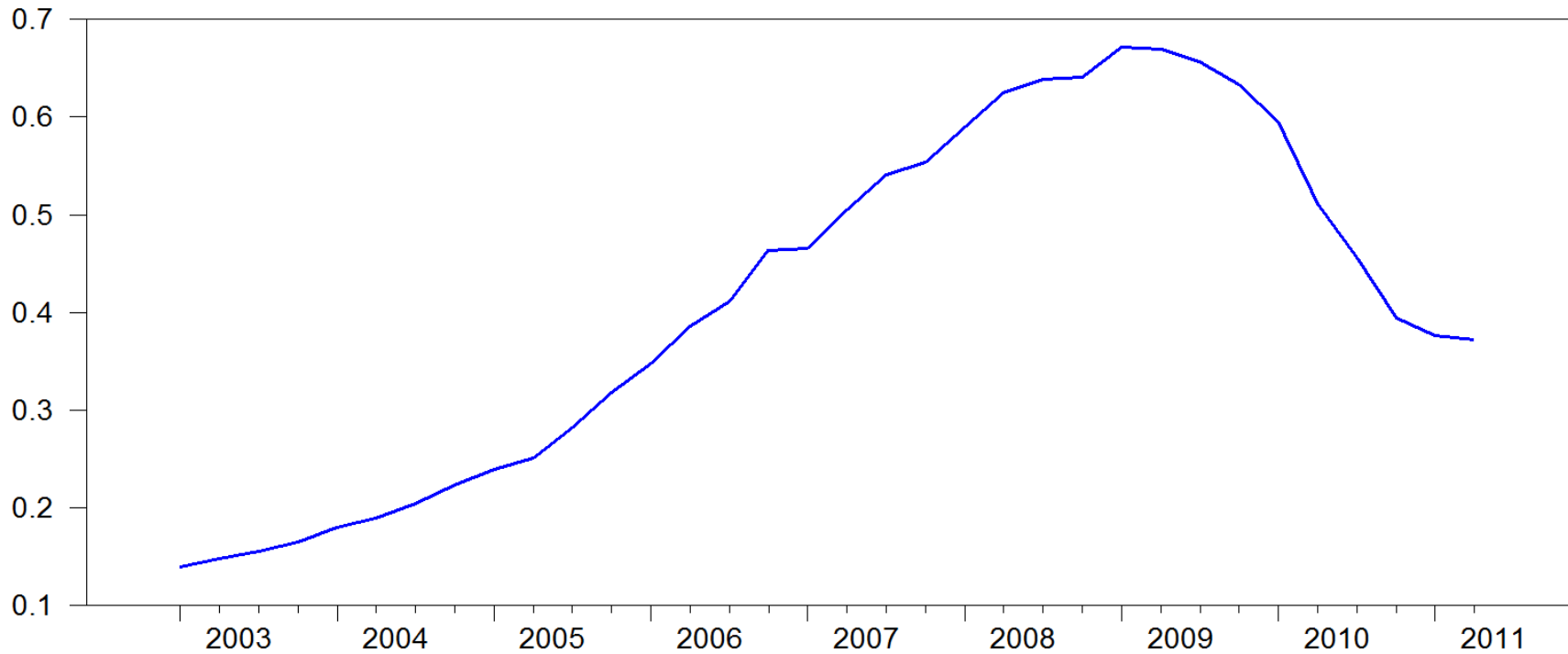
Irish House Prices

January 2005=100

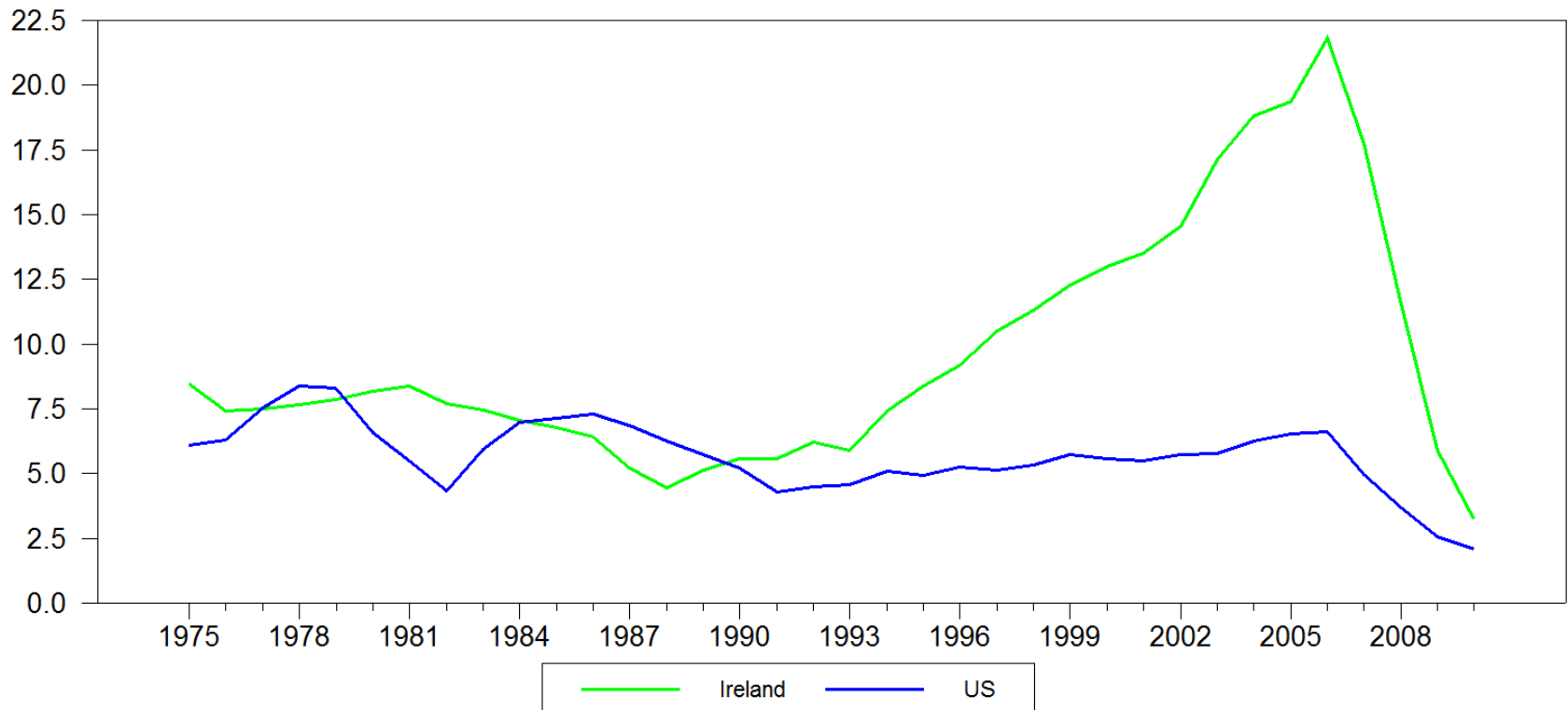


And Massive Speculative Construction and Real Estate Activity

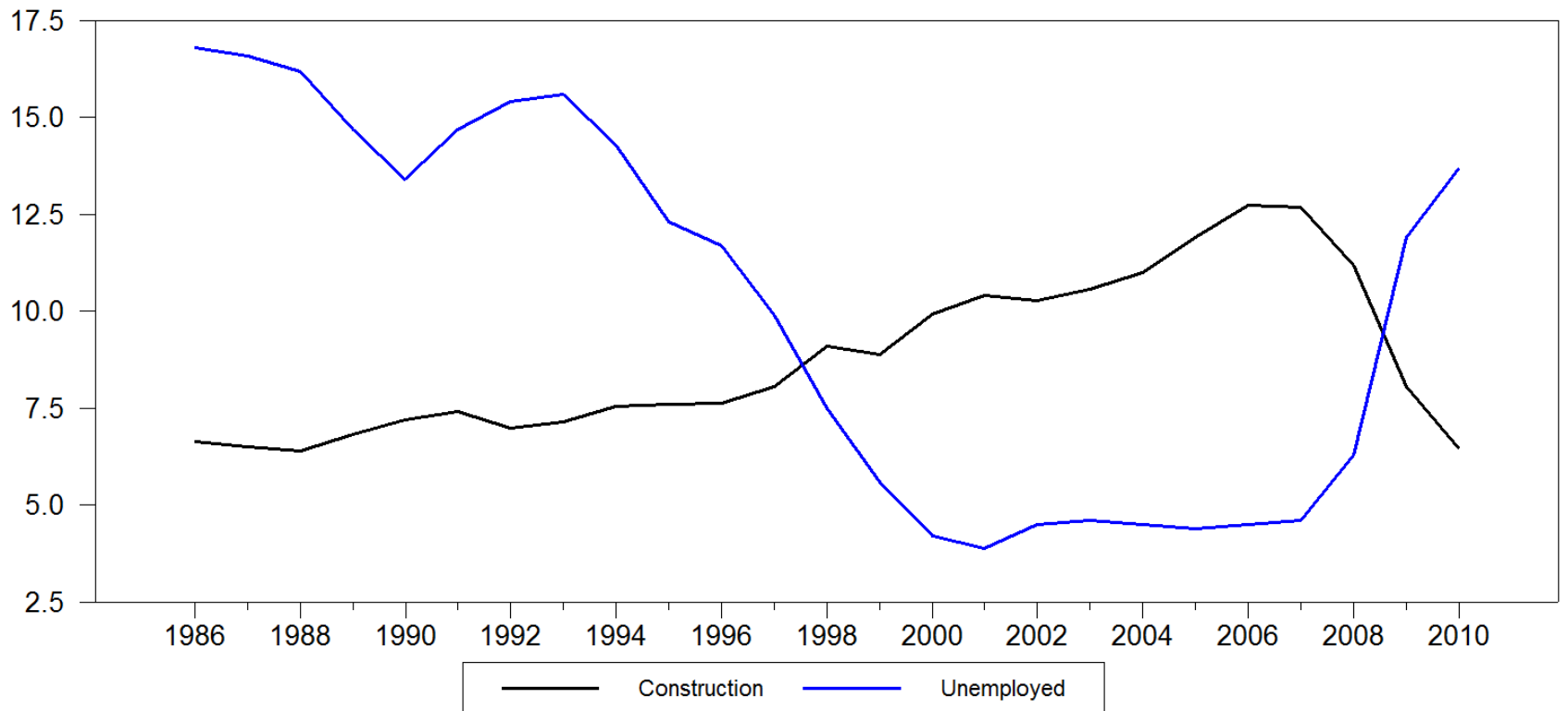
Ratio of Construction and Real Estate Loans to GDP



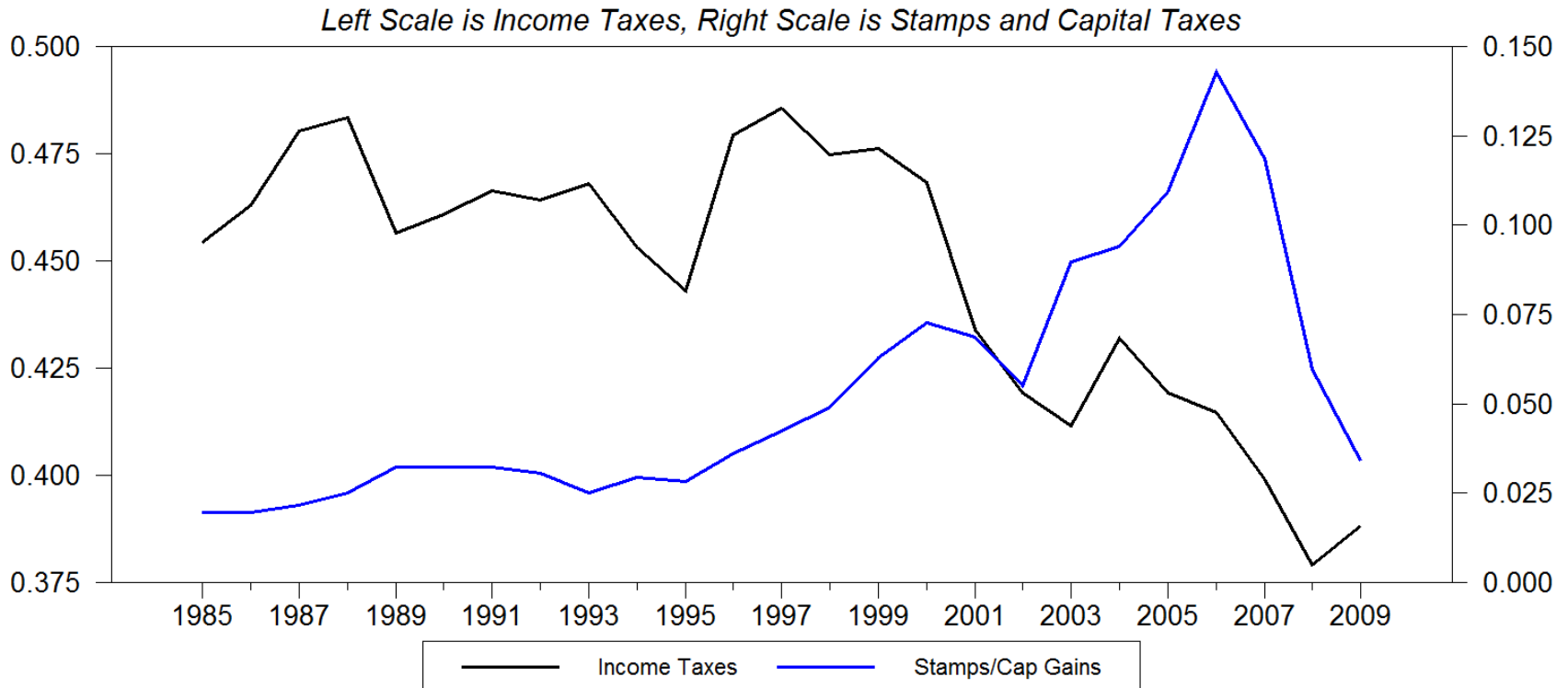
Housing Completions Per Thousand People



Fraction of Labour Force in Construction and in Unemployment



Tax Base Increasingly Relied on the Housing Market

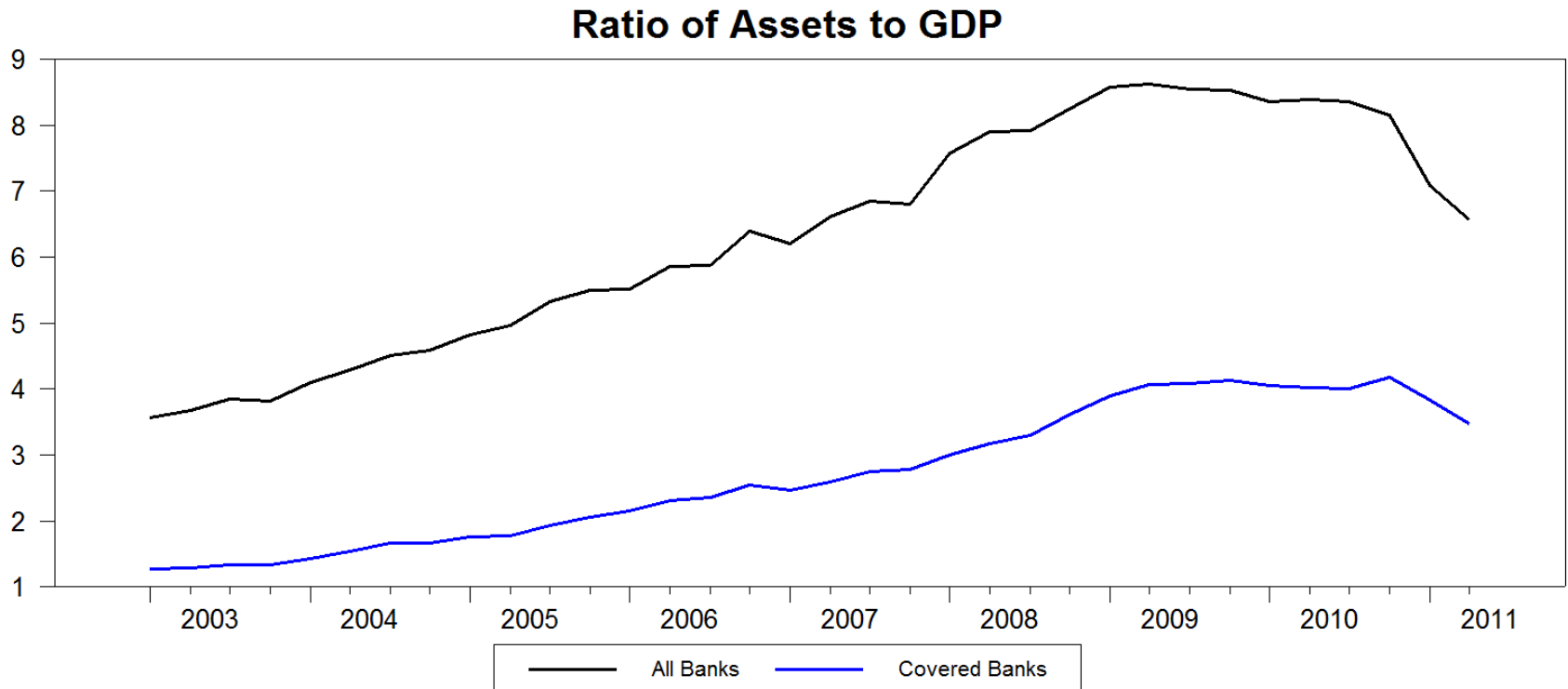


POLICY REACTION TO THE BANKING BUST

Lead-Up to September 30, 2008

- **Spring 2008 onwards:**
 - Shares in Irish banks plunge, particularly Anglo Irish Bank (a property specialist without a retail deposit base).
 - Irish banks become shut out of the bond market and increasingly reliant on ECB funding.
- **September 2008:**
 - Anglo starts to run out of ECB-eligible collateral and is close to failure.
 - On September 30, the Government introduces a blanket guarantee of liabilities of six main Irish banks.
- A few days later, Iceland adopted a completely different approach, splitting its banks into new and old banks and, ultimately, allowing bondholders to take serious losses. Fiscal costs of banking crisis will be far lower in Iceland.

Ireland's Ratio of Assets/GDP Lower For "Covered" Domestic Banks



Reasons For the Different Approach to Iceland?

- Guaranteed banking sector was smaller relative to GDP than in Iceland.
- A belief that the problem was liquidity not solvency.
- Absence of preparation for a systemic banking failure.
- Euro membership meant most banks still had access to liquidity.
- But none of this prevented the government from adopting a less blanket approach, e.g. guaranteeing only selected new borrowing.

Post-Guarantee Policy: Denial

- **Late 2008:** Government employs consultants PWC to “go deep into the banks”. Is told there is no solvency problem.
- **December 2008:** Plans to provide state capital of €2 billion each to Bank of Ireland and AIB and €1.5 billion to Anglo.
- **January 2009:** Government nationalises Anglo, which is clearly a basket-case but claims bank is solvent.
- **February 2009:** Plans to provide €3.5 billion each to AIB and Bank of Ireland.
- **May 2009:** Anglo announces it has lost all of its €4 billion capital and says there’s another €4 billion loss to come.
- And so on.

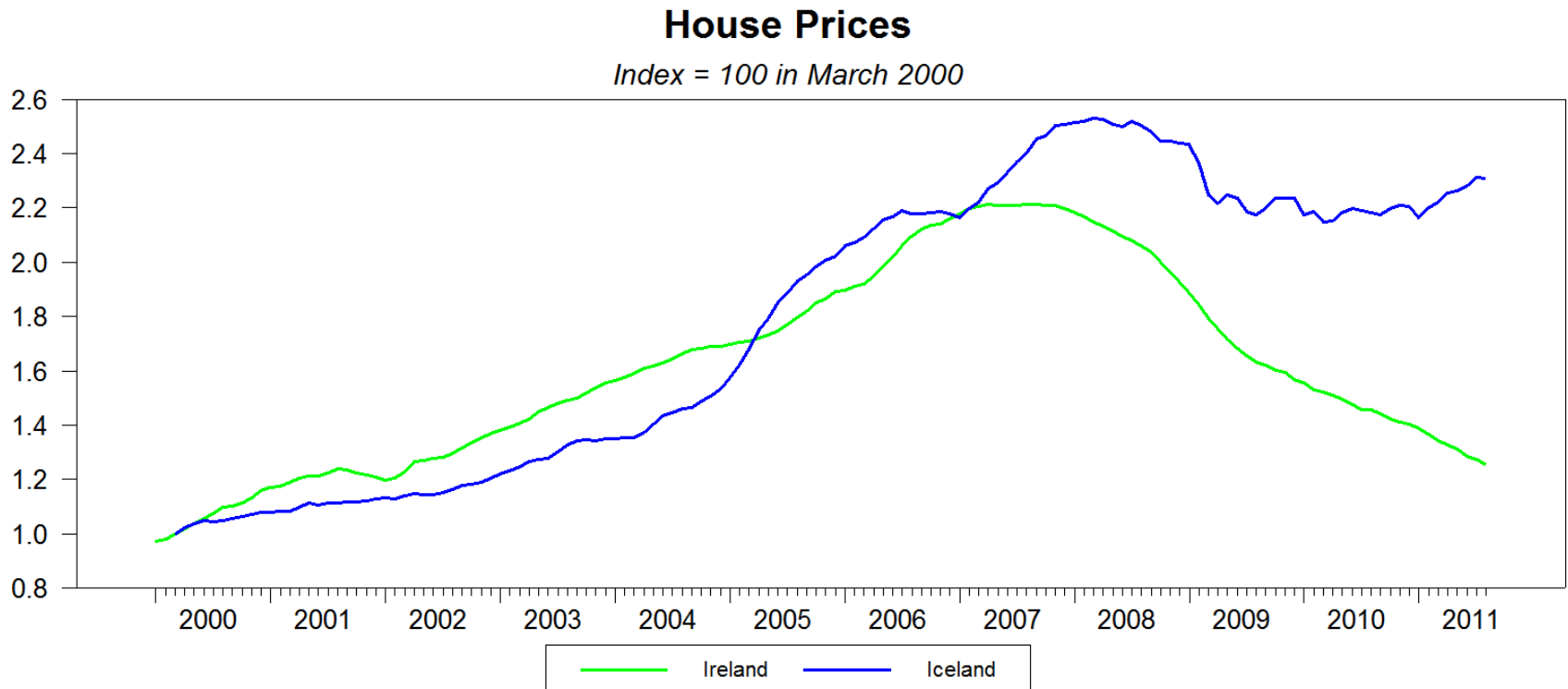
A Focus on Liquidity, Not Solvency

- **Spring 2009:** Government proposes National Asset Management Agency (NAMA)
 - Purpose is to take property loans off the banks at “fair value” in exchange for government bonds.
 - Government insists losses on these transfers won't trigger nationalisation of any more banks.
- NAMA bill takes six months to pass and EU-overseen loan acquisition process from privately-owned banks proves tortuous, dragging on through late 2010.
- Irish banks remained heavily reliant on ECB for funding. But the ability to use NAMA bonds for repo at ECB is marketed by government as their big advantage.

April 1, 2010 Minister for Finance Interview with Irish Independent

- **Headline: Ireland must not welch on its debts but can bear the heavy cost.**
- "With the banks playing for time, and the regulatory system discredited, we needed to establish an asset-relief programme like NAMA. That takes time to put into practice. It can't be done overnight."
- He [Lenihan] makes a point that tends to be overlooked in discussions of whether more should have been done sooner. It could not have been done 12 months ago, with the financial markets fretting over the scale of the budget deficit.
- The country came close to not being able to borrow the money to keep it running. Attempting to cover the bank losses as well might have made that danger a reality. For Mr Lenihan, the priority over all else is that Ireland will not default.

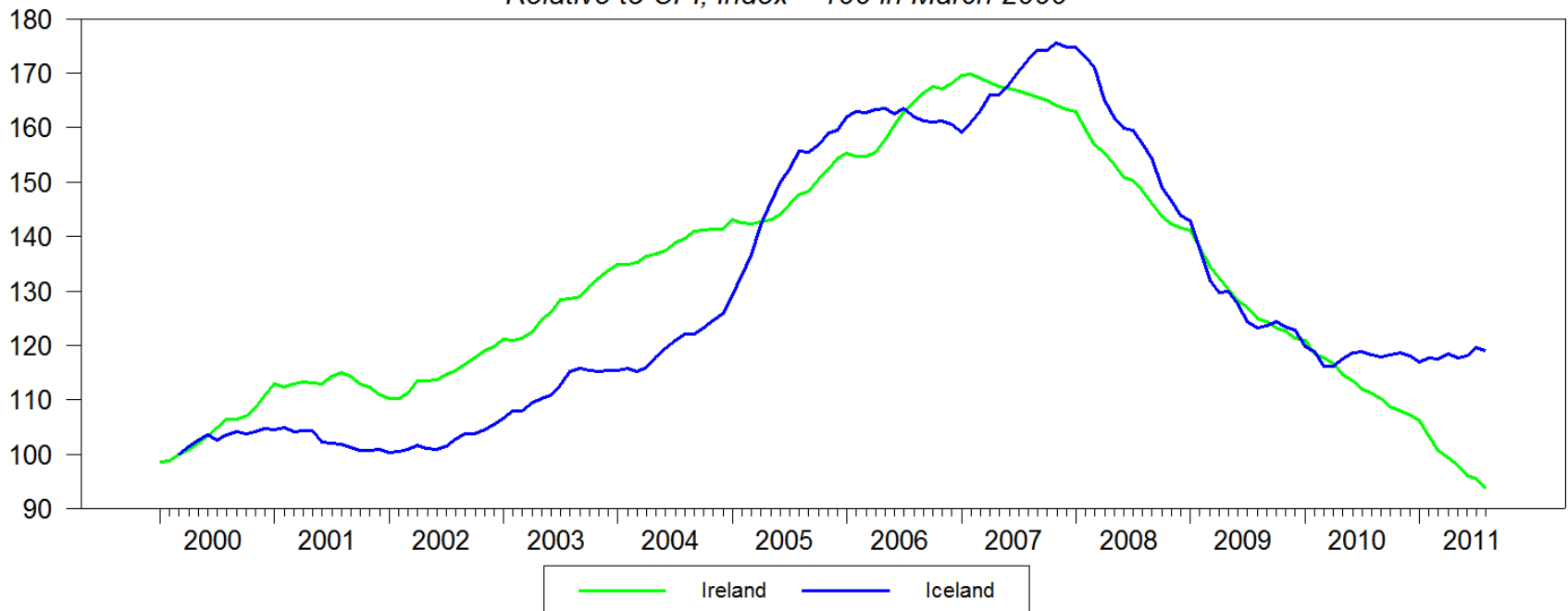
Nominal House Price Decline Much Bigger in Ireland than Iceland



Though Real House Price Decline Was Closer

Real House Prices

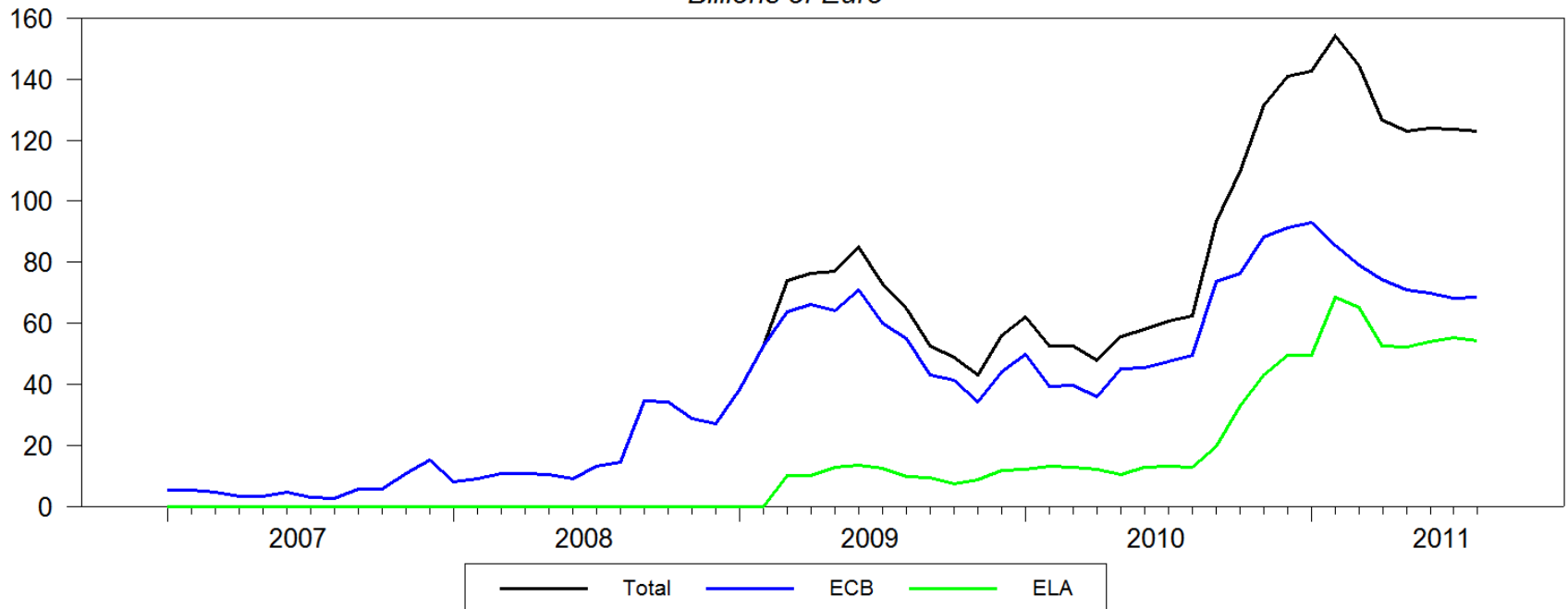
Relative to CPI, Index = 100 in March 2000



Reliance on Central Bank Borrowing

Covered Banks Borrowings from ECB and ELA from Irish Central Bank

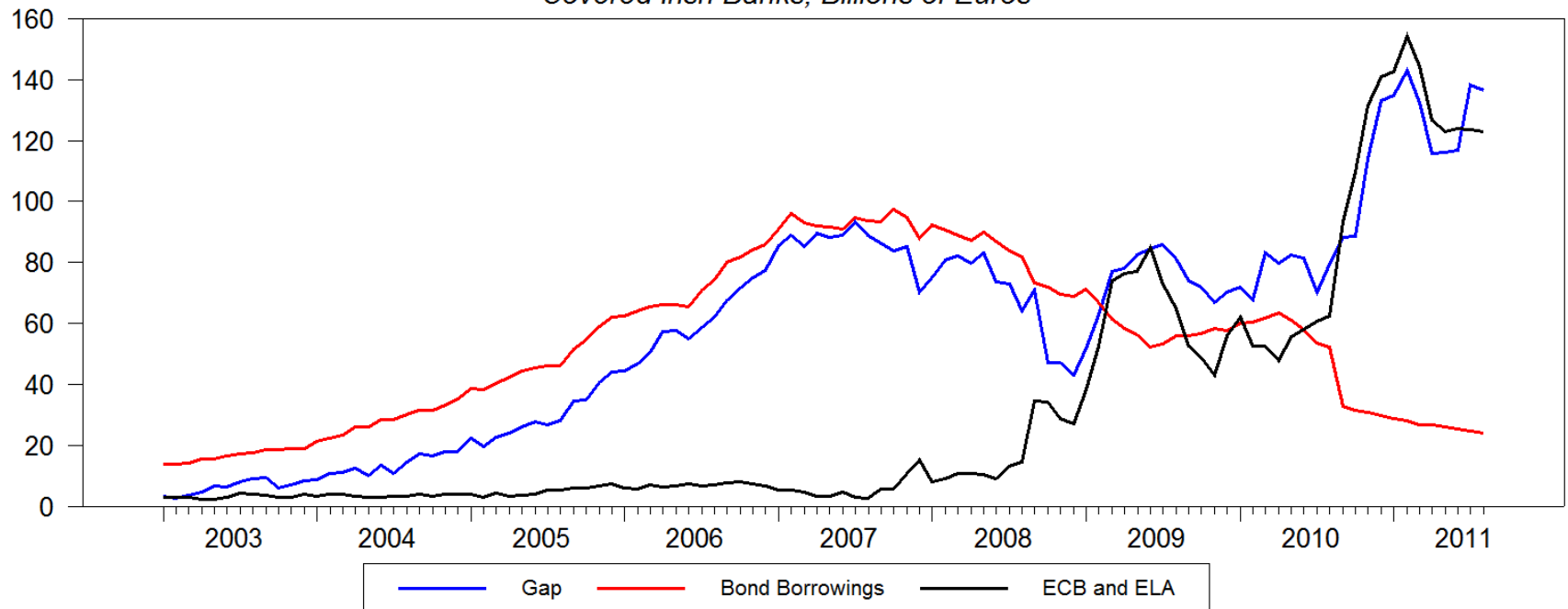
Billions of Euro



Which Replaced Bond Market Funding

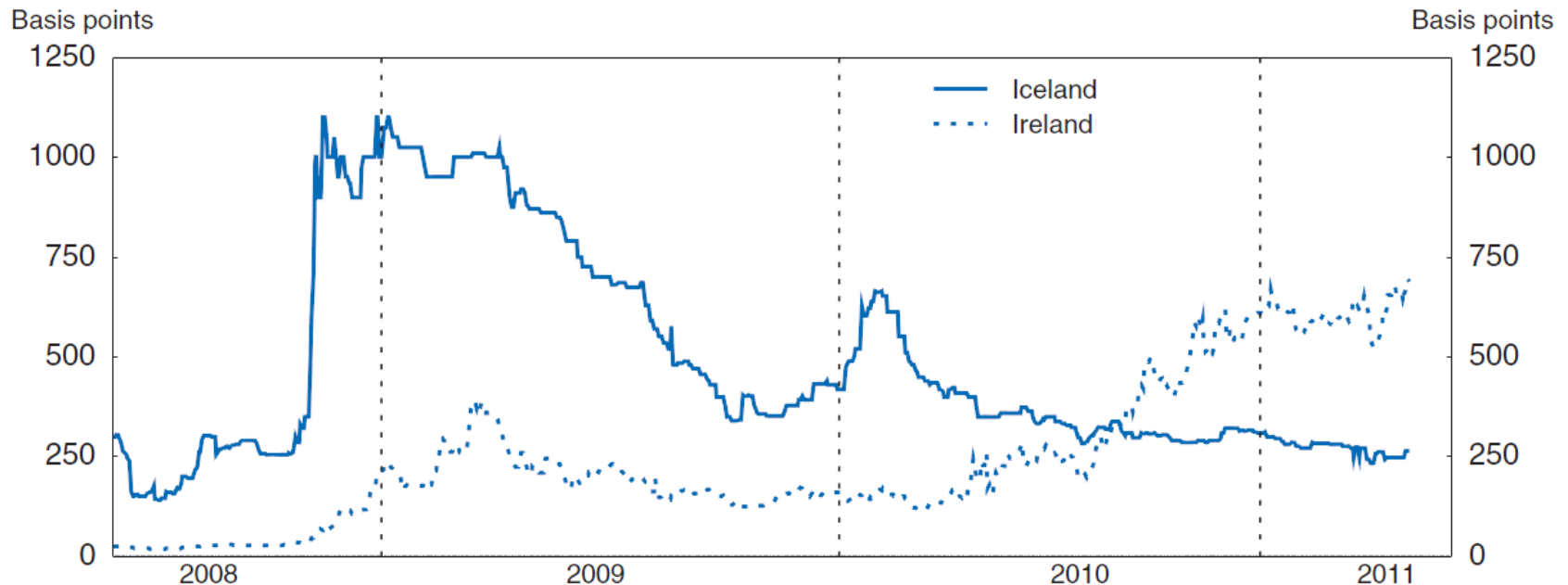
Funding Gap, International Bond Debts and CB Borrowing

Covered Irish Banks, Billions of Euros



Bank Debts Bring Down the Sovereign

Figure 1.3. **Credit default Swap (CDS) rates on sovereign debt are now much lower in Iceland than in Ireland¹**



The End Game

- **September 2010:**

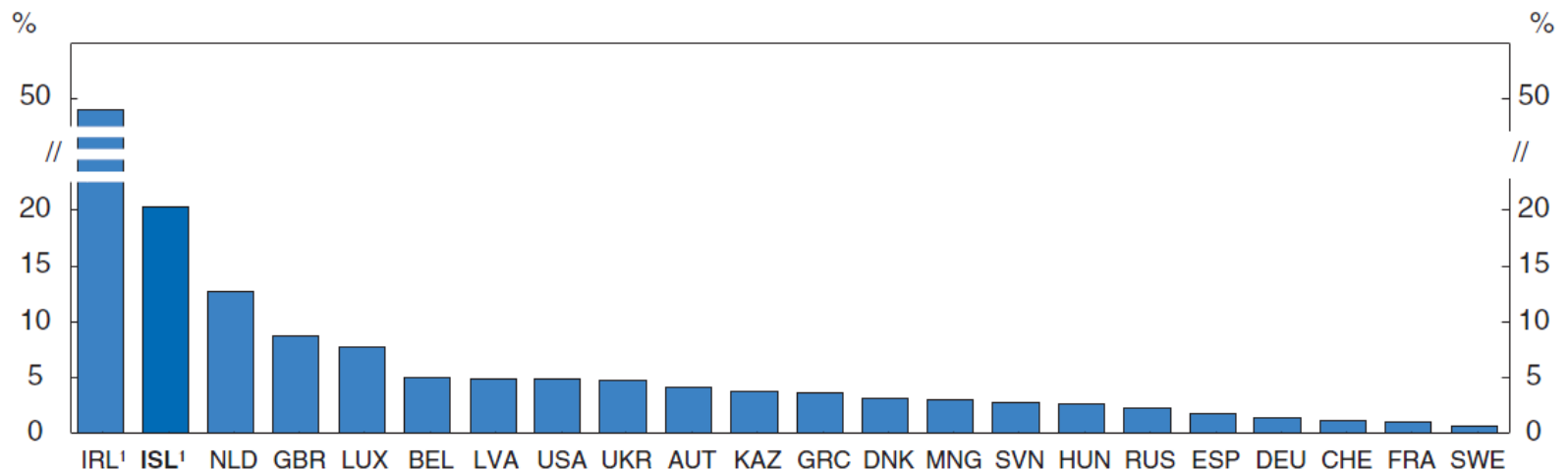
- Government admits cost of Anglo alone will be over €30 billion, about €7,000 per head.
- Non-resident deposit flight begins. Other banks run out of ECB-eligible collateral and sovereign backed ELA starts in a big way.
- Original blanket guarantee expires and large amounts of bondholder debt is paid off.

- **November 2010:**

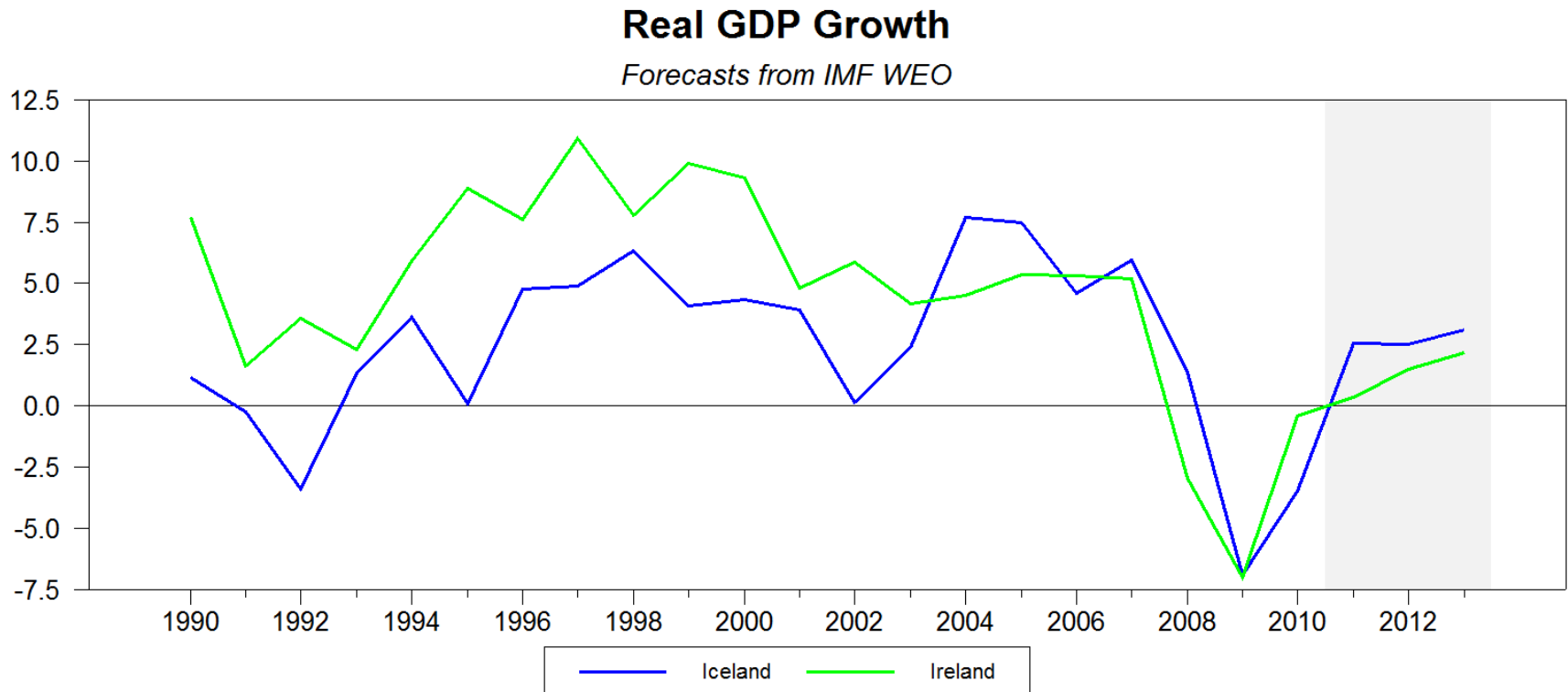
- ECB decides it has had enough. Threatens to pull funding unless Ireland enter an EU-IMF programme.
- Further round of stress tests and recapitalisation in 2011. All banks apart from Bank of Ireland are fully nationalised.
- Final costs run to at least 40 percent of GDP.

Ireland Bank Bailout the Most Costly

Figure 1.2. **Direct fiscal costs of the financial crisis over 2007-09**
As per cent of 2009 nominal GDP



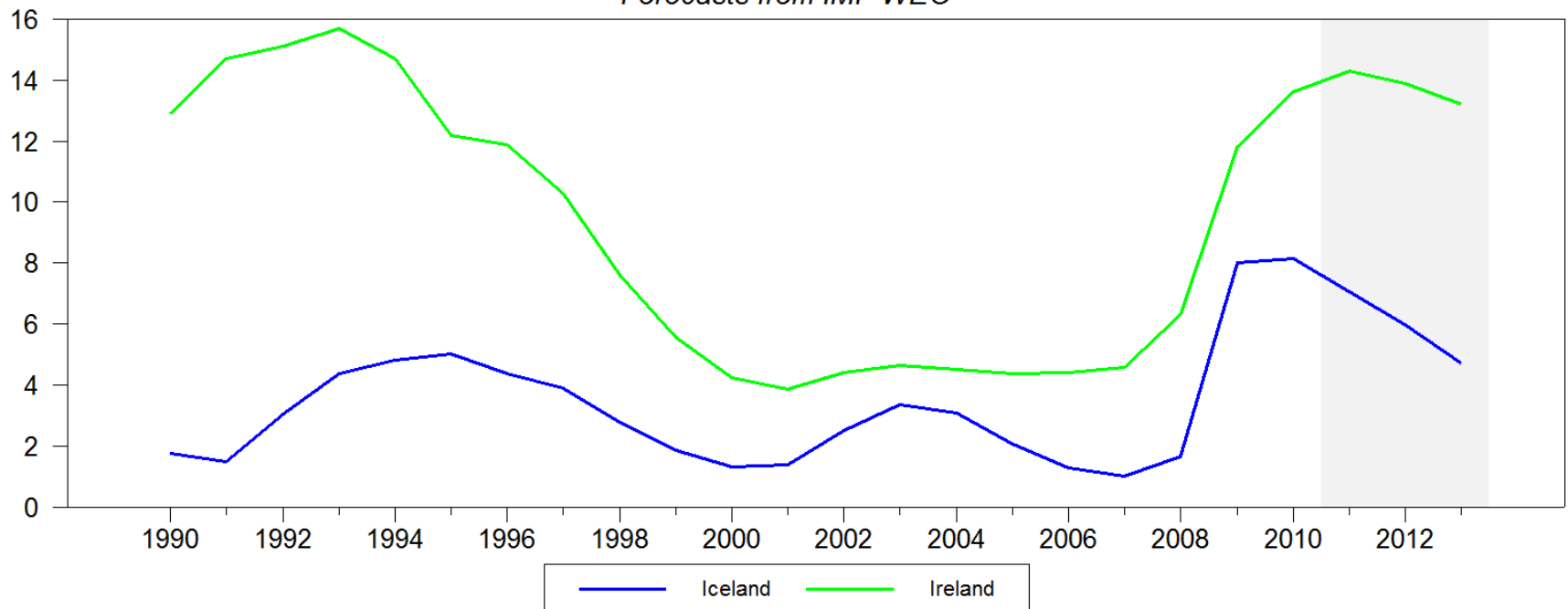
Both Ireland and Iceland Were Hit Hard By Their Crises



But Iceland Maintained Lower Unemployment and Its Rate is Falling

Unemployment Rate

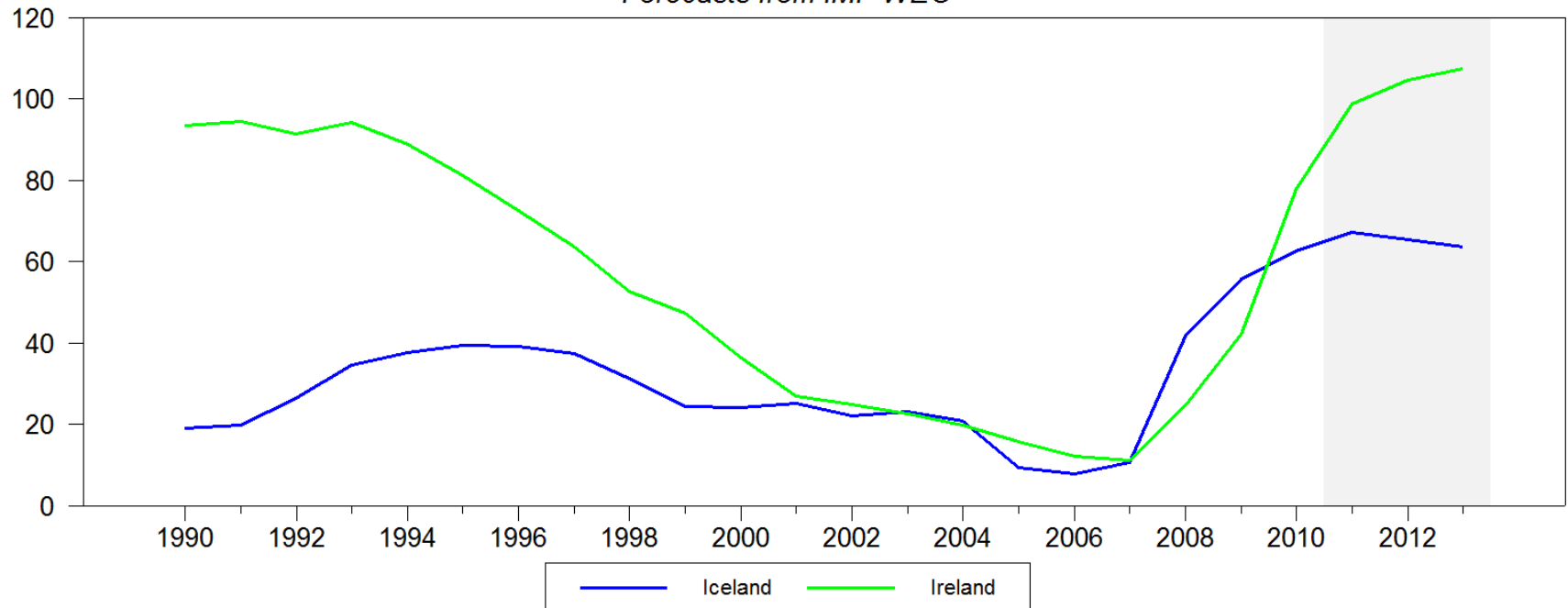
Forecasts from IMF WEO



And Has a Much Better Net Fiscal Debt Position

Net Debt-GDP Ratio

Forecasts from IMF WEO



Is Criticism 20/20 Hindsight?

- No: Contemporary commentary from Irish economists was generally very critical.
- Some examples from my own comments:
 - Articles in Spring 2009 arguing the government was underestimating the bank losses and proposing systemic resolution and recap. e.g. February 2009 “four point plan” (Nationalise, Reorganise, Recapitalise Privatise).
 - June 2010 article: “the final legacy of the guarantee may be a full-blown crisis later this year as banks struggle to pay off their maturing debts and the State struggles to honour its ill-starred guarantee.
- As larger losses became more evident, pressure on the government to introduce burden-sharing for bank bondholders increased. The government (supported by the ECB) considered this to be heresy.

We're Not Iceland!

- The Irish government responded critically to pressures for burden-sharing with bondholders or for systemic interventions such as good bank\bad bank.
 - Shouldn't upset "bond investors". Minister of Finance in May 2009: "These professional investors are the same international investors who invest in our government bonds"
 - On systemic interventions and bank resolution, the government regularly cited Iceland as a failed example, apparently believing that policy actions taken after the crash were actually its cause.

Slide From Irish Minister of Finance Presentation: February 2010



Those who argued for 100% nationalisation are wrong.

- Statutory State takeover of the banks.
 - Would have undermined confidence.
 - Dried up funding for the banks and the State.
- Banks de-listed from stock exchange.
 - Would have made the eventual exit from State ownership difficult and expensive.
- Only one country has followed this approach in this crisis: Iceland!

Did Euro Membership Help or Hurt?

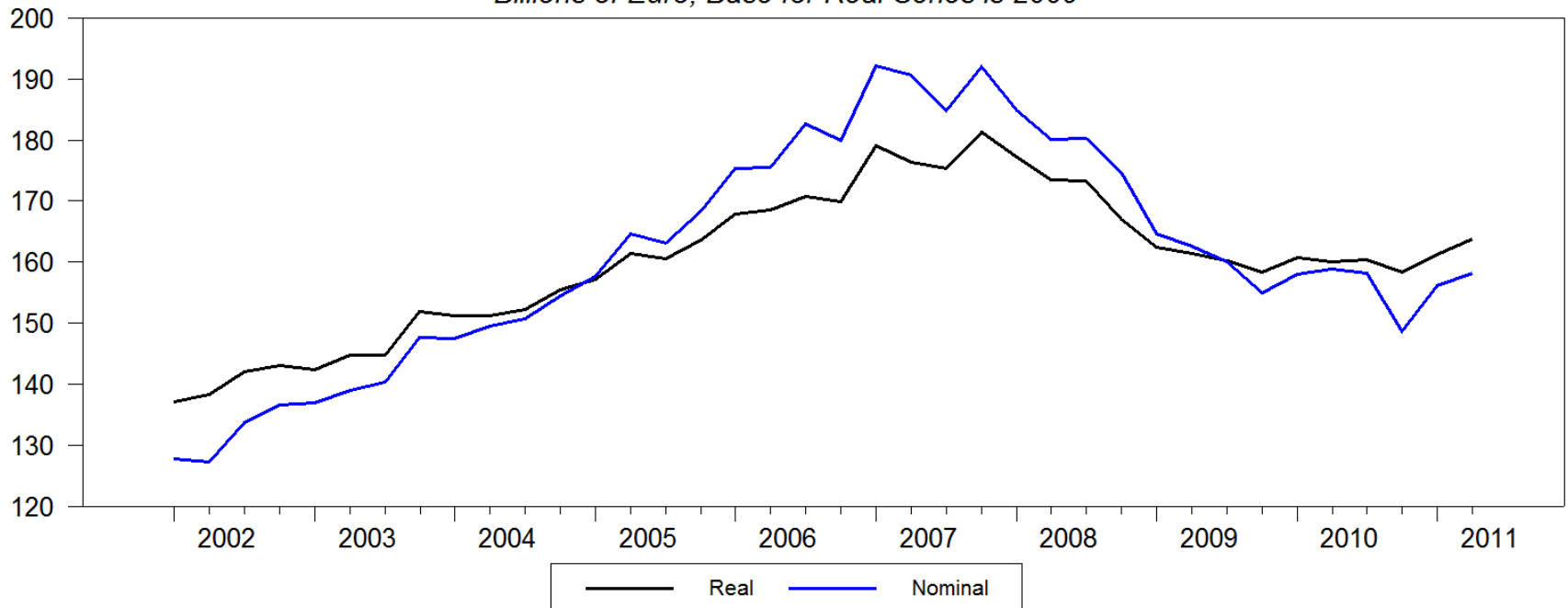
- Euro membership proved a mixed blessing for Ireland. It helped prevented an liquidity crisis in 2008 and kept the money flowing from the ATM machines.
- However, there were severe negatives:
 - Enabled a denial-driven policy on bank losses.
 - EU membership likely made dealing quickly with bank creditors more complex and ruled out “heterodox” policies such as capital controls.
 - Bondholders being paid back in full became an explicit condition of ECB funding.
 - LOLR function had limits: By Autumn 2010, much of the liquidity support (the ELA) required Irish fiscal guarantees.
- Without a clear policy on bank resolution, the Eurozone is not a good place to have a systemic banking crisis.

PROSPECTS FOR IRELAND

Economy is Returning to Growth

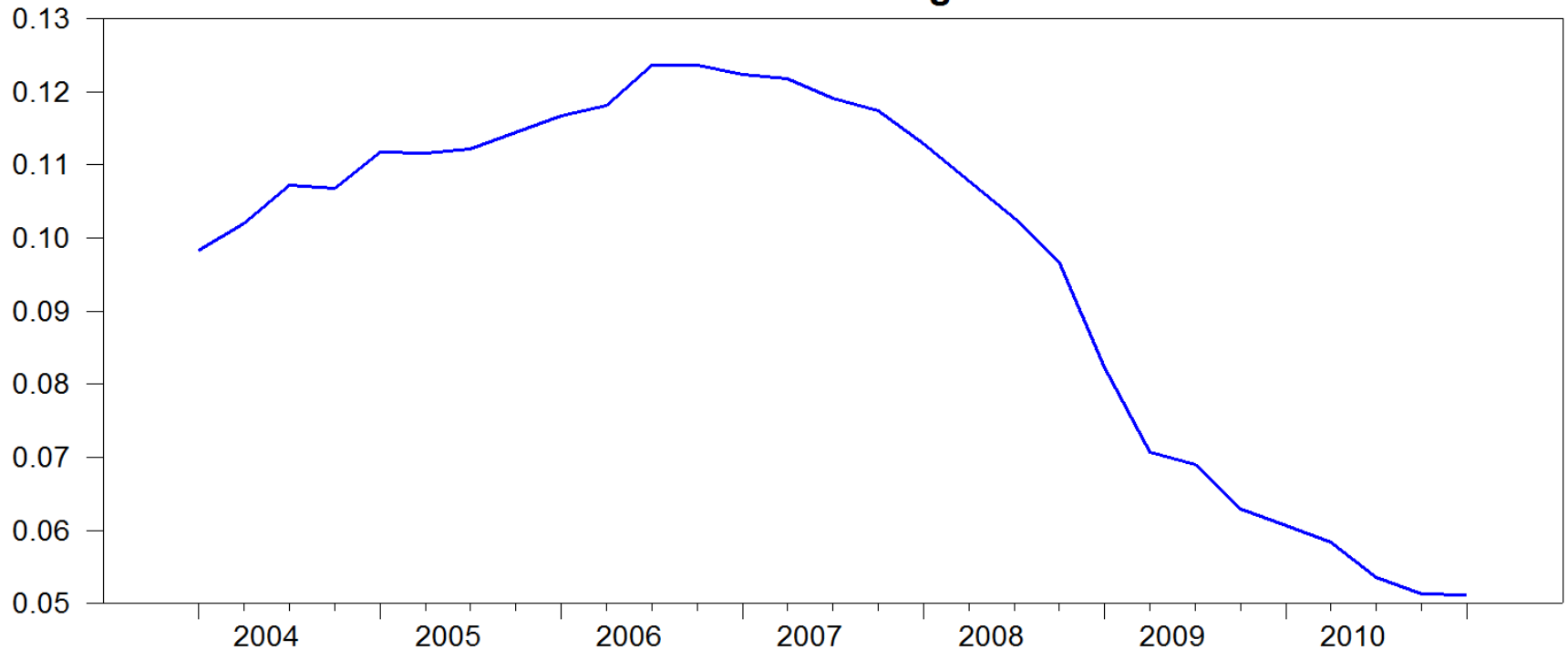
Real and Nominal GDP in Ireland

Billions of Euro, Base for Real Series is 2009

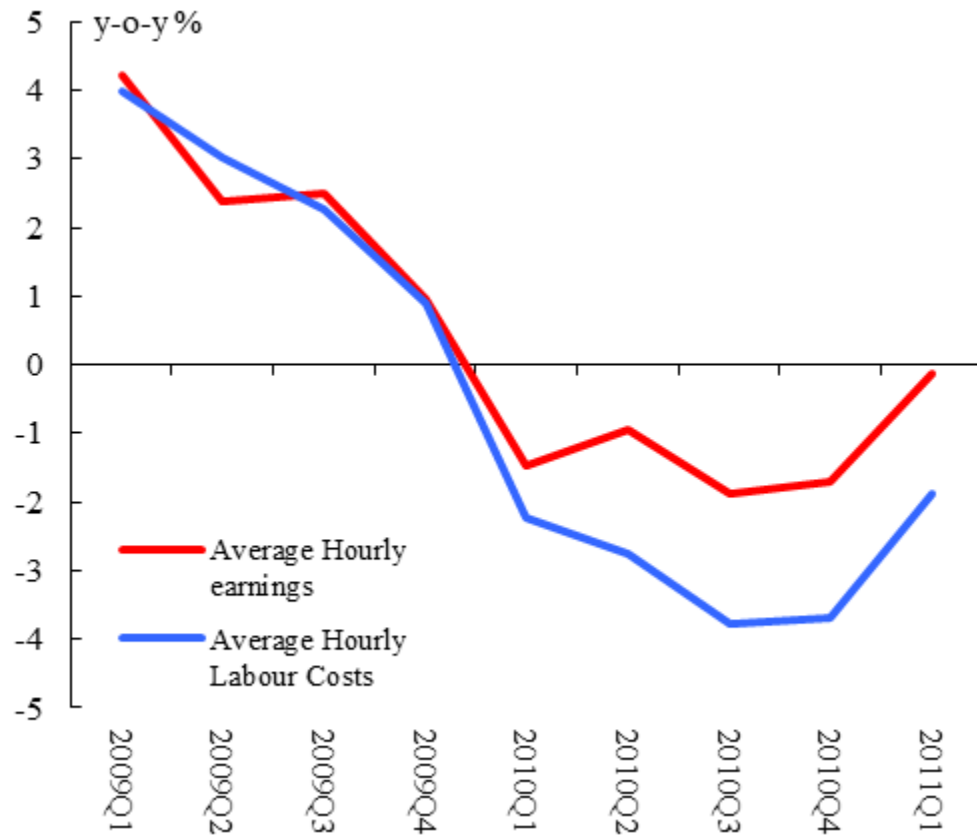


Construction Bubble Well Popped

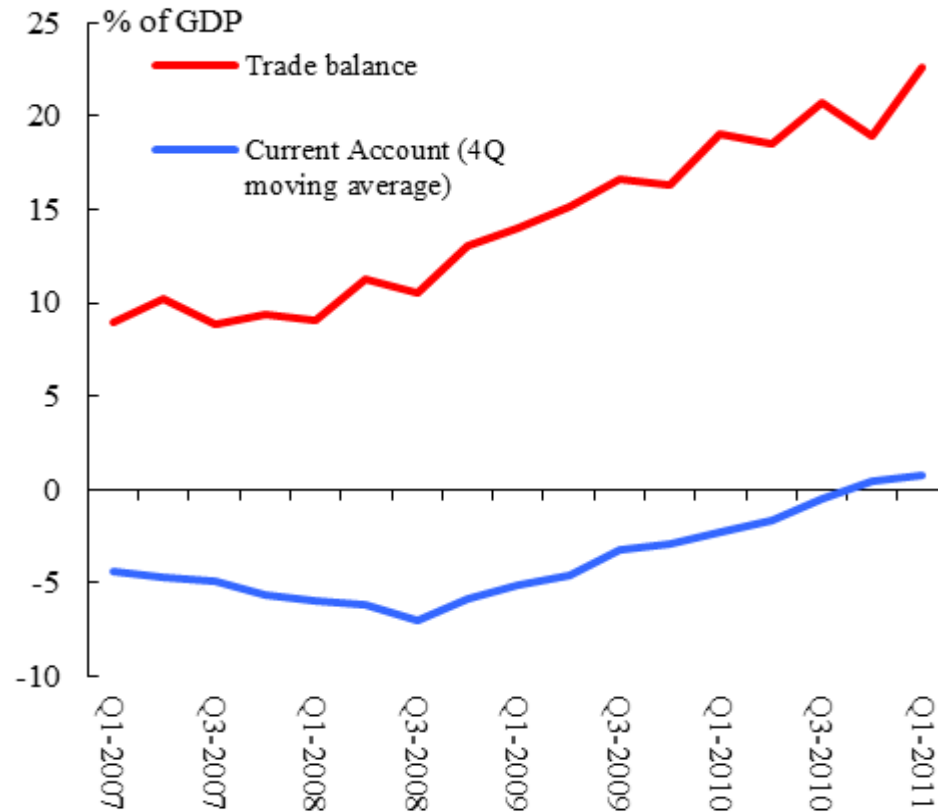
Fraction of Labour Force Working in Construction



Wages Declines Have Improved Competitiveness



Large Trade Surplus, Current Account in Balance



Sovereign Bond Yields Have Fallen in Recent Months



The Negatives

- House prices still falling and mortgage arrears rising fast.
- But little progress on restructuring distressed mortgages.
- Banks still hugely reliant on central bank funding and deleveraging plans (selling off foreign assets to repay the ECB) are ambitious.
- Many of the previous sources of fast growth are played out.
- Growth risks seem mainly to the downside
 - Large fiscal contraction still to come.
 - Debt overhang for firms and households.
 - Tight credit as banks deleverage.
 - Uncertainty surrounding potential default.
 - Slowing global demand.

A Further EU-IMF Deal?

- Ireland's EU-IMF deal provides sufficient funds to get through 2013 (if no further bank recap).
- But there is a €12 billion bond (about 7.5% of GDP) due in January 2014.
- Officially, the plan is for a return to sovereign debt market in late 2012.
- This seems unlikely to happen: Most likely, Ireland will need to request more official funds in 2013.
- Will this happen without debt restructuring?

Relieving Burden of Bank Debt?

- Bank bailouts have cost the Irish state €64 billion so far, around 40 percent of GDP.
- Anglo Irish, a dead bank with no deposits, owes about €40 billion (about 25 percent of GDP) in ELA to the Central Bank of Ireland .
- Supposedly a temporary measure, government is putting in €3.1 billion a year from a “promissory note” (already counted on the debt) to repay the ELA.
- An loan from an expanded EFSF to pay off the ELA, then repaid to EFSF over a very long time period, could be very helpful in improving debt sustainability.

Euro Breakup Scenarios?

- It is unlikely that any Irish government would actively choose to leave the Euro when other reasonable options were open.
- But one can imagine scenarios where all the options are bad ones.
- A Greek financial crisis, followed by capital controls in Greece and elsewhere, could force many countries to rethink Euro membership.
- One positive: ELA bank debt of nationalised banks (and perhaps some debt from ECB open market operations, also actually owed to the CBI) could be written off.
- As the sum of ECB and ELA debts of covered banks are about 80% of GDP, this is not a small consideration.