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Economics Group

Special Commentary

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Ireland Agrees to Seek Financial Help

The details are not finalized yet, but Ireland likely will receive assistance worth about as much as the Greek rescue package this spring.

Ireland announced on November 21 that it would seek international assistance to help extinguish the crisis that has engulfed its financial markets recently. At this point, details of the rescue package and the conditions attached to it still need to be worked out, and it could be another week or two before all the details are announced. That said, media reports estimate the size of the eventual rescue package will total €80 billion to €90 billion ($110 billion to $125 billion at current exchange rates), which would be roughly in line with the €110 billion bailout package that Greece accepted in May. The vast majority of the money would come from the €750 billion facility that the European Union (EU) and the International Monetary Fund (IMF) put in place in May for the purposes of rescuing Greece and other European countries with potential sovereign debt problems. Sweden and the United Kingdom may also contribute with some bilateral loans.

The root of Ireland's problem is the collapse in its real estate bubble. Between 1996 and 2006, housing starts in the Emerald Isle tripled and house prices shot up fourfold. However, a widely followed national price index has declined more than 30 percent since 2007, which has crushed Ireland's real estate-laden banking system. Unlike Greece, the fiscal position of the Irish government was strong before the global financial crisis. In 2007 the Irish government had a balanced budget and a debt-to-GDP ratio of only 30 percent. However, the steps that the Irish government took to shore up the nation's troubled banking system, including a blanket guarantee of all deposits and the establishment of a "bad bank", caused the government's deficit shoot up to more than 30 percent of GDP this year and the debt-to-GDP ratio mushroom to about 80 percent.[1]

Negotiators will now hammer out what further fiscal steps Ireland needs to take. The government has already announced plans to slice €15 billion (nearly 10 percent of GDP) from its baseline budget over the next four years, but EU and IMF negotiators may demand further budget cuts. Of special interest will be the fate of Ireland's low corporate tax rate, which currently stands at only 12.5 percent. The Irish see the low corporate tax rate as the cornerstone of their previous prosperity because it attracted numerous foreign businesses to set up shop in Ireland over the past decade or so. However, Ireland's low corporate tax rate has long been criticized in other EU countries with much higher tax rates, and these countries may now demand an increase in the rate before they agree to pony up any money for the Irish Republic.

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A rescue package of the size that is being bandied about in the press would ensure that the Irish government, which has enough cash to fund operation through spring, does not need to tap international credit markets for a few years. If ultimately approved, the package would significantly reduce the probability of Irish default in the near term. However, the Irish economy still faces a very long road ahead. For starters, the significant fiscal consolidation that was noted above will exert significant headwinds on the economy over the next few years. In addition, forty percent of Ireland's exports go to other Eurozone countries. Therefore, the inability for the

[1] **The National Asset Management Agency (NAMA) purchases bad loans from the banking system to sell to the highest bidders. Because the loans are worth much less than their face value, the government ends up taking a loss on the transactions.**

nominal exchange rate to adjust vis-à-vis these countries means that export growth will be held back as well. With real GDP down 13 percent relative to its 2007 peak, it would not be a stretch to say that that Ireland is in a depression at present (Figure 1).

Figure 1

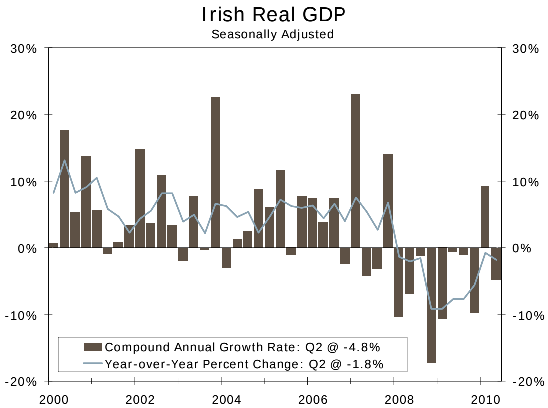
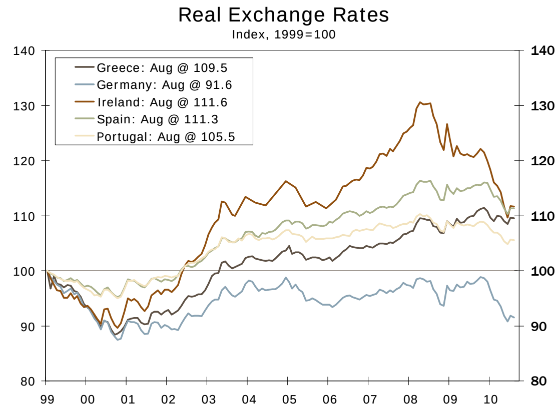


Figure 2



Source: IHS Global Insight, International Monetary Fund and Wells Fargo Securities, LLC

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Unfortunately, we are not overly confident that today's announcement will bring an end to the sovereign debt crisis in the Eurozone. We think it is likely that Portugal will eventually be forced to seek a rescue package from the EU/IMF facility. Although the deficit of the Portuguese government is expected to decline from about 7 percent of GDP this year to 5 percent in 2011, the debt-to-GDP ratio of the government exceeds 90 percent at present. Yields on Portuguese government bonds relative to their German counterparts are hovering near all-time highs. If yields remain at these levels, growth in Portugal would remain depressed for some time, which could eventually lead to a debt spiral. A rescue package for Portugal on the scale of the Greek and the impending Irish agreements could eventually be announced.

Spain, which has an economy that is more than six times as large as GDP in Ireland and Portugal, is not out of the woods either. Although the debt-to-GDP ratio of the Spanish government is manageable at roughly 70 percent at present, the budget deficit is expected to remain elevated at roughly 6 percent of GDP in 2011. The Spanish government bond market has not melted down like comparable markets in Ireland or Portugal, but yields on longer-dated Spanish government bonds are up 80 bps to 100 bps over the past month. If yields remain elevated, the Spanish government could eventually face its own funding crisis. The EU/IMF facility is large enough to handle Greece, Ireland and Portugal. However, a Spanish bailout would stress the facility due to the sheer size of any rescue package. We wrote last spring that we anticipated a long road ahead for many indebted European countries.[2] In our view, there is further to travel down the road before the long journey of the European sovereign debt crisis is completed.

[2] **See "European Union Moves to Put Out Greek Fire" (May 10, 2010), which is available from the author upon request.**

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