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Another week older and deeper in debt

25 April 2010 By Cliff Taylor

Each year, around this time, EU statistical body Eurostat publishes its revised estimates for the level of government borrowing in EU member states for the previous year. It was unfortunate for Ireland that this year's publication came as the debt crisis in Greece was ratcheting up another notch.

There is never a good time to announce that the official measure of government borrowing last year - the general government deficit - was 14.3 per cent of gross domestic product (GDP), compared with earlier estimates of 11.5 per cent.

The government was right to present it as a 'technical adjustment', in the sense that it is moving money already spent from one area to another.

However, the problem is that it has focused the attention of international investors again on Ireland's level of borrowing, our rapidly-rising indebtedness and the huge burden on the public finances from the banking crisis.

We need to borrow substantial amounts of money for each of the next five years at least, to bridge the gap between spending and revenue, and meet the cost of the bank bailouts.

What we have to hope is that - at a time when other countries are also seeking to raise vast sums in cash - we can continue to borrow this money at reasonable interest rates. The cost of our borrowing edged up over the past week, driven by the Greek crisis and not helped by the Eurostat revisions.

What is not clear now is how the markets are going to react to the proposed Greek bailout, and whether it will, as EU leaders hope, calm nerves or lead the markets to target other highly-indebted countries, such as Portugal, Ireland, Spain and even Italy.

In the case of Greece, international investors brought things to a head by refusing to lend at anything but exorbitant interest rates - more than 10 per cent for two years' borrowing. They had simply lost faith in Greece, in the way it presented its exchequer finances and its ability to get its finances back in order.

Last week the interest rate on our debt rose from 4.3 per cent to 4.7 per cent, this is 1.7 points above German levels. Portugal, whose ten-year interest rate is over 5 per cent, is the only other country with a higher rate than us, bar Greece, of course, whose ten-year rate closed last week at close to 9 per cent. "We are not anywhere near the cross hairs of the market now," said Simon Barry, chief economist at Ulster Bank, last Friday.

The job now for the government is to stay out of the firing line. So what happened last week? It is easy to get lost in the figures here, so let's try not to. The general government deficit (GGD) is the measure used to compare borrowing in different EU states. Broadly speaking, this is the gap between revenue and spending in each EU state. For the sake of publishing consistent figures for all EU countries, Eurostat counts some things in and some out of this calculation.

Last year, Eurostat was faced with an unprecedented question. How should it account for money used by member governments to bail out the banks? The approach it took was the following: if the money is an investment - in other words, it might be recouped some time in the future - then it is counted as an investment and is, thus, not included in borrowing. If it is just state money being thrown in to cover a gap between the assets and liabilities of a bank, then it is counted as borrowing and is included in the GGD.

Last December, Brian Lenihan, the Minister for Finance, estimated that our GGD last year was €19.2 billion, or 11.7 per cent of GDP. We all knew at the time - and the issue was widely debated - that the state had also incurred other liabilities during the year, mainly the €4 billion it had injected into Anglo Irish Bank to keep it afloat. A further €7 billion had been invested by way of preference shares into the two big banks, AIB and Bank of Ireland.

As of last December, there was no indication that any of this money had to be counted as part of the GGD. This was because, in the official 'books', it was still counted as a financial investment. This was fair enough in relation to AIB and Bank of Ireland.

But it was already clear last December that, in relation to Anglo, this was a bit of a fiction - and none of the €4 billion would ever be seen again. However, as Anglo's new management was getting to grips with the scale of the problem and putting together a plan for the bank's future, this allowed the government to continue the pretence that it was 'investing', rather than pouring money down a hole.

Now, one could argue that this is just a technical issue. After all, the government did not hide its investment in Anglo. However, it was convenient to keep it out of the official borrowing measure because including it would - as we have now seen - move Ireland's GGD for 2009 to the top of the EU league table.

And, of course, in this particular league table, the winners are at the bottom. Canny investors in government debt would already have factored in the costs of the banking crisis to the exchequer, but explicitly including the figures in the GGD makes it crystal clear.

Why did this happen? Each member state has to submit to Eurostat its revised estimates for the previous year by March. By the time it came to put in the Irish figures, the government officials and Central Statistics Office experts dealing with the issue realised that there was no way the investment in Anglo of €4 billion last year could ever be portrayed as an investment.

By that stage, it was clear that further billions of euro would be needed - another €8.3 billion was committed by the government to Anglo last month, and Lenihan warned that a further €10 billion might be needed in the years ahead. Against this background, any claim that we might ever again

see the €4 billion invested last year was clearly farcical.

This meant that the €4 billion had to be reclassified. It could no longer be counted as a financial investment and was, instead, classed as a straight capital transfer from the exchequer coffers. It was spending, not investment. Thus - like all normal capital spending during the year - it must be counted as part of the GGD.

The money invested in AIB and Bank of Ireland was different - these entities remain quoted on the stock market and there is some prospect of getting the money back. But the funds invested in Anglo are gone. So the figures were restated, and our borrowing level last year rocketed to 14.3 per cent of GDP.

The question now is, what happens to the €8.3 billion we have committed to Anglo this year - and the further €2.6 billion put into Irish Nationwide? This money has been put into the two organisations via promissory notes, which allow the institutions to draw down the money over a period of years and, thus, spread the cash impact on the exchequer.

However, they are a liability being 'accrued' by the state this year. So the latest official figures have added these to the official measurement of our national debt - the stock of outstanding money we owe as a country. This takes our debt over €100 billion for the first time.

For the moment, they are not being added to the estimated GGD for 2010. This means that the official government target remains to cut the deficit to €18.5 billion this year. It appears only a matter of time, however, before the money being put into Anglo and Irish Nationwide is counted as part of the 2010 deficit. Like the €4 billion put into Anglo last year, it is money down the drain.

The EU is still considering the plan by Anglo to reinvent itself after most of its loans are transferred to the National Asset Management Agency (Nama). However, whatever plan comes into effect, it is most unlikely that anything beyond a small proportion of the €8.3 billion put in this year will ever be recovered - and the same goes for the vast bulk of what is going into Irish Nationwide. So this money will also almost certainly be added to the 2010 deficit.

This may not be the end of it. In his major speech on banking last month, the Minister for Finance indicated that a further €10 billion may have to go into Anglo.

It remains unclear what the timing of further cash injections will be. That will be heavily influenced by the business plan approved by the EU Commission and the attitude taken by the Financial Regulator about what kind of capital levels Anglo must have if a bad bank/good bank split does go ahead.

However, there is a good chance that a significant extra amount of this cash may have to be paid in this year, further increasing our borrowing levels.

So, here is how it adds up. The current forecast for the GGD is €18.8 billion for 2010. If we add the €11 billion already committed to Anglo and Irish Nationwide, this brings the total to about

€30 billion. With a further possible €900 million earmarked for Irish Nationwide, the GGD this year could be 18 per cent of GDP.

If any of the other further liabilities to Anglo are accrued in 2010, then it could rise further. If, say, another €6 billion goes into Anglo this year (a total of €14.3 billion for 2010 payments into Anglo) then the GGD would go over 22 per cent of GDP - if the full €10 billion goes in, it could rise to 25 per cent of GDP.

Of course, we knew already that we had taken on - or were about to take on - all these liabilities. The government will emphasise that its plans to tackle the underlying borrowing position remain intact. The GGD will shoot up this year, but due to a series of once-off payments. Depending on the timing of the final payment needed to clean up Anglo, the level of borrowing should fall back sharply in 2011 or 2012.

Of course, this assumes that the government delivers on its other commitments to cut spending or increase taxes in the next few budgets, and that some recovery in economic growth also kicks in and helps to lift tax revenues.

In terms of the amounts of money we need to raise to meet our borrowings and bail out the banks, the Eurostat decision does not change anything.

Bond market experts Glas Securities estimates that the government will need to raise more than €25 billion in new lending this year and next, and between €21 billion and €24 billion in each of the subsequent three years.

However, what it does do, by adding much of the cost of the bank bailout to our official borrowing and debt figures, is highlight the huge burden of this on the exchequer. Added to this debt is the uncertainty about how much Nama will cost us in the long term. Some €45 billion will be issued to the banks in bonds to pay for this debt. The state will get 'assets' in terms of the bank loans in return.

For this reason, they are not being counted as part of the national debt or the GGD. However, if the loans and the assets underlying them turn out to be worth less than Nama is paying for them, this will be a further addition to our debt down the line. All these factors will be counted in by the financial markets, as they assess the terms on which they will lend money to us. Two things are now vital. The first is their assessment of the economy's ability to bear this.

The second is the international environment in which this judgment is made. Will the Greek crisis explode into an international debt crisis, or will the EU action clamp things down, perhaps after a brief hiatus? The next few weeks will tell a lot.