Thepost.ie

ThePost.ie

Credit crunch: the sequel

23 May 2010 By Cliff Taylor

Are we facing into another leg of the credit crunch? The market upheavals of the last few weeks have the same theme as those which hit at the height of the crunch, following the collapse of Lehman Brothers in autumn 2008 - fear of risk.

Then, it was investorsâ€™ fear of the risks hidden in bank balance sheets. Now it is fear of whether EU countries - and particularly the smaller, more highly borrowed ones - can find away out of their financial mess. This has been at the root of all that has happened as the Greek crisis spread - and letâ€™s not fool ourselves, Ireland is right in the middle of this one. Like countries such as Spain and Portugal, we can only access cash on international markets at a reasonable interest rate because the European Central Bank has stepped into the market for government bonds and the EU and the International Monetary Fund have put in place a backstop for any country that runs into trouble.

What is going to happen next? Who knows? The crisis may build. Or the unprecedented action being taken by EU governments and the ECB may let us all muddle through. We just donâ€™t know. But what is clear is that these market conditions, if they continue for a prolonged period, will cause problems and extra costs - both for the Irish government and for the banks in raising cash.

By Friday evening the markets had settled a bit, but it had been another week of extraordinary volatility. What we saw last week was what is known in market jargon as a â€˜flight from riskâ€™. Investors had decided they didnâ€™t want to get stung again and were starting to withdraw money from global equity markets and sell the euro. The proximate cause was the move by Germany to ban some types of market speculation - including types of short selling where investors bet against the euro or against the government bonds. This worried investors,who then asked if the German authorities knew something they did not.

It also stoked fears that EU governments were struggling to act in concert - bringing to mind the old Henry Kissinger question: â€˜â€˜Who do I call, if I want to call Europe?" As well as dumping the euro and avoiding government bonds, investors sent out another important signal last week.

They demanded a higher return for corporate borrowings and for lending to banks. The interbank markets - where banks lend to each other - also showed worrying signs, with lending rates edging upwards and heading back towards the kind of rates seen last summer. Hence the fears that, unless things start to ease up, we could be entering another leg of the credit crunch.

The government

The good news was that the National Treasury Management Agency (NTMA) managed to flog €1.5 billion of bonds last week - in other words raise this amount from international investors. The interest rate on this was a bit higher than the NTMA would have liked, with investors demanding a return of 4.7 per cent on our ten-year bonds. On the face of it there was strong demand, with the offer three times oversubscribed. However, what is not clear is how much of this was underpinned by the presence of the ECB in bond markets.

The ECB cannot, under its rules, buy bonds directly from governments. However, it has been active in buying bonds from other investors, thus putting a floor on the price. Sources in Dublin have said that there was some demand from private investors for the bond auction, but that clearly the ECBâ€™s presence in the market remains crucial.

â€˜â€˜It is far from an efficient and properly functioning market," said one senior bond market source. â€˜â€˜We must assume that central bank buying is continuing - after the initial burst the previous week - although more discreetly now.The real private investor money has not returned to the marketplace." By the end of the week, Irish ten-year bond rates were at 4.7 per cent; the gap with comparable German levels had risen to more than 2 percentage points, up from 1.7 points a week ago.

Meanwhile, the difference in price between what brokers would buy and sell our bonds at - the socalled bid/offer spread - had widened considerably, a sure sign of nervousness and very low trading. This has not been unique to the Irish market - nervousness also hit eurozone bond markets in general and particularly those of other indebted euro countries such as Spain and Portugal. It is not a problem if this nervousness persists for a couple of months and then things quieten down.

Last weekâ€™s auction meant that the NTMA has now raised two thirds of the €20 billion it has estimated it will need this year (it will probably try to raise a bit more if it can). It also has a cash pile of shorter term borrowings of €20 billion plus. This puts us in a strong cash position, but we still have huge borrowing needs over the next few years. The problem is that the markets are now being driven by fundamental fears about the structure of the eurozone and the sustainability of the position of countries such as Greece, Spain, Portugal and Ireland.

The only way to correct the public finances of these countries is to cut spending or hike taxes - the fear is that this will only drive economic growth lower. Speaking about Ireland, Ciaran Oâ€™Hagan, a fixed-income strategist with Societie Generale in Paris, said the big reserves of cash provided protection from any short-term credit squeeze on the exchequer. However, he said that Ireland remained exposed if it did not act quickly to cut the huge gap between exchequer revenue and spending, which is still targeted to be more than 10 per cent of GDP next year.

â€˜â€˜Running future budget deficits at some €25 billion per annum, before counting money to recapitalise the banks, would be the surest way to end up as Europeâ€™s dominion," Oâ€™Hagan warns. Ireland has got come credit from investors because of the budgetary action taken so far, but our borrowing remains high and international commentary remains mixed. The Financial Times, for example, has generally taken a favourable view of the actions taken by the government. However, an article published on the Baseline Scenario website last week and also

carried in summary on the New York Times website illustrates the alternative view.

Written by Peter Boone of the London School of Economics and Simon Johnson, formerly chief economist of the International Monetary Fund, it said that â€˜â€˜the Irish miracle was a mirage driven by clever use of tax-haven rules and a huge credit boom that permitted real estate prices and construction to grow quickly before declining ever more rapidly." It went on to argue that Ireland would likely need help from the EU and IMF and might not be able to stay in the euro in the long term. For the moment the government can still raise money, albeit that it is going to cost us a bit more for the moment. The worry is whether the market can gradually return to normal and be weaned off ECB support.

The banks

Ireland needs to raise money as a sovereign borrower, but our banks need to raise money, too, to fund their operations. As they are raising most of this under government guarantee, this is a kind of quasi-national debt. Glas Securities has estimated that the Irish banks need to raise about €30 billion this year, of which they have already raised close to €19 billion. Like the state, they have raised considerable sums early in the year. However, the price of Irish bank debt has fallen on the markets again this week and the interest rate gap demanded by investors for bonds issued under the government guarantee - compared to Irish government debt - has widened from 0.75 percentage points a few weeks ago to 1.25 points now.

The price of shorter term unguaranteed paper has also risen. There are also tensions in the short-term interbank market. The key issue for the banks will be weaning themselves off the guarantee. This is due to end in its current form in September; around the same time the ability of the banks to raise funds under the eligible liabilities scheme - a separate guarantee covering many forms of debt issue - will also run out.

The government is now trying to negotiate an extension to December, the same date as was set by the Financial Regulator for banks to meet the new capital standards he set down. The guarantee may continue in some form into 2011. Indeed, it may have to. Market conditions have made it difficult for the banks to raise funding. Most of what they have raised is under the guarantee, with only short-term funding available on a non-guaranteed basis. In other words, investors will only lend to Irish banks for short periods - weeks or a month or two - without the cover of the guarantee.

In general, bank sources have said that lending is increasingly on a short-term basis. Loans previously granted for three months are being rolled over into loans for five or six weeks, as investors become more cautious with their cash. This move to shorter funding is fine for a period, but dangerous if prolonged. The question of what happens when the guarantee ends remains.

The Nama process and the shrinking of the bank balance sheets will lower the need the banks have to raise cash on wholesale markets, but it will not remove it. Like the government, the banks need the credit markets to free up again if they are to avoid the kind of squeeze on funding which caused such problems over the last few years.

Ireland Inc

Our government and our banks need to raise a lot of cash in the months ahead. They now face having to do so at a time when major investors, particularly in the US, have said â€˜noâ€™ to European investment and when these same investors - and many across the world - are choosing to reduce their overall exposures to smaller EU markets, such as Portugal, Spain and Ireland.

There are plenty of other places to lend to. If the turmoil continues, then it will put a squeeze on our exchequer finances, which will certainly make it more expensive to raise funds and put more pressure on the budget sums for 2011. It will also put a squeeze on our banks and, in turn, make it more difficult for them to provide credit to the rest of the economy.

We need market conditions to ease in the next short while, if the promising growth indicators of recent weeks are to have a chance of turning - however gradually - into some kind of recovery. We also need to build investorsâ€™ faith in Ireland. Every facet of our budget will now be continually examined and particularly whether we can meet our promise to cut borrowing further next year. Failure - or even fudge - is not an option.

© Thomas Crosbie Media 2010.