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## Ireland is caught in a debt dilemma

18 July 2010 By Cliff Taylor

Another week, another wobble.

Media attention may have been focused on the domestic reaction to reports on our economy from the Economic and Social Research Institute (ESRI) and the International Monetary Fund (IMF).

But in the international markets another game is playing out - one with major implications for us all. Put simply, the question is whether international investors will be prepared to continue lending money to the government and to our banks and, if they are, on what terms?

While conditions had calmed a bit by last Friday, earlier in the week investors had been selling our bonds again, worried by the IMF conclusion that we would not meet our budget targets in the years ahead.

At the moment, the government can only raise funds because the market is effectively underwritten by the European Central Bank (ECB), and our banks can only raise money because they are underwritten by the government.

We need a significant improvement in financial market conditions if this is going to change in the months ahead.

It is now almost three years since the credit crunch first hit international markets after the explosion of the US sub-prime mortgage crisis.

Back then the problem that first emerged was that banks were unwilling to lend money to each other, fearful of what lay hidden on the balance sheet of the bank to which they were lending funds.

This crisis has morphed a few times over the past three years, but now it is presenting Ireland with particular problems.

Now, across Europe, investors are nervous of lending not only to banks which have been exposed to losses but also to governments who themselves are highly borrowed, either due to the need to support their banks or because of big deficits between tax and exchequer spending.

Ireland ticks all these boxes and so investors are demanding a high return on the money they invest here, not far off three percentage points more than they charge Germany for similar loans.

After some signs that these pressures might be easing just a bit, last week there was a relapse.

The ESRI report focused attention on what investors should already have known - the EU is likely to insist that a big chunk of the cost of bailing out Anglo Irish Bank and Irish Nationwide be included in the official exchequer deficit figures for 2010, even though the money will be paid out over a period of years.

This will send the measured level of borrowing shooting upwards from around 11.5 per cent of GDP to around 20 per cent, depending on what exactly is counted in. Rational investors would already have factored this in to their calculations - but in the current febrile atmosphere not all investors are thinking entirely rationally.

More seriously, the IMF cast doubt on the government's budgetary strategy of reducing borrowing to three per cent of GDP by 2014. Growth was likely to be slower than the government assumed, it said, and lower growth means less in tax revenue. So it said that the targets for cutting the deficit were likely to be missed unless further savings were made over the next few years.

The government is targeting borrowing of 10 per cent of GDP next year, but the IMF feels existing policy promises will still leave us borrowing over 11 per cent and by 2014 they see borrowing stuck near 6 per cent of GDP, compared to the official target of 3 per cent.

The IMF's growth forecasts are a good deal lower than those produced by the government, or the ESRI for that matter, and such is the uncertainty surrounding forecasts at the moment that goodness knows who is correct.

However, the IMF's warnings were enough to spark off a significant sale by investors of Irish government bonds last Wednesday.

By yesterday, the interest rate on Irish 10-year government bonds was around 5.5 per cent, more than 2.9 percentage points above German bond levels. This gap had narrowed to below 1.7 points earlier this year, before the Greek crisis broke, and in recent weeks had been down as low as 2.65 points.

Now, however, investors are again looking for a bigger premium to invest in Irish debt, to account for the risk they perceived of not getting all their money back.

The message from the government and the National Treasury Management Agency (NTMA) is twofold.

First, the economy has turned the corner, and second, there is a commitment to meet the targets set down to reduce borrowing. And they have some aces up their sleeves.

The main one is that the NTMA has raised 80 per cent of the €20 billion it needs to raise in 2010 to bridge the gap between exchequer spending and revenue.

With short-term cash reserves of a further €22 billion plus also to hand, it said last Friday that it could afford to stay out of the market until the end of the first quarter of next year, if it needed to.

So far it has chosen not to do this and will push ahead with an auction of longer-term debt next week to raise between €1 billion and €1.5 billion.

It is likely to be successful in raising the money, but may have to pay up for it.

Spain succeeded in raising €3 billion in 15-year bonds last week, but had to promise investors an interest rate of more than 5.1 per cent, compared to just over 4.4 per cent in April.

And remember this is at a time when ECB support is still available in the market, even though the ECB has announced that it has scaled back its activity significantly after it went in with all guns blazing when the Greek crisis broke.

The problem for countries like Ireland, Portugal and Spain is that refinancing debt at higher interest rates is manageable for short periods, but becomes prohibitively expensive if rates remain high for a prolonged period.

Unless conditions turn very nasty and lead us to have to dip into our cash reserves pile, bond experts Glas Securities expect the NTMA to try to raise about €10 billion by the end of 2010, to give it a cushion moving into 2011. Glas points out that the average cost of money raised so far this year has actually declined a little to 4.5 per cent, compared to 4.7 per cent for the same period last year.

Next week's auction may change this arithmetic if the nervousness of last week continues.

However, the tricky issue for Ireland is that not only does the government have to raise money, but our banks do as well.

What we are talking about here is not the money needed by the banks to replenish their capital due to property write-downs, it is the funding they need to maintain their normal operations.

Banks do not take in enough cash through deposits to fund all their ongoing lending commitments, even in a situation where lending is falling significantly. So they need to borrow cash internationally.

This is difficult at the moment, and only possible at all because the government is underwriting it all through a guarantee which is now due to run out in December but which may, as the IMF hinted, now need to be extended.

Glas reckons that the banks have raised some €19 billion so far this year in longer-term debt - in other words, borrowings of a year or more. They reckon they need to raise about the same again over the balance of the year, a sizeable amount.

Some €25 billion of longer-term debt matures at the end of September, as this was the end of the two-year guarantee granted in September 2008 (the guarantee scheme was later modified through a new scheme - the eligible assets guarantee - which now runs out in December).

This will not all need to be refinanced, as the banks are shrinking their balance sheets, but clearly significant fundraising is needed over the next few months.

In addition to this longer-term funding, banks also need to refinance significant short-term borrowings. The total debt maturing in 2010 counting these shorter-term funding requirements along with the longer term debt is €74 billion.

With significant maturities in September, the banks need to raise new cash.

The plan had been for them to start issuing new bonds under the government guarantee in the run-up to the August break - when markets are generally quiet - and then to raise further cash in September.

It remains to be seen whether this is possible.

Beyond that, they face into 2011 not knowing whether the EU commission will agree to a further extension of the bank guarantee from December.

On the plus side, the banks will be able to cash in the bonds they are getting from the state in return for the loans being transferred to Nama, with the European Central Bank as an additional source of funding.

This gives them a substantial cushion heading into 2011, as substantial Nama bonds will be transferred by the end of the year.

So neither the government nor the banks face a short-term panic in terms of getting their hands on cash.

But the problem remains that the costs to the government of raising cash are going up and we are vulnerable if there is a further crisis in sovereign debt markets.

Meanwhile, the banks are limping along, and at the moment have no prospect of raising funding without the government guarantee.

Three years on, we are still a long way from normal service being resumed, and we remain heavily reliant on a general improvement in the mood of the markets and on their continued confidence in the government's ability to get borrowing under control.

Tricky times.