

# Focus on Economics

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## Ireland: Return with risks

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After three years of refinancing via a support package from the International Monetary Fund (IMF) and the EU, Ireland is set to be the first of the Eurozone programme countries to return to the capital market in early 2014. And it looks like it is going to succeed. The Celtic tiger is widely regarded as the Troika's model pupil, who has implemented the strict consolidation requirements in an exemplary fashion.

The first hesitant steps on the capital markets have been well received by investors and interest rates have fallen sharply. Ireland's economy is still haunted by the banking crisis that struck the unsuspecting country in 2007/2008 and culminated in a sovereign debt crisis. The sustainability of the comeback on the financial markets depends on whether the banking system is able to put its past problems behind it. If the economy kicks into gear, the solvency of the Irish state is likely to be assured. If the recovery fails to take hold, however, the celebrated return to the capital markets could end in a relapse into dependency on renewed aid payments.

At the end of September 2010, Ireland issued its last bond on the capital markets for the time being. Since then, Ireland has predominantly been financed via an IMF and EU aid package. The consolidation programme that Ireland has been following in consultation with the Troika is designed to enable the country to regain the confidence of international investors as well as permanent access to capital markets. With the ex-

piry of the aid package at the start of 2014, Ireland wants to be able to completely refinance with private investors and finally leave the financial crisis behind it.

### **Looking back: A banking crisis becomes a sovereign debt crisis**

The origins of the Irish financial crisis lie in an excessive expansion of the banks' credit business in the real estate market. When house prices began to fall in 2007, the banks ran into difficulties due to insufficient provisions. The Irish state – assuming that it was primarily a liquidity and not a solvency crisis – issued guarantees for six of the country's largest banks, which cost over EUR 64 billion (39 % of the GDP in 2012) and would not be discharged until March 2013. The recapitalisation of some large banks left them under partial state control and the Irish government itself in financial difficulty. A rescue package of EUR 85 billion (54 % of GDP in 2010) was agreed

with the IMF and EU: In return, Ireland undertook to conduct consolidation measures to the tune of EUR 15 billion (10 % of GDP in 2010).

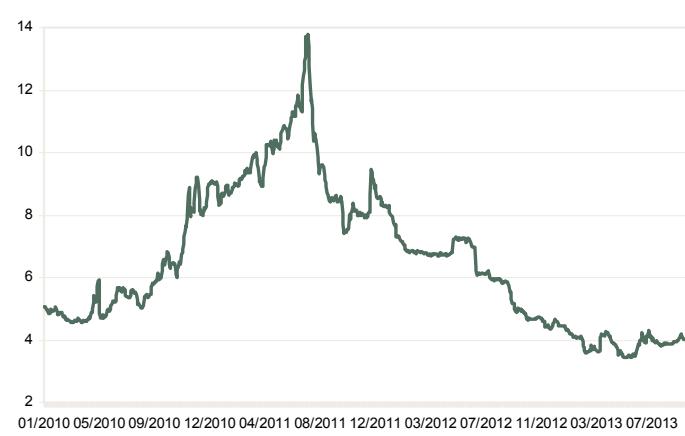
### **Consolidation on schedule, cautious return to the capital markets already successful**

The first signs of success can be seen. For instance, Ireland was able to test sentiment on the capital markets in 2012 and successfully placed bonds worth more than EUR 12 billion (7 % of GDP in 2012). The issue of a 10-year bond for EUR 5 billion in March 2013 is considered a great success – initially only three billion was planned, and offers were made for EUR 12 billion.<sup>1</sup> This was preceded by the placement of EUR 2.5 billion so that Ireland's refinancing needs for 2014 have already been covered according to the Irish Department of Finance. It was thus possible to avoid a feared "funding cliff," the refinancing of a multibillion bond maturing in January 2014, which was considered to be a major obstacle in the rapid and complete return to the capital markets.

But it is not only the successful placement of the first bonds that is encouraging, the trend in interest rates for outstanding Irish government bonds also gives cause for optimism (see Figure 1).

**Figure 1: Return on 10-year Irish government bonds**

Up to 14<sup>th</sup> March 2013 October-2020 bond, from 15<sup>th</sup> March 2013 March-2023-bond (in percent)



Source: Bloomberg

Returns have continuously fallen since the high point of the crisis in mid-2011; the spread over 10-year German federal bonds shrank to just over 200 base points in summer 2013. While it is true that the OMT pledge of Mario Draghi in summer 2012 played its part in the trend – the narrowing of spreads over federal German bonds can also be observed in other periphery states – the reasons can also be found in Ireland itself.

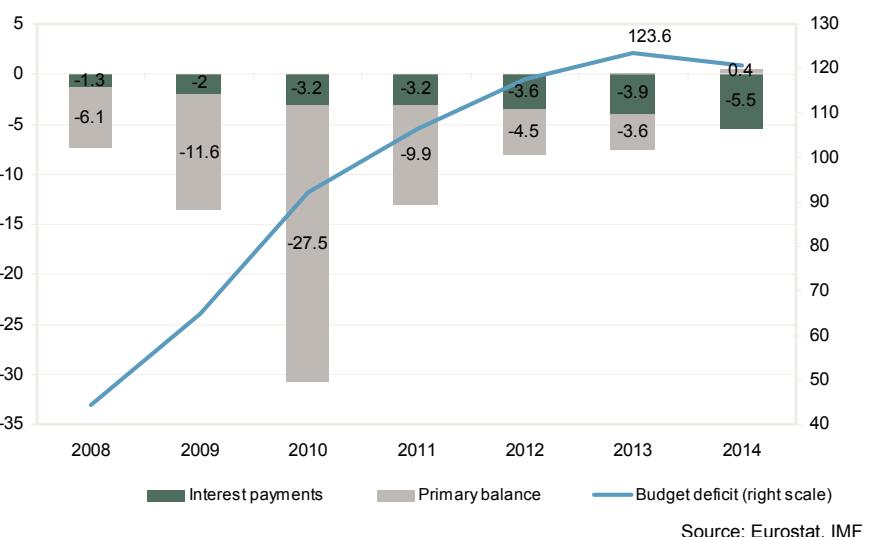
One reason is the consolidation programme, which up to now has been implemented in an exemplary fashion (see Figure 2). Although the deficit for 2012 of 8.2% of GDP is still very high, it is clearly below the Troika's target of 8.6%. In particular, high tax receipts provided relief and generated unanticipated additional revenue, which will also provide relief for budgets in the years ahead. Further progress can be reported in 2013 and the deficit will remain under the limit set in the programme. The Department of Finance is planning to achieve a primary surplus again for the first time in 2014 and to again stay within the Troika's deficit limit.

The trend in unemployment is likely to make continued consolidation even easier. In September 2013, the unemployment rate was 13.3% and thus two percentage points below the high point reached during the crisis.

Investor confidence also reflects the successful negotiation of the Irish fi-

**Figure 2: Government deficit and indebtedness**

Share of GDP (as percentage)



Source: Eurostat, IMF

nance minister Michael Noonan with the European Central Bank (ECB) in spring 2013. He obtained agreement to swap promissory notes, which are associated with annual payment liabilities in the order of billions, against long-term government bonds. As these bonds will not have to be serviced until 2038, the state budget will be relieved of just over EUR 20 billion (12 % of GDP in 2012) in the coming ten years.<sup>2</sup> A second deal cut by Noonan has also contributed to the manageable debt situation: He negotiated a maturity extension of the outstanding EFSM and EFSF loans by seven years, thus avoiding more than EUR 5 billion of repayment liabilities in

2014 alone. The agreement also saw the average residual maturity of Irish government bonds increase to a comfortable twelve years, significantly more than the EMU average of just over seven years.

#### Debt sustainability not yet assured

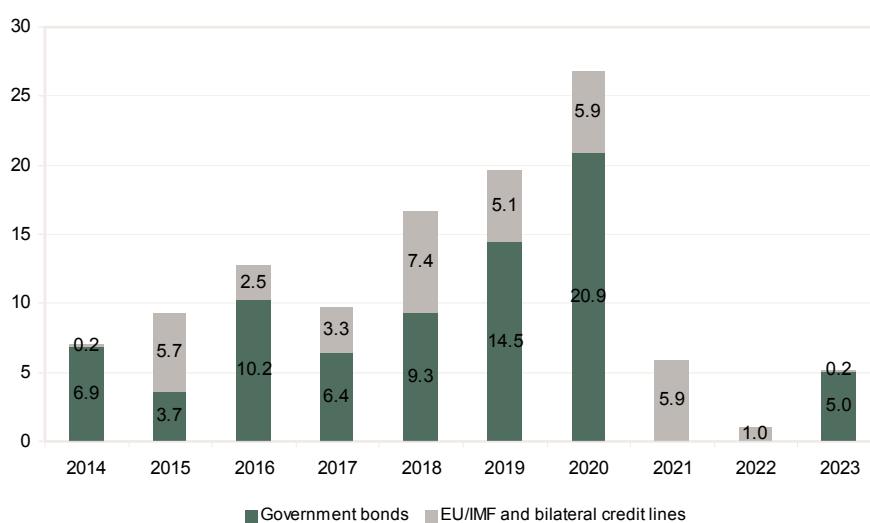
Despite these successes, the sustainability of Ireland's return to the capital markets is not yet completely assured. Ireland will only be able to stand on its own two feet in the long-term if investors regain trust in its debt sustainability. This will initially be compromised by higher expected refinancing costs in the coming years. Even if repayments of less than EUR 10 billion fall due in 2014 and 2015 respectively, the debt to be refinanced rises sharply from 2018 onwards and by 2020 comes to just under EUR 27 billion (17 % of the GDP in 2012) (see Figure 3).

Whether Ireland is actually able to finance these anticipated additional costs ultimately depends on one key variable: growth. Both the IMF and the Irish Department of Finance assume that the level of debt measured as a fraction of GDP will already peak this year at 123 %. This is based, however, on the assumption that Ireland's growth increasingly gains momentum and in 2015 reaches values of 2.5 % p.a. (IMF) or even exceeds these (Finance Department).

The latest economic numbers give grounds for caution, however. The EU

**Figure 3: Maturity profile of Irish long-term government bonds**

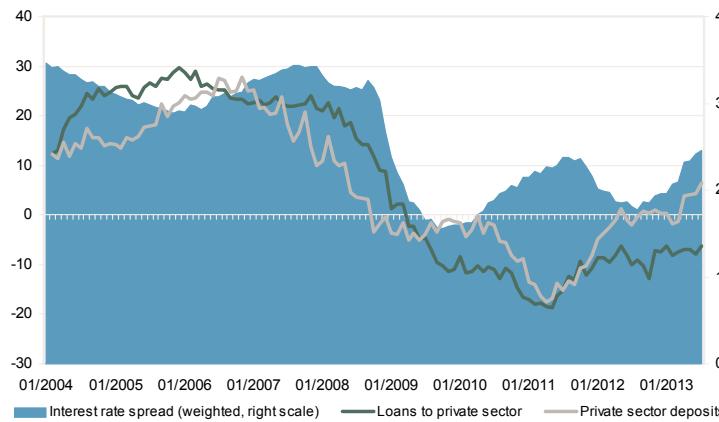
(in EUR billion)



Source: NTMA

**Figure 4: Outstanding volumes of loans and deposits, interest margin**

Growth rate compared with previous year (loans and deposits as a percentage) and weighted interest rate spread (interest margin, in percentage points)



Source: Central Bank of Ireland

Commission has cut back the growth forecast for 2013 to only 0.3 % and the growth rate for the previous year at 0.2% was significantly lower than initially expected. If growth in the coming years is lower than forecast, the debt momentum could reverse: The IMF assumes that with an average annual growth rate of only 1%, the ratio of debt to GDP would not achieve a sustainable trajectory.

### Banking system is Achilles heel

Another major risk for debt sustainability in the eyes of the IMF lies in possible additional costs for the restructuring of the banking system. These are potential legacy costs from the banking crisis, which could once more encumber the state budget. If, for example, the earnings from sales by the state's bad bank NAMA (National Asset Management Agency) turn out lower than expected or the results of the bank stress test due for the start of 2014 indicate a need for considerable additional capital, the state could be forced to inject billions of Euros more.

Obtaining an accurate inventory of the state of the banking system is therefore of central importance for a permanent return to the capital markets. The condition of the banks directly determines whether the state will again have to foot the bill for capital injections. Furthermore, a healthy banking system is, via the cranking up of lending, an essential prerequisite for economic recovery, which in turn underpins the sustainability of debt.

The adjustment process in the Irish banking system is not yet complete. The banks have yet to return to profitability; they continue to reduce their loan portfolios and the balance sheets of the six banks backed by the state guarantee shrunk by 37 % between the end of 2010 and mid-2013. On the other hand, this shrinkage is also reducing dependence on ECB credit lines. In January 2011, these still amounted to EUR 93 billion, but by May 2013 had fallen to just under EUR 36 billion.<sup>3</sup>

The refinancing terms of the banks have also improved. In March 2013, for example, the Bank of Ireland was able to issue a five-year EUR 500 million bond at a rate of only 2.75 %, while the interest rate stood at around 3.13 % only four months earlier. Furthermore, Irish savers are now increasing their deposits with the banks, leading to falling deposit rates and thus to falling interest rate margins (see Figure 4.) Along with the continued decrease in lending, the increasing deposits are also normalising the loan-to-deposit ratios of the banks, which, before the crisis, had got out of control at up to 220 %.

A central reason for the continued shrinkage of new loans is the large share of non-performing loans on the banks' balance sheets. This share increased again in 2013 and, in the first half of the year, comprised over 26 % of outstanding loans (for comparison, Greece: 29 %, Spain: 12.2%).

Especially on the mortgage market borrowers are increasingly falling into arrears, with the share of non-performing mortgages rising continuously since the start of the crisis and topping 17 % in June 2013 (for comparison, Spain: 5.2%). A supporting effect could be generated by a recovery in house prices. These have roughly halved since September 2007 and since January 2012 have been marking time. At present, however, an upwards trend can be discerned, which could point to a recovery – driven by the capital, Dublin. The recent slight fall in the number of mortgages with less than 90 days in arrears may also be a straw in the wind.

The popular tracker mortgages present a double-edged dilemma. The lending rate for these mortgages is pegged to the ECB base rate. At present, this base rate is so low that it is below the deposit rates and thus burdens bank margins. If the Eurozone recovers and the base rate is raised, there is a risk of yet more mortgage losses if by that stage the Irish economy has not achieved enough momentum to provide borrowers with sufficient income to service their mortgages.

Up to now, banks have resisted any write-downs of losses from their mortgage business. The central bank has therefore required banks to offer a certain proportion of defaulting borrowers viable debt restructuring plans. In order to increase the pressure, fixed targets will be provided for agreed restructuring plans and if the banks fail to meet these targets, they will have to write down mortgage debts. However, the central bank is not likely to be too strict with its targets as it would otherwise risk a new wave of bank failures.

Greater clarity about the quality of bank balance sheets should be provided by a balance sheet audit, due to be completed at the end of November, and a second comprehensive stress test – the results of which are not expected until March 2014 as its methodology is to be based on the ECB Asset Quality Review.<sup>4</sup> The IMF remains sceptical and still sees high potential costs on the bank balance sheets. If there is a need for further injections of capital, a credible backstop should therefore be provided.

## Outlook: Not yet out of the woods

Ireland appears to have regained the confidence of investors for now. The consolidation is proceeding according to plan and the agreements with the ECB and EU have created additional room for manoeuvre. The country has correspondingly won plaudits from investors. Interest rates have fallen markedly; the offer of the first bonds on the capital markets can be counted as a resounding success. At present, everything indicates

that the return to the capital markets in 2014 will succeed.

Whether this good news is sustained and whether Ireland can avoid the need for assistance in the future depends on the recovery of the Irish economy and the stability of Irish banks. If growth takes off as hoped, the situation of the banks is likely to stabilise and the volume of new loans will expand. A stimulus to growth from the domestic economy is, however, for its part dependent on new loans. In

this context, and in view of the dependence of the Irish economy on exports (109 % of GDP in 2012), attention turns to the trading partners abroad. And thus the sustainability of the return to the capital markets will ultimately depend on an economic recovery in the rest of the Eurozone, the United Kingdom and the USA. Ireland is not yet completely out of the woods. ■

<sup>1</sup> Investors demanded a (weighted) return of 5.95 % for a five-year and an eight-year bond in July 2012.

<sup>2</sup> When the Anglo Irish Bank, in particular, felt that it was no longer in a position to refinance itself on the interbank market as a result of the financial crisis, the Irish government promised via promissory notes to make annual payments to Anglo Irish so that the latter was able, with this guarantee behind it, to obtain emergency liquidity assistance (ELA) from the ECB. In total, the government issued promissory notes to a value of EUR 31 billion (19% of the GDP); the annual payments would have amounted to EUR 3.1 billion p. a. (2 % of the GDP) for the next twelve years, thus massively burdening the state budget over many years and hindering the return to the capital markets.

<sup>3</sup> In addition, with the winding up of IBRC – the Anglo Irish successor institute – in February 2013, ELA support loans of around EUR 40 billion ceased to be required. In all, this means that the use of Eurosystem funds (ECB facilities plus ELA loans) has been reduced by over EUR 120 billion overall from its peak at the start of 2011 of just under EUR 160 billion (98 % of GDP in 2012).

<sup>4</sup> In the first stress test (the Prudential Capital Assessment Review, PCAR) in 2011, the Central Bank of Ireland determined an additional capital requirement of EUR 24 billion for the three banks investigated (Allied Irish Bank, Bank of Ireland and Permanent TSB), whereupon the state provided new injections of capital and the Central Bank conducted regular capital and liquidity tests.