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In Ireland, Dangers Still Loom

By Simon Johnson and Peter Boone September 2, 2010 6:00 am

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Is the global economic recovery still on track? The mainstream view is: yes, without a doubt. But increasingly, there are reasons to fear another financial disruption — particularly given the latest developments in Ireland.

The consensus among officials and most of the international banking community is that the global economy has stabilized and is now well down the road to recovery. The speed of this recovery is proving disappointing — as seen in the revised second-quarter growth estimate for gross domestic product in the United States, with annualized growth down to 1.6 percent. But, according to this view, easy monetary policy and still-loose fiscal policy around the world will keep sufficient momentum going.

Never mind that Japan, the United States and most of Europe are running unsustainable fiscal policies, while the Federal Reserve chairman, Ben Bernanke, is fretting over how to prevent deflation with a limited tool box, and Jean-Claude Trichet, president of the European Central Bank, is calling for more fiscal tightening. To enjoy this rosy global picture, we are also told to ignore the plight of heavily indebted peripheral euro-zone nations still suffering from uncompetitive wages and prices, and concerns over default, that strangle their credit markets and growth.

An essential part of this relatively positive view is that the euro-zone economies have stopped the series of "financial runs" that, earlier this year, took intense market pressure from Greece to Portugal and Ireland and threatened to move on to Spain and potentially almost everywhere else (except, presumably, Germany). A collapse was averted in large part by the euro-zone countries' agreeing to rescue one another — meaning that the Germans agreed to support Greece and other weaker countries — with some additional cash resources provided by the International Monetary Fund.

However, let's be clear: Europe's headache remains large, and this should concern all of us. Just look at Ireland to see how misunderstood and immediate the remaining dangers are. Ireland's difficulties arose because of a huge property boom financed by cheap credit from Irish banks. Ireland's three main banks built up loans and investments by 2008 that were three times the size of the national economy; these big banks (relative to the economy) pushed the frontier in terms of reckless lending. The banks got the upside, and then came the global crash in fall 2008: property prices fell more than 50 percent, construction and development stopped, and people stopped repaying loans. Today, roughly one-third of the loans on the balance sheets of major banks are nonperforming or "under surveillance"; that's an astonishing 100 percent of gross national product, in terms of potentially bad debts.

The government responded to this with what are currently regarded as "standard" policies in Europe and the United States. It guaranteed all the liabilities of banks and began injecting government funds to keep these financial institutions afloat. It bought the most worthless assets from banks, paying them government bonds in return. Ministers have promised to recapitalize banks that need more capital. Despite or perhaps because of this therapy, financial markets are beginning to see Ireland as Europe's next Greece. In the last few weeks, the perceived probability of default by Ireland (as traded in credit-default swap markets) has shot up, so that markets now price a 25 percent risk that Ireland will default within five years.

Until very recently, Ireland was seen as Europe's poster child of prudent reforms. Mr. Trichet himself highlighted Ireland as an example that Greece and other financially stricken nations should follow. His message was simple: If only

Greece or Portugal or Spain would cut public wages, reduce the budget deficit and make structural reforms as Ireland had done, then growth could occur and default could be prevented.

But it is now apparent that Ireland has not done enough to stem its march toward further crisis. The ultimate result of Ireland's bank bailout exercise is obvious: one way or another, the government will have converted the liabilities of private banks into debts of the sovereign (that is, Irish taxpayers), yet the nation probably cannot afford these debts. According to the Royal Bank of Scotland, Irish banks have debt worth 26 billion euros, or one-fifth of Ireland's national income, coming due in the month of September alone. Ireland's third-largest bank just announced it was likely to need 25 billion euros in total capital injections from the government (19 percent of G.N.P.), while Standard & Poor's argues that this figure is too low. In total, the debts of Irish banks could easily result in a charge to government debt equal to one-third of G.N.P.

These debts need to be added to the fiscal deficit, which also remains dangerously out of control. This year, the government will run a deficit of 15 percent of G.N.P., and with nominal G.N.P. falling, it could well remain that high next year, even if the government cuts spending by the 2 to 3 percent of G.N.P. currently envisaged.

The government is gambling that growth will recover to more than 4 percent a year starting in 2012, in order to make all this spending and debt affordable, and officials insist that growth is already under way. Ireland's gross domestic product did grow in the first quarter of 2010, but that was not the good news that many news media and officials claimed.

This misunderstanding stems from Ireland's success as a tax haven. Many years ago, Ireland cut corporate taxes to attract business. This created one of Europe's most impressive tax havens — it is possible to set up a corporation in Ireland, channel sales through that head office (with some highly complicated links to offshore tax havens in order to avoid paying Irish tax) and then pay a minuscule corporate profits tax. Ireland boasts a large industry of foreign "tax minimizers" that do this, but these tax minimizers hardly employ any people. Nearly one-quarter of Irish G.D.P. comes from the profits of these ghost corporations.

The likes of Google, Yahoo, Forest Labs and many others helped Ireland's exports grow in the first quarter, but the domestic economy (when excluding their profits, as measured by G.N.P.) actually contracted, and so did Ireland's tax revenues and employment. Today, Irish unemployment is estimated at 13.8 percent, up from 13.1 percent at the start of the year.

Ireland, simply put, appears insolvent under plausible possibilities with current policies. The idea that Ireland, Greece or Portugal can cut spending and grow out of overvalued exchange rates with still large budget deficits, while servicing all their debts and building more debt, is proving — not surprisingly — wrong. Such policies leave nations burdened with large debt overhangs that effectively tax businesses and borrowers — because interest rates must stay high to reflect risk.

Investors must wonder whether businesses and homeowners can afford these higher interest rates, so banks and investors cut credit lines and reduce lending. This strangles economies, even when the fiscal authorities take tough steps needed to cut deficits.

Ireland had more prudent choices. It could have cut the budget deficit while also acknowledging insolvency and requiring creditors to share some of the burdens. But a strong lobby of real estate developers, the investors who bought banks' bonds and politicians with links to the failed developments (and their bankers) prefer that taxpayers, rather than creditors, pay. The European Central Bank, the European Union and the International Monetary Fund share some responsibility; they advocate these unlikely programs so that European and global banks, which provided the funds to the Irish banks, do not suffer losses from such bad lending decisions.

The Irish government plan is — with good reason — highly unpopular, but the coalition of interests in its favor seems strong enough to ensure that it will proceed, at least until it either succeeds and growth recovers, or ends in failure with the default of banks or the nation itself.

Under the current program, we estimate that each Irish family of four will be liable for 200,000 euros in public debt by 2015. There are only 73,000 children born into the country each year, and these children will be paying off debts for decades to come — as well as needing to accept much greater austerity than has already been put into force. There is no doubt that social welfare systems, health care and education spending will decline sharply.

Watch for renewed emigration from a famously footloose population. If current policies continue, the calamity of the Irish banking system will lead to a much deeper recession and the consequences will be felt for decades. Watch also for further global financial disruption as this kind of deal starts to fall apart.