Political-Economic Context in Ireland

Alan Ahearne

National University of Ireland, Galway and Bruegel

Paper prepared for Resolving the European Debt Crisis, a conference hosted by the Peterson Institute for International Economics and Bruegel, Chantilly, France, September 13-14, 2011.

Summary Description of the National Political Situation and Near-Term Outlook

Parliamentary elections held on 25 February 2011 returned a new coalition government of Fine Gael and the Labour Party. The new coalition government holds more than two-thirds of the seats in parliament, the largest majority in Ireland's history (see table 1).

Table 1 General election result, February 25, 2011

Party	Seats
Fine Gael	76
Labour	37
Fianna Fáil	20
Independents & small parties	19
Sinn Féin	14
Total	*166*
memo: Fine Gael/Labour Government	*113*

The next general election is due in 2016 at the latest.

Current Governing Coalition

During the election campaign, both Fine Gael and Labour promised a significant renegotiation of the terms of the EU-IMF programme which had been agreed with the previous Fianna Fáil-led government. Both parties' campaigns included promises to impose losses on senior bondholders in Irish banks. Since the election, some changes to the EU-IMF programme have been agreed with the Troika (EC, ECB, and IMF) and the new government has shown a strong willingness to meet the programme's targets. In its third quarterly review in July, the Troika concluded that Ireland's programme remains on track.

Minister for Finance Michael Noonan said recently that Ireland had shown that it "can and will meet demanding fiscal targets". He added that the EU-IMF programme provided a "clear path of sustainability." "At a political level, the willingness to meet the targets is underpinned by the new government which has such a large parliamentary majority," he said.

There have been some public differences recently between Fine Gael, a centre-right party, and Labour, a centre-left party, over relatively minor aspects of the EU-IMF programme.

Some political analysts worry that more serious tensions between the Coalition parties may emerge as the Government faces up to a range of unpalatable decisions in coming budgets. For example, another round of public sector pay cuts would undermine support for Labour amongst its political base. Labour will come under particular pressure from smaller left-wing parties who oppose the EU-IMF programme.

There is also some concern that the size of the government's majority may lead to indiscipline and that some backbench members of parliament might not support difficult measures that affect their own areas, thereby weakening the resolve of the government.

Opposition

The main opposition party, Fianna Fáil, lost three-quarters of its seats (dropping from 78 to 20 seats) in the February election. Fianna Fáil was in government from 1997-2011 and voters blamed the party for the economic boom and bust. Fianna Fáil supports the implementation of the EU-IMF programme, which it had negotiated with the Troika last November when in government.

Sinn Féin, a left-wing republican party, along with most independents strongly oppose the implementation of the EU-IMF programme. In particular, they oppose most spending cuts that affect low- and middle-income citizens. They also believe that the fiscal cost of recapitalising the banks has pushed the public debt to unsustainable levels and have called for burden sharing with senior bank bondholders to reduce the debt.[1]

How Is the Debt Crisis Debate Framed in the National Public Arena?

The main feature of the economic backdrop to the debate over the debt crisis is the significant ongoing reductions in disposable incomes resulting from the deep recession and budgetary adjustments.

- Real GDP has dropped 15 percent from its peak in 2007; nominal GDP is down 20 percent.
- Real personal consumption is down 12 percent from the peak in 2007:Q4.
- The unemployment rate has jumped to 14½ percent from 4½ percent in 2007.
- Budgetary adjustments of €21 billion (13 percent of GDP) have been implemented since summer 2008. An additional €10 billion (6 percent of GDP) of adjustments are planned over the next three years to reduce the deficit to 3 per cent of GDP by 2015.[2]
- Nominal wages per employee in both the public and private sectors have fallen. Average public sector wages have been cut by 15 per cent over the past three years.

Ireland's gross public debt/GDP ratio is expected to peak at around 115 percent in 2012/2013. [3] There are mixed views amongst Irish economists and other commentators in the media as to whether this projected level of debt is sustainable.[4]

---

1 Sinn Féin's Finance spokesperson Pearse Doherty said recently that: "The economics of austerity and socialising the losses of private banks is not working."

2 FitzGerald, John and Ide Kearney (2011) "Irish Government Debt and Implied Debt Dynamics: 2011-2015" ESRI, argue that Ireland is likely to outperform this target, in part because of the reduced debt burden resulting from the decision at the EU Summit on 21 July to lower the interest rate on borrowings from EU funds from 5.8 percent to 3.5 percent.

3 The Irish authorities hold significant liquid financial assets composed of cash deposits and liquid investments at the National Pension Reserve Fund. Taking these assets into account, net public debt/GDP is expected to peak at around 105 percent.

4 See FitzGerald and Kearney (2011) for an examination of Ireland's debt dynamics.

A key feature of the popular discourse on public debt is the distinction that many commentators make between increased indebtedness that has been incurred because of fiscal deficits (excluding banking outlays) and that which has resulted from the bank bail-out. Table 2 shows that public funds amounting to around €62 billion (40 percent of GDP) have been used to recapitalise Ireland's banks. More than half of this amount has been injected into Anglo Irish Bank and INBS (largely in the form of promissory notes which are counted as part of Ireland's gross government debt), which are nonviable institutions that have been merged and are being run down.[5]

Table 2 Public resources used to recapitalise Irish banks

Public capital injections into banks	€bn
Total	62
of which:	
Going-concern banks	27
Nonviable banks in run down	35
Total as a share of 2010 GDP	*40%*

There is a strong political consensus—that seems to be shared by the general public—that the country's so-called "sovereign" debt (that is, government debt resulting from fiscal deficits, excluding banking outlays) must be honoured in full. It is well understood that Ireland is a small open economy that relies heavily on international trade and foreign direct investment. The county's reputation for honouring contracts is viwed as important for future economic growth.

However, there is significant public dissatisfaction with the bail-outs of the banks. The public attitude is shaped by several factors:

- For starters, the cost to Irish taxpayers of rescuing the banks is very large. As shown in Table 3 below, only five banking crises in the last four decades are estimated to have had a larger gross fiscal cost. Each of these five more expensive crises occurred in emerging economies: The scale of public resources used in Ireland to recapitalise the banks is unprecedented among advanced economies.

- It is perceived that the sustainability of the sovereign debt may have been put in question by the scale of the bank bail-out.

- In popular discourse, the focus is mainly on the banks' creditors who have benefitted from the bail-out at the expense of taxpayers. The view that tends to dominate in the public debate is that the bailing out of (mainly foreign) bank bondholders has been unfair. The dominant view seems to be that financial institutions that invested in the bonds of reckless Irish banks during the boom should be required to bear some of the banks' losses. There does not appear to be a public appetite for burden sharing to extend to ordinary depositors.

[5] The management of Anglo Irish Bank has said recently that the final cost of bailing out the bank could be up to €4 billion lower than previously expected.

Table 3 Fiscal cost of banking crisis (percent of GDP)

Country	Start date of crisis	Gross fiscal cost (percent of GDP)
Indonesia	1997	56.8
Argentina	1980	55.1
Jamaica	1996	43.9
Thailand	1997	43.8
Chile	1981	42.9
Ireland	**2008**	**40.0**
Turkey	2000	32.0
Korea	1997	31.2
Advanced economies:		
Japan	1997	23.0
Finland	1991	12.8
United States	1988	3.7
Sweden	1991	3.6
Norway	1991	2.7

Source: Author's estimates for Ireland; Laeven and Valencia (2008) for all others.

- In the public mind, Irish bank bonds are largely owned by German and French banks. This gives rise to a perception that Irish taxpayers are being asked to bear a huge burden to rescue the European banking system.[6] This distribution of the costs is perceived in Ireland as unfair. In addition, it was widely reported in the Irish media last October that Russian billionaire Roman Abramovich owned bonds issued by INBS. The term "bondholder" is therefore often associated with large foreign banks, hedge funds, and mega-rich individuals.

- The Irish public are aware that financial regulation in Ireland utterly failed during the boom years. But they do not seem to accept that it therefore follows that Irish taxpayers should bear the full burden of bailing out banks' creditors. In the public mind, authorities in countries whose bank invested in Irish banks' bonds also failed to regulate properly.[7]

- There is an (incorrect) view among sections of the public that fiscal austerity is being implemented in large part to generate funds to put into the banks. "You are taking money from me to put into the banks" was a common charge put to government politicians during the last election campaign. In fact, the budget deficit of about 10 percent of GDP this year largely reflects the gap between government spending (excluding banking related costs) and revenues.

[6] The rescue of Anglo Irish Bank, a monoline property lender, has been particularly expensive for Irish taxpayers with State injections of capital approaching €30 billion (19 percent of GDP). In an interview in March 2011, when asked what would have happened had the Irish Government allowed Anglo to collapse, Central Bank Governor Patrick Honohan replied: "There would have been a lot of problems. This would have been problematic for Europe as well, it would have been a European Lehmans."

[7] The public mood is well reflected in a letter from former Irish Prime Minister John Bruton to José Manuel Barroso in January 2011 in which he wrote: "I agree the main responsibility does rest with Irish institutions, the Irish Government, the Irish Central Bank, the Irish banks, and the Irish individuals who borrowed irresponsibly. But you should know that this is not the whole story. British, German, Belgian, American, French banks, and banks of other EU countries, lent irresponsibly to the Irish banks in the hope that they too could profit from the Irish construction bubble. These banks, who lent to the Irish banks, were supervised by their home Central banks, who seemingly raised no objection to this lending, which was so ill advised. So these non Irish Central Banks must take some share of responsibility for the mistakes that were made. Yet the non Irish banks, who so foolishly lent to the Irish banks, are now being spared any share in the losses, because the Irish taxpayer is bailing them out."

- Several official investigations into possible criminal wrongdoing in the banking sector during the boom are ongoing, but progress has been slow. There is frustration among the public that no bankers have been called to account for their actions. More generally, there is a perceived lack of accountability over the banking collapse that has not been appeased by several inquiries into the causes of the crisis. There seems to be a public demand for vengeance.

Sharing the Burden of Bank Losses

Large losses have been imposed on both bank shareholders and holders of subordinated bonds.

- Shareholder equity in the Irish banks peaked at €25 billion in 2007, all of which has been wiped out.[8] The banks have been recapitalised largely by the State and in the case of Bank of Ireland by injections of private capital.

- Subordinated loan capital peaked at just over €20 billion in 2007. Subordinated debt has been bought back by the banks for discounts generally ranging between 70c-90c in the euro. Holders of these bonds have absorbed about €16 billion in losses.

To-date, no losses have been imposed on holders of senior bank bonds.

- Senior bank bonds were included in the two-year blanket State guarantee of banks' liabilities introduced on 28 September 2008. Senior bank bonds that matured after the introduction of the guarantee and before 28 September 2010 were covered by the guarantee and repaid in full.

- Since September 2010, senior bank bonds that had been issued before September 2008 have no longer enjoyed a State guarantee. Nonetheless, those (unguaranteed) bonds that have matured since last September have also been repaid in full. It has been widely reported in Ireland that the ECB is firmly against default on senior bank bonds. Therefore any burden sharing with senior bondholders would have to be executed against the wishes of the ECB. Given the significant support that the ECB is giving to the Irish banking system, both the previous government and the new government have said that they will not act unilaterally on the issue of senior bank bonds.[9]

- Senior bank bonds issued after December 2009 continue to be covered by a State guarantee.

Table 4 below shows the amounts of outstanding senior bank bonds. €21 billion of bonds are covered by a State guarantee. There are €35.6 billion of unguaranteed senior bonds, of which €19.1 billion are secured on banks' assets and €16.5 billion are unsecured.

The new Government has said it will not impose losses on the senior bondholders of the so-called "pillar" banks, that is the merged AIB/EBS bank and Bank of Ireland. Finance Minister Michael Noonan has said the "last red cent" of debt owed by the Government and the two pillar banks will be repaid.

---

[8] Nyberg, Peter, 2011, Misjudging Risk: Causes of the Systemic Banking Crisis in Ireland, Report of the Commission of Investigation into the Banking Sector in Ireland, page 42.

[9] Total Eurosystem lending (that is, ECB lending and ELA lending from the Central Bank of Ireland) to resident Irish banks has been running around €130 billion over recent months.

Table 4 Irish bank senior bonds, February 2011 (€billion)

Institution	Senior bonds guaranteed	Senior bonds unguaranteed secured	Senior bonds unguaranteed unsecured
AIB	6.1	2.8	5.9
Bank of Ireland	6.2	12.3	5.2
EBS	1.0	1.0	0.5
ILP	4.7	3.0	1.2
Anglo Irish Bank	3.0	0	3.1
INBS	0	0	0.6
Total	21.0	19.1	16.5

Source: Central Bank of Ireland.

That leaves the question of whether losses will be imposed on the unguaranteed senior bonds of the two nonviable banks that are being run down, Anglo Irish Bank and INBS. [10] As shown in Table 4, there are €3.7 billion of such bonds outstanding. Roughly €700 million of these bonds are scheduled to be repaid in early November 2011 and a further €1.25 billion in January 2012. The Government has said it wants senior bondholders to share in the losses of these two institutions.[11] It has said that it will raise the issue again with the ECB this month and with Trioka officials at the next Programme review in October.[12] Media reports suggest that the ECB remains firmly opposed to any burden sharing with senior bank bondholders.[13]

The Public Attitude to Euro Area-Wide Solidarity

A poll conducted last December shortly after Ireland's entry into the EU/IMF programme showed that 51 percent of people welcomed the bailout deal, while 37 percent did not. The public recognised that Ireland could not borrow from capital markets and the budget deficit would have to have been eliminated immediately without bailout funds.

There was general consensus among economic commentators that the interest rate of 5.8 percent charged on the EU/IMF loans was excessive. Complaints about the interest cost of the loans have abated since 21 July when EU leaders agreed to cut the interest rate on EU loans from 5.8 percent to 3.5 percent and to lengthen maturity terms.

There does appear to be public recognition that the country is receiving relatively low-cost funding from Europe in the form of funds from the EU/IMF programme as well as large amounts of liquidity support (around €130 billon) from the Eurosystem to Irish banks at 1.5 percent.

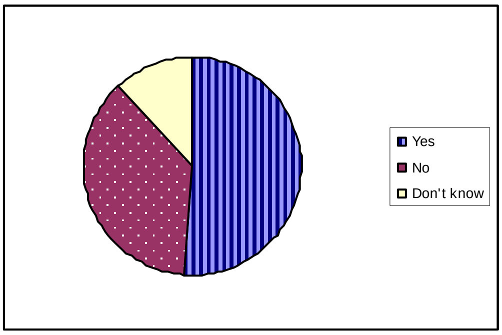
[10] Anglo Irish Bank and INBS were merged in July 2011.

[11] Finance Minister Michael Noonan in June said: "We don't think the Irish taxpayer should redeem what has become speculative investment—we don't believe it should be redeemed at par." The Government argues that most of these bonds have probably been sold on secondary markets to hedge funds at significant discounts over the past couple of years.

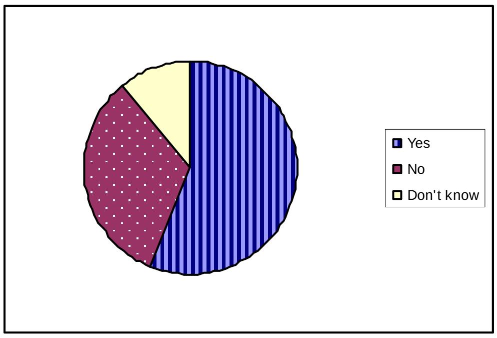
[12] On 7 September 2011, Minister for Finance Michael Noonan said that is seeking a meeting with European Central Bank president Jean-Claude Trichet on the matter. The Minister previously declared that the IMF was supporting his effort to impose losses on the holders of unguaranteed, unsecured senior bonds in Anglo.

[13] On 14 July 2011, the Irish Independent reported that: "Officials from the ECB have warned the Government that any efforts to force losses on senior bondholders at Anglo Irish Bank and Irish Nationwide could lead to the withdrawal of €50bn of central bank liquidity for the two institutions."

Do you welcome the EU/IMF deal?



Has sovereignty been surrendered?



Last December's poll also revealed that 56 percent of people believed that sovereignty had been surrendered against 33 percent who said it had not. The new Coalition government has regularly over the past six months justified the introduction of unpopular measurers by saying that the government has no choice since the measures are contained in the agreed EU/IMF programme.

It is difficult to gauge how the public attitude to Europe has changed over the past year. On the one hand, the public recognise that without help from Europe, the Government would have run out of money to keep the country running. The public may also be encouraged by recent reports in the international media praising Ireland's efforts in adhering to the Programme and signs that the Irish economy is stabilising.

On the other hand, there are several areas in which dissatisfaction with Europe is evident:

- It is widely perceived that Ireland's membership of the single currency contributed to the country's property bubble. Interest rates in the euro area were too low for the strongly growing Irish economy during the boom. In addition, entry into EMU gave Ireland's banks increased access to funding from international capital markets which facilitated their catastrophic ramping up of lending to the property sector. That said, the view that the euro is partly to blame for the unsustainable boom does not seem to translate into a desire to leave the euro area.[14]

- It seems that many people put the lion's share of the blame for the high cost to taxpayers of rescuing the banks on the introduction of the State guarantee of banks' liabilities in September 2008. However, the public debate on burden sharing since the blanket guarantee scheme expired last September has focused on the unguaranteed bank bonds, especially those issued by Anglo Irish Bank and INBS. Media reports have regularly pointed to the Government's efforts to force losses onto these bonds being blocked by the ECB.[15]

---

[14] In an informal poll last May for a Sunday newspaper, 80 percent of people said that Ireland should stay in the euro area.

[15] For example, in February 2011 Bloomberg reported the following comments by then Finance Minister Brian Lenihan: "No unguaranteed senior debt has been dishonored in the eurozone to date. That has been the practice and that has been the consistent message we have received from the European Central Bank. I couldn't see the European Central Bank contemplating discounts on senior debt at present. But again in the context of the winding up of an institution or the gradual winding down of an institution these options can be put on the table. I pressed for it in the context of a multilateral discussion with Europe. It is an issue and we have an ongoing dialogue with the bank and with the European authorities."

- Pressure on the Irish government earlier this year from French President Nicolas Sarkozy to change Ireland's corporate tax rate was widely criticised in the media in Ireland.[16] Prior to the 21 July EU Summit agreement, the interest rates attached to Ireland's borrowings from EU rescue funds were higher than those charged to Portugal and Greece. There was much criticism of President Sarkozy's insistence that a lower interest rate be contingent on Ireland raising its corporate tax rate. There were several dimensions to this criticism:

    - Ireland's corporate tax rate is seen as a crucial policy tool in attracting inward foreign direct investment and very important for economic recovery.
    - It was widely believed that President Sarkozy was taking this approach solely for domestic political purposes.[17]
    - Media reports pointed to the fact that France's effective rate of corporate tax was actually lower than Ireland's rate.[18]
    - It was perceived that, having "taken one for the team" in bailing out the euro area banking system (including French banks), Ireland was now in a vulnerable position and was being victimised.

Conclusions

It is worth repeating several key features of the domestic political situation that are relevant to how developments on the European debt crisis might be received in Ireland. First, the current Government has a huge parliamentary majority and the next general election is not due until 2016. This should give the Government the political space to continue to implement the country's demanding adjustment programme. Regaining Ireland's access to international sovereign debt markets would be a huge political win for the Government. Second, public anger for the crisis is largely directed at the previous government, with polls showing that voters are still taking a benign view of the new Coalition. Finally, the Government will face criticism if bonds issued by Anglo Irish Bank that mature this November and January are repaid in full.

[16] The Irish Times in January 2011 reported President Sarkozy as saying: "I deeply respect our Irish friends' independence and we have done everything to help them. But they cannot continue to say 'come and help us' while keeping a tax on company profits that is half [that of other countries]."

[17] The Irish Times in March 2011 reported former Minister for Finance Brian Lenihan as saying that internal politics was the reason why France was being so insistent. "As in many European matters, this comes back to local politics and the position of different politicians in their own state. I believe President Sarkozy is pushing this situation solely for domestic purposes." The paper reported that Mr. Lenihan urged his successor Michael Noonan and Taoiseach Enda Kenny to stand firm against any attempts by France or Germany to use Ireland's corporation tax rate as a quid pro quo for a reduction in the interest rate on the EU-IMF loan.

[18] The *Irish Times* in March 2011 reported that the French Agency for International Investment cites an effective tax rate of 8.2 percent in advertising literature aimed at attracting foreign business to France, compared with an effective tax rate of more than 11 percent in Ireland.