



Ted Scott on the wire

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Ireland request a bailout

Summary

- **Details of the bailout**
- **What are its implications?**
- **Will it bring growth to the economy?**
- **The potential impact on the Eurozone**

The detail of the bailout

Over the weekend the Irish government officially asked the EU for financial assistance following weeks of turbulence and speculation. Although not unexpected, it represented a dramatic U-turn by the Fianna Fail government, led by Prime Minister Brian Cowan, who had repeatedly denied that Ireland needed external aid. Ultimately, a bailout was forced on the government due to a sharp loss of confidence in its ailing banking sector that was rapidly seeing deposits withdrawn.

The terms of the bailout have not yet been agreed but the announcement was made to assuage markets before they opened on Monday morning. The details will be negotiated over the next few days and agreed before the end of this month, November. The broad principles of the bailout are as follows:

- It is to be a 3 year loan package to be financed by a combination of the European Financial Stabilisation Mechanism (EFSM), the European Financial Stability Fund and bilateral loans, definitely including the UK and Sweden.
- The size of the bailout has not been announced but is thought to be in the region of €85bn. This is less than the Greek bailout of May this year which was €110bn.
- Unlike Greece, only part of the loan will be used to provide fiscal assistance to the State and the majority of it will be earmarked to help recapitalise the banking sector. The split is expected to be about €35/50bn in favour of the banks.

- The controversial issue of whether Ireland will have to raise its corporate tax rate from 12.5% appears to have been won by the Irish government that has insisted that an increase would lead to an exodus of businesses, talent and foreign investment and further worsen the financial crisis.
- The main area of reform will be in the banking sector. In return for the loan, the Prime Minister has said that the banks will have to significantly shrink in size. This will involve asset sales and consolidation. Higher capital requirements are likely to be imposed but no details have been provided.
- The Irish government is due to announce the details of its 4 year consolidation plan soon, which will include where spending cuts and tax increases are to be applied. The bailout may require acceleration and additions to these measures but is unlikely to be too draconian given the fragile nature of the economy and the fact that, unlike Greece, Ireland has already imposed considerable fiscal austerity on its people.

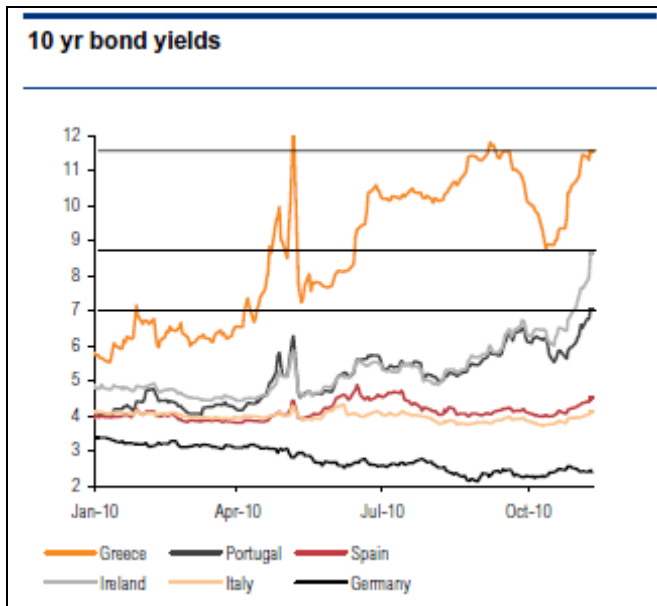
What are the implications of the bailout?

In recent weeks Ireland found itself in the unusual situation of trying to resist substantial financial aid from institutions that were desperate to advance the money. Usually, it is the other way round, but Ireland was keen to retain its economic sovereignty and avoid the humiliation of falling into the arms of the IMF and EU.

Unlike Greece before it, Ireland had done everything expected of it to address its burgeoning debt problem by imposing severe fiscal austerity measures and implementing a rescue plan for its bloated banking sector. Alas, it has proved to be insufficient and the dramatic loss of confidence in recent weeks, as shown in the sharp spike in Irish bond yields in the chart below, has forced the reluctant Irish government to accept reality.



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Source: Datastream

For its part the EU politicians' motives for requesting a bailout were less to do with Ireland than the broader Eurozone. As the crisis in Ireland escalated the market was already speculating which country was the next most vulnerable and in this respect Portuguese bond yields had risen sharply and even yields on Spanish debt had widened (see chart above).

It was imperative for the EU that calm was restored to the markets and that the authorities were seen to be acting decisively. Once it became clear that a bailout for Ireland was inevitable, bond yields, not only in Ireland but also in other periphery countries, rallied strongly. Equity markets also rose as investors believed a deepening crisis had been avoided but two important longer term questions remain: firstly, will the bail out be sufficient for Ireland to turn around its economy and banking sector and, secondly, will it help restore confidence in the periphery countries and the Eurozone in general and the euro currency in particular? The two questions are inter-related as the revival or economic failure of Ireland will help determine to what extent contagion is avoided elsewhere in the Eurozone.

Will the bailout restore growth to Ireland?

On the issue of Ireland, it is important to recognise that its crisis is very different from Greece's earlier in the year. Ireland, as the government repeatedly pointed out, is fully funded until the middle of next year and its debt to GDP ratio (75%) is much lower than Greece and some other Eurozone economies.

The problem with Ireland is that its banking sector is bleeding the country dry. Although the Government has guaranteed the deposits and most of the debts of the Irish banks it grossly underestimated the scale of the losses and the erosion to the banks' capital bases. As recently as September, the Government reviewed the banking sector and announced further financial support and capital raising in an effort to put an end to speculation of a full scale banking crisis - but it was not enough. Ireland's banks are now almost totally reliant on funding from the ECB to provide the necessary liquidity on a day to day basis but they are effectively insolvent. The market recognised this and as bond yields shot up, deposits were being rapidly withdrawn so further weakening the banks' capital bases.

The new bailout will provide a significant financial buffer for the banks that will help strengthen their balance sheets. Furthermore, the agreement will require the banks to consolidate and make disposals that will improve capital ratios further. This will save the banking sector from the threat of insolvency, which is the nightmare scenario the EU and the markets feared. It is estimated that the Irish banks have €80bn of outstanding bond debt, much of which is held by other banks and institutions around Europe, especially in the UK and Germany. A write-off of these bonds together with the Credit Default Swaps (CDS) that would be triggered would be a catalyst for a major banking and financial crisis similar to the after-effects that followed the demise of Lehman's in September 2008.

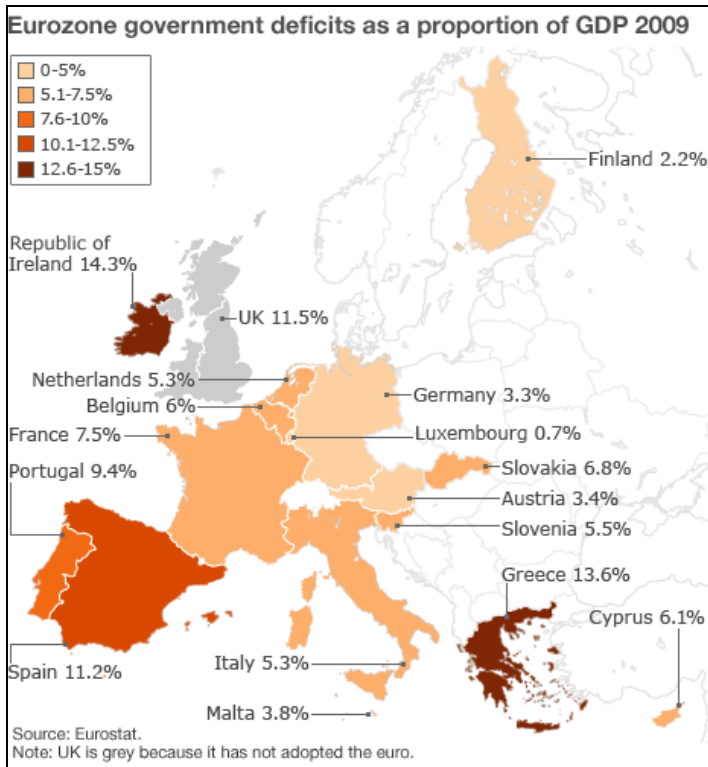
Therefore, the bailout will succeed, for the time being, in averting a potentially devastating banking crisis that would ripple across Europe and beyond. Whether it succeeds in providing a platform for the Irish economy and its banks to turn around in the longer term is, I believe, unlikely.

I have been critical in the past of the EU's management of the sovereign debt crisis and, regrettably, I believe the same mistakes are being made in response to Ireland's problems. Ever since the crisis escalated in the early months of this year the EU authorities have been reactive rather than proactive, and this has made matters worse. It has been evident for some time that the Irish banks were badly short of capital but it was only when the market pushed up bond yields that the EU responded. Admittedly, the response has been quicker and more decisive than was the case with Greece but the market has now become more sceptical about the ability of the EU/IMF to deliver effective change.



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The bailout will only work if it succeeds in reducing Ireland's debt burden as a percentage of GDP while stabilising the banking sector. Including the banks' debts the fiscal deficit is a whopping 32% of GDP and almost 15% excluding the banks' debts, the highest in the Eurozone as the map below shows:



Ireland needs to bring down its deficit by creating fiscal surpluses and so reduce its overall debt burden. To achieve this, the austerity measures will help by reducing public spending and increasing tax revenues but they can only be effective if real GDP does not suffer as a result of the fiscal consolidation. On this point, Greece serves as a warning because it has failed to meet its targets as part of its own bailout as the economy has been dragged down by the austerity programme. In particular, the tax revenues have fallen well short of projections and the danger is that the debt to GDP will continue to grow despite the bailout. It may not now receive its third tranche of money from its bailout because it has not met the necessary conditions.

We are currently in a climate where there is limited support from external demand, especially from developed economies that represent some of Ireland's biggest export markets. Therefore, I strongly believe that the bailout will only provide temporary respite as the economy remains in dire straits, as we are currently seeing in Greece.

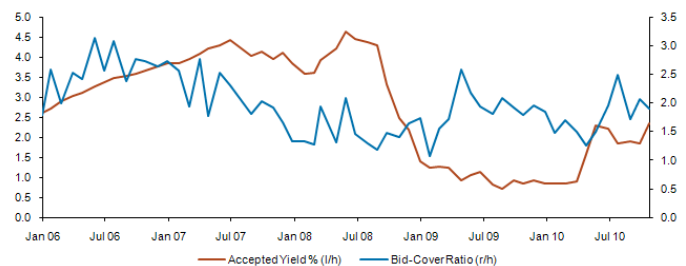
If and when it becomes apparent that the extra austerity measures will exacerbate the weakness of the economy then the market will quickly lose confidence once more and bond yields, and therefore the cost of borrowing for the government, will rise again. Indeed, after a short relief rally on Monday morning CDS spreads on Irish bonds have risen.

The wider implications of the bailout to the Eurozone and the euro

If it becomes clear that the bailout in Ireland is not working effectively then contagion to other periphery countries will spread quickly. This is the scenario that the EU wanted to avoid but as their response is misguided it is the author of its own misfortune. Portugal is the next most vulnerable nation and the yields on its bonds have continued to rise following the Irish bailout announcement. Like Greece and Ireland, it is small in the context of the Eurozone but Spain is much more significant and would be next in the firing line.

The size of Spain's economy is bigger than the three smaller periphery countries combined and represents about 11.5% of the Euro area's GDP. There is also €460bn of core bank assets tied up in Spain; if Spain failed, it would be too large for the Eurozone institutions to rescue and could bring the edifice of the Euro project down with it. As well as Portugal where yields have leapt up recently, Spanish bond yields have also risen. Recent auctions of bonds have proved more difficult to cover and expensive for the government as the chart below shows:

Spanish 12 Month Treasury – increasing accepted yields and deteriorating bid-cover ratios in recent auctions



Source: Matrix

Another cause for concern is whether private sector creditors are going to be liable for the losses in the bonds. The EU, at the behest of Germany, hinted at this recently when postulating whether a permanent mechanism could be set up that shared the burden for losses on sovereign debt.





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This panicked the market and was partly responsible for the increase of periphery bond yields over the last fortnight. However, the question has been given renewed relevance by the decision on Friday of the subordinated bond holders of Anglo Irish Bank to accept an 80% 'haircut' on their holdings. The danger of this is that the market could believe it creates a precedent for other banks in Ireland and elsewhere and lead to further selling of periphery bonds in the most vulnerable countries.

In essence, as we are seeing in the immediate response to the bailout, the risk of the debt crisis widening further is high. While the market could cope with another bailout to Portugal, because of its negligible size compared to the total Eurozone, Spain is the elephant in the room that the market fears. Because of Portugal's proximity and close ties in Portugal a deepening crisis there would lead to a corresponding loss of confidence in Spain. The EU needs to pre-empt this possibility by taking decisive action sooner rather than later.

Conclusion

While we await the details of the bailout, the market has greeted the news with scepticism. It is another band aid solution for a gaping wound that needs to be operated on. Every time the EU authorities attempt to buy time through its reactive approach the market will become more discerning and less tolerant.

Only by implementing fundamental reforms that deal with the lack of competitiveness of the periphery countries can this be achieved. At present, the austerity measures are attempting to achieve this by lowering the costs, especially wages, of the weaker nations whereas it should be done the other way round by raising the wages and domestic demand of the stronger members, especially Germany. The lack of unity and political will in the Eurozone render this most unlikely and for the euro project to succeed it will ultimately require fiscal as well as currency union. In the meantime, the crisis will move on to Portugal and it is then that the real test will come as Spain is put under the microscope of the markets.

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