

## South Asia

Dec 7, 2010

### Flight to weakness

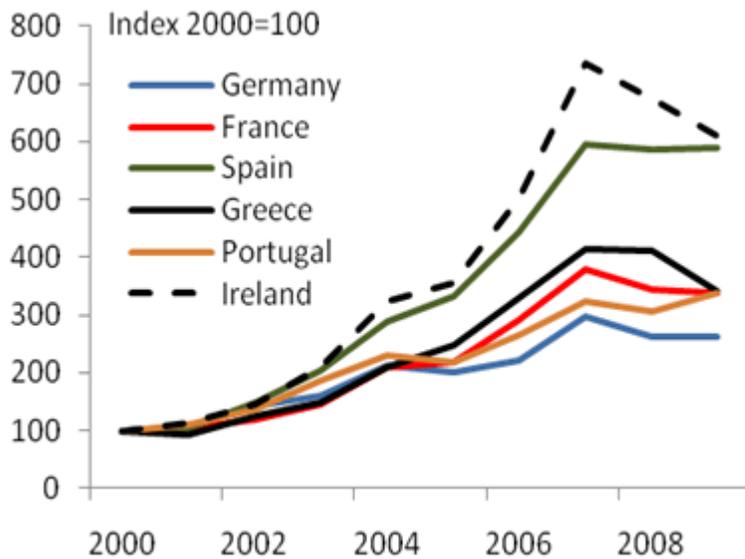
By Kunal Kumar Kundu

As the PIIGS economies - aka Portugal, Ireland, Italy, Greece and Spain - get pummeled, the sham that was the European Central Bank's stress test is now exposed.

The much-hyped stress test results that were announced on July 23 by the Committee of European Bank Supervisors (CEBS), showed that only seven banks failed - five Spain's Cajas, Germany's Hypr Real Estate and Greece's ATE - with a combined capital shortfall of just 3.5 billion euros (US\$4.67 billion). Surprisingly, there was not a single Irish bank in the list.

In fact, by looking at the net risk exposure data provided by Bank for International Settlements (BIS), it can be observed that the Irish banks were exposed the most to such assets and yet none of them were in the list.

#### Net risk exposure by country



Source: BIS, my calculation

Not surprisingly, Irish officials continued to live in a denial mode, telling all and sundry who cared to listen that the country did not require a bailout and that their proposed budgetary cuts were good enough to bring the economy back on track. But when the day of reckoning came, they had no other choice but to accept the fact that there was no alternative to a bailout.

The package that was finally announced (six months after Greece similarly sought to be rescued) was worth 85 billion euros (US\$114 billion) - of which 45 billion euros came from European governments, 22.5 billion euros from the International Monetary Fund and 17.5 billion euros from Ireland's cash reserves and national pension fund.

Interestingly, contrary to the expected combined shortfall of only 3.5 billion euros for all the 91 banks that were put to test, as much as 35 billion euros of bailout fund has been earmarked for sweeping reform of the country's embattled banks and 50 billion euros for governmental budgetary needs.

According to the present available information, Allied Irish Banks will become virtually nationalized by the end of February, using up about 5.3 billion euros of fresh state cash in the process. Bank of Ireland will be given 2.2 billion euros of state cash at the end of February, unless it can raise the money on the private markets first. The state's stake in Bank of Ireland could rise to more than 80%. State-owned Anglo Irish Bank and Irish Nationwide are drawing up a joint restructuring plan that could see them pass over about 16 billion euros of deposits to Allied Irish and Bank of Ireland. All banks, including Irish Life & Permanent, which expresses interest in not taking state cash, will have to sell assets and become smaller businesses.

Of the 35 billion euros in support, 8 billion euros would be used to help banks meet new demands as was laid down by the central bank on November 28. The demands force the banks to hold 12 euros in reserve for every 100 euros they lend, so they're able to deal with loan defaults. Previous rules required them to hold only 8 euros.

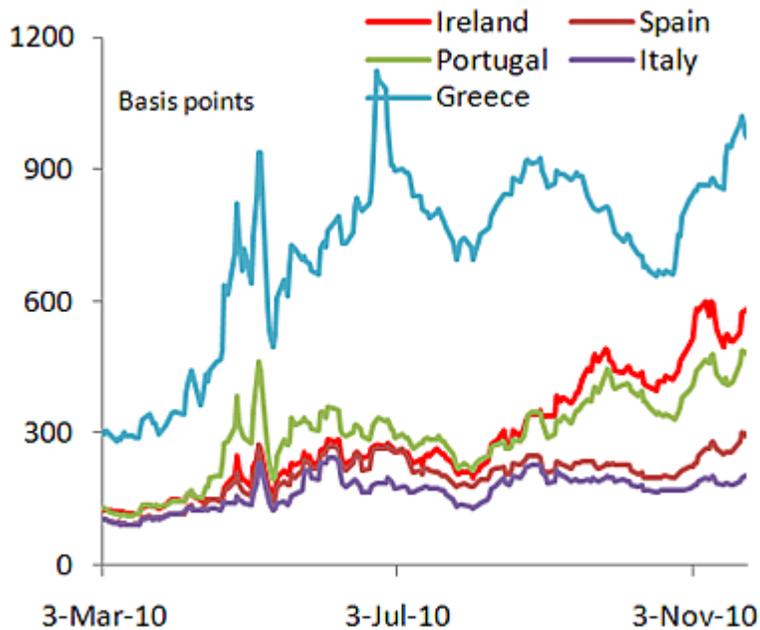
It is calculated that between them, the banks would need an extra 8 billion euros to get to the 12 euro target. In addition, another 2 billion euros will be utilized for "immediate" support that will help the banks wean themselves off deposits on short-term wholesale money markets. The remaining 25 billion euros will be a "contingency" fund that can be called upon to fund any unforeseen future losses or help the banks meet any future central bank demands.

The miracle that was the Celtic Tiger has, unfortunately, now been severely exposed due to faulty policies. As the economy started to grow at a fast pace, real estate soon took the center stage since it was soon hit by speculative frenzy. Easy finance (led by the reckless banks) led to artificial demand that jacked up the prices to stratospheric levels. As a result, outstanding household and Non-Profit Institutions Serving Households debt ended up being more than 200% of gross disposable income. In fact, the debt to disposable income ratio doubled in just five years - a testimony to the reckless lending and borrowing that epitomized economic activity at the time.

Then the bubble burst and the banks were staring at huge losses. Rather than allow the banks to pay for their folly, the government stepped in to guarantee their debt. Before the blow up, Ireland had manageable levels of public debt. But, with this decision, the Irish government effectively converted a banking problem to a fiscal problem.

However, the huge obligation of the government (because of the guarantee) and dwindling revenue meant that Ireland's credit worthiness was hit. Hence, as markets became nervous, the spread on Ireland credit default swaps rose.

### **Spread on credit default swaps by country**



Source: Bloomberg

Recently, the Irish government has announced a four-year plan to achieve a budget deficit below 3% by 2014 (the bailout package gives Ireland a cushion of an additional year, ie 2015, to achieve the 3% deficit norm), including fiscal consolidation of 15 billion euros over the whole period (2011-14), with 6 billion euros front-loaded in 2011.

The government is adroitly trying to use the crisis to embark on meaningful reforms such as broadening the income tax base and moving public sector pensions from a final-salary to a career-average basis. On the other hand, such stringent measures could spawn another round of recession in Ireland.

It is important to note here that the 85 billion euro bailout package that has been extended to Ireland comes with an interest rate obligation of 5.8%, if the entire amount is to be drawn down immediately. Of course, the final rate will vary depending on the timing of the drawdown and market conditions. Given that the amount is more 50% of Irish gross domestic product, or GDP (2009 Irish GDP stood at 159.65 billion euros), the economy should grow at 2.9% simply to service this particular debt if the drawdown is immediate.

Given that the imposition of the austerity measures is likely to slow down the economy and given that borrowing from the international community cannot be defaulted against, Ireland is set for a pretty longish period of gloom and doom - more so because the current austerity measures also include 25,000 job cuts.

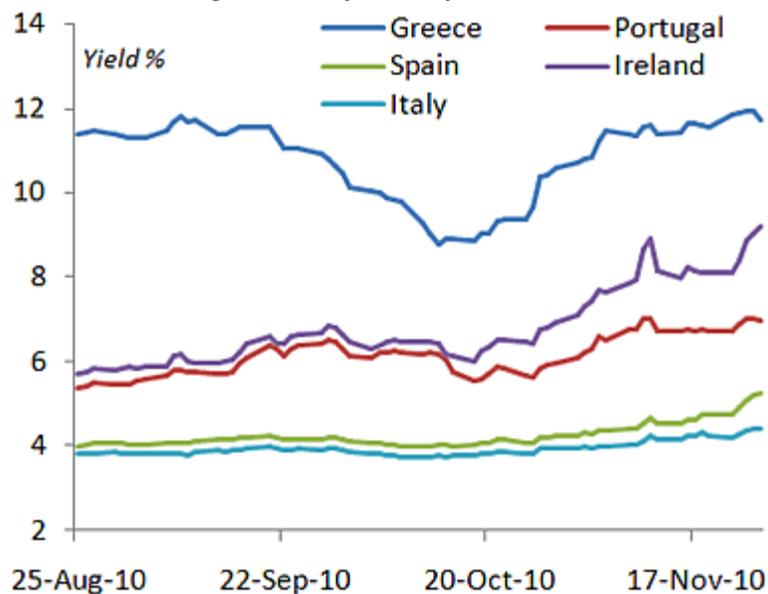
Additionally, there is now speculation as to whether senior bondholders would need to take a haircut (ie, a loss on their investment - a practice that's generally followed only during bankruptcy) as Ireland embarks on the path of recapitalizing its banks.

While senior bondholders should have been made to accept a haircut for their folly of undisciplined investment, so far this has been resisted. But for how long, is the question. Although the Ireland bailout had been accompanied by plans for new ways to rescue troubled eurozone countries after 2013, when

the current emergency schemes run out, there's much too confusion in the market. It is not clear how bondholders would be expected to share the losses of countries that were allowed to reschedule their debt after 2013 - in effect defaulting.

Not surprisingly, the market is jittery and investors are frantically trying to understand where the next crisis will erupt. For this, they are carefully scanning the PIIGS economies. Their nervousness on these economies is palpable as the rising yields on the sovereign bonds testify.

#### Yields on sovereign bonds by country



Source: Bloomberg

The average yield of these economies has moved up to 7.49%, which is as much as 4.81 percentage points more than the equivalent German bund (highest since the euro came into existence), which are considered to be the safest.

From the market perception point of view, Portugal seems to be the next source of worry, although the government there does not resort to falsification of public accounts, nor has it faced real estate bubbles like Ireland (or for that matter, Spain). However, Portugal is clearly struggling with its public debt.

According to Bank for International Settlement estimates (BIS Working Papers No. 300 - The future of public debt: Prospects and implications) Portugal's fiscal deficit is expected to be around 7.8% of the country's GDP by 2011 and its debt-to-GDP ratio is expected to be around 97%.

Portugal is struggling in this regard. Recently, its parliament approved a 2011 austerity budget that aims to trim the budget deficit to 4.6% of GDP, from a projected 7.3% this year. This austerity measure is likely to knock off the wind out of their growth sails.

While the aim of this austerity measure is to assure the investors about the country's credibility, they are not keen to buy the argument now - which is why the yield on Portuguese sovereign bonds is rising. Additionally, even Portuguese banks are under threat. Data culled out from BIS shows that the exposure

of Portuguese banks to only Greece, Ireland and Spain account for nearly 35% of their total external exposure. That's a big risk.

Yet, Portugal is a small economy, and even if it is required to be bailed out the problem can still be contained. But what if the contagion spreads to bigger economies like Spain and Italy? While the European Union could easily manage a rescue of Portugal (rough estimates put the figure of likely bailout of Portugal at about 100 billion euros) but coming to the aid of Spain, the euro zone's fourth-largest economy, would stretch the 750 billion euro loan facility it set up with the IMF back in May after a bailout of Greece.

The problem is that when there's panic in the market, confusion is a bad ally. More so, as contagion feeds on confusion.

Clearly, the bailout of Greece was not the end of the problem, merely the beginning. It is now spreading to other (read bigger) economies. This is likely to put pressure on the euro going forward. As this triggers a flight-to-safety mentality, the US dollar can be expected to strengthen - despite its fundamental weakness.

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