

Ireland and Allied Irish Bank

Ireland and its banks have in the last few weeks moved to the foreground of economic debate. The country has suffered heavily under the burst of a gigantic real estate bubble. Property prices have plunged on average by about 45% since the high reached in 2008. Huge write-downs had to be taken mainly on commercial properties. Private home owners so far have a default rate of 5%, which is high but much lower than in the US with over 9%. An important difference between the two countries is that house owners in Ireland guarantee the loan with their personal assets, whereas in the US only the property is pledged. Once the value has fallen below the mortgage owners can walk away.

In the last two years Irish banks had to be refinanced by the State to the tune of over €40 billion and in particular Anglo Irish Bank needs another €12 billion over the coming years. This bank has been taken over by the State and will be liquidated. The other two banks, Bank of Ireland and Allied Irish Bank, have been supported by the State and will be sufficiently capitalized at the end of the year with primary equity of about 8.5%. In the case of AIB the State Employee Pension Fund will in the next few weeks inject €5.3 billion and then control over 90% of the shares. Under normal circumstances this would be more than enough to let the banks work with their own deposits and to borrow the rest in the interbank markets. In the present panic stricken atmosphere lenders are very reluctant to give them credit. Some deposits have also been withdrawn. For financing, the banks including the Central Bank of Ireland, have had to turn to a large extent to the European Central Bank to maintain their lending and stay liquid. As a result of the crisis, total debt of the Republic has jumped to 100% of GDP, partly due to the support for the financial system, but also owing to lower tax revenues and higher social expenses. A rigorous austerity program should cut the deficit to 3% by 2014. The country has so far responded to the crisis with discipline and a willingness to make sacrifices, but there are limits.

The European Union is worried that the apparent pessimistic reaction of the market, a few months after the Greek crisis, could spill over to other peripheral EU countries and could endanger the common currency of the Union. Their members are therefore eager to stop the downtrend with a financial facility of support. Ireland opposes such a move out of concern for its independence. It is also eager to keep its low corporate tax rate, one of its main attractions and an important reason for the economic rise in the last 15 years. In the end they may have no choice but to accept help.

A possible solution could be to overcapitalize the two public Irish banks to re-establish confidence in their staying power. Confidence is fast lost but regained only very slowly. It probably would have to be done by credits from the IMF and the EU and guaranteed by Ireland. All Members of the EU, the trading partners and the lenders have a strong interest to get Ireland and its banks back on track again.

Ireland has an open, very competitive economy. Exports are over 50% of GDP. Debt levels are high, but they should be manageable. They have been even higher in the early nineties and have been subsequently reduced. Negative is that Irish households have high consumer loans outstanding. Luckily the euro-zone is financially quite a bit less leveraged than the US or Japan and the peripheral economies are relatively small. A reasonable solution therefore should be possible. Jean Monnet, one of the founders of European cooperation, has said many years ago that Europe will be built through crises. He seems to be right.

Roland Schwab, November 18, 2010