

Ireland Goes Bust, Irish Bank Run

By Mike Whitney

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There was a bank run in Ireland on Wednesday. LCH Clearnet, a London based clearinghouse, surprised the markets by announcing it would increase margin requirements on Irish debt by 15 percent. That's all it took to send investors fleeing for the exits.

Yields on Irish bonds spiked sharply as banks tried to close positions or raise the capital needed to meet the new requirements. The Irish 10-year bond soared to 8.9 percent by day's end, more than 6 percentage points higher than "risk free" German sovereign debt. The ECB will have to intervene. Ireland is on its way to default. This is what a 21st century bank run looks like. Terms suddenly change in the repo market, where banks get their funding, and the whole system begins to teeter.

It's a structural problem in the so-called shadow banking system for which there's no remedy. Conventional banks exchange bonds with shadow banks for short-term loans agreeing to repurchase (repo) them at a later date. But when investors get nervous about the solvency of the bank, the collateral gets a haircut which makes it more expensive to fund operations. That sends bond yields skyrocketing increasing the liklihood of default. In this case, the debt-overhang from a burst development bubble is bearing down on the Irish government threatening to bankrupt the country. Ireland is in dire straights. Here's an excerpt from an article in this week's Irish Times which sums it up:

"Until September, Ireland had the legal option of terminating the bank guarantee on the grounds that three of the guaranteed banks had withheld material information about their solvency, in direct breach of the 1971 Central Bank Act. The way would then have been open to pass legislation along the lines of the UK's Bank Resolution Regime, to turn the roughly €75 billion of outstanding bank debt into shares in those banks, and so end the banking crisis at a stroke.

With the €55 billion repaid, the possibility of resolving the bank crisis by sharing costs with the bondholders is now water under the bridge. Instead of the unpleasant showdown with the European Central Bank that a bank resolution would have entailed, everyone is a winner. Or everyone who matters, at least." ("If you thought the bank bailout was bad, wait until the mortgage defaults hit home", Morgan Kelley, Irish Times)

So, the Irish government could have let the bankers and bondholders suffer the losses, but decided to bail them out and pass the debts along to the taxpayers instead. Sound familiar? Only, in this case, the obligations exceed the country's ability to pay. Austerity measures alone will not fix the problem. Eventually, the debt will have to be restructured and the losses written down. Here's another clip from Kelly's article:

"As a taxpayer, what does a bailout bill of €70 billion mean? It means that every cent of income tax that you pay for the next two to three years will go to repay Anglo's (bank) losses, every cent for the following two years will go on AIB, and every cent for the next year and a half on the others. In other words, the Irish State is insolvent: its liabilities far exceed any realistic means of repaying them....

Two things have delayed Ireland's funeral. First, in anticipation of being booted out of bond markets, the Government built up a large pile of cash a few months ago, so that it can keep going until the New Year before it runs out of money. Although insolvent, Ireland is still liquid, for now.

Secondly, not wanting another Greek-style mess, the ECB has intervened to fund the Irish banks. Not only have Irish banks had to repay their maturing bonds, but they have been hemorrhaging funds in the inter-bank market, and the ECB has quietly stepped in with emergency funding to keep them going until it can make up its mind what to do."

Ireland has enough cash to get through the middle of next year, but then what? The bad news has rekindled fears of contagion among the PIIGS. Greece is a basketcase and Portugal's bond yields have spiked in recent weeks. Portugal's 10-year bond hit 7.33% by Wednesday's close. The euro plunged to \$1.37 even though the Fed is trying to weaken the dollar by pumping another \$600 billion into the financial system. Troubles on the periphery are escalating quickly dragging the 16-nation union into another crisis. This is from the Wall Street Journal:

"For a decade, Ireland was the EU's superstar. A skilled work force, high productivity and low corporate taxes drew foreign investment. The Irish, once the poor of Europe, became richer than everyone but the Luxemburgers. Fatefully, they put their newfound wealth in property.

As the European Central Bank held interest rates low, Ireland saw easy credit for construction loans and mortgages. Developers turned docklands into office towers and sheep pastures into subdivisions. In 2006, builders put up 93,419 homes, three times the rate a decade earlier....

The party ended in 2008, when the property bubble popped and the global economy tipped into recession...by September, Irish banks were struggling to borrow quick cash for daily expenses. The government thought they faced a classic liquidity squeeze. Ireland—whose hands-off regulator had assigned just three examiners to two major banks—didn't recognize the deeper problem: Banks had made too many bad loans, whose defaults would leave the lenders insolvent." ("Ireland's Fate Tied to Doomed Banks", Charles Forelle and David Enrich, Wall Street Journal)

The Irish government hurriedly put together a new agency, the National Asset Management Agency (NAMA), to buy to toxic bank loans at steep discounts., but the banks books were in much worse condition than anyone realized, more than €70 billion in bad loans altogether. By absorbing the debts, the government is condemning its people to a decade of grinding poverty and a deficit that's 32% of GDP, a record for any country in the EU.

On Thursday, at the G-20 conference in Seoul, European Commission President José Manuel Barroso, said that he was following developments in Ireland closely and that he would be ready to act if necessary. The EU has set up a €440bn bail-out fund (The European Financial

Stability Fund) that can be activated in the event of an emergency, although critics say that the fund is more aspirational than a reality. The crisis in Ireland will test whether the countries that made commitments to the fund will keep-up their end of the bargain or not. If they refuse, the EU project will begin to splinter and break apart.

Ireland will surely need a bailout, although not just yet. For a while the ECB can maintain the illusion of solvency by funneling liquidity to banks via its emergency facilities. That way, bondholders in Germany and France get their pound of flesh before the ship begins to take on water. All the risk-takers and speculators will be "made whole" again before the full-force before the debts are shifted onto Irish workers. Here's how Kelly sums it up:

"Ireland faced a painful choice between imposing a resolution on banks that were too big to save or becoming insolvent, and, for whatever reason, chose the latter. Sovereign nations get to make policy choices, and we are no longer a sovereign nation in any meaningful sense of that term."

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