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An Overview: Ireland's Bailout and associated Budget for 2011

1 Background

On 7 December 2010, the European Union formally approved an €85billion financial rescue plan (or 'bailout') for Ireland. This financial intervention was deemed appropriate, amidst rising yield rates[1] on Irish bonds, to safeguard the financial stability of the Eurozone. This paper summarises the key aspects of the Irish bailout, and the Government's associated recovery plans, including the Irish Budget for 2011 announced by Finance Minister, Brian Lenihan, on 7 December 2010.

[1] In November 2010, the yield difference on 10 year Irish bonds versus German Bund bonds rose to 6.65%. Yield rates might be interpreted as an indicator of 'risk', including that in respect of a sovereign default, i.e. of the country being unable to honour all outstanding debts.

Ireland's road to the IMF, *Financial Times,* 19 November 2010

2 Timeline: Ireland's road to Bailout

- **Sept 2008:** Lehman Brothers collapses, sparking turmoil in global financial system[2].
- **Oct 2008:** Irish parliament enacts legislature for a full-scale rescue of financial system, including a €400bn guarantee scheme, covering six main banks[3].
- **Dec 2008:** Irish government announces plan to inject €5.5bn into 3 main banks[4].
- **Jan 2009:** Irish government nationalises Anglo Irish, country's third largest lender[5].
- **Mar 2009:** Ireland's credit rating cut from AAA to AA+. Later in year it is cut to AA-[6].
- **Jan 2010:** Irish sovereign debt for 2009 rises to 65.5% of GDP from 44.3% in previous year.
- **Mar 2010:** Anglo Irish reports a loss of €12.7bn; largest in Irish corporate history.
- **May 2010:** IMF and eurozone countries announce €110bn bailout for Greece. A total €750bn euro bailout fund is agreed on.
- **Sept 2010:** Another bailout for Anglo Irish, Allied Irish and Irish Nationwide. Final bailout bill reaches €35bn, inflating the estimated budget deficit to almost 3% of GDP.
- **19 Nov 2010:** Brian Cowen, Irish Prime Minister, confirms for the first time that negotiations are under way with the European Union (EU) and International Monetary Fund (IMF) on a bailout package[7].
- **28 Nov 2010**: The Irish Government agrees, in principle, to accept €85bn of financial support from Member States of the European Union, through the European Financial Stability Fund (EFSF) and the European Financial Stability Mechanism; bilateral loans from the UK, Sweden and Denmark; and the IMF's Extended Fund Facility (EFF) on the basis of specified conditions[8].
- **7 Dec 2010**: The EU formally approves the €85bn rescue package – this was largely a procedural step; however, a sudden change of heart could have created a panic. The plan was cleared just hours before Finance Minister, Brian Lenihan, delivered his austerity Budget outlining €6bn in tax hikes and spending cuts[9].

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[2] Timeline: Ireland's road to the IMF, *Financial Times,* 19 November 2010
[3] Ibid
[4] Ibid
[5] Ibid
[6] As per Standards & Poor (S&P), the credit rating agency.
Timeline: Ireland's road to the IMF, *Financial Times,* 19 November 2010
[7] Ibid
[8] http://www.rte.ie/news/2010/1128/govtstatement.html
[9] EU sources said the aid was not conditional on the Budget passing, but that it was 'obviously quite crucial'. BreakingNews.ie, 7 December 2010

3 Key Aspects of the Bailout

3.1 European Union finance ministers agreed a €85 billion bail-out for Ireland on 7 December 2010, having concurred that the provision of the loan to Ireland was warranted to '*safeguard financial stability in the euro area and the European Union as a whole*'[10];

3.2 According to the Irish Government, the purpose of the financial support is to return the economy to sustainable growth and to ensure a properly functioning, healthy banking system[11];

3.3 The State's contribution to the facility will be €17.5bn, which will come from the National Pension Reserve Fund and other domestic cash resources[12]. Thus the actual extent of *external* assistance is €67.5bn.The sources of the external support are as follows: €22.5bn from the European Financial Stability Mechanism (EFSM); €22.5bn from the International Monetary Fund (IMF); and €22.5bn from the European Financial Stability Fund (EFSF) and bilateral loans[13].

3.4 A significant part of the €85bn package (€35bn) is intended to support the banking system; €10bn of this €35bn will be used immediately to inject fresh capital to buffer the effects of expected loan losses. The remaining €25bn will comprise a contingency fund, which can be drawn upon by the banks as/when required[14].

3.5 It is worth highlighting that this €25bn fund allows for losses on buy-to-let property loans to rise to 10 per cent – double the level projected by the Central Bank under stress tests last March – and residential mortgage losses to rise from 5 per cent to 6.5 per cent. Under these higher stress test scenarios, the banks were estimated to require an additional €15bn in capital; however, the international monetary authorities insisted that an additional €10bn be set aside as a further contingency[15];

3.6 The remaining €50bn will fund the Irish Government's budgetary financing needs[16].

3.7 The funds in the facility will be drawn down as necessary; the amount used will depend on the capital requirements of the financial system, amongst other things[17].

3.8 If the total funds were drawn down with immediate effect, the combined annual average interest rate would be of the order of 5.8% per annum. The actual rate paid will depend upon when the funds are drawdown and market conditions at that time[18].

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[10] http://www.rte.ie/news/2010/1128/economy.html
[11] Ibid
[12] http://www.rte.ie/news/2010/1128/govtstatement.html
[13] The bilateral loans will be subject to the same conditionality as provided by the programme. http://www.rte.ie/news/2010/1128/govtstatement.html
[14] Ibid
[15] Bailout injection to help banks sell off EUR20bn of non-core assets, *The Irish Times,* 6 December 2010
[16] http://www.rte.ie/news/2010/1128/govtstatement.html
[17] Ibid
[18] Ibid

4 Some Considerations

4.1 ***Contagion Effect?*** There has been some debate around the possibility of a contagion effect, with further bailouts being required, in particular with regards to Spain and Portugal (long-term rates for Portuguese and Spanish debt have been rising, indicating that the markets are anxious about debt levels/possibility of default). This has raised the issue of whether the resultant scale of interventions could be beyond the capacity of the European Financial Stability Fund (EFSF). On the 6 December, it was reported that European Finance Ministers were debating whether the €750bn euro-zone bailout facility should be enlarged to boost confidence in the currency[19]. The comments of the EU bailout fund chief, Klaus Regling, are noteworthy in this regard:

"I sometimes hear and read that the EFSF might be insufficient, that the amount might be too small to deal with relevant cases and I think this is wrong. The amounts needed for the Irish programme, which are agreed…are relatively small compared to the lend capacity of the EFSF. The EFSF will use for Ireland much less than 10 per cent of its overall lending capacity and this implies that there are sufficient resources left to deal with other relevant cases if needed"[20]

4.2 ***Extent of Remaining Toxic Debt?*** Point 3.5 above alludes to the possibility of remaining 'toxic debt' within banks. This will be a key determinant of the scale, and associated costs, of the contingency funds drawdown by the Irish Government – essentially, this depends on whether there are remaining 'black holes' within the Irish banks. It is possible that the true extent of remaining toxicity within banks will transpire as interest rates begin to rise (an inevitable eventuality over coming years) and repayment capacity is squeezed further (artificially low interest rates may currently be masking some potential issues around repayment capacity and risk of default, for homeowners, investors, etc).

4.3 ***National Asset Management Agency (NAMA):*** As part of the bailout plan, an additional €16bn in loans (approximately 10,000 in total) will be moved to the National Asset Management Agency (NAMA) from AIB and Bank of Ireland, as the threshold for eligible loans was reduced[21]. It is unclear at this stage whether this relates to any assets in Northern Ireland – it is important that Northern Ireland's interests continue to be protected in this regard.

4.4 ***Growth Forecasts:*** As outlined in section 5.1 below, the Irish Government is expecting real GDP to grow by an average of 2.75% from 2011 to 2014. If this turns out to be excessively optimistic, (which is possible in view of the austerity measures implemented by Budget 2011; indeed it is above the expectations of the Central Bank (2.4% in 2011)[22]), the Government's repayment capacity might be stretched further.

[19] Ministers consider bigger EU bailout fund, *The Irish Times,* 6 December 2010 http://uk.finance.yahoo.com/news/U-S-back-bigger-EU-stability-reuters_molt-1992686834.html?x=0
[20] Regling denies bailout fund is too small, *Business World (Digest),* 7 December 2010
[21] http://www.finfacts.ie/irishfinancenews/article_1021185.shtml
[22] http://imarketnews.com/node/21946

5 Deficit Reduction Plan and Budget 2011[23]

5.1 Deficit Reduction Plan

The deficit reduction plan required for the bailout included the following measures /assumptions[24]:

- Corporation tax rate to remain unchanged at 12.5%
- €10bn (£8.5bn) of spending cuts between 2011-2014, and 5bn euros in tax rises
- Minimum wage to be cut by one euro to €7.65 per hour
- €3bn of cuts in public investment by 2014
- €2.8bn of welfare cuts by 2014, returning spending to 2007 levels
- Reduction of public sector pay bill by €1.2bn by 2014
- The reform of public sector pensions for new entrants with pay cut by 10%
- 24,750 public sector jobs to be cut, back to 2005 level
- VAT up from 21% to 22% in 2013, then 23% in 2014
- Raise an extra €1.9bn from income tax
- Abolition of some tax reliefs worth €755m
- Real GDP to grow by an average of 2.75% from 2011 to 2014
- Unemployment to fall from 13.5% to below 10% in 2014
- The introduction of domestic water charges by 2014.

5.2 Budget 2011

On 7 December 2010, Mr Lenihan announced some €6bn in adjustments to public spending in Ireland in 2011, referring to the Budget as a '*substantial down payment on the journey back to economic health*'. The main points contained in the Budget 2011 include[25]:

- No reduction in the **state pension**;
- €10 reduction **in Child Benefit** rates (for first two children, with an additional €10 for the third child)
- €8 cut for **social welfare, jobseekers** payments
- 4c on **petrol**, 2c **on diesel** from midnight
- Revised **air travel tax** of €3 from March – being introduced on temporary basis, until 2011, when it will be reviewed. Mr Lenihan stressed that this should not be used as an opportunity, by airlines, to raise fees and charges[26].

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[23] http://www.rte.ie/news/2010/1207/budget2011_main_points.html
[24] http://www.bbc.co.uk/news/business-11831935
[25] http://www.rte.ie/news/2010/1207/budget2011_main_points.html
[26] http://www.rte.ie/news/2010/1207/budget_tourism.html

- €40 payment for **fuel allowance** recipients
- New **minimum wage** not in tax net
- **Public service pay** will not be cut
- **Public sector salary** capped at €250k
- **Public service pensions** over €12k cut by 4%
- **Taoiseach salary** cut by €14k; ministers by €10k
- Next **President's salary** to be capped at €250k
- **Employee Pay Related Social Insurance (PRSI)/health levy** relief on pension contributions are being abolished.
- **Income/health levies** to be replaced by single **universal social charge.** Rates on the charge will be 0% below €4,004 a year, 2% up to €10,036, 4% from €10,036 to €16,016 and 7% above this level
- **Pension contributions** subject to PRSI and Universal Social Charge
- **Employee PRSI contribution** ceiling removed
- Increase in the **PRSI rate for the self employed**, higher earning public servants and office holders
- 1% tax on **residential transactions** up to €1m; 2% over £1m
- All **stamp duty** exemptions abolished
- **Car scrappage** extended for six months
- No change to Ireland's **corporation tax rate**
- **Value of tax bands and credits** to be reduced by 10%
- **Deposit Interest Retention Tax (DIRT)** rate on ordinary deposit accounts increased by 2 points to 27% and on longer-term deposits by 2 points to 30%.
- **Online betting** will be subject to the same betting duty as in bookie shops
- **Carer's Allowance** for those under 66 to be cut by €8 to €212 per week. However, allowance for people aged 66 years and over will remain unchanged[27].
- **Disability Allowance** being cut by €8 to €186 per week
- **Business Expansion Scheme** to be revamped
- 15,000 activation places for **unemployed (**at a cost of some €200m[28])
- **Third-level student charges** are to rise by €500 to €2000
- **Student grants** are to be cut by 4%
- New **passport fees** for over 65s

[27] http://www.rte.ie/news/2010/1207/budget_welfare.html

[28] Ibid