

22 November 2010

The Irish bailout: what are the options and what will they solve?

Key points:

- Ireland's problems – while owing to several factors – have been locked in by the loss of competitiveness arising from its EMU membership. Since joining the eurozone, Ireland has lost over 27% in competitiveness relative to Germany, according to some measures. In many ways, the Irish debt bubble is a symptom rather than the cause of the real problem.
- Ireland is clearly in a better position to rebound from the current problems than Greece and Portugal, due to its relatively open economy. However, there are five reasons why a one-off bailout for Ireland will not solve the eurozone's problems – although it could buy Ireland some valuable time:
 1. Temporary loans or greater budget discipline across the eurozone will do very little to help countries such as Greece, Ireland or Portugal regain competitiveness, the main problem these countries face.
 2. In essence, what was asked of Greece, and soon Ireland, is two-thirds of a traditional IMF package – cuts in expenditure and increased taxes. However, the third, vital ingredient – currency depreciation – is not permitted within a single currency. Instead, currency devaluation has to be replaced by so-called “internal depreciation”, meaning even more squeezes to jobs and wages which aren't politically or socially affordable.
 3. The ECB is likely to continue to pursue a German-style monetary policy, leading to an undervalued currency for Germany (fuelling German export-led growth) but an equally overvalued currency for the weaker economies such as Portugal and Spain (although Ireland itself could be helped by a weaker euro). This, in turn, locks in a multi-speed eurozone, with the same type of tensions we've seen over the last year coming to the fore again in future.
 4. The politics of a loan bailout and stronger supranational budget rules are unsustainable. The lending countries, most importantly Germany, can only sell a de facto debt union to their electorates if it comes with strict rules and terms. But such terms imposed from the outside seriously undermine the ability of the borrowing countries to democratically govern themselves.
 5. The role currently being played by the ECB is untenable, both for political and economic reasons:

- a) Politically, the ECB's decision back in May to start buying 'junk' government bonds from the secondary market has compromised its independence – which the Germans were promised would never happen. A bailout using loan guarantees from other EU states may allow the ECB to withdraw its emergency funding for now, but without a long-term solution the ECB is likely to be called on again to prop up ailing states.
- b) Economically, the situation is unsustainable as well. The Eurosystem of eurozone central banks that underpins the ECB is leveraged 24 times¹, while the average hedge fund is only leveraged 3 to 4 times. A fall in assets of only a few percent would wipe out the ECB's reserves, which could lead to the ECB itself being in need of a "bail-out".
- There are no obvious long-term solutions that do not come with huge political and economic costs. The dilemma facing the eurozone remains whether it is to become a fully fledged United States-style fiscal and therefore political union with huge continuous transfers from the German-led bloc to those on the periphery – which would inflict serious damage on the German economy; or prepare for a messy divorce possibly in the form of a two-tier euro and even some countries exiting altogether.
 - Germany is keen on a bailout package for Ireland, as it wants to decrease Ireland's dependency on the ECB, replacing the current support measures with government-backed loans, which can be linked to specific demands, such as a restructuring of the banks or changes to the tax system. The ECB's generous liquidity supply also goes against the 'hard currency' philosophy that Germany was promised when giving up the Deutschmark in the 1990s and strikes to the heart of worries that the ECB is becoming a "bad bank" itself.
 - The UK is hugely exposed to Irish banks and debts. However, the decision on whether the UK is involved in a bailout is largely out of the UK Government's hands because the EU bailout fund, partly underwritten by British taxpayers, can be activated by majority voting, meaning that Britain could be outvoted. This means that the EU rescue mechanism of which the UK is part completely lacks democratic legitimacy in Britain. The UK is also likely to provide bilateral support and contribute through its membership of the IMF. Reports suggest that the total amount guaranteed by Britain in an Irish bail-out will be in the area of £7 billion. However, in the absence of regained growth and competitiveness in Ireland, and the other weaker economies in the eurozone, the UK will remain exposed to future failure in EMU.

¹ The ECB's Monetary Policy Statistics show that as of 12 November 2010 the Eurosystem had liabilities €1,878,979m and capital reserves of €78,191m, see <http://sdw.ecb.europa.eu/reports.do?node=100000129>

1) How did we get here?

Ireland's problems – while owing to several factors – have been fuelled by a loss of competitiveness arising from its EMU membership. In many ways, the banking crisis and now the state of the Irish public finances are symptoms rather than causes of this loss of competitiveness.

Unlike Greece, in the years preceding the financial crisis in 2008, Ireland remained within the eurozone's budget deficit limit of 3 percent of GDP and the debt limit of 60 percent of GDP, as the table below shows.

	Budget deficit/surplus²	Public debt³
1999	2.7	48.5
2000	4.8	37.8
2001	0.9	35.6
2002	-0.3	32.2
2003	0.4	31.0
2004	1.4	29.7
2005	1.6	27.4
2006	2.9	24.8
2007	0.0	25.0
2008	-7.3	44.3
2009	-14.4	65.5

However, at the same time, Ireland lost huge levels of competitiveness relative to stronger economies, particularly Germany, as the table below illustrates.

Country	Loss of competitiveness since 1999⁴	Loss of competitiveness since 1999 (compared to Germany)
Greece	6.7%	24.5%
Ireland	9.4%	27.2%
Spain	10.6%	28.4%
Italy	7.8%	25.6%
France	0.9%	18.7%
Belgium	1.3%	19.1%

Low eurozone interest rates, essentially designed for a sluggish Germany, encouraged a huge boom in the Irish economy in the early 2000s and encouraged

² Eurostat, "General government deficit (-) and surplus (+) as a percentage of GDP" (table) <http://epp.eurostat.ec.europa.eu/tgm/refreshTableAction.do?tab=table&plugin=1&pcode=teina200&language=en>

³ Eurostat, "General government consolidated gross debt as a percentage of GDP" (table) <http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&language=en&pcode=tsieb090&plugin=1>

⁴ Source: *European Central Bank*, 'Harmonised competitiveness indicators based on unit labour costs indices for the total economy' (table) – figures are updated to the second quarter of 2010 http://www.ecb.int/stats/exchange/hci/html/hci_ulct_2010-04.en.html. There are several different criteria to measure the competitiveness of a country's economy. The table below is based on unit labour costs indices for the total economy. Figures in the far-right column have been derived adding up each country's absolute data and the 17.8% competitiveness gain experienced by Germany over the same period.

excessive lending by the Irish banks, while the government turned a blind eye. The abundance of cheap credit fuelled a property bubble that burst with the financial crisis in 2008.

This private debt has now become a state debt problem, with the Irish government partially bailing out the banks. However, the Irish banking sector remains more or less insolvent but for the ongoing intervention of the European Central Bank. The ECB is currently lending the Irish banking sector €130bn, around a fifth of the ECB's entire loans to European banks.⁵ However, the ECB – not least due to worries that it's turning into a “bad bank” – now wants to cut down on its liquidity supply to banks in Ireland and elsewhere.

Although the Irish government says it doesn't have to borrow any more money on the bond markets until mid to late 2011, investors have pushed up the yields on Irish government bonds in recent weeks. Besides their fears over the state of the banks, the German plans for a ‘permanent crisis mechanism’ for the eurozone have also contributed to investors' reluctance to buy Irish debt or that of other struggling eurozone governments, such as Portugal.

Under the proposed plans, which would replace the ad hoc €440bn European Financial Stability Facility put in place after the Greek bailout, investors would be asked to take losses, either in interest or capital, should a eurozone state restructure or default on its debt. EU leaders have stressed that these ‘haircuts’ would only apply to debt issued post-2013, when the current €440bn bailout guarantees expire.

Nonetheless, the bond markets are understandably unconvinced by these reassurances. If by 2013 countries like Greece, Ireland and Portugal are still in poor economic health, any new debt issued will continue to carry excessive yields, which these countries may still be unable to finance in the long term. This is the risk that investors are currently pricing into Irish debt.

2) What's next for Ireland?

Ireland has now officially asked for an EU/IMF loan, likely to be in the region of €80-€90bn – although this could easily shoot up if the situation deteriorates further (as in the case of Greece).

Once in receipt of EU and IMF aid, the Irish government will be under external demands on decisions over future cuts and there has also been significant EU pressure for Ireland to raise its low corporate tax rate, a cornerstone of Ireland's economic policy. Irish Taoiseach Brian Cowen has insisted that the corporate tax is “non-negotiable” and that the country will retain its economic sovereignty.

However, in October, the EU's Economic Affairs Commissioner Olli Rehn stated that Ireland may have to sacrifice its 12.5 percent rate. “In the coming decade, it's a fact of life that after what has happened, Ireland will not continue as a low-tax country, but it will rather become a normal tax country in the European context,” he said⁶. Austrian Finance Minister Josef Proell said in November that, “When the [aid] takes effect, then there also needs to be talks with the [Irish] government about this issue.”⁷

⁵ Cited in *Irish Times*, ‘ECB keen for State to draw up to €80bn stability loan’, 16 November 2010; <http://www.irishtimes.com/newspaper/ireland/2010/11/16/1224283411496.html>

⁶ *FT*, ‘Ireland may have to sacrifice low-tax status’, 2 October 2010; <http://www.ft.com/cms/s/0/a4634960-cd68-11df-ab20-00144feab49a.html>

⁷ *Reuters*, ‘Austria ties Irish aid to corporate tax rate’, 17 November 2010; <http://www.reuters.com/article/idUSLDE6AG23420101117>

There are a number of important dates in the coming months that will be key for how the Irish situation develops:

22-26 November – Irish government, IMF, ECB and Commission officials work out the details of the Irish bail-out

Officials from Ireland, EU countries, the Commission, ECB and IMF are currently working out the details of the bail-out of Ireland. It's unclear when the negotiations will be concluded.

24 November – Irish government to publish new spending cuts

The Irish government has said it will publish a plan showing how it will make €15 billion of cuts over four years with significant “frontloading” of the measures coming in the first year.⁸ The announcement is expected on 24 November and Finance Minister Brian Lenihan has said that EU and IMF officials had seen the outline of the budget plan, and “it is unlikely that they will request changes”⁹.

25 November – Irish parliamentary by-election

The outcome will be interpreted as a vote of confidence in the government. The government cannot lose its majority, but defeat would cut it to just two seats and could dent markets' confidence that the government will deliver on its plans for tougher spending cuts.¹⁰

2 December – ECB to decide on lending support measures

The ECB has said that it will decide on 2 December what support will be kept in place for the New Year, with Board Member Jürgen Stark saying that “The phasing out of our liquidity support measures will continue after the end of the current quarter.”¹¹ The ECB will be under pressure from Germany in particular to reduce its lending to struggling countries such as Ireland (see below), which is likely to put Irish banks under greater strain due to their current reliance on ECB support.

7 December – Irish budget

The Irish government's budget for 2011 is due to be presented to parliament on 7 December.¹²

16-17 December – EU leaders meet in Brussels to discuss permanent eurozone rescue mechanism

⁸ Irish Department of Finance press release, 'Information note on the forthcoming economic and budgetary outlook 2011-2014', 4 November 2010;
<http://www.finance.gov.ie/viewdoc.asp?DocID=6564&CatID=1&StartDate=1+January+2010&m=n>

⁹ BBC, 'Euro and shares rise after Irish rescue deal', 22 November 2010;
<http://www.bbc.co.uk/news/business-11808577>

¹⁰ As suggested in FT, 'Dublin coalition nears breaking point', 18 November 2011;
<http://www.ft.com/cms/s/0/2864ce80-f27d-11df-a2f3-00144feab49a.html#axzz15ctPzkSn>

¹¹ Reuters, 'ECB will scale back lending support in new year – Stark', 18 November 2011;
<http://in.reuters.com/article/idNIndia-52954220101116>

¹² Irish Department of Finance, 'Information note on the forthcoming economic and budgetary outlook 2011-2014', 4 November 2010, p9;
<http://www.finance.gov.ie/documents/publications/guidelines/infor2010.pdf>

The draft plans for the German-led permanent rescue mechanism for the eurozone are due to be revealed at the European Council meeting on 16-17 December. Given the market uncertainty surrounding the current plans, any announcement could have major consequences for the fortunes of Ireland, Portugal and even Spain.

23 December – ECB loan repayment deadline

Eurozone banks have to pay back or re-borrow over €200 billion as the expiry of the ECB's final 12-month loan coincides with the repayment of €104bn billion taken in a 3 month operation in September.¹³ According to the ECB, borrowings by Irish-based lenders' from the European Central Bank rose to €130 billion (as of 29 October), up almost €10 billion from the end of September.¹⁴

3) Different ways in which Ireland could be bailed out

The ECB's current support to the Irish banking sector is already acting as a form of EU bailout but Irish, EU and IMF officials have a number of options when negotiating the details of the bail-out.

The most likely option is some sort of contingency fund for banks, provided for by the EU/IMF, or bilateral loans, possibly held by the Irish government as a buffer in case a bank were to run out of capital – to serve as “fire power” in the words of Irish Finance Minister Brian Lenihan¹⁵. This is sometimes known as “substantial contingency capital”, or “CoCo”. The loans would be guaranteed by a share scheme.

Choice 1: Source of funding

Option	What does it entail?	UK involvement?
Indirect bailout via the ECB.	Lending more ECB funds to Irish banks and purchasing government bonds. However, this is unlikely to be sufficient enough to recapitalise the Irish banking sector.	No, but the UK contributes 1.4% of the ECB's paid-up capital, meaning that it underwrites part of the ECB's balance-sheet. Non-eurozone countries are not supposed to be liable for any ECB losses ¹⁶ .
Bilateral loans.	The UK is reportedly considering offering direct bilateral loans to Ireland bypassing the EU.	Yes.
Using the EU's €60bn European Financial Stability Mechanism to guarantee Irish debt.	This fund is guaranteed by all EU member states via the EU budget.	Yes. The UK's potential liabilities are between £6bn and £7bn. The UK has no veto on the use of this fund as it can be

¹³ ECB press release, 'ECB announces details of refinancing operations with settlement from 17 October 2010 to 18 January 2011', 2 September 2010;

http://www.ecb.int/press/pr/date/2010/html/pr100902_1.en.html

¹⁴ Cited in <http://forex.fxdd.com/93582/economic-statistics/irish-bank-borrowings-from-ecb-jump-to-e130-billion>.

¹⁵ Bloomberg, 'Ireland seeks bailout as "outsized" problem overwhelms nation', 21 November 2010 <http://www.bloomberg.com/news/2010-11-21/lenihan-says-he-will-recommend-ireland-should-formally-ask-for-eu-bailout.html>

¹⁶ ECB, Capital subscription; <http://www.ecb.int/ecb/orga/capital/html/index.en.html>

		activated by qualified majority voting.
Using the €440bn European Financial Stability Facility to guarantee Irish debt.	This fund requires unanimous agreement of the all the eurozone members that contribute to the fund. It would be topped up with guarantees from the IMF.	No.
A mixture of all or some of the above.	An Irish bailout will probably combine money from the eurozone's €440bn fund with either bilateral loans or funds from the EU's €60bn fund. The IMF would also be involved. The €440bn fund may take longer to activate than the other options because it requires unanimity amongst its contributors. As Chancellor George Osborne has confirmed, the UK is likely to be involved in a bailout in some form or another, either through bilateral loans or via the EU's €60bn fund.	Yes.

Choice 2: Recipients of funding¹⁷

Option	What would it involve?	Drawbacks
A full-scale bailout whereby the IMF/EU lend directly to the government at rates of interest below those available in the bond market.	Providing the government with the required funding for the next four years would lower the cost of debt interest for the government and allow the banks to be nationalised and recapitalised.	EU and Irish taxpayers have to take on responsibility for the banks.
A partial bailout whereby the government takes a loan from the IMF/EU, but the banks do not actually tap any money. This has also been described by Finance Minister Brian Lenihan as “substantial contingency capital”.	The availability of this money might give the markets assurance that no matter how bad bank losses become there is enough capital available to plug the gaps.	It may allow banks to avoid coming clean on their bad loans, simply drawing out the problem.
Bank bailout plus government borrowing.	The majority of the funds go to the banks, with the IMF/EU taking over the	Dependence on the ECB may simply be replaced by

¹⁷ See also *Irish Independent*, ‘The bailout choices and what they could mean for country’, 19 November 2010
<http://www.independent.ie/national-news/the-bailout-choices-and-what-they-could-mean-for-country-2427287.html>

	ECB's role in providing money to the banks.	dependence on the IMF/EU.
Bailout promise.	The IMF, for example, offers so-called "precautionary access" to funds. Such arrangements are used when countries do not intend to draw on approved amounts, but retain the option to do so should they need it.	This wouldn't actually provide any funds to deal with the banking crisis so the markets are unlikely to be convinced.
Government borrows with guarantee.	The government's normal borrowing would be guaranteed by the IMF and EU, lowering the cost of borrowing. It would be one last chance to convince the bond market.	The markets are unlikely to be convinced unless there is a credible plan to fix the banks.

4) Why is Germany so keen on the loans?

Germany has actively been putting pressure on Ireland to agree a bailout – unlike in the case of Greece, when the Germans were far more hesitant.

This is unsurprising, as German investors have a \$138 billion exposure to Ireland according to the Bank for International Settlements, through the government, banks or companies.¹⁸ A bailout of Ireland would therefore amount to an indirect German bailout of German banks which have made risky investments in Ireland.

There is, however, a second reason. Germany now wants to decrease Ireland's dependency on the ECB, replacing the current support measures with government-backed loans, which can be linked to specific demands, such as a restructuring of the banks or changes to the tax system. The ECB's generous liquidity supply matters tremendously since it goes against the 'hard currency' philosophy that Germany was promised when giving up the Deutschmark in the 1990s and strikes to the heart of worries that the ECB is becoming a "bad bank" itself.¹⁹

The Irish banks, which incidentally passed the EU's stress tests in July²⁰, have already received significant financial support from the ECB for several months, while the ECB has also purchased Irish government 'junk' bonds either from Irish banks or other sources. Irish-based lenders' have borrowed €130 billion (as of 29 October)

¹⁸ According to data from the Basel-based Bank for International Settlements, the Irish government, banks and companies owe foreign investors \$731 billion (540 billion euros). Banks in Britain hold the highest stake with \$149 billion, followed by Germany with \$138 billion, the United States with \$69 billion, Belgium with \$54 billion and France with \$50 billion. <http://www.dw-world.de/dw/article/0,,6243496,00.html>

¹⁹ Cited in *EUBusiness*, 'ECB risks becoming "bad bank" with bond purchases: economist', 18 May 2010 <http://www.eubusiness.com/news-eu/ecb-eurozone-bank.4rp/>

²⁰ See *WSJ Real Time Brussels* blog; <http://blogs.wsj.com/brussels/2010/11/18/building-a-firewall-in-ireland/>

from the ECB, according to some estimates²¹ – an amount almost equivalent to Ireland's GDP²².

The ECB's extensive bond purchasing programme and other emergency measures are subject to fierce criticism in Germany.²³ German Bundesbank President Axel Weber has consistently criticised this practice, saying in October that,

“As the risks associated with the securities market programme (bond buying) outweigh its benefits, these securities purchases should now be phased out permanently”²⁴.

Others also worry about the ECB's growing exposure to bad debt. Deutsche Bank Chief Economist Thomas Mayer, for example, has argued against the purchase of government bonds by the ECB, because should a government default on its debt, then “ultimately, the shareholders of the ECB will then be asked to pay the bill, whereby the largest part would have to be paid by Germany.”²⁵

In addition, for Germany it's absolutely vital that the current crisis is stopped before it spreads to Spain – which even Germany couldn't afford to bail out. And while it is not in as bad a shape as the other weaker economies, Spanish Central Bank governor Miguel Ángel Fernández Ordóñez put public pressure on Dublin to apply for help, amid rising borrowing costs for the Spanish government. Ireland is fully funded for all the first half of next year and Portugal has already completed its 2010 bond sales, but Spain has two more bond auctions scheduled for this year so any increase in borrowing costs would have a significant impact.²⁶

5) How much will the UK contribute to an Irish bail-out?

The UK is likely to contribute in three ways – through the IMF, the EU's bail-out fund and bilateral loans. Bizarrely, the decision on whether Britain should participate in a bail-out of Ireland does no longer rest solely with the UK Government. This is because the part of the eurozone bail-out package which Britain could be underwriting to the tune of £6-7 billion – the €60bn European Financial Stability Mechanism – is triggered by a majority vote amongst EU ministers. In other words, the UK would be unable to block it.

²¹ Barclays Capital estimated that more than 10% of all the loans and investments made by Ireland's banks are financed with ECB money:

http://www.bbc.co.uk/blogs/thereporters/robertpeston/2010/11/will_the_ecb_pull_the_plug_on.html

Another source claims that about €90bn of ECB money was in the Irish banks by the end of October:

<http://www.independent.ie/business/irish/ecb-will-find-it-very-difficult-to-offer-special-aid-to-the-irish-banks-2425480.html>

See also <http://online.wsj.com/article/SB10001424052748704648604575620251565111376.html>

²² Eurostat forecasts Ireland's GDP to be €155bn in 2010;

http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nama_a&lang=en

²³ See, for instance, *Bloomberg*, 'German Government bonds as Weber says ECB should halt bond purchases', 13 October 2010

<http://www.bloomberg.com/news/2010-10-13/german-government-bonds-fall-as-weber-says-ecb-should-halt-bond-purchases.html>

²⁴ *Reuters*, 'Weber-ECB bond buying programme should be scrapped', 12 October;

<http://uk.reuters.com/article/idUSFAB01579220101012>

²⁵ *BoerseGo.de*, 'Rettung oder Sündenfall', 12 May 2010

<http://www.boerse-go.de/nachricht/Rettung-oder-Suendenfall.a2172458.html>

²⁶ Cited in *Businessweek*, 'Spain to pay more for bonds amid Irish contagion', 17 November 2010

<http://www.businessweek.com/news/2010-11-17/spain-to-pay-more-for-bonds-amid-irish-contagion-euro-credit.html>

The deal was signed off by Alistair Darling the day before the Coalition government was formed in the UK – during the weekend when EU leaders agreed to the EU/IMF shock-and-awe €750 billion euro rescue package, bending various EU laws to breaking point in the process (to be fair to Darling the decision to establish the EFSM was also based on majority voting so George Osborne may not have fared much better).

That such a decision – which effectively makes taxpayers in one country liable for the debt of a government over which they have no democratic control – should be subject to majority vote in a forum consisting of 27 different member states completely undercuts democracy. But that's what the Coalition government is now facing. The stabilisation mechanism is likely to be triggered first, as the EU's second bail-out fund, the €440 billion European Financial Stability Facility, of which the UK is not a part, is subject to unanimity and therefore more difficult to get off the ground quickly.

The British and Irish economies are clearly inter-linked, and according to the Bank for International Settlements, UK banks have an exposure of £140 billion to Ireland.

The Treasury is therefore considering ways to assist Ireland through bilateral loans. Bilateral rescue arrangements between similar economies have a far better chance of ending happily than messy multilateral bail-outs – which involve conflicting interests and highly politicised demands. The joint loan given by the Nordic countries to Iceland in 2008 could be one model. One complication in this is that, unlike the EU mechanism which involves the Commission raising the funds, the UK government would itself be forced to raise new money on the markets in order to lend to Ireland. The exposure to taxpayers would remain the same, however.

6) But will more bail-outs and stronger conditions actually solve anything?

The real question is whether a one-off bail-out will actually solve the problems underlying the Irish crisis. Without Ireland regaining competitiveness, and without growth, the UK could be caught in the trap of throwing good money after bad.

Ireland is clearly in better shape than Portugal, Spain and Greece in terms of economic competitiveness, thanks to its open economy and flexible and skilled labour market, and there is a chance that substantial loans could buy Ireland enough time to get its economy in order – if the right choices are made and the banking system is flushed out. But there's also a big risk that these loans won't solve anything at all, due to the constraints Ireland is subject to within EMU (see below).

In addition to short-term loans to Ireland, EU leaders are now proposing a two-pronged regime to address the ongoing problems in the eurozone: stronger rules and sanctions to ensure budget discipline within EMU; and a permanent rescue mechanism, which, if the Germans have their way, involves creditors taking a haircut should eurozone countries default and need assistance (see above).

This new regime could well lead to more budget discipline, and Germany's proposal for a permanent crisis mechanism is sensible, as it will transfer risk away from taxpayers to creditors – where the risk belongs (although the timing in announcing it was unfortunate).

But in themselves, these proposals will do nothing to help countries such as Greece, Ireland or Portugal to get out of their current troubles.

First, while these economies differ – with Greece’s in by far the worst health – they suffer from one common problem: the difficulty of regaining competitiveness within a monetary union with one interest rate and no option of devaluation. All of them have lost too much competitiveness since joining the euro, which is now coming back to haunt them (see table in section 1).

In essence, what was asked of Greece, and will be for Ireland, is two-thirds of a traditional IMF package – cuts in expenditure and increased taxes. However, the third, vital ingredient – currency depreciation – isn’t permitted.

Instead, currency devaluation has to be replaced by so-called “internal depreciation”, meaning that cuts to jobs and wages must take up all the slack. But the question is if it’s realistically possible for Ireland or any country to cut enough costs to catch up with Germany – as this would involve squeezing citizens to breaking point. Ireland has already pushed through extraordinary cost saving measures. On its part, Greece is unlikely to be able to pay back its huge loans in the medium to long-term, since it lacks the required sources of revenue (some sort of restructuring is likely), let alone regain competitiveness through continuous austerity. In the absence of growth and regained competitiveness, none of the underlying problems will actually be solved.

Secondly, at the same time, the ECB is likely to continue to pursue a German-style monetary policy, leading to an undervalued currency for Germany (fuelling German export-led growth) but an equally over-valued currency for the weaker economies such as Portugal, Greece and Spain. While a weak euro could benefit Ireland, due to it being a relatively open economy, it will never fall to such low levels as to help the other peripheral eurozone economies.

This, in turn, locks in a multi-speed eurozone, with the same type of tensions we’ve seen over the last year coming to the fore again in future. Until these problems are solved, the euro will continue to fuel regional bubbles periodically punctured by recessions.

Thirdly, the politics of a loan bail-out and stronger supranational budget rules are unsustainable. The lending countries, most importantly Germany, can only sell a de facto debt union to their electorates if it comes with strict rules and terms. But such terms imposed from the outside would seriously compromise the ability of the borrowing countries to democratically govern themselves. It would be very difficult – if not impossible – to sell this to the electorate. We see such problems illustrated in discussions over bringing the Irish corporate tax rate in line with the rest of Europe’s – which is unacceptable for Ireland – or the demands on Greece to do more to chase down tax evaders, which is culturally difficult for Greece.

The Irish situation is further complicated by the rescue operation being perceived as a ‘bank bailout’, which is very unpopular with electorates virtually everywhere.

Fourthly, the role currently being played by the European Central Bank is untenable, both for political and economic reasons. Politically, the ECB’s decision back in May to start buying ‘junk’ government bonds from the secondary market has compromised its independence – which the Germans were promised would never happen.

A bailout using loan guarantees from other EU states may allow the ECB to withdraw its emergency funding for now, but without a long-term solution the ECB is likely to be called on again to prop up ailing states.

Economically, the situation is also increasingly unsustainable. In fact, at the moment, the ECB is more leveraged than the average hedge fund. The Eurosystem of eurozone central banks that underpins the ECB is leveraged 24 times²⁷, while the average hedge fund is only leveraged 3 to 4 times. A fall in assets of only a few percent could wipe out the ECB's reserves, in which case the ECB itself might have to be recapitalised.

The ECB could print more euros in order to pay off its losses but this would seriously threaten its low inflation and price stability mandate.

7) So what are the long-term options?

There are no solutions to the eurozone's problems that are not painful both economically and politically.

Within the existing eurozone arrangements, in *theory*, there seems to be three ways out of the current mess. First, is the continual transfer of funds from the current account surplus countries, led by Germany, to prop up the economies that suffer from excessive public and private debt bubbles to compensate for the large differences in competitiveness.

A series of loan guarantees spread over a few years under the current bail-out arrangements are unlikely to work. What is needed is continuous fiscal transfers, turning the eurozone into that famous (or infamous) fully fledged United States-style fiscal (and therefore political) union. This would be unacceptable to German taxpayers, as the transfers would have to be huge – to the point of inflicting serious damage on the German economy. The political and democratic costs of entering into such a union without citizens' consent will be plain to Chancellor Merkel, who will also be fearful of the German Constitutional Court.

The second option would be a massive devaluation of the euro. It would have to be a big devaluation, as anything less would not be enough for Greece or Ireland. Again, given its pre-Second World War experience, the necessary scale of depreciation with the threat of very high inflation in Germany makes this an impossible option. In addition, devaluation would in fact unbalance the eurozone even further, with Germany becoming even more competitive relative to weaker EMU countries.

The third option is an orderly default, or some sort of restructuring of debts, along the lines of what Angela Merkel has proposed. This might help Ireland to a certain extent, because again it's a more open economy, and will force creditors to shoulder part of the burden for poor investments (which would make the eurozone fairer). However, a restructuring of debt in, say, Ireland, would put massive pressure on markets elsewhere, and send borrowing costs rocketing in other peripheral economies. In addition, an orderly default would still not have solved the most fundamental problem – loss of competitiveness.

Leaving these three options aside, it's hard to see any viable way forward. This leaves the option of some form of orderly break up of the eurozone, allowing those countries that cannot live with a German-style currency to devalue. This could be in the form of a slimmed down monetary union with a strong northern currency, leaving

²⁷ The ECB's Monetary Policy Statistics show that as of 12 November 2010 the Eurosystem had liabilities €1,878,979m and capital reserves of €78,191m, see <http://sdw.ecb.europa.eu/reports.do?node=100000129>

the weak periphery with a choice: they could either form their own soft-euro bloc, or they could revert to their old national currencies.

This would have painful consequences for French and German banks, for example, which have lent extensively to the weak eurozone states. But it is now time to consider all the options on the table, taking into account all the democratic and economic consequences.