Ours is not to reason why, ours is but to do or die

Buenos Aires, Argentina: Dec 6, 2010: Does the new 5.8% rescue fund interest rate demonstrate European solidarity with Ireland? Is the European Union abandoning the Irish people? What about the IMF, will they save Ireland? Why are voices in the media mentioning a deal when a budget has yet to be approved?

What follows is a realistic Argentine perspective on this critical phase of debt negotiation. The hindsight offered by historical comparisons with Argentina in 2002 is not 20/20 but Argentina's experiences may provide some general guidance. If only one thing can be made clear it is that the IMF and the ECB are in Dublin for systemic global financial stability (of creditors). They are not there to protect the Irish taxpayer.

Focusing on interest rates, now, in December 2010, is putting the cart before the horse. Creditors set interest rates, and interest rates change. The question faced by the Irish people at this juncture is simple. Their representatives need to negotiate to keep down Ireland's public external debt? Until Dáil representatives pass a budget, this number is not a done deal. Irish negotiators need to be crystal clear. Unsustainable public external debt is non-negotiable. If the negotiators do not do their jobs they must be replaced till someone does.

Ireland in December 2010 shows many analogies with Argentina in December 2001. This phase of the negotiations cost Argentina dear; riots, deaths, banking collapse and frozen accounts (the notorious "Corralito"). The peso all but destroyed with a 75% depreciation and this lead to the largest sovereign default in the history of modern finance.

There was considerable social unrest. Three presidents were forced to resign between December 2001 and January 2002 because they did not offer solutions acceptable to the public. There were massive riots in the streets. Police shot demonstrators. IMF representatives tried to remain calm, pressing the Argentine congress for changes in national corruption laws and working feverishly in their offices in the Argentine Economics Ministry. They were dark days indeed. Former Minister for Economics and Argentine statesman Aldo Ferrer wrote of this period citing Dante Alighieri, "Abandon hope, all ye who enter here."

In Dublin this week large sums of money are in play especially in the secondary European and US debt markets where Irish bank debt has been re-packaged (like US sub-prime mortgages) and sold on to foreign derivatives markets. Irish negotiators will be under extreme pressure, their performance now, and the actions of the Dáil in revising, renegotiating and passing a budget, will mark a defining hour in the history of the Irish state.

Seen from the perspective of recent Argentine history some Irish indications seem far from positive. NAMA, a band-aid measure with limited transparency designed to cushion just one industrial sector was ineffective and very expensive. The infinite deposit guarantees on banks were overly generous. Both risk bringing the Irish state dangerously close to sovereign default. Government declarations and interviews with Taoiseach Cowen show a dangerous confusion between the running costs of government and the woes of the private banking sector. Financial analysts do not confuse these matters; they are worried about Ireland's banking problems. The budget and the banking problems are quite distinct and must be treated as such. The budget gaps can and must be fixed by Ireland alone, the banking woes may be beyond repair by Ireland without systemic instability in Irish state finances.

Banking Instability, an International issue

Financial analysts have been watching the contagion in the global debt derivatives (or asset-backed debt) as they spread causing banking instability. Financial sector risks prompt national financial rescues; a variety of Good-bank / Bad-bank schemes. Few schemes were quite so generous as Ireland's NAMA.

NAMA was like a giant cushion shoved under defaulting speculator loans from Irish banks. Instigated by Fianna Fáil and the Greens in 2009, NAMA was a critical mistake, a panicky reaction with more than a tinge of corruption. NAMA seems more akin to what one might expect in the 1970's Latin American Banana republics than a sovereign OECD state.

The Irish banking system faces bankruptcy not the Irish nation. If the bad loans in the Irish bank's cause institutional default, there will be losses internationally for bondholders. These private foreign creditors face ugly losses and torturous lawsuits in bankruptcy courts. If the IMF and the ECB could convince Ireland that saving bondholders with sovereign borrowing of bailout funds is a national priority, much of this pain can be transferred to the Irish taxpayer.

The NAMA system and a bloated budget are both problems faced by the Irish nation but only the budget is a sovereign issue. The budget can be trimmed, and it should be, taking account of the national social priorities. But the banks are another story. Financial assessments by experts suggest unwinding the banking sector in as controlled a manner as possible. Most of the banks are still private enterprises. Shrinking, then removing NAMA should be part of any budget passed. This is not happening, quite the contrary. The Irish Central Bank[1] is citing plans to grow NAMA. If this is what the ECB/IMF advisers are pushing, Irish negotiators need to draw a line in the sand. NAMA in its current form is becoming more and more dangerous to Irish public finances. It should be eliminated quickly. Extending NAMA endangers national financial stability. NAMA is now (and always was) the wrong way to fix the private banking sector. Every cent added to NAMA will be paid by the Irish poor and middle classes for decades to come. NAMA means Ireland risks becoming overwhelmed by debt. Every day that NAMA exists questions the legitimacy of Irish sovereignty.

So how can the imposition of illegitimate debt (to rescue the banking sector) be prevented? Foreign financiers do not have this answer. The IMF and the ECB will fight tooth and nail to load as much debt onto the Irish people as they are willing to bear! This is a political issue. Unlike Argentina and many other South American States where private debt was taken onto the public sector in the 1980's by dictators; Ireland is a democracy. This would imply that the Irish people can and should refuse to elect any representative, or hire any consultant, unwilling to fight hard on this issue. Politicians and consultants are paid well by the Irish people to represent them.

Any budget passed must be concomitant with national financial stability. If this means forcing the losses of the banking defaults onto the shoulders of the speculators who borrowed from these banks, then so be it. Failing that, they fall to the shoulders of the foreign bondholders who speculated on speculator debt. Irish negotiators need to understand that it is these same foreign bondholders that politely asked their governments to send the IMF and the ECB to Dublin.

In financial terms losses are referred to as “haircuts”; typically a reduction in the value of a bond. The Irish politicians need to learn to cut hair. It is not their job to save foreign bondholders. Bondholders are gamblers, investors in banking derivatives on unregulated markets; gamblers can afford to take losses, the Irish state cannot. The derivatives investors gambled that a corrupt Irish government could be leaned on to protect corrupt Irish speculators. The IMF and the ECB negotiators are leaning on the Irish now. It is time to call their bluff.

A banking crash will cause disruption. In the collapse, the government will have to stand by personal deposits, as any legitimate government would. A reasonable level of coverage might be 50,000 to 100,000 euros per account (similar to FDIC insurance in the USA.) Unlimited and corporate guarantees backing deposits will have to be eliminated. They should never have been put in place. The national economy will wobble and contagion will ripple through the international debt markets forcing losses on CDOs[1], but a sovereign Ireland will make it known that it protects its citizens and not unscrupulous speculators. Other fragile nations like Portugal would benefit indirectly from such a hard-line stance possibly increasing solidarity in the European Parliament groups.

The Euro

The Irish problem is not a budget issue, nor is it a euro-punt issue; it is a debt issue. In Argentina in 2001 the peso was pegged to the US dollar at one peso to one dollar. The devaluation brought relative values to four pesos to one dollar, stabilizing at three-to-one. The Argentine peso today is again worth just 25 US cents. Though similar, this is not analogous to Irelands marriage to the Euro. Membership of the Eurozone is a somewhat more reciprocal relationship. Though divorce is possible, counseling should be sought before any such relationship is terminated.

A new Irish punt will be prone to speculative attacks. It will be hard to convince markets of the stability of a defaulted currency. The resultant devaluation would be severe, pushing up euro-denominated debt obligations. The state would have to maintain high foreign currency reserves. None of this is optimal, but it is possible, and if it proves necessary it may be the least-worse scenario. It should be possible to maintain real public debt obligations close to half of GDP. It will take time before it can get back to the excellent 2007 levels of 25% as GDP drops as a result of adjustments.

The Irish people will need a government that negotiates an effective budget with adjustments that will hurt a little. Deflation will help the poor to bear their part in trimming the fat. Adjustments could begin with politician's salaries and limits to executive and director pay. By accepting a pay cut, Ireland’s new leaders might renew moral legitimacy allowing them to raise taxation in a socially progressive way. Irelands personal and corporate taxation levels are low; sectors best able to pay can contribute more to national recovery.

Housing prices will drop further making them again accessible to a new middle class, this is inevitable under any scenario. Eventually housing prices will stabilize and the government could optionally choose to take measures to help certain people in danger of losing their home. This was done in the US with rental options or mechanisms for handing back the keys for those holding underwater mortgages. It is important to note that such costly policy options might not be possible if mistakes are made now.

Conclusion

The critical issue in December 2010 is that the new budget bring less public money to the banks, not more! The crisis will be over by Spring, the World will keep on spinning, the Euro will survive, and the EU experiment (which in general is a good thing for Ireland) will also continue. It will be necessary to apply significant pressure on the ECB to democratize the euro and there will have to be more Central bank coordination. Most important, from an Irish perspective, this return to stability can happen without loading decades of misery onto the Irish people.

So first things first! Have your voices heard in those snowy streets and prevent a bad budget! If the current government or future governments show any signs of corruption, change them. Their mismanagement to date should make such political changes not just necessary but popular. Elect a government who can be trusted to represent national interests against global financial power and capable of cooperating with European allies.

The remit of the IMF and the ECB includes the protection private financial interests abroad. They will make the Irish pay till they scream. Learn a lesson from Argentina, scream early and scream loud. It will mean less pain in the long run. Ireland needs to take back control of its public finances and play hardball with foreign financial interests now. Argentina is watching you. Sovereign debt is a sovereignty issue; time to prove your mettle.

[1] A CDO is a Collateralized Debt Obligation, bundles of debt, re-bundled and sold on to other banks (often internationally), in this case with the backing (collateral) of Irish and Irish-owned assets such as NAMA properties.

[2] http://ftalphaville.ft.com/blog/2010/11/28/418441/new-capital-requirements-for-irelands-banks/ Financial times, nov 29, "Alphaville" blog entry analyses new capital requirements for Ireland's banks mentioning (new) "Loans eligible to transfer to NAMA with value less than €5m, and between €5m and €20m" http://www.financialregulator.ie/press-area/press-releases/Documents/Technical%20Statement%20-%20PCAR%20PLAR%20-%2028%20November.pdf Download: Prudential Capital Assessment Review ("PCAR") from Central Bank of Ireland Web page" (see also “How nama went from bad to worse” http://www.ft.com/cms/s/0/65f372b4-0098-11e0-aa29-00144feab49a.html#axzz17KYNasfm