AllianceBernstein

ECONOMICS: EUROPEAN PERSPECTIVES—NOVEMBER 22, 2013

# Ireland's Bailout Exit: Hope or False Precedent?


- **Dennis Shen**
  Economic Associate—Global Economic Research, + 44 (020) 7173 9270
- **Darren Williams**
  Senior European Economist—Global Economic Research, + 44 (020) 7959 4543


With its decision to go it alone, Ireland plans to return to full market financing in 2014 without precautionary support. We believe this decision is justified given the country's unique economic and financing circumstances. But it may set a false precedent for other countries in the euro-area periphery.

Last week, Ireland's Prime Minister Enda Kenny confirmed that the country will make a clean exit from its three-year, €67.5 billion bailout from the European Union (EU) and International Monetary Fund (IMF) on December 15, and that it will do so without a precautionary credit line. With this decision, Ireland becomes the first euro-area country to successfully break away from a full EU/IMF financial assistance facility as it exits next month.

In recent months, the EU had recommended the precautionary line as the safest route forward. Even if Ireland never used the credit line, it might have allowed it to qualify for the European Central Bank (ECB)'s bond purchases program. At the time, the Irish government appeared to agree. As recently as September, finance minister Michael Noonan stated that Ireland wanted a precautionary line worth €10 billion to ease its exit plans and "give confidence to our lenders."

Since then, the decision has visibly changed, possibly in response to better market conditions. In addition, Ireland's large cash reserves provide a substantial cushion, so that any precautionary line would be unlikely to be accessed in 2014.

## Politics Also Guided Decision

However, politics have also played a decisive role in the change of heart. While the conditions attached to a precautionary line would not have been overly restrictive compared with the hard reforms of recent years, maintaining it would still have required quarterly visits from the European Commission and ECB. The opportunity to reclaim economic sovereignty has therefore been central to the decision.

Meanwhile, the decision is also politically convenient for EU policymakers, as it enables them to present Ireland as the success story of the bailout programs. Jeroen Dijsselbloem of the Eurogroup, a body that brings together the finance ministers of euro-area countries, recently stated that Ireland's exit "proves these programs work and deliver when they are successfully implemented."

Display 1
Market Confidence Returns

As of November 21, 2013
Source: Financial Times

For countries that are still in bailouts, Ireland's decision may send two signals. The first is a projection of hope and optimism—that after years of economic hardship and political and social crisis, there is a way forward. However, the decision may also set a problematic precedent by encouraging other countries in the periphery to consider an early exit when they are not fully prepared for this next step.

## Improvements in the Economy

Ireland's decision is justified in part by improvements in its economy and financing conditions. The Irish economy is

unique in the euro-area periphery for its openness and market flexibility. Moreover, the development of high value-added sectors and a sizable correction in unit labor costs (down 16% from the peak in late 2008) have helped export industries, which supported the local economy in the face of fiscal consolidation and a financial crisis. In the process, the current account balance improved by an impressive 12 percentage points between 2008 and the first half of 2013, from a deficit of 5.6% of gross domestic product (GDP) to an estimated surplus worth 6.2% of GDP.

After three quarters of recession, the Irish economy expanded by 0.4% in the second quarter, led by exports and stabilizing private consumption. Monthly indices for consumer sentiment and industrial production indicate that third-quarter growth is likely to pick up from the second quarter. Unemployment has dropped from a peak of 15.1% in February 2012 to 13.6% by this September—the second-largest improvement in the euro area over this period. At the same time, public finances have continued a multiyear adjustment, with the fiscal deficit on track to meet this year's target of 7.5% of GDP, while debt levels peaked earlier this year and are expected to dip to 124% of GDP by year-end.

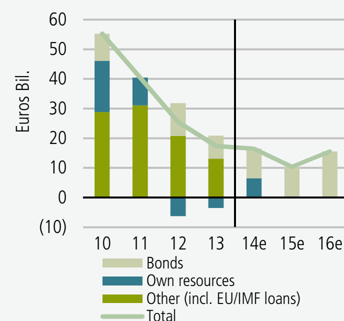
The economic recovery and broader improvements in Europe have led to more sustainable market conditions for Ireland. The government's 10-year bond yield has dropped to 3.5% recently from 7.5% in mid-2012 **(Display 1, previous page)**. The current 10-year spread to German Bunds of 178 basis points is close to its lowest level since early 2010. Against this backdrop, Noonan interpreted the quiet market reaction to Ireland's announcement to go it alone as a reflection of growing investor confidence in the country and justification for the government's exit policy.

## Reserves Help Financing Outlook

So, will Ireland be able to finance itself in 2014? Our estimates suggest that the total financing requirement will be €16.4 billion next year **(Display 2)**, assuming that Ireland meets its 2014 budget objective for a 4.8% of GDP deficit. The government has indicated that part of its financing needs will be met via the substantial cash balance (at present €21.5 billion) built up over the past two years. If the government draws €6.5 billion next year from its cash reserves (which would still leave €15 billion, about 1.5 times the estimated 2015 financing requirements), then it would need to issue around €10 billion in 2014. This is more than the amount issued in 2013, and about equal to that in 2012.

Display 2
Ireland's Financing Needs

Financing Needs by Source of Financing, 2010–2016




As of November 22, 2013
*2014–2016 estimates assume Ireland meets budget targets.
Source: European Commission, IMF, Ireland Department of Finance, AllianceBernstein

In the event of a crisis, Ireland would of course be forced to draw on its cash reserves much more quickly than this. In this sense, the cash balance would fulfill the same role as a precautionary credit line. Seen this way, we believe that Ireland's decision to do without the additional assistance is justified. And, in the worst case scenario, assistance from the EU could be re-requested.

## Mixed Messages for the Periphery

How will Ireland's decision be seen by countries in the euro-area periphery—such as Portugal, Greece and Cyprus—which are still in bailouts? On the one hand, Ireland has shown that it is possible to complete a multiyear adjustment and return towards some type of normality. While Ireland still has many years of hard work ahead, the exit from the bailout is a symbolic victory and marks a new step in this long-term recovery.

On the other hand, Ireland's decision may also set a false precedent, particularly for Portugal which comes to the end of its own bailout next year. Portugal has watched Ireland's decision closely but has less supportive fundamentals and financing conditions; as such, a comparable move to reestablish policy independence may not be possible without considerable risks. In this way, the Irish decision sets a somewhat unrealistic precedent for other countries, and may encourage them to follow its example prematurely.

While Ireland's decision was finely balanced, we believe the country's decision to do without external help was justified by better economic and market conditions, its own precautionary cash balance and the need to reestablish economic sovereignty. Its transition back to markets will mark an important milestone in the country's path towards a more sustainable future. From the perspective of other peripheral nations, Ireland's decision sends an expression of hope, though it may be still too early for some to follow this precedent. ■

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