What crisis?

“‘For Greece, the problem is completely over. I don’t see any other case now in Europe. I don’t think there is any reason to think the euro system will collapse or will suffer greatly because of Greece.’”

Romano Prodi, former EU president and 2 times Italian PM, May 2010

"There's no application for IMF or EU funds and it's not helpful to speculate. There's no reason why we should trigger an IMF or EU-type bail-out… Ireland has made no application for external support."

Brian Cowen, Irish PM, November 15, 2010

"I think what was happening recently, was that Portugal was being hit by the lack of confidence over Ireland. I hope that the Irish government's decision (to request a bailout) will end this uncertainty and restore confidence to markets. There is no reason to have a lack of confidence over Portugal. The country does not need any help."

Jose Socrates, Portuguese PM, November 22, 2010.

"There are no analogies to be made; the Irish case is very specific. The decisions concerning Ireland are also meant to stop any possible tension and contagion to other economies."

EU Commission spokesman, November 23, 2010
Ireland approaching crisis

CDS measure the cost of insuring against a default.

Spreads for Portugal and Ireland are at distress levels – markets see a high risk of default.

Greece is out of the game.

What happens next?
- Bail out, default, quit the euro, or pay it back?
“A generation ago, the very idea that a British politician would go to Ireland to see how to run an economy would have been laughable. The Irish Republic was seen as Britain’s poor and troubled country cousin, a rural backwater on the edge of Europe. Today things are different. Ireland stands as a shining example of the art of the possible in long-term economic policymaking, and that is why I am in Dublin: to listen and to learn.”

George Osborne, 2006.

- In the decade through 2006 the Irish economy grew at an average annual rate of 7%
- Unemployment was 3.9% in 2001
- But, since the financial crisis, GDP has fallen 17%, and the unemployment rate now stands at 13.6%.
- House prices have fallen 36% - 50%
- In the crisis the household savings ratio has doubled to 11%
Anglo Irish Bank

- From 1998 to 2008 Anglo Irish Bank’s loan book swelled from €3bn to €73bn
- Toxic property loans have been bought by the National Asset Management Agency (NAMA) at discounts ranging from 55% to 67%

Credit-default swaps on subordinated debt of Allied Irish Banks are 57% upfront and 5% a year, meaning it costs €5.7m in advance and €500k annually to insure €10m of the bank’s debt for five years.
Some might harbour the illusion that the crisis will pass them by and only affect their neighbours. In today’s post-Lehman world with its dense network of economic and financial systems, that is indeed an illusion.” L Bini-Smaghi, June 2010

European institutions hold nearly $509bn of Irish exposure, according to the most recent figures from the Bank for International Settlements. Britain’s share of that exposure is about $150bn – 7 per cent of GDP – while Germany’s stands at $140bn.
Anglo Irish Bank was nationalised in January 2009
Government has a 36% stake in Bank of Ireland
Allied Irish Banks were effectively nationalised with €7.2bn of support
€2.7bn has been given to Irish Nationwide Building Society

Bank bailout could cost a total of €100bn
The size of the bailout is equal to €45000 for every tax payer
The equivalent of about a third of the Irish economy has gone into supporting the banks – compared with 6% in the UK for RBS, Lloyds and Northern Rock put together
Overview

- Debt crisis: first the banks, now the sovereigns – two sides of the same coin.

- Immediate stress is on the PIIGS, and especially Ireland, who are trapped in the single currency - but we’re all in it together.

- The underlying problem is private sector debt – there’s too much of it.

- Many economies, including the UK, are stressed – and eventually the spotlight will fall on us too.

- The best defence is:
  - Fiscal consolidation
  - QE – once more, with feeling
Transfer pricing: from the SIVs to the Banks to the Sovereigns...to the...

Banks and sovereigns are two sides of the same coin, but the underlying problem is private sector debt.

Financial risk maybe like matter – a constant

Source: Reuters EcoWin / Fathom
The underlying source of the crisis was a build up of private, non-financial debt.
In particular, debt secured against the rising price of housing. According to the OECD by 2008, all but Germany and Japan had overvalued housing markets – UK only behind Ireland and Australia.
BIS analysis suggests the average decline in debt/GDP after a debt crisis is 38 pp. The US is about one-third of the way through this process. The UK has barely begun.
Not so easy in a fixed currency

- Previous experience of debt cycles suggests that recovery is much faster in countries which can inflate their currency.
- The Gold Standard meant the quantity of currency in circulation was tied to the amount of gold held in reserve.
- The ‘30s started with all major currencies in the GS – but Britain left during 1931, followed by the US in 1933 and France (and others) in 1935.
- Leaving GS was the trigger for a sustained recovery in all cases – but it was opposed at the time by those who feared inflation.
- Today, the equivalent is the euro.

Impact of the Gold Standard on per capita GDP

Index 1929 = 100

- Britain leaves GS
- France leaves GS
- USA leaves GS
Options within a currency union

- **Bail out.** Involves some mechanism for fiscal transfers within the currency, such as exist within the dollar. The EFSF (May 10) introduced such a mechanism for the EA.

- **Default.** The dollar allows individual states or municipalities to default, and Merkel proposes something similar in EA. But those arrangements are not yet in place.

- **Inflate.** If the debt crisis affects the whole of the currency union, then it can print money and inflate away the debt burden. Not the case in the EA though.

- **Repay.** The worst option in the short term, implying a major and long-lasting recession.

Neither option is great, but there have been examples of both within the dollar, and the governments concerned have continued to function throughout.

- **Case studies** - Orange County; New York City. Both municipalities defaulted on their debt. NYC was ultimately bailed out by the Federal government, unlike OC.
UK deficit is large

- It is sometimes claimed that Britain’s public debt is still historically low. That is only true if you include wartime debts.
- According to the OECD, the UK has the second largest deficit in both headline and structural terms.
- Market patience was not a luxury on which the UK could gamble.
Government is saving...

**UK Government Taxes and Spending**

Per cent of GDP

- Tax receipts
- Spending

**Source:** Reuters EcoWin / Fathom

**Contribution of Expenditure & Revenue to the Fiscal Consolidation**

Per cent

- Successful
- Expansionary
- Unsuccessful
- Contractionary

- Primary expenditures - cycl. adj.
- Total revenue - cycl. adj.

**Source:** Alberto Alesina

**Structural Government Budget Balance**

Share of potential GDP, per cent

- OECD estimate

**Lots of talk about tax receipts having collapsed in the recession, but the evidence does not support it. The budget blowout mostly reflects a surge in (non-cyclical) spending.**

- Government austerity plans are stacked 73:27 in favour of spending cuts.

- The evidence suggests this is the right track.
Good news – fiscal impact can be positive

<table>
<thead>
<tr>
<th>Country</th>
<th>Change in cyclically adjusted net lending, 1994-99 (percentage points)</th>
<th>Change in number of jobs, 1994-99 (a) (thousands)</th>
<th>Contributions to GDP growth 1994-99 (percentage points)</th>
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<td>Public</td>
<td>Private</td>
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<tr>
<td>Canada</td>
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<tr>
<td>Sweden</td>
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<td>UK</td>
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<td>7.9</td>
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<td>1950</td>
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(a) Comparison is from 1993 Q4 to 1999 Q4

Source: Fathom calculations

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<th>Country</th>
<th>Change in cyclically adjusted net lending 1979-86 (percentage points)</th>
<th>Change in number of jobs, 1979-86 (thousands)</th>
<th>Contributions to GDP growth 1979-86 (percentage points)</th>
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<tr>
<td></td>
<td></td>
<td>Public</td>
<td>Private</td>
</tr>
<tr>
<td>UK</td>
<td>2.34</td>
<td>-633</td>
<td>424</td>
</tr>
</tbody>
</table>

Source: Fathom calculations
Britain is not borrowing

Mortgage approvals have yet to reach even half the level they peaked at before Northern Rock.

The incipient recovery has stalled and is now seems to be slowly going backwards.
Banks say that there is no demand.
But price is a key determinant of demand...
...and the price is very high.
And the banks are still bust

- On the face of it, UK banks appear to have closed their funding gap...
- ...but only if the level of house prices stays where it is
- But prices are already falling:
  - Nationwide index shows 5 falls in past 6 months
  - Halifax 4 out of past 6 months
  - Fathom’s API shows that auction discount is widening again
- Assuming a 20% fall in house prices reopens the funding gap to £180bn by 2012, without more capitalisation
- And then there’s the removal of the SLS (Jan 2012)...

Market value of UK banks’ books
Relative to face value, £ billion

Source: Reuters EcoWin / Fathom

UK Funding Gap
Relative to face value, £ billion

Source: Reuters EcoWin / Fathom
Zombie households on the rise

- Comparisons with Japan are usually dismissed, by people outside of Japan. But how different are we?
  - 15 years of ZIRP has left Japan with a glut of ‘zombie companies’ only kept afloat by the free cash-flow drip.
  - In our view, the UK (and the US) are at risk of creating ‘zombie households’.
- Near-zero interest rates may have helped to keep mortgage defaults and housing repossessions much lower than they otherwise would have been, but at what long-term cost?
- UK household deleveraging process stopped when rates hit 0.5% - debt/income ratio has flatlined since. It stands at 155.7%.

**Debt-Servicing Burden**
Share of disposable income, per cent

**Household debt**
Share of disposable income, per cent

Sources: Reuters EcoWin / Fathom
A solution: TARP into the UK

- We have consistently argued that policy measures should be targeted at the source of the problem – the housing market. We recently published a new policy paper along these lines. In short:
  - The Treasury should set up a new bank, to purchase troubled assets from the UK commercial banks, at a substantial discount under current market prices
  - Our Auction Price Index provides the floor for that purchase price, and fair value provides the ceiling
  - The new bank should issue a bond to finance its purchases of troubled assets
  - The Bank of England should purchase that bond using QE