CEPS COMMENTARY
Thinking ahead for Europe

How to make Ireland solvent

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The Republic of Ireland can no longer raise funds on the capital market and has had to accept a bail-out financed jointly by the IMF and the European Financial Stability Facility or EFSF (the EU's rescue fund). Many investors fear that by the time European support ends as planned in 2012, the country will not have market access, and might then be forced into default if anti-bail-out forces are determining policy in Germany at that point.

But this dependency of Ireland on foreign support is difficult to understand given that the country has not lived continuously above its means in the past. Ireland has run a current account deficit (which means the country uses more resources than it produces) only for a few years; and if one totals the current account balances over the last 25 years, one arrives at a foreign debt of about €30 billion. This should not be too difficult to finance given that it represents only about 20% of the country's GDP of €150 billion. Moreover, Ireland is on track to run a current surplus this year and should thus not have any need for additional foreign funds.

So why does the government need a continuing bail-out? The reason is that the government has a huge foreign debt whereas the Irish private sector has huge foreign assets. To make matters worse, the government pays exorbitant interest rates on its large foreign debt whereas the private sector earns very little on its foreign assets (and keeps these meager returns for itself). If this is allowed to go on, the government could indeed still have to default.

This was the case in Argentina where the private sector had large foreign assets while the government had an even larger amount of foreign liabilities. The Republic of Argentina went bankrupt with only a moderate net foreign debt because wealthy Argentines had spirited their assets out of the country, and thus out of the reach of the government, while the poor Argentines refused to pay the taxes needed to satisfy the claims of the foreign creditors.

Ireland is not Argentina and should be able to avoid its fate; but only if the government can mobilize private foreign assets. This should be possible given that these foreign assets are mostly held by institutions, such as pension funds and life insurance companies.

The little data published by the associations of Irish pension funds and that of (life) insurance companies suggest that these two groups of financial companies own over €100 billion in foreign assets, of which about €25 billion are in non-Irish government debt and about €72 billion in foreign equities.[1]

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[1] Sources available from the author.

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From the point of view of the country, it makes no sense that Irish pension funds invest in Bunds which yield about 2-3%, whereas the government pays close to 6% on fresh money to foreign official institutions (and Irish government bonds promise yields of close to 10%). A very strong case can thus be made that Irish pension funds and life insurance companies should somehow be 'induced' to invest their entire portfolio of gilts in Irish government bonds. The €25 billion in financing that this would yield for the government is equivalent to the entire contribution of the IMF to the rescue package.

A similar case can be made for the €72 billion in foreign equity investments. If two-thirds of that sum (or €48 billion) were also be invested in Irish government bonds, the total financing available for the government would rise to over €73 billion, more than all the foreign funds made available to Ireland under the rescue package.

Would this mean robbing retirees of their future? The opposite seems to be the case: the rate of return achieved by the average Irish pension fund has been only around 1.7% over the last decade (as claimed in a recent report of the public pension fund). A massive investment in the bonds of their own government, which offer a return of close to 10% (on the secondary market), should actually be in the interest of present and future Irish retirees as well. Moreover, by doing so, the probability of a state default would actually be much reduced, which in turn will preserve growth prospects for the economy – the most important determinant of future pensions.

The EU might of course protest that any restrictions on the investments of Irish pension funds and life insurance companies smack of capital controls. But this could be finessed by either a waiver under Article 65 of the EU Treaty, or a clever wording of the 'directed' investment. Moreover, the public pension fund has already been obliged to accept a 'directed' investment, without any opposition from the EU.[2]

Given the scale of foreign assets owned by Irish residents there should be no need for the government to depend on the funds of the EFSF and the IMF, which are very expensive in both political and economic terms. There will be practical and political obstacles to mobilizing pension fund assets, but they should be overcome if the future of the entire country hangs in the balance.

[2] A technical note: Pension liabilities are bond-like in nature, so the present heavy weighting in equities represents a substantial mismatch and investment risk in itself. There may thus be scope within appropriately framed solvency requirements to facilitate/encourage pension funds to more closely match their bond-like liabilities with instruments issued by their own sovereign.