

Chapter 3

State Funding Developments

Central Government

State Funding Developments

3.1 The yield on Irish bonds increased to almost 7% by the end of September 2010¹⁵. This made funding by way of longer-term borrowing overly expensive for the State.

3.2 The Minister for Finance announced on 30 September 2010 that the National Treasury Management Agency had decided not to proceed with bond auctions scheduled for October and November 2010. No further bond auctions or Treasury Bill auctions have been held since the announcement.

Chapter Focus

This chapter outlines

- the international background to the funding difficulties
- the international arrangements put in place to address Ireland's borrowing requirements
- the updated debt position at 31 July 2011
- the cost and burden of debt.

International Background

3.3 In the third quarter of 2008 the Euro Area entered its first recession as a result of the global financial crisis that commenced in 2007. The crisis bore more heavily on countries at the periphery. The impact on different countries varied depending on the scale of exposure to risky assets and the size of the financial sector, the export dependency of the economy and current account position as well as the extent to which house prices had been overvalued and construction industries oversized¹⁶.

3.4 By late 2010, Ireland had reached a point where the cost of borrowing was challenging and a package of measures was negotiated with the International Monetary Fund (IMF), the European Union (EU) and the European Central Bank (ECB) and bilaterally with the United Kingdom (UK), Denmark and Sweden.

3.5 In December 2010, a programme of financial support from the EU and the IMF (the Programme) was put in place for Ireland. Under the agreement, Ireland can access up to €7.5 billion from the following sources

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| ▪ IMF – Extended Fund Facility (EFF) | €2.5 billion |
| ▪ EU – European Financial Stability Mechanism (EFSM) | €2.5 billion |
| ▪ EU – European Financial Stability Fund (EFSF) | €1.7 billion |
| ▪ Bilateral loans (UK, Sweden and Denmark) | €4.8 billion. |

¹⁵ The yield is the return demanded by lenders or purchasers of Irish debt.

¹⁶ European Economic Forecast – Autumn 2010, European Commission.

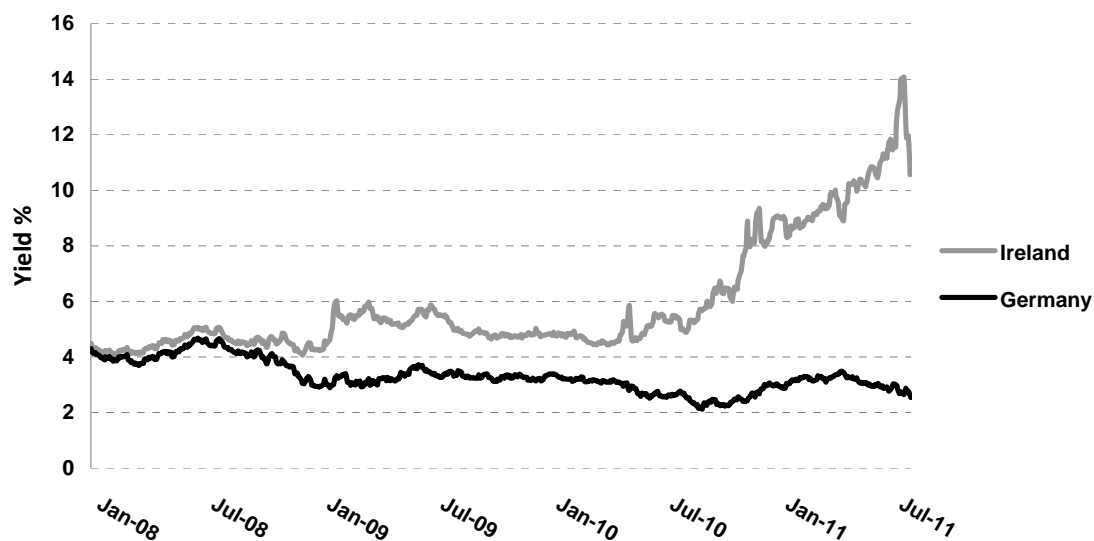
The International Arrangements

The key instruments for the provision of facilities are

- Loans from the IMF – the Fund, which currently has 187 members, was created in 1945 to protect the stability of the international financial system. A member country can apply to the IMF for a loan if it cannot access finance to make international payments or maintain a safe level of reserves. Loan disbursements are dependent on the achievement of specific targets as set out in the country's programme of economic policies.
- The EFSM was established by EU finance ministers and came into being on 12 May 2010. To qualify for assistance under the EFSM, a member state must be either experiencing or be in serious threat of a severe financial disturbance caused by events beyond its control. The European Council makes the decision to grant the assistance. Economic policy conditions, established by the European Commission in liaison with the ECB, attach to the assistance. These are set out in a Memorandum of Understanding and must be complied with by the assisted member state.
- The EFSF is a company that was incorporated in Luxembourg on 7 June 2010 whose shareholders are the Euro Area states. A state that cannot borrow on capital markets at acceptable rates makes a request for assistance and negotiates a country programme with the European Commission and the IMF. The Euro Area finance ministers must accept the programme. A Memorandum of Understanding between the borrowing country and the European Commission is signed containing economic policy conditions. The EFSF issues bonds, or other debt instruments, on the market in order to raise funds to lend to applicant states.
- Bilateral loans from the UK, Denmark and Sweden.

3.6 The Programme does not preclude Ireland from seeking funding directly through the market. The yields on Irish bonds will be a key determinant of when Ireland returns to borrow in the market. The yield spreads¹⁷ on Irish debt compared to those of Germany began to diverge substantially from mid-2010. The yields on 10-year Irish and German bonds for the period 2008 to mid-2011 are compared in Figure 13.

¹⁷ Yield spread is the difference between the yields on two bonds of the same maturity.

Figure 13 Irish and German 10-year Bond Yields 2008 to July 2011

Source: National Treasury Management Agency

National Recovery Plan

3.7 The Government published a National Recovery Plan (the Plan) on 24 November 2010. The Plan's objectives formed the basis for the fiscal policy and structural reform part of the Programme. The Plan provided for €15 billion in budgetary savings over the period 2011-2014 derived from expenditure cuts and tax increases of €10 billion and €5 billion respectively. These were the savings projected to be required to bring the budget deficit below 3% of GDP by 2015¹⁸. The Plan aims to return sustainable growth to the economy by

- setting out measures to be taken to restore order to the public finances
- identifying areas of economic activity that will provide growth and employment
- specifying Government reforms needed to accelerate growth in these key areas.

¹⁸ The European Council had extended this target date from 2014 to 2015 on 7 December 2010.

EU-IMF Programme

3.8 The Programme, which was agreed with the European Commission, the ECB and the IMF, has two parts - the first dealing with fiscal policy and structural reform and the second dealing with bank restructuring and reorganisation¹⁹. The Programme's purpose is to

- provide a secure source of funding that can be availed of while the process of restoring sustainability to the public finances continues
- identify reforms to improve the economy's efficiency in order to enhance growth potential
- fundamentally restructure the banking system by downsizing, reorganising and recapitalising the banking sector so it is proportionate to the size of the economy and is capitalised to international standards
- introduce institutional reforms to improve the shock-absorbing capacity of the economy, a special resolution regime for banks, stronger supervision and greater budgetary oversight.

3.9 Progress in implementation of the policies under the Programme is monitored through quarterly reviews upon which the release of further funding depends. Ireland had successfully completed the first and second quarterly Programme reviews (the Spring review)²⁰ with the European Commission, the IMF and the ECB by May 2011²¹. The purpose of the quarterly reviews is to evaluate Ireland's performance against its assigned targets²². The review team reported following the Spring review that

- the economy is rebalancing away from domestic demand and towards net exports
- fiscal targets have either been met or are on track to be met
- steps have been taken towards structural reform objectives
- a comprehensive strategy to recapitalise, restructure and deleverage domestic banks has been developed based on thorough stress tests.

3.10 The team noted, however, that challenges still remain and that strict Programme implementation would be a crucial factor in Ireland returning to the capital markets at affordable interest rates.

3.11 A further quarterly review was carried out in July 2011. It was announced at the conclusion of the review mission that Ireland's compliance with the programme remained on track. The review will be formally concluded in September 2011 when the IMF Executive Board and Eurogroup/Ecofin²³ consider the appraisal reports on Ireland's performance prepared respectively by the IMF and the European Commission.

¹⁹ The EU/IMF Programme of Support for Ireland is available on the Department of Finance's website.

²⁰ The first and second quarterly reviews were combined and are referred to as the Spring review.

²¹ A revised Memorandum of Understanding between the European Commission and Ireland (May 2011) drawn up following the Spring review is available on the website of the Department of Finance.

²² Targets have been set for fiscal policy and structural reform as well as bank restructuring and reorganisation targets.

²³ The Eurogroup comprises the Finance Ministers of the Eurozone while Ecofin comprises the Finance and Economic ministers of the member states of the EU.

National Debt at mid-2011

3.12 At the end of July 2011

- The gross national debt including borrowing under the Programme was €126.4 billion (December 2010: €109.6 billion).
- The State held €3.6 billion in related assets (December 2010: €16.2 billion).
- The net national debt was €12.8 billion (December 2010: €3.4 billion).

3.13 Net borrowing increased by €19.4 billion between January and the end of July 2011. The increased borrowing was applied for

- capitalisation of the banks arising from the Prudential Capital Assessment Review (PCAR) carried out by the Central Bank of Ireland to an amount of €7.6 billion²⁴
- meeting Promissory Note payments of €3.1 billion in March²⁵ and
- funding a residual Exchequer deficit of €3.7 billion²⁶ in the period to 31 July 2011.

Details of the national debt at 31 July 2011 are set out in Figure 14.

Figure 14 Net National Debt Components - July 2011

Gross National Debt	€m	€m
Government Bonds – maturity more than one year	89,684	
Other Medium/Long-Term Debt – maturity more than one year ^a	22,924	
Short-Term Debt – maturity less than one year	870	
Borrowings from other State Funds	1,721	
Government Savings Schemes – maturity of up to 5½ years	11,237	126,436
Related Assets		
Exchequer Account	(6,500)	
Capital Services Redemption Account	(138)	
Bank Deposits	(3,182)	
Housing Finance Agency Commercial Paper	(3,786)	(13,606)
Net National Debt		112,830

Source: National Treasury Management Agency

Note: a Includes borrowing under the EU-IMF Programme.

²⁴ If the assumptions underpinning the PCAR are borne out, no further Exchequer cash outlays (excluding annuities under Promissory Notes) should be required for bank capitalisation.

²⁵ Annual payments of €3.1 billion will be made until the principal amount of the Promissory Notes (€30.85 billion) and accrued interest on the Notes has been repaid.

²⁶ The deficit takes account of €460 million of net expenditure from the Capital Services Redemption Account.

3.14 By the end of July 2011, the State had drawn down just over €23 billion in funding under the EU/IMF arrangements. The funds were borrowed from the EFSM (€1.4 billion), the IMF (€7.4 billion) and the EFSF (€4.2 billion)²⁷.

3.15 The bulk of Irish borrowing at the end of 2010 was in the form of Government bonds. Government bonds constituted just under 60% of gross national debt at the end of 2008 rising to 82% at the end of 2010. This proportion had fallen by the end of July 2011, due to borrowing under the Programme which has increased the proportion of borrowing in classifications other than Government Bonds to 29% from 18% at the end of 2010.

3.16 The amount of short-term debt held has fallen in the last two years from 30% of gross national debt at the end of 2008 to 6.4% at the end of 2010 and, subsequently, to less than 1% at the end of July 2011.

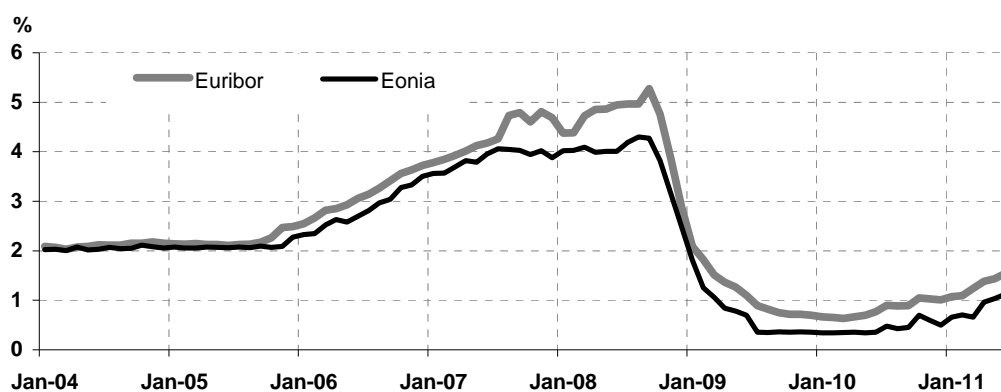
Ireland's gross national debt was €26 billion at the end of July 2011 and the Programme provides for further borrowings of around €45 billion.

Cost of Irish Borrowing

3.17 The cost of borrowing in recent years has been largely driven by the coupon rate on Government bonds. The weighted average²⁸ interest rate on Government bonds between the end of 2007 and end of July 2011 has risen from 4.41% to 4.64%.

3.18 The cost of short-term borrowing has varied significantly over the same time period. The average annual interest rate on short-term debt reflects market rates and has ranged from around 4% in 2007 and 2008 to around 1% as interest rates fell in 2009 and 2010. The amount of short-term debt has fallen from €22 billion at the end of 2008 to less than €1 billion at end of July 2011 and the fact those borrowings have been replaced with longer-term debt has caused an increase in the cost of servicing. Figure 15 shows the trends in key short-term rates²⁹ for the period from January 2004 to June 2011.

Figure 15 Eonia and 3-month Euribor Interest Rates 2004 to June 2011



Source: National Treasury Management Agency

²⁷ The amount received by the State following pre-payment of some interest was €22.4 billion.

²⁸ The weighted average coupon rate takes account the different rates at which debt was issued.

²⁹ The Euro Overnight Index Average Rate (Eonia) and the three-month Euro Interbank Offered Rate (Euribor)

3.19 The interest cost on the various Government savings schemes has also varied. The two biggest savings schemes are Savings Certificates and Savings Bonds, which together accounted for around 80% of the total amount invested in Government savings schemes. The rates paid on savings bonds and savings certificates vary with the period of investment – at the end of June 2011, the highest rates on offer for those schemes were between 3.2% and 3.5%.

3.20 The weighted average effective interest rate for the loans drawn down under the EU-IMF Programme was 5.58% while the effective interest rates for the individual loans³⁰ ranged from 4.7% to 6.48%

- the effective interest rates for the IMF loans were 4.7% to 5.01% which take account of hedging undertaken by the NTMA – cross currency swaps undertaken to fix the exchange rate at which the loans will be repaid and interest rate swaps which were used to convert the IMF floating rate of interest to a fixed rate. The weighted average maturity of these loans was seven and a half years.
- the effective interest rates for the loans denominated in Euro were 5.54% to 6.48% (EFSM) and 5.9% (EFSF) taking account of fees and prepaid interest in the case of the EFSF funds³¹. The maturities of these loans range from just under five years to ten years and the higher interest rates apply to the loans with the longest maturities.

Taking into account the interest rates applying to all of the debt components, the weighted average interest rate being paid for the debt was just under 4.7% at the end of July 2011.

Ireland's Debt Burden

3.21 The level of debt relative to the economic output and taxation raised is indicative of the burden of public debt on the economy. Key debt indicators that are relevant to Ireland's capacity to generate resources to service and repay its debt include

- the ratio of net national debt to GDP which shows the level of debt relative to the economy's output
- the net national debt by comparison with taxation revenue which indicates the number of years of future taxation that would have to be devoted to debt repayment.
- the ratio of debt interest costs to taxation revenue which indicates the financial cost of the debt as a proportion of tax revenue.

³⁰ The variable rates pertaining on IMF loans when those loans were issued were 1.925% to 2.426%, while for other loans the rates were fixed at rates between 5.425% to 6.425% (EFSM) and 5.22% (EFSF).

³¹ In a statement following a meeting of the Heads of State or Government of the Euro Area on 21 July 2011, it was announced that the rate on EFSF loans to Greece would be reduced and that the maturity of future loans to Greece would be extended to a minimum of 15 years and up to 30 years with a grace period of 10 years. The statement noted that the EFSF lending rates and the maturities agreed for Greece would also be applied to Ireland and Portugal.

3.22 The salient facts relating to the change in these ratios since 2007 are

- the net national debt, as a proportion of GDP, rose from 20% to 60%
- this net debt represented 80% of taxation raised in 2007 and almost 300% by 2010 i.e. it constituted less than one year's taxation revenue in 2007 but by the end of 2010 it would require all tax revenue for three years to repay it.
- the proportion of taxation required to service the national debt rose from under 4% in 2007 to over 11% in 2010.

3.23 The trends in those indicators up to end 2010 are set out in Figure 16. The trend continued in 2011 due to further borrowing to meet debt stabilisation payments and fund the deficit.

Figure 16 Debt Indicators 2007 to 2010

Ratio	2007	2008	2009	2010
	%	%	%	%
Net National Debt: GDP	19.8	28.0	46.8	59.9
Net National Debt: Taxation	79.5	123.6	227.4	294.3
Debt Interest: Taxation	3.5	4.0	8.0	11.4

Views of the Department

3.24 In regard to the debt burden, the Accounting Officer stated that the sharp downturn in economic activity since 2007, three years of large budget deficits and the significant level of State support required for the banking sector have combined to drive the ratio of Irish Government debt to GDP up steeply. He noted that a continuation of this upward trajectory is not sustainable and the debt ratio must be stabilised and returned to lower, safer levels as quickly as possible. The evolution of the debt ratio depends on the relationship between economic growth, the interest rates applying to Government debt - both the stock outstanding and new debt - and the level of budgetary adjustment.

3.25 The Accounting Officer pointed out that a crucial requirement for debt sustainability is that the ratio of debt to GDP stabilises and starts to come down. Based on the economic and fiscal forecasts contained in the Stability Programme Update (SPU) which was published by the Department in April 2011, the General Government debt³² to GDP ratio³³ is expected to peak at 118% in 2013, before declining to 111% by 2015. He stated that the narrowing of the gap that exists between revenues and expenditure through additional fiscal consolidation, together with the implementation of policy measures that will assist in boosting economic growth will help in this regard, as will the achievement of a primary surplus - an excess of revenues over expenditure excluding interest expenditure - by 2014.

3.26 In addition, the Accounting Officer pointed out that on the basis of the SPU forecasts, some 21% of tax revenues will be required to pay interest on the national debt by 2015. While a significant level, it is below the ratio experienced in the mid-1980s when around a third of the tax revenues generated in the State went towards servicing the interest on the national debt.

³² The General Government Debt measures indebtedness taking account of all liabilities included in the national debt without offsetting liquid assets, together with other liabilities of the State including Promissory Notes, non-commercial State agencies and local authorities.

³³ In 2010, the General Government Debt to GDP ratio was 95%, up from 65% in 2009.

Conclusion

In December 2010, having withdrawn from borrowing on the markets following the increase in yields on Irish government bonds, an EU/IMF Programme of Financial Support was negotiated by Ireland. Under the Programme, Ireland can access up to €67.5 billion in external borrowing.

In November 2010, the Government approved a National Recovery Plan, which forms the basis for the fiscal and structural reform part of the Programme. Progress in implementing policies under the Programme, which also provides for bank restructuring is monitored by way of quarterly reviews by the European Commission, the ECB and the IMF. The first reviews have been successfully completed.

By the end of July 2011, the net national debt stood at €12.8 billion, an increase of a further €19.4 billion since December 2010. The associated borrowing was applied as follows

- €7.6 billion to meet the capitalisation requirements of the banks following the Prudential Capital Assessment Review carried out in 2011
- €3.1 billion in respect of financial obligations under Promissory Notes issued by the State
- €8.7 billion to fund the residual Exchequer deficit for the period to the end of July 2011.

The weighted average interest rate on Irish Government bonds, which comprised the bulk of debt to the end of 2010, has risen marginally in the period since 2007 to around 4.64%. During 2009 and 2010, the amount of short-term debt, which generally carries lower interest rates than Government bonds, has fallen sharply and been replaced with longer-term debt with a consequent increase in the overall cost of servicing the debt.

The effective interest rates charged for borrowing under the EU-IMF Programme averaged 5.58% and have ranged between 4.70% and 6.48% for the amounts drawn to date. The lowest rate applies to the IMF loans while for the EFSF and EFSM loans, higher interest rates apply to the loans with the longer maturities.

At the end of July 2011, the weighted average interest rate for the total debt was just under 4.7%.

By the end of 2010, the net national debt stood at around 60% of GDP and around three times the amount of tax revenues in 2010. In 2010, over 11% of tax revenues was applied in the payment of interest on the national debt.

