Economy Watch

Snapshot of Irish Economic Forecasts

DKM ECONOMIC CONSULTANTS

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BEEN DOWN SO LONG IT LOOKS LIKE UP TO ME

Although economics has a reputation as the dismal science – thanks to Rev. Malthus – economists are as vulnerable as others in society to searching for a chink of sunlight when the clouds have stayed over for a long period of time. Hunting for green shoots has become a global pastime. For the mathematically minded the debate is about the sign of the second derivative. The fact that the rate of decline is slowing is heralded as an optimistic sign. From my graduate school days I recall a classic sixties counter-culture novel by Richard Farina called "*Been Down So Long It Looks Like Up to Me*". It could also be the title of many of the forecasts for the Irish economy in the year ahead.

It is hard to be optimistic that the decline in domestic spending will halt and reverse any time soon. Private investment is likely to fall as projects are completed and financial constraints combined with market conditions prevent the start of new projects. Consumers battered by falling incomes and rising unemployment in 2009 are unlikely to change habits until there are clear signs that the worst is over in terms of job security and potential taxation. Although the cut in public spending may be less than suggested by Bord Snip Nua there is no doubt that it will contribute to a further decline in domestic spending. This may lead to a further downward revision of output forecasts for 2010.

Special piece on NAMA on page 5.

- GNP to fall by 9.3% in 2009.
- Investment to contract 51% over 2008-2010.
- Unemployment rate to exceed 15% in 2010.
- Targets for general government deficit in 2009 and 2010 appear unattainable according to forecasts.

In this issue:

- *Opinion: NAMA Special*
- Economy to contract 14.4% by end 2010, with domestic demand staying weak.
- Slight improvements recorded in Irish competitiveness, not yet enough for an export-led recovery.
- Focus on the External Environment.

At a Glance

Summary of forecasts*	2008a %	2009f %	2010f %
GNP	-2.8	-9.3	-2.9
GDP	-3.0	-8.3	-2.0
Private Consumption	-1.0	-8.0	-3.9
Public Expenditure	2.6	-0.4	-0.8
Investment	-15.5	-31.3	-15.7
Exports	-1.0	-4.7	-0.2
Imports	-2.1	-9.9	-3.2
Unemployment Rate	6.3	12.4	15.2
Employment Growth	-1.1	-8.3	-4.3
Wage Growth	4.0	-2.9	-2.4
CPI Inflation	4.1	-4.2	-0.1
HICP Inflation	3.1	-1.4	0.0
General Gov. Balance	-6.3	-11.5	-11.9

*2009 and 2010 are forecast averages, see note on back page

Snapshot of Irish Economic Forecasts

Annual % change

	GNP		GDP		Private Spending		Public Spending		Investment		Exports		Imports		Forecast Date
	2009	2010	2009	2010	2009	2010	2009	2010	2009	2010	2009	2010	2009	2010	
AIB	-11.3	-2.5	-9.0	-3.0	-8.0	-4.0	-0.3	0.0	-28.5	-13.9	-6.0	-3.0	-10.2	-5.5	7/09
BOI	-10.0	0.0	-7.0	0.0	-7.5	-3.0	1.0	-2.0	-27.7	-17.5	-3.7	2.0	-10.0	-4.0	7/09
Bloxhams	-8.7	-2.5	-8.5	-2.3	-7.5	-3.3	-0.5	-1.2	-32.7	-11.8	-4.3	0.0	-10.6	-3.6	7/09
Central Bank	-9.4	-3.5	-8.3	-2.7	-8.0	-4.5	-0.5	-1.5	-34.5	-16.2	-4.5	-1.3	-10.7	-3.8	7/09
Davy	-8.6	-3.0	-7.9	-2.6	-9.0	-2.0	-1.8	-4.2	-30.7	-16.8	-3.9	-0.7	-9.4	-3.1	5/09
Dept Finance	-8.0	-2.8	-7.7	-2.9	-7.8	-3.7	-0.4	0.0	-27.0	-16.0	-6.1	-3.1	-10.1	-6.1	4/09
ESRI	-8.9	-2.3	-7.9	-2.3	-7.0	-3.0	0.0	-3.0	-30.5	-17.2	-3.9	-1.4	-8.6	-4.8	7/09
EU			-9.0	-2.6	-7.9	-4.0	-0.6	2.0	-29.2	-15.6	-8.9	-0.2	-12.5	-2.5	5/09
Goodbody	-10.7	-4.9	-8.6	-4.5	-9.0	-6.5	0.0	0.0	-35.8	-23.8	-4.2	-1.2	-9.6	-4.0	7/09
IBEC	-9.2	-3.1	-8.4	2.9	-8.7	-5.0	-1.0	-1.0	-31.9	-10.0	-4.0	-1.5	-9.5	-4.0	7/09
IMF	-7.4	-3.6	-8.5	-3.0	-9.0	-5.0	0.7	0.6	-25.4	-14.8	-6.0	-1.5	-10.2	-4.8	6/09
NCB	-9.0	-3.7	-8.1	-3.1	-8.1	-4.1	-0.4	-0.7	-30.3	-15.1	-4.8	0.8	-8.8	-1.3	7/09
NIB			-7.0	-1.0	-8.0	-2.5	-1.0	0.0	-35.0	-12.0	0.2	4.0	-7.2	2.0	7/09
OECD			-9.8	-1.5	-7.2	-3.6	-1.1	1.5	-34.9	-15.6	-10.4	0.7	-14.5	-2.1	6/09
Ulster Bank	-8.9	-3.2	-8.0	-2.8	-7.5	-3.0	-0.3	-2.0	-29.4	-19.9	-3.0	0.4	-8.3	-2.9	8/09
Average	**-9.3**	**-2.9**	**-8.3**	**-2.0**	**-8.0**	**-3.9**	**-0.4**	**-0.8**	**-31.3**	**-15.7**	**-4.7**	**-0.2**	**-9.9**	**-3.2**	

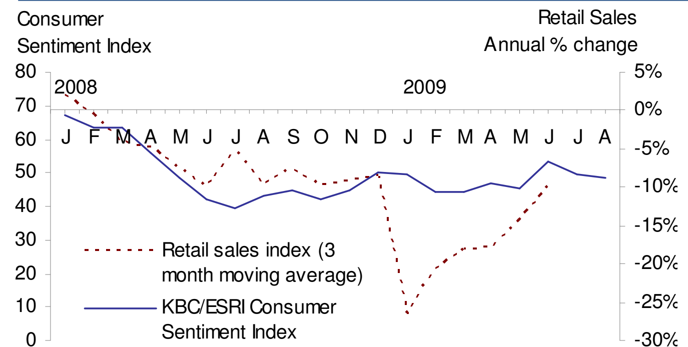
Economy to contract 14.4% by end 2010

The *DKM Snapshot* of GNP forecasts has worsened to -9.3% in 2009 with a further -2.9% contraction in store in 2010. This follows the -2.8% recorded in 2008.

National Accounts for Q1 2009 showed GNP had fallen 12% from its level in Q1 2008. While there is increasing optimism for recovery of the global economy, the outlook for Ireland remains uncertain and is likely to lag recovery elsewhere.

The forecasts reflect significant downside risks, including the NAMA process, the crisis in the financial sector, fiscal retrenchment, lack of competitiveness and weak demand in key trading partners (see page 4).

Retail Sales and Consumer Sentiment



Source: CSO, KBC/ESRI.

Domestic demand to stay low through 2010

The *DKM Snapshot* forecasts that private consumption will decline 8% in 2009 and 3.9% in 2010. Modest declines in government spending are projected (-0.4% in 2009 and -0.8% in 2010), but some of the strongly negative numbers for 2010 may be more realistic.

Retail sales and consumer sentiment have stayed low through the first half of 2009 (see chart, above right).

Retail sales (right axis) have not regained ground lost in the month of January, despite rising slowly since – sales volumes in the first 6 months of 2009 were 9.9% below a year earlier. Volumes in June were up 2.2% from May. (CSO)

The KBC/ESRI Consumer Sentiment Index (left axis) fell again in August, due to worsened expectations, and the poor outlook for the labour market. This offset a slight improvement in perceptions of the current climate.

Investment forecasts have deteriorated – the *DKM Snapshot* projects a 31.3% decline in 2009, falling a further 15.7% in 2010, following the 15.5% drop already seen in 2008. This implies a total 51% drop over 2008-2010.

Average national house prices fell a further 1.1% in July, 10.7% over the first 7 months of 2009 vs 2008 and were 23.2% below the peak in February 2007 (ptsb/ESRI House Price Index). Although interest rates are low, poorly functioning credit markets, expectations of further price falls and reductions in incomes are restraining buyers.

… an export-led recovery remains evasive

The *DKM Snapshot* projects exports will decline 4.7% in 2009 and a further 0.2% in 2010.

The value of exports fell by 9% from April to May 2009, but grew by 5% over the next month, seasonally adjusted (SA) while imports recorded +3% and -9% respectively.

Weak global and domestic demand led to the 19th consecutive month of contraction in the Manufacturing sector in August, according to the NCB Purchasing Managers' Index (PMI). While the overall rate of contraction has slowed, new orders declined sharply and job shedding intensified. Both the NCB Services PMI and Ulster Bank Construction PMI also contracted in August, although the rates eased. The pace of job cutting in both sectors remained high

The Central Bank's nominal Harmonised Competitiveness Indicators (HCI) declined by an average of just 0.6% in the first 7 months of 2009, but the improvement is greater when adjusted for relative consumer prices. Real HCI fell by 2.2%, reflecting our lower inflation relative to our main trading partners together with exchange rate movements, and should help the competitiveness of domestic exporters.

With the historic upward trend in unit labour costs likely to be reversed as a result of the recession, the significant loss of price competitiveness over recent years should begin to turn around. However, if the gain is to be sustained, we need to also address productivity, public sector inefficiencies, the regulatory burden and greater competition. .

Snapshot of Irish Economic Forecasts

Annual % change — * year average; ** as a % of GDP

	Unemployment Rate*		Employment Growth		Wage Inflation		CPI Inflation		HICP Inflation		General Government Balance**		Forecast Date
	2009	2010	2009	2010	2009	2010	2009	2010	2009	2010	2009	2010	
AIB	12.0	15.0	-8.0	-4.0	-0.9	-3.0	-4.0	0.5	-1.2	0.8	-10.75	-10.75	7/09
BOI	11.7	13.7	-8.0	-4.0			-3.7	1.1	-1.0	1.0	-10.75		7/09
Bloxhams	11.8	14.2	-7.3	-3.8	-4.5	-3.0	-4.5	0.0	-1.8	0.5	-10.80	-10.70	7/09
Central Bank	12.8	15.0	-8.8	-4.5	-3.9	-3.1	-4.1	-0.4	-1.3	-0.3	-10.75	-10.75	7/09
Davy	12.8	14.3	-8.4	-6.8	-4.0	-3.0	-3.8	-2.0	-1.1	-1.5	-11.60	-10.80	5/09
Dept Finance	12.6	15.5	-7.8	-4.6			-3.9	0.3	-1.4	0.5	-10.75	-10.75	4/09
ESRI	12.6	16.1	-8.8	-5.1	-3.0	-1.6	-4.6	-0.3	-1.6	0.2	-12.20	-11.40	7/09
EU	13.3	16.0	-9.0	-4.0	-4.1	-2.4			-1.3	0.4	-12.00	-15.60	5/09
Goodbody	14.9	17.5	-10.1	-4.9	-2.4	-5.0	-3.6	-0.8			-12.90	-14.00	7/09
IBEC	12.2	15.7	-8.0	-5.4	-3.0	-1.0	-4.3	0.2	-1.0	0.5	-11.30	-11.00	7/09
IMF	12.0	15.5	-7.9	-5.0	-3.2	-2.5			-1.5	-0.3	-11.80	-12.70	6/09
NCB	12.3	15.8	-7.4	-5.4	-3.5	-2.0	-4.2	-0.7	-1.4	-0.3	-11.80	-11.50	7/09
NIB	11.8	14.3	-8.0	-3.0	-1.0	+1.0	-5.0	+0.5	-2.0	0.0			7/09
OECD	12.2	14.8			-2.7	-3.2			-1.3	-1.5	-11.50	-13.60	6/09
Ulster Bank	12.0	15.0	-8.3	-4.8			-4.3	0.1	-1.5	0.2	-11.10	-11.10	8/09
Average	**12.4**	**15.2**	**-8.3**	**-4.3**	**-2.9**	**-2.4**	**-4.2**	**-0.1**	**-1.4**	**0.0**	**-11.45**	**-11.88**	

Unemployment to exceed 15% in 2010

The CSO's Standardised Unemployment Rate hit 12.2% in July (SA), almost double the rate at the same time last year. In August another 5,400 people joined the Live Register (SA). Taking emigration into account, forecasters predict this will continue to grow into 2010.

The *DKM Snapshot* projects that employment will fall by an average 8.3% in 2009 and 4.3% in 2010.

Businesses are likely to be cautious about increasing their labour costs until the economic environment is more certain. That means job creation will lag economic recovery and unemployment will remain high in 2011.

The weak labour market is also reflected in projections for wage inflation, of -2.9% in 2009 and -2.4% in 2010.

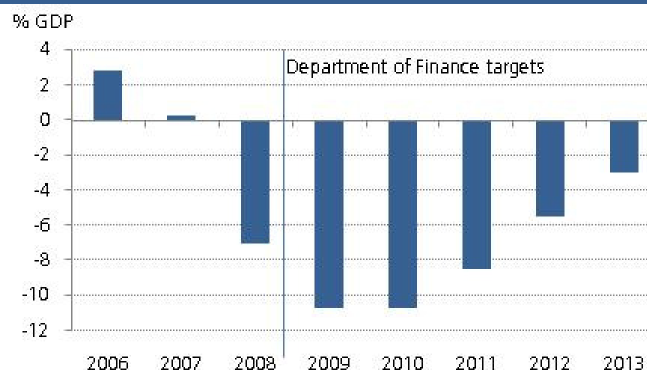
Price deflation to continue

The *DKM Snapshot* projects 4.2% CPI deflation in 2009, and a further 0.1% deflation in 2010.

The July CPI fell by 0.8% from June, generating a new record low for annual inflation of -5.9% compared with -5.4% in June. Seven of the 12 main commodity groups in the CPI registered a decline. Within the commodity groups, the largest decline was recorded by Housing & Utilities (-26.8% y o-y in July), followed by Clothing & Footwear (-11.2%), Transport (-6.2%) and Food & Non-alcoholic Beverages (-4.2%). Energy products fell by 13.4% in the year to July. Mortgage interest costs alone, down by 47.5%, continued to exert a strong downward pressure on inflation. These trends reflect the weakness in demand and the reduced capacity of firms to drive up prices. Of the remaining five groups, the highest increase was recorded by Alcohol & Tobacco (+7.7%).

HICP inflation (which excludes mortgage interest) also fell by 0.8% in the month of July, generating an annual decline of 2.6%, down from 2.2% in June. The latter compares with a decline of just 0.1% in the Euro Area and 0.6% across the EU as a whole, confirming that the Irish price level is continuing to adjust relative to our trading partners, generating a welcome improvement in competitiveness

General Government Balance (% of GDP)



Source: Eurostat, Department of Finance (2008 estimate), *DKM Snapshot* (forecasts)

Restoring the Government Balance – the long road ahead

The *DKM Snapshot* projects General Government Balance will exceed the Department of Finance's target deficit of 10.75% of GDP in both 2009 and 2010.

At the end of August, tax receipts were down €4bn y-o-y and the Exchequer deficit had grown by €2.3bn, to €18.7bn (€10bn higher than in August 2008). The five-year plan to rein in the deficit included projected deficits of 10.75% of GDP in both years, with progressively lower deficits out to 2013.

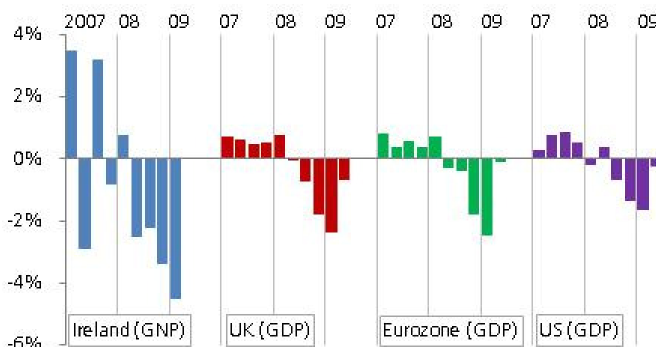
Most of the forecasts above expect the targets for 2009 and 2010, as set out in the April Budget, will be missed.

The preparation of the 2010 Budget thus represents an unenviable challenge to government, having to struggle towards a sustainable fiscal position against increasing resistance from the population. Balancing the painful implementation of the recommendations of the McCarthy and Commission on Taxation reports in addition to the highly unpopular NAMA proposal, in an effort to retain access to international borrowing, will be exceedingly difficult, particularly if Lisbon were to be lost again.

FOCUS ON THE EXTERNAL ENVIRONMENT

Recent data show signs of a turnaround in the global economy. South-East Asia appears to have returned to strong growth, while the pace of contraction decelerated in Europe and the US in Q2 (see chart below). In the UK and US, significant downside risks remain and it may be that the apparent 'green shoots' are a result of stimulus packages, rather than the beginnings of a sustainable recovery.

Quarterly Economic Growth (% change qoq)



Source: European Commission
Note: Q2 2009 figures are not yet available for Ireland.

UK

UK GDP fell by 0.7% in Q2, following a 2.4% decrease in Q1 (the largest quarterly decrease since 1958). GDP in Q2 was 5.5% below its level a year earlier. Bank of England August forecasts suggest that the recession bottomed in Q1, and the UK will return to positive growth by end 2009. Unemployment reached 7.8% at the end of June, as more than half a million redundancies were made in the first six months of the year.

Retail sales were up 3.3% y-o-y in July – aided by the VAT rate cut from 17.5% to 15% (part of the £20 billion fiscal stimulus package). Manufacturing activity (PMI) appears fairly static in July (slight increase) and August (slight fall), suggesting an end to the heavy reductions seen earlier this year and in 2008.

The tide may be turning for construction output, which was fairly static in Q2 (-0.5% from Q1, SA). House prices rose during August, with gains mainly limited to areas where housing is in short supply. On an annual basis price reductions slowed to 2.7% in August, compared to 6.2% in July.

These trends have not prevented imports from falling further in one of Ireland's key trading partners. Total imports fell 11% in Q2 (y-o-y SA), with imports of manufactured goods falling 13% over the same period.

US

The rate of contraction of US GDP slowed to 1% in Q2 after a 6.4% contraction in Q1 (SA). Some 'green shoots' have been indicated to date, however, in general, these run in opposition to strongly negative forces, and can be attributed to the direct impact of government stimulus policies.

For example, the US $787.2 billion package aimed at boosting consumer spending included a $3 billion car scrappage scheme, "cash for clunkers". By August 26, the programme had generated around 700,000 new car sales. Perhaps buoyed by this, the US manufacturing sector grew in August for the first time since January 2008 (ISM index).

In August, the unemployment rate rose to 9.7%, up 4.8 points since December 2007 (US Bureau of Labor Statistics). Job losses have slowed considerably since Q1, when 697,000 were lost on average per month – to around 200,000 in August. Unemployment is not expected to peak until 2010, having a negative impact on domestic demand.

However, continuing foreclosures (reaching 360,000 in July, up 30% on a year earlier) and a tax credit for first time buyers have made housing more affordable. This led to a sharp rise in sales of existing homes and new construction of single-family homes in July. The S&P Case-Schiller index, which tracks home prices in 20 cities, recorded a small uptick – the first since the market peaked, in May 2006, at 30% above its current level.

Returning to sustainable global growth

On 4 September, the IMF warned against early withdrawal of stimulus packages, "The global economy is emerging from a deep downturn but the recovery will be sluggish and unwinding stimulus measures too soon could derail an upswing." Substantial funds have been committed by central banks to support the functioning of credit markets:

- The US Federal Reserve has committed up to $1.75 trillion (12.6% of GDP) to purchase longer-term securities.
- The Bank of England has committed £175 billion (12% of GDP) to an Asset Purchase Facility, a vehicle for injecting money into the economy.
- The ECB has only committed €5.1bn to purchases of covered bonds. This may not be enough to contain price deflation. The ECB has reported that Eurozone consumer prices were down 0.7% annually in July.

Withdrawing the stimulus too late could risk inflation. This is of greatest concern in the UK where, as yet, prices have remained high relative to Europe. Moreover, with growing budget deficits in both the UK and US, containing expenditure on stimulus and rescue packages is a priority. The IMF projects that general government debt will approach 100% of GDP over the next 5 years in the UK and the next 10 years in the US, on the basis of current policy and the risk that greater spending will be required for the recovery.

NOTE: The average figures presented in this report (referred to in the text as the *DKM Snapshot*) represent a weighted average of the latest forecasts for the Irish economy from 15 independent sources, compiled by DKM. Older forecasts are given a smaller weighting in calculating this average. Figures quoted represent the latest available figures from each source at the time of going to press.

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Serious shortcomings with existing NAMA proposal

Economic recovery only via export markets……

While exporters may have benefited from productivity and unit wage cost gains in 2009 this has been achieved mainly by reductions in employment and only partially by actual cuts in nominal wages. The absence of a devaluation option makes it less likely that export demand can replace the negative influences of domestic demand on final demand and output. The best that Irish policy makers can do is cheer on the signs of recovery in the Euro area and in the US. Recovery in our main export markets – although far from certain – is likely to be the only source of real green shoots next year.

…. not through NAMA

Certainly it is hard to see the reconstruction of the banking system through the creation of NAMA contributing much to short-term recovery in the economy. Indeed, it could be argued that there is a very real danger that the operation of NAMA, subject as it is bound to be to the political whims of the moment, could have a prolonged negative impact on construction capital spending in the economy for years to come.

It has to be said that the debate over NAMA is taking place adrift of any real economic context. It is a racing certainty that the 2010 Budget to be introduced in a couple of months will involve substantial cuts in government spending, especially capital spending, and increases in taxes and charges. This reduction in public spending will take place against a background of highly depressed private demand which shows few signs of picking up. The seriously pro-cyclical policy is justified by the need to curtail public borrowing for the sake of future generations (and for the sake of the interest rate margins Ireland has to pay over German borrowing costs).

Yet at the same time the Government is proposing to borrow massive amounts – which could be more than all the existing government debt outstanding – in order to become the virtual monopoly developer of land and property in the State for the next decade. It is as if public policy is being determined by the mad offspring of Hugo Chavez and Margaret Thatcher.

There is little wonder that public support for NAMA is so low when the reality of the 2009 tax increases and the prospect of more pain in 2010 hits so hard. Enduring economic hardship now so that the State can become the sole lender to the property sector is a difficult sell. It is not made easier by the day by day modifications of how NAMA will acquire the assets, what it will pay for them and what it will do with them.

NAMA part of the Government's strategy for economic recovery

The concept of NAMA was born out of a report by Dr. Peter Bacon, an economist turned property developer. It argued that the property loans advanced by the Irish banks were on a scale that, if called in, would lead to a collapse in property values and the bankruptcy of the banks. If the banks were to avoid collapsing the property market by exercising forbearance and by realising assets over time this could lead to "zombie" banks, unable to finance any economic recovery.

The Report recommended that the State, through a special agency, could acquire the property loans from the banks – so preventing an accelerating rate of foreclosures and liquidations which would lead to a property market collapse – and manage out these loans over time. Banks would, with the stroke of a pen, be freed from the need to nurse these loans back to health or make the decision to pull the plug. Refreshed with cash from the State (actually with bonds from the State which they could sell or discount at the ECB for cash) the banks could get on with the business of lending money to borrowers (presumably excluding property developers) and so help revive the economy.

So far so good, but…

Unfortunately as the proposals moved towards the implementation stage a number of key issues arose.

- The first, and most obvious, was the price the State should pay for the loans. If the State paid the "market value" for the loans acquired from the banks then the

bankruptcy of the banks – which the proposals sought to avoid – was inevitable. After all the market price – assuming any could be obtained in an environment almost completely lacking price discovery and with severely restrained credit availability – must be no more than the realisable value of the loans discounted for the time and effort in realising them. The realisable value would, of course be the very depressed values likely to occur if all the banks acted to call in their loans when due or when payments were suspended or covenants breached.

The acquisition of the loans would not stop the banks from suffering the consequences of a property collapse even if it prevented the actual collapse by providing a haven for property loans safe from immediate repayment and enforcement.

- The second issue was how to finance the banks which would collapse into bankruptcy if forced to dispose of their property loans at highly distressed values. One solution was to pay the banks the long run "economic value" of the loans i.e. the value the loans might be expected to realise if realised over an extended period assuming a cyclical recovery in the property market. As this would mean paying the banks in excess of market value for the loans it was denounced by Opposition leaders and by a highly vocal group of economists and finance academics as unfair.

- The third issue was how to ensure that the banks, newly refreshed with funds from NAMA, would start to expand lending (other than to property developers). We know that less than 60% of the lending by Irish banks was financed by deposits and loans from the Irish public. The balance was funded by borrowing from overseas banks and investors. In the post-Lehman era this source of funding dried up forcing the Government to guarantee the banks' liabilities and forcing the banks to rely heavily on the ECB for funding. The latter source of funding was restricted by the nature of the assets the ECB would accept in exchange for funds.

NAMA may not lead to an expansion in credit

The banks continue to struggle with funding issues even with the ECB window and the government guarantee. While the term structure of borrowing has improved – as overseas banks are prepared to lend for longer periods – the over reliance on non-domestic funding by the Irish banks is no longer a viable business model (notwithstanding the success of Bank of Ireland's recent bond issue). The most likely use of the funds supplied by the NAMA purchases will be to reduce reliance on overseas funding especially funding in the wholesale money markets. In effect the balance sheets of Irish banks will shrink as assets are transferred to NAMA and foreign liabilities repaid. This may lead to a more sustainable banking system but will not lead to an expansion in credit.

Nor indeed should it be expected to. The quantitative easing in Europe and the US has not led to credit expansion. The best the Bank of England has achieved by its massive effort at easing has been to encourage disintermediation as corporate borrowers have raised funds via the bond market and repaid bank loans. In a recession, quality borrowers are hard to find and quality Irish borrowers may well be an endangered species.

Valuation in the absence of a market – will the courts have to decide?

The official response to the criticisms of the original NAMA proposals has been ad hoc, indicating that policy is being made on the hoof. It has been pointed out, quite reasonably, that in the current economic environment the market price of illiquid assets, such as undeveloped land, semi-completed developments and unlet commercial buildings, is difficult to determine. Price discovery is an important economic process and when it is absent or impaired it is impossible to have a properly functioning market. Indeed, although this has not been officially advanced, there is no reason why banks would want to sell loans to NAMA at a price which they could obtain elsewhere in the market place. Any buyer of a loan would look at the ultimate realisable value and discount it by a high discount rate to reflect the risk involved and the costs of recovery. Why would a bank not wish to retain this loan and reap the high rewards that might be expected from any recovery in asset values?

The question of the bank valuation of a property related loan versus a "market" value becomes more acute when it is realised that NAMA proposes to acquire performing loans which are meeting interest payments and are within covenants as well as impaired loans. Given that the legislation provides for the compulsory acquisition of loans it will be difficult for NAMA to pay less than the value of the loan to the bank from which the loan is acquired without substantial risk of litigation. Even if the management of banks is cowed by the scale of the public shareholding in the bank there would be no such constraint on private shareholders especially

bondholders who face losses due to the acquisition by NAMA of assets at too low a price.

EC proposed long run economic value to prevent State-aid

Defenders of NAMA have pointed out that it is a requirement of the EC that the long run economic value be paid for the loans. It should however be noted that this requirement is designed to prevent national governments from over-paying for loans and so subsidizing domestic banks at the expense of competing banks located in other jurisdictions. In any event it now appears that NAMA will not be paying the long run economic value for loans acquired from the banks. Following a suggestion from the prospective Governor of the Central Bank, Dr. Patrick Honohan, it appears that NAMA will purchase the loans for "market value" plus a participation in any upside on this valuation achieved by NAMA. The most recent suggestion is that the banks will receive part of the consideration in the form of a bond whose value will depend on the recovery rate of NAMA. This risk sharing sounds attractive but it begs the question as to how the bonds will be accounted for on the banks' balance sheets. If a bank sells a loan to NAMA at less than it has valued the loan on its books it will suffer a write-off which could impair its capital. This write-off could be reduced by the value of the contingent bond it has acquired from NAMA in addition to the bond it received for the loan. But how is this bond to be valued? If it is valued at zero then the shareholders have suffered an accelerated write down in excess of the long term economic value of the asset. One of the more urgent jobs facing the new Governor could well be devising a valuation methodology for the contingent assets in NAMA held by the banks he regulates.

NAMA will be profitable at the expense of the banks

The more enthusiastic supporters of NAMA have begun to sound like stockbrokers promoting an IPO. NAMA, it is asserted, will be profitable. On analysis, some part of its profit will arise from arbitraging the yield curve. By borrowing short – through the issue of floating rate bonds to the banks – and by lending long through the acquisition of longer term property debt NAMA can make a profit. It is open to the NTMA to make a similar profit by issuing similar short dated securities and investing the proceeds in long dated German government securities.

NAMA is also expected to make a profit because when the loans are repaid (or the security underlying the loans realised) the proceeds will exceed the original cost. If one assumes that what is ultimately realised is the long term economic value of the assets then NAMA can only make a profit by paying less than the long term economic value. In effect most of the NAMA profits, if any, will be at the expense of the banks from which it acquired the asset.

Nationalising banks vs nationalising property development

In recent days new ingredients have been added to the pot. The Green Party has secured significant changes to the NAMA bill, including a risk sharing mechanism between NAMA (the taxpayer) and the banks, and a windfall tax on developers. In the case of the windfall tax the distant sounds of belatedly closing stable doors can be heard. And, of course, the best way to depress any recovery in future property values is to impose a high tax on appreciation. The requirement that NAMA responds to social and political demands highlights all too clearly the dangers of creating a state-owned virtual monopoly presence in development land and property. The Government has rightly warned of the dangers – mainly in terms of price discovery – of a wholly nationalized banking sector. It does not appear to have the same concerns about a similar nationalization of property development.

A substantial proportion of fixed investment in housing along with commercial and retail development takes place on a speculative risky basis. When the current overhang of built but unsold and unlet property is eliminated there will be a need for additional finance to fund new investment. Who will provide this finance and who will undertake the developments are unanswered questions in the current NAMA proposals. Our best guess is that a recovery in investment in development related construction will be some distance off and some of the longer term economic growth projections which have not taken account of the radically changed institutional environment caused by NAMA are too optimistic.

Scorched earth policies offer no solution

It is possible to have concerns over the NAMA proposals without adopting the scorched earth policies favoured by some economists and Fine Gael. The collapse of Lehman Brothers was the result of a short-lived policy of testing whether markets could handle a 'let the market decide' approach to financial crisis. Quite why anyone –

other than academics interested in analysing the outcome of the experiment – would propose the deliberate bankruptcy of the entire Irish banking system so that a new State bank could arise phoenix-like from the ashes is hard to fathom. It is even harder to fathom when one realises that many of the supporters of this approach have been highly critical in the past of the impact of state companies on markets and competition in Ireland.

The truth is that, like it or not, the Irish State has guaranteed the liabilities of the Irish banks at least until September 2010. Something has to be put in place to replace that guarantee. It is unlikely that an extension of the guarantee will be allowed in its present form. The NAMA operation could allow the banks to survive without the guarantee by

(a) restoring confidence in the valuation of assets in their balance sheet and

(b) by providing funds to reduce Irish banks' reliance on wholesale money markets.

But it will do so by massively expanding Irish Government debt outstanding at a time when citizens are being asked to pay higher taxes and accept lower public spending in order to curb public borrowing.

The exercise being undertaken by NAMA in attempting to determine the longer term economic value of the banks' property loans and assets is worthwhile. If it had not been done by NAMA it should have been done by the Financial Regulator as a check on the banks' solvency and balance sheets. No one pretends that it is an easy exercise and one would hope that there is full transparent disclosure of the model used to determine these values so that it can be the subject of discussion and debate.

An alternative option: The Guarantee Approach

But having determined the economic value of the loans is there any need for the State to acquire these assets?

If the Government has confidence in the NAMA valuation (or at least as much confidence as is required to issue billions of debt in exchange for the assets) why does it not simply provide a guarantee to the banks up to a maximum of the longer term economic value? The banks would have to pay a substantial price for this guarantee but it would underpin their balance sheets and make it easier for them to retain wholesale money market funding.

The Bacon Report rejected the guarantee approach although the arguments it advanced against a guarantee scheme are less than compelling. It seems to have been unduly influenced by the fact that the State guarantee of €440 billion of bank liabilities did not reassure the lenders to the banks who were concerned that the State could not actually make good on the guarantee. However if a State guarantee of, say €50 billion, is not credible then how would a sceptical market view the additional €50 billion of Exchequer bonds sitting in the banks' balance sheets. It would appear that the State would be relying on the ECB to adopt a valuation for Irish government bonds which is far greater than the market would adopt.

The NAMA approach would, of course, shrink the banks' assets and liabilities. Assuming that no replacement lending occurred, the banks' need for capital would diminish. This could be highly attractive to existing shareholders of the banks who might otherwise have to put up more capital as the losses on the property loans were recognised.

If the banks had to write down existing loans to the guarantee level they would have to raise more capital either from existing shareholders or from the Exchequer. The Minister has indicated that if the banks need additional share capital it will be contributed by subscribing for ordinary shares. It is not obvious why an investment by way of ordinary shares not paying a dividend is preferable to an investment by way of convertible preferred shares paying a coupon but no doubt that will be explained if and when the time comes to make the investment.

Risk sharing could be incorporated…..

The risk sharing element favoured by the next Governor of the Central Bank could be incorporated by requiring the banks to pay a fee (in cash or in equity) related to any shortfall in realisations relative to the guarantee. In the short run the Exchequer would not have to borrow large amounts to acquire property loans from the banks. It may have to borrow to subscribe equity to the banks but not on any greater scale than it would have to assuming the NAMA proposals were implemented.

The banks which created the loans would have to work to ensure that the long run economic value was achieved. As the loans were realised the State guarantee of the loan book would be reduced until finally

eliminated over the cycle. If the proponents of NAMA are right there will be no need for the State to meet any shortfall and no need for the banks to pay the Exchequer for failing to achieve the guarantee level.

……without leading to Zombie banks

Of course it could be argued that this would leave the banks as zombie banks. The simple reality is that lending for development and construction is an important part of any regional banking system and the Irish banks are small regional banks within the Euro area. If that role is removed from them via NAMA they will have to shrink considerably. If on the other hand the task of managing the loans sold to NAMA remains with the banks then it is hard to see how their approach to lending for non-property purposes will be much different under a guarantee scheme.

NAMA could be with us for a very long time?

Indeed it could be argued that the only way in which the longer term economic value of the property loans will be realised will be if banks start lending for property related developments again. The value of land with planning permission for apartments will never be realised (even at a large discount to 2007 values) if there is no funding for the construction of apartments. One of the original justifications for an asset management approach was that NAMA would be able to help develop out the properties by providing additional funding, bringing in partners etc. This is not the role of NAMA as currently described by its proponents. If indeed this is the role intended, then the initial funding for NAMA will only be the beginning and further borrowing by the State will be required to achieve the values underpinning the first level of borrowing.

At that point NAMA will, as predicted by a leading Irish property expert, be "the only game in town". We can only hope that it is not comparable to the one run by Nathan Detroit and frequented by Sky Masterson and Harry the Horse. Of course it is possible that by then the players will have already decamped to another town where the odds makers could be willing to give a sucker an even break.

Brendan Dowling, September 2009

NOTE: The average figures presented in this report (referred to in the text as the *DKM Snapshot*) represent a weighted average of the latest forecasts for the Irish economy from 15 independent sources, compiled by DKM. Older forecasts are given a smaller weighting in calculating this average. Figures quoted represent the latest available figures from each source at the time of going to press.

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