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The spirit is willing but the flesh is weak: A

Wildebeest in the making?

Dr Geeta Lakshmi, Senior Lecturer in Finance, Lincoln Business School: Last week, Ireland's attempts to burden itself with further cuts did not impress and the markets remain inured to the self-inflicted fiscal measures. Over the weekend, Ireland has been granted a reprieve with a bailout of $89 billion jointly administered by the European Commission, Bilateral […]

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Dr Geeta Lakshmi, Senior Lecturer in Finance, Lincoln Business School:

Last week, Ireland's attempts to burden itself with further cuts did not impress and the markets remain inured to the self-inflicted fiscal measures. Over the weekend, Ireland has been granted a reprieve with a bailout of $89 billion jointly administered by the European Commission, Bilateral Aid and the International Monetary Fund. On Sunday evening, the global politicians held their breath to watch the reaction to this bailout as they waited first for the Asian markets to react and subsequently the European markets. The reception has been warm but time will tell whether enough has been done.

Willingness to pay has been touted as an important ingredient to help the stricken climb out of a crisis. Economists have focused on two indicators: ability

to pay and willingness to pay. They have agreed that the second indicator is considered as important as the first, if not more so.

Thus when governments are ready to slash budgets, increase taxes and reduce costs to reflect better prudence ratios, why is it that markets did not calm down last week?
Despite a deflated Brian Lenihan trying to placate the public and the foreign eyes, he remained an unpopular man.

Analysis of the Problem

The reason is that investors worry that the countries are not afflicted the same way; the risks in Greece, Spain and Portugal do not neatly fit in the same box as the cause of the Irish troubles. The latter is spurred on by the fragility of the banking system whereas investors in the Club Med countries are worried about their global competitiveness. The second reason is that the populist view in Ireland does not sit well again with the cuts which the finance minister suggests. Not only are the junta more than unimpressed, the opposition too cast questions on the reliability of the measures. The third reason is the idea of contagion i.e. the spread will afflict other countries as well because the countries are united by the Euro, which is not the cause but might become the target. The fourth is the worry that the rescuers will be sinking themselves into a morass of debt and hardship. Another factor was the inability of the Germans to agree that bailout should be sanctioned through the institutions rather than the private investors

writing off some of their losses. The crisis is also exacerbated by a loss of confidence based on a reliance on market expectations. Although the cause for concern is different in various countries, the impact is the same – the target becomes the devaluation of the Euro, the weakness of which will send global shockwaves.

Valuation and its Impact

The two extreme valuations of debt models in finance straddle book value of debt and, on the other extreme, market capitalisation. Both have their uses and their limitations. The former relies excessively on historical figures and is slow to change. Market value on the other hand relies on perception and thus can be very volatile. For companies which are reliant on new investment the cost of capital can make or break their project. Usually the cost of capital is a mark-up over the cost of borrowing for sovereigns or interbank costs and when they go up, the cost of borrowing for corporate increases. Thus a simple solution is to manage the market perception and this is where the willingness to pay comes in. This becomes crucial for a country like Ireland which has earned its name as the Celtic Tiger based on being a willing and hospitable recipient for global companies to be based in. If markets do not believe in the host country, the cost of borrowing will soar evermore, causing new and old to flee Ireland's shores, thus eroding its hard-earned reputation as a haven for private capital. The willingness to pay (or here, in the case of the European countries, the willingness to sacrifice) is manifested in the cuts which governments have

imposed upon themselves. Though the causes of the Club Med and Ireland crisis are very different, the remedial action has been taken on the same grounds.

Fair market valuations rely on large numbers of borrowers and lenders to set the price and normally sovereign loans work as those issued by a competitive player in the market. This works well when the markets are working as normal. However, in the case of market failure, bailouts are required to rescue the free falls in value which might result due to an overly pessimistic mood. This is where sovereign loans become a public good and need to be treated as such. The $89 billion loan is thus an admission that the world is prepared to treat Ireland's woes as a public good.

The role of the UK

We in the UK have been congratulating ourselves that we are not priced in the Euro currency. However, there are two reasons why we are married to the Irish Republic for better or for worse: our banks have investments in those Irish banks which are at the centre of attraction and secondly we have trade links with the country. It is the first reason, which though remains unsaid by George Osborne, has caused the UK to act swiftly and offer aid. The aid is a sound economic decision by all accounts, the rate of interest earned covering the rate at which it is borrowed.

Volatility

Markets treat debt-ridden countries in different ways. Countries with leptokurtic distributions of debt appear to be safer than platykurtic distributions. In other words, it does not matter what the absolute level of debt is but the volatility of outcomes is what appears to jitter markets. The Irish have always had an entrepreneurial streak and though they were the first in the recession in 2008, they have always had the capacity to rebound.
Interest rates (agreed in the bailout package) based on 5-6% borrowing are way different from the market yields which we saw last week. I suspect the truth lies somewhere in between but if the borrowing rates are set too low, it implies debt forgiveness. Does debt forgiveness mean that the country is too poor to pay or does this imply renewed confidence? Ireland is beset with banking woes, but the outlook as far as investment goes is strong with the US investing a large chunk in Ireland and the markets bouncing back with renewed enthusiasm today.

We are all in this together and need to attack the wildebeest jointly.

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A Broken Model of Housing Finance

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