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The Impact of Financial Sector Support on the Public Finances in Ireland and the EU

Rónán Hickey, Linda Kane and Diarmaid Smyth[1]

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Abstract

Drawing on a pan-European database, this Letter takes a comprehensive look at the direct impact that financial sector support measures had on the fiscal position in Ireland from 2008 to 2016. At end-2016, it is estimated that these support measures added approximately €58 billion (21 per cent of GDP and 31 per cent of GNI*) to the stock of gross government debt, a figure which vastly exceeds the impact of the crisis in the EU. The final cost of the support on the public finances will depend on how various banking positions are unwound and the cumulative cost of servicing the related borrowing. Securing the best possible return on remaining banking investments and managing the transition to lower and more sustainable levels of public debt will remain a key challenge going forward.

1 Introduction

The financial crisis had a significant effect on the public finances in the EU, and in Ireland in particular, with countries experiencing both direct and indirect costs. Indirect costs were those caused by the broader economic downturn, such as lower tax revenues and increased welfare related spending. Direct costs, on the other hand, were the result of Governments having to provide direct support to the financial sector through a range of measures, including equity injections, capital transfers, guarantees and nationalisation. The focus of this Economic Letter is on these direct costs. EU Member States are required to submit estimates of the fiscal impact of government financial support measures to Eurostat twice per year as part of the Excessive Deficit Procedure (EDP) notification process[2]. These are subsequently

[1]Corresponding authors: ronan.hickey@centralbank.ie, linda.kane@centralbank.ie and diarmaid.smyth@centralbank.ie. The views expressed in this Letter are those of the authors only and do not necessarily reflect the views of the Central Bank of Ireland (CBI). We would like to thank colleagues in the CBI and the Central Statistics Office (CSO) for comments received, in particular Gillian Roche, Reamonn Lydon, Mary Cussen and John Flynn. All remaining errors and omissions are our own.

[2]See Eurostat (2017). The data relates to activities undertaken to directly support financial institutions. It excludes support measures for non-financial institutions, financial institutions not in need of rescue interventions, or general economic support measures.

published as the 'Supplementary Tables for the Financial Crisis'. While the data does not allow us to quantify the *total* impact of the financial crisis on the fiscal position, it provides a clear picture of how public intervention in the sector has affected the general government (GG) balance and debt. The recent sale of part of the Government's stake in AIB has brought these support measures back to the fore. Accordingly, it seems timely to re-examine the impact of the measures on the Irish public finances (Section 2) and to put them in context by examining the developments in the broader EU, with a particular focus on public debt (Section 3).

2. The Impact of Financial Sector Support on the Irish Fiscal Position

The financial crisis resulted in unprecedented levels of government support being provided to the financial sector in Ireland since 2008. This period was marked by a host of complex transactions - notably the bank guarantee scheme, a series of capital injections (including nationalisation), and the setting up of a state agency to manage distressed loans (NAMA)[3]. Financial sector support measures contributed to a record high GG budget deficit of 32.1 per cent of GDP in 2010 and a sharp increase in government debt. On the back of uncertainty over the scale of banking sector losses and the severe deterioration in the fiscal position, Ireland entered an official Assistance Programme in December 2010.

Impact on the General Government Balance

As part of Excessive Deficit Procedure (EDP) related reporting, Member States are required to estimate the impact of financial sector support on the GG balance by quantifying revenue and expenditure impacts. On the expenditure side, there are four main sources of crisis related spending. These are interest payable (from additional borrowing), capital injections, calls on guarantees, and other (residual) expenditures. The main categories on the revenue side are fees received in return for guarantees provided to financial institutions, interest income (on loans provided), dividends (from holdings of equity) and other (residual) income.

The direct expenditure and revenue impacts of the financial crisis for Ireland are summarised in Table 1. This shows that the overall net impact on the GG balance of providing financial sector support was -€46.7 billion (17.0 and 24.7 per cent of 2016 GDP and GNI* respectively), although the impact has declined in recent years. Of course, the indirect effects of the crisis on the deficit were also significant. Excluding the support measures, the underlying GG balance had deteriorated from a small surplus in 2007 to a deficit of 10.9 per cent of GDP (13.8 per cent of GNI*) in 2010.

By far the biggest contributor on the expenditure side has been capital injections, which have accounted for three-quarters, €48.9 billion, of total support spending. This number is lower than the frequently reported €64 billion bank recapitalisation cost[4]. This is due to the classification of some of the recapitalisation payments as financial transactions - as they are expected to yield a reasonable rate of return - rather than deficit worsening capital transfers. Financial transactions do not have any impact on the GG balance. Capital injections were particularly large in 2010 because of the issuance of promissory notes, mainly to Anglo Irish Bank. The other large expenditure category is interest, which accounts for higher spending directly attributable to financial crisis related borrowing[5].

[3] The National Asset Management Agency (NAMA) is classified outside of the general government sector given its structure as a short-term special purchase vehicle set up to deal with the financial crisis.

[4] See, for example, Irish Times (2016) and Oireachtas Questions (2013). The latest comparable estimate is €66.8 billion by the C&AG (2017).

[5] Accrued interest payable arising from financing of interventions, mainly due to issuance of debt instruments.

Table 1: Impact of Financial Sector Support Measures on the GG Balance in Ireland

€ billion	2008	2009	2010	2011	2012	2013	2014	2015	2016	Total
Revenue	**0.1**	**0.9**	**1.7**	**3.1**	**3.0**	**2.8**	**2.3**	**2.2**	**1.7**	**17.8**
Guarantee fees	*0.1*	*0.4*	*1.1*	*1.2*	*0.9*	*0.4*	*0.2*	*0.1*	*0.0*	*4.4*
Interest	*0.0*	*0.4*	*0.5*	*1.0*	*1.5*	*1.1*	*0.7*	*0.5*	*0.1*	*5.9*
Dividends	*0.0*	*0.0*	*0.0*	*0.3*	*0.5*	*0.8*	*0.8*	*1.0*	*0.7*	*4.1*
Other	*0.0*	*0.1*	*0.1*	*0.5*	*0.1*	*0.5*	*0.7*	*0.7*	*0.8*	*3.4*
Expenditure	**0.1**	**4.7**	**37.3**	**9.4**	**2.7**	**2.4**	**2.3**	**4.0**	**1.7**	**64.6**
Interest	*0.1*	*0.7*	*1.9*	*2.1*	*2.0*	*1.9*	*1.5*	*1.2*	*1.0*	*12.5*
Capital injections	*0.0*	*4.0*	*35.4*	*7.1*	*0.3*	*0.0*	*0.0*	*2.1*	*0.0*	*48.9*
Calls on guarantees	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
Other	*0.0*	*0.0*	*0.0*	*0.2*	*0.4*	*0.5*	*0.8*	*0.7*	*0.7*	*3.2*
Impact on GGB	**0.0**	**-3.8**	**-35.5**	**-6.4**	**0.4**	**0.4**	**0.0**	**-1.8**	**0.0**	**-46.7**
Memo:										
Headline GGB	-13.1	-23.5	-53.7	-21.9	-14.1	-11.0	-7.1	-5.0	-1.8	:

Source: Eurostat and CSO

The CSO estimates that our interest bill has been €12.5 billion higher since 2008 due to interventions in the financial sector. Annual interest costs will persist for some time. Finally, other expenditure reflects a range of factors such as Irish Bank Resolution Corporation (IBRC) related spending and developments related to the Credit Institutions Resolution Fund. While increasing in recent years this expense has been broadly offset by income linked to similar factors.

Financial crisis related revenues have received far less attention, but as Table 1 shows, they have contributed a cumulative €17.8 billion since 2008. Guarantee fee related income and interest inflows – components that initially drove revenue developments – have declined notably over time. The former was close to zero in 2016 reflecting the ending of the bank guarantee scheme, while the latter have fallen due to the sale of assets such as preference shares and contingent capital coupons. Dividend income, which has remained solid in recent years, mostly relates to that portion of Central Bank surplus income directly attributable to the crisis. Initially driven by revenues accruing to the Central Bank through the provision of Emergency Liquidity Assistance (ELA)[6], more recently this surplus arises from income earned on the Special Portfolio. While currently large, this income is temporary in nature and will decline over time as the portfolio is disposed of by the Central Bank of Ireland.

Impact on the General Government Debt

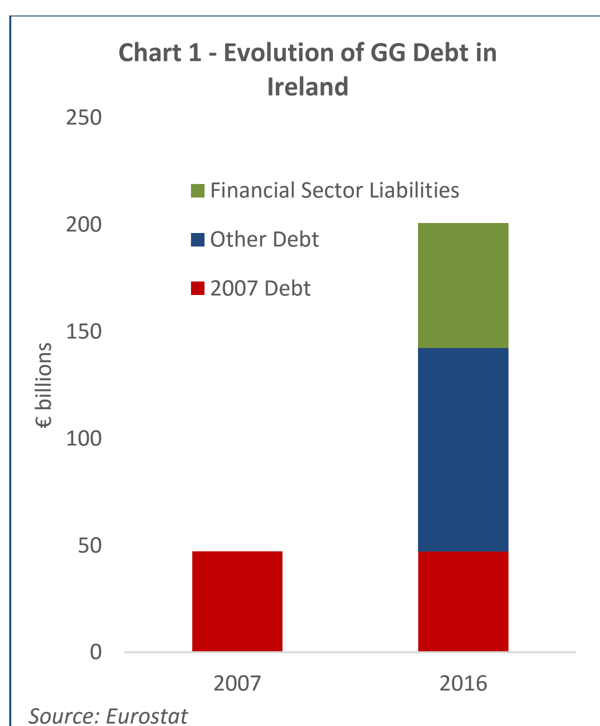
The 'Supplementary Tables' also provide a detailed breakdown of the impact of financial support measures on the government's overall balance sheet. Ireland's GG debt increased rapidly following the onset of the downturn, peaking at €215.3 billion in 2013. As Chart 1 outlines, the increase in debt reflected both the direct and indirect consequences of the crisis, with the broader impact - the running of primary deficits - playing the bigger role (see Department of Finance 2017). The chart, and Table 2, also show however that the direct impact of providing financial sector support on debt has been sizeable.

[6] ELA refers to support provided from a national central bank to a solvent financial institution facing temporary liquidity problems.

Table 2: Impact of Financial Sector Support Measures on GG Assets and Liabilities in Ireland[7]

€ billion	2008	2009	2010	2011	2012	2013	2014	2015	2016
Government Assets	***0.0***	***7.0***	***6.6***	***36.4***	***31.6***	***22.3***	***11.7***	***8.2***	***6.4***
Loans	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
Debt Securities	*0.0*	*7.0*	*5.3*	*8.3*	*8.3*	*5.5*	*5.5*	*1.6*	*0.0*
Equity	*0.0*	*0.0*	*1.2*	*2.6*	*4.2*	*3.2*	*3.2*	*3.6*	*3.6*
Other Assets	*0.0*	*0.0*	*0.0*	*25.5*	*19.1*	*13.6*	*3.1*	*3.0*	*2.7*
Government Liabilities	**0.0**	**10.8**	**46.7**	**83.7**	**81.8**	**72.3**	**60.9**	**60.0**	**58.4**
Loans	*0.0*	*0.0*	*31.4*	*28.9*	*25.8*	*0.2*	*0.2*	*0.0*	*0.0*
Debt Securities	*0.0*	*10.8*	*15.2*	*33.9*	*38.2*	*59.4*	*59.4*	*59.3*	*57.7*
Other Liabilities	*0.0*	*0.0*	*0.0*	*20.9*	*17.8*	*12.7*	*1.2*	*0.7*	*0.7*
Net Assets	**0.0**	**-3.8**	**-40.0**	**-47.3**	**-50.2**	**-50.0**	**-49.1**	**-51.8**	**-52.0**

Source: Eurostat



Source: Eurostat

Focusing on liabilities (which are broadly comparable to GG debt[8]), Table 2 reveals that as of end-2016, financial sector support measures had added €58.4 billion (21.2 and 30.9 per cent of GDP and GNI* respectively) to public debt. This compares to an overall GG debt increase of €153.4 billion between 2007 and 2016[9].

Taking a closer look at the liability components, loans were composed mainly of the 2010 promissory note and, accordingly, peaked in that year[10]. Following the decision to liquidate the Irish Bank Resolution Corporation (IBRC) in 2013, a portfolio of long-dated government bonds replaced the promissory note. These are included in the sub-category 'debt securities', along with other debt linked to the provision of financial support (such as that related to the Prudential

[7] For a full description of each of the components of Table 2, see Eurostat (2016), pp13.

[8] GG liabilities are broader than GG debt. The latter includes debt liabilities under ESA 2010 categories currency and deposits, debt securities and loans. The former includes these items as well as liabilities in derivatives, equity liabilities, pension and insurance liabilities and accounts payable. For more details, see: http://www.cso.ie/en/releasesandpublications/er/gfsa/governmentfinancestatisticsapril2015/

[9] GG debt increased from €47.1 billion in 2007 (23.9 per cent of GDP) to a peak of €215.3 billion in 2013 (119.5 per cent) before declining to €200.6 billion in 2016 (75.4 per cent).

[10] Total promissory note payments amounted to €30.8 billion (€25.3 billion to Anglo, €5.3 billion to INBS and €0.3 billion to EBS).

Table 3: Impact of Financial Sector Support Measures on GG Assets and Liabilities in the EU

% of GDP	2008	2009	2010	2011	2012	2013	2014	2015	2016
Government Assets	***1.8***	***2.9***	***4.9***	***4.2***	***4.4***	***3.9***	***3.5***	***2.8***	***2.4***
Loans	*0.5*	*0.5*	*0.2*	*0.2*	*0.4*	*0.2*	*0.1*	*0.1*	*0.1*
Debt Securities	*0.2*	*0.4*	*0.3*	*0.2*	*0.2*	*0.2*	*0.1*	*0.0*	*0.0*
Equity	*0.6*	*1.3*	*1.5*	*1.0*	*1.2*	*1.3*	*1.2*	*0.9*	*0.7*
Other Assets	*0.5*	*0.6*	*2.9*	*2.7*	*2.6*	*2.2*	*2.1*	*1.8*	*1.6*
Government Liabilities	**1.9**	**3.1**	**5.5**	**5.4**	**5.7**	**5.1**	**4.8**	**4.3**	**4.0**
Loans	0.1	0.2	0.4	0.4	0.8	0.7	0.6	0.6	0.6
Debt Securities	*1.5*	*2.5*	*2.1*	*2.0*	*2.0*	*2.1*	*1.9*	*1.7*	*1.5*
Other Liabilities	0.3	0.5	3.0	3.0	2.9	2.3	2.3	2.0	1.8
Closing Balance Sheet: Net Assets	**-0.1**	**-0.3**	**-0.6**	**-1.2**	**-1.3**	**-1.3**	**-1.3**	**-1.4**	**-1.6**

Source: Eurostat and internal calculations.

Capital Assessment Review). As a result, there were no loans outstanding by end-2016, while debt securities remained substantial. The remaining liabilities in the 'other' category are primarily the result of IBRC being classified as part of the GG sector from 2011 onwards. While this initially had a significant impact on the balance sheet, the effect has diminished over time as IBRC was wound down. This transaction has driven the overall reduction in liabilities that has taken place since the 2011 peak.

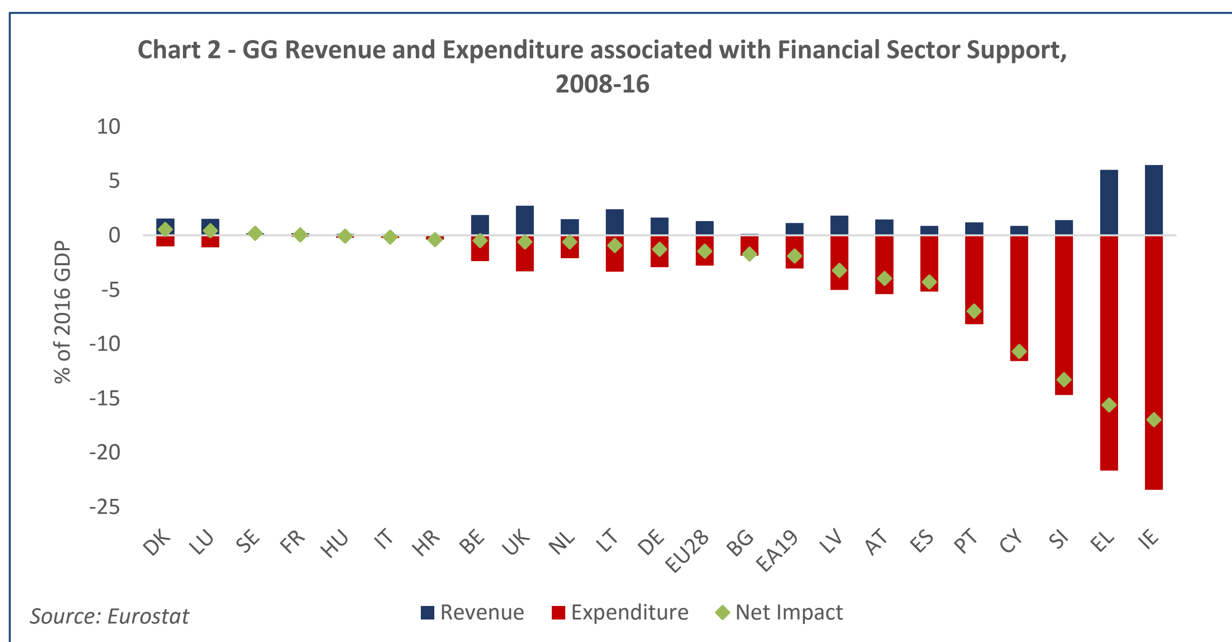
Table 2 also shows the Government's asset position fluctuated sharply over the crisis period. Assets linked to financial assistance measures reached a peak of €36.4 billion in 2011, but have since fallen in value significantly, to just €6.4 billion in 2016. This largely reflects the acquisition and subsequent wind down of IBRC, and the disposal and conversion of other banking related assets. The €6.4 billion figure is lower than the potential market valuation of the Government's bank shareholding; the National Treasury Management Agency valued this at 5 per cent of GDP last year[11], while the recent AIB share sale implied a total market capitalisation of the bank of around €12 billion at that time. As noted above, however, in terms of its impact on the GG position, the share sale revenue is treated as a financial transaction and, thus, is excluded from the GG[12]. Reflecting asset developments, the increase in the *net* debt position due directly to financial sector support measures was €52 billion at end-2016 (18.9 and 27.5 per cent of GDP and GNI* respectively).

3. The Impact of the Financial Crisis on the EU Fiscal Position

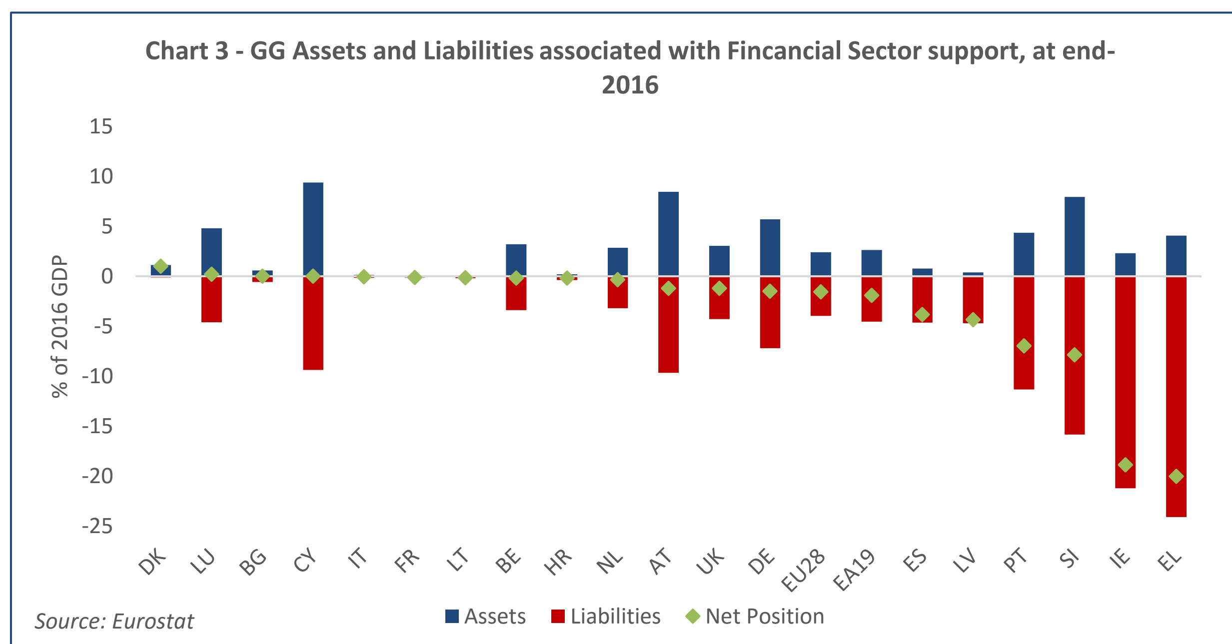
To put the Irish figures in perspective, Chart 2 shows the impact of financial sector support measures on the GG balance across countries from

[11] See slide 40 in NTMA (2016).

[12] The €3.4 billion raised in the AIB share sale earlier this year impacts on the Exchequer balance but not the general government position.



Source: Eurostat



Source: Eurostat

2008 to 2016[13]. In total 21 countries had to provide such support. The overall impact for the European Union (EU) and the Euro Area (EA) was -1.5 per cent and -1.9 per cent of 2016 GDP respectively. This, however, masks very heterogeneous effects across countries, with the impact in Ireland particularly marked. In the EU, total revenues amounting to 1.3 per cent of 2016 GDP (€194 billion) have been collected since 2008 while expenditures were higher at 2.8 per cent of GDP (€412 billion), resulting in a net cost of €218 billion over this period.

[13] EE, MT, PL, RO, SK, FI and the CZ are omitted from Figures 2, 3 & 4 as no financial sector support measures were carried out between 2008 and 2016.

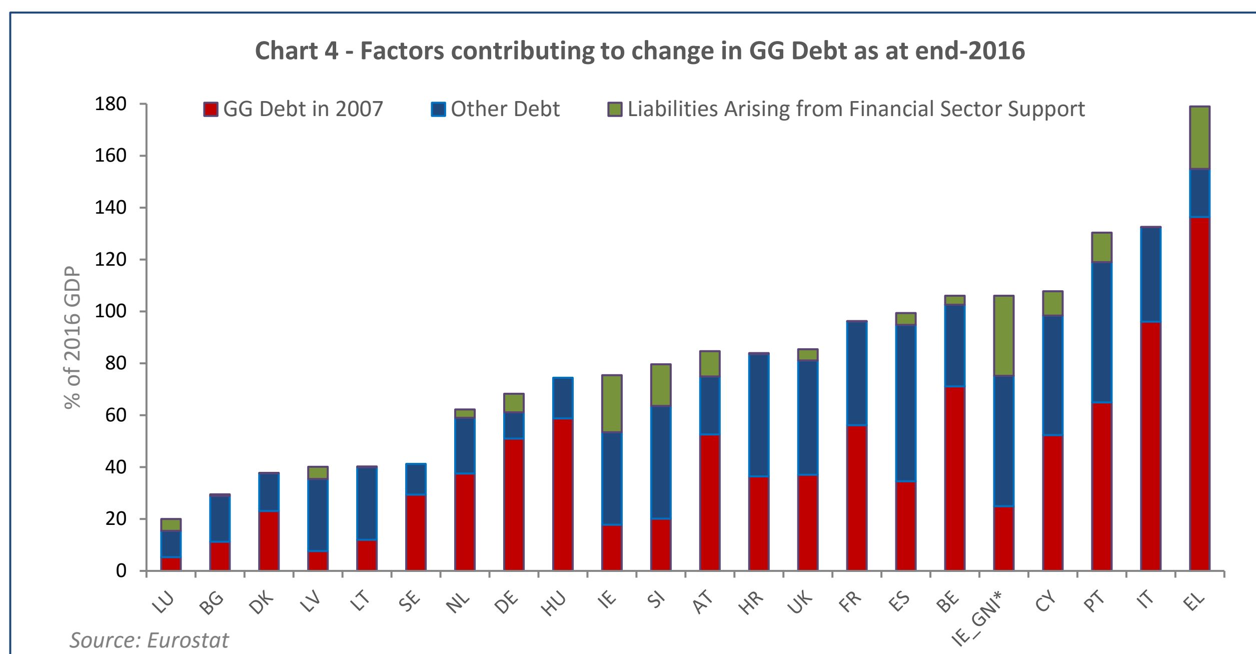


Chart 4 - Factors contributing to change in GG Debt as at end-2016

Source: Eurostat

The impact on EU and country balance sheets is summarised in Table 3 and Chart 3, where once again, the Irish experience stands out; only Greece had higher outstanding net liabilities at end-2016 due to support provided. For the EU as a whole, liabilities arising out of assistance to the financial sector were valued at 4 per cent of GDP in 2016. This aggregate again masks heterogeneous outcomes across countries. It is unsurprising that in the case of both the GG balance and debt the impact in countries that ultimately required a Programme of financial assistance has been especially notable.

As previously mentioned in the Irish case, financial sector support measures were only partly accountable for the increase in government debt that occurred during the crisis. This is highlighted in Chart 4, where the factors contributing to increases in GG debt ratios between end-2007 and end-2016 are split between the initial starting point, liabilities arising from financial sector support, and other debt incurred[14].

Prior to the crisis, most of the countries that subsequently had to provide support to their financial sector had debt ratios at or below the Stability and Growth Pact (SGP) threshold of 60 per cent of GDP. In fact, one-third of these 21 countries had debt ratios below 30 per cent of GDP, including Ireland. In some cases, a favourable starting position helped to keep debt low (Luxembourg, Latvia, Lithuania) or at the very least contained (Netherlands) in the crisis years. In many other cases, however, even a favourable starting position could not insulate countries from the impact of the crisis due to the strong economic downturn (UK, Spain, Croatia) or a combination of the downturn <u>and</u> having to provide significant financial sector support (Ireland, Slovenia).

The eight countries that had debt ratios above the SGP threshold in 2007, meanwhile, were amongst the most indebted by 2016, even where minimal financial sector support was required (France, Belgium, Italy). In the case of Greece, a very weak starting position was exacerbated by an unravelling of the fiscal position and significant bank support requirements. This resulted in a debt

[14] Given the issues surrounding the measurement of Gross Domestic Product in Ireland we have also included ratios using adjusted Gross National Income (GNI*).

ratio of close to 180 per cent of GDP in 2016. Unsurprisingly given the broader impact of the financial crisis on overall economic activity - and the public finances - the countries that required financial support for the most part also had significant 'other debt' accumulation over the period.

More generally, government debt levels in the EU remain extremely elevated. Ten of the EU-28 members had gross debt ratios of greater than 80 per cent of GDP in 2016, with the average for the region as a whole at 84 per cent of GDP. This compares to just three countries in 2007 and an average ratio of 58 per cent of GDP[15]. In the Irish case, when GNI* is used as the denominator - rather than the inflated GDP figure - the debt ratio was over 100 per cent in 2016.

4. Conclusion

The scale of direct financial support the Irish State provided to the domestic financial sector during the recent crisis was unprecedented and had a severe impact on the public finances. Taking account of revenues as well as expenditure, a total amount of €46.7 billion (17.0 per cent of GDP, or 24.7 per cent of GNI*) was directly added to the GG deficit between 2008 and 2016, leading Ireland to record the highest GG deficit as a percentage of GDP in EA history in 2010. As the financial effects of the crisis dissipate, GG impacts should become smaller. The longer-term impact of the crisis on the public finances are harder to gauge due to the different sources used to fund banking interventions and the variety of assets held. Crisis related support measures directly added €58.4 billion (21.2 and 30.9 per cent of GDP and GNI* respectively) to the stock of gross general government debt at end-2016. The ultimate costs may end up being higher or lower depending on how various banking positions are unwound and the cumulative cost of servicing the related borrowing. Securing the best possible return on remaining banking investments and managing the transition to lower and more sustainable levels of overall debt will remain a key challenge in the years ahead.

International comparisons highlight the magnitude of support provided by the Irish Government to the financial sector. As a percentage of GDP, Ireland's banking sector support measures had a larger impact on the GG deficit than in any other EU country and had the largest impact on liabilities by a sizable margin[16].

More generally, public debt levels in the EU - and Ireland - remain extremely high. The increase in debt levels has not been solely caused by financial support measures but also by a combination of high initial starting positions (in terms of debt) and other consequences of the crisis, such as weak economic growth. Developments over the past few years have also served to highlight the deficiencies in fiscal governance in the region, with little or no focus placed on debt developments prior to the crisis. The introduction of the 'Macroeconomic Imbalance Procedure' and the strengthened deficit and debt rules are important steps to rectify these problems, and it is important that rules are fully operationalised in the years to come. This would help to ensure that debt ratios move to safer and more sustainable levels over time, thus creating more room to manoeuvre in the event of future adverse shocks.

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[15] The three countries with debt ratios above 80 per cent in 2007 were Belgium, Italy and Greece.

[16] In Ireland, liabilities associated with financial sector support measures peaked at 48.7 per cent of GDP in 2011.

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