

# Statement to the Oireachtas Joint Committee on Finance and the Public Service

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## Part I

# What is ELA and What is the Promissory Note?

ELA is money. It is not a bond. Dealing with ELA does not involve dealing with bondholder although the money so created was used to redeem (pay off) bondholders. The acronym ELA stands for *Extraordinary Liquidity Arrangement*, and the name of indicates what it is. It is first and foremost *extraordinary*, in that it is a facility extended to commercial banks by central banks when ordinary (usually taken to be interbank or regular central bank ) short or medium term funding is not available for whatever reason. It is *liquidity*, in that it is designed to allow a bank to maintain liquidity to its operations and customers, rather than a solvency arrangement, which is designed to ensure that the organization is well capitalized and able to trade in the longer term. It is a basic tenet of corporate finance that we draw a distinction between these two concepts ; solvency, achieved through capital, is a longterm concept while liquidity is a rolling short-term issue. Liquidity crises, for countries or for companies, can arise when lenders no longer have confidence in the solvency of the borrower. This is what happened in September 2008, the initial focus being on the solvency of Anglo and Irish Nationwide (now collectively known as Irish Bank Resolution Corporation, IBRC).

ELA is money. In the normal course of events in the eurosystem money is created under agreed mechanisms. Central Banks have the power to create money '*by fiat*' that is to say they can create it from nothing. ELA is not part of the normal operation of this monetary creation but is allowed in extraordinary circumstances. ELA is carried as an asset on the balance sheets of the creating central bank, in the case here the Irish central bank. It is not created by borrowing from other central banks. It is not a bond. It is not money loaned to the central bank of Ireland from the ECB, nor money loaned from the other central banks. It is money, as real as any other form of credit agency. It is pure money creation, by fiat, allowed in exceptional circumstances. As of end-2011 this domestically created money amounted to some €44billion.

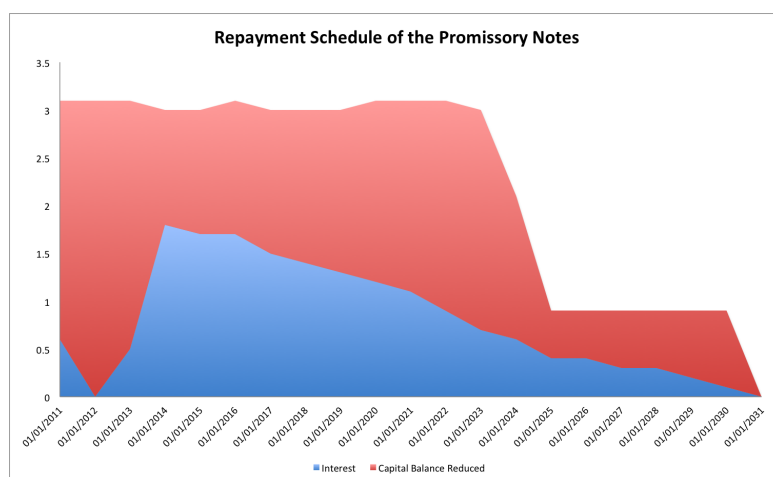
How is this money mobilized? When Anglo/INBS became hopeless and obviously insolvent the Irish government recapitalised them. The largest part of this recapitalisation was via the creation by the Irish government of a Promissory Note which was issued to the banks. This was not and is not a sovereign bond. We know that it was not and is not as the ECB refused to accept this for normal liquidity operations, forcing Anglo/INBS to instead go to the central bank of Ireland and swap this for money which was then used to finance Anglo/INBS, including paying off senior bondholders, paying staff wages, payment of interest on deposits etc. In effect the Central Bank of Ireland monetized the government IOU. The government have agreed to pay off the Promissory Note over a 15 year period. As there is, to put it mildly, considerable doubt as to whether the

remaining assets of IBRC are sufficient to generate income to repay its debts the Minister for Finance in March 2010 as well as creating the Promissory Notes also gave (as of this date secret) letters of comfort to the Central Bank (Sole shareholder, the Minister for Finance) promising repayment of the ELA were IBRC unable to repay. Thus the state in effect is indemnifying itself against its own actions. An analogy might be that we borrow from a bank, put that money into a pocket, then move it to another pocket, then take it out and burn it. The effect is the same. Money is destroyed in the same amount as it was created, in order that the european money supply does not increase

## Part II

# How much is this going to cost us?

The schedule for the repayment of the notes is given below. In essence, through the next 15 years the state will repay the promissory note at a rate of approximately €3.1b per annum.



**NOTE 6**  
**NON-VOTED CAPITAL Expenditure**

See footnote (1)	2011 €m	2012 €m
<i>Payments under the European Communities Acts</i>		
ERDF and Cohesion Fund Repayments	-	30
FEOGA	770	800
<i>Other Capital Payments</i>		
Advance to Credit Union sector	250	250
Exchequer Contribution to Insurance Compensation Fund	280	396
Promissory Note payments to certain banking institutions	3,085	3,085
Banking recapitalisation	7,568	1,300
Miscellaneous	6	5
<b>Total</b>	<b>11,959</b>	<b>5,866</b>

Note that rounding can affect totals

This repayment is treated in the government accounts as a capital expenditure, and can be found in Note 6 of the 2012 estimates as show above. This expenditure cannot therefore be deployed to other, productive, usage. Each year a capital allocation is made for the repayment of these. This capital must be either raised from taxation or borrowed. The true interest issue therefore of the Promissory Note is NOT the implicit interest rate which is paid on them, rather it is the cost of the funds borrowed to, in effect, recapitalize the banks holding the Promissory Notes. Thus seeking concessions on the interest rate element of the Promissory Note is seeking the wrong concession.

Another issue as to why this matters and why we are paying is that Eurostat decided that as the Promissory Note was irrevocable it was appropriate to treat this as a €31b increase in the national debt, resulting in a world-beating 32% of GDP deficit in 2010. There is no doubt in my mind that the nature of the note and the consequent realization that it was in fact debt played a large part in the slow but inexorable locking out of Ireland from the regular bond markets and the need to become wards of the Troika.

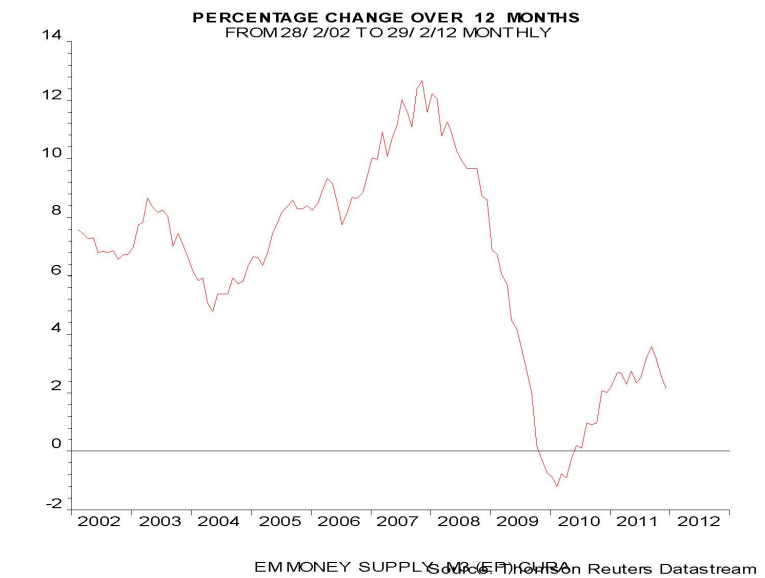
### Part III

## What can be done about this and who can do it?

The essence therefore is as follows: the Central Bank of Ireland has created money, outside the *normal* course of Eurosystem operations for the creation of money. This it is allowed to do under delegated power. However, this delegated power is circumscribed. In effect the ECB council can veto the action of the national central banks when they act in the manner in which the Central Bank of Ireland has done, but only by a 2/3 majority. Thus the presumption is that

in general when central banks act to extend ELA they are doing so in a manner that does not interfere with the normal actions of the ECB.

This is where the crux of the matter lies I submit. While the creation of €40b or so of additional money by the central bank of Ireland is small in the context of a Euro area M3 (broad money supply) of €9800b, amounting less than 1/2 of 1%, the ECB has a mandated inflation fighting role. Add to this the historic antipathy of Germany, the dominant power in European monetary affairs, to any form of inflation and we see that the creation of money in this manner is potentially problematic. Were the Central Bank of Ireland not to require the repayment of the ELA, and the writing down of the money supply, this would represent a permanent increase in the monetary base of the Eurozone. 1/2 of 1% is not much but what if other countries were to commence to refinance their banks in this manner? What if in fact countries were to take up a suggestion made that the debtor countries refinance their sovereign debts in this manner? Ireland issues a €X hundred billion promissory note to IBRC, IBRC swaps that at the Central Bank of Ireland for newly created money, the NTMA issues a €X hundred billion bond for 100 years duration at a low interest rate, and IBRC purchases the bond with the real money which the state now has on hand on deposit to fund itself while we restructure the financial and economic system. What if Greece were to do this? Clearly we could quickly find hundreds of billions of ELA created euros being added. This is what is known as monetising the debt and it is anathema to the ECB for reasons of inflation as well as being a *de facto* breach of the rule that the ECB is not allowed to finance government deficits directly. Such monetary creation is further anathema to countries such as Germany who have in the past suffered episodes of hyperinflation. I would note that at 3% inflation we are far from hyperinflation. European money supply (M3) has remained within a narrow band of €9.2tri to €9.8tri since the middle of 2008 and in recent months has in fact begun to fall sharply.



It is highly probable that were countries to seek to do this they would

find themselves running a real danger of being cut off from further and ongoing liquidity support, might be accused of having the central banks funding the deficit (deficit financing) and be in breach of treaties. Such a move would only be used *in extremis* but it does show that ELA has the potential for unlimited monetary creation and should be treated as such. It should be noted that we have had experience of a large currency union breakup in the recent past, with the breakup of the Rouble Zone, which zone lasted after the political union of which it was the currency, the Soviet Union. For further analysis of this see [1]. Nonetheless, such debt monetisation while a solution to the immediate liquidity problems of countries would in the long term pose a threat of inflation and would not in any case solve the solvency issues of countries or banks and would in the long term pose more problems than it would solve (see [2])

There are three ways in which we can deal with the cost of the ELA.

1. One is to extend the term of the ELA repayment from 15 years to a much longer period. Extending by 10 times, to 150 years would reduce the annual cost in the same manner. However, we would be 'stuck' with IBRC for potentially that period.
2. Another way we could deal with this cost is to simply write the whole issue off. This is NOT burning bondholders, nor is it burning ourselves. However, the consequence of removing the Promissory Note and associated Letters of Comfort might be to render IBRC technically as opposed to functionally dead. IBRC, if we write off the ELA and the associated Promissory Notes, would have remaining assets (loans not transferred to NAMA) and liabilities (some remaining ELA , some ECB loans, a small

amount of deposits and some remaining bonds. If after restructuring the balance sheet IBRC is not able to service its liabilities then it can and should be wound up. Again this seems to have been ruled out by successive governments and the ECB over the years, despite that it too would be the effect of saving the state the ongoing drain of €3.1b per annum.

3. A third solution would be to seek to defer, to continue in the kicking of the can at which successive governments and European institutions have excelled. We have already received deferment till 2014 of the implicit interest payment on the Promissory Notes, and if such were to be extended for a number of years the strain would be at least be deferred.

All of these however, of which I prefer the second, would require that the ECB accede to this request. The Irish voice on the ECB is not answerable to either this committee nor any organ of government, which is right and proper. It is in my view highly improbable that Governor Honohan has not raised these or similar proposals at the ECB, but the evidence is that so far there is no will from the ECB to allow movement. Why that is remains unclear as it has recently shown willingness to accept heretofore unpalatable actions in regard to Greece. Removing the burden of the Promissory Notes in some manner would only assist the government. It would assist it politically in terms of implementing the needed closing of the gap between state expenditure and taxation and it would assist in base monetary terms. If the Troika wish to have a 'good example' of its policies as opposed to a set of 'horrible warnings' they could do worse than quietly monetize the Irish banking debt, making clear that this is (at least in principle) a one off and reflects the reality that in doing so they acknowledge the role the Irish taxpayer has played in preventing contagion into the banking bond market in 2008/9.

## References

- [1] Dabrowski, Marek, The Reasons of the Collapse of the Ruble Zone (November 1, 1995). CASE Network Studies and Analyses No. 58. Available at SSRN: <http://ssrn.com/abstract=1312324>
- [2] Bordo, Michael D. and James, Harold, A Long Term Perspective on the Euro (February 2008). NBER Working Paper Series, Vol. w13815, pp. -, 2008. Available at SSRN: <http://ssrn.com/abstract=1093653>