# Eurozone: the second domino falls

One rationale for the U.S.'s misadventures in Vietnam in the 1960s and 1970s was that, if Vietnam is "lost" to communism, other countries in Asia would also succumb to the disease, falling like dominos. As it happened, they all moved rapidly towards globalization and a private sector based growth model, even after Vietnam was "lost". In the 1990s, the domino effect was seen in East Asia with the balance of payments crisis in Thailand quickly engulfing Indonesia, Malaysia and South Korea. In the eurozone, after Greece a year back, it is now the turn of Ireland; more ominously, bond yields and CDS spreads on Portuguese and Spanish sovereign debt have gone up, even as their ratings have been revised downwards.

After trying to avoid a rescue package as long as it could, Ireland finally bowed down to the inevitable last week, and negotiated a € 85 bn loan from the EU/IMF, accompanied by the usual conditions of fiscal compression. While both Greece and Ireland have been forced to seek multilateral assistance, the root causes of their problems are different. In the case of Greece, ultra-loose fiscal policy and a huge current account deficit led to the crisis; in the case of Ireland, the problem is its bloated banking system, needing public support on a massive scale thanks to its huge exposure to weak assets. Ireland still has a surplus on the current account.

For students of economics and finance, Ireland is a very interesting case. Until lately, it was the fastest growing economy in the European Union, hailed as the "Celtic miracle". The economy was extremely competitive, attracting a lot of foreign investment (thanks partly to the EU's lowest corporate tax rate -- 12.5%) and immigrants, and boasting fast growing manufacturing and IT sectors. So what went wrong? In one word, a huge and wasteful investment in the real estate sector financed by the commercial banks who, in turn, were borrowing money from non-residents and in the capital markets. The aggregate total of the bank assets increased to much more than the country's nominal GDP, with non-resident deposits exceeding domestic deposits. The government had also encouraged property development, tempted by the tax revenues generated by the fast growing sector. Today, acres of brand new commercial and residential property are lying vacant with no buyers or renters. At the height of the boom, as much as 60% of the Irish banks' assets, amounting to 250% of the country's nominal GDP, were loans to the real estate and construction segments! After the collapse of Lehman, there were worries of a run on the banking system. This led (forced?) the government to guarantee all liabilities of Irish banks, to residents and non-residents, to depositors and capital markets.

Having guaranteed the liabilities, the government took prompt steps to cut expenditure and increase taxes, even as the economy shrank 11% in 2009, and unemployment increased well into double digits. Ireland's preemptive actions since before the Greek crisis helped reassure the financial markets for a time, but were obviously not enough once the aggregate scale of the baking problem became known, forcing the government to go in for a humiliating bailout from the EU/IMF. This loan should cover the Irish government's borrowing requirements for two years – provided the revenue and expenditure projections hold. It is, however, anybody's guess whether the brutal fiscal compression would lead to an even sharper fall in economic activity, thus upsetting all projections.

Ireland is hardly likely to be the last eurozone member needing massive rescue. Portugal could be next (a EUR 60 bn package?) The big worry is whether Spain (the fourth largest eurozone economy (bigger than the other three PIGS taken together) would be forced to follow suit: hedge funds have taken huge bets on both these countries! To be sure, Spain's fiscal position is much stronger, but unemployment is 20% and there is a deficit on the current account in excess of 4% of GDP, necessitating reliance on foreign savings.

Many countries in Europe are facing social unrest, union agitations, strikes, etc. in protest against the measures aimed at fiscal compression. Recently, France faced weeks of agitations and strikes against the decision to increase retirement age from 60 to 62, which, one would have thought, was a relatively harmless measure. Overall, problems in the eurozone are looking increasingly intractable, with the very future of the supranational currency in its present form, coming under question, a point I will revert to at a later date.

Tailpiece: As country after country in Europe takes steps to cut public expenditure and benefits, and increase taxes, across the Atlantic, President Obama was forced to agree to extend tax concessions on dividends, capital gains, and to those earning more than $ 250,000, which he was committed to eliminating. He had already frozen public sector wages for two years. All this is the political price for getting the opposition Republican Party's support for extending unemployment benefits beyond 99 weeks, as unemployment remains stubbornly near double digits.

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