Ireland will trump Germany in bailout bluff

Both players in the euro crisis know the stakes are high, but neither will risk bringing the house down

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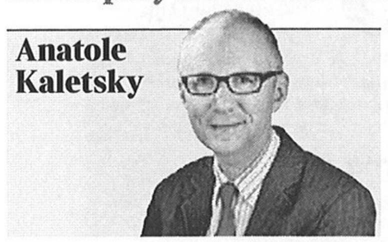

Here we go again. In May it was Greece; now it is Ireland. Before that it was Lehman and AIG, Royal Bank of Scotland and Northern Rock. The financial world stands again on the edge of a precipice and the question is whether our leaders step back from the brink or step forward. Either way, history seems to repeating itself, but as Karl Marx said, events that first appeared as tragedy often return as farce.

Comic possibilities certainly abound in the three-way stand-off today between the Irish Government, the global financial markets and Angela Merkel, the German Chancellor. Most obvious is the way the feckless Irish keep refusing handouts, while Mrs Merkel, that proud and sanctimonious guardian of financial respectability, alternates between begging and bullying them to accept a blank cheque.

Then there is the legendary good humoured fatalism of the Irish, which I observed last weekend when I joined my wife, an Irish filmmaker, at the Cork film festival, which featured many amusing ruminations on the country's debt-induced transformation: "When you put your card in a cash machine these days and it says 'Insufficient Funds', you can never be sure if it means you or the bank."

The comic features of the Irish financial crisis and the Irish national character are more significant for the world economy than is generally realised. They help to explain why this latest outbreak of the global financial crisis is likely to end less badly than many eurosceptics, myself included, would have predicted a year ago.

To see why the euro probably will come through what Herman Van Rompuy, the European Council President, described yesterday as the "survival crisis", it helps to consider the contrasting stereotypes of the Irish and Germans.

The Irish are shrewd and enthusiastic gamblers, with a breezy scepticism about rules and regulations. The Germans, by contrast, are famously cautious, calculating and legalistic. Each side knows about the other's character and this mutual knowledge will be reflected in their interactions. And that implies several unexpected conclusions.

> The European Central Bank is now a rehab clinic for bust banks

First, Germany wants to bail out Ireland more than the Irish want to be bailed out. The Irish financial problem, in contrast to the Greek one, is not caused by excessive government borrowing but by the enormous losses suffered by the country's private banks, which owe tens of billions of euros more to their foreign creditors than they can expect to recoup from their dud property loans. But banks in the eurozone can borrow unlimited funds from the European Central Bank and indefinitely avert failure.

This behaviour horrifies the Germans, who see that the ECB has been transformed from a bastion of monetary orthodoxy into a rehab clinic for bust banks. Ireland, by contrast, does not give two hoots about the reputation of the ECB and is positively pleased if market scepticism about its policies produces a weaker euro. For Germany it is therefore vital to bail out Ireland if it wants to restore the integrity of the ECB.

Second, the stand-off between the two countries is not just about a bailout. It is also about Germany's determination to impose a degree of political discipline on Europe. In particular, the crisis is seen by many German politicians as a perfect opportunity to stop Ireland's buccaneering policies of low taxes, which have made it difficult for Germany to raise domestic taxes. Ireland's 12.5 per cent rate of corporation tax, by far the lowest in Europe, is often cited in Germany as the worst example of "harmful tax competition".

For Ireland, however, a big increase in corporation tax would be totally unacceptable, causing an exodus of foreign companies in the middle of a deep recession. This may turn out to be the sticking point on which neither the Irish nor the Germans will concede.

Even so, a permanent stalemate is unlikely. While the Irish may be born gamblers and the Germans may be legalistic pedants, their governments are neither stupid nor reckless. They will not push the global financial system casually over a cliff, as the Bush Administration did on September 15, 2008, when it bankrupted Lehman.

The Irish and German governments both know that, just as the bankruptcy of Lehman triggered runs on AIG, Merrill Lynch, Citibank and many other US financial institutions, a default by any Irish bank would cause runs on all other Irish banks, as well as in Greece, Portugal and Spain. Just as in Ireland, most of the banks in these countries have relied for their survival on explicit or implicit guarantees from their governments and the ECB. If Dublin was now to renege on its bank guarantees, then all other European guarantees would lose their credibility. Trillions of euros would immediately be withdrawn from the Greek, Irish, Portuguese and Spanish banking systems — and perhaps also from Italy and France — to be deposited in Germany, Holland and Switzerland. Such a flight of capital would certainly mark the end of the euro.

> Germany wants to stop buccaneering Irish low-tax policies

While such an outcome might be welcome to me and other British eurosceptics, it would be unacceptable to every significant politician in the eurozone. What, then, are European leaders likely to do to avert the euro's demise?

First and foremost, they will have to ignore the many academic economists, financiers and media commentators who are urging the Irish Government to default on its guarantees and force bank creditors to take losses. The people suggesting that Ireland should penalise bank creditors were in most cases advising the Bush Administration to let Lehman go under for the same reason — to protect taxpayers from moral hazard and the socialisation of bank losses.

The result was, of course, exactly the opposite. Within weeks of the Lehman failure, governments were forced to offer unlimited and unconditional guarantees to every financial institution in the world. And taxpayers suffered much bigger losses from the recession triggered by the post-Lehman bank runs than the modest costs they would have borne if the banks had been given guarantees.

Once it is understood that the EU cannot afford to let the Irish Government default on its bank guarantees, a surprising conclusion follows. If the Irish play their cards right, the terms of their bailout will not be dictated by Germany, the European Commission or the ECB, but by the Irish Government itself. And remember, the Irish are damned good at cards.