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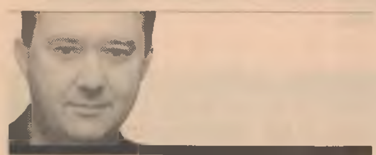
Things fall apart The FT debates the origins and consequences of Ireland's crisis

An Irish bail-out and a British nightmare



Philip Stephens

This is not the time to gloat. Heavily indebted Britain is borrowing another £7bn or so to lend to catastrophically indebted Ireland. Tory Eurosceptics are not sure whether to cheer or jeer – to savour the eurozone crisis or to berate David Cameron's government for contributing to the Irish bail-out.

As it happens, Ireland's property-boom-turned-banking-bust had little to do with its membership of the single currency. Ireland is not Greece. The closer parallels are with Iceland and, dare one say it, Britain. Gordon Brown got precious few things right as prime minister, but his bank rescue package probably saved Britain from Ireland's fate.

Those who imagine the euro to be responsible for Europe's ills are left to explain Britain's financial mess or why, say, France has ended up with a much smaller fiscal deficit.

As for Britain's contribution to the Irish package, George Osborne was suitably dismissive of his critics. The chancellor – no fan of the euro – observed that a carping "we-told-you-so" approach scarcely amounts to an intelligent economic policy.

The self-interest behind the British loan (those fulminating that the money would be better spent on schools and hospitals should note it is a *loan*) is self-evident. Britain is Ireland's biggest creditor. Its banking system is heavily exposed to Ireland's banks. So are its export industries: Ireland is a bigger market for British goods than the four Bric countries put together.

This is before you get to less tangible things such as neighbourly solidarity and sustaining the political trust required to safeguard a fragile peace in Northern Ireland. I heard one Tory Eurosceptic declare that Britain's duty was to help Ireland reclaim its sovereignty by forcing it out of the single currency. There is a contradiction in there somewhere.

On the other hand, there is nothing like someone else's misfortune to make people feel good about their own troubles. Listening to the sceptics was to imagine that Britain's recovery is now plain sailing. If only that were so. Britain has just about sorted out its banks, but, as far as making inroads into the deficit is concerned, it is about where Ireland was a year ago.

At first, the vigour with which Dublin wielded the spending axe won plaudits from bond markets. But the deflationary impact of the cuts has since seen the deficit widen. That is the fear haunting Britain as its own cuts bite into Whitehall budgets.

Governments cannot deflate their way back to budget balance – a proposition Ireland may yet test to destruction

The nervousness is apparent at the Bank of England, where the monetary policy committee has all but suspended its inflation target. The MPC could never admit as much, of course. But all the evidence says it has concluded that sustaining economic recovery counts for more than keeping prices down.

We are not talking here about letting inflation rip. Rather, the MPC seems to have decided that it can live with rises in the consumer prices index of 3 per cent or so – a percentage point above the official target of 2 per cent.

On the other hand, inflation as measured by the more widely recognised retail prices index looks firmly stuck above 4 per cent. And the Bank's own forecasts suggest that the pace of price rises will accelerate in coming months. It will be 2012 before the official target comes back into full view.

Mervyn King, the Bank governor, is one of the foremost fiscal hawks. He has promised Mr Osborne that the MPC stands ready to pump even more cheap money into the economy if the recovery falters as a result of the fiscal squeeze. With the base rate already 0.5 per cent that will be easier said than done.

That said, the MPC has made an intelligent choice. Competitive austerity may be the current European fashion, but growth is the sine qua non of successful repair of the public finances. Governments cannot deflate their way back to budget balance – a proposition that Ireland's latest austerity package may yet test to destruction.

Rising inflation, though, carries its own costs. It cuts household incomes and redistributes from savers to borrowers. It has particularly harsh effects on those dependent on fixed incomes – the more so at a time of historically low interest rates.

When British policymakers congratulate themselves for not swapping sterling for the euro what they really mean is that keeping the pound has given them the chance to devalue it. Sterling is now worth about 20 per cent less than it was three years ago.

What the policymakers do not say is that they have simply chosen higher inflation over more direct ways of taking money from consumers.

Inflation can also develop a mind of its own; a little can quickly become a lot if wages start to chase prices. A cursory glance at Britain's postwar history tells you that the competitive advantages that flow from devaluation are fairly easily squandered.

Britain needs buoyant export markets – starting with Ireland. The real nightmare for Mr Osborne is a combination of faltering growth and rising inflation. No, there is nothing yet for Britain to gloat about.

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How Germany could kill the euro

Gideon Rachman

"Tell me how this ends," was the question posed by General David Petraeus about the Iraq war. European leaders are asking the same question as they contemplate the crisis in the eurozone.

Having failed to construct a firebreak in Greece, the Europeans are hoping that they can stop the euro crisis in Ireland. But, even as an Irish rescue package is put together, the bond markets are already looking with unhealthy interest at Portugal. After Portugal, Spain is assumed to be next. And, if a really big economy such as Spain needed to call the financial fire brigade, the whole future of the euro would be in serious peril.

The question of "how this ends" is therefore obvious and urgent – but also fiendishly difficult to answer. It is like watching a three-dimensional game of chess – in which the financial, economic and political levels all interact with each other.

My current best guess is that the single currency will indeed eventually break up – and that the euro's executioner will be Germany, the most powerful country and economy inside the European Union.

The headline on one of the most-read stories in the Financial Times last week was "Anger at Germany boils over" – reporting accusations by some Europeans that the latest twist in the euro crisis had been triggered by inflexible German policies.

But Germans themselves have plenty of reasons to be cross about the way the single currency is developing. Their country has been through a painful decade of wage restraint and cuts in government services. Many voters are outraged that their tax-euros might be used to finance early retirement for Greeks, or Ireland's super-low corporate tax.

The German people were also promised that the euro would be as stable as the Deutschemark – and that there would be a "no bail-out clause" that would prevent the richer countries in Europe having to save the indigent. Both promises look perilously close to being violated. That, in turn, is triggering growing concern that Germany's constitutional court could declare their government's participation in European "bail-outs" illegal.

The German government's fear of its own constitutional court has already been a crucial driver of the crisis. This year, the Germans were accused of acting far too slowly to organise a rescue for Greece. But official sloth was driven by a fear that speedy action would be deemed to violate the European treaties.

The immediate crisis in Ireland was triggered about a month ago when Angela Merkel suggested that, in future euro crises, private bondholders should bear more of the losses and that further European treaty changes were needed. This remark was also made under pressure from the courts.

Germany's actions have, in turn, created political and legal pressures in bail-out nations. In Greece, we have seen deadly riots in Athens and a senior government minister evoking the Nazi occupation of the 1940s. In Ireland, there is much lamentation about the threat to national sovereignty. Yesterday, the government itself was wobbling.

It is possible that the rise of nationalist and anti-capitalist parties such as Ireland's Sinn Fein will cause recipient countries to stick two fingers up to the EU – and to see whether life might be better outside the single currency. Countries such as Greece and Portugal might be a lot more competitive if they could devalue their currencies. But quitting the euro might feel like a national humiliation for members of the southern periphery. There is also no mechanism for quitting the euro in an orderly fashion. Any obvious preparations to do so might trigger a bank run.

So if the euro is to break up, the country that sues for divorce is likely to be a strong economy – with Germany as the likeliest litigant. The Germans would not take this step quickly or lightly. A commitment to European integration has been a leitmotif of German foreign policy for half a century.

But if the Germans became convinced that their eurozone partners were simply impossible to deal with – and that therefore the whole single currency experiment could not work – they might decide to quit. There are two ways I could imagine this happening.

The first is a successive wave of financial crises across the eurozone, affecting larger countries, which gradually sap German taxpayer confidence that the "loans" that the EU is extending to its weaker members will ever be repaid. The second is if, as seems quite likely, the treaty changes that the German government is demanding to satisfy its courts fail to be ratified by some of the other 26 EU members. At that point, the Germans might throw up their hands and say, in effect, "Well, we tried our best, but the other Europeans won't do what is necessary to save themselves." Germany might then feel released from its historic obligation to "build Europe".

I realise that, in setting out these scenarios, I am laying supposition upon supposition. It only takes one point in the chain of argument to be wrong and events could charge off in another direction. All I would point out is that the optimists who put together the euro – and still argue that the currency will surmount its current problems – also made a lot of suppositions. And theirs don't seem to be working out too well.

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Ireland is paying the price of three follies

Garret FitzGerald

Ireland is today facing a political as well as an economic crisis, with the government under growing pressure to resign. The inflaming of passions is all too understandable. The sorry saga, which has seen a reluctant government accept a European rescue package with the aim of restructuring its banking system, is a consequence of three major policy mistakes in the past decade, the impact of which has been compounded by two external factors.

The first error was the decision of a minister for finance earlier in the decade to double the rate of growth of public spending over several years, just after Ireland had achieved full employment for the first time in its history and had also joined the eurozone. This precipitated an increase of prices and wages to a rate well above twice that of the rest of the monetary zone. The consequent severe loss of competitiveness abruptly ended Ireland's Celtic Tiger export boom, which since 1993 had doubled Ireland's share of developed countries' exports. Between 2001 and 2009 that share fell back by one-fifth.

The second Irish problem, was, of course, the subsequent housing boom, which led to a home construction rate six times that of Britain, and which was encouraged rather than checked by the government. The resultant bubble was hugely stimulated by a banking system within which a combination of the activities of a domestic rogue bank, Anglo Irish, and of a number of foreign banks seeking a foothold in Ireland, panicked the rest of the banking system into disastrous uncontrolled competition.

It was inevitable these events would then hit the public finances. The damage there was greatly aggravated because in the closing stages of the boom the government persisted with excessive income tax reductions, financing them with taxes on what turned out to be temporary property transactions. This led to a situation in which this year, even after £12bn of tax increases and spending cuts in the past two years, the budget deficit will be €16bn, or 11.5 per cent of gross domestic product – exclusive of the cost of bank bail-outs.

This deficit is, however, being vigorously tackled. The budget due in a fortnightwill involve a further £5bn fiscal adjustment, two-thirds in the form of spending cuts and one-third in the form of tax increases. All the main political parties are agreed that over the four years to 2014 there will have to be a further £7.5bn adjustment in order to reduce the deficit to 3 per cent of GDP by that year. These proposals now have the approval of the eurogroup and Ecofin ministers.

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Also, regarding the first error, since the advent of the crisis three years ago, cost reductions, including cuts in pay in both the private and public sectors, have led to a marked recovery in Irish competitiveness, the fruits of which since last April can be seen in a little-noticed 9 per cent rise in manufacturing output, mainly for export. This extends to a majority of industrial sectors, indigenous as well as multinational. Moreover Ireland, unlike the southern European states in difficulties, is moving rapidly to a balance of payments surplus.

So, if the problem of competitiveness is being successfully tackled, and there is agreement on the steps being taken to restore Irish public finances, why is aid to Ireland necessary?

Two external factors have brought this about. The first stems from the unfortunate timing of the recent proposal by Angela Merkel, German chancellor, that bondholders should share with taxpayers the burden of future financial crises. Because it was not clear to the markets this would not apply to bonds issued before 2013, financial institutions involved panicked. A clarification had merely a temporary impact on Irish bond interest rates.

At around the same time the European Central Bank became alarmed at the apparently insatiable demand of Irish banks for its assistance. ECB president Jean-Claude Trichet may already have been coming under pressure from some colleagues over the fact that almost a fifth of ECB financial assistance was going to one small country with barely 1 per cent of the eurozone's population. As a result of this, and of concern about contagion threatening Portugal and perhaps even Spain, ECB fears crystallised 11 days ago in a call for the Irish government to seek financial aid from the European stability finance facility, together with the International Monetary Fund.

The government did not believe it needed such aid and unwisely sought to persuade the electorate there were no discussions on this, a double misjudgment that damaged it abroad as well as at home.

Happily the leading opposition parties are committed to the same fiscal targets as the government, and with what is certain to be an overwhelming majority this year, will be well-equipped to carry through the fiscal adjustment and an overdue reform of governance. Despite the gloom a very different and more effectively governed Ireland should yet emerge from this humiliating crisis.

The writer was taoiseach from July 1981 to February 1982 and from December 1982 to March 1987

Long-term corporate plans may be lost in translation

Michael Skapinker

In *A Time of Gifts*, his account of a 1930s hike across Europe, Patrick Leigh Fermor recalls sitting in a coffee house in Bratislava listening to customers speak Yiddish. "The German strain in the language always made me think that I was going to catch the ghost of a meaning," he wrote. "But it eluded me every time."

This account of an apparently familiar language drifting away occurred to me last week as Paul Polman, chief executive of Unilever, outlined his company's "sustainable living plan". Anyone who has followed corporate pronouncements in recent years should be fluent in sustainability. The opening phrases are about customers demanding that their goods be ethically sourced and that companies help preserve the environment. Fortunately, there are no losers. Sustainability requires that companies reduce their use of water, energy and packaging. This cuts costs and boosts profitability, so shareholders win too.

The Unilever briefing began in familiar fashion. Consumers were increasingly turning to socially responsible brands, such as the company's Small & Mighty concentrated laundry detergent, which washes at lower temperatures. By 2020, Unilever's transport carbon dioxide emissions would be at or below current levels in spite of significantly higher volumes. Unilever would achieve this by reducing truck miles, using lower-emission vehicles and relying more on rail and ships.

I listened for something I wasn't hearing. Where were the figures on cost savings? Where were the promises about savings flowing to the bottom line? I wasn't the only person feeling this way. Someone asked: what will investors make of this?

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Mr Polman gave an answer I hadn't heard from a corporate leader before: "Unilever has been around for 100-plus years. We want to be around for several hundred more years. So if you buy into this long-term value-creation model, which is equitable, which is shared, which is sustainable, then come and invest with us. If you don't buy into this, I respect you as a human being, but don't put your money in our company."

What was so striking is that Mr Polman said this in the week the Financial Times reported his company's shares were lagging behind both competitors' and the market. Analysts gave Mr Polman credit for six quarters of year-on-year volume growth, raised margins and greater cash generation. But they doubted his ability to maintain this pace.

Mr Polman appeared unworried. "We certainly don't want to attract the investor base that wants higher and higher and quicker results against targets that we put out every 90 days," he said. In fact, he had stopped giving earnings guidance.

What are we to make of this suggestion that short-term shareholders get lost? First, Unilever has a long history of doing well by doing good. William Lever, one of its founders, created Lifebuoy soap to encourage cleanliness and reduce infectious diseases in Victorian Britain. Today, in the developing world, 3.5m children under five die from diarrhoea and respiratory infections. Teaching children to wash their hands is a way of reducing this toll. The company sees opportunities to save lives and sell soap.

Unilever believes there is a "fortune at the bottom of the pyramid" – that companies can profit by selling cheap products to the poor. Half of Unilever's sales are in emerging markets. In India, it has 45,000 people selling door-to-door. Last week it showed off Pureit, its low-cost water purifier. Mr Polman hoped to drink imported Mumbai water after putting it though the device. UK customs vetoed this, so he downed purified Thames water.

There is business logic, too, to Mr Polman's pledge to buy all Unilever's soya beans, fruit and palm oil from sustainable sources by 2015. The palm oil promise is particularly significant. Companies, including Unilever, have faced protests over palm oil suppliers causing deforestation in Indonesia. Mr Polman has pledged to double group turnover in 10 years. That will be hard to do if Unilever's suppliers in emerging markets don't use their land in a way that helps them to carry on producing what the company needs.

Mr Polman's appeal to shareholders to take the long view is admirable, but I felt nervous about his own long-term prospects. Even the most patient investor eventually needs a decent return. If Mr Polman fails to deliver that, he may run short of supporters who understand his language.

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