Ireland's sovereign debt crisis

Both the Fed and the ECB use similar tools to implement monetary policy, although some differences do exist between the method used to manage the money and influence short term interest rates (Cecchetti & O'Sullivan, 2003).

The fed conduct an overnight repurchase agreements (repos) which are made of collateralized loans. The fed provide reserves to a small number of designated dealers in exchange for government securities, and agree to reserve the transaction at a future date. The Fed decide each morning the level of reserves to supply, by forecasting the demand of reserves the goal by doing so is to keep the federal funds rate as close to its target as possible. However, in case of sustained increases in reserves demand the Fed purchases government securities outright in the secondary market. With the reserve requirements, the Fed has another tool to stabilize the demand for reserves and also it makes it easier to control the fed funds rates. At the same time the discount rate gives us the cost of funds available to banks to borrow through the discount window. Banks are obliged to finish all other sources of financing before going to discount window. Although funds in the discount window are available at a rate lower than the market rate, borrowing in the discount window is perceived as the bank being in trouble.

According to the definition from Wikipedia, Anopen market operation(OMO) is an activity by a central bank to give (or take) liquidity in its currency to (or from) a bank or a group of banks. The central bank can either buy or sell government bonds in the open market (this is where the name was historically derived from) or, which is now mostly the preferred solution, enter into a repo or secured lending transaction with a commercial bank: the central bank gives the money as a deposit for a defined period and

synchronously takes an eligible asset as collateral (Open market operation, 2017).

1. From the perspective of the Federal Reserve and the European Central Bank (ECB), identify and explain how the short term policy rate is implemented as part of monetary policy. Describe identifiable economic target variables that these central banks attempt to control and the degree of transparency applied in implementing policy. Incorporate a discussion of how operating procedures and institutional practice are managed in the respective jurisdictions (U. S. and Eurozone). Make reference to Wikipedia’s description of Open Market Operations. Compare and contrast where appropriate. Make reference to Taylor (1993), The Cecchetti Chapters 15 and 16.

During the two decades before 2007, the Irish economy made a significant progress through implementation of wide range of policies. Those policies helped the country to stimulate productivity. The country ‘ industrial policies focused successfully on encouraging export-oriented foreign direct investment. Adding to that the country focused on improving education with large expansion of the third level sector. As result of those policies, the Irish economy outpaced advanced economies, and its labor productivity was not far from US by mid-2000. The country put a lot of people into work during the Celtic Tiger, for a country that did not have a lot of institution it was a huge labor participation. In the late 1980 the country had 1. 1 million of people at work but by 2007 It grew to 2. 1 Million. While the country in late 1980 had a low rate of labor force participation, from mid-1990 onwards Irish people who lived abroad started to take job at home. Due to that the Irish

economy became incredible employment creating machine. The country lowed tax rates and raised public spending. Given that; the country experimented a very gracious growth, and at the same time it had sufficient tax revenue to generate budget surplus. While the country was wishing for that period to last forever, things did not go like that and the bubble popped in 2007.

Factors that contributed to Ireland’s Sovereign debt crisis

Huge deficit:

Banking crisis: International borrowing of the 6 mains banks in Ireland rose from less than 15billion in 2003 to almost 100 Billion by 2007the credit boom and acceleration of housing activity were all financed by the Irish banks. Whelan (2011) stated that prior to 2003 they operated normally, with the boom they changed strategy and increased their property lending at rapid rates and financed much of this expansion with bonds issued to international investors. That created a huge exposure of the Irish banks to property developers, as the only way for the banks to get their money back was if the housing price kept increasing. As most of the property developers found misfortune during the collapse of the housing boom, it was difficult for those banks to get their money back and at the same time they found it hard to raise funds on bond markets as international investors became concern about their exposure.

In what ways is Ireland Sovereign Debt Crisis akin to the crisis experienced in other Eurozone jurisdictions. In what way is it different?

As Ireland a lot of countries in the Eurozone were operation a debt/GDP ratio above 90% prior to 2000, and with joining the Eurozone and changing currency some of them saw a growth of the economy in a way they were not expecting. The major banks of the Eurozone were all highly exposed to the losses in the US market in asset-backed securities. The end of the credit boom saw the economy growth of countries that were benefiting from it slowed down, they saw a fall in their fiscal revenues. The banking sector of some of the Eurozone countries deteriorated in way that for the outside world investors they posed fiscal risks. At one point they represented such a risk for the overall euro that they were shout out of the bond market.

While the crisis experienced by other countries in the Eurozone was in some way similar to Ireland, the difference was the other countries were running large and sustained external deficits. However, in Ireland the government through the boom of the housing market focused less on taxing income taxes but most of the revenue of the government was from taxing the property developing market. According to Philip R. Lane (2012) in Ireland the government was not a net borrower during 2003-2007 while in countries like Portugal and Greece the government and corporations were both significant borrowers.

Lane (2012) argued that the origin and propagation of the European sovereign debt crisis can be attributed to the flawed original design of the euro”. While the euro area enjoyed years of happiness and growth, it was a half concept since from the beginning it was built of the Dollar union. There was an incomplete understanding of the fragility of a monetary union during crisis. Furthermore, it was created without a significant degree of banking

union or fiscal union. While originally the monetary union was designed to tackle the over-borrowing of some countries, retaining national responsibility for financial regulation and fiscal policy never took away the risks some countries was building from years. With the euro, the fiscal risks increased before the crisis as the euro made finance available to countries which already had problem controlling their debt/GDP ratio. During the crisis it was more difficult to save the banks, and also the fiscal costs of rescuing them increased. If the euro was same as the dollar, the monetary union would have been out of the crisis quicker than what actually happened. The single currency took away the tools for a country to adjust its economy during time of crisis. First, cutting the interest rates to stimulate demand, but at the start of the crisis the ECB did the opposite and raised the interest rate, which put countries like Ireland, Portugal, Spain, Greece and others in a bad position. The second was to devaluate the currency in order to boost exports. While most countries that were hit at the same time as Euro managed to recover from the financial crisis, the difficulty of pulling the same trick failed here as the recovery is slow and some of the euro countries still hang on the edge of collapsing.

Definition and Characteristics of hedge funds

It is not clearly defined what hedge funds are, but different typical characteristics are enumerated in order to give some clarification on what they were. Stulz (2007) defined them as unregulated pools of money managed by an investment advisor, the hedge fund manager, who has a great deal of flexibility. Cottier, 2000 and Jakobsons, 2002 agreed with Stulz, 2007 on the fact that they are all form of investment funds, companies and

private partnerships that use derivatives for directorial investing. Those investments are permitted to go short and also use a substantial leverage through borrowing. Hedge funds have a limited number of investors who can participate, and also they cannot make public offering in order to avoid regulation. Ahedge fund is typically a collection of funds managed by the hedge fund manager-typically through a separately organized company, the management company (Stulz, 2017). Hedge fund managers focus on maximise the increase in investment value rather than simply perform better than average. They are paid based on the amount of wealth increase they made, and most of their compensation depends on giving investors a positive absolute return.

Stulz (2007) argued that “ the hedge fund industry may have played more of a role in creating liquidity and making markets efficient than the mutual fund industry. The hedge fund industry could do so because it was generally not regulated, so that funds were free to take whatever positions they wanted and to make full use of financial innovations.” As hedge funds are enormously free from regulations that hold back mutual funds to operate at the best capacity, they have developed a better sophisticated, unconventional and proprietary investment strategies. Hedge fund means that risks are being hedge in order, but for some hedge funds take an aggressing approach with no particular hedging policy. The fees of a hedge funds are higher and depend on the performance which distinguishes them from mutual funds. Certain funds do not have the opportunity to take short positions, invest in derivatives but investing in hedge funds give them a simple way to expand their scope of investing. Hedge funds managers are

given the chance to search for profitable opportunities that other investors do not have the resources or expertise to find. Looking at the track of top hedge funds managers, we can affirm that they very much found these opportunities. Hedge funds often make profits by providing liquidity to the markets – by buying securities that are temporarily depressed because of market disruptions (Stulz, 2017). Furthermore, a hedge fund manager focuses on achieving absolute returns by finding as many profit opportunities as possible that are immune to market gyrations-in industry lingo, generating *alpha* (returns uncorrelated to market performance) rather than *beta* (imf, 2017) .

According to Duffie and Stein (2015) how was LIBOR manipulated by Banks and Traders? What solutions do they propose?

From definition, LIBOR is the London Interbank offered Rate, it is a daily fixed rate used by the banks to borrow between each other. LIBOR play a central role as benchmark in modern financial markets. During the financial crisis of 2007-2009, banks were more concerned on the image they sent to the world. None of them wanted to be seen as creditworthy than others. As result from such behavior, when the banks were polled to produce LIBOR, some understated their costs. Which is known as a form of manipulation. In other cases, traders looking for profit on a position would ask bank officials to bias their reports. By doing so they would cause the benchmark to move one way or the other. In some instances, more significant distortions were achieved through collusion that coordinated the misreporting among several banks (Duffie & Stein, Spring 2015).

Various policymaking group that acknowledged the manipulation problem associated with LIBOR believed that it would be in the best interest of financial market to part away with the current practice. They wanted to change from the fixing LIBOR rates using judgmental submissions from a panel of banks something more secure. According to Duffie and Stein (2015) different types of solution might be worth looking into. They acknowledge that a transition from the current methodology to something might be hard to do but necessary if we wanted to tackle the problem. Their first solution was using the interest rates set by the Federal reserve as benchmark. The federal reserve set two rates: the rate it pays to banks on their excess and the overnight reserve repurchase rate. Because those rates are used to implement monetary policy and are set by Federal reserve they are shield from manipulation.

Another solution they put forward was the use of the rate on short-term treasury bills. While this market is not manipulation-proof, it is certainly much deeper and more active than the market for unsecured bank borrowing (Duffie & Stein, Spring 2015). Although this solution may provide some benefits, in some moments of stress on the economy they realised that investors tend to walk away from it. However, they concluded the merit in using should make us give some careful consideration.

Treasury general collateral risk repo rate is another near-riskless rate they argued might be a solution. It is made of the average rate at which dealers acquire overnight financing secured by treasury securities. It is a market that is highly liquid and as the treasury bill, we would expect general collateral repo rates to be robust to manipulation.

The last one is the overnight index swap, according to Duffie and Stein (2015) it pays a predetermined fixed interest rate in exchange for receiving the compounded daily federal funds rate over the 3-months term of the contract. An advantage of OIS is that it does not incorporate the same kind of safe-haven premium as Treasury bills (Duffie & Stein, Spring 2015).

A liquid derivatives market has an incentive of manipulation from the participants using the underlying benchmark. As big as the derivatives market is, one should expect a flaw in efficiently operating in and manipulation should be considered as the inevitable cost of doing business. Cause reforming the whole system at this point would cost a lot money and time and would not necessary tackle the problem.

According to Armour et al (2011) what has been the impact of bank fines on Banks. Explain the event study methodology as proposed by Armour et al (2011) to determine the impact of bank fines.

as stated by Armour, Mayer and Polo (2011) a firm’s ‘ reputation’ reflects the expectations of partners of the benefits of trading with it in the future. They believed certain types of revelation may be expected to impact negatively on trading parties’ expectations of a firm’s future performance. An announcement by a regulator that a firm has engaged in misconduct may constitute precisely this type of revelation. They observed that the penalized firms ‘ stock prices experience statistically significant abnormal losses of approximately nine times the fines and compensation paid. They interpreted the fall in equity market value in excess of mandated payments as the firms ‘ reputational loss (Armour, Mayer, & Polo, 2017).

They used the statistical method to assess the impact of the public announcement of misconduct on the value of the firms. It was done in order to see how the investors respond to such news about the firms. The basic idea is to calculate the irregular price reaction around the event, using the market model as benchmark model for normal returns. They used a pioneer methodology by Fama et al (1969) which evaluates the reaction of stock price to the public announcement of misconduct. Adding to that They followed the " residual approach" used by Jarrel and Peltzman (1985), Karpoff and Lott (1993) and Karpoff, Lee and Martin (2008).

Using 260 days period, they analysed the ordinary least square regression of $R_{i,t}$, and $R_{m,t}$ which are the returns on firm *i* ' s common stocks on day *t* and the index of market returns on day *t* . They use this formula" Reputational loss = Î" Vt – Fine – Compensation" to measure the reputational losses. After getting the 3 days' average cumulative abnormal returns of -1. 68% which represent an average of the effect of all press statements. Then their sample was decomposed into cases which characterised investors and customers and also third parties in order to see the effect of press statements referring to misconduct that affected them. In the third parties group we had entities like the states, other companies' investors. Doing this allows us to see that shareholder wealth effects are highly dependent on this stratification (Armour, Mayer, & Polo, 2017). They observed that there is a -2. 62% share price drop when the wrongdoing affects the customers and investors, a 0. 24% increase when it is third parties. This is consistent with theories which suggest that revelation of information of misconduct by a firm will cause its trading partners – its customers and investors – to downgrade

their assessments of its quality and adversely affect its terms of trade (Armour, Mayer, & Polo, 2017).

Why is banker pay relevant?

Are bankers paid too much for what they are doing as job? Why even after the financial crisis bankers are still paid huge sum of money when other workers in different sectors saw their salaries cut due to the recession? Those are some of the questions that have been bothering people for quite sometimes now. Bebchuk, Cohen and Spamann (2010) performed an analysis using the period of 200-2008. They compared the performance of companies directed by top earning CEO to their salaries. In order to analyze if they were really worth paying those salaries.

They found that those companies operated on incentive basis. Those firm’s bonus compensation structure, gave executives the incentives to seek improvement in short term earning figures even at the cost of losing the investments in the future. Originally the executives take the money and invest them to maximize the profit. The higher the risk the more profit the investments will make. Most executives focus on the bonus they will collect on those investments, the higher the risks they are taking, higher will be the bonus they will collect. And when the investments go bust and turn into massive losses, they still hold on to the bonus they made. Most banks arrange their pay in that way because they want excessive profitability. Most banks will prefer to retain the services of extraordinarily talented traders. In order to attract those people, they are ready to pay substantial premium for their services. In football you have Messi and Ronaldo and the rest follow,

same principle with top traders (best CEO). The decision bankers make not just affect the bank but the economy as a whole which is why most firms are willing to provide a good incentive in order to be profitable. Also there is a notion that if you pay a banker in a good way it perform better.

In the aftermath of the financial crisis of 2008-2009, there widespread beliefs that executive pay arrangements could have encouraged excessive risk-taking and that fixing those arrangements will be important in preventing similar excesses in the future (Bebchuk, Cohen, & Spamann, 2017). They argued that during the period 2000-2008, top executives of Bear Stearns and Lehman Brothers cashed large amounts of performance-based compensation. Annual salaries of those top executives have hardly changed, and kept increasing due bonuses. During the crisis, top bankers in 2011 had their pay fully recovered to the point where they were getting more money than before the crisis. If bankers are paid in a competitive labour market and simply rewarded for their talent, there seems little reason for government intervention, at least on efficiency grounds. That was why in late July 2011 the European commission unveiled its proposals known as CRD IV which covered the following area

- the bonus cap

It restricted the senior staff bonuses to 100% of their fixed remuneration in any given year or 200% with agreement of shareholders. It recommended performance pay based on a combination of an assessment of the individual and the overall results of the firm. In addition, performance should be assessed in a multi-year framework in order to ensure that the assessment

process is based on longer-term performance and that the actual payment of performance-based components of remuneration is spread over a period which takes account of the underlying business cycle of the credit institution and its business risks (Ferrarini, 2015).

- the Pay Out Process Rules
- the de minimis principle

While the CRD IV proposed a very good alternative for banker’s remuneration, it is apparent that the application of such are doomed to be limited by the sad reality of our world. It has said the bonus cap is counter-productive, because it drives up fixed pay, reduces firms’ cyclical cost flexibility and perversely makes material risk takers less personally accountable for risk management failures, by reducing the proportion of their pay that can be lost as a result of any failure (out-law, 2017). It is natural that cutting the incentive of getting high compensation through bonuses would encourage most of the senior staffs to seek a different way to maximize their profit. It will put pressure to increase fixed pay and . Another limitation is the one size fits all approach taken to tackle the problem. Not all the credit institutions are the same, so an incentive structure that may work for one firm is not necessarily suited to another.