John Hurley: Economic assessment and the role of the Central Bank

Opening statement by Mr John Hurley, Governor of the Central Bank & Financial Services Authority of Ireland, to the Joint Oireachtas Committee on Economic Regulatory Affairs, Dublin, 10 March 2009.

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Good morning Chairman and members of the Joint Committee. Thank you for the invitation to speak with you today. I am accompanied by Tony Grimes, the Director General of the Central Bank, and Tom O'Connell, Assistant Director General, Economics.

I am aware that the Chairman and senior officers of the Financial Regulator were before this committee recently dealing with their own area of responsibility. In my own opening remarks today, I would like to update the Committee on our current economic assessment, and to outline briefly the on-going role of the Central Bank in dealing with the various issues that confront our financial system. I will refer to the international debate concerning how central banks and financial supervisors can work better together to reduce the chances of events like these happening again. In this context, the Taoiseach announced recently the Government's intention to incorporate both central banking functions and prudential supervision in a unitary organisation.

Economic assessment

The disruption to global financial markets, which was triggered in August 2007, has evolved into the most severe systemic crisis in almost a century. The extent of the turmoil has been far worse than was envisaged and it is still very unclear when the crisis will end and what the ultimate effects will be. The financial crisis has fed directly into developments in the global economy. Prior to the collapse of Lehmann Brothers in mid-September it remained unclear how big an impact the financial turmoil would have on real economic activity. The subsequent broadening and intensification of the financial crisis has led to a rapid deterioration in confidence, a development encapsulated in the substantial and persistent downward revisions to global growth forecasts that have taken place.

For example, in July last year, the IMF was expecting global growth of 3.9 per cent in 2009, a development that they described as "a pronounced slowdown". Since then the Fund has issued three new forecasts as it became increasingly obvious that the financial turmoil would have a significant effect on real economic activity, and its impact would not be limited to the advanced economies. This included taking the unprecedented step of issuing two forecasts in the final quarter of 2008. In October, the global growth projection was revised down to 3 per cent, in November to 2.2 per cent and most recently, in January, to 0.5 per cent. This latter revision was particularly sharp, and if correct would represent the slowest global growth rate since World War II. The situation in advanced economies is actually worse as, within these global growth projections, the significant downward revisions to growth in the advanced economies, which are expected to contract this year by 2 per cent, are balanced by relatively better performance in emerging markets.

These exceptionally unfavourable global economic and financial conditions are making our own already very difficult domestic economic situation worse. Ireland is now experiencing an unprecedented contraction in output, which is set to persist this year and next. While the initial downturn in activity was driven by the sharp decline in the Irish property and construction sectors, this has now broadened out into a marked weakening of domestic demand, which is being significantly amplified by the contraction in export demand as a result of the movement into recession of all our main trading partners. Reflecting the scale and speed of developments, Irish economic performance has deteriorated markedly – the contraction in activity has deepened significantly, there has been a sharp rise in unemployment and a rapid deterioration in the fiscal position. With the global recession deepening and domestic demand exceptionally weak, the overall outlook for growth has continued to deteriorate in recent months. Based on what is currently known, our latest unpublished estimates suggest that GDP will fall by over 6 per cent this year, with a broadly similar fall likely in the level of employment. This is likely to result in an unemployment rate averaging over 11 per cent for the year. However, risks to this outlook remain to the downside.

No one should be in any doubt about the seriousness of the global situation, which is not easing, and the seriousness of our own difficulties. We face significant challenges and it is critical for present and future generations that we work together now to confront them. If we do so, our economy will recover and has the potential to grow solidly again in the medium term. Our economy's strengths are important in this respect. We still have favourable demographic trends, there is the capacity for a rebound in productivity growth, the Irish labour market continues to be more flexible than most and at the start of the crisis public debt as a percentage of GDP was low. However, the achievement of this potential is not inevitable and is contingent on sound economic management. This calls for timely and what are inevitably unpalatable measures in the short-run to ensure that the public finances remain sustainable, as well as pursuing policies that help restore competitiveness and, over the medium-term, provide the platform for realising growth potential. The significant measures already announced in relation to the public finances, in addition to those to be adopted over the coming weeks, signal our determination to make this difficult adjustment.

Against this general background, the pressures on the Irish financial system have intensified significantly. Irish banks continue to face very difficult conditions. Their share prices have declined dramatically over the past year. The impact of the marked deterioration in the wider economy on the banking sector is a key concern. However, recent Government actions with respect to the banking system demonstrate a commitment to take whatever measures are necessary to stand behind the financial system. Most recently in this context, the Government, in a similar fashion to those in many other countries, announced details of its recapitalisation scheme for the two major domestic banks. This increases the main banks' core Tier 1 capital ratios, which are regarded as a key indicator of financial soundness. In addition, under the terms of the recapitalisation package, there is provision for a greater supply of credit to the real economy. The two main banks have confirmed their commitment to increase lending capacity to small- and medium-sized enterprises by 10 per cent and to provide an additional 30 per cent capacity for lending to first-time home-buyers in 2009.

As part of the recapitalisation package the Government announced that it is looking at other possible measures to enhance the stability of the overall financial system. Discussions are underway with the other domestic financial institutions covered by the guarantee concerning their respective capital positions. In the context of the six-month review of the Guarantee Scheme, consideration is being given to adapting the scheme to facilitate longer-term bond issuance. In addition, the Government has announced its intention to examine proposals to mitigate the impact of risks related to specific exposures on the assets side of banks' balance sheets, in line with ongoing work on this issue at European level.

The role of the Central Bank

The Central Bank has responded to the unfolding crisis in a number of ways.

Provision of liquidity

The Irish central bank, on behalf of the Eurosystem, and along with central banks globally, has been providing significant volumes of liquidity to the banking sector, since major financial stress began to become evident in autumn 2007. The Eurosystem entered this crisis with a relatively broad collateral framework for supplying liquidity to banks. It has made its liquidity more easily accessible for banks by widening its list of eligible collateral, providing the funds on a full allotment basis and extending the maturity of its operations. This has been of significant benefit to our own banks and, indeed, other banks throughout the system.

Euro area monetary policy

In response to the turmoil, and the associated impact on the real economy, central banks in all the major economies, including the Eurosystem, have eased monetary policy, in many cases to levels not previously seen. In this regard, the Governing Council of the ECB has cut its policy interest rate by 2 ¾ per cent since the beginning of last October. Despite tensions in financial markets, this has had a significant impact on interest rates at the retail level. Of course, uncertainty concerning the economic outlook remains very high and, as always, the Governing Council will continue to monitor closely all developments. You will also be aware that some central banks have also started to engage in more non-standard monetary policy operations, such as the outright purchases of private and public assets. I should mention that the ECB is currently studying possible non-standard monetary policy measures.

Contributing to financial stability

Through the formulation and publication of financial stability assessments, central banks in the major industrial countries draw attention to risks to the financial system. In our annual Financial Stability Reports, Quarterly Bulletins and other public statements, the Central Bank has highlighted risks to financial stability. The major risk was identified as the interaction of a significant international shock and certain vulnerabilities in the domestic economy relating, for instance, to property prices, credit growth and the extent of the banking sector’s reliance on wholesale funding. However, our financial stability reports and the warnings they contained, no less than those in similar reports issued by other central banks, were not as effective as they might have been as they did not lead to a sufficient or timely change in behaviour. But for the massive deterioration in the external environment, these risks would have been more manageable, albeit with difficulty.

Financial regulatory architecture

In the light of the crisis over the past two years, there is recognition that the architecture of financial regulation and supervision, both here and internationally, needs broad-ranging review and reform

Within the European Union(EU), the European Commission’s High-Level Group on Cross-Border Financial Supervision, chaired by Jacques de Larosière, has completed an urgent review of financial supervision in the European Union and reported its findings two weeks ago. This Group was mandated to consider the future of European supervision and regulation in light of the financial crisis. Their Report summarises the serious situation that we are all facing and I quote *“[s]ince July 2007, the world has faced, and continues to face, the most serious and disruptive financial crisis since 1929. Originating primarily in the United States, the crisis is now global, deep, even worsening. It has proved to be highly contagious and complex, rippling rapidly through different market segments and countries. Many parts of the financial system remain under severe strain. Some markets and institutions have stopped functioning. This, in turn, has negatively affected the real economy. Financial markets depend on trust. But much of this trust has evaporated.”* The Group concluded in its review that there have been real and important supervisory and regulatory failures. They suggest two initiatives to repair the supervisory and regulatory system within the EU.

First, there is a recognition that, while financial stability reports produced by central banks make a significant contribution to the analysis of risks and seek to influence financial market participants through “moral suasion”, there is a need to add operational effectiveness to these reports, to ensure that the risks identified therein can be acted upon in more specific and timely ways. This is the weakness in existing arrangements that has been highlighted by the current crisis. At the European level, the de Larosière group recommends that a European Systemic Risk Council should be set up under the auspices of the European Central Bank(ECB) and chaired by the President of the ECB. Its role will be to gather information on risks to the wider financial system, commonly labelled macro-prudential risks. However, of crucial importance, is the Group's proposal for a mechanism to ensure follow-up action on these issues by supervisors across the EU.

Second, they propose a new European System of Financial Supervision – essentially an integrated network of European Financial Supervisors. Existing national supervisors, who are closest to the markets and institutions they supervise, would continue to carry out day-to-day supervision but a European centre would coordinate the application of common high level supervisory standards and guarantee strong cooperation with other supervisors. Further, supervisors will operate in a changed international regulatory environment. The Group pointed to weaknesses in many international regulations, such as capital requirements and accounting standards, which they recommend should be reflected upon and revised.

The Government's recently announced plans to reform the regulatory structure here dovetails with these international developments. The proposed arrangements envisage a much more explicit link to be put in place between financial stability and prudential supervision. While the specific details have yet to be announced, we look forward to working closely with Government and other relevant parties on the full implementation of those reforms, to ensure that our arrangements evolve in line with best international standards and that the new approach is implemented rigorously.

Both myself and my colleagues are available to take your questions now.