Patrick Honohan: International credit and financial market integration – after the storm?

Opening remarks by Mr Patrick Honohan, Governor of the Central Bank & Financial Services Authority of Ireland, at the 8th INFINITI Conference on International Finance, Trinity College, Dublin, 14 June 2010.

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It is a pleasure to open the 2010 INFINITI conference, an acronym I understand to mean "international financial integration studies at Trinity". Research on international financial policy issues has never been more important in Ireland and abroad than it is now. The Great Financial Crisis has thrown up many key questions for research.

Our own experience in Ireland has many international financial ramifications. For, even if I have been emphasising recently how much of Ireland's banking difficulties were home grown, they have certainly occurred in an international context. Ireland is one of the most globalised economies in the world – one indication: the ratio of exports to GDP approaching one (which, by the way, you will realise is not a theoretical upper bound). And its property price and construction bubble was financed to an important extent from abroad. Over a four year period 2003–2008 net indebtedness of the banks to the rest of the world jumped from 10 per cent of GDP to over 60 per cent.

Interestingly, this foreign borrowing was not only used to finance the domestic property bubble but also to finance property development abroad – mirroring a common phenomenon of high income countries incurring foreign debt to acquire foreign equity – in this case equity in the property market some of which did not perform too well.

And there was another international development that was important in igniting the property boom. In line with Shiller's theory of how bubbles get going, a myth that a new economic era was unfolding drove expectations. Thus there was not only an unrealistic expectation that the Irish economy would grow beyond the sustainable level of output – close to the production frontier and at full employment – which it had achieved in the Celtic Tiger period based on sustainable improvements in competitiveness and efficiency. In addition, the sharp fall in nominal and real interest rates on euro entry led many investors to exaggerate the degree to which a higher capitalization rate would apply to long-lived assets such as property.

What new areas come to the fore now as topics for study? I would like to emphasise a number of issues which relate to the interaction of fiscal and banking policy. The direction of the interaction is two-way. Banks can affect the fiscal position, as in Ireland when first the property-related transactions, capital gains and profits taxes generated by the bank-led property bubble induced the government to become reliant on such transient forms of tax revenue, creating a vulnerability in the fiscal position.

Likewise, when it became evident that there would be banking losses, the uncertain scale of these losses hung over the public finances as a threat. At the Central Bank, we have dealt with the latter problem by applying quite severe stress tests to the banks, and requiring them to inject additional capital this year, with a view to ensuring that, after they have transferred their big property loans to the National Asset Management Agency (which is purchasing them at a price related to market value, and thus at a deep discount to book value), and after they have absorbed further losses that can be expected as a result of the recession, they will come through this loan-loss cycle with a comfortable buffer of core tier 1 capital – 8 per cent in the base case, which itself is more pessimistic than that of the banks, and 4 per cent even under a severe stress. When this recapitalisation is completed, the market will be able to take comfort from the removal of the large uncertainty that was hanging over both the banks and the government's accounts.

Conversely, the fiscal position can affect the banks, and we have seen this recently in Europe with heightened market concerns about the fiscal situation in some countries have spilled over to banks and sovereigns, in turn hampering the transmission of low monetary policy rates throughout the euro area. Frozen interbank markets reflected what seemed an overblown response to perceived fiscal risks.

We've seen an extensive policy response to tackle this. Not only quite sharp fiscal adjustment measures, but a huge commitment of public funds – some €750 billion, which is huge in relation, for example, to the outstanding stock of debt in the countries affected. There's also the ECB's Securities Market Programme, directed at promptly unblocking money market conditions.

Clearly, then, this interface between fiscal and banking conditions is a fruitful area of policy research right now.

Let me just mention two specific issues within this. First, the Stability and Growth Pact, which needs the addition of a focus on sustainability of the fiscal accounts, and not just on a particular deficit or debt level. Ireland was not the only country for which the downturn had a very unusually sharp and large impact on the deficit reflecting the unsustainability and transient nature of a large part of the tax system, For me there is a lesson here from banking regulation. Just as banks are required not only to make provision for expected loan losses in their accounts, but also have to hold capital reserves to meet unexpected losses, the SGP targets should make allowance for the risk that unexpected fall-offs in revenue may occur.

Finally, a word on the taxation of financial intermediaries, which is back on the policy agenda. I see that Financial Transactions Taxes are being discussed again, though I suspect that the conclusion will be that they do little for improving the efficiency or safety of the financial system (they would have done nothing to discourage derivatives related to sub-prime lending, for example), and also would not generate as much revenue as some suppose.

Nevertheless, it does seem possible to use some form of Pigouvian corrective taxation as a kind of graduated type of regulation, potentially better than outright banning of products, and a useful complement to the regulation-by-ratio that has become the norm over the past quarter century.

With such a long list of researchable topics, I look forward to seeing a large international attendance again at INFINITI, and I declare the 2010 conference open.