Jörg Asmussen: The Irish case from an ECB perspective

Speech by Mr Jörg Asmussen, Member of the Executive Board of the European Central Bank, at the Institute of International and European Affairs, Dublin, 12 April 2012.

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Dear Mr Halligan,

dear Mr. O'Ceallaigh,

dear Ladies and Gentlemen,

Introduction

Coming to Ireland yesterday was a very short journey for me, leaving my office in Frankfurt at 3 pm and arriving in downtown Dublin at 6 pm. On the way from the airport my Counsellor, who is accompanying me today, remarked that Ireland, however, has apparently come a long way compared to the time when she visited Ireland for the first time as a backpacking student almost 20 years ago in the early 1990s. While she recalled that her first impression of travelling from the airport downtown was rather sad, with run down warehouses and poor residential buildings, the picture has completely changed: modern office buildings and residential areas line the streets on the short trip from the airport to downtown nowadays.

This is anecdotal evidence, of course, but I think it depicts in a nutshell Ireland's truly remarkable economic development over the last 20 years. Ireland managed to find a unique selling proposition in the European context and made use of the instruments the European Union offers to foster economic development and growth such as the structural and regional funds in a very smart and sustainable way.

Nevertheless, the Celtic tiger was not immune to the challenges that the financial crisis posed to many of the world's advanced economies. On the contrary: Ireland has had to deal with more severe challenges than most. Much has been written about how Ireland arrived in this position.

But let me state this right at the beginning: Ireland is not the only country that needs to reform. Fiscal consolidation and growth enhancing structural reforms are needed everywhere in Europe to remain competitive on a global marketplace. Ireland is, however, one among several countries with more severe adjustment needs.

Our view is that to set the correct course, we must be clear-headed about the reasons why we are where we are. To frame the issue somewhat bluntly, the Irish State and people woke up to a painful new reality when the Irish housing bubble burst at the onset of the international financial crisis in 2007. Extraordinarily high growth in the run up to the crisis had gone hand-in-hand with the build-up of economic and financial imbalances.

The path back to full fitness has been enormously difficult and entailed wrenching economic, financial and social change. And the path has not been smooth. Indeed, about one-and-a-half years ago the economy was close to cardiac arrest. The patient required life support – kept alive with the substantial assistance from international lenders, as well as the continued levels of extraordinary support from the Eurosystem. But progress since then has been good: the programme is on track. So far, Ireland has delivered. I am confident it can be a "success story".

Nonetheless, substantial challenges remain. Ambitious structural and financial reforms are still needed: to put unemployment on a downward trajectory; to ensure that government finances are put on a sustainable path; and to secure a banking sector that can stand on its own feet again and support the Irish economy.

And that last item – financial sector repair – is absolutely crucial. The support from the Eurosystem in the form of monetary policy and emergency liquidity loans to Irish banks has been extraordinary by any measure.

With these considerations in mind, I would like today to start by considering, first, the origins of the crisis. I will then discuss some macro-fiscal aspects of the adjustment process. However, I want to spend the majority of my remarks discussing, thirdly, financial sector issues and the role of the ECB. I would like to present a clear view on how the ECB has supported Ireland through the adjustment process, working as a true partner to help this country resolve its problems.

1. The origins of the crisis

A somewhat colloquial, description is that when the bubble burst, the economy was lacking competitiveness, that it was unfit and overweight. Is that really a fair description of the Irish economy around 2007? It is perhaps a little harsh – it clearly misses some of the important strengths that still underpin the Irish economy and which will be crucial components of the recovery in the years to come. Yet we can see many elements of the Irish situation in the years 2007 and 2008 in that description.

Lacking competitiveness: clearly, wages and prices had risen much too fast since the start of monetary union. From 2000 until 2008 wages (compensation per employee) in Ireland increased on average by nearly 6% per year, more than twice the rate seen in the euro area. This eroded Ireland's competitive position. Unit labour costs had risen by 50% between 1998 and 2008 while they had risen by only 19% in the euro area during the same time.

Unfit, in various aspects of its national economic and especially supervisory policies. All of this made it not well equipped to counteract the emerging imbalances at an early stage and to match the challenges facing the economy when the crisis took hold. Ireland's current account deficit was 5.3% in 2007 and accounted for 5.6% in 2008.

And certainly overweight, in some sectors at least. Ballooning credit and spending excesses had overheated the economy and misdirected resources. In 2007 Ireland was an economy that had become dangerously dependent on construction and housing as a source of economic growth and tax revenue. Overly optimistic expectations both in the private and the public sector played a major role. An over-sized and lightly-regulated financial system not only fed on these excesses but actively supported them. And government expenditures had been set on a clearly unsustainable course, based on the false assumption that very high tax receipts stemming from the booming housing sector and exceptional real growth where a lasting feature of the Irish economy. For example, from 1998 to 2010 nominal public wages per government employee increased by more than 90%, significantly outpacing public wage increases in most other euro area countries by 40 or more percentage points. Only Greece saw larger increases than Ireland.

2. The adjustment process

As anyone who has ever undergone the grinding process of recovering fitness will attest, the process can be long and painful. And so it has proved. Domestic demand has shrunk. This was unavoidable as both public and private spending had increased to levels well above the sustainable productive capacity of the economy. Unemployment has strongly increased.

Programme milestones

I would identify three major milestones of the macroeconomic and fiscal adjustment programme:

- First, a return to growth, already in 2011.

- Second, the progressive return to market funding well in advance of the end of the programme in 2013.
- Third, reaching a fiscal deficit of 3% in 2015.

Measured against these milestones, I must admit that I am truly impressed by the way Ireland has handled its tough challenges, especially since the beginning of last year: the economy is well on the way to restoring competitiveness, reducing the fiscal deficit (–10.6 in 2011; –8.6 goal for 2012), overhauling the institutional framework and restructuring the banking sector. It is the only programme country that has managed to close its trade deficit and to return to growth last year, even if at modest rates (0.7% in 2011; projections: 0.5% in 2012; 2.0% in 2013). This turnaround would not have been possible without Ireland's biggest asset: a talented, well-educated workforce. This strength is maybe most clearly reflected in the fact that the export sector has continued to attract foreign investment in the midst of one of the worst crises to hit the world economy in the last century.

Structural reforms

True, structural reforms are helping to restore competitiveness and flexibility, and Ireland, all-in-all, benefited from a much more flexible labour market than, for example, Greece or Spain. It is true that some of the structural reforms will take time to show full effect, but their capacity to improve the situation for ordinary citizens should not be underestimated. Just to give you some examples: the market for legal and medical services is currently being deregulated and made more competitive. This is something that will lower prices for Irish consumers, expand activity and increase employment. In the labour market, an important overhaul of employment contracts has been announced. This should lead to a more modern and flexible system to align wages to productivity in particular sectors or firms. This will improve prospects for domestic firms to hire staff.

A long way to go…

But we must remain honest with ourselves: even though considerable progress has been made, we still have a long way to go before the situation normalises. House prices have continued to fall. The domestic economy remains fragile. And there is still considerable work to do on fiscal and structural reform. This is of course very demanding for Irish households who have already seen their disposable income and wealth decline a lot over recent years. It is thus important that also the relatively rich and wealthy carry a fair share of the adjustment burden. Worst of all, perhaps, is the fact that a large portion of the population is currently out of work. This makes job creating structural reforms so important.

The deep recession, high levels of public spending, a narrow tax base and the burden of supporting the financial sector have all have put stress on the fiscal position of the State. As a result, the fiscal deficit has surged. The government has therefore rightly embarked on a path of progressively cutting expenditures while taxes have had to be increased.

But here there are no easy solutions either. Whether inside or outside a monetary union, fiscal consolidation would be required, in the best interests of the country. Put simply, a government cannot for long periods spend substantially more than it receives in revenues. Too often, I think the debate misses this simple but crucial point. Fiscal consolidation is also not simply a consequence of the banking collapse. The financial crisis has clearly added to the Irish debt burden, but we must not lose sight of the continued high deficits run in Ireland, which must be brought under control.

Let me briefly put my remarks on the need for fiscal consolidation in Ireland in a broader European context: At the European level, the crisis revealed clear gaps in the framework for fiscal and economic governance in the EU. The reform effort to close these gaps, have been substantial with the six pack, the two pack and the fiscal compact, to use Brussel-style acronyms. All initiatives aim at one goal which is to establish fiscal rules and achieve a degree of fiscal co-ordination which lives up to the requirements of a monetary union. In our view, the steps taken so far are necessary, but they will not suffice in the long term. Further steps towards a fiscal union are ultimately needed. But enhanced fiscal co-ordination does not necessarily imply and must not be confused with further fiscal centralisation on the European level. There are many ways to organise fiscal co-ordination in a decentralised manner, Germany, Switzerland, the US, Canada and India are examples of how a fiscal union can be organised in different ways.

I would like to make it very clear that I by no means have the intention to lecture an Irish audience on the best way forward for Ireland as regards the fiscal compact. This is to be decided by the Irish voters in the upcoming referendum at the end of May.

From an ECB perspective, a crucial element in overcoming the sovereign debt crisis in Europe is to regain confidence of market participants in the sustainability of public finances. Therefore we believe it to be of utmost importance that all euro area members adopt – and implement – the fiscal compact.

For the Irish economy to achieve full fitness it is of course also necessary to heal the wounds that caused so many of today's problems. Let me therefore turn attention to Ireland's financial sector.

3. The financial sector and the role of the ECB

The role of the Eurosystem in Ireland over recent years, and more specifically that of the ECB, has often been misunderstood. Sometimes, it has been misrepresented. I would like to take this opportunity to set the record straight.

Relative to the size of the economy, no other euro area country has received so much support from the Eurosystem. And no other institution has provided more help to Ireland than the ECB. EU/IMF programme finances combined are EUR 67.5 billion in total. Eurosystem liquidity support – to all of Ireland's eligible banks – has often been more than double that amount. And let me recall that Eurosystem loans currently carry much lower interest rates than the loans from the IMF and EU Member States.

To be clear: ECB support and IMF / euro area member state support are not on an equal footing. They are no substitutes and for good reasons there is a distinction between central bank funding and fiscal financing.

By the time the programme of financial support was agreed with the international lenders in late 2010, the ECB had already been providing extraordinary levels of support for several years. To continue the analogy, the Eurosystem was providing life-sustaining transfusions to the banking system. While this support was fully in line with the general rules applied by the ECB to all euro area countries, Ireland benefited more than any other country as its banking sector imbalances were particularly large.

The ECB was thus an established key partner of the Irish authorities in staving-off the worst effects of the crisis, well before the EU/IMF programme was designed. This state of affairs is a far cry from the claims that the ECB "bounced" Ireland into the programme in late 2010. By that time, we had already been standing for quite some time with Ireland, and that remains the case today. This support would, of course, not have been possible had Ireland not been in the euro area.

Before the EU/IMF programme was agreed, the total Eurosystem loan support for Ireland (combining monetary policy operations to all eligible banks and emergency liquidity assistance from the Central Bank of Ireland) amounted to about 100% of Irish GDP. Our total loan provision now stands at above EUR 125 billion.

There are however statutory limits to what the Eurosystem can do, and a clear dividing line between the tasks of a State and the tasks of a central bank. There can also be no doubt that the current amount of liquidity support extended by the ECB and the Central Bank of Ireland to Ireland's banks needs to be substantially reduced over time, and we expect that the Irish authorities and the banks are working hard to achieve this. For Ireland's economy to recover, its banking system must be sound and fully functioning. A virtuous cycle must blossom. That will be difficult to instil with banks that remain dependent on Eurosystem support. With measures in place to break this dependency, the conditions will be in place for recovery.

The foundation for this recovery has already been laid. In late 2010, the ECB played a key role in mitigating the challenges facing the banking system, and in designing programme measures to reverse the situation. I hope you share my view that these measures achieved their initial aims: the stabilisation of the banking system.

I know that the decisions concerning the repayment of bondholders in the former Anglo Irish Bank have been a source of controversy. Decisions taken by the Irish authorities such as these are not taken lightly. And the consequences of subsequent actions are weighed carefully. It is true that the ECB viewed it as the least damaging course to fully honour the outstanding senior debts of Anglo. However unpopular that may now seem, this assessment was made at a time of extraordinary stresses in financial markets and great uncertainty. Protecting the hard-won gains and credibility from the early successes in 2011 was also a key consideration, to ensure no negative effects spilled-over to other Irish banks. Determined action and a willingness to take tough, even controversial decisions, has placed Ireland's financial system on a steadier footing.

A necessary step for Ireland to emerge from this crisis will be to ensure the long-term viability of the banking system as a pillar of the Irish economy. Doing so will further enhance confidence in the system and limit the burden that the banking system places on the taxpayer. Any proposal to reorganize and strengthen the Irish banking sector, and in this context to replace promissory notes with support from the EFSF must meet important criteria, including that it should improve the chances of both the State and the banks returning to market-based funding, and of the banks reducing their extraordinary reliance on the Eurosystem. The ECB is ready to work with the Irish authorities on such proposals.

I understand the strong desire of the authorities to minimise the costs associated with the banking sector rescue, including costs incurred to date, and those still to come. Let me make some comments in this area. When the programme for Ireland was designed, the costs of the banking sector measures already in place, including the promissory notes, were fully factored in. The annual cash repayments of promissory notes is thus financed by programme resources. That programme is on track. Any deviation from that programme should be considered very carefully indeed. The perceptions that have built-up around Ireland's successes in the programme should not be jeopardised. It has been hard-won and it is worth fighting for. Therefore, the ECB remains of the opinion that Ireland should honour its commitments stemming from the promissory notes, as foreseen. This in our view is the best way to regain sustainable market access.

I frequently hear in the Irish debate the sense that the debt resulting from the bank rescue is not Ireland's debt. I can understand this sentiment and how many people feel about this situation. But what must be understood, is that in the run-up to the crisis, insufficient domestic policies (banking supervision and economic policies) played a major role in excessive credit growth and risk management failures in the Irish banking sector, the bubble in the housing market and the loss of competitiveness.

The ECB has no supervisory responsibilities, despite claims to contrary. However, the ECB had warned years before the crisis that imbalances were building up in a number of euro area countries. Moreover, from a market perspective, those debts associated with the banking crisis are not differentiated from other sovereign debt. With the guarantee of 2008, large parts of the debt of Irish banks became a debt of the State, and any desire to offload this debt could have dire consequences. Furthermore, to suggest that debt-relief should be considered risks undermining the programme by inferring that it is needed, when as I mentioned, the programme is on track and Ireland has very good chances to return to markets before the end of the programme, secure debt sustainability, and along with it, a bright future.

Conclusion

Let me conclude, Ireland has received unprecedented support from other European Member States. The Eurosystem has, within the limits of its mandate, been very supportive of the Irish banking sector, and thus of the programme for Ireland.

Eurosystem financial support provides a good example about the difficult balancing act which policymakers currently face: wean the patient off the support too quickly and we might set back the recovery. Leave it too long and we risk dependency, undermining efforts for adjustment and impeding the return to full fitness.

The ECB is obliged and can be trusted to always fulfil its role and deliver on its Treaty mandate, and this is above all to secure price stability in the euro area as a whole, which consists of 17 countries. And there are clear limits to what the central bank is entitled or even able to do. It is impossible for the ECB to provide guarantees or assurances concerning future funding amounts or interest rates over the medium term. Certain tasks should and can in Europe only be dealt with by the Member States, and not by the ECB or the Central Bank of Ireland. Our common objective therefore must be to reduce over time the reliance of Irish banks on central bank funding and in particular on the emergency liquidity assistance.

The Irish government has the capacity to further consolidate and implement the necessary reforms, so that there will be no lingering doubts about the sustainability of government debt. I am thus confident that Ireland will continue to fully implement the necessary adjustment and reforms, and that on this basis, Member States will continue to show solidarity towards Ireland.

I understand that Minister Noonan has said that champagne corks will be popped on the night the Troika leaves Dublin. As long as Ireland continues to implement fully its programme and preserves its credibility as a State that honours all its obligations, I think that day will come in the not too long future, at the end of this programme in 2013. And what will the ECB be doing on the day the troika returns home? Well, we won't perhaps be engaging in similarly wild celebrations – we are central bankers, after all. But I suspect that I, and my fellow board members, may raise a quiet toast to the achievement of a country in so admirably fighting its way back to solvency and stability. I wish you continued success in meeting that goal and we stand ready to work with you in achieving this goal.