Patrick Honohan: Speeding up the economic correction

Remarks by Mr Patrick Honohan, Governor of the Central Bank of Ireland, at the Annual Meeting of the Irish Economic Association, Dublin, 26 April 2012.

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After five straight years of decline in, for example, employment and in aggregate personal consumption expenditure, the Irish economic correction is proving to be quite long-drawn out. Even if, on these indicators the turnaround will come in 2013, as is forecast by most analysts, it is not unreasonable to wonder whether more could and should be done to accelerate the correction. Members of the Irish Economic Association are collectively well-placed to contribute to this debate and for this reason I would like to take the limited time at my disposal this evening to touch on three dimensions of the adjustment which might be thought to moving slowly: (i) the property market; (ii) the banks and (iii) the fiscal position. Given the limited time, I can only be very selective, with the intention to promote debate rather than to present settled findings.

1. Property prices – taking their time to reach the bottom

There are a good number of open questions about the residential property market. Why is it that prices have been taking so long to reach their new equilibrium? One reason of course relates to the willingness of banks to allow arrears to accumulate without foreclosure. This reduces the supply of properties on the market. (Impatient buyers who want to occupy may be prepared to buy even though they know the price is above equilibrium. There may be more of these than of impatient sellers, given the patience of banks. Patient buyers (waiting for equilibrium prices) and owner/occupiers availing of moratoria and who hope to stay in occupation will not transact. The end result: very few transactions and those that do occur are disproportionately at above equilibrium prices.)

Until the March data published today, prices have nonetheless been falling – and in recent months faster than before (according to the CSO series on the prices of properties where the purchase is financed by banks, which refers to loan drawdown date and as such lags contracted prices). When will the price equilibrium be reached, and when will transaction volumes reach steady state levels? Given elevated levels of uncertainty, will the relative price of housing – as a risky asset – converge to a price that undershoots that which would prevail in less uncertain times?

Even if aggregate availability of credit is not constrained by lack of liquidity or lack of capital – and the open-handed provision of liquidity by the Central Bank even through the most acute phases of the crisis, supported by the ECB, have certainly worked to ensure that there has been sufficient liquidity, while the Government has also poured in capital – could it be that more cautious mortgage underwriting (reflected for example in lower loan-to-value ratios currently being offered by those banks still active in the sector) have the effect in the downturn of depressing prices below the prospective new equilibrium (as is assumed in some credit-focused models[1]), even if the latter is determined more by the fundamentals of demand and supply (such as incomes, interest rates, demography, housing stock, construction costs).

Second-guessing asset prices is not easy, but at least in the case of housing, pricing in non-boom times is not dominated by speculative considerations. That indeed is why the prices do not snap quickly to a new equilibrium. The duration of price corrections after property

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[1] Cf. Gerard Kennedy and Kieran McQuinn, "Why Are Irish House Prices Still Falling?" *Central Bank of Ireland Economic Letter* 2012(5), April 2012 forthcoming.

bubbles elsewhere has varied a lot: in Japan, prices have been falling for 82 quarters, whereas the duration of decline in the Scandinavian crises varied between 9 and 20 quarters. The Irish price fall so far is more of an outlier in terms of depth than of duration. Probably, the faster prices reach a new equilibrium, the better the outcome for the economy as a whole. Wealth effects on consumption are one thing.[2] Also – and this may be a psychological factor more than anything else – there is probably something in the widespread view that falling house prices increase uncertainty leading to more saving to bolster balance sheets and delaying the economic recovery.

2. The banks – not yet back in the market.

"Decide speedily on loss allocation, remove failed management, insist on prompt and ample recapitalization." These are the standard policy recommendations for resolution of failed banks. Some of these actions were taken very quickly in Ireland, notably the first. But the scale of the banking losses is so high, relative to the capacity of the State, that its ability to err on the side of over-recapitalization was limited.

By as early as mid-2009, it was evident to close observers that the net long-term Exchequer cost (given the guarantee), inherently uncertain though it was, could reach €50bn. (I told an Oireachtas Committee as much at the time). That figure could still be within most analysts' current range of estimates, not least because it did prove possible in the end to achieve a substantial burden-sharing with the subordinated debt-holders as the guarantee on those liabilities expired.

(As is well known, partner pressure inhibited burden-sharing with the holders of senior Anglo Irish / IBRC debt even after the guarantee ran out leaving more than €4 billion unguaranteed. This is a point which needs to be borne in mind by those who focus too exclusively on the famous night of the guarantee. Though there is much to criticize about that guarantee, it is quite clear that, absent the guarantee, similar pressure would have been exerted by external partners to ensure that bank creditors were all paid.)

Nevertheless, getting unassailable estimates in this matter of loan losses has proved to be very challenging. That the NAMA timeline of purchases would turn into a drip-feed of bad news through the middle months of 2010 was clearly unfortunate. My initial idea of stuffing the banks with so much capital that they could absorb anything that NAMA pricing and the residential mortgage market denouement could throw at them was defeated by the clear threat to the State's market access that this would have caused (no doubt advancing the need to fall back on the IMF et al.).

Besides, hard evidence on the exact scale of losses was elusive. Denial at all levels in the banks persisted, and, absent sufficient information in the banks' own systems to make firmly-based and defensible projections, even the loss estimates embedded in the Central Bank's first (2010) PCAR were robustly challenged by some banks as being too tough. It is amusing now to recall that the Central Bank was pressed to agree that the capital requirements would be revised downward if subsequent NAMA valuations came in higher than the first tranche.

Restructuring of the banks as long as the guarantee was in effect was inhibited by the fact that any significant restructuring was likely to trigger an immediate entitlement for immediate payment in cash of all bondholders under the terms of the guarantee. This reason alone can explain why steps to deal definitively with even the two weakest banks were deferred to the end of the guarantee period.

The slimming-down of the banks' balance sheets is progressing: this is guided by two principles: avoid fire-sale losses and protect the core business of the banks (ample liquidity

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[2] Cf. Reamonn Lydon and Niall O'Hanlon "Housing Equity Withdrawal, Property Bubbles and Consumption." Paper to be read to the Statistical and Social Inquiry Society of Ireland, 17th May, 2012.

to support new lending is assured). The process will reduce their need for wholesale funding, but in any case access of the banks and the Sovereign to funding is now closely interlinked.

Possibly the slowest part of the adjustment so far has been the resolution of the distressed residential mortgages. On the assumption that financiers would aggressively pursue delinquent borrowers, the Central Bank's initial priority here was to protect the consumer against unfair harassment and to give time for balance sheet repair and adjustment in the finances of the distressed households. Some lenders have been aggressive, but overall we now feel that the main banks have been too slow to organise themselves sufficiently for the very large and complex task of engagement with delinquent borrowers with a view to getting their mortgage book back into performance, with realistic loan modifications where – and only where – necessary, and not shying away from foreclosures in the BTL segment in cases where this proves inevitable. The Central Bank has been working intensively with the banks over the past six months to ensure improvements here, something which will definitely be needed when the new insolvency legislation is in place.

3. Speed of fiscal adjustment.

With the economic downturn well under way, the need for fiscal correction in Ireland was already clear before September 2008, and the budget of October 2008 got the process away to an early start. Of course the fiscal pressures were greatly amplified by the over-dependence on bubble-related sources of taxation which evaporated at the same time as the sharp weakness in global export demand of 2008–9. Thus the automatic stabilizers kicked in and the deficit increased sharply even as adjustment measures were being implemented.

Has the Troika programme caused the fiscal adjustment to be protracted? Yes indeed it has, and this is fortunate indeed. The programme has allowed the reduction in the fiscal deficit to be a gradual one, with the scheduled deficit for this year higher than anywhere else in the EU. Without Troika financing, the fiscal adjustment would have had to be much more abrupt and disruptive.

But, beyond a certain point, a longer-drawn out adjustment is not necessarily less painful. After all, the longer you run big deficits, the higher the debt you end up with, prospectively implying a long-term drag on the economic recovery as that higher debt has to be serviced through higher than otherwise tax levels, or less costly public service. It is for this reason that we at the Central Bank had raised the question whether it would not be better to get the adjustment over a bit more quickly, implying a somewhat faster pace of fiscal correction over the coming years (not more cuts in total, but not dragging them out quite as long). That way, the duration of the negative demand impulse and any associated uncertainty would be shortened, in order to speed the resumption of more rapid growth.

One element of our reasoning here is the consideration that, by now, households and firms have made as much preparation as they can hope to weather the downturn. There can be different views about this: fiscal adjustment can be too fast as well as too slow. In the end, the Government has opted to stick to the slower pace that had been negotiated with the Troika.

Since Ireland embarked on the Troika-financed Programme, the Fiscal Compact has re-opened an old debate among economists about what might be the best form of fiscal rule, and to what extent its implementation should allow for circumstantial deviations. Given how important access to official funding has been to moderating the fiscal adjustment that would otherwise have been forced by the market, and given the fact that Ireland has found itself in a critical fiscal position twice now within a generation, is it a forgone conclusion that a constitutional rule, as has been agreed in the Fiscal Compact is the way to go? Let's not be too glib about this. While the previous Irish crisis of the 1980s was a classic one of fiscal indiscipline, the latest one owes much also to the regrettable socialization of so much bank debt. True, the non-banking part of the accumulation of debt since 2007 is the bigger part.

No simple fiscal rule would have prevented the risky over-dependence on bubble-related tax sources.

Certainly, the Fiscal Compact does introduce a tighter set of rules on future (post-Programme) fiscal policy than was embodied in the original Stability and Growth Pact.

However – and this is important given the potential for the unexpected to happen in an economy as globalized as that of Ireland – the operational rules of the Fiscal Compact, which are already decided as part of the so-called “Six-Pack”, provide that the European Commission’s operational assessment of whether an excessive deficit exists involves considerable discretion and judgement. For example, it has to take account *inter alia* of the state of the business cycle; it will be important to ensure that, if needed, such flexibility is fully exploited in Ireland’s case.[3]

The scope for operational flexibility helps reassure me that signing up to the Treaty has been the safer alternative for Ireland. For the Government to have done otherwise would have been to turn our back on a framework of European cooperation at the heart of what has been – despite the recent reversals – Ireland’s very considerable economic progress over the past four decades.

Above all, as has been remarked across the political spectrum in Europe in recent days, that cooperation must emphasise a growth and employment focus which, if successful, could have the effect of dissolving debt and deficit problems faster than anything else.

3 Cf. Council Regulation 1177/2011 of 8 November 2011, Recital 13–14, and Article 1 (2)(b).