Patrick Honohan: The experience of financial integration – Ireland, Britain, Europe

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Cheerleaders for financial integration are having a hard time these days. It can seem that the financial crisis was exported from the United States and that the waves of liquidity surging around the world ended up washing away several years of growth in the advanced economies.

Indeed, I think it can fairly be said that it without the complacent expansion of credit by a globally integrated financial market, we would not now be seeing the stresses of over-indebtedness that are impairing economic recovery not only in the euro area (Ireland being a conspicuous example), but in many other advanced economies which I am too polite to enumerate. Despite its overriding importance, I will not today expand on the question of short-term adjustment of over-indebtedness and imbalances, in favour of looking at the wider and longer term issue of the approach that our two neighbouring countries should be adopting in relation to financial integration.

After all, international financial integration is as much a product of technology as of liberalising financial policy and, as such, is with us, whether we like it or not. Exchange rate regimes, financial flows and provision of financial services are its chief vehicles. Mostly we can like it, but it can and has run amok, so needs well designed and policed regulation.

That regulation itself happens in an international environment, often with an initial regional layering. Ireland's age-old financial links with Britain have not been impeded by our shared adoption of the envelope of European Union legislation governing finance, nor even by Ireland's adherence to the euro with its even greater ambitions – currently, to be sure, suffering a setback (partly because the risks presented by over-elastic international flows were not sufficiently understood or managed) – for harnessing the power of financial integration.

My overall message today is that we in these islands have much in common as we work within European structures to develop more effective regulatory and policy regimes that will do a better job of handling financial integration than was managed in the first decade of the new millennium.

Keynes' view

It was in Dublin in a speech given in 1933 before an audience of the professional middle-classes that John Maynard Keynes made one of his earliest, most widely quoted and most succinct expressions of doubt about international financial integration. "Ideas, knowledge, science, hospitality, travel – these are the things which should by their nature be international. But let goods be homespun whenever it is reasonably and conveniently possible, and, above all, let finance be primarily national." For the elite of a newly independent country which valued the financial stability they had inherited and retained from the colonial era, this was not a welcome message.

Indeed, the message was largely ignored. The one-for-one exchange rate parity for the Irish pound with sterling embodied first in a currency board arrangement and then with a limited-function central bank, survived for almost another half-century, as did the banking and stock exchange links. Indeed the English, Scottish and Irish banking systems have long been intertwined. For example, it was Kerryman Daniel O'Connell ("the Emancipator") who set up the National Bank in London in 1835 – one of the seven great clearing banks, whose English branches later formed part of Royal Bank of Scotland (and now presumably heading to Santander) – with the goal of providing banking services "across borders" into Ireland to compete with the monopoly which had been granted there to the Bank of Ireland. Right into the twentieth century, the Irish banks collected deposits from rural parts – not least in the wartime years when food prices soared and there was little available in the prevailing international conditions on which to spend the export receipts; and so the savings were placed in the London money market. Finance was not "primarily national" then, and has not been since.

But was Keynes right?

The conventional wisdom identifies several dimensions of financial integration which can be ranked by their potential net benefits in terms of growth and stability. Exchange rate regimes determine the overall degree of monetary stability and can be designed to achieve price stability – but if so, may be vulnerable to other pressures. Mobility of financial flows allows for risk-sharing and consumption smoothing – but can open the door to destabilizing speculative movements. Provision of banking and other financial services by foreign firms can convey lower costs and greater sophistication as well as better risk-sharing – but can leave the host country high and dry if the service-providers choose to withdraw.

Both Ireland and Britain have experiences the rough and the smooth in each of these three dimensions. But the information technology revolution implies that international financial integration is not a question of whether, but of how.

Ireland's path of integration

Ireland's "how" started through a narrow, mainly banking channel and a fixed peg to one major financial node, London. Over the years, and especially after the inflation and slowing UK growth of the 1970s, Ireland took the opportunity of the creation in 1979 of the European Monetary System and its exchange rate mechanism (ERM) to diversify away from this too narrow channel and, within a governmental structure defined by Europe and the euro-area, integration now passes through a multitude of channels, albeit with Britain still a key route.

Britain is also squarely within the institutional and legal framework of the European Union, so far as financial integration is concerned. And it will not come as a surprise to hear me say that the officials of the UK are highly influential not only in EU decision making bodies but clearly on the global stage through the G-20 and the FSB.

The crisis has generated a sense in some quarters that, in these matters of financial integration, the old days were better, both when seen from the Irish and the British point of view, but is that really true?

I certainly would not want to glamorise that *ancien regime* of Irish banks integrated in the UK system. Just as economic historians have often castigated the Victorian British banks for contributing little to the growth of British industry, so the Irish banks might have contributed more if they had been geared-up to spotting lending opportunities for budding exporters. The marginal efficiency of capital in Ireland was probably a good deal higher in those days than the discount rate in London. Besides, there was more to global finance even then than the London money market. (Though this is a point that was probably not appreciated by whoever in Dublin decided to convert the US dollars, received from Marshall Aid, into sterling just weeks before the sterling devaluation of 1949.) But adherence to global finance through the sterling link did more or less guarantee that Ireland would import whatever degree of monetary stability was attained in Britain. Only once, in 1955, did Irish policymakers try to break out of the discipline of a currency board, arm-twisting the Irish banks not to follow London's bank rate increase. The consequence then was an outflow of funds, followed by a hasty fiscal over-reaction and the worst recession for a couple of decades.

Britain and the prospective reconfiguration of world finance

It would be a great understatement to characterise the past two centuries of British finance as being not "primarily national". After all, for much of that period London was *the* centre of global finance as well as of international economic relations generally. Having reinvented itself in the 1960s, and in the 1980s, and perhaps again today, London's role in global finance has outlived – indeed outgrown – its imperial origins and remains a key node in a multipolar system. But that is a system which has been shaken by the evolving crisis from which it will emerge in a reconfigured form. Influencing the design of this reconfiguration through domestic, regional European, and wider international governance structures is a major preoccupation of financial policymakers: what will the role of London be in the reconfigured system, how will Ireland fare? These are key issues preoccupying you and me respectively, and they are not unrelated.

Perhaps the most contested part of the on-going and prospective reconfiguration relates to the role of governments in the financial systems of the future. And, in the European context, that includes the question: which governments or governmental agencies for which roles? What should be at the national level, what at the regional – in our case European – and what to the global level? Let me take some examples of issues that have arisen and have been dealt with in a variety of ways to illustrate the import of these questions.

Banks, sovereigns and financial de-integration

For many years now, a mantra of most financial development economists has been to emphasise the failures of government involvement in the running of banks. Country after country suffered severe set-backs when the degree to which the lending policies of government-controlled banks were exposed – in a downturn – as having been largely politically-motivated and more like grants than loans. The recent crisis has also entangled banks and governments again, but in a different way (albeit one which was also seen in other developing countries in the past), namely the socialisation of private banking losses destabilizing the finances of the State.

Even where the State did not pick up the tab for the bank debts, namely Iceland, the consequences for the State of the losses have been severe. And I think it is fair to say that the Icelandic events have also shaken the underpinnings of the European single banking market. The idea of cross-border branch banking has been undermined by regulatory responses in some European Union countries no longer prepared to accept the validity of the single passport and requiring foreign-owned banks who wish to operate across borders to create, for example, a local subsidiary. Regulatory ring-fencing of local bank liquidity has also been observed – clearly contrary to the spirit of the single banking market. What this seems to come down to is a loss of confidence in the idea that foreign regulators could be relied upon and, perhaps also, a perceived lack of creditworthiness of some sovereigns even within Europe. The latter may be seen as not altogether unjustified, given the recent restructuring of Greek sovereign debt. Still, it is noteworthy that banking debt has been repaid across Europe despite the pressures that have been placed on sovereigns. In this process, there has been a sharp reduction in cross-border banking exposures in the market. Thus, both in regulation and in market behaviour, the single banking market has suffered a notable retreat.

Restructuring and downsizing of European banks has had a similar effect, some of it ironically the consequence if pro-competition measures taken by the European Commission.

By the early 2000s, the Irish banks had moved from their historic position as exporters of funds to the rest of the world to champion importers of funds to be recycled into finance for mortgages and for property development in the Irish world-beating property and construction bubble. Although this boom coincided with Ireland's euro membership, I have argued elsewhere that the link was a tenuous one. One indication: the fact that the British banking connection held up well in this period also: the two biggest UK banks were among those leading the headlong charge for property lending. Now they, and the local banks (and government), are licking their wounds in terms of heavy actual and prospective loan-loss charges. Financial integration generally – not just the euro – fuelled the boom to dizzying heights from which the fall has been painful.

By now, the Irish banks, faced with a "sudden stop", have repaid vast borrowings from the globalised financial system largely using central bank funds to do so – though, also using some of the Troika funds via the recapitalisation of the banks at mid-2012. Financial integration intermediated through official channels has, for the moment, replaced international market integration.

And the same replacement is also happening across the euro area. Continental banks in several of the largest countries have switched to central bank financing over the past several months as they repaid cross-border market funding. While commentators have rightly emphasised other aspects of the expanded borrowing from the Eurosystem through the 3-year LTRO – notably the use by banks in some countries of some of the borrowed funds for the acquisition of government bonds, and the way in which the LTRO has eased the sharp tightening of credit conditions that had occurred in the last quarter of 2011 – the disintermediation of cross-border bank finance in Europe has been quantitatively larger than these other two effects.

A multi-country zone in which, despite a single currency, credit risk hampers the free-flow of banking finance is not what the inventors of the euro had in mind. One approach to correcting the situation is to reduce credit risk by increasing the capital of banks; certainly we need to move and are moving steadily in that direction. But when the lack of creditworthiness is entangled with the questions about creditworthiness of the national governments, it is not evident that even increased bank capital will be immediately sufficient. I for one have not been expecting the large recapitalisation of Irish banks to enable them to access international capital markets on a large scale ahead of the market re-entry of the Irish sovereign itself. The maxim that a sovereign rating normally provides a ceiling on the rating of any other entity has sound foundations.

Getting away from the pernicious dynamic whereby the indebtedness and contingent exposure of sovereign and banks to each other does have what seems to be a simple solution, though not one which has yet been accepted let alone implemented. Using pooled European funding mechanisms directly as a means of recapitalising weak banks and acting as a backstop for future problems is an obvious way of pooling risk and breaking the sovereign-bank linkage. When I say directly, I mean without entailing a sovereign indebtedness. For example, the €17 billion injected by the Irish government last year alone, to bring the going concern banks' accounting capital up to the high ratios built into the stress tests conducted in March 2011 as part of the Troika-financed programme, added some 13 per cent of GNP to Ireland's debt. (Of course the Irish government also spent a lot more than that paying off creditors in the "gone concern" banks.) But if a sizable fraction of the sums invested that had been injected directly as capital by the EFSF, debt sustainability would be much less of a concern to the rating agencies and the EFSF could look forward to upside in the recovery by being the owner of two banks with a substantial national franchise.

Although the Irish case has been exceptionally severe, it is evident that the same formula could be relevant to other countries. The Greek debt restructure brought most of Greece's banks under water, and they are being recapitalised by injection of EFSF bonds. But once again the Government – in this case the Greek government – is assuming the corresponding debt, and acquiring or increasing its ownership stakes in the banks. If there's any European government that doesn't need any more debt, it's the Greek one. Another missed opportunity, one might say, in the design of restructuring and resolution policies for European banking.

While the banking losses for UK banks were on a smaller scale relative to the size and fiscal capacity of the UK economy, looking ahead, policymakers in countries even as large and prosperous as the UK look with some trepidation at the scale of their largest financial institutions – together with the fact that these institutions hunt in packs and do not represent a diversified pool of risks. One solution is to shrink the institutions and distance their liabilities from the State. This is definitely needed. In addition, though, especially looking to future risks, a complementary strategy, relying for bank recapitalisation where needed not on one sovereign but on the pooled fiscal resources of a larger and more diversified entity such as the EU needs to be developed.

It's not hard to see, though, that to get such a degree of cross-border public financial engineering working smoothly at the European level requires an institutional structure that is both more comprehensive and more streamlined than exists today. It is clearly something much more ambitious than has ever been attempted by the IMF and World Bank.

A Banking Union in Europe

As you may have guessed, I have used a less familiar route to back into what is increasingly becoming a conventional line of argument, namely that we have found that a monetary union needs to be accompanied by stronger arrangements to ensure what might be called a Banking Union. In simple terms, the main elements of a banking union would be a degree of (i) centralised bank regulation, licensing and supervision as well as (ii) central responsibility for resolution and for depositor protection and any public sector solvency support.

It's not just the spillover effects that warrant centralised supervision. "Keen is the eye of the guest" (*Glöggt er gests augað*) as an Icelandic proverb has it. Of course nationals should be involved in supervision: often it is they who pick up the vibes and the market talk. And – while I do think that many governments don't want to cede control over bank licensing issues to foreigners, I don't attach as much importance as some to the relevance of national political pressures on the supervisor. Thus, it's not just the implicit political protection that a plausible rogue may seek and secure: any national regulator worth their salt should be able to stand against that. But in periods of collective national myopia such as that which generated the property bubble in Ireland, the chance of getting somebody whose judgement is not affected is greater, the more distant their base. It's time to start the ball rolling in a direction going well beyond the current mandate of the ESRB and the ESAs.

Let me be clear that centralised supervision should not blindly apply common macroprudential ratios across the whole of Europe regardless of national, regional or sectoral credit conditions. Where circumstances warrant it, transitory variations in capital ratios and other macroprudential tools (such as loan-to-value ratios for household mortgages) must be part of the toolkit. That is needed today: maximum harmonisation, understood to mean, for example, that minimum capital ratios must never vary by country, is not necessary to retain the advantages of the single market. Even when regulation is as centralised as I would wish it to be, the regulators must not hide behind the single market as an excuse for dodging unpopular bubble-bursting measures of restraint.

A pan-European Deposit Guarantee Scheme is often mentioned as the second key element of any banking union. But of course the current guarantees, covering up to €100,000 per person, do not cover the largest and most mobile funds. It is not by paying out on insured depositors that the Irish public finances have been crippled. No: the direct fiscal costs of bank failures have always come in large part from indemnifying non-insured depositors. No bank senior creditor in the euro area has lost a penny in the crisis and the same is true in the United States – but only since September 2008; before then bondholders and uninsured depositors did suffer losses in the US. Even if the Irish government had not stepped-in pre-emptively with its rash and overly-broad guarantee at the end of September 2008, there can be no doubt that irresistible partner country pressure would have been brought to bear on the government to avoid bondholder losses (as indeed happened after the period of guarantee ended in respect of the remaining out-of-guarantee bonds, as a quasi-condition for continuing Troika support). In a former existence I have argued that covering bondholders' claims in bank resolution can be counterproductive in limiting the costs of banking crisis. I have not changed my mind. A fortiori, I could not see the case for asking a stressed Government to do this order to protect the functioning of the bank bond market in other countries. Such decisions, and paying for them, should at least be the responsibility of a Europe-level resolution agency.

Long overdue mechanisms and legislation for managing bail-in of private creditors in bank resolution also are something that, in practice, has to be resolved at EU-wide level and wider.

Note that I refer to the EU as a whole here and not just to the euro area. While the policy spillovers are undoubtedly greater as between euro area countries, the case for centralized supervision and resolution can plausibly be extended to the whole single market. After all, the Icelandic problem in UK banking arose out of the mismatch between the single market in banking and the uneven effectiveness of bank supervision and regulation in the European Economic Area. The alternative to moving towards a banking union could be a progressive dismantling of the European single banking market, of which we may even have seen some policy signs in the past few years. I'm not at all sure that this will be a benefit, from the perspective of Ireland or the UK. It is not just the smallest countries that would benefit from a system where risks in Europe were pooled, rather than falling arbitrarily on one country or another.

Concluding remarks

Some have taken the message from the euro crisis that financial integration has gone too far in Europe. My read is different. Inasmuch as any country that did not adequately operate sustainable macro and financial policies would suffer greatly from the denouement of policy deficiencies, the euro embodied a strong commitment device. The costs of that policy failure are being felt now. But the answer is not to fall back on the more autarchic policies of the 1960s and 1970s, but to try again, try better. The markets – gullible as we know they can be – naively assumed that the commitment device would be effective so that they need no longer fear unsustainable policies. They know better now, and so do the governments. Next time around will (to this extent) be different: this particular lesson has been learnt.

I have no illusions that a euro area restored to health would be enough to immediately attract UK membership (even though that would be a welcome development for Ireland), but the banking union which is a prerequisite for a healthy euro area holds attractions for the whole membership of the European Union. Ireland and Britain now have much in common in the general approach to the design of a banking union. Although this is a medium-term project, initial steps themselves could be catalysts for the growth recovery which is so essential for all of us in the immediate future, and which will of course require a suite of other policies to discuss which would take me far too far afield today, especially as I have already exhausted my time!