Stefan Gerlach: Ireland – from crisis to recovery

Address by Mr Stefan Gerlach, Deputy Governor of the Central Bank of Ireland, at the Berlin Finance Lecture, a joint initiative of Deutsche Bank Research and the Departments of Mathematics and Economics of Humboldt University, Berlin, 14 January 2013.

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1. Introduction

I am very pleased to be in Berlin today and to speak on economic developments in Ireland in recent years in this distinguished lecture series.

As you know, the Irish economy underwent a disastrous boom-bust cycle in the last decade. Following the bursting of the bubble in 2007/8, the economy entered a period of almost free-fall. In response to the crisis, the Irish authorities have been working conscientiously on stabilising and returning the economy to growth. That process started immediately after the bubble burst and a number of important policy measures were taken in 2008 and 2009. Initially, the focus was on ensuring that the banking system continued to function and on restoring fiscal soundness. However, despite significant measures in both the banking and fiscal areas, serious concerns persisted about Ireland's financial balance sheet. In the fall of 2010, a few weeks after the Deauville statement that suggested that private sector investors could experience losses on their holdings of sovereign debt, confidence in the Irish sovereign collapsed.[1] This forced the Irish Government to seek external financial assistance from the ECB, the European Commission and the IMF, the "Troika".

Access to official funding under the programme has been very helpful and has enabled the Government to pursue the reform process that had already started. As readers of the Troika's quarterly reviews of Ireland's progress during the programme will know, policy implementation has been strong and the authorities have delivered on all the commitments they have entered into.[2]

Although domestic demand continues to shrink, this is being offset by growth in net external demand and as a result overall Irish economic activity has been broadly stable and there are a few signs that a modest recovery could potentially take hold this year. While real GDP growth has been very weak, it was positive in both 2011 and 2012, and is forecasted to increase to a little over 1 per cent in 2013. Similarly, house prices, which have been falling since 2007, were broadly flat in the second half of 2012 although there is no expectation of a significant increase. Finally, unemployment has started to fall, but the improvement, from a peak of 15 per cent in early 2012 to 14.6 per cent by year end, is small and partially due to net emigration.

For a small and very open economy such as ours, domestic economic conditions are critically influenced by the external economic environment. Unfortunately, this has been extremely challenging in recent years and considerably worse than was forecasted when the programme was agreed in 2010. In particular, the euro area has experienced serious economic and financial tensions with GDP forecasts frequently being revised downwards. A shift towards fiscal consolidation, although essential in most countries and urgent in some,

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1 Events preceding entry into the programme in 2010 are reviewed by Governor Honohan in the address on "Recapitalisation of Failed Banks: Some Lessons from the Irish Experience" given at the 44th Annual Money, Macro and Finance Conference, Trinity College Dublin, September 2012. See www.centralbank.ie.

2 See: www.imf.org/external/pubs/ft/scr/2012/cr12336.pdf.

and the necessary process of bank deleveraging in Europe have not helped recovery in Ireland. While the overall direction of the policy response within Europe to the crisis has been appropriate, the pace of change has been uneven and this has generated a high level of uncertainty which has not been beneficial.

The Government has made a good start in re-entering debt markets, but the market is conscious that economic conditions remain fragile and the stock of public debt is very high at 120 per cent of GDP (or almost 150 per cent of GNP, which may be a more relevant measure in the case of Ireland). There is therefore little, if any, safety margin and even a small adverse shock to market confidence in the Irish Sovereign could complicate the exit from the programme. A successful exit, on the other hand, would be a very positive development not just for Ireland but also for Europe more broadly. Actions that would help reduce the sovereign-bank link and that would improve debt sustainability could greatly enhance Irish prospects of exiting the programme on schedule.

But I am getting ahead of myself. Given that the assistance programme is scheduled to end late this year, this is a good time to take a look at the Irish Government's progress in resolving the crisis and take stock of where we stand. To organise the material, I have decided to structure the discussion in three parts. First, I will discuss the crisis itself, its causes and consequences for the Irish economy. Next I will review the main policy measures adopted by the Irish authorities in response to the crisis. Finally, I will review what the most pressing challenges are this year.

2. The crisis

Ireland experienced a massive housing bubble, whether measured in terms of prices, credit or the scale of construction activity within the economy. Unfortunately, this appears to have been one of the worst boom-bust cycles on record.[3] The exceptional size of the shock is of course the main reason why it is so difficult to overcome.

The bubble took the form of a very large increase in residential and commercial property prices which rose almost four-fold between 1997 and 2007. Like many other bubbles, it started from strong growth, which in Ireland's case began around 1990 and largely resulted from greater economic integration with Europe. During the 1990s, growth was underpinned by fundamentals, as exceptional export performance was accompanied by moderate wage and price inflation and healthy public finances. The expansion was aided by EU structural funds of up to 3 per cent of GDP per annum. Of course, the large fall in Irish interest rates as part of the move to Monetary Union also exerted a powerful force. For instance, mortgage rates fell from over 11.5 per cent in 1990 to lows of close to 3.5 per cent in 2005.

In the early 2000s, however, as the economy approached full employment and technological constraints began to bind, the nature of the boom changed from one that reflected strong fundamentals to one that was fuelled by excessive credit expansion. Strong economic growth and lower interest rates led to an increase in both the demand for and price of housing and rapid growth in credit. Both domestic and foreign-owned banks with branches or subsidiaries in Ireland participated in this expansion, lending heavily to developers and retail mortgage borrowers. As a result, the fraction of non-financial private-sector lending that went to the property sector – that is, mortgages and lending for commercial property – rose from 60 per cent in 2000 to 80 per cent in 2007.[4] The boom was not just a price bubble, but involved a huge expansion in lending and construction activity.

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[3] A recent IMF working paper by Laeven and Valencia (2012) assesses the size of banking crisis since 1970 in a number of countries and in a number of ways and concludes that the Irish crisis has been one of the costliest.

[4] Figures are exclusive of residential mortgages securitisations.

We now know that this explosion in lending reflected an astounding neglect of credit risk by lenders. Primary responsibility for the soundness of individual institutions rests squarely with the management of the financial firms themselves. However, it is clear that ineffective regulation and supervision – both at the level of the individual firm and on a system-wide basis – also played a role.[5] While Ireland's problems were homemade, it is natural also to ask how Irish banks financed this rapid increase in lending. The data show that the bulk of it was financed by wholesale funding from abroad. One wonders what led to this surge in lending. Did foreign lenders to banks not understand how dangerously unbalanced the Irish economy was becoming and that credit risks were rising? Or did they assume that if the property bubble burst, they would be able to get out in time or that they would be bailed out? Whatever the explanation, the Irish property bubble was aggravated by the apparent willingness of foreign financial institutions to fund reckless lending in Ireland.

Housing prices peaked already in 2007, but any hope of a soft landing vanished the following year. The banks' heavy reliance on cross-border wholesale funding and concerns about the scale of their losses as a result of the collapse in property markets help explain why they began to find it increasingly difficult to attract longer-term funding through early-2008, and meant that they were particularly affected by increased fears of counterparty risk as markets froze following the collapse of Lehman Brothers in September 2008.

From then the process has followed a familiar pattern: with the economy weakening, market sentiment worsening and banks unwilling to lend, demand for property declined and the fall in house prices accelerated. As a consequence, construction, which during the boom had grown to over one-fifth of the Irish economy, collapsed significantly weakening aggregate demand and employment. The end result has been a vicious circle of continuous and sharp falls in property prices, bank lending and aggregate demand, and rising loan losses and unemployment which has now lasted more than five years. A few statistics tell the facts: between 2007 and 2012 GNP fell by 11 per cent in real terms and 20 per cent in nominal terms, while domestic spending fell by almost 25 per cent in real terms and almost 30 per cent in nominal terms.

The bursting of the bubble had devastating effects on public finances and forced the Government to ask for external assistance. Two factors account for the sharp increase in debt.

First, the socialisation of banks' severe loan losses – in the first instance through the September 2008 guarantee and later through the unwillingness of our programme partners to consider burden sharing with unguaranteed senior bondholders – resulted in a very large infusion of public funds to restore their solvency.[6] To date, the Irish State has injected €64 billion into the banking system, or approximately 40 per cent of 2012 GDP.[7]

The second factor is fiscal policy. A stylised fact of many housing booms is that rapid growth of revenues makes the Government's fiscal position appear much stronger than it is. Governments frequently respond by raising spending and reducing their reliance on revenue from non-property sources, while rapid nominal GDP growth erodes the debt-to-GDP ratio. Ireland was no different; although public spending was well constrained in the 1990s, eventually in the 2000s spending surged, driven by pay rates and social benefits. At the same time tax rates were reduced, while the debt-to-GDP ratio fell from 100 per cent in 1991

5 For a review of the shortcomings of financial regulation and supervision before the crisis, see the report by Governor Honohan to the Minister for Finance, entitled "The Irish Banking Crisis: Regulatory and Financial Stability Policy 2003–2008", at www.bankinginquiry.gov.ie.

6 There was burden sharing with subordinated debt holders of about 10 per cent of GDP.

7 Of the €64 billion injected, €43 billion added to gross debt; the remaining €21 billion came from the National Pension Reserve Fund and did not add to gross debt.

to about 25 per cent in 2007.[8] Particularly unfortunate was the decision to permit strong increases in current spending which were dependent on windfall revenues, rather than other, more permanent, sources of revenues. Consequently, when tax revenues collapsed as the boom turned to bust with a vengeance, a large gap between Government expenditure and revenue rapidly developed.

3. Policy responses

Following the burst of the bubble, the Irish Government has taken a number of actions to stabilise the banking system and strengthen public finances in order to support recovery. Let me focus on some of the most important.

3.1 Stabilising the banking system

The initial policy response in September 2008 took the form of a general guarantee of the liabilities of the banking system.[9] The initial guarantee covered a broad range of liabilities including some existing subordinated debt and covered bonds, and amounting to almost 2½ times GDP.[10] Following the initial guarantee, new debt and deposits continued to be guaranteed on a second scheme which has been rolled forward on a six-monthly basis. This is still in force, but it is probably no longer necessary, and will likely be discontinued in the near future.

As I have noted, during the pre-crisis credit expansion, banks became increasingly reliant on shorter-term wholesale funding. The guarantee was introduced in the belief that the main problem facing the banks was merely difficulties attracting funding following the collapse of Lehman Brothers. That the system faced a solvency problem was not recognised at the time. However, as doubts emerged about the solvency of the banks in light of increased property losses and the ability of the Sovereign to backstop such a large guarantee, the Irish banking system suffered a massive withdrawal of funding. Over time, Irish banks were shut out of almost all debt markets, while a flight of retail and, particularly, corporate deposits also occurred. To fund the resulting liquidity deficit and ensure the Irish banking system's ability to function, the ECB has provided an unprecedented level of liquidity support.

As the property market continued to decline it became clearer that the banking system needed capital to remain solvent. The initial step to recapitalise banks in December 2008 marked the beginning of a series of injections over the following years, as estimates of the capital needs were made in a highly uncertain environment characterised by systematic loan underwriting errors, inadequate management information and intrinsic uncertainties about borrowers' ability to repay loans in negative equity. An initial independent assessment of the banks covered by the guarantee was already undertaken in 2008. Based on the results, the Government decided to recapitalise the banking system and to nationalise Anglo-Irish Bank in early-2009. By June of that year, the Government had injected €10 billion into the three major banks. Despite already receiving a 4 billion injection, by the end of 2009, it was clear

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8 It is important to note that as judged by the fiscal criteria of the Maastricht treaty, Ireland's record before the crisis was exemplary: it was exceeded the deficit criteria only in 2008 and the debt criteria in 2009.

9 The policy responses to the banking crisis are reviewed by Governor Honohan in the address on "Recapitalisation of Failed Banks: Some Lessons from the Irish Experience" given at the 44th Annual Money, Macro and Finance Conference, Trinity College Dublin, September 2012. See www.centralbank.ie.

10 The initial guarantee scheme covered a broad range of liabilities from 29 September 2008 – 29 September 2010. The scheme covered all existing and new liabilities within these categories for a period two years, making it difficult for the banks to issue debt beyond the end-date of the guarantee. The second guarantee scheme covered a narrower range of liabilities, excluding covered bonds and dated subordinated debt. This guarantee also covered new longer-term new debt issued – eligible liabilities with maturity up to 5 years could be covered – while banks could also issue unguaranteed debt if they chose.

that Anglo-Irish Bank would have a further capital shortfall; this was met, following discussions and approval by the European Commission, by a “Promissory Note”.[11]

In 2009 the Government established the National Asset Management Agency with the objective of removing commercial property and development loans from banks’ balance sheets. In total, NAMA purchased loans with a face value of €73 billion at an average discount of 57 per cent. The transfers of loans to NAMA crystallised losses and led to a need to inject further capital into the banks. Estimates of losses, both NAMA and non-NAMA related, were conducted in 2010 with further capital being injected, leading to an increase in the Promissory Note.

These initial recapitalisations took place as Government finances were deteriorating significantly due to the collapse in economic activity, limiting the capacity to over-capitalise the banks. A major objective of the programme, especially of the funders, was to remove this constraint. However, as the programme did not envisage burden sharing with senior bank creditors and the additional capital was added to Government debt, issues of debt sustainability persisted. Nonetheless, the assistance provided by programme partners allowed a more ambitious approach to be taken than previously, with strong external validation and greater transparency built-in as features of the exercise. Using loan-by-loan data and a systematic data verification process, BlackRock Solutions conducted a bottom-up multi-year loan-loss forecasting exercise, applying parameters estimated from emerging patterns of loan delinquency. Compared to previous estimates, this exercise involved higher percentage capital ratios; higher three-year loan loss projections; a buffer for loan-losses beyond the three-year horizon; and costs associated with deleveraging non-core assets. The result, announced in March 2011, was a further required capital figure of €24 billion.[12]

3.2 Strengthening public finances

The collapse of the bubble had a disastrous effect on the Government’s finances. With the budget deficit spiking to 31 per cent of GDP in 2010 (if banking support costs of 20.2 per cent per cent of GDP are included) and public debt rising very rapidly from 2007 onward, the Irish Government has taken a number of measures to strengthen public finances. Austerity is never popular but, as evidenced by the pre-programme actions of the Government, it was recognised at an early stage that there was no alternative to this policy. With debt markets in the fall of 2010 becoming unwilling to fund the Irish Government, it faced the choice of either closing the massive budget deficit literally overnight, or spreading the necessary correction over a longer period of time by asking for a financial assistance programme from the Troika.

Adopting the programme has allowed the fiscal restructuring to be done in a much more deliberate and targeted way than otherwise would have been possible. This has increased the likelihood that the improvement will be both structural and lasting in nature, and that as a result the Irish Government will be able to access debt markets on a sustainable basis from this year onwards. That said, the sheer size of the necessary correction has meant that both revenues and spending levels have had to be adjusted sharply.

The fiscal consolidation programme adopted by the Irish Government has been front loaded and, between 2008 and 2013, has entailed measures equal to almost 18 per cent of GDP.[13] The size of this adjustment is second only to that of Greece. Since the total adjustment necessary by 2015 has been estimated at €34 billion (or 21 per cent of GDP), it follows that the lion’s share of that, about 85 per cent, has already been done. Broadly, one third of the

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[11] The Promissory Notes, which were issued while Ireland still had an AA credit rating and interest rates spreads against Germany were less that 200 bps, can be thought of as a bespoke and non-marketable bond.

[12] Following the 2011 FMP injections, a further €1.3 billion was injected into Irish Life in 2012.

[13] For a review of fiscal policy measures undertaken in Ireland since the crisis erupted, see Chapter III of “Ireland: Selected Issues”, IMF September 2012, available at www.imf.org.

adjustment comes from the revenue side and two thirds from the spending side. Among the measures taken to increase revenues are an income levy, changes to social insurance, the introduction of a health levy, changes to tax credits and bands, increase in excise duties, a 2 percentage point increase in the VAT and the introduction of a property tax in 2013. On the spending side, current savings achieved to date include paybill reductions, covering pay rates and headcount, a public sector pension levy, and reductions in social welfare rates.

Despite these significant adjustments, however, the budget deficit remains very large. The most recent forecasts suggest that the deficit in 2012 will be somewhat below 8 per cent of GDP. Although this is less than the target of 8.6 per cent, public debt is continuing to accumulate rapidly and is expected to peak in 2013 at 121 per cent of GDP.

4. The current situation

But while many measures have been taken by the Irish authorities to overcome the crisis and to prepare for the exit from the programme, concerns remain. Two are readily apparent. The first arises from the high level of mortgage arrears; the second is the risk to sovereign debt sustainability arising from the high debt-to-GDP ratio.

4.1 Mortgage arrears

As a consequence of the crisis, mortgage arrears have risen sharply, with some 15.1 per cent of mortgages now in arrears for more than 90 days. A key determinant of mortgage arrears is the unemployment rate which stands at just under 15 per cent, three times the level at the start of 2007. Mortgage borrowers who become unemployed may rely on savings to meet debt repayments for some period of time. However, the long-term unemployment rate has increased more than six-fold, with the effect that large numbers of people have experienced sharply reduced incomes for more than a year, raising arrears rates. For the banking sector, the combination of mortgage arrears and negative equity is major determinant of loss rates. While borrowers that become unemployed and therefore are unable to service their mortgages but who are not in negative equity can in principle sell their houses and repay the loans, those that are in negative equity cannot.

Moreover, it is difficult for banks to assess the repayment capacity of distressed borrowers. Some borrowers may be experiencing temporary financial difficulties, from which they will recover relatively quickly. These borrowers may need some breathing space until they, for instance, find a new job. Other borrowers may be experiencing a permanent decline in income, and require a more extensive modification of their mortgages, while others still may never be able to service their debts and banks may have to pursue the route of repossession. These difficulties faced by banks in distinguishing between types of borrowers, together with the fact that it is costly to modify mortgages for borrowers that in fact would have been able to service them, have arguably caused banks to be slow to tackle the problem of mortgage arrears.

Unfortunately, the delay in doing so and in resolving the uncertainty faced by households and banks alike has had detrimental effects on the economy. Uncertainty about the future makes households save more, dampening consumption spending and preventing the economy from returning to growth. The prospect of a large number of repossessed properties being placed on the market in the near future has made households hesitate to purchase property now. For banks, uncertainty about the potential for future mortgage losses has made it difficult to attract sufficient deposits and market funding, requiring them to rely on the eurosystem for funding. Combined, these factors in turn impact banks' ability and willingness to lend, with further negative knock-on effects on the real economy.

A further source of uncertainty arises from the new Personal Insolvency Bill, agreed with the Troika, that will come into law in 2013. It will reduce the bankruptcy period from 12 years to 3 years, establish an insolvency service to help people manage their debt and create three non-judicial voluntary debt settlement procedures. Although these procedures are untested, they should speed up the resolution of arrears, and will be an important part of the solution for managing private-sector indebtedness.

4.2 Fiscal sustainability

Improving debt sustainability by breaking the sovereign-bank link would enhance the prospects of a full return to debt markets at the end of the programme. There are two essential aspects of debt sustainability: first, the level of the debt-to-GDP ratio, and second the rate at which it is increasing. The level of the debt-to-GDP ratio is high at about 120 per cent. The safety margin is therefore minimal: any unexpected increase in the ratio risks triggering worsening market sentiment about the Irish Sovereign. Furthermore, slower economic growth in Ireland would reduce tax revenues and have a direct effect on the evolution of the debt-to-GDP ratio. While the ratio is expected to decline slowly after peaking in 2013, forecasts are highly sensitive to nominal GDP growth, which is critically influenced by nominal GDP growth in the euro area and other main trading partners.

Since debt dynamics depend on the difference between the nominal interest rate and nominal GDP growth, the debt-to-GDP ratio is also sensitive to the interest rate on the public debt, which depends on market confidence. If financial markets believe that the Government will not have any problem rolling over its debt in future years, interest rates will be lower and it will be easier for the Government to service the debt. Conversely, market concerns about debt sustainability will raise interest rates, making it more difficult for the Government to borrow in the markets.[14] Hence, expectations are self-fulfilling, permitting both a good and a bad equilibrium.

To facilitate a smooth exit from the programme, it is therefore important that financial market concerns about the future debt service burden of the Irish Sovereign are allayed. Continued sound implementation of the programme is crucial, while developments at the European level can also be helpful. I have already noted the importance of economic developments in Europe to Ireland's growth. In addition, European policy announcements can also have a significant impact on market confidence and the Irish Sovereign's ability to re-enter the markets.

In this regard, markets responded positively to the 29 June EU Summit statement and the announcement of the ECB's programme of Outright Monetary Transactions.[15] Irish Sovereign yields declined sharply, facilitating limited bond issues since then. However, these positive developments depend crucially on market sentiment, which can change rapidly. Any new development leading to a reassessment of euro area risk by financial markets could result in an abrupt reversal of the recent declines in yields.

The 29 June EU Summit announcement of the potential future use of the ESM to recapitalise banks following the establishment of banking union could reduce the total nominal level of debt. However, the timeframe for implementation of the ESM and uncertainty about the amount of banking-related public debt that would be eligible, were the ESM to be applied retrospectively, are unclear. For Ireland, greater certainty on this issue could provide support for successfully exiting the programme in 2013.

The announcement also included a reference to examining the situation of the Irish financial sector. This has raised expectations of a possible reprofiling of the Promissory Notes, on which the Government makes an annual payment of €3.1 billion, or 2 per cent of GDP. Agreement that results in a more favourable time profile of payments would improve the

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[14] See "Rettung für den Musterknaben", Der Spiegel, January 7, 2013, p. 28.

[15] For the 29 June EU Summit Statement, see: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf. For information on the Outright Monetary Transactions programme, see: http://www.ecb.int/press/pr/date/2012/html/pr120906_1.en.html.

Government's fiscal position and greatly enhance its ability to regain full access to the markets.

5. Conclusions

Ireland has undergone a disastrous boom-bust cycle in the last the decade. Following the burst of the bubble, the Irish economy experienced an exceptionally severe contraction and massive bank losses. Lower revenues and large capital injections in the banking system have led the debt-to-GDP ratio to rise from 25 per cent to about 120 per cent since 2007.

In response to the crisis, the Irish Government has taken a large number of measures to reform the financial sector, strengthen public finances and return the economy to growth. The first of these measures were adopted already in 2008. Since 2010 they have been part of an assistance programme agreed with our European partners and the IMF. In this period, the Irish authorities have delivered on all of their commitments and made good progress on restructuring the economy.

While the economic freefall has now stopped, economic performance has been weaker than anticipated when the programme was agreed, largely because the external environment has been much more challenging than expected. Overall, economic conditions are still fragile.

With the ending of the programme later this year, the Irish Government will be relying again on funding from the private debt markets. The stock of public debt is very large, the level of mortgage arrears is still high and banks are not yet profitable. The safety margin is therefore small. Improving debt sustainability would greatly enhance the prospects of a successful exit.