John Hurley: Financial stability and recent market developments in Ireland

Opening statement by Mr John Hurley, Governor of the Central Bank & Financial Services Authority of Ireland, to the Joint Oireachtas Committee on Finance and the Public Service, Dublin, 21 January 2009.

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Good morning Chairman and members of the Joint Committee. Thank you for the invitation to speak with you today. I am accompanied by Tony Grimes, the Director General of the Central Bank and Tom O'Connell, Assistant Director General, Economics.

The Central Bank and Financial Services Authority of Ireland consists of the Central Bank and the Financial Regulator, each with its own responsibilities. Among the Central Bank's key responsibilities are the maintenance of price stability, the provision of liquidity and contributing to financial stability. The Financial Regulator's key responsibilities are prudential regulation focussed on the individual financial institutions and consumer protection.

In my own opening remarks, I would like to briefly recall the background to the current issues in our financial system and in the economy more generally, up to and including the nationalisation of Anglo Irish Bank, and to outline the on-going role of the Central Bank in dealing with these issues. As you know, last week's Government decision regarding Anglo Irish Bank was taken in consultation with the Central Bank and Financial Regulator. This necessary decision reflects the commitment of the authorities here to maintaining the stability of the financial system and demonstrates that whatever actions are necessary in that regard will be taken. With reference to financial stability issues more generally, I will comment on the actions taken by the authorities here to secure the stability of our domestic financial system, particularly since the Lehman's bankruptcy last September.

The domestic economy

The Irish economy is currently going through a very difficult period and is facing into a second consecutive year of contraction. The contraction in output is set to result in significant job losses and a sharp rise in unemployment. Given the uncertainty as to the speed with which the global financial market crisis can be overcome, the assessment of the domestic economic outlook is especially difficult. What is certain is that we are in a significant downturn and two courses of action are essential. It is imperative that we move to correct the sizeable deficit in the public finances over a reasonable timeframe. It is also vital that we improve our competitiveness, which has weakened steadily in recent years. This is necessary to protect employment, to maintain and attract foreign investment and, over the longer term, to improve the potential for the economy to grow. In our present circumstances, pay developments need to take account of the changed outlook for inflation and the extremely difficult situation facing the Government's finances. They also need to take account of the necessity to restore competitiveness in a difficult international trading environment so as to be in a position to avail of improved economic conditions worldwide when these eventually emerge.

Notwithstanding current difficulties, Ireland's medium-term prospects are good. On the basis of still favourable demographic trends and some improvement in productivity growth, Ireland has the potential to grow strongly again in a few years. However, the achievement of this potential is not inevitable and is contingent on sound economic management. In the short term this will involve painful but necessary action to ensure long-run sustainability in the public finances and to restore our competitive position.

The global financial crisis

When I last appeared before you in July, I pointed out that we were in a challenging environment. At that time, we were experiencing a greater-than-expected slowdown in domestic growth in conjunction with a generalised disruption in international money markets. In mid-September this situation deteriorated dramatically with the failure of Lehman's bank in the United States. This event served both to accentuate and accelerate the adverse effects of the crisis across global financial markets.

Among developed countries, as confidence and trust waned, even the strongest banking systems were affected. To protect financial systems, which are so vital to every country's economy, policymakers internationally moved from interventions in individual institutions to scaled-up assistance, including funding guarantees and recapitalisations, on a system-wide basis.

I have made it clear over the last number of years that the Irish economy was facing an increasing number of downside risks and that, if an international shock interacted with these domestic vulnerabilities, it would give rise to serious consequences for our economy. In the event, this is what occurred and a rebalancing in the domestic economy, which could have been painful but manageable, has turned into a much more difficult challenge.

The excess supply of liquidity and large global imbalances, which emerged in the early years of this decade, were major causes of the significant vulnerabilities that materialised within the global financial system. These vulnerabilities included excessive credit growth, increasing leverage in the financial sector, and a search for yield leading to an under-pricing of risk in financial markets generally.

These developments had a marked influence on the Irish financial system. Although the Irish banks avoided the toxic assets associated with the US subprime market, there were specific domestic vulnerabilities, such as the banking system's strong credit growth, over-exposure to property-related assets and growing dependence on international wholesale funding.

These domestic and international vulnerabilities were identified clearly in our Financial Stability Reports in recent years. However, the severity, breadth and rapid onset of the financial crisis that has developed and the consequent impact on the global economy is unprecedented. This is reflected in the very large deterioration in financial stocks globally and exemplified in our own market. The upshot of all these developments is that all banking systems in advanced industrial countries have now required a number of rounds of support from their respective authorities. We have seen actions in this regard by some of those authorities again this week.

The Central Bank's response to the current crisis

The Central Bank has responded to the unfolding crisis in a number of ways.

Provision of liquidity

The Irish central bank, on behalf of the Eurosystem, and along with central banks globally, has been providing significant volumes of liquidity to the banking sector, since major financial stress began to become evident in autumn 2007. The Eurosystem entered this crisis with a relatively broad collateral framework for supplying liquidity to banks, in comparison with other major central banks. It has since made its liquidity more easily accessible for banks by widening its list of eligible collateral, providing the funds on a full allotment basis and extending the maturity of its operations. Other central banks have since moved closer to the Eurosystem model.

Euro area monetary policy

In response to the turmoil, and the associated impact on the real economy, the Eurosystem along with other major central banks, has eased monetary policy, in some instances, to levels not previously seen. The Governing Council of the ECB has cut its policy interest rate by 225 basis points cumulatively since last summer. This substantial fall in rates over the last few months has been a response to reduced inflation risks at a time of deteriorating economic and financial developments in the euro area. Clearly, if events cause our expectations regarding inflation to be revised, then the Governing Council remains ready to act.

Membership of the euro area has given us significant advantages, for example, in relation to liquidity support to our banks and elimination of exchange rate risk within the euro area. The advantages can also be seen by the fact that debates are now taking place in countries outside of the euro area regarding the benefits membership could bring them. However, membership of a monetary union and the absence of an independent monetary and exchange rate policy means that member state's domestic economic policies have to be appropriate. In particular, as I have mentioned earlier, in the absence of an independent monetary policy, it is essential in present circumstances that a strong focus is placed on policies to restore competitiveness.

Contributing to financial stability

While monetary policy and liquidity provision have always been the key functions of central banks, in recent years there has been an increasing emphasis on their contribution to financial stability.

Through the publication of financial stability assessments, central banks in the major industrial countries draw attention to risks to the financial system. This information and analysis is provided to the wider public, financial market participants and directly to the banks so that they are informed about the economic and financial environment, thus allowing them to adjust their behaviour consistent with those risks.

It is precisely this role that the Central Bank here has played over the past four to five years pointing out the domestic and international risks to the economy at a time when house prices and credit growth were increasing at very high rates. These risks, based on our ongoing analysis and research, were highlighted not only in our annual Financial Stability Reports, but also in our Quarterly Bulletins and in statements made by me regularly. In the context of an unprecedented period of expansion and wealth creation, this proved a difficult message to get across. It is evident there was not a sufficient or timely change in behaviour in response to these warnings. Other central banks around the world faced similar headwinds in changing behaviour consistent with the risks identified in their own financial stability assessments.

An international debate has now begun on how authorities might directly change the behaviour of financial market participants to mitigate the risks identified in Financial Stability Reports. This debate, in part, is focusing on whether central banks need specific powers to intervene directly in this regard. For example, one proposal is that central banks might have an explicit role in setting capital ratios in response to emerging risks identified in their financial stability assessments.

A further area for discussion is how monetary policy might better respond to asset price developments. For example, should policy "lean against the wind" by tackling asset price inflation more directly.

Recent developments

In late-September, following the Lehman's bankruptcy and when the global interbank markets froze and funding was unavailable even at the shortest maturities, the Central Bank formed the view that the risks to financial stability were becoming unacceptably high with knock-on effects for the wider economy. The scale of liquidity outflows was such that some of our institutions had acute liquidity risks. The concentrated nature of the Irish banking system meant that there was a high risk of contagion in the event of an individual bank encountering difficulties. There was no impending pan-European initiative to address these international pressures at that time, although it was to emerge subsequently. Our own Government decision to guarantee key liabilities of the banking sector was taken at that time to protect the stability of the domestic financial system by ensuring renewed access to funding for Irish financial institutions. A success of this measure was evident by the immediate improvement in the liquidity situation, including a substantial net inflow of funds in the days after the guarantee was introduced, and the ability of a number of the covered institutions subsequently to raise longer-term finance on the international markets. In the subsequent weeks, most other European countries moved to introduce some form of guarantee arrangements.

It was recognised at the time that it would also be necessary to determine if additional capital was required, particularly in the context of demands for higher Tier 1 capital by international investors and pressure on property valuations in the context of a much more significant downturn. Accordingly, after consultation with the Central Bank and the Financial Regulator, the Government announced details last month of its capitalisation scheme. The risk for banks that do not meet higher market standards is that they face a much more difficult environment for raising funds. It was not acceptable to the authorities that banks would attempt to achieve these higher ratios by curtailing credit to the real economy. A very important aspect of the capitalisation scheme is the agreement of the participating banks to develop specific credit policies targeted at small and medium sized enterprises, first time buyers and consumers generally.

As part of the response of the authorities to ongoing events, the Government last week made its decision to bring Anglo Irish Bank into full public ownership in order to secure the bank’s continued viability. The action was in response to a weakened funding position and the reputational damage to the bank arising from unacceptable practices that took place within it at a time when overall market sentiment was already negative towards the institution. It meant that recapitalisation was no longer the appropriate and effective way to secure its continued viability. So far as Allied Irish Banks and Bank of Ireland are concerned, the Government has reiterated that it sees these banks as central to the Irish financial system and essential to the proper functioning of the economy. It has also indicated its intention that both banks remain as independent banks in private ownership and has stated that it is proceeding with the planned re-capitalisations of both banks.

A well functioning financial system is central to the well-being of any economy. The Government has underlined the strong commitment of all the authorities to take whatever action is necessary to achieve this outcome.

Amando M Tetangco, Jr: Sustaining partnerships in a year of challenges

Speech by Mr Amando M Tetangco, Jr, Governor of the Central Bank of the Philippines (Bangko Sentral ng Pilipinas), at the Annual Reception for the Banking Community, Manila, 16 January 2009.

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Members of the judicial, legislative, and executive branches of government; leaders of the Philippine banking community; special guests from the diplomatic community, the private sector, the academe, and the media; fellow central bankers; ladies and gentlemen, a pleasant good evening to all of you.

On behalf of the Monetary Board, I thank you all for taking the time to join us tonight for our traditional Reception for the Banking Community.

That we are celebrating 60 years of Central Banking in the Philippines in 2009, makes this reception doubly meaningful. We are happy therefore that we have with us tonight former deputy governors and members of the Monetary Board; two former governors under the Central Bank of the Philippines – Governor Jaime Laya and Governor Jose Cuisia, Jr.; and one former governor of the Bangko Sentral ng Pilipinas – Governor Gabriel Singson. Ladies and gentlemen, let us acknowledge all central bankers – past and present – on this 60-year milestone with a round of applause.

We have 60 years of central banking behind us and we move forward to the future with confidence having learned many lessons along the way. We therefore look forward to more opportunities for us to shape a better future for ourselves, our families, our communities, and our country through sound and responsive monetary and banking policies.

Take the year just past, for instance. No doubt about it, 2008 was challenging given the difficulties we had to face. But it was also the same difficulties that allowed us to confirm.. that our collective reform efforts have put our financial system in better shape.

Indeed the irony of financial markets is that crises invariably occur despite the best intentions; yet, it is in facing the next challenge in relative strength that we can truly say we have learned from the past.

Ladies and gentlemen, we are fully cognizant of the difficulties that the current global financial crisis has created and the spillover effects that it would certainly generate. Our continuing efforts to clean up our domestic banking system and root out malpractices that particularly victimize the most vulnerable customers and our financial safety nets may also be creating short-term anxiety alongside global turmoil.

But I stand before you tonight to affirm that our banking system, in all its vital components – rural and cooperative banks, thrift banks, and commercial and universal banks, is in much better shape today than it was during the last crisis we faced. And I can tell you, the Monetary Board and the rest of the Bangko Sentral ng Pilipinas family remain confident that our banking system can work through these challenges.

I assure you, this is not meant to be a self-acclamation. Rather, it is our tribute to the collective efforts we have invested in our shared future. As a community of stakeholders, it is this common future that requires of us.. shared responsibilities to take on challenges together in order to grow and gain as one. I refer specifically to the Bankers Association of the Philippines, the Chamber of Thrift Banks and the Rural Bankers Association of the Philippines. The Bangko Sentral ng Pilipinas thanks you and salutes your efforts in sustaining economic activities not only in urban centers but also in the countryside through responsible and responsive banking. Ladies and gentlemen, let us give a round of applause to the Philippine banking sector.

There is a saying that it is okay to build sand castles in the sky for as long as our feet are well planted on the ground. What is the context, what do I mean by this? There are three points I wish to make.

First, the best strategy is always to move forward as one. This is not an inspirational punch line but the hard reality of market dynamics. We appreciate that banks are inherently business concerns, but protecting the institutional bottom line requires nurturing sustainable relationships in a thriving environment. What is not too obvious is that the financial system as a whole moves forward only when we work together. Ultimately, it is this stability from working together that gets us through the business cycles, even as this starts from a position of competing interests. As competitive elements within one system, we can always agree to disagree but we cannot fall into the trap of disagreeing to agree.

Second, it is critical that any lingering risk aversion from whatever source does not spill over into our ability to provide needed financial services for our real economy. Global conditions will be challenging. But in the same breath, let us not allow fears of off-shore conditions to pre-judge our on-shore actions, when and where such links are not warranted. If we are to consolidate our position of relative strength, we need to seize opportunities when they present themselves, while mindful of our basic fiduciary responsibilities and our mandate to act prudently.

This is a call for active participation at a time when the real economy needs us the most. We have seen how successful partnerships between the Bangko Sentral and the banking sector generated positive results for our people, our economy, and our country. I refer specifically to the banking sector as effective and responsive transmission channel for the Bangko Sentral's policies concerning money, banking and credit.

And now, to pro-actively move forward, I also ask for a re-affirmation of our partnership across a spectrum of initiatives – from expanding access to and improving the quality and cost of our services especially to the poor, to small enterprises, and to our overseas Filipinos; to building and deepening financial awareness and literacy; to promoting better consumer protection; to structuring organized and transparent financial markets. The times are challenging but they are as much a test of our own resolve; this will prove to be the first hurdle in building sustainable relationships in a thriving environment.

Third, the global financial architecture is broken because less attention was given to the details as markets moved faster, forward, and further. There was over reliance on market pressures to instill market discipline and global institutions – from multilaterals to regulators to market players – took comfort from the on-going work on best international practices. As we are now reminded, market failures happen at a painful cost to the displaced and that best international practices will mitigate domestic risks only if the supervisory framework evolves with market dynamics.

Moving forward, I believe that the need is not necessarily for more complex and rigorous new regulations but for greater accountability. Much more would therefore be required of the Board of Directors of banks and of the technical expertise of the line functions that relate to prudential management of risks. This is the form of market-driven accountability that I believe will be needed in restructuring the financial landscape – and it is quite different from just simply having more regulations. Let us therefore work more closely together in crafting regulations that would make markets more efficient and dynamic.

Will 2009 be a difficult year? Given the downward trajectory of the global economy, volatile commodity prices, and the continuing financial turmoil, conventional wisdom says that it will be.

Nevertheless, I believe that together we have the capacity to ride out the challenges before us. The key is to manage the factors that are within our control, to maintain a positive mindset, and to capitalize on our time-tested resiliency and ability to innovate amidst challenging times.

And don't forget, our economic fundamentals continue to be a source for optimism. This includes sustained economic growth, slowing inflation, declining interest rates, record high international reserves, balance of payments surplus, a competitive peso and a stable banking system.

In the end, the challenge in 2009 for the banking sector is to quickly act on the painful lessons of the global financial crisis. It is simply far too convenient to point at the complexities of structured products, the over-leveraging, or the fundamental dilemma with market greed. All these were necessary inputs but together they are not sufficient to explain where the world is today. More importantly, debating the whys and wherefores will have its place, but at this juncture we need to act decisively with conviction, in unison, and move forward.

Ladies and gentlemen, while the global prognosis for 2009 is daunting, the Bangko Sentral continues to believe that the Philippines remains in a position of relative strength as we navigate through these difficult times. What we do to consolidate our gains rests squarely on us. In the case of the Philippine banking community, I am confident it will prevail and remain sound and stable.

On behalf of the Members of the Monetary Board, I thank all the sectors represented here tonight for their continuing support: the banking community; the legislative, executive and judicial branches of government; the private sector, the diplomatic corps, the academe, the media, our special guests, and our partners in bilateral and multilateral agencies.

Together, let us offer a toast to our continuing partnership in sustaining economic growth in our country and improving the quality of life of Filipinos. Cheers!

Finally, before it becomes totally unfashionable, let me take this opportunity to wish all of you blessings of good health, success, and prosperity this New Year.

Mabuhay!

Thank you all and enjoy the rest of the evening.