

Patrick Honohan: The intertwined recent experience of the Irish and UK economies

Address by Mr Patrick Honohan, Governor of the Central Bank & Financial Services Authority of Ireland, to the British-Irish Parliamentary Assembly 40th Plenary Conference, Cavan, 22 February 2010.

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Introduction

I can think of no better topic for an address to the British-Irish Parliamentary Assembly than the similarities and contrasts between the performance of our intertwined economies before and during the global economic crisis. Economic activity and employment have contracted sharply and property prices have plunged. Our economies have been hit hard by the global financial crisis but in addition, for all of us, the crisis has served to expose strikingly similar pre-existing vulnerabilities in our economies – not shared by most others in Europe – which would sooner or later have led to trouble even if it had not been for the global meltdown, notably:

- the wide-ranging imbalances created by a credit-fuelled property boom;
- the growing dependence of the financial sector on wholesale market-funding, increasingly in the form of foreign borrowing, and
- the extent to which the credit and property booms significantly boosted transitory windfall tax revenues, which came to be relied on to finance strong growth in public spending.

While the economy of the Republic of Ireland was the more vulnerable, and has been hit much harder, I think that these parallels are no coincidence. Indeed, the involvement of banks from each side in funding the property boom of the other is an interesting dimension of the pre-crisis bubble. This of course reflects the fact that our economies have long been intertwined on a broader front.

As we begin to recover, though, there is one important emerging contrast. Inflation has been persistently negative in the Republic for over a year, reflecting the unwinding of the bubble against the background of a strong currency. But UK prices have been rising and the international value of sterling has been at historic lows. The contrasting exchange rate, price and wage environment presents its own difficulties, not least for Irish businesses struggling to remain cost-competitive, especially when wages had edged up to uncompetitive levels in the last years of the boom.

Fiscal policy

Even before the global crisis metastasized in September 2008, Ireland's fiscal position was coming under pressure, not just because of an accelerated expansion of spending in the previous few years, but especially because of the sharp fall in tax revenues which began soon after the property prices started to turn down.

To elaborate, the marked deterioration in the Irish fiscal position in recent years reflects in part the effects of strong growth in public spending first during the boom years, and then resulting from the demands imposed by the jump in unemployment. But a much more significant driver has been sharp collapse in tax revenues. The scale of the latter has been remarkable. The tax take, having averaged over 24 per cent of GDP in the first seven years of the new millennium, collapsed to barely 20 per cent of a greatly reduced GDP by 2009.

This reflected a fundamental weakness in the tax structure and, in particular, an excessive reliance on revenues related to the value of property transactions.

Looked at more broadly, this was the continuation of a trend that has been evident over the past two decades, which has seen a systematic shift away from more stable and reliable revenue sources such as income tax, VAT and excise taxes, towards more cyclically sensitive taxes. The result was more and more dependence on corporation tax, stamp duties and capital gains tax as sources of revenue; the contribution of this group of taxes grew from about 7 per cent of total tax revenue in 1987 to over 35 per cent two decades later. The buoyancy of these taxes during the boom period facilitated both a reduction in the income tax burden and the numbers in the tax net. It also financed a strong and persistent rise in public spending. While reliance on “boom time” taxes made these developments possible for a time, it left the fiscal position particularly exposed to a downturn. It also meant that fiscal policy was effectively operating in a pro-cyclical manner during this period and was itself stoking the boom. (Indeed, it has recently been estimated that the contribution of the residential property market to total tax revenue through VAT, stamp duty and capital gains alone more than doubled to over 12 per cent in the seven years to 2006, Addison-Smyth and McQuinn, 2009).

There is also the issue of the extent to which the nature and design of the tax system itself partly fuelled the construction boom. Tax incentives for developers and homeowners have long been a feature of the Irish taxation system and must have contributed significantly to the oversupply of houses which now exists, especially in parts of the country where underlying demand is likely to remain weak for many years to come.

The impact of the subsequent collapse in what were in reality largely windfall revenues can be gauged from the fact that, since 2007, total tax revenues have fallen by 30 per cent, while the combined receipts from stamp duties, CGT and corporation tax have fallen by 58 per cent over the same period. In total, just over half of the revenue loss since 2007 reflects declines in these three categories.

Along with the collapse of tax revenues, an expansion of Government spending – partly driven by policy, partly by the automatic response to a deteriorating output and employment situation – resulted in the sudden emergence in Ireland of a sharp fiscal deficit, after years of surpluses.

I don't need to dwell today on the robust, measured and appropriate policy response in Ireland that has stemmed and begun to reverse this fiscal set-back. Instead, I want to note the striking extent to which UK fiscal trends up to 2009 have paralleled, albeit in a more muted way, those of Ireland.

As I understand it, the recession in the UK has also been characterized by a fall-off in tax revenues and a rise in spending which, though not quite as sharp as in Ireland, have together resulted in the emergence of a deficit of comparable proportions as a percentage of GDP (in this case following a number of years where the deficit ran at around 3 per cent).

UK tax revenue too has been sensitive not only to the economic cycle, but also to the level of housing market and financial sector activity. In terms of corporation tax, for example, revenues from the financial sector have typically accounted for around 25 per cent of the overall corporation tax take, while the housing sector has provided revenue in much the same way as I have described for Ireland. UK Treasury estimates suggest that receipts from taxes linked to these two sectors rose from around 3 per cent of GDP in 2002–03 to 4¼ per cent of GDP by 2007–08 and accounted for around half of the increase in total current receipts over this period. Receipts from the two sectors are projected to decline to around 2¾ per cent of GDP in the current fiscal year, down by over one-third as a share of GDP. Public spending has also been growing, not least designed to offset some of the downturn in other spending.

In summary, in both countries, the collapse of the housing and credit booms has had a major impact on the public finances. For Ireland at least, the lesson has been that our taxation system needs to be on a firmer footing than in the past.

British and Irish banks and the property bubble – home and abroad

While tax incentives undoubtedly played a part in the Irish story, however, it was banks that primarily fuelled the property bubble. In short, there was too much bank lending, financed by heavy foreign borrowing; this funded an unsustainable construction and property price boom. To expand credit on the scale which happened, banks leveraged their deposits with sizeable borrowings from abroad. Funds were readily available in a global economy awash with surplus savings, with increasing possibilities for securitisation and helped by the absence of exchange rate risk on euro borrowings. Without large-scale foreign borrowing by the banks, the property boom could not have grown as it did.

Irish banks also engaged in extensive lending to finance projects outside of Ireland, though, in practice, this offered them little real diversification. Such lending was once again largely focussed on property-related activities, quite often involved Irish residents and tended to be concentrated on markets which were strongly correlated to Ireland. Consequently, overinvestment in property by Irish people was not confined to this country; the boom period also saw strong expansion in overseas property investment, particularly commercial property. Much of this investment was concentrated on the UK. While comprehensive data on the scale of such flows (lending for investment in UK property market) is not published, industry estimates suggest that up to half of such commercial investment went to the UK and that, during this period, Irish investors accounted for a not insignificant share of activity in the UK commercial property market.

While the expansion of Irish banks stands out for the scale on which these things occurred, it is clear that this experience was not unique. Global financial conditions were characterised by an abundance of liquidity and very low risk aversion across most markets. Ireland was not the only banking market which expanded by lending for property. A similar pattern was seen in the UK, where a similar combination of macroeconomic imbalances and financial sector developments, accompanied by a similar lowering of credit standards, drove rapid expansion of credit. To be sure, the British financial sector is much larger and more complex than that in Ireland. Nevertheless, a significant part of its expansion in the mid-2000s was related to funding of the property market. It has also been argued that accounting standards designed to reflect observable facts and limit the role of judgement as to future possibilities and risks, further contributed to pro-cyclicality in credit provision and pricing. The increase in property prices in Britain was not far behind that in Ireland, though the construction boom was much less pronounced, limiting the scale of the subsequent overhang. Nevertheless, as we all know, several sizable British banks got into difficulties too and had to be intervened or rescued.

Both the Irish and British banking systems are unusually international in character. For the Irish banks, a key part of their international activities relates to their long-standing and sizable presence in the UK – going well beyond their clearly central role in Northern Ireland. And the wide global reach of the largest British banks is an important aspect of London's continued role as a leading global financial centre hosting a deep and complex matrix of financial activities. Unsurprisingly, during the boom period, growth in the UK-owned financial sector was not just confined to the UK itself.

Indeed, bank competition in Ireland was strikingly influenced by the decision of one UK-based bank (HBOS) to expand more vigorously into the Irish mortgage market with especially keen pricing (though I would stress that it was not the most aggressive competitor in the Irish market). This bank's actions had the initially favourable effect of reducing lending margins and introducing new products, such as the tracker mortgage, which assured borrowers that interest rate changes on floating rate mortgages would not be arbitrary. These

innovations were subsequently adopted more widely, by both Irish controlled and foreign controlled banks in Ireland, as was an extensive reliance on wholesale funding.

Indeed, without questioning the largely-home-grown nature of the Irish credit bubble, it may well be that the rapid – and ultimately unwise – expansion of some of the UK banks both at home and in Ireland may have helped to lull Irish observers into a sense of false security. (The same might be said of the property price surge that was going on in parts of Britain).

At any rate, these new lending features became unsustainable in Ireland once the global financial crisis broke, with the scarcity and increased cost of wholesale funding to many banks undermining the profitability of tracker mortgages. Not surprisingly, both of the big British banks that have suffered most in the crisis (HBOS and RBS) have – like the locally controlled banks – reported a severe loan-loss experience on the lending of their Irish subsidiaries.

Both countries have acted decisively to protect crucial but weakened segments of their banking systems. Extensive asset insurance (UK) and asset purchase (Ireland) schemes have been put in place and government has injected capital into major banks on both sides of the Irish Sea, nationalizing some of them. The Irish measures will soon be completed when the major asset purchases of NAMA are finalized, and the main banks are recapitalized, at least in part with further investments by Government. While the scale of the Irish measures is larger than those in Britain, and the design of the measures different in detail, as is warranted by the contrasting nature and scale of the distressed assets held in the two banking systems, their broad outlines have striking similarities.

I am confident that these measures will succeed both in confirming the solidity of the banks, and in further restoring confidence in the finances of the State, free as it will then be of any shadow of prospective commitments to the banks.

Since the outbreak of the crisis, banks have tended to withdraw from international commitments, reflecting not only a broad upswing in what is often termed “home bias” in finance, but also the intensified pressure to deleverage – a pressure which has been considerably reinforced by the decisions of the European Commission, concerned to prevent State aid to banks from distorting banking markets. In line with these trends, the new management of HBOS has recently moved to retrench its Irish operations, closing its retail branch network here, a decision which is understandable though disappointing. I am glad to have been reassured of the determination of Ulster Bank – the RBS subsidiary – to remain in Ireland for the long haul. I feel sure that this commitment will be rewarded over time, and I would like to take the opportunity to emphasize how much we welcome the presence of British and other foreign banks providing financial services in Ireland.

Wage competitiveness

If, on the other hand, we are to seek contrasts, we need look no further than to wage, price and exchange rate developments. Clearly, wage competitiveness is a key to restoring economic activity and reversing the rise in unemployment. This aspect of competitiveness deteriorated significantly in Ireland during the boom, and, given the fact that euro-area inflation will continue to be low in the years ahead, recovering wage competitiveness in the short run must depend largely on containing and indeed reducing nominal wage rates – as indeed has already formed part of budgetary strategy. Though tough, this should be somewhat less painful than might appear at first sight, given the fact that inflation in Ireland has been negative now for well over a year – quite a contrast with the UK, where inflation currently exceeds the official target. Even indebted households may, for the present, be better able to absorb nominal wage cuts to the extent that most floating mortgage rates are currently still lower than they were before the crisis. It’s a different matter, of course, for the many affected by unemployment.

In contrast, international wage competitiveness of the UK has been strongly assisted by the weakness of sterling since the crisis began (albeit at the cost of rising inflation). The sharp decline in the value of sterling, especially from late 2007 to early 2009, has of course been inconvenient, to say the least, for businesses in the Republic exposed to UK competition – and let's not forget that we have long been and are still among the UK's largest trading partners. The contrasting exchange rate regimes and policies have certainly complicated life. Achieving cost savings sufficient to offset the exchange rate movement – albeit partially mitigated by higher UK inflation – has proved difficult, as is well understood by businesses in border counties such as Cavan.

Achieving lower nominal wage rates is not easy. But it is undoubtedly an essential component of a pro-employment recovery strategy for Ireland – and not simply a means of achieving budgetary savings. I want to end with this message, as I think that it is both the most important policy message that I can deliver in the current environment, and one which highlights in a dramatic way the similarities, contrasts and interdependencies of the economies of the Republic of Ireland and the United Kingdom, as we both face the volatilities and surprises of the globalized world.