Stefan Gerlach: Ireland's road out of the crisis

Address by Mr Stefan Gerlach, Deputy Governor of the Central Bank of Ireland, to the ZinsFORUM, Frankfurt am Main, 8 December 2011.

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1. Introductory remarks

Ladies and gentlemen, first I would like to begin by thanking the organisers for the invitation to speak here at this conference today.

From all the available evidence, it is clear that the global economy is experiencing a period of unprecedented economic and financial instability. Risks have increased substantially in recent months. The crisis, and not just here in Europe, has entered a new and dangerous phase. Against this background, the a priori expectation would have been that a country with its own considerable banking and fiscal difficulties, and one that was already in an external assistance programme, would see its situation worsen. However, that is not what has happened to Ireland. While market sentiment still remains fragile, and even allowing for the recent reversal in Irish bond yields, there has been an improvement in market perceptions of the risks associated with the Irish sovereign and the domestic banking sector since the summer. Notably, Ireland has also received favourable comment in some official circles, being referred to as an example, and even a role model, in terms of implementing a programme of adjustment.

While these are welcome developments, they largely reflect the fact that, to date, Ireland is performing well under the terms of the adjustment programme. This is good, but there are no grounds for complacency. Ireland is a small and very open economy and, more than most, it is subject to the fluctuations of the international economy. More immediately, the recent rise in Irish bond yields is a reminder that market perceptions are volatile and can change quickly. So, while good progress is being made in returning the economy, the public finances and the banking system to a sustainable path, much still remains to be done. As it has been to date, the adjustment must continue to be comprehensive, convincing and transparent if it is to deliver lasting success.

Having said this, as it is around one year on from Ireland's entry into an external assistance programme, it is probably timely to give an account of how Ireland is charting a path out of the crisis and what its progress has been. It will become apparent from this account that Ireland's adjustment began well before its entry into the EU-IMF programme and that many of the elements of that programme were already in place before Ireland had to turn to the Troika. What involvement with the external partners has provided are the invaluable funds needed both to keep the government and the banks financed and to implement the programme of fiscal, banking and structural adjustment over a reasonable time frame, as well as welcome external discipline and oversight.

2. Some background

To begin, it is useful to go back in time and recall a little of Ireland's recent economic history in order to understand how the country found itself in the difficult situation it has faced in recent years and to provide a context for explaining the approach taken to managing the crisis.

For much of the 1970s and 1980s, the Irish economy was a problem economy, characterised by low growth, high inflation and high and rising public debt. In addition, relative to the EU average, living standards were low. This period came to an end in the late 1980s, when the economy, first, stabilised and then was transformed through the second-half of the 1990s on the back of very rapid output, employment and productivity growth. As can be seen from the chart (Chart 1), the main engine of growth during this period was the strength of export growth, which was underpinned by wage restraint. Consequently, after an extended period of underperformance, the 1990s witnessed rapid economic convergence with Europe while maintaining macroeconomic stability. As a result, the unemployment rate fell from almost 17 per cent in 1987 to just over 4 per cent by the turn of the millennium, the fiscal balance moved from a deficit of over 8 per cent of GDP to a surplus of 2.7 per cent and the debt-to GDP ratio from in excess of 110 per cent to under 40 per cent over the same period.

This period, up to 2000, was the true "Celtic Tiger" era, characterised by buoyant export-led growth, strong employment growth, moderate wage and price inflation and healthy public finances. There was no single factor which accounted for the buoyancy and stability of the economy during this period. Rather, the period saw the coming together of a number of factors, both long and short-term, which helped to generate strong and stable growth. These factors included:

- Broad macro policy stability, which was built on the back of successful fiscal consolidation in the late 1980s;
- A strong focus on improving the economy's external competitiveness through wage restraint;
- Strong growth in labour supply and a dividend from earlier investment in education;
- A marked increase in inward foreign direct investment;
- Increased infrastructural investment (partly funded by the EU); and
- Micro reforms of labour and product markets.

3. The growth of imbalances

By 2000, economic convergence with Europe had been achieved, full employment had effectively been reached and there was little spare capacity left in the economy. At that point, one would have expected growth to slow, moving to the more moderate rates normally seen in post-convergent economies. While, against the background of the global recession of the time, Irish economic growth did slow in 2001–02, growth picked up strongly again from 2003 onwards. Notably, however, the sources and composition of growth after 2003 differed significantly from those of the 1990s. Growth became predominantly driven by domestic factors and, in particular, by a surge in construction activity, reflecting a boom in housing and commercial property investment. On the external side, there was a sharp deceleration in the rate of export growth as compared to the 1990s, reflecting, in turn, a considerable loss of competitiveness. In addition, there was also a significant slowdown in productivity growth.

This period, from 2003 to 2007, saw the emergence of significant imbalances in the Irish economy, which were at the root of the problems which emerged later. In summary, there were three sets of problems:

- An uncontrolled credit-fuelled construction boom which gave rise to an overheated property market and over-exposed banks;
- On the fiscal side, a tax structure and public expenditure levels which became too dependent on revenue from cyclically sensitive sources; and
- A trend loss in wage competitiveness, the labour market impact of which was masked by the transitory strength of parts of the domestic economy.

3.1 The property market and banking

Looking, first, at developments in housing and the construction sector. While both housing output and house prices grew reasonably strongly over the course of the 1990s, these developments could largely be justified by both the initial low level of the housing stock and property values at the start of that decade. As a result, over the course of the 1990s the housing stock grew from 1.2 million to 1.4 million homes. However, over the following eight years, the number of homes increased by a further half a million (Whelan 2010), a staggering 36 per cent increase in the stock. As a result, investment in dwellings in Ireland as a share of GDP rose from being close to the euro area average in the mid-1990s to being more than double that average a decade later (Chart 2). At this point, the share of construction output in GDP had also doubled in a decade, rising to around 10 per cent, while construction jobs accounted for more than one-eighth of total employment.

Despite the remarkable increase in supply, however, Ireland also experienced an exceptionally strong boom in house prices (Chart 2), reflecting the fact that demand, at that time, was significantly outstripping even the considerable growth in supply. In nominal terms, house prices increased by over 300 per cent in the decade between 1996 and 2006, with average annual growth in the region of 15 per cent over the period. Irish house price inflation over these years far outstripped that of any other advanced economy, with the rise in house prices across a selection of other OECD countries for which data is available, averaging around 6 per cent over the same period.

There were both fundamental and other, less comforting, reasons why Irish house prices grew so strongly during this period. Strong growth in per capita real disposable incomes and favourable demographic and household formation trends, boosted by sizeable net immigration, underpinned some of the increase in demand. However, worryingly, the rise in even basic valuation measures, such as the ratio of house prices to disposable incomes, was considerable. There were also other influences at work. The interest rate convergence process as a result of the move to EMU brought about a sharp fall in nominal short-term interest rates, with ex-post real interest rates further impacted by the higher rates of Irish inflation relative to the euro area. Also, there were significant incentives at the micro level, in terms of favourable tax treatment, which also served to stimulate the demand for property.

For this greatly increased demand for housing and other forms of property to be satisfied, however, finance had to be provided – and it was, and in extremely large amounts. While banks had not been central to the financing of the export-led Celtic Tiger period, which was income-led rather than credit-led, they were central to developments in the housing and property markets from 2003 onwards. Stimulated by financial market liberalisation and increased competition in banking, as a result of the entry of some foreign banks into the Irish market, competition in the mortgage market intensified. This led to a significant easing of loan conditions, such as maximum loan-to-value ratios and the rigour of creditworthiness assessments, as well as a narrowing of margins on lending. Against this background, there was rapid credit expansion throughout the banking sector (Chart 3). While much of this was related to house purchase, lending for property development also soared.

Given the scale of mortgage lending, it is no surprise to find that this resulted in an over-concentration of lending to the property sector and increasingly, over time, to property developers. It was the latter, which was to prove particularly problematic. At the peak of the boom, lending to the property sector accounted for two-thirds of the total outstanding amount of lending advanced by domestic Irish banks (Chart 3). This effectively tied the fate of the Irish banks to the evolution of the market for property and for development land. An additional problem was that, with growth in credit greatly exceeding growth in the deposit base, a significant proportion of the funding for this lending came through short-term wholesale foreign borrowing by Irish banks. While this development occurred in other euro area countries as well, reflecting the fact that the introduction of the euro facilitated a significant increase in the availability of cross-border funding, in the case of the Irish banks the increased reliance on this source of funding was quite dramatic. Between late-2003 and early-2008, the net external indebtedness of domestic Irish banks had jumped from around 10 per cent to over 60 per cent of GDP.

As noted by Honohan (2010), the later difficulties of the Irish banks, whether in terms of liquidity or solvency, are directly attributable to their over-lending for land and property investment during this period and to the fact that much of it was financed through external borrowing. In summary, both the scale and funding of property related lending between 2003 and 2007 were systemic risks which were very poorly managed and have been a major subject of official reports into the Irish crisis. The very costly lessons learned from this episode have informed subsequent decisions with respect to the transformation of financial supervision and regulation in Ireland in recent years.

3.2 Fiscal issues

In addition to the imbalances which were being created in property and banking, there were also less visible problems being built up in the fiscal area. There was both a particular and general aspect to these problems. The particular aspect stemmed from a growing reliance on revenues generated by the booming housing market. This was not just an Irish phenomenon, however. In many other countries, during this period, government revenues also benefitted from surging house prices, financial asset prices or strong growth in the financial services industry. We are now more aware that these gains are, to a large degree, cyclical, and need to be viewed as such. However, adjusting for the impact of housing booms or asset bubbles on tax revenue is not straightforward and is not something that was explicitly corrected for either in Ireland or elsewhere at that time. By not taking account of this effect, however, the underlying health of the fiscal position is overstated and its vulnerability to the cycle is understated.

In Ireland's case, given the scale of the housing boom, this was a significant factor. Estimates suggest (Addison-Smyth and McQuinn, 2010) that the contribution of residential property market taxes to total tax revenue doubled to almost 16 per cent between 2002 and 2006 (Chart 4). If one adds revenues from Corporation Profits tax to this, the share of this group of taxes rises to around 30 per cent of total tax revenue. This would be around 4 times higher than the share of this same group of taxes two decades earlier. This raises the more general problem that had been gradually been increasing over time, which was a reduced reliance for revenue on more stable and reliable sources, such as income tax and VAT, and a greater reliance on more cyclically sensitive taxes. Growth in the latter had been used to facilitate a significant narrowing in the income tax base over the longer term and had also been used to fund relatively strong expenditure growth in the 2000s (Chart 4). The dangers inherent in this approach were to materialise once the source of these cyclical revenues dried up.

3.3 Competitiveness

The emergence of imbalances during the boom period was also reflected in a sharp loss of wage competitiveness. Following EMU entry, some deterioration in competitiveness was probably inevitable, given that, by then, the economy had reached full employment and had probably achieved a level a level of competitiveness that was unsustainable. To some extent, this would have been a natural equilibrating mechanism in a strongly growing economy in a currency union. However, the scale of the loss of competitiveness which occurred went far beyond what might have been reasonable (Chart 5). The domestic demand driven nature of the boom, particularly after 2002, generated a strong boom-fuelled labour market. Notwithstanding strong inward migration, wage growth moved well ahead of that in trading partner countries. In turn, export growth slowed and the balance of payments moved rapidly into deficit (Chart 5), a development reinforced by the sharp increase in the net external liabilities of the domestic banking system, referred to earlier.

4. The crisis unfolds

As time passed, it became increasingly apparent that the boom was based on unsustainable drivers. The over-extension of credit had given risen to significant over-investment in housing, an excessive increase in house prices and a sharp rise in indebtedness. Growth had come to be increasingly driven by domestic demand, as external competitiveness deteriorated. There was an evident property price and construction bubble, the banks were over-exposed to this and there had been an effective loosening of fiscal policy, financed by an increasing dependence on cyclical tax revenues. This was unsustainable.

A slowdown in activity loomed once the housing cycle began to turn in late 2006, in response to evident oversupply and the impact of rising interest rates on affordability. In early 2007, the broader level of economic activity peaked and the bubble started to burst. The adjustment in the housing market, once it began, was relatively swift and spread quickly to the wider economy. The effect on the wider economy was, in turn, then aggravated by the outbreak of global financial market turmoil from mid-2007 onwards. However, with or without this turmoil, the Irish economy would have undergone a significant downward adjustment. So while the global recession of 2008/09 undoubtedly amplified the Irish downturn, Ireland's problems were home-made.

The collapse of the housing market over the following years was at the centre of the recession and the unwinding of economic imbalances. The level of annual housing output has fallen by around 90 per cent from peak (Chart 6), with output now little greater than the estimated depreciation rate of the housing stock. House prices have also collapsed, with the national average price currently around 45 per cent below peak and still declining (Chart 6). To give some context, the Japanese house price fall, which began in the early 1990s, is the only housing market decline across OECD countries which exceeds the Irish one in terms of depth and duration (Kennedy and McQuinn, 2011).

The recession triggered by the housing crash and amplified by the fall-out from the correction of the significant imbalances which had been created between 2003 and 2007 has been extremely severe. While less than the fall in output experienced by the Baltic countries in 2008–09, it is the largest contraction within the OECD area. Chart 7 shows that the fall in average annual GDP between 2007 and 2010 was just over 10 per cent. With the price level falling, the fall in nominal GDP, at close to 18 per cent, has been much greater.

Not surprisingly, given the nature of the preceding boom, the contraction in activity has been greatest on the domestic side of the economy, particularly on the investment side, reflecting the collapse of construction activity. On an annual average basis, total building and construction output fell by more than two-thirds between 2007 and 2010 and it is the fall in this component which has subtracted the most from growth in recent years. Consumption has also been hard hit. However, exports have performed better than expected, with the composition of Irish exports proving to be somewhat acyclical during the global trade downturn of 2008–09.

With the domestic side of the economy being relatively more labour intensive, the downturn has resulted in a sharp rise in the unemployment rate, which has risen from over 4 per cent to stand at over 14 per cent at present. Ireland's unemployment rate is now one of the highest in the OECD and over half of the jobless have been unemployed for over twelve months. Construction has accounted for close to half of the jobs lost. Large losses have also occurred in manufacturing and labour intensive services such as retail, hotels and restaurants. Younger workers without tertiary qualifications have been hardest hit. Mitigating the rise in the unemployment rate somewhat has been a sharp fall in the rate of labour force participation and also a rise in net outward migration.

4.1 Fiscal and banking developments

Turning to fiscal developments, the crisis triggered a dramatic shift in the state of the public finances. Having appeared a model of fiscal probity, running a budget surplus every year, except for one, between 1997 and 2007, Ireland rapidly moved into sizeable fiscal deficit from 2008 onwards. While I will deal later with the fiscal implications of the banking crisis, I would emphasise that a large part of the movement into deficit reflected the fact that the crisis revealed a weakness in the public finances which was not apparent during the boom years – the increased reliance on cyclical revenues derived from property related sources. While a movement into deficit could have been expected given the scale of the collapse in economic activity, the deterioration in the fiscal position in 2008–09 was driven, in large part, by a sharp collapse in Exchequer revenues (Chart 8), which fell at almost twice the rate at which nominal GDP declined. This reflected the fact that a large and growing share of boom-time tax revenues, which had been boosted by the property bubble, all but vanished during the downturn.

The most obvious impact of the crisis, however, was on the banks. The sharp correction in property prices exposed very severe vulnerabilities in the banking sector. Given the scale of lending during the boom and the heavy exposures to the property sector, and particularly to property developers, banks found themselves awash with bad or rapidly deteriorating assets, once the property market began to collapse. During the boom, the Irish banking system had lent excessively to fund a huge increase in credit, concentrated on the property sector. While most lending was to Irish residents, Irish banks also lent extensively abroad, though generally for property-related assets and in markets strongly correlated to Ireland. In effect, there was little risk diversification. The bulk of the lending advanced during the boom was secured against property and once the value of the latter began to fall, which it did dramatically in the case of development land, and with the economy also moving into a severe recession, a surge in non-performing loans and impairments became inevitable (Chart 9).

Although Irish banks had little or no exposure to the US sub-prime market, their heavy reliance on cross-border wholesale funding and concerns about the scale of their likely losses as a result of the rapidly unfolding collapse in property markets, meant that they were particularly vulnerable once liquidity began to dry up in global financial markets. However, concerns in relation to the Irish banks were not confined to liquidity, as evidence of the scale of their losses emerged (Chart 10) solvency concerns intensified and the Irish banks experienced a sharp rise in their credit-default swap spreads and a steep fall in their share prices (OECD 2009). With the growing prospect of their capital being eroded, and in some cases entirely exhausted, the State was forced to step in to underpin the banking system.

5. Policy responses

The extent of the deterioration in both the fiscal and banking situations required immediate policy actions and I will now turn to discuss these and talk about the approach taken by the Irish authorities to, first, respond to, and, then, gradually start to begin to work their way out of the crisis. In doing this, it will become apparent that much was done before Ireland entered the EU-IMF programme and that the programme essentially represents a continuation and deepening of the adjustment strategy that had already been put in place. Crucially, however, this is now happening within a secure funding environment for the next two years and is benefitting from the engagement and support of partners.

While the aim has obviously been to unwind the imbalances in the economy and, in particular, to correct the problems in the fiscal and banking areas, the underlying approach has increasingly been to recognise the need to reduce both the level of debt in the economy and also the perceived tail risks associated with that debt, especially in relation to the banks. The lesson is that reducing uncertainty and risk in this way helps, not only to improve market perceptions, but also to demonstrate clearly that progress towards a resolution of the problems is being made. Successfully managing risk perceptions, through convincing and transparent actions, is crucial in the current market environment.

5.1 Banking

Turning to the policy response on the banking side, the first point to make is that, while policy actions were taken relatively quickly in response to the emerging crisis in banking, for reasons outlined in a moment, it took some time to get a clear and credible estimate of the potential upper limit of the losses of the banking system in a stressed scenario. Up to that point, despite the scale of the policy actions taken, concerns about uncertainty and risk in relation to further bank losses dominated assessments of the outlook for both the banking system and fiscal policy.

A timeline of banking sector developments from September 2008 is shown in Chart 11. As it shows, the initial response of the Irish Government, in September 2008, to the severe funding difficulties of the Irish banks and the intense concerns which emerged about the viability of the Irish banking system was to introduce an extensive guarantee of bank liabilities for a period of two years. While this guarantee was introduced in highly pressing and urgent circumstances, as Patrick Honohan (2010) noted in his report on the Irish banking crisis, "it complicated and narrowed the eventual resolution options for the failing institutions and increased the State's potential share of the losses". This guarantee was superseded by a narrower, more time-limited, scheme which has continued to be extended after the expiry of the original guarantee scheme and still remains in place.

It should be added, at this point in the narrative, that, governed by a detailed legal framework, the ECB provided ample liquidity to the Irish banking system all through this period, thereby considerably reducing risks for the domestic banks. During this time, the Central Bank of Ireland has worked with the ECB to ensure that the necessary liquidity has been made available to allow the Irish banking sector to continue to function.

Returning to the banking strategy, in practice, it has come to be organised around three objectives – recapitalise, resize and restructure. The first move to recapitalise banks was in late 2008, though these injections were small relative to what would come later. To help stabilise and start to resize the system, it was decided to establish a national asset management agency (NAMA) to purchase the largest property development-related loans, removing them from banks' balance sheets. By removing the uncertainty about future losses on these loans, the intention was that it would leave banks in a stronger position to recover. The NAMA approach, with a view to breaking even over time, was to buy loans at market-related prices from banks. Given the state of the property market, this implied substantial haircuts and necessarily entailed crystallising sizeable losses on banks' balance sheets. This generated a large and transparent recapitalisation need, which was met by the State. While it was recognised that this would be costly, it gave visibility to the process.

However, there were difficulties. As a result of a requirement to apply competition law, it was necessary to value and transfer loans individually. This made the transfer process a relatively lengthy one, which worked against the objective of moving quickly to cleanse balance sheets. More significantly, an unforeseen consequence was the fact that the average size of the haircut increased over time, as the typical size of haircut on the later tranches proved unexpectedly large. As a result, the final recapitalisation need arising from the NAMA process was greater than the initial indications from the earlier tranches of loan transfers had suggested. This added to the uncertainty as to the ultimate cost of State support for the banks and, given that this news emerged as the European sovereign debt crisis itself was unfolding, it added to pressures on the Irish sovereign at a crucial time in 2010.

Taking everything into account, the total recapitalisation need up to end-2010 was slightly over €46bn, of which just under €36bn (over one-fifth of 2010 GDP) was gross debt enhancing. The bulk of this €36bn was accounted for by the cost of recapitalising Anglo Irish Bank, a bank with catastrophic development-related losses and which had been nationalised in early 2009. The remaining public capital injections in 2009–10, of just under €11bn, into the two major domestic banks were recorded as financial investments and were funded from the National Pension Reserve Fund.

The effect of the sizeable sovereign support for the banks, which impacted significantly on the 2010 fiscal deficit, allied to the rapid deterioration in the underlying fiscal deficit (Chart 12), led to an extremely sharp rise in the general government debt ratio (Chart 12). This increased from a relatively low level of 25 per cent of GDP in 2007 to rise to more than 90 per cent of GDP by 2010. The increase in the deficit and debt ratios occurred despite the fact that considerable fiscal consolidation had already been underway since 2008. In total, over five fiscal adjustment packages, this amounted to cumulative ex-ante consolidation measures of the order of almost 10 per cent of GDP. Their impact in improving the fiscal position, however, was being countered by the effect of the sizeable contraction in economic activity on the public finances.

By the third quarter of 2010 then, despite significant measures in both the banking and fiscal areas, concerns remained elevated about Ireland's financial balance sheet. The fiscal deficit was high, the debt ratio had risen sharply and had reached a level where there were growing concerns about sustainability, particularly given the perceived uncertainty about the ultimate costs of bank support and, in particular, about the uncertainty regarding the associated tail risks. In addition, the economy, particularly the domestic side, was still contracting.

Against the background of the heightening of tensions in European sovereign debt markets, there were obvious risks in these circumstances. Added to this was the looming deadline of the expiration of the bank guarantee scheme introduced in September 2008. Irish government bond yields began to rise and deposits flowed out of the domestic banking system at an accelerated rate. Crucially, despite a sharp increase in the need for central bank funding, the Eurosystem continued to fund the growing liquidity deficit, with lending carried out either through normal Eurosystem operations or directly from the Central Bank of Ireland.

5.2 EU-IMF programme and banking measures

Pressures continued to mount, however, and an adverse shift in international market sentiment drove yields on Irish debt in November 2010 to levels that signalled the market was no longer willing to provide funding to the sovereign at reasonable rates of interest. At this point, external assistance in the form of recourse to the financing facilities of the EU and IMF became essential.

Through providing financial support out to end-2013, subject to specific conditionality, the programme provides time for Ireland to tackle its problems. In terms of conditionality, as I mentioned earlier, the programme essentially required a continuation and deepening of existing policies. In particular, the EU-IMF programme endorsed the overall policy approach to banking, while facilitating a more rapid and far-reaching implementation of this strategy. The central aim remained to recapitalise, resize and restructure. First, capital was being injected to reach the newly increased capital standards. Second, an explicit strategy for downsizing and reorganising the banking sector was to be implemented. Third, the institutional weaknesses that had become apparent during the banking crisis were to be addressed.

To ensure that bank balance sheets were strengthened and that deleveraging plans could be implemented, the Central Bank carried out painstakingly detailed capital and liquidity assessment reviews of the domestic banks, the results of which were published in end-March this year (Chart 13). While a number of previous capital assessment reviews had been carried out earlier, this one differed in some important respects, with tougher loan loss assessments, the insertion of an additional capital buffer, strong external validation and greater transparency, all features of the exercise. A highly conservative approach was taken to the estimation of loan losses, with an independent loan loss assessment exercise carried out by internationally recognised experts in this area. These assessments were carried out on the basis of more granular and demanding information gathering and analysis of the impaired loan portfolio and financial condition of the banks. In addition to oversight by the external consultants, the detailed findings were subject to close scrutiny by the Troika teams. Stress loan-loss estimates were then set at a level sufficient to cover even extreme and improbable losses. Banks capitalisation requirements were, in turn, determined on that basis. The results were then published, with much fuller detail provided than before, to reinforce to market participants the quality of the exercise.

The results, which suggested an additional recapitalisation requirement of €24bn (of which only €6.5bn would be gross debt enhancing, with the remainder coming from the National Pension Reserve Fund and liability management exercises by the banks) were seen as convincing by the market. In effect, this dealt with the tail risk issue in relation to the banks and, allied to the plans outlined for fiscal consolidation in coming years, was a huge step forward in convincing markets that there was now a more certain upper limit to Ireland's debt problem. The beginning of the more positive assessments of Ireland's prospects date from after the publication of the results of this exercise.

In addition to ensuring capital adequacy, there is also a commitment to a schedule of deleveraging of the banking system. This reflects the fact that loan losses and credit quality are only part of the problem of the Irish banking system, the other part being the funding position of the banks, which is linked to their structure. To address this problem, the Irish banks have been given a schedule of deleveraging and liquidity targets to be achieved by end-2013. The key targets here are the planned reduction in the loan-to-deposit ratio to 122.5 per cent (from an average starting level of close to 180 per cent) and the requirement for banks to meet specified targets to fund a greater proportion of their lending activities with stable, long-term funding. Deleveraging is to be achieved through the identification and sale of non-core assets, mainly foreign-held assets. In this way, the impact of deleveraging on the domestic economy should be minimised. To the extent that assets can be sold outright then bank recourse to official funding can be reduced.

Restructuring of the system has also been taking place, with the establishment of two pillar banks based around the two main domestic banks, with those banks which are no longer sustainable being wound down and their deposits transferring. Further progress has also been made in the resolution of terminally damaged institutions.

Assessments of progress on the banking and financial sector elements of the programme have been very positive, with implementation seen as strong during the first year of the programme.

5.3 Fiscal adjustment

On the fiscal side, the programme largely represents a continuation of the approach which has been taken to date, looking to build on the progress that has been made in arresting the deterioration in the underlying deficit (that is, net of the cost of the banking assistance measures). Having stabilised this measure of the deficit, the aim now is to implement a medium-term programme of measures which will reduce the deficit to below 3 per cent of GDP by 2015. Implementation on the fiscal side has also been judged to be strong. Including 2011, the value of total consolidation measures undertaken to date amounts to around 13 per cent of GDP since the process started in late 2008 (Chart 14). In keeping with the findings of both theory and best international practice, the bulk of the consolidation has taken place on the expenditure side, mostly through public sector payroll reductions and reductions in social welfare spending. Significant capital savings have also been made.

While there can be arguments about the need to do even more in terms of future adjustment, the broad assessment of the Troika is that proposed medium-term path of deficit adjustment is credible and balanced, envisaging, as it does, a return to primary surplus to help stabilise the debt. The view is that the best contribution that fiscal policy can make, to ensure a return to a sustainable medium-term position, is to adhere to the programme targets that have been set. In this regard, it is encouraging to see that the scale of planned fiscal adjustment in 2012 and 2013 has been increased slightly to ensure that the agreed deficit targets in those years will be reached, despite the projected slowdown in growth.

With regard to the debt position, the greater clarity which has emerged in relation to the banking situation has helped to ease tail risk concerns in this area as well. The consensus view, including that of the Troika, is that, on current projections, the debt-to-GDP ratio will peak in 2013 before gradually beginning to decline thereafter. However, while the debt position remains manageable, it could not be described as comfortable. In particular, continuing strains in the euro area and global economies clearly pose some risk to the outlook.

The programme also requires improvements to the medium-term fiscal framework, many of which are currently being put in place. A new Fiscal Council has been established, with an independent mandate to assess budgetary projections and the appropriateness of the fiscal stance. A multi-annual planning and budgeting framework and formal fiscal rules are also in the process of being put in place.

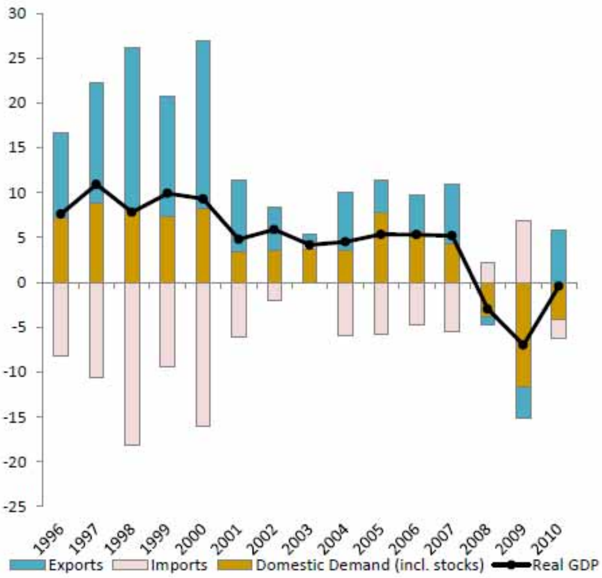
6 Some concluding thoughts

To conclude, with respect to progress made in implementing the adjustment programme and meeting the milestones along the way, Ireland has done better than most might have expected one year ago. Despite the very challenging environment, both fiscal consolidation and financial sector reform are progressing on schedule. The external assessments by the Troika note that programme implementation has been strong. This is encouraging, and reflects the fact that much heavy lifting has been done domestically to try and put the public finances and the banking system back on track. Much more remains to be done, however. Significant imbalances remain to be corrected, with debt, both public and private, still very high. The overwhelming evidence is that recoveries from banking crises are slow and gradual.

One could be somewhat more confident about the outlook if the external backdrop was more favourable. What Ireland is trying to achieve is difficult. Policy implementation has been strong and important progress has been made, but much will depend on how the international situation evolves, and the outlook there continues to be increasingly uncertain. Ireland is doing well in terms of its own adjustment programme, we will find out in time is that enough.

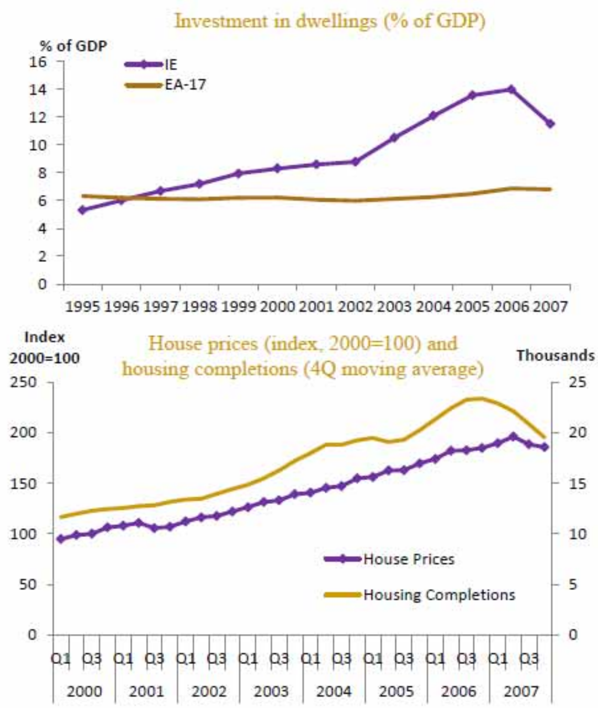
Contributions to GDP Growth Year-on-Year

- Strong growth transforms economy in second half of 1990s
- Exports the main engine of growth
- This facilitated rapid economic convergence with Europe
- Macroeconomic stability maintained



Housing Market

- Housing investment takes off from mid-1990s
- Share of construction output in GDP doubles in a decade
- House prices increase by over 300 per cent between 1996 and 2006
- More than double the average rate of increase in OECD area



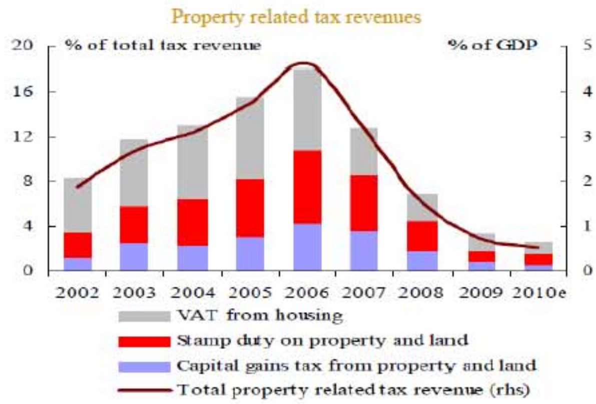
Credit Expansion and Bank Exposures

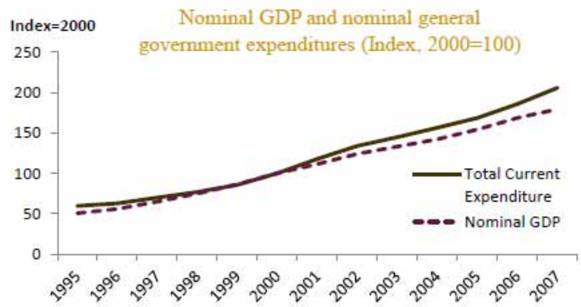
- Increased demand for housing met through rapid growth in mortgage credit
- Lending for property development also soared
- Over-concentration of lending to the property sector
- Increasingly funded through foreign borrowing by banks

* Excludes IFSC. Property-related lending refers to the construction, real estate activities, and residential mortgages sectors.
Source: Central Bank of Ireland, Statistics

Windfall Revenues

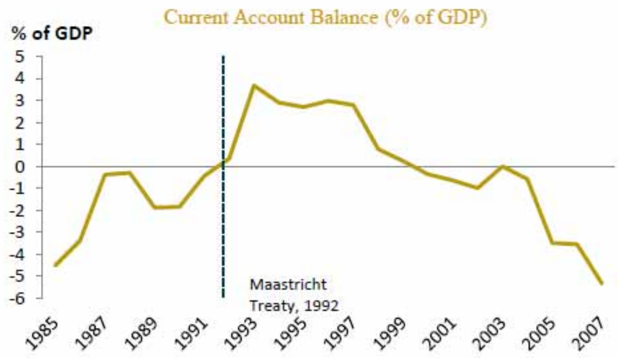
- Government revenues benefit from surge in housing activity
- These revenues are largely cyclical
- Reliance on more stable revenues reduced
- Government expenditure grows faster than nominal GDP growth each year after 2000





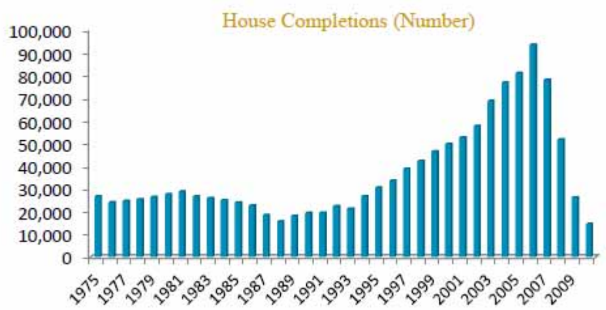
Competitiveness and Current Account

- Economy highly competitive in 1990s. Some loss inevitable later
- Sharp deterioration from 2000 onwards
- Export growth slows and balance of payments moves rapidly into deficit



Housing Collapse

- Housing collapse at centre of recession
- Housing output down almost 90 per cent from peak
- House prices collapse also
- Prices currently 45 per cent below peak



Deep Recession

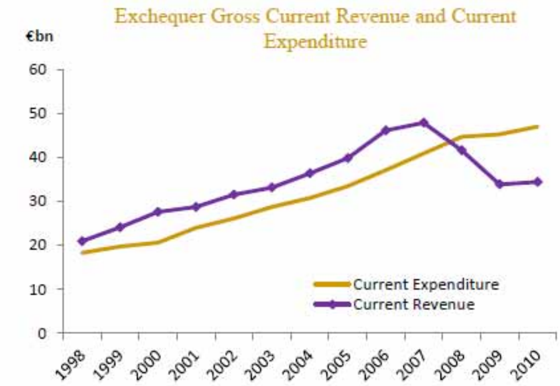
- GDP falls 10 per cent in average annual terms between 2007-10
- Sharper fall in nominal GDP
- Domestic side of the economy hardest hit
- Exports not as adversely affected during downturn

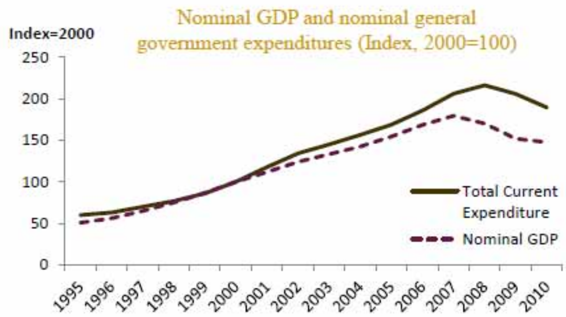
Economic indicators – 2007-2010

GDP	↓	-10.1%
Personal Consumption	↓	-8.6%
Investment	↓	-52%
Unemployment (ILO measure)	↑	from 4.5% to 14%

Public Finances

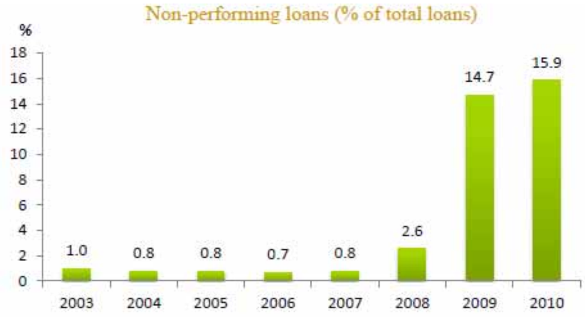
- Sharp loss in revenues
- Windfall revenues collapse
- Automatic stabilisers keep expenditure levels high

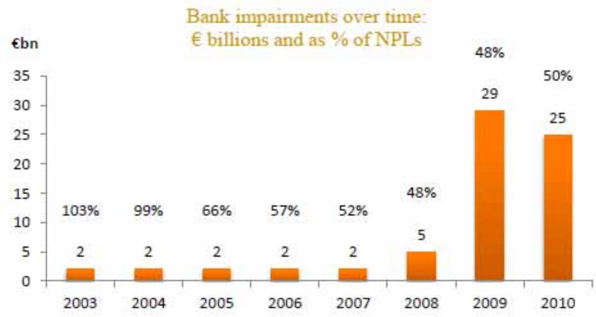




Non Performing Loans & Impairments

- Bulk of lending had been secured against property
- Collapse in property market and wider economy pushes up NPLs and impairments

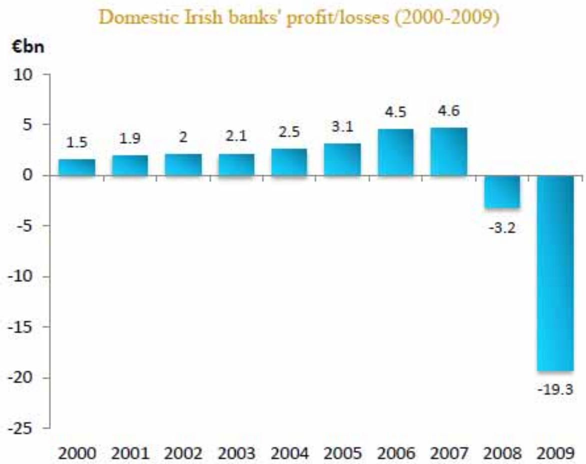




Note: Applies to domestic Irish banks only. Includes non-current assets held for sale.
Source: Central Bank of Ireland Prudential Statistics

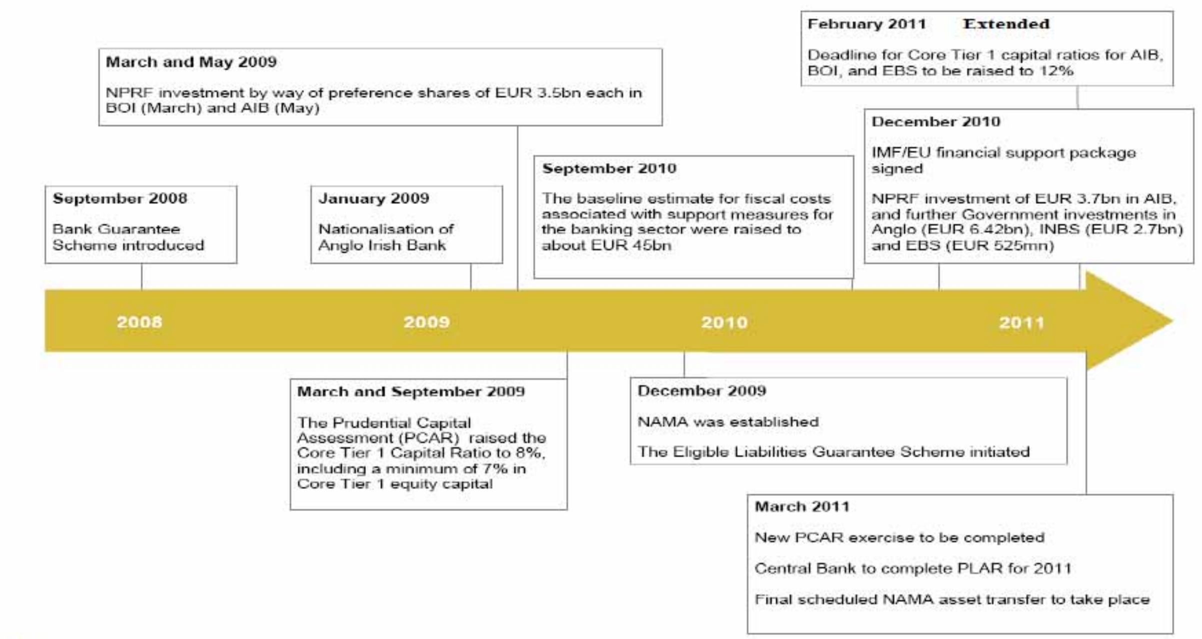
Banking Losses Mount

- Property collapse leads to sharp rise in banking losses
- Solvency concerns grow
- Funding issues also arise



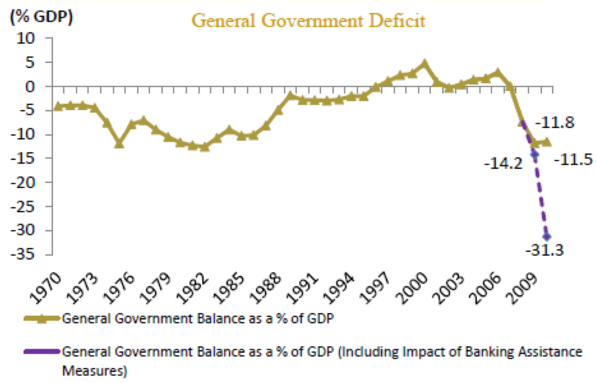
Note: Applies to domestic Irish banks only.
Source: Central Bank of Ireland Prudential Statistics

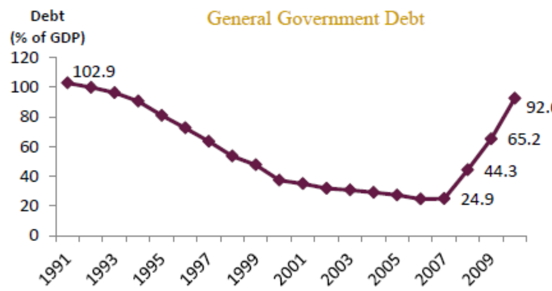
Timeline of banking sector developments



Deficits and Debt

- Sharp deterioration in deficit from 2007 onwards
- Banking support measures impact in 2010
- Debt ratio rises by almost 70 per cent between 2007 and 2010
- Sustainability concerns grow





Sources: CSO and Department of Finance. Based on ESA-95 definition of deficit.

Banking programme strengthens individual banks and brings stability to the sector as a whole

1 Ensuring that the banks are adequately capitalised

- A top-down Prudential Capital Assessment Review was carried out by the banks, in a base and a stress scenario
- Independent loan loss exercise performed by Blackrock Solutions
- Stress loan-loss estimates set at a level sufficient to cover even extreme and improbable losses
- Banks capitalisation requirements determined on this basis

2 Guaranteeing sufficient liquid standards

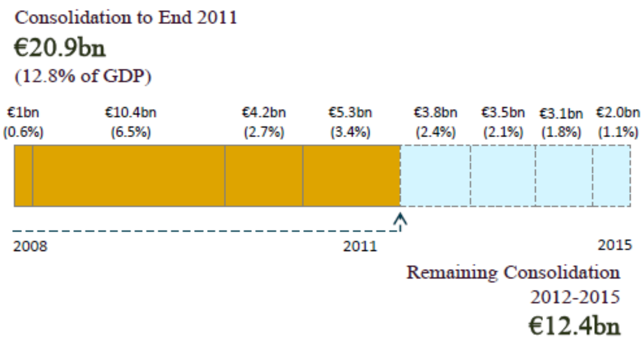
- With the agreement of the Troika, a sustainable Loan to Deposit Ratio for the aggregate banking system of 122.5% targeted for 2013
- Targets set for each institution and banks required to identify and dispose of non-core assets
- Deleveraging will serve to create a sustainable sector and wean banks off short-term, central bank funding

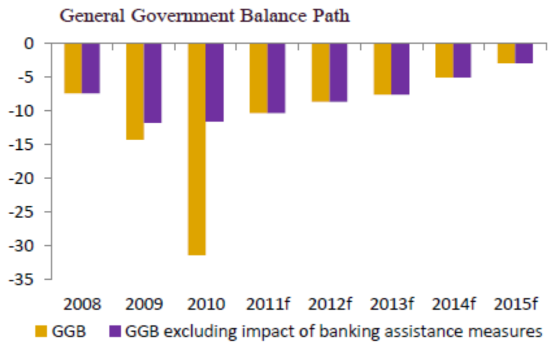
3 Restructuring banking sector to ensure future stability

- In tandem to the work carried out around the capital and liquidity requirements of the individual banks, restructuring of the broader sector happening
- Two 'pillar' banks to form the basis of the banking system going forward
- Irish Bank Resolution Corporation established

Fiscal Consolidation

- €20.9bn (12.8% GDP) consolidation made to date. €12.4bn remaining (7.4% GDP).
- Revenue raising measures of €7bn to date (income levy €2bn, further increases in income levy, changes to PRSI). Recent tax savings focussed on income tax in 2010. Further revenue raising of €4.7bn planned by 2015.
- To date total current savings of €10.5bn achieved, mostly through public sector payroll reductions (through imposition of public sector pension levy and postponing of social partnership increases) and reductions in social welfare spending. Further €6.4bn current cuts planned by 2015.
- Capital savings to date totalling €3.5bn. Further €1.5bn capital cuts over 2012-2015 planned.





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