Patrick Honohan: "More Europe" in the financial arena – good for Ireland?

Address by Mr Patrick Honohan, Governor of the Central Bank of Ireland, at the Institute for International and European Affairs, Dublin, 29 June 2012.

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Thanks once again to the Institute for International and European Affairs for arranging such an interesting event and for inviting me to speak at it. It is almost 18 months since I spoke here last, in the immediate aftermath of the bailout deal with the Troika, that combination of the European Commission and the IMF "in liaison with" the ECB. The engagement with the Troika has certainly generated a lot "more Europe" in the financial affairs of Ireland and I will come back to that in a few minutes, but first I want to harken back to earlier days.

European bank supervision

One of the two inaugural publications of the Institute back in 1991, a study entitled *Economic and Monetary Union*, explored the implications of the freshly minted draft Maastricht Treaty which laid the constitutional foundations for EMU. The study goes into the question of whether bank supervision should remain at the national level in the new monetary union and concludes that "an opportunity may be missed […] arguably, a centralised bank supervision authority (whether a department of the ECB or a separate entity) with wide powers would be more able to operate above national political pressures in acting decisively to prevent a failing bank from continuing to operate in an unsound manner." "There would [the study astutely goes on to observe], of course, be a need to retain a local-based inspection system for supplying the local feel which is essential for detecting the early warning signs of distress. But, so far as action to restrain unsound banking practices is concerned, here again, as in the case of monetary management, it may be worthwhile for national governments to cede power to the centre in order to 'save them from themselves'".

Well, it seems from the banking part of the 4 Presidents' report[1] (remarkably entitled "Towards a Genuine Economic and Monetary Union") and from this morning's Summit statement that this two-decade old idea's time has finally come. At last there is a clear push towards integrated banking supervision with ultimate authority at the European level enforcing a common rule book. Of course a significant national component of supervisory activity would continue, and probably extensive cross-border use of national supervisory capacity – for Ireland both outward and inward – would likely be a conspicuous part of the supervision in the years ahead.

The other two banking elements of the 4 Presidents' proposed "integrated financial framework" (formerly known as a "banking union"), namely the establishment of a European bank resolution scheme fund and a European deposit insurance scheme, could help break, for the future, the damaging link between bank failure in smaller countries and the taxpayer burden in those countries. In particular, centralised resolution, combined with the European Commission's recent proposals on bailing-in uninsured bank creditors would clearly ensure that what happened in Ireland would not be repeated elsewhere in the future.

It may not be popular these days in some circles here to speak favourably of "more Europe", but in this arena of financial integration at least, I therefore believe there is very little by way of threat to Ireland in moving forward; rather there is quite a lot to gain. Indeed, the Irish experience points rather clearly to the need for measures along these lines.

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1 http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131201.pdf.

An opportunity for coherence in system design was missed in 1991 by the architects of the euro area; it should be seized now. Of course there will be practical and political difficulties, and the 4 Presidents' report leaves many critical decisions unanswered, but the broad direction is established.

Debt yield spreads in Europe – too high

It remains to be seen whether the initiatives in this direction (banking supervision, deposit insurance and resolution) will be enough in themselves to reassure markets, sufficiently narrowing again the spreads on Government debt to the tight range that was observed throughout almost all of the first decade of the euro. There is, of course, much more in the 4 Presidents' report than just the proposals on financial integration: specifically that report also covers the large areas of integration for budgetary and economic policy frameworks and a strengthening of democratic legitimacy and accountability. I will not go into those matters here, but all in all it is to be expected that, while designing and adhering to such a road-map is surely necessary to rebuild both market and especially intergovernmental confidence, it may take time for market yields to converge to the extent desired.

Recall that one of the Maastricht criteria for admission to the euro area is that a country's long-term bond yields should not be more than 200 basis points (2 percentage points) above the average for the three countries with the lowest inflation rates. Yesterday Spanish long-term yields reached about 550 basis points above those of Germany; the figure for Italy was more than 450 basis points. Clearly these market conditions – relating to three of the four largest countries – are not what was envisaged by the Delors committee way back then and are not consistent with the integrated monetary transmission called for in the Treaty. This has to be corrected, and quickly.

What has been going on to generate these high spreads? Here's one oversimplified take on it but one that I think conveys some of the reality. Even very high national debt ratios in the euro area can be seen by the markets as tolerable as long as interest rates are low – and interest rates were indeed low throughout the euro area before the crisis. The low interest rate environment owed much to the effective and credible control over inflation rates that had come into effect and represented such a welcome relief for many countries relative to what had been experienced in the 1970s and 1980s. Introduction of the euro ensured low interest rates in the low debt countries, but low yields also prevailed in the high debt countries as long as markets thought that the debt levels were tolerable and that the debt would be repaid without any doubt. Even for countries to which the ratings agencies did not attach a high credit rating, sovereign debt traded for most of the first decade of EMU as if it was AAA or close.

The same very high debt ratios do not appear so tolerable if interest rates are high. And, alas, markets will demand higher interest rates if debt does not appear tolerable. This vicious circle has gripped half a dozen euro area countries with a vengeance. (Now the spreads again seem out of line with credit ratings – but this time the range of spreads is wider than the ratings would normally imply.)

A sense that countries in trouble would eventually be bailed out despite Treaty prohibitions may also have been at work in keeping debt yields low in the past: but that belief too has been eroded by the market's experience with the Greek PSI debt exchange.

Of course, by piling up debt in many euro area countries (some of which were already high; some not so high), the fiscal and banking policy responses to the crash of 2008–9 (countercyclical fiscal policy and the assumption of the obligations of failing banks) have contributed to moving countries from safety into the risk zone where the good equilibrium – low interest rates, low perceived default risk, could flip, and has flipped, into the bad equilibrium of high interest rates and less certainty. Getting debt ratios back to moderate levels is the medium-term solution, but that takes time.

Breaking this vicious circle should be possible even in the short-run – a number of techniques is available – but to do so in a way that is broadly acceptable across Europe and in a way that maintains overall stability in other dimensions requires the steps adumbrated by the 4 Presidents; this morning's Summit pushes the process forward. Until this vicious circle is convincingly broken, and a more sustainable configuration of bond yields is restored, financial market conditions will continue to appear fragile. That is why there is increasing recognition that it is not something to be left on the long finger.

Europe and Ireland's finances: the programme

Ireland's financial interactions with Europe also relate, of course, more specifically to the Troika financing and the Programme of adjustment which is now about half way through.

When I spoke to the Institute last in January 2011 it was, as I have mentioned, with an analysis of where the Programme at its introduction situated Ireland. I pointed out that Ireland faced a serious problem of excessive indebtedness, public and private, and that the Programme would not solve this, but would give time for Ireland to deal with the level of debt. I pointed out that tail risk in the banks remained high, and that the EU and IMF had not been able to include in the Programme any financial instruments that would help insulate Ireland from tail risk. The hope had to be that tail risks would not materialise.

These two issues: high public debt and the working out of the banks' distressed loans remain central. Progress has been made but more is needed. Let me speak first about the public finances and public debt, and then about the banks. In both aspects, Ireland's interaction with Europe and the Rest of the World generally is a crucial part of the story, but a lot is home-grown also.

With regard to the public finances, clearly the aftermath of the bank-driven boom and bust is the context for everything. Still, it is convenient in turn to separate in our minds the sums arising directly from the recapitalization of the banks, and those related to the rest of the evolution of the public finances.

Recapitalising the banks

The Government has now injected sums equivalent to over 50% of this year's GNP into the Irish-controlled banks. About a half of this has been a cash injection – much of it from the NPRF, which had to sell the bulk of its external investments in equities and bonds, etc. to provide this – and the rest in deferred form: promissory notes and conventional Government bonds provided to IBRC, the successor bank to Anglo and INBS. Until these deferred amounts are settled in cash, the cash needs of IBRC are being met with some €42 billion of exceptional liquidity assistance from the Central Bank of Ireland. The drawings of the Central Bank on the Eurosystem that, in effect, meet this ELA is subject to remuneration at the ECB policy rate, currently 1 per cent.

As long as these arrangements continue, then, they have a sizable impact on the gross – and especially the net – debt of the State, but the overall running cost to Ireland has been relatively low,[2] thanks to the indulgence (in this matter at any rate) of the locally oft-maligned ECB! Although this financing arrangement continues for the time being; still, from the market's point of view, the lack of any explicit commitment to long-term low cost financing of IBRC's cash needs no doubt has represented one of the obstacles to Ireland regaining market access on the necessary scale in the immediate future. With last night's Summit statement, it may not be unrealistic to hope that this important loose end can be tied-up relatively soon.

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[2] Less than €1½bn compared to total servicing costs of the National Debt of €7½ bn in 2012.

At the Central Bank of Ireland, our initial approach to the recapitalization of Irish banks back in late 2009 was to imagine putting in not just enough capital, but so much capital as to fully dispel any market concerns. The rapidly mounting actual and prospective public debt ratios coming from the non-banking deficit meant that, given the scale of the prospective losses, (as announced in September 2010 following the painfully prolonged process of determining the first full analysis), put paid to that idea. Overcapitalising the banks under such circumstances would simply destabilise the State. That is why we were reluctant (as indicated in my January 2011 speech) to endorse further accumulation of indebtedness of the State in order to recapitalise the banks to insulate the financial system and the economy against tail risks. Even if external *insurance* was not available, direct injection of the capital from external sources would have been a much better solution. However (as has been seen again with the case of Spain) this was simply not on offer, limiting the possibility for decoupling the pressures of the banking system from those of the sovereign.

Global upward pressures have increased the amount of capital banks are expected to maintain as both market participants and regulators reassess the uncertainty and volatility surrounding bank asset valuations. And it's not just a question of ratios: upgraded regulatory requirements will soon disallow some elements of what used to be counted as capital, placing further upward pressure. For Ireland, the agreement with the Troika requires Irish guaranteed banks to hold sufficient capital not only to meet the CRD (international regulatory requirements), but to have enough to absorb prospective losses over the period 2012–2014, based on the independent calculations of BlackRock Solutions, and the cost of selling-off non-core assets sufficient to bring the loan-to-deposit ratios of the banks back into a plausible range (not more than 122½%), *and* to maintain the higher threshold of 10½% capital (even excluding elements of capital that are not regarded as "core tier 1") in the base case scenario.

This is what determined the additional capital requirements announced in March 2012. Our assessment of the capital needs of the banks will evolve over the coming years. As I stressed here eighteen months ago, loan-loss projections following a big bust involve an irreducibly large element of uncertainty. At the Central Bank, we continue to research the determinants of loan losses. Economic conditions (including house prices) facing the borrowing firms and households are not the only determinants. As we have been stressing in other fora, the effectiveness of the banks' engagement with their stressed borrowers, as well as the legislative and administrative framework for dealing with insolvency (details of which are being announced by the Government today) are important factors. It should not be thought a paradox that a more engaged and holistic approach by banks, and a less rigid and costly insolvency framework can help *reduce* loan losses over time.

Meanwhile, given the final view of the Troika lenders that only the holders of subordinated debt – and not of senior debt – could be required to share in the losses, these additional capital requirements brought the total state injection from €47bn to €64bn.[3] By now, the Irish Government has provided about a half of the capital requirements generated by the crisis. The original shareholders of the Irish banks, the subordinated debt holders and the shareholders of the foreign-owned banks split the remainder between them.

Europe and the Irish fiscal adjustment

So far I have not spoken much about the adjustment of Government spending and taxation, i.e. what is now being called "austerity". Let's be clear about this. When Ireland lost access to the markets, the availability of borrowed funds depended on the foreign official lenders. They have authorized sufficient funds for what has to be described as a rather gradual glide-path

[3] Almost all of the unguaranteed senior bonds of IBRC have now been repaid.

of the Government deficit, certainly relative to the alternative of no access, but also relative to what is being implemented in other countries such as Britain, Spain, and the US, despite the much lower debt ratios in those countries. Indeed, the striking fact is that, right through to the end of the Programme, there is a resource transfer from the official lenders to support non-interest net spending of the Irish Government. It is only after the end of the Programme's scheduled term that Ireland is expected to be actually reducing the Government debt ratio. As such, it can fairly be said that the higher taxes and cuts in public spending are, thus far, *not* being used to pay off the banking debt. The scale of fiscal adjustment needed even then is an indication of how badly-skewed our public finances had become in the boom, with what proved to be transitory revenues used to increase the level of spending well above what could be sustained.

Achieving fiscal targets is easier when the economy grows; more important, there are more jobs and more income to go around when the economy grows. In the face of weakening economic activity in many parts of the euro area there has been a tendency for international comment to consider the Irish economy's current performance as rather good. Export growth, the current account surplus in the balance of payments, compliance with budgetary targets and improvements in cost competitiveness are rightly emphasised. But emphasis is sometimes placed on indicators such as aggregate productivity and unit labour costs which in Ireland can flatter. In fact, after the very steep fall during the crash of 2008–9, the economic activity has been broadly unchanged since early 2009. Growth in export-oriented sectors has been offset by shrinkage in domestic demand. Only in 2013 does the Central Bank expect the domestic demand to stop falling. Aggregate employment has been falling for five years now. Bank lending, despite all of the policy efforts, remains timid. Despite the fact that exports have held up, adverse external factors have been holding the Irish economy – one of the most open in the World – back. For example, the fact that economic activity in Ireland in 2012 is almost 2 per cent below what was expected at the outset of the Programme gels with an average underperformance of the rest of EU economy of about the same percentage. The continued high rate of personal savings and the fiscal adjustment have also been adverse factors – though as I mentioned the latter factor has been minimised thanks to the availability of Troika funding.

Any overall assessment that must therefore by highly qualified. Though there have been several setbacks in the euro area and some missed opportunities, step by step actions have been taken to build the conditions needed to ensure a stronger recovery of the Irish economy. According to the forecasters, a return to output and employment growth is in sight, and, while there will no doubt be some more setbacks on the way, it is not unreasonable to hope that the balance of negative and positive surprises will be better than it was. However, the high and still-growing debt is reflected in the yield spreads: financing conditions do need to be improved, as has been acknowledged at the latest Summit.

While some may have hoped for more from Europe in the past couple of years, any fair-minded assessment must acknowledge that the official financing received has been a lifeline. If financial markets and growth conditions in Europe can indeed be stabilised, if financing conditions for Ireland can be improved, and if restraint remains the policy watchword at home, the corner can soon be turned.