Patrick Honohan: Reconciling diverse interests in an international stabilisation programme – some thoughts about the EU-IMF Programme for Ireland, November 2010

Remarks by Mr Patrick Honohan, Governor of the Central Bank of Ireland, prepared for the session "Politics by Other Means? Eurozone Institutions and National Sovereignty in the Bank Bailout Negotiations" at the INET Annual Conference "Liberté, égalité, fragilité", Paris, 9 April 2015.

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The charts can be found at the Central Bank of Ireland's website (http://www.centralbank.ie/press-area/speeches/Pages/RemarksbyGovernorPatrickHonohanfortheINETAnnualConferenceLiberteegalitefragilite.aspx).

Introduction

The EU-IMF Programme of Financial Assistance for Ireland, negotiated in November 2010 and involving a three-year disbursement schedule subject to policy conditionality of €67.5 billion in funds from the IMF and European partners – a sum just shy of 50% of that year's Irish GNP – has attracted much comment, some of which is spot on, some mythical.

In line with the topic of the session I will address the role of European institutions in the stabilisation programme and the impact on national sovereignty, but I will start by identifying some neglected or disputed truths – and exposing a few myths – about the crisis in Ireland that led to the need for the bailout, before turning to the role of the lending institutions. Of course the issues are complex and nuanced. Much of what is often said about all of this can be regarded as "partly true", and I will mention some of these propositions also.

Background to the bailout

Fact 1: "It was the unrestrained and reckless and behaviour of the Irish banks that destabilised the Irish economy and public finances." Of course there are many ways of allocating blame, but in my view the first line of defence against what has happened must be the directors and managers of the banks. Over just a few years, this credit-fuelled bubble created a pattern of over-indebtedness and mispricing (profits, wages, house prices) that made Ireland's economic performance during the "Great Recession" period among the worst in Europe. With greater prudence by management and boards of the lending banks, this bubble could not have happened. It is also worth emphasising that international lenders too were an essential part of the process: they were surely lucky to recover all of the funds they complacently advanced to fuel the boom. (Figure 1 shows the build-up and unwind of foreign liabilities of the banks.)

Partly true 1: "It is lax supervision that was to blame in Ireland." Only partly because, as mentioned, any attempt to assign responsibility must start with the banks. Still, we must not neglect the ineffectual supervision which failed to inhibit this banking behaviour. These supervisory flaws were similar in character to what happened in half a dozen other countries, reliant on un-intrusive supervision that presumed a well-managed bank would not create systemic failure. But in Ireland the scale of the bank credit expansion and the associated construction and housing price boom was of a different life-threatening order of magnitude. Credit expansion on such a scale should have rung alarm bells triggering much more intrusive examination of the vulnerabilities and corrective measures should have been introduced. (Also, not to be neglected are the inappropriate pro-cyclical fiscal policies including specific subsidies and tax expenditures for the construction sector as they were important factors in incentivising and supporting the credit-led boom – these policies also hint at the political climate in which the supervisors were operating. And of course every loan needs a borrower; the borrowers – especially the property developers – also played an important part).

Myth 1: "No banker has been convicted". For the most part, unwise behaviour of bankers in the run-up to the Irish crisis appears to have been unwise rather than criminal. Nevertheless, there have been convictions of some senior Irish bankers found to have committed a criminal offence in the latter phases of the crisis (though no prison sentences), and a number of other cases, criminal and civil, are still in preparation. But the Irish legislative framework deserves to be strengthened to take account of egregious recklessness in risk-taking by those who were in charge of failed financial firms. Recently the UK enacted legislation of this type which I believe could be usefully mirrored in Ireland.

Myth 2: "It is chiefly the bank guarantee that brought about the need for fiscal austerity and generally crippled the Irish economy." Certainly it was the market alarm at the scale of the funds that had to be injected into the banks in 2010 – and which were recorded promptly in the General Government deficit prepared in the Autumn of that year – that was the wake-up call focusing global attention on the fragile fiscal situation and brought forward the need for action urgently. But redressing the emergent deficit in day-to-day spending was actually going to require a much larger adjustment in government revenue and spending (not least because of the degree to which boom-time tax revenue fell off). By 2013, the spending and revenue measures that had been adopted totalled almost €30 billion per annum, whereas the total outlay on bank recapitalisation came to a one-off €64 billion, of which at least a third should be recoverable as the banks are sold off again (Figures 2 and 3 shows the relative size of fiscal policy tightening since 2007 and the fiscal cost of bailing out bank creditors).

Myth 3: "The bailout caused the Irish recession." There is a danger that some such proposition – preposterous though it would have seemed to any contemporary observer at the time of the bailout – has gained some traction among latecomers to the Ireland case. A glance at charts of output or employment confirms that the economy had already pretty much hit bottom by the time of the bailout. At most it could be discussed whether the terms of the bailout and indeed wider euro area policies at the time might have delayed the recovery relative to some other set of policies. The same charts also show that the Irish downturn – led by an exceptional construction crunch – was well under way by the time of the notorious bank guarantee (which was granted just a couple of weeks after the Lehman bankruptcy) (Figures 4–7 show the time-line on relevant macro indicators).

The institutions and sovereignty

Fact 2: "The IMF agreed to endorse a programme which risked debt unsustainability, justifying this by the need to avoid spillover effects on other countries." The Irish authorities agreed to the EU-IMF programme despite sharing doubts as to its sustainability on the grounds that it represented the best short-term course of action for Ireland[1] and left open the possibility of later relief, which in due course came, not least through the reduction in EU interest rates (from an initial level of 5.8 per cent per annum) and lengthening of the loan maturities, and subsequently through the financial arrangements around the liquidation of the failed bank IBRC (successor to the notorious Anglo Irish Bank). The national authorities also felt that it would not be necessary to use all of the €35 billion pencilled-in to the loan agreement for bank recapitalisation. The capital required as a result of the aggressive PCAR 2011 stress test of March 2011 was met with about a half of that, thanks in part to the bail-in of subordinated debt holders.

[1] Without access to the private financial markets, the Irish Government would have had to constrain spending suddenly and drastically. In addition, without support from the ECB it would not have been able to continue in the euro.

Fact 3: "The EU and IMF insisted that the Programme would not contain a bail-in of senior bank creditors." Many involved IMF staff had envisaged a partial haircut on senior debt, but they were not supported when a majority of finance ministers of the G7 decided that bail-ins of senior bank bonds was a bad idea. (Attitudes subsequently changed: bail-in later became an emphasis of EU resolution policy). Irish officials had already been exploring whether and how it might be possible, post-guarantee, to bail-in remaining unguaranteed senior bondholders of Anglo and INBS. They could have continued to plan for this and – who knows – might possibly have been able to do so during 2011 had the matter not already been raised abortively at the time of the bailout negotiations in November 2010, thereby pre-emptively sensitising some of the lenders to the issue. (Admittedly, though, "Fact 4 below suggests that this notion may be somewhat fanciful.)

Fact 4: "The lenders again refused in March 2011 to countenance bail-in of senior bondholders of the failed banks Anglo and INBS." While bail-in was not part of the Programme, the Irish Authorities had *not* undertaken that the old unguaranteed debt of the failed banks would be repaid, but was strongly discouraged from keeping the bail-in option publicly on the table at the time of the announcement of the stress test results of March 2011. Although the amounts involved here at that stage were less than €5 billion (or about 3% of GDP), this widely known episode is the one hardest to rationalise, even taking account of the persistent stress in European banking market conditions at the time.

Myth 4: "The EU partner countries used the crisis to leverage Irish policy changes in other areas damaging to the Irish economy." Unfair issue linkage was certainly a danger for the Irish side in the negotiations. In the end, though, the danger was headed off, and the lenders did not attempt to force beggar-thy-neighbour policy changes in unrelated areas. With debt restructuring clearly off the table, the needed path of fiscal adjustment was pretty much a arithmetical calculation. Getting the debt path back into clearly sustainable territory left little scope for discretion. The size of the Government's remaining cash balances at the outset of the programme helped ensure that the speed of fiscal adjustment was not excessively fast – given the accumulation of debt. Interestingly, the fiscal multipliers used in the Programme design held up quite well: Ireland's growth evolution relative to projection did not underperform that of the rest of the EU even in the first couple of years. And by mid-2012 a growth dynamic had reasserted itself.

Myth 5: "It was the euro that did in for Ireland." To be sure, the euro contributed some fuel to the fire in the form of low interest rates (that encouraged borrowing) and the removal of exchange risk on cross-border borrowing by Irish banks. But the euro was not an essential ingredient in the bubble: several other non-euro countries also relied on the period of financial liberalisation and global savings glut to finance bubbles (Iceland and Latvia the most conspicuous). Nothing in the euro regime prevented Irish regulatory and fiscal policy from moderating this boom. When the crash came, the decision to guarantee the banks (flawed though it was in its design – blanket coverage and in the lack of prior consultation with partners) was underpinned by ECB liquidity support which prevented the chaotic currency depreciation which would surely have been the inevitable consequence had Ireland been outside the euro area. (Of course, some depreciation of a domestic currency could have helped boost the country's international competitiveness more quickly.)

Partly true 2: "The European Institutions pushed Ireland into the EU-IMF programme." An unequivocal public indication by Europe that it would continue to underpin the liquidity needs of the Irish banking system might well have avoided the need for a programme – but it would not have avoided the need for austerity. Such an assurance was not forthcoming in the period September-November 2010. Indeed, as is now well known, the ECB indicated privately in November 2010, albeit not fully credibly, to the Irish Government that it could pull the plug on Irish bank liquidity if Ireland did not apply for a programme. That said, already by the end of September 2010, Ireland actually stood to gain more from a programme than from trying to struggle along borrowing at the very high rates available to it by that stage. Indeed, it was recognition of the unaffordability of such high spreads that induced the Irish Government to announce at the end of September its decision to stop borrowing for a period of months until rates improved (Figures 8 and 9 show the evolution of Irish and German Government 10–year bond yields).

Myth 6: "Ireland would have been better off with an IMF-only loan." The experience and hard-headedness of the IMF staff certainly helped keep the initial and subsequent negotiations on track and may have helped avoid false steps. But if the European Union means what I think it means, it also embraces a degree and extent of collegiality that make European institutions natural partners in financial assistance for a member state that has come under pressure from distrustful markets. For Europe to decline such a role would be a great step backwards. The member states of the European Union are bound together too closely for that. Even if there have been missteps in the handling by European institutions of the Irish crisis – as for some others – I prefer to see this as teething problems. While the terms and conditions of the overall European financial arrangements surrounding the Irish Programme at its outset can readily be criticised, they ended up in a different space, and justified the persistence of Ireland in staying with the Programme.

Partly true 3: "Ireland did not lose its sovereignty in the bailout process." As for sovereignty, the loss of its ability to finance the pre-existing level of public spending (along with the repaying the creditors of the banks) came as a result of the emerging fiscal and debt imbalance, not from the bailout. Availability of bail-out funds enabled a slower fiscal adjustment than would have been possible without the bail-out and resulted in a smaller overall amount of "austerity". The steps taken by the EU and IMF to protect their interests in recoverability of the sums lent in terms of policy conditionality were – as always – robust, but they in the end, as mentioned, did not include linkages to unrelated matters of divergent interest. Aside from the issue of the bail-in of bank debt, the ingredients of the fiscal adjustment actually adopted were already in the priority list prepared by Irish officials and part of the national economic debate long before the arrival of the Troika; as such they cannot be thought of as wholly external impositions. Emblematic here is the rapid reversal of the Troika's proposal for a cut in the minimum wage: although actually included in the Government's four year plan announced pre-Programme, this cut had not really been an accepted national policy priority and did not stick. So yes, a tight budget constraint was suddenly imposed by the crisis and national politicians had much less room for manoeuvre during the programme's disbursement period, but in Ireland this did not result in a violation of the political system's capacity to choose between viable alternatives within the available budgetary resources.

Conclusion

What has struck me about the Irish bailout and others is not so much the loss of national sovereignty as the extent to which the shared sovereignty of the European Union and the eurosystem was strained by the scale of the financial commitments involved and the loss of trust that was generated by the rapid emergence of these commitments.

Yes the ECB extended sums totalling well over 100 per cent of Ireland's GDP to the Irish banking system – the bulk of which has now already been repaid – but having done so it seemed to suffer a transitory lack of confidence that, despite early fiscal and regulatory action, the national authorities would bring things under control.

In addition, some steps were taken for the sake of avoiding spillovers, and not specifically in the interest of Ireland.

On the whole, though, it is now beyond doubt that the interest and maturity terms that were ultimately arrived at for covering the financial commitments are such as to have made the whole operation a very good net success for the Irish people – and for Europe.

But I also think that the experience highlights remaining gaps in the institutional structure of Europe (even after creation of the Banking Union which takes bank supervision and resolution out of domestic hands): less than a fiscal union, more than a currency union, it has survived a severe and divisive asymmetric shock which has highlighted the importance of further institutional development.