

The Irish Banking Crisis and European Monetary Union: Opening Statement*

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In this opening statement, I focus on how the Irish economy and financial system was affected by the creation of the euro. In turn, I also address the implications of the single currency for the conduct of domestic macro-financial policies and crisis management.

1 Structural Changes in the Global Economy and the International Financial System

From the outset, it is vital to understand that there were several structural changes in the international economy and international financial system from the mid-1990s onwards, so that the creation of the single currency cannot be viewed as the sole (or even primary) factor behind the extraordinary growth in international financial flows during the pre-crisis period.

Globally, the growing share of emerging Asia (especially China) in output and international trade was associated with a reconfiguration of comparative advantage, with asymmetric effects across individual European economies. Some countries (especially Germany) gained from the rising international demand for capital goods; other countries (Portugal, Greece, Italy) saw increasing competition in lower-skill industries such as textiles and footwear. At a European level, a similar dynamic also was in train in terms of the integration of Central and Eastern Europe into the wider European economy.

In relation to the international financial system, the counterpart to growing trade surpluses in emerging Asia was a surge in international financial flows into the US financial system, which was concentrated on the purchase of super-safe US Treasury securities. In turn, this contributed to a sharp reduction in low-risk long-term interest rates in the US financial system, which were also being driven lower by the low policy rates introduced by the US Federal Reserve in response to the 2001 recession. With inflation at low levels, there was increasing confidence that a “Great Moderation” was in place that would ensure

a long period of low interest rates and low risks.

The high demand for safe assets by Asian central banks, the low interest rate environment and perceptions of low risk also combined to stimulate a wave of financial innovation from 2003/2004 onwards. The asset-backed securities markets grew very rapidly, with the pooling and tranching of mortgages and other credit products enabling the creation of synthetic low-risk assets and also synthetic higher-risk assets that offered higher interest rates than available on US Treasury securities. In parallel, the dollar money market sector expanded, as savers shifted from deposits to low-risk money market funds that offered higher interest rates. In turn, this enabled European banks that lacked a US deposit base to raise considerable funding in the US from money markets and other wholesale markets. Alternative investment products that offered the promise of higher returns also grew rapidly (hedge funds, private equity), with these entities taking on high debt loads in view of the low interest rate environment and the high risk tolerance on the part of investors.

Accordingly, these international financial developments were associated with a spectacular increase in the size of cross-border financial flows, which were largely intermediated through banking systems. The assets and liabilities of the major international banks expanded at a rapid pace, with these banks deploying funding raised in the US and other major financial markets to boost lending in many national markets, while also purchasing asset-backed securities and sovereign bonds. Local banks in national markets were the main customers for the global banks, with most cross-border flows taking place between foreign banks and domestic banks rather than between foreign banks and domestic non-bank borrowers (households, corporates, public sector).¹

The boom in cross-border banking was further accommodated by regulatory changes during this period. At the global level, the 2004 agreement on the Basel II set of regulations on the capital adequacy of internationally-active banks acted to support the expansion of

¹See also Committee on International Economic Policy and Reform (2012), Lane (2013), Bruno and Shin (2014) and Everett (2014).

bank balance sheets; at a European level, the implementation of harmonised EU regulations reduced barriers to cross-border flows; in Germany, the deregulation of the Landesbanks provided a new source of funding for cross-border lending.

A feature of the new banking environment was the growth in multi-country banks that operated subsidiaries or branches in multiple countries. In Europe, the geographical pattern in multi-country banking was not especially aligned with currency areas, with Santander acquiring Abbey National in the United Kingdom, the expansion of Nordea bank across Scandinavia and various Western European banks building significant market shares in Central and Eastern Europe. In Ireland, the main foreign banks that were active in the domestic market were units of UK and Danish banks.

The high levels of cross-border funding also facilitated larger and more persistent external imbalances across countries. Those countries with high savings rates relative to low domestic investment demand were able to funnel excess savings overseas, while those countries with low savings rates relative to high domestic investment demand were able to tap external markets to close the gap. Traditionally, sizeable imbalances could only be sustained for a limited period; under the global financial conditions prevailing in the mid-2000s, large imbalances persisted with little pressure to adjust.

The nature of European imbalances also shifted during the 2002-2007 period, taking on a significantly more procyclical role, with those countries projected to grow more quickly running larger deficits and those countries projected to grow more slowly running larger surpluses (Lane and Pels 2012). The pattern of net international debt flows was also closely aligned to differences in domestic credit growth, with those countries experiencing domestic credit booms marked by high external borrowing and those countries experiencing slow growth (or even a contraction) in the credit-output ratio marked by an increase in international net lending (Lane and McQuade 2014).

However, it is important to appreciate that the scale of net cross-border financial flows are an insufficient guide to risk analysis. In the Irish case, the pre-crisis current account

deficit (reflecting aggregate net financial flows) peaked at 5.4 percent of GDP in 2006, far below the double-digit current account deficits recorded in Greece, Portugal, Spain, Iceland and the Baltics. However, Irish banks were also aggressive lenders overseas (especially in the United Kingdom), so that the total credit risks acquired were much larger than just the domestic exposures.²

2 EMU and the Global Context

It is in this global context that the role of the euro should be understood. While there was certainly a “entry” effect during 1997-2001 that boosted the euro periphery as a result of the convergence of interest rates across the member countries (further augmented by the sizeable depreciation of the euro against the dollar during 1999-2001), this process had largely played out by 2001, with the dot.com recession marking the end of this entry phase.

Rather, the credit supply shock triggered by the global financial boom during 2002-2007 represented a new phase for the euro area. Importantly, this new phase occurred at a time when some key underlying fundamentals were deteriorating for the euro periphery. Rapid growth over the previous decade meant that the convergence dynamic was inevitably weaker than before; the sharp appreciation of the euro against the dollar over 2002-2007 was an external blow to the competitiveness of many European firms and further contributed to the growing trend towards imports from emerging Asia; the new member states from Central and Eastern Europe were tougher competitors for the location of manufacturing activities; rising commodity prices represented an income transfer from commodity importers to commodity exporters; and demographic factors constrained aggregate growth at the European level. In Ireland and Spain, a construction boom obscured the underlying deterioration in fundamentals; in Portugal, expenditure was maintained through external borrowing despite weak output growth; in Greece, fiscal deficits sustained the domestic

²See also Kearns (2007).

economy.

It is plausible that the single currency acted to amplify the impact of the global financial boom. The absence of intra-area currency risk facilitated cross-border financial flows: for the first time, the euro periphery was able to borrow internationally in a large-scale manner while limiting currency risk, while banks in the euro core were also better able to lend across borders with limited currency risk. Most directly, euro-denominated loans within the euro area could be viewed as having zero currency risk. Indirectly, the status of the euro as a major international currency meant that banks could also obtain funding in US dollars and other foreign currencies (Sterling, Swiss Franc, yen) and hedge the currency risk through low-cost currency derivatives markets. Foreign investors were also re-assured by the potential availability of ECB liquidity to banks in all member countries, which was further copperfastened by the ECB collateral policy of treating the sovereign bonds of all member countries as low risk.

3 EMU and the National Macro-Financial Policy Framework

During a global financial boom period, what instruments are available to policymakers in an individual country to mitigate macro-financial risks? For members of the euro area, the absence of a national currency and national interest rate policy increases the importance of using other policy instruments.

Most directly, a credit boom can be addressed through vigorous macro-prudential regulation of the banking system. A wide range of policies can be implemented: loan-to-value limits; debt service to income limits; sectoral concentration limits in lending; high capital asset ratios; cyclical capital charges; and limits on the use of non-core funding. The very limited use of these tools in Ireland in the mid-2000s meant that regulatory policies did

too little to offset the scale of credit expansion. A common objection to the use of macroprudential policies is that the effectiveness of these tools is weakened through regulatory arbitrage with curbs on domestic lending leading to growth in cross-border lending. However, even if some substitution towards cross-border lending did take place, the balance of risks would have been shifted, since the credit risks would be on the books of foreign-based banks rather than domestic banks.

In addition, fiscal policy can be deployed at both microeconomic and macroeconomic levels. At a microeconomic level, the property boom could have been countered through reforms that reduced the tax incentives offered to developers and households. At a macroeconomic level, at a minimum, a government under such conditions should seek to maintain a cyclically-neutral budget, with a countercyclical budget balance even more desirable. While Ireland achieved small headline budget surpluses during the boom period, the underlying budget balance was much less healthy, given the reliance on construction-intensive tax revenues. The scale of the boom was such that significantly more positive budget surpluses were warranted, with the deterioration in fiscal discipline towards the end of the boom period especially unfortunate. In 2007, the fiscal surplus in Ireland was just 0.2 percent of GDP, whereas it was 5.1 percent in Finland, 5 percent in Denmark, 3.3 percent in Sweden and 2 percent in Spain.

Running large budget surpluses is politically difficult, given the pressures to meet spending demands and cut taxes. In terms of safeguarding the public balance sheet, it may be more effective to establish a fiscal reserve fund in recognition of the contingent nature of the windfall revenues during a credit boom and the fiscal risks associated with banking crises. While Ireland did set up a reserve fund (the National Pensions Reserve Fund), its mandate was long-term in nature rather than cyclical and its equity-dominated investment strategy was not appropriate to address cyclical shocks (such a banking crisis).³

³Ireland also set up a household scheme (Special Savings Investment Accounts - SSIA) to boost the household savings rate during a period of low interest rates. However, this was for a fixed time duration

Rather, an additional cyclically-focused fiscal reserve fund that held a liquid-assets portfolio should have been established (Lane 1998).⁴ Such a rainy day fund could have provided dedicated funding for the recapitalisation of banks and/or the funding of a NAMA-type asset management agency, while also providing supplementary resources for the general budget in the event of a severe downturn. In the runup to joining the euro, the desirability of such a fund should have been evident in view of the prominent financial crises that took place in the 1990s (the Scandinavian banking crisis; the Mexican crisis; the East Asian crisis; and the Russian crisis). Moreover, the lack of an independent exchange rate and the scope for foreign borrowing in a monetary union reinforced the importance of adopting a more prudential approach to credit regulation and fiscal policy (Lane 1997).

Would Ireland have been less vulnerable to a banking crisis had it decided not to become a member of the euro area? At a surface level, it might seem straightforward that the Central Bank of Ireland would have selected higher interest rates under an independent monetary regime and thereby limited the scale of the credit boom. This is quite plausible for the 1999-2002 period, in view of the much higher inflation rates experienced by Ireland relative to the euro area average and contemporaneous estimates of overheating (as captured by the estimated output gap).⁵

However, the gap between Irish inflation and the average inflation rate for the euro area narrowed during 2003 and was quite small during 2004-2005 and contemporaneous estimates suggested that the economy was operating slightly below potential, such that it is not obvious that the Central Bank of Ireland would have selected higher interest rates during the acute phase of the credit boom if it followed an inflation-targeting regime.

(2001-2002 to 2006-2007), rather than tied to the cyclical state of the economy.

⁴The appendix reproduces the proposal of a fiscal reserve fund from Lane (1998).

⁵This initial burst of relatively high domestic inflation was driven by a mix of the disproportionate impact of the large euro-dollar depreciation during this period, the inadequate scale of the 1998 Irish pound revaluation prior to joining the euro and the strong momentum in Irish wage growth during this phase (Honohan and Lane 2003).

A more substantial inflation differential re-emerged during 2006-2007, such that the final phase of the credit boom might have been met by an interest rate tightening; however, the estimated output gap remained negative during this period which might have limited the scale of any interest rate hikes.

In addition, even if higher interest rates had been imposed during the boom period, the effectiveness of interest rate policy in sharply limiting a credit boom is open to question. First, given that central banks choose to vary interest rates within a fairly narrow band (since small interest rate movements have powerful effects on the real economy), even a moderately-higher path for interest rates may not have sufficiently deterred investors that expected sizeable capital gains in the property market.⁶ Second, a positive interest rate differential between Ireland and other advanced economies would have encouraged domestic investors to borrow in foreign currencies, just as happened in Iceland and several countries in Central and Eastern Europe. Third, the appreciation of the Irish pound that would have been associated with a higher path for interest rates could have encouraged extra borrowing by risk-taking entrepreneurs since the capacity to lever up in foreign currencies through loans collateralised against Irish assets would have been enhanced.⁷

The risks embedded in the 2005-2006 European macro-financial configuration were clear, even if the timing of a future disruptive shock was unknown. For example, Lane (2006, page 64) laid out this scenario: *“As another example, consider the scenario in which a severe slump or a banking collapse in a member country engenders a national debt crisis, with an increase in risk premia and potential spillover effects on area-wide financial markets. The capacity of the euro area to respond to such a financial crisis is as yet untested. Perhaps emergency fiscal transfers would be made to a member country in crisis, which, in turn, might lead to more effective restrictions on national fiscal policies as a way of formalizing the conditions under which emergency fiscal transfers might be paid in the future. An*

⁶Doyle. Gerlach.

⁷See Bruno and Shin (2014) on the role of currency appreciation in boosting leverage.

emergency fiscal transfer could also take the form of a subsidized loan from the European Central Bank. If the national financial crisis threatened the stability of area-wide financial markets, the ECB might be compelled to set aside its inflation target for a time. In the event of a banking crisis, pressure would also grow for the transfer of financial supervision responsibilities to a European-wide regulatory authority.”

As it turned out, the trigger for the end of the international credit boom originated in the United States, with a sustained tightening in funding markets from August 2007 onwards and an intensification in the financial crisis between the near-collapse of Bear Stearns in March 2008 and the collapse of Lehman Brothers in September 2008. A sustained decline in funding conditions in combination with the deterioration in the domestic outlook for the Irish banks (the plateauing in Irish residential property prices since mid-2006, the increasingly-evident decline in the scale of construction activity, the revision in expectations about future growth prospects) set the stage for the acute phase of the crisis (Lane 2011).

4 EMU and the Crisis

During 2007-2009, the availability of eurosystem liquidity provided an important buffer during the international financial crisis: banks in the euro area could replace private funding with central bank funding. For banks with insufficient eurosystem-eligible collateral, national central banks could also provide emergency liquidity assistance (ELA), within the framework set out by the eurosystem. Even dollar funding was available through the eurosystem, thanks to the currency swap arrangements between the ECB and the Federal Reserve Board. Since individual countries had different funding shortages, these liquidity policies had asymmetric outcomes across the individual member countries, as captured by the intra-system Target 2 imbalances. At this level, membership of a common currency area provided an important bulwark against the global financial shock by allowing cross-border liquidity flows to replace cross-border private flows. By way of contrast, such generous

cross-border liquidity flows were not available to other European countries that retained their own currencies but had significant foreign currency liabilities.

In the absence of cross-border eurosystem liquidity flows, the 2008-2009 global financial crisis would have played out quite differently in the euro periphery. While it is difficult to specify the exact nature of the likely counterfactual, it is plausible that the recessionary impact on high-deficit countries would have been more severe. However, the costs of adjustment would also have been shared with foreign investors to some degree, through some mix of forbearance and burden sharing, since a primary use of cross-border liquidity flows is to permit foreign investors to withdraw without taking a loss. Had cross-border liquidity flows not been available, foreign lenders might have concluded that debt standstills and debt restructuring agreements would have offered a higher return than uncontrolled defaults.

At the same time, the application of eurosystem liquidity policies involved some discretionary judgement calls. In particular, there are strong feedback loops between liquidity and solvency in the case of a system-wide national banking crisis that revolves around long-term property loans. For instance, in the absence of medium-term liquidity support, forced deleveraging over a short-time timescale can be self-defeating by driving down property values in a firesale process. At the same time, open-ended liquidity provides incentives to delay excessively the resolution of problem loans, such that the monetary authority must strike a difficult balance in setting liquidity policies.

In September 2008, it is possible that the lack of precedents and the untested nature of the ELA framework (given the short history of the eurosystem) may have deterred the Central Bank of Ireland from deploying ELA to buy some time in managing the severe liquidity squeeze on Anglo Irish Bank. In Autumn 2010, the ECB linked the ongoing provision of eurosystem liquidity to Ireland entering an official programme that would involve fiscal consolidation and financial sector restructuring (including bank recapitalisation), with a view to reducing over time the dependence of Irish banks on eurosystem liquidity. Strik-

ing the balance between fiscal support for the banking system and liquidity support for the banking system was an important topic in the ongoing negotiations between the Irish authorities and the Troika.

In related fashion, the differing views on the restructuring of unguaranteed senior bank bonds in Autumn 2010 and Spring 2011 can be linked to the different perspectives of a national government and a multi-country central bank that is charged with maintaining area-wide financial stability. At the very least, this debate underlined the desirability of financing bank resolutions at a common level in situations in which area-wide financial stability was a relevant factor in determining that senior bank bondholders should be protected.

Finally, another important role for a central bank is to act as a stabilising force in the sovereign debt market, in cases in which speculative dynamics push up yields above fundamental values. During 2010-2012, one source of speculative pressure related to redenomination risk, by which investors feared that some countries might leave the euro and redenominate sovereign debts into new national currencies. Eventually, the ECB succeeded in addressing this risk factor through the launch of the Outright Monetary Transactions (OMT) programme. At the same time, it is plausible that national governments facing solvency problems are less likely to receive central bank support in the euro area than would the case under an independent national currency (in relation to domestic-currency sovereign debt).

Had Ireland not joined the monetary union, the resolution of the crisis would have been quite different.⁸ Since the scale of the pre-crisis credit expansion would only have been possible by taking on large-scale foreign-currency liabilities, the Central Bank of Ireland would have been limited in its capacity to provide substantial foreign-currency liquidity. In the event of a large-scale flight of bank depositors and bank creditors, the imposition

⁸For the purpose of this argument, I assume here that a similar credit expansion could have occurred even without the euro and focus on the implications of an independent currency for crisis dynamics.

of capital controls and/or liability restructuring would have been necessary. At the same time, a loss in confidence in the domestic currency would have resulted in a large devaluation. While devaluation over time is helpful in stimulating economic recovery by improving domestic cost competitiveness, its immediate impact is to further exacerbate balance sheet problems in relation to foreign-currency debts. Taken together, these forces would have led to a more acute type of crisis, with a deeper initial recession, larger movements in interest rates and asset prices, a jump in domestic inflation and more debt restructuring. However, in the other direction, medium-term recovery might also have taken hold more quickly, in view of post-crisis recovery tools open to a country with an independent currency (currency devaluation, local-currency liquidity provision to the banking system).

Appendix: A Fiscal Reserve Fund (Lane 1998)

The proposal for a fiscal reserve fund from Lane (1998) is reproduced here:

“Banking and financial crises have plagued numerous countries in recent years, including the 1990s S&L crisis in the US, Scandinavia in the early 1990s, Mexico in 1995 and Japan and South-East Asia at the present time. Such crises can have significant adverse output costs, as collateral values fall and investment plans must be curtailed. Property-backed lending is a frequent source of problems, since shocks to the domestic economy have a magnified impact on local property values.

A characteristic of modern financial systems is that “unnecessary” crises can occur. For whatever reason, creditors may become pessimistic about prospects for the economy and seek to withdraw funds from local banks. Since banks maintain reserves that are only a small fraction of liabilities, not all creditors can be simultaneously repaid. Banks must call in loans, inducing debtors to inefficiently liquidate long-term projects and pushing many into default.

A central bank that is not bound by a fixed exchange rate commitment can forestall such

unnecessary crises by acting as a “lender of last resort” to the banking system, providing the funds that allow banks to meet the demands of its creditors without having to call in illiquid loans. Indeed, the very existence of an institution that has the capacity to act as a lender of last resort may be sufficient to forestall panic-induced attacks, since creditors need not fear being squeezed out in a scramble for the limited reserves of the banking system.

Under EMU, national central banks will not have the monetary autonomy to act as local lenders of last resort. Moreover, the ECB is unlikely to intervene in the case of a purely regional financial crisis that does not pose a risk to the overall euroland financial system. One solution to a regional crisis would be a fire-sale of local financial institutions to deep-pocketed international banks.⁹ If the government rather wished to maintain locally-owned banks, an alternative may be to establish a fiscal “reserve fund” that could fulfill, at least partially, a lender of last resort function. Such a fund would have to be kept distinct from the general government budget, since its resources would have to be available for immediate disbursement in the event of a crisis. Moreover, to make such a rapid response feasible, the fund should mostly hold highly liquid assets. Of course, to minimize moral hazard problems, resources should be released only when there is a serious systemic risk to the local financial system and with significant penalties imposed on recipient institutions.

In addition to the provision of liquidity, a fiscal reserve fund may also be helpful in financing a reorganisation, were the banking system to fall into chronic difficulties. As has occurred in such circumstances elsewhere, it may be efficient for the government to restart normal lending activity by buying out the nonperforming loans of the banking sector.¹⁰ The international experience is that such bailouts may entail upfront costs in excess of 10% of GDP and, in the absence of a reserve fund, this could severely damage the government’s

⁹See also Prati and Schinasi (1997).

¹⁰These delinquent loans could then be administered by a so-called “bad” bank in the hope of eventual, partial repayment. In the rescue of the AIB-owned Insurance Corporation of Ireland, such an entity was established and is still in operation today (Icarom). See Honohan and Kelly (1997) for more details on the ICI case.

fiscal position and have especially adverse implications in the context of the limits imposed by the Stability and Growth pact.

Upon reflection, the idea of a fiscal reserve fund is quite analagous to the central bank's holding of external reserves. Even when Ireland had very large gross external debt, serviced at high interest rates, substantial foreign currency assets were held to guard against currency crises. Similarly, a fiscal reserve fund can act as a bulwark against local financial crises. Indeed, that part of the central bank's reserves that will not be handed over to the ECB may be an appropriate source of initial capital for such a fiscal reserve fund."

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