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# Oireachtas Committee of Inquiry into the Banking Crisis

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## Introductory statement, 18 February 2015

It is a pleasure to be here in Dublin and an honour to have been invited to appear before this committee in its inquiry into the banking crisis. I have been asked to deliver a statement on the European Commission's role in monitoring the Irish economy in the years prior to the crisis. I will structure my statement in two parts: the first part will focus on the economic developments in the run-up to the crisis, both international and domestic. In the second part, I will review the Commission's role in economic surveillance at that time.

When analysing economic growth in Ireland before the banking crisis, it is useful to distinguish between two different periods: from the early 1990s up until 2000, and from about 2001 until the burst of the housing bubble in 2007.

The first period is often referred to as the 'Celtic Tiger' period. It was a period of extraordinary strong growth: The annual increase in real GDP averaged 7.2%, as opposed to just above 2% in the euro area. As a result, there was an impressive and unprecedented convergence in living standards. In 1990 gross national income per person stood at around 60% of the euro area average. Ten years later it was already above the euro area average.

In the 1990s, economic growth was led by exports. Ireland was able to take advantage of the Single European Market and globalisation. It raised exports in high-value sectors such as computers and pharmaceuticals. Thanks to a flexible and English-speaking economy, Ireland attracted significant FDI inflows that boosted productivity growth and enhanced competitiveness. The current account recorded an average surplus of 1.6% of GDP in the 1990s.

During this period, employment growth was brisk with minimal wage pressures since unemployment was still relatively high, female participation in the labour force low and net inward migration flows increased the labour force. The unemployment rate fell from 13.4% in 1990 to 5.6% in 1999. Fiscal adjustment undertaken in the late 1980s to tackle the very high stock of public debt supported this expansion as government spending restraint and salary agreements also underpinned wage moderation. In the 1990s, inflation was low and averaged 2.3%, close to the average recorded in the euro area as a whole. General government debt fell by half to around 47% of GDP.

The year 2000 marked the end of the ICT boom, which had pushed growth rates in Europe and the US to close to 4%. By then in Ireland real economic growth was close to 10%, wages were rising by more than 13% and annual HICP inflation exceeded 5%.

From about this point until the onset of the Irish banking crisis, there was a striking shift in the Irish economy. The overall growth momentum remained strong but became largely reliant on domestic demand. Between 2001 and 2007, real GDP growth averaged 5%, as opposed to close to 2% in the euro area. Average inflation increased to above 3%, while it stayed at slightly above 2% in the euro area as a whole. Ireland had reached full employment: wage pressures began to emerge and competitiveness deteriorated with tight labour conditions. Subsequently, export growth began to wane and export market shares fell. The current account balance deteriorated and by 2007 it recorded a deficit of about 5.4% of GDP.

Economic growth became increasingly reliant on construction. Interest rates had declined substantially and access to credit increased with Ireland's entry into EMU. This helped trigger a boom in investment in housing and commercial property, with rapidly rising property prices. The positive wealth effect from rising housing prices also contributed to buoyant private consumption.

By the mid-2000s, the construction sector and especially its residential housing component had become very large. Construction investment grew to about one fifth of GDP, the highest in the euro area. Employment growth also became increasingly reliant on the construction boom and the rate of unemployment fell to 4.4% in 2005. The proportion of those employed in construction peaked at the unprecedented level of about 13.5% in 2007. The construction sector benefitted from strong net inward migration flows, particularly from the 2004 EU enlargement countries. Nonetheless, the labour market remained tight pushing up wages. The reallocation of resources into the housing sector, which was traditionally labour-intensive and employed low-skilled workers, left limited room for improving productivity.

House price inflation surged in Ireland. It rose by more than four-fold between 1993 and 2007, amongst the highest of any advanced economies. On the demand side, demographic trends, higher disposable incomes, lower real interest rates and easier access to mortgage finance supported the booming property market. Government policies also played a role through the favourable tax treatment of housing, such as the deductibility of mortgage interest payments. The supply of housing also rose sharply, but eventually beyond the needs of the population. The idea that house prices would increase forever turned into a recurrent and dangerous motive.

One of the main factors which fuelled the housing boom was the rise in private sector credit. The private sector debt-to-GDP ratio rose to over 200 % by 2008. As the bulk of credit was supplied by banks, this led to a major expansion in banks' balance sheets. There was an increase in competition amongst the banks with many new entrants into the market; lending standards weakened and average loan-to-value ratios increased significantly. Lending to households and property developers soared, boosting private sector debt levels. Domestic banks also engaged in a rapid expansion of foreign activities. At the end, the Irish banking sector was severely oversized relative to the size of the local economy and the fiscal capacity of the Irish sovereign.

The lending boom by the Irish banks was facilitated by the international context during this period. Banks increasingly funded themselves easily on external wholesale markets as cross-border financial flows boomed in the international financial system, supported by low global interest rates. Moreover, EMU had eliminated currency risk within the euro area and this contributed to rising cross-border borrowing. As credit expanded faster than deposits, Irish banks became increasingly dependent on international market funding, leading to an imbalanced funding structure. This left banks vulnerable to the eventual tightening in international capital markets. Ireland was not the only such case. Similar developments took place in Spain.

The role of the Irish financial supervisor and regulator during the boom years has been extensively analysed and assessed by many observers. I understand there have been dedicated sessions on this issue in this forum. I therefore don't intend to elaborate at length. It may suffice to say that I agree with those who conclude that the domestic financial supervisor did not acknowledge and address the risks associated with the credit and housing boom. I also believe that the supervisors in the originating countries share some of the responsibility, but this is not to detract from the primary responsibility of the domestic supervisor (as has been widely acknowledged in Ireland). More generally, supervisors in a number of Member States did not seem to care sufficiently about the risks of rapid year-on-year loan growth, the increasing concentration of investment in their construction sector and the relative size of their banking sectors compared to GDP, and Ireland is probably the most extreme example of what can happen when these problems are ignored. More generally, supervisors in many Member States were concerned almost exclusively with micro-prudential supervision (checking the soundness of individual banks) and there was insufficient attention placed on macro-prudential supervision (risks to the financial system as a whole).

The housing and lending boom also impacted Irish public finances. Government spending rose sharply as a percent of GDP, financed by the additional tax revenues linked to the housing boom. Still, the budget was in surplus as of 2003 and the general government debt declined to a low of 24.6% of GDP in 2006. We know that the structural budget balance, the balance net of temporary components, was expansionary and contributed to the overheating of the economy. Revenues became overly reliant on the property market and the income tax base shrank due to successive tax cuts. This left the budget exposed to the ensuing downturn in the property market.

So far I have given you our assessment of the most important economic developments in Ireland in the years preceding the crisis. Let me now move on to how economic surveillance was implemented at the EU level during the boom period. I will start with the surveillance instruments that were available prior to 2007 and then move on to the question of how they were used in practice.

The European Commission acts as the 'Guardian of the EU Treaty'. Within this general mandate, the Directorate General for Economic and Financial Affairs (DG ECFIN) is the service in charge of economic policies. It carries out its duties, under the supervision of the competent Member of the Commission, by

- monitoring and assessing economic developments in the Member States;
- reporting on the findings of our assessment to Member States directly and to the public at large; and
- initiating specific surveillance procedures for Member States where economic developments move outside or risk moving outside the perimeters laid down in EU legislation.

In the pre-crisis years, the EU framework for economic surveillance was a reflection of the principles enshrined in the Maastricht Treaty. The Treaty, which entered into force in 1993, laid the foundations of the Economic and Monetary Union (EMU): Monetary policy was entrusted to the ECB, while fiscal policy remained a prerogative of the Member States, but to be carried out in line with commonly agreed rules.

The Treaty also included a general provision according to which Member States – and here I quote - *"shall regard their economic policies as a matter of common concern and shall coordinate them within the Council"*. In the years following the entry into force of the Maastricht Treaty, the EU strengthened fiscal surveillance via the Stability and Growth Pact (SGP). The same did not happen for structural policies. This asymmetry was not an oversight. It was a reflection of the macroeconomic paradigm prevailing at the time in Europe and beyond.

This paradigm - sometimes referred to as the 'Great Moderation' paradigm – reigned until 2007, the onset of the most severe economic and financial crisis in post WWII history. According to the 'Great Moderation' paradigm, overall macroeconomic stability was to be ensured by meeting two overarching conditions: (i) low and steady inflation; and (ii) prudent and sustainable fiscal policy. Experience in advanced economies since the late 1980s corroborated this view, especially when compared to the more unstable 1970s and early 1980s: Countries that kept their fiscal house in order and inflation reasonably low and stable followed a relatively smooth path of macroeconomic development.

Other macroeconomic compartments such as the financial sector, house price developments or the current account were not thought to create major problems on their own. They were expected to be restrained by prudent monetary and fiscal policies.

Today we know this is not the case, but until 2007 the focus of macroeconomic surveillance in the EU was clear: the ECB looked after price stability, with a very strong mandate, and the European Commission monitored national fiscal policy making against the parameters of the SGP. There was also an instrument to coordinate economic policies beyond public finances, the so-called Broad Economic Policy Guidelines (BEPGs). However, this instrument amounted to soft coordination only with no enforcement power.

With the benefit of hindsight, there is little consolation to be gained from the fact that not only Europe followed the 'Great Moderation' paradigm in implementing and monitoring economic policy. At the same time, it is important to underline that, with very few exceptions, the economic profession at large relied on this paradigm.

Let me now return to the case of Ireland: How was the EU economic surveillance framework applied to this country in the years prior to 2007? I will start in 2000 for essentially three reasons. The SGP effectively entered into force only in the late 1990s. Only since then can we speak of a functioning EU fiscal surveillance framework. Second, the early 2000s coincide with the onset of the second and - as indicated earlier - less healthy part of the catching-up process of the Irish economy. Thirdly, in 2000 the Irish government adopted a draft budget for 2001, which for the first time brought Ireland onto the Commission radar screen signalling potential macroeconomic problems. Against the backdrop of clear signs of overheating in the Irish economy, the budget was expansionary and risked adding fuel to the fire.

On 24 January 2001 the Commission issued a critical opinion on the 2001-2003 stability programme. It concluded that Irish fiscal policy was inconsistent with the Broad Economic Policy Guidelines the European Council had endorsed just half a year earlier. Those guidelines had asked Ireland to avoid further overheating of its economy by containing public expenditure.

In parallel to the critical opinion on the Irish stability programme, the Commission also recommended the Council to ask the Irish government, under Article 99(4) of the Maastricht Treaty, to take countervailing measures in the course of 2001. The ECOFIN Council adopted the recommendation on 12 February 2001. As some of you may remember, the recommendation was not very well received in Ireland; it was not implemented. Also many in the economic profession derided the Commission accusing us of focussing more on decimals rather than acknowledging the strength of the Irish economy.

Based on the information available at the time, the Commission played its role as Guardian of the Treaty well. There was a clear inconsistency between the government's budgetary plans on the one hand and the economic policy guidance endorsed by the European Council on the other. Picking up on this inconsistency, and within the existing surveillance framework, the Commission put in motion the relevant wheels and the Council followed.

At this point, I should maybe stress that all EU surveillance documents, that is, the Commission technical assessment of the stability programme updates, the Commission recommendation for a Council opinion and the Council Opinion are all available on the website of DG ECFIN.

In retrospect, the assessment of whether the 2001 Council recommendation to Ireland was a good idea or not is less clear cut; even controversial. As we all know, the ICT bubble burst in the course of 2001 triggering a sharp economic slowdown in the US and Europe. Ireland was also affected: quarterly GDP growth moved from more than 13% in Q1 to almost stagnation in Q4.

With the Irish economy cooling off so abruptly, the Council's call for a tighter budget to avoid overheating, did not seem particularly appropriate any longer. In fact, later in 2001 when the assessment of the 2002 budgets and stability programme updates were due, the Council reviewed its assessment. On a recommendation from the Commission it issued an opinion that approved of the budgetary plans of the Irish government. The Council still urged Ireland to aim for a neutral fiscal stance. However, the assessment no longer raised any major issues. The case of the 2001 recommendation under Article 99(4) of the Treaty for Ireland was closed.

In sum, the Commission was right in stressing the need to avoid a pro-cyclical fiscal expansion in a boom period, even if due to the unexpected burst of the ICT-bubble, the recommendation turned out to be ill-timed.

In the subsequent years the Commission did not shy away from taking a critical view of Irish fiscal policy making. On the contrary, the annual technical assessments of the Commission of the successive stability programme updates regularly expressed concerns about strong government expenditure growth and only moderate budgetary improvements in the face of a solid economic recovery. In fact, in the years after 2001 Commission recommendations for a Council opinion on the Irish stability programmes consistently urged Ireland to strictly control government expenditure, including through the implementation of an effective expenditure framework. The first such call was already included in the 2002 Council opinion, but did not fall on fertile ground in Ireland. Helped by the growing inflows of revenues from the housing boom, the government successively increased expenditure and lowered taxes.

As the government deficit remained below 3% of GDP, the post-2001 Council opinions did not identify any formal conflict with the existing EU fiscal rules. At the same time, the Commission's assessments did indicate a few points, which, with the benefit of hindsight, turned out to be crucial. For instance, the Commission regularly stressed the uncertainty surrounding estimates of the structural budget balance for the Irish economy, that is, the budget balance net of temporary components.

After 2002, the Commission noted several times that the Irish government's targets for the general government budget balance may not have been particularly ambitious in view of the very solid recovery of economic growth. Underling this message was the sense that the structural fiscal position was weaker than the official estimate suggested. But then, there was no way to substantiate this view. The method agreed by the ECOFIN Council in 2002 to estimate the structural budget balance for the purposes of EU fiscal surveillance did not signal any specific problem for Ireland.

The second point the Commission underlined clearly in its post-2001 assessments, was the strong contribution of construction to economic growth. For instance, in its assessment of the 2005 update of the Irish stability programme, the Commission identified the very high valuation of the existing housing stock and a possible sharp downturn from the extended residential construction boom as downside risks to the economy and public finances. A year later, the Commission's assessment of the 2006 update explicitly referred to the unsustainable level of residential construction. More specifically, the unsustainably high level of residential construction was seen as the main factor fuelling inflationary pressures. Together with very high residential property prices, the construction boom was thought to carry the risk of a sharp downward adjustment in the wider economy.

But then again, the identification of risks linked the construction boom did not translate into concrete surveillance actions. The EU economic surveillance framework was centred on public finances, and Ireland complied with existing rules.

I am not trying to argue that the Commission saw everything coming, but couldn't do anything. What I am trying to say, however, is that the Commission did, within its remit, pinpoint issues which in retrospect turned out to be important.

But then, even if we had anticipated the end of the economic boom and the beginning of a collapse in Ireland before 2007, we would not have had the legal tools for asking Ireland to take any corrective measures. But the lack of legal instruments was not the real constraint for EU surveillance. The real constraint was our, at the time, limited understanding of what can really endanger overall macroeconomic stability.

Yes, we understood that the Irish housing boom would not be sustainable. But in line with the 'Great Moderation' paradigm we, as others, did not anticipate that the end of the housing boom could give rise to the dislocations that eventually emerged after 2007 and which later on lead Ireland to ask for financial assistance from the EU and the IMF.

The financial sector was thought to simply channel funds in an efficient manner to where the real economy needed them. Dangerous excesses were thought to originate only in monetary and fiscal policy making.

This is evidenced by the fact that between 2001 and 2007 no Commission assessment of the Irish stability programme updates reviewed developments in the banking sector. The assessment of financial stability was also not part of the BEPG process. Financial stability risks were mainly thought to be an issue for individual banks but not for an economy as a whole. Moreover, financial supervision was a national prerogative. My colleague Mario Nava from DG FISMA (Financial Stability, Financial Services and Capital Markets Union) was before this Committee earlier this month. He clarified that in the 2000s, the EU regulatory framework followed a principles-based approach that was embodied in the principle of minimum harmonisation. National supervisory authorities were responsible for applying and enforcing the minimum prudential requirements set out in EU Directives. We worked under the assumption that national supervisors and regulators would be well equipped to address any nascent stability issues in the banking sector. We assumed they would do their job in a conscientious manner.

The post-2007 financial and economic crisis showed us the hard way that our conceptual framework of the macro economy was incomplete. Ireland was a particularly drastic albeit not the only example. The sudden drop in residential house prices undermined the viability of most Irish banks and exposed a striking lack of supervisory and regulatory rigour. The government had to step in with its deep pockets to stave off the collapse of the financial sector and the economy as a whole. Later on the government's pockets had to be filled with international financial assistance as access to financial markets had been lost at sustainable rates. The rest is now history. End 2013 Ireland successfully completed the EU-IMF financial assistance programme. While important challenges remain, the country is now back on track towards balanced and sustainable growth.

As regards EU economic surveillance, the post-2007 financial and economic crisis has not been wasted. As you are aware, the EU immediately launched an important and far-reaching reform process to upgrade and complete its economic governance structure. Firstly, EU fiscal surveillance has been strengthened with the so-called six pack. Second, the scope of EU surveillance has been extended to include all relevant developments beyond public finances; this was achieved with the introduction of the Macroeconomic Imbalances Procedure (MIP). This was also part of the six-pack initiative: since 2011 the Commission consistently monitors Member States for imbalances in all areas of the macro economy. Third, the banking union was introduced including in particular the Single Supervisory Mechanism (SSM) and a Single Resolution Mechanism (SRM).

It would go beyond the scope of my intervention here today to go through the details of all these institutional innovations and what they mean for EU economic governance; again, my colleague Mario Nava outlined the regulatory response at the EU level to the crisis. It may suffice to say that they constitute a major step forward. I am convinced they will help us not to repeat the mistakes of the past.