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Joint Committee of Inquiry into the Banking Crisis

Witness Statement of

Ajai Chopra

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Joint Committee of Inquiry Into the Banking Crisis

Statement of Ajai Chopra

September 2, 2015

My role in context

As Deputy Director of the European Department in the International Monetary Fund (IMF), I supervised the 2009 and 2010 IMF Article IV consultations with Ireland. The supervision was from the IMF's Washington DC headquarters and I did not travel to Dublin for the consultations. My colleague Ashoka Mody led those discussions in Dublin.

In November 2010, I led the IMF team that visited Dublin to discuss the request for an EU-IMF supported program. I continued as team leader for visits to Dublin through the middle of 2011, after which Craig Beaumont handled the discussions for numerous program reviews. My Washington-based supervision of the IMF's work on Ireland continued until the conclusion of the program in December 2013. I retired from the IMF in March 2014 after nearly thirty years with the institution.

This statement deals with the questions and themes put to me by the Committee. This is my personal statement and I do not write or speak for the IMF. I remain bound, however, by IMF confidentiality rules as these also apply to former staff members and as I have not been authorized to reveal any confidential information of the IMF. I am, therefore, prohibited from revealing any unpublished information known to me by reason of my service with the IMF, or use or allow the use of unpublished information known to me by reasons of my service. Furthermore, the IMF has not waived its immunities from legal process with respect to my testimony before this Committee.

Entry into the EU-IMF supported program

On the level of engagement with the Irish authorities prior to the November 2010 formal request for IMF assistance

An Article IV consultation did not take place in 2008 when Ireland's serious internal imbalances and the fragility of the banking sector came hurtling to the fore. Ashoka Mody made an informal visit to Dublin in February 2009. That visit was the first time the staff raised the question of whether an IMF-supported financial arrangement might be useful to help smooth the inevitable adjustment facing the Irish economy. The 2009 Article IV consultation discussions followed in April and IMF staff again raised the possibility of Ireland requesting an IMF program, perhaps on a precautionary basis. The question was raised again during the May 2010 Article IV consultation discussions. On each occasion, the authorities considered the possibility but did not pursue program discussions.

The June 2009 Article IV staff report focused on immediate crisis management tasks. The report emphasized that the banking sector was fragile and that the losses faced by banks were likely to be extensive. Thus, safe exit from the bank guarantee, the report cautioned, could be a long-drawn process unless aggressively managed, including through proper design of the National Asset Management Agency that was being established at the time. The report also highlighted that weaknesses in the financial sector, public finances and economic growth could reinforce one another if not effectively tackled.

The July 2010 Article IV staff report went further, providing the broad template for the eventual EU-IMF program. It outlined policy imperatives such as restructuring the banking system, resolving impaired loans, strengthening supervision, establishing a special bank resolution regime, and strengthening the fiscal framework.

Outside the Article IV consultation framework, interactions between the IMF staff and the Irish authorities intensified in the second half of 2010, as maturing bank bonds and deposit outflows required Irish banks to rely increasingly on ECB liquidity support and market conditions for Irish sovereign bonds deteriorated. Irish officials kept IMF staff informed about developments and policy initiatives over the summer and autumn, including through telephone discussions. Starting in late September 2010, the European Commission hosted a set of informal meetings with Irish officials in Brussels, involving teams from the EC, ECB and IMF. In October 2010, Ashoka Mody and I also met with Finance Minister Lenihan and Governor Honohan when they visited Washington DC for the IMF's Annual Meetings. The various meetings and contacts during this period focused on key policy issues such as the financial sector strategy, the macroeconomic outlook, and fiscal adjustment.

The engagement with Irish officials prior to the request for financial support from the EU and IMF should not be characterized as technical discussions for a possible program. Rather, they helped all parties be prepared with a common information base. The purpose was to come to common understandings on how some key issues would be approached if a request for external financial assistance were made. Irish officials had only a rudimentary knowledge of how IMF financial assistance programs worked, which was natural because the previous relationship had been one of annual health check ups in the format of Article IV consultations. They were keen to know the policy requirements to get IMF assistance and the terms of the assistance, including the interest rate. Wisely, Irish officials were doing their due diligence before making a decision to request external assistance.

On the implications of entering a program either earlier than November 2010 or delaying further

As a general matter and not specific just to Ireland, it is advantageous to enter into a financing arrangement with the IMF early and before markets force the event because it is easier to deal with problems during periods of relative calm than during periods of extreme stress. In other words, it is better to seek assistance early to stem vulnerabilities rather than having to deal with them in the midst of a crisis. For effective crisis management it is important to recognize past mistakes, identify and allocate losses quickly and equitably, and move on.

Going from these general principles to the specifics of Ireland was inevitably an imprecise exercise that required judgment. Starting in 2008, the Irish government took a number of assertive and important steps—both in the area of banking and fiscal adjustment—that had bought them some credibility. But this was not sufficient as unforeseen shocks and steady revelation of the increasing size of the hole in the banking system undermined confidence. Although systemic banking problems in Ireland first blew up in 2008, it was the publication of the transparent March 2011 stress test results, conducted under the external assistance program, which provided markets with greater confidence that these problems were being adequately tackled. Against this backdrop, it is possible to paint a plausible scenario where earlier entry into a program might have reduced uncertainty and generated greater confidence, including by facilitating and earlier and more robust bank recapitalization and restructuring; the economy might not have contracted as sharply; and property prices might have overshot by less on the downside.

On whether Ireland was pushed into entering the EU-IMF program or whether it was a free choice, and statements to the Committee by Kevin Cardiff on this matter

I understand and sympathize with Mr. Cardiff's view that "at the moment we entered it [i.e., the program] we were pushed quite hard." Elaborating on his perspective, he said, "The ECB advice in regard to entry to the EU-IMF programme was specific, it was directly tied to conditions they had outlined in correspondence, and there were consequences for non-compliance. The ECB had its reasons and I don't say they were wrong from their perspective, certainly, but their view was an important pressure point."

That said, and as Mr. Cardiff also amply recognized, the decisive push into a program of official external assistance came from Ireland's loss of access to the sovereign bond market at interest rates compatible with public debt sustainability as the banking sector's woes eroded the sovereign's credibility. Ireland would not have been able to finance itself in 2011. In view of these market pressures and work that was already underway by the Irish authorities and external partners to prepare the ground for a program, the letters from ECB President Trichet to Finance Minister Lenihan were, indeed, "gratuitous," as Governor Honohan described them before this Committee. In addition, the demands in the ECB letters went beyond that institution's mandate.

Program financing and debt sustainability assessment

On the allocation of program funding for different purposes

The program was constructed with a financing package of €85 billion, broken down as follows: €45 billion from the EU and bilateral European lenders; €22.5 billion (the approximate euro value of SDR 19.5 billion) from the IMF; and a contribution of €17.5 billion from Ireland's cash reserves and assets in the National Pension Reserve Fund (NPRF).

Out of the €85 billion, the program incorporated a notional buffer of €35 billion to support the banking system. Two passages from the December 2010 IMF report making the request for an IMF arrangement explain this notional buffer:

- "The actual amount used is expected to be less than this buffer. In the first instance, up to €10 billion would ensure the immediate recapitalization of banks up to 12 percent in Core Tier 1 capital and the remaining €25 billion would be available on a contingency basis to maintain a capital ratio of 10.5 percent of Core Tier 1 capital under a stress scenario" (page 16, paragraph 20).
- "Staff estimates suggest that it is unlikely that bank recapitalization needs will exceed €35 billion. If that amount is needed, the authorities would use their own resources of up to €17.5 billion and €17.5 billion would be added to sovereign debt" (page 22, paragraph 27).

After subtracting the amount available to support the banking system, the residual €50 billion was available for normal budget financing. This amount was determined based on the projected path for the fiscal deficit, the need for debt refinancing given the lack of market access for the Irish sovereign, and assumptions about the gradual restoration of market access during the course of the three-year program.

In the event, bank capital injections by the government under the program amounted to about €17 billion, well within the amount available for the purpose. The remainder of the buffer, however, helped cover delayed and smaller market access during 2012 compared to program assumptions. Recall that for a part of 2012 there were tangible threats to the very existence of the euro area. The additional buffer also helped Ireland end its external assistance program in December 2013 with a strong cash position that avoided the need for a follow-on program.

On Ireland's €17.5 billion contribution to the financing package

The rationale for using Ireland's own resources was best provided by Minister of Finance Lenihan in his December 1, 2010 statement to the Dáil on the EU/IMF Programme for Ireland and the National Recovery Plan 2011-2014:

> "… the State is in the happy position of being able to contribute €17.5 billion towards the €85 billion from its own resources, including the National Pension Reserve Fund …
>
> … Why would we borrow expensively to invest in our banks when we have money in a cash deposit earning a low rate of interest? And how on earth can we ask tax payers in other countries to contribute to a financial support package while we hold a sovereign wealth fund? We have a large problem with our banks which has forced us to seek this external assistance. In these circumstances, it is surely appropriate that our cash reserves should be deployed to help solve that problem."

Indeed it is to Ireland's credit that it had a sovereign wealth fund upon which it could draw, thus lowering the amount of debt it needed to take on. This was a sign of strength. Not many countries are in such a position when they seek external financial support. Ireland's own contribution to the financing package had an additional benefit—it helped mute ill-advised calls from some European creditors to obtain collateral for official loans and equally ill-advised calls from some other European creditors for Ireland to raise its corporate income tax rate.

On the interest rate for IMF financial assistance

As is standard practice for all countries with programs supported by IMF financing, the interest rate on IMF loans to Ireland were tied to the IMF's variable market-related SDR interest rate (calculated based on three-month Treasury bill yields for the euro, yen, pound sterling, and dollar), plus a uniform margin of 100 basis points. On amounts exceeding three-times a country's IMF quota, there is also a surcharge of 200 basis points for large loans (Ireland's quota is SDR 1.26 billion). If credit remains above three-times a country's quota after three years, this surcharge rises to 300 basis points, and is designed to discourage large and prolonged use of IMF resources.

In the middle of December 2010 when the program was launched, the SDR rate was 0.34 percent. Adding to this the 100 basis points margin, and the 200 basis point surcharge because loans to Ireland met the definition of being large, resulted in an interest rate on IMF loans of 3.34 percent at the start of the program (although the average interest rate was lower because up to SDR 3.8 billion of borrowing had an interest rate of 1.34 percent as surcharges apply only to amounts over three-times quota). This interest rate was set according to a schedule approved by the IMF's Board for all countries and the IMF's operating procedure does not allow it to negotiate the interest rate charged. Ireland thus paid the same interest rate as any other country borrowing a large amount from the IMF. It was also a rate that was much lower than what Ireland would have been able to borrow on the market. By repaying most of the IMF lending early when market conditions for Ireland became more favorable, Ireland was able to avoid much of the jump in surcharges that kick in after three years of borrowing.

There is often a misperception that the interest rate on IMF loans at the start of the program was 5.8 percent, similar to the interest rate being charged by the EU at that time on its loans. As explained above, the interest rate on IMF loans was 3.34 percent at the time. However, because IMF lending is linked to a currency basket and is tied to short-term market interest rates, the Irish authorities apparently preferred to swap from SDRs into a single currency (euros) and also from a short-term floating interest rate to a long-term fixed rate. It is these hedging costs that presumably pushed up the effective interest rate on IMF loans to the frequently mentioned 5.8 percent. In retrospect, as short-term interest rates remained low, Ireland would have saved money by paying the floating rate on IMF loans rather than hedging into a fixed-rate.

On the public debt sustainability assessment and market access

Ireland's public debt-to-GDP ratio appeared to be on an unsustainable path without an external assistance program. However, the Irish government's implementation of a comprehensive bank restructuring strategy and articulation of a medium-term fiscal adjustment plan under the program, together with the potential for asset recoveries, were seen as helping to reduce government debt back to sustainable levels in the medium term. But as the December 2010 IMF report stated: "uncertainties around such a debt path make it difficult to state categorically that this is the case with high probability" (page 29, paragraph 43). As IMF staff were unable to state that debt was sustainable with high probability, providing Ireland a large loan required the IMF to invoke its new "systemic exemption" policy, put in place a few months earlier in the context of the large loan to Greece.

A key source of uncertainty at the time was the amount that would be added to public debt because of bank recapitalization. The baseline debt projection scenario was premised on the conservative assumption that the full €35 billion notional buffer would be needed for recapitalization, with half the amount being added to sovereign debt and the other half coming from Ireland's own resources as explained above. Alternative scenarios with smaller recapitalization needs were also presented. Other important risks to debt sustainability included (i) weaker growth and more prolonged deflation than projected, which would have powerful negative effects on debt dynamics; (ii) larger fiscal financing needs because of a deterioration in the outlook for public finances; and (iii) materialization of the sizable contingent fiscal liabilities on the government's books relating to guarantees for emergency liquidity assistance, other bank liabilities covered by the eligible liabilities guarantee (ELG) scheme, and its ownership of the Irish Bank Resolution Corporation (IBRC) and the National Asset Management Agency (NAMA).

From the outset the Irish government was determined to pay its sovereign debts and honor guarantees. The program was therefore designed on this assumption, providing a financial lifeline so that the sovereign did not need to rely on market finance. It was recognized that it would take some time for uncertainty to be reduced because risks are typically elevated when emerging from a crisis. The focus therefore was to manage these risks through determined policy implementation. The key was to get growth and job creation going, which inevitably takes time when the economy is going through a wrenching adjustment.

It is important to emphasize that the problems that Ireland faced in 2011 and much of 2012 was not just an Irish problem. They were a shared European problem. Despite Ireland's vigorous policy efforts, its sovereign bond yields remained stubbornly high into the first half of 2012, reflecting primarily the broader euro crisis, which delayed reentry into the bond market at reasonable cost. What was needed, and what was lacking for a considerable period, was a European solution to a European problem. For Ireland, in addition to what it could do domestically, it was going to be important that the uncertainty created by the lack of a concerted euro area crisis response also be dispelled. It was only in the second half of 2012 that broader euro area concerns began to diminish following policy announcements such as the June 29 summit statement on moving to a banking union and the ECB's potential outright monetary transactions, reducing the headwinds faced by Ireland due to the wider EMU crisis and thus improving debt sustainability prospects. Indeed, Ireland's return to Treasury bill issuance came soon after the June 29 statement, and market access was then deepened step-by-step.

Eventually, Ireland's debt dynamics turned out to be somewhat better than anticipated at the outset of the program. Several factors contributed. First, although the need for additional bank capital was identified to be €24 billion in the March 2011 stress test, capital injections by the government amounted to about €17 billion. The rest was covered by "liability management exercises" for junior bank debt and private equity. This government capital injection was well below the conservative figures incorporated in the baseline debt scenario, reducing the need for the government to take on as much debt as had been assumed. Second, actual cumulative nominal GDP over the four years since the start of the program turned out to be close to original projections (although the path itself differed from what had been projected), reducing worries about adverse growth outturns that would have been destructive for debt dynamics. Third, the interest rates on EU support were eventually reduced and the promissory note transaction (discussed below) improved the sovereign's financing profile by reducing rollover needs over the next decade. And fourth, the scale of contingent liabilities that could add to debt if realized was reduced as property markets improved and NAMA bonds were repaid, the ELG scheme was phased out, and the liquidation of IBRC reduced the need for the government to provide guarantees of emergency liquidity assistance.

Nonetheless, the IMF's 2015 Article IV consultation report (published in March 2015) concluded that although Ireland's public debt outlook has improved over the last year and financing conditions are benign (owing in part to the ECB's quantitative easing program), public debt is still very high and its projected further decline remains vulnerable to lower growth, especially if this is coupled with a fiscal primary balance shock and a rise in interest rates on new borrowings. Possible debt reductions from asset sales, however, provide some upside potential.

Burden sharing with senior bank creditors

From the outset IMF staff noted that Irish sovereign obligations would be lower if debt owed by banks was restructured. By containing costs borne by the public sector, burden sharing with bank creditors would weaken the bank-sovereign loop that can undermine public debt sustainability, as was the case in Ireland. Sharing losses with creditors also reduces moral hazard and helps contain the risk of future crises.

IMF staff stressed that imposing losses on bank creditors should not be restricted only to junior bondholders and that a decision to share losses with senior unguaranteed and unsecured bank bondholders should, in principle, be based on

(i) the magnitude of a banks' overall losses; (ii) the need to return the bank to a more stable funding structure; and (iii) the potential knock-on effects on others. Burden sharing would also need a robust legal and institutional framework that strikes a reasonable balance between creditor safeguards and flexibility. The "Credit Institutions Stabilization Act" passed in late 2010 provided such a framework.

In their testimony before the Committee, Ireland's former Attorney General, Paul Gallagher, and the Department of Finance's outside counsel, Pádraig Ó Ríordáin, pointed to the IMF staff's proactive approach on this subject, noting that in November 2010 IMF staff made Lee Buchheit, a specialist international lawyer on these matters, available to the Irish authorities in Dublin to advise on how burden sharing might be done to avoid legal challenges.

The Irish government, however, emphasized that any burden sharing with bank senior bondholders would be undertaken in consultation with European authorities. And the European authorities were opposed. They feared that imposing losses on senior bondholders of Irish banks would adversely affect euro area banks and their funding markets. As put by Finance Minister Lenihan in his December 1, 2010 statement to the Dáil, "There is no way that this country, whose banks are so dependent on international investors, can unilaterally renege on senior bondholders against the wishes of the ECB."

Thus, when the program was agreed in December 2010 it did not include burden sharing with senior bank creditors. However, the staff report for the program request explicitly referred (in paragraph 28) to the three criteria mentioned above. The purpose was to leave open the possibility for burden sharing with senior bondholders later in the program, especially for failed banks where there was a stronger case for greater burden sharing with creditors. In particular, Anglo Irish was a failed bank with losses that were many multiples of its capital and it did not need to worry about future counterparty relations.

Sizeable liability management exercises for banks' junior debt were underway when the program started and further such exercises were envisaged, helping to reduce fresh injections of capital by the government.

When the new government took office in March 2011, about three months after the launch of the program, and prepared for the announcement of the bank stress test results on March 31, 2011, they made a distinction between "pillar banks"—that is, going concern banks such as Allied Irish and the Bank of Ireland undergoing restructuring with public support—and failed banks such as Anglo Irish and Irish Nationwide. Their position was that the pillar banks need to be able to operate in the market as strong banks with a positive future and ongoing relations with all counterparties. In making such a distinction, the hope was that burden sharing with the senior creditors of the failed banks would be allowed. It was therefore a great disappointment that European partners precluded even this more limited approach to burden sharing with senior bank creditors.

It is understandable that there is a strong sense in Ireland that burden sharing between Irish taxpayers and bank creditors has been unfair. In late 2010, remaining unguaranteed and unsecured senior bondholder exposure was about €16 billion, somewhat above the magnitude of envisaged fiscal adjustment over the next four years. This comparison made the issue very visible. Even if spillover risks dominated, the question remains—why should Irish taxpayers have to bear a disproportionate burden to address wider euro area concerns?

Furthermore, as pointed out in the IMF's January 2015 ex post evaluation of IMF financial support for Ireland, the evidence is not clear on the risks of cross border spillovers from bailing in senior bank creditors in Ireland, and policies could have been put in place to address these risks more directly if they arose. To quote:

> "Spillovers should have been limited if markets and bondholders of Irish senior unsecured bank debt were expecting a bail in. Indeed, Irish (senior unsecured) bank bonds traded at the time at levels consistent with clear anticipations of a principal haircut, reflecting that some burden sharing was anticipated by bondholders and markets. While the anticipation of risks does not always preclude additional repercussions if these risks actually materialize, the magnitude of the repercussions should generally be more contained. Moreover, even if cross border contagion risks were considered important, steps could have been taken to ring fence these through appropriate policy responses in the affected markets. This could have included supporting steps by country authorities in cases where their banks' solvency would be threatened from writing down their direct exposures to Irish senior unsecured debt; and/or, if needed, by forceful liquidity support by the ECB to ensure no disruptions in euro banks' funding markets" (page 28, paragraph 51)

Recent academic research confirms the view that spillover risks were exaggerated. An empirical analysis of funding cost spillovers in the euro zone (NBER Working Paper 21462, August 2015) finds that contagion between most euro zone banks is limited because they have fairly weak links, and that contagion risks are significant only when the biggest euro zone banks are involved.

Promissory note transaction

As the Irish government had not been allowed to impose losses on senior bondholders, the authorities began to seek alternative means to improve debt sustainability. These efforts started in 2011 with various approaches being considered and debated, some trying to take advantage of policy initiatives floated in the broader euro zone context. Securing better terms was seen as essential to help contain the political cost of the decision on burden sharing, thereby protecting coalition support for fiscal consolidation.

From the start, a priority was to find a way to tackle the much-hated promissory notes, which were essentially government debts placed in Anglo Irish Bank and Irish Nationwide to ensure these entities were adequately capitalized in order to be eligible for Eurosystem liquidity. These notes ended up on the balance sheet of their successor, the Irish Bank Resolution Corporation (IBRC). They carried a high debt service burden and also served as a collateral for emergency liquidity assistance. The objective was to extinguish both the promissory notes and emergency liquidity assistance, thereby achieving the twin goals of lowering the government's annual financing needs over the next decade and removing the uncertainty overhanging IBRC funding because emergency liquidity assistance is not stable funding.

IMF staff were strongly in favor of finding a solution to the vexing promissory notes and the huge stock of emergency liquidity assistance. Although there was a substantial amount of ongoing work to find a solution, published IMF reports were guarded in discussing the matter because sensitive discussions among the key parties were underway. But the reports for the sixth review (published in June 2012), the seventh review and 2012 Article IV consultation (published in September 2012), and the eighth review (published in December 2012) did contain brief discussions of the challenges posed by the promissory notes. The reports highlighted the benefits of finding a solution to the heavy amortization schedule, including for securing market access and thus reducing and eventually eliminating the reliance on official funding. Indeed, the report for the eighth review contained a box titled "How to Improve the Sustainability of the Program" that also looked at potential elements other than a promissory note transaction. Proposed elements included ESM bank equity participation following the famous June 29, 2012 commitment by euro area leaders to enhance the sustainability of Ireland's program and the emphasis the leaders put on finding ways to break the vicious circle between banks and sovereigns.

Following painstaking and tenacious efforts by the Irish authorities—with Governor Honohan and Minister Noonan in the lead—involving numerous iterations over more than a year to find a workable solution, a satisfactory promissory note transaction was eventually concluded in February 2013. This was a situation where the staff teams from the ECB, the EC, and the IMF were very much on the same page assisting the authorities to find a pragmatic solution. The matter of promissory notes and emergency liquidity assistance was primarily in the bailiwick of the ECB, and admirably their staff labored diligently to devise an effective solution.

Finally, as a general matter and not specific to Ireland or the issue of promissory notes, the IMF's apparent restrained stance on a matter should not be taken to mean that it is not engaged with a range of technical and political counterparts to promote better policies.

Social consequences of the program

The social consequences of the economic policies agreed under the external assistance program featured prominently in the discussions. Protecting the socially vulnerable at a time of difficult economic adjustment was a central policy goal.

Even before the program started, deep fiscal consolidation had been implemented in 2008, 2009 and 2010 with comparatively modest social distress.

This reflected the maintenance of a strong social safety net during the consolidation, which served Ireland well despite the difficult choices that had to be made. Indeed, as documented in the IMF's 2012 Article IV report, the progressive design of consolidation and strong social protection helped Ireland retain the second lowest "at-risk-of-poverty gap" in Europe in 2010, despite suffering a deeper crisis.

Nevertheless, it was well recognized that frustration was running high because of continued upward revisions of the need for fiscal consolidation and the enormous cost of supporting the financial sector. Unemployment had already shot up from 4½ percent in 2007 to 13½ percent in 2010, and was expected to rise further in the coming years, which it did. Therefore it was imperative that the program be designed with keen awareness of the social consequences and that steps would be necessary to mitigate the adverse consequences whenever possible.

The government that negotiated the program in 2010 had articulated a National Recovery Plan that aimed for social fairness and protection of the most vulnerable and maintaining Ireland's due regard for a social safety net. When the new government took office in March 2011, it began by engaging with external partners to redesign aspects of the program to suit its own priorities. In particular, it sought to revise the mix of budget measures to promote job creation. The cut in the minimum wage envisaged by the previous government was also eliminated. External partners quickly acquiesced to this request. Importantly, within the agreed magnitude of annual fiscal adjustment, the Irish authorities and Irish parliament decided the specific revenue and spending measures that were implemented under the program in the budgets for 2011 to 2014.

Half way into the program, the IMF's 2012 Article IV discussions provided an opportunity to step back and review the approach to fiscal consolidation to ensure that remaining consolidation needs would be met in a manner that was both durable and protected the vulnerable. The IMF staff's advice in the 2012 Article IV report was as follows:

> "Given the still-fragile economy and high unemployment, it is vital that the choice of budget measures minimizes the drag on demand and job creation. At the same time, the measures need to entail fair burden-sharing across income groups, generations and family types, while effectively protecting the most vulnerable. To achieve these goals, staff encouraged the authorities to base fiscal consolidation on the following approaches: • Better targeting the state's social supports and subsidies to ensure support is directed to those who need it; • Reforming key government services, especially health and education; and • Focusing revenue effort on base-broadening rather than rate hikes" (page 22, paragraph 31).

And on the issue of unemployment, that report pointed out that although economic recovery will be the main vehicle to reduce unemployment, it is also important to ensure that jobseekers are willing and able to fill jobs when they become available. To realize the full benefits of the Pathways to Work initiative, the report recommended additional well-trained caseworkers to support jobseekers, regular monitoring of training outcomes, and further reforms to the structure of social benefits to avoid inactivity traps for the long-term unemployed.

Finally, the dialogue on the social fallout from the crisis was not confined just to discussions with the Irish authorities. Teams from the EC, ECB and IMF made a concerted effort to exchange views with labor unions and other organizations that had direct experience in dealing with vulnerable parts of society. These exchanges were very useful. I suspect, however, that these counterparts did not think we did enough to address their concerns and adopt their recommendations, and I can understand that perspective. But they should not underestimate the influence they had on us, especially in our discussions with the authorities, encouraging the government to design its policies with fairness and equity very much in mind.

Fiscal targets and the windfall gains from lower interest payments

As documented in the IMF's January 2015 ex post evaluation of the program, interest savings relative to the original program path (a cumulative €4.4 billion during 2011-13, or 2.7 percent of 2013 GDP) reflected in part lower-than-forecast interest rates and reduced interest margins on European loans. The ex post evaluation report goes on to argue that, "saving just over half of the interest savings vis-à-vis the original program assumptions in the final program year would have secured an improvement in the structural deficit of about 1 percent of GDP in 2013. It would have moved Ireland somewhat further along toward debt sustainability, and could have alleviated some of the concerns about adjustment fatigue that seem to have gained momentum in the post-program domestic debate" (page 30, paragraph 55).

I disagree with this view. The fiscal anchor under the program was the annual fiscal effort specified in billions of euros, not as a percent of poorly predictable nominal GDP. The program agreed a phased amount of fiscal effort over time, which was maintained and did not require modification. The principle was to allow fiscal automatic stabilizers to work so that negative shocks to growth and thus the fiscal deficit did not require additional fiscal tightening, which would have exacerbated the shocks and undermined financial stability and debt sustainability. Furthermore, the structural adjustment in the primary fiscal balance (that is, excluding interest payments) under the program was already sizable, estimated at 4½ percent of GDP at the time of the last review of the program (before final data for 2013 were available) and more recently calculated at 5.6 percent of GDP. And, in the event, overall fiscal deficit targets were consistently met with some margin, implying that a portion of interest savings was indeed saved.

Regulation and supervision

Deficiencies in regulation and supervision in Ireland in the run up to the crisis have been documented in Governor Honohan's report of May 2010 ("The Irish

Banking Crisis: Regulatory and Financial Stability Policy 2003-2008") and in Peter Nyberg's report of March 2011 ("Misjudging Risk: Causes of the Systemic Banking Crisis in Ireland"). These are both superb reports and I have nothing to add to their fundamental conclusions.

For its part, the IMF has acknowledged faults in IMF surveillance ahead of the crisis. For example, the 2012 Article IV staff report said: "Regulators—and the IMF in its surveillance role—failed to issue proper warnings as a vast commercial and residential property bubble inflated and bank assets grew to some 500 percent of GDP" (page 4, paragraph 2). And the IMF's January 2015 ex post evaluation of financial assistance to Ireland said: "Ireland's long history of economic success may have contributed to the fact that risks were largely not recognized or downplayed, both by domestic and foreign observers. … This also applied in general to Fund surveillance prior to 2008, although staff reports noted that the 'impressive' economic performance of Ireland was 'increasingly reliant on house building.' … The 2006 Financial Sector Stability Assessment, while highlighting vulnerabilities, did not raise significant flags" (page 6, paragraph 6). The IMF is a learning institution and a review of its role in the euro area crisis by its Independent Evaluation Office (IEO) is forthcoming. I expect that the IEO will publish additional critical analysis of the IMF's pre-crisis analysis and policy advice for the euro area and Ireland.

Over the last five years, impressive strides have been made to address the institutional weaknesses that contributed to the crisis. Importantly, bank supervision has been strengthened and a comprehensive bank resolution framework, including a special resolution scheme for deposit taking institutions, has been established. The capacity to implement proactive macro prudential measures has also been strengthened. And, at the European level, the single supervisory mechanism is in place for the euro area and the Bank Resolution and Recovery Directive will soon come into force. Notwithstanding these strides, this is a constantly evolving area both domestically and internationally, and work to make the financial system safer and more robust is never quite done.

Banking sector profitability, distressed debt and access to credit

When the program was designed, it was recognized that regaining profitability and tackling banks' funding was necessary for banks to sustain new lending. The initial focus of the financial sector strategy under the program, however, was on financial stability concerns, especially ensuring that banks had sufficient capital. This was appropriate because until stability was restored, banks would not be able to perform the normal business of financial intermediation. As gains were made on the stability front, the program put greater stress on improvements in bank profitability. The focus was on addressing bad loans and other distressed debt on banks' books, and better aligning banks' operating cost structures with their lower revenue streams.

In the event, banking sector profitability was not restored until the first half of 2014, for the first time since 2008. Although this slow progress was a disappointment, it is not a surprise given the depth of Ireland's banking crisis.

Banking sector losses declined and intermediation margins improved over the program period, but the high level of bad loans and provisioning costs limited progress. Furthermore, low returns on sizable asset positions (including on tracker mortgages), combined with slow progress in improving efficiency and reducing operating costs, weighed on bank profitability. A fall in costs on both deposits and market funding bolstered operating income, and provisioning expenses fell as impaired assets stabilized. Increased property prices also contributed.

Could more have been done earlier to tackle impaired loans and to improve efficiency and reduce costs? Perhaps. The IMF's January 2015 ex post evaluation concludes:

> "Bank recapitalization alone does not advance debt workouts and restore bank profitability—supervisory interventions and other supportive steps are also needed. … stronger supervisory guidance—for example, by fully using the room provided under IFRS and prudential regulations …—as well as further legal reforms could have facilitated more progress in addressing the high levels of NPLs in a sustainable manner. Earlier adoption of a stronger insolvency framework could also have facilitated progress in this area. Similarly, stronger supervisory guidance on bank restructuring could have helped in reducing operating costs and improving bank profitability. Taken together, more forceful actions, taken at an earlier stage, could have supported a stronger economic recovery" (page 37, paragraph 64).

There is merit to these conclusions, but they are overstated. In particular, analysis by IMF staff in 2012 concluded that weak lending is mostly demand-driven, with supply factors playing a smaller role that was limited to mortgages and pockets of SME lending (see Chapter III of the Selected Issues Paper prepared in conjunction with the 2012 Article IV consultation). The paper went on to suggest a small-scale and well-targeted SME credit guarantee program to relieve financing constraints for SMEs with profitable growth opportunities, emphasizing that care would be needed that guaranteed credit does not flow to SMEs that do not need it or have alternative sources of financing.

Nevertheless, the case to speed up the restructuring of bad loans was valid. More intense efforts by banks to work out distressed debt, especially distressed mortgages, prodded by supervisors, would have helped repair private sector balance sheets and reduce the debt overhang faster, solidified prospects for economic recovery and sound lending opportunities, and ultimately helped restore the viability of banks more quickly.

Encouragingly, data presented in the IMF's March 2015 Article IV report indicate that rising earnings of Irish enterprises appear to be limiting their need for external financing at this stage of Ireland's recovery. Recent surveys find that SMEs are making fewer loan requests and SMEs also see a greater willingness of banks to lend and they face lower loan rejection rates.

Post-program fiscal consolidation needs

The 2009 and 2010 Article IV staff reports recommended a strengthening of Ireland's fiscal institutions to help avoid past mistakes and sustain the implementation of planned fiscal consolidation. Since the crisis, there has been a marked strengthening of Ireland's fiscal institutions, meeting most criteria of international good practice. The Fiscal Responsibility Act of 2012 provided the legislative underpinnings for an independent fiscal watchdog, the Irish Fiscal Advisory Council (IFAC). The IFAC has a strong mandate and in just a few years it has established its credibility and enhanced the quality of the debate on fiscal matters in Ireland. Equally, the "Medium Term Budgetary Framework" prepared by the Department of Finance has been valuable to extend the horizon for fiscal policy-making beyond the annual budget calendar.

Ireland's strengthened fiscal institutions and framework, operating in conjunction with the EU's fiscal framework, should foster the conduct of sound fiscal policy that provides room for counter-cyclical demand management when needed, promotes creditworthiness and debt sustainability, delivers a stable tax and benefit structure, and addresses demographic pressures. Importantly, past mistakes of pro-cyclical fiscal policy and allowing expenditure to ramp up based on unsustainable revenue need to be avoided. The combination of pressure to reverse past austerity measures, strong growth, and elections can provide a toxic mix that requires the antidote of strong fiscal institutions and frameworks, which Ireland now possesses.

In translating these general principles to specific policies for the future, I agree with the recommendation made by my former IMF colleagues in the 2015 Article IV report and the June 2015 post-program monitoring report. What follows draws heavily on these reports.

As Ireland emerges from the EU's excessive deficit procedure, it should establish a medium term goal to balance the budget over the cycle. Achieving and maintaining fiscal balance over the cycle will ensure that growth progressively erodes Ireland's high public debt burden over time, underpinning confidence to invest and create jobs. Declining debt will also rebuild the fiscal space needed to allow Ireland to cushion future shocks to growth. Moreover, maintaining a balanced budget over the cycle will reduce the risk that the fiscal stance amplifies economic fluctuations, as was historically common in Ireland.

IMF staff estimate Ireland's structural fiscal deficit to be 1½ percent of GDP in 2015, and project that the small remaining output gap will close in 2017-18. The aim should be to reduce the structural deficit by about ½ percent of GDP per year so that structural balance is reached by 2018. This pace of adjustment would imply only a modest drag on growth, enhance economic stability, and also define the room available for budgetary initiatives from year to year, making adjustment more manageable. Making steady progress toward structural fiscal balance over the next three years, while growth is especially strong, requires avoiding a repeat of past spending overruns. It would also be best to save any over performance in revenue.

There is scope for a mix of expenditure and revenue measures to support the needed adjustment, instead of relying primarily on expenditure saving. Public investment has been reduced to low levels, making it important to evaluate the amount and quality of spending to ensure adequate maintenance and avoid growth bottlenecks. Expenditure reforms are needed to deliver core public services at manageable cost, requiring continued wage restraint, better targeting of spending on social protection, greater cost efficiency of healthcare provision, and reforming higher education funding while protecting low income students. Revenue efforts should build on the base-broadening reforms achieved in recent years, especially as it is likely that evolving international tax standards will affect the tax base in the medium term.

Other policy debates

A number of policy debates that emerged in program discussions have already been addressed in previous sections of this statement. This section briefly discusses two additional policy debates: (i) the pace of fiscal adjustment and (ii) the pace of bank deleveraging.

The fiscal adjustment path and the excessive deficit procedure

In September 2010, just a couple of months before the launch of the program, the Irish authorities and the euro group had reaffirmed that under the excessive deficit procedure Ireland would reduce its fiscal deficit to below 3 percent of GDP by 2014. Adjustment of €15 billion over four years was envisaged to achieve that target. ECB staff pressed for massive up front fiscal consolidation in the 2011 budget, while IMF staff argued that with the economy contracting, and with fiscal credibility having been established with substantial austerity in 2008-2010, excessive front loading would be unwise. The Commission staff were somewhere in the middle of this debate, and a compromise was achieved.

Furthermore, the IMF staff's more conservative growth projections, which were eventually accepted by partners, showed that the envisaged fiscal adjustment path would not deliver the 3 percent of GDP deficit by 2014. The worry, therefore, was that even more pro-cyclical adjustment might be sought by European partners to maintain the 2014 excessive deficit deadline. This would have been damaging for the economy. Happily, in late November 2010, just a few days before the conclusion of program discussions, Commission staff were able to convince their bosses, and eventually the euro group, to delay the excessive deficit deadline to 2015. Revising the target date to achieve the 3 percent of GDP threshold right from the start of the program provided a more stable set of fiscal objectives.

The eventual compromise on front loading, namely for €6 billion of adjustment in 2011, equivalent to 40 percent of the four year total adjustment of €15 billion, was more aggressive than warranted by the weak state of the economy, the unavailability of an endogenous monetary policy offset in the euro area, and Ireland's strong track record of fiscal adjustment in the two years prior to the program. Frontloading of, say, €4 billion (about 2½ percent of 2011 GDP) would have been sufficient for markets to view it as an appropriate balance between an ambitious start to consolidation under a full-fledged program on the one hand, and smaller headwinds for growth on the other.

Pace of bank deleveraging versus disposal cost

The purpose of bank deleveraging plans under the program was to reduce the size of the enormous banking sector. It was important to align the size of bank assets with stable funding sources and reduce reliance on wholesale funding and ECB liquidity support. A central issue was almost €160 billion of ECB financing, of which more than a third was emergency liquidity support. That size of funding simply could not be obtained by asset sales or credit enhancements using program resource. At the same time, the ECB hoped that proceeds from asset sales would allow the quick reduction of its huge exposure to Ireland. Eventually, the ECB quietly extended its financing, recognizing that fire sales of assets would be counterproductive.

To monitor progress in deleveraging, the initial approach was to target a loan-to-deposit ratio of 122.5 percent by the end of 2013, that is, phased over three years. But this approach ended up introducing distortions to deposit pricing and lending, and was eventually dropped. Instead the focus switched to monitoring targets for the disposal of banks' noncore assets. The asset disposal program focused mainly on offshore assets and included safeguards against fire sales. With depressed domestic markets, the sale of Irish assets, including mortgages, was not a viable option to advance rapid deleveraging.

It is noteworthy that under the program there was no ex ante commitment of liquidity support from the ECB, even though this was a critical component of the program. The best that could be achieved was a statement of need in the December 2010 staff report requesting a program, namely that, "… the ECB would need to continue providing liquidity support to the domestic banking sector, as needed, over the course of the program" (page 10, paragraph 10). Thankfully, the ECB did deliver on this front.

Risks facing Ireland

It is difficult not to be upbeat about the Irish economy these days following many difficult years after the country's boom turned into a bust. Prospects for a self-sustaining recovery with high growth appear favorable and employment is increasing. Fiscal deficits are small and the government's financing needs are modest. The country's market access appears robust and on highly favorable terms, owing both to the improved economic outlook and quantitative easing by the ECB. The economy remains competitive.

But high headline growth rates should not mask that only now in 2015 is the level of real per capita GDP expected to reach its 2007 level. And, although the unemployment rate has fallen back to single digits it is still double the level that prevailed before the crisis hit. Youth unemployment is still a high 20 percent. And, although there has been considerable balance sheet repair, household debt of 170 percent of disposable income is one of the highest levels among advanced countries. Loan distress remains elevated with over half of arrears cases being prolonged. And the so-called "Texas ratio" (the ratio of non-performing loans to the sum of the provisioning stock and core tier 1 capital) for Irish banks is still in the danger zone above 100 percent.

Overall, however, Ireland's fundamentals are much improved and vulnerabilities have been sharply reduced. The "Risk Assessment Matrix" in the IMF's 2015 Article IV report provides a convenient summary of the risks facing the country. Five risks are identified, the first three with a relatively high subjective likelihood, and the fourth and fifth with a medium subjective likelihood:

- A surge in financial volatility because investors reassess underlying risk and move to safe-haven assets. With its high level of private and public debt, Ireland would be susceptible to such financial contagion. The ECB's QE and OMT should help contain this risk, which is also mitigated by low budget financing needs.
- A protracted period of slower growth in advanced economies, especially in the euro area. The euro area accounts for some 40 percent of Ireland's exports. But apart from the direct trade impact, protracted euro area weakness could undermine domestic confidence, investment and FDI inflows.
- Low inflation that remains stuck well below the ECB's target. This would slow the declines in Ireland's high public and private debt levels, leading to higher savings and lower investment.
- Bond market stress from a reassessment of sovereign risk. For example, with Irish elections due no later than early 2016, external political developments could increase challenges to expenditure control in 2015 and undermine adjustment in Budget 2016. But the Irish authorities' strong track record and better fiscal institutions limits such risks.
- Financial imbalances from protracted period of low interest rates. The international search for yield appears to be a significant factor driving Irish commercial real estate markets. Although low domestic credit growth limits risks, further strong inflows into commercial real estate could generate over-building and risks of future slump in prices.

The IMF report from which this list of risks is taken was written and published in March 2015, a few months before the heightened tensions associated with how euro area creditors handled the situation in Greece. This episode has created new risks in the euro area, and Ireland would not be immune. In particular, Germany's Minister of Finance has made it politically legitimate to discuss ejecting a country from the euro zone, and the German Council of Economic Experts has also suggested that exit from the monetary union become integral to the way the euro area operates. In addition, the ECB has shown a willingness to shut down a euro area member's banking system. The monetary union's flawed and divisive political and economic mechanisms appear likely to condemn the bloc to fragility and repeated crises. This is a tragedy for the entire euro area, not just Greece.