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Witness Statement of

Marco Buti

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3 September 2015

Oireachtas Committee of Inquiry into the Banking Crisis

Marco Buti, Director General for Economic and Financial Affairs, European Commission

10 September 2015

Introduction

I welcome the opportunity to be here in Dublin for a second time and to contribute to the Inquiry as a sign of the Commission's availability in the discussion of the Irish crisis and its adjustment. When I appeared before this committee in February, the focus of attention was on the years preceding the crisis. I understand that the statement I gave at the time and the evidence I provided are part of the comprehensive documentation available to the committee.

For today, I have been asked to deliver a statement and to provide evidence on the so-called 'nexus phase' of the Irish banking crisis which covers the post-2007 period including the implementation of the EU-IMF financial assistance programme. With this in mind, in my opening statement I will focus on four subject areas:

(i) the implosion of the Irish economy;

(ii) the surveillance and economic policy initiative of the European Commission during the crisis years;

(iii) the reforms to the EU economic governance framework in response to the Irish and euro-area crisis; and

(iv) the EU/IMF financial assistance programme to Ireland.

Let me stress upfront that in my testimony I can only provide evidence on issues that are related to the responsibilities of the institution that I represent, namely the European Commission, in particular its Directorate General for Economic and Financial Affairs, or short DG ECFIN. In particular, I can provide evidence on matters pertaining to EU economic surveillance and the implementation of the EU-financial assistance programme. I *cannot* comment on matters of financial supervision or regulation and, link to that, on matters pertaining to individual banks or financial institutions before or during the crisis period.

As pointed out during my first appearance before this committee, the remit of EU economic surveillance prior to the crisis and during the first years of the crisis was fairly limited in scope. It essentially amounted to fiscal surveillance. Other surveillance instruments, albeit available and anchored in the EU Treaty, notably the Broad Economic Policy Guidelines (BEPGs), had no enforcement power. I made this point during my first appearance. Plus, all Member States were, understandably, keen on defending their sovereignty in economic policy making.

With hindsight, the limited surveillance mandate of the European Commission turned out to be a serious problem. Many crucial events that took place in Ireland between 2008 and end 2010 concerned the banking sector and, thus, fell outside the then operating range of the European Commission in general and DG ECFIN in particular. Most importantly, the European Commission played essentially no role in regulating and supervising domestic banks. This point was clarified by my colleague Mario Nava who appeared before this committee in February. He explained in great detail the supervisory and regulatory setup in Europe at the time; a setup that, in hindsight, was far from optimal but which determined the responsibilities of national and supranational actors.

Things obviously changed when Ireland entered the EU-IMF financial assistance programme as the Commission was part of the so-called troika. The involvement of the European Commission also changed with the various waves of reforms of the EU economic surveillance framework. The reform significantly broadened and strengthened the responsibilities of the European Commission. I will come to that later.

Build up to the crisis

The years immediately prior to the Irish crisis were marked by very strong economic growth. The Irish economy was expanding at a pace of 5% or more per year, as opposed to around 2 ½ % in the Euro area as a whole. However, strong economic growth masked important imbalances in several key areas of the economy notably housing, the banking sector, public finances and the external accounts.

A number of observers, including the European Commission, noted the build-up of these imbalances. During my first testimony, I indicated the various EU surveillance documents issued prior to 2007 which highlighted risks linked to both the Irish construction boom and the rapid expansion of government expenditure during economic good times. But I also made it clear that the key macroeconomic indicators we had to monitor under our narrow mandate were all satisfactory.

In 2008, against the backdrop of international economic and financial dislocations, the imbalances of the Irish economy started to unwind in an abrupt manner giving rise to a downward spiral of interacting forces: property prices collapsed; budgetary windfalls linked to the property boom vanished and exposed a huge gap in government finances; banks started making important losses as their real estate exposure went bad, international investors became increasingly worried and wholesale funding for Irish banks vanished;

liquidity outflows from the banks left them increasingly reliant on the Eurosystem for funding and on emergency liquidity assistance (ELA) from the central bank.

Because of the unprecedented size of the debt-financed housing bubble, its burst gave rise to a particularly strong and persistent feedback loop between the financial system and the real economy. The sharp decline of real estate prices annihilated a large part of the banks' and households assets which in turn seriously impaired the banks' capacity to intermediate as well as the households' capacity to consume. The oversized construction sector collapsed abruptly, releasing an army of mostly low-skilled workers. In addition, government revenues continued to fall and expenditure to rise not least in an attempt to safeguard the stability of domestic banks. The boom had turned into a daunting bust and policy makers, both domestic and at the EU level, were faced with formidable challenges.

In sum, I very much concur with the conclusions drawn by most witnesses that appeared before this committee. The post-2007 economic and financial crisis in Ireland was domestically generated. Its roots were not only in the banking sector, but also in pre-crisis fiscal policy making. The depth, scope and resolution of the crisis were influenced by the global economic and banking crisis.

The domestic policy response

Starting in 2008, the Irish government took a series of measures in response to the crisis. One of the main, and possibly the most emblematic policy action was the so-called blanket guarantee. To confront the perceived liquidity crisis of the domestic banks in late September 2008, the government decided to implement a two-year guarantee on banks' liabilities. The guarantee covered almost all liabilities of the domestic banks except for subordinated debt.

It is not for the Commission to judge whether, ultimately, the decision to issue the guarantee was a good one or not. With hindsight, I believe the guarantee was too generous and magnified the fiscal impact of the banking crisis. At the same time it is clear that the decision was taken in a very difficult situation characterised by great risks and uncertainty. I certainly do not envy those who had to make a decision in late September 2008. The only point of criticism that I can make here is that the Irish government did not consult with its European partners. The blanket guarantee heightened competition for bank funding at a moment of growing tensions in financial markets across Europe.

The blanket guarantee was the first such scheme put forward by a European country during the crisis. In September 2008 there were no specific guidelines concerning the acceptable or desirable features of state guarantee schemes for banks. They were adopted one month later, in October 2008, setting out a fairly strict set of rules. The blanket guarantee was broader than the new rules allowed.

In December 2009, the blanket guarantee was complemented and eventually replaced by the Eligible Guarantee Scheme (ELG). The ELG allowed Ireland to align its guarantee scheme with those in place in other European countries and to limit its exposure towards banks. Importantly, the ELG also allowed Ireland to earn a fair remuneration on the guarantees provided to banks.

At the time, the two guarantee schemes provided some relief to the banks but they did not restore their market access for funding. What initially was thought to be a liquidity problem relatively quickly turned into an acute solvency problem especially for some of the domestic banks. As a result, and in a bid to safeguard macro-financial stability, the Irish government made a number of capital injections into the banks. Through cash or promissory notes, the government provided capital to five domestic institutions (Anglo Irish Bank, Allied Irish Bank, Bank of Ireland, Irish Nationwide Building Society and EBS Building Society) totaling about EUR 49 billion or 29% of GDP in 2009-10. All capital injections had to be approved by the European Commission, specifically by the Directorate General for Competition.

The economic and financial crisis in Ireland also had a profoundly negative impact on public finances. Starting in 2008 and until the start of the EU-IMF financial assistance programme, the Irish government adopted and implemented five fiscal consolidation packages with a net deficit-reducing impact of 9% of GDP in 2008-10. Still, and because of the particular depth and scope of the crisis the general government deficit ballooned to just over 32% of GDP in 2010 and the general government debt jumped to 87% of GDP in 2010, up from 24% of GDP three years earlier. The majority of this was due to the one-off banking support measures, but also due to the collapse in property-related revenues and the structural increases in spending over previous years. The share of property-related government revenue in total tax revenue had increased from 8 ½ % in 2002 to 18% in 2006, and fell to less than 3% in 2010.

EU economic surveillance of Ireland during the crisis

Let me now turn to how the EU responded to the Irish crisis. I will start with the policy initiatives for Ireland undertaken under regular EU economic surveillance and then move to the EU's response the euro-area crisis more generally.

Until end-2011 - when the so-called six pack entered into force - EU economic surveillance was largely centered on fiscal policy, notably the implementation of the Stability and Growth Pact. Financial sector developments were not considered to pose a threat to overall macroeconomic stability. I clearly highlighted this shortcoming in my first testimony before this committee. While the EU has learned the lessons from the crisis and the economic governance framework has been improved significantly, the Commission's surveillance activities for Ireland in 2008-2010 need to be assessed against the backdrop of the framework prevailing at the time.

Once the Irish housing bubble had burst and the economic troubles began, the European Commission deployed the instruments foreseen by existing EU legislation. In particular, it launched the excessive deficit procedure, or short EDP, for Ireland in spring 2009. Importantly, the EDP for Ireland was embedded in the European Economic Recovery Plan, a cross-country initiative aimed at boosting aggregate demand in Europe and which allowed a considerable amount of flexibility in defining national adjustment paths. I will talk more about the European Economic Recovery Plan later on.

Member States with a general government deficit in excess of 3% of GDP were given much more time to implement fiscal consolidation. This was also the case for Ireland. When the EDP was opened in spring 2009, Ireland was given four years to correct the excessive deficit (until 2013); under normal conditions it would have been a one-year deadline. Moreover, in the following years, the ECOFIN Council, upon a recommendation from the European Commission, repeatedly extended the deadline for the correction of the excessive deficit, first to 2014 and then to 2015. I believe the Commission's initiative to stretch the period of fiscal adjustment in Ireland was crucial and its importance is probably underestimated in the public debate.

The Commission and the Council were also concerned about developments in the Irish banking sector. EU surveillance documents issued in 2008 and after include references to banks. For instance, both the Council recommendation under the EDP of spring 2009 and the Council opinion on the 2009 stability programme mention the fragility of the financial sector and its possible implications for the sustainability of public finances. There were even more extensive references to the financial crisis in Ireland and its implications for fiscal sustainability in the Council opinion on the 2010 stability programme.

However, beyond such references, the Commission and in particular Directorate General of Economic and Financial Affairs, did not have any instruments to help Ireland address the banking crisis. As indicated by my colleague Mario Nava before this committee, financial supervision and regulation was still a national prerogative in the governance framework at the time.

Nonetheless in early 2009, DG ECFIN stepped up its internal monitoring of the Irish economy. Senior management was updated more frequently on economic and financial developments. The exchange of information between DG ECFIN and DG Competition, which is in charge of support measures for banks, intensified.

In addition in April 2009, DG ECFIN provided input to a dedicated discussion on Ireland in the Eurogroup. As a result of that discussion, the ministers of finance asked the government to consider a comprehensive reform package to address the serious economic and financial challenges. Ireland reported back in May 2009, including on the supplementary budget it had just adopted in April. However, public communication regarding financial crises is a very sensitive issue. Thus, neither the Commission nor the Eurogroup did publicize this kind of 'enhanced surveillance'.

The EU's response to the systemic euro-area crisis

By mid-2008 it was obvious that the euro area and the EU as a whole would be heading towards an unparalleled drop in the aggregate economic activity and employment. It was also evident that (i) the limits imposed by the EU fiscal surveillance framework would become much too tight for many EU Member States and (ii) important elements had been missing in the EU economic governance framework. Thus starting in 2008, the European Commission and more generally the EU put in place an array of initiatives. I will not cover the full set of initiatives here. The policy response is well documented on the European Commission's internet webpages. Let me just highlight very briefly the most significant stages which were particularly relevant for Ireland.

At the end of November 2008, the European Commission launched the European Economic Recovery Plan. The main objective of the plan was to provide a coordinated boost to aggregate demand across the EU. Hence, the European Commission did not stubbornly implement the commonly agreed fiscal rules. On the contrary, it explicitly encouraged Member States to use the available fiscal space to lean against the strong head winds and many Member States implemented fiscal stimulus packages.

To ensure credibility, Member States were asked to embed their expansionary policies into multi-annual strategies that would ensure the long-term sustainability of public finances. Without the European Economic Recovery Plan the economic contraction in the euro area would most likely have been even sharper with the usual spillovers to small open economies such as Ireland.

The EU also reacted quickly to the emerging sovereign debt crisis. In 2009, Member States and the European Commission began putting in place so-called 'firewalls', or measures to help countries facing temporary difficulties in borrowing from financial markets. In May 2010, the European Financial Stability Mechanism (EFSM) of the European Union became operational with a capacity to lend up to a total EUR 60 billion. Shortly after, the private European Financial Stability Facility (EFSF) was established with a capacity to provide loans of up to EUR 440 billion to euro-area countries. In 2012, the EFSF was replaced by the permanent European Stability Mechanism (ESM) with a lending capacity of EUR 500 billion.

The EU, with important contributions from the Commission, also began work on measures to help prevent a reoccurrence of future financial crises:

- First, the EU economic surveillance framework was strengthened and extended with the so-called six-pack in 2011 and the two-pack in 2013. I already mentioned these innovations in my first appearance before this committee and am happy to provide further evidence in the Q&A part of this hearing.

- Second, extensive work started towards the banking union with the establishment of the Single Supervisory Mechanism (SSM) and the Single Resolution Board (SRB). In February, my colleague Mario Nava, provided a comprehensive overview of how the system of financial supervision and regulation in Europe has changed in response to the crisis. There is nothing that I can add on my part, not least because matters of financial regulation and supervision do not fall under the responsibility of DG ECFIN. Let me just say that the banking union represents a natural complement to the Economic and Monetary Union. It addresses severe problems and gaps that were revealed by the crisis, including cross-border financial linkages. The banking union is underpinned by a common set of rules, including for bank resolution, that are designed to minimise costs to tax payers.

On top of the key EU reforms, there were of course also the important initiatives taken by the European Central Bank (ECB) to safeguard the financial stability of the euro area. I will not review them in detail here. They still need to be mentioned because of the interplay between different macroeconomic instruments. In particular, the ECB’s Outright Monetary Transactions (OMT) programme was decisive in addressing the sovereign debt crisis in several euro-area countries including Ireland. In combination with other policy initiatives undertaken both at national and the EU level, it very much helped restore confidence and facilitated the return to market funding at sustainable rates.

The transition to the EU-IMF financial assistance programme

From around spring 2010, the spreads on Irish sovereign bonds over German bunds began to widen significantly and became more volatile due to increasing worries over the capacity of the Irish to shoulder the mounting level of government debt. There was also contagion from Greece as it applied for external financial assistance in April 2010. Moreover, we must not forget that these financial jitters went along with very dire economic conditions in Ireland. In 2008-2009, Irish GNP fell by more than 11%. This was, by far, the strongest economic contraction in the euro area in those years. The unemployment rate more than doubled from less than 5% in 2007 to 12% in 2009, before rising further to close to 15% in 2011. A small government surplus in 2007 turned into a very large budgetary shortfall of close to 14% of GDP in 2009, with the prospect of a much larger deficit to come.

In fact, over the summer of 2010 concerns grew over further losses in the Irish domestic banks coupled with the imminent end of the two-year government bank guarantee. Liquidity outflows from the banking sector picked up. At the end of September, the government promised to provide a final estimate of the cost of restructuring the banks and it announced its intention to strategically withdraw from the markets since it was fully funded until mid-2011. By then, spreads had increased to almost 450 basis points.

In an effort to address mounting economic and financial concerns, the government told the European Commission in September that it was preparing a four-year national recovery plan to be published in November 2010. The plan aimed to reduce the budget deficit to below 3% of GDP by 2014. In the context of the Europe 2020 process - the EU's strategy for smart, sustainable and inclusive growth launched in spring 2010 - the Commission undertook a mission to Dublin at the end of September to discuss the challenges facing Ireland and gave input on the reforms envisaged in the national recovery plan. Following this, contacts between the Commission and the Irish authorities continued. As is well known by now, these contacts also encompassed talks about the possibility of a joint EU-IMF financial assistance programme, as part of contingency planning. To be clear, at that stage these talks did not involve any negotiations.

During the course of October and November market pressures intensified with further bank deposit withdrawals and the spread of Irish bonds over German bunds widening further. By early November, bond spreads had gone above 680 basis points, a new high, and a level that was not considered to be consistent with sustainable public finances. In addition, the announcement by the government of fiscal consolidation packages was not enough to calm investor worries. It was against this dire background in mid-November 2010 that more concrete talks began between the Irish authorities, the ECB, the IMF and the Commission in Brussels and Dublin. This was to explore the scope and content of a possible financial assistance programme.

The EU/IMF financial assistance programme

The Irish government formally requested a financial assistance programme from the EU and IMF on 21 November 2010 and formal negotiations begun. In parallel, it published a four-year national recovery plan 2011-14 on 24 November which, to a very large extent, formed the basis for the policy conditionality of the new programme. I emphasise this point because it was crucial for the ownership of the programme and ultimately for its success. In fact, after the completion of the programme in December 2013 the current minister for finance indicated in public that the Troika had not imposed one single measure on Ireland. All policy conditions, and certainly the more important ones, had been agreed and put forward by the Irish government and subsequently included into the programme. This is not to say that the Troika had no say in negotiating the programme. Rather, it underscores the fact that the government programme had identified the right policy challenges, including due to its previous exchanges with the IMF, the ECB and the European Commission.

The main objectives of the programme were to restore financial market confidence in the Irish banking sector and in the sovereign, break the financial-sovereign loop and recover market access. In order to do this, the programme was based on three main economic elements: the first was financial sector reform entailing fundamental downsizing and reorganisation of the banking sector, the second factor was fiscal consolidation to restore sustainability based largely on expenditure restraint, and the third was structural reforms to boost growth by enhancing competitiveness and employment creation. In order to ensure fairness and minimise the social impact, all programme measures were inspired by the overarching principle of protecting the most vulnerable.

The European Commission and the other troika partners also showed considerable flexibility in defining the fiscal adjustment path. Most importantly, the programme documents included an extension of the deadline for the correction of the excessive deficit by one year, from 2014 to 2015. This extension allowed for a more gradual, and arguably a more growth-friendly fiscal adjustment.

Extending the fiscal adjustment turned out to be the right strategy. Fiscal consolidation remained on track throughout the programme period and cumulative GDP growth in 2011-2015 - the period covered by the EDP - has been practically in line with the forecast underpinning programme negotiations. This is quite remarkable, taking into account the size of the overall fiscal adjustment and the very uncertain economic outlook prevailing at the time.

The implementation of the financial assistance programme was, on the whole, smooth and effective. Most importantly, the EU-IMF financial assistance programme achieved its main objectives: Ireland implemented substantial financial sector repair and fiscal consolidation, regained market access, returned to sustainable economic growth and started to create jobs again.

The Irish sovereign recovered market access already in July 2012, well ahead of the end of the programme, when it issued EUR 500 million in treasury bills at a rate of 1.80%. Economic growth – as measured by real GNP growth - returned to positive territory also in the second year of the programme, and last year Ireland was the fastest growing economy in the EU as a whole. The rate of unemployment started to decline in 2012 and has been below the euro-area average since 2014.

Although less celebrated, the programme also succeeded in containing the impact of the adjustment process on the most vulnerable. Admittedly, the distribution of market income, as measured by the Gini coefficient, deteriorated significantly in Ireland in 2007-2013. By contrast, the distribution of disposable income, that is, taking into account taxes and social transfers, remained essentially unchanged. This result is quite remarkable. This is not to say that the adjustment programme had no impact on people’s economic conditions; we know it had. However, it shows that fiscal policy was definitively geared towards mitigating the gap between the rich and the less well off.

The single most important determinant of the programme’s overall success was national ownership as policy conditions were consistent with national preferences. The openness of the Irish economy, the flexibility of its economic institutions and the labour force also played an important role.

Last but not least, the EU partners took several important decisions aimed at improving the sustainability of public debt. The lending rate margins on the EFSM and EFSF loans were eliminated and the average maturity extended from 7.5 years to 12.5 years in 2011 and again to 19.5 years in 2013. In 2013, with the wind-up of Irish Banking Resolution Company (IBRC), the promissory note transaction also improved public debt sustainability. This transaction involved exchanging EUR 25 billion of short-term government promissory notes with marketable long-term bonds.

Post-programme performance

Ireland is now subject to post-programme surveillance (PPS), as foreseen by the two-pack Regulation. PPS started after the expiry of the EU/IMF financial assistance programme and lasts until a minimum 75% of the financial assistance has been repaid.

The Irish economic and financial situation has continued to improve. Ireland is currently among the fastest-growing economies in the euro area, public finances have recovered significantly and the situation in the three Irish domestic banks is encouraging. Of particular note is also the fact that Irish bonds have suffered little contagion from recent troubles elsewhere in the euro area. This underscores the improvement in fundamentals.

While we all welcome the current state of the Irish economy, we are equally conscious of the fact that the adjustment process Ireland went through since 2008 was an extremely difficult one. Nonetheless, many authoritative observers agree that if programme funding had not been available from international partners, the economic adjustment and the impact on the Irish people would have been significantly stronger. I concur with this assessment, not just because I represent one of the three former programme partners. Rather, I see the financial assistance to Ireland and all the other policy initiatives undertaken at the EU level during the crisis as part of the wider European project which may not always progress smoothly, but which succeeds if we work together.