MacGill Summer School, Glenties, Donegal

MANAGING THE ECONOMY AND PUBLIC FINANCES AFTER THE TROIKA

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Ladies and Gentlemen,

It is an honor to be invited to the MacGill Summer School and to be speaking alongside such a distinguished set of speakers. It is great to be in Glenties and I am proud to say that this isn't my first trip to Donegal—I managed to spend some time around the Inishowen and Fanad peninsulas earlier this year and can now claim to have been from Malin Head to Mizen Head!

The topic for the panel is rather wide-ranging. I thought I'd limit myself to a few points on key achievements under Ireland's EU/IMF-supported program, remaining challenges in the fiscal and financial areas, and strategies to deal with them.

Unfortunately I won't be able to do justice to all the achievements! But, on the other hand, there may also be a few challenges, including on the structural side, that I will not be able to cover.

The bottom line of my talk here tonight will be: "Keep the momentum!" Why? To ensure that the benefits of all the efforts and sacrifices made are secured and put Ireland firmly on the path of sustained recovery.

In the remainder of the talk I will illustrate this point with respect to, first, the overall macroeconomic situation, then the financial sector, and finally public finances.

I. MACROECONOMIC SITUATION

Program performance. In the first two years of the program, 2011-12, cumulative growth in GDP has been fairly close to what had been expected. In late-2010, we had anticipated that real GDP in 2012 would be 2.8 percent higher than in 2010. Taking into account recent data revisions, it turned out to be 2.4 percent higher. A similar analysis for GNP is more favorable. Although there has been understandable disappointment domestically—especially in relation to unemployment—this result is remarkable given that trading partner growth in 2011-12 was less than half of what had been anticipated in late 2010.

Current Prospects. Recent national accounts data show weaker economic activity in the first quarter of 2013 than previously estimated. But there is a tension with a range of high frequency indicators that have been more positive, including the housing market and the labor market. Overall, we are expecting modest positive growth this year as the external environment improves and the domestic economy stabilizes. We will be monitoring developments closely given the divergent signals in the data so far this year.

Challenge. The key-medium-term challenge is to promote sustained recovery amid ongoing fiscal consolidation and private sector deleveraging. Both constrain spending and limit near-term growth but are unavoidable in restoring the health ofof the economy.
Recent growth, especially in 2011, has been export-led, benefitting from early competitiveness gains and favorable developments in the sectors that dominate Irish exports. The slowing in growth in 2012 was a wake-up call, with weakening goods exports making it clear that Ireland cannot rely only on export-led growth. Sustained

recovery will increasingly require a job-creating revival of domestic demand.

Strategy. The question is how to achieve that revival. Already the decline in final domestic demand has slowed from 3 percent in 2011 to 1 percent in 2012 and we are expecting demand to be broadly flat this year.

For next year, we expect modest domestic demand growth, though it depends on a few factors coming together sufficiently to outweigh the drag from fiscal consolidation:

- First, in Ireland's case a broader external recovery is a vital ingredient for domestic recovery.

- Second, continued stabilization in employment and house prices would support incomes and net worth. A sense that the crisis is being overcome could allow some easing in precautionary savings.

- Third, perhaps the most important factor is completing the repair of the financial sector. Banks' lending capacity needs to be improved so they can meet the working capital and investment needs of SMEs, and also the mortgage financing needs of the less indebted younger cohort of households. The critical factors are for banks to work out their very high nonperforming loans and improve their profitability.

II. FINANCIAL SECTOR ACHIEVEMENTS AND CHALLENGES

Background. It’s stating the obvious, but Ireland’s crisis was first and foremost a banking crisis, so dealing with the financial sector has really been the heart of Ireland’s EU-IMF supported program.

Achievements. Much progress has been achieved in this area under the program. I would like to highlight two key aspects: recapitalization of the banks and their subsequent shrinking and reorganization.

1) **Recapitalization:** At end-March 2011 the CBI completed a robust and comprehensive assessment of the capital and liquidity conditions and needs of domestic banks under a baseline and a stringent three-year stress scenario. It helped to greatly reduce market uncertainties and by July 2011 the recapitalization of domestic banks was substantively completed.

2) **Downsizing and Reorganization:** To address the excessive scale of banks’ assets, and focus the banks on serving the needs of the Irish economy, a major deleveraging of non-core assets has been implemented while avoiding fire sales. This process is largely completed. Bank assets are more in line with their deposit base, and their reliance on ECB support is greatly reduced. The authorities have also reorganized the system, merging several institutions. Banks have also reduced costs by reducing branches and staff. The ongoing liquidation of IBRC is further progress.

Challenges. Notwithstanding these achievements significant challenges remain. The key question is how to get the financial sector to a point where it can step up and lend to credit constrained but creditworthy borrowers. One quarter of banks’ loans is not performing and they incurred significant losses last year even before provisions, though prospects for 2013 are better. So two key challenges are:

(i) making banks profitable so that they can build the capital needed to lend;

(ii) resolving non-performing loans to reduce market uncertainty about bank health, which is needed to ensure access to funding at reasonable costs. In the process, households and SMEs will be put on a more sustainable footing, which aids economic recovery.

Program Strategy. Under the program these issues are being addressed. The establishment of a framework of residential mortgage resolution targets, reviewing consumer protection rules for mortgages in arrears, activating the new personal insolvency framework, and updating bank provisioning guidelines are all designed to promote finding sustainable solutions, with the strategic goal of achieving a durable reduction in arrears.

Deliberate speed of resolution. It should be recognized that the case-by-case resolution of a large number of impaired loans is going to take time. It takes time to establish whether a borrower's changed economic circumstances are temporary or permanent. Creditors need to properly determine their client's payment capacity before a permanent solution can be found as they need to preserve their scarce capital. At the same time, a prolonged process is a drag on prospects for economic recovery. We would therefore support largely completing this resolution process by the end of 2014. This won't be easy as it implies facing difficult issues for the parties involved. But the temptation not to face these difficult issues should be resisted so Ireland can break free of the legacies of the crisis.

Let me now turn to public finances.

III. FISCAL ACHIEVEMENTS AND CHALLENGES

Background. Although Ireland had a balanced headline budget going into the crisis, booming revenues masked a significant weakening in the underlying fiscal position. During the boom public finances were directed towards improving social outcomes and expanding public services and were accompanied by structural tax cuts. Once the temporary flood of property-related revenues and other cyclical factors are stripped out, we estimate the so-called structural primary deficit was around 10 percent of GDP in 2008. Together with the uncertainties around bank capital needs, this made for a very difficult starting point, which proved unsustainable as Ireland lost access to markets.

Achievements. The crisis prompted a sharp fiscal course correction, with substantial consolidation implemented in recent years. Over the last five years (2009-2013) we calculate there were cumulative budget measures of almost 15 percent of GDP. This huge effort has helped to nearly close the structural primary deficit. It is impressive that this major consolidation was achieved during a deep economic slump while preserving social cohesion. Without this achievement, Ireland would not have reached its current position of having market access on reasonable terms with broad investor interest.

Challenges. Currently the state still spends €1 billion every month more than it takes in while its debt burden is high at just over 120 percent of GDP. Confidence that Ireland will reduce that debt burden over time is needed for durable market access. Preserving that confidence will continue to be a high wire act for the next few years, where further reductions in the fiscal deficit need to be achieved, while at the same time returning to more solid and sustained growth.

Strategy. Since the outset of the program the IMF team has urged a focus on steady predictable budgetary adjustment as being least harmful for growth. To help protect the fragile economic recovery we have repeatedly urged that if growth is weaker than expected, that additional measures are not taken just to meet a particular target for the headline deficit as a share of GDP.

After consolidation efforts of €7.8 billion in 2012-13, we continue to support a total effort of €5.1 billion during 2014-15 to maintain the credibility that has been built-up painstakingly over the last few years and help ensure durable market access. Under our current macroeconomic outlook, this scale of effort will also help reach the government's 3 percent of GDP target by 2015.

CONCLUSION

To sum up:

- Ireland has faced formidable challenges in the wake of a massive banking-property crisis against the backdrop of broader distress in the euro area. It has tackled them admirably, and has also built a sound framework to address some key remaining challenges.

- To overcome these challenges fully the determination Ireland has displayed so far would need to be maintained, while recognizing that further progress within the euro area on building a genuine monetary union is also important.

I hope the lessons from the crisis, and perhaps also the experience with the troika—both good and bad!—will help sustain the momentum of adjustment and reform going forward, to ensure that Ireland truly recovers.