The Irish crisis and the EU from a distance

Discussion of Barry Eichengreen's paper

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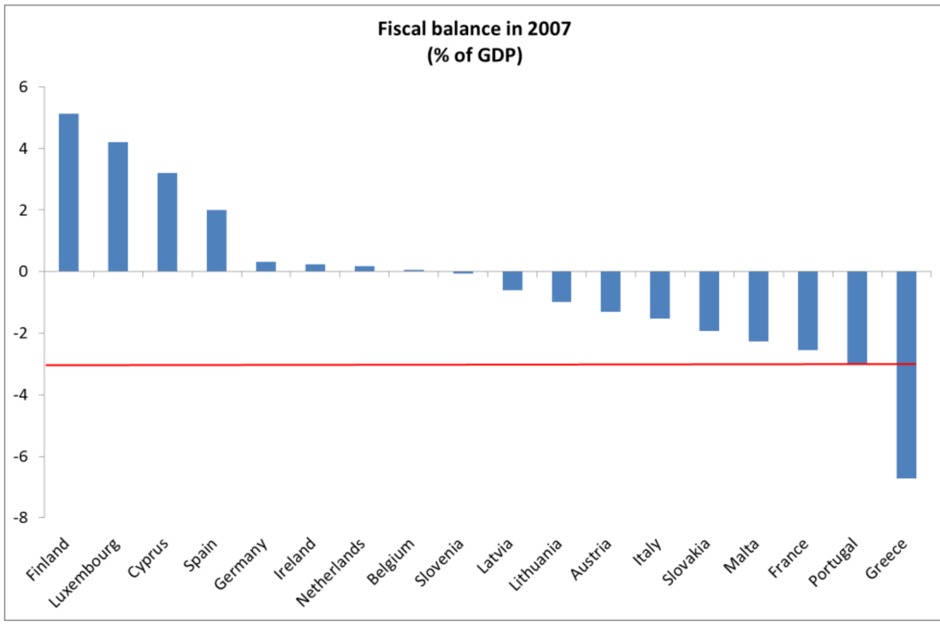
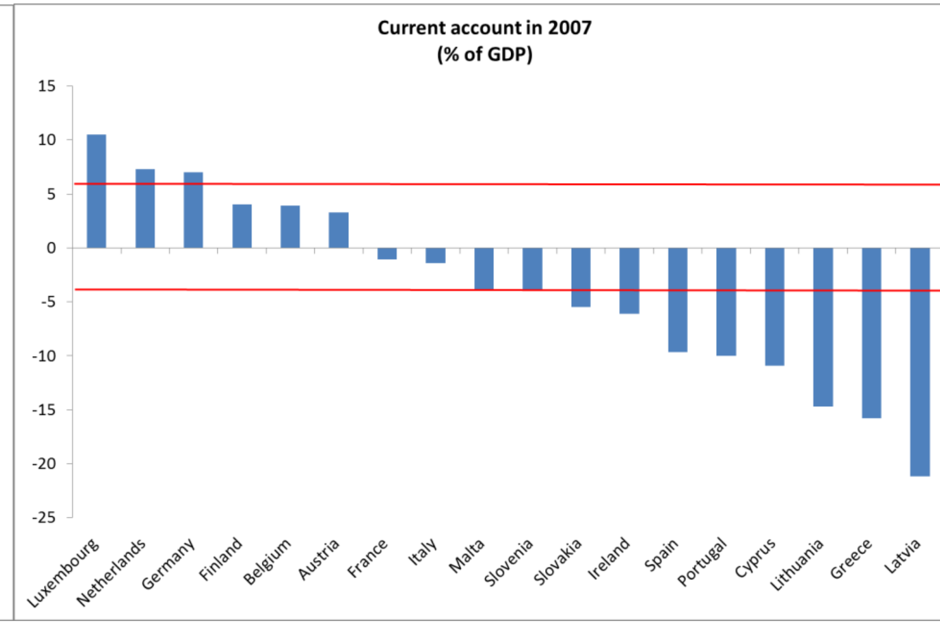
CBI-CEPR-IMF conference on *Ireland-Lessons from Its Recovery from the Bank-Sovereign Loop*, 19 January 2014

Before the crisis





Source: Ameco.

A neglect of Broad Economic Policy Guidelines

Commission, 24 January 2001. The European Commission adopted today a recommendation to the Council of Ministers on the 2000 update of Ireland's Stability Programme (2001-2003). The Commission concludes that the 2000 update is **in line with the requirements of the Stability and Growth Pact** but that Irish budgetary plans for 2001 are **inconsistent with the 2000 Broad Economic Policy Guidelines (BEPG)** adopted last June by the European Council in Feira. […] The Commission welcomes such surpluses, that would clearly be sufficient to provide a safety margin against breaching the deficit threshold of 3% of GDP in the event of normal cyclical fluctuations. However, given the evidence and further risks of overheating of the Irish economy, the Commission and the Council have in the 2000 BEPG urged the Irish authorities to **use budgetary policy to ensure economic stability**. In the course of 2000, the extent of overheating has increased even if the headline inflation in December 2000 ended slightly below the November peak. **CPI inflation averaged 5.6% in 2000** against a prediction of 3.1% in the last stability programme update. In spite of this, **budgetary plans for 2001 are expansionary and pro-cyclical** […]. The Commission has therefore recommended to the ECOFIN Council to adopt, on [12 February 2001], a recommendation under Article 99.4 addressed to the Irish government with a view to ending the inconsistency of the expansionary aspects of budgetary plans with the BEPG.

A neglect of BEPGs (ctd)

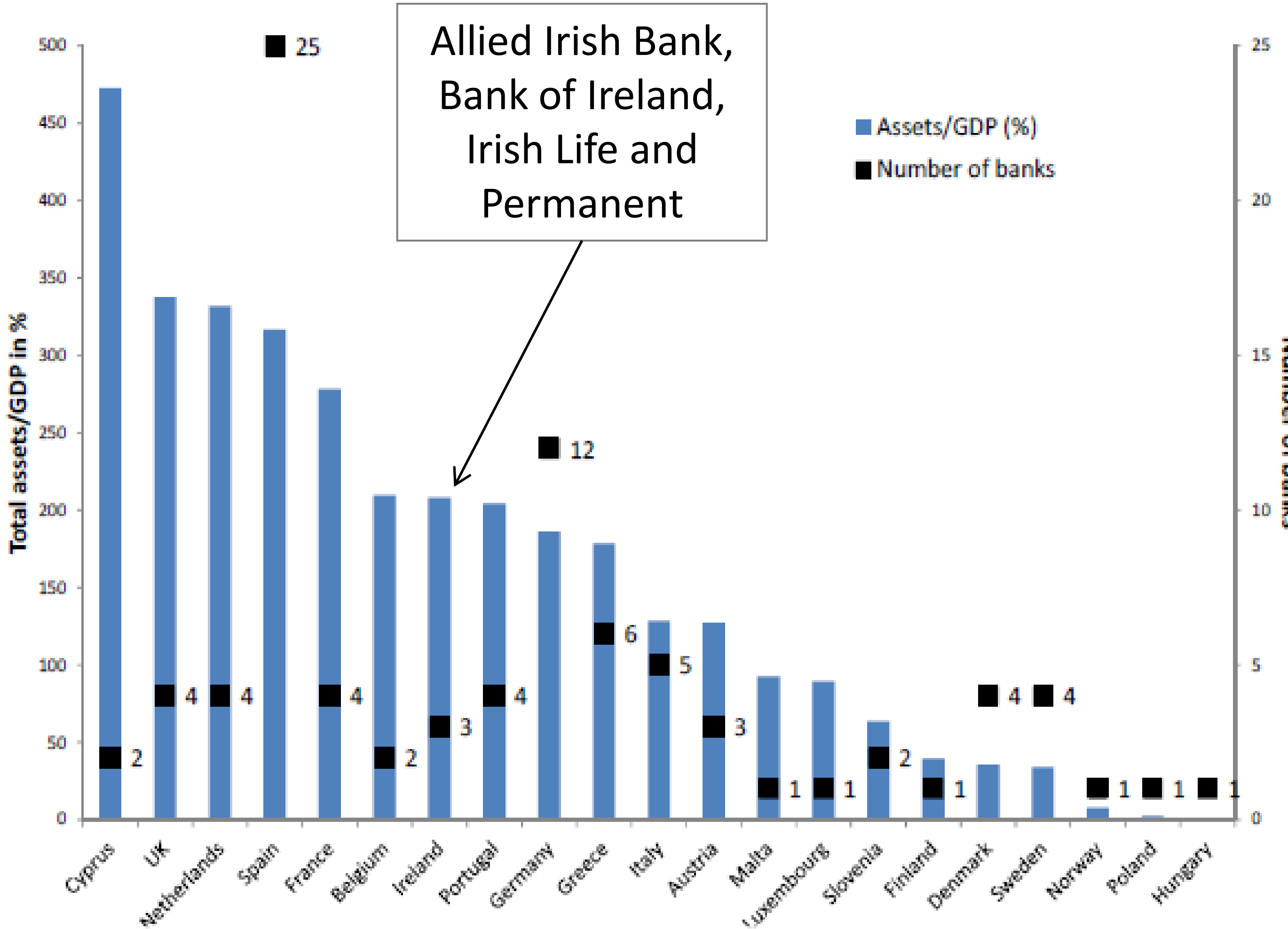
Council, 12 Feb. 2001. Against this background, the Council finds that **the planned contribution of fiscal policy to the macroeconomic policy mix in Ireland is inappropriate**. The Council recalls that it has repeatedly urged the Irish authorities, most recently in its 2000 broad guidelines of the economic policies, to ensure economic stability by means of fiscal policy. The Council regrets that this advice was not reflected in the budget for 2001, despite developments in the course of 2000 indicating an increasing extent of overheating. The Council considers that **Irish fiscal policy in 2001 is not consistent with the broad guidelines of the economic policies** as regards budgetary policy. The Council has therefore decided, together with this Opinion, to make **a recommendation under Article 99(4)** [now 121(4)] of the Treaty establishing the European Community with a view to ending this inconsistency.

Correct diagnosis but:

- Only fiscal instrument (not macro-prudential)
- No sanctions.

Off-balance-sheet liabilities: TBTF

Figure 1: SIFIs total assets in percent of GDP, end-2011



Source: EBA.

Tax gaps for EU27 countries, year 2011

Table 4 4-year tax gaps with exposure to banking crises, micro-based, EBA approach, 2011

	Tax gap with micro-based crisis costs, in percent			Micro-based cost x_i (% of GDP)	Impact of a 1 pp increase in $r - \gamma$ on tax gaps (in pp)
	$p = 0\ \%$	$p = 5\ \%$	$p = 10\ \%$		
Austria	0.2	3.8	6.9	77.9	+0.7
Belgium	–0.5	2.4	4.9	63.2	+1.0
Cyprus	1.1	14.4	25.7	287.0	+0.6
Germany	–2.4	–0.3	1.5	44.7	+0.8
Denmark	0.8	5.1	8.9	94.5	+0.4
Greece	3.9	7.9	11.4	87.8	+1.3
Spain	2.3	10.0	16.7	167.5	+0.6
Finland	–2.2	–1.2	–0.4	20.8	+0.5
France	0.2	4.5	8.0	90.7	+0.8
Hungary	–11.7	–10.5	–9.6	24.2	+0.8
Ireland	3.8	9.4	14.1	119.3	+0.9
Italy	–0.5	2.5	5.1	64.6	+1.2

Source: Bénassy-Quéré and Roussellet (ITPF 2013).

New economic governance
(SGP+, 6 pack, 2 pack)

- **SGP** strengthened: early warning, reverse majority, additional rules (structural adjustment, debt reduction, spending growth)
- Macroeconomic Imbalance procedure (**MIP**): multi-factor (scoreboard), de facto secondary compared to SGP
- National ownership through independent **fiscal committees**, but Commission still dominant.
- Banking union

Three objectives of surveillance:

- **Debt sustainability:** public and private debt, SGP one instrument
- **Competitiveness**: unit labor costs
- **Saving-Investment balance**: current account, exceptional circumstances.

⇨ A streamlined, comprehensive scheme is needed

The Irish bank bail-out

Government

- Issues promissory notes
- Uses the cash to recapitalize IBRC
- Uses CBI profits to pay interests to CBI

Irish Bank Resolution Corp.

- Takes the promissory notes on its balance sheet
- Refinances them with the CBI
- Uses the cash to buy the promissory notes

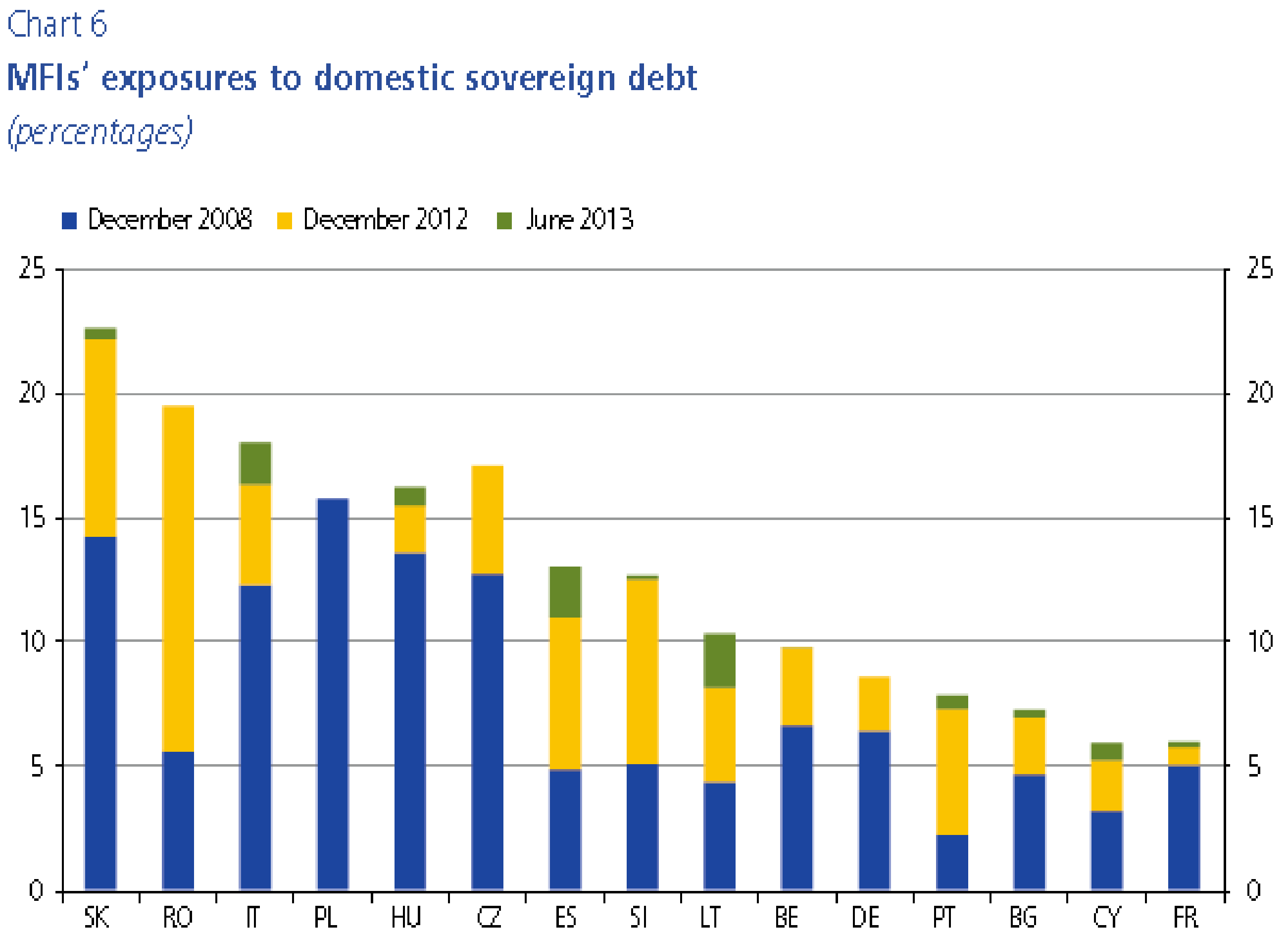
CBI

- Refinances the promissory notes
- After IBRC liquidation: takes the (restructured) promissory notes on its balance sheet

Equivalent to the CBI directly lending the cash to refund bank creditors

- Fiscal dominance? Bank dominance?
- Why just Ireland? ESM?
- Who bears the risk? CBI or the ECB? ESM? No risk?
- Emergency Liquidity Assistance not very transparent

The sovereign-bank loop



Source: ESRB annual report, July 2014.

How to diversify sovereign risk

- Extend large exposure rules to sovereign risk
  - RWA on a single exposure < 25% of equity
- Introduce a federal, « safe » asset
  - A bundle of national sovereign bonds
  - A eurobond based on a debt-exchange