

# Ireland and the EU from a Distance

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Dublin, January 19, 2015

# I adopt this title in self-defense

- In commissioning this paper, management asked me to review the role of the EU & its institutions in the crisis
  - Not a study of details
  - Not a study of the inner workings of the EU
  - Not a detailed account of the crisis and EU response
  - Rather, some reflections on how Ireland's status as a member of the EU and EZ shaped its crisis.
  - And, necessarily, some discussion of the role of not just the EU and ECB but also the Fund.

# Before the Crisis

- Essential point is that conditions in Ireland could not have developed as they did absent the roles of the EU and EZ.
  - A very large banking system grew out of the high mobility of capital within the Single Market
  - This reflected the freedom with which Irish banks were permitted to establish and acquire subsidiaries in other EU countries.
  - It reflected the ease of accessing wholesale funding in what was perceived as the absence of exchange risk.
  - It reflected the (mis)perception that monetary union had somehow rendered sovereign risk a thing of the past.
  - And it reflected the absence of a single supervisor and single resolution mechanism. It reflected monetary union without banking union, in other words.

# One can challenge that the EU & EZ were integral to these processes

- On the grounds that other non EU/EZ economies were equally capable of engaging in Irish-style excesses.
  - (“Difference between Iceland and Ireland is one letter and three months.”)
- But even developments in Iceland were not entirely independent of the EU (recall the role of the European Economic Area in its financial expansion).
- That said, the Icelands of the world remind us that, at a minimum, the connections between Iceland’s crisis and its membership in the EU & EZ are complex.

# Bringing us to the banking crisis



# While the role of governance problems in Irish financial system is well known

- It is important to recall that agency problems in the financial system are not peculiar to Ireland.
- The question relevant to my discussion is why external oversight failed to flag them.
  - Committee of European Banking Supervisors did not flag such problems.
    - It was preoccupied with defining standards and best practice; actual practices received little scrutiny.
  - European Commission evidently had little to say about Irish banking.
    - Preoccupied by fiscal policy and compliance with the Stability Growth Pact.
    - (Which of course provides no protection against financial-crisis risk.)
  - IMF surveillance “confirmed the soundness of the Irish banking system” as late as 2007.
    - One suspects that Ireland was seen as a role model by virtue of its strong growth (confusing real and financial aspects).

# The Crisis & the Guarantee

- Justifiably controversial. Full story still is not known (at least to me).
- It does not appear that the ECB or the Commission were directly involved in the initial decision to extend the guarantee.
- Unclear that they were even consulted before the fact.
- Decision to extend the guarantee appears to reflect the misapprehension that the banks had a liquidity problem, not a solvency problem.
- Which in turn reflects lack of information on the part of the regulators, other officials and even bank management itself.
  - Or so the Anglo Tapes suggest.
- Problems that should have been flagged in EU and IMF surveillance, but were not.

# And, I would argue, the EU's role circa 2008 extends beyond that

- But Ireland's policy that no bank would be allowed to fail was also the EU's de facto policy.
- The broader problem was that each national authority was left on its own to deal with its own situation.
- The EU failed to anticipate the problem, offer an alternative to blanket guarantees on the one hand or disorderly bankruptcy on the other.
- The EU had no framework for orderly resolution in place.
- More generally, the EU failed offer a coordinated response.



# A factor in the decision to issue the guarantee may have been uncertainty over ELA

- The government could have instructed the banks to apply for ELA from the Central Bank of Ireland, despite the fact that they lacked ECB-eligible collateral.
- The ECB Governing Council would then have had to agree (or at least not object).
- But Irish officials may have been uncertain whether the Council's agreement (lack of objection) would have been forthcoming, given uncertainty about the ability of the Irish sovereign to stand behind additional liabilities.
- There was the feeling that stigma was attached to ELA, so that drawing it might damage confidence.
  - A more proactive ECB might have alleviated these concerns.

# To be sure, Irish decision-makers could have done better

- Irish officials could have guaranteed deposits and new wholesale funding while requiring haircuts of existing bank bondholders.
- They could have exempted from the guarantee holders of undated subordinated debt.
- They could have guaranteed the liabilities of banks other than Anglo-Irish and Irish Nationwide, or simply allowed them to resort to ELA, while seizing, resolving and recapitalizing the two troubled institutions.
  - This, if I understand it, was the thrust of Governor Honohan's testimony before the Bank Inquiry last week.

- But this would have required a judgment that Anglo and Irish Nationwide were insolvent whereas other banks were only illiquid.
  - But, again it seems clear that Irish policy makers themselves were operating under a severe asymmetry of information. They took at face value the assurances of Anglo's management that the problem was simply one of liquidity.
    - Although some of them, like Brian Lenihan, may have thought otherwise.
  - Also, this approach again assumes confidence in the availability of ELA.
- And not having devised a resolution strategy ex ante, their lack of information extended to how best to respond to market pressures.

# Then there was the regrettable absence of haircuts in 2010

- Banks had become dependent on ELA in the interim.
- The ECB was uncomfortable about extended use of this supposedly temporary facility, about the scale on which it was being used, and about growth in its use from February 2010.
- The ECB, through its then president, “indicated” that the continued extension of ELA was contingent on the country negotiating a Troika program.
- The ECB appears to have opposed imposition of losses on the banks’ senior unsecured, unguaranteed debt (on fear-of-contagion grounds).
  - A better way of dealing with potential contagion would have been for the ECB to reiterate its commitment to provide funding to banks elsewhere in the EZ, including solvent Irish banks (to “do whatever it takes”).
- With hindsight the IMF looks wise for having supported the application of haircuts in 2010, but less wise for having ultimately acceded to the ECB’s (and U.S. Treasury’s?) position.

# Other issues

- Promissory note deal of 2010.
  - Again, designed to reassure the ECB that ELA could be wound down.
  - Not a big deal so long as bond sales do not occur at excessive speed (and at depressed prices), although some would argue they have.
- Over-optimistic forecasts of Irish recovery.
  - Not limited to Ireland, of course.
  - Reflected lack of understanding of the EZ-wide nature of the crisis.
- Turbulence surrounding Deauville declaration.
  - Leading to a sharp increase in spreads on Irish government bonds.
- Unhelpful ECB policies.
  - Interest-rate increases in 2008 and 2011 couldn't have helped a struggling Ireland.

# Uncontroversial conclusion: The Irish crisis could have been handled better

- Of course, with hindsight all crises can be handled better.
  - Economic costs are high, unavoidably, and distributed unevenly.
  - Emergency lenders don't lend without attaching (politically difficult) conditions.
  - Adjustment and recovery goals are, by the very nature of the circumstances, difficult to meet.
  - Crisis countries do not look back fondly on such experiences.

While the guarantee decision was Ireland's, the country did not receive the best help

- It did not receive wise counsel: Ireland's policy that no bank would be allowed to fail was the EU's de facto policy, circa 2008.
- Uncertainty surrounded the provision of ELA; the authorities were not reassured that all Irish banks would receive ELA, or that if they immediately put Anglo and Irish Nationwide into receivership other banks would receive ELA.
- The ECB appears to have applied pressure for Ireland to enter a program in 2010 and to refrain from administering additional haircuts.

# Wider (mis)management of the EZ crisis was also part of the problem

- Uncertainty surrounding Greece and its debt restructuring spilled over.
- Deauville didn't help.
- Official talk about the possibility of exit or a “temporary holiday” from the euro, even if prompted by the problems of other countries, affected market sentiment toward Ireland.
- Inaccurate assumptions about fiscal multipliers, botched stress tests, and on-again-off-again progress toward banking union made things unnecessarily difficult.



# That said, the EU learned from the experience

- The creation of a banking union with a single supervisor, harmonized deposit insurance, a resolution mechanism capable of directly recapitalizing troubled banks, and a dedicated resolution fund perhaps best symbolizes this fact.
- Making this progress not just symbolic but real will now require giving that single supervisor real teeth, fully funding that resolution fund, and allowing the ESM to assume meaningful amounts of credit risk.
- Will it happen? Stay tuned.