



Financial Stability & Euro Adoption: Lessons from Ireland?

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Outline

1. **Why Ireland?**
2. **Global and euro setting**
3. **Financial trends in Ireland**
4. **Bank governance issues**
5. **Domestic policies**
6. **Lessons for others?**



Why Ireland?

Ireland was the 'poster child' of EU convergence, rising from poorest (1973) to 2nd richest EU member

After euro adoption it underwent a severe financial boom & bust, triggered proximately by global crisis, with blanket bank guarantee & major intervention

Why did Ireland suffer so badly: what are lessons?

Regling-Watson report commissioned by Minister Lenihan in Feb. 2010 to analyse global and domestic sources of crisis and explain to Irish parliament



Global Conditions



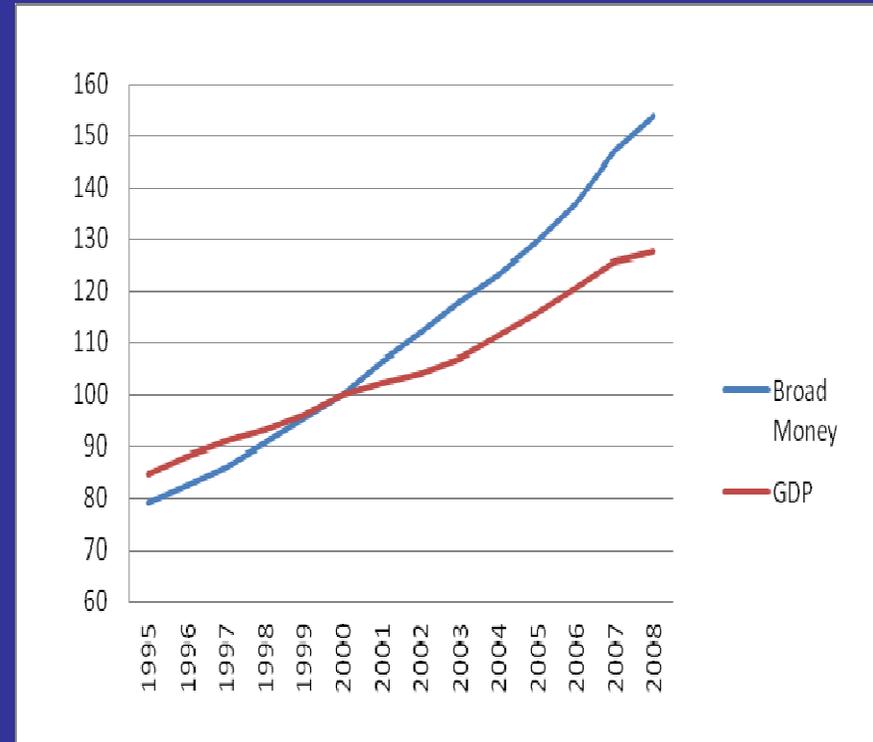
Long-term interest rates in percent*



Source: OECD

*Long-term government bond yields (10 years).

Broad money and GDP*

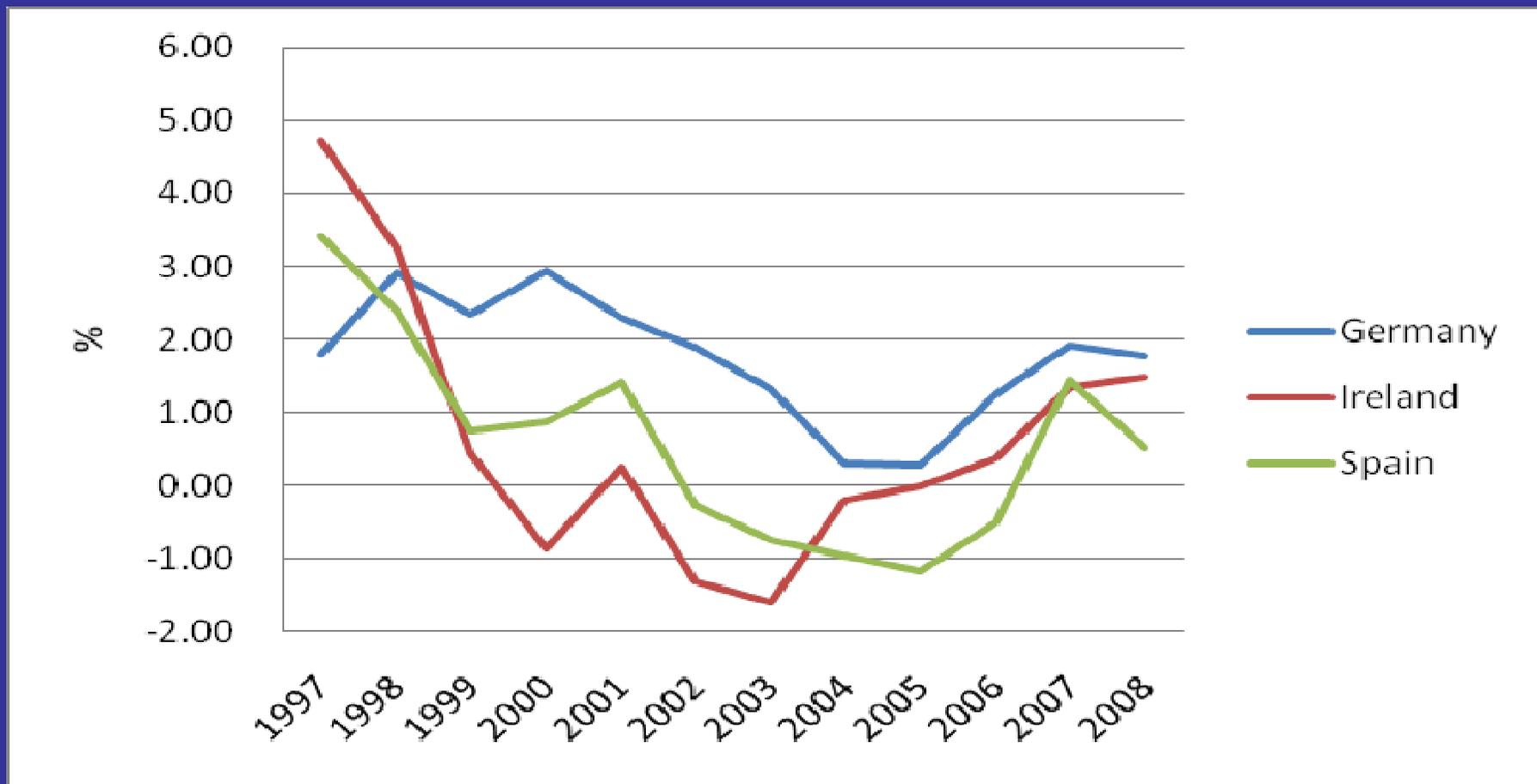


*Nominal GDP converted at constant PPP and broad



Euro Area Conditions

Real short-term interest rates*

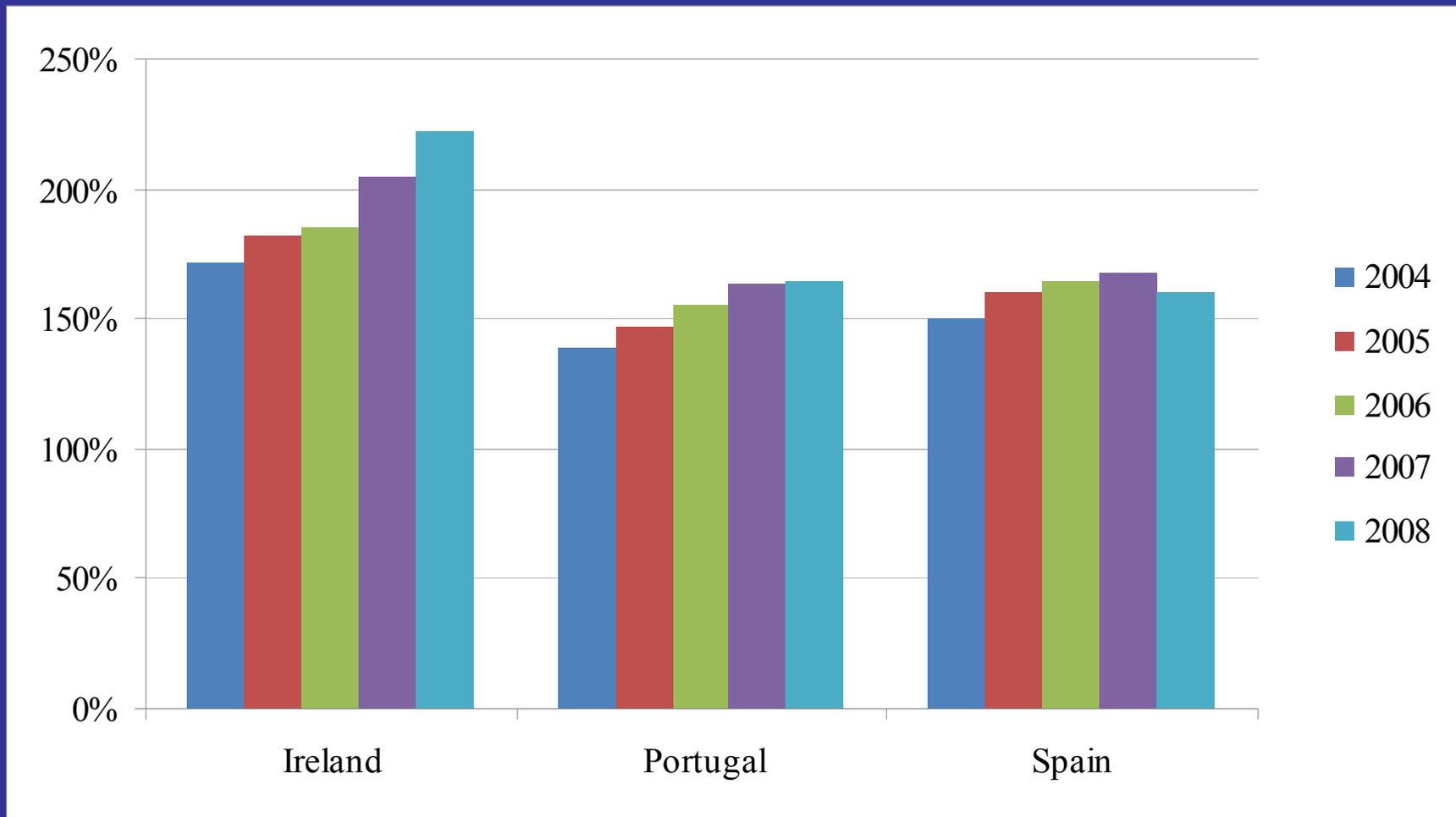


Source: OECD

*3-month interbank interest rates deflated by the harmonized index of consumer prices



Loan-to-Deposit Ratios





Global and Euro Setting

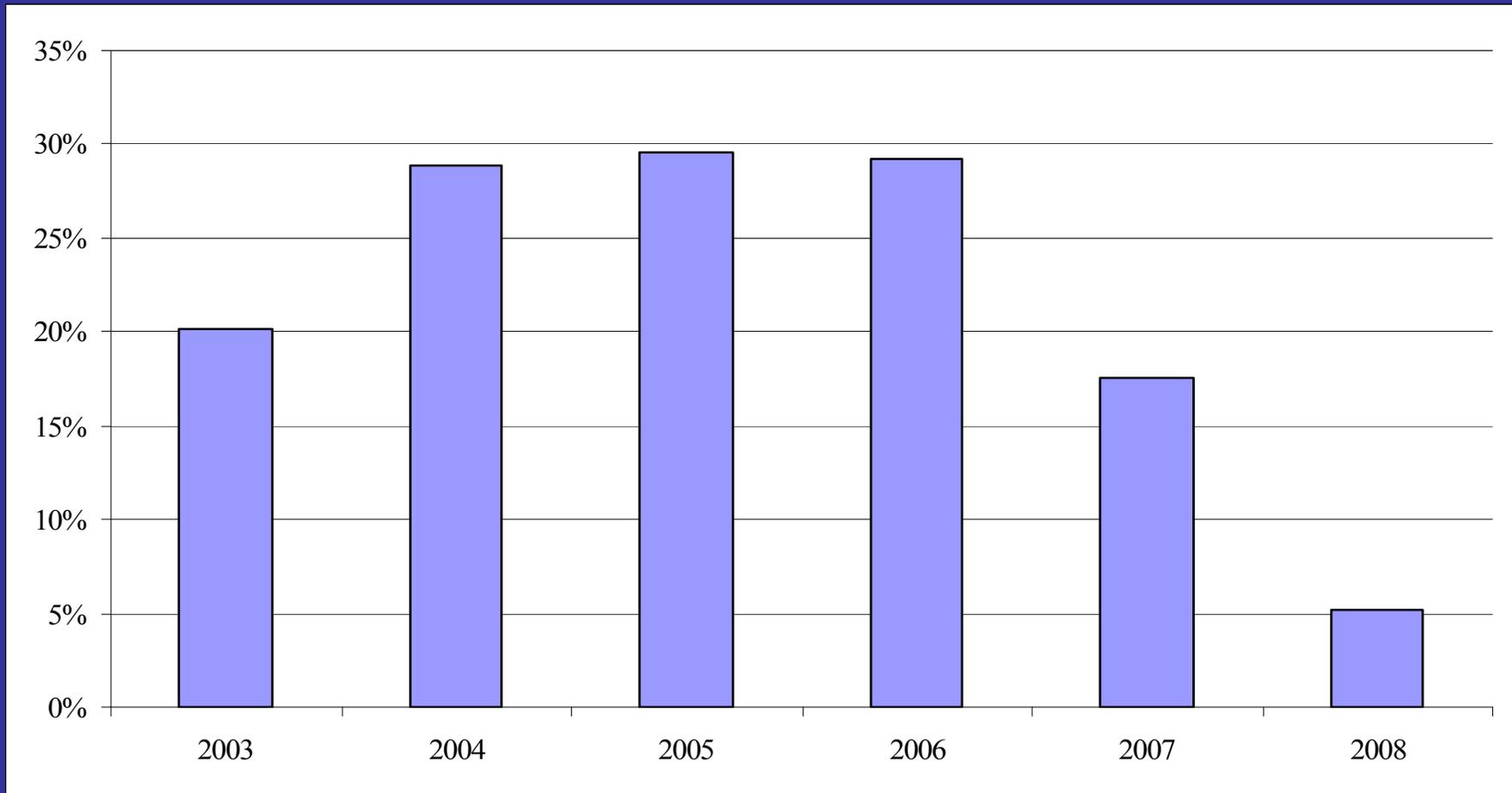


This setting featured a confluence of

- **easy global monetary, fiscal & financial setting**
- **euro monetary conditions were easy relative to Ireland's cyclical position**
- **EU/euro boost to financial integration in terms of wholesale market funding and competition**
- **lower risk premia accompanying euro adoption**
- **Basel trend to rely on market, ignore liquidity**



Private Sector Credit

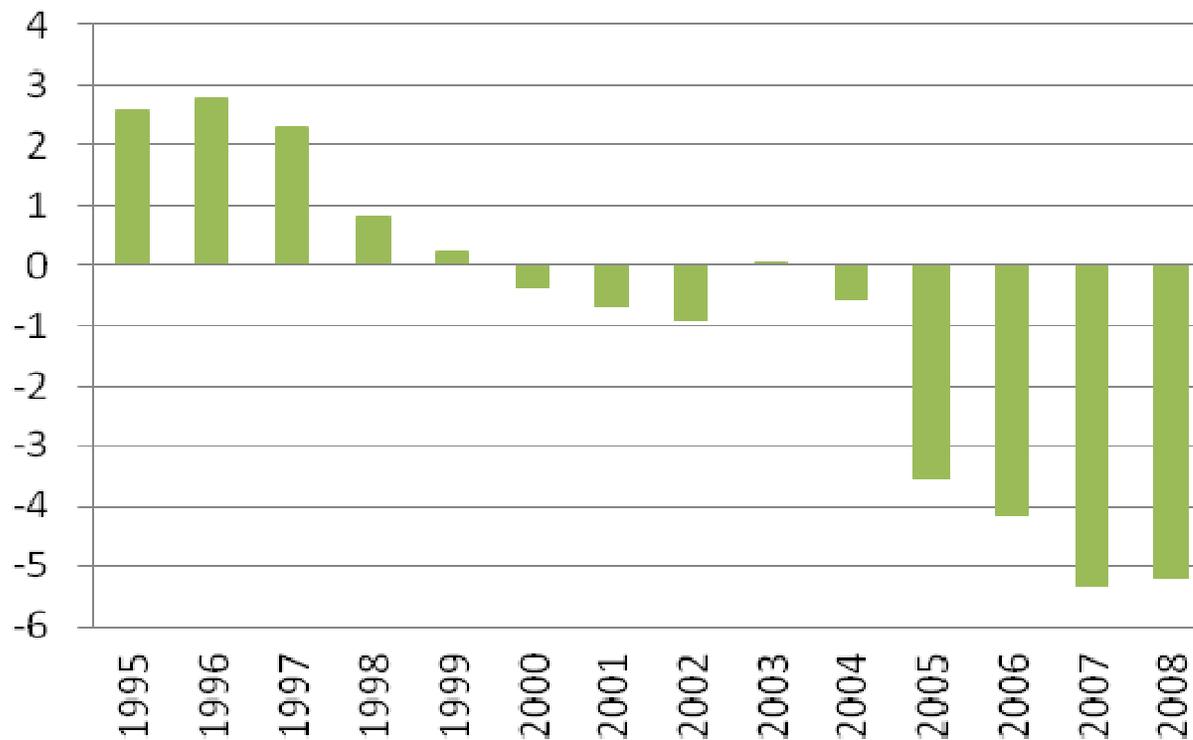


Source: Central Bank of Ireland
Includes subsidiaries of foreign banks in Ireland
Includes securitised residential mortgages



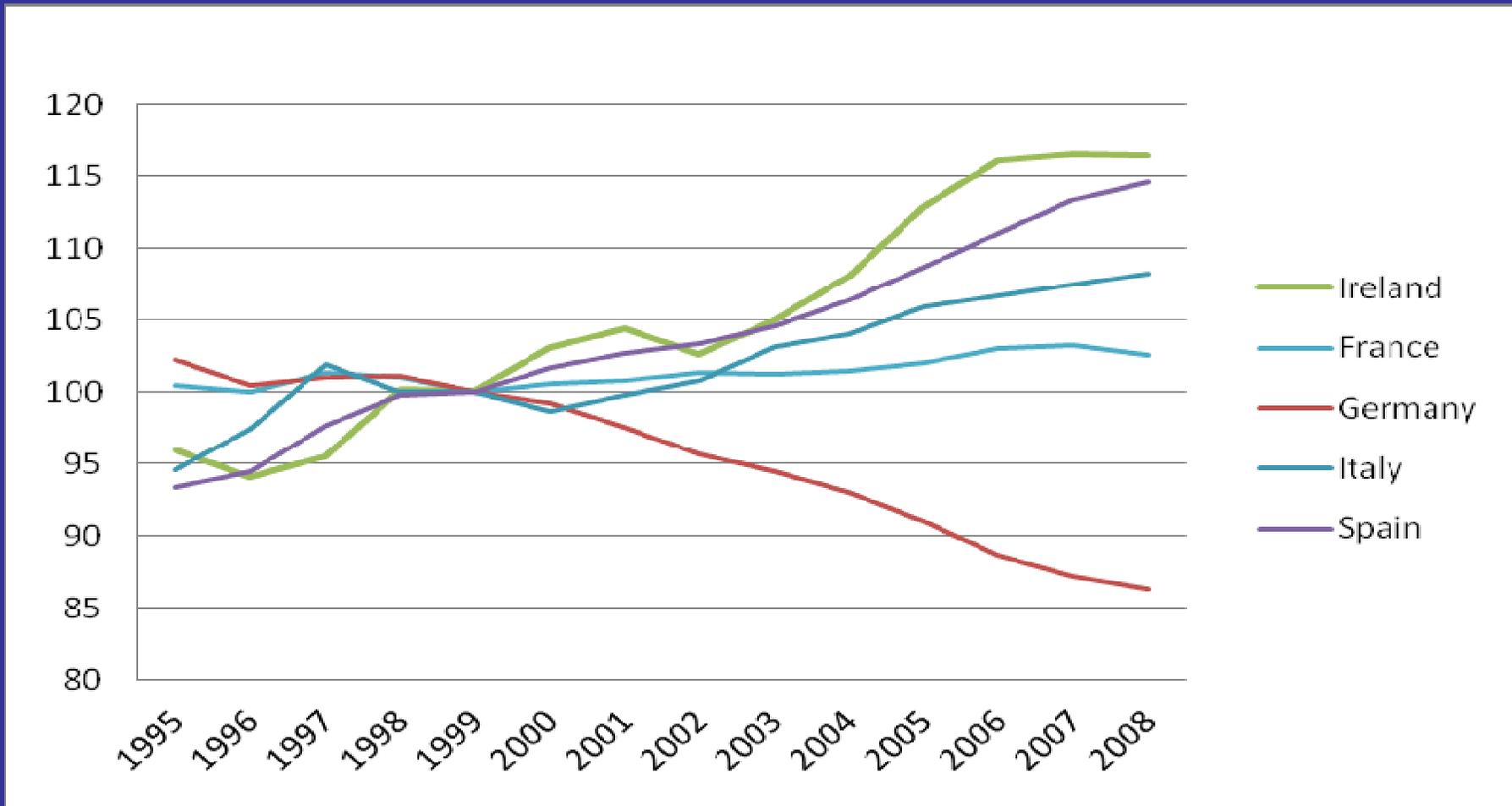
External Balance

Chart 3: External current account
percentage of GDP





Relative Unit Labour Costs*



Source: OECD

* Unit labour costs compared to Euro Area, total economy, double export weights



Financial Trends in Ireland

A rapid expansion of credit and a shift into current account deficit were a natural result

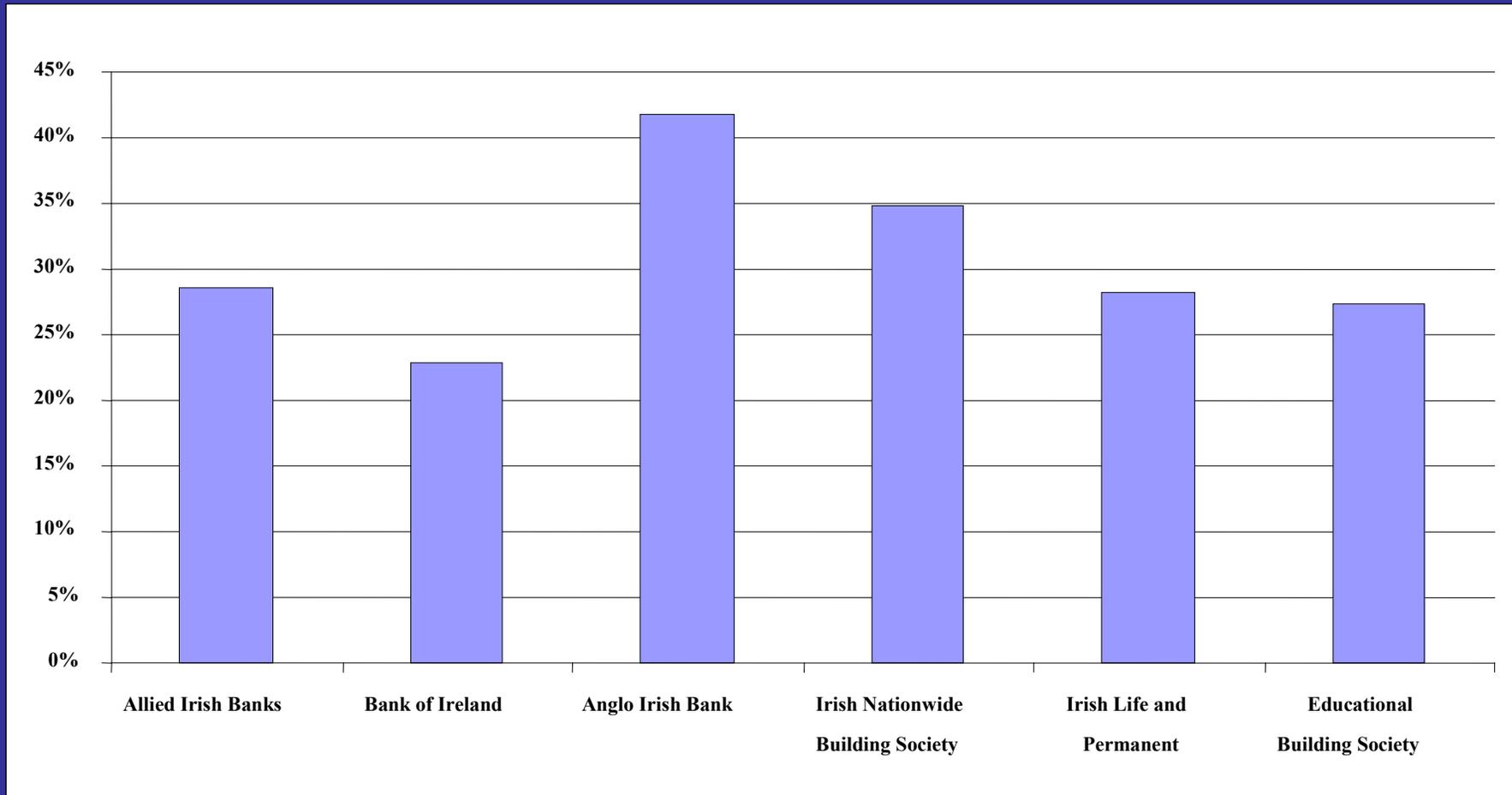
An expansion of credit specifically to the property sector was also to be expected (as euro area factors amplified trends evident in many global markets)

A competitiveness loss with the rest of the euro area was the equilibrium mechanism to slow this boom

In this setting, the challenge for bank governance was to avoid excessive risk taking; while for fiscal and prudential policies it was to dampen the cycle



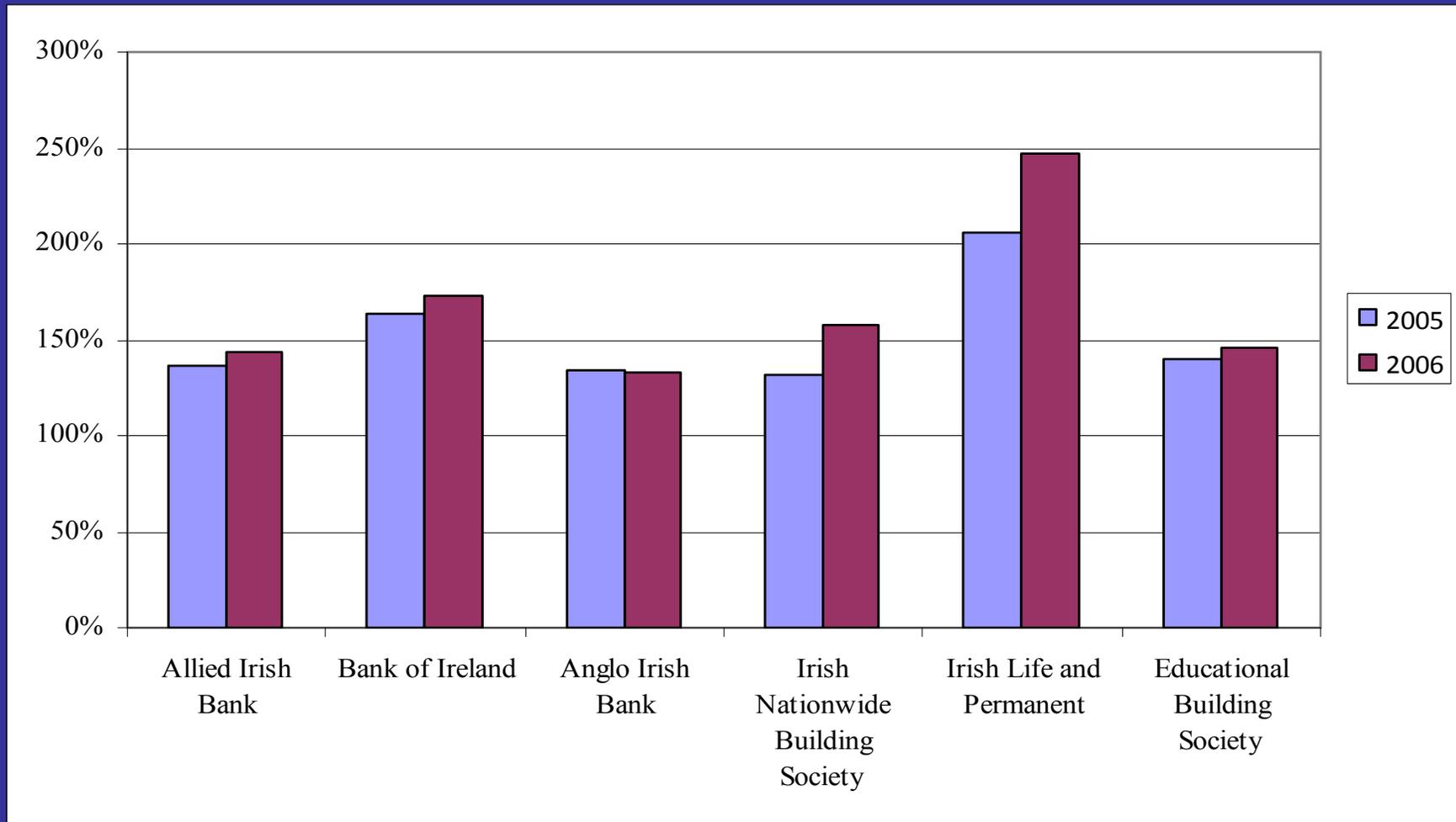
Compound Loan Growth



*Loans are at group level and so include foreign lending as well as domestic lending
Source: Annual Reports
Bank of Ireland data are for the financial year ending March in the following year



Loan-to-Deposit Ratios



* Loan to deposit ratio calculated at group level, incl. foreign loans and deposits.

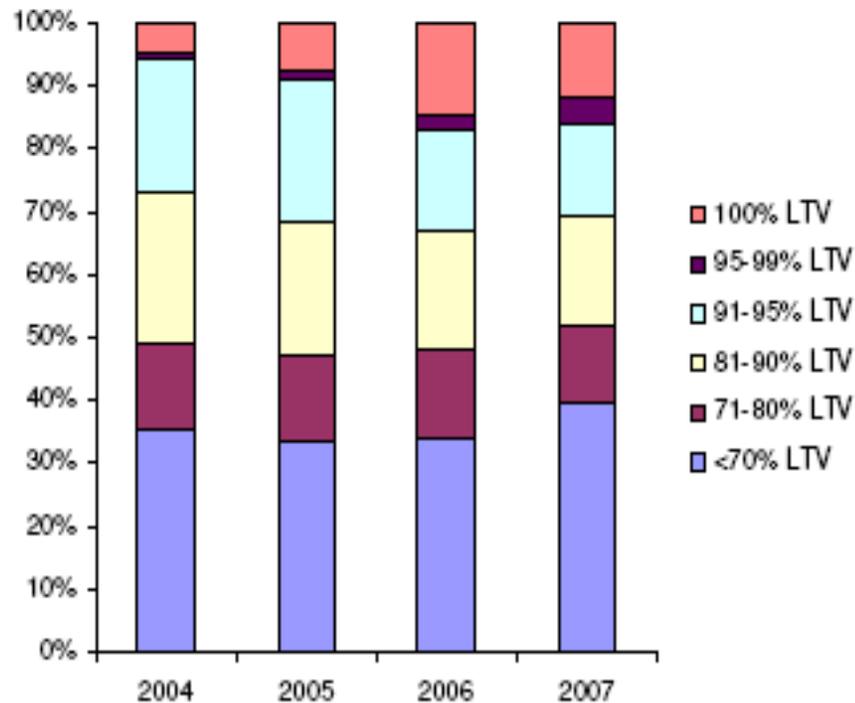
Source. Annual Reports

All data at December 2006, except Anglo Irish Bank data September 2006 and Bank of Ireland data March 2007

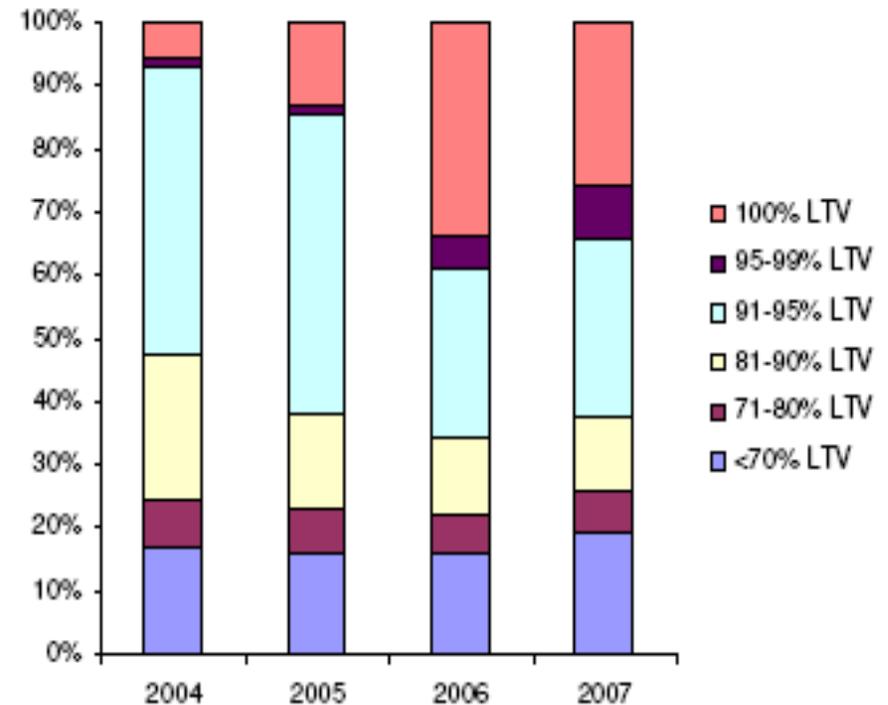


Loan to Value (Mortgages)

LTV rates – all loans



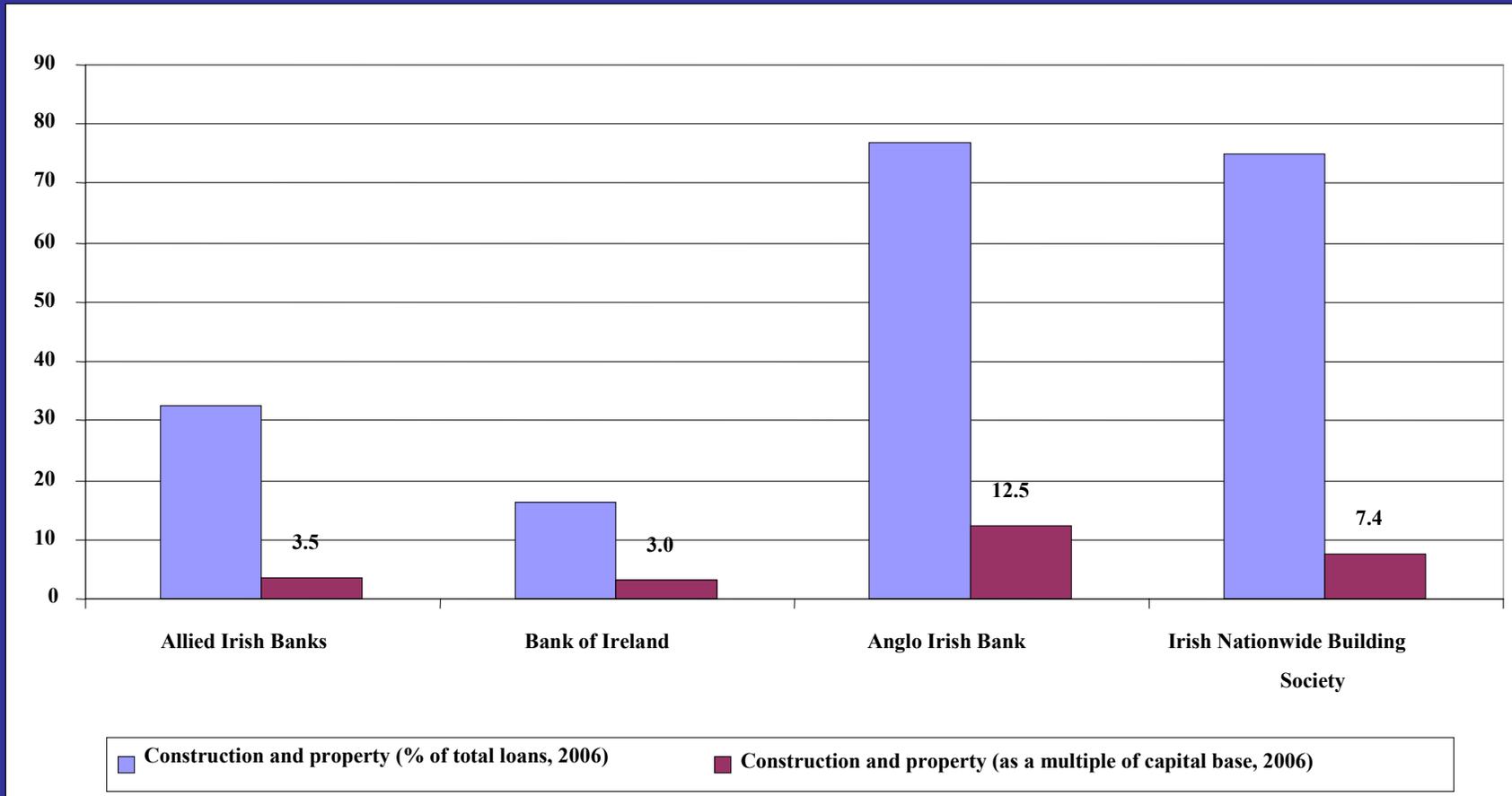
LTV rates -- first time buyers



Loan-to-value for Irish residential mortgages, 2004-7 (Source: Central Bank of Ireland)



Commercial Property Loans



*Data exclude residential mortgages and can thus be taken as representing the exposure of banks to commercial property in a broad sense.
Source: Annual Reports 2006
Specifically the data are for: Allied Irish Banks and Irish Nationwide December 2006; Bank of Ireland March 2007;
Anglo Irish Bank September 2007; JH&Co. Annual Report 2006.



Bank Governance Issues

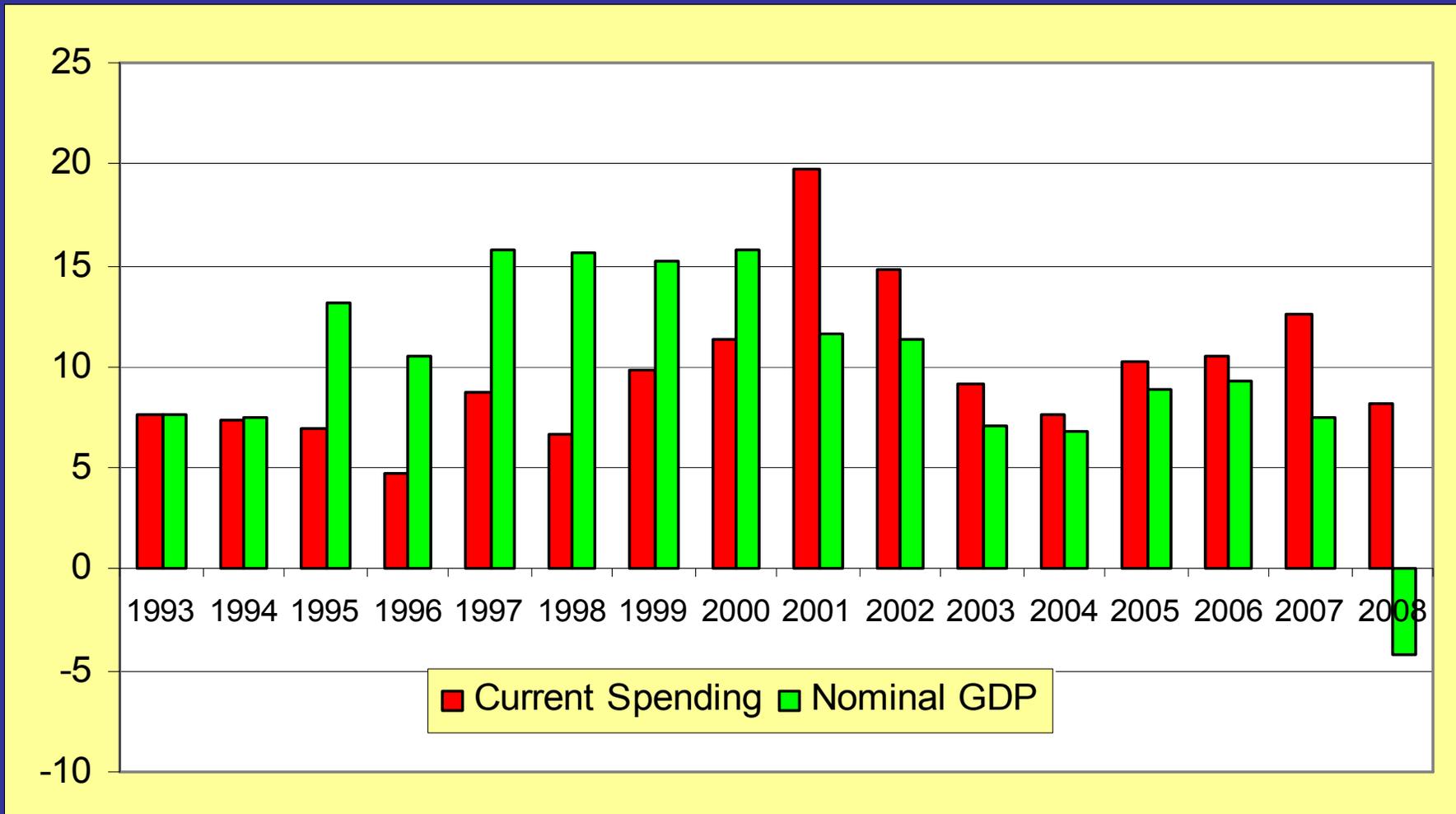


Bank governance/audits failed in plain vanilla ways:

- **internal safeguards overridden to preserve market share: LTVs on residential mortgages raised; exposures to commercial real estate dangerously high (& concentrated), especially with high cross-border funding; documentation of loans poor; remuneration incentive issues;**
- **there were (more limited) severe governance abuses involving (e.g.) loans to directors and non-transparent liquidity management.**



Public Expenditure

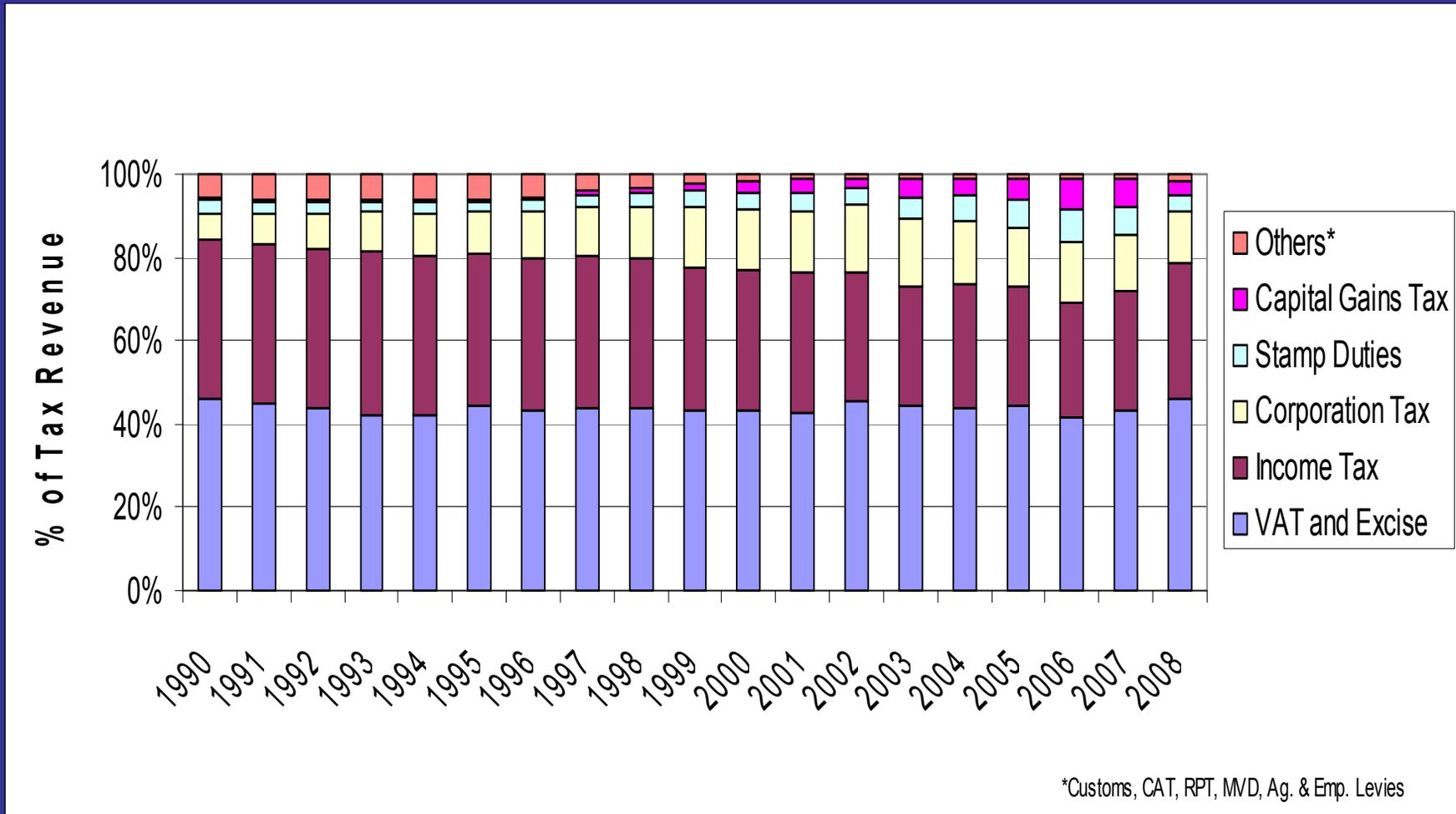


Government Current Expenditure and Nominal GDP: Annual Changes (%)

Source: O'Leary, Jim (2010), "External Surveillance of Irish Fiscal Policy during the Boom",



Tax Revenues



*Customs, CAT, RPT, MVD, Ag. & Emp. Levies



Domestic Policies

Fiscal policy missed transience of tax boosts; fastest spending in OECD. At micro level, eroded durable parts of tax base, subsidised commercial property. Mortgage deductibility, no property tax.

Bank policy emphasised competition; supervisors acted on property & liquidity, but too little too late; failed on governance; did not inform policy-makers. Approach too hands-off, and staff/skills inadequate.

Financial stability reports & FSSA saw soft landing. By 2006 commercial property loans, cyclical/fiscal dynamics, & governance problems ruled this out.



Lessons for Others?

Euro a clear plus, but strong policy implications:

- **fiscal & prudential policies must take more account of ‘mismatched’ monetary conditions**
- **‘external’ imbalances matter under euro while fiscal & labour market policies are national; wholesale liquidity not indivisible even in € area: thus private sector imbalances matter**
- **Cyclically Adjusted Balance needs fine-tuning with more indicators; tax swings need analysis; consider fiscal council, and expenditure rules**



Lessons for Others (2)

- **intrusive, not light touch, supervision needed; must probe macrofinancial risks: e.g., asset risk correlations & asset-liability interactions; centrale de risques can be valuable**
- **stress tests have limitations: financial stability analysis must feature 'contrarian' scenarios**
- **cross-border macro-pru risks are an EU issue**

Some of these are global lessons; but crucial in euro run-up as risk premia fall / financial integration rises