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Excerpt
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Introduction

It would be an understatement to say that Ireland's economic and financial condition in late 2010 was extraordinarily stressed. Numbers at work had fallen by about 15 per cent. The government's borrowing requirement had been reported at the astonishing equivalent of more than a third of annual national income. Every one of the country's main banks needed a capital injection in order to avoid insolvency.

Official efforts to get to the bottom of the banking losses, and to consolidate the public finances, had so far not been sufficiently fast or thorough to convince the markets. In the absence of supportive messages from official European voices, investors had lost confidence that they would be repaid in full and on time. Billions of euros were flowing out through the banks each week. Week-by-week the yield on Irish government bonds was rising to unaffordable levels.

A sense of economic panic began to seep through Irish society, especially as the government began to project an impression of indecision and drift.

The role of the Central Bank of Ireland in this situation was multidimensional. Responsible for the prudential supervision of banks, it had clearly failed to prevent their reckless property-related lending during 2004–7 that had now gone so sour. The government's two-year old attempt to backstop the banks with a blanket guarantee had failed, with the result that the Central Bank was now lending unprecedented sums totalling more than the equivalent of one year's gross domestic product (GDP). Without these loans the banks would have been unable to meet withdrawals from international and local depositors, and would have collapsed, triggering (thanks to the guarantee) cash calls on the government – which would have forced it too into default. The Central Bank could make these loans because of Ireland's membership of the euro area, but the loans were only short term, and could be renewed only with the acquiescence of the European

Central Bank (ECB) – and the ECB was becoming increasingly perturbed at the scale of borrowing.

In November 2010 a term loan of tens of billions of euros was offered by the International Monetary Fund (IMF) and Europe as a means of restoring confidence and providing time for Ireland to prove its commitment and ability to bring the situation under control. At first, the loan's financial terms were too onerous, and there were missed opportunities in its design, not least because of the de facto prohibition on bailing-in unguaranteed senior bank bond holders. But that loan, and the seal of approval it provided to the stabilizing policies of the Irish public authorities, did the trick (especially with improvements in the financial terms on the various sums borrowed). It enabled Ireland to return to a sustainable path of employment growth, though not without wrenching disruptions: despite best efforts, these were unavoidable, given the pre-crisis excesses.

THE BOOK

The story of Ireland's spectacular financial crisis of 2008–13 is told in this book from the viewpoint of a central banker.

But I also want to place the account in a wider context, both historical and institutional. I want to describe what Ireland's monetary and central banking arrangements looked like in the earlier decades of independence before euro membership; this goes some way to explaining why Ireland signed up for the euro with apparent enthusiasm. I want to give my perspective on the basic question of what central banks are for, what they can realistically hope to achieve, and what is in practice beyond their reach.

A reader interested primarily in the crisis narrative can turn straight away to Chapter 7.

The Irish crisis raises many questions for monetary and financial policy in small countries. Was the euro exchange rate regime simply wrong for Ireland? If not, how could it have been better managed? What about banks: can they be better controlled, given the international context in which they now typically operate? And as to the international official partners, should they have done more to steer Irish policymakers away from the abyss, or to shoulder more of the burden when the catastrophe struck?

At the heart of each of these questions is the role of central banking. Scarcely noticed by the general public in the years before the crisis, whether in Ireland or elsewhere, the world's central banks took centre stage in economic policy from 2008. This reflected both their collective failure to prevent the crash and their ability to take unorthodox action to bring the main elements of the financial system back into working order. If central banks were too reliant on passive and mechanical strategies before the crisis and controversially aggressive in their response to it, it seems that central banking remains an art rather than a science. Central banks are inherently limited in their ability to advance the quality of national economic performance. Over-enthusiastic central banking actions have often been the cause of distortions and distress; but passivity in the face of excess and crisis is also to be avoided.

Much has been written about the conduct of monetary and financial policy in large economies. But most countries are small. This book seeks to provide a coherent perspective on the functions of a central bank in a small European country. It takes a historical approach, noting alternative policy choices that have been made by Ireland in the past and by other countries in similar circumstances. Ireland's recent experience is seen to have deep roots and, while the scale of the boom and the subsequent collapse were certainly very large by global historical standards, they were certainly not unprecedented in their shape.

My own qualifications for considering these issues draw on three different strands of my professional experience. Most obviously, as the Central Bank Governor from September 2009, I was assigned the task of pulling the Irish financial system out of the slump. In addition, earlier in my career as an economist in Ireland I was lucky enough to have ringside seats at several turning points in Irish financial policy such as the breaking of the Irish pound's one-for-one link with sterling in 1979 and the devaluations of 1983 and 1986. Finally, through my research and policy work at the World Bank 1987–90 and 1998–2007, I learnt much that is relevant from successes and failures with financial crises and financial policy, both historical and contemporary, in a wide variety of other countries.

With the benefit of hindsight it is easy to see many things that could (and should) have been done far better in the two decades of Ireland's euro membership. Domestic macroeconomic management should have been better adapted to the exchange rate regime. In particular the fiscal authorities should have recognized the transitory nature of the revenue boom which masked the fact that fiscal policy was on as damaging a path by 2005 as it had been in 1977. Prudential policy should have been less passive. There should have been a more inclusive European approach to crisis management exhibiting more solidarity.

What is surprising is that this crisis happened after a century during which Ireland had had long experience of a fixed exchange rate regime (before 1979) and during which its banks became well accustomed to operating in an international environment and through periods of weak economic performance without suffering more than trifling loan losses. To an extent it may have been the very stability that had marked the first half century of Ireland's independence that lulled policymakers into a false sense of security.

High finance may seem abstruse, and there are indeed elements of complexity. But what emerges from Ireland's experience is the importance of what might be termed common sense – or at least a number of widely accepted pragmatic principles – relative to ideology, political preferences or doctrinal fashions, in ensuring that finance performs adequately in supporting economic prosperity. Common sense, informed by an awareness of the lessons of financial history, should have been sufficient to alert informed participants that Ireland's banking system had embraced the global wave of financialization to excess. Common sense and an instinct for self-preservation should have prevented politicians from driving Ireland's public finances over a cliff twice in a generation. Designing and implementing recovery demanded on both occasions a practical sense of what is and is not possible in dealing with economic and financial relationships. Most Irish people, being residents of what is perhaps the most globalized economy in the world, have that common sense, even if they have sometimes lost sight of it. The speed with which Ireland recognized the severity of the crash, and the scale of the adjustment that would be required, helped speed the adjustment. International partners helped more in the end than they were willing to at first.

Despite the depth of the recent economic downturn, the second half-century of Ireland's independence has seen a sustained growth in economic prosperity. Unlike what has prevailed in other countries, finance has not been a conspicuous contributor to that prosperity. And this is regardless of the exchange rate regime in effect. The financial sector's performance has been at best mediocre; it has been an obstacle during several significant episodes. Ireland needs to manage finance better over the decades to come, through the informed and strategic application of common sense.

THE IRISH MACROFINANCIAL CRISIS

The Irish downturn is rightly seen as a central element in the euro area crisis, itself a key strand in the global financial crisis of those years. But Ireland was hit particularly hard by these events because Ireland had generated its own home-grown macrofinancial crisis which was only brought to a head by the global events and deepened by the problems of the euro area. Though straightforward, it is worth summarizing here the bones of the Irish story.

In recent decades Ireland has built its economic growth model around an effective embrace of globalization. Successive governments have crafted economic and social policy in a manner designed to attract inward direct investment by the most innovative multinational corporations in such sectors as pharmaceuticals, information and medical technology and software. Money and banking policy has hewed closely to the prevailing international doctrines and fashions. After half a century of relative economic stagnation punctuated by sharp recessions, adoption of this policy approach began to yield tangible results. Employment and income growth accelerated, especially from the mid-1980s, generating a degree of euphoria and complacency as the economy approached full employment in the late 1990s.

At that point the global surge in financialization seemed to be the next wave for Ireland to join. Irish banks, most of them with historic roots dating from when Ireland was part of the United Kingdom, and reliant for many subsequent decades on the London money market for their wholesale activities, were no strangers to international finance. They jumped on this bandwagon with enthusiasm. Poorly managed and weakly supervised, they had easy access to funding in the world's capital markets and took their cue from the innovations of British banks in what became, by the early 2000s, an out-of-control expansion of mortgage credit and lending for property development. Lower interest rates, ensured by adoption of the euro in 1999, helped underpin loan demand. Acceleration of credit pumped up house prices and convinced many people that property investment was not only profitable but also essential. The property price and construction bubble boosted tax revenue, encouraging government to reduce income tax rates, increase benefits and salaries and generally expand spending as if the boom would last forever.

Irish house prices had already peaked before the global financial crisis hit and Irish banks, with their large exposure, especially to property developer loans, began to seem vulnerable long before the Lehman Brothers bankruptcy. As their international funders withdrew, and as they ran out of collateral eligible for borrowing at the ECB, the Irish banks suddenly found themselves on the brink of failure. An improvised blanket guarantee of the banks' liabilities announced by the government in September 2008 provided temporary relief, but the damage had been done. With the economy now hit by the global economic downturn on top of the collapse in construction and a contraction of consumer spending, job losses multiplied during 2009. The evaporation of boom-related revenue now meant that the budget deficit was sure to balloon, making nonsense of the Ireland's AAA rating. The government recognized the need to dial back its spending and restore the cuts that had been made to income tax rates.

As property prices continued to fall, the banks risked being overwhelmed by the challenges of managing a huge non-performing property-backed loan portfolio. The government attempted to stabilize the situation by carving out the large property-related loans, obliging the banks to sell them at long-term economic value to a purpose-created asset management body, National Asset Management Agency (NAMA). The huge losses thus crystallized wiped out almost all shareholder value, alarming investors not only about the banks' assets but about the creditworthiness of the Irish government, as the latter had guaranteed to cover losses not met by shareholder funds. With the banking system now relying heavily on emergency liquidity from the Central Bank, and the government faced with prohibitive interest costs on its borrowing, the only safe course was to seek the assistance of the so-called Troika (effectively the IMF plus European lending facilities coordinated by the European Commission, in association with the ECB), to provide financial support while it proved its determination to restore balance to the public finances.

The financial terms on which the assistance came were at first unfavourable. The interest rates on the official funds being borrowed were dangerously high. Even though the large and still uncertain banking losses were a major factor in weakening market confidence in Ireland, the official lenders had also said no to both of two obvious steps that could help put an end to such uncertainty. Thus they refused either to countenance a bail-in of the unguaranteed senior creditors of the failed banks or to absorb some of the risks by directly recapitalizing the other banks. Later, though, the interest rates on the European loans to Ireland were lowered, and their maturity extended, and the liquidation of the failed banks was carried out in a way that limited the net financial cost to Ireland.

The economic and fiscal projections made at the time the programme of assistance was negotiated proved to be sufficiently accurate for market confidence to be gradually restored. Aggregate economic recovery was under way by mid-2012. Unemployment, which had soared from below 5 per cent in 2007 to 16 per cent five years later (despite emigration), began to fall steadily, dropping below 6 per cent in 2018.

Many scars remained and many households had suffered greatly. Indebtedness of households remained high, with unresolved non-performing mortgage loans. Aggregate real household spending regained its pre-crisis level only in 2016 (despite population growth), while current public spending remained below the peak after a decade (in real terms, including higher interest costs and despite an increasing population). Likewise, it was 2018 before the total numbers at work matched the previous peak. But the worst was over.

POINTS OF CONTENTION

Although these main outlines of the Irish macro-financial crisis of 2008–13 may be well known, it will become clear in the chapters that follow that many details are little known; some aspects remain disputed and some misunderstood. The following are among the most significant examples.

The main cause of the crisis was certainly the wave of reckless bank lending, but most of the fiscal austerity measures did not go to pay for the bank losses. Even without the bank losses, measures were going to be needed to make up for the large hole that had opened up in the public finances when the flow of tax revenue from the property bubble suddenly ceased, revealing that the reductions in income tax and the spending increases that had been embarked over the previous few years were not sustainable.

Where the banking losses had a big impact was in accelerating the need for the government to adjust its budget. The income tax and levy increases, the cutbacks in public services and the public servant salary reductions could have been spread out over a longer adjustment period if investor confidence in Ireland had not been tipped over by the progressive disclosure of such heavy banking losses.

Likewise, the Troika programme did not cause Ireland's austerity; it eased it. Ninety per cent of the job losses had happened by the time the Troika arrived. By providing loans when the private market would not, the programme allowed the government to make the fiscal adjustments in a more orderly and gradual manner. The choice of what taxes and spending measures to target was largely one for the government. The Troika had suggestions, some of which they pressed vigorously, but for the most part they were content with any reasonable choice of measures as long as the net impact on the government's deficit was sufficient.

While it is easy to point to design shortcomings in the euro, the Irish crisis cannot be blamed on membership in the euro area. As with previous exchange rate regimes, economic performance depended on the accompanying fiscal and regulatory policies being well adapted to the new regime.

Ireland's fiscal and regulatory policies in the first decade of the system fell far short of what was needed to stay safe.

But management by Europe of the crisis was also poor. Even governments with sufficient headroom terminated their countercyclical fiscal spending too soon. The ECB's response, though vigorous, failed at first to recognize and fully understand the severity of the unfolding crash. The actions taken both by the ECB and the Eurogroup Ministers lacked clarity and persistence. In many cases censoriousness and lack of trust permeated the approach from officials on the creditor side. At first, the official lending to Greece, Ireland and Portugal was at rates of interest that did not make sense. Only later was a more reasonable approach adopted.

After the expiry of the initial bank guarantee, the Irish government would have willingly seen losses imposed on the unguaranteed senior debt of the failed, gone-concern banks Anglo and INBS. As several participants subsequently realized, it was wrong-headed of the ECB to prevent this (and inconsistent with the general policy on bank resolution subsequently adopted in Europe). They likely hope that their acquiescence in the complex financing arrangements around the subsequent liquidation, which have worked for Ireland even better than hoped, has made amends.

As in other countries, crisis management brought the Central Bank of Ireland, long accustomed to a largely passive role, into unfamiliar territory. For a while it assumed a much greater prominence in the economy and society. Ensuring that the country would not slide further into a semi-permanent slump of over-indebtedness was the first priority. No longer deferential to the banks, the Central Bank nevertheless found, as in other countries, that it was a difficult and slow job to get the banks to acknowledge the scale of their prospective losses; to deal with non-performing borrowers in a fair, sensitive and sustainable manner; and to eliminate sharp practice and worse vis-à-vis their customers – behaviour engendered by a long-standing culture of corporate entitlement.

The recent macro-financial crisis was the most dramatic and probably the worst in the history of the Irish State, though it is close run by that of the 1980s. Understandably, successive crisis-period governments sought to recover as much as possible of the prosperity that the globalized Irish economy had enjoyed before the property bubble. This was not going to be fully possible, and choices had to be made. In large part, though, governments chose not to radically reimagine any significant aspects of the Irish economy as they coped with the downturn: surely a missed opportunity.

WIDER IMPLICATIONS FOR CENTRAL BANKING

When the euro began, some had asked: why does Ireland need its own central bank? It was a fair question. Central banks are about money and credit, and these aspects of the Irish economy have long been globalized. But the euro did not make national central banks redundant. Instead, Ireland's experience, both before the euro and during the past twenty years, provides an instructive case history or what central banks are for; what they can and cannot do (in Ireland's case both at the national level and as part of the Eurosystem). The Central Bank of Ireland has been close to the heart of much of the crisis story, both in regard to the macroeconomic aspects, seeking to ensure that economic recovery could be attained and the costs of the crisis minimized, and in regard to the microeconomic challenges of supervising the conduct and risks of the banks.

If, in previous decades, a consensus had been growing that central banks should have an aggressively independent and exclusive focus on ensuring price stability through the application of simple policy rules, the crisis has shown the inadequacy of such a limited concept. While this is nowhere more evident than in Ireland, the lesson is a global one.

Around the world, the ambitions of, and general expectations for, national central banks grew dramatically in the recent crisis. Central banks have greatly expanded their balance sheets. Many of them have been assigned new responsibilities for the regulation and supervision of banks and have adopted a greater degree of intrusiveness in these activities.

In an increasingly complex and evolving financial environment, it is unlikely that this deeper engagement will or should be simply a transient phase, to be succeeded soon by a return to the more passive and mechanical mode that had become fashionable.

For, by the second half of the twentieth century, a caricature had emerged of the sound central banker as one who would be sparing and terse in his or her communication. Central bank independence was sometimes interpreted as entailing a relationship with government that should verge on hostility. As to the control of banks, these were often seen as best run by those who had a financial stake in their profitability and as requiring only relatively light official supervision of their governance structures.

Countries whose central banks did not comply with these constraints were warned that they would be bedevilled by high and volatile inflation, growth-sapping distortions of the allocation of credit, and periodic crises of banking insolvency.

Although historical examples of such failures can be multiplied, our narrative here illustrates the degree to which the narrow ideal of central banking needs to be qualified. The crisis has exposed the inadequacy, even for the central bank of a small country, of that jaded caricature of an isolated, rule-bound central bank reluctant to interfere in a smoothly functioning market mechanism where financiers can be relied on for prudence and fair-dealing.

That is not to deny the attraction of a regime in which central banks were encouraged to focus on simple rule-based policies – fixed exchange rates, steady monetary growth paths and mechanical interest rate rules. Poorly crafted monetary activism risks being punished by the financial markets.

The experiences described in what follows provide evidence that the effective central bank is increasingly an active and intrusive body, willing to innovate in its response to critical situations, and prepared to cooperate with, but not accept dictation from, government.

Thus, a central bank's independence from government does not mean its indifference to national economic performance and to the ability of the national government to pursue a coherent macroeconomic policy. The central bank is an arm of the state, albeit not of the government. There are occasions, especially during crisis, when the central bank needs a deep understanding of the policy and capacity of the government, so that it can act as a trusted policy adviser and, without pandering to political short-termism, can cooperate with government policy to achieve its mandated objectives more effectively. This applies also within the euro area, where the potential conflicts of objectives can require careful management.

Clearly, the central bank in a small country must understand that it is constrained by market forces and international conventions. All too often, defiance of these constraints results in a whiplash. But this implies that success in achieving a central bank's national goals must be sought by active manoeuvring within these constraints and working with the grain of market functioning and international financial diplomacy.

The effective central bank, however small, will not be passive. Maintaining price stability, whether or not it is underpinned by an exchange rate peg, requires determination and vigour in acting against public or private actions that put that goal at risk. Insufficiently forceful or consistent central bank actions can allow the emergence of damaging bubbles and other spending excesses.

This means that, even in a small country, macroprudential and microprudential policies must be pursued actively to ensure that banks do not create havoc. Powerful though modern financial markets may be, no one