Index of Contents

Summary and Conclusions

A summary list of recommendations for action arising from this report includes the following:

- The Central Bank should put intensified pressure on commercial banks to assess and address instances of problem mortgages;
- The proposed Personal Insolvency legislation should be put in place as a matter of urgency to underpin confidence that problems can be addressed;
- The legislation should confer a right to a PIA for secured debt thereby removing the veto that mortgage providers would have under current proposals;
- A National Mortgage Bank should be created with a commercial mandate to grow its loan book by offering competitive mortgages for residential purchase that address the issues that are currently keeping potential buyers out of the market. This bank should be created to compete with the commercial banks but without legacy problems with a view to privatisation once it has completed its public policy mandate;
- This new bank should be formed as a joint venture between the Irish state and a private sector partner. Addressing potential obstacles should be a priority as the problems created by lack of funds to finance house purchases need to be tackled as a matter of urgency;
- The new bank should be created with a target that it will be operational within a year and provide 10,000 mortgages per annum once operational. To achieve this is should aim to provide mortgages with a value of €9.5 billion in its first five years of operation.
- Various sources should be examined to identify funding for this bank, including the use of funds from asset sales and structuring the bank in a manner to make it attractive to an outside investor;
- The NAMA proposal for the sale of houses using partly deferred mortgages should be progressed but on a much larger scale;
- The lender-borrower relationship, which is being evolved by NAMA, has become adversarial, it would appear, in a significant number of cases. Such an environment is not conducive to achieving the maximum long term value for taxpayers. Where dispute is unavoidable it is recommended that mediation would be a more cost effective means of resolving issues in dispute rather than court proceedings and accordingly should be used where possible.
- The merits of (part) privatising NAMA now, to an international private equity investor or international property investment company or a consortium of such interests should be examined. It would be consistent with the approach being considered in relation to other State owned assets. As a minimum the Government should undertake a review of the business strategy of NAMA, including the statutory basis on which it is based, to determine if it offers the best prospect of securing the best return for the taxpayer in the longer term. In particular, the focus of review should be to determine if a superior outcome would be likely from replacing the lender-borrower relationship with one of joint venture partnership, based on equity investment by joint venture partners. There is sufficient scale and scope in the NAMA portfolio for some such joint ventures to be publicly quoted. This would permit the State to monitor the value it holds on a more or less continuous basis and if desired or required it could realise its interest in the long term value of projects by selling some or all of its shareholding, rather than selling the underlying asset, before its long-term potential has been attained.
- The timetable for sales of publicly owned assets should be accelerated. We appear to be still at least a year away from funds being realised;
- A much wider range of assets should be included in the programme such as schools, Government buildings and licences for services many of which are currently undertaken within the public sector; Opportunities for leverage of funds raised should be examined and a range of projects identified and placed on a ready to go basis in advance of fund being raised;

- The potential to create a State Investment Bank should be examined and progressed to provide venture capital for firms. Enterprise Ireland has been undertaking a role along these lines for a number of years and this activity should be spun off into a separate entity with public and private shareholding to promote long term economic development; There should be a review of PPP legislation and practices to identify why only projects in a restricted number of sectors have been undertaken;
- Ireland should formulate a National Growth Programme based loosely on the Programmes of the 1990s to provide a framework for the expenditure of these funds and to prepare for the prospect of funds becoming available from outside sources such as the EIB. Sectors such as green energy and third level education should be prioritised for these funds.

Differences in the International Policy Response to Financial Crisis

1. Since 2008, the economies of most developed countries have moved from crisis into a period of slow growth or recession. However, as a result of different policy approaches and starting conditions, the impact of the slowdown has differed across countries. The Eurozone has fared poorly in general and some countries including Ireland remain locked in a crisis of falling living standards. Forecasts do not suggest that it is going to get much better any time soon.

2. Western economies experienced a period of high and fairly stable growth which ended suddenly in 2008 with a severe credit crunch. This resulted in a very sharp fall in economic performance and recession in 2009. However, in many countries, growth had resumed by 2010 and returned almost to its earlier rates last year. The latest IMF estimates and forecasts for 2012 to 2014 published in April 2012 show growth continuing but at a lower level than 2011 or 2008.

3. The years since 2008 have seen significant deleveraging in the private sector and deflation in many economies. However, superior economic growth performance in the USA has coincided to a considerable extent with the application of aggressively loose monetary and fiscal policies, which were implemented there from 2008, to get the economy back to growth rapidly. The ECB has also acted but the response has generally lagged that of the USA in timeliness and on a number of occasions has taken a different direction, actually raising its interest rates - in 2007 and again in late 2008 - before also engaging in a steady fall from the early part of 2009, apart from the difficult to understand decision to raise rates during the first half of 2011 – a decision that was reversed in November and December 2012.This is not totally unexpected given the strong mandate of the ECB to protect the currency – a mandate that it has interpreted as targeting an annual rate of inflation of 2% for the currency area – unlike the mandate of the Fed in the USA, which includes promoting economic growth as well as controlling inflation among its objectives. In addition, the ECB did not engage in Quantitative Easing policies, similar to those of the Fed (and the Bank of England) up until late 2011 but has, since then, begun to supply funds at low interest rates to the banks under its LTRO (long term refinancing operation) programme. So far, the experience would appear to be similar to the USA with banks taking the funds but not increasing lending, although it is too early yet to draw any firm conclusions. What is clear, though, is that the ECB has been much slower to adopt supportive economic policies compared with the Fed.

4. The contrast between the fiscal response of the Eurozone and the USA has been even more pronounced, than that of monetary policies. The USA, and the UK, responded with an aggressive expansionary fiscal policy to support economic growth, manifested in widening of the fiscal deficit as a proportion of GDP. While, these responses were unable to address all of the immediate impacts of the financial crisis they played a role in getting the economies growing again. Arguably, given the issue of the very low money multiplier in the USA, it is the fiscal response rather than the aggressive action of the Fed that was more responsible for recovery there. In contrast, the Eurozone as a whole responded much less on the fiscal front, despite the fact that the national budgets of a number of member states slipped into deficit. This was probably due more to an automatic response to a slowdown, as tax revenues fell and welfare payments rose, rather than a targeted policy response, let alone a co-ordinated response to address the asymmetric impacts of the slowdown as we discussed above. This difference in response might be understandable if there was a higher rate of public sector indebtedness in Europe. However, gross debt of general government as a percentage of GDP is higher in the USA than for the

aggregate of Eurozone countries. In summary, while there is a sovereign debt crisis in the Eurozone at the level of some individual countries – just as some states within the USA have serious budgetary problems – the situation at the aggregate, or Federal level, which is what ultimately matters for the Euro and the level where the monetary policies of the ECB are implemented, is actually better in the Eurozone than in the USA. This means that despite greater latitude at the EU level to loosen budgetary constraints, even though such options are much more restricted at the national level in certain member States, the EU response overall has been very cautious. In this it mirrors the more restrictive approach of the ECB in respect of monetary policy.

5. The policy response in the USA has emphasised stimulus over stability, in contrast to what we have seen in Europe. But how sustainable is either response? The monetary and fiscal stimulus that has been provided in the USA is potentially inflationary. That this has not triggered inflation to date is due to the fact that there is still considerable spare capacity in the US economy, which is itself in part a consequence of the very low money multiplier. We can characterise the process in the USA, as it has operated over the past three to four years as follows. The USA government runs a deficit in order to stimulate growth. It needs to fund this deficit by issuing Treasury bonds. These are purchased partly by savings flowing in from Asia but purchases using domestic sources of funds are also needed. The USA Fed has provided high liquidity to the domestic banks i.e. money lent at low interest rates. The banks have used this, not to lend to 'real economy' investors, but to buy the Treasury bonds. This is profitable since the bond yield, while historically low, exceeds the Fed funds rate. It is also very low risk as the USA Government can always redeem the bonds and there is no currency risk as both the loans and bonds are denominated in US dollars. If the economy picks up such that the banks would prefer to lend to higher return borrowers in the private sector then this would mean that the US deficit would also likely fall as the stimulus could be withdrawn.

6. The big danger, of course, is inflation. If the economy picks up then so too will the money multiplier and quantity theory leads us to expect that an increase in the money supply in excess of the growth of output will eventually be reflected in inflation. The gamble is that the Fed and the Treasury will both withdraw the stimulus in time to head off such inflationary pressures. While usually thought of as an increase in prices, inflation is more usefully defined as a fall in the value of money. It can also be seen as an alternative to tax or expenditure cuts. Fiat money is a liability of the issuing authority, usually a Central bank under the ownership of the Government although the legal status of the Federal Reserve in the USA is more complex. Therefore, for any nominal amount of public debt, inflation reduces its real value. While a stability programme focuses on reducing debt by reducing the deficits that lead to debt, an inflationary programme aims to allow short term deficits that will be eliminated by growth in the medium term with the debt reduced in effect by inflation.

Sustainability of the European Approach to date

7. So what does this imply for the sustainability of current policies? We have noted the gamble that the USA is taking. The European emphasis on stability may be required again to resist inflationary pressures from the USA or from a shock such as another oil price increase. The question then is whether the Eurozone, given that it could face this problem with a much weakened – perhaps stagnating – economy, would have the strength to overcome such inflationary pressures as they would almost certainly imply a tightening of monetary policy, higher interest rates an even tighter controls on Governments' budgets. Therefore, while the sustainability of the USA policy approach can be questioned, so too can that of the Eurozone. In the same vein, it must be noted that objective of protecting the Euro has been achieved only partially, notably with respect to the US$ and £Sterling, However, this is more a result of the tight monetary policy pursued by the ECB relative to authorities in the USA and UK. When compared to other countries such as Japan, Switzerland or Australia that have not acted to stimulate their economies we see that the Euro has weakened considerably.

8. Finally, there is the question of the political sustainability of the European policy response. Populations generally perceive and accept that debts must be repaid – a capitalist economy could not function otherwise – and understand the financial implications of this. However, the psychological implications of a combination of high debt and the actions required to repay this debt, namely rising unemployment and falling employment and low growth, present serious issues that go beyond financial accounting. At the extreme these can be manifest in a withdrawal of support for the legitimacy of government and the 'system' and there is evidence of this in the more seriously affected countries in Europe and among the more radicalised parts of the population. However, we need not argue the case

that these are important issues on the basis of extreme situations. The problem is that for the majority of people in the majority of situations the normal reaction is to feel insecure in these situations. This quickly leads to cautious economic behaviour – increased savings, deleveraging debt, less economic risk taking, and lower investment. This is so even though the greatest opportunities for gains usually accrue to those who act at the bottom of the economic cycle. However, the responses alluded to make the economic situation worse leading to a further intensification of fear. This is market failure on a grand scale, a macroeconomic market failure. And a resolution will not emerge organically from within the market unless action is taken to reverse the slide. There is growing evidence that member states are coming to realise the shortcomings of the Eurozone policy response to date and a need for greater emphasis on growth supporting policies.

The Position of Ireland

9. The problem in the Irish economy is clear: domestic demand is in severe recession even though exports are performing well. Economic 'uncertainty', or 'fear' in large measure underlies these weak conditions. Uncertainty can be thought of as that part of the unknown that we cannot assess reliably. The part that can be assessed reliably – at least, in the aggregate – is usually described as 'risk'. Perceptions concerning the relative importance of risk and uncertainty can change. In boom times, risk tends to dominate, in other words, people act as though they can accurately assess the future and therefore act positively. However, in recessionary times, uncertainty comes to the fore and people act cautiously. As a result, even if credit becomes available again and even if the need to repay debts is manageable, a lack of confidence can work to reinforce and impose requirements to change behaviour leading to an over-reaction. We see this manifested in recessions in the form of higher savings, lower investment, deflation, rising interest rates – unless the monetary authorities act to provide liquidity – and a self-reinforcing pessimism that can lead to a viscous circle as the economy shrinks further. There is nothing new in this and it underlies the well observed economic cycles that have always been a feature of market economies.

10. In the absence of a turnabout in the upward trend in the household savings ratio in recent years, (which will not occur so long as households are surrounded with economic uncertainty, fear of unemployment and the effects of unsustainable indebtedness) the outlook for the economy remains one of sluggish growth with weak domestic demand, high unemployment and painfully slow adjustment of public and household finance imbalances. In order to bring this change about effective initiatives are required which reduce and remove those factors which are undermining confidence and causing households to behave fearfully.

11. Total household debt rose rapidly during the boom from below €80 billion in 2003 to €210 billion at its height in 2008. For as long as house prices in Ireland continued to rise the impact of the build-up in household debt was not a major concern for home owners since house price rises were more than adequate to offset the increase in indebtedness. This process resulted in a rise in the net worth of Irish households to over €600 billion at the height of the boom. The fall in house prices since then, has reduced net worth, despite the deleveraging process in this period that saw debt repayments exceeding borrowings. Recent data from the Central Bank indicate that household net worth stood at €457 billion in Q4 2011, a decline of 37 per cent since the peak. The household savings ratio which had fallen to below 8 per cent in 2007 rose to 14.1 per cent in 2011. Increased savings ratios reflect lower confidence and are a major leakage of demand from the domestic economy and a drag on growth and recovery when there is spare capacity.

12. Household disposable income fell from over €100 billion in 2008 to €89 billion in 2011. Thus, a one percentage point reduction in the savings ratio from here would be equivalent to an injection of €890 million of demand into the economy. Since domestic demand is an important determinant of disposable incomes, this process would have a dynamic element so that as recovery began additional falls in the savings rate would have a reinforcing impact as disposable incomes rose. ***A return of confidence should see the savings ratio decline to about 10 per cent fairly quickly, equivalent to an injection of demand of about €4 billion into the economy. This would boost economic growth. A fall of 4 percentage points in the savings ratio to 10 per cent would boost GDP by €2 billion or about 1.25 per cent.*** There would also have a positive impact on employment. An injection of €4 billion from an increase in domestic demand would ***create 50,000 jobs and support a further 20,000 as a result of secondary effects.***

Mortgage Arrears and Banks' Balance Sheets

13. These estimates for potential job creation underline the importance of addressing domestic demand as well as promoting export growth. Exports have performed well in recent years but the employment situation has not improved. This is similar to the period of 'jobless growth' that Ireland experienced in the late-1980s and early-1990s as the economy began to emerge from recession and grow. It was a number of years after this growth had begun before domestic demand began to rise and Ireland's long standing high rate of unemployment truly began to fall. The missing element then as now is the confidence that is required to promote the behaviour that will facilitate this growth. The following paragraphs summarise the economic requirements and rationale that would permit these gains to be realised.

14. Developments in the housing market and related mortgage credit have played a very important part in undermining households' confidence and the rise in savings ratios that has occurred. The house price collapse, since 2008 has been a key factor in this process, by eroding household net worth and leaving 40 per cent of homes in negative equity. In addition, falling incomes and employment have resulted in a growing mortgage arrears problem affecting in the region of 10 per cent of homes. However, the problem of arrears is a concentrated one whereas negative equity and the damage to confidence that this situation causes is a widespread one. ***Getting the housing market working and house prices reversed is an important requirement given the impact of this on consumer confidence and the importance of confidence in addressing those parts of the Irish economy that are not recovering, most notably, domestic demand.*** This is not to suggest that a return to the situation of a decade ago where there were successive years of double digit house price inflation is either desirable or required. However, there is an important lesson to be learned from what was happening in the years before the crash. This was a period with a clear market failure that the state failed to address. The market failure was excessive confidence bordering on hubris***: market participants failed to correctly assess the risks of buying property and taking on mortgage debt on the scale they did at that moment of the economic cycle. Exactly the same thing is happening now only that the failure is an over-assessment of the risk rather than the under-assessment that characterised the earlier period. Thus, we now see a vicious circle where falling prices reduces confidence which suppresses demand and causes prices to fall further.***

15. Following the bank stress tests carried out in 2011the Central Bank indicated that banks would need to set aside €5.8 billion to cover bad mortgages. The Central Bank concluded that Irish banks do not require any additional capital having been recapitalised following the Prudential Capital Assessment Review process in March 2011. However, on-going recession and continuing falls in house prices have led to more recent estimates indicating that bad mortgages could result in losses as high as €8 to €9.5 billion. If the higher of this estimated range proved to be correct then taking the banks in aggregate and simply applying the losses to their current Tier 1 capital, the ratio would fall to 12%. While this is a crude calculation it suggests that even in a worst case scenario adequate capital ratios could be maintained by the Irish banks without additional assistance. However, there are indications that the banks will require new capital in coming years to meet future regulatory requirements. Currently, the reluctance of the banks to confront the issue and deal with it comprehensively means that it is not possible to reach any conclusion as to how or when this problem will be resolved.

Limitations of the Present Policy Approach

16. There is no doubt that Ireland, faced with an economic crisis over recent years, has engaged actions that have gradually stabilised the worst aspects of that crisis. This report does not dispute the need to take the kind of measures that have been taken, although the timeliness of the actions is a different matter. However, economic policy remains in crisis mode and needs now to move on to a recovery phase. ***The external environment appears to be turning positive in the sense that there is a growing realisation in Europe that there are alternatives and that reform of the policy approach is not only desirable but essential if political crisis is to be avoided. There is a real impetus for change evolving. This provides opportunities but Ireland needs to move on from basing growth aspirations on hopes that a stimulus will come from abroad. This is the core rationale of the export based recovery strategy and, while not in any sense dismissing the positive contribution of exports to the economy, the fact is that exports have been performing well in recent years without resulting in the core problems in Ireland being addressed.***

17. ***In contrast to the predominant idea that Ireland is utterly constrained in its ability to act due to the requirements of the IMF-EU bailout deal, it is believed there are actions that can be taken, which would place the Irish economy on a higher growth trajectory than is currently in prospect*** . A summary agenda for action is set out below in terms of a number of concrete proposals that are focussed on addressing issues of confidence and funding that are severely constraining the domestic economy. None of these are without risks and costs, both financial and in terms of the need to change mind-sets. However, for as long as economic policy in Ireland remains in crisis mode, focussed solely on addressing mistakes of the past it will fail to realise the opportunities of the present.

Resolving Personal Insolvency

18. Prompting a recovery in Irish house prices is considered to be a core requirement for the economy to regain growth. It is argued that house prices are up to 25 per cent below what might be expected based on the fundamentals but that there is every possibility given current influences in the economy and experience following housing crashes elsewhere that they could drift even further. Furthermore, affordability has risen with the fall in prices and interest rates remain low. The key missing ingredient is confidence: ***the confidence required for potential purchasers to act and the confidence required for mortgage suppliers to lend***. Banks have unrealised losses on residential mortgages in Ireland, probably in the region of €6 billion but perhaps as high as €9 billion. The Central Bank of Ireland has reported that current capital in the banks is adequate to deal with the arrears in residential mortgages and in fairness, is putting pressure on the banks to clarify the situation. However, the strategy of banks to date to address the arrears issue has failed to resolve the problem.

19. In late January, the Government published Heads of a proposed Personal Insolvency Bill. This contained proposals to reform existing bankruptcy arrangements to allow the write down of both secured and unsecured debt by qualifying individuals; the introduction of three non-judicial debt settlement arrangements, as an alternative to bankruptcy - these are Debt Relief Certificates (DRC), Debt Settlement Agreements (DSA) and Personal Insolvency Arrangements (PIA) relating to secured debt.

20. A PIA would be possible where there is negative equity and substantial arrears and it must be the case that a DSA would not make the debtor solvent within a five year period – in other words, the mortgage is the main problem. A PIA would normally run for six years and the debtor could not be forced out of a principal private residence during this period if the obligations entered into under the PIA are being met. The Bill is flexible in respect of the actual arrangements that might be agreed. All secured debt is treated the same irrespective of whether it relates to a principal residence or buy-to-let property. ***However, the mortgage provider would not be compelled to accept the arrangement.*** Once a PIA is awarded the creditor could not look for bankruptcy and all debts would be deemed to be discharged once the debtor complies with the terms of the PIA. It is thought that the reduction in the mortgage discharge period would encourage lenders to agree to PIAs although a flood of mortgage write downs seems unlikely as it may just formalise what many lenders are already doing. It may also be the case that the Bill would reduce uncertainty in relation to the valuation of the Irish banks by potential international buyers, even though their rights as secured creditors would be eroded.

21. There is no doubt that the introduction of the Bill would improve the situation faced by many people in financial difficulties as it would provide a legal alternative to bankruptcy and create an independent entity in the form of the Insolvency Service to assist in putting management plans in place. It is not known precisely to what extent PIAs and bankruptcy would lead to write downs in the value of mortgages, since PIAs will entail six year work-out agreements. However, they should lead to write-downs corresponding with the extent of bad mortgages, which has been estimated to amount to as much as €9 Billion. Even if this was the extent of write-downs this could be absorbed by banks without compromising capital adequacy ratios, (see Section 4.5). ***PIAs would be formal arrangements that would provide certainty. The impact of the informal arrangements currently being followed by the banks with respect to financially distressed households is unclear, as regards either the household sector or banks' balance sheets. However, certainty is the key requirement.***

22. It was initially planned, as agreed in the IMF/EU bailout deal, that the second draft of the Bill would be provided in late April but this has been deferred until the end of June and references to the complexity of the Bill in Department of Justice statements suggest that further delays are possible. It will then go to the Second Stage in the Dail and further revisions are likely. Furthermore, the voluntary

nature of participation in a PIA, which means that the mortgage providers would effectively have a veto is considered a real weakness of the current proposals. ***Instead the legislation should establish a right of access by individuals who meet explicit economic criteria to Personal Insolvency Arrangements, with enforcement and oversight powers lying with the proposed Insolvency Service, the establishment of which is provided for in the Bill.***

23. ***The economic significance of this legislation lies in the extent to which new insolvency arrangements would reduce uncertainty in respect of a household's prospective net worth and work to restore confidence to stimulate spending. However, it needs to be put in place as a matter of urgency and it needs to be sufficiently robust to ensure that it confers the rights on individuals rather than that the mortgage provider can voluntarily acquiesce or not, as the case may be, to any proposed arrangement.***

Widening the availability of Residential Mortgage Finance

24. While recognising the need to address the situation in relation to people in financial distress, the solutions needed to address the excessive weakness of the housing market require a response that is much broader in scope. ***People who are not in such distress represent potential demand for houses but are not acting due to a lack of confidence or an inability to access mortgage finance, a situation that could be addressed by state intervention in the form of a bank that provided mortgages for house purchases with innovative features to address the concerns of these potential buyers***. Banks seem reluctant to engage in lending for residential purchase and seem not to have a clear business strategy for developing this business profitably. Indeed, the legacy effects of the housing debacle may very well mean that they are incapable of developing and implementing a profitable business strategy to supply mortgage facilitate that would facilitate future housing demand. ***In these circumstances a solution may be to create a residential mortgage bank that would provide residential mortgages with built-in features to address the concerns that are preventing individuals from purchasing homes***. In some respects this mirrors the original rationale behind the establishment of ACC and ICC when they were first established – i.e. they loaned to viable sectors where perceived risks or market failures prevented existing commercial banks from venturing. Such an initiative could remain in place for a finite period of time say a specified number of years or perhaps until house prices had shown three consecutive years of growth. The bank would be owned in part by the State and a private sector partner, with a commitment to privatisation once it has achieved its public policy mandate,. An emphasis would need to be placed on creating this bank in a timely manner to ensure that potential obstacles do not make it ultimately redundant. It would compete directly with existing banks but would not inherit any legacy bad mortgages and so would not be burdened by the problems that have arisen due to excessive risk taking in the past or the effects of the fall in prices in recent years. The commercial banks could then either compete with this bank to retain a meaningful share of what is actually the best sector of the mortgage market i.e. borrowers that are not distressed, or they could lose their share as the mortgage bank succeeded. A target is identified that the bank would provide loans in the form of 10,000 mortgages per annum in the first five years worth a total value of €9.5 billion. ***The bank would need finance to get started but would appear to be a very attractive candidate for the use of funds generated from sales of state assets, the partner bank and leveraged with outside funds either from EU sources or international banks***.

NAMA

25. NAMA was established with two objectives: firstly to purge Irish banks' balance sheets of property loans (other than residential mortgages), whose growing impairment was eroding the capital base of banks leading to market concerns about their viability and in consequence banks were finding it increasingly difficult to satisfy liquidity requirements in inter-bank markets. It was expected that the outcome would be to restore banks to a 'business-as-usual' situation in which it would make loans to creditworthy borrowers, in pursuit of growing their businesses. Secondly, through active management of the portfolio of property assets and by overcoming shortcomings in the structures of property developers' businesses and ensuring an appropriate balance sheet structure in relation to the portfolio it would create and realise the potential value of the portfolio for the benefit of the taxpayer.

26. The first objective was not substantially attained, for numerous reasons discussed in the Report, (see Section 6.3). Moreover, at this juncture, it is difficult to disagree with the conclusion of the Comptroller & Auditor General (C& AG) that NAMA faces considerable challenges in achieving its

(current) minimum target to recover at least its outlay and costs from the interim management and ultimate disposal of the loan assets. Its interim target is to reduce its debt by 24% by the end of 2013 with the entire process extending up to 2020 at least.

27. In the light of the circumstances described in paragraph 26 and given the constraints under which NAMA appears now to be working, especially the requirement to reduce loans by 24 per cent by end 2013, against a background where the domestic credit market is not working, ***a better return for the tax payer might be secured by the Government (part) privatising NAMA now, to an international private equity investor or international property investment company or a consortium of such interests. It is recommended that the merits of such a proposal should be examined. It would be consistent with the approach being considered in relation to other State owned assets. As a minimum the Government should undertake a review of the business strategy of NAMA, including the statutory basis on which it is based, to determine if it offers the best prospect of securing the best return for the taxpayer in the longer term.***

Leveraging State Assets

28. Over a year after the McCarthy report on the scope for selling State Assets, it would appear that it will be a further year before any actual sales will be made. ***This is far too slow when the Irish economy is stagnating and where funds could be generated and invested to support growth***. In addition, while it has not been confirmed that any particular projects have been identified for investment it would be very negligent if work in this respect was not progressing and it is essential in terms of forward planning that decisions in this regard are announced as soon as possible. ***There is no need to wait for funds to hit the exchequer for these decisions to be made. Furthermore, the range of assets being considered for sale appears far too limited and largely restricted to some of the semi-state companies. Examination is required of a much wider range. For example, the state is engaged in a number of service-activities that could be licensed. Among these are prison operations, revenue collection and administration of welfare, education and health services. A property right exists in respect of each of these areas while the ownership of the service could continue to reside within the state, a licence to the right to undertake the service could be sold. For example, would it not be possible to licence a private company, for a fee, to collect the new household charge?*** In the area of fixed assets a much wider range should also be considered. ***For example, the state owns large numbers of primary schools. A sale and leaseback arrangement would provide funds that could be invested, in part, in upgrading the schools themselves, thereby addressing a pressing problem of inadequate facilities. Furthermore, there is no clear economic case for the state to continue to own many of the buildings from which government business is conducted and a similar sale and lease back would generate fund for investment.***

29. Indications so far are that sales totalling €3 billion are being considered with 50 per cent of the proceeds becoming available for investment by the Exchequer. However, this should not be considered to be the upper limit on the funds that will be available and options to leverage these funds without incurring additional public debt should be pursued. This could entail greater private sector involvement. To date, PPPs in Ireland have tended to be limited to major infrastructure projects. ***The existing legislation and procedures should be examined to see if there is a constraint to expanding PPPs into other areas of activity where the state's input could be an existing property that should not be sold or a property right to undertake an activity. By entering PPPs, the funds generated from the sale of assets could be leveraged up. So, if there are assets worth €3 billion currently being considered, consideration of a further range of assets such as those alluded to above could increase this to, say, €4 billon. If 50% must be used to reduce debt then it should be possible to leverage the remaining back to at least €4 billion.*** NAMA has recently announced plans to procure €2 billion to allow debtor clients to complete certain construction projects in the period up to 2016. It estimates that this will create 25,000 direct and indirect construction jobs and a further 10,000 indirectly. The use of funds generated from the sale of state assets as outlined here offers the potential of double this, creating 50,000 jobs directly and a further 20,000 indirectly.

30. The potential to create a State Investment Bank should be examined and progressed to provide venture capital for firms. This would have a role even if the flow of credit from banks was not as constrained as is currently the case. Enterprise Ireland have been undertaking a role along these lines for a number of years and this activity should be spun off into a separate entity with public and private

shareholding to act as a source of venture capital. This source of funds would undoubtedly be useful in the current climate, but this entity would also have a long term role in economic development.

31. The potential here is clearly considerable but it needs to be progressed as a matter of urgency. Mind-sets and arguments that point to perceived risks of change or benefits of continuing as is, need to be challenged and constraints on progress, which appears unjustifiably slow, need to be bypassed. The cost of inertia is an economy that continues to stagnate.

Preparing for a change in the EU Policy Stance

32. A National Growth Programme is required to set out and guide how Ireland can best realise the opportunities that are currently available and to prepare for new opportunities such as access to Eurobonds or new spending by the European Investment Bank (EIB), if its role and resources are increased. This Programme should be based in its initial stages on existing capital deficiencies and priorities, identifying how these would be addressed and evaluating the best way to do so. It needs to look beyond current and recent constraints realising that there are opportunities, as identified above and that the situation is changing, in favour of recovery policies at the EU level. Sectors such as green energy and third level education should be prioritised for these funds. ***By doing so, Ireland would be able to move beyond the thinking that has been necessary to manage the crisis created by the mistakes of the last decade and create the basis for recovery into the next decade by building on growth policy approaches that have been shown to work in the past.***

1. Introduction

Since 2008, the economies of most developed countries have lurched from crisis into a period of slow growth or recession. However, as a result of different policy approaches and starting conditions, the impact of this slowdown has differed across countries. The Eurozone has fared poorly in general and some countries including Ireland remain locked in a crisis of falling living standards. Forecasts do not suggest that it is going to get much better any time soon.

The trigger for this slowdown was a financial crisis as asset bubbles that were founded on debt burst in succession. In this regard, the current recession differs from the global slowdown in the 1970s which was mostly the result of factors such as loss of productivity. The solution then was to work harder, to work smarter and gain efficiencies. But in a country such as Ireland, where confidence has been shattered, that approach is inadequate. Achieving balance and stability will not work unless there is a stimulus to act.

Eurozone macroeconomic policy has diverged from that being followed in the USA over recent years but there are signs that the strategy being pursued is being rethought. To what extent does this provide an opportunity for Ireland? And to what extent is Ireland positioned to avail of and realise this opportunity? These are the central questions of this report.

Section 2 provides an overview of the financial crisis as it has developed and its current stage. This is followed in Section 3 by a discussion of the macroeconomic policies that have been followed and shows that the Eurozone policy is neither moderate nor the only option. Section 4 looks at the Irish economy and the policy response in Ireland. It also discusses development in the banks, the reaction of households to the downturn and the housing market. Section 5 shows that a continuation of recent Irish economic policy means consigning the economy to a viscous cycle of decline that will result in a stagnating economy for many more years to come. However, there is an alternative and core elements of this are set out in Section 6. But putting this alternative into action will not be without its difficulties and at all times the costs must be assessed against the benefits in terms of getting the Irish economy back onto a growth path. The final section summarises the recommendations that should be progressed to achieve this objective.

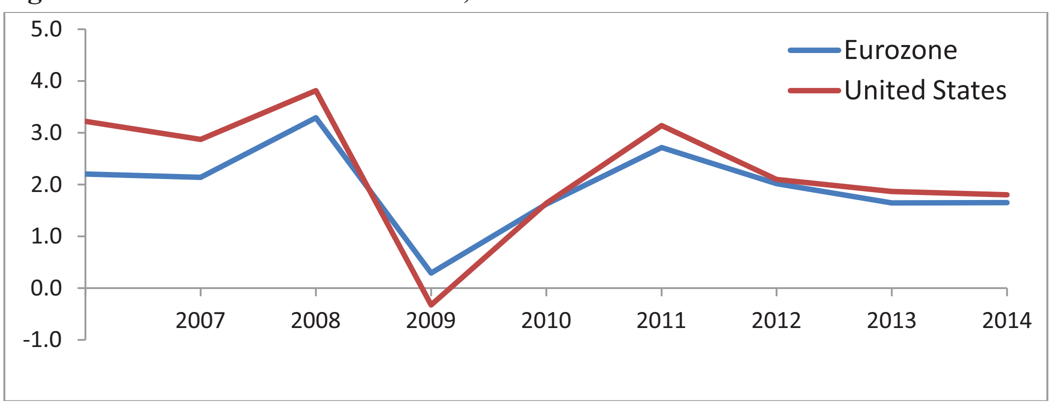
2. The Great Recession

2.1 Overview of Recent Economic Performance

While the recession has been particularly severe and persistent in Ireland, it has occurred in the context of a general slowdown in almost all developed economies that was triggered by the financial crisis of late 2008 but that has its roots in the debt fuelled growth of previous years. This section provides the economic background to Ireland's performance by providing an overview of the 'Great Recession' and its aftermath. It also provides the context for the discussion of the various policy responses that have been applied at the level of regional economic blocks.

Western economies went through a period of high and fairly stable growth that ended in 2008. While this ended suddenly in a severe credit crunch, the impact of this phase on economic growth was over within about a year. We can see this in Figure 2.1 using real GDP growth in the two largest economic groupings – the USA and the Eurozone – to represent developments.

Figure 2.1: Economic Growth Rates, 2006 to 2014



Source: IMF World Economic Outlook April 2012. Values for 2012-14 are IMF forecasts

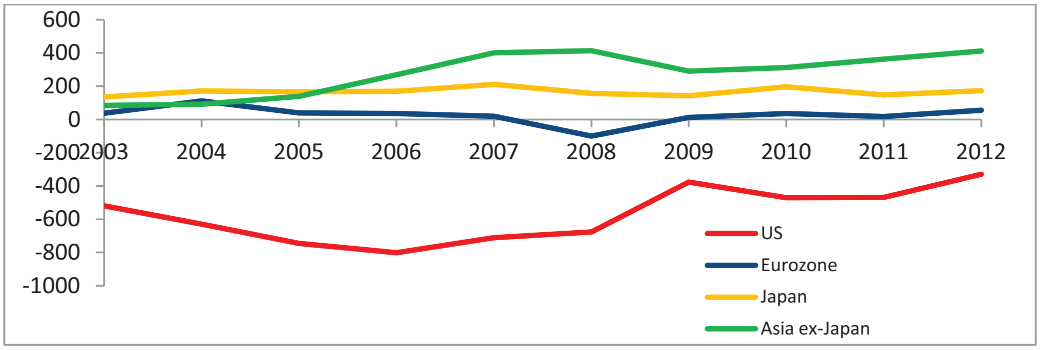
The credit crunch which was triggered by the sub-prime crisis in the USA resulted in a very sharp fall in economic performance and recession in 2009. However, growth had resumed by 2010 and returned almost to its earlier rates last year. The latest IMF estimates and forecasts for 2012 to 2014 published in April 2012 show growth continuing but at a lower level than 2011 or 2008[1].

The years since 2008 have seen deleveraging in the private sector and deflation in many economies. However, as shown in Section 3 below, the superior economic growth performance in the USA has coincided to a considerable extent with the application of aggressively loose monetary and fiscal policies which were implemented there from 2008, to get the economy back to growth rapidly. The ECB has also acted but as shown in Section 3, the response has generally lagged that of the USA in timeliness and on a number of occasions and most notably through much of 2011 has taken a different direction.

[1] The data in this section are mostly taken from the Statistical Annex of IMF (2012) *World Economic Outlook April 2012: Growth Resuming, Dangers Remain*

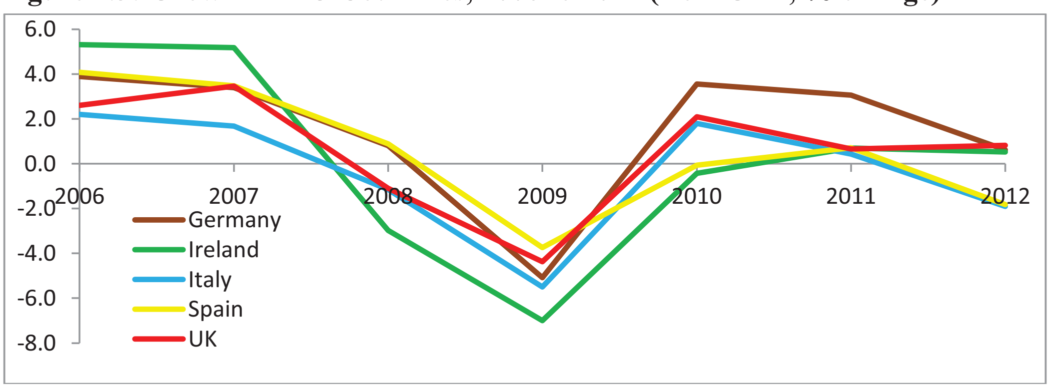
The aggregate picture of the Eurozone hides important differences between the various member states. The build-up of debt in the USA was – and continues to be – financed to an extent by Asia, but expansion of debt in the Eurozone was much more dependent on internal rather than external sources. We can see this in Figure 2.2 which shows a large current account deficit for the USA and surplus for Asia, principally China. Since the capital account must balance the current account – we must get money to finance our purchases if they exceed our earnings – then the big surplus on the USA capital account is primarily borrowings from Asia where savings remain high.

Figure 2.2: Current Accounts, 2003 to 2012 (US$ billions)



One result of this internal financing within the Eurozone is that the repayment of debt is having different effects on different countries i.e. the borrowers must transfer funds to the lenders. This means that efforts to balance budgets while in recession places a greater adjustment on countries holding debts than on creditor countries. One reflection of this has been that, as shown in Figure 2.3, high debt Eurozone countries such as Ireland, Italy and Spain have been growing more slowly than Germany. However, this chart also shows that as a result of ongoing crisis in the Eurozone, the growth rate in Germany is forecast to fall this year.

Figure 2.3: Growth in EU Countries, 2006 to 2012 (Real GDP, % change)

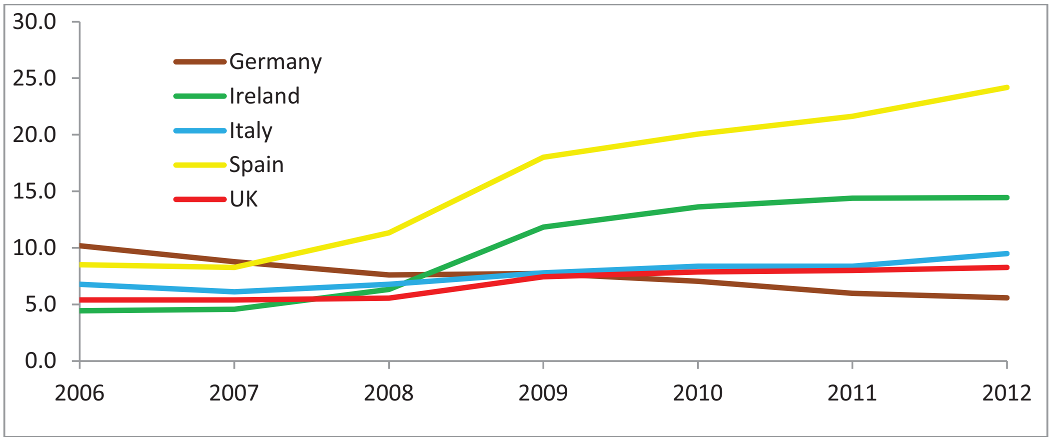


Source: IMF World Economic Outlook April 2012.

This chart shows the lowest growth in the most deeply indebted countries but the fastest recovery from the crisis in Germany, and in the UK which acted more in line with the policy response of the USA than the Eurozone.

The impact of these differences is magnified when cutbacks create fears in consumers and households, one of the greatest fears being the threat of unemployment. As figure 2.4 shows, high rates of unemployment and rapid growth of unemployment is also a feature of these high debt countries.

Figure 2.4: Unemployment in EU Countries, 2006 to 2012



Source: IMF World Economic Outlook April 2012.

Populations generally perceive and accept that debts must be repaid – a capitalist economy could not function otherwise – and understand the financial implications of this. However, the psychological implications of a combination of high debt and the actions required to repay this debt, namely rising unemployment and falling employment and low growth, present serious issues that go beyond financial accounting. At the extreme these can be manifest in a withdrawal of support for the legitimacy of government and the 'system' and there is evidence of this in the more seriously affected countries in Europe and among the more radicalised parts of the population. However, we need not argue the case that these are important issues on the basis of extreme situations. The problem is that for the majority of people in the majority of situations the normal reaction is to feel insecure in these situations. This quickly leads to cautious economic behaviour – increased savings, deleveraging debt, less economic risk taking, and lower investment. This is so even though the greatest opportunities for gains usually accrue to those who act at the bottom of the economic cycle. However, the responses alluded to make the economic situation worse leading to a further intensification of fear. This is market failure on a grand scale, a macroeconomic market failure. And a resolution will not organically emerge from within the market unless action is taken to reverse the slide.

2.2 Perspective on the Nature of Economic Cycles

The global economic problems of recent years were not caused by low growth or some form of loss of competitiveness or productivity. Instead they are a reaction to excessively high growth rates in the previous period and the factors which underpinned it, notably unsustainable public sector borrowing and household indebtedness. All debt must ultimately be repaid in some form, but not always by the borrower. If a loan goes into default then it must be paid out of the equity of the lender, unless it can be transferred to some other entity as happens in the case of a bail-out. This means that a boom founded on increasing debt can only continue as long as lenders perceive that they are likely to be repaid. By definition, a debt must be balanced by savings somewhere else in the system. The debt boom that ended in 2007-08 was mostly financed by savings from the developing economies, principally China, but there are also other important financial flows at sub-regional levels such as the flows of funds from German banks to the Eurozone periphery.

However, if a situation arises where lending growth stops and is retracted – which essentially is what has happened from 2008 – there are several reasons why the economic growth rate will not simply return to its long term trend. Firstly, the availability of credit is likely to contract below what is required for stable growth. In the absence of additional problems this should be fairly short term and as opportunities arise the flow of credit should resume. Growth will be lower than previously but this does not imply a recession, much less a prolonged period of crisis. Secondly, once the exuberance of a growth phase has passed the debts that were accumulated in that period will need to be repaid. Thus, economic growth will be suppressed in debtor economies save to repay debts accumulated during the growth phase. Thus, we expect a period when real growth is suppressed as the imbalances created during expansion are worked off. If a recession ensues such that the economy is shrinking in size then this burden can grow even if the nominal debt is not growing. This process can take a number of years, but it can be assessed in financial terms and solutions adopted to promote the speed of adjustment. This is essentially the thinking behind an arrangement such as the IMF-EU bailout in Ireland. The bailout amounts to a process of giving the country more time than markets would allow to work through its adjustment. In effect by increasing national savings and allowing deficits to be reduced to a level that would once again make it attractive for commercial credit providers to lend, i.e. reduce bond yields.

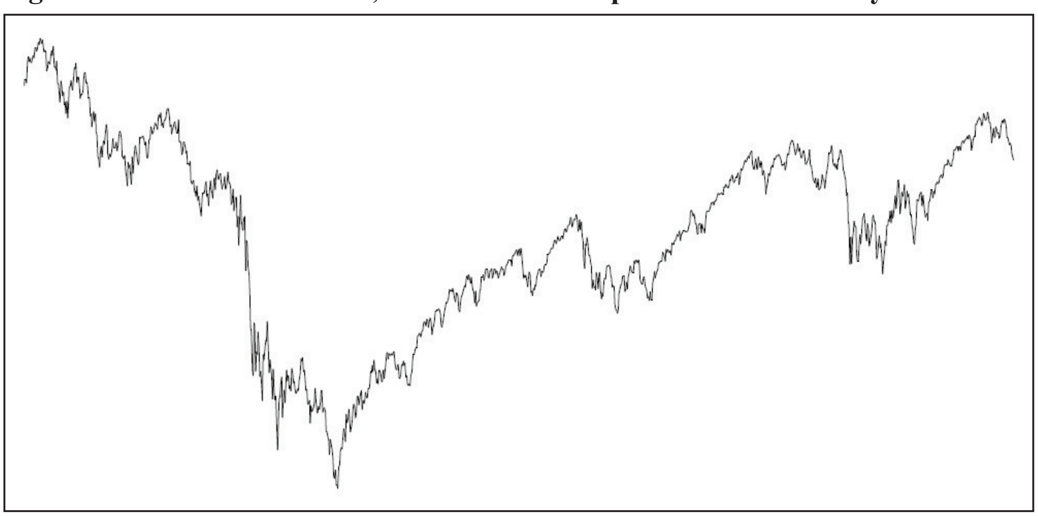
However, there is a third process at work that is much harder to capture in terms of financial projections because its characteristics are psychological. We can capture this idea in the word ‘uncertainty’ or ‘fear’ when it becomes intense. Uncertainty can be thought of as that part of the unknown that we cannot assess reliably. The part that can be assessed reliably – at least, in the aggregate – is usually described as ‘risk’. Perceptions concerning the relative importance of risk and uncertainty can change. In boom times, risk tends to dominate, in other words, people act as though they can accurately assess the future and therefore act positively. However, in recessionary times, uncertainty comes to the fore and people act cautiously. As a result, even if credit becomes available again and even if the need to repay debts is manageable, a lack of confidence can work to reinforce and impose requirements to change behaviour leading to an over-reaction. We see this manifested in recessions in the form of higher savings, lower investment, deflation, rising interest rates – unless the monetary authorities act to provide liquidity – and a self-reinforcing pessimism that can lead to a viscous circle as the economy shrinks further. There is nothing new in this and it underlies the well observed economic cycles that have always been a feature of market economies. It is also known that these cycles can reduce the trend rate of growth. Getting away from these was a central objective of the policy prescriptions developed by Keynes almost ninety years ago and the idea can also be seen in the increased independence given to Central Banks in recent decades.

2.3 The View from the Markets

Developments in financial markets provide a useful picture of economic developments over the period under consideration. Stock markets do not always react in line with actual economic performance and can be considerably more volatile than the economy in general, but a chart of stock market prices does show what investors think was happening and what was likely to happen at any point in time. In this sense, it is an unbiased representation of opinions and these opinions are based on the available information. Of course, this does not mean that these opinions are correct. Not only might the available information be incomplete but it might not be correctly interpreted, and investors are just as liable to biases in their expectations as the population in general.

Figure 2.5 shows the S&P 500 over the period September 2007 to the present (May 2011) The S&P 500 is an index of the stock market prices of the 500 companies that are considered to best represent the economic performance of the US economy. The US had experienced a housing market bubble just like many other developed countries but US house prices had started to ease from the summer of 2006. However, the wider US economy continued to perform well for about a further year. As the chart shows, the stock market began to react to weakening economic data during the last few months of 2007 with the S&P500 having peaked at a value of 1576 in early October.

Figure 2.5: US Stock Market, S&P500 Index September 2007 to May 2012



At first the decline was fairly normal – if unpleasant for investors – so that by September 2008 prices, at 1250 on the S&P index, were at about the same level as they had been in the first half of 2006. The fall of 20% up to that point was clearly a recognition that the market had gone too far too fast but the severity of the downturn that had begun was not appreciated. Then the crisis began to unfold rapidly and the market plunged following the collapse of Lehmann Brothers reaching a low of 667 in March 2009, a fall of 58% from its peak. An over-reaction is a typical response to either bad or good events and while the exuberant peak of 2007 was an overreaction on the upside, so too the low in March 2009 was an over-reaction to the downside. Soon thereafter the market began to recover and, despite a sharp fall in August 2011 it reached a high of 1422 in April this year. In other words, it recovered to about 90% of its pre-crash value before easing back a little over recent weeks.

This provides a useful picture of developments in the US economy – an initial reaction to a shock followed by a recovery that continues, albeit a little fragile at present. However, stock-market indices in respect of the Eurozone economy show a rather different picture. If the STOXX Europe 600 Index is used to represent stock markets in the Eurozone, the data show European stock markets peaking in June 2007 with this index at 400. Thereafter, it was a similar picture to the USA with a crash to a low of 160 in March 2009, a fall of 60%. As in the USA, the market then began to recover but the recovery halted in February 2011 at 292, 73% of the 2007 high. Since then performance has diverged from the US market and the index is currently back around 241, 60% of the peak. This performance shows that while there were common initial triggers to the declines, Eurozone performance since the beginning of 2011 has fallen markedly behind that of the USA, due to internal problems of the Eurozone and the failure of policy makers to deal effectively with these.

3. The Policy Response

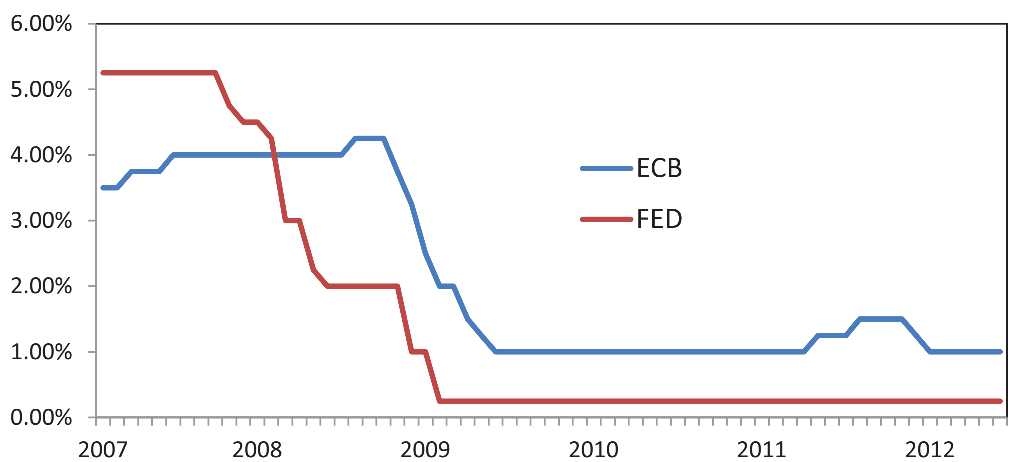
3.1 Monetary Policy

The story so far is that a financial crisis inevitably led to an economic slowdown, initially as credit became scarcer, but then because debts needed to be repaid. However, when these responses are combined with the psychological impact on households of economic uncertainty and reduced security, financial difficulties can result in serious problems for the real economy.

The first two stages above are unavoidable although there are measures such as liquidity and restructuring that can ease their impact. It is worth seeing how policy makers responded to the issues. Since the initial problem was financial the first reaction was in the area of monetary policy.

Figure 3.1 uses changes in official interest rates to reflect monetary policy in the Eurozone and in the USA in the wake of the 2008 crisis. What matters in this graph is not the relative magnitude of the two interest rates, as their definitions differ, but the policy changes that have occurred. The chart shows that the Federal Reserve in the USA acted far more aggressively than the ECB to lower interest rates when the 2008 crisis hit. The Fed rate was lowered progressively from late 2007 and throughout 2008 to reach 0 to 0.25% in early 2009, as inflation in the area fell well below the target level of 2%. It has been maintained at this level since then.

Figure 3.1: ECB and Fed Interest Rates, January 2007 to May 2012

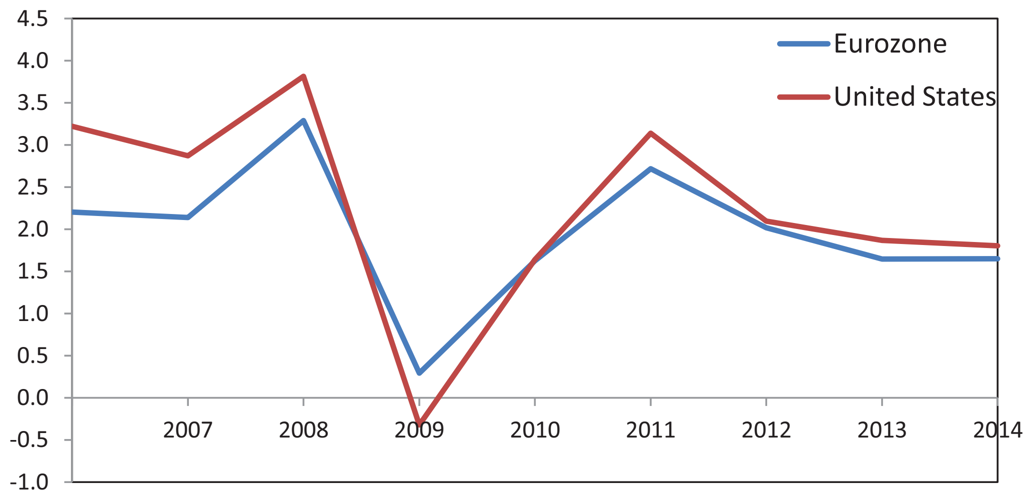


Note: The rates used in this chart are the Fed Funds Discount Rate and the ECB Discount Rate

In contrast the ECB actually raised its interest rates in 2007 and again in late 2008 before also engaging in a steady fall during the early part of 2009. Apart from the difficult to understand decision to raise rates during the first half of 2011 – a decision that was reversed in November and December 2012 – the ECB has maintained its discount rate at 1% since mid-2009. In summary, the ECB followed a more restrictive policy emphasising a concern to control inflation, while the US Fed followed a very loose monetary policy in the hope of stimulating the economy.

However, this does not capture the whole story as the Fed during this period has pumped liquidity into the financial system of the USA through its programmes known as 'Quantitative Easing'. This amounts to initiatives to increase the money supply. The danger of this policy, and the rationale put forward for why the ECB has not done likewise, is that it has potentially inflationary consequences. Put simply, if the money supply grows at a faster rate than the rate of economic growth in an economy then the difference between the two rates will eventually translate into inflation. However, when we compare inflation in the USA and in the Eurozone in recent years, as is done in Figure 3.2, we see little sign of this occurring to date or envisaged in the latest IMF short-term economic forecasts.

Figure 3.2: Eurozone and US Inflation Rates, 2006 to 2014

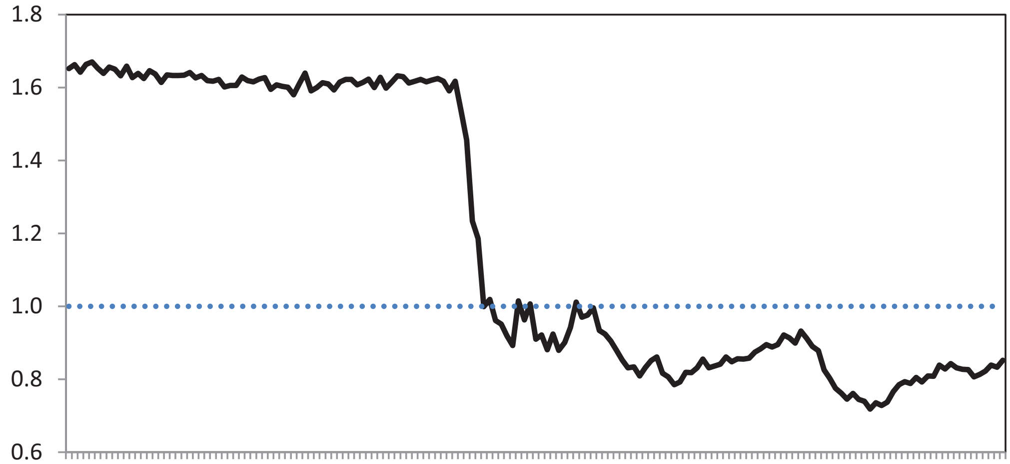


Source: IMF World Economic Outlook April 2012. Values for 2012-14 are IMF forecasts

The reason why we are not seeing inflation is that the money supply depends not just on the actions of the Central Bank but also on the banking system in aggregate. In a properly functioning economy the process of banks lending to customers and taking deposits enhances the impact of any increase in the liquidity that is supplied by the Central Bank. The relationship between the impact of the Bank and the ultimate impact on the money supply in the economy is known as the money multiplier. We would typically expect this to exceed a value of 1 but this has not been the case in the USA in recent years, (Figure 3.3).

The money multiplier in the USA fell sharply during the 2008 credit crisis and has remained below 1 more or less since then. Thus, while the Fed has been pumping liquidity into the financial system of the USA the impact on the economy is lower than might be expected both in terms of stimulating demand and inflation. However, banks in the USA have been able to move back to profitability and ensure there is less risk of a repeat of the 2008 financial crisis by having an adequate supply of funds at low interest rates.

Figure 3.3: US Money Multiplier, 2006 to 2012

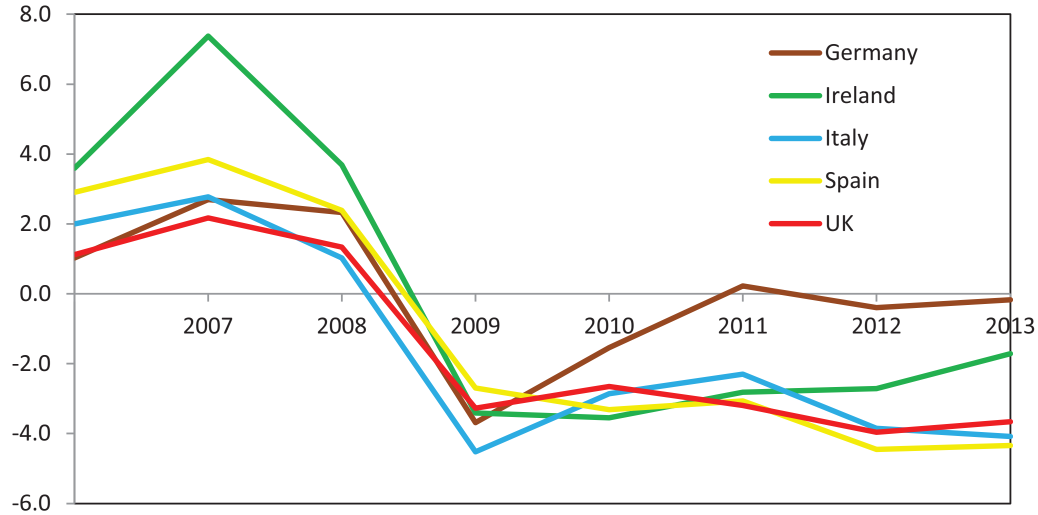


The policy of the ECB during most of this period stands in considerable contrast. This is not totally unexpected given the strong mandate of the ECB to protect the currency – a mandate that it has interpreted as targeting an annual rate of inflation of 2% for the currency area – unlike the mandate of the Fed in the USA, which includes promoting economic growth as well as controlling inflation among its objectives. While interest rates have been lowered the ECB refused to engage in similar liquidity operations in the Eurozone up until late 2011 but has, since then, begun to supply funds at low interest rates to the banks under its LTRO (long term refinancing operation) programme. So far, the experience would appear to be similar to the USA with banks taking the funds but not increasing lending, although it is too early yet to draw any firm conclusions. What is clear, though, is that the ECB has been much slower to adopt supportive economic policies compared with the Fed – but at least it now appears to recognise that such polices can play a role.

3.2 Fiscal Policy

The lack of a policy response in Europe is far more pronounced in the case of fiscal policy. It's not as though there is no case for a response, as the size of the output gaps shown in Figure 3.4 indicate. The output gap is a measure of the difference in percentage terms between actual output (GDP) in an economy and its potential output. Therefore, countries with large output gaps are performing well below their long term growth potential. A large output gap is also often associated with deflation and stagnation if it persists over a number of years.

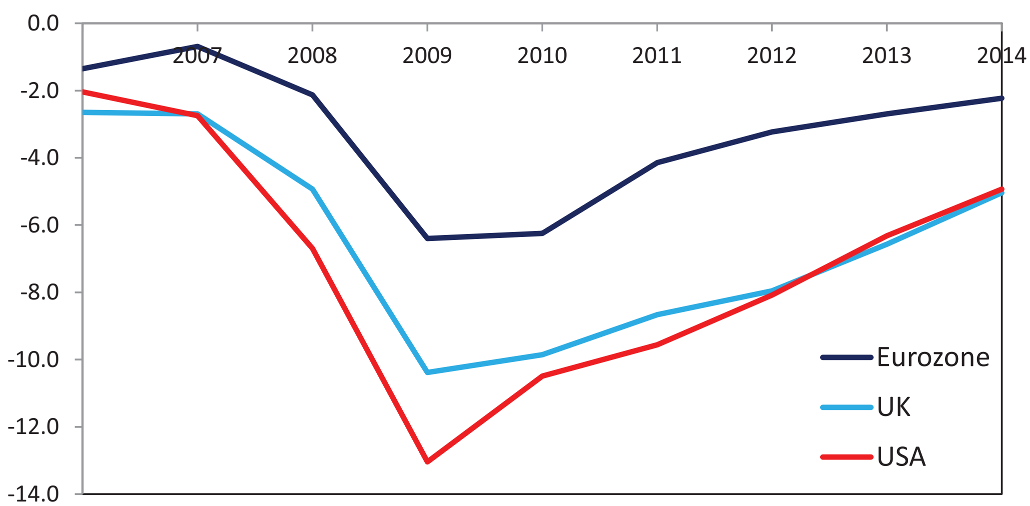
Figure 3.4: Output Gap in EU Countries, 2006 to 2013



Source: IMF World Economic Outlook April 2012. Values for 2012-13 are IMF forecasts

The contrast between the fiscal response of the Eurozone and the USA to the financial crisis is seen very clearly in Figure 3.5. The USA, and the UK, responded with an aggressive expansionary fiscal policy to support economic growth, manifested in widening of the fiscal deficit as a proportion of GDP. As we saw earlier, these responses were unable to address all of the immediate impacts of the financial crisis but they played a role in getting the economies growing again. Arguably, given the issue of the very low money multiplier in the USA, it is this fiscal response rather than the aggressive action of the Fed that was more responsible for recovery.

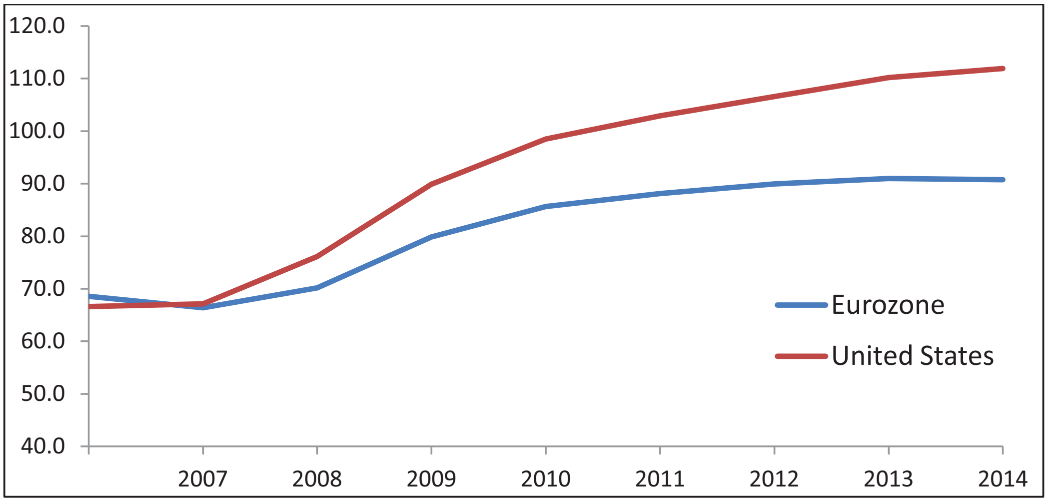
Figure 3.5: European and US Fiscal Deficits, 2006 to 2014 (% of GDP)



Source: IMF World Economic Outlook April 2012. Values for 2012-14 are IMF forecasts

In contrast, the Eurozone as a whole responded much less on the fiscal front, despite the fact that the national budgets of a number of member states slipped into deficit. However, this was probably due more to an automatic response to a slowdown, as tax revenues fell and welfare payments rose, rather than a targeted policy response, let alone a co-ordinated response to address the asymmetric impacts of the slowdown as we discussed above. This difference in response might be understandable if there was a higher rate of public sector indebtedness in Europe. However, as shown in Figure 3.6, gross debt of general government as a percentage of GDP is higher in the USA than for the aggregate of Eurozone countries.

Figure 3.6: Eurozone and US Government Debt, 2006 to 2014 (% of GDP)



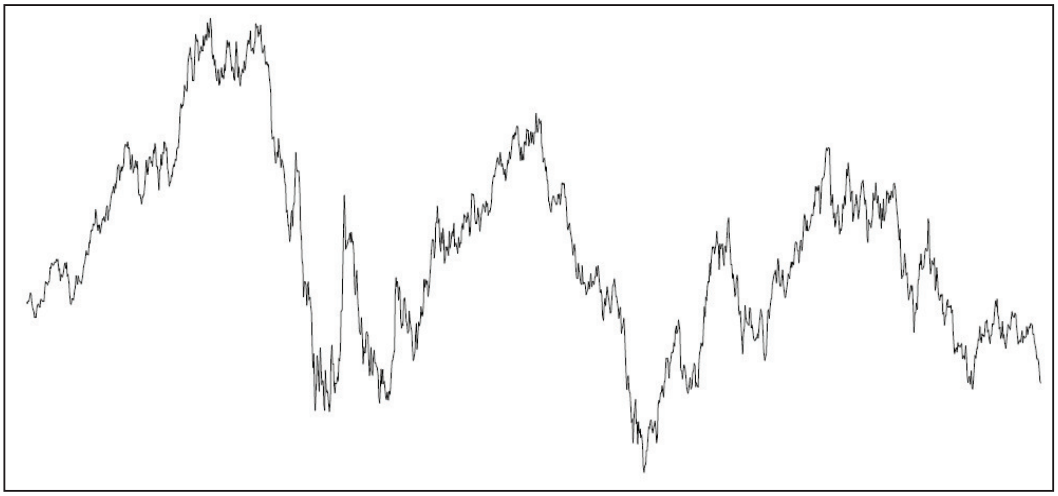
Source: IMF World Economic Outlook April 2012. Values for 2012-14 are IMF forecasts

In summary, while there is a sovereign debt crisis in the Eurozone at the level of individual countries – just as some states within the USA have serious budgetary problems – the situation at the aggregate, or Federal level, which is what ultimately matters for the Euro and the level where the monetary policies of the ECB are implemented, is actually better in the Eurozone than in the USA. This means that despite greater latitude at the EU level to loosen budgetary constraints, even though such options are much more restricted at the national level in certain member States, the EU response overall has been very cautious. In this it mirrors the more restrictive approach of the ECB in respect of monetary policy.

3.3 Protecting the Euro

The extent to which Eurozone economic policy has concentrated on protecting the value of the Euro rather than the performance of Eurozone economies is reflected in the performance of the Euro on foreign exchange markets. We saw earlier that the US stock market recovered much more strongly following the 2008 crash than was the case in Europe. To the extent that this indicates relative weakness in the Eurozone, one would expect a relatively weak Euro. However, this has not been the case even given the widely expressed fears about the medium to long term viability of the currency and seemingly endless stream of bad economic news from successive member states, (Figure 3.7). After reaching a high of about $1.60 in the first half of 2008, the Euro fell sharply against the US dollar as investors fled from risk as the financial crisis hit. It briefly went below $1.24 but recovered as the stock market did from March 2009. Apart from a fairly brief excursion back to and below these levels during mid-2010, as the problems in the Greek economy began to emerge, the Euro has generally stayed well above its low following the 2008 crash in subsequent years.

Figure 3.7: Euro-US$ Exchange Rate June 2007 to May 2012



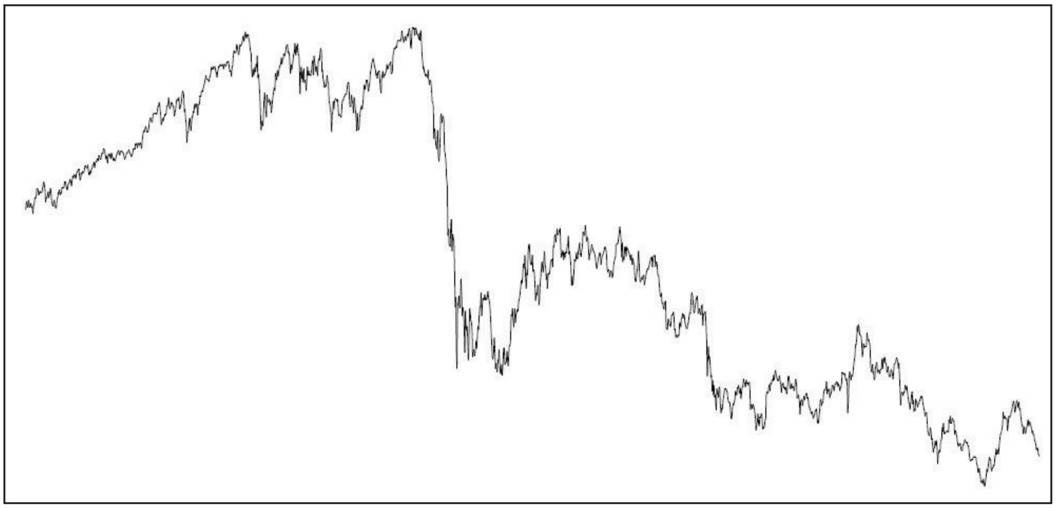
If we were to extend the period covered in the chart it would also show that, since the crash, the Euro has traded either in or above the range where it traded against the US$ during the boom period of 2003-07, which was itself well above its value in the years following its launch. On first look this appears contradictory: why should a currency beset with such problems as the Euro be valued more highly relative to a currency valued for its stability such as the US$ during a period of economic crisis than was the case during the years when economic crisis was well off the radar?

The answer lies in the respective economic policies that have been followed by Central Banks in the two currency areas. Foreign exchange prices are a reflection of a complex array of factors but obey one basic law: they react to relative supply and demand. Without wishing to be overly simplistic, the demand for a currency can be thought of as a reflection of investors' confidence in the economy. The supply can be thought of as responding to policy decisions by the relevant monetary authorities i.e. the Central Banks. Of course, the market is more complex than this but adopting this simple approach can help in understanding exchange rate trends and permits insights into their relative economic performances. A result of these policy differences, apart altogether from the fact that there may be an impending funding crisis in European banks, is that the weak demand for the Euro that would result from the weak economic performance in the Eurozone has been matched by tight supply of the currency. In contrast, the relatively stronger demand that would be expected for the US$ due to a return to growth there has been counteracted by strong monetary supply actions by the Fed so that the Euro has generally maintained its strength against the US$.

We see a similar picture when we look at the Euro against sterling. In the UK, the Bank of England has also followed a much looser monetary policy than the ECB in order to support the economy so that for most of the period the Euro has remained fairly steady against the UK£ despite all the problems.

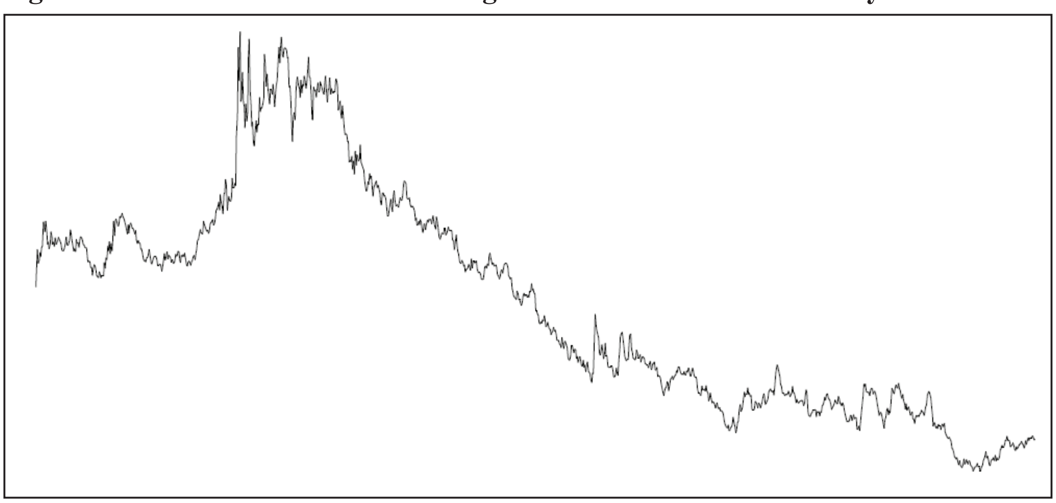
However, when we look at the currencies of countries where such loose policies were not maintained during this period we get a clearer picture of the underlying weakness of the Eurozone. Figure 3.8 shows the value of the Euro against the Japanese Yen since 2007. The Yen is often seen as a safe haven for USA investors and tends to rise during period of economic crisis. The chart shows that the Euro, which had risen to about 170 Yen in the early part of 2007, maintained this level until August 2008 before falling sharply to almost 110 as the crisis unfolded in the USA. However, despite bouncing in early 2009 to almost 140 it has been unable to maintain this level and fell to below 100 earlier this year.

Figure 3.8: Euro-Yen Exchange Rate March 2006 to May 2012



A similar picture emerges for the Euro against the Swiss franc which is often seen as a safe haven, despite the fact that the Swiss National Bank pursued an active policy of trying to weaken the franc throughout 2011. The picture is even clearer in the case of the Euro against Australian dollar, (Figure 3.9).

Figure 3.9: Euro-Australian$ Exchange Rate December 2007 to May 2012



The Royal Bank of Australia has maintained a fairly tight control on monetary policy in recent years given that the economy was performing fairly well for most of the period. Much of this performance relied on strong demand for commodities, particularly from Asia. However, the economic crisis in late 2008 indicated that economic growth and therefore demand for commodities would be lower in the future and the Aus$ fell sharply against all currencies including the Euro. At the start of

2009 the Euro was trading at about Aus$2. However, as the Eurozone economy stagnated, it fell against the Aus$ to close to 1.22 earlier this year.

These charts and this discussion show that despite all the negative news about the Euro, it has stayed fairly stable against many currencies. However, this is more a result of the tight monetary policy pursued by the ECB relative to authorities in the USA and UK. When compared to other countries such Australia that have not needed to act to stimulate their economies we see that the Euro has fallen consistently and this is a better indication of the actual economic performance of the Eurozone economies.

3.4 Stimulus, Stability and Sustainability

The policy response in the USA has emphasised stimulus over stability, in contrast to what we have seen in Europe. But how sustainable is either response? We saw above that the monetary and fiscal stimulus that has been provided in the USA is potentially inflationary. That this has not triggered inflation to date is due to the fact that there is still considerable spare capacity in the US economy, which is itself in part a consequence of the very low money multiplier. We can characterise the process in the USA, as it has operated over the past three to four years as follows. The USA government runs a deficit in order to stimulate growth. It needs to fund this deficit by issuing Treasury bonds. These are purchased by savings flowing in from Asia but the recession in the USA, by suppressing consumer demand, has reduced the USA current account deficit. As a result, the capital account surplus, i.e. net money inflows, has also fallen so that domestic sources of funds are needed. The USA Fed has provided high liquidity to the domestic banks i.e. money lent at low interest rates. The banks have used this, not to lend to 'real economy' investors, but to buy the Treasury bonds. This is profitable since the bond yield, while historically low, exceeds the Fed funds rate. It is also very low risk as the USA Government can always redeem the bonds and there is no currency risk as both the loans and bonds are denominated in US dollars. If the economy picks up such that the banks would prefer to lend to higher return borrowers in the private sector then this would mean that the US deficit would also likely fall as the stimulus could be withdrawn.

The big danger, of course, is inflation. If the economy picks up then so too will the money multiplier and quantity theory leads us to expect that an increase in the money supply in excess of the growth of output will eventually be reflected in inflation. The gamble is that the Fed and the Treasury will both withdraw the stimulus in time to head off such inflationary pressures.

Inflation can be seen as a tax or, perhaps more meaningfully, an alternative to tax or expenditure cuts. While usually thought of as an increase in prices, inflation is more usefully defined as a fall in the value of money. Fiat money is a liability of the issuing authority, usually a Central bank under the ownership of the Government although the legal status of the Federal Reserve in the USA is more complex. Therefore, for any nominal amount of public debt, inflation reduces its real value. In effect, while a stability programme focuses on reducing debt by reducing the deficits that lead to debt, an inflationary programme aims to allow short term deficits that will be eliminated by growth in the medium term with the debt reduced in effect by inflation.

The USA authorities may be able to accomplish this, but there is a further over-riding issue. History is not without examples of debt crises caused by excessive public deficits. That a sizeable part of the USA deficit has its origin in private deficits is immaterial as the stimulus deficits, along with programmes such as the TARP in the immediate aftermath of the credit crunch, can be seen as a means of translating these into public liabilities. Similar processes have been seen in other countries with bank nationalisations/bailouts and public deficits. When we look at historical examples of public debt crises, we see that many were resolved, not by big increases in taxes or reductions in expenditure, but by inflation. We can see examples of this throughout history. For example, the Roman Emperors, even the very best ones, ran into many problems of inflation as they expanded the money supply to pay the troops that were engaged in military conquests[2]. The Silver denarius, which had been introduced by Augustus as the basic coinage at the end of the 1st century BC, was initially 95% silver. Trajan reduced this to 85% in 117AD, Marcus Aurelius to 75% in 180AD and by the time of Caracalla in 217AD it was only 50%. The consequences of inflation in this period have been identified as one of the contributory factors leading to the 'crisis of the 3rd century' when Roman power and legitimacy transferred to the military and a succession of short-lived emperors[3].

A well known example from history occurred during the reign of Henry VIII. Henry attacked France in 1542 partly in response to a growing alliance between France and Scotland. Within two years he was fighting with two armies one against France and one against Scotland. While he had military successes on both fronts he had to withdraw from France due to a lack of money to finance the war. Neither campaign produced any long-term gains but the cost of the wars, estimated at about £3 million, almost bankrupted the crown. He attempted to finance the costs initially by selling assets and by big tax increases, but failed. This led to a currency debasement and English currency, which up until then was made of valuable metals, principally gold and silver, so that the face value was approximately the same as the inherent value of the metal, was replaced by a mixture of silver and copper. Fairly soon the silver content had fallen to less than 50%. In other words, the value of the currency had fallen by 50%. This led to rampant inflation that was only eliminated in the 1560s after the debased coins were fully withdrawn from circulation in 1562. Again, the public debt crisis had been resolved by inflation.

---

[2] Edward Gibbon, author of "*Decline and Fall of the Roman Empire*" (1776-89), wrote that "If a man were called to fix the period in the history of the world during which the condition of the human race was most happy and prosperous, he would, without hesitation, name that which elapsed from the death of Domitian to the accession of Commodus." This was in the second century AD, when Rome's "five good emperors" – Nerva, Trajan, Hadrian, Antoninus Pius and Marcus Aurelius – brought a stability that Gibbon believed western Europe would never see again. It was also the period that saw the maximum extension of the Roman Empire under Trajan. However, these conquests and the demand for resources to protect the empire from invaders, particularly during the reign of Marcus Aurelius, led to regular bouts of inflation as the Emperors failed to perceive the link between minting coins to pay the army and inflation.

[3] Joseph Peden (1984) "Inflation and the Fall of the Roman Empire," Seminar on Money and Government, Houston. Of 26 recognised Roman emperors in the 3rd century, all came from a military background and only one managed to survive long enough to die of a natural death.

We also see a much more recent example in the 1970s when the stimulus provided to the USA economy by the need to finance the Vietnam War led to inflation, which was transmitted to European countries through overly generous welfare states – relative to productivity – and oil price increases. Europe was unable to resist these inflationary forces even though it went into the crisis with economies that were mostly in a fairly healthy state, apart from the UK and inflation was worst there.

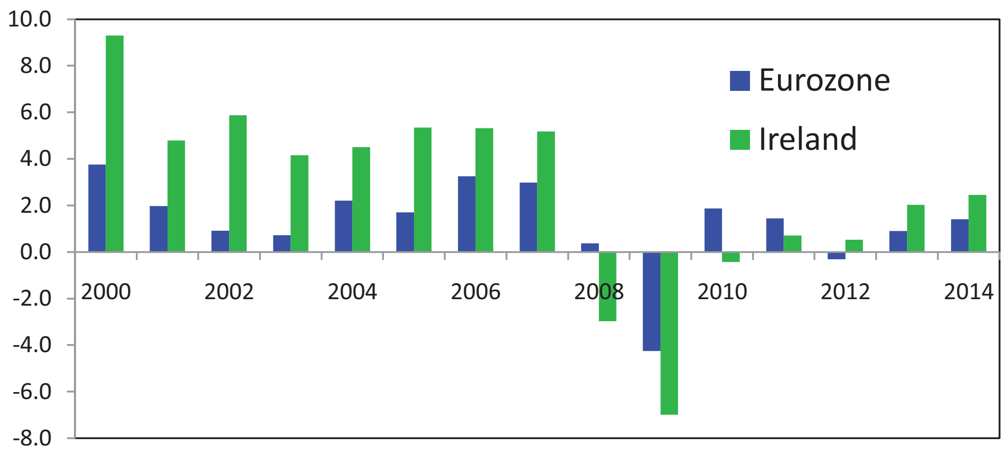
So what does this imply for the sustainability of current policies? We have noted the gamble that the USA is taking. The European emphasis on stability may be required again to resist inflationary pressures from the USA or from a shock such as another oil price increase. The question then is whether the Eurozone, given that it could face this problem with a much weakened – perhaps stagnating – economy, would have the strength to resist such inflationary pressures as they would almost certainly imply a tightening of monetary policy, higher interest rates an even tighter controls on Governments' budgets. Therefore, while the sustainability of the USA policy approach can be questioned, so too can that of the Eurozone.

4. Ireland's Economic Challenge

4.1 Economic Performance

No-one needs reminding that the Irish economy has suffered badly in recent years. The magnitude of the impact of the recession on Ireland can be seen from Figure 4.1 which shows Irish and Eurozone GDP growth since 2000. While recognising that GDP can overstate the actual domestic performance of the Irish economy, the change in performance after 2007 was dramatic and a return to growth of about 4% - which would be consistent with stable, low unemployment in the long run – is not expected within the forecasting period[4].

Figure 4.1: Economic Growth Rates, Real GDP, 2000 to 2014



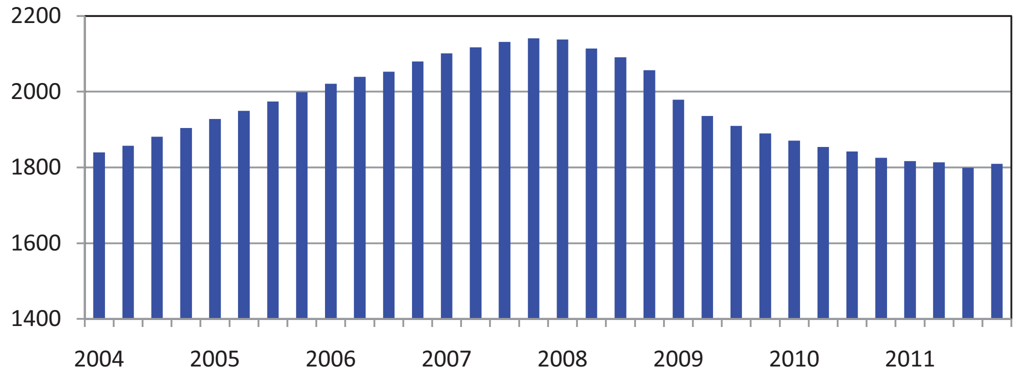
Source: IMF World Economic Outlook April 2012. Values for 2012-14 are IMF forecasts

CSO data show that Irish GDP, which peaked at €190 billion in 2007 fell to €156 billion in 2010 while GNP fell from €156 billion to €129 billion. In real terms, GDP fell by over 10% by 2010. Latest forecasts from the ESRI and others point to low positive growth, below 1%, for 2012 and a similar outcome in 2013.

The impact on the labour market has been even more pronounced. Figure 2.4 above showed Irish unemployment has risen to 14.5% and while the IMF forecasts indicate a levelling off at this rate it is not expected to fall back below 10% for more than five years, at least. While unemployment is an important metric, history shows that it is not that well correlated with growth in the economy and employment is a better indicator of labour market performance. Employment in Ireland grew steadily up until mid-2007 when it reached 2.15 million. It then fall very sharply, and reached 1.8 million in late 2011. This amounts to a fall of just over 16% of those employed in 2007, (Figure 4.2).

[4] The IMF forecast covers the period up to 2017 and it sees Irish growth levelling off below 3%. This is above the medium term Eurozone forecast of 1.7%, similar to the UK forecast and below the forecast of 3.3% for the US.

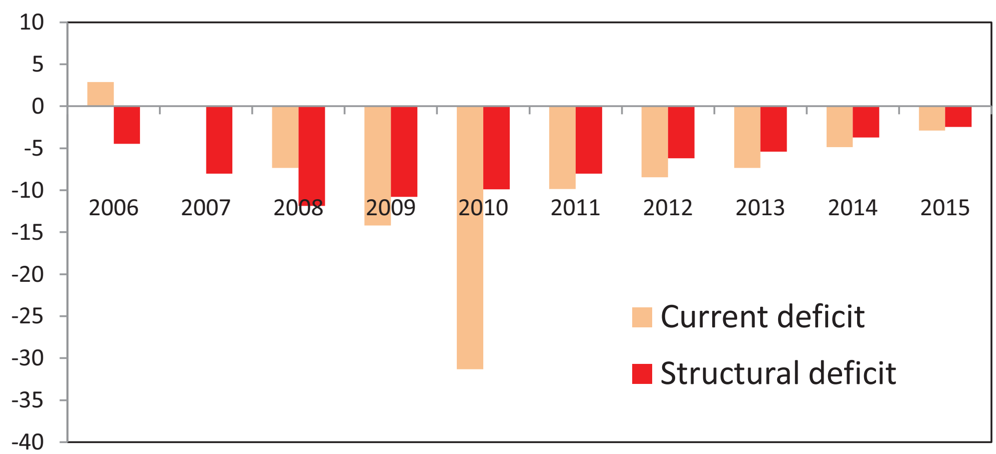
Figure 4.2: Employment in Ireland, Q1 2004 to Q4 2011



Source: CSO Quarterly National Household Survey (seasonally adjusted data)

However, it is the impact of the recession on the public finances that has driven economic policy in this period. Figure 4.3 shows the balance on the Central Government account as measured by the IMF[5]. This shows that a small surplus that had been achieved in the boom years – apart from 2002 – disappeared in 2007 and turned into a rapidly rising deficit. The 2010 figure is exceptionally large due to the cost of recapitalising the banks. The data cover the period of the IMF-EU bailout agreement and show the current deficit falling to below 3% in 2015. Of course, the policies still have to be implemented in order for this to be achieved.

Figure 4.3: Ireland's Current and Structural Deficit, 2006 to 2015 (% of GDP)



Source: IMF World Economic Outlook April 2012. Values for 2012-15 are IMF forecasts

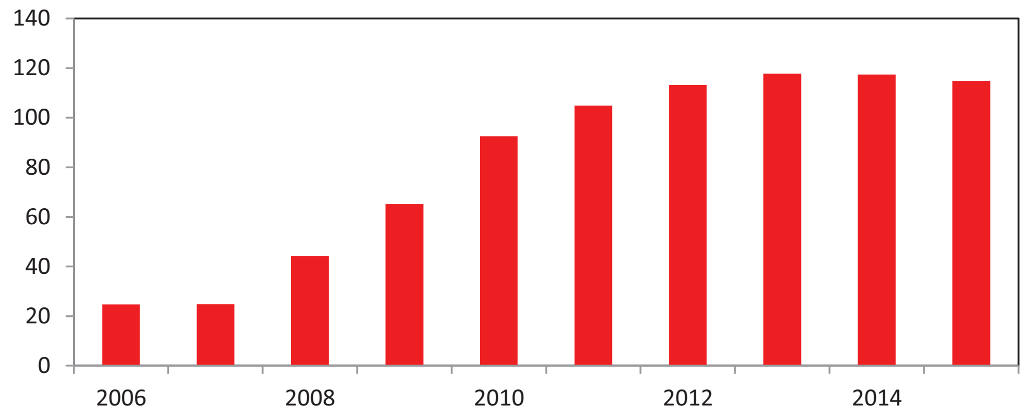
According to the IMF calculations, Ireland operated a structural budget deficit every year since 2001, indicating the extent to which Irish fiscal policy had become pro-cyclical. This deficit hit a high of 11.9% of GDP in 2008 and is now falling. However, the fall in 2009 was largely due to the process of calculating the structural deficit where the extent of the fall in GDP in 2009 reduced the structural element and

[5] The current deficit is defined by the IMF as the General Government Net lending/borrowing balance as a percent of GDP. The structural balance as defined by the IMF differs somewhat from the definition that is used by the EU and should is not directly comparable with the 0.5% limit contained in the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. However, the trends under the two definitions will be fairly similar.

the exclusion of extraordinary items from the structural deficit calculation meant that the cost of the bank recapitalisation in 2010 was not included.

However, useful as the concept of structural deficit is to determining the stance of macroeconomic policy, the cost of recapitalisation is a cost to the economy and the fall in GDP means that the burden of any nominal value of debt is increased. Figure 4.4 shows the Irish national debt as a percent of GDP. After being as low as 25% during the boom, this measure has ballooned to almost 120% of GDP. It is projected to level off and decline slowly from here and by 2015 gross Irish debt as a per cent of GDP is projected to be below the level of the USA. However, the net figure will be notably higher due to the extent of USA investments abroad.

Figure 4.4: Irish Government Debt (gross), % of GDP, 2006 to 2015



Source: IMF World Economic Outlook April 2012. Values for 2012-15 are IMF forecasts

Aggregate figures and averages reduce detail and boost clarity but sometimes it is important to examine what is happening below the surface. When we do so, certain features of the Irish economy become apparent. Certainly, there is a recession but it is hitting the economy very unevenly. As shown in Figure 4.5, the big fault line in performance is between exports, which depend on demand in other countries, and domestic demand.

Figure 4.5: Exports and Domestic Demand (€m.), Constant 2009 prices, 2006-11

Source: CSO Online Database, National Accounts Quarterly (Seasonally adjusted)

This chart shows that both domestic demand and exports peaked in 2007 and that both fell during 2008. However, the correlation in performance ends there. The decline in the volume of exports, i.e. the inflation adjusted value, ended in 2009 and there was a strong recovery so that the previous high was exceeded in mid-2010. However, the decline in domestic demand was much more precipitous and extended and while there was an uptick in the final quarter of 2011, it is far from certain that decline has ended. Based on these quarterly data, the value of exports rose from €154 billion in 2007 to €162 billion in 2011, a gain of 5%. In contrast, domestic demand fell from €163 billion in 2007 to €126 billion in 2011, a fall of 23%.

Since the recession began, aggregate gross disposable income fell by 16% (Q4 2007 to Q3 2011) while spending fell by 24%. The most recent Central Bank quarterly has concluded that households in Ireland are cutting debt and adding to savings faster than anywhere else in Europe. As a result, and in combination with wage reductions, the Bank forecasts that personal spending will fall by 1.5% this year and domestic demand will continue to fall this year and next.

The problem in the Irish economy is clear: domestic demand is in severe recession, exports are performing well.

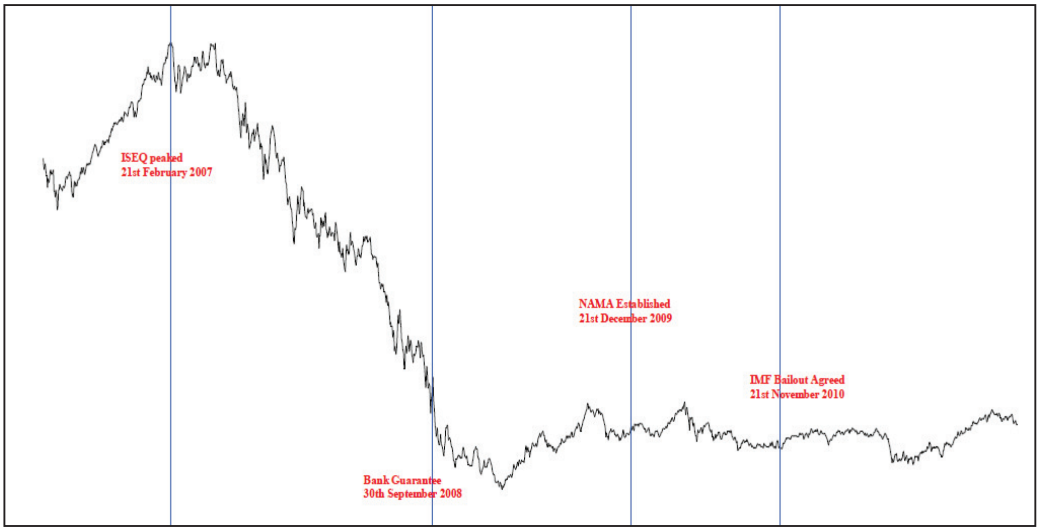
4.2 The Policy Response

Given the magnitude of the shock to the Irish economy it is not surprising that the policy context and nature of Irish economic policy has been changed utterly in recent years. However, what is very notable is how slow policy was to respond to the situation initially and then how reactive it has been since.

The Irish stock market is small and the components of the ISEQ Index are not as good a representation of the economy as is the S&P 500 in the USA. However, it is worth having a look at the ISEQ chart over this period. Figure 4.6 shows that the index peaked in February 2007 at 10,041. After a few months of sideways movement it then began a long steep decline to reach a low of 1880 in March 2009, a fall of 81% from its peak. The magnitude of this fall compared to other countries is partly a feature of the relatively narrow focus of the index which was heavy weighted towards the banks and construction-related businesses. Following an initial bounce, the index moved broadly in line with the Eurozone index so that there has been no progress since June 2009 when it rose to just short of 3000. Thus it has, at the time of writing, recovered only 29% of its pre-crash value.

Given what has happened to Irish banks we would not have expected a recovery of anything close to the 2007 peak and so the overall performance is not the main point to be taken from this chart. Rather, it is important to recognise the following important facts. The first is that Ireland was not hit by a sudden shock in mid to late 2008 that no-one could have foreseen, as has been often contended. The fact is that the stock markets could see what was coming and by October 2008, when the steepest declines occurred in the USA markets pretty, much of the decline in the Irish index had already occurred.

Figure 4.6: Irish Stock Market, ISEQ Index June 2006 to May 2012



The second important lesson is the extent to which the policy response to the situation lagged the crisis. Major events are indicated by the blue lines. Three major aspects to the Irish economic crash can be noted: the banking crisis, the property price collapse and the public deficits. Irish house prices and the ISEQ had peaked in early 2007. However, the first major response – the bank guarantee – did not emerge until the end of September 2008 after the crisis had hit. It may be partly coincidence and partly the result of international markets, but the ISEQ began to stabilise thereafter. The problems were by now fairly clear but the next major intervention to address the property collapse was not until almost fifteen months later with the establishment of NAMA in late 2009. Then it was almost a year later before the necessary actions to handle the consequences of the third aspect of the crisis, the big increase in the public deficit, were put in place with the IMF bailout.

The conclusion is clear. Not only did Irish policy not react to imminent events, but such interventions as were made happened long after the impacts could be seen. No-one is suggesting the economic policy should be made simply in response to the whims of financial markets. But there is a very clear pattern here with policy responses being taken much later than they were required. One lesson to be taken from this is that policy must react much more quickly to both emerging problems and opportunities and must move beyond the reactive phase to stimulate and chart a recovery path.

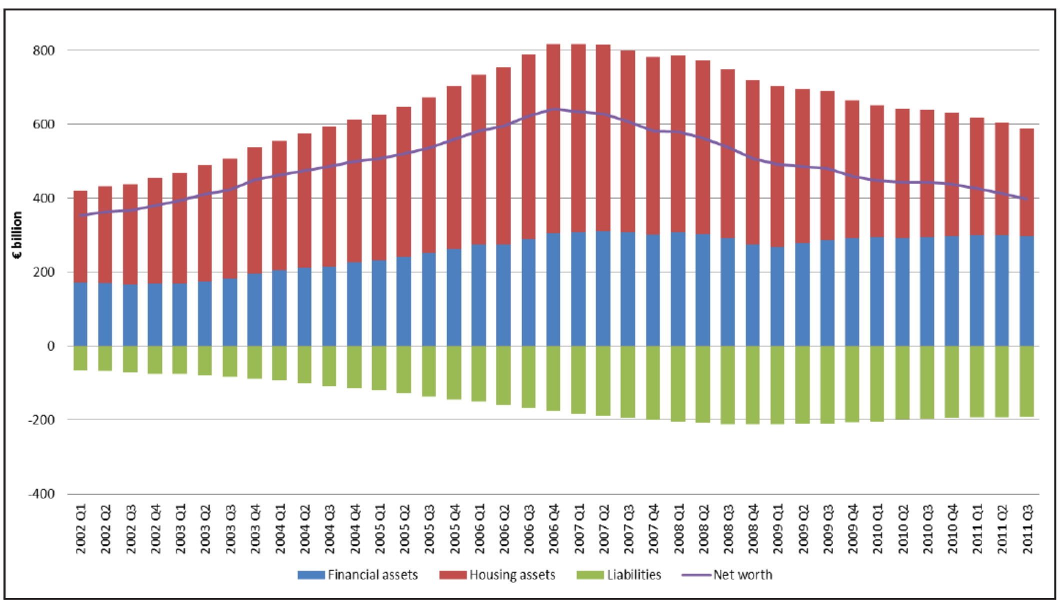
In macroeconomic terms, and in many microeconomic aspects of policy, the agenda is framed and constrained by the terms of the IMF-EU bailout. In return for funds totalling €67.5 at interest rates that would support a sustainable debt burden, Ireland agreed to implement a range of measures. While the official announcement of the deal included a statement that the purpose was to return Ireland to growth, it was always clear that the true purpose was achieving financial stability through bank recapitalisation and ensuring that Ireland would have the funds it requires for current expenditure up to 2014. While the bailout was placed within the context of the National Recovery Plan 2011-14 that had been published by the Government in late 2010, the targets and structure of the deal are clearly better described as crisis management and ensuring stability with €35 million of the funds earmarked for the banks and an adjustment of €15 in the Irish budget to be achieved over four years.

Ireland is far from being in a position where it can be concluded that the terms of the bailout can be implemented in full, particularly in relation to the repayment schedules. However, as has been widely discussed, Ireland to date, has met all the targets for adjustment that were laid down. However, while not disputing that the deal was required and that an adjustment along these lines is an inevitable corollary of such an intervention, meeting the terms of an adjustment programme is not a development policy. As a result, the achievements remain confined to simply handling the problems created by the mistakes of the past and should not be seen as promoting a stimulus or availing of such opportunities as may be present today. It is vitally important that Ireland and Irish policy does not get locked in to a vision that sees meeting the terms of the bailout as a guarantee of either stability or recovery.

4.3 Household Indebtedness and Savings

Total household debt rose rapidly during the boom from below €80 billion in 2003 to €210 billion at its height in 2008. For as long as house prices in Ireland continued to rise the impact of the build up in household debt was not a major concern for home owners since house price rises were more than adequate to offset the increase in indebtedness. This process resulted in a rise in the net worth of Irish households to over €600 billion at the height of the boom. The fall in house prices since then has reduced net worth as shown in Figure 4.7 despite the deleveraging process in this period that meant debt repayments have exceeded borrowings. Recent data from the Central Bank indicate that household net worth stood at €457 billion in Q4 2011, a decline of 37% since the peak.

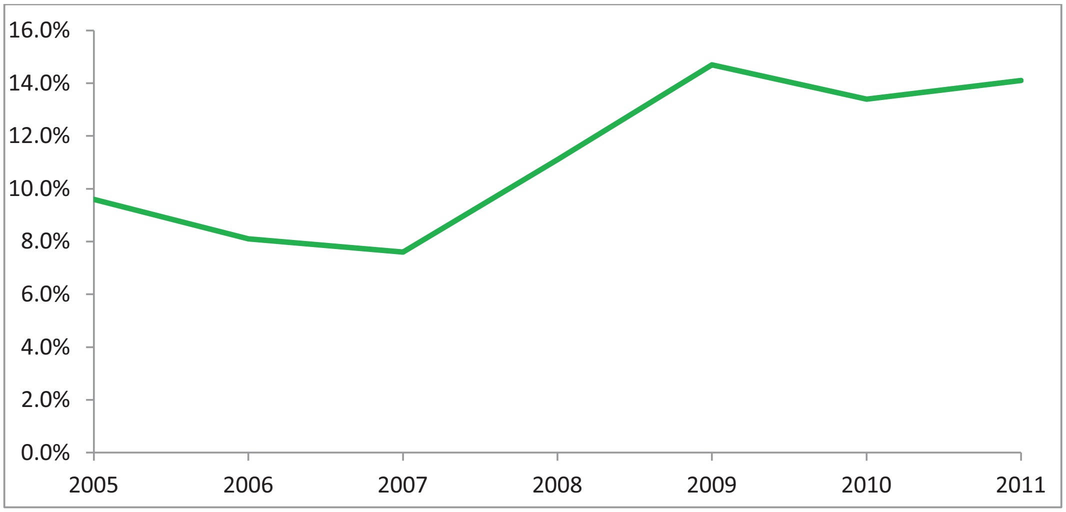
Figure 4.7: Household Assets, Liabilities and Net Worth, 2003-2011



Source: McNeill (2012) using Central Bank of Ireland data

The reaction of households to this change in the economy was considerable. Debt, which had been rising rapidly, began to fall as new loans dried up and households increased savings, resulting in a rise in the savings ratio[6] as shown in Figure 4.8. The household savings ratio had fallen below 8% in 2007 but rose to 14.1% in 2011.

Figure 4.8: Irish Household Savings Ratio, 2005 to 2011



Source: CSO StatBank Database

The leverage ratio of Irish households – defined as liabilities as a percent of disposable income – was just over 100 in 2003 compared to a Eurozone average of 80[7]. Although the Eurozone average rose in subsequent years to almost 110 currently, the Irish leverage ratio accelerated far ahead and levelled off at about 220 in 2009. However, such international comparisons can be misleading given the difference is home ownership rates in Ireland and many Eurozone countries and most household debt is Ireland relates to mortgage debt which accounts for about 70% of total liabilities[8]. Research by the Central Bank of Ireland finds that while the change in household behaviour in Ireland following the crash is not unusual and was seen across Europe, Irish households reduced their liabilities more than any other country since 2008. However, because disposable income also fell, the change in behaviour is not reflected in the leverage ratio[9].

The definition of household debt in Central Bank statistics comprise three categories: mortgages, consumer credit – consumer loans and credit cards – and other loans, the last category including lending to sole traders, partnership and some other businesses for non-property investment purposes. This final category rose rapidly during the boom and was the first to decline at the time of the credit crunch, but it is not the

[6] The household savings ratio is defined as gross household saving expressed as a percentage of gross household disposable income adjusted for any change in the net equity of households in pension funds.

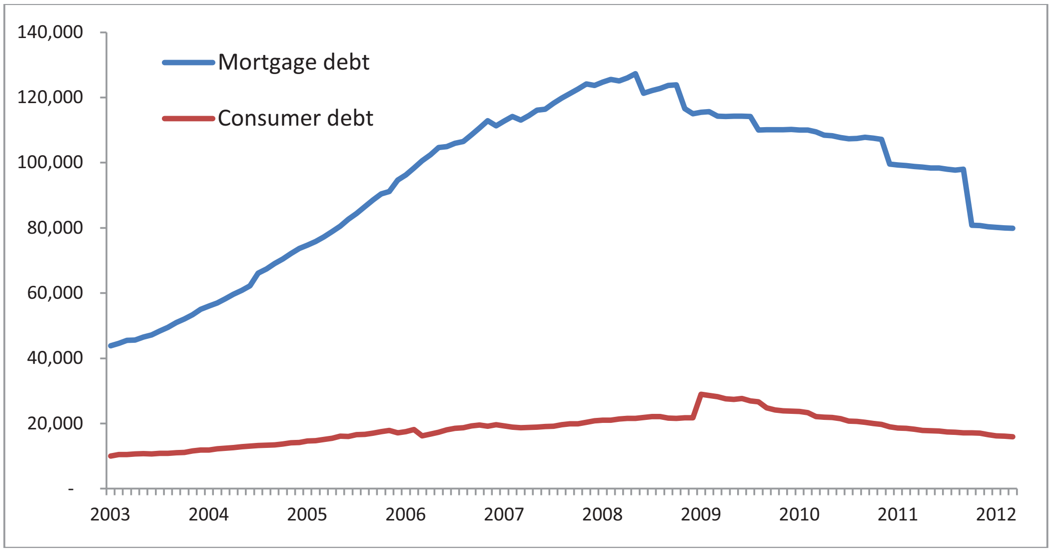
[7] McNeill, J. (2012) 'Statistics on Personal Non-Mortgage Debt' Presentation to Joint Committee on Finance, Public Expenditure and Reform, 8th February 2012

[8] See Cussen, M., B. O'Leary and D. Smith (2012) 'The Impact of Financial Turmoil on Households: A Cross Country Comparison'. Central Bank of Ireland Quarterly Bulletin Q2, April. Based on earlier research, they identify variations in risk aversion, property ownership rates, wealth levels, age structure and tax systems as factors that affect the composition of household portfolios of assets. This will also be reflected in liabilities.

[9] Cussen *at al*.

focus of this section which concentrates on credit advanced to households. Figure 4.9 shows the trend in mortgage and consumer credit outstanding since 2003.

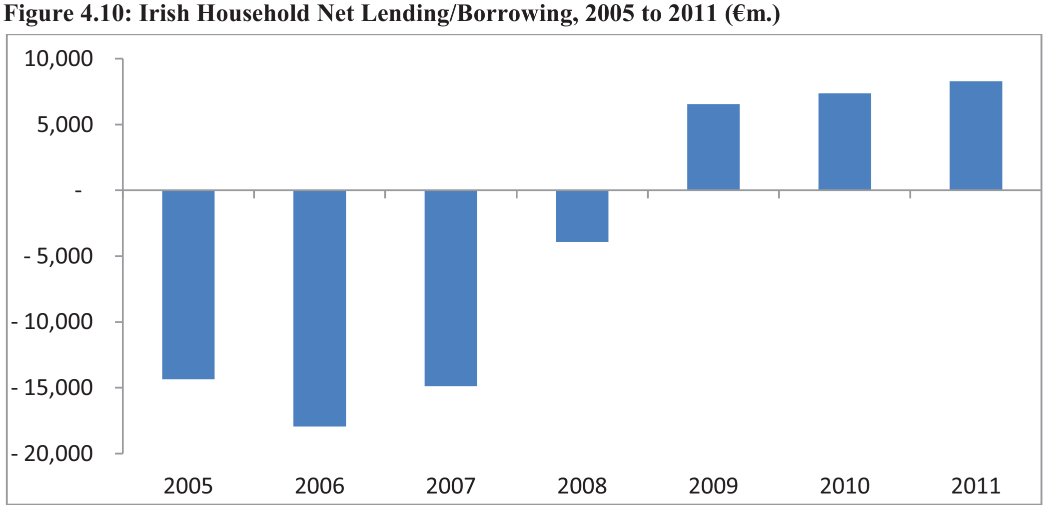
Figure 4.9: Irish Household Mortgage and Consumer Debt, 2003 to 2012 (€m.)



Source: Central Bank of Ireland, Quarterly Financial Accounts

From a total value of just under €54 billion at the start of 2003, the mortgage and consumer debt of private household increased to €149 billion in mid-2008, an increase of 176%. Consumer debt rose at a slower pace in this period but more than doubled from €10 billion to €21.5 billion. However, it continued to rise as mortgage debt began to fall from 2008 and peaked at €29 billion at the start of 2009 before also declining. By March 2012, total debt had fallen to €96 billion, a fall of 36% from its peak with mortgage debt falling by 37% and consumer debt by 46% from their respective peaks. Mortgage debt rose to a high of 86% of the total in 2007 and now accounts for just over 83% of the total. This deleveraging process has meant that Irish households, which had been net borrowers during the boom, became net lenders in 2009 as shown in Figure 4.10.

Figure 4.10: Irish Household Net Lending/Borrowing, 2005 to 2011 (€m.)

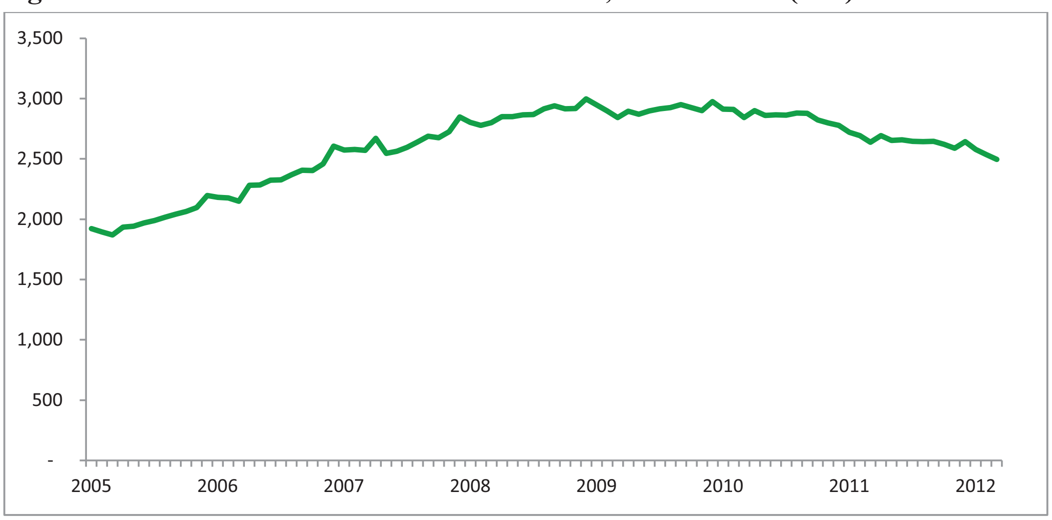


Source: CSO StatBank Database

One point that needs to be quickly identified is that regular media commentary about Irish households 'drowning in a sea of debt' to use one clichéd phrase and then comment on consumer splurges and unaffordable credit card debt are missing the facts. Such debt is a small proportion of household debt, even though it needs to be recognised that interest rates on such debt tend to be higher than mortgages. Importantly, Irish consumers have been paying back this debt at a very rapid rate and look set to halve the outstanding amount in 3½ years from early 2009 to mid-2012. Unlike arguments that can be made in respect of mortgages where it is possible to identify supply constraints as a potentially important reason for the fall in the level of debt – existing mortgages are being repaid but banks are unwilling to lend to potential new borrowers – there is much less constraint on the availability of consumer loans. Credit card limits are not generally being reduced and while banks have not been providing personal loans in the way they did during the boom for the purchase of consumer products such as cars, finance for such purchases is available. This means that the fall in consumer debt is primarily a result of a decision of consumers to deleverage. This is a common symptom of a lack of confidence.

Credit cards represent the most accessible source of credit to private households and the trend in the balances outstanding is shown in Figure 4.11 for 2005 to 2012[10]. This peaked at just under €3 billion at the end of 2008 and has since declined to €2.5 billion, a fall of 16%. So, even where credit is easily available, Irish consumers have preferred to pay back debt rather than maintain existing balances, let alone increase indebtedness, as was the case during the boom. With repayments running at €772 million per month this represents just over 3 months of repayments on average.

Figure 4.11: Irish Household Credit Card Debt, 2005 to 2012 (€m.)



Source: Central Bank of Ireland, Quarterly Financial Accounts

Increased savings ratios reflect lower confidence and are a major leakage of demand from the domestic economy and a drag on growth and recovery when there is spare capacity. Household disposable income fell from over €100 billion in 2008 to €89 billion in 2011. Thus, a one percentage point reduction in the savings ratio from here would be equivalent to an injection of €890 million of demand into the economy. Since domestic demand is an important determinant of disposable incomes and so this

[10] 2003 and 2004 are not included as earlier data aggregated business and private credit cards.

process would have a dynamic element meaning that as recovery began additional falls in the savings rate would have a greater impact as disposable incomes rose. The savings ratio was well below 10% during the boom but this was below what might be considered to be the normal level. A return of confidence should see the ratio decline to about 10% fairly quickly, equivalent to an injection of demand of about €4 billion into the economy.

This would boost economic growth. There has been much comment on the size of multipliers in the economy and there is general agreement that, given the open nature of the economy, the fiscal multiplier is probably quite small. The IMF has estimated that fiscal multipliers in small open economies tend to lie in the range of 0.5 and this might even be a bit high for Ireland. However, multipliers for marginal growth in demand in sectoral studies – such as tourism and construction – have tended to indicate that increases in demand that originate within the economy as distinct from a change in fiscal policy may be greater than this. As a result, a multiplier of 0.5 does not seem excessive. Therefore, a fall of 4 percentage points in the savings ratio to 10% would boost GDP by €2 billion or about 1.25%. There would also have a positive impact on employment. NAMA has recently proposed to invest €2 in construction projects and estimate that this will create 25,000 construction jobs with a further €10,000 jobs supported elsewhere in the economy. Using these estimates, which do not seem excessive based on analysis of individual projects, an injection of €4 billion from an increase in domestic demand would create 50,000 jobs and support a further 20,000 as a result of secondary effects. And unlike the construction jobs that would be created by the NAMA investment, these jobs would be permanent as the increase in expenditure would be sustained in subsequent years.

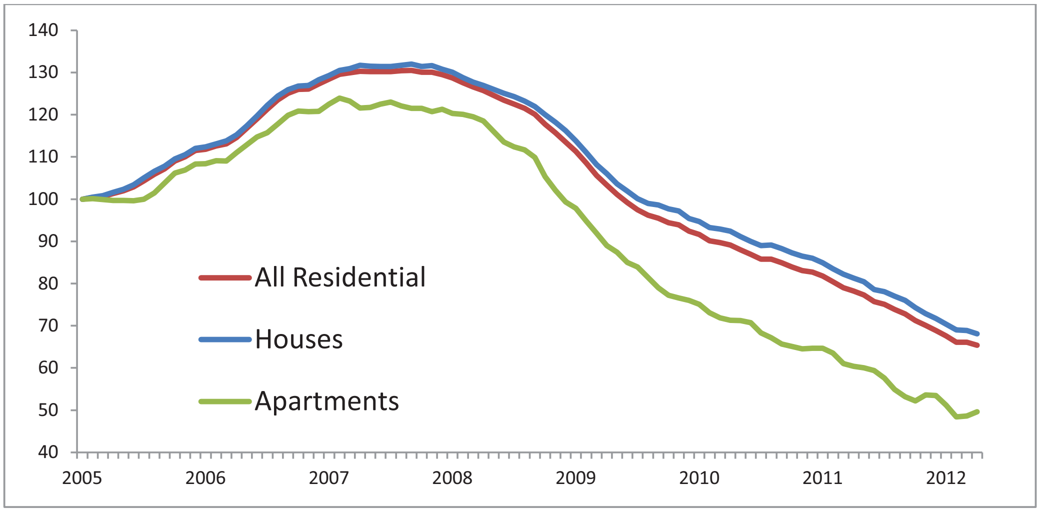
These estimates for potential job creation underline the importance of addressing domestic demand as well as promoting export growth. Exports have performed well in recent years but the employment situation has not improved. This is similar to the period of 'jobless growth' that Ireland experienced in the late-1980s and early-1990s as the economy began to emerge from recession and grow. It was a number of years after this growth had begun before domestic demand began to rise and Ireland's long standing high rate of unemployment truly began to fall. The missing element then as now is the confidence that is required to promote the behaviour that will facilitate this growth.

4.4 The Housing Market

Irish house prices, which had been increasing rapidly for about 15 years up to 2007 have fallen since and there is no strong evidence that a sustainable base has been found. The trend since 2005 is shown in Figure 4.12. It shows that since the peak in September 2007, the price of houses in Ireland had fallen by almost exactly 50% up to April 2012 and now they are at only 65% of their level in January 2005, at the start of what is often considered to be the bubble phase of the boom.

Despite the extent of these falls, there are claims that the CSO Index underestimates the actual decline as cash transactions are excluded. This may well be the case as such transactions are likely to arise in distressed situations, especially where there is a lack of lending[11]. Auction prices suggest a 60% fall, but again these figures may be distorted, this time providing and overestimate of the decline as distressed sales will tend to be over-represented in auctions. Figure 4.12 also shows that prices for apartments have also fared worst recording a fall of 60% on this index to just below 50% of their price in January 2005. The extent of the fall from peak prices in Dublin has been greater than in other parts of the country, but Dublin prices display similar results relative to their 2005 values as for the economy in total.

Figure 4.12: Irish House Price Index, 2005 to 2012, (Jan 2005 = 100)



Source: CSO

The fall in prices means that the affordability of housing has improved considerably. The ratio of house prices to disposable income has fallen to 3.8. This is similar to its level in the mid-1990s and well below the UK, where it stands at 5.1. It is estimated that the average new mortgage for house purchase absorbed 26.7% of incomes in 2011, below the long term average since 1973 of 29.4%[12]. Developments in 2012 are likely to reduce this ratio further to 23.9%, the lowest level since 1997. Furthermore, buying a property, given current interest rates, is now cheaper than renting.

Yet, the general expectation is that prices will fall further. The aggregate oversupply of housing as a result of excess development during the boom is certainly one factor. However, with only 10,480 units completed in 2011 and 8,000 forecast for 2012 – 80% of which are expected to be one-off houses as distinct from developments – this is well below estimated annual demand of 20,000 units, even allowing for ongoing net emigration[13]. With completions this year expected to amount to only 10% of their peak, the overhang is being eliminated even though demand remains very depressed. However, the aggregate picture for over supply is hiding important differences between Dublin and the rest of the country. The 2011 Census showed a vacancy rate of 8.3% in Dublin, compared to a rate of 16.7% in other areas. Even if holiday homes are removed from the calculation, the vacancy rate outside Dublin still remains at 13.3%. The number of mortgages awarded in 2011 fell to just 11,100 – also 10% of

[11] Irish Housing Market, Davy Research Report , March 2012
[12] The Irish Property Review, March 2012, Bank of Ireland Economic Research Unit
[13] Housing Market Bulletin, February 2012, AIB Economic Research

the 2006 peak – with the total value of mortgage loans just €2.1 billion. Of these, first time buyers accounted for 50%[14].

Overall then, prices are at, or below, levels that could be considered affordable, new supply is well below what the demographic fundamentals in Ireland would require, new mortgages are also well below this level, and prices in Dublin where the overhang is much less than elsewhere are not yet recovering to any significant degree. Other research has found that prices have fallen below what might be expected on the basis of fundamental measures. Kennedy and McQuinn (2012) compared actual prices to the prices that are predicted by four different models of demand estimation[15]. This work found that by Q3 2011, Irish house prices were between 12 and 26 per cent below the level that would be expected based on an analysis of fundamental factors in the Irish economy. House prices have continued to fall since then. Such 'over-corrections' have been seen in house cycles elsewhere, with prices falling by up to 35% below what might be expected based on fundamental factors. Negative expectations regarding price developments are an important issue in explaining this process and the evidence confirms that this is also important in Ireland, in addition to the lack of supply of finance which is also currently an important constraint on demand in Ireland.

The conclusion then is that the falls in Irish house prices since 2010 are not the result of fundamental demand and supply factors such as population or supply overhang. Rather, a combination of fear, uncertainty, lack of finance and expectations that prices will fall further are preventing the market from finding a price base from which it can recover. Most importantly, this process becomes self-fulfilling: expectations of price falls constrain demand which reduces prices further. And even if this cycle were to be weakened, the lack of mortgages would probably prevent recovery from becoming self-sustaining.

So what are the financial implications of these developments? This analysis above shows that household debt, including both mortgage debt and consumer loans, has fallen in recent years, as households have deleveraged. This has been a response to falling house prices which have resulted in a fall in the net worth of households of over €200 billion, about 35%, since 2007, even as the balance on borrowings fell. This fall in net worth has resulted in the emergence of negative equity as a fairly widespread phenomenon (see Figure 4.10) and commentary on this issue has tended to confuse the impact of negative equity – which is primarily through the wealth effect suppressing demand – and the sustainability of outstanding debt. The only time negative equity will have a direct financial impact on current decision making is where a change of house is being considered. However, it does have important psychological or wealth effect impacts on current expenditure decisions.

Negative equity and arrears are often assumed to occur together and to have similar financial implications. Negative equity is most likely to be associated with houses that were bought at the height of the bubble from 2005 to 2008 and the fact that lending criteria were very relaxed at that time means that arrears are most likely to arise in the case of people who bought their first property or increased their property

[14] The Irish Property Review, March 2012, Bank of Ireland Economic Research Unit
[15] G. Kennedy and McQuinn, K. (2012) 'Why are house prices still falling?' *Economic Letter Series* Vol. 2012, No. 5. Central Bank of Ireland

holding at that time. However, of the 673,000 mortgages that were given by Irish banks in that period, about 225,000 were in respect of people who were either switching their lender or were topping up their mortgage. A further 145,000 related to people that were trading up having sold their previous house and so their new mortgage would likely have been a fairly small proportion of the cost of the new house. Overall, only 125,000 (18.6%) of the mortgages taken out in this period were loans to first time buyers, the group most often associated with being in financial difficulties due to mortgage costs, and 40% of all mortgages were at less than 70% loan to value. Importantly, negative equity is a result of changes in house prices while arrears arise principally due to changes in incomes. Many people who may be in negative equity but have maintained their incomes and so can handle mortgage payments while others may have equity in their homes but have fallen into arrears because of the recession reducing their incomes.

The need for caution is borne out by the data. Figure 4.10 shows the extent to which there is correspondence between negative equity and arrears for primary homes (excluding buy-to-let)[16]. This crosstab shows, using data for end-2010, that 40% of homes were in negative equity and that 9% of homes were in arrears for more than 90 days. Only 5% of this 9% were also in negative equity. In total, 92% of homes are not in arrears, including 35% of homes that are not in arrears even though they are in negative equity. This indicates that a mortgage in arrears is almost as likely to relate to a property not in negative equity as to one that is, while almost 90% of mortgages relating to homes in negative equity are not in arrears.

Figure 4.10: Arrears and Negative Equity (% of homes, end 2010)

		In Negative Equity?	
		No	Yes
In Arrears?	No	57	35
	Yes	4	5

Source: Honohan (2012)

Importantly, arrears depends not only on mortgage costs but also on available savings and current income so many people who have maintained their incomes through the recession will not be in difficulties despite being in negative equity. Honohan (2012) concluded that '*negative equity for owner-occupiers is not a reliable indicator of stressed living standards*' and quoted from other research which concluded that negative equity is not a major factor in driving arrears but that it is affordability and the general macroeconomic environment that matters[17]. He went on to note in a footnote that '*some of those who are still on tracker mortgage rates, like the bulk of borrowers towards the end of the boom, may be paying much lower servicing costs on their mortgages than when they bought the house, offsetting at least some of the tax increases and – for some – wage and salary cuts that have occurred*'. This point is often ignored: while the recession has led to an overall fall in living standards in the region of 17% of its peak and has made it difficult for many to service debt repayments it is also the case that many are actually better off, or at least no worse

[16] This figure is extracted from Honohan, P. 'Household indebtedness: context, consequences and correction'. Paper presented to Limerick Law Society, University of Limerick, March 2012.
[17] Honohan, P. 'Household indebtedness: context, consequences and correction'. Paper presented to Limerick Law Society, University of Limerick, March 2012.

off, due to falls in mortgage interest rates, even among those who bought at the height of the housing boom.

The implication of this discussion is that, while there will be overlap, addressing arrears requires measures to improve incomes, in other words, general measures to get the economy growing, while addressing negative equity requires a separate set of measures to get the housing market working. The focus of policy has been on achieving stability as a prelude to a return to growth. But leaving aside the viability of this approach in the absence of a growth strategy – which is discussed elsewhere in this report – getting the housing market working and house prices reversed is an important requirement in its own right given the impact of this on consumer confidence and the importance of confidence in addressing those parts of the Irish economy that are not recovering, most notably, domestic demand. In addition, the problem of negative equity affects 40% of homes – given further price declines in 2011 this is now higher – whereas arrears affects in the region of 10% of homes. Thus, the problem of arrears is a concentrated one whereas negative equity and the damage to confidence that this situation causes is a widespread problem.

4.5 The Banking Sector

NAMA paid the banks a total of €32 billion for assets representing loans valued at €74 billion and €35 billion was earmarked in the terms of the IMF-EU bailout deal for bank recapitalisation. These sums indicate the scale of the losses that were incurred in the banking sector as a result of property related lending, other than residential mortgage finance. Over the past couple of years attention has turned increasingly to potential losses from bad mortgage loans to households and the impact that this could have on the banks. The fear is that Ireland could be faced with a further round of losses in the banks that would require further recapitalisation. So, how real is this fear?

The total value of residential mortgage loans outstanding at the end of March 2012 was €112.7 billion with 764,138 loans. A total of 77,630 of these, or 10.2% of loans, were in arrears by more than 90 days amounting to €15.4 billion or 13.7% of outstanding loan balances[18]. A further 38,658 (5.1%) were restructured but are not in arrears. According to Honohan (2012), of those in arrears, 70% are in negative equity[19] so the other 30% remain fully secured. So, there is €10.8 million of mortgage loans outstanding, 9.6% of the total, that are in arrears and in negative equity. We don't have details on the extent of the shortfall in negative equity on these impaired loans, but we will assume that the bank could recover 50% of the loan value on average. While some properties have fallen by more than this and it is to be expected that sales of houses by banks would not realise the price of equivalent houses being sold in a more usual transaction. However, it is also the case that many of these cases will relate to properties where the original mortgage was less than the value of the property and many were bought before the peak of house prices. Therefore, the fall in price will be lower than the total fall in house prices since the peak. In any event,

[18] Central Bank of Ireland Information Release '*Residential Mortgage Arrears and Repossession Statistics: Q1 2012*', 25th May 2012
[19] Honohan (2012) *op. cit.*

some part of the original mortgage amount will have been repaid in many cases. It is often ignored that only 20% of first time buyers during the boom years of 2005 to 2008 actually borrowed 100% of the house price and around 15% of the amount borrowed in 2006 will have been repaid by now. This means a potential loss for the banks of about €5.4 billion on these mortgages – if all these mortgages were closed and the properties sold at this time, which is unlikely to be the case.

Therefore, the maximum potential losses as a result of mortgage debt appear to lie in the region of €5 to €6 billion and so the problem, while potentially serious, is not of the magnitude of the developer loans problem being addressed by NAMA. Furthermore, the vast bulk of mortgages are not in arrears and given that the Ireland's current 'loan-to-value ratio for all housing assets and mortgages is about 35%[20], there is no prospect of a widespread default although the percentage of loans in arrears could rise further. This rise could happen even if there is no increase in the number of mortgages in arrears as existing mortgages are being paid off and few new loans are being provided.

The most recent examination of the ability of the banks to withstand such losses was the exercise to examine the adequacy of the capital reserves of EU banks, including Irish banks, undertaken by the European Banking Authority (EBA) in late 2011. The EBA required that banks must establish a buffer against losses such that the Core Tier 1 capital ratio reaches 9% by the end of June 2012. The Central Bank of Ireland requires the three Irish banks to maintain a minimum Core Tier 1 ratio of 10.5% on an ongoing basis. The results for the Irish banks are summarised in Table 4.1. This shows that, using data for end of September 2011, all the Irish banks exceeded this target. Taken in aggregate, the banking system had Core Tier 1 capital equal to 17.47% of RWA and common equity equal to 12.98% of RWA[21].

Table 4.1: Results of EBA Capital Exercise (Irish Banks)

	AIB	Band of Ireland	ILP
Common Equity (€m)	11,786	7,360	3,612
Government support (€m)	6,051	1,817	0
Core Tier 1 capital (€m)	17,837	9,177	3,612
RWA (€m)	88,718	71,428	15,134
Core Tier 1 % of RWA	**20.11%**	**12.85%**	**23.87%**
Of which common equity	13.28%	10.30%	23.87%

Note: RWA stands for risk weighted assets and measures capital requirements taking into account the riskiness of a bank's assets.

This data provides a context within which the scale of the problem of impaired mortgage loans and the potential impact on the banks can be evaluated. Large scale mortgage relief would certainly impact on the banks' balance sheets. Following the 2011 bank stress tests the Central Bank indicated that the banks would need to set aside €5.8 billion to cover bad mortgages. The results of the capital exercise above led the Central Bank to conclude that the Irish banks do not require any additional capital having been recapitalised following the Prudential Capital Assessment Review

[20] Top Ten Facts in Relation to Ireland's Mortgage Debt and Arrears. www.ronanlyons.com

[21] The Irish Bank resolution Corporation (formed from the merger of Anglo Irish Bank Irish Nationwide) was not included in this exercise for understandable reasons. Its Tier 1 ratio stands at 15.1% according to its 2011 results released in March.

process in March 2011[22]. However, the ongoing recession and continuing falls in house prices have led to more recent estimates indicating that this problem could result in losses as high as €8 to €9.5 billion. If the higher of this estimated range proved to be correct then taking the three banks in aggregate and simply applying the losses to the Tier 1 capital, the ratio would fall to 12%[23]. While this is a crude calculation it suggests that even in a worst case scenario adequate capital ratios, under existing rules, could be maintained by the Irish banks without additional assistance. However, tighter regulatory controls to be introduced under the upcoming Basle III rules will place additional capital requirements on banks in coming years[24]. Even with the prospect of this additional requirement, the reluctance of banks to re-enter the market through the provision of loans in any effective way is a conservative strategy. Furthermore, the reluctance of the banks to tackle the problem of existing mortgage arrears means it is not possible to reach any conclusion as to when this problem will be resolved. . These facts mean that banks appear unlikely to act to remove the constraints on demand in the housing market as a result of uncertainty and the non-availability of finance any time soon.

The situation therefore appears to be one where banks, having adopted a very liberal approach to lending criteria and capital ratios during the boom have moved to the opposite extreme now on both counts. This indicates a strategy that is based on past experience and mistakes rather than current conditions. Such as approach will seldom be optimal in terms of meeting the needs of the economy but may be understandable in terms of the incentives facing decision makers within the banks. While such decision makers operate within systems and guidelines, economic analysis will always emphasise that decisions are made in response to the incentives that are provided. This idea is not confined simply to incentives in the form of potential earnings but it can be useful to think in these terms. A decision maker within one of the Irish banks currently has survived a unique period of turmoil in an organisation that has survived when its performance in earlier years meant that it should not have. That is the implication of the recapitalisation and other interventions such as the bank guarantee and NAMA. But should there be any repeat a similar outcome is highly unlikely. Faced with this situation, the correct strategy for any decision maker is one of extreme conservatism. There are likely to be few plaudits for risk taking i.e. following a growth strategy, when survival is the objective. However, the bad decisions of the past cannot be undone, and while lessons must be learned from this experience, one of them is not that banks need to act in an ultra-conservative manner such as that of recent years. There is a clear market failure here, a mis-match between the incentives facing decision makers in t banks and the requirements of the economy to have a banking system that acts in a manner that supports growth rather than deflation.

[22] Central Bank Information Release, 8th December 2011

[23] This calculation is done simply for the purposes of illustration and it assumes that the capital falls in line with losses, it does not adjust the asset valuation, it takes the banks in aggregate and it ignores the fact that many Irish mortgages are held with banks other then the three Irish banks included here.

[24] Financial Regulator Matthew Elderfield has indicated an additional requirement for €3 to €4 billion over the next five or six years to meet these new requirements.

5. Economic Prospects

5.1 The Current Policy Stance

The preceding sections of this report provide an overview of economic performance since the credit crunch in 2008 and contained a discussion of the policy responses that have been implemented. In summary, a financial crisis shocked economies and evolved into an economic crisis as tighter credit conditions and a loss of confidence resulted in lower investment and demand. Policymakers in the USA responded quickly by removing toxic assets and flooding the system with liquidity. This was accompanied by a loose fiscal policy that also stimulated growth. The policy has not been totally successful and carries risks but it has returned the economy of the USA to growth. In contrast, Eurozone policy makers have emphasised the risks associated with expansionary policies and focussed on the need to reduce debt. This has resulted in a much slower recovery and many European economies appear to be slipping back into recession, with increased political tensions and social unrest. Thus, the stability approach carries its own risks. The conclusion, which appears to be gaining increasing support at the level of policymaking in Europe, is that the approach that has been followed in Europe is quite extreme and is not the only option.

Against this background, Ireland has provided a very stark example of what can happen when an asset bubble, built on debt finance, bursts. The domestic policy response, even allowing for effective constraints and the uncertain background, was slow and attempted to deal with successive crisis as they arose. Policy over the past eighteen months or so has been guided by the need to meet the terms of the IMF-EU bailout agreement. This is inevitably a deflationary policy and amounts to meeting the terms on the basis that a return to growth will happen when stability is restored as confidence will then return. However, while the policy is likely to help confidence in financial markets, at least in the short term, the opposite is true in terms of the behaviour of households. In this case, a cycle of falling asset values – principally housing – is resulting in a cautious stance as savings rates rise and domestic demand contracts. This results in low economic growth and high unemployment which is resulting in a rise in financial difficulties particularly in respect of household mortgage arrears. Banks are also behaving cautiously emphasising the need to build capital ratios leading to an ongoing lack of lending for mortgages and other investments which is further depressing house prices and job creation.

Ireland is not the first country to experience such a crash and vicious cycle of deflation and the circular feedback means it can continue. Indeed, economic forecasts, based on current policies and recent performance, indicate that stagnant economic conditions *will* continue. Furthermore, the potential exists for the cycle to intensify so that forecasts based on a gradual recovery from the shock of the crash may prove overly optimistic. Table 5.1 shows the recent economic forecast from the IMF for Ireland up to 2017. The basic story here is that while there won't be any improvement in 2012 compared with 2011, thereafter there will be a gradual return to growth and a reduction in unemployment as the public deficit comes under control. So, Ireland can expect low growth for the next five years or so with unemployment remaining above 10% for the foreseeable future.

Table 5.1: IMF Economic Forecasts for Ireland

	2011	2012	2013	2014	2015	2016	2017
GDP growth	0.7	0.5	2.0	2.5	2.8	2.9	2.9
Unemployment %	14.4	14.5	13.8	13.0	12.0	11.2	10.5
Public deficit % of GDP	9.9	8.5	7.4	4.9	2.9	2.4	1.9

Source: IMF World Economic Outlook April 2012.

While this is not quite stagnation, it is not far from it. There is also a contrast with past experience when Ireland required a growth rate in the region of 3.5 to 4 per cent to reduce unemployment meaningfully. For example, the most recent *Medium Term Review* of the ESRI, while accepting that it was prepared at a very early stage in the economic downturn before the extent of the crash was realised, indicated that Ireland had the potential to grow at 3.75% per annum over the following decade[25]. This was predicated to a considerable extent on favourable trends in the labour force, in other words, that although unemployment was low in Ireland in 2008 when the Review was prepared, the growth of the labour force would be adequate to support annum growth of 3.75% without hitting constraints that would damage competitiveness. As a result, it is difficult to see how Irish unemployment will fall with growth remaining below 3% as in the IMF forecast unless there is under-employment, withdrawal from the labour force and ongoing significant emigration.

The problem with forecasts that indicate a slow return to low steady growth with current policies is that such policies do not address what has been identified in this report as key to stopping and reversing the vicious cycle that has taken hold. These are the interacting forces of low domestic demand, low confidence and falling asset values. When we look at forecasts of the domestic components of the Irish economy we see little that suggests a return to growth. Table 5.2 shows the range of forecasts that have been published recently for these variables.

Table 5.2: Forecasts for Components of Domestic Demand & GNP

Annual percentage change	2011	2012	2013	2014	2015
Personal Consumption	-2.7 to -3.0	-1.5 to -1.8	0.2 to 0.0	1.0	1.2
Government Expenditure	-3.6 to -3.7	-2.2 to -4.2	-2.0 to -2.2	-2.3	-2.1
Investment	-10.6 to -14.6	-2.5 to -3.3	-1.9 to +1.5	3.8	4.5
GNP	-0.6 to -2.5	-0.7 to +0.1	1.0 to 1.5	2.3	2.3

Sources: 2011 to 2013 forecasts are from recent publications by ESRI, Dept of Finance, AIB, Bank of Ireland and Central Bank. Forecasts for 2014 and 2015 are from Department of Finance (2012) *Ireland – Stability Programme Update*, April

The issue here is not that there is uncertainty as indicated by the fact that there is a range of forecasts for each variable – this is almost inevitable given the difficulties involved in constructing economic forecasts. Rather it is the fact that growth in all the main components of domestic demand, namely Personal Consumption, Government expenditure and Investment are expected to be negative this year and close to zero in 2013. Only in the forecasts for 2014 and 2015 from the Department of Finance is there any sign of a pick-up in these variables and even then the forecasts remain very low. This means that there is no upturn in the factors that are suppressing recovery in the economy and, as a result, such growth as is identified in the longer term is based

[25] ESRI (2008) *Medium Term Review 2008-2015*

on growing exports. Put simply, if Ireland keeps doing what it is doing then we will keep getting similar results with our hopes based on a recovery in the global economy that will enable a return to slow growth in Ireland.

5.2 The Opportunity for Change

This discussion indicates that while the crash may be coming to an end, it does not appear that a recovery of any substance is in sight. Furthermore, the reliance on exports to get Ireland going does not address the factors that are causing the downturn to persist. Realistically, the only way for an upturn in exports of the modest magnitude that is envisaged to translate into a genuine economic recovery in Ireland is through a positive impact on employment. This would be a real gain, but would not be sufficient on the basis of the dynamics of the Irish labour market to reduce unemployment meaningfully. Crucially, there is nothing in the forecasts to indicate that confidence is likely to return to Irish consumers any time soon and nothing to indicate that the forces that are suppressing the Irish housing market are in the process of being reversed.

There is no doubt that Ireland was faced with an economic crisis over recent years and the actions have gradually been put in place to stabilise the worst aspects of that crisis. This report does not dispute the need to take the kind of measures that have been taken, although the timeliness of the actions is a different matter. However, economic policy remains in crisis mode and needs now to move on to a recovery phase. The external environment appears to be turning positive in the sense that there is a growing realisation in Europe that there are alternatives and that reform of the policy approach is not only desirable but essential if political crisis is to be avoided. There is a real impetus for change evolving. This provides opportunities but Ireland needs to move on from basing growth aspirations on hopes that a stimulus will come from abroad. This is the core rationale of the export based recovery strategy and, while not in any sense dismissing the positive contribution of exports to the economy, the fact is that exports have been performing well in recent years without resulting in the core problems in Ireland being addressed.

In contrast to the predominant idea that Ireland is utterly constrained in its ability to act due to the requirement to meet the terms of the IMF-EU bailout deal, there are actions that can be taken. An agenda for action is set out in the next section in terms of a number of concrete proposals that are focussed on addressing issues of confidence and funding that are constraining the domestic economy. None of these are without risks and costs, both financial and in terms of the need to change mindsets. However, for as long as economic policy in Ireland remains in crisis mode, it remains focussed on addressing the mistakes of the past rather than acting to realise the opportunities of the present.

6. A Renewed Domestic Policy Agenda

6.1 Stimulating House prices

Prompting a recovery in Irish house prices is a core requirement for the economy to regain growth. We have seen above that prices are up to 25% below what might be expected based on the fundamentals but that there is every possibility given current influences in the economy and experience following housing crashes elsewhere that they could drift further. Furthermore, affordability has risen with the fall in prices and interest rates remain low. The key missing ingredient is confidence: the confidence required for potential purchasers to act and the confidence required for mortgage suppliers to lend.

A recovery in house prices, in line with economic fundamentals would provide benefits to the economy in a number of ways.

> First, it would provide confidence to potential entrants to the market that now is the time to act as prices have stopped falling. A fear that they might fall further is considered to be an important factor that is preventing entry in many cases. Of course this is not really a rational assessment on the part of potential buyers given that the possibility to buy at the low point is no greater, and indeed may be less, than the chances of buying at any other point in the cycle. However, it is perception that matters.
>
> Second, it would provide a much needed boost to the confidence of existing home owners who although not in extreme difficulties, have experienced a significant reduction in their wealth and who may have boosted savings in response. This is the key cohort that must be engaged simply due to their large number and the fact that they have latent spending power. While those in difficulties have, rightly, received the most media coverage, their potential spending power is by definition, and will remain, constrained.
>
> Third, rising prices (or even stabilised prices) would ease the potential pressure on banks' balance sheet from unrealised losses as it would act to reduce the incidence of negative equity in distressed mortgages.
>
> Fourth, rising prices would enable the market to begin to function again as people wishing to move but currently caught with marginal negative equity would be able to transact in a normal manner.
>
> Finally, while there remain many unsold houses in the country in aggregate, the rate of completions in recent years is well below estimates of demand based on fundamental factors. Furthermore, in urban areas and in Dublin in particular, the number of unoccupied houses is lower than the aggregate numbers indicate. A recovery in demand would soon address any remaining oversupply in urban areas meaning that a rise in prices, if triggered, could soon become self-sustaining.

This is not to suggesting that a return to the situation of a decade ago where there were successive years of double digit house price inflation is either desirable or required. However, there is an important lesson to be learned from what was happening in the years before the crash. This was a period with a clear market failure that the state failed to address. The market failure was excessive confidence bordering on hubris: market participants failed to correctly assess the risks of buying property and taking on mortgage debt on the scale they did at that moment of the economic cycle. Exactly the same thing is happening now only that the failure is an over-assessment of the risk rather than the under-assessment that characterised the earlier period. Thus, we now see a vicious circle where falling prices reduces confidence which suppresses demand and causes prices to fall further.

Some initiatives have been formulated to address the problems in the housing market and some of these, albeit a minority, have been implemented in some form. For example, there were recommendations for flexible mortgage arrangements such as split mortgages in the Keane Report for dealing with people experiencing difficulties in meeting repayments and Bank of Ireland has lunched mortgages it considers suitable for people in negative equity. NAMA has also begun to pilot its 80/20 deferred payment initiative. These should certainly be continued, but the scope and range of these interventions is far too narrow. These initiatives are designed to address situations where borrowers are in financial distress or arrears in the market or relate to specified properties only, as in the case of the NAMA pilot which is limited to a mere 115 houses.

Obviously initiatives in this regard are important but they do not address the market failure that is inhibiting recovery. This is because this failure arises primarily in the form of potential buyers that are, by definition, not in distress and in the banks which are not lending. Consequently an emphasis needs to be placed on enabling opportunities rather than just addressing problems that exist as a result of mistakes made in the past. The hard reality is that people in financial difficulties cannot be the catalyst for recovery but recovery would assist them to work their way back to a more sustainable situation. The initiatives that have been developed are targeted and fairly narrow in scope. The problem is a more widespread one of confidence. Thus, it requires a solution that is attractive to a wide range of people.

A second problem that arises with many of the initiatives that have been formulated so far is that they rely on commercial agents i.e. the banks, to voluntarily implement them. Progress has been slow in bringing flexible mortgages, like those discussed in the Keane Report to the market. Even the NAMA 20/80 proposal relies on existing mortgage suppliers to provide the mortgages. This is certainly not because the banks do not wish to see recovery but because they do not see the commercial opportunity for them. This may well be the correct assessment but the banks as just as liable to mis-perception due to the market failure discussed above as anyone else.

So, a solution must have two features: it must be targeted at a broad range of households not solely those who are in severe financial distress and its implementation cannot rely solely on voluntary decisions of commercial banks. This means that it requires a state organised and sponsored initiative. Inevitably there will be criticism of a proposal for state money to be spent to incentivise people into the housing market who are not suffering financial hardship while many others continue to struggle. However, this misses the point. Good state interventions must answer three questions positively:

- Is there a rationale for the intervention i.e. is it designed to address an identified market failure?
- Can the State address the problem or is it one that we must simply learn to live with?
- Is there a net benefit to the economy i.e. a positive result from a CBA?

To all these questions the answer is yes. There is a clear market failure in the housing market due to the lack of confidence. The state can act as outlined below. The potential benefits are large while the risks to acting are likely to be very small.

A solution would be to create a residential mortgage bank that would provide residential mortgages with built-in features to address the concerns that are preventing individuals from purchasing homes. In some respects this mirrors the original ACC and ICC when they were first established – they loaned to viable sectors where perceived risks or market failures – prevented existing commercial banks from venturing[26]. It would be sufficient for the proposed entity to remain in place for a finite period of time say a specified number of years or perhaps until house prices had shown three consecutive years of growth. The bank could be State owned, with a commitment to privatisation, once it had achieved its public policy mandate but there are reasons as discussed below why it should be structured as an independent legal entity with public and private shareholdings. It should compete directly with existing banks but it would not inherit any legacy bad mortgages and so would not be burdened by the problems that have arisen due to excessive risk taking in the past or the effects of the fall in residential prices in recent years. Banks could then either compete with this bank to retain a meaningful share of what is actually the best sector of the mortgage market i.e. borrowers that are not distressed, or they could lose their share as the mortgage bank succeeded.

If the proposed bank was to build up a new loan book, given the target market and the current level of prices, then it would be a valuable entity in a few years with low levels of bad loans. If it failed to build this position in the market then it would either be because existing banks were able to compete successfully with it – which would be an acceptable outcome – or because there is no potential latent demand that could be realised. In this case, the only losses would be administrative ones associated with creating and running the entity, which in overall terms would be relatively small.

One of the most important issues to be considered in relation to this proposal is the fact that the initiative is required to be in place now, at this point in the economic cycle. As discussed earlier, the levels of loans being provided to house purchasers is well below what might be expected given the fundamentals of the Irish economy with the result that the housing market is stagnating and house prices continue to fall. If there were to be any significant delay in progressing this recommendation then it

[26] The ACC was created in 1927 to lend to agriculture and its successful led to the creation of ICC to lend to industry. This was an initiative at a very early stage in the formation of Ireland as a state that addressed a clear problem successfully. In effect, the state was able to take on the perceived risk of lending to farmers on the basis that the benefit to the general good was such as to counteract the additional risk of doing so. The parallels with the housing market of today are striking.

could easily be redundant. The housing market will eventually stabilise, but at a very low level and living standards will continue to fall.

At the same time, it is recognised that there is potential for considerable delays to arise before any new mortgage provider would be up and running and meeting all relevant regulatory requirements. To avoid unnecessary delays occasioned by, bureaucratic inertia and risk aversion the creation of a proposed mortgage bank should be progressed with clear targets to be achieved in a number of areas. At this stage these should include

- an initial target date, for setting out the parameters of the operations of the bank and identifying an appropriate international partner, before the end of 2012;
- a target size of lending operations for the bank; and
- a target date for granting loans, which should be within one year from now.

As well as providing a framework for decision-making, these targets would also provide an incentive for existing banks to re-engage with the residential mortgage market and compete, as it would alter their risk environment. In effect, it would alter the risk environment from being dominated by the fear of providing loans in a market that is still falling to the fear of losing any chance of recovery as they would lose a very important part of their business.

The target size of the mortgage bank is indicated by the gap between the number of mortgage loans being granted currently and what might be expected in the economy at this juncture. In 2011, only 11,100 new mortgages were drawn down with a total value of €2.1 billion[27]. Any projection of what the demand for mortgages in Ireland now 'should' be i.e. if there was not a funding constraint and confidence was not so damaged, requires assumptions to be made in relation to emigration, which has a large impact on the house buying age group, the impact of the increase in availability of houses for renting and the propensity to rent, and the impact of the recession on the willingness of households to purchase. Taking account of these influences, it is projected that the normal long run level of demand is 41,200 per annum, about 30,000 above its level in 2011[28]. However, this projected level is unlikely to be achieved any time soon. If a new mortgage bank were to target a market share of 50% of the

[27] Data from IBF/PWC as quoted in *The Irish Property Review*, March 2012 published by Bank of Ireland Economic Research Unit

[28] This number is calculated as follows. We assume that if there was a neutral economic background with no change in population then the number of mortgages would remain constant. There were 768,917 mortgages in existence at the end of 2011, a fall of 17,247 from a year earlier. Since 11,100 new mortgages were provided in 2011, this means that a total of 28,347 (i.e. 17,247+11,100) would have been required to maintain the number constant. However, the Irish population is projected to grow at about 1.5% per annum in the period 2011 to 2026 – we will take this to be its normal long term growth rate if the impact of swings in net emigration is excluded – and household size is falling from about 2.8 to a projected 2.5 by 2020. This increases underlying demand and we would expect the number of mortgages to be growing in line with these fundamental factors. These factors would be expected to create demand for an additional 12,850 mortgages per annum given the current size of the population and the stock of mortgages. Thus, against a neutral economic background where there is no constraint on availability or on the willingness of households to take out a mortgage, we would expect the number of mortgages to be running at about 41,200 per annum (i.e. 28,347+12,850). The average mortgage size in 2011 was €189,000 so this would imply a total market of €7.8 billion per annum, which is 54% of the 2008 total and 28% of the peak in 2006. On this basis, the 'potential gap' of 30,000 mortgage drawdowns (i.e. 41,200-11,100) would be worth about €5.7 billion per annum.

number of new mortgages that are likely to be demanded over the *next* five years, this would amount to approximately 10,000 mortgages per annum[29]. The average new mortgage in 2011 was €189,000 so these would imply a value of €1.9 billion per annum and €9.5 billion over five years.

A new mortgage bank would need capital invested to get started but the creation of an entity with a potential loan book of this amount would appear to be a very attractive candidate for the use of funds generated from sales of state assets, leveraged with outside funds either from EU sources, the proposed private partner and international banks.

In summary, therefore, while recognising the need to continue to address the situation in relation to people in financial distress, the solutions that are required to address the problems in the Irish economy in relation to the housing market require a response that is much broader in scope. Those, would-be householders, who are not in such distress represent potential demand for houses but are not acting due to a lack of confidence or an inability to access mortgage finance, a situation that could be addressed by an initiative in the form of a mortgage bank that provided mortgages for house purchases with innovative features to address the concerns of these potential buyers. This would aim to realise the opportunities that are currently presented rather than concentrating on the problems that exist as a result of past mistakes. However, this proposal relies heavily on a commitment to undertake to create this entity without delay and to find and implement ways to bypass bureaucratic obstacles that would almost inevitably arise. This means it is important to identify targets for the establishment and operations of such a dedicated mortgage bank at an early stage and establish a clear line of responsibility for achieving them.

6.2 Addressing Personal Insolvency

Part of the solution that is required to begin to build confidence in the housing market and the domestic economy in general is the need for banks to clarify the situation in relation to mortgage arrears. This would address the problems faced by households in severe difficulties and would remove the negative implications of the perception that despite already investing huge sums, the banks may need yet further capitalisation. This requires engagement by the banks but it also requires that individuals in severe difficulties have both access to a process and the incentive to resolve their problems. For as long it remains the case that there is perceived to be a cohort of people of unknown but growing in number who are facing financial ruin but have no reasonable way of addressing their situation there is a clear incentive for others to act cautiously in terms of their own finances. This has the effect of increasing households' savings and suppressing demand.

[29] The estimated figure of 10,000 mortgages per annum is derived as follows. Potential mortgage demand is 41,200 but the lack of confidence and the overhang of housing that will be available to rent will mean that demand will likely fall short of this number. If we assume that demand for mortgages will be 75% of this long run potential then an average of 31,000 new mortgages would be demanded per annum. This is 20,000 above the level provided in 2011. The new bank would compete for market share and if it gains a share of 50% then this would amount to 10,000 mortgages per annum.

It has long been known, even before the economic crisis began, that Irish personal insolvency legislation was outdated and in need of major overhaul. However, progress has been slow to non-existent until recently. In late January, the Government published the heads of a proposed Personal Insolvency Bill. This proposes the introduction of three non-judicial debt settlement arrangements and a reform of the existing bankruptcy arrangements to allow the write down of both secured and unsecured debt by qualifying individuals. There is likely to be considerable review of this initial draft and considerable changes are possible. It was initially planned, as agreed in the IMF/EU bailout deal, that the second draft of the Bill would be provided in late April but this has been deferred until the end of June and references to the complexity of the Bill in Department of Justice statements suggest that further delays are possible. It will then go to the Second Stage in the Dail and further revisions are likely.

The Draft Bill contains proposals in relation to bankruptcy and introduces formal alternatives to bankruptcy (an informal arrangement mechanism has operated in the past under High Court protection). The effects of the Bill in relation to Bankruptcy are that it would be available only where a debtor's liabilities exceed €20,000, the discharge period would be reduced to three years from twelve years currently, and a court could order that a discharged bankrupt must continue to make payments to creditors for a period of up to five years after discharge. As an alternative to bankruptcy, the Bill proposes that a new Insolvency Service should be set up and identifies three separate non-judicial settlement arrangements that could be used as an alternative to bankruptcy. These are Debt Relief Certificates (DRC), Debt Settlement Agreements (DSA) and Personal Insolvency Arrangements (PIA). All these relate to individuals only, who meet certain criteria, and only the PIAs affect secured debt.

A PIA would be possible where there is negative equity and substantial arrears and it must be the case that a DSA would not make the debtor solvent within a five year period – in other words, the mortgage is the main problem. A PIA would normally run for six years and the debtor could not be forced out of a principle private residence during this period if the obligations entered into under the PIA are being met. The Bill is flexible in respect of the actual arrangements that might be agreed. All secured debt is treated the same irrespective of whether it relates to a principal residence or buy-to-let property. The mortgage provider would not be compelled to accept the arrangement and once a PIA is awarded the creditor could not look for bankruptcy and all debts would be deemed to be discharged once the debtor complies with the terms of the PIA. It is thought that the reduction in the mortgage discharge period would encourage lenders to agree to PIAs although a flood of mortgage write downs – as might be suggested by figures on mortgage arrears – seems unlikely as it may just formalise what many lenders are already doing. It may also be the case that the Bill would reduce uncertainty in relation to the valuation of the Irish banks by potential international buyers, even though their rights as secured creditors would be eroded.

There is no doubt that the introduction of the Bill would improve the situation faced by many people in financial difficulties as it would provide a legal alternative to bankruptcy and create an independent entity in the form of the Insolvency Service to assist in putting management plans in place. However, its impact in terms of stimulating domestic demand might be quite limited. The DRC restrictions in the

Insolvency Bill are so tight– they are restricted to people with less than €60 per month of disposable income – that it is likely that the impact on demand as a result of resolutions under this scheme would be very small. It is likely that the number qualifying for DSAs would also be small as most people in this situation would require PIA arrangements.

It is not known precisely to what extent PIAs and bankruptcy would lead to write downs in the value of mortgages, since PIAs will entail six year work-out agreements. However, they should lead to write-downs corresponding with the extent of bad mortgages, which has been estimated to amount to as much as €9Billion. Even if this was the extent of write-downs this could be absorbed by banks without compromising capital adequacy ratios, (see Section 4.5 above). PIAs would be formal arrangements that would provide certainty. The impact of the informal arrangements currently being followed by the banks with respect to financially distressed households is unclear, as regards either the household sector or banks' balance sheets. However, certainty is the key requirement.

It is hard to avoid concluding that the resources of the State are not being brought to bear to get the required legislation in place expeditiously. Already, the timetable for drafting has been extended. Furthermore, the proposed voluntary nature of participation in a PIA would mean that the mortgage providers would effectively have a veto is a real weakness. This decision should lie with the individual i.e. there should be a right to access the arrangements, for individuals meeting explicit economic criteria with enforcement and oversight powers lying with the Insolvency Service.

The importance of this legislation therefore lies in the extent to which the new insolvency arrangements would reduce uncertainty in respect of a household's prospective net worth and work to restore confidence to stimulate spending. However, it needs to be put in place as a matter of urgency and it needs to be sufficiently robust to ensure that it confers the rights on individuals.

6.3 The Role of NAMA

NAMA was established with two objectives: firstly to purge Irish banks' balance sheets of property loans (other than residential mortgages), whose growing impairment was eroding the capital base of banks leading to market concerns about their viability and in consequence banks were finding it increasingly difficult to satisfy liquidity requirements in inter-bank markets. Secondly, through active management of the portfolio of property assets and by overcoming shortcomings in the structures of property developers' businesses and ensuring an appropriate balance sheet structure in relation to the portfolio it would create and realise the potential value of the portfolio for the benefit of the taxpayer.

When originally proposed the face value of property loans (i.e. development land, work in progress and investment properties) amounted to some €156 billion. In establishing NAMA the Government decided that loans with a face value of about half this amount would be transferred to the new entity and by 31 December 2011 NAMA had acquired loans with a face value of €74 billion from the five financial institutions covered by the scheme. On balance, it was considered that the potential gains of removing the entire class of loans from banks' balance sheets, namely that investors and lenders could be assured that the capital resources of the banks would not be eroded by impairments of this category of lending would be less than the risks to the Exchequer of attempting to take on liabilities of this scale. This judgement was a correct one, as illustrated by the fact that the market proved unwilling to finance Ireland's government debt on acceptable competitive terms and external assistance was required by way of the EU-IMF

The expected outcome was that with banks' balance sheets purged of bad property loans and recapitalised to levels regarded by investors and lenders as adequate, the banks would be able (and willing) to return to their usual business of making loans to creditworthy borrowers. However, this has not been the outcome to date. It is possible to point to a number of factors which may have prevented the expected outcome from becoming reality:

> Firstly, it would not have been possible to remove all of the loans over which investors and lenders had doubts;
>
> Secondly, the process of acquisition of loans by NAMA, during which there were several upward revisions of the discount that was being applied, did not inspire confidence to lenders that the authorities had a clear and accurate assessment of the scale of the problem. The fact that no satisfactory explanations were provided, at the time (or subsequently), as to the reasons why discounts were much greater than originally envisaged may have reinforced these doubts.
>
> Thirdly, it was becoming increasingly clear that Ireland was not alone in having a banking sector that was seriously undercapitalised. As a result investors and lenders were becoming increasingly cautious and unwilling to extend liquidity in the usual way, not only to Ireland, to the point where the ECB has recently had to provide in excess of €1 trillion to European banks in liquidity support.
>
> Fourthly, it does not appear that there is any great desire on the part of banks to return to a 'business-as-usual' approach. The reasons are unclear but perhaps they may not consider they have adequate risk assessment techniques or managers with the requisite skills, or that there are not creditworthy clients seeking to borrow from them, or that the risk reward relationship from attempting to grow their businesses is not attractive.

The key features of the acquisitions made by NAMA have been described in a recent report of the Comptroller & Auditor General[30], including the following:

- It is estimated that when all loans are finally valued the acquisition price paid by NAMA to the banks will represent around 43% of their par value i.e. the amount owed by borrowers to the banks.
- The uplift to long-term economic value in the valuation of the underlying property collateral was almost 9% for the loans that have been finally valued.
- When discount rates for distressed loans are applied, it is estimated that, even after a write-down of 57% at acquisition, the acquisition price incorporates state aid of over one-fifth to the financial institutions.

[30] Special Report, *National Asset Management Agency*, Comptroller & Auditor General, February 2012

- The vast bulk of the loans that were acquired related to properties that had been completed representing 71% of the collateral with land making up a further 20%. Around 9% is made up of properties that are in the course of development.
- Over half of the underlying collateral (56%) is in the State with a further one-third in Britain.
- The predominant relationship that NAMA is managing is one of lender-borrower. The bulk of the loan assets that are managed relate to property that continues to be managed by debtors. Overall, NAMA has taken steps to structure its relations with its debtors through legal and quasi-legal agreements.
- In practice, most of the debt is managed directly by NAMA. However, of the original debt of €74 billion, €13 billion is managed on its behalf by the participating financial institutions.
- While NAMA has, following the receipt of business plans, completed relatively few loan restructurings it is pursuing restructuring for around 28% of the directly managed debt. In broad terms a further 34% of these loans are subject to disposal or enforcement actions with a further third of them at an interim letter of support stage. No restructuring has occurred of loans managed by participating institutions.
- As well as seeking to manage the loans, NAMA has taken steps to identify assets of borrowers that may be available as additional security.
- It estimated that up to €500 million additional security may be pledged as a result.
- NAMA has adopted strategies to guide the management of its approach to loan workouts and the timing of disposals as well as the approach to be adopted in different markets. These take account of conditions in both industrial sectors and geographic areas. It will be necessary for it to review these strategies on an on-going basis in the light of alterations in its corporate strategy that take account of market conditions and have control and reporting mechanisms to assure itself that the individual loans are managed in accordance with policies tailored to the emerging conditions.
- NAMA uses part of loan repayments to fund new advances. Up to the end of December 2011, it had approved new lending amounting to €975 million of which €720 million had been drawn down by debtors.
- NAMA's most recent estimate of the amount of new lending by way of working capital and development loans that it anticipates making to all borrowers over the full period of NAMA's life is around €3.5 billion, the bulk of which (€2.6 billion) will be advanced in the period from 2012 to 2015. NAMA anticipates that it will recover the bulk of those funds it advances for capital and development.
- Because the debtors continue to manage the underlying property, NAMA agrees the level of overheads arising out of staffing and general administrative costs incurred by borrowers in managing the funded business. The principal determining component of the overhead is the agreement by NAMA with debtors of the appropriate organisational structure and associated cost that should relate to each business.
- The other major cost that can occur arises out of the use of insolvency practitioners. In the case of receivers, NAMA is moving to a process of

payment based on budgets that are submitted in advance by firms and requiring that receivers set out a strategy for the assets to which they have been appointed.

When it published its first business plan in mid-2010, the financial outcome of its activities over its expected lifespan was projected to range from a net present value deficiency of €0.8 billion, in circumstances where NAMA recovered 10% less than the long-term economic value of acquired loans, to a surplus of €3.9 billion where it recovered 10% more than the long-term economic value. For 2010, the first full year in operation, a loss of €1.12 billion was incurred following an impairment charge of €1.5 billion, arising out of a further diminution in the value of the loan assets purchased by NAMA. From its earlier target contained in its original Business Plan of seeking to make a profit on its overall operations, its target now, according to the C &AG Report, is a minimum target to recover at least its outlay and costs from the interim management and ultimate disposal of the loan assets. The C &AG considers that '*NAMA faces considerable challenges in achieving this income goal. Its interim target is to reduce its debt by 24% by the end of 2013 with the entire process extending up to 2020 at least*'.

There are a number of features above worthy of further comment. Firstly, is the decision to pay long-term economic value of the loans as opposed to current market value. While the C& AG report is quick to highlight the State-aid to financial institutions of some €4.96 billion, which arises to date on foot of this decision, it is presumed that this was not the rationale behind paying long-term value. However, what is clear is that, taking the portfolio as a whole, there will be losses to the taxpayer if aggregate disposals are below this level, as recognised in NAMA's first business plan of mid-2010 and alluded to above. Indeed it is hard to disagree with the C &AG's assessment that NAMA will struggle to meet its minimum target. Property markets have generally weakened since NAMA acquired its portfolio, so that current market values have drifted further from long term values paid by NAMA when it acquired the loans. When combined with the intention of reducing its loans by 24 per cent by end 2013 it seems inevitable that NAMAs losses are set to rise – significantly, especially considering that credit availability in the domestic market for property is so poor.

In identifying an asset management model as the preferred approach to the issue of bad property loans one of the key influences was the fact that a feature of Irish property investment and development enterprises was their privately incorporated status and high reliance on bank debt. Indeed it was argued that the absence of balance sheets adequately structured with equity finance, was a key factor underlying the financial collapse of these companies, with consequential losses for their lenders. It was considered that the best opportunity to remedy this deficiency was to have NAMA closely associated with the NTMA, whose core competence is in financial markets instruments and has achieved due acknowledgement amongst many international capital markets participants. However, it is to be noted carefully that the C & AG report finds that 'the predominant relationship that NAMA is managing is one of lender-borrower. The bulk of the loan assets that are managed relate to property that continues to be managed by debtors. Overall, NAMA has taken steps to structure its relations with its debtors through legal and quasi-legal agreements'. That is precisely the same kind of relationship these enterprises had with banks, prior to

NAMA. Replacing one provider of debt finance with another will not result in any restructuring of balance sheets that would enable the long-term value of assets to be realised. Indeed, it is noteworthy that, after NAMA's three years in existence, the C& AG notes that it has 'completed relatively few loan restructurings'[31] never mind achieve an appropriate balance of capital liabilities, which includes equity. In addition, the lender-borrower relationship, which is evolving, has become adversarial it would appear, in a significant number of cases. Such an environment is not conducive to achieving the maximum long term value for taxpayers. Where dispute is unavoidable it is recommended that mediation would be a more cost effective means of resolving issues in dispute rather than court proceedings and accordingly should be used where possible.

It is noted that NAMA intends instituting a Qualified Investment Fund, before the end of this year as a means of attracting international equity funding. Given the constraints under which NAMA appears now to be working, especially the requirement to reduce loans by 24 per cent by end 2013, against a background where the domestic credit market is not working, a better return for the tax payer might be secured by the Government (part) privatising NAMA now, to an international private equity investor or international property investment company or a consortium of such interests. It is recommended that the merits of such a proposal should be examined. It would be consistent with the approach being considered in relation to other State owned assets. As a minimum the Government should undertake a review of the business strategy of NAMA, including the statutory basis on which it is based, to determine if it offers the best prospect of securing the best return for the taxpayer in the longer term. In particular, the focus of review should be to determine if a superior outcome would be likely from replacing the lender-borrower relationship with one of joint venture partnership, based on equity investment by joint venture partners. There is sufficient scale and scope in the NAMA portfolio for some such joint ventures to be publicly quoted. This would permit the State to monitor the value it holds on a more or less continuous bases and if desired or required it could realise its interest in the long term value of projects by selling some or all of its shareholding, rather than selling the underlying asset, before its long-term potential has been attained.

6.4 Leveraging State Assets

The McCarthy report[32] recommended a planned programme of sales of state assets as a means for Ireland to reduce its rapidly rising debt. However, the report was careful to recommend that this should not be undertaken without ensuring that appropriate values were obtained. It considered it important that this programme of sales should be seen as part of long term recovery plan to make improvements in the competitiveness and efficiency of the economy rather than as a means solely to bridge current deficits. However, while pointing to numerous potential candidates for sale, the report did not provide any indication of what values might be obtained for these assets although it did identify that the net asset value of the commercial company

[31] To judge from Table 3.3 of the C & AG Report restructurings have been completed with respect to two debtors, in respect of loans with a face value of €1.66 billion, from a total of €61.4 billion being considered in one way or another by NAMA

[32] Report of the Review Group on State Assets and Liabilities, April 2011

assets was about €5 billion. The IMF-EU bailout referred to the sale of state assets as a means of raising funds in the context of the Programme for National Recovery but did not identify any targets. However, consultation with the Troika is required before any action is taken.

The assets identified as suitable for sale include semi-state companies but not energy transmission assets and property rights should be sold rather than actual land. So, while much of the existing ESB and Bord Gáis could be sold, the transmission network and interconnection assets should be retained. Similarly, Bord na Mona should be privatised but not the bog lands, and Coillte should be privatised along with its timber assets and unused land, but forested land should not be sold.

Although a commitment to sell assets was included in the Programme for Government, little progress seems to have happened during 2011 as the prevailing understanding at the time was that the proceeds could not be used other than to reduce debt. Following negotiations in February 2012 it was agreed by the Troika that one-third of the proceeds could be used for re-investment with the remainder being used to reduce debt. This agreement also committed the Government to selling assets up to a value of €3 billion rather than the €5 billion value that was mostly spoken about before then as a result of the estimate in the McCarthy report. This agreement also reiterated as 'principles' that there would be no fire sale and that transmission assets would not be included. The main assets identified to be sold are the Energy business of Bord Gáis (excluding the transmission and distribution systems and the interconnectors), part of the ESB's generating capacity, Coillte (excluding the land), and the Aer Lingus shareholding. However, the timetable for action does not suggest that there is much current momentum behind the programme. It is the current objective that any remaining regulatory issues be resolved during 2012 'in order to facilitate transactions beginning in 2013'.[33]

Following the most recent Troika review – the 6th review undertaken in April – it has been reported that the Taoiseach has stated that the portion of the funds generated from sales that can be used for investment rather than debt repayment has been increased to 50%[34] and subsequent comments suggest that there may be additional flexibility. However, the official statements indicate that while it may be above the one-third that was previously agreed, no final agreement on this higher figure has been reached. There are also indications that there will be controls on how this money is spent with the creation of jobs being emphasised. It will be possible to start using the money for investment once a sale proceeds rather than waiting for the programme to be completed.

Examination of the potential to sell of state assets would be a good idea even if Ireland did not face funding difficulties. In the case of a fixed asset, the key question is whether the funds invested could be better used elsewhere if the holding is liquidated. In a funding crisis the likelihood of a positive answer to this question is greatly increased. If the asset in question is the right to provide a service then a second question is if there would be an efficiency gain through privatisation. In other words, there may be two reasons for privatisation with the second arising irrespective

[33] Dept. of Public Expenditure Reform Press Release 22nd February 2012.
[34] Irish Times, April 26th 2012

of any constraints on funding. However, although the McCarthy report did refer to the potential to sell non-fixed assets under the programme, the emphasis appears to have continued to be placed on the potential to generate funds from fixed assets.

A number of comments on what is happening in this regard are warranted. The first is the lethargy with which progress is being made. Over a year after the McCarthy report, it would appear that a further year will pass before any actual sales will be made. This is far too slow and it leaves the Irish economy stagnating when funds could be generated and invested to support growth. In any event, there is no need to wait for the funds to hit the exchequer for investment decisions to be made, there is always a lead-in time to investment spending. Furthermore, the range of assets being considered appears far too limited and largely restricted to some of the semi-state companies. Examination is required of a much wider range. For example, the state is engaged in a number of service-activities that could be licensed. Among these are prison operations, revenue collection and administration of welfare, education and health services. A property right exists in respect of each of these areas while the ownership of the service could continue to reside within the state, a licence to the right to undertake the service could be sold. For example, would it not be possible to licence a private company, for a fee, to collect the new household charge? In the area of fixed assets a much wider range should also be considered. For example, the state owns large numbers of primary schools. A sale and leaseback arrangement would provide funds that could be invested in part in upgrading the schools themselves thereby addressing a pressing problem of inadequate facilities. Furthermore, there is no clear economic case for the state to continue to own many of the buildings from which government business is conducted and a similar sale and lease back would generate funds.

The indications so far are that sales totalling €3 billion are proposed with 50% of the funds becoming available for investment. However, this should not be considered to be the upper limit on the funds that will be available and options to leverage these funds without incurring additional public debt should be pursued. This would entail greater private sector involvement. To date, PPPs in Ireland have tended to be limited to major infrastructure projects. The existing legislation and procedures should be examined to see if there is a constraint to expanding PPPs into other areas of activity where the state's input could be an existing property that should not be sold or a property right to undertake an activity. By entering PPPs, the funds generated from the sale of assets could be leveraged up. So, if there are assets worth €3 billion currently being considered, consideration of a further range of assets such as those alluded to above could increase this to, say, €4 billon. If 50% must be used to reduce debt then it should be possible to leverage the remaining back to at least €4 billion. NAMA has recently announced plans to procure €2 billion to allow debtor clients to complete certain construction projects in the period up to 2016. They estimate that this will create 25,000 direct and indirect construction jobs and a further 10,000 indirectly. The use of funds generated from the sale of state assets as outlined here offers the potential of doubling this, creating 50,000 jobs directly and a further 20,000 indirectly.

Of course, the household sector is not the only part of the Irish economy that has been constrained by credit in recent years. A proposal has existed for a number of years that a State Investment Bank should be created to provide venture capital for firms.

This would have a role even if the flow of credit from banks was not as constrained as is currently the case. Enterprise Ireland has been undertaking a role along these lines for a number of years but they have not been in a position to leverage existing funds by accessing sources of private capital within the economy. The opportunity to spin off this function into a separate entity with public and private shareholding to act as a source of venture capital should be examined and progressed. While such a source of funds would undoubtedly be useful in the current climate, this entity would also have a long term role in economic development.

The potential here is clearly considerable but it needs to be progressed as a matter of urgency. Mindsets and arguments that point to perceived risks of change or benefits of continuing as is, need to be challenged and constraints on progress, which appears unjustifiably slow, need to be bypassed. The cost of inertia is an economy that continues to stagnate.

6.5 Preparing for a Change in EU Policy

This agenda has concentrated on actions that Irish policy should progress irrespective of developments at the EU level. However, it is clear that there are changes occurring as EU leaders, and particularly Eurozone decision makers, start to realise that the policy of recent years has not been moderate but extreme and not one that guarantees stability but risks alienating sufficient parts of the population to cause political instability in addition to the economic instability it is designed to address. What will replace this approach remains unclear but it is safe to assume that it will be more oriented towards growth. Other elements also appear probable, for example, in return for countries introducing national laws to curb excessive deficits Germany will consider a move towards a system of Eurobonds. Such move would be very positive for Ireland. But is Ireland prepared for a change in the EU approach that will provide opportunities?

From the late 1980s and into the 1990s, Ireland benefitted greatly from EU Structural Funds. Obviously such funds are a thing of the past in terms of their potential impact on the economy. But Ireland was successful not just because it got access to these funds but because it spent them well. This expenditure was undertaken within a succession of National Development Programmes and supporting agreements and programmes at the national level. The current situation is that these have been replaced by the crisis management programme that is the National Recovery Programme. This approach has been required, but it is inadequate for recovery.

A National Growth Programme is required to set out and guide how Ireland will realise the opportunities that are currently available and to prepare for new opportunities such as access to Eurobonds or new spending by the European Investment Bank (EIB), if its role and resources are increased. This Programme should be based in its initial stages on existing capital deficiencies and priorities, identifying how these would be addressed and evaluating the best way to do so. It needs to look beyond current and recent constraints realising that there are opportunities, as identified above and that the situation is changing in favour of recovery policies at the EU level. For example, with the new East West

Interconnector close to making available for the first time an additional 500 megawatts of interconnection capacity between the Irish and British electricity markets, and the first capacity auction scheduled to take place on June 19th, a significant obstacle to greatly expanding Ireland's green energy sector is about to be removed. The green energy sector is a hugely important opportunity for Ireland and represents a key sector for strategic investment and support. By targeting such investments, along with ensuring that the development of Irish third level education is not constrained through lack of funds, Ireland would be able to move beyond the thinking that has been necessary to manage the crisis created by the mistakes of the last decade and create the basis for recovery into the next decade by building on growth policy approaches that have been shown to work in the past.

7. Towards a Brighter Economic Future

7.1 Conclusions

In late 2008, the global financial system was plunged into a crisis of historic importance. The sources of the problem lay in the debt fuelled asset boom that had preceded it, the final phase of which was rapid house price inflation in many developed economies. After the initial crisis was managed, the shock translated into an economic slowdown. Policymakers in different areas differed as to the correct response to these developments with the USA pursuing aggressively loose monetary and fiscal policies while Eurozone leaders emphasised the importance of bringing debt under control of enable a return to stability. It is now clear however, that although the recovery in the USA is somewhat more fragile than had been hoped, the economy there has returned to fairly steady low rates of growth. In contrast, the Eurozone continues to be embroiled in crisis and the policies that have been followed to date risk becoming a part of the problem rather than offering a solution. Opinions are changing on how to proceed.

Having experienced a notable boom and very high property price inflation, the crash in Ireland has been even more pronounced and the policy response even more extreme. Initial reaction was slow but the need for extreme measures was mandated by the IMF-EU bailout terms. Since then, policy in Ireland has continued to operate in a framework of crisis management and is deflationary. The economy has stagnated with rising unemployment and no near-term prospect of recovery. However, the focus remains on hoping that rising exports will drag the economy to growth even though the problems are in the domestic sectors of the economy and exports have been performing well.

The main conclusion of this report is that policy needs to be reorientated towards addressing the lack of growth, and indeed ongoing decline, in domestic demand. The keys to this lie firstly in stabilising house prices and rejuvenating a moribund housing market. Secondly, Ireland has more options than might be thought to begin this process. Some of these are already in the public area but are progressing at much too slow a pace. Implementing the recommendations of this report is not without its challenges, many of which may come from entrenched interests. However, the alternative is that the opportunity will be missed and Ireland will be consigned to a more prolonged period of economic stagnation.

7.2 Recommendations

This report has identified a number of measures that can be taken. These cannot be characterised simply as attempting to spend our way out problems and it is advocated that proper evaluation of the costs and benefits of interventions should be undertaken for all expenditure. To get the Irish economy onto a growth path, it is recommended that:

- The Central Bank should put intensified pressure on commercial banks to assess and address instances of problem mortgages;

- The proposed Personal Insolvency legislation should be put in place as a matter of urgency to underpin confidence that problems can be addressed;
- The legislation should confer a right to a PIA for secured debt thereby removing the veto that mortgage providers would have under current proposals;
- A National Mortgage Bank should be created with a commercial mandate to grow its loan book by offering competitive mortgages for residential purchase that address the issues that are currently keeping potential buyers out of the market. This bank should be created to compete with the commercial banks but without legacy problems with a view to privatisation once it has completed its public policy mandate;
- This new bank should be formed as a joint venture between the Irish state and a private sector partner. Addressing potential obstacles should be a priority as the problems created by lack of funds to finance house purchases need to be tackled as a matter of urgency;
- The new bank should be created with a target that it will be operational within a year and provide 10,000 mortgages per annum once operational. To achieve this is should aim to provide mortgages with a value of €9.5 billion in its first five years of operation.
- Various sources should be examined to identify funding for this bank, including the use of funds from asset sales, structuring the bank in a manner to make it attractive to an outside investor,;
- The NAMA proposal for the sale of houses using partly deferred mortgages should be progressed but on a much larger scale;
- The lender-borrower relationship, which is being evolved by NAMA, has become adversarial it would appear, in a significant number of cases. Such an environment is not conducive to achieving the maximum long term value for taxpayers. Where dispute is unavoidable it is recommended that mediation would be a more cost effective means of resolving issues in dispute rather than court proceedings and accordingly should be used where possible.
- The merits of (part) privatising NAMA now, to an international private equity investor or international property investment company or a consortium of such interests should be examined. It would be consistent with the approach being considered in relation to other State owned assets. As a minimum the Government should undertake a review of the business strategy of NAMA, including the statutory basis on which it is based, to determine if it offers the best prospect of securing the best return for the taxpayer in the longer term. In particular, the focus of review should be to determine if a superior outcome would be likely from replacing the lender-borrower relationship with one of joint venture partnership, based on equity investment by joint venture partners. There is sufficient scale and scope in the NAMA portfolio for some such joint ventures to be publicly quoted. This would permit the State to monitor the value it holds on a more or less continuous bases and if desired or required to realise its interest in the long term value of projects by selling some or all of its shareholding, rather than selling the underlying asset, before its long-term potential has been attained.

- The timetable for sales of publicly owned assets should be accelerated. We appear to be still at least a year away from funds being realised;
- A much wider range of assets should be included in the programme such as schools, Government buildings and licences for services many of which are currently undertaken within the public sector;
- Opportunities for leverage of funds raised should be examined and a range of projects identified and placed on a ready to go basis in advance of fund being raised;
- The potential to create a State Investment Bank should be examined and progressed to provide venture capital for firms. Enterprise Ireland has been undertaking a role along these lines for a number of years and this activity should be spun off into a separate entity with public and private shareholding to promote long term economic development.
- There should be a review of PPP legislation and practices to identify why only projects in a restricted number of sectors have been undertaken;
- Ireland should formulate a National Growth Programme based loosely on the Programmes of the 1990s to provide a framework for the expenditure of these funds and to prepare for the prospect of funds becoming available from outside sources such as the EIB.

Ireland has an opportunity to begin to genuinely put the damage done by mistakes in the last decade into the past. It can do this only by adopting a new mindset that aims to realise the opportunities of the present rather than simply dealing with the mistakes of the past. Given the developments in Europe, the time to act is now.