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"Did the ECB Cause a Run on Irish Banks? Evidence from Disaggregated Data"

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Did the ECB Cause a Run on Irish Banks?

Evidence from the Disaggregated Data.

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The paper closely examines events leading up to the Irish crisis of November 2010. It traces the effects of these events on both the onshore banking sector and on an offshore sector that is almost as large but is very different in terms of structure and commitment. Both sectors benefit from liquidity support by the European Central Bank (ECB) but the offshore sector does not benefit from a Government guarantee on deposits and securities and no bank in this category would expect to be recapitalised by the Irish Government in the event of its insolvency. Therefore, by examining the effects of certain events on deposits in each sector, one can distinguish between a crisis of confidence in monetary support (that would apply to both sectors) and an erosion of credibility in fiscal policy (that would apply to domestic banks only). The paper suggests that a systemic run on Irish banks was the proximate cause of the November crisis (even if a financing package might have been needed anyway) and that it probably resulted from public musings by ECB Council members on the need to curtail liquidity support to banks. An ECB commitment in May to support government bonds had undermined its ability to reign in monetary policy and left it searching for an exit.

Introduction

House prices in Ireland quadrupled during the economic boom of 1994-2007 and then crashed by one third of their end-2007 peak during 2008-10 (according to The Economist's measure). In addition to creating significant negative equity in the private sector, this caused two major problems for government: revenues plummeted due to an over-reliance on property-transfer taxes and the banking sector was severely undermined by an over-exposure to the property market. Budget spending was slashed in response, the tax base was broadened and the government sought to clean up and recapitalise the banking system. Notwithstanding the corrective budgetary measures, government debt in Ireland is projected to increase from 25 percentage points of GDP in 2006 to almost 115 percentage points in 2011 (according to the IMF (b) 2010).[1]

House prices fell gradually, if swiftly, and the economic outlook worsened steadily in 2008-10. Estimates of the magnitude of the necessary budgetary correction jumped in response and the Government now envisages undertaking adjustments of 9.6 percentage points of (2010) GDP during 2011-14 in addition to the 9.4 percentage point adjustment already carried out.[2] Moreover, the estimated total cost of the bank bailout has risen steadily and is now put at some 50-60 percentage points of GDP (in 2010).[3]

[1] Even at the end of 2011, the budget will not reach a sustainable balance for a further three years.

[2] The Government's National Recovery Plan for 2011-14 (page 5) envisages further measures of €15 billion in 2011-14, in addition to "savings and revenue-raising of around €14.6 billion on a full year basis (that) have already been achieved" In five separate adjustment packages during 2008-10. The IMF (2010, page 24) puts a lower estimate (of 6.7 percentage points) on the adjustment already secured.

[3] The Economic and Social Research Institute of Ireland put the costs at €73 billion (in April 2010) and Standard and Poors raised their estimate to €90 billion in August 2010. Some funding will be recouped through the sale of impaired assets.

Eventually, the markets lost confidence in Ireland's ability to service its government debt. Irish Government (10 year) bond yields averaged 4.5 percent in early 2008 and touched 6 percent during the Greek crisis of early 2010 before retreating. They did not significantly breach the 6 percent level until mid September 2010 (see Figure 1) and then rose by a further 3 percentage points between mid October and mid November. A full-blown crisis had developed at this stage and, at the end of November, Ireland announced that it had agreed to an IMF/EU/ECB financing package. Notwithstanding this agreement, Irish debt yields have still not fallen significantly.

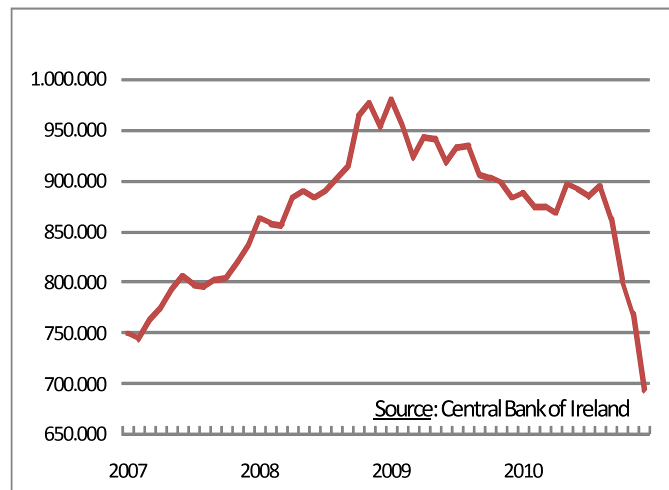
Figure 1: Government (10 year) Bond Yields in Ireland and Greece in 2010.

Source: Bloomberg.

The late-September surge in Irish bond yields took place in spite of a (temporary) lowering of pressure on Greek bonds (see Figure 1). The markets turned their full attention to Ireland's economic problems in mid September 2010 and then catapulted the debt beyond redemption--in the sense that Ireland would not be able to refinance its debt on a sustainable basis if she had to pay interest rates of 8-9 percent. The Government was taken completely by surprise (and has since fallen) and had delayed any further corrective action (such as an early budget) because it had a €20 billion reserve to see it through into mid 2011. It was well known that the Government had this substantial reserve in place so there is an open question as to why the markets acted when they did.

But the November 2010 crisis was precipitated by a significant loss in bank deposits rather than by a critical need for government financing. Deposits at Irish banks declined steadily from the beginning of 2009 but appeared to have stabilised in mid 2010 (see Figure 2). Then, in September, a significant and rapid drain in deposits set in again. In the three months to the end of November, Irish banks lost €125 billion in deposits (or 14 percent of their total) and the ECB, as lender of last resort, was obliged to provide €43 billion in liquidity loans. This is what forced the Government to accept the financing package—it was quickly assembled to save the banks. And this made the Irish crisis of late 2010 very different from the Greek crisis of May 2009—it was a financial crisis rather than a debt crisis. And a further €75 billion in deposits left in December.

Figure 2: Deposits at Irish Banks (in euro millions)

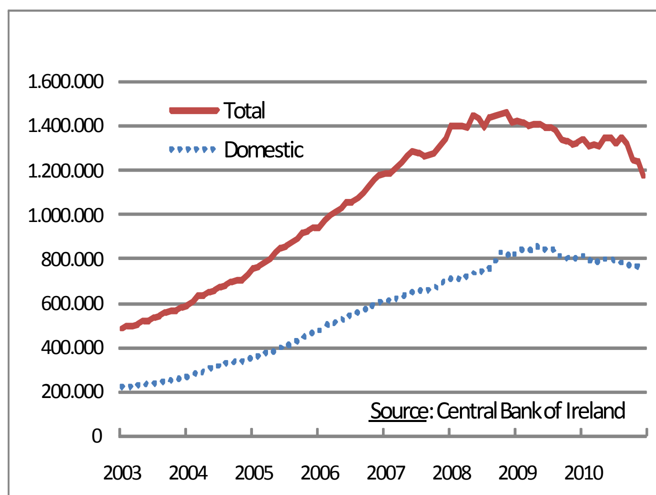


But why did deposits leave the Irish banks so rapidly in September 2010? The paper first examines developments in the structure of the banking system in 2003-10. A large off-shore sector made up for half of the total. Both halves of the system relied heavily on foreign financing during the boom and suffered severe liquidity problems after 2007. But the domestic sector was far more heavily exposed to the domestic market. The paper then examines, in sequence, the emerging crisis of 2008-09 and the full crisis of 2010. It examines whether the banks had a chronic (deteriorating) liquidity problem leading up to the events of late 2010, given that the domestic sector was then recognised as largely insolvent. The events of Autumn 2010 prompt four questions: was there a run on banks; if so, was it caused by a lack of confidence in the monetary or the fiscal authority; and what were the proximate and underlying causes of the loss in credibility? A final section draws some implications for ECB policy and for the future of the Irish economy.

Structure of the Banking System

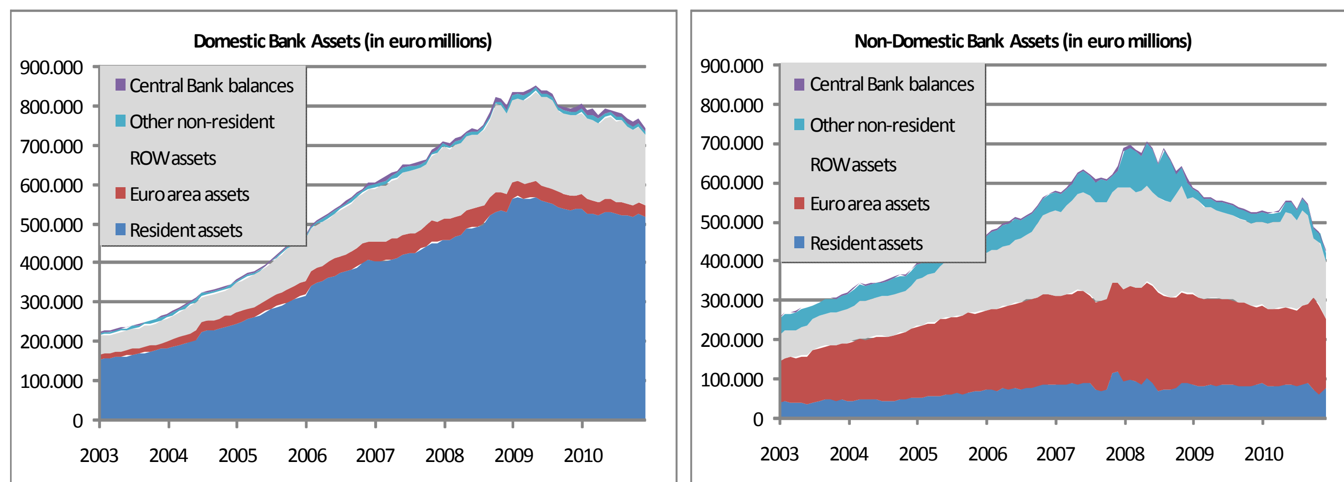
The Irish banking system grew very quickly during the boom years and came to measure more than €1.4 trillion (or 800 percent of GDP) at its height in mid 2008 (see Figure 3). This extraordinary amount included, however, an off-shore sector that accounted for almost half of total banking assets at that stage. The domestic banking sector—made up of those banks that had a majority exposure to the domestic economy—had, nevertheless, quadrupled its size in the six years from 2003 to 2009, having grown from €200 billion to €800 billion. After the global financial crisis began to have an effect in mid 2008, the off-shore sector quickly fell from 50 percent to 40 percent of the total banking system. And by mid 2009, the domestic banking system also began to diminish in its size.

Figure 3: Bank Assets in Ireland (in euro millions)



For domestic banks, exposure to Irish residents stayed in a range of 65-70 percent of total assets throughout 2003-2010 (See Figure 4). As might be expected, the off-shore (or non-domestic) sector had far

Figure 4: Composition of Bank Assets by Residency of Debtor.



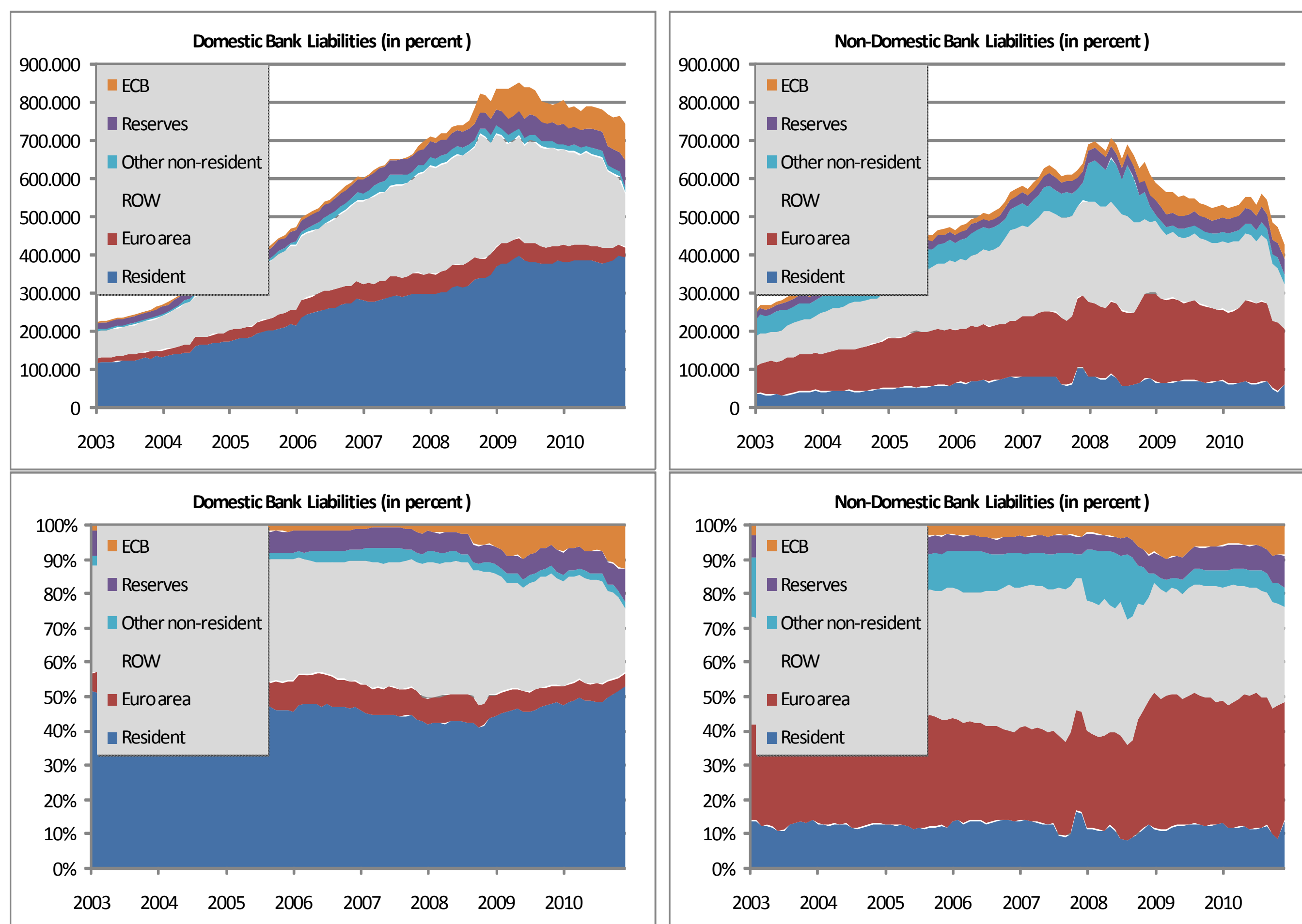
Source: Central Bank of Ireland.

lower exposure to Irish resident assets and its concentration in the Irish market has seldom deviated from 15 percent of total assets. The non-domestic sector increased its holdings of non-euro resident loans and securities (denominated as "ROW assets" in Figure 4) from about 25 percent of total assets in 2003 to almost 45 percent before the onset of the September 2010 crisis. Both sectors significantly reduced their balance sheets after the onset of the world financial crisis but the non-domestic sector acted more quickly.

The phenomenal increase in domestic bank assets during the boom—an increase that invariably led to the bubble in property prices—was most directly attributable to loose monetary policy at the level of the euro-zone. Patrick Honohan, now Governor of the Central Bank of Ireland, calculates that real interest rates averaged minus 1 percent in Ireland in 1998-2007 compared to more than 7 percent in the early 1990s (even excluding the crisis of 1992-3). And after 2003, banks began to borrow heavily from abroad. "No wonder [that] long-lived assets like residential property, capitalized at permanently lower discount factors, seemed and were appropriately valued more highly than before. The problem was to determine just how much higher. European Monetary Union introduced that element of uncertainty." (Honohan, 2009, page 6).

Both the domestic and non-domestic sectors derived an increasing share of funding from non-euro area and non-resident sources (denominated as "ROW assets" in Figure 5) after 2003. For the domestic sector,

Figure 5: Composition of Bank Liabilities by Residency of Creditor.

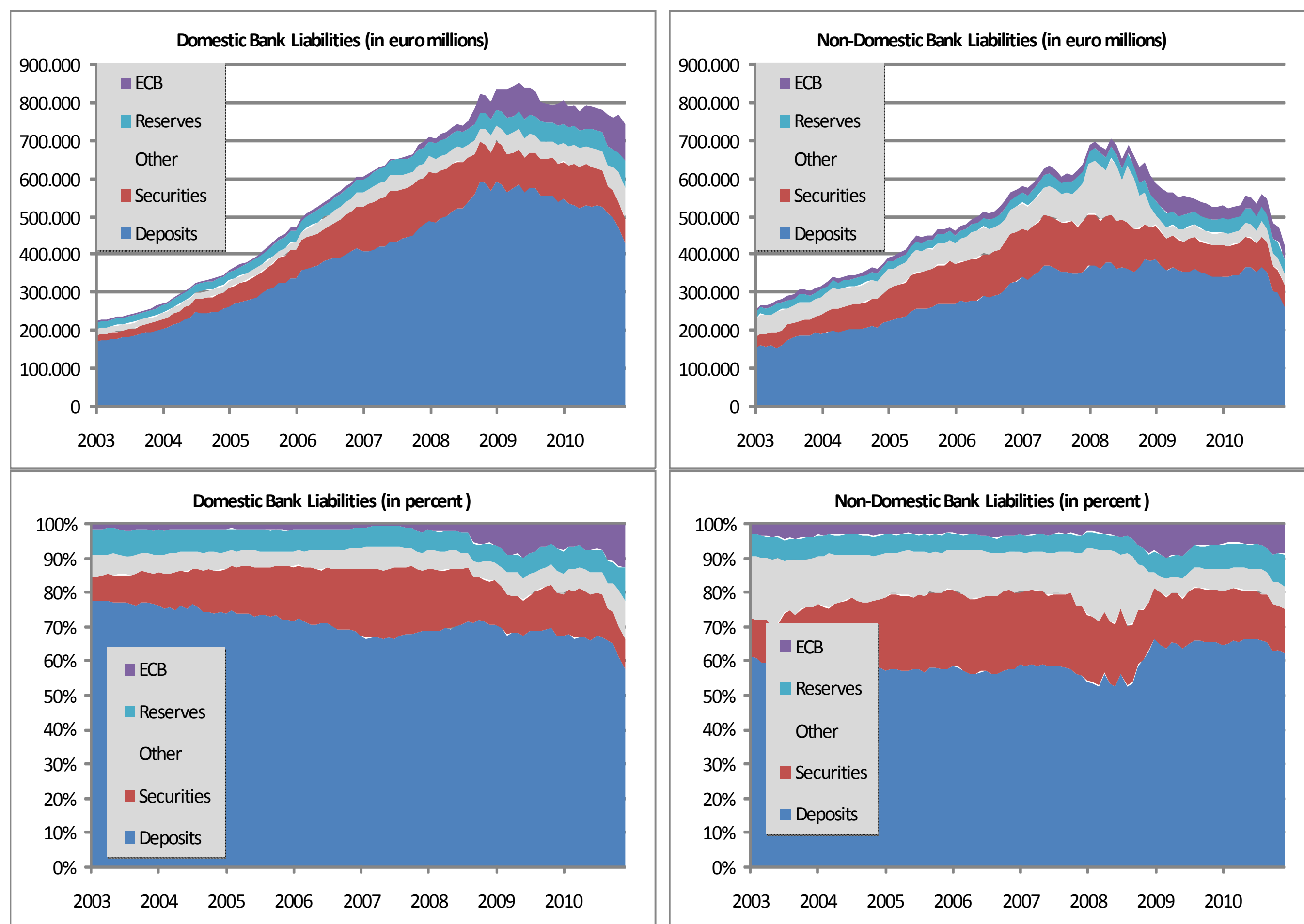


Source: Central Bank of Ireland.

the share attributable to the rest of the world (ROW) rose from 31 percent in 2003 to 39 percent at its height in late 2008. It fell back to 30 percent in August 2010 before dropping to 23 percent in November. It is worth noting, however, that funding from resident sources for domestic banks has remained stable since early 2009. For the non-domestic sector, the share attributable to the rest of the world (ROW) rose from 30 percent in 2003 to almost 45 percent at its height in late 2007. It fell back to 30 percent by the end of 2010. In both cases, the ECB had to replace some of the funding lost from abroad: domestic banks had 7.7 percent ECB funding at the end of August 2010 and this rose to 12.7 percent in November; and non-domestic banks had 6.2 percent ECB funding at the end of August 2010 and this rose to 8.7 percent in November.

The domestic banks also began to rely on securities more than on deposits during the boom. The share of funding obtained from deposits fell from 78 percent in 2003 to 66 percent in mid 2007 (see Figure 6). For both sectors, funding from security sales dropped significantly from mid 2007 and was never to recover. In addition, for the non-domestic sector, shorter-term ("Other") funding dried up abruptly at the end of 2008.

Figure 6: Composition of Bank Liabilities by Funding Instrument.



Source: Central Bank of Ireland.

In summary, the Irish banking system is composed of two very different sectors—one with far lower exposure to resident debtors—and both came to rely heavily on foreign financing during the boom years.

Foreign financing dried up quickly in 2008 leaving both sectors significantly dependent on ECB liquidity loans. They both attempted to shrink their balance sheets—through the disposal of assets—but the non-domestic sector was able to act more quickly and more extensively. As of the end of August 2010, the balance sheet of the non-domestic sector had been reduced by one third from its height (in May 2008), but the balance sheet of the domestic sector had declined by just 10 percent from its height (in May 2009).

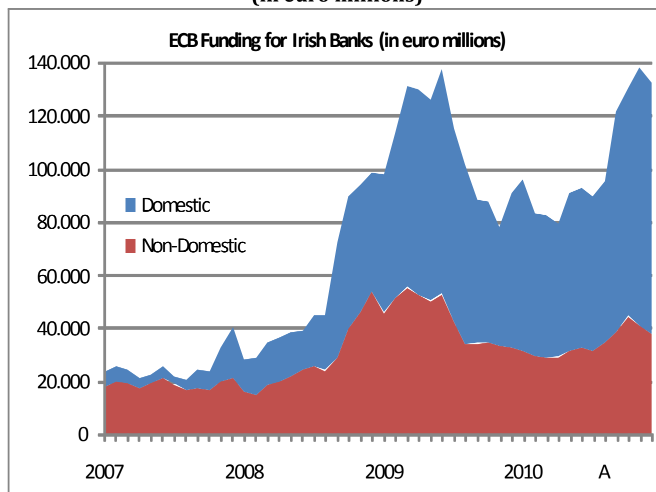
Of course, the off-shore sector was far more nimble because its assets were largely non-resident and, therefore, more liquid. Moreover, the domestic sector had a significant portion of seriously impaired assets and the government guaranteed all deposits and most securities in this sector in September of 2008 in an attempt to fend off a funding crisis. It also began the slow process of recapitalising and nationalising banks.

The Crisis of 2008-09 and the Need for ECB Support

A solvency problem can cause a liquidity problem in banks but liquidity alone can never resolve a solvency problem. And because the extension of liquidity support by a central bank can undermine monetary policy, there will be an extreme reluctance to extend growing liquidity support when insolvency is driving this requirement. When this is the case, the fiscal and regulatory authority—the government—must resolve the solvency problem quickly. But in the context of a global financial crisis, it is difficult to disentangle a liquidity problem from an insolvency problem. This section will examine the extent to which ECB liquidity support to Irish banks in 2008-09 was driven by insolvency alone or was due to the global liquidity crisis. (And Appendix I provides a timeline of major events).

In the year after September 2007, the ECB almost doubled its support to the Irish banking system to alleviate a severe liquidity shortage (see Figure 7). At the same time, share prices of the major banks began a steady decline and, by the Summer of 2008, shares in the three largest Irish banks had lost about two-thirds of their values at the peak (in mid 2007). Then, the collapse of Lehman Brothers in September 2008 prompted the government to guarantee €485 billion in domestic bank assets and there was a surge in ECB support. Still, the crisis was treated as one of liquidity and the Government waited until mid December to promise to invest up to €10 billion in recapitalising the banks in the context of another steep fall in share prices. In January-February 2009, the Government decided to nationalise the weakest bank and to recapitalise the other two largest banks.

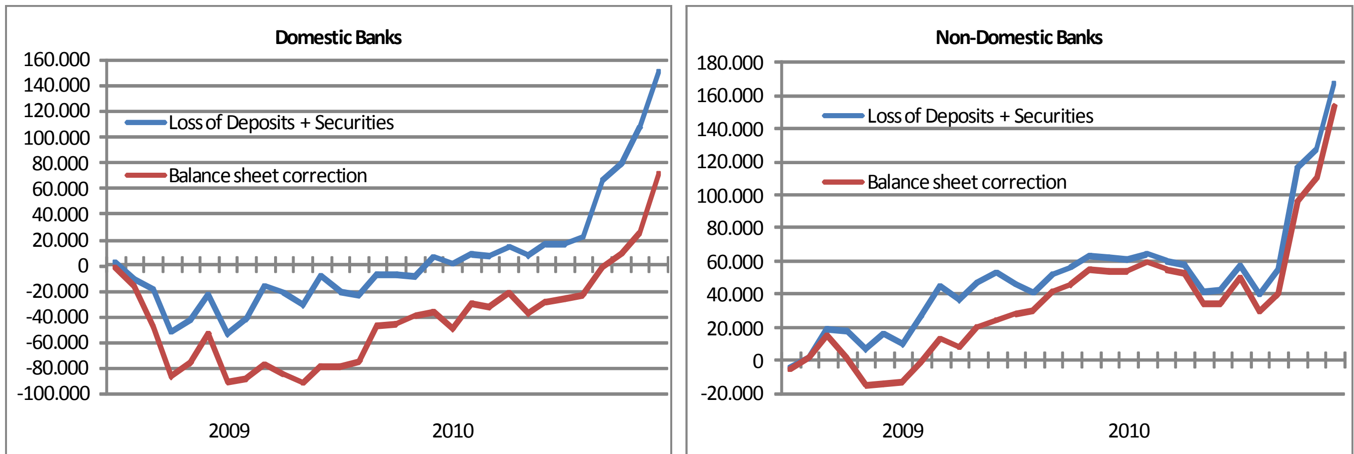
Figure 7: ECB Funding for Irish Banks
(in euro millions)



Source: Central Bank of Ireland.

The failure of the Irish regulator to spot the insolvency only became apparent after the collapse of Lehman Brothers and a subsequent loss in funding. Figure 8 (blue line) measures the cumulative (or growing) loss in funding from deposits and securities that was suffered after the middle of 2008. Domestic banks had an initial increase in funding of €40 billion before losing this and a further €100 billion. Non-domestic banks lost €60 billion by early 2010 and the situation improved before the Autumn crisis raised the loss to €120 billion. Figure 8 also measures the balance sheet correction undertaken by banks in response to the loss in funding. These corrections—either through the sale of assets or an appeal to other sources of funding—would obviate the need for funding from the ECB if undertaken *pari passu* with the loss in funding. Therefore, the difference between the blue and red lines in Figure 8 measures the need for ECB support.

Figure 8: Cumulative Liquidity Problems and Correction after Mid 2008 (in euro millions).

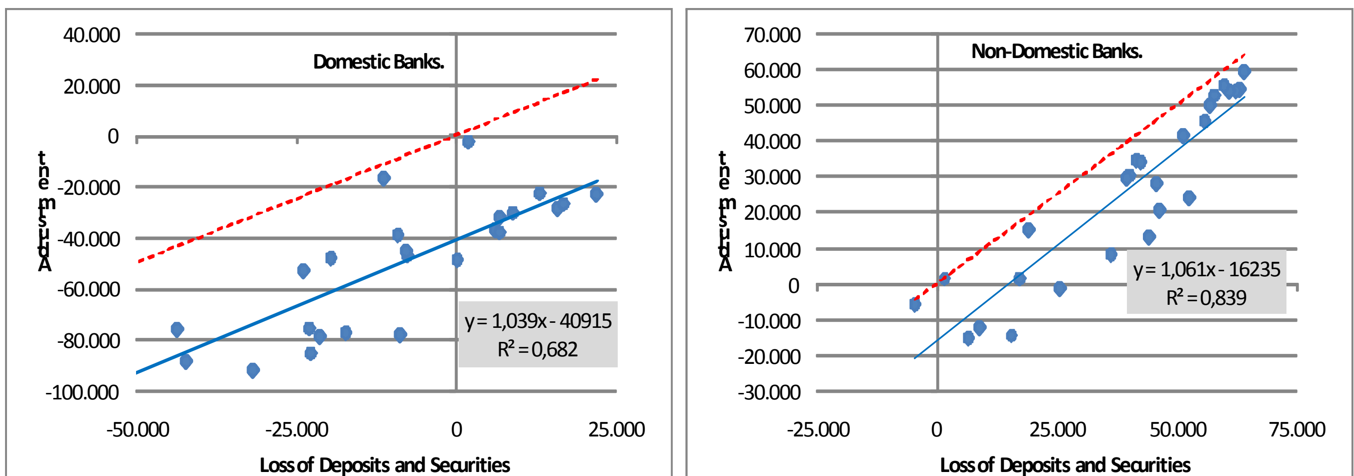


Source: Central Bank of Ireland.

Domestic banks initially increased their reliance on the ECB by about €60 billion before lowering it again and non-domestic banks increased their reliance on the ECB by about €30 billion before lowering it substantially. In both cases, a subsequent reduction in ECB support in late 2009 lasted through most of 2010 and took place despite an ongoing reduction in funding from deposits and securities.

This suggests that the insolvency problem in the domestic banks had not led to ongoing erosion in its liquidity position (and that the non-domestic banks did not have a deteriorating liquidity problem either). And this suggestion is bolstered by an examination of the statistical relationship between (i) the cumulative loss in funding from deposits and securities and (ii) cumulative balance sheet corrections (in the two years from mid 2008 to August 2010). In both panels of Figure 9, a rightward movement along the horizontal axis represents a loss in funding and an upward movement on the vertical axis represents an increasing adjustment to the balance sheet. A rightward movement along the dashed red line would measure an immediate correction in the balance sheet when funding from deposits and securities dropped.

Figure 9: Cumulative Liquidity Problems and Correction from Mid 2008 to August 2010 (in euro millions).



Source: Central Bank of Ireland.

In Figure 9, a coefficient on the regression that is significantly lower than 1 would suggest that a chronic (and growing) funding problem existed while the intersection with the vertical axis measures the permanent nature of the problem that arose. The coefficients are close to 1 for both sets of banks, suggesting that they made adequate correction on an ongoing basis, but this was only after an initial €40 billion in liquidity funding had been secured by domestic banks and €16 billion by non-domestic banks. In fact, both coefficients are slightly larger than 1, suggesting that a gradual improvement was under way.

But while their liquidity positions were not continually deteriorating, both sectors had seen a permanent increase in their reliance on ECB funding after the middle of 2008 and there was no sign of this abating. Meanwhile, the Government was slow to introduce a resolution mechanism for the domestic banks. The transfer of bank assets to a National Asset Management Agency, on foot of needed recapitalisation, was proposed at the end of April 2009 but the first tranche of loans was not transferred until May of 2010—a full year later. In the meantime, estimates of the final costs of bank resolution were mounting constantly.

The Crisis of 2010

In April of 2010, a significant increase in the yield on Greek bonds (from 6 to 10 percent) led to a full-blown crisis in the euro zone. A joint IMF/EU/ECB financing package for Greece was quickly assembled in early May and the European Union also agreed to establish an emergency loan fund that (with IMF support) could reach 750 billion euro. This would alleviate the pressure that had started to build on other European countries—most notably, Spain and Portugal at that stage. Also, and crucially for this paper, the ECB launched a "Securities Markets Programme" that would allow it to buy and support corporate and government security prices. The Bundesbank, among others, was infuriated at this new mandate for the ECB and gave clear vent to its feelings. (See, for example, the Wall Street Journal of June 1, 2010).

In Ireland, bond yields were also under pressure in the early summer but briefly dropped back below 5 percent (on 10 year Gilts) in early August. A mid-June Staff Report by the IMF noted (IMF (a), page 24) that the "remaining sovereign financing need in 2010 is limited. The average maturity of Irish treasury bonds is high—at 7½ years—and the rollover need is therefore limited." The Report went on to note that "[t]he authorities maintain sizeable cash balances, financed by short-term debt, which could act as a buffer against any temporary difficulties in issuing long-term debt." The Government raised €1.5 billon in 4-8 year bonds at 6 percent on September 21 and a further €400 million in short-term bills was sold on September 24. So there was no imminent financing problem for the government.

But, as noted elsewhere in the IMF Report (page 16), there were imminent liquidity pressures on the banks. The Report noted that over €70 billion of banks' obligations would mature by September and that, even though some debt had been pre-funded, "the sizeable rollover of banks' funding in the third quarter of this year will outstrip the sovereign's direct annual borrowing needs." It recommended an extension of the Government's Eligible Liabilities Guarantee scheme beyond its September deadline and, in early September, the Government did extend the scheme to the end of the year. (In November, it further extended the scheme to mid 2011). Meanwhile, fresh concerns about the cost of Anglo Irish Bank, coupled with media articles casting doubt on the accuracy of the results of recent "stress tests" by the Central Bank (in cooperation with the ECB), were being blamed for yields rising to 6 percent again in early September.

The Government was somewhat sanguine about its position in early September and criticized a downgrade by Standard and Poors (to AA-). But, within days, there was renewed pressure on bond prices and the Government and the IMF had to deny (on September 17) that they were in discussions on a financing package. Pressure continued unabated and when, on October 18, Germany and France announced

proposals for a bail-in clause for investors, bond yields sky-rocketed to 9 percent in a matter of three weeks. On November 16, the IMF announced "short and focused" consultations with the Government that would ultimately lead to agreement on a three-year financing package on November 24.

Of course, when crises occur they occur quickly, but there are some perplexing questions regarding the hectic two-month period leading up the IMF package. One, as noted earlier, is why the Government acceded to the package when it had sufficient reserves to fund it into mid 2011? In this context, a second question is why the package was assembled in such haste? The story has all the hallmarks of a financial crisis, rather than a debt crisis (that would have allowed more time), and this prompts four questions: a) was there a run on banks; if so, b) was it caused by a lack of confidence in the monetary or the fiscal authority; c) what were the proximate causes of the loss in credibility; and d) what were the underlying causes of the loss in credibility? These questions are addressed in turn.

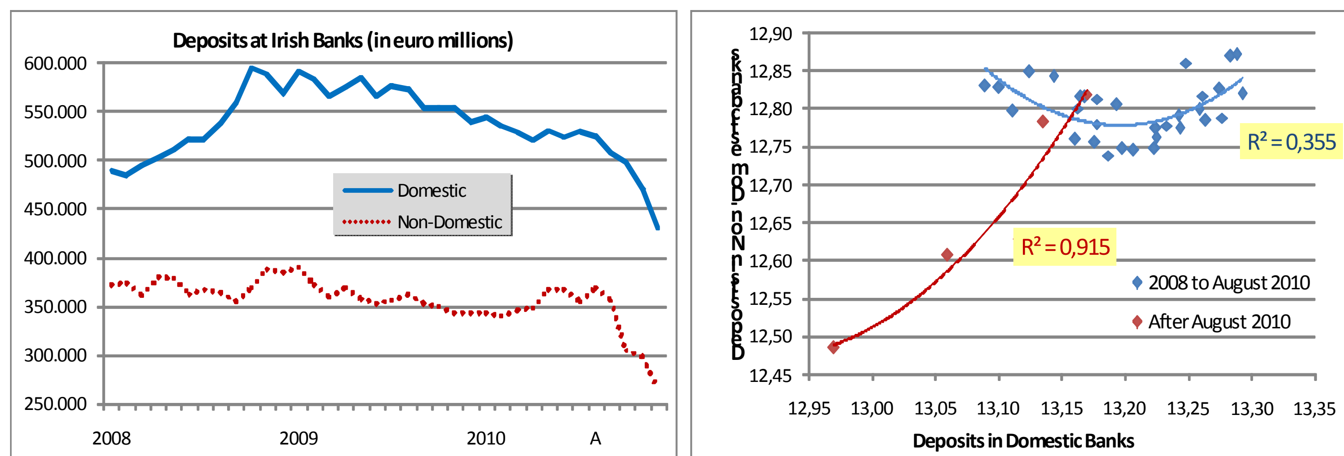
a) Was there a run on the Irish banks?

It was widely reported in late September that Irish banks had increased their reliance on the ECB by almost €6 billion during August. This was mostly (€3.5 billion) for non-domestic banks that had also increased their funding from deposits and securities by €27 billion in that month while domestic banks had a smaller increase in ECB credits (of €2.1 billion) to partly make up for a lost €5 billion in funding. There was no significant deterioration in evidence at this stage and, as we have seen, the non-domestic banks were likely to repay the credits. During September, however, domestic banks lost almost €18 billion in deposits and non-domestic banks lost €13 billion. And the downward pressure on deposits accelerated thereafter, as is evident from the left-hand panel in Figure 10 (where the end of August is denoted by an "A").

The size of the deposit withdrawal immediately raises suspicions but the true definition of a bank run is that it is system wide. A systemic run on Irish banks would require that it apply to both domestic and non-domestic sectors. And it is evident from Figure 18 that whereas the domestic sector witnessed an acceleration in deposit losses (that had, nonetheless, seemed to abate in the Summer), the non-domestic banks underwent an abrupt and startling decline from a stable (or growing) level of deposits.

The correlation between the rates of decline in deposits in each sector after August 2010 is 91 percent (see the right-hand panel of Figure 10, where deposit levels are in log form) and this is a strong indication of the

Figure 10: Deposits at Domestic and Non-Domestic Irish Banks (in euro millions).



Source: ECB.

existence of systemic problem. It contrasts very starkly with the previous 2½ years that saw deposits in the domestic sector decline (and move from right to left in the right-hand panel) while deposits in the non-domestic sector were far more stable (or increasing). After August, deposits in both sectors moved sharply downward and together. They had a common problem—at least in the eyes of depositors—and €125 billion in deposits were lost. In December, after the package was agreed, a further €75 billion were lost

b) Was the bank run due to a loss in fiscal or monetary credibility?

The answer to this question also appears to lie in the disaggregated data because (most of) the domestic banks were covered by a blanket Government guarantee on deposits while the deposits in the non-domestic sector were not covered by the scheme (see Appendix II for a list of relevant banks). [4] If the markets only lost confidence in Ireland's fiscal sustainability in September, this could have led to a loss of credibility in the guarantee scheme (or to a loss of confidence in the Government's ability to recapitalise the domestic banks). In such circumstances, one might have expected a run on the domestic banks only.

But the non-domestic banks have no claims whatever on fiscal assistance. In fact, given their low levels of funding from residents (about 12 percent before September), it is highly unlikely that the Irish Government would ever feel compelled to come to the aid of these banks or their depositors. A loss in fiscal credibility simply would not affect these banks at all. Of course, one could argue that Ireland had suffered damage to its reputation that had an effect on depositors, but one would then have to explain why deposits had actually risen in the year before September in non-domestic banks, despite the mounting fiscal challenges that had clearly taken a toll on deposits in the domestic sector.

The argument for blaming an erosion of fiscal credibility was recently put forward by Lorenzo Bini Smaghi, an Executive Director of the ECB, in the Irish Times (of January 15, 2011). He is the first senior European official to publicly describe in detail, from the perspective of an EU institution, the sequence of events that led Ireland over the edge in November:

> "Markets waited and waited and since they saw no policy reactions they started to lose confidence in the course of the summer. Remember there was a downgrade – in August – but there was no policy reaction, no announcement that a tough budget was in preparation and no announcement of the measures. The loss of confidence also affected the banking system and this created a spiral which led to the crisis and in the end the request for financial assistance."

Mr. Bini Smaghi also claims that the ECB had argued in August 2010 for an early budget. But the Government had already undertaken substantial measures and had announced that it would launch a further series of fiscal measures in the context of a four-year plan to be released in December. It was ultimately released as the National Recovery Plan for 2011-14 in November).

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[4] On 29 September 2008, the Government put in place a guarantee arrangement to safeguard all deposits (retail, commercial, institutional and interbank), covered bonds, senior debt and dated subordinated debt (lower tier II), with the following financial institutions: Allied Irish Bank, Bank of Ireland, Anglo Irish Bank, Irish Life and Permanent, Irish Nationwide Building Society and the EBS Building Society and such specific subsidiaries as may be approved by Government following consultation with the Central Bank and the Financial Regulator. On 9 October 2008, the Minister extended the scheme to cover Ulster Bank, First Active, Halifax Bank of Scotland, IIB Bank and Postbank. Ulster Bank, First Active, Halifax Bank of Scotland and IIB Bank subsequently opted out of the scheme. (See NTMA).

But the crisis was systemic, as demonstrated above, and applied to all Irish banks. It seems far more likely, therefore, that the crisis was caused by a loss of credibility in the commitments of the one institution that did affect both sets of the Irish banking system—the ECB. A common problem usually has a common cause and, as noted earlier, both sectors of the banking system were significantly dependent on ECB funding. Domestic banks relied on the ECB for 7.7 percent of their funding at the end of August and non-domestic banks for 6.2 percent. Moreover, both sets of banks implicitly relied on the ECB for emergency funding in the event of any future liquidity problems. Any loss in credibility in the commitment of the ECB as lender of last resort would certainly be of concern to depositors in both sets of institutions.

And Mr. Bini Smaghi does admit (in the Irish Times, January 15, 2011) that the ECB confronted a serious banking problem that started in September:

> We were seeing that the banks – particularly in September when they were not able to refinance themselves – were increasingly resorting to the liquidity provided by the ECB and the Central Bank of Ireland. The amount of the exposure with the ECB was in the order of tens of billions and going up … the perspective that the ECB would replace entirely the market was not acceptable.

He does not address why there would be a systemic problem across both sectors.

c) What were the proximate causes of the loss in credibility?

In mid September, a number of ECB Directors were frustrated by the continued reliance of some euro-zone banks on ECB funding and began to ponder—prompted by Mr. Draghi and quite publically—on whether it would be possible for the ECB to restrict certain banks' ability to refinance exclusively at the central bank. A set of so-called "unconventional measures" to support banks had been introduced at the height of the world financial crisis but the funding was still substantial at that stage and frustrated the ECB's ability to reign in monetary policy at a time when inflation was rising. On September 2, the ECB had extended its emergency 3-month support for banks until at least January 2011 but some Council members were clearly looking for an exit. On September 17, Council-member Nowotny said that the ECB would consider the unwinding of non-conventional liquidity measures before hiking policy rates and Messrs. Weber and Mersch warned that banks could not rely on the ECB forever (all as reported in Reuters, 2010).

And the markets did not take long to establish where the main concerns lay. On September 21, for example, imarketnews.com reported that "of the nearly €591 billion in loans made by the ECB to commercial banks in August, about 68 percent of that amount went to banks in Greece, Ireland, Italy, Portugal and Spain … Renewed fears about the periphery are emerging at a time when many Council members are openly talking about the unwinding of unconventional measures, the core element of which is refinancing to banks with full allotment at a fixed rate of 1 percent." "Council members are openly acknowledging that a solution must be found to pull back from unlimited support to the banking sector. It seems highly likely that the Council will have to withdraw measures before the peripheral banking system is fully healed. The onus will land then, as Nowotny pointed out, on domestic governments to deal with their own banking sectors."

On September 29, rawfinanceblog.com quoted Juergen Stark, a member of the ECB executive board, as saying that the ECB was in the process of phasing out the nonstandard measures. "This week and in the fourth quarter of 2010, a number of nonstandard measures will mature, and they will not be renewed," he explained. And this immediately led the blog to speculate on "what these moves mean for Ireland and its banks, [because] such uncertainty may make it even more expensive for both the banks and the government to borrow." "Two years ago," the blog noted, "Irish Finance Minister Brian Lenihan persuaded

lawmakers to support a bank guarantee to buy time for financial institutions to phase out support from the ECB. Banks, however, have become increasingly dependent on ECB support, triggering investor fears about not only the banks but also the government."

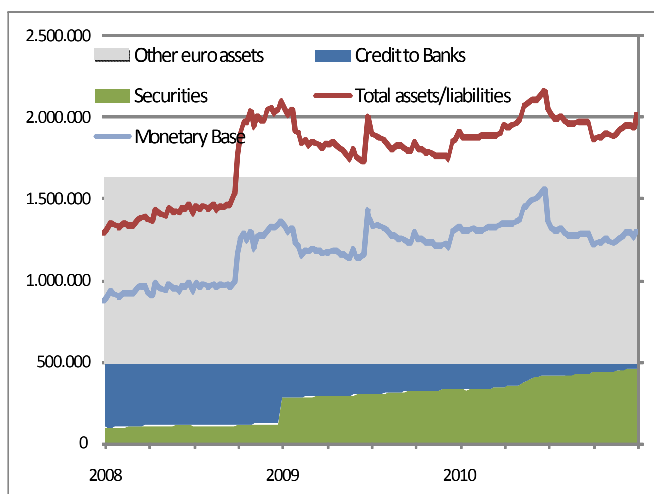
From this time forward, markets watched ECB funding levels to Irish banks very closely—even reporting widely on the modest €6 billion increase in August. As any deposits left the system or securities matured (as expected by the IMF), ECB funding increased and led to a further flight of deposits. The irony was, of course, that the ECB could not afford to see the bank run worsen and had to, in the end, provide further liquidity support. And the ECB has still not been able to execute a strategy to reduce bank funding. But a financing package for Ireland became inevitable in order to reassure markets about support for the banks. (And the Government's original four-year plan for fiscal consolidation became a part of the package).

Of course, frustration with continued Irish banks' reliance on ECB support was probably understandable in September. But a strategy to deal with this problem should have been worked out behind closed doors and in consultation with the Irish Government so that it would have a chance to speed up its bank resolution. There is no suggestion that such detailed discussions took place. But another source of pressure on the ECB emerged during the Greek crisis in May and this severely limited an ability to reign in monetary policy.

d) What were the underlying causes of the loss in credibility?

The ECB had seen its balance sheet balloon as a result of the Lehman crisis in late 2008 (see Figure 11). A significant increase in credits to banks on the asset side had seen its liabilities to euro area residents pushed from some €1 trillion to about €1.3 trillion. (In Figure 11, the term "monetary base" is loosely used to describe all euro liabilities, including notes. The difference between euro-area assets and total assets is comprised of foreign reserves and claims). The pressure seemed to continue unabated and, in mid 2010, the "monetary base" topped €1.5 trillion for the first time. The ECB had a mandate to secure low inflation and to preserve stability in the financial sector. But, by mid 2010, inflation had risen close to the target level of 2 percent and the new mandate to buy securities was undermining an ability to reign in the money supply.

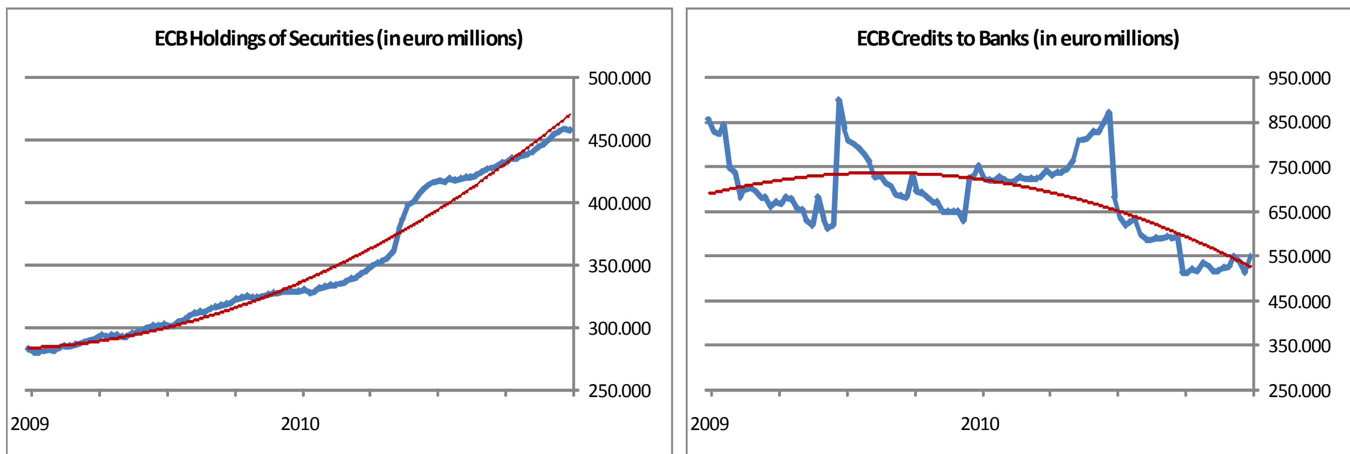
Figure 11: ECB Assets and Liabilities (in euro millions)



Source: ECB

An upward trend in security purchases was significantly boosted in May of 2010 and the pressure on monetary policy now derived mainly from this source (see Figure 12). Direct support to the banking system was actually trending downward but was being squeezed between a monetary-policy imperative to reduce the money supply on the one hand and a need to support fiscal policy in peripheral countries (through the securities purchase programme) on the other. The ECB's ability to credibly commit to both an inflation target and support for bonds was under question and was being frustrated by a continuing need to support the banks. When credibility is under question, any mutterings by policy makers can have very serious repercussions and can lead to unintended consequences.

Figure 12: Selected ECB Euro Assets (in euro millions).



Source: ECB.

Concluding Remarks

The interplay between monetary and fiscal responsibility always leads to difficulties between the monetary and fiscal authorities when there is a serious banking problem. Typically, the fiscal authority will play down the problem or otherwise play for time in the hope that the problem will resolve itself or that the banks will be able to resolve it themselves. (And the problem banks will usually make such a promise). But the monetary authority will be anxious to repair the initial problem as quickly as possible lest it undermine the entire banking system. In the countries of the euro zone, the monetary authority is represented by the pan-national ECB but fiscal authority still resides at national level. Therefore, the advent of a serious banking problem can cause particular difficulties and the need for more pan-European cooperation in supervision and well-defined procedures for the resolution of banking problems appears obvious.

Moreover, the banks of the euro zone are now truly pan-national and are closely connected both through financial links and their being subject to the same monetary policy. Therefore, savings will tend to flow to the higher-growth countries and will create significant liabilities in local banks there. This must be recognised as a consequence of monetary policy. The IMF programme for Ireland put significant emphasis on possible spill-over effects on euro-zone banks and is quite clear that possible financial contagion from Irish banks was a main source of concern (while "global banks' direct exposure to Irish sovereign debt remains very limited," see page 6 of IMF Staff Report, 2010b). This is a problem for the banking system.

The Irish episode seems to point to a serious lapse in the ECB's ability to provide financial stability in the euro zone, even if this was not due to deliberate policy. It suggests, moreover, that monetary policy in the euro zone cannot fulfill all of its current commitments—to prices, banks and sovereign bonds. Therefore, there is a monetary problem in the euro zone and it must be resolved by joint action of the members.

Ireland was precluded from writing down bank debt by the terms of the financing package, lest this have a negative impact on the entire banking system, and domestic banks have already repaid €29 billion in securities since August. A debt write down would have substantially reduced the fiscal burden in Ireland and Irish people are well aware that a monetary problem aggravated their ability to reduce a fiscal problem. Meanwhile, the crisis is portrayed by a vocal faction in Europe as a failure of Irish fiscal policy. This faction is calling for Ireland's low-tax model to be abandoned and for greater fiscal harmonisation in the euro zone. So it is important to point out that the crisis was due to a failure of monetary policy in the first instance, at the level of the euro zone, and was not solely due to a fiscal problem in Ireland.

A Note on Data:

The Central Bank of Ireland produces data on the balance sheets (i) for all Credit Institutions and (ii) for Domestic Market Credit Institutions at www.centralbank.ie. It does not publish separate data for (iii) the Non-Domestic Credit Institutions that make up part of the whole (i). In this paper, the data for non-domestic credit institutions were created by simply subtracting (ii) from (i). Because it is likely that some data consolidation was undertaken when (ii) and (iii) were combined into (i), the result of the subtraction may not be fully accurate. But these consolidations are believed to be relatively small and to not materially affect the conclusions that were drawn in the paper. Also, credit unions were added to the list of domestic credit institutions from January 2009 and, while no attempt was made to compensate for this change, it is not expected to have had a material influence on the conclusions of the paper.

The data on borrowing from the ECB in the Banking Statistics do not distinguish between borrowing from the ECB and borrowing from the Central Bank of Ireland "for monetary operation". There is one category for both and the paper uses this only. But this excludes Emergency Liquidity Assistance from the Central Bank, which likely rose by some €30 billion in the past few months (see www.nber.org/~wbuiter/ela.pdf).

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Appendix I

Timeline of Events:

2008

September	Ireland has AAA credit rating with S&P. Government recognizes that economy is in recession. Government announces that it will introduce an early emergency budget.
September 28	Irish Government Bank Guarantee Scheme introduced and approved by EU.
December 21	Government injects capital into three major banks and effectively nationalizes Anglo Irish Bank (with a 75 percent share).

2009

January 20	Anglo Irish Bank is nationalised.
February 11	The Government announces an increase in bank recapitalisation at Bank of Ireland and Allied Irish Bank.
March 30	S&P downgrade to AA+ from AAA, citing concerns over public finances and growth.
June 28	S&P downgrade to AA from AA+, citing concerns over the potential costs of banks.

2010

May 10	ECB launches purchases of government bonds.
June 24	IMF Article IV Consultation concluded, with a warning that significant bonds were due for repayment by the domestic banks.
August 24	S&P downgrade to AA- from AA, citing concerns over potential costs of banks.
August 20	ECB governing council member Alex Weber supports extension of emergency assistance for banks until early 2011 and euro drops one percent.
September 2	ECB extends emergency 3-month support for banks until at least January 2011 but 6 & 12 month financing have been phased out (automatically—not renewed).
September 17	ECB governing council member Nowotny (Austria) says the ECB will consider unwinding of non-conventional liquidity measures before hiking policy rates. He agrees with Council members Weber (Germany) and Mersch (Luxembourg) that banks cannot rely on the ECB forever (Reuters). German media highlighted this dilemma … and report that Council member Draghi (Italy) had raised the question of whether it would be possible to restrict certain banks' ability to refinance exclusively at the ECB. (imarketnews.com)
September 17	Irish Independent newspaper reports Ireland "perilously close" to seeking IMF assistance, based on a report from Barclay's Capital that, despite adequate liquidity, help could be needed if bank losses mounted or growth slowed.
September 17	Irish Government and IMF deny bailout rumours.
September 21	Successful Irish Bond auction (followed by T Bill auction on September 24).
September 21	imarketnews.com notes that "[r]enewed fears about the periphery are emerging at a time when many Council members are openly talking about the unwinding of unconventional measures…" "It seems highly likely that the Council will have to withdraw measures before the peripheral banking system is fully healed."
October 18	Germany and France announce proposals for a bail-in clause for investors.
October 29	EU leaders endorse German calls for a rewrite of EU treaties to create a permanent debt-crisis mechanism that would allow private investors to bear some of the costs.
November 14	Portugal Foreign Minister says Portugal may have to leave the euro.
November 15	Ireland still denies bailout rumours.
November 16	IMF announces "short and focused" consultation.
November 24	Government launches National Recovery Plan
November 28	Ireland and IMF announce terms of financial package (leaving the Government's fiscal plan unaffected).

Appendix II

Credit Institutions Resident in the Republic of Ireland (78 Institutions)

Aareal Bank AG
ABN AMRO Bank (Ireland) Limited
ACC Bank Plc
AIB Mortgage Bank *
Allied Irish Banks Plc *
Anglo Irish Bank Corporation Plc *
Anglo Irish Mortgage Bank *
Bank Of America National Association
Bank Of Ireland Mortgage Bank *
Bank Of Montreal Ireland Plc
Bank Of Scotland (Ireland) Ltd
Bankinter SA
Barclays Bank Ireland Plc
Barclays Bank Plc
BNP Paribas
BNP Paribas Securities Services
BNY Mellon International Bank Limited
Caceis Bank Luxembourg
Caja de Ahorros y Monte de Piedad de Madrid
Citco Bank Nederland NV
Citibank Europe Plc
Citibank International Plc
Commerzbank Europe (Ireland)
Danske Branch AS
DePfa ACS Bank
DePfa Bank Plc
DePfa-Bank Europe Plc
Dexia Banque Belgique
Dexia Credit Local
Dexia Municipal Agency
DZ-Bank Ireland Plc
EAA Bank Ireland Plc
EAA Covered Bond Bank Plc
EBS Building Society *
EBS Mortgage Finance *
Elavon Financial Services Limited
FCE Bank Plc
Goldman Sachs Bank (Europe) Plc
Helaba Dublin Landesbank Hessen-Thuringen International
Credit Unions as regulated by the Registrar Of Credit Unions
Hewlett-Packard International Bank Plc
HFC Bank Plc
HSBC Bank Plc
Hypo Public Finance Bank
ICS Building Society *
ING Bank NV
Intesa Sanpaola Bank Ireland Plc
Investec Bank (UK) Limited
Irish Life & Permanent Plc *
Irish Nationwide Building Society *
J.P. Morgan Bank (Ireland) Plc
J.P.Morgan Bank Dublin Plc
KBC Bank Ireland Plc
KBC Bank NV Dublin Branch
Landesbank Hessen-Thuringen Girozentrale
Leeds Building Society
LGT Bank (Ireland) Ltd
Marks and Spencer Financial Services Plc
MBNA Europe Bank Ltd
Merrill Lynch International Bank Limited
Naspa Dublin
Nationwide Building Society
Northern Rock Plc
Pfizer International Bank Europe
Postbank Ireland Limited *
Rabobank Ireland Plc
Rabobank Nederland
RBC Dexia Investor Services Bank S.A.
Scotiabank (Ireland) Limited
Societe Generale
The Bank Of New York Mellon (Ireland) Limited
The Governor & Company Of The Bank Of Ireland *
The Royal Bank Of Scotland N.V.
Ulster Bank Ireland Limited
Unicredit Bank Ireland Plc
Volkswagen Bank Gmbh
Wells Fargo Bank International
WGZ-Bank Ireland Plc
Zurich Bank

Key:

Domestic Market Credit Institutions (22 institutions)
Non-Domestic Credit Institutions (56 institutions)

* Banks guaranteed under the 2008 Credit Institutions (Financial Support) Scheme (7 institutions, and their affiliates)

1. Allied Irish Bank
2. Bank of Ireland (including ICS Building Society)
3. Anglo Irish Bank
4. Irish Life and Permanent (Permanent TSB)
5. Irish Nationwide Building Society
6. Educational Building Society
7. Postbank Ireland Limited