

How To Restart Growth in the Midst of a Financial Crisis

Ladies and Gentlemen

It is a pleasure to address this conference of the Irish Banking Federation, with its very timely focus on the topic of 'Building the New Banking Architecture'. I only regret that I am not able to be there in person with you due to crisis-related pressing commitments in Brussels.

Ireland is one of the worst hit economies in the financial and economic crisis which started in Europe in the autumn of 2008. GDP declined by some 12 % in 2008 to 2010. Unemployment has increased from below 6 % to 14 %, and public debt from 25 % to 110 % GDP. This audience does not need anybody from outside the country to explain what these cold numbers have meant and mean to Ireland and to the Irish people.

An unfortunate fact is that recoveries from financial crises tend to be a protracted affair. A key element of almost all financial crises is excessive, unsustainable debt levels, private or public or both. Improving the balance sheets requires higher savings which are away from investment and consumption, and thus away from job creation.

A prerequisite for the resumption of growth and job creation is that the financial market turbulence calms down, that interest rates and asset price volatility come down and credit starts to flow to businesses and households again. This is the first part of any successful recovery.

I'm glad to note that Ireland has come far in this first part of paving the way for a sustained recovery. This is based on effective policy action to ensure the liquidity and solvency of both the sovereign and the banking sector. The EU-IMF financial assistance programme set up last autumn to help Ireland, and the strong support from the ECB, have been essential for this. But of course the biggest contribution comes from the Irish authorities and the Irish people themselves.

Ireland indeed has made significant progress on both the financial sector front and the fiscal policy front.

The recapitalisation of Irish banks has now been completed. It has led to significantly lower costs for the taxpayer than originally anticipated. This has been achieved thanks to the burden-sharing with subordinated debt holders, the sales of assets and a sizable infusion of private capital into one of the two pillar banks.

Banks are also making progress towards the agreed deleveraging targets and reducing the size of their balance sheets. Two planned mergers (of Allied Irish Banks with EBS Building Society and of Anglo Irish Bank with INBS) have been completed ahead of schedule, and bank boards are being renewed. And Irish banks' success in regaining access to term wholesale funding markets is also encouraging.

Overall, Ireland is well on track to achieve its objective of creating a smaller and better capitalized banking sector, which can regain investor confidence and provide financing to credit-worthy borrowers in the country.

Similarly, substantial budgetary adjustments have taken place. Their overall impact by the end of this year will be close to 12 % of GDP, a very sizeable figure. The budget deficit from 2011 is projected to be well below the 10½ percent of GDP programme ceiling.

Overall, the government is succeeding in its objective of restoring sustainability to Irish public finances, and I welcome its strong commitment to reduce its budget deficit to below 3 percent of GDP by 2015, in line with the recommendations of the ECOFIN Council. Tough decisions remain ahead but I have full trust that they will be taken with the same determination as the decisions so far.

Restoring a solid and well-functioning financial sector and budgetary consolidation are necessary conditions for resuming growth, but they are not sufficient. When growth cannot be based on fiscal stimulus or increasing private debt, the first push has to come from exports. This should then feed into a gradually increasing productive investments, job creation and finally strengthening domestic consumption based on incomes and savings rather than debt.

I have three reasons to be confident that this process of export-led recovery will succeed in Ireland.

The first one is the experience of my home country Finland and the neighbouring Sweden. Both of them experienced deep financial and economic crises in the early 1990s, which in fact resemble very much what Ireland has been going through now. For Finland some of the numbers were even uglier than those for Ireland. In particular, unemployment increased in three years from less than 4 % to 17 %.

Both of these countries put the banking sectors on a sound basis by very unpopular bank support measures and in the case of Finland brutal restructuring: half of the 50 000 jobs in the banking sector disappeared. Both consolidated public finances strongly. At the same, a lot was done to improve the competitiveness of the economy. Currency devaluation – not an option for Ireland – was one of them. But it was not the only one. In both countries public financial support and incentives for innovation were increased in the midst of budget cuts. Integration of the economies with the rest of Europe was strengthened by EU membership. In Finland a major tax reform was implemented to encourage capital formation.

The results were impressive. The average growth rates for the following 6 years until the global slowdown in 2001 were 4.5 % and 3.7 %, for Finland and Sweden, respectively. Public sector deficits turned into substantial surpluses and also employment recovered, although painfully slowly, particularly in Finland.

My second reason for optimism is the fundamentals of the Irish economy. While a large part of the pre-crisis unsustainable boom was due to excessive domestic demand, also a lot of it was based on the attractiveness of Ireland as a business environment. And here I'm not talking about the controversial low corporate tax rate, but about the availability of highly educated labour force, the increased emphasis on innovation policies, and flexible labour markets.

Thirdly, and I would say most importantly, the last six months have provided evidence that Ireland indeed is on its way to an export-led recovery. Exports are increasing robustly and the current account is turning positive. And despite the continued deleveraging of households, companies and banks, domestic demand has held up reasonably well, most probably based on the confidence that things are getting better in a not too distant future. As a result, GDP increased by 2.3 % in the second quarter (y-on-y).

I would emphasize a very important aspect: labour market flexibility. The fact that Ireland is part of a wider currency area has not prevented it from improving its cost competitiveness fast. This is thanks to wage flexibility. The Irish labour market is flexible also in other dimensions. I know that some of this flexibility, i.e. the emigration of young Irish to seek employment elsewhere is a matter of concern, and rightly so. But I'm also pretty confident that these flows turn when the Irish economy continues to recover, and at that point the work experience abroad can be an additional asset for these people and the Irish economy.

What about Europe at large? While some countries have steamed ahead quite robustly and even on average the EU has been on a steady although slow path of recovery already for two years, growth is now stalling. Moreover this is happening while unemployment only has stabilised at a high level and public finances still are badly in the red.

We are indeed in a very dangerous situation. We have not been able to put down the stubborn financial market bush fires centring on the sovereign debt market. These are now spreading again leading to new worries about the solidity of the European banking system. The real economy has been clearly affected: most of the recent slowdown can be traced back to the renewed financial market turbulence. If we don't get an upper hand of this turbulence soon, the standstill we are now experiencing will turn into a new recession. No part of Europe would be saved from the consequences, including of course Ireland, which so much depends on the growth of its export markets for its recovery. Strong coordinated action is needed, now.

Fortunately, the necessary sense of urgency of action – crisis consciousness if you like – is emerging. Also consensus about what needs to be done is in the making:

- First, we need to get certainty about Greece
- Second, we have to build much stronger fire walls, including making the maximum of the reformed financial backstop EFSF, and taking concerted action to beef up the capital base of the European banks
- Third, based on the newly adopted six-pack on fiscal and macroeconomic surveillance, we have to strengthen the stability orientation in economic policy making
- Fourth, create a vision of and a road map towards substantially tighter economic governance in the euro area, and
- Fifth, we must frontload structural reforms to enhance growth and job creation.

The Commission will present its proposals of taking these policy initiatives forward very soon. In fact, we will finalise our ideas when you are watching this recording.

The upcoming European Council and the euro area summit are a key juncture. If we can agree on determined policy action on the five points I mentioned, we have a good chance of not only averting a financial calamity, but to put Europe back to the path of sustained recovery. The determination Ireland has shown in its efforts to conquer its economic crisis should be the example for all European policy makers.

Thank you very much for your attention.