Remarks by Patrick Honohan, Governor of the Central Bank of Ireland, at the Bank of Finland Conference in Memory of Pentti Kouri, Helsinki, June 11, 2010

My interaction with Pentti Kouri goes back to the earliest part of his career and mine in 1971 when we were both 22-year old kids at the IMF at the end of the Bretton Woods period. Even then Pentti was a larger than life figure who was a driving force behind what was called the Wednesday Brown Bag Research lunch. This was the first time I had ever heard of such a thing as a brown bag lunch! The goal of the lunch meetings, exemplified by presentation of an early draft of Kouri-Porter, was to discuss "real" research—as distinct from what the official agenda of the Research Department of the IMF was felt to be by some young researchers. With Olivier Blanchard here today I am sure things are different now. Although Pentti was only six months older than me he had already established himself as a magnetic personality and as something of a role model—though I did not follow him all the way in that regard.

The issue of fiscal policy in the euro area which so pre-occupies us today is, as Jose de Gregorio suggested, the sort of problem which would have been bread and butter to IMF staff at that time. So why are we here again?

In my view, neglect of some important interactions between fiscal policy and bank behaviour have a lot to do with that. Even 20 years ago in the early 1990s, many academics were sceptical about the necessity of the SGP, regarding it as a "belt and braces" approach not strictly necessary. They held a dichotomised view of fiscal and monetary policy. But this neglected the two-way-interaction between fiscal and bank.

This interaction is exemplified in the case of the Irish bubble. This was a local bubble within the general financial expansion of the 200s: an eddy in the rapids. For Ireland, to use the phrase suggested earlier today by Ned Phelps, the McGuffin, or initiating myth in the Irish bubble was the fall in the cost of funds as Ireland entered the euro area after years of solid Celtic Tiger growth. Lower nominal and real interest rates lifted expected equilibrium house prices by a hard-to-calculate multiplier. The banking system was the key amplifier of this boom once it got going. Banks piled into property lending both wholesale and retail, financed with heavy borrowing from abroad. This is similar in some respects to what was happening in other countries – the US, UK, Spain – but it was (i) much bigger and (ii) did not involve any exotic financial innovation.

The Irish bank-driven boom boosted fiscal revenue and relaxed spending constraints. A sovereign wealth fund was set up to absorb some of the excess revenue (and is proving useful today), but reliance on non-core elements of the tax system were reduced, leaving the fiscal accounts very vulnerable to transient bubble-related sources of revenue.

A second wave of influence from the banks to the fiscal accounts started after it became clear that the banks were heading for sizable losses. The uncertain scale of these losses hung over the public finances as a threat. At the Central Bank, we have dealt with the latter problem by applying quite severe stress tests to the banks, and requiring them to inject additional capital this year, with a view to ensuring that, after they have transferred their big property loans to the National Asset Management Agency (which is purchasing them at a price related to market value, and thus at a deep discount to book value), and after they have absorbed further losses that can be expected as a result of the recession, they will come through this loan-loss cycle with a comfortable buffer of capital. When this recapitalization is completed, the market will be able to take comfort from the removal of the large uncertainty that was hanging over both the banks and the government's accounts.

Conversely, the fiscal position can affect the banks, and we have seen this recently in Europe with heightened market concerns about the fiscal situation in some countries have spilled over to banks and sovereigns, in turn hampering the transmission of low monetary policy rates throughout the euro area. Frozen interbank markets reflected what seemed an overblown response to perceived fiscal risks.

We've seen an extensive policy response to tackle this. Not only quite sharp fiscal adjustment measures, but a huge commitment of public funds – some €750 billion, which is huge in relation, for example, to the outstanding stock of debt in the countries affected. There's also the ECB;'s Securities Market Programme, directed at promptly unblocking money market conditions.

Clearly, then, this interface between fiscal and banking conditions is a fruitful area of policy research right now.

Let me just mention two specific issues within this. First, the Stability and Growth Pact, which needs the addition of a focus on sustainability of the fiscal accounts, and not just on a particular deficit or debt level. Ireland was not the only country for which the downturn had a very unusually sharp and large impact on the deficit reflecting the unsustainability and transient nature of a large part of the tax system, For me there is a lesson here from banking regulation. Just as banks are required not only to make provision for expected loan losses in their accounts, but also have to hold capital reserves to meet unexpected losses, the SGP targets should make allowance for the risk that unexpected fall-offs in revenue may occur.

Finally, a word on the taxation of financial intermediaries, which is back on the policy agenda. I see that Financial Transactions Taxes are being discussed again, though I suspect that the conclusion will be that they do little for improving the efficiency or safety of the financial system (they would have done nothing to discourage derivatives related to sub-prime lending, for example), and also would not generate as much revenue as some suppose.

Nevertheless, it does seem possible to use some form of Pigouvian corrective taxation as a kind of graduated type of regulation, potentially better than outright banning of products, and a useful complement to the regulation-by-ratio that has become the norm over the past quarter century.

Such topics, at the interaction of government policy and open economy macroeconomics, would have been easy meat for Pentti Kouri.