Sharon Donnery: The outlook for the Irish economy

Remarks by Ms Sharon Donnery, Deputy Governor of the Central Bank of Ireland, at the Global Interdependence Center (GIC) "Central Banking Series: Dublin, Ireland", Dublin, 29 September 2016.

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Introduction

Your Excellency Ambassador O'Malley, former Governor Honohan, President Harker, members of the Irish-American Business Chamber and Network, esteemed guests, on behalf of the Central Bank of Ireland it is a pleasure to welcome you today.[1]

The mission of the Central Bank of Ireland is '*safeguarding stability, protecting consumers'*. Our mandate is broad and varied. As part of the Eurosystem, our primary objective is price stability, defined by the ECB's Governing Council as aiming for inflation rates of below, but close to, 2% over the medium term.

The Bank is both the macroprudential authority and national resolution authority for Ireland. These responsibilities, conferred on us after the financial crisis, give us a key role in the overall financial stability of the State.

In addition, the Bank is the regulator and supervisor of most financial institutions operating in Ireland. This broad mandate covers both prudential and consumer protection aspects and covers a wide range of firms including inter alia, banks, insurers, stockbrokers, investment funds, credit unions and intermediaries. Much of our regulatory and supervisory work is carried out in a European context for example as part of Banking Union and the European System of Financial Supervision.

An important part of the Bank's role is the provision of forward-looking, independent economic advice and commentary. We provide both commentary and analysis based on: a significant and increasing range of analytical activities; the further development of our economic models and tools; and the growing volume of financial statistics we collect.

The provision of high quality statistics and analysis are essential in informing evidence based policy decisions both at domestic and international levels and in explaining financial market developments. In this context, today I would like to share our view on the outlook for the Irish economy, the impact of monetary policy and highlight some of the risks to the economic outlook, notably the decision by the United Kingdom to leave the European Union.

The Irish economic outlook

The Irish economy is performing well. This is confirmed by a wide range of indicators – from the labour market to consumer and underlying investment spending.

However, two factors in particular have made it more difficult to get a clear picture of both the performance and the outlook for the Irish economy.

The first of these is the recent very large revisions to the Irish National Accounts, in particular the large upward revisions to the value of GDP and GNP in 2015. Second, is the fact that the outcome of the UK referendum on membership of the European Union has introduced significant risk and uncertainty to the outlook for the Irish economy.

Angus Deaton the winner of the 2015 Nobel Prize in Economics recently noted that "*Headline statistics often seem simple but typically have many moving parts…, we must always work from multiple sources, and look deep into the cogs and wheels*".[2]

I think that we can all agree that the workings of the clock in the case of Irish macroeconomic and financial headline statistics are becoming more and more complicated.

This was most recently observed in the national accounts data which showed a 26 per cent increase in GDP. Although compiled in full accordance with international manuals, these data revisions make it difficult for policy makers and analysts, both domestically and internationally to interpret.

Rather than giving an accurate picture of the actual level of domestic economic activity, the numbers reflect the statistical 'on-shoring' associated with a level shift in the size of the Irish capital stock.

This has arisen from corporate restructurings and balance sheet reclassifications in the multinational sector and also growth in aircraft leasing activity.

As a result, National Accounts data now include a very significant amount of activity carried out elsewhere, but formally and correctly recorded as part of Irish GDP and GNP.

To get a more accurate measure of the level of activity in the domestic economy it is necessary to look beyond the headline GDP and GNP figures to other more reliable spending and activity indicators. These suggest that, while not growing at a rate of 26 per cent, economic activity continues to expand at a reasonably healthy pace.

In particular, consumer spending has recovered strongly, supported by solid gains in employment and rising earnings. Underlying domestic demand – that is, the sum of personal consumer spending, net government spending on goods and services and investment excluding in aircraft and intangible assets, grew by close to 5 per cent in 2015.

Together with employment growth of 2.5 per cent and wage increases of a similar magnitude, this points to growth in domestic activity broadly in the region of 5 per cent.

This rate of expansion is far removed from the measured increase in GDP of over 26 per cent last year, but is over twice the average rate in the Eurozone.

The availability of good statistics is paramount from the Bank's perspective, as we are not only intensive users, but also significant producers. However, solving these issues is not easy or straightforward. Nonetheless, it is imperative that we explore ways of overcoming these challenges. In this context, a consultative group has been established by the Central Statistics Office in Ireland, chaired by Governor Lane, to develop supplementary statistical information that will generate more comprehensive insight to the dynamics of the Irish financial and economic system.

Unconventional monetary policy and the Irish economy

A central 'cog' supporting the economic outlook is the current accommodative monetary policy stance of the ECB.

A sequence of non-standard monetary policy measures has been implemented by the Eurosystem, since mid-2014. The stimulus package comprises a number of tools, including:

- the introduction of a negative interest rate on the ECB's deposit facility,
- a credit-easing package in the form of targeted long-term refinancing operations (TLTROs),

- an asset purchase programme consisting asset-backed securities (ABS),
- the re-ignition of the covered bond purchase programme (CBPP3), and
- a forward guidance strategy.

Further deterioration of the inflation outlook in late 2014 motivated the Governing Council in January 2015 to announce the extension of this asset purchase programme to include public sector securities. This is collectively known as the expanded asset purchase programme (EAPP).[3]

The portfolio rebalancing channel is frequently considered to be the most effective channel through which central bank asset purchases affect the real economy. Investors that sell securities to the central bank can retain the proceeds of their sales on deposit or they may reallocate their portfolios towards other assets, for example corporate bonds and/or equity securities. Increased demand for relatively riskier assets drives up their prices and lowers their yields, leading to positive wealth effects for investors and reducing the borrowing costs of corporates. Both increased wealth and compressed credit costs have the potential to improve the prospects for the real economy, by boosting spending and investment.

The bank lending channel is also associated with central bank asset purchases.

As a result of asset purchases a bank may receive a positive shock to its liabilities in light of sales to the central bank by its customers.[4] These deposits offer banks a new source of funding, thereby having the potential to facilitate expanded credit supply to the real economy.

The announcement and implementation of an asset purchase programme by a central bank demonstrates its intention to meet its inflation objective and signals that it expects to maintain interest rates at a low level for a sustained period. Increased confidence and certainty in the economic outlook, alongside reduced long-run real interest rates should not only encourage spending but could also increase credit demand. Finally higher inflation expectations could cause firms to raise prices in anticipation, leading to a more direct impact on inflation.

Relative to the US credit market, the financial structure of the euro area is one in which banks play a prominent role. The credit easing package strengthens the pass-through of accommodative monetary policy by incentivising banks to lend to non-financial corporates and households. Furthermore the TLTROs provide banks with the opportunity to ease their refinancing conditions by substituting comparatively more expensive legacy wholesale funding with funding obtained via the TLTROs.

In this context, the recent modifications to the package of non-standard measures should contribute further to have a positive impact on economic and financial conditions in the Irish economy.

For example, over the second quarter of 2016 Irish banks reported improved access to retail and wholesale funding. Nearly two thirds of Irish retail banks participated in the first operation of the modified credit easing package (TLTRO II).[5]

Moreover, the introduction of the package of non-standard measures has also supported the improvement in capital ratios of Irish banks. In the context of favourable funding conditions for banks, supported by improved economic growth, in 2015 Irish-owned banks refinanced preference shares and expanded their fully-loaded capital base. Capital ratios are also expected to increase further over the next 6 months, due to retained earnings and capital issuance.[6]

However, impaired assets continue to weigh on Irish banks' portfolios.[7] Non-performing loans contribute to banks' balance sheet fragility, impinge on profitability and strain capital buffers, impeding bank lending. Therefore, the continued deliberate and determined work-out of NPLs coupled with ongoing improvements in the Irish economy, will reduce the burden they pose and support the extension of new loans to the real economy.

The pass-through of reductions in policy interest rates is evident at the euro area aggregate level. However, lending rates continue to be higher for many countries. For example, in Ireland interest rates on mortgages have declined since 2014 but remain comparatively high.[8] Interest rates for SMEs vary significantly across Europe and are driven by a number of factors including firm characteristics (such as size and turnover), as well as country-level differences.[9] One challenge faced by Irish SMEs is the relatively higher cost of credit compared to those in other euro area countries. Since the start of 2014 SME interest rates have declined across the euro area but have remained stubbornly high in Ireland.[10]

High levels of household and SME debt, a hangover from the Irish credit boom, continue to remain a source of vulnerability in terms of both of net worth and servicing costs. Higher debt levels negatively affect consumption and investment decisions, compress demand for bank credit, thereby reducing the effectiveness of unconventional monetary policy measures on the real economy.

In the household sector, for example debt stood at €148.5bn in Q1 2016 and remains high when compared to our European counterparts.[11] However declines in key indicators suggest an improvement in the sustainability of household balance sheets.[12]

As the deleveraging process in the household sector continues, the combined effect of the re-formulated credit easing package (TLTRO II) with the suite of non-standard measures implemented since 2014 should continue to enhance the availability of credit and reduce the cost of funding for both Irish households and SMEs.[13]

Increased demand for loans for both house purchases and consumption was reported by Irish households in the second quarter of 2016. For example, in July growth in credit for consumption of 2 per cent was the highest annual growth rate of credit supply to households since February 2009.[14]

Year-on-year declines in lending of 6.4 per cent in July reflect the on-going balance sheet correction of Irish corporates. Although the accommodative monetary policy stance is envisaged to facilitate increased demand for loans, given corporates desire to fund investment.

Immediately following the Governing Council's announcement in March of this year to supplement its asset purchase programme to include purchases of corporate bonds, spreads between a wide range of corporate bond yields and the risk free rate tightened. Since then, a number of Irish private and semi-state companies already availed of the opportunity to access bond markets, locking in lower interest rates and benefiting from the opportunity to retire more expensive legacy debt.

In addition to these impacts on the banking system, households and SMEs, non-standard monetary policy has clearly influenced developments in government bond markets.

Over recent months, yields on Irish government bonds continued their downward trajectory across the curve, notably following the expansion of the asset purchase programme to include purchases of public sector bonds in January last year. This also reflects the continued improvement in the public finances.[15]

Yesterday, for example the yield on the 10 year Irish government bond was 0.34 per cent. This equates to a spread of 47 basis points over the equivalent German bund, and the narrowest spread relative to other euro area countries most exposed to the sovereign debt crisis.[16]

It is a far cry from July 2011, when in the midst of the European sovereign debt crisis yields stood at 13.9 per cent.

In terms of volumes, the National Treasury Management Agency (the Irish Debt Management Office) issued €13 billion of bonds in 2015. The weighted yield was 1.51% with weighted average maturity of just under 18 years. This compares with a weighted average yield of 2.84% in 2014 and an average maturity of just under 12 years. **This is also reflected in Ireland's recent issuance of treasury bills at –0.36 per cent.**

Ensuring the public debt burden continues on a sustainable trajectory is essential to the ongoing economic recovery.

Forward guidance has been an important policy tool employed by the Governing Council as a part of its communication strategy. From a monetary policy perspective the asset purchase programmes "are intended to run until the end of March 2017, or beyond, if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its aim of achieving inflation rates below, but close to, 2% over the medium term."

Furthermore in the context of interest rates "the Governing Council expects the key ECB interest rates to remain at present or lower levels for an extended period of time, and well past the horizon of our net asset purchases." Therefore monetary policy should remain supportive to the domestic recovery.

However, the outlook for the Irish economy is complicated by a number of risks, particularly the outcome of the Brexit referendum in the UK.

The economic impact of Brexit on Ireland is difficult to estimate with any precision. It is clear, however, that the impact will be negative and material, both in the short-term and in the longer term.

The long-run economic impact of Brexit on Ireland will be influenced by the nature of the withdrawal agreement between the EU and the UK and the subsequent evolution of both economies.

The eventual macroeconomic impact for the Irish economy will reflect the extent to which the exit arrangements bring about any change to the free movement of goods, services, capital and labour.

Trade, FDI and the labour market are the key channels for the macroeconomic effects of Brexit. Any agreement which keeps the UK access to the single market largely intact would have a more limited impact but the scale of the impact could be much more significant under a more restrictive agreement.

In the short-term, downside risks for the Irish economy, the UK and the broader European economies, arise mainly from the macroeconomic, financial and currency market effects of Brexit related uncertainty.

An important element of this uncertainty revolves around the terms of the relationship between the UK and the EU, how long it will take to work out that relationship and how it will impact in the interim. This heightened uncertainty could act to dampen consumer demand and investment decisions by firms.

While the Irish economy has become less reliant on the UK for trade over recent decades, the UK remains a particularly important market for many indigenous firms. Some sectors, including agri-food, clothing and footwear and tourism continue to have a relatively high dependency on exports, consequently could be affected disproportionately.

The Banks most recently published forecast for the Irish economy and an updated projection to be published next week have taken account of the potential negative Brexit effect. Compared to a no-Brexit baseline, projected GDP growth has been revised down by 0.2 per cent in 2016 and by about a half of one percent in 2017.

Nevertheless even after these revisions, the outlook for the economy remains positive. Ireland remains on track to be the fastest growing economy in the EU this year, for the third year running and a similar outcome is in prospect for next year.

To conclude, against a backdrop of balance sheet repair for Irish banks' combined with on-going deleveraging by Irish households and SMEs, the Irish economy continues to deal with the legacies arising from the crisis. Risks and uncertainties remain, notably from the UK's decision to leave the European Union. Nonetheless, economic activity continues to expand at a reasonably healthy pace.

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1 I would like to thank Mary Everett, Mary Cussen, Terry Quinn and Micheál O'Keeffe and for their contribution to this speech. The views expressed in this speech are personal and do not reflect the views of the Commission of the Central Bank of Ireland, or the Eurosystem.

2 See Deaton Angus, (2015) 'Statistical objectivity is a cloak spun from political yarn' Opinion, Financial Times, 2nd November, 2015 available here.

3 The Governing Council noted in January 2015 that since *'potential second-round effects on wage and price-setting threatened to adversely affect medium-term price developments, this situation required a forceful monetary policy response'.* See introductory statement, 22 January 2015: www.ecb.europa.eu/press/pr/date/2015/html/pr150122_1.en.html

4 See Butt, Nicholas & Domit, Silvia & McLeay, Michael & Thomas, Ryland & Kirkham, Lewis, (2012), "What can the money data tell us about the impact of QE?," Bank of England Quarterly Bulletin, Bank of England, Vol. 52, No.4, pp. 321–331 for a detailed discussion of how an asset purchases programme affects money supply.

5 Irish responses to the ECB's Bank Lending Survey, July 2016.

6 Irish responses to the ECB's Bank Lending Survey, July 2016.

7 See Macro-Financial Review, H1 2016, Central Bank of Ireland.

8 The interest rate for new house purchase loans in Ireland stood at 3.38 per cent as of February 2016. See Central Bank of Ireland, Household Credit Market Report, H1 2016, available here.

9 See Carroll, James. & McCann, Fergal, (2016) Understanding cross-country interest rate variation in Europe Central Bank of Ireland Quarterly Bulletin, 2016, 2, April.

10 SME lending rates, proxied by rates on loans to NFCs of up to €1 million, were 4.71 per cent in Ireland in July 2016, substantially higher than the euro area average SME interest rate of 2.36 per cent.

11 See Central Bank of Ireland, Household Credit Market Report, H1 2016.

12 Household debt sustainability continues to improve with both debt-to-income and debt-to-assets levels decreasing. As of Q1 2016 household debt as a proportion of disposable income was 149.4 per cent. Debt as a portion of household total assets, is also on a downward trend, falling from a peak of 28 per cent in 2012 to 19 per cent in early 2016.

13 Under TLTRO II, eligible net lending by banks includes loans to euro area non-financial corporations (NFCs) and households, excluding loans to households for house purchase. Banks whose eligible net lending exceeds a benchmark can avail of this funding at an interest rate as low as that on the deposit facility.

14 Growth in medium term (with a maturity of 1 to 5 years) consumption credit provided the largest contribution to these growth developments.

15 Exchequer tax revenue grew by 9.2 per cent on an annual basis in the year to June, with strong gains across

most tax categories.

[16] Such euro area countries include Ireland, Italy, Spain, Portugal and Greece.