Philip R Lane: Macro-Financial Perspectives on the Irish Economy

Speech by Mr Philip R Lane, Governor of the Central Bank of Ireland, at the Institute for International and European Affairs, Dublin, 2 August 2016.

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Introduction

It is a pleasure to address the membership of the Institute for International and European Affairs today. It is timely to provide a mid-year assessment of the macro-financial environment facing Ireland, especially in the aftermath of the Brexit referendum. The last few weeks has also seen the publication of a number of studies by the Bank, the International Monetary Fund (IMF), the European Banking Authority (EBA) and the Central Statistics Office (CSO), which are all relevant in forming a considered view of the current state of the Irish economy and financial system.

The plan for this speech is as follows: first, I will provide a brief overview of the European and Irish macroeconomic environment; second, I will outline the lessons from the IMF's Article IV and Financial Sector Stability Assessment (FSSA) reports for Ireland; third, I will discuss the recent banking stress test exercises; fourth, I will examine the implications of Brexit both from a macroeconomic perspective and in relation to Ireland's role as an international financial centre; finally, I will conclude by discussing the measurement challenges in assessing the Irish macro-financial environment.

The macroeconomic environment

In relation to the broad euro area macroeconomic environment, the latest ECB Governing Council monetary policy meeting on July 21st assessed that the economic recovery is expected to proceed at a moderate pace, supported by accommodative financial and monetary conditions. Given prevailing uncertainties, the Governing Council will continue to monitor economic and financial market developments. Over the coming months, when we have more information, including new staff projections, we will be in a better position to reassess the underlying macroeconomic conditions, the most likely paths of inflation and growth, and the distribution of risks around those paths. If warranted to achieve its objective, the Governing Council will act by using all the instruments available within its mandate.

Turning now to the Irish economy, it is possible to filter the noisy headline data (of which more later in this speech) to identify a range of domestically-focused aggregate variables including employment, consumer spending and a suitably-adjusted measure of investment to indicate that the Irish economy is performing well. Although living standards and employment remain below pre-crisis levels, much of the ground lost during the crisis has been recovered over the last three years. Even allowing for a material adjustment for the negative impact of Brexit (of which more later in this speech), the Bank's latest Quarterly Bulletin still conditionally projects output growth rates of 4.9 percent and 3.6 percent for 2016 and 2017 respectively, with unemployment declining to 7.2 percent next year. At the same time, the legacy of high public and private sector debt levels and the sensitivity of small, highly-open economies to international shocks means that there remain considerable downside risks to this central projection. The IMF's recent Article IV report provides a valuable independent risk assessment, together with a range of recommendations to mitigate these downside risks and support a robust and inclusive medium-term growth strategy.

Financial Sector Assessment Program (FSAP)

The IMF has also published its FSSA report for Ireland. The FSSA report is based on a comprehensive Financial Sector Assessment Program (FSAP), which is an in-depth exercise to assess the resilience of the financial sector, the quality of the regulatory and supervisory framework and the capacity to manage and resolve financial crises. The FSAP started in September 2015 and involved extensive engagement with the Central Bank, Department of Finance, ECB and other financial sector stakeholders. To give you a sense of the scale and scope of the assessment, the third and final mission visit in March 2016 involved ten IMF staff on the ground in Dublin, more than 130 meetings in Dublin, Frankfurt and London and the submission of over 300 documents, many of which were hundreds of pages long.

The conclusion of the FSAP (and the publication of the FSSA) marks an important milestone for Ireland, since it is the first such review since the financial crisis and provides a timely assessment of our progress against international standards and best practice. In addition, it represents a further marker of the re-normalisation of Ireland's relationship with the IMF.

The Bank welcomes the broadly-positive assessment, which reflects the efforts of the Irish authorities in recent years to address the weaknesses in structural, regulatory and supervisory arrangements that existed prior to the crisis. The FSSA recognises the significant strengthening of Irish financial system, the major structural changes that have taken place since the financial crisis and the implementation of a more proactive regulatory approach, concluding that "the authorities have been effective and vigorous in strengthening prudential regulation and supervision, implementing the lessons of the crisis, and keeping up with developments in European and international good practice." In relation to the supervision of securities markets, the FSSA also acknowledges the Bank's leading role in the analysis of collective investment activities, which is significant in view of the large scale and international interconnectedness of the Irish investment funds sector.

At the same time, the IMF has also made a number of important recommendations to increase further the resilience of the Irish financial sector and improve the effectiveness of the Bank as a regulator. The Bank has already started to work on these recommendations, in conjunction with other Irish and European authorities. To take one example, the Bank has recently formed a new internal advisory committee on the design of domestic macroprudential policy measures, including the borrower-based mortgage rules, the counter-cyclical capital buffer and the other systemically important significant institution (OSII) buffer. In line with the IMF's recommendation to improve further the degree of public transparency in relation to our decision-making processes and our own ongoing commitment to provide evidence-based explanations for our policy measures, summary records of the meetings of this new macroprudential measures committee (MMC) will be published.

Stress tests

An important element of the FSAP was a stress test exercise for the banking system. The forward-looking assessment of the resilience of banks to various risk scenarios is a key tool in informing supervisory actions and financial stability policies. In fact, the Bank has recently participated in three stress testing exercises: first, as part of the IMF FSAP; second, as part of the wider bank stress tests across the European Union, led by the European Banking Authority (EBA); and third, the Single Supervisory Mechanism (SSM) stress tests, which followed the EBA methodology and ran concurrently with it. The Bank also continues to review and challenge the banks' own stress testing approaches and outcomes. I will focus on the first two exercises, as the outcomes are now in the public domain.

The Bank's analytical framework was used to support the IMF FSAP bank stress test. The FSAP adverse scenario was not predictive but designed to assess the capacity of Irish banks to withstand a severe but plausible scenario of a simultaneous downturn in the Irish and UK economies, characterised by a fall in property prices and a widening of sovereign spreads that triggers increased funding costs for banks. The exercise confirmed that the risks within the banking sector are manageable at a system-wide level. Unsurprisingly, it also highlighted that some vulnerabilities still exist as a consequence of the recent crisis.

The EBA stress test serves as a useful barometer to assess the health of the European banking sector and focuses on the largest banks operating in the European Union. Relative to other member countries, the Irish banking system has experienced higher loan loss rates since 2008. Since projected credit losses in the adverse scenario are calculated based on past experience, the capital depletion in the adverse scenario is inevitably more pronounced for Irish institutions. Stronger starting capital positions coupled with ongoing balance sheet repair has enabled European banks, including the Irish banks, to withstand a more severe scenario than in the 2014 stress test exercise. As with the FSAP stress test results, the primary message from the exercise is that the Irish banks included in the EBA sample (AIB and Bank of Ireland) are adequately capitalised but remain vulnerable to a downturn, especially in relation to the continued workout of problem loans and the sustainability under stress of current profitability levels.

The FSAP, EBA and SSM stress test results, together with additional supervisory stress testing work, are being combined with the full risk assessment for all in-scope banks to feed into the annual supervisory review and evaluation process (SREP), which is used to determine capital requirements and capital guidance for banks. In addition, the stress tests and SREP inform the risk mitigation programmes, which are focused on driving the banks to continue to reduce their risk profiles. As the ECB is now the competent authority for the supervision of Irish banks, the focus of our joint work includes ensuring that banks make further progress in the workout of problem loans, have credible business strategies and risk management plans to increase resilience to deterioration in their operating environment, including any adverse consequences of Brexit.

Brexit

The short- and medium-term macroeconomic effects on Ireland of Brexit depend on several factors. Most directly, a slowdown in UK output growth and a depreciation of Sterling against the euro adversely affect UK-orientated Irish exporters. These factors explain why we have materially revised our growth forecasts for 2016 and 2017. While the Irish economy has become less reliant on the UK for trade over recent decades, the UK remains an important market for many indigenous firms, with the agri-food and tourism sectors especially exposed. At the same time, it is important to put the the recent depreciation of Sterling against the euro into context, since it can also be interpreted as an unwinding of the bilateral appreciation that began in Summer 2014: the current £/€ rate (0.84) is remarkably close to the average rate between the start of 2009 and Summer 2014 (0.85). Still, the £/€ rate remains considerably weaker compared to pre-crisis patterns: the average £/€ rate between 1999 and Summer 2007 was 0.67.

Despite some initial fears, we have yet to see the operation of more powerful transmission mechanisms by which Brexit triggers a more general international decline in confidence indicators and/or initiates a "risk off" phase in the international financial system that would involve a general repricing of risk premia, a decline in asset values and a tightening in financial conditions. Rather, the international markets have initially focused on the likelihood of a prolongation of low policy rates, with a visible drop in the yields in many sovereign bond markets (and a related reduction in bank equity values).

While financial contagion channels have not been strongly operative during the initial post-Brexit period, the gradual crystallisation of the prospective new relationship between the UK and the EU over the coming months carries the continuous risk of triggering adverse market developments if a “harder” form of Brexit emerges as the more likely final outcome. Moreover, in view of its tight economic and financial linkages to the UK and its high levels of private and public sector debt, Ireland is especially vulnerable to any Brexit-related reversal in international financial sentiment.

There is also an active debate about the implications of Brexit for the configuration of the European financial sector. The impact on the geographical choices of producers of international financial services depends on a wide array of factors, including the accumulated track records as financial centers, the nature of national legal and tax systems, the relative levels of operating costs, transport links, and the relative attractiveness of different cities to the families of internationally-mobile financial workers.

Since the EU has a harmonised approach to financial regulation, regulatory competition among member states should not be a driving factor in determining locational choices within the EU. This applies a fortiori to the euro area, since the ECB-led SSM provides a unified institutional framework for the supervision of banks.

Accordingly, the Bank's approach to authorising and regulating financial firms is firmly embedded in the wider European System of Financial Supervision (ESFS). In particular, the Bank has a well-established approach to authorisations, in line with the practice of our continental peers. We implement our mission statement of "Safeguarding Stability, Protecting Consumers" by ensuring that the applicant comply with all relevant EU and national legislative and prudential requirements. These requirements protect consumers of financial services from the potential effects of fraud or failure and assure the various types of funders of financial entities that corporate governance safeguards are robust. In addition, the stability of the domestic and international financial systems is a key focus for the Bank and international regulators, with well-designed recovery and resolution plans for financial firms (especially systemically-important institutions) an important element in limiting contagion and protecting taxpayers in the event that a firm goes bust.

The Bank is committed to providing a clear, consistent, open and transparent authorisation process, while ensuring a rigorous assessment of the applicable regulatory standards. The authorisation gateway forms an important part of our supervisory model, based on assertive risk-based supervision in line with international standards, and underpinned by the credible threat of enforcement. To ensure transparent and predictable authorisation timelines for high-volume processes, the Bank publishes on a semi-annual basis its service standards in respect of processing authorisations: coincidentally, the latest report in this series will be published later today.

In relation to unique and complex applications, the authorisation process is inevitably more layered than routine cases, requiring a substantial commitment of resources and the assembly of dedicated project teams with the requisite technical skills and internal governance processes. To deliver an efficient and robust regulatory regime, the Bank has expanded its target staffing levels in recent years, subject to the capacity to recruit and retain those with the required skills and experience.

Since the establishment of the SSM, the ECB, with input from the relevant national competent authority (in Ireland, the Bank), is the competent authority for granting banking licences. The assessment criteria are detailed, rigorously applied and unchanged by Brexit. Equally, the SSM is directly responsible for the supervision of significant institutions, with Frankfurt-based personnel leading the joint supervisory teams overseeing each individual significant institution, such that banks can locate in any member country of the euro area and receive the same supervisory treatment, which is an important principle of an area-wide banking union.

Macro-financial statistics

Finally, let me turn to the challenges involved in measuring macro-financial developments in Ireland. For the conduct of monetary and macroprudential policies, it is essential that there exist robust measures of the levels of domestic incomes and production, together with reliable ancillary measures of sectoral and international financial accounts. More generally, such indicators are also vital for fiscal analysis and many private-sector decisions.

The highly-globalised nature of the Irish macro-financial system means that accurate implementation of UN/Eurostat statistical manuals does not provide sufficient guidance, as is evident from the debate following the most recent CSO official releases. Over time, it is desirable that international conventions in the measurement of flows and stocks of economic and financial variables are redesigned in order to avoid anomalous national statistical outcomes and provide sufficient granularity that the different domestic and external users of national statistics can be accommodated.

In the near term, there are two domestic challenges. First, I welcome the initiative by the CSO to establish a consultative group (which I will chair) that will consider, inter alia, the potential for the development of supplementary statistical series that may enhance understanding of the Irish economy and financial system. In recent years, the CSO has published a series of high-quality explanatory notes about the impact of multinational firms on the national accounts; it is timely to build on this work in order to construct useful alternative indicators on an ongoing basis. Second, policymakers should take care to look through the headline national and financial accounts data, in order to develop and communicate alternative policy targets that are not affected by the various statistical issues that have been much discussed in recent weeks.

Conclusions

I have covered a wide range of topics. Still, it is possible to identify some common threads that underpin the analysis. First, we should recognise that the baseline case remains quite positive, with considerable momentum supporting a broadly-based recovery. Second, at the same time, it is obvious that much remains to be accomplished in addressing the adverse legacy effects of the crisis and establishing the foundations for sustainable and inclusive medium-term growth. Third, Ireland continues to be especially vulnerable to downside shocks, such that policies to improve the resilience of the private and public sectors are vital.

Accordingly, the management of the macro-financial implications of Brexit should be underpinned by due consideration of these three factors. For the Bank, the issues identified in my speech today imply a busy ongoing work programme in fulfilling our mandate: I look forward to leading our efforts in the coming months.