Philip R Lane: Prospects for the Irish economy

Speech by Mr Philip R Lane, Governor of the Central Bank of Ireland, at the Cork Chamber of Commerce, Cork, 23 February 2017.

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Good afternoon. It is a pleasure to have the opportunity to address the Cork Chamber of Commerce. Today, I want to focus on the prospects for the Irish economy. First, I will give an overview of our latest projections for the economy. Next, I will discuss some external challenges facing the economy. Finally, I will turn to the role played by our macroprudential mortgage measures in underpinning macro-financial stability.

The Irish economy: current developments

The highly-globalised nature of the Irish economy and the impact of the activities of foreign multinational firms on the headline national accounts mean that it is necessary to look at a range of domestically-focused spending and activity indicators to get a more accurate measure of the level and composition of activity in the domestic economy.[1] The evidence from indicators such as employment, consumer spending and a suitably-adjusted measure of investment is that economic activity continues to grow at a significant pace.

The recovery of the economy in recent years has been led by the strength of domestic demand. This has been supported by the combination of relatively strong and broad-based growth in employment, increasing real disposable incomes and more favourable financial conditions. Since the low point reached in 2012, employment has grown by over 200,000, at an average annual rate of almost 2.5 per cent. Employment growth has been broadly based across the private sector and has predominantly reflected growth in full-time employment. This has helped incomes to recover and has supported strong growth in consumption in recent years, with per capita consumption moving back towards its pre-crisis peak.[2]

The impact of the economic crisis in the South West region (including Cork) and the subsequent recovery has been broadly similar to the national experience. Employment declined by 16 per cent nationally, which was also the scale of the decline in the South West region. Since then, both nationally and in the South West, about two-thirds of jobs lost in the crisis have been recovered. However, unemployment at just under 7 per cent nationally and slightly below 6 per cent in the South West remains above pre-crisis levels.

In many ways, the economy of the Cork region mirrors the national economy, having both significant multinational and domestic components. Cork is at the centre of the Irish pharmaceuticals industry and has a vibrant IT sector, as well as having significant indigenous business and tourism sectors. Given its diversified economic structure, it is likely that the outlook for the region will be subject to the same risk factors as for the rest of the country.

External risk factors

Looking ahead, the central forecast is for economic activity to continue to grow at a healthy pace, with the main impetus to growth expected to come from domestic factors. However, the outlook is characterised by uncertainty about the external environment such that risks to economic forecasts are to the downside. One obvious risk factor relates to Brexit. Looking at the wider international picture, given the strong presence of multinationals in the economy, there are also risks related to the potential for changes to broader international taxation and trade arrangements.

Both in the short term and the longer term, the economic impact of Brexit on Ireland is set to be negative. Reflecting this, the Central Bank revised down its economic forecasts in the wake of the UK referendum. To date, in the absence of any weakening in the UK economy, the impact of Brexit has mainly been experienced through the sizeable depreciation of Sterling against the euro.

In addition, however, those sectors with a high dependency on exports to the UK remain exposed to any future adverse UK economic developments and also the threat of new barriers to trade. Even for those parts of the economy not directly dependent on the UK market, there are potential indirect effects via competition from UK imports, supply-chain linkages and increased cross-border shopping.

While exporters selling to the UK are most immediately affected, there are additional channels by which shifts in the Sterling-euro exchange rate affects the economy. First, in many domestic sectors, the market share of domestic firms will be affected by import competition from the UK. Second, many domestically-orientated firms are suppliers to exporters or rely on employees in exporting firms as customers. Third, Sterling depreciation is associated with an increase in cross-border shopping, including a greater volume of online purchases from UK websites.

While these are adverse forces, it is also important to point out that a weaker Sterling may benefit some firms that rely on imported inputs from the UK and that real income gains to households due to cheaper imports from the UK may in part be recycled into higher spending on domestically-produced goods and services.

Over the longer term, Irish firms will have to adapt to the post-Brexit environment. The current uncertainty about the future UK-EU relationship will delay many investment plans. In turn, as clarity about the post-Brexit world improves, firms will have to develop new strategies to respond to the new configuration. In response to higher trade barriers between the UK and the EU, some firms may plan to serve UK customers through FDI into the UK, while others may search for new export markets. In the other direction, some UK firms may look to set up affiliates in Ireland both to serve the Irish market and as a platform for EU-wide trading.

Turning to global risk factors, any increase in protectionism is sure to pose a challenge for Irish-resident exporters and especially the multinational sector. This is of most concern to firms that export primarily to countries that might seek to penalise importers relative to domestic producers but the complex characteristics of global value chains and inter-sectoral linkages mean that the impact of protectionism will also affect firms and locations through indirect channels. Shifts in tax policies and exchange rates are additional factors that may influence the strategies of multinational firms in the coming years. Given the importance of the multinational sector to the Irish economy, monitoring and assessing external developments in these areas must be a high priority for domestic policymakers.

The policy framework

The intrinsic volatility of highly-open economies means that domestic economic policies should be firmly focused on underpinning stability by ensuring resilience in the face of external shocks. A robust macro-financial policy framework must include a prudent fiscal framework that recognises the value of building buffers during high-growth phases in order to act counter-cyclically during downturns.

In addition, it is essential that the Central Bank plays its part in underpinning financial stability. As part of the ECB's Single Supervisory Mechanism (SSM), an important dimension is to make sure that capital ratios and liquidity ratios are sufficient for banks to withstand adverse shocks, which is further reinforced by a proactive supervisory engagement programme. In cooperation with the Single Resolution Board (SRB), a second important element is that the balance sheets and organisational structures of banks are designed to facilitate the restructuring and resolution of

troubled institutions while minimising the need for injections of taxpayer funds.

A third component is provided by the national macroprudential policy framework, under which the Central Bank sets additional capital buffers for banks and also enacts borrower-based measures to mitigate the risks associated with boom-bust financial cycles. We view our mortgage measures that put ceilings on loan-to-income (LTI) and loan-to-value (LTV) ratios as essential in limiting systemic financial risk, while acting to protect consumers from the risks associated with overborrowing.

It is critically important to appreciate that our framework sets limits on the size of mortgages: the LTI and LTV ratios are not targets but ceilings. In buying a home, a household should take into account the protections offered by putting down a higher deposit in terms of limiting repayment burden and risks associated with excessive debt levels. Equally, lenders are required to assess the loan-bearing capacity of each mortgage customer and restrict the size of the mortgage if indicated by the analysis of the borrower's credit risk.

While the November 2016 revisions to the mortgage rules do raise the maximum loan size for first-time buyers seeking to buy homes above €220,000 in value, it is important to take into account several considerations. First, borrowers also have to satisfy the LTI requirement, which remains unchanged at a cap on loans of 3.5 times income. For many households, this will limit the capacity to increase the mortgage size. Second, to the extent that the revisions lead to an increase in aggregate mortgage credit volumes, this should be interpreted in the context of the subdued level of lending in the aftermath of the crisis.

Third, our framework is designed to avoid spiral dynamics between house prices and credit volumes. Since the mortgage measures were initially flagged in late 2014, there has been a sharp moderation in expectations for annual gains in house prices, since it is widely understood that persistently-high rates of increase in house prices are not likely in a system in which measures place ceilings on LTI and LTV ratios.

In particular, the LTI rule limits the capacity of house prices to grow too quickly relative to income levels, while the 80 percent LTV ceiling on loans taken out by second and subsequent buyers attenuates the feedback loop by which rising house prices increase the capacity of existing home owners to increase leverage. Furthermore, our macroprudential regulations can be tightened if there is emerging evidence of elevated risks in the mortgage market, especially in relation to the rate of credit growth.

Finally, it is important to appreciate that many factors influence the dynamics of house prices. While rising incomes typically support some trend growth in house prices, the prospect of future expansion in housing supply and tightening in the international funding conditions for lenders are significant factors that will restrain house prices over the medium term. In addition, the highly-open nature of the Irish economy means that income and employment levels are highly sensitive to external shocks. For instance, slowdowns in output growth in our major trading partners, major currency movements and adverse shifts in global trading regimes could trigger a reversal in the currently benign growth and employment environment.

For these reasons, the range of uncertainty about the future path for house prices is an important risk factor that motivates the need for ceilings on LTI and LTV ratios, while also making it vitally important that households and lenders conduct rigorous assessments as to the level of risk-adjusted sustainable debt in each individual case.

Conclusions

In these remarks, I have attempted to convey the Central Bank's current perspective on Irish economic prospects. It is certainly welcome to be able to observe strong recent economic performance, with a projected continuation of favourable trends in the near term. At the same

time, it is important to avoid the temptation to extrapolate recent success by adopting overly-optimistic medium-term forecasts. Most important, it is essential that Ireland's macro-financial policy framework recognises the intrinsic volatility of highly-open economies. For the Central Bank of Ireland, this means setting regulatory and macro-prudential policies that will enhance resilience in the event of future reversals in the economy.

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[1] I recently chaired the Economic Statistics Review Group (ESRG), which was commissioned by the Central Statistics Office to examine the implications of globalisation for the Irish national accounts. The ESRG report recommends that the CSO develop a set of supplementary indicators in order to provide a better guide to the evolution of the size and structure of the Irish economy.

[2] In volume terms, aggregate consumption has returned to its pre-crisis level; however, it still remains below its pre-crisis level on a per capita basis.