Philip R Lane: Macro-financial risk management

Speech by Mr Philip R Lane, Governor of the Central Bank of Ireland, at the Central Bank of Ireland Economics Roundtable, Dublin, 8 September 2017.

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It is a pleasure to welcome you to the Bank for the annual economics roundtable. Our interactions with the external economics community help us in shaping our analysis and policy positions; I hope the roundtable also enables the participants to gain an improved understanding of the work of the Bank. This afternoon's thematic sessions promise to provide new insights on the topics of labour market conditions, non-performing loans, and the European monetary environment.

In these opening remarks, I will first review current macro-financial conditions. Subsequently, I will discuss some current policy issues in relation to macro-financial risk management, focusing on the potential stabilising contributions from counter-cyclical macroprudential and fiscal policies. My discussion of fiscal policy reflects the content of the pre-Budget letter that I recently sent to the Minister of Finance, which is published today.

The macro-financial environment

The near-term and medium-term projections for the Irish economy are for significant expansion. The economy continues to grow at a strong pace, supported by the buoyancy of domestic economic activity. Underpinning the recovery has been broad-based growth in employment, which has helped incomes recover and supported solid growth in consumer spending, while domestic investment has gained traction. Modified domestic demand, a measure of domestic spending which excludes investment in intangibles and aircraft leasing, grew by 4.7 per cent in 2016.

Looking ahead, the outlook is favourable, although external uncertainty persists. The main impetus to growth will continue to come from domestic demand, driven by continuing gains in employment and incomes. Reflecting this, prospects for consumption and investment remain positive and modified domestic demand is forecast to grow by 4.5 per cent this year and by 4.0 per cent next year. Although the pace of employment growth is projected to moderate, unemployment is set to fall towards 5 per cent, with growth in compensation likely to average around 3 per cent.

At the same time, there are clear downside risks to the growth outlook at both global and domestic levels. At a generic level, Ireland is especially exposed due to the sensitivity of small, highly-open economies to international shocks. In particular, the state of global economic and trading conditions and the configuration of major exchange rates are important determinants of Irish economic performance, given the dominant role of global firms in our tradable sector.

In addition, the legacy of high public and private sector debt levels means that Ireland is vulnerable to shifts in funding conditions. The low interest rate environment that has persisted in recent years has generated a positive financial terms of trade shock for debtors. In the other direction, any upward shifts in policy rates, term premia or risk premia will pose adjustment challenges for indebted sectors and may have a material impact on asset valuations.

Finally, disorderly versions of Brexit would disproportionately affect Ireland relative to other European economies. As the EU-UK negotiations proceed, scenarios in which trading frictions between the EU and UK are increased would be damaging for the productivity of the Irish economy.

Macro-financial risk management: policy issues

There are two basic elements in macro-financial risk management. First, the capacity to withstand adverse shocks is enhanced by improving the resilience of the macro-financial system through the strengthening of sectoral balance sheets and the design of a legal and regulatory architecture that lowers the costs associated with dealing with unsustainable debts and failing institutions. Second, counter-cyclical policy measures can dampen cyclical fluctuations in conditions.

At global, European and domestic levels, financial regulatory reforms in recent years have been directed at improving the resilience of banking systems. Banks are now required to satisfy tougher capital and liquidity requirements, while recovery and resolution regimes have been introduced to make it easier to deal with distressed institutions. These regulatory reforms are backed by a more intrusive supervisory system, including more extensive on-site inspections and enhanced enforcement powers. Legal systems have also been reformed to improve insolvency frameworks, even if much remains to be done.

In addition, under the domestic implementation of the European macroprudential policy framework, the Central Bank of Ireland now sets additional capital buffers for banks and also specifies borrower-based measures to mitigate the risks associated with boom-bust financial cycles.

In relation to capital ratios, the Bank sets an additional buffer for each systemically-important institution (the so-called O-SII buffer).[1] In addition, the counter-cyclical capital buffer (CCyB) is a policy tool that can be activated in response to cyclical credit dynamics by raising the minimum capital ratio for banks during periods of above-normal credit growth and lowering it during periods of below-normal credit growth. A primary objective is to increase the resilience of banks to unexpected reversals in credit dynamics; in addition, depending on circumstances, it is possible that the credit cycle might also be dampened by such counter-cyclical measures.

While new lending is picking up, our assessment is that the credit cycle remains subdued, which is reflected in the current zero value for the counter-cyclical capital buffer. Still, since the counter-cyclical capital buffer is reviewed on a quarterly basis, this policy tool provides a high-frequency (compared to the typical duration of financial cycles) mechanism to respond to cyclical shifts in credit conditions. A small but increasing number of EU countries have raised the counter-cyclical capital buffer in recent times.

Of course, the bedrock of our macroprudential policy framework is formed by the borrower-based measures we have introduced in relation to mortgage loans. 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 emanating from the mortgage market, while acting to protect consumers from the risks associated with overborrowing.

Such borrower-based measures are intended to improve the resilience of the financial system and the overall economy by improving the sustainability of mortgage loans, leading to a lower probability of default and smaller losses in the event of defaults. Moreover, such measures are reinforced by the higher capital requirements facing banks, which improves their capacity to absorb loan losses.

An important property of the mortgage measures is that the LTI rule acts as an automatic stabiliser in relation to house price dynamics: house prices cannot persistently rise faster than the income levels among the pool of potential purchasers. In addition, the differential LTV ratios for first-time and second-and-subsequent buyers recognises the asymmetric impact of house price increases on these different groups: whereas a rise in house prices requires extra savings to meet the deposit requirement for a first-time buyer, an incumbent house owner experiences a decline in the LTV ratio on her existing property which expands her borrowing capacity in further housing market transactions.

In similar vein, the additional LTV requirement for buy-to-let (BTL) investors limits the feedback loop between house price rises and the conversion of increases in home equity values into borrowing capacity in the BTL category. The operation of these mechanisms means that the combination of the LTI ceiling and the ladder of differentiated LTV ceilings provides some in-built brakes in housing price dynamics.

A further stabilising mechanism is that our macroprudential regulations can be tightened if there is evidence of materially-elevated risks in the mortgage market, especially in relation to adverse feedback loops between the rate of credit growth and house price increases. Our commitment to an annual review process ensures that a rigorous evaluation of the mortgage measures is conducted each year, such that indicators of a combination of excess credit growth and unsustainable house price levels can be met by a revision in the rules. Given this policy regime, participants in the housing market can be confident that the feedback loop between credit growth and house prices will no longer operate in an unbounded fashion.

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 did 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, the scope for exemptions to the LTV limit for first-time buyers has been restricted to just 5 percent of lending to this group, whereas the previous regime allowed 15 percent of lending above the LTV ceilings and did not restrict the allocation of exemptions between the first-time and second-and-subsequent buyer pools: in our analysis, many first-time buyers above the €220,000 threshold were receiving exemptions (or were looking for loans below the LTV ceiling) so that previous rule was not fully binding. Third, to the extent that the revision is contributing to an increase in aggregate mortgage credit volumes, this should be interpreted in the context of the subdued level of lending in recent years.

Finally, it is important to appreciate that many factors influence the dynamics of house prices. Moreover, there is no fixed relation between credit conditions and the evolution of house prices: the importance of credit conditions is clearly diminished in settings in which a significant proportion of purchasers do not require mortgage finance.

While rising incomes, low interest rates, high rents and post-crisis adjustment dynamics are currently contributing to significant house price pressures, the prospect of future expansion in housing supply should restrain house prices over the medium term. In particular, an expansion in the housing stock would simultaneously relieve pressure in both the rental and home ownership categories.

In addition, as discussed earlier, the highly-open nature of the Irish economy means that income and employment levels are highly sensitive to external shocks. For instance, slowdowns in global output growth, major currency movements, adverse shifts in international trading regimes and a tightening in funding conditions could trigger a reversal in the currently benign growth and employment environment. Given these considerations, there are no one-way bets in the housing market and our macroprudential framework is fundamental to mitigating these risks.

A resilient macro-financial system also depends on stable public finances, especially in view of the feedback loops between fiscal stability, financial stability and macroeconomic stability. In terms of the public finances, a long-term public debt target can provide an important anchor. Indeed, the greater the commitment to attaining a long-term debt target, the more is it possible to run a flexible, counter-cyclical fiscal policy in response to temporary shocks. The case for a prudent target for public debt is further reinforced by the trend implications of an ageing population for expenditure on pensions and healthcare.

While the European fiscal framework prescribes a target ceiling for the stock of public debt (at 60 percent of GDP), there are compelling reasons to develop a national target for the stock of public debt. In this respect, I welcome the commitment in the *Summer Economic Statement* to maintain a long-term debt target of 45 percent of GDP. At the most basic level, the new CSO calculations indicate that the underlying size of the Irish economy (as captured by GNI*) is about one-third smaller than GDP, such that a debt ratio of 60 percent of GNI* maps to a debt ratio of 40 percent of GDP. More generally, the prudent stock of public debt naturally varies across countries in line with different risk exposures: the volatile nature of the Irish macro-financial system and the history of crises suggests a debt target that should be materially below the appropriate level for a larger, more stable economy. Of course, a target for the stock of public debt should be appropriately interpreted in the context of the wider public sector balance sheet, with due allowances for the dynamics of various types of financial and non-financial assets (including public capital) and the range of contingent and implicit liabilities.

In relation to the cyclical budgetary stance, the pursuit of macro-financial stability requires that the government runs a counter-cyclical fiscal policy. In addition to the mechanical operation of the automatic stabilisers that are embedded in the dynamics of tax revenues and transfers, a government may need to take further discretionary measures to tighten budgetary policy during phases of robust economic growth. The development of a counter-cyclical fiscal strategy should also strike the balance in the allocation of surplus revenues between the proposed rainy day fund and reducing the gross stock of public debt. In addition to ensuring that the fiscal balance is set at a cyclically-appropriate level, the government can use additional tools to mitigate overheating pressures, including the deployment of cyclically-varying expenditure taxes.

Determining the optimal counter-cyclical fiscal stance may soon be quite relevant for budgetary policy if the economy hits full employment. For instance, the macroeconomic implications of the projected further expansion in public investment during 2019–2021 that is signalled in the Summer Economic Statement depend on whether and when the economy attains full employment. While additions to the public capital stock can be expected to raise the productive capacity of the economy and/or assist in the attainment of social objectives over the medium term, the process of public investment acts to raise aggregate demand in the near term. While the demand-raising impact of public investment can be stimulative during periods of economic slack, a surge in public investment under conditions of full employment requires counter-vailing measures to limit the risk of costly over-heating dynamics. Alternatively, stretching out a planned public investment programme over a longer horizon can limit pressures on the absorptive capacity of the economy.

Finally, it is important to note the complementarities between counter-cyclical macroprudential and fiscal policies.[2] In one direction, a robust macroprudential policy framework mitigates credit-driven cyclical shocks, easing the burden on fiscal policy. In the other direction, counter-cyclical fiscal policy moderates the income volatility that is an important source of credit shocks, reducing the strain on the macroprudential stance.

Conclusions

At the current juncture, Ireland faces two types of risks. In one direction, there remain many legacy issues from the crisis, with the elevated stocks of private and public debt implying significant vulnerability to adverse shocks to incomes or interest rates. In the other direction, upside shocks may provide a new type of challenge in addressing potential overheating risks in the economy. The responsibility of policymakers is to maintain a vigilant and agile stance in order to ensure that Ireland can cope with either type of shock.

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[1] The acronym O-SII stands for Other Systemically Important Institutions.

[2] See Philippe Martin and Thomas Philippon (2017), “Inspecting the Mechanism: Leverage and the Great Recession in the Eurozone,” *American Economic Review* 107(7), 1904–1937.