Philip R Lane: Financial globalisation and central banking in Ireland

Remarks by Mr Philip R Lane, Governor of the Central Bank of Ireland, to the Financial Globalisation Symposium as part of the programme to commemorate the 75th anniversary of the Central Bank of Ireland, Dublin, 2 February 2018.

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It is a pleasure to welcome you to this symposium, which is part of our programme to mark the 75th anniversary of the Central Bank of Ireland. I am especially delighted that Francois Villeroy de Galhau is joining us today to give a keynote address. I am looking forward also to learning from the excellent lineup of speakers later in the afternoon.

The topic of financial globalisation is a natural theme for the Central Bank of Ireland. At a macroeconomic level, the global financial cycle is a primary determinant of financial stability conditions in small open economies. This lesson was painfully learned across the advanced economies during the international credit boom that occurred over 2003–2008.

During that period, the Irish property bubble was amplified by a surge in foreign funding raised by the domestic banking system. In related fashion, an excess of domestic spending over domestic incomes was financed during that period by the running of a significant current account deficit. However, the rapid expansion in the balance sheets of the domestic banks also took the form of an expansion in lending to foreign speculative ventures, such that the scale of net inflows understated the growing exposures of Irish banks to a reversal in conditions.

It follows that the Central Bank needs to be vigilant in understanding the international financial environment. This includes enhanced surveillance of international financial risks by tracking and interpreting data on international financial flows, international balance sheets, international imbalances and international asset prices. To obtain useful insights, it is desirable to go further by linking the external data with domestic sectoral data in order to understand the shifts in sectoral balance sheets that are the counterpart to a shift in the external balance sheet, even if this poses significant challenges in terms of data availability.

Since Ireland is a major hub for international financial intermediation, it is also our duty as part of the international regulatory community to contribute to global financial stability analysis by exploring the international financial flows that are routed through Ireland but where the original investor and the ultimate destination are located elsewhere. To illustrate the scale of the international financial sector in Ireland, the balance sheets of the internationally-orientated banks and insurance companies that we regulate aggregate to €519 billion. In addition, the assets of the investment funds that we authorise amount to €2.3 trillion euro, while we also gather information on other entities such as special purpose vehicles.

We use our data to actively contribute to the shadow banking monitors published by the Financial Stability Board and the European Systemic Risk Board. We also have published numerous studies on the characteristics of the investment funds and special purpose vehicles that are located here. Since we also adopt a data-intensive approach to the supervision of investment funds here, we find that there are significant analytical complementarities across our different central banking and regulatory functions in advancing our understanding of international financial flows. Our internal International Financial Data Working Group (IFDWG) provides a forum for the different teams working on these issues to share analytical insights and receive feedback on work in progress.

The increasing prominence of global firms in the international financial system also means that there are now significant crossovers between the international financial data and the national accounts. While this is also true for other countries with large multinational sectors, this phenomenon is especially acute in Ireland. The main issues relate to internationally-mobile capital assets such as intellectual property and aircraft: the relocation of these assets across borders triggers shifts in the national accounts and the international financial accounts. Developing new analytical and accounting frameworks that address this issue should be a high priority for the international statistical system; there may be some lessons from the modified national income and modified current account measures that were introduced here last year.

Let me now turn to the policy challenges facing the Central Bank of Ireland in maintaining domestic financial stability and protecting consumers in a financially-globalised world. In relation to the banking system, the European system builds resilience by requiring banks to maintain sufficiently-high capital and liquidity ratios. At the national level, we can add an extra capital buffer (the counter-cyclical capital buffer) if we assess that there is a risk of excessive credit growth. We also have introduced borrower-based measures in the form of ceilings on loan-to-income and loan-to-value ratios in the mortgage market. These mortgage measures make the banks safer, while also protecting consumers from over-indebtedness. We review the calibration of all of our macroprudential measures on a regular basis in order to stand ready to respond in an agile manner to shifts in the distribution of financial stability risks.

At this point, it is also necessary to remind you that cross-border financial flows can also take form of equity investments, especially direct investment in the context of the Irish economy. While equity investment has desirable risk sharing properties and does not generate the same financial stability risks as debt flows, a boom-bust cycle in equity funding can still contribute to macroeconomic volatility. However, fiscal policy is the appropriate stabilisation instrument to manage such cycles, rather than our macroprudential policy tools which are designed to manage debt-generating flows.

Let me also emphasise that membership of the monetary union provides an important buffer against international financial shocks. Under the counterfactual of maintaining an independent currency, international financial shocks can generate volatility in exchange rates and interest rates, even if the underlying domestic macroeconomic environment is stable. Such volatility is especially problematic for small open economies.

In a financially-globalised world, it is also the case that banks, firms and households in small open economies may incur foreign-currency liabilities. In a crisis environment, the existence of such foreign-currency liabilities may be destabilising, especially if foreign-exchange reserves are insufficient to provide cover against the risk of a run on these foreign-currency liabilities. In contrast, the capacity to raise cross-border funding in a common currency together with access to the common liquidity facilities of the European Central Bank acts as a stabilising mechanism in the event of a crisis event. In this way, monetary union can be an effective mechanism in addressing the macroeconomic and monetary challenges posed by financial globalisation.

In similar fashion, the coordinated European System of Financial Supervision (ESFS) allows Europe to manage the regulatory and supervisory challenges posed by international trade in financial services. A common rule book and a level playing field means that firms cannot engage in regulatory arbitrage across the member countries, while home-host coordination issues can be managed within the institutional framework provided by the European Supervisory Authorities (ESAs). In banking, the successful operation of the Single Supervisory Mechanism (SSM) has proven its value in fostering the development of a unified approach to banking supervision. Of course, EU regulation and supervision takes place within a broader global context, with an important role for global coordination of regulation through institutions such as the Basel Committee for Banking Supervision, the Financial Stability Board and IOSCO. Through international coordination among regulators, it should be feasible for the industry to reap the scale economies available to multi-country financial groups, while recognising the importance of ensuring that each individual legal entity within a group is appropriately regulated and supervised.

Let me conclude by posing the question: what will the international monetary and financial system look like in 2043, when the Central Bank of Ireland celebrates its centenary? No doubt, this question will be settled by the end of this afternoon's symposium. Regardless of how the future unfolds, I am certain that the Central Bank of Ireland will pursue with great dedication our mandate to safeguard stability and protect consumers.