Philip R Lane: The business environment in Ireland

Address by Mr Philip R Lane, Governor of the Central Bank of Ireland, to the Dublin Chamber of Commerce, Dublin, 9 November 2018.

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Introduction

I am pleased to have the opportunity to address the Dublin Chamber of Commerce.

Economic success depends on a thriving enterprise sector: the employment, investment and innovation decisions made by the over two hundred thousand private sector firms active in Ireland are critically important in determining national economic performance. In addition, the behaviour of firms also has a wider impact in terms of making progress in meeting the country's social, environmental and regional objectives.

Accordingly, it is important that there is an active dialogue between the business sector and the Central Bank: in one direction, our policies help to shape the business environment facing your members; in the other direction, we seek to gather information and views from many perspectives in determining our own policies and risk assessments. For instance, we have benefited from our interactions with firms in the distribution sector in gaining a better understanding of the prospective impact of Brexit on trade logistics and distribution networks.

In what follows, I have divided my remarks into three parts. First, I will comment on the current macro-financial outlook. Second, I will turn to the financing of the SME sector. Third, I will briefly comment on the new strategic plan of the Central Bank that we are launching today.

The Macro-Financial Outlook

The Irish economy is currently experiencing a sustained expansion phase. This is underpinned by robust and broad-based growth in employment, which is driving an increase in incomes and, in turn, consumer spending. In addition, some key components of domestic investment have picked up strongly, including in the construction sector. Looking ahead, the Central Bank's central forecast is that underlying economic activity will grow at a relatively strong pace in 2018, with some moderation in growth in prospect in 2019 and 2020.

It is important to emphasise that the current phase of strong economic performance is driven by strong fundamentals, rather than being fuelled by unsustainable increases in domestic credit. Looking ahead, the central forecast remains positive: underlying domestic demand is projected to grow by 5.6 per cent this year, moderating to 4.6 per cent in 2019 and 3.8 per cent in 2020. The projections for the labour market continue to signal that the economy is moving towards full employment, although some extra capacity is possible through further inward migration and increased participation in the labour market. Nevertheless, under the central forecast, capacity is set to tighten further in coming years.

However, the Irish economy is intrinsically volatile: there can be sudden and sizeable adverse shifts in fundamentals, especially for small and highly open economies. The list of downside risks includes: an unexpected tightening in international financial conditions or a downgrading of future global growth prospects, relative to the benign environment that has been in place for the last number of years; shifts in international trade and tax regimes that fundamentally challenge the Irish economic model; disorderly Brexit scenarios; and domestic policy errors that add to pro-cyclical dynamics in the economy.

Given this current configuration of risks, macro-financial risk management should have two aims. First, policy actions should not amplify pro-cyclical dynamics, if overheating risks in the economy and the financial system are to be contained. Second, macro-financial resilience requires buffers to be accumulated during good times that will enable Ireland to cope more easily with future downside shocks.

As a general rule, the running of budget surpluses during phases of strong economic performance is a pre-condition for the running of stabilising counter-cyclical deficits in the event of a future downturn.

In relation to the financial system, our macroprudential policies such as the countercyclical capital buffer that we triggered this summer and our mortgage rules are intended to ensure that resilience is enhanced during phases of good economic performance. The aim is that a more resilient financial system will be better placed to absorb the impact of future downturns, with more sustainable funding positions and greater capacity to tolerate a decline in the credit environment.

The Financing of the Business Sector

Let me turn to my second theme: the financing of the business sector in Ireland.

By and large, multinational firms are financed through the treasury arms of their global parents (some of these are also located in Ireland). The largest domestic corporates are able to tap international bond markets, in addition to bank finance.

In contrast, the funding of the SME sector primarily depends on internal resources and access to bank credit. The losses incurred during the crisis severely limited internal funding for an extended period but the uptick in profitability in recent years has improved self-funding capability.

In relation to debt dynamics, deleveraging has been extensive in the aftermath of the crisis. The proportion of firms reporting no debt rose from 25 per cent in 2013 to 50 per cent in 2017. The average debt-to-turnover ratio among indebted firms fell from 48 per cent to 31 per cent over the same period. This survey evidence tallies with aggregate statistics, which show a large fall in outstanding bank credit to SMEs between 2010 and 2018.

The substantial paying down of legacy debts incurred before the crisis have occurred in tandem with rapid growth in the issuance of new loans. Our statistics report that new bank lending to SMEs outside of the financial and property-related sectors rose from €1.9 billion in 2013 to €3.7 billion in 2017. The Agriculture and Wholesale and Retail sectors to have received the largest share of this new lending, at just over 45 per cent between them.

Regionally, SME lending is broadly balanced: the proportion of new lending to SME borrowers based in Dublin is about in line with the capital's population share. The increases in new bank lending volumes have occurred simultaneously with steady declines in the share of SME credit applications being rejected and a decline in the share of SMEs reporting more difficult financing conditions.

An interesting feature of this new credit landscape is that loan application rates have not increased during the economic recovery, and are currently lower in Ireland than in many European countries. As many as half of SMEs currently report that they are not applying for credit because they hold sufficient internal funding.

One interpretation is that this simply reflects limited funding needs due to the nature of the activities undertaken by these firms. A possible alternative interpretation is the scarring effects of the crisis has increased risk aversion in the business community, limiting the appetite to undertake riskier or more ambitious investment programmes.

There are a number of government initiatives to facilitate greater access to the finance, and have formed an important part of the post-crisis response in Ireland. The Strategic Banking Corporation of Ireland administers a range of schemes channelling funds through the traditional banking sector and through non-bank finance providers. By the end of 2017, SBCI had facilitated over €900m in loans to SMEs. The Ireland Strategic Investment Fund (ISIF) also participates in the SME finance market, including by taking direct equity positions in companies and facilitating greater access to credit. At the end of 2017, ISIF had €663m in commitments to SME-orientated projects. In the first half of 2018, ISIF invested a further €110m in non-bank finance providers involved in provision of financing to Irish SMEs.

While this synopsis suggests that financing constraints have become a less salient concern in recent years, it is important to recognise that improvements in access to finance for Irish SMEs have been uneven. The observed reduction in decline rates for credit applications is much less pronounced for micro enterprises. These enterprises, who make up close to 92 per cent of all active firms in Ireland and 28 per cent of total private sector employment, also report lower levels of credit demand and higher levels of non-application due to bank-related reasons, often referred to as borrower discouragement. However, the economic performance of micro enterprises in terms of profitability, employment rates, and turnover has been similar to that of larger SMEs during the recent recovery. This suggests that the relationship between bank lenders and smaller borrowers may have systematically changed, potentially resulting from changes in the operating models of banks.

While the availability and volume of SME finance have improved over the last five years, the cost of bank lending for smaller firms in Ireland remains high relative to peers elsewhere in the euro area, both in absolute terms and relative to the cost of borrowing of local larger companies . In this context, it is important to recognise the high levels of concentration in the SME bank lending market: the share of the three largest banks in new SME loans in the first quarter of this year was 93 per cent. The crisis saw the exit of a number of banks from the Irish market: the maintenance of the post-crisis recovery and the cleaning up of legacy debts are preconditions for the entry of new lenders into the Irish market. Furthermore, the fragmentation of the European financial system will be eroded if more progress is achieved in the development of banking union and capital markets union in Europe.

There is also a significant role played by non-bank finance providers in the SME market. These entities facilitate activities such as leasing, invoice discounting, trade finance, and peer-to-peer lending.

Venture capital funding, another form of external financing available primarily to high-productivity, high-potential firms, has increased substantially in recent years. In 2017, almost €1 billion was raised through this channel, with most of this being sourced from international investors. The number of firms in receipt of this funding is however extremely small in the context of the entire SME sector, around 175 or so per annum, and these firms are mostly concentrated in the software, life sciences, and FinTech sectors. These businesses will often have a short track record and a high risk of failure, so venture capital offers an important non-bank funding option for these kinds of innovative firms.

The Role of the Central Bank of Ireland

I wish to conclude by providing a brief outline of the new strategic plan of the Central Bank of Ireland, which is launched today and is available from our website. In common with the wider European system, the last decade saw the Central Bank initially immersed in crisis management, followed by the reconstruction of the regulatory system in recent years. It is now timely to enter a period of consolidation, in which the progress made in recent years is maintained, while the taking on of new challenges is accompanied by a focus on improving our efficiency and capability in delivering existing tasks.

The plan identifies five thematic priorities for the Bank. First, we will continue to strengthen the resilience of the financial system, both through our system-wide macroprudential policies and ensuring that major firms are well capitalised, maintain adequate liquidity buffers and have effective resolution plans if firm survival is called into question.

Second, we have a clear responsibility to address the implications of Brexit for the financial system: this includes taking a rigorous and efficient approach to the authorisation and supervision of the new wave of firms seeking to set up or expand operations; it also includes assessing and mitigating the financial stability risks associated with disorderly Brexit scenarios.

Financial stability risks arise from direct exposures to the UK market but there are also indirect exposures. For instance, many firms in Ireland are vulnerable to interruptions in international supply chains and increased competition from UK firms in the event of a further sharp fall in Sterling. In addition, if a disorderly Brexit scenario induces an extended phase of uncertainty about the future of UK-EU relations it would have a chilling effect on investment plans and be associated with a decline in a broad range of asset prices.

Third, we are committed to the further expansion of our consumer protection framework. Amongst other measures, this will involve more intrusive and targeted assessments of those firms and products that pose the greatest potential harm to consumers, an enhanced focus on the culture of firms and the individual accountability of the people who run the firms we regulate. These measures are intended to embed high standards of conduct in order to deliver fair outcomes for consumers and will be reinforced by a commitment to take enforcement actions where these standards are not met.

A fourth priority is termed “engaging and influencing”. Our capacity to deliver our public service mandate will be enhanced by an expansion of our public engagement programmes, both in order to listen to the concerns of the public and explain the policies and work of the Central Bank. At both domestic and international levels, we are committed to sharing our expertise with the broader policymaking community, while being influential in the collaborative policy development activities that underpin the shaping of policy decisions in the Eurosystem and the European System of Financial Supervision.

Fifth, we will undertake measures to enhance our internal capability: this includes enhancing the skills of our workforce, embracing the potential of data analytics and improving the efficiency of the operational systems that underpin the work of the Bank.

Wrap Up

In these remarks, I have tried to cover a lot of ground: an update on the macro-financial outlook; a review of the financing of the business sector; and an outline of the Bank’s new strategic plan. Still, I am sure you will have plenty of questions, so let’s turn to Q&A.

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