Philip R Lane: The Brexit discontinuity

Speech by Mr Philip R Lane, Governor of the Central Bank of Ireland, to the 2019 European Financial Forum, Dublin, 13 February 2019.

* * *

Introduction

I am pleased to address the 2019 edition of the European Financial Forum. Currently, both policy officials and private-sector participants in the global financial system are confronted with a combination of cyclical and structural concerns. At the cyclical level, the recent revision in global growth projections and the downside shift in the risk distribution require a careful assessment of the likely duration of adverse shocks and the potential offsetting impact of some mitigating stabilising factors: this exercise will be aided by the arrival of the incoming hard data on macroeconomic outcomes in the first months of 2019.

At the structural level, longer-term prospects depend on the traditional determinants of global productivity (such as investment and innovation rates), the steady-state cross-country distribution of national income levels relative to the frontier and demographic trends. In addition, climate change (together with the international policy response) will exert an increasing influence on the path for global output.[1]

However, both short-term and long-term prospects are currently also subject to an unusually high level of uncertainty about the paradigms governing policymaking. At the global level, the primary focus is on the future of the multilateral policy framework underpinning international trade. Within Europe, Brexit constitutes another paradigmatic shift: the departure of the United Kingdom from the European Union represents a disruptive event across many dimensions, including the operation of the single market. A full analysis of such paradigmatic events requires a multi-field integrated approach that draws upon history, political science, international relations as well as economics and finance. I will not attempt such a comprehensive approach in this speech: rather, I will focus on some of the implications of Brexit for the Irish economy and the Irish financial system.

The Central Bank of Ireland has been focused on Brexit risks since the announcement of the 2016 UK referendum. Our work has focused on ensuring that: (i) the risks to the Irish economy and consumers are understood; (ii) regulated firms prepare appropriately for all scenarios, in order to protect consumers; (iii) where necessary, the required policy and legal adjustments are prepared to counteract the cliff-edge risks of a hard Brexit to the delivery of vital financial services; and (iv) we perform our gatekeeper role in a robust and efficient manner for new firms seeking authorisation or existing firms revising business plans.

We have taken a transparent approach to this work: we publish the work of our Brexit Task Force, release answers to frequently asked questions, hold stakeholder roundtables, and have published a series of analytical reports and speeches. This research and analysis both informs our own work and seeks to assist other policy makers and stakeholders.

In what follows, I will first discuss the domestic macroeconomic implications of Brexit before turning to its impact on the financial system.

Brexit and the Irish Economy

The Irish economy expanded at a strong pace in 2018, supported by the strength of activity on the domestic side of the economy and a still-favourable international environment. Looking ahead, the Central Bank's latest central projection is that the outlook for the economy remains broadly positive, even if some moderation in growth is in prospect. This moderation partly reflects the limits imposed by domestic capacity constraints due to the tightening of conditions in the labour market and current bottlenecks in the housing market. It also is the domestic counterpart to the pullback in the international economic environment, even if this is partly offset by the expansion in domestic government spending.

We have also explored the scenario of a sudden and disorderly Brexit, using a range of modelling approaches. In view of the deep adaptation of the Irish economy to a EU28 single market that has included Britain, a sudden, no-deal scenario would have immediate disruptive effects that would permeate almost all areas of economic activity. The agri-food sector would be disproportionately affected, with a corresponding outsized impact on rural regions, especially near the Border.

Our modelling work suggest that a disorderly Brexit could reduce the growth rate of the Irish economy by up to four percentage points in the first year. In addition to the direct disruption to international trading arrangements, adverse developments in the UK economy have a general spillover impact in Ireland, via export demand, the value of Irish-owned operations in the UK, asset prices and confidence effects. Moreover, a significant further depreciation of Sterling against the euro would adversely affect those firms dependent on the UK market, even if there are some offsetting positive effects for domestic firms through the favourable impact on the terms of trade.

Given the current favourable forecasts for the economy as a result of domestic demand and the strong non-UK multinational sector, our assessment is that there would still be some positive growth in output this year and next even under a no-deal scenario, but materially lower than in the central forecast. A further mitigating factor is that the state of the public finances will permit the running of a counter-cyclical fiscal deficit through the operation of the automatic stabilisers on tax revenues and transfer payments.

Brexit and the Financial System

The scale and complexity of the Irish financial system is increasing as a result of Brexit. Well over one hundred firms have applied for new authorisations or permission to expand their existing businesses. While some of these applications relate to firms that now plan to serve Irish customers directly rather than through a UK entity, most of the volume is driven by export-orientated international firms that will serve EU27 customers from an Irish base.

Our gatekeeping role is critically important in maintaining the integrity of the EU27 single market in financial services market and protecting consumers, whether resident in Ireland or elsewhere in the EU27. It is imperative that any new firm authorised here meets the high standards that are expected of any entity authorised in the EU. Equally, we have engaged closely within the Single Supervisory Mechanism and the European Supervisory Authorities to ensure that similar regulatory and supervisory approaches are adopted across the EU27.

More generally, within the framework laid out in legislation, the post-Brexit EU will have to develop and implement a revised supervisory approach that recognises the shift in the geography of cross-border trade in financial services within the EU27, with less reliance on the UK as a bilateral trading partner and more reliance on newly-formed and expanded connections across EU27 member countries. In addition, in meeting their individual mandates, EU and non-EU regulators will have to work together in the supervision of large financial groups, in view of the ongoing intra-firm sharing of technology and services platforms and inter-linked balance sheets between EU entities and non-EU entities (including UK entities).

A strategic priority for the Central Bank of Ireland is to increase further our engagement in the relevant EU and international fora in order to contribute our own expertise in shaping this new agenda. This is a continuation of the substantial effort we have made since the international financial crisis in actively contributing to the shaping of international regulatory and supervisory standards.

On the basis of the work that we and others have undertaken, I am satisfied that the immediate cliff-edge risks of a hard Brexit have been largely addressed. In addition to the preparations by individual firms, this has included the temporary permission by the European authorities for the UK central securities depository (CSD) to continue to serve Irish securities during the transition to an alternative EU27 CSD arrangement.

There are some remaining risks of consumer detriment. The Irish and UK financial systems are closely connected, with UK firms and firms from Gibraltar providing financial services to Irish consumers, including insurance and payment services. We have worked with the European and UK authorities to ensure that those firms providing services to Irish consumers are able to continue to do so in the event of a hard Brexit. The vast majority of UK-based firms have taken appropriate action, but not all have to date. In this context, I am pleased that the Central Bank of Ireland has worked with the Department of Finance to support the drafting of legislation to create a temporary run-off regime that will protect insurance customers in event of a no-deal Brexit.

In terms of financial stability risks, our assessment is that the improvements in the resilience of the financial system over the last decade provide a vitally-important buffer. Taken together, the more balanced macroeconomic profile, the restructuring of the Irish banking system, the much-higher capital and liquidity ratios, the decline in the non-performing loan ratio and the more intrusive supervisory regime mean that the capacity to absorb negative shocks is much greater than in the past.

Conclusions

While there remains much uncertainty about the final nature of Brexit, the Central Bank of Ireland (and, more generally, the international central banking and regulatory community) has been active since the calling of the referendum in preparing for the full range of Brexit scenarios. Our near-term focus is in ensuring that our contingency planning covers the unfolding situation, while continuing to work with those firms that have not yet finalised their Brexit plans. Regardless of the precise outcome, the intrinsic discontinuity represented by any form of Brexit means that it is certain the 2020 edition of the European Financial Forum will be discussing a fundamentally-different European financial system compared to the system that has been in place for the last several decades.

---

[1] See for example Lane, Philip R., (2019), Climate Change and the Irish Financial System, Economic Letter, Vol. 2019, No.1, Central Bank of Ireland