Sharon Donnery: Risks and resilience in uncertain times

Address by Ms Sharon Donnery, Deputy Governor of the Central Bank of Ireland, to the Institute of International and European Affairs, Dublin, 8 March 2019.

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Good afternoon, it is a pleasure to address the Institute of International and European Affairs.

The ebbs and flows of a country's economic and financial fortunes are not always predictable.[1]

In Ireland, even less so.

While, sometimes, there are patterns or regularities for such events – they are not always a perfect indicator of what's to come.

Uncertainty always accompanies predictions.

When Seamus Heaney died in 2013, the Economist magazine published an obituary remembering him, with the by-line 'a shy soul'. They noted that "during his years studying to be a schoolteacher in the 1960s, he used the pen-name "Incertus", meaning "uncertain".….

Yet there is little that is hesitant in his poems."

There are plenty who may think there's no poetry in economics, but economics, like any field, can learn from the greats in others.[2]

A central theme of my remarks today is uncertainty.

Ireland today faces considerable uncertainty. Put simply, the Irish macrofinancial environment could change significantly over the short and medium term.

The UK leaving the EU is not the only risk. The international economic environment has deteriorated, yet the domestic economy is currently robust.

So, we find ourselves in the interesting position of assessing a potential slowdown in the external international environment, the UK departing the EU, while also worrying about potential overheating from a domestic perspective.

Plotting a course through such an environment, with the potential for a wide range of future outcomes, is indeed challenging.

While we can state with certainty that we have greatly expanded and strengthened our toolkit to deal with various risks, it is important that we maintain a sense of humility about what we can forecast and, more to the point, what we can control.

Yet like Heaney, despite the uncertainty we face – we cannot be shy, hesitant or complacent in our words, not least in our actions and policies.

Today, I would like to discuss the economic outlook, both for Ireland and critically, the international environment. Then, I will elaborate on some of the risks that Ireland faces. I will finish by giving some thoughts on what policy can do when facing these very different risks.

The economic environment and outlook

Given I have the opportunity to speak to the IIEA and given the timeliness of this speech following the announcement of yesterday's monetary policy measures, I will begin by focusing on the euro area and global economic outlook.

Just yesterday, I returned from a meeting of the Governing Council of the European Central Bank. A key concern of the Council was uncertainty. Specifically, the persistence of uncertainties related to geopolitical factors and the threat of protectionism appear to be leaving marks on economic sentiment. On account of this, the risks surrounding the euro area growth outlook are still tilted to the downside.

Incoming data have continued to be weak, in particular in the manufacturing sector, reflecting the slowdown in external demand compounded by some country and sector-specific factors. The impact of these factors is turning out to be somewhat longer-lasting, which suggests that the near-term growth outlook will be weaker than previously anticipated.

This assessment is broadly reflected in the March 2019 ECB staff macroeconomic projections for the euro area. These projections foresee annual real GDP increasing by 1.1% in 2019, 1.6% in 2020 and 1.5% in 2021.

Compared with the December 2018 Eurosystem staff macroeconomic projections, the outlook for real GDP growth has been revised down substantially in 2019 and slightly in 2020.

Ireland's trade and financial openness is a fundamental structural characteristic of the economy.

This is most evident from the familiar multinational brands headquartered here. The Irish economy is highly integrated with the international economy, both in terms of trade and with global financial markets, and particularly with regard to cross-border capital flows.

Over recent decades, Ireland has benefited very positively from developments in the global economy and the move toward high value, low volume trade. This has provided many benefits in terms of revenue and employment. For example, multinationals are estimated to account for 22 per cent of total employment.[3] However, this means structural shocks emanating from abroad can have an important bearing on the performance of the economy. These can include changes in global trade or international taxation regimes. Indeed, the structure of Ireland's economy means that it can even be affected by idiosyncratic shocks facing individual sectors or firms operating here.

Whilst providing many positives, this openness therefore also increases the propensity – and sensitivity – of the Irish economy to global shocks – be they structural shocks I just described, or cyclical – driven by the global economic cycle or by developments in global financial conditions for example.

This is evident in the data. The Irish macrofinancial environment has been more volatile than its European peers in the past. Cross-country volatility of a range of macrofinancial variables since 1980 – including house prices, GDP, household income, employment, and credit, for example – illustrates this.[4]

In summary, there are big benefits for Ireland being a highly globalised economy. But these benefits also bring risks. And the risks need to be managed appropriately.

Turning to home, a range of indicators we monitor and analyse show that the economy grew robustly in 2018.

The strength of activity has been supported by strong growth in employment. This has, in turn, stimulated incomes and supported consumer spending. We have also seen an acceleration of investment in the economy, for example in building and construction.

Taking a slightly longer-term perspective, the strong recovery since 2013 has yielded several important benefits.

One of the most clearly tangible places we can all see this, is in the number of people in work. Nearly 420,000 additional people have found employment since the low point of 2012. Nearly 2.3 million people are currently in employment, exceeding the peak of 2007. Crucially, growth in employment has been broad based across different sectors of the economy. For example, construction employment accounted for 1 in 9 jobs in 2007. Today, it makes up just 1 in every 16. The improvement in labour market conditions has also been felt across different regions.

We've also seen the overall size of the labour force grow. More people, particularly older people, are participating in the work force. Net inward migration has also resumed. In the year to April 2018, it amounted to 34,000 people. This is equivalent to 1.4 per cent of the labour force. This is a clear signal of the strength of domestic economic activity.

Looking ahead, our central forecasts assume that the UK parliament will ratify a withdrawal agreement and that a transition period will come into effect until the end of 2020.

Based on this key assumption, the outlook for the Irish economy over the coming years remains broadly positive.

However, we expect that a tightening of conditions in the labour market and bottlenecks in the housing market will contribute to a moderation in growth. This moderation also reflects the less favourable international economic environment I discussed earlier, with prospects for growth in our main trading partners less positive than previously anticipated.

We now expect GDP growth this year of 4.4 per cent. Our forecasts suggest this will moderate to 3.6 per cent next year. Underlying domestic demand, a measure that gives a more accurate picture of economic activity, is forecast at 4.1 per cent this year, moderating to 3.3 per cent in 2020.[5]

We expect further growth in employment in 2019 and 2020, of the order of 2.2 per cent this year and 1.7 per cent next year. Given our forecasts for labour force growth, this implies that the unemployment rate will drop to 4.9 per cent this year and 4.7 per cent next year.[6]

So, our central forecasts indicate that the current economic prospects for the Irish economy are quite robust.

Risks from inside and out

Risks however are prevalent from both inside and out.

However, it is important that we are not complacent in thinking that the UK's departure from the EU is the only risk to the Irish economic outlook. The international outlook is uncertain. And should we avoid a disorderly UK exit, and the dent to Irish economic growth that comes with it, a continued fast growing economy is only desirable as long as growth is sustainable.

Events could result in outcomes well beyond what we expect from our current central forecasts.

In the current circumstances, much of the uncertainty arises from the lack of clarity regarding our future relationship with the UK. From the spectrum of potential outcomes, a no-deal disorderly departure represents a worst-case scenario for Ireland. The abrupt ending of cooperation agreements would have material and immediate economic implications.

In our latest Quarterly Bulletin, using our economic modelling tools, we examined the possible macroeconomic implications of a sudden and disorderly Brexit. Given the unprecedented nature of a 'no deal' scenario, quantification is highly uncertain and this exercise represents a scenario analysis and not a forecast – it considers what could happen under certain assumptions, not necessarily what is most likely to happen.[7]

With a disorderly departure, significant additional frictions and costs would arise. These result not just from the introduction of new trading arrangements, but from a breakdown in some of the arrangements that make trade possible. For example, regulatory and customs issues, border infrastructure issues and legal uncertainties. People are likely to feel this in their everyday lives. This would be likely to have immediately damaging consequences for trade and the functioning of supply chains for production, distribution and retailing.

Models and forecasting tools can be used to estimate the impact of long-run changes to trade arrangements. However, they are less suited for predicting the short-run effects and potential disruption arising from a breakdown in those arrangements. The scale of disruption would also be influenced by the ability of firms and retailers to respond and adjust. Policy responses or mitigating actions would also help to ameliorate the situation. Nevertheless, it is clear that a no deal scenario would have very severe and immediate disruptive effects, which would permeate almost all areas of economic activity.

Certain sectors would be disproportionately affected, particularly agriculture and food. Border regions for example, would also be heavily affected.

We calculate that a disorderly Brexit could reduce the growth rate of the Irish economy by four percentage points in the first year, albeit this figure is subject to much uncertainty.

However, 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 over the coming years – even under a no-deal scenario. This would be materially lower than in the central forecast I outlined earlier – and would be closer to one per cent growth in both years.

A fast-growing economy is desirable as long as growth is sustainable. However, sometimes the economy can grow too fast and overheat. This happens when an economy reaches the limits of its capacity to meet demand from individuals, firms and government. One element of this is the concept of “full employment”, which occurs when almost everyone who wants to work has a job. When this happens, there is very little available slack. In other words, the amount of unused resources, or spare capacity in the economy – is very limited or non-existent.

The problem with overheating is that it tends to result in a harmful downturn.[8] Temporary surges create dynamics that are difficult to reverse. For example, wages can rise quickly to unsustainable levels.

Overheating can make households and firms over-optimistic about their future income prospects, and lead them to take on too much debt. If this future income fails to materialise, readjusting to a sustainable growth path can be painful. The result can be bankruptcies, job losses, wage reductions and cuts to public services.

I mentioned earlier that our central forecast suggests some moderation in growth over the coming years. However, despite this, we still see labour market conditions tightening further.

Surveying a range of indicators reveals mixed evidence as to the extent of current overheating pressures. Investment in the real economy remains well below its previous peak.[9] Overall credit growth is subdued as households continue to reduce their debts. The modified current account of the balance of payments – an important indicator of imbalance –recorded a small surplus in the most recent data.[10]

While these measures are not indicative of significant overheating pressures currently, past episodes demonstrate that the position can change quickly. As the economy moves closer to full employment, there is a need to guard against the risk that economic conditions give rise to overheating dynamics. To date, the tightening of the labour market has not been accompanied by significant evidence of strong wage or price pressures. However, further increases in aggregate demand may lead to overheating in the economy.

Financial system resilience and macroprudential policy

So, we find ourselves in the interesting position of considering a potential slowdown in the international environment and the UK leaving the EU. And at the same time, also worrying about potential overheating from a domestic perspective. The potential for a wide range of future outcomes, and associated uncertainty, is indeed challenging.

To guard against these risks, we need to build resilience.

Resilience in households, resilience in businesses, resilience in the public finances and resilience in the financial system.

This is important to withstand future downturns. If buffers are built up during the good times, policy can react during a downturn. Counter-cyclical policy therefore offers a way to moderate the effects of downturns, supporting demand in the economy when necessary. However, the ability to implement counter-cyclical policy relies crucially on taking advantage of positive growth periods to build the buffers.

Given our continued strong growth right now, reducing Ireland's high debt to safer levels should remain a priority – both in order to protect the public finances in the face of risks and to lay the foundations for sustainable future growth. Ireland's debt-to-GNI[11] ratio remains elevated and above 100 per cent. Reducing the debt burden is vital to future-proofing the economy to weather possible shocks.

The unpredictability of corporate tax revenues in recent years points to the dangers of relying on what might prove to be a partly transitory surge in revenues to fund lasting spending commitments. In recent years, the public finances have benefited from an exceptional growth in corporation tax revenue. They have also benefited from savings on national debt interest payments due to the low interest rate environment internationally. Since 2015, revenue from corporation tax has consistently outperformed the Department of Finance's forecasts by an average of almost €1.4 billion per annum. Saving, rather than spending, such windfalls would help to mitigate against potential overheating and allow the build up of buffers which can be used in the event of future downturns.

So, just as fiscal buffers can be used to absorb shocks to the economy, the financial system also needs to have such buffers. Without these, the financial system may react in a way that further deepens the economic stress faced by households and firms in a downturn, by curtailing the supply of credit for example. Indeed, the costs of the financial system having insufficient buffers to absorb shocks became painfully obvious in the crisis.

The Central Bank's mission is to serve the public interest by safeguarding monetary and financial stability and by working to ensure that the financial system operates in the best interests of consumers and the wider economy.

An essential outcome of this mission is strengthening the resilience of the financial system. This is one of our five strategic priorities of our Strategic Plan 2019–2021. Our aim is to ensure that we at the Central Bank can, and do, play our part in strengthening the resilience of the system as a whole, building on what has been achieved since the financial crisis.

So what has changed for the domestically relevant banking system since the crisis in terms of its resilience to deal with negative shocks?

At a headline level, three things come to mind:

1. Its capital position (relative to risk-weighted assets) has improved almost threefold relative to 2007.[12]
2. Reliance on short-term wholesale funding from international capital markets has reduced. The share of customer deposit funding has increased from less than half to around four fifths.[13]
3. Funding costs have fallen and, despite recent market volatility, have remained contained. This suggests that counterparties' view of the creditworthiness of Irish banks has not changed, which in itself is a reflection of the financial resilience of the core of the banking system.

And what of the role of policy generally, and the Central Bank in particular, in promoting resilience and safeguarding financial stability?

Changes to the international regulatory and supervisory architecture have played a part in restoring confidence and promoting resilience in the financial system. We have also done much work in preparing the financial system for the UK's departure from the EU.

I spoke on Tuesday to central bank experts from across the EU who were visiting the Central Bank of Ireland. There I highlighted some of the contingency planning we have undertaken. In particular, I explained how the Irish market is unique in the area of securities settlement. In simple terms, when shares in a stock or other securities – like government or corporate bonds – are bought and sold, they are settled at a central securities depository or CSD. Securities settlement systems provide the institutional and technical infrastructure that allows trading to happen. Due to the fact that Ireland has no domestic infrastructure and utilises a number of settlement systems located across Europe, following the departure of the UK from the EU the current arrangements are not sustainable.

Therefore, the Central Bank in conjunction with the Department of Finance has engaged extensively with European counterparts to mitigate against the potential disruption from this immediate cliff edge risk. I am happy to report that it has been largely mitigated – notably with the European Commission's decision to grant temporary equivalence to the UK's legal and supervisory arrangements for CSDs until 29 March 2021. The Central Bank will continue to liaise with the relevant stakeholders to ensure a long-term solution is implemented on time.

I am happy to discuss more on Brexit in the following Q&A but for the remainder of my remarks today, I will pay particular attention to how our macroprudential policy framework aims to strengthen resilience to withstand adverse macroeconomic shocks.

Earlier in my remarks I discussed how as a small, open economy, Ireland is not only exposed to risks from within but also from the external environment. It is vital that a small and highly globalised economy like Ireland is proactive in using macroprudential policy to mitigate systemic risk and build resilience. Our macroprudential framework and toolkit builds resilience in the system against different risk factors, and complements the firm-specific resilience that is the focus of micro-prudential regulation and supervision.

To date the Central Bank has activated a number of tools which, to a greater or lesser extent, aim to enhance the resilience of the system.

- The Other Systemically Important Institutions (O-SII) buffer looks to build additional resilience for institutions whose failure would have a bigger impact on the economy and the financial system. The O-SII framework was introduced in Ireland in 2015 when two institutions were identified as systemically important, with a buffer of 1.5 per cent phased-in between 1 July 2019 and 1 July 2021. Our latest review identified six Irish authorised institutions as O-SIIs.[14]

- Promoting resilience in the banking sector, for example, is the primary rationale underlying our policy stance for the countercyclical capital buffer (CCyB), which we announced last year. We introduced the CCyB because a number of indicators suggested a sustained trajectory towards a gradual build-up of cyclical systemic risk. Our aim is to mitigate against a negative reaction of bank lending to the real economy in any future downturn or period of systemic stress.
- Increasing bank and borrower resilience, so as they are more able to withstand the impact of negative shocks, is one of the objectives behind the mortgage measures.

Each of the macroprudential policy interventions that the Central Bank takes has the objective of protecting financial stability by targeting different elements of systemic risk. Individual macroprudential tools have different objectives, operate through different transmission channels and look to address different sources of systemic risk.

I began my remarks by discussing how the Irish economy is very integrated with the international economy both in terms of trade and with global financial markets. I also highlighted the vulnerabilities that this entails. It is important banks hold sufficient structural buffers as well as cyclical buffers to guard against the higher levels of macroeconomic risk Ireland faces.

Having buffers means capital depletion does not lead to instability in financial markets. This makes a tightening of credit conditions less likely.

Resilience in the banking system should be locked in through the more active use of capital buffers. This is important given the higher levels of risk intrinsic to a small highly globalised economy. It also allows the system to withstand both unexpected negative developments and the ebb and flow of financing conditions.

Conclusion

To conclude, the wide range of possible future paths means building resilience is not only desirable, it is necessary.

Incertae – uncertainty – will always be a feature of the system, and therefore, we need to be humble about the extent to which we can forecast and predict, while being aggressive in building defences against potential risks.

The government, firms, households and financial sector participants should be cognisant of the range of potential outcomes and the risks contained within.

The Central Bank has particular powers, and will use them to safeguard monetary and financial stability and to ensure that the financial system operates in the best interests of consumers and the wider economy.

This is how we best serve the public interest.

Thank you, I look forward to the discussion.

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1 I would like to thank Eoin O'Brien, Martin O'Brien, Thomas Conefrey, Paul O'Brien, Paul Reddan and Micheál O'Keeffe for their contributions to my remarks.

2 The Economist: Remembering Seamus Heaney – A shy soul (2013)

3 National Competitiveness Council: Ireland's Competitiveness Challenge (December 2018)

4 Donnery, Sharon: When is the right time? Macroprudential policy and the cycle, National University of Ireland (31 May 2018)

[5] Underlying domestic demand is a measure of spending in the Irish economy. It excludes trade in aircraft by aircraft leasing companies and imports of R&D related to intellectual property imports from headline investment. This measure more accurately reflects economic activity within the domestic economy than standard measures such as GDP and GNP.

[6] Central Bank of Ireland: Quarterly Bulletin 1 (2019)

[7] Conefrey, T, O'Reilly, G and Walsh, G: ' The Macroeconomic Implications of a Disorderly Brexit', Central Bank of Ireland, Box B Quarterly Bulletin No.1 (2019)

[8] Central Bank of Ireland: Explainer – What does overheating in the economy mean?

[9] Underlying investment refers to overall investment excluding intangible assets and aircraft.

[10] Central Bank of Ireland: Quarterly Financial Accounts

[11] Source: Central Statistics Office – Current Account Balance for Ireland 2007 – 2017

[12] Capital here refers to common equity capital less intangibles and deferred tax assets as a proxy over time for CET1.

[13] Sibley, Ed: Safety and soundness – Strategic priorities for the next three years, BPFI Risk Management & Supervisory Conference (January 2019)

[14] Central Bank of Ireland: Identification of Other Systemically Important Institutions in Ireland and Announcement of Associated Buffers (12 November 2018)