Sharon Donnery: The departure of the UK from the EU – implications for the Irish economy and financial system

Internal dinner address by Ms Sharon Donnery, Deputy Governor of the Central Bank of Ireland, to visiting staff from other central banks, Dublin, 5 March 2019.

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Introduction

First, welcome to Dublin! It is a great pleasure join you this evening.[1]

The departure of the UK is particularly important for us in the Central Bank of Ireland given:

- The significant trade and investment links with the UK mean that the Irish economy is more exposed to the risks from the UK's departure than any others, apart from the UK;
- The largest domestic Irish banks have very substantial UK exposures and any deterioration in the UK economy could impact on their asset quality;
- Dublin is one of the small number of European capitals that is likely to see considerable inward investment of financial sector firms, which will significantly affect the size and complexity of the financial system here;
- In policy fora, Ireland will lose a close ally on certain issues; and
- UK firms passport into Ireland across a range of sectors including insurance and payments services, for example, and for consumers there will be implications when this is no longer possible.

Therefore, in this context, in my remarks this evening, I will first take the opportunity to outline the broad approach we have taken in the Central Bank in our preparations. I will then go on to discuss some of the contingency planning and outline some specific areas where public authorities have had to take action. Third, I will outline the structure of the Irish economy and discuss some of the more macroeconomic aspects to the departure of the UK. I will highlight some of the channels through which a no-deal/no-transition outcome would affect the economy here in Ireland. Finally, I will conclude with some thoughts on life after the UK's exit for European authorities.

Our broad approach

In addition to our national central banking functions, the Central Bank of Ireland also acts as national competent authority for the supervision of credit institutions, investment firms, and insurance firms. The Central Bank is also the securities and markets regulator and the national financial conduct authority, as well as being the national macroprudential authority and national resolution authority. Given this wide range of mandates, we must look at economic and financial sector issues in a holistic fashion, and this is particularly the case for Brexit. This means analysing the macroeconomic effects and addressing possible financial stability implications, ensuring firms across the whole financial system are prepared, and minimising the potential impact on consumers.

The international nature of the financial sector here means we cooperate closely with our European partners: not just the ECB and Single Supervisory Mechanism (SSM), but also the Single Resolution Mechanism (SRM) as well as extensive engagement with the European Supervisory Authorities (ESAs): the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA).

We consider the work we undertake on international engagement to be of such importance that it is one of the five strategic priorities in our three year Strategic Plan we launched earlier in the year (the UK leaving the EU is another).[2]

Broadly speaking our work on the UK leaving the EU has focused on four key areas. These are ensuring that:

1. Risks to the Irish economy and consumers are understood;
2. Regulated firms prepare appropriately for all scenarios;
3. Where necessary, the required policy and legal adjustments are prepared to counteract the cliff-edge risks of a hard exit to the delivery of vital financial services; and
4. We perform our gatekeeper role in a robust and efficient manner for new firms seeking authorisations or existing firms revising business plans.[3]

To meet these objectives, we established a Task Force in 2016. More recently a Steering Committee was set up to oversee the final stages of the Central Bank's preparations for cliff-edge risk mitigation. In line with our commitment to transparency, the reports of the Task Force are regularly published in redacted format.[4]

We have made every effort to ensure that the financial system has the necessary level of resilience to avoid financial stability risks in the event of a no-deal scenario. Our preparations have involved a significant amount of engagement with financial firms and this has focused on ensuring that all necessary steps have been taken to mitigate the risks to their customers and businesses from the UK's exit, with a particular focus on a disorderly scenario.

The scale and complexity of the Irish financial system has already changed considerably as a result of the UK leaving the EU. Work dealing with the authorisation or extension of business for over 100 firms has required the Central Bank to substantially increase our workforce as well as prioritising and reallocating our existing resources to ensure that we took decisions in an effective, efficient, predictable and timely fashion.

The Central Bank does not view the authorisation process through a solely domestic lens – we are cognisant that the standards we hold firms to are relevant for the entire EU27 single market in financial services. Cooperation with the SSM and the ESAs has therefore been crucial to ensure a level playing field and avoid regulatory arbitrage or a race to the bottom.

Broadly speaking, while we continually assess the risks and challenges posed by the UK's departure to the overall financial system in Ireland, we have not provided a blueprint for firms to follow when considering their own particular risks. Firms are responsible for their own plans to mitigate risks to their businesses and customers. We have stressed this point clearly and consistently through our supervisory work and in our public communications. In the cases when firms have not made plans – we have made our concerns known. Additionally, there are some areas where the Bank, with other public authorities, have had to intervene to put in place measures to mitigate specific financial stability concerns.

Contingency planning

One area which has been of particular importance is the effect a no-deal scenario would have on the use of a UK-based central securities depository (CSD) by the Irish market.

Securities settlement is a central component of the financial system.

For those unfamiliar with market infrastructure issues, 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.

Today paper certificates are rarely used – since so-called dematerialisation – the settlement system has operated on a real-time basis. The Irish market however is unique in the area of securities settlement due to the fact that it has no domestic infrastructure and utilises a number of settlement systems located across Europe.

Furthermore, due to the level of integration of the UK and Irish financial markets, Ireland has for many years used a UK based CSD, to settle equity trades and Exchange Traded Funds (ETFs) through its CREST electronic platform.

Multi-currency settlement (euro/dollar/sterling) is also an important feature of the Irish market.

However, due to the UK leaving the EU, the current arrangements are not sustainable.

To mitigate against potential market disruptions, the Central Bank has engaged extensively with European counterparts including the ECB, the European Commission, ESMA, and the Bank of England while also working with domestic stakeholders including the Department of Finance, the National Treasury Management Agency and the relevant regulated firms.

Thankfully, this immediate cliff edge risk has been largely mitigated 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.

The CSD issue outlined above is not the only area where financial regulatory authorities have had to take steps to mitigate against cliff edge risks. Work from the Prudential Regulation and Financial Conduct pillars in the Central Bank has highlighted some remaining risks of consumer detriment and corresponding mitigating measures. For example, the Central Bank has worked with the Department of Finance to support the drafting of legislation to protect customers of insurance products in the event of a no-deal scenario.[5]

The recently published Brexit Omnibus Bill includes amendments to allow for a temporary run-off regime, which will allow certain UK/Gibraltar insurers and brokers to continue to service existing insurance contracts with Irish policyholders. This is necessary to protect consumers in the event of a hard exit.[6]

Authorities have also taken steps with respect to Investment Funds. Some issues that have arisen include the loss of passporting for UK Fund Management Companies acting for Irish Funds and the loss of the ability for Irish funds to delegate their portfolio management to UK investment managers.

As with the other issues we have faced, the Central Bank has engaged intensively with other relevant stakeholders to mitigate these problems and cooperation with our European partners has been essential.

ESMA recently agreed Memoranda of Understanding with the Financial Conduct Authority (FCA) of the UK which allows activities, such as fund manager outsourcing and delegation, to continue to be carried out by UK based entities on behalf of counterparties based in the European Economic Area (EEA).[7]

Cooperation with UK authorities has also been important with the FCA implementing a temporary permissions regime that allows EEA-based firms currently passporting into the UK to continue regulated business within the scope of their current permissions in the UK in the event of a no deal Brexit.[8]

The Irish economy and the UK leaving the EU

Moving to macroeconomic aspects of the UK's departure from the EU, much has been said regarding the particular vulnerability of the Irish economy and I think it is true that Ireland will be the country most affected, outside of the UK.

Since the referendum in June 2016, the impact on Ireland of uncertainty related to the UK's exit appears to have been small. Instead, the main impact thus far has been through the depreciation of sterling against the euro, which has been about 12 per cent.

Despite the depreciation, Irish exports to the UK have generally held up well – until recently at least. However, the weaker sterling exchange rate has put downward pressure on import prices and as a result overall consumer price inflation over the past three years.

More recently, we have seen some deterioration in business and consumer sentiment as the exit date has come closer, and the possibility of a no-deal scenario has come into greater focus.

The UK, however, has not yet left the EU.

The risks from the UK's exit are not shared equally throughout the Irish economy. Some sectors, like agriculture for example, and areas such as the border region are disproportionately exposed.

In addition, while the UK remains one of Ireland's most important trading partners, this relationship has evolved over time, particularly since 1973 when Ireland joined the European Economic Community (EEC). Therefore, I will take a few moments to articulate the evolution of the structure of the Irish economy to help you understand the channels by which the UK's departure will affect the domestic economy here.

The Irish economy has changed dramatically over the past thirty years. In the 1990s, Ireland experienced a period of sustained growth as well as large inflows of foreign capital, often via foreign direct investment from US firms.

Exports rose steadily and an increasing share of employment came from these foreign multinational corporations (MNCs).

Living standards converged to European levels and measures such as GDP per capita have remained above the European Union and Euro Area averages since the late 1990s.[9] Underpinning this success story was a productive and well-educated work force while access to the European market through EU membership was also a key attraction for foreign firms and investors.[10]

Ireland became a much more open economy over this period as the share of exports in GDP increased rapidly.[11]

The composition of this trade also changed significantly.

Looking back to 1972, prior to joining the EEC, Ireland was heavily dependent on the UK for both exports and imports. This dependence decreased rapidly in the following decades and the Irish economy is much less UK focused presently.[12] The change in the type of goods exported has been similarly substantial with the economy becoming orientated around services and high value added manufacturing, as opposed to agriculture.[13]

This openness has become a defining feature of the Irish economy and was a key factor in the 'economic miracle' of the 1990s and early 2000s.

However, this openness is also a source of vulnerability.

As a typical small open economy, Ireland can be strongly influenced by global factors outside of its control. This vulnerability, combined with a domestic credit fuelled property bubble, contributed to a severe downturn in Ireland from 2008 although exports also played a large role in the ensuing recovery.[14]

Increasing integration with the EU has also been a defining feature for Ireland in recent decades, probably illustrated most vividly by the adoption of the common currency in 1999. The establishment of the Single Market in this period was crucial for the Irish growth story.[15] The benefits of the EU for Ireland are reflected in the views of Irish citizens who are the most likely in Europe to have a positive image of the EU according to the Eurobarometer survey.[16] Approval of the euro is also among the highest in the EU at 84 per cent.

Now, let me turn to the present day.

The Irish economy remains extremely open and has grown strongly over the past five years as evidenced by annual average growth of over 4 per cent in underlying domestic demand.[17] This measure abstracts from the measurement issues around GDP in Ireland and gives a more accurate indication of real activity. The labour market also gives evidence of robust growth with employment now above its pre-crisis peak.

The economy is focused on services and high value added manufacturing. Strong pharmaceuticals boosted overall export growth significantly in 2018 with one product, vaccines, accounting for 36 per cent of total merchandise exports on average in the ten months to October 2018.[18]

MNCs continue to play an important role in the Irish economy today and are estimated to account for 22 per cent of total employment.[19]

The public finances in Ireland have improved markedly since the crisis although the debt-to-GNI* ratio remains elevated and above 100 per cent. GNI* is an alternative measure of national income that more accurately reflects the size of the economy compared to GDP and thus gives a more informative picture of debt sustainability.[20]

The reason I have outlined this assessment of the Irish economy is that all these elements factor into our thinking on the effects of the UK leaving the EU.

From a historic perspective, the Irish economy is now far more diversified than in the past when the UK was by far the most important market for Irish exports and when these exports were highly focused on agricultural products.[21]

However, this reduction in exposure does not mean that the risks from the UK leaving the EU are not serious. The UK is still a hugely important market for certain sectors and regions in Ireland as well as being Ireland’s nearest neighbour.

The closeness of the Anglo-Irish relationship is evident in the data.

Research from the Economic and Social Research Institute, for example, has highlighted the contrast between Irish-owned and foreign-owned exporting firms in Ireland.[22] Their findings show that Irish-owned firms are less diversified then their foreign-owned counterparts, both in terms of products and markets. They also highlight that around 40 per cent of exports from Irish-owned firms are sent to the UK, with food exports particularly important.

Research from the Central Bank has also shown that the UK is the most significant market for agri-food exports and increases in tariff or non-tariff barriers have the potential to significantly reduce trade.[23] And while primary agriculture accounts for a small share of overall national output, the broader agri-food sector (including food processing) makes a sizeable output and employment contribution, particularly when assessed on a regional basis. Some 50 per cent of Irish beef exports go to the UK. Research has estimated that in a hard Brexit scenario, agriculture products would attract some of the highest tariffs.[24] Teagasc estimates suggest the tariff on fresh boneless beef, which accounts for two-thirds of the value of beef exports to the UK, would be 69 per cent.[25]

Further research from the Central Bank focusing on the specific effects of non-tariff barriers estimates a 9.6 per cent decline in trade flows between the UK and Ireland with the largest effects on fresh foods exports, as well as on manufacturing materials and machinery and transport.[26]

The most recent analysis from the Central Bank assessing the effects of a disorderly exit underscores the potential challenges that the Irish economy would face, particularly in the short term. Modelling work suggests that a disorderly departure could reduce the growth rate of the Irish economy by up to four percentage points in the first year.[27]

The effects of a disorderly exit would be felt through several channels.

- There would be heightened stress in financial markets and a potentially large depreciation of sterling.

- The deterioration in economic conditions and a more adverse outlook would cause firms to delay or cancel investment plans.

- Consumer spending would also be negatively affected, reflecting concerns over future job losses and income prospects.

- At least for an initial period, it is likely that there would be disruption at ports and airports if infrastructure is unable to cope with the new arrangements.

Given the deep supply chain linkages between Ireland and the UK, reflected in the reliance on the UK for imports of intermediate goods used in production by Irish firms, and also given the scale of food and consumer goods imports from the UK, there would be implications for firms through disruption to their production processes and for households through the price and availability of consumer goods.

- Exports would fall due to an immediate and large reduction in demand from the UK and the fall in sterling, with some sectors being further affected by any imposition of tariffs and non-tariff barriers.

- Those sectors – as I discussed – which are more reliant on trade with the UK or which are more vulnerable to the imposition of tariff and non-tariff barriers, such as agriculture, food and smaller scale manufacturing, are likely to be more adversely affected. These effects are also likely to be focused on rural areas and, in particular, the border regions.

So, there are a variety of ways that the departure of the UK can adversely affect the Irish economy and contribute to a material slowdown in growth.

However, it is important to note that in this scenario, our modelling work still suggests that there would be growth in output this year and next.

Quantifying the impact of a disorderly UK exit through these channels is extremely uncertain but the insight to be taken from this result is that some of the structural elements of the Irish economy also have a role to play as the process moves forward. Structural factors include the diversified nature of production in many sectors. While some sectors are heavily reliant on the

UK as an export market, for others, the UK is an important market but nonetheless not the only one.

The current status of the public finances are also relevant. There is scope to run a counter-cyclical fiscal deficit through the operation of automatic stabilisers on tax revenues and transfer payments in the event of a severe downturn. Moreover, there is some scope for temporary investment to support trade routes after the UK's departure and temporarily help hard-hit sectors adjust to new realities.

Of course, while the UK leaving the EU is the most clear current downside risk to the Irish economy, there are others including the weakening of the European and global economic outlook. The openness of the Irish economy is again a key factor here as some of the sectors that may be able to weather a slowdown related to the departure of the UK by relying on a variety of other markets may not have as much space to operate if a global slowdown also persists. Aside from external risks, the cyclical upswing in Ireland also gives rise to concerns about the economy's position in the business cycle and the potential for overheating.

To summarise, the Irish economy is currently in a good place but this outlook is subject to an unusually high degree of uncertainty given the lack of clarity around the withdrawal terms of the UK exit process. Also, we at the Central Bank find ourselves in the interesting position of considering a potential slowdown from external events on one hand while also worrying about potential overheating from a domestic perspective.

Conclusion – Life after the UK leaves

Dealing with the departure of the UK has been a challenging process and can seem almost all consuming at times.

However, life will go on.

The UK will still share a land border with Ireland – how visible this border is remains to be seen – and the UK will still be less than 40 kilometres from the continent.

Interlinkages between the economy and financial systems of the UK and the Members States of the EU will also remain.

My hope is that cooperation can continue between the UK and EU, albeit inevitably in not quite as close a fashion as at present. The expertise of colleagues from the UK will be missed.

Cooperation within the EU will become ever more important in my view, particularly with respect to financial sector supervision.

As financial services from the UK disperse to various locations in the EU, regulators will need to work together to supervise large financial groups with balance sheets spreading across EU borders as well as to non-EU countries, including of course the UK.

In concluding, I would to thank everyone for their attention and I look forward to any further discussion.

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[1] I would like to thank Paul Reddan and Micheál O'Keeffe for their contributions to my remarks.

[2] Central Bank of Ireland: Strategic Plan 2091 – 2021 (2019)

[3] Lane, Philip R: The Brexit Discontinuity, address at the 2019 European Financial Forum (13 February 2019)

[4] Central Bank of Ireland: Brexit Task Force Reports.

[5] Sibley, Ed: Towards a more resilient insurance industry, address at the Central Bank Insurance Conference (15 February 2019)

[6] Withdrawal of the United Kingdom from the European Union (Consequential Provision) Bill 2019)

[7] ESMA: Esma and EU Securities Regulators Agree No-deal Brexit MOUs with FCA (1 February 2019)

[8] Central Bank of Ireland: FCA announces window for notifications under their temporary permissions regime (16 January 2019)

[9] Source: Eurostat.

[10] Lane, Philip R: The Irish Crisis, CEPR Discussion Paper No. 8287 (2019) and Whelan, K.: Ireland's economic crisis: The good, the bad and the ugly, Journal of Macroeconomics, Vol. 39, pp.424–440 (2014).

[11] Source: CSO National Accounts Statistics.

[12] O'Rourke, K: A Short History of Brexit: From Brentry to Backstop, Penguin Books (2019)

[13] In 1998, the Services sectors accounted for about 64 per cent of employment – at the end of 2018, this share has risen to over 76 per cent.

[14] Central Bank of Ireland: Quarterly Bulletin – Contributions to GDP

[15] O'Rourke, K: A Short History of Brexit: From Brentry to Backstop, Penguin Books (2019)

[16] European Commission: Eurobarometer Survey (Autumn 2018)

[17] Central Bank of Ireland: Quarterly Bulletin – QB1. Figure for 2018 is estimated as full data for the year not yet available (2019)

[18] Central Bank of Ireland: Quarterly Bulletin – QB1, Box C p35 (January 2019)

[19] National Competitiveness Council: Ireland's Competitiveness Challenge 2018 (December 2018)

[20] Lane, Philip R: The Treatment of Global Firms in National Accounts, Central Bank of Ireland Economic Letter, Vol. 2017, No.1 (2017)

[21] O'Rourke, K: A Short History of Brexit: From Brentry to Backstop, Penguin Books (2019)

[22] Lawless, M, Siedschlag, I. and Z Studnicka: Irish enterprise exporting patterns in goods and services, ESRI Research Bulletin (April 2017)

[23] See Conefrey, T. Irish Agriculture: Economic Impact and Current Challenges. Central Bank of Ireland Economic Letter, Vol. 2018, No.8 (2018)

[24] InterTradeIreland: Potential Impact of WTO Tariffs on Cross-border Trade (June 2017)

[25] See Teagasc "Brexit Update: Possible impacts on the Irish Beef Industry". For an overview see 'Irish Agriculture: Economic Impact and Current Challenges", Conefrey, Thomas, Economic Letter Vol. 2018, No.8.

[26] Byrne, S and J Rice: Non-Tariff Barriers and Goods Trade: A Brexit Impact Analysis , Central Bank of Ireland Research Technical Paper, Vol. 2018, No.7 (2018)

[27] Central Bank of Ireland: The Macroeconomic Implications of a Disorderly Brexit, Quarterly Bulletin 1 (2019)