Philip R Lane: The academy and the economy

Remarks by Mr Philip R Lane, Governor of the Central Bank of Ireland, to the Trinity Business + Technology Forum 19, Trinity College Dublin, Dublin, 23 May 2019.

* * *

Introduction

I am pleased to be invited to speak at the Trinity Global Business + Technology Forum 19, especially on the occasion of the opening of the new Trinity Business School building.

Let me start by commenting on the important potential economic and social contributions of business schools, before turning to the more general role of universities. First, high-quality business education and training at all levels (undergraduate, postgraduate, executive education) is a significant determinant of living standards and economic performance. On this point, the most compelling evidence has been generated by the long-running World Management Survey, which measures the contribution of management practices to firm performance in a large-scale cross-country cross-industry panel of firms (worldmanagementsurvey.org). The many studies that have exploited this dataset conclusively show that a major factor driving productivity differentials across countries and across firms is the quality of management.

Second, business education is especially pivotal in countries that specialise in the provision of business services on an international scale (see also McKinsey Global Institute 2019). This broadly describes the Irish economy, with the Irish affiliates of multinational firms (plus the domestic ecosystem of supporting professional services firms) typically providing a range of business services to the global operations of these companies and many Irish firms exporting business services to overseas clients.

Third, business education is itself a significant export activity, with Irish business schools and universities educating many international students, both locally and through a range of external partnerships.

Fourth, given the importance of the business sector in delivering essential and socially-valuable goods and services, business schools have a special responsibility to ensure that their graduates are properly equipped to fulfil their social and ethical responsibilities to wider society.

Fifth, the diversity and dynamism of the business sector constitutes a gold mine for research across a wide range of disciplines. This is especially true for a business school that is an integral part of a full-scale university, in view of the high potential of multi-field approaches in understanding both the drivers of firm performance and the economic and social impact of business.

This last point is well illustrated by today’s event. A basic function of a university is to explore the inter-connections across different fields of knowledge: the agenda and list of participants for this forum vividly illustrates the wide range of disciplines that are relevant in exploring the myriad economic, business and social implications of technological innovation and digitalisation. This also holds true for another topic that was discussed in this morning’s programme: climate change. Universities have a vital role to play in tackling the implications of climate change, in view of the all-encompassing nature of challenges posed by global warming.

These topics – the technological revolution and climate change – are also central to the work of the Central Bank of Ireland.

In relation to the technological revolution, this is relevant for all parts of our mandate. In terms of macroeconomic performance, the global technology-producing sector is a major driver of
employment, productivity and tax revenue in Ireland, while all sectors in the economy must respond to the changes in market structure and consumer preferences induced by technological change.

Of course, the financial sector is among the most prominent sectors affected by these developments. This is natural, since information processing (in a very general sense) is the defining characteristic of financial services and digitalisation constitutes a paradigm shift for the whole sector. Incumbent firms that wish to survive and prosper must invest heavily in IT in response to the entry of new providers of financial services (the fintech sector) and the expansion into financial services by the major technology firms (the BigTech sector).

In this contest between existing firms and new entrants, the role of regulators is to ensure that all providers of financial services meet regulatory requirements, since households and firms in choosing their providers should be able to rely on a common set of expectations about the prudential and conduct standards of all firms. To this end, the Central Bank of Ireland’s Innovation Hub provides a platform that helps fintech firms reconcile the deployment of new financial technologies and compliance with regulatory requirements.

The digital transformation of financial services also poses new supervisory challenges. For instance, a high priority is the monitoring and remediation of operational risk, in view of the potential damage caused by systems failures in the provision of digital services. In addition, new methods of delivery (such as robo-advisors in financial planning) must be carefully assessed to ensure that an appropriate balance is struck between the potential gains and possible new types of risk.

The shift towards electronic payments and the emergence of many new providers of e-payments services is enabled by the back-end plumbing provided by the real-time gross settlement (RTGS) systems maintained by central banks. To this end, central banks are also investing to improve the speed of these systems. For instance, the European Central Bank recently launched its new market infrastructure service – TIPS (TARGET Instant Payment Settlement) – to enable payment service providers to offer fund transfers to their customers in real time on a 24–7–365 basis. TIPS is an extension of the TARGET2 RTGS provided by the Eurosystem and is based on the SEPA Instant Credit Transfer scheme, which is expected to be used by many payment service providers to offer pan-European instant payments.

The digital revolution also extends to the work of central bankers and financial regulators. For instance, as with many other disciplines, central banking and financial regulation can benefit from the data analytics revolution. Each day, we receive high volumes of numerical data and documentation from regulated firms and other entities that are required to submit information to us, together with a tsunami of data on market prices and transactions. New analytical methods that can draw insights from these data goldmines promise to improve the identification and mitigation of risks to the financial system and enhance the efficiency of our policy interventions. This potential explains why we have been investing in developing our in-house analytics expertise over recent years.

Given the symbiosis between our in-house work and the data analytics community in the university system, we see the value in fostering a broader range of research in analytical subjects. For instance, the Central Bank of Ireland is pleased to participate as an industry partner in the new Science Foundation Ireland Centre for Research Training in Foundations of Data Science. In addition, I am pleased to announce that we plan to launch a new programme of doctoral scholarships in data analytics, which will support students in Irish universities that wish to explore methods and data relating to the work of the Central Bank of Ireland.

These initiatives complement our well-established tradition of sponsoring our own staff members to undertake doctoral degrees: for instance, twenty-four staff have completed doctorates since 2011. In fact, our commitment to the further education of our staff is extremely broad, with staff
members taking diplomas and post-graduate degrees across a wide range of disciplines.

In relation to climate change, the Central Bank of Ireland fully recognises that climate change and the transition to a low-carbon economy and society constitute major policy challenges, with profound implications for macroeconomic outcomes and the behaviour of the financial system (Donnery 2019, Lane 2019a). As a member of the Network for Greening the Financial System (NGFS), we will be collaborating with central bankers and financial regulators from around the world in monitoring associated risks and developing suitable policy frameworks.

However, it is clear that an extension of the university sector’s programme of work on climate change to include academic analyses of its macroeconomic impact and its implications for the financial system would provide a valuable external and independent expert perspective on these issues. In particular, given the global efforts in this area, it would be especially valuable to see academic studies that are customised to the specific challenges facing the Irish economy and the Irish financial system.

Beyond topics such as digitalisation and climate change, it is important that central banks and financial regulators also incorporate the latest thinking in academic research. For instance, the fields of behavioural economics and behavioural finance have become mainstream over the last decade. These fields study how people actually make choices, taking insights from both psychology and economics. For instance, the evidence shows that people are sensitive to the way that information is presented – the so called ‘framing effect’ – and that decisions can reflect emotions and biases, such as overconfidence or loss aversion.

These fields are beginning to shape financial regulation, since the research shows that people often make predictable, persistent and costly errors when choosing and using financial products. The models developed by researchers allow us to understand why these errors arise and what we can do to ameliorate them. In relation to policy impact, the 2009 Credit Card Accountability Responsibility and Disclosure (CARD) Act in the United States was informed by behavioural evidence that showed that consumers misunderstand the true cost of credit. In the United Kingdom, the Financial Conduct Authority banned the sale of add-on insurance products through automatic tick boxes on the basis of behavioural evidence that consumers cannot compare products in this setting (Iscenko et al 2014). Since behavioural economics and finance can help to create more targeted and effective policy solutions, the Central Bank of Ireland is committed to using insights from these disciplines to strengthen consumer protection and promote healthy household finances.

In terms of my wish list for university research, let me highlight several more areas.

First, the demographic transition will have a profound impact on the national and international economies, together with an array of associated implications for society, families and individuals. In terms of the financial system, an ageing population changes saving and investment behaviour, while also requiring the implementation of a sustainable approach to pensions provision. While universities such as Trinity College Dublin have extensive research programmes on many dimensions of ageing, the pervasive macro-financial implications of demographic change remain insufficiently understood.

Second, the financial system in Ireland and at the international level has undergone significant transformation in the wake of the crisis. One significant trend is the increasing role played by non-bank financial institutions in financing the economy and in providing direct and indirect savings vehicles for households: while much has been learned about the banking sector, relatively less is understood about non-bank financial intermediation, especially under crisis scenarios. In connected fashion, the policy framework for preserving financial stability in the non-bank intermediation sector is relatively less developed. Accordingly, academic researchers have an important role to fulfil in advancing our understanding of the universe of non-bank financial intermediation.
Third, important lessons from the crisis are that limiting credit growth, improving the capacity of banks to absorb losses and ensuring that banks can be safely restructured or resolved in the event of failure are important elements in maintaining financial stability. This has resulted in a significant expansion in the mandates of central banks and financial regulators, with the Central Bank of Ireland receiving new mandates to act as the macroprudential authority and the resolution authority.

A central issue in any macroprudential analysis is the conundrum that policy decisions that limit credit dynamics and require extra bank capital buffers are intended to build resilience in the event of a future adverse (cyclical or structural) shock but that support for such pre-emptive policies can erode during sustained periods of good economic performance in the hope that “this time is different” (Reinhart and Rogoff 2009). Given the damage caused by the property boom-bust cycle and our unusually high exposure to tail risks such as shifts in global trade and taxation arrangements, the Central Bank of Ireland is strongly committed to being a leader in the implementation of a comprehensive macroprudential policy framework (Lane 2019b).

At the same time, both the macroprudential and resolution policy mandates are relatively new and the accumulated international evidence on their effectiveness is relatively scarce. In addition, our macroprudential rules that place limits on the size of mortgage loans compared to house values and income levels are a central element of our macroprudential policy framework: since these rules touch the lives of so many people, it is vitally important that these rules are robustly evaluated and assessed.

While we conduct considerable internal analysis and research to formulate and evaluate our policies, these constitute additional areas in which university researchers can play a vital role as independent assessors of the quality of our policies.

Such academic work has high societal value, given that a failure to fulfil our macroprudential and resolution policy mandates would put the country at risk in the event of a future crisis. Many lessons should be learned from the severe crisis that Ireland has suffered, including the importance of fostering serious and substantive debate on macro-financial stability across participants from all sectors, with a special role for academic voices in this dialogue (Casey 2018).

Fourth, central banks and financial regulators are increasingly the focus of academic research, especially given the increased powers delegated to central banks and financial regulators in recent times. The Central Bank of Ireland has been transformed in the wake of the crisis, both in terms of its mandate and the size of the organisation. It is vital that the work we do is externally scrutinised and challenged, given our important mission of serving the public interest by safeguarding monetary and financial stability and working to ensure that the financial system operates in the best interest of consumers and the wider economy.

In recognition of the importance of independent analysis on policy topics that relate to the work of the Central Bank of Ireland, we are committed to increasing our engagement with the academic research community through a range of initiatives such as visitor and exchange programmes, facilitating (where possible) access to our datasets and the funding of external research.

In summary, while I may be an exile from my previous career as a university professor, I am convinced that the academy (both business schools and, more widely, the university sector) has a pivotal role in determining economic and social outcome through its educational and research activities. To this end, I wish to convey my best wishes to all the inhabitants (both staff members and students) of this impressive new building!

References


Reinhart, Carmen M. and Kenneth S. Rogoff (2009), This Time is Different: Eight Centuries of Financial Folly, Princeton University Press.