Sharon Donnery: Weathering storms - Brexit, overheating pressures, and global factors

Address by Ms Sharon Donnery, Acting Governor of the Central Bank of Ireland, to MacGill Summer School, Dublin, 22 July 2019.

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Good morning[1].

It is a personal pleasure to speak at MacGill Summer School. Over the last nearly forty years the School has made an important contribution to public policy. And – I hope it will continue to do so for the next forty.

The global environment is uncertain, and with Brexit looming, we should be ready to respond if the risks they pose materialise. But at the same time, it is imperative that we are nimble and ready to cool a potentially overheating economy on the other side[2].

Today, my main message therefore is:

We must not only be prepared, but prepared to act.

We must ensure the system is resilient, and continues to function into the future, come rain, hail or shine.

To paraphrase a remark attributed to Mark Twain, 'If you don't like the weather in Ireland, just wait a few minutes…'

The weather is something we cannot control. It is not very consistent. Most importantly it is something that can greatly affect the outcome of a trip.

The Irish economy is not dissimilar. We are a small open economy, greatly exposed to the global environment. Crucially, we can't influence many of these outside factors. So we need to make sure we are resilient to them.

That we are prepared.

When global times are good, we do better. Similarly, when the global economy slows down, we are affected. While we benefit from global opportunities, we need to also ensure we build defences to the risks.

Now Brexit is a prime example of an external event that can affect the Irish economy. Although it is unique to many other external or global risks. It will touch on all realms of Irish life: socially, politically and economically.

Moreover, it is an historically emotive event, and due to its proximity, a risk that can overshadow others.

However, focusing all our attention on one risk is a bit like packing the suitcase full of raingear with no sun cream.

Risks: 'the clouds on the horizon'

Brexit

Brexit is rightfully forefront to many minds when we think of risks to the Irish economy. Especially given the rising likelihood of a no deal or a disorderly outcome.

Just a couple of weeks ago, the Central Bank published our revamped Financial Stability Review[3]. Even if you don't get through the whole report, I recommend the first couple of pages at least. They highlight what we see as the key risks currently facing the Irish economy and financial system. It also addresses how we can build resilience to these risks.

A disorderly Brexit is one of the main risks on the horizon. As the possibility of a no deal scenario looms ever larger, the uncertainty around the final outcome is already weighing on business and consumer sentiment.

Within the Central Bank, we have been working on Brexit since before the referendum[4]. The work has focused on a few main areas:

First – Understanding the possible effects of Brexit, in terms of the risks to the Irish economy, to the financial system, and to consumers. Since the referendum in June 2016, the main impact thus far has been through the depreciation of sterling against the euro. However, 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.

Second ensuring that existing Irish financial services firms understand and are planning for the impact that Brexit will have on their businesses, so that firms can continue to serve customers after the UK departs the EU.

The third important area has been wider contingency planning for the system and taking actions to mitigate the most important and immediate threats to the financial system. Ensuring there is no loss of market access for the payment and settlement of equities and exchange traded funds (ETFs) for example.

Finally, we have been dealing with the authorisation of firms. Of which there were well over 100 applications for either new licenses or extensions to existing ones. These applications vary from large banks to small investment firms or payment institutions.

Overall, in terms of our wide work on Brexit, we have tried to be as transparent as possible. For example, we have published our quarterly reports prepared for the Commission of the Central Bank (our Board), albeit in redacted format on our website[5].

A no-deal Brexit would likely bring considerable volatility to financial markets, with heightened stress and a potentially large depreciation of sterling[6].

Following the financial crisis, we have been building resilience in the financial system for the last decade. Through our preparations over the last three years we have more specifically strengthened resilience to Brexit.

Today, the main outstanding source of risk to financial stability stems from a worse than expected macroeconomic shock. A particularly sharp increase in uncertainty or fall in confidence could lead to greater macroeconomic disruption.

The significant uncertainty around a hard Brexit makes the macroeconomic outcome hard to predict.Our estimates indicate severe and immediate disruptive effects of a no deal Brexit with Irish economic output estimated to be 6 percentage points lower after two years than otherwise expected[7].

Global risks: Trade tensions, global financial markets and political uncertainty

But Brexit is not the sole risk.

As I mentioned in my introduction, we are heavily exposed to the global environment, and the current outlook is somewhat unfavourable.

Changes in world demand have a considerable impact on Irish exports, unemployment and wages.

Thinking beyond Brexit, structural changes in the global economy such as the ongoing trade tensions between the US and China, and slowdown in investment, could indirectly dampen Irish growth prospects.

In economic parlance, Ireland has a relatively high elasticity to global developments[8].

Another risk to financial stability comes from global financial markets. Against the background of lacklustre economic outlook, markets are reassessing the global outlook for growth.

An abrupt repricing of risk premia could lead to a rapid tightening of global financing conditions. One of the effects of this is it could be more expensive to borrow – for the State, for businesses and, ultimately, for households.

That is the outlook for the international environment. The strong economic performance of the domestic economy stands in stark contrast.

Domestic overheating – low unemployment, wage growth, housing market, and corporate tax receipts.

While Ireland helps to shape and influence policies at the European and wider international level, it cannot dictate the response to international events.

One of the areas we have more control over as policymakers is domestic developments. Ireland has had a remarkable recovery to the crisis and this has been broad-based across both export and domestic orientated sectors.

Irish employment is approaching an all-time high[9]. There are over four hundred thousand more people in work than in the low of 2012. And wages are creeping upwards[10].

The multinational sector, crucial for jobs, is also contributing significantly to the exchequer, paying over three quarters of corporate tax receipts in 2018. The corporate tax take has more than doubled since 2014[11].

Meanwhile, there are also pressure points in the housing market, with rents continuing to rise.

These are the kind of factors generally associated with strong economic performance. However, they also point to an increased risk of an overheating economy, which we must be wary of.

Resilience: 'packing the right suitcase'

Having outlined some of the main risks, let me now turn to how we can try and protect against them.

With the uncertain global environment, and with Brexit looming, we should be ready to respond to any of these risks should they materialise.

As a central bank, our 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. Reflecting our mandate, we are working to build resilience to and understand the risks that we face.

As I mentioned earlier, we have undertaken substantial contingency planning for Brexit.

While regulatory elements all play a critical role, today I will focus on the macro-prudential tools at our disposal to build the resilience of the financial system, particularly for borrowers and lenders.

Starting with lenders, a necessary part of promoting such resilience is the completion of the macroprudential framework for bank capital.

I noted the small and open nature of the Irish economy.

Whilst providing many positives, this openness increases the propensity – and sensitivity – of the Irish economy to global shocks. These can be structural shocks – like Brexit or changes in global trade or international taxation regimes. Or cyclical shocks – driven by the global economic cycle.

It is important that banks hold sufficient buffers to guard against these higher levels of macroeconomic risks Ireland faces. To guard against cyclical risks, we have implemented a counter cyclical buffer. And set this at 1 per cent. The buffer aims to promote the sustainable provision of credit to the economy. It means banks have more capital when times are good, so they can use that to absorb losses in tougher times.

Moving beyond the economic and financial cycle, we are also proactive in using our policies and tools to build resilience to structural risks and shocks.

Following our request, we recently received confirmation from the Minister of Finance and Public Expenditure and Reform that a legislative provision will be introduced to complete our macro-prudential toolkit for bank capital. This gives the Central Bank the power to introduce a systemic risk buffer (SyRB), which would help to counter structural shocks to the economy. This buffer aims to build the resilience of the banks to big shocks or tail risks, by requiring banks to have appropriate capital to absorb losses in case these risks were to crystallise[12].

A central policy to build resilience of lenders and borrowers, is the mortgage measures we have had in place for a number of years.

This is particularly important given the inherent volatility of the Irish economy.

Neither the price level, nor the level of growth of house prices are the objective. Our measures are carefully calibrated to strengthen both bank and borrower resilience and to reduce the likelihood of a credit-house price spiral emerging.

The mortgage measures are working as we designed them to. They are also flexible enough to take into account specific circumstances. A system of allowances for example is in place that allows banks to lend above the mortgage measure limits. To give an example, in 2018, one in eight loans to first time buyers were above the loan to income (LTI) limit of 3.5[13]. Further, almost 50 per cent of these allowances were for loans issued with an LTI ratio above 4.

Looking at both first and subsequent borrowers last year, one fifth of the value of total mortgage lending was issued with an allowance to the loan to income (LTI) or to value (LTV) limits. The framework therefore is sufficiently flexible and the allowances enable banks to take individual borrower circumstances into account.

We are all acutely aware of the current challenges in the Irish housing market and the supply constraints. These challenges clearly impact on young couples and families. Be they buying a new home or renting. But I have seen no evidence that more debt for these same young couples and families is the answer.

More supply is.

We have a pool of buyers chasing a limited number of properties. And the legacy of non-performing loans (NPLs) is a harsh reminder of what can happen when credit grows independent of incomes and fuels house prices. Our borrower-based measures aim to reduce the risks and hardship to households during a possible downturn or a house price shock and make them more resilient both now, and into the future.

As usual, we will review the effectiveness of the measures in meeting their objectives during the Autumn.

Be prepared, but prepared to act

The variety of these macro-prudential tools provide flexibility that may be required in response to many shocks, domestic or global. Standing alone, a disorderly Brexit would argue for accommodative policies, for example allowing the automatic stabilisers to work and targeted fiscal measures for the most severely affected sectors.

If any of the more global risks were to crystallise and have a significant effect on the domestic economy, they would likely pose different challenges. Whether it be dealing with the effects of storms blowing in from abroad, or having protection from the sun on those warm Irish summer days, the Central Bank stands ready to adjust the CCYB (buffer) in either direction as the risk environment evolves, in order to support a sustainable supply of credit to the economy.

We can't control the weather. But we must ensure the system is resilient, and continues to function into the future, come rain, hail or shine.

Finally, I hope you will allow me take the liberty of speaking at an event like MacGill to briefly look beyond the Central Bank tool kit.

As policymakers, we serve the Irish public, the risks we face often overlap. And it is beneficial for all when our policy responses are in tune.

While the domestic economy is doing well, we have the opportunity to boost our resilience to future shocks and risks. Prudent management of the public finances are needed. Interest payments on national debt are lower than expected and corporate tax receipts are high, but neither situation should be regarded as permanent[14]. These funds should be put to work to buffer against the next downturn or crisis and not to finance current expenditure or to boost an economy which is close to capacity.

A clear strategy guiding the use of unanticipated revenue inflows should be promptly established. Moreover, the reduction of public debt ought to remain a key priority given its very high level. To somewhat labour the analogy, we must 'fix the roof while the sun is shining'.

Final points

Finally, as I said at the beginning, the global environment is uncertain, and with Brexit looming, we should be ready to respond if these risks materialise. But it is imperative that we are nimble and ready to cool the warming economy if these risks dissipate.

We must not only be prepared, but prepared to act.

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1 I would like to thank Caroline Mehigan and Micheál O'Keeffe for their contribution to my remarks.

2 Donnery, Sharon: Risks and Resilience in Uncertain Times, Address to the Institute of International and European Affairs (8 March 2019).

3 Central Bank of Ireland: Financial Stability Review (2019:1).

4 Donnery, Sharon: The departure of the UK from the EU – implications for the Irish economy and financial system. Internal dinner address to visiting staff from other central banks (5 March 2019).

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

[6] National Institute of Economic and Social Research: The Economic Effects of the Government's Proposed Brexit Deal (26 November 2018) Assume that sterling would depreciate against the euro by ten per cent while in a worst case stress scenario published by the Bank of England it is assumed that sterling could fall by 30% against the USD in a disorderly Brexit. Bank of England: Stress Testing the UK Banking System: Key elements of the 2019 annual cyclical scenario (March 2019).

[7] Conefrey, O'Reilly, Walsh: Box B: The Macroeconomic Implications of a Disorderly Brexit Central Bank of Ireland, Quarterly Bulletin No.1 (2019).

[8] Birmingham & Conefrey: The Irish Macroeconomic Response to an External Shock with an Application to Stress Testing, Technical Research Paper, Central Bank of Ireland (2011).

[9] Byrne, Stephen and Tara McIndoe-Calder: Quarterly Bulletin 2019 Q2, Central Bank of Ireland (2019).

[10] Ibid.

[11] The Revenue Commissioners: Corporation Tax 2018 Payments and 2017 Returns (May 2019).

[12] Lane, Philip: Tail risks and The Irish Economy (2019).

[13] Central Bank of Ireland: Financial Stability Review, 2019:1 (2019).

[14] Irish Fiscal Advisory Council: Fiscal Assessment Report (June 2019).