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Small Open Economies – Vulnerabilities in a Changing World - Deputy Governor Sharon Donnery

13 September 2019 **Speech**

Speaking at the Dublin Economics Workshop 2019, Wexford.

Good afternoon,

It is a pleasure to be here speaking at the Dublin Economics Workshop today, and I especially welcome the topic of this panel - Small open economies – Vulnerabilities in a Changing World.[1]

The concept of openness has perhaps never been so pertinent.

Until recently, the world was broadly becoming more open, tariffs and capital controls were being eased or removed entirely.

Ten years ago it would have been hard to imagine the rising protectionist sentiment, and indeed actions we see in parts of the world today and the pressures on multilateralism. And while not the focus of my remarks today, this reflects that globalisation or openness can come at a cost, leading to more competition and so creating winners and losers.

This can cause higher unemployment and reduce wages in affected sectors.[2] Indeed it does seem at times that some of the merits of economic openness have been all but forgotten.

However, historically, the opening of markets has been closely linked with improved economic performance. Creating new benefits and opportunities for people, workers and businesses. Open economies tend to grow faster than relatively closed ones, lowering prices and providing jobs.[3]

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Turning to home, Ireland offers an example of a small economy that benefits greatly from openness.

Ireland went from being one of the poorer members of the European Union on joining to, today, being one of the most prosperous.

The first part of my remarks will focus on the benefits to Ireland of being a highly globalised economy. While the second part will look at the vulnerability of the Irish economy due to its openness.

Finally, I will reflect on what we can do as a central bank to build resilience to the vulnerabilities associated with being small, open and highly globalized.

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Openness- breaking down barriers

Today, the Irish economy is one of the most open economies in the world for trade and finance.

Migration has also played a crucial role in the recent economic peaks and troughs. It is therefore worthwhile to recall that it wasn't until the late 1950's that heralded the end of protectionism in Ireland.[4]

At that time, Ireland's largely agricultural-based economy was characterized by its dependence on the UK.

T.K Whitaker, senior public servant and former Central Bank Governor, often referred to as the "architect of modern Ireland" proposed policies that bid "farewell to the old outmoded ideas for economic and social progress…"

His policies removed barriers that closed off the country to the world. Pushing Ireland from being an isolated island to an international hub.

As part of the process of deepening its engagement and integration with the global economy, Ireland joined the International Monetary Fund and the World Bank in 1957, joining the then EEC in 1973.[5]

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Access to the single market and policies to attract inward investment enabled the economy to flourish and broaden its export markets.[6]

One way of looking at key trading partners is using a value added perspective. This method examines the ultimate market for Irish exports, essentially who the final consumers are. The UK accounts for one eighth of exports using this metric.7 And this share is similar for merchandise exports to the UK, which measures goods leaving Ireland.[8]

An important caveat however is that smaller firms are more reliant on the UK market, with 36% of exports from small and micro firms destined for the UK.9 Together, Europe and the United States demand the bulk of Irish exports, both on a value added and merchandise basis. The composition of our exports is also a far cry from the largely agrarian economy of the 1950s.

Today, services form the majority of our exports, while industry or manufacturing form almost a third.[10]

Within merchandise or goods exports, the share of food, beverages and livestock exports is relatively small compared to pharma or other manufactured goods.[11] And lest we not forget, that in our most recent crisis, our openness – whilst bringing with it vulnerabilities, was critical to our recovery.

Recent research by the ESRI discusses how “Openness to Trade Rescued the Irish Economy”, finding that the recovery from the crisis was mainly driven by exports.[12]

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Our membership of the Euro is one representation of our financial openness. Another is our role as a financial centre. For example, the Irish share in EU GDP, is smaller than the Irish share of the value added of financial corporations in the EU.[13] Much of this financial activity takes place in the International Financial Services Centre (IFSC) in Dublin, established in 1987. In terms of the real economy, today almost forty thousand people work in the IFSC, with a further 10,000 employed outside Dublin in over 500 firms.[14]

The support services such as legal and accountancy firms that grew around the IFSC provide further jobs. In addition, these firms contribute substantially to the Exchequer, paying over 1 billion euro in corporate taxes each year, and about the same in payroll taxes. And while it is not the focus of my remarks, the presence of the financial centre also brings with it certain financial stability risks.

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But the employment benefits of Ireland’s openness extends well beyond financial services. The large presence of foreign-owned multinational companies in Ireland reflects both our trade and financial openness as an economy. Multinationals directly employ 14% of people working in the country.[15]

This could be engineers producing orthopedic knees in Galway.[16] Chemists manufacturing pharmaceuticals in Cork. Or the many software engineers working in the tech companies dotted around the Dublin Docks. These foreign multinationals account for the biggest share of production in the economy compared with other European members.[17]

The presence of these firms substantially benefit the Irish Exchequer, with employees in foreign multinationals contributing forty per cent of both income tax and the Universal Social Charge in 2017.[18]

This is on top of significant contributions to other tax receipts such as corporation tax, a widely discussed point.[19]

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Considering the last twenty years, migration and the openness to it, has played a key role for the Irish economy.

Net migration during the early 2000s was important in sustaining employment growth.

This occurred through the positive effects of migrants on participation, demographic and employment channels.

Following the crisis, the substantial emigration dampened a further rise in the unemployment rate.

However, now as the economy approaches “full employment”, employment growth at or around this level is typically accompanied by growth in wages and prices.

Recent research by Central Bank staff has noted that net inward migration growth will be the most important source of employment growth in the short to medium term.[20]

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Sensitivities to the global economy and structural vulnerabilities

While there are many benefits from being a small, open highly globalised economy, it brings vulnerabilities and risks. And while I will not dwell on it today, the extent of the openness also complicates the measurement of the economy, which has been widely discussed and documented.[21]

The Irish economy is especially sensitive to developments in the global financial cycle as well as being more prone to structural macroeconomic shocks. These can be evidenced by the volatility of the economy.

This is how much variables move, for example with credit, the differences between credit booms and busts. Which can be thought of as a symptom of being small, open or having a strong reliance on certain sectors.

The historic volatility of the Irish macro-financial environment is perhaps the most visible representation of being small, open and highly globalised. Recent Central Bank research has looked at the cross-country volatility or unpredictability of a range of macro economic financial variables since 1980.[22]

Relative to its European peers, Ireland's macro variables move more, or in other words, have higher highs and lower lows.

Credit and house prices display the largest divergence to our European neighbours, and with the recent credit boom and house price peaks and troughs this is perhaps no surprise. However GDP, household income, and employment also move more relative to European countries.

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As evidenced by our volatility, the Irish economy has vulnerabilities, these can be cyclical or structural.

I will first briefly look at cyclical sensitivities, before speaking in more detail on structural ones.

Cyclical can be how responsive the Irish economy is to the global economic cycle.

Depending whether the global economy is performing strongly or weakly, how much does this affect Ireland.

Central Bank research compares the effect of a global output shock on Ireland, the US, UK and euro area.[23]

Of those large economies studied, over time, Ireland is the most affected by, or the most responsive to, a negative global shock. Looking further within a subset of small open economies, Ireland is less negatively affected than Singapore or Sweden, but more affected than Switzerland and New Zealand for example.

Today, the responsiveness to the global economy is particularly relevant with weakening global growth prospects and subdued global final demand.

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Turning now to structural vulnerabilities.

These are features of the Irish economy that would mean it is more susceptible to idiosyncratic structural shocks that may have significant macroeconomic effects.

One way of looking at the propensity for structural shocks of the Irish economy is to compare how much actual economic performance is different to previous forecasts through time.

In other words, how hard it is to anticipate future performance from current information. The bigger the differences the harder it can be for businesses and households to prepare for the future.

It is illustrative to see how we compare with other countries. The forecast errors for Ireland are at the higher end of the scale when comparing across EU Member States. [24]

In fact, Ireland has the highest forecast errors among pre 2004 Member States.

Greater volatility or uncertainty requires flexibility and preparation by our people, businesses and policy makers so that we are resilient to shocks, both positive and negative.

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Having looked at the higher propensity to these structural shocks, I will now discuss these structural vulnerabilities.

Our small size is one such a structural feature of the economy.

Central Bank research suggests that small countries tend to have higher 'tail risk' at all stages of the financial cycle.

Tail risk is an unlikely event, but were it to occur it would have a large effect.

The research finds that growth prospects in small countries is more susceptible to these unlikely events than for larger countries.[25]

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And while we have moved away from the UK centric export model of the past, our current export profile could suggest another vulnerability.

Strong reliance on one sector or industry can mean a shock to that area would have wider macroeconomic consequences.

Recently, the growth in Irish merchandise exports has largely been driven by pharma.[26]

While looking at services exports, computer services are dominant, accounting for a substantial share of the export growth. This strong growth means computer services now make up approximately half of Irelands services exports.

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Closely linked to the role of the pharma and computer services sectors, is the substantial and US centric role of multi-national companies in the economy.

This is a vulnerability. Many of the top exporters from Ireland are US owned companies, and over 70 per cent of foreign direct investment in Ireland is by US firms.[27]

This concentration in the source of FDI can be a source of risk. While multinationals generate many benefits, their extensive role in jobs, trade, value added and corporate tax receipts can be a vulnerability.[28]

Changes in the international trade or tax regimes, sector or firm specific shocks could have significant macro-financial consequences. The dependence by the Exchequer revenues on multinationals is reminiscent of that on the construction sector in 2007 before the crisis.[29]

Corporation tax receipts have more than doubled since 2014, with multinationals accounting for almost eighty per cent of receipts in 2018.[30]

I raised the danger of relying on these unpredictable revenues to fund lasting spending commitments in my pre-Budget letter to the Minister of Finance and Public Expenditure and Reform.[31]

It is important to adopt a prudent approach to windfalls, to build buffers to protect against future downturns.

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Taken together, the fundamental structural characteristics of the Irish economy imply many vulnerabilities. The openness, heightened volatility, the role of multinationals, pharma and computer services driven export growth, and simply being small.

These factors point to the economy, the public finances, businesses and households being more exposed to macroeconomic risk than larger economies.

This means that the domestic banking system is– at all points in the cycle – exposed to greater macroeconomic risk than banking systems in larger, more diversified economies.

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Policy responses- Building Buffers

So now let me turn to what can be done about the relatively greater exposure to this macroeconomic risk, about building resilience.[31]

Resilience to structural shocks can come from many areas. Structural features such as flexible labour markets, a skilled labour force or an environment of innovation can help in the face of shocks.

Today, I will approach resilience through the Central Bank's remit, macro prudential policy, and address how we can build resilience of households and banks to withstand these shocks.

The completion of the macro-prudential framework for bank capital is a central aspect for promoting the resilience of the lenders. It is important that banks hold sufficient buffers to guard against these higher levels of macroeconomic risks which Ireland faces.

We need to build resilience to these cyclical and structural vulnerabilities I mentioned earlier. Cyclical vulnerabilities, are especially important in the context of a strengthening domestic credit environment and strong recovery in domestic asset prices since the crisis.

These include the influences of the ebb and flow of the global cycle on the domestic cycle. To guard against cyclical risks, we have implemented the counter cyclical capital buffer. And set this at 1 per cent.

The buffer aims to promote the sustainable provision of credit to the economy, and can go up as well as down. It means banks have more capital when times are good, so they can use that to absorb losses in tougher times. However, slow-changing structural characteristics require a different capital buffer, such as a Systemic Risk Buffer.

This buffer is designed so that banks have sufficient capital to withstand a shock related to the fundamental structure of the economy.

A Systemic Risk Buffer aims to build resilience against the higher probability and larger effect of structural shocks, for example being small and highly-globalized. Following our request, over the summer we 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.[32]

These buffers, counter cyclical and systemic will be considered in parallel as part of the macro-prudential framework considering the adequacy of bank capital.

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Sometimes when we speak, the language we use implies that people are removed from this volatility and vulnerability.

A central policy to build resilience of lenders and home owners, 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. These borrower-based measures are there to build the resilience and reduce the risks of hardship to households from negative shocks, either domestic or global.

Unfortunately, today, we don't have to look far for such a potential shock, as we approach the 31st of October. Lessening the effect of an income shock to households finances through prudent borrowing is central to the mortgage measures.

However beyond negative shocks, the measures are calibrated to reduce the likelihood of a credit-house price spiral emerging. The large concentration of the banking system to property underlines the importance of prudent underwriting by the banking system.

The Central Bank's mortgage market measures help in this regard, by protecting banks and borrowers against a marked loosening of such underwriting. As I said before, I have seen no evidence that more debt for young couples and families is the answer to the current challenges in the housing market.[33]

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Ireland has come a long way since the isolated island of the 1950's, of barriers and protectionism.

Today Ireland is part of the global economy, through trade, finance and migration. Benefitting in terms of jobs, exchequer revenues and production. Yet this brings an exposure, a vulnerability, a need to build buffers.

In order that our banks, businesses and households benefit from the openness of our economy, we need to build their resilience to the highs and lows of being a small, open and highly globalised country.

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

2. For the seminal piece see Autor et al (2013)

3. For an overview see for example: http://www.oecd.org/trade/understanding-the-global-trading-system/why-open-markets-matter/

4. Note that Ireland had a very free trade policy position from independence in 1921 until 1932 when protectionist policies were introduced in line with the practice elsewhere.

5. In 1961, Ireland applied to join the European Economic Community.

6. The extent of our openness also complicates the interpretation of our statistics, so it is important to look at a number of measures of trade for example than gross exports and imports.

7. Using the OECD WTO TiVA database (2014) indicator "Domestic value added in foreign final demand- partner shares" the US demanded 18 per cent and the sEU excluding the UK accounted for 33 per cent.

8. Merchandise exports are often used to measure Irish goods exports as they do not include contract manufacturing for example. In 2014 for comparison (bracket values for 2018), merchandise exports to the UK were 14% (11 %)of the total, the US accounted for 22 per cent (28%) with 40 per cent (39%) going to the EU non-UK.

9. See the CSO data

10. OECD TiVA database data for 2014.

11. Exports for Jan-Jun 2019: Food and live animals (5688 million euro), beverages (720 million euro), or 16 per cent of the total merchandise exports.

12. See https://www.esri.ie/publications/how-openness-to-trade-rescued-the-irish-economy

13. See Table 1, Calo & Herzberg (2019) , this paper also provides a forward looking view on financial sectors after Brexit.

14. https://www.ifsc.ie/page.aspx?idpage=6

15. Amounting to 318,000 people –https://www.cso.ie/en/releasesandpublications/ep/p-fdi/foreigndirectinvestmentinireland2017/ae/

16. Ireland produces three quarters of global production of orthopedic knees with many medical technology firms based around Galway https://www.idaireland.com/doing-business-here/industry-sectors/medical-technology

17. See Eurostat indicator "Value added in foreign controlled enterprises". In 2015 these firms accounted for 59% of value added of the total business economy the highest in the European Union.

18. See Corporation Tax 2018 Payments and 2017 Returns, Revenue Commissioners

19. See Hickey & Kane Quarterly Bulletin Q2 2019 , Conefrey et al, Central Bank Economic Letter, 2019 for example.

20. See Byrne & McIndoe Calder (Quarterly Bulletin 2019 Q 3)

21. See for example the Report for the Economics Statistics Review Group

22. See "Financial stability considerations of being a small, highly globalised economy" FSR 2019 H1

23. https://centralbank.ie/docs/default-source/publications/research-technical-papers/09-rt-17-global-and-domestic-modeling-of-macroeconomic-shocks.pdf?sfvrsn=9 For the Irish economy, while there is almost no contemporaneous effect on domestic output, the peak effect of 1.37% of output is the largest loss observed for the studied group of economies. While the breakdown is not included in the paper, the estimates calculated for other small open economies are reported to provide a comparison. The study also highlights the size of the error bands around the Irish impulse response is larger than those of the other large economies. This may be reflective of Ireland's volatile economic position as a small open economy.

24. See Fiormanti et al. (2016)

25. Refer "Financial stability considerations of being a small, highly globalised economy" FSR 2019 H1

26. In fact, at times in 2018, merchandise export growth would have been zero and at times slightly negative were it not for exports from the pharma sectors. See the Exports and Imports section of the Central Bank Quarterly Bulletin 2019: 3

27. See CSO FDI data.

28. Brady (2019) finds that there are around three additional jobs created in a county for each job created in an IDA supported job in the same county.

29. See Hickey & Kane Quarterly Bulletin Q2 2019

30. See Corporation Tax 2018 Payments and 2017 Returns, Revenue Commissioners

31. See the pre-Budget Letter to the Minister of Finance and Public Expenditure and Reform dated 26th July 2019.

32. Another part of being a globalised economy, has been the development of a large, mainly externally focused non-bank sector. These are primarily investment funds and other investment vehicles. Macro prudential policy in this arena is at an early stage of development internationally, but the Bank is partaking in on-going assessment of the risks with a view to working with our international colleagues to develop a macro prudential toolkit in this sector.

32. See speech by former Governor Lane Tail Risks and the Irish Economy

33. See the speech delivered at the MacGill Summer School 2019.