Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Risks, Resilience and Policy Responses to COVID-19 - Deputy Governor Sharon Donnery

17 June 2020 **Speech**

Deputy Governor, Sharon Donnery, speaking at the IIEA, 17 June 2020

Introduction

Good morning, it is a pleasure to address the Institute of International and European Affairs.[1]

Today I will speak about the macro financial environment in Ireland amid Covid-19, the risks to Irish financial stability, both domestic and international, the resilience of the economy and financial system that was built up over the last decade, and the recent policy responses that we have taken at the Central Bank of Ireland and with our colleagues in Europe.

The key message is that while we have built up resilience in the financial system over the last decade, we have only seen the initial economic effects of the pandemic materialise so far. There remains significant uncertainty on the path of the virus, the duration of the shock and the economic implications. Ensuring our policy responses promote a sustainable contribution from the financial system so that it can absorb and not amplify the shock of COVID-19, will remain to the forefront of our minds at the Central Bank.

COVID-19 - An exceptional shock

COVID-19 is fundamentally different in nature and scope to previous economic shocks, certainly in my living memory.

Firstly, this crisis is truly global. Unlike the 2008/2009 financial crisis when some emerging markets acted as an engine of growth, today the pandemic is affecting all four corners of the world. The World Bank reports it is the deepest trough since World War II and the most synchronised since records exist.[2]

The OECD has warned of the worst peacetime recession in a century.[3] Their latest numbers, in a single wave scenario, estimate global economic activity to fall 6% this year. In contrast, at the peak of the 2008/2009 financial crisis, global growth fell by 1.7%.[4] And by the end of May, 102 countries have requested emergency financing from the IMF, an unprecedented number.[5]

Secondly, the size and speed of the shock is unprecedented. In February, less than one in twenty people in the Irish labour force were unemployed. By May over one in four were out of work when we take into account those receiving the pandemic unemployment payment (PUP).[6]

Thirdly, the very speed of the effect on the economy presents a challenge to policymakers given that key official indicators generally come with a lag.[7] A Business Cycle Indicator (BCI) for the Irish economy, developed by the Central Bank, offers more timely assessment.[8] The BCI indicator fell to an unprecedented low in April, almost twice as low as the trough of the financial crisis in 2008/2009.

The severity and steepness of the drop suggests that the initial economic effects of the COVID-19 pandemic are worse than the last crisis. It remains to be seen how these effects persist as the economy slowly reopens, and businesses, workers and policymakers learn to live with COVID-19 over the medium term.

Speaking here at the IIEA last year, I pointed to the uncertain path ahead for the Irish economy, the clouds on the external horizon, contrasted with potential domestic overheating.[9] Today, uncertainty stems from the path of the virus, the ability of global public health efforts to suppress or manage it, and how these efforts are intrinsically linked to the level of economic activity. Looking at a range of forward looking measures, there has been an enormous increase in economic uncertainty, greater than that seen in the 2008/2009 financial crisis. [10] In this uncertain environment, swift, decisive and credible policy action can provide some certainty.

Risks

In the last few months, there has been an abrupt and severe deterioration in the macro-financial outlook in Ireland. The collapse in global economic activity has the potential to trigger long-identified risks to financial stability.[11]

Firstly, this collapse in activity poses risks to financial stability through possible defaults.

The duration of the shock will largely dictate whether short term liquidity issues will, in turn, become solvency issues for households, businesses and – by implication – parts of the financial sector. In addition, the Central Bank/SCSI property survey reports a median expectation of falls in property price valuations, while the ECB Bank Lending Survey reports expectations of reduced demand for some forms of credit.[12]

Secondly, in terms of financial markets, the shock led to a re-pricing of risk premia, with large falls in risky asset prices and tighter financing conditions globally.[13] Recent research shows that Ireland is particularly sensitive to a tightening in global financial conditions.[14]

Tightening global financial conditions have implications for domestic lending, asset prices and economic output.

Thirdly, in response to the shock, governments around the world have significantly - and necessarily - increased spending to support their economies. [15]

This support has been absolutely necessary to both to support affected households and business and to minimise the long-term damage of the shock to the economy. However, this also brings risk over the medium term with higher public debt levels. Heightened public debt issuance could put pressure on government bond yields in some euro area countries. And while sovereign yields remain low in Europe, this is against a backdrop of an incomplete financial architecture.[16]

The macro financial risks of possible defaults, rising risk premia, tightening financial conditions and increased debt burdens are coupled with the structural vulnerabilities we are exposed to as a small open economy. I have spoken previously about how our macro indicators tend to have higher highs and lower lows than other countries. [17]

Our open economy is more sensitive to global developments.[18] The smooth functioning of global value chains, the health of the US economy and the presence of multinational enterprises (MNEs) in Ireland are all factors that affect Irish output and household incomes.

Other risks have also not disappeared. The ongoing uncertainty surrounding Brexit negotiations is a serious concern. We will focus on this in our next Quarterly Bulletin, to be published in July. The financial stability risks of climate change and de-globalisation have not gone away. Crystallisation of these risks would further test the resilience of the economy and the wider financial system.

Resilience

Now let me turn to the resilience of the economy and financial system.

An important positive is that the starting resilience of households, businesses and the domestic banking system is significantly stronger compared to the onset of the 2008/2009 financial crisis. Since then, Irish banks have been deleveraging substantially and in recent years the government has been reducing external net debt liabilities. On the eve of the Covid-19 crisis, Ireland's external balance sheet vulnerabilities were relatively limited. [19]

However, on the other hand, the scale of the shock is unprecedented, and we have only seen the initial effects of the economic shock. The full implications on households, businesses and the financial sector will emerge over the coming months and years.
Cash flow, or liquidity, is the main concern for many businesses. Half of large corporations hold less than 8% of annual turnover in cash. [20] Half of SMEs hold less cash and SMEs have less access to undrawn credit than their larger counterparts. While the government stepped in to provide support in the form of wage subsidies and the deferral of tax liabilities, for example, and the banking system provided liquidity via payment breaks and lending, the risk remains of liquidity turning to solvency issues.

As with all facets of this crisis, the extent will depend on the path and duration of the virus. As the severity and scarring will differ across sectors and regions, careful analysis and subsequently targeted policy will be critical. [21]

Households are in a much better financial position than on the eve of the 2008/2009 crisis. Their debt burdens are lower, the ability to service their debt is higher, and they are more resilient to falls in house prices. [22]

Payment breaks have provided some breathing space for those hardest hit – and is a key way in which the banking system is easing liquidity strains in the household sector. However, some borrowers may continue to experience difficulties when their payment breaks expire. In such cases, the Central Bank expects lenders to ensure appropriate solutions, including forbearance, are available. We expect lenders to engage with borrowers well in advance of the expiry of the payment break to support customers, and our existing arrears handling frameworks, including the statutory Code of Conduct on Mortgage Arrears (CCMA), will apply in the normal manner. Those frameworks are designed to protect the interests of borrowers, particularly in times where they are experience financial difficulties because of illness or loss of income. They require all lenders to engage sympathetically and positively with the customers, with the objective at all times of supporting them through this time. We are carefully supervising this process to ensure our expectations are being met. [23]

The resilience of borrowers is of course intertwined with that of the lenders. Banking crises cast the longest shadow, especially those fuelled by credit. Avoiding such a scenario is therefore paramount. [24] As lenders can ease or amplify an economic crisis, their resilience is central to minimise potential scarring.

Through the steps taken in recent years, the domestic banks are now more resilient today than they were in the past. The capital requirements imposed on banks have ensured that they are better prepared for economic shocks such as the one we now face.

In addition, the lending practices of the domestic banks have been more prudent in recent years than in the run-up to the financial crisis and they are also able to rely on capital buffers to absorb losses and continue to lend to the economy.
The banks do, however, have significant exposures to the sectors most affected by COVID-19, and their profitability had fallen in the run-up to the pandemic.
In other words, the resilience of the banks is not unlimited. The banking system is expected to make losses, the scale of which will depend on the evolution of the virus and the scarring effects of this crisis.

Beyond domestic resilience, the interconnections of the financial system in a time of global crisis will also have a bearing. The investment fund sector globally saw large redemptions in March, and the subsequent “dash for cash” - especially dollars - put significant pressure on other markets, markets that had previously been seen as safe and liquid. This tightening of global financial conditions was partly mitigated by central bank interventions.

Over time, the question over the extent to which structural vulnerabilities from liquidity mismatches and leverage in the global funds sector contributed to market disruption will need to be addressed.

Policy Responses

Now let me turn to the policy responses, both domestic and global. Over the last three months, we have seen a range of fiscal, monetary, macroprudential and microprudential actions. These policies have been designed to support households and businesses through the crisis, and so that the financial system can best absorb and not amplify the shock.

Governments world-wide have introduced fiscal policy, with common features being household income supports, business loans and guarantees. While fiscal policy is crucial to ease the effects of the crisis, monetary policy can ensure the cost of borrowing remains low. In understanding the important differences between these two policy spheres, the Chairman Powell of the Federal Reserve captured it well when saying that the “FED has lending powers not spending powers”. [25]

Central banks have conducted monetary policy to maintain liquidity in the financial system, to support the flow of credit to the real economy and prevent a tightening of financing conditions. Central to our pursuit of price stability, the current aim of monetary policy is to help ensure the continued supply of credit to the economy through the crisis and to aid its recovery from the shock. As a member of the Eurosystem, the Central Bank of Ireland has been central to the ECB response. [26]

As I mentioned earlier, the resilience of the banking system has been enhanced over the last decade. Macro and micro prudential polices have resulted in increased capital and liquidity buffers, to be used precisely in a crisis like this. To echo my colleague Sir Jon Cunliffe of the Bank of England, “while building resilience in the financial system in good times might seem expensive, it is the better economic bet over the long run”. [27]

In March, the Central Bank of Ireland reduced the counter cyclical capital buffer (CCYB) from 1% to 0%. The release freed up approximately €940 million of capital across the domestically relevant banking sector. [28] The OS-II buffer can also be used to absorb losses in times of stress. Consistent with the EBA guidelines, the Central Bank has been clear that credit institutions should not pay dividends for the financial years 2019 and 2020 until at least 1 October 2020 and should refrain from share buy-backs aimed at remunerating shareholders. [29]

The mortgage measures have built both bank and borrower resilience since their introduction in 2015, the benefits of which are evident in a period of stress like this. Today, over one quarter of the stock of lending is in scope of the measures. [30] The measures have two objectives to strengthen bank and borrower resilience to negative economic and financial shocks and they are designed to prevent a re-emergence of a credit price spiral.

All these measures aim to reduce the risk of a credit crunch, it is in the interest of borrowers and lenders alike to maintain the supply of credit in a sustainable manner. Former Governor Lane, and now ECB Executive Board member, Philip Lane noted last week that the ECB is “determined to make sure that this crisis is not made worse by an avoidable credit crunch”. [31]

Conclusion

Reflecting the words and actions of central banks and regulators all around the world, in the Central Bank of Ireland we are working to ensure that financial system can best absorb and not amplify the fallout from the pandemic.

As the initial effects of this exceptional economic shock have materialised, the banking and financial system has withstood the initial pressures. The system has benefitted significantly from the painstaking and globally coordinated effort by policymakers and regulators to build up resilience over the last decade.

On the eve of the crisis, the financial system was stronger than a decade ago, but its resilience is not limitless, and its continued stability is being heavily supported by policymakers worldwide. The full effects of this crisis will emerge over time as the damage and scarring to sectors is realised, and the extent depends on the path, persistence and waves of the virus and the necessary public health responses.

---

1. I would like to thank Caroline Mehigan for her assistance in preparing my remarks.

2. Global Economic Prospects, June 2020, World Bank.

3. OECD Economic Outlook, Volume 2020 Issue 1, June, OECD

4. World Bank, 2009 GDP growth (annual).

5. International Monetary Fund, “The IMF's Response to COVID-19”, May 20, 2020.

6. CSO, Monthly Unemployment Data (February) and COVID-19 Adjusted Monthly Unemployment Rate (May)

7. The Central Bank has published additional real time data indicators, on credit demand, job postings and daily spending patterns to assist in the analysis of the economic effects of the pandemic.

8. Conefrey, T. & G. Walsh "Measuring Economic Activity in Real Time during COVID-19" Central Bank of Ireland, Economic Letter Vol. 2020, No. 7.

9. Donnery, Sharon (2019) "A Tale of Two Tails, Risks and Resilience in Uncertain Times", Speech delivered to the Institute of International & European Affairs, 8th March 2019.

10. Baker, S., Bloom, N., Davis, S., & S. Terry. "COVID-induced economic uncertainty and its consequences", VOX CEPR Policy Portal, posted 13 April 2020.

11. Financial Stability Review 2020:1, Central Bank of Ireland.

12. See for example: Byrne, S., Holton, S. & C. Parle "COVID-19 Bank Credit Conditions and Monetary Policy Reference" Central Bank of Ireland, Economic Letter Vol. 2020, No. 5.; McElligot, R., Sherman, M. & M. Woods "Has Demand Changed for New Loans Changed During the COVID-19 Crisis", Central Bank of Ireland, Behind the Data 2020, & Central Bank/ SCSI Property Survey.

13. Financial Stability Review 2020:1, Central Bank of Ireland.

14. See: Emter, L. "Global financial conditions and downside risks to growth: lessons from past shocks", Box 1, Financial Stability Review, 2020:1, Central Bank of Ireland; Beutel, J., Emter, L., Metiu, N., Prieto, E. and Schueler, Y., (2020), "Dilemma or Trilemma? Evidence from the International Transmission of US Financial Shocks to Downside Risks to Growth", mimeo, available at SSRN.

15. Financial Stability Review 2020:1, Central Bank of Ireland.

16. Ibid.

17. Donnery, Sharon (2019) "Small Open Economies – Vulnerabilities in a Changing World", speech delivered to the Dublin Economics Workshop, 13th September 2019.

18. Ibid.

19. Galstyan, V. & V. Herzberg "External Balance Sheet Risks in Ireland – Part II", Central Bank of Ireland, Financial Stability Notes, Vol 2020, No. 4.

20. Financial Stability Review 2020:1, Central Bank of Ireland.

21. Quarterly Bulletin Q2, 2020, Central Bank of Ireland.

22. Financial Stability Review 2020:1, Central Bank of Ireland.

23. See Dear CEO Letter 8 June 2020, Central Banks Expectations for Payment Breaks in Banks and Other Lenders.

24. See: Laeven, M.L. and Valencia, M.F., 2018. “Systemic banking crises revisited”, International Monetary Fund, also Jordà, Ò., Schularick, M. and Taylor, A.M., 2013. “When credit bites back”, Journal of Money, Credit and Banking, 45(s2), pp.3-28.

25. Powell, Jerome. H. “Covid-19 and the Economy” speech at the Hutchins Center on Fiscal and Monetary Policy, The Brookings Institution, Washington, D.C., 09 April, 2020.

26. Holton, S., Stuart, R. & G. Phelan “COVID-19 Monetary Policy and the Irish Economy” Central Bank of Ireland, Economic Letters, Vol 2020, No. 2.

27. Cunliffe, John “Financial System Resilience: Lessons from a Real Stress”, speech delivered to Investment Association Webinar, London, Tuesday 9 June 2020.

28. Denora, G., O’Brien, E., & M. O’Brien, “Releasing the CCyB to Support the Economy in a Time of Stress”, Central Bank of Ireland, Financial Stability Notes, Vol 2020. No. 1.

29. See Central Bank of Ireland communication here and the ECB guidance here.

30. Ibid.

31. Lane, Philp. R., Interview with Il Sole 24 Ore, 11 June 2020.