John Hurley: A central banker's perspective of the Irish and international economic situation

Speech by Mr John Hurley, Governor of the Central Bank of Ireland, at the Finance Dublin Conference, Dublin, 25 March 2003.

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The international and euro area economy

This is a time of exceptional uncertainty in the world economy. This uncertainty has been driven by a number of factors, notably the deterioration of equity and financial markets during 2002 and more recently, rising geopolitical tensions and the ensuing war in Iraq. As a result, the outlook for global economic growth has weakened compared with earlier expectations.

The impact of the war in Iraq on the global economy will depend on the extent and duration of the conflict. The range of scenarios is wide but one can characterise two contrasting situations. In one case, a prolonged conflict could trigger a marked increase in oil prices and undermine consumer and business confidence, slowing consumption and investment spending and leading economic growth to weaken. Alternatively, a short and decisive conflict would eliminate the uncertainty that now exists. It is not possible at this point to assess conclusively the implications for the euro area. But the Governing Council has made it clear that developments will be monitored closely, that it stands ready to act if necessary and will provide liquidity should that be required.

The geopolitical situation masks the fact that, by historical standards, this has been an unusual economic recovery. Evidence from the past half-century suggests that typically a recovery in economic growth is driven by rising equity prices and falling savings rates, in addition to low interest rates. Over the past year, however, equity markets have weakened further, while savings rates have risen. These developments reflect to a large degree an attempt to correct the problems of the past, in particular the significant economic and financial imbalances generated during the preceding boom in the US. The current account deficit has, moreover, continued to grow and is now being driven by the emergence of a sizeable fiscal deficit. Ultimately, this situation has to be corrected, and this will undoubtedly have implications for the rest of the world.

With the external impetus to growth likely to be modest, euro area growth will have to be driven largely by domestic demand. However, the recent track record of larger euro area economies is not encouraging. Their underperformance has acted as a headwind to sustainable economic recovery and this situation may change only gradually. In summary, I would remain concerned that, even in the event of an unwinding of geopolitical tensions, euro area growth is set to remain modest for some time yet.

The Irish economy

Turning now to the Irish economy, I should say that the Central Bank's Spring Bulletin is due to be published to-morrow. It will be giving a fairly detailed analysis of how we see the outlook for the economy. I will confine my remarks today, therefore, to a few general observations.

Over the past year or so, the pace of economic growth has slowed greatly in the wake of a much more subdued international performance. With such a high dependence on international trade and a disproportionately large ICT sector, it was inevitable that Ireland would feel the draughts from the developments in the international economy. It was also clear that the high growth rates experienced since 1994 would decline as the economy increasingly encountered infrastructural pressures and labour market tightness, and this inevitably happened. However, the speed of the deceleration in GNP growth was much faster and its extent was significantly greater than expected. Such a sharp deceleration was clearly going to be felt in people's pockets and on the jobs front.

Given the deterioration in the general international economy, the immediate cause of the slowdown here is the weakness of demand. Export growth here last year is now estimated to have been only about 4 ¼ per cent, compared with average annual increases of 19 per cent, for example, in the three years to 2000. With such a large traded sector, this slowdown was bound to be felt right through the economy. This has spilled over into domestic demand with both consumption and investment demand showing only modest growth last year.

With business and consumer confidence indicators quite weak, it is unlikely that there will be much of a recovery in domestic spending in the short-term. On top of this, we have the outbreak of hostilities in Iraq and the major uncertainties that this adds to the equation. At present, we are factoring in only modest growth this year in domestic spending. With only a small pick-up in export growth, GNP growth is likely to be a little less than 2 per cent. There is also some downside risk to this forecast.

In this more difficult environment, the pursuit of prudent policies will leave us well-placed to participate in the upturn in the world economy when it comes. An important element in this is that, the rate of increase in public expenditure needs to continue its downward path to a more sustainable level; it should be contained to the 7% planned for this year. This will help to limit domestic inflationary pressures. It would also limit the damage to our competitiveness in the event of a sharp appreciation of the euro.

As our Spring Bulletin points out tomorrow, we still have an inflation problem. The excess inflation over that of our euro area partners is largely a services sector phenomenon. Nominal pay increases in recent years have been much higher than the euro area. While higher productivity increases here have partly offset these differences, these have been confined to a relatively small number of industrial sectors. The strengthening of the euro since the middle of last year has exacerbated the effect of these unfavourable trends on competitiveness. It behoves us, therefore, to focus on all policy areas in order to quickly reduce our inflation rate to that of the average of our euro area partners. In this regard, I am happy to see, as part of the anti-inflation initiative in the proposed national partnership agreement, that representatives of employer and union organisations will work with the Government in an effort to target domestic sources of inflation.

The financial sector

I would now like to make a few comments on the financial sector. As a major player in the economy, the broad financial sector benefited from the strong economic performance before the recent slowdown. This was reflected in strong growth in balance sheet sizes and in employment. The IFSC continues to be a success story. The main area of growth in the IFSC has been in the funds sector; these now account for about half of total employment of about 11,000 with aggregate authorised funds amounting to over euro 300 billion.

Irish banks have faced a marked deterioration in their business environment in the past year or so. In response to this, they have become more conscious of managing both their primary and secondary exposures to particular industries and sectors. In terms of performance, it is too early to make an assessment of the overall profitability of the banking sector in 2002. However, some key results published to date, suggest that Irish credit institutions continue to increase profits, but at a slower rate than in previous years. Irish banks remain well capitalised with strong solvency ratios and, to date, there has been only a marginal increase in impaired loans. Provisioning levels have also been maintained suggesting that the banking system is well covered against loan losses. Notwithstanding the currently stable picture, it is important to bear in mind that bad debts lag the economic cycle. Therefore, loan quality will be a topical issue for some time.

Regarding the broad property sector, the weaker state of the economy, together with a continuous expansion of housing output, would seem to point to more subdued prices ahead. In the commercial property sector, prices have ceased rising. The growth in residential mortgage and commercial property lending, nevertheless, remains strong despite the underlying weakness in the economy and the uncertain outlook. Our continuing concerns in this area will be dealt with in our Bulletin tomorrow.

The new Regulatory Authority

Before concluding, may I refer briefly to the establishment of the new Regulatory Authority. As you know, the Interim Board of the Irish Financial Services Regulatory Authority has been in place since last April. I have been working very closely with Brian Patterson to ensure a smooth transition to the new structures. We are very confident that we will be ready for the implementation date, expected to be in early May.

As provided for in the draft legislation the Financial Services Regulator will be a new authority with its own independent responsibilities for prudential supervision and consumer protection across the full spectrum of the financial services industry.

In his address this morning, Liam O'Reilly described how the Authority will discharge its functions. Liam and his staff have made excellent progress over the past several months in mapping out the way forward for supervision. I wish him every success in the important work ahead.

Conclusion

In summary, the world economy is currently labouring in the aftermath of past excesses, particularly in regard to asset markets, as well as present geopolitical uncertainties. These have seriously affected consumer and business confidence resulting in weak demand across the world economy. The international climate is evidently an important determinant of our economic performance, and there remain significant doubts over how and when the world economy will emerge from its current subdued state. Our own policies should be directed to limiting domestic inflationary pressures and protecting competitiveness. While, our inflation looks set to moderate somewhat, as the year progresses, it will require a concerted effort to narrow the inflation differential against the average for the euro area.