John Hurley: Recent economic and financial developments in Ireland

Address by Mr John Hurley, Governor of the Central Bank & Financial Services Authority of Ireland, at the Russian Bankers' Federation Conference on "The Transition to the Market Economy: Actual Problems in the Economic and Finanical Sectors", Dublin, 20 April 2004.

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Ladies and Gentlemen, let me begin by welcoming you to Ireland. I hope that you will find this conference helpful and that you can draw on some of the lessons learned from Ireland's experience in our transition to a more market-oriented economy. Initially, I will briefly outline the main metamorphoses undergone as our economy developed to a stage where standards of living are now broadly comparable to those of other advanced European economies. The process of income convergence was 'telescoped' into a relatively short period compared with many other countries. However, the fundamental factors underlying the convergence are based on lessons learned over a significantly longer period. I will go on to speak about monetary and exchange policy in Ireland prior to our entry to the Exchange Rate Mechanism of the European Monetary System, our experience in the mechanism itself and our experience in the euro area. I will also give some indication of the current economic outlook.

Economic development and policies in Ireland.

For much of the first half of the last century, Ireland adopted predominantly protectionist, heavily regulated and inward-looking policies with the focus largely on promoting domestic indigenous industries behind high tariff barriers. These policies ultimately proved to be unsuccessful, as employment stagnated, emigration became endemic, and living standards, as measured by GDP per capita, remained persistently well below European levels.

Coupled with the protectionist policies of the time, the state played a relatively major role in the commercial life of the economy. With few major industries or wealthy individuals in the country at the time of our independence, a strategy of creating State-sponsored bodies to fill the gaps left by the lack of private enterprise was adopted. State companies were established in areas such as banking, transport and resource-based utilities. By the 1970s the State still played an extensive role in most areas of the economy. However, since then the role of the state has diminished considerably.

There was a fundamental shift in thinking about a decade and a half or so before Ireland joined the EU in 1973, with a move away from protectionist inward-looking policies to one of opening up the economy to trade and investment. This entailed a policy of encouraging foreign-owned firms to establish manufacturing bases in Ireland and, to this day, industrial policy has been geared towards high productivity export oriented foreign and domestic businesses.

Economic performance from the early 1960s until the first oil shock in 1973 was quite good. The economy was reorganised structurally, shedding jobs in agriculture and low productivity indigenous industry sectors and opened up to foreign trade and investment. Significant foreign direct investment flows were an important factor in this improvement. A second important element was an emphasis on improving access to education at both second and tertiary levels. This commitment to developing the skills of the population has been maintained since then. However, the first oil price shock and the associated slowdown in world demand resulted, in hindsight, in some inappropriate policy responses; this was the case with many other countries at the time. The slowdown over the 1970s and the negative real income effects of the adverse movement in the terms of trade associated with the oil price increase, resulted in increasing public deficits and a very high national debt. By 1985, these reached over 10 per cent and 100 per cent of GDP, respectively. In the early part of the 1980s economic growth was negligible and unemployment and inflation soared.

The road to convergence

In the face of these persistent problems, in the mid-1980s a fundamental reorientation of economic policies, both macro and micro, was undertaken with the aim of putting the economy on a sustainable path of economic growth. There were several strands to the reorientation of economic policy that contributed to economic success. In the macroeconomic area, fiscal policy was put on a more stable footing. This was achieved through effecting sharp cuts in public spending which had grown to 53 per cent of GDP by 1985. At that time, interest payments on the public debt were absorbing over one-third of total tax revenue. The restraints on spending involved a curtailment of many public services, a reduction in the number of public sector employees and a cutback in public investment. There was also an acceptance that tax rates, particularly personal tax rates, had increased to unsustainable levels during the early 1980s as taxes were raised in an effort to contain public borrowing. This had led to a contraction of the tax base as the economy stagnated and unemployment rose substantially.

There was an increased commitment to low inflation, having experienced the adverse effects of high inflation earlier. There was also an increased emphasis on competitiveness in the economy.

In the micro-economic sphere, the major changes occurred in the personal taxation area. The disincentive effect of high marginal tax rates was substantially reduced with significant reductions in unemployment and poverty traps along with reductions in the replacement ratio. For a number of years from the mid-1980s, these tax reforms were traded off against moderate increases in nominal pay rates. These were negotiated as part of social partnership agreements between Government, labour unions and employers. Continued importance was also attached to ensuring that non-wage labour costs for employers remained low. In many other countries these are high and are widely recognised as inhibiting employment growth.

More generally, there was a concern to foster an environment favourable to business development and growth. Corporate tax rates remained low, the administrative/red-tape burden on business continued to be limited by comparison with international standards, and various State agencies facilitated business development and adaptation.

Increased resources devoted to education from the late 1960s began to bear fruit in an increasingly well-educated population that was seen as a major asset to businesses, particularly in the more high-skilled sectors. Ireland’s labour market, particularly in the private sector, became increasingly flexible and this helped businesses to cope with changing market conditions.

I should also say that Ireland’s membership of the EU contributed to this better economic performance. In a direct sense, EU Structural Funds contributed to the capability of the productive sectors, to the provision of public infrastructure and to education and training. Various evaluations conclude that the Structural Funds were used effectively in improving economic performance. EU membership also, of course, has continued to benefit the country through increased trade and financial integration and through the effects of greater competition on economic efficiency.

Finally, I should say that the road to economic recovery in the latter part of the 1980s was facilitated by the pick-up in global economic activity, particularly in the UK. The reduction in world interest rates, which had a direct effect in reducing the country’s large debt-service burden, was also an important factor.

Now I would like to turn to the changes in the country’s monetary arrangements culminating in our entry to the euro.

Monetary and exchange rate policy

In the monetary sphere, since the introduction of the Irish pound in the late 1920s, Ireland maintained a one-for-one link with sterling for more than fifty years with no exchange controls between the two countries. This reflected the fact, inter alia, that Britain was (and still is) our largest single trading partner. Until well into the 1960s, the London financial markets were used extensively by Irish financial institutions. London served as an inter-bank market and large sterling liquid assets were held there by Irish banks. Measures were taken in the 1960s, within the constraints of the monetary union with sterling, to promote a domestic money and foreign exchange market.

The link with sterling began to be questioned in policy circles as we imported a high and volatile inflation rate from the UK during the 1970s. This monetary and exchange rate regime continued until the opportunity to join the European Monetary System arose in 1978 with the prospect of linking the Irish pound to the more stable core EU economies, an important milestone in the movement towards a single currency.

The new exchange rate arrangements provided a major impetus to the domestic money market and led to the establishment of a range of liquidity management instruments by the Central Bank. For some considerable time the Central Bank continued to be the dominant player in the domestic money market until more active market-making by financial institutions began to develop.

The early years of Ireland's experience in the European Monetary System were difficult. On the one hand, domestic macroeconomic policies were somewhat undisciplined. In particular, problems arose from inconsistencies between the exchange rate regime and the monetary financing of public sector deficits. There emerged what amounted to a carousel effect whereby money market imbalances deriving mainly from the monetisation of the government deficit were placing continuing downward pressure on the exchange rate. In turn, the exchange rate was supported by using the proceeds of Government foreign currency borrowing. This was an unstable situation that could not continue for very long. A second issue, which arose somewhat later, was the volatility of sterling against EMS currencies, including the Irish pound. On two occasions, two sharp sterling depreciations led to downward realignments of the Irish pound within the EMS.

As I have said, a significant reorientation of economic policies occurred in the mid 1980s. This entailed a devaluation of 8 per cent within the EMS, substantial cuts in nominal public spending and a commitment on the part of the social partners to low nominal wage increases in exchange for cuts in income tax. These tax rates had risen substantially as the country tried to cope with the fiscal imbalances in the first half of the 1980s. All of these changes contributed to a turnaround in economic performance. Gradually, economic conditions in Ireland began to improve. Foreign direct investment inflows, particularly from the US in high technology sectors, began to rise. From the mid-1990s the Irish economy grew very strongly, with GDP growth averaging nearly 10 per cent a year over the second half of the decade. The employment rate for the adult population reached 66 per cent by the end of the millennium, which was above the EU average and about a third higher than a decade earlier.

Ireland's decision to join the single currency was a further step towards deeper integration. This was a natural progression from our involvement in the Exchange Rate Mechanism and EMS. The increased trade and investment opportunities offered by the elimination of exchange rate risk, lower nominal interest rates and the inflation credibility bonus of an independent ECB outweighed the costs of joining a single currency without the UK, still our largest trading partner. With the decision to join Economic and Monetary Union came the Maastricht nominal convergence criteria, which provided a stable and solid foundation for economic growth in the second half of the 1990s. The criteria provided a good nominal anchor for both inflation and inflation expectations. Together with a lower interest rate environment, these were a significant element in our successful convergence.

Supervision of the financial sector

Before moving on from monetary issues, I would like to say a few words on the supervision of the financial sector. The Central Bank was a relatively early mover in adopting a more formal process of supervision of the financial sector - in the early 1970s. Initially, the main concern was with the banking sector. In Ireland, at least at the retail and small business level, the two large domestic banking groups have been the dominant players. As the economy developed, many foreign banks established here and, as part of the single market, EU-based banks can serve the Irish market from their home bases. Over the past decade and a half, an International Financial Services Centre, mainly oriented to provide financial services to non-residents, has been promoted by Government. As a result of legislation enacted last year, supervision of almost the entire financial sector is the responsibility of a constituent, but autonomous, element of the Central Bank and Financial Services Authority of Ireland. The legislation has placed a significantly increased emphasis on consumer issues.

In the banking area, a high degree of importance has been attached to the authorisation process - prevention is better than a cure. In the early days of formal supervision, prudential standards were set down that struck a balance between being over prescriptive and too relaxed. These worked well. More recently, with the greater complexity of banking and finance, an increased emphasis has been placed on ensuring that banks operate appropriate internal control systems. Since the late 1980s, the Basle capital adequacy standards have applied. The Bank is currently a party to the protracted discussions to developing these standards to deal with the changing financial environment.

Our experience in the euro area

I would like to turn now to our experience with the single currency. In the run up to the euro and in its early phase, very buoyant economic conditions in Ireland tested our capacity to cope with the single currency. With GDP growth running in excess of 10 per cent and unemployment at historically low levels, capacity constraints inevitably resulted in increasing inflation, which exceeded 5 per cent for much of 2000 and 2001; this was more than twice the euro area average. By contrast, economic growth in the core euro-area economies was sluggish and, with a single monetary policy, monetary conditions are set by reference to economic conditions in the euro area as a whole. With relatively low nominal euro-wide interest rates, high inflation and inflation expectations in Ireland pushed real interest rates into negative territory. In addition, the euro weakened substantially after its inception, further easing monetary conditions in Ireland.

Until recently, these easy monetary conditions contributed to some widening of Ireland's inflation differential over that of the euro area. However, the strengthening of the euro through 2003 and slower economic growth than previously have reduced inflationary pressures. This year, the Bank forecasts inflation to be about 2 per cent.

Although buffeted by the Information and Communications Technology sector shock in 2001 and the more uncertain international economic conditions in the recent past, the Irish economy has performed well. Economic growth (GNP) last year was 3.3 per cent, amongst the highest in developed economies, and employment has continued to perform strongly. Unemployment — currently 4.6 per cent — is amongst the lowest of EU countries and is very low by historical standards in Ireland. This good performance in a more difficult economic climate reflects, inter alia, the resilience and flexibility of the labour market.

Economic stabilisation in a region of a monetary union is left to other areas such as fiscal policy, and structural, including incomes, policy. Fiscal policy has been managed prudently in Ireland for many years. This allowed the automatic stabilisers to soften the impact of the ups and downs of the economic cycle. At the same time, from a position of substantial surplus in 2000, the Government's borrowing requirement has conformed to the requirement of the Stability and Growth Pact to be kept close to balance or in surplus. Last year, for example, the Government had a surplus of 0.2 per cent of GDP. The stock of debt is one of the lowest in the EU — 33 per cent of GDP —down by two thirds on its level twenty years earlier. In the structural area, Ireland has made relatively good progress in implementing labour and product market reforms aimed at improving competition and flexibility. This has played an important role in mitigating the economic fall-out from asymmetric shocks in a monetary union. Ireland's relatively good record in these areas is borne out by the EU Commission's recent review of countries' performance in implementing the EU's Broad Economic Policy Guidelines.

The current outlook

As I have indicated, the global slowdown and, more specifically for Ireland, the negative shock to the Information and Communications Technology sector in 2001, has resulted in a significant slowdown in economic growth from what was clearly an unsustainable pace over the long run. For the current year, the Bank expects growth of a little over 3 per cent of GNP, as the pace of the international recovery picks up. The recent sharp fall in inflation to about 2 per cent is a welcome development as price levels in Ireland compare somewhat unfavourably with the rest of Europe, due to several years of relatively high inflation rates.

In terms of current challenges and prospects, the rapidity of the real convergence process has placed significant strains on domestic infrastructure, which requires further sustained investment. In the convergence period and the run up to EMU, Ireland benefited significantly from EU Structural and Cohesion Funds, which provided a significant boost to domestic infrastructure projects. As our economy improved these transfers have decreased over time. The National Development Plan 2000 - 2006 outlined a substantial programme for improving and expanding domestic infrastructure, amounting to over €51 billion over the life cycle of the proposals. Investment in the capital stock, including infrastructure, in education and training and in research and development must continue if future growth potential is to be realised.

A second area of concern has been the large and persistent increase in the price of housing over the last decade. New house prices have increased by 183 per cent between 1995 and 2003, an average increase of nearly 14 per cent a year, while existing house prices have increased more rapidly still. This has been accompanied by continued strong increases in residential mortgage lending in the 20 to

25 per cent range for a number of years. Demand for housing has undoubtedly increased significantly in recent years due to strong fundamental factors such as income and employment growth, a relatively large young population in the household-formation age-group and net inward migration. In addition, the adoption of the single currency and the credible price stability mandate of the ECB have meant that nominal interest rates have fallen and are likely to remain low by Irish historical standards; debt-servicing costs for mortgage-borrowers now are roughly half of what they were a decade ago. There has, more recently, been a relatively good supply response, with housing output increasing by about 69,000 units in 2003, suggesting that the market may be approaching equilibrium as this demand is at least partially satisfied. Concern still remains, however, that certain sub-sectors of the market could be vulnerable if some adverse developments were to occur.

Some lessons from Ireland's experience

As a small open economy on the edge of Europe, Ireland's transition to a more market-oriented economy and attainment of average EU living standards are of significant interest, particularly to the accession countries. Our experience shows that good economic performance requires both an environment of openness to foreign trade and investment and macroeconomic stability together with well functioning markets. Flexible, well-functioning markets are developed and sustained by appropriate structural and microeconomic policies. In our progression from a closed, heavily regulated, protected economy to a very open, competitive economy, we benefited significantly from policies that promoted labour market participation and improved the skills of the work force. A well-educated and well-trained workforce was crucial in facilitating the large-scale transfer of labour from an agricultural/old industrial economy to a more modern service-orientated economy with a modern industrial sector. In addition, increased competition and reduced State involvement in many sectors has promoted efficiency and reduced the prevalence of uncompetitive practices. International studies suggest that Ireland's product and labour markets are among the most flexible in the OECD. Increased flexibility in product and labour markets is vital in supporting economic growth and in facilitating economic performance generally in the single currency area.