John Hurley: Some perspectives on Ireland's and Europe's economic performance

Address by Mr John Hurley, Governor of the Central Bank and Financial Services Authority of Ireland, to the Cork Chamber of Commerce Business Breakfast, Cork, 28 January 2005.

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Introduction

It gives me great pleasure to speak to you today. I should first of all like to wish you every success in your year as the European Capital of Culture. The formal launch of this on 8 January was a most impressive spectacle.

Like many other areas of the country and, indeed, like the country as a whole, Cork has witnessed a great economic transformation over the past decade or two. The Cork area is now widely known for its thriving chemicals and pharmaceuticals sector and other high technology businesses. Of course, the county of Cork continues to be a major producer of agricultural products and this broad sector has adjusted well to changing circumstances. The great modernisation of infrastructure in the Cork region is also a clear indicator of very impressive progress.

Irish economic growth

The Irish economy's performance over the past decade or so has been very satisfactory. The annual average growth in Gross National Product, the best measure of our living standards, has been about 6½ per cent a year. This excellent performance has brought our living standards up to those of other developed countries. On a Gross Domestic Product basis, our living standards would be among the highest in the world. However, this is a not a true measure of our living standards, since a significant part of our GDP is repatriated overseas. This reflects the relatively large presence of multi-national companies in the Irish economy compared with elsewhere. When based on GNP, our living standards are slightly above the European average and rank sixth, for example, among the twelve euro area countries.

Economic growth results from increased employment and productivity growth. During the past decade or so, we boosted our employment rate substantially. As a proportion of the working age population, the employment rate increased by about a third from around 50 per cent to the present rate of 66 per cent. This has been a major achievement. Ireland's principal economic problem in the past has been our inability to provide employment for a sufficiently large fraction of the population. As a result, we suffered from large-scale involuntary emigration. It is hard to believe that, as recently as the early 1990s, our unemployment rate was in the 15 to 16 per cent range.

Our excellent employment performance has enabled us to reduce unemployment to its current low rate of 4½ per cent. This provided greatly enhanced employment opportunities for those who had not been in the work force before. It facilitated the employment of a continuing movement of labour out of the agricultural sector. It also supplied off-farm income opportunities for farmers. Immigrants, both returned Irish and others, were readily absorbed. Over the past decade or so, employment has increased by about 50 per cent - around 4 per cent a year. Increased part-time working and a shorter working week reduced this annual increase in labour producing goods and services to 3 per cent. With regard to the second element in economic growth - productivity - our improvement, while somewhat less spectacular, is, nonetheless, quite satisfactory. The average annual increase in productivity, calculated on a GNP basis, was about 3½ per cent. This was a good performance compared with most industrial countries; for example, the corresponding figure for the euro area was only about 1¼ per cent per cent a year.

It is clear, looking ahead, that it would be unrealistic to expect a continuation of the growth rates of the past decade, particularly the more than 8 per cent GNP growth rate in the Celtic Tiger period between 1994 and 2000. The reason for this is that we have largely absorbed into employment those who in the past were either unable to find employment or were discouraged from seeking employment by apparently poor job prospects.

However, there is still some scope for raising our employment rate. For example, there is still a significant gap between Ireland's employment rate and that of Scandinavian countries and the US; the employment rate in the US is about 71 per cent compared with 66 per cent for Ireland. Apart from raising the employment rate to such a level, the potential growth in employment depends on the natural increase in the labour force and the level of immigration. This would permit employment growth of the order of 2 to 2½ per cent in the coming years.

Both economic analysis and international experience show that productivity growth is determined by increased capital per worker and technical progress. The advance of technology was seen in the past as developing generally in response to influences that were outside the scope of economic policies. More recent insights into economic growth processes show that the advance of technical progress can be aided by sound, purposive policies. It is now widely accepted that an environment that is favourable to investment and innovation promotes growth. Both economic theory and experience make it clear that such an environment requires two elements - a stable macroeconomic setting and a well-functioning market economy.

In the macroeconomic sphere, it is clear that a framework of price stability and sound public finances provides the best basis for growth. As a central banker, I would place major emphasis on the importance of price stability. Our inflation rate is currently running at about 2¼ per cent a year. After a long period of relatively low inflation, we may have forgotten its importance for economic progress. High inflation results in high nominal interest rates, and, from an economic growth and development perspective, it is detrimental to long-term investment. It also erodes the real value of fixed incomes. These are just a few examples of the distortions and inefficiencies caused by inflation. It is now well established and, I think, very widely accepted, that price stability is a necessary condition for good economic performance. That is why the European Central Bank and, indeed, central banks generally attach so much importance to ensuring price stability.

Fiscal policy is also a major element of macroeconomic policy. We know from our own experience that sound fiscal policy minimises the risk of overheating and inflation. It also limits the pressure that could otherwise be placed on the monetary authorities to maintain a stable macroeconomic environment. Sound fiscal policy also enables the tax burden to be kept to a reasonable level. An important aspect is that it leaves Government in a better position to finance the investment in infrastructure that is necessary for economic growth. All things considered, Ireland has done generally well in the macroeconomic area - both in terms of inflation and fiscal policy - over the past decade or so, and this has undoubtedly contributed greatly to our good economic performance.

Complementary to macroeconomic stability, well-functioning markets are also a pre-requisite for good economic performance. This boils down in practice to the need to ensure that product, labour and financial markets are characterised by competition and that they are adaptable and flexible. A very important aspect of this is to ensure that the forces of competition can operate effectively. Where this is not the case, firms produce less than with the presence of competition and prices will be higher. The absence of competition in sectors of the economy also tends to induce complacency in incumbents. This leads to a lack of dynamism and slowness to embrace innovation, which represents a drag on economic performance and, in particular, on productivity growth.

The European dimension

Before I address these issues in some more detail, I think it is useful to put them in a European context. What is most relevant here is the Lisbon Agenda. This has been focussed on improving economic performance in Europe over the past few years. It has been motivated by Europe's generally poor record, apart from a few countries including Ireland, in regard to both employment and productivity growth. Moreover, in recent years, the growth performance of the European economy has been disappointing, with the economic upturn in Europe much weaker than in the US and Asia.

The longer term trend is also worrying - the European economy has grown less quickly than the US over the last decade, during which time Europe has moved from having a higher rate of productivity growth than the US, to a lower one. The problem, however, is not simply the comparison with the US - productivity growth in Europe has deteriorated with respect to its own past. The net result has been a slowdown in the rate of growth of output per head, the main determinant of living standards. Relative to the US, in terms of the improvement in living standards, Europe is now losing ground.

These developments have raised questions as to whether Europe's economic structures are less favourable for economic growth. In particular, it would appear that structural rigidities have meant that the European economy has been slow to adapt to the increasing pressures of globalisation and rapid technological change. International competition is intensifying and Europe faces a dual challenge from the US and Asia. For Europe to prosper, it needs to have an appropriate economic base, recognising that in the decades ahead competition in global markets is going to be intense.

It was for these reasons that, in Lisbon in March 2000, the then 15 EU leaders agreed that the EU should commit to raising the rate of economic growth and employment. In the Lisbon strategy European leaders committed the EU to become by 2010 "the most dynamic and competitive knowledge-based economy in the world capable of sustainable economic growth with more and better jobs". However, so far, progress in achieving the Lisbon objectives has been poor. There are various reasons for this. In terms of the economic environment, the last four years have not been helpful to the chances of achieving the Lisbon goals. Many countries have found themselves in a dilemma - because of structural weakness and weak demand, national economic performance has been poor. As national economic performance has been poor, it has been more difficult to implement the Lisbon agenda.

However, the problems in delivering on Lisbon objectives have not been solely or even largely due to outside circumstances. There is the problem that the strategy itself has become too broad. In order to improve the chances of achieving the Lisbon objectives, the coherence and consistency of structural reform policies need to be improved, as does the process of delivery. Success of the reform agenda is essential if Europe is to generate more growth and more employment in an environment of increasing global competition, population ageing and enlargement.

In keeping with the principle of subsidiarity in the EU, it is the responsibility of each country to take the structural reform measures to improve its economic performance. However, it is clear at the half-way stage of the ten year period for the Lisbon Agenda that, across Europe in general, progress has been very poor. With the new EU Commission, steps are being taken to relaunch the Agenda, and this is now underway. It seems likely that this will involve a more focused approach with a clearer statement of where responsibilities lie for making progress.

Ireland and the Lisbon Agenda

While, as I have indicated, progress with the Lisbon Agenda has been very poor across Europe as a whole, particularly in the larger continental countries, Ireland's record has been relatively good. It may be useful to consider in broad terms some of the major structural reform issues in the Lisbon Agenda, and to briefly assess how Ireland has performed.

Promoting the knowledge economy

The objective in relation to the knowledge economy is to adopt policies that promote research and development and the application of information technology and innovation generally with a view to improving productivity and growth. While there is a role for direct participation by Government agencies in research and development activities, it can arguably best facilitate private R&D activities by creating the appropriate framework conditions for such activities. In particular, the strengthening of academic-industry links and ensuring adequate intellectual property rights are important. Most Governments, including our own, are conscious of the need to distinguish between inputs and outputs in this regard. A careful evaluation of the effectiveness of schemes is necessary. Foreign investment inflows can be an important and efficient channel for disseminating new technologies, and Ireland has benefited significantly from this. It is also necessary to ensure that an adequate skilled workforce is available both to conduct research work and to apply the new technologies. In particular, an adequate supply of scientists and engineers is of fundamental importance. On most counts, Ireland has done well in this broad area. The data show, however, that private R&D activities are conducted on a fairly modest scale here, and would need to be stepped up.

Ensuring more competition

In recent years, more competition has been evident in the economy. Being a very open economy has meant that Ireland is very much affected by international competitive forces. The EU internal market and the wide range of measures taken to implement it are a strong influence. At home, the powers of the Competition Authority have been strengthened and it has been quite active and effective in pursuing its agenda. Nonetheless, there is scope for considerable progress.

There are a number of areas, common to Ireland and a large number of other European countries, where such progress could be made. The National Competitiveness Council has drawn attention to our very high utilities' prices in its reports. Because of their structure and characteristics, utilities sectors are highly concentrated, and their operations must be subject to special competition and regulatory arrangements. We also have a long way to go in introducing more competition to the services area generally. In its assessment of Ireland's progress with the EU's Broad Economic Policy Guidelines, the EU Commission has drawn attention to the need to foster competition in professional services, retail distribution and insurance. There still are significant barriers to entry in many professional services in particular, and, as a consequence, prices here are very high by international standards.

Fostering entrepreneurship

A dynamic economy requires an environment that is supportive of entrepreneurship. There are a number of aspects to this. At one level, the administrative burden of establishing and running a business should be kept to a minimum; "red tape" should be eliminated where possible. Where necessary, public sector efficiency should be improved. Educational policies should be supportive of entrepreneurship, and there may be a need to improve access to finance. Ireland would seem to score well in this area. Although there is, no doubt, always room for improvement, the OECD has confirmed that the regulatory burden on business in Ireland is low. There is also the fact that our business taxes are low by international standards. The expansion of the economy, new business start-ups and employment growth are indicative of our positive performance in this area.

Promoting employment and greater social cohesion

The EU ECOFIN Council last year emphasised the importance of a number of labour market reforms. These highlighted the need for greater flexibility of labour markets, to adapt employment protection where necessary to improve employability, and to adapt tax and benefit systems to improve work incentives. It was recognised that employment was the best way to ensure social inclusion. Wage flexibility and adequate infrastructure were seen as desirable for coping with regional differences, and the social partners were urged to balance the interests of both insiders - the employed - and outsiders - the unemployed.

In general, Ireland performs well against these recommendations. This is evident from our very good labour market record in the face of general economic weakness in the past few years.

Ensuring long-term sustainability of the public finances

The fifth and final area that I would mention in regard to the Lisbon Agenda is the issue of pensions and the related risks that this may pose for the public finances in the years ahead. If appropriate measures for dealing with this are not taken in good time, there could be very substantial additional claims on the public finances as well as the risk of pensions being inadequate for a significant proportion of pensioners. All European countries are going to experience a substantial ageing of the population over the next twenty to thirty years. There will be more elderly people and fewer people of working age. There is a three-pronged approach for dealing with this: increasing employment rates and improving productivity performance, reducing public debt before the problem becomes less manageable and, thirdly, reforming pension systems. Governments are currently grappling with these big issues. In our own case, we are relatively well placed for coping with these issues. Firstly, the ageing of our population is relatively limited compared with countries like Italy and Spain. Secondly, some provision for public pensions is being made through building up the National Pension Reserve Fund by setting aside each year 1 per cent of Gross National Product.

In addition, our economic growth potential is good relative to many other countries, and this increases the capacity for dealing with the issue. Nonetheless, there is no scope for complacency for a number of reasons. First, about 40 per cent of the workforce, comprising nearly half of private sector workers, is at present not covered by an employment-related pension or an individual pension. Those not so covered will be reliant on the state pension, which provides a basic level of retirement income. A recent estimate of the Minister for Social, Community and Family Affairs indicated that only about one quarter of private sector workers have near-adequate pensions. Consequently, the whole issue must and is being kept under review to ensure that we are in a strong position to deal with the ageing of the population.

Conclusion

The Irish economy has performed very well over the past decade or so. Our living standards have caught up with those of other advanced countries. This convergence was telescoped into the past decade, whereas other developed countries raised their living standards over a much more prolonged period since the Second World War. One result of this more concentrated convergence process has been pressure on the country's infrastructure. This is currently being addressed in a very substantive way, although it is not something that can be done overnight.

Of course, our economic progress has not been without its ups and downs. We were affected quite significantly by the downturn in the Information Technology sector in 2001, for example, and by the variations in oil prices and exchange rates. At the same time, we have experienced a rate of business closures and layoffs that is an inevitable, if sometimes painful, feature of modern, open economies in the light of changing consumer tastes and technological change. In the face of this, the important objective is that other opportunities are created and that the workforce is sufficiently flexible and skilled to be quickly re-employed. We have been quite successful at this.

Looking ahead, we must continue to tailor our policies to promote growth and employment. We must ensure a stable macroeconomic environment and continue with our successful supply-side policies and structural reform. This will leave us well placed to deal with the inevitable unforeseen shocks that will arise. It is also important that we are realistic in our expectations, whether in regard to incomes or what we expect to be delivered by way of public services. At present, while our inflation rate is low, our price levels are high relative to those of most European countries, so that it is especially important that we do not exacerbate this. If we remain conscious of this and continue with the generally sound policies that have delivered such good results over the past decade, there is no reason why we should not be optimistic about our future economic prospects.

However, I have to add a few important caveats regarding future prospects. First, on the domestic front, developments in house prices and the rapid increase in mortgage credit pose some concerns. I continue to believe, however, that a soft landing in this market is the most likely scenario, although there is no room for complacency. Secondly, as a very open economy, we are vulnerable to adverse developments in the global economy. The biggest risk is a disorderly unwinding of global imbalances, especially the twin deficits in the US. If this were to occur, we could experience a rapid decline in the US dollar and a sharp euro appreciation, which would impinge on our competitiveness. The other main external risks are developments in energy markets and the uncertain geopolitical situation.

To conclude, I feel that our main challenge is to maintain international competitiveness so that we can continue to ensure sustainable economic growth over the medium- to long-term.