John Hurley: Economic developments in Ireland and other issues

Opening statement by Mr John Hurley, Governor of the Central Bank and Financial Services Authority of Ireland, at the presentation of the Annual Report 2004, Dublin, 12 July 2005.

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You are all very welcome to this press briefing to mark the publication of the Central Bank's Annual Report for 2004.

The Annual Report gives a detailed account of our activities in 2004. It again proved to be a very busy period for us, with major developments at both domestic and European levels.

The re-structuring of the Central Bank that took place in 2003 was firmly bedded down last year. As you know, the creation of the Financial Regulator as a distinct component of the Central Bank and Financial Services Authority of Ireland was a major development that has led to significant change throughout our organisation. I am happy to report that these new arrangements are working very well. The Financial Regulator will be publishing its own Annual Report next week, which will give details of its very busy agenda of the past year or so.

While the Central Bank has overall responsibility for financial stability, the Financial Regulator is, in addition to its very significant consumer mandate, responsible for the prudential supervision of individual financial institutions. The greatest interaction between the two sides of the organisation is in the area of financial stability. We have in place a joint committee, the Financial Stability Committee, as a very important element in this cooperation. The Central Bank will be publishing the Financial Stability Report in October. As was the case last year, it will focus in particular on risks to financial stability.

As is usual, the Annual Report today contains detail on our extensive Eurosystem responsibilities, including those in the areas of monetary policy, payments, financial markets and currency.

Economic developments

I would now like to turn to the general economic situation. The Irish economy is continuing to perform well with GNP growth of 5½ per cent in 2004 (GDP, 4.9 per cent). This underlying strength is reflected in the labour market with unemployment at around 4½ per cent in 2004, falling to just over 4 per cent in the first quarter of this year. Total employment grew by almost 4 per cent in the same period. This was the fastest rate of growth since the end of 2000, with the construction and related sectors accounting for almost half of this increase. This reflects the fact that the construction sector here is large in relation to other euro area countries, accounting for about 12 per cent of employment compared to about 8 per cent for the euro area. The main reason for this concentration in Ireland is that we are still endeavouring to address the infrastructure shortfall while, at the same time, housing construction has been exceptionally high. This high level of house building will inevitably moderate over time.

Despite the continued strong employment situation, inflationary pressures have remained relatively subdued. Inflation fell back in Ireland last year to 2.3 per cent (HICP), very close to the euro area average of 2.1 per cent, following some years of adverse differentials. However, we have seen some increase in the Irish inflation rate in the past couple of months, due to higher oil prices, from the low point of 1.9 per cent in March.

The economy is expected to grow at a similar pace this year, with GNP growth of 5¼ per cent in 2005 (GDP 5½ per cent). A significant increase in employment of about 2¼ per cent is also expected.

One of the challenges we face is to ensure continuing low inflation against this background of continuing strong economic performance. It is of vital importance that future pay increases and other cost factors take account of the low inflation environment that we are now in.

There has been a small deterioration in the economy's price competitiveness position in the last year, as reflected in the Central Bank's Competitiveness Index; this followed a number of years when there was a more significant worsening. However, competitiveness issues remain of concern. In particular, the Irish economy is exposed to any sharp weakening of the US dollar against the euro that might emanate from the large global imbalances. Additionally, our price level is some 15 per cent higher than the euro area. It is necessary now to embed the low inflation regime that we have experienced over the past year in order to protect our competitiveness.

You will recall that this time last year, we expressed our concerns about house price increases, which were running at a year-on-year rate of increase of 12 – 13 per cent. We felt at the time that unless house price increases were to slow to about the same level as nominal GNP, there was the risk of a sharp correction at some stage. House price increases have indeed shown a welcome deceleration with a year-on-year increase now of 7 per cent, against the background of increased housing supply. Currently, house prices are increasing at an annualised rate of about 4 per cent.

Given the slowdown in house prices, the main concern now is both the rapid growth and high level of indebtedness in the economy. Total private sector credit is growing at an annual rate of about 25 per cent. There is no longer any doubt that the private sector is highly indebted by international standards and this level will very soon match the levels recorded in Europe's most indebted economies. The ratio of debt to disposable income of the household sector is now in excess of 120 per cent and is growing very strongly.

Regarding the mortgage component of private sector credit, it can be expected that the slowdown in house price increases and, in time, a reduction in housing volume to more sustainable levels should also lead to a slowdown in mortgage credit growth. However, we will remain concerned until we see some evidence of such a slowdown. The point of most concern about the high and growing level of indebtedness is that it is occurring at a time of historically low interest rates so that any significant increase in rates or downturn in economic activity in the future would cause problems, particularly for recent and more highly indebted borrowers.

Looking further ahead, most indicators would point to the Irish economy continuing to grow strongly at a rate of about 5 per cent over the next few years. As a very open economy, the performance of Ireland is significantly dependent on the global economy, the prospects for which are broadly favourable.

There are downside risks to these forecasts. Internationally we have seen a sharp increase in oil prices and uncertainties remain in this regard. As I said earlier, unfavourable moves in exchange rates could also impact on growth. Domestically, there are also some risks, the main ones being the high and growing level of indebtedness, threats to competitiveness and the expanded construction sector.

Turning briefly to fiscal policy, it should be framed in a way that provides a capacity to cope in the event of the downside risks to the economy materialising. Such an approach would also help avoid overheating pressures in an economy that is growing at more or less full capacity.

Monetary policy and the euro area economy

Focusing on the euro area, the expectation is that growth will moderate this year from the increase recorded in 2004, which itself marked a recovery from successive years of extremely weak growth. However, the 2 per cent recorded last year masked a sharp slowdown over the course of the year. Moreover, the increase of 0.5 per cent in the first quarter of 2005 overstated the strength of the economy somewhat and the indications are that growth has subsequently remained subdued. Though the economic recovery has lost momentum, nevertheless, we expect to see a gradual improvement in economic activity, supported by historically low interest rates and other favourable domestic and external factors. At the same time downside risks to this outlook still exist – most notably the strength of energy prices, the large global imbalances and the low level of business and consumer confidence prevailing in the euro area.

Rising energy prices have contributed to inflation increasing to 2.1 per cent in the euro area in June, and to the expectation that it will persist around the 2 per cent level for the remainder of this year. Uncertainties relating to oil prices and to indirect taxes and administered prices constitute upside risks to inflation that warrant careful monitoring. Underlying domestic inflationary pressures remain contained. However, liquidity is ample by any standard and ongoing vigilance is required if inflationary expectations are to be kept in line with price stability.

In the light of the information currently available, the present monetary policy stance of the Governing Council of the European Central Bank is that interest rates are at an appropriate level. Of course, we continue to monitor and to carefully assess all emerging data.

Financial results

Profit for 2004 in the Central Bank amounted to €122.5 million, an increase of €53 million on the previous year. The Surplus Income paid by the Central Bank to the Exchequer in respect of 2004 is €103 million. The ongoing level of profits reflects the prevailing lower interest rate environment.

Conclusion

Before concluding, I would like to briefly draw your attention to another aspect of our Annual Report. As you know, last year, following the re-structuring, we published a three-year Strategic Plan for the Central Bank. This allowed us to detail clearly, and publicly, our responsibilities, both in the Eurosystem and domestically. It also set out our approach to delivering on those responsibilities. Today, as part of the Annual Report, we publish a Progress Report on the implementation of that Strategic Plan.

In conclusion, I would like to thank the members of the Board of the Central Bank and Financial Services Authority of Ireland for their assistance, work and leadership in another very significant and busy year for the organisation. I would also like to thank the Chairman and Board of the Irish Financial Services Regulatory Authority for their effective co-operation in ensuring that our new arrangements work as smoothly as they do. Finally, I would like to express my sincere thanks to all of the staff, both in the Central Bank and Financial Regulator, for their work and commitment in contributing to a very successful year.

This concludes my opening remarks. My colleagues and I are now available to answer questions.