John Hurley: Prospects for productivity and growth in Ireland and the euro area

Opening statement of Mr John Hurley, Governor of the Central Bank and Financial Services Authority of Ireland, at the Central Bank and Financial Services Authority of Ireland Conference “Prospects for Productivity and Growth in Ireland and the euro area”, Dublin, 15 September 2006.

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Ladies and Gentlemen,

I would like to welcome you to this one-day conference on the Prospects for Productivity and Growth in Ireland and the euro area. I extend a special welcome to those who have come from abroad, in many cases travelling long distances.

Today's event brings together a wide range of participants to discuss these important topics, not just academics and policy-makers but also representatives of commercial banks, international organisations, the public sector, industry groupings and economic commentators.

The day will be divided into two sessions, the first dealing with the Irish economy and the second with the euro-area economy. These sessions will begin with a number of presentations by invited speakers, including some of the Bank's economists, and will be based largely on the speaker's own research. After contributions from discussants, there will be an opportunity for a more general discussion of the issues. Of course, we do not expect that the conference will end with a consensus on all the issues. The conference topics are ones on which there can be quite a range of views and each of today's participants will naturally present their own particular analysis. However, I hope that, by the end of the day, most of you will feel this event has been useful and that it will stimulate further debate on matters that are of critical importance to Ireland and the wider euro area.

I would like to stress that this conference is about growth prospects over a number of years or even decades. It is not about what will happen in the next quarter, the interpretation of the latest data or any aspect of the conjunctural situation. It focuses instead on the medium to longer-term growth potential of the economies in question and the factors that will determine this potential over time. At the most basic level, these factors are the supply of labour and capital and the increasing efficiency with which these are used over time, that is, total factor productivity growth.

The evolution of each of these three individual components - labour, capital and productivity - is a very complex story in itself. For example, the supply of labour reflects developments in a range of underlying variables, not just demographic developments such as ageing and migration; it also includes behavioural aspects, such as the decision whether to participate in the labour force or not. The availability of a plentiful supply of labour, even a well-qualified labour force, does not in itself guarantee a favourable growth performance. It may be a necessary, but not sufficient, condition for growth, as the Irish experience of the 1980s shows.

The supply of capital is another key element in an economy's growth potential, whether that reflects domestic capital accumulation or, as in Ireland's case, significant foreign direct investment inflows. Again, the story here is quite complex. It may be clear that rates of capital accumulation and, in some cases, the nature and composition of investment, is weak or unfavourable, particularly when compared with other economies. Often, however, the reasons for this are difficult to discern. Why, for example, does the application of information and communications technology in certain sectors of the US economy, such as retail distribution, seem to be noticeably greater than in Europe? The answers are not immediately clear.

Even more intractable, perhaps, is the question of the determinants of total factor productivity growth. Certainly, it is likely that rising skill levels and the accumulating knowledge of how to apply new technologies more efficiently may account for much of this productivity growth. There are also other important factors involved, however, such as institutional factors that enhance the efficiency with which both capital and labour are deployed in an economy in response to all sorts of developments, including technological progress. In other words, the flexibility of an economy, and the institutional features that give rise to this flexibility are an important part of the picture. This is the type of analysis that underlies the Lisbon Strategy and the structural reform process in Europe generally.

The importance of research in this area is clear. Productivity growth is the key driver of living standards in the long run. Over time, an economy's productivity growth performance will be a major determinant of both the absolute level of living standards in an economy and its relative ranking vis-à-vis other economies. The rationale behind this is fairly clear; in the long run, there has to be a fairly strong relationship between increases in output per head, the corresponding rise in incomes this generates and increases in the level of consumption.

How do the concepts of productivity and competitiveness relate to each other? These terms are often used interchangeably in public discussion. In a narrow sense, competitiveness is often about short-term developments, as measured by a range of various indicators, including, in particular, relative labour and other input costs. It is very important to pay attention to these variables. For instance, it is likely that sharp losses in competitiveness, stemming from exchange rate changes or excessive earnings growth domestically, could adversely impact on the traded goods sectors and cause damage that could take a long time to undo, through losses in market shares and the closure of firms. One has to distinguish this concern, however, from a concern about longer term developments.

Over a longer perspective, it is productivity growth that matters. By moving from the production of low-valued-added and low-productivity activities to higher value-added higher-productivity ones, facilitated by flexible markets and appropriate policies, an economy can increase its export earnings and its command over internationally traded goods and services. It can also benefit from the increased efficiency of production of non-traded goods and services. The alternative is simply to stick with low-valued activities and, typically in today's world, be faced with limited prospects, due to competition from lower cost production locations. One might be able to technically maintain competitiveness in such circumstances, but only by paring back labour earnings and domestic incomes. Clearly, this is not a very desirable long-term strategy.

It is evident, therefore, that a certain amount of structural change is a desirable feature in an economy. Ireland has undergone very high levels of structural change and the results have generally been beneficial. If we had simply tried to maintain the production structure of the past, with its greater concentration on lower-value added traditional activities, it is implausible to suggest that the economy could have performed in the manner that it has. In fact, Ireland tried to pursue this approach up until the late 1950s with unsatisfactory results. Further structural change will clearly continue to be required if we are to maintain and improve our relative position. The policies to be pursued, therefore, are ones that permit, or even encourage, structural change to occur on an ongoing basis and in as smooth a manner as possible.

Determining what is important in terms of promoting productivity growth constitutes a key challenge for economic research. The importance of this topic has led the Bank to prioritise it as an area of research alongside the ongoing commitments of its research function to ECB activities. The Bank also sees itself as having a role to support the adoption of policies domestically that boost long-term sustainable growth, as well as contributing to research within the Eurosystem on this important topic.

The first session today will deal with the domestic economy. It will commence with an overview paper followed by others relating to two specific topics that have been, and remain, key factors in this regard. These are foreign direct investment and the role of education in improving the quality of the labour force. Given the rather striking growth performance of the Irish economy in recent years, I hope that the discussion of the domestic economy will be of interest to all of you, including those who have travelled from abroad.

This is a particularly appropriate time to consider the prospects for overall growth and productivity performance for Ireland. The much-discussed era of exceptionally strong growth - representing a delayed catch-up process, if you like - is clearly behind us now. Growth still remains relatively robust by comparison with most other mature economies but it is running below the average rates of growth of the late 1990s. There are also a number of specific concerns, albeit some of a more short-term nature. In particular, growth has become somewhat unbalanced in recent years, with an unusually high reliance on the construction sector, combined with some deterioration in the economy's export performance. The productivity performance of the economy has also weakened, partly in response to this shift in the pattern of activity.

The second session of today's conference will focus on the wider euro-area economy and on its potential for growth. Unfortunately, developments in recent years point to a rather poor performance on a relative basis, in particular, in comparison with the US economy. Europe had been catching up on the US productivity performance over much of the latter part of the last century but, since about the mid-1990s, this process of convergence towards US living standards essentially stalled and, indeed, has even reversed itself somewhat. This reflected a pick up in US productivity growth that was not emulated in Europe.

Measurement issues may play some role in explaining these differing trends. Measures of output in the US take greater account of quality changes, so that for any given value increase in investment or the output of the high-technology sectors, greater volume growth may tend to be recorded in the US. These measurement issues are not central to the argument, however. It is clear that, abstracting from them, the underlying story, though slightly less dramatic, is essentially unchanged.

An unusual feature of US developments has been the fact that productivity growth remained strong even during the downturn at the beginning of this decade. Typically, productivity performance is often poor in a downturn as output growth falls back but employment does not respond immediately. This performance was also recorded despite a peaking in information technology investment, but perhaps the impact of previous investment was only evident with a lag. In contrast, in Europe, the downturn saw further declines in productivity growth, although there has been some improvement recently. Possible explanations for these trends and the implications of their continuation will be central to the afternoon session. Clearly, the prospects for European productivity growth are very important, not least, because in the future population ageing will mean that each worker will be supporting more dependents.

Before concluding, I would like to say something about the links between the conference topics and central banking. There are a number of important ways in which monetary policy and potential output growth interact. For example, it is important for monetary policymakers to have a reasonably accurate estimate of the sustainable rate of growth of the economy, so that the stance of policy can be adjusted in a timely fashion to avoid inflationary pressures emerging in an economy. Equally, monetary policy can itself contribute to maximising potential output growth by maintaining price stability. Relative price movements and the required re-allocation of resources that they may indicate are important signals and they can be distorted against the background of unstable prices.

It is also important to recognise what monetary policy cannot achieve. Monetary policy cannot permanently raise output levels through adopting a stance that is too accommodating. This might increase demand in the short-term but it will ultimately hamper, rather than boost, the economy's growth potential and is likely to end in a damaging inflationary episode.

In a specifically domestic setting, the Bank sees itself as having role in contributing to policy formation, specifically, by encouraging the adoption of policies that support long-term sustainable development. It can do so by sharing the results of its economic research and facilitating the discussion of important policy issues. Today's conference contributes to the Bank's overall efforts to meet its goals in this regard.

In conclusion, I am looking forward to an interesting and stimulating discussion and exchange of views. I will now pass you over to the Bank's Assistant Director General, Tom O'Connell, who will act as chairman for today's sessions.