John Hurley: Recent economic developments in Ireland and the outlook for the economy

Opening statement by Mr John Hurley, Governor of the Central Bank and Financial Services Authority of Ireland, at the presentation of the Annual Report 2006, Dublin, 11 July 2007.

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You are all very welcome to this press briefing to mark the publication of the **Annual Report of the Central Bank and Financial Services Authority of Ireland**.

I will briefly introduce my colleagues who join me today. Liam Barron, our Director General, Deputy Director General Brian Halpin, Director General Designate, Tony Grimes, and Maurice McGuire, Head of Economic Analysis and Research.

As you know, Liam Barron is retiring as Director General next month. At the outset today I would like to thank Liam for his outstanding contribution to this organisation over a long and distinguished career, in particular as Director General and as a member of the Board. I would also like to take this opportunity to wish Tony Grimes all the very best in his new role. Tony is well placed to bring this organisation forward and to meet the various challenges in the years ahead.

The Annual Report describes in detail our activities in 2006, which proved to be another busy year for the Bank, both in terms of our domestic and our euro area responsibilities. Today we are also publishing our strategic plan for the coming three years.

I should also mention that the annual Financial Stability Report will be published in the autumn and that the Financial Regulator will publish its own Annual Report later this month.

Economic developments

I will begin by reviewing economic developments in Ireland over the past year or so, before moving on to discuss the outlook for the economy for this year and next.

The latest CSO National Accounts data, which were released after the Annual Report was finalised, indicate that the economy performed very well last year with GNP growth of 6.5 per cent and GDP growth of 5.7 per cent.

Reflecting the strength of output growth, last year was another good year for employment. An expansion of almost 4½ per cent in the numbers employed brought total employment above the 2 million mark for the first time. The unemployment rate remained low, below 4½ per cent – essentially full employment conditions.

The pace of expansion last year was, in fact, somewhat above the economy's medium term potential and, partly as a result, there was an increase in inflation. The Harmonised Index of Consumer Prices, which is the most appropriate measure, rose by 2.7 per cent compared with 2.2 per cent the previous year. The rate of inflation for goods remained broadly in line with the euro area average but services inflation moved noticeably higher. This undoubtedly reflected the strength of domestic demand in particular, and occurred in spite of the significant increase in labour supply through substantial inward migration.

Domestic demand was the main source of output growth. Construction spending was still a major contributor, although it is clear, in retrospect, that housing completions reached a peak last year and are declining towards a more sustainable level. Consumption growth also remained strong in 2006, buoyed up by the continued growth in employment and earnings. In contrast, export growth was quite muted. The volume of exports of goods and services grew by just 4.4 per cent, mostly due to trade in services. This implies a decline in Ireland's share of world trade.

Another feature of last year was the further increase in the current account deficit on the balance of payments. The latest CSO data indicate that the deficit reached nearly 5 per cent of GNP last year. This indicates a need to rebalance growth. Some of this rebalancing will occur, as a matter of course, as the growth in consumer spending is expected to moderate next year. This is likely to result in reduced import growth. A recovery in export growth is, however, also required as a part of this rebalancing. In the long run, in a small open economy like Ireland, continued growth in incomes and employment depends, to a significant extent, on a satisfactory performance by the traded goods sectors. In this regard, there are welcome signs of a somewhat improved export performance in the first quarter of this year but we need to see further data in the coming months before we can be confident that a sustained improvement is taking place.

Last year was a very good one for the public finances. The strength of growth helped to boost revenues resulting in a General Government Surplus of 2.9 per cent of GDP, one of the best performances in the European Union. Some of the strength of revenue, however, reflected the composition of growth, with construction and the property market contributing significantly. This factor was taken into account in framing the fiscal forecasts for 2007 in the context of the last Budget.

There were also important developments in the price of residential property last year. You may recall, at this time last year, that the Bank was very concerned about the reacceleration in house prices that had occurred. Current developments are more consistent with stability in the market. Looking forward, it is important to recall that the major underlying factors supporting the demand for housing are employment growth, increases in incomes, demographics and social changes. The prospects for these key factors remain favourable, even allowing for some moderation in the growth rate of the economy, and we continue to believe that the most likely scenario is a soft landing for the housing market.

There has also been a welcome deceleration in the rate of growth of credit in the economy, though it is still at high levels. The rate of growth in overall private sector credit has fallen from over 30 per cent in June of last year to just under 21 per cent in May of this year. The rate of increase in mortgage credit growth has also decelerated from a peak of over 28 per cent in March 2006 to about 20 per cent this May. If this trend continues, the growth rate in mortgage credit should be substantially lower at the end of the year.

Turning now to the outlook for the economy generally for this year and 2008, the Bank's current projections are that output growth will moderate, though still remaining strong. Overall growth this year is expected to be about 5 per cent, in terms of both GDP and GNP. The data for the early part of this year suggest that growth was probably in excess of these levels but there are two factors that will act to reduce growth somewhat as the year progresses and into next year. These are the impact of the gradual decline in house building towards sustainable levels and a moderation in consumer spending growth. In spite of the deceleration in growth and a modest rise in unemployment, the projected growth rate for next year, at about 4 per cent, remains favourable by comparison with other economies with broadly similar level of incomes. HICP inflation is projected to ease from an average of 2¾ per cent this year to about 2¼ per cent next year.

It is, nevertheless, important to discuss some downside risks to the outlook, always bearing in mind that they are risks rather than forecasts. Some risks reflect factors or events completely outside the control of domestic policy makers. The most obvious of these, at the moment, are exchange rate movements and oil price volatility. There is still the risk that there could be a sharp depreciation of the dollar against the euro as part of a correction mechanism for persistent global current account imbalances. It is impossible to quantify this risk but it would be complacent to rule out the possibility of a correction occurring that involved significant exchange rate movements. Given the openness of the Irish economy, this would impact on our competitiveness position and highlights the need to keep a focus on all the various factors that can contribute positively to the economy's competitiveness and its ability to respond flexibly to adverse developments. The Irish economy is also particularly exposed to oil price volatility as the country's dependence on imported oil as an energy source is high by international standards.

There are also some other domestic vulnerabilities. The house building sector, though currently reducing its output, is still large – as a share of activity – by international standards. I have already outlined the Bank's view that a gradual decline in output to more sustainable levels is the most likely outcome, but a sharper than expected contraction in housing output cannot be completely ruled out, particularly in the event of a greater than anticipated downturn in the economy that affects employment and incomes. There has also been a recent deterioration in competitiveness and measures should be taken now to reverse this trend, in order to avoid a more serious situation emerging in the future. Key elements in this regard would be to continue policies and behaviour which maximise productivity growth and limit inflationary pressures, for example, by investing in infrastructure, providing a framework that fosters R&D and promoting increased levels of competition in the economy. While many of these measures require action at national level, in practice, productivity improvements ultimately take place at enterprise level, making it essential for public and private enterprises to focus on efficiency in their operations in an increasingly globalised environment.

Appropriate pay developments, which take account of productivity trends and the low-inflation environment of the euro area, are also important. In particular, pay developments in the more sheltered sectors of the economy should not put pressure on wages and costs in the economy more generally.

In order to cope with any unanticipated slowdown in the economy, whether from international or domestic risks, it is important to maximise flexibility in the economy. One element of this is maintaining a strong fiscal position and thus providing a buffer in the public finances which will help any adverse developments to be absorbed. This would make it more likely that remedial fiscal measures could be avoided against a background of somewhat reduced economic growth and facilitate a quicker rebound in the performance of the economy.

In summary, the outlook for the domestic economy remains favourable. There will be some deceleration in growth, which will reflect a return to a more sustainable level of housing output and more moderate consumer spending. The growth rate is still expected to be strong by international standards, however, as I have indicated, there are some risks to the outlook that have to be considered in framing policy.

International and euro area economy

Turning to the international background for the Irish economy, developments have remained broadly favourable. The global economy expanded rapidly in 2006, and while some moderation is projected this year, global activity is expected to continue to grow strongly. Economic growth in the euro area increased by 2.7 per cent in 2006, its fastest pace in six years, and activity has remained robust in the first half of this year. Growth has become increasingly broad based, with the strength of fixed investment spending particularly impressive. The conditions are in place for sustained growth over the medium-term, with domestic demand remaining strong and global growth continuing to provide support for euro area exports. But downside risks that I have already referred to, relating to potential volatility in the oil market and the possibility of a disorderly adjustment of global imbalances, are also relevant.

With regard to euro area price developments, the headline rate of inflation has stabilised at just under 2 per cent in recent months, but is expected to increase somewhat in the final quarter of the year. Looking past this short-term volatility and focusing on the policy relevant medium-term horizon, risks to the outlook for price stability remain on the upside. Against the backdrop of high capacity utilisation and the rapidly improving labour market, there is the potential for supply side pressures to emerge, and there is also the risk of further unexpected increases in oil prices. In order to ensure that these risks to price stability do not materialise over the medium term, and that inflationary expectations are kept firmly anchored, the Governing Council will continue to monitor closely all developments. As you know the Governing Council never pre-commits to a specific course of action.

Activities and financial accounts

The annual report gives a full and detailed account of the Bank's activities. I will just refer here to our financial accounts. The Bank's profits for 2006 amounted to €110.2 million. After transfers to reserves and adjustments related to the recognition of the Bank's pension liability as required under FRS 17, the Bank's surplus income amounted to €98.5 million, which accrues to the Exchequer. In addition, a total of €39.5 million, in respect of the net proceeds of coin issued, was also paid to the Exchequer.

Strategic plan

We are also publishing our new three-year Strategic Plan today. The plan sets out the key challenges facing the Bank over the next three years. These include our role in the Eurosystem and in the domestic economy, management of investment assets, both on behalf of the CBFSAI and the ECB, the management of risk and management of resources.

Our Strategic Plan sets out eight high level goals. Individual strategies with specific actions and timeframes have been established to achieve these goals. The inclusion of specific actions will allow them be easily included in work plans of departments and performance objectives of staff.

This concludes my opening remarks. My colleagues and I are now on hand to answer any questions you may have.