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 2007, Dublin, 10 July 2008.

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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. Tony Grimes, our Director General, Deputy Director General Brian Halpin, and Tom O'Connell, Assistant Director General, Economics.

The Annual Report describes in detail our activities in 2007, which proved to be a challenging year for the Bank, both in terms of our domestic and our euro area responsibilities.

In my statement today, I will begin by reviewing current developments in the Irish economy. We have seen a substantial adjustment in the domestic housing market, international financial market turbulence and, more recently, the effects of higher oil and food prices. This has led to a greater-than-anticipated slowdown in growth and higher-than-expected inflation. Notwithstanding the challenging short-term outlook, we continue to believe that the medium-term outlook is favourable and that growth should gradually recover and inflation moderate. However, such an outcome is not guaranteed and will require concerted action.

Current developments in the Irish economy

The latest CSO National Accounts data, which were released after the Annual Report was finalised, indicate that growth in the domestic economy remained robust in 2007 with real GDP and GNP increasing by 6.0 per cent and 4.1 per cent respectively, in line with average output growth over the previous five years. While the performance of the Irish economy was strong in 2007 as a whole, there was a significant moderation in growth as the year progressed. This slowdown has accelerated considerably this year.

While the emergence of a slowdown in the economy was not unanticipated, the loss of momentum has been greater than expected this year. This has arisen from a sharper than expected adjustment in the housing sector alongside a deterioration in the international environment.

Growth prospects for the next 18 months or so are now significantly less favourable and we will be revising our forecasts to reflect this. Overall, it seems likely that both GNP and GDP growth will remain positive this year, albeit significantly less than 1 per cent. Although some improvement is in prospect, growth is likely to remain below potential in 2009 at about 2 per cent.

The downturn in the housing market and the consequent reduced employment in that sector will contribute to a sharp slowdown in the overall rate of job creation and a rise in the unemployment rate to about 6 per cent on average this year.

Although the weakness in economic activity is being reflected in some moderation in domestic inflationary pressures, Ireland, in common with other developed economies, is facing significant inflationary pressures arising from very elevated levels of energy and other commodity prices.

Residential housing market

The housing market weakened significantly during 2007 with sharp declines in both output and prices. An adjustment in the housing market had been envisaged by most economic commentators since housing output was well above the sustainable rate taking account of underlying housing needs for a number of years. Housing investment peaked at around 13 per cent of GDP in 2006, which was well in excess of international norms. This is likely to reduce to about 7½ per cent of GDP in 2008, which represents a very substantial scaling back of activity. The significant weakening in the housing sector is going to detract considerably from growth this year.

Housing output should broadly stabilise during the course of next year, but clearly risks are to the downside. In general, however, the declines in both output and prices represent a movement towards a more sustainable position in the long term. Unfortunately the adjustment process is a difficult, if unavoidable, one.

International economy

There are two fairly distinct sets of events driving developments in the global economy at the moment. Firstly, there are housing market adjustments in the major economies and the associated difficulties in international financial markets and, secondly, the more recent sharp increases in food and energy prices. As a result, growth in the global economy has slowed while inflation has picked up. Unfortunately we are more exposed than most to countries, like the US and the UK, where the slowdown in growth has been particularly marked and where changes in the exchange rate raise competitiveness problems. The US economy experienced a significant slowdown in the final months of 2007 and economic activity remained subdued in the first half of 2008. Over the past year, growth has also slowed noticeably in the UK economy. Economic activity in the euro area has remained stronger, but an easing in the growth rate is expected in the next few quarters before a recovery towards its potential growth rate. The risks to the growth outlook are, however, on the downside in our main trading partners.

More recently, the sharp rise in energy and commodity prices has added to the challenging situation, driving up headline inflation rates globally, prompting concerns about a possible broadening out of these increases into higher inflation generally. In discharge of its primary duty to control inflation, the ECB Governing Council last week decided to raise rates by 25 basis points. Our approach is to take action now to keep inflation expectations in line with the definition of price stability, preserve purchasing power in the medium term and, thereby, support employment and growth across the euro area. It was also made clear, following the increase in rates, that the Governing Council has no bias regarding future monetary policy decisions, which will be determined by the incoming data. In addition, we pointed to the need to avoid behaviour that might exacerbate the difficulties of the situation, for instance, by attempts to compensate ourselves for a change in the relative price of imported commodities.

Financial market developments

I would like to turn now to financial market developments. As you know, over the past year, there has been a generalised disruption in normal money market operations between banks resulting mainly from uncertainty regarding the extent of losses on complex financial instruments linked to sub-prime mortgages in the US. Central banks responded strongly to counteract these adverse conditions in money markets. The ECB, in particular, was in a position to take effective action in the light of the pre-existing arrangements whereby banks had an extensive range of collateral that could be used to access central bank liquidity. These arrangements effectively addressed the problems at the short-end of the money market. However, with questions of transparency and asset valuation remaining, term interest rates continue to be elevated with higher than normal spreads remaining between longer-term rates and official rates. This will only change when confidence is restored among financial market participants. In the medium term, the assessments by ECOFIN and by the Financial Stability Forum have provided roadmaps for strengthening the resilience of the international financial system.

The Irish financial sector is not immune to these global developments. Medium- to long-term funding is not as readily available on wholesale markets and this has increased the need for banks to focus on liquidity management. While the share prices of Irish banks have fallen, it is important to point out that the direct and indirect exposure of Irish banks to US sub-prime mortgages is negligible, and there is no sign of a material increase in loan arrears. Accordingly, the banking sector here has not experienced the write-down of assets that has required some of their international peers to raise additional capital, thus Irish banks are well capitalised with good asset quality. In line with the results of previous exercises, the preliminary results of our latest macroeconomic stress tests on the banking sector, which are designed to test the financial position of banks in the face of a serious economic downturn suggest that the banking sector's shock absorption capacity remains strong. This strength is an essential prerequisite for the more challenging times that have arisen.

Outlook and assessment

The Central Bank continues to believe that the medium-term outlook for the economy is favourable and that growth will return to stronger levels. Growth should pick up next year on the basis of a bottoming out in domestic housing output and some improvement in the external environment. Beyond that, growth in the Irish economy could begin to move towards its long run sustainable potential rate of about 4 per cent. However, this recovery is not guaranteed without concerted action. To ensure a sustainable recovery in growth back towards potential, it is important to focus on some key areas under our own control. These include the public finances, the efficiency and effectiveness of public spending, particularly in relation to increasing the productive capacity of the economy, and overall competitiveness.

The slowdown in economic activity is impacting on the fiscal position. Exchequer data indicate a decline in tax revenue in the first half of 2008, primarily reflecting a slowdown in property related taxes, but also indicative of a sharp slowdown in consumer spending. On the expenditure side, emerging weakness in the labour market is increasing social expenditure. This points to significant deterioration in the fiscal deficit for 2008 relative to earlier projections. I note that the Department of Finance has revised its estimate for the full year General Government Balance to a deficit of about 2¾ per cent of GDP. Our own internal estimates are broadly in line with this assessment.

Given the sensitivity of Irish public finances to economic developments (evident during the 2000 to 2002 period), the slowing of growth coupled with the external risks facing the Irish economy highlight the need to adopt a prudent approach to fiscal policy. Ireland's commitments under the Stability and Growth Pact further stress the need for such an approach. On the basis of current trends, it will be a major challenge to remain within the terms of the Stability and Growth Pact next year. It should be emphasised, however, that the targets set under the Stability and Growth Pact represent a prudent approach to the management of the public finances.

Within these constraints, it will be necessary to carefully manage the allocation of scarce public funds and examine measures to increase the efficiency and effectiveness of government spending, both current and capital. A particular priority within the capital programme should be the maintenance of expenditure on key infrastructural projects, which contribute to the productivity performance of the economy and enhance the potential for the economy to grow in the future.

Policies that promote productivity and competitiveness can help the economy to weather the effects of adverse developments and of lower growth in the global economy. They also serve to increase the medium-term performance of the economy, protect employment and allow for sustainable increases in living standards. For these reasons, boosting productivity growth and promoting flexibility in response to short-term shocks is particularly important. In addition to enhancing the efficiency of public spending and continuing to address the country's infrastructure deficit, a number of other measures can be identified which would promote this goal. These include greater competition in the more sheltered sectors of the economy, continuing to encourage innovation and R&D activity and enhancing the skill level of the labour force.

There is an ongoing challenge to Ireland's competitiveness position arising from the combination of exchange rate appreciation and the sharp rise in energy and other commodity prices. Ireland's competitiveness position had already weakened in recent years because wage and other cost inflation have been higher in Ireland than in our main trading partners. Given a lower domestic impetus to growth, a sustained recovery in export performance is essential and will require a concerted effort to improve competitiveness. While recognising that competitiveness in its broadest sense encompasses a wide range of factors, a realistic approach to wage determination by everyone is nevertheless an essential element in improving competitiveness. I would like to re-emphasise the point that I made earlier that we cannot compensate ourselves for commodity price rises over which we have no control. If we attempt to do so, then we risk repeating the mistakes of the past, from which the economy took so long to recover.

Activities and financial accounts

The Annual Report gives a full and detailed account of the Bank's activities in 2007. I will just refer here to our financial accounts. The Bank's profits for 2007 amounted to €228 million. Surplus income of €193 million will be paid to the Exchequer. In addition, a total of €59 million, in respect of the net proceeds of coin issued, was also paid to the Exchequer.

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