Padraid McGowan, Ireland - experiences in EMU

Presentation by Mr Padraig McGowan, Director General of the Central Bank of Ireland, at the Central Bank of Iceland on 7th December 2000.

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Ladies and Gentlemen, let me begin by thanking you for inviting me to speak here today. It is a great pleasure for me to have this opportunity to discuss the recent performance of the Irish economy as well as some of the challenges for Ireland which participation in Economic and Monetary Union (EMU) presents.

Economic performance since 1994

The performance of the Irish economy in recent years has been excellent, both in historical terms and by international standards. Since 1994, the economy has expanded at an annual average rate of around 8%. Expressed another way, output at the end of 2000 will be around 70% higher in real terms than at the beginning of the current phase of strong growth. To put this into perspective, the annual growth rate of the Irish economy averaged around 3½% between 1960 and 1993.

The buoyant economic conditions of recent years have facilitated a significant improvement in living standards - as measured by GDP per capita - relative to the EU average. In Ireland's case, however, GNP per capita - around 85% of per capita GDP - is a more appropriate measure of domestic living standards, given the large profit repatriations of foreign-owned multinational corporations whose scale of operations in Ireland has expanded significantly in recent years. On this measure, income per capita, although rising, remains somewhat below the EU average. In addition, the stock of wealth in Ireland remains below the EU norm.

This strong growth has paid large dividends in the labour market - traditionally Ireland's Achilles' heel. For many years, Ireland's employment performance had been quite anaemic, with many commentators characterising the economic situation as being one of "jobless growth". Total employment actually fell during the 1980s. Since 1994, however, strong economic growth has been associated with employment increases of around 4¾% per annum. In overall terms, employment is now almost 40% higher than in 1994. This large increase in employment has been facilitated by transfers from unemployment into employment as well as a significant increase in the size of the labour force. The latter reflects the increase in the population of working age, increased participation and net inward migration. This has resulted in the employment rate for the active population increasing by around one-quarter between 1994 and this year.

Unemployment has fallen below 4% and, while precise estimates are difficult to pin down, it is now clear that the economy is operating at or very close to full-employment. For an economy with a long history of unemployment problems, the virtual attainment of full-employment is the most encouraging feature of the recent economic performance. With sustained strong labour demand, the level of long-term unemployment, i.e. unemployed for one year or longer, has fallen dramatically since 1997 to 1.4% at present. Involuntary emigration - for so long a symbol of Ireland's dismal economic performance - has been eliminated and, for a number of years now, Ireland has experienced net inward migration. Since 1994, the population has expanded by around 1% per annum, with net inflows - returning migrants and others - accounting for about two-fifths of this increase.

The transformation of the economy which has led to a higher level of economic activity has also resulted in a reversal of fortunes for the public finances. A surplus has been recorded since 1997 and this year, a general government surplus of 3.7% of GDP is currently expected. The improved fiscal position and the increase in output have resulted in a decline in the ratio of debt to GDP, to around 41.5% this year, one of the lowest ratios in the EU. With the increase in output experienced in recent

years and with nominal interest rates relatively low by international standards, the burden of debt has fallen significantly.

These favourable developments have given rise to a range of issues, some of which are new to us. The rate of inflation has picked up significantly, there are increasing labour market pressures, and a wide range of asset prices have been increasing very substantially for some years. This has been associated with a rapid increase in bank lending and an accompanying increase in private sector indebtedness. In addition, a considerable infrastructural deficit has emerged which has implications not just for economic development but for the quality of life in Ireland. With Ireland's participation in EMU, monetary policy cannot be used to deal with these developments. I will return to these issues later.

Recent Indicators of Economic Performance [a]

	1994	1995	1996	1997	1998	1999	2000 (f) [c]
GNP	6.3	8.2	7.4	9.3	7.8	7.8	8½
GNP per capita	6.0	7.7	6.6	8.3	6.6	6.7	7¼
Employment [b]	3.2	5.0	3.6	3.9	6.8	6.3	4¾
Unemployment [b]	14.7	12.2	11.9	10.3	7.8	5.6	4½
Inflation (CPI)	2.4	2.5	1.6	1.5	2.4	1.6	5½
Exports/GNP	78.8	86.3	87.6	90.7	98.9	102.4	107.0
General Gov. Balance	- 2.0	- 2.2	- 0.2	0.7	2.1	1.9	3.7
Revenue/GDP	40.1	37.4	37.8	36.9	36.0	36.2	35.2
Expenditure/GDP	42.1	39.7	38.0	36.2	33.9	34.3	31.5

(a) Growth rates, except unemployment (rate) and Government balance (percentage of GDP).

(b) As at April of each year, except for 1999 and 2000 which are full year averages of quarterly data.

(c) Central Bank of Ireland forecasts (Autumn 2000).

Experience in the EU

Changing structure of the economy

For about two decades up to the late 1970s, the Irish economy had performed relatively well, following the adoption of more outward-oriented policies from the late 1950s. This necessitated a restructuring of the economy and the inevitable demise of some firms and sectors which had developed behind sometimes quite high tariff barriers. Membership of the then European Economic Community in 1973 was a major milestone on this road. However, given the point from which Ireland was starting in 1973, it was evident that the advent of free trade resulting from membership would bring major changes to the trading relations and structure of the Irish economy. Prior to membership, Ireland had a relatively large agricultural sector, which was highly dependent on the adjacent UK market. Industry was predominantly small-scale, and was still in the process of adjusting to the lowering of tariff barriers to improve competition and to the adoption of a more export-oriented perspective. In this environment, productivity and living standards were relatively low.

GDP by Sector: Percentage Distribution

	1970	1980	1990	1999
Agriculture	17	12	9	4
Industry	36	37	35	38
Services	47	51	56	58

Source: National Income and Expenditure (various issues), Central Statistics Office.

Transformation of Manufacturing Sector: Per Cent of Total

	1983		1990		1998	
	Irish	Foreign	Irish	Foreign	Irish	Foreign
Output	41	59	32	68	18	82
Employment	61	39	55	45	53	47

Source: Census of Industrial Production, various issues.

The structure of the manufacturing sector has been radically altered in the thirty-odd years since EU entry. The traditional sectors - typically relatively low skilled relying on local inputs - have declined in relative importance, and have been replaced by high-technology, largely foreign-owned firms in sectors such as computer hardware, chemicals, software and medical instruments. Currently, these modern sub-sectors account for almost three-quarters of output and around one-third of employment in the manufacturing sector. The structural changes in the economy have also been associated with substantial change in the destination of exports, mainly from the UK to the rest of the EU.

Destination of Total Exports: Percentage Distribution

	1970	1980	1990	1999
UK	66	43	34	22
Other EU [a]	9	32	41	43
Elsewhere (Including USA)	25	25	25	35

(a) Countries comprising EEC/EC/EU in the relevant years.

Source: Central Statistics Office.

Foreign direct investment

There are a number of factors that lie behind this transformation of industry. First, the regulatory environment for setting up and running businesses in Ireland has been relatively light. Secondly, an emphasis was placed on the rapid modernisation of the telecommunications infrastructure. Finally, and most importantly, has been the successful industrial policy of encouraging inward foreign direct investment. A wide range of measures have been used to attract foreign firms to Ireland. These include a low corporate tax environment, the development of the educational and technical skills of the workforce, a relatively low cost environment and the opportunity to use Ireland as a gateway to the vast EU market.

Traditionally, foreign direct investment (FDI) in Ireland has typically taken the form of "greenfield" investment as well as expansions of existing plants. This has had a greater direct impact on output and employment than would have been the case if it had taken the form of mergers and acquisitions. In addition, foreign direct investment has helped to transfer technology, skills and modern management methods in a relatively easy way to the Irish economy. The high-technology sectors have imparted a

new dynamism to business, and have led to a large number of start-ups by former employees of these foreign-owned enterprises - the software industry being perhaps the best example. It should also be stated that, although there has been a sizeable shake-up of domestically-owned industry in the new free-trade environment, much of domestically-owned industry has been radically modernised and put on a sound, efficient footing.

US Direct Investment Abroad: Irish Percentage Share of EU Total

	1994	1995	1996	1997	1998
Manufacturing	8.4	2.9	10.9	15.0	7.0
of which:					
Chemicals	6.9	2.4	13.0	17.3	15.4
Electrical & Electronics	7.6	5.4	18.0	33.2	39.2

Source: US Department of Commerce.

A significant proportion of FDI inflows into Ireland originates in the United States: in 1998, 41% of all foreign-owned manufacturing firms in Ireland were from the US. Between 1994 and 1998, annual inflows of manufacturing FDI from the US amounted to around 1½% of Irish GDP. Indeed, Ireland receives a large share of all US FDI. For example, in 1998, Ireland received 7% of all US manufacturing inflows into the EU, a not insignificant proportion for a country with around 1% of the EU GDP.

The success which various foreign multinationals have enjoyed has encouraged others to establish manufacturing bases in Ireland. As a result, agglomeration economies have developed over time: success has bred success. In more recent years, the manufacturing economy has benefited from what is known as “distance independence” - transports costs as a percentage of output value have fallen substantially for high-technology outputs such as software and chemicals. This has significantly reduced Ireland’s peripheral location disadvantage.

A number of implications arise from this policy of targeting high-technology FDI. Firstly, a sharp dichotomy has emerged within the industrial sector between the relatively low value-added traditional sector which produces largely for the domestic and UK markets, and the more dynamic higher value-added technology sector, which produces primarily for the rest of the EU and US markets. This dichotomy is most apparent in the productivity data, with the high-technology sector being an estimated five times more productive than the traditional sector. Secondly, in Ireland, the relative importance of the industrial sector has been rising in recent years, albeit at a moderate rate. This situation contrasts strongly with the experience of other advanced economies, where the industrial sector has been in relative decline for some time.

EU financial support

I should also mention that the various financial support mechanisms of the European Union - the Structural Funds and the Cohesion Funds - have been of assistance in adapting to the new economic structures and in financing infrastructural development. These supports have averaged around 2¼% of GDP since 1989, and have been in relative decline during the past six to seven years of strong economic growth. Indeed, it has been argued that the impact of the structural fund process on the administrative and political system has been at least as important as the investment itself. In particular, transfers under the Community Support Framework encouraged the government to raise public investment from its extremely low level in the 1980s. Finally, transfers to the agricultural sector under the Common Agricultural Policy, which have averaged 3½% of GDP since 1989, have provided protection to the farming sector from global trends.

Experience in the EU single market

The full implication of the EU single market by the end of 1992 was regarded with some trepidation, it has to be acknowledged, by a number of commentators on the Irish economy, when this EU initiative was taken in the mid-1980s. This centered around a concern that the core countries of the EU would reap most of the benefits of the new single market, with the countries on the periphery running the risk of becoming economic backwaters. These fears focused on the possibility that positive externalities and increasing returns to scale were most likely to be available to the developed, industrial core of the EU. Industries that are characterised by increasing returns to scale - motor vehicles, heavy chemicals, man-made fibres etc. - were deeply embedded in the economies of the countries at the centre of the EU, but were of little significance in most of the peripheral countries such as Ireland. In this view, the developed regions of the EU would therefore benefit from first mover advantage.

The counter-argument pointed to the benefits that could accrue to small countries from the much larger market. Even if, for historical reasons, small countries did not have many sectors characterised by increasing returns to scale, the opportunity existed for these to operate at an efficient scale in the new large single EU market. The removal of barriers to trade and lower transport costs also reduced the necessity for industry to be located close to the largest markets. Thirdly, less developed regions in the EU were normally characterised by lower costs, and this, *ceteris paribus*, placed them at an advantage in the development of new sectors and enterprises. Finally, it was evident that the location of new knowledge–based industries characterised by innovation and technology was much less tied to comparative advantage based on natural endowments. Comparative advantage in these sectors was something that could be created and acquired in the right institutional and policy environment. In the event, the worst fears of the pessimists in the argument of the periphery vis-à-vis the centre have not been realised, with the experience of peripheral regions in the single EU market, including Ireland, being generally satisfactory.

Ireland and the single monetary policy

Ireland adopted the euro at its inception in January 1999 and became part of a large monetary union. This was not something fundamentally new in Ireland, however, as until 1979 Ireland had participated in a currency area with sterling for over one hundred and fifty years previously; the Irish currency and sterling were amalgamated at parity in 1826. With the introduction of the Irish pound in the late 1920s, there was a no-margins one-for-one link between the Irish pound and sterling which prevailed until 1979. Coupled with complete freedom of capital mobility, this resulted in virtually the same levels of interest rates in Ireland and the UK. Given the high degree of trade integration as well as capital and labour mobility which existed during this period, it could be argued that this exchange rate regime was an entirely natural phenomenon; in this regard, Ireland and the UK could have been regarded as an optimum currency area.

In the mid-1970s, the link with sterling began to be questioned following persistent high inflation rates in the UK coupled with a significant depreciation of sterling which inevitably resulted in broadly similar rates of inflation in Ireland. The establishment of the European Monetary System (EMS) - with its primary objective of being a “zone of monetary stability” - provided an alternative to the sterling link. Ireland joined the EMS at its inception in 1979, and the link with sterling ended shortly afterwards as sterling rose against EMS currencies.

The experience in the EMS has not always been positive, particularly in the early years, with a sizeable appreciation of sterling and the pursuit of pro-cyclical fiscal policies which undermined stability. In August 1986, the Irish pound was devalued by 8%, in part to reverse an unwarranted appreciation of the Irish pound’s effective exchange rate that had occurred mainly due to a sharp weakening of sterling. For over a decade thereafter, the nominal effective exchange rate for the Irish pound was generally stable, apart from the 10% devaluation in January 1993. This devaluation, in the context of the European currency crisis of 1992/1993, was again partly correcting an unwarranted appreciation in the Autumn of 1992. This was an example of where Ireland was affected by contagion in the international foreign exchange markets.

From 1994, the Irish economy began to grow strongly. During this period, economic policy was primarily driven by the need to meet the criteria for EMU membership. Policies of fiscal prudence were continued while exchange rate policy was consistent with price stability. In the two years prior to membership of the euro area the Irish pound was relatively strong. This was consolidated by a 3% revaluation of the Irish pound in the EMS in March 1998.

Benefits of EMU

In a small open economy with a high degree of trade integration into the EU and world economies, it is logical for Ireland to be amongst the keenest supporters of EMU. A small economy such as Ireland, which exports a significant part of its output to other participating countries, should stand to derive significant benefit. Secondly, the prospect of monetary stability will have a long-term beneficial impact on investment and growth. Over time, in accordance with the price stability mandate of the ECB, inflation is unlikely to exceed 2% per annum for any sustained period of time. As a result, nominal interest rates should not, in general, carry a significant inflation risk premium. In addition, EMU imposes a discipline on participating countries, in the sense that sound fiscal policies and enhanced structural reform assume greater importance in a monetary union. Finally, some positive effects resulting from the single currency will become evident in capital and financial markets. Over time, for example, the development of deep and liquid capital markets will improve the potential for companies to raise finance. This will enhance the growth prospects of younger firms, in particular; these are typically innovating firms which bring new technologies to the market. In addition, the increased efficiency and competitiveness of financial markets in the euro area will facilitate an increase in corporate restructuring through mergers and acquisitions activity. On the latter point, there is evidence that this process is already underway.

Implications for policy of joining the euro area

From an Irish macroeconomic perspective, however, the initial impact of the adoption of the single currency on 1 January 1999 was a significant easing of monetary conditions. While the decline in nominal interest rates had for the most part been discounted, subsequent developments in relation to real interest rates - in the light of Ireland’s higher inflation rate - have led to a further easing of monetary conditions. This has been compounded by the decline in the external value of the euro. This easing of monetary conditions has occurred at a time when the Irish economy is performing very well compared to the central euro area countries, with strong domestic demand in particular giving rise to significant risks of overheating in the economy. With monetary policy now geared towards the objective of price stability for the euro area as a whole, it cannot be deployed to meet region-specific requirements. The corollary of this is that, in order to cope with regional or country-specific difficulties, policies other than the single monetary policy must be employed more vigorously.

Fiscal policy

In particular, fiscal policy must assume a greater role in restoring macroeconomic balance. Within EMU, fiscal policy must be conducted within the framework of the Stability and Growth Pact, which requires the national authorities to ensure that their budget balances are “close to balance or in surplus” over the medium-term. The reason for this is to limit negative externalities resulting from lax fiscal policy by individual countries within the single currency.

For Ireland, it is arguably the case that fiscal policy is now more effective than in the past. With both interest and exchange rates now given, the effects of fiscal policy are no longer likely to “crowd out” or “crowd in” private sector consumption and investment. In these circumstances, fiscal policy is a relevant policy instrument for Ireland. Despite this, the impact of fiscal policy is subject to a number of limiting criteria. Firstly, given the high degree of openness of the Irish economy, it is inevitable that at least part of the impact of fiscal policy will be reflected in external trade developments rather than in domestic activity. Secondly, given the large exchequer surpluses which have been recorded for some time now, expectations may impose some constraint on a tighter fiscal policy stance. Finally,

given the consensus-based approach to macroeconomic determination, the stance of fiscal policy is, at least to some extent, somewhat pre-empted in Ireland by commitments made under national wage agreements.

Incomes determination

The evolution of pay in Ireland has been conducted within a partnership framework, encompassing government, employers and unions since 1987, with the first agreement applying from the beginning of 1988. The current agreement - *Programme for Prosperity and Fairness* - is the fifth such agreement. The pay terms typically involve a three-year process in which unions accept moderate nominal wage increases in return for income tax reductions. Indeed, these reductions in income taxes have delivered a not insignificant part of the increase in take-home pay.

National agreements were undoubtedly an important feature in restoring confidence and competitiveness in the late 1980s and early 1990s. The moderate evolution of nominal pay created a virtuous cycle in which the economy's competitiveness improved and total employment rose. As I outlined earlier, the public finances were put on a more stable footing while, over time, the income tax burden was reduced significantly. In 1988, the standard and higher rates of income tax were 35 and 58% respectively; for the tax year which began in April 2000, the corresponding rates are 22 and 44%, and the income level at which the higher rate in particular is applied has been increased significantly. More recently, the usefulness of national wage agreements in an environment of virtually full employment has been questioned. The fact that, at present, the wage agreements apply formally to only around one-third of workers, many of whom are in the public sector, is encouraging this questioning.

However, for a small open economy where competitiveness is extremely important, one should be wary about dismissing the partnership process. In particular, given the recent acceleration in headline inflation, the partnership approach may have an important role to play in preventing inflationary expectations becoming entrenched in the decision making process and the emergence of a wage-price spiral. Such an adverse eventuality could set the conditions for a serious loss of competitiveness in the future, particularly if exacerbated by a significant strengthening of the euro.

Structural reform and competition policy

Structural reform is another tool available to policymakers in EMU, although, by definition, the benefits of any reforms will be limited in the short-term. Nevertheless, policies aimed at improving the functioning of both product and factor markets can enhance the business environment and increase the flexibility of markets in the medium-term. Such reforms play an important role in meeting the economic objectives of higher growth and employment without creating inflationary pressures, and as a result, in delivering higher living standards.

Some reform of markets has been undertaken in recent years. The labour market is one area where flexibility has been improved. For example, income tax reforms have enhanced incentives in recent years, while labour market legislation in Ireland is somewhat lighter than elsewhere in the EU. In product markets, the process of liberalisation has been speeded up. In particular, markets which have traditionally been under direct control of government have undergone significant reform: the telecommunications sector, for example, has been fully liberalised and this is already having a favourable impact on prices. Elsewhere, however, the pace of reform has been slower, with barriers to entry, in particular, remaining a feature of a number of markets.

Prudential standards in the financial sector

The fourth strand in the range of policies that can be employed in EMU relates to the maintenance of a sound financial sector. In Ireland, the Central Bank is responsible for supervision of almost the entire financial sector, apart from insurance companies. In particular, credit institutions are required to conform to a wide range of standards that have been agreed at BIS and EU Commission levels. What is of importance for us at present is that credit institutions are constrained from over-extending their

lending to individual, or a group of related, economic sectors. This limits the risk, for example, of an undue concentration of lending to the broad property sector, which has frequently been subject to booms and busts in many countries, with consequential problems for the solvency of the financial sector.

The Central Bank has been active in alerting banks to the risks posed by rapid overall and property-related lending. As part of this process, banks have been required to conduct regular stress tests to assess how fitted they are to cope with various types of shocks including a catastrophic fall in property prices. The results of tests so far suggest a high degree of resilience to such adverse developments.

Earlier this year, Ireland participated in the World Bank - IMF Financial Sector Assessment Program (FSAP). This entailed an assessment of financial sector vulnerabilities and of the observance and implementation of supervisory standards and best practices. The FSAP found that Ireland had a sound and highly developed financial system that has been very stable even during periods of international turmoil. Banking sector capitalisation and asset quality are high, and profitability levels are higher than for most European competitors. The assessment also found that the overall framework of prudential regulation and supervision in the Central Bank is well developed, and shows a high degree of observation of international standards and codes. The review noted that current developments - financial sector innovation, increased competition, increased cross-border activities associated with Dublin's International Financial Services Centre and sustained rapid credit growth - pose a considerable challenge to market participants and supervisors to maintain Ireland's record of financial stability.

In summary, Ireland is now participating in a single currency where monetary conditions are set in terms of requirements for the euro area as a whole. Individual countries must operate within this context. This may not always be appropriate to their specific needs. As outlined above, policy-makers have a number of instruments available to tackle macroeconomic imbalances and to respond more efficiently to regional-specific shocks that will inevitably occur from time-to-time. The effective use of these tools should minimise the impact on the economy of the loss of monetary and exchange rate policy.

Current problems and issues

As I mentioned earlier, the greatest challenge within EMU is to steer the economy onto a more sustainable growth path after having experienced very strong growth over the last seven years. This will be no easy task given that imbalances have already begun to manifest themselves.

Inflation

Perhaps the most visible example of current problems is the acceleration in headline inflation which has occurred over the last twelve months or so. The Harmonised Index of Consumer Prices (HICP) has accelerated from its most recent low-point of 1.8% in mid-1999 to the current rate of 6.0%. While some of this increase reflects temporary factors such as indirect tax changes, general inflationary pressures have been evident for some time. The headline rate in Ireland is around 3¼ percentage points higher than the comparable rate for the euro area as a whole. It is estimated that, in the context of the decline of the euro in the foreign exchange markets, the greater exposure of the Irish economy to non-euro currencies accounts for around ½ of a percentage point of this difference. In addition, approximately 1 percentage point can be explained by higher productivity growth in the traded sector relative to the non-traded sector. This results in higher wages in the non-traded sector, which when combined with lower productivity growth in this sector, leads to upward pressure on prices. Taking account of these factors implies that the remaining inflation differential vis-à-vis the euro area is about 1¾ percentage points. About ¾ percentage points of this is due to Irish indirect tax increases, with the remainder largely attributable to the strength of domestic demand in Ireland.

Decomposition of Irish Inflation vis-à-vis the Euro Area

HICP - Ireland	6
HICP - euro area	2¾
Inflation Differential	3¼
of which:	
Price Level Convergence	1
Larger Effective Exchange Rate Effect	½
Indirect Tax Effect	¾
Excess Domestic Inflation	1

Wage expectations

The labour market is an area where imbalances have been evident for some time. The virtual attainment of full employment, with the resulting transfer of bargaining power from employer to employee, has put upward pressure on wages in all sectors. While rising wage levels may ultimately be one of the mechanisms which will slow the economy, there is a risk that wage developments are being driven by expectations based on the exceptional growth of the recent past. In this context, wage settlements must recognise the inevitability of a reduction in growth to a more sustainable rate, as well as the openness of the economy which increases its exposure to external developments. At present, firms in Ireland, particularly those in the indigenous sector, are benefiting from the decline in the value of the euro against sterling. In this environment, wage increases which were compounded by any significant appreciation of the euro could impose serious competitiveness difficulties on these firms.

Infrastructure

The strains on the economy's infrastructure - most notably transportation and housing - have been evident for some time. In more developed countries, economic development was, generally speaking, a more gradual process. This facilitated improvements in the physical infrastructure to be undertaken *in tandem* with economic growth. In Ireland, infrastructural developments have been unable to match the intensity of economic growth which has occurred over a relatively short period of time, so that bottlenecks have emerged. In an effort to reduce the infrastructural deficit, the Government has initiated a programme of significantly increased expenditure as part of the National Development Plan. However, since the construction sector is already operating at full capacity, it will be some time before the benefits of this are visible.

Diversification/exposure to sector shocks

By definition, it is difficult for small open economies to ensure a high degree of diversification. As a result, a shock affecting one sector can have implications for the economy as a whole. In Ireland's case, it is useful to focus on the two very distinct broad sectors in the economy. The first comprises the indigenous manufacturing sector as well as parts of the agricultural sector. These sectors remain quite dependent on the UK market and are exposed to euro/sterling exchange rate developments. Particularly severe trading conditions could arise if an acceleration of wages in this sector was compounded by a sudden, significant rise in the euro against sterling. Secondly, parts of the high-technology sector remain particularly exposed to developments in the world economy and the US in particular. An insight into this exposure is obtained from the fact that, in 1999, ten foreign-owned enterprises accounted for over one-third of total exports of goods and services.

Asset price increases

In the housing market, the rate of increase of prices accelerated sharply in 1996, and with very high annual growth rates being recorded since then, house prices have more than doubled. A number of factors have contributed to this. The demand for housing has risen substantially. This reflects fundamental factors such as the rise in the population in the household formation age group, significantly higher employment and rising disposable income levels. In addition, the expectation - and now the reality - of lower interest rates resulting from EMU participation have contributed to the sharp increase in prices. On the other hand, the response of supply until recently was quite sluggish. Over the last year or so, however, there has been a significant increase in output, so that some moderation in the rate of house price inflation is expected.

Property Prices: Annual Percentage Increases

	Residential [a]	Commercial [b]	Rents [c]
1994	4.1	7.6	2.3
1995	7.2	4.2	1.8
1996	11.8	11.1	8.2
1997	17.2	17.0	10.6
1998	22.6	32.1	14.6
1999	18.5	23.8	16.1
2000 [d]	13.9	21.6	16.2

(a) Department of Environment and Local Government, National New House Prices.

(b) Jones Lang LaSalle, Capital Values.

(c) Jones Lang LaSalle, Rental Value for Irish Commercial Property.

(d) Jan.-Sept. 2000, year-on-year.

Commercial property prices have followed broadly similar trends to residential property prices with the rate of increase accelerating from 1996 onwards. Since then, prices have risen by 113%. The rate of increase in rents in the commercial property sector also accelerated in 1996, and while still strong, the cumulative rate of increase has been somewhat lower than for commercial property prices. These increases reflect very low vacancy rates, low nominal interest rates and a high level of business confidence.

Associated with this acceleration in residential and commercial property prices, and perhaps to some extent driving it, has been a large rise in bank lending. Personal sector credit, which is dominated by residential mortgage lending, has risen strongly in recent years, although at a slower rate than total private-sector credit. The share of non-housing personal sector credit in total lending has remained relatively stable in recent years and was lower at end-1999 than end-1994. Lending to real estate and construction activities rose from some 6% of total lending at end-1994 to over 8% at end-1999.

Bank Lending: Annual Percentage Increases to Selected Sectors

	Total Private-Sector Credit [a]	Personal [b,c]	Building and Construction [b,d]	Financial [b,g]	Other [b,h]
1994	11.8	10.5	16.1	15.2	4.0
1995	11.2	13.1	12.1	2.1	7.2
1996	15.4	15.9	26.3	12.3	17.1
1997	23.6	21.0	19.8	47.9	13.5
1998	23.6	19.3	58.1	35.7	21.4
1999	31.6	26.0	50.2	86.9	22.9
2000 [i]	24.2	17.8	58.4	39.3	25.6

(a) Adjusted for lending to non-bank IFSC entities and for valuation effects resulting from exchange rate changes. The 1999 figure could not be adjusted for valuation effects because of the introduction of the euro in that year. The 1999 figure is also boosted, for technical reasons, by the impact of the merger between *Irish Life* and *Irish Permanent.*

(b) Year-on-year growth rate in November for the years 1994 to 1998; for 1999, the figure is November 1998 to December 1999.

(c) Understated to some extent by the increasing prevalence of securitisations of residential mortgages.

(d) Break in the series in 1997. Lending to building and construction includes lending to property companies but does not include lending under the heading hotels and restaurants.

(g) Excluding IFSC.

(h) Total lending from sectoral return less lending to the personal, building and construction and financial sectors.

(i) Based on year to end-October. For Personal, Building and Construction, Financial and Other, Sept. 2000 vs. Aug. 1999.

Total indebtedness to resident credit institutions rose from 71% of GNP to just over 100% between 1994 and 1999. Personal sector indebtedness, as a proportion of GNP, rose from 33% to 44% over this period, and to a greater extent in relation to personal disposable income. The indebtedness of the property sector, as a proportion of GNP, doubled between 1994 and 1999. Overall levels of indebtedness, having risen from a relatively low level, are not currently particularly high by international standards. However, continued growth at the current pace would, at some point, raise concerns about financial stability. In addition, higher levels of indebtedness increase vulnerability in the event of an economic downturn.

Indebtedness to Banks: Percentage of GNP [a]

	Total [b]	Personal [c,g]	Building and Construction [d,g]	Financial [g,h]	Other [g]
1994	71	33	5	8	24
1995	70	34	5	7	23
1996	73	35	5	7	24
1997	79	37	6	9	24
1998	85	39	8	11	25
1999	101	44	10	18	28

(a) Outstanding credit by resident banks to various sectors.

(b) Excluding lending to non-bank IFSC entities. End-December data for credit.

(c) Includes residential mortgages.

(d) See footnote “d” in previous table.

(g) End-November credit data for 1994 - 1998. End-December for 1999.

(h) Excluding IFSC lending.

Investment

Against the background of strong economic growth, investment has increased sharply, rising at an annual average rate of around 14% between 1994 and 2000. As a result, the investment share has risen from around 18% to 28% of GNP over this period. Within this sector, building and construction has expanded very strongly over the period, rising from about 10% of GNP in 1994 to 18% this year. Tighter monetary conditions in the euro area and a restoration of more sustainable growth rates would inevitably reduce the returns on investment. This could raise questions about the viability of some of this investment.

Investment: Percentage of GNP

	Total	Building and Construction	Machinery and Equipment
1994	18.4	10.5	7.9
1995	19.3	11.0	8.3
1996	21.0	12.5	8.5
1997	22.9	14.1	8.8
1998	25.0	15.3	9.7
1999	27.4	17.0	10.4
2000 (f)	28.5	18.0	10.5

Source: National Income and Expenditure Central Statistics Office, and Central Bank forecasts.

These developments that I have outlined in relation to property prices, bank credit and investment inevitably raise concerns about the soundness of the financial sector. The Bank, as the supervisory authority, has impressed on credit institutions the need to continue to maintain prudent standards in lending. In relation to mortgage finance, lenders have been requested to adhere to prudent norms in regard to loan-to-value ratios of houses and conventionally accepted income multiple norms. As I mentioned earlier, institutions have also been required to undertake sensitivity analyses in relation to adverse events such as an economic downturn or a sizeable interest rate increase. Institutions are constrained by sectoral limits in regard to lending to specific sectors - this is a significant constraint on undue exposure to individual sectors. Institutions must also apply prudent loan loss provisioning policies. In this regard, the Bank is exploring ways in which counter-cyclical provision policies should be actively pursued by credit institutions.

Conclusion

Ireland’s economic performance has been exceptionally strong over the period since 1994 following the uncertainty and turbulence associated with the EMS exchange rate crisis of late 1992/early 1993. Over this period, the growth in Ireland’s Gross National Product has averaged about 8%. Decomposing this growth into its components in a growth accounting exercise indicates that about 4½ percentage points of this growth is due to increased inputs of labour and capital, with all other influences accounting for about 3½% of GNP growth. Some part of these other influences that increase growth may be due to “new economy” effects associated with structural changes in the economy and the contribution of foreign direct investment, mainly from the US. However, the greater part of the overall strong growth performance is due to the substantive increase in inputs of capital and labour in economic activity. This is borne out by the large increase in the employment rate of the active population, which has risen by around one-quarter since 1994. These facts would suggest that our strong economic performance has been as much, if not more, a transitional catch-up phenomenon rather than a cyclical one.

Nonetheless, with the economy now operating at close to capacity following this protracted transition, economic policy now faces some new issues. As I have outlined, the risks now relate to overheating in product, labour and asset markets in a relatively easy monetary environment and being able to cope with country-specific shocks that may arise. In regard to possible overheating, the principal task now is to decelerate demand growth to a rate that is more in line with the medium-term growth potential of the economy. This is currently estimated to be about 4½ to 5% and somewhat less than this further out. Monetary policy in EMU is now set by reference to euro area economic conditions and cannot be geared to deal with problems peculiar to particular regions or countries. The principal policy instruments available to dampen inflationary pressures peculiar to Ireland are fiscal policy, which should be set on a prudent, moderately restrictive path, and incomes policy. At the present conjuncture, it is desirable that incomes evolve in a manner that does not set off a wage-price spiral in response to the current, essentially temporary, upturn in inflation. In addition to these policies, a continuing policy of structural reform and the promotion of competition will help to mitigate idiosyncratic shocks that may arise in monetary union. Finally, in its role as supervisor of the financial sector, the Central Bank will continue to ensure that banks pursue prudent lending policies that do not jeopardise financial stability.

While there are risks of excesses arising in the current environment, it should be emphasised that these vulnerabilities are not critical. As well as the four policy instruments that are available for limiting these risks, two critical features that could enhance these risks are now absent from the Irish case. Firstly, Ireland has quite limited exposure by way of short-term external liabilities - much of the inflows in recent years have taken the form of long-term direct investment. Secondly, by the same token, the absence of a specifically Irish exchange rate also removes a vulnerability that has been evident in other countries where excesses have threatened to emerge. In summary, after a period of very strong economic growth, the authorities in Ireland are now faced with effecting a deceleration of demand to the feasible growth rate in the context of monetary union where monetary conditions in the round are relatively easy. This presents a challenge to us where we must rely on the remaining domestic policy instruments to effect the transition from exceptionally high growth to moderate growth in as smooth a manner as possible.