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 2002, Dublin, 23 June 2003.

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The international context for the Irish economy has been difficult for some time. The expected pick-up in economic growth internationally has failed to materialise, primarily due to a series of adverse shocks. Growth in the US, though weak, is still better than that of the euro area where economic performance has been disappointing. It would now appear that the euro area recovery will not begin to gather pace until early 2004. Against this background, it is not surprising that economic growth in Ireland has decelerated sharply over the past few years. Real GNP growth last year was only 0.6 per cent. Our forecast at this point for the Irish economy this year is for GNP growth of about 1½ percent (GDP 2¾ per cent). This represents a small downward revision of the GNP forecast of 1¾ per cent (GDP 3¾ per cent) in the Spring Bulletin; the revision reflects the postponement of a global recovery. Our GNP forecast is an improvement on last year, but it is still well below potential growth.

On balance, the economy has been performing as well as can be expected in this difficult global environment and after a period of domestic overheating. While growth was modest last year, nonetheless, the economy has retained the substantial gains in living standards and employment achieved since 1994. Between 1994 and 2001, GNP and employment growth averaged 8 per cent and 5 per cent a year, respectively. To date, the Irish economy has proved to be fairly resilient in the face of the weaker international economy. There is now a greater degree of flexibility in the economy than in previous years and this is essential in a less benign economic environment.

Even though the economy has, to date, performed relatively well, there are a number of significant risks to the resumption of trend growth. Apart from the weak international economy, there are issues of deteriorating competitiveness driven by domestic inflation and a rapidly appreciating euro; since the start of 2002 the euro has appreciated by 32 per cent and 14 per cent against the US dollar and sterling, respectively. The threats to competitiveness have become more stark, with the Irish price level currently estimated to be some 12 per cent higher than that of the euro area as a whole. Although our inflation rate by year-end may be less than 3 per cent, it is still likely to be twice that of the euro area. This underlines the need to continue to focus domestic policies on promoting competitiveness.

So far as fiscal policy is concerned, the commitment to limit the increase in public spending to 7 per cent and to hold the General Government deficit to 0.7 per cent of GDP is to be welcomed. Adherence to this target should help to restrain inflation and help competitiveness.

In the pay area, the increase in private sector pay this year, on foot of the new social partnership agreement, will be of the order of 3½ per cent, assuming no upward drift. This is close to that in the euro area generally. However, public sector pay increases will be significantly higher than 3½ per cent. This underlines the imperative of delivering productivity improvements that are linked to benchmarking increases in the period ahead. Continuing efforts are required to improve productivity performance generally, particularly in the sheltered sectors of the economy and in the indigenous traded sectors. This is especially important in the light of the rapid strengthening of the euro in the recent past and the risk that it could further appreciate.

The Bank has repeatedly expressed its concern about the excessively high level of mortgage credit growth. There has been very little improvement in this, with the increase still running at 24 per cent. The Bank has written to the credit institutions on this matter and it has followed this up by on-site inspections. The results of these are being processed at the present time.

The Bank has also been concerned about the pick up in house prices in 2002 which continued into the early months of 2003. The property market now appears to have slowed somewhat. It appears that this easing has been underpinned by the fact that the market is now closer to balance than previously. However, we do not consider that a sharp downward correction is likely unless there were some external shock that would cause a hard landing of the economy

Financial Stability

As was the case last year, this year's Annual Report contains an extensive Chapter on Financial Stability. The key conclusion is that the Irish financial system continues to be stable. It is sufficiently well capitalised, diversified and healthy to weather an adverse shock. However, the deterioration of the performance of the global economy - especially the delayed recovery - and uncertainty in financial markets since the last Financial Stability Report has eroded its resilience somewhat over the last year.

Monetary Policy

The decision of the ECB Governing Council at its meeting on 5 June to reduce its key interest rates by 0.5 percentage points to 2 per cent was made in the context of a more benign outlook for inflation and of subdued economic growth in the euro area. This brings the total reduction to 1.25 percentage points since last December.

As you are aware, following its review of monetary policy strategy at its meeting of 8 May, the Governing Council clarified its definition of price stability. Price stability is now defined as year-on-year price increases of close to, but below, 2 per cent over the medium term. The Governing Council also confirmed that its monetary policy decisions would continue to be based on a comprehensive analysis of the risks to price stability under both pillars of the monetary policy strategy: the general economic assessment and the monetary dimension.

Supervision

The Government's decision to establish the Irish Financial Services Regulatory Authority was passed into law on 1 May 2003. We have worked closely throughout the implementation phase with the Chairman, Brian Patterson, and the Interim Board to ensure a smooth transition to the new arrangement.

The principal task of the new Financial Regulator is the regulation of all financial institutions in Ireland. In line with the legislation there is an enhanced focus on consumer protection.

The Financial Regulator is independent. There is, however, a functional relationship between the prudential area of the Financial Regulator and the Central Bank with regard to overall financial stability. The Annual Report gives a comprehensive account of supervisory practices and policy developments during 2002. In future, the Financial Regulator will publish a separate Annual Report.

Financial Results

The Bank's profits for 2002 amounted to €829 million, an increase of €266 million over 2001. Of this increase, €240 million arose from the write-off of unredeemed Irish pound banknotes. Bank profits since 2000 have been exceptionally high primarily due to net exchange rate gains; these amounted to €311 million in 2002.

We had a successful year managing the Bank's large investment portfolio of €8.4 billion. This yielded a rate of return of 5.47 per cent, a little more than that on the benchmark portfolio. This rate of return does not include exchange rate gains.

Miscellaneous

I should also say that, at my invitation, Dr. T.K. Whitaker was kind enough to contribute to the Report some personal reflections. The Report also contains a Chronology of Developments pertinent to the Bank over the past decade.