

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 2003, Dublin, 12 July 2004.

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I would like to welcome you all to the publication of the Bank's Annual Report for 2003.

As you know, 2003 was a very significant year for us. We have been through a major restructuring process, which has seen the establishment of a new financial regulatory system. The Irish Financial Services Regulatory Authority is now responsible for consumer protection and prudential supervision while the Central Bank deals with all matters relating to Financial Stability. I am happy to report that these new arrangements, which are in place for over a year now, are working very well.

This restructuring has allowed us to take stock. As a result, we are also today publishing a three-year Strategic Plan for the Central Bank and Financial Services Authority of Ireland. A further important development will be the publication of a stand-alone Financial Stability Report in mid-September. Up to now, this was included in the Bank's Annual Report.

I would also draw your attention to the reproduction in this Report of the first lecture in the Whitaker lecture series. This series has been established in honour of the former Governor, Dr. T. K. Whitaker, and is intended to contribute to general economic debate in Ireland. The inaugural lecture was given by the President of the European Central Bank, Jean Claude Trichet. The Report also includes an article on Foreign Direct Investment in Ireland, a vital component of our recent economic success. The study highlights the principal reasons for our success in this area: a stable macroeconomic background, a favourable business environment in its many aspects and a strong emphasis on education and skills. Looking to the future, we need to ensure that we have the appropriate policies in place to continue to be an attractive location for Foreign Direct Investment.

Economic developments

Turning now to the economic situation: in the context of a weak, if improving, international environment, the Irish economy performed well, relative to other countries, in 2003. The latest official data put GNP growth at 2.8 per cent (GDP, 3.7 per cent). There was significant employment growth last year, which contributed to keeping unemployment at a low level - currently 4.4 per cent.

For 2004, Ireland's growth prospects appear generally good - particularly as the US and East Asia economies improve. However, considerable uncertainties remain. Global imbalances continue to pose a risk of a sharp adjustment of exchange rates with implications, in particular, for the US dollar/euro exchange rate. A second significant uncertainty surrounds oil prices, which continue to be subject to the influence of geo-political tensions in the Middle East. While recognising the implications of these risks for our economy, we have revised our forecasts for GNP up to 4 $\frac{1}{4}$ per cent (GDP growth, 4 $\frac{3}{4}$ per cent) this year. The contribution to growth by different sectors is fairly broadly based with services, manufacturing and construction all showing significant output increases.

There were positive developments in inflation during 2003 and into 2004. By early 2004, inflation was running at a rate close to that of the euro area generally. The current inflation forecast for this year is 2 $\frac{1}{4}$ per cent for both measures of inflation - the CPI and the HICP.

Turning to the outlook for 2005, the acceleration in world economic activity should result in higher growth here. The forecast growth in Ireland's GNP is put at 5 per cent (GDP, 5 $\frac{1}{4}$ per cent). Ireland's inflation rate is forecast to increase slightly to 2 $\frac{3}{4}$ per cent (CPI) with HICP inflation of 2 $\frac{1}{2}$ percent.

Experience here and elsewhere shows that it is quite difficult to bring inflation under control once it takes hold. There is generally a high degree of persistence in inflation as inflationary expectations tend to become embedded. In our own case, inflation has been, on average, over 2 percentage points a year higher than in the euro area for the five years since the inception of the single currency. It has taken some time, and it has not been easy, to reduce our inflation rate to that of the euro area generally. With the economy in an expansionary phase, it is important to secure this low inflation environment. The maintenance of a competitive economy is particularly important in order to ensure that Ireland remains an attractive location for foreign direct investment. The success we have had in

attracting foreign direct investment could be undermined if inflation were to pick up significantly again. This is all the more important since our price levels are already higher than those of our trading partners.

Looking beyond the next few years to the medium-term, the economy's growth potential is likely to be somewhat lower than in the recent past. There are two main reasons for this. Firstly, the scope for employment increases is less than in the past, given the earlier large increase in the participation rate and the current low rate of unemployment. Secondly, productivity increases over the past decade or so were boosted by structural changes in the economy which involved transferring labour from low to high productivity sectors, notably in the high-technology areas. The scale of this cannot be continued in the future. This would suggest that growth potential in the medium-term would be at the lower end of the 4 to 5 per cent range. It is important that expectations are adapted to this somewhat lower, but still very satisfactory, rate of potential growth over the medium-term.

Credit growth continues to be a worry. In May, Ireland's adjusted private sector credit growth rate of 23 per cent was four times the euro-area rate of 5.8 per cent. If such divergent rates of increase were to persist, Ireland would become one of the most indebted countries in the euro area within a few years. This increase in credit has mainly been accounted for by mortgage credit. The Bank remains concerned at the continuing large increases in house prices - currently running at 12 to 13 per cent - especially in the light of the substantial increase in housing supply. If the increase in prices were to continue, the risk of a significant correction would increase.

Monetary policy and the euro area economy

Current prospects for the euro area economy are reasonably positive. With external demand remaining strong, growth is expected to average 1.7 per cent this year and 2.1 per cent in 2005. Largely due to higher oil prices, inflation will be above 2 per cent this year and into the early part of 2005. I feel however, that on balance, the current evidence points to inflation in the euro area being in line with price stability over the medium-term.

Supervision

This Annual Report contains a review of financial supervision issues covering the period from the 1st of January to the 30th April 2003, with a short summary of activities from May to December 2003. In accordance with the new legislation, the Financial Services Regulator will publish its own Report covering the 20-month period from the 1st of May 2003 to the 31st of December 2004 in mid-2005. In the meantime, the Financial Services Regulator published a Progress Report in June of this year outlining its first year of operation. In addition to supervising financial institutions from a safety and soundness viewpoint, a comprehensive regulatory structure for consumer issues was put in place during 2003 with the appointment of a Consumer Director as provided for in the legislation.

Financial results

The Surplus Income paid by the Bank to the Exchequer in respect of 2003 is €321.7 million. This amount comprises €69 million in profits before unrealised gains and €258 million transferred from pre-EMU exchange rate gains, of which €108 million was in respect of unrealised foreign exchange losses in 2003 due to the appreciation of the euro. The only transfer to reserves from profits was a transfer of €5.4 million to the Superannuation Reserve. In addition, €78 million proceeds of the coin issue were paid to the Exchequer by the Bank in 2003.

Strategic plan

Today, in addition to the publication of our Annual Report, the Central Bank is issuing a three-year Strategic Plan. This is a comprehensive piece of work and provides us with the opportunity to outline:

- the role and responsibilities of the Central Bank, both in the Eurosystem and domestically;
- the nature and purpose of our work; and
- the plans for new initiatives in the future.

Since our entry into the Eurosystem, there has been a significant change of emphasis in our work, towards a greater focus on Eurosystem responsibilities. We have, of course, undergone a major change in our structure and the Strategy gives us the opportunity to clarify our role vis-à-vis the Financial Services Regulator and to reinforce the cooperation between us in areas of common interest.

Articulating our Strategy now is very timely, as we can now draw on five years of experience in EMU and as the Eurosystem is facing up to challenges of expansion. Our Strategy was developed following a comprehensive consultation process throughout the organisation. We have defined specific strategic actions, which will be implemented over the next three years.

For any of you who have a particular interest in this issue and would like more information, we would be glad to arrange a meeting with Ann Marie McKiernan who was heavily involved in preparing the Strategy.

Before concluding, I would like to thank the members of the CBFSAI Board of Directors for their work and help throughout the year. I also greatly appreciate the dedication and commitment of the staff who have ensured that the reorganisation has been such a success. I would also like to thank the Chairman, Mr. Brian Patterson, and the Board of the Financial Services Regulator, with whom we have worked closely to ensure a smooth transition to the new organisation.

I am also pleased to say that the 2003 Annual Report is available simultaneously in both Irish and English.

This concludes my opening remarks. My colleagues and I are now available to answer questions.