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 2005, Dublin, 12 July 2006.

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You are all very welcome to this press briefing to mark the publication of the Central Bank's Annual Report for 2005.

The Annual Report describes in detail our activities in 2005, which proved to be another busy year for the Central Bank, both in terms of our domestic and our euro area responsibilities.

I should also mention at the outset that the Financial Regulator will publish its own Annual Report later this month, which will detail its activities over the past year, while the Central Bank will publish our annual Financial Stability Report in the autumn.

Economic developments

Let me start by briefly reviewing the main developments in the Irish economy over the past year or so.

The economy performed well in 2005 with GNP growth of 5.4 per cent. This was a notable increase on 2004, when the figure was 4 per cent. GDP grew by 4.7 per cent last year. I understand that the CSO will release new National Accounts figures tomorrow, which may include revisions to figures for 2005.

The strength of the economy was evidenced by another robust performance in the labour market, with an additional 87,200 persons at work and with the unemployment rate averaging 4.3 per cent. This labour market performance, coupled with relatively stable economic growth rates over the last few years of about 4½ to 5 per cent, indicates that the economy is operating at capacity.

The Budgetary position has been very sound with General Government surpluses each year since 2002, in which year a small deficit was recorded.

Growth last year was driven by domestic demand, principally by consumption and investment expenditure. The construction sector continued to grow at a very strong rate, with average employment growth of more than 14 per cent. This sector now accounts for approximately 13 per cent of total employment, an exceptionally high ratio by international and historical standards. The strong performance in this sector has been driven primarily by residential house building, with 2005 again characterised by a record number of new house completions. In addition, the home improvements sector also grew strongly. There was also quite marked growth in personal consumption expenditure last year, with a volume increase of 5.6 per cent, which was the fastest rate of growth since 2000. This was a reflection of the strong employment gains experienced in the economy, rising disposable incomes and relatively favourable financing conditions.

Growth in the economy over the past couple of years, and particularly last year, was concentrated mainly in predominantly labour intensive sectors, namely construction and services, with a correspondingly weaker productivity performance. While the overall performance of the economy has been positive, the relatively unbalanced nature of growth in recent times is a concern, particularly the modest developments in productivity. Specifically, in the latter half of the 1990s, average productivity growth in Ireland was about 3¼ per cent per annum, whereas over the past two years productivity increases have been running at about 1 per cent annually. While increases in employment contribute to economic growth, it is important that a major effort is focused on improving trend productivity growth across the economy.

The sector that traditionally delivers high productivity growth is the manufacturing sector, which grew by about 3 per cent last year compared with growth of just ½ per cent in 2004 and double-digit rates of growth in the late 1990s. Since the 2001 downturn, the sector has been characterised by more modest growth rates. While a move to services activity is a feature of more mature economies, the weaker performance of the manufacturing sector reflects a deterioration in cost competitiveness in the economy and stronger international competition. The decline in competitiveness is evidenced by a disappointing export performance. In 2005, exports of goods and services grew by 1¾ per cent, whereas world trade grew by 7½ per cent, indicating a loss of market share. However, the latest trade data show some recovery in exports.

Turning to inflation, in 2005 the average increase in the Harmonised Index of Consumer Prices was 2.2 per cent, the same as that recorded in the euro area. Furthermore, inflation excluding energy prices was much weaker last year and well below 2 per cent. However, this has not continued. Inflationary pressures have increased so far in 2006 due to higher energy prices and a pick up in services sector inflation. As a result, quite a significant gap has again emerged between Irish and euro area inflation. This is a concern particularly in view of the fact that the price level is already high by international standards. It is likely that HICP inflation will average about 2¾ per cent this year, although much will depend on energy price developments. The recent increases in interest rates, as well as the resurgence in house prices, have contributed to a widening in the differential between the Consumer Price Index and the HICP measures of inflation, as the former includes mortgage repayments. The CPI increased by 3.9 per cent in the year to May 2006, whereas the HICP increased by 3 per cent.

The economy is expected to grow by about 5 per cent this year - a broadly similar rate to that in recent years. With relatively favourable conditions in the global economy, it is hoped that exports will pick up through the course of the year. Nevertheless, the main driver of growth is likely to continue to be domestic demand. Strong growth in consumer expenditure and investment is forecast on the back of strong employment growth, the maturing of the SSIAs and rising income levels. The labour market is expected to continue growing, albeit at a slightly reduced pace given the projected moderation in the growth of the construction sector. The unemployment rate is forecast to remain broadly unchanged.

There are risks and vulnerabilities in the domestic economy that could affect the relatively good economic outlook. I will now outline some of those risks.

- In relation to the housing market, while moderating through much of last year, the recent re-acceleration in house price increases, well in excess of the increase in nominal incomes, is a concern and has increased the risk of a sharp correction in the market. For the most part, house price increases over the last decade have been well supported by fundamentals, such as demographics, employment and incomes. However, the recent re-acceleration in house price inflation does not seem to be fully driven by a corresponding upturn in fundamentals. This could suggest that there is a danger some gap may be emerging between actual house prices and the price warranted by the fundamentals. However, given the wide range of measures that different valuation methods tend to show, it is not possible to be precise about this. Even if there were some over-valuation in the market, this need not necessarily lead to a sharp correction. It could, for example, ease over time, by a combination of a broad stabilisation of prices and continuing improvements in the fundamentals. This gradual easing over time continues to be our expectation.
- Borrowing levels have continued to increase strongly. Residential mortgage lending has been increasing at annual rates of about 30 per cent in the early part of 2006. The household sector's debt to income ratio is now very high by international standards.
- Another risk relates to an over reliance on domestic demand. Personal consumption expenditure picked up in 2005 after a number of years of quite modest growth, combined with exceptionally strong investment expenditure. There was, however, a much weaker export market performance, which needs to improve. In addition, the heavy weighting of the construction sector in the economy is a concern. This risk was highlighted last year in our Financial Stability Report, which looked at the implications of a sudden correction in the construction sector.
- As I already pointed out, the economy has lost competitiveness in recent years. Given the already high price level in Ireland and the rising cost base, every effort should be made to avoid a further erosion of competitiveness. An important element in this is to ensure that our productivity performance improves so as to avoid further losses.

On the external side, the volatility in energy markets and the possibility of sharp changes in exchange rates arising from global imbalances continue to be the main risks facing the economy. Ireland's dependence on oil remains higher than most developed countries, thereby raising our exposure to movements in oil prices. Similarly, with 60 per cent of Irish exports going to countries outside of the euro area, the economy is more vulnerable to sharp movements in exchange rates than other euro area members.

Monetary policy and the euro area economy

Turning to the international background for the Irish economy, developments have been broadly favourable. The global economy continued its robust expansion in 2005, withstanding most of the dampening influence of higher oil prices, and is projected to grow at a broadly similar pace in 2006. Closer to home, the euro area recovery has gained momentum, with growth becoming more broadly based and sustained in the first-half of this year. While external trade continues to provide significant impetus to euro area growth, there are now also signs of an improvement in domestic demand. Business confidence has strengthened significantly and we have seen a welcome recovery in investment. However, progress remains slow in relation to consumer spending, though there are some signs of improvement. Forecasts and projections point to an improved euro area growth outlook for this year and next compared with the past two years, with economic growth of around 2 per cent projected for both 2006 and 2007.

Turning to euro area price developments, the headline rate of inflation has been above two per cent since the start of the year and is expected to remain above that level into 2007. Risks to outlook for price developments remain on the upside and relate to the potential for further increases in oil prices, stronger pass-through into consumer prices than expected or further increases in administered prices or indirect taxes. In addition, risks to the medium to longer-term outlook are also being signalled by strong growth in the money supply. In the light of the various risks to the outlook, the Governing Council has increased interest rates on three occasions, totalling 75 basis points, since last December.

Looking ahead, the Governing Council has signalled that it will exercise strong vigilance to ensure that risks to price stability do not materialise and that inflation expectations are kept firmly anchored. As we have emphasised consistently since last December, future interest rate decisions are not pre-determined and there is no pre-commitment to any future policy action - either in terms of timing or scale. The Governing Council always bases its actions on its latest assessment of the risks to price stability, taking account of the most up-to-date information and analysis of the economic and monetary situation and prospects. Doing this ensures that the euro area recovery, which is now widely projected by all the major economic forecasters, takes place in an environment of price stability.

Financial results

I will now briefly mention our financial results for the year, the full detail of which is contained in the annual report. In 2005, the Central Bank recorded a profit of €122 million, compared with the equivalent figure of €107 million for the previous year. The Surplus Income paid by the Central Bank to the Exchequer in respect of 2005 was €109.2 million. An amount of €45 million, representing the net proceeds of coin issued during the year, was also transferred to the Exchequer.

Conclusion

To conclude, I would like to express appreciation to the staff of the Central Bank and Financial Regulator, for their work and commitment throughout the year. I would also like to thank the members of the Board of the Central Bank and Financial Services Authority of Ireland for their efforts, advice and diligence through another busy and challenging year. I would also like to thank the Chairman and Board of the Irish Financial Services Regulatory Authority for their co-operation throughout the year so ensuring continued excellent working arrangements between the Bank and the Financial Regulator.

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