John Hurley: Prospects for the Irish economy and banking sector

Address by Mr John Hurley, Governor of the Central Bank and Financial Services Authority of Ireland, at a Bloomberg Business Lunch, Dublin, 16 October 2007.

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The economic outlook remains broadly positive at the global level but the international environment is clearly somewhat more uncertain following the financial market turbulence that began in early August. Central banks have sought to limit the impact of financial market developments on real economic activity. The provision of additional liquidity has brought some measure of stability and there are signs of improvement in the key inter-bank market, although some difficulties still remain It is impossible to say how long it will be before such markets will fully return to their normal functioning; market participants remain uncertain about where exposure to risk lies and, while this continues to be the case, some tensions may persist. With regard to monetary policy, as far as the euro area is concerned, more information will be needed on the impact of recent developments before drawing any further conclusions in that regard. The turbulence also seems to signal the need for changes in the financial system that are likely to centre on issues such as transparency – including the links between on- and off-balance-sheet vehicles – making improvements to risk management frameworks, valuation standards and market functioning including looking at the role of rating agencies.

Although the Irish banking system had relatively little direct exposure to many of the original sources of turbulence, there has inevitably been some pressure on interest rates, resulting from the tensions in the inter-bank market and some generalised tightening of credit conditions seems likely as a result. One cannot rule out other possible direct effects on the economy, such as a reduction in confidence for example, but the main concern centres on indirect effects at this stage, in particular, the possibility of a sharper than expected US slowdown. This could impact on the domestic economy through its extensive trade and investment links with the US. There are other risks that could affect the prospects for growth domestically also, including exchange rate movements and oil price developments.

In its most recent Bulletin, the Bank projected some deceleration in domestic growth. GNP is likely to expand by about 4¾ per cent this year but the growth rate will probably drop to about 3¼ per cent next year. This arises from the combined effect of declines in housing output and a likely slowing of consumption growth next year from its current very high levels. Inflation is likely to ease, however, with an average HICP rate of 2.8 per cent this year falling to about 2¼ per cent next year, effectively eliminating the inflation differential with the euro area. This is likely to reflect an easing in services inflation and generally reduced inflationary pressures as the economy slows. Unemployment is likely to rise modestly, probably to about 5¼ per cent next year from an average of about 4¾ per cent this year. This would, however, still represent close to full employment conditions.

As regards the housing market, the current situation reflects a return to a more sustainable position. Prices have levelled off and are declining modestly and output is falling back to levels that are more in line with medium-term demand. Fortunately, this is happening against what has been a relatively favourable backdrop. The rest of the construction sector is still experiencing favourable demand conditions, particularly as regards large public and private projects. The remainder of the economy is also continuing to experience strong growth with overall employment still expanding.

It is important to take a balanced view of prospects and not to concentrate disproportionately on the downside risks to the economy. The economy also has many positive aspects. It has also shown itself to be flexible in the past and should be able to adapt to adverse developments, if they were to occur. For example, the current fiscal position should allow the authorities to put a fiscal buffer in place to help deal with the impact of any such developments, while still continuing to fund key infrastructural improvements.

Over the medium-term, the economy still has the potential to grow by around 4 to 4½ per cent. In order to realise this potential, there will have to be a re-balancing of growth with a strengthening of the country's external trade performance. This, in turn implies a concentration on maintaining and improving the competitiveness of the economy. The key to a continued improvement in living standards is maximising productivity growth through appropriate policies, including investment in infrastructure and education, measures to boost competition in the non-traded sectors, providing a support environment for R&D, as well as a continuing focus on stability in the public finances. The current phase of globalisation involves the reallocation of activities across countries with many low-skill activities moving to low cost locations where the supply of low-skilled labour is plentiful. This leaves countries like Ireland increasingly competing for more high-value-added activities and the country needs to position itself appropriately in order to pick up a significant share of this type of investment. There are also medium-term challenges to be faced, most notably perhaps, the implications of population ageing. Although occurring somewhat later in Ireland than elsewhere, the impact is likely to be significant. Some measures have already been taken, such as increasing the retirement age in the public sector and the setting up the National Pension Reserve Fund to meet future public pension liabilities.

In summary, the outlook for the domestic economy remains positive, if somewhat more uncertain. Some slowdown in growth seems inevitable but its extent and duration will be affected both by developments in the international environment and our response to them. The risks have increased in recent times but if there is an appropriate response domestically and a continued focus on boosting productivity growth over the medium term, the prospects for continued growth and improvements in living standards remain good.