John Hurley: International economic and financial developments and prospects for the Irish economy

Address by Mr John Hurley, Governor of the Central Bank & Financial Services Authority of Ireland, to the Irish Association of Pension Funds Annual Dinner, Dublin, 28 February 2008.

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Introduction

I would like to thank your chairman for the invitation to address you this evening on the occasion of your annual dinner. In my speech tonight, I will comment on international economic and financial market developments as well as prospects for the domestic economy. I will also briefly address the issues of population ageing and pensions.

International economic developments

Prior to the recent slowdown in economic growth, the global economy had, over the previous four years, experienced its strongest period of expansion since the early 1970s. While this might not have been apparent in the euro area, where growth only started to pick up in the second-half of 2005, the evidence from the rest of the global economy is clear. Not only was there robust global growth during this period, a number of other features were also striking. In particular, increasingly global growth was spread more widely, with emerging market and developing economies accounting for a higher share of growth. An important factor behind these developments has been globalisation, which has had both a significant real and financial dimension.

The economic impact of these developments has meant that the emerging market economies now account for a greater share of world economic activity. Integration, however, works both ways. As a result, I would not expect that these economies can remain immune from the current slowdown in global economic activity. The main sources of this slowdown are rooted in the US economy and, in particular, its housing sector. The adjustment in that sector is having a significant effect on the US economy and also on other major economies. This reflects the fact that a range of complex financial products linked to housing, in particular in the area of sub-prime lending, has amplified the impact on the real economy of what were not large changes in themselves. This, in turn, reflects the way in which these products were distributed and valued within the financial system.

The actual scale of the slowdown in the US remains rather uncertain. There has been a significant monetary and fiscal policy response, but it is still unclear how deep or how long the slowdown may be. It is apparent, however, that growth will slow substantially.

The second area of uncertainty is the impact on other economies. Given the weight of the US in the global economy and its extensive linkages with other economies, there will certainly be some impact. As regards the euro area, possible spillover effects on growth are one of the downside risks to activity that have been identified by the Governing Council, although the upside risks to inflation at present are also very clear.

Financial markets

Turning to financial markets, it is clear that these too have become much more integrated over time. From a position where sectors like your own have tended to have a “home bias” in asset allocation, portfolios have become much more international in nature. One consequence of this is that it has made possible the financing of ever growing global current account imbalances. This may have facilitated the rise of these imbalances, and the national

spending and savings behaviour that lies behind them by, for example, a tendency to keep the cost of borrowing lower than it might otherwise be in countries with savings deficits.

It has been argued that financial globalisation and, in particular, the scale and speed with which it has developed, has played a part in generating some of the excesses in financial markets which have crystallised over the past six months. However, there have also been other factors at work. I would like to turn now to comment on some of these.

At this stage, the events of the past six months are well known. After a long period during which financial market conditions were extremely buoyant, global markets have witnessed a substantial and warranted repricing of risk. This follows a prolonged period when asset prices were driven to exceptionally high and unsustainable levels in many parts of the world, and inadequate attention was paid to risk. The unwinding of these excesses has generated significant turbulence in financial markets and strains in money markets. These problems reflect vulnerabilities which have been uncovered about the way risks have come to be assessed, valued and distributed in today's markets. Once they surfaced, these vulnerabilities have led to a substantial degree of financial reintermediation and deleveraging.

Central banks have responded in a determined manner to counteract disorderly conditions in money markets. The actions undertaken since August have alleviated problems at the short-end of the interbank market. They have also helped to encourage a narrowing of the wide spreads that had opened up between longer-term rates and policy rates. While having eased back, however, concerns about credit quality and asset valuations persist. International stock markets have also been affected by the turbulence, particularly financial sector stocks. Irish bank shares, which are a significant part of the Irish equity market, did not remain unaffected by these events, although another factor was the rebalancing of growth away from the construction sector in the domestic economy. These recent developments, however, have to be placed in the context of previous substantial increases in Irish bank shares.

During this period of exceptional turbulence, Irish banks, like their international peers, faced an environment where medium to long term funding was not as readily available on wholesale money markets as heretofore. However, adequate overnight liquidity was available at all times and, since the end of the year, conditions in the interbank markets have eased, and term funding is now more freely available and at lower, if not normal, interest rates.

The current situation and outlook for the stability of Irish banks, based on an assessment of developments so far, is positive. The sector's shock absorption capacity has been largely unaffected by the turbulence in international financial markets. The domestic banking system reports no significant direct exposures to US sub prime mortgages and only negligible exposures through investments and links with other financial companies or special purpose vehicles. In addition, our stress-testing of the banking system indicates that Irish banks are solidly profitable and well-capitalised.

As far as drawing conclusions at the global level in relation to the turbulence is concerned, there needs to be a careful and balanced assessment made of the lessons to be learned from recent events. Indeed, we must also be conscious that this turbulence may persist for some time yet. The elements which came together to generate the recent turbulence involved a weakening of credit discipline, a build-up of leverage, with risks transferred in an opaque way through the global financial system. Added to this was a degree of investor complacency, encouraged by benign economic conditions and a long period of low market volatility. All of these together led investors to focus heavily on return while under-weighting risk. It will be important, as the lessons of recent experience are absorbed, to improve risk management, in particular in relation to liquidity issues, market transparency, and valuation standards of complex financial instruments and vehicles. The management, assessment and monitoring of credit risk, the assessment of counterparty risk and the role of credit rating agencies are also issues which require consideration. These are all areas identified in the

roadmap of actions endorsed by EU Finance Ministers last October. Work on this roadmap is on track and a detailed report on these issues is due to be considered by ECOFIN in April.

The domestic economy

I should say that, at times like this, the protection afforded to a small country by membership of the euro area comes sharply into focus. It is undoubtedly the case that our ability to cope with recent challenges has been greatly enhanced by our membership of economic and monetary union.

Before commenting further on the domestic economy, I would like to make a few remarks about monetary policy. As you may be aware, the most recent assessment of the Governing Council was that, as the reappraisal of risk in financial markets continues, there remains an unusually high degree of uncertainty over its impact on the real economy. It is clear that the risks to the outlook for economic activity in the euro area lie on the downside; however, risks to price stability over the medium-term are on the upside. The latest data have tended to confirm this assessment of risks. At our next meeting in March, we will, of course, have the benefit of new macroeconomic projections.

The prospects for the Irish economy this year are for some moderation in economic growth following the strength of recent years. Nevertheless, growth is expected to remain relatively favourable by international standards. The Bank projects GDP growth of around 3 per cent this year, with GNP growth expected to be somewhat lower at about 2.6 per cent. This represents a significant deceleration, as the economy enters a phase where domestic demand will lose much of its recent buoyancy, with exports playing a more significant role. Export growth is expected to grow broadly in line with export market growth, although this will mean a somewhat slower pace than last year, given current external headwinds. A further rebalancing of economic growth, with less dependence on domestic demand and a stronger external performance, is therefore envisaged. Indeed, such a rebalancing is required in order to maintain a satisfactory overall performance and to put the economy on a sustainable path.

This underlines the importance of preserving and improving the economy's competitiveness position. The linkages between our economy and the US and, indeed, the UK, suggest that there will inevitably be some effect from developments in these economies through various channels such as trade, financial flows and even perhaps foreign direct investment. The scale of the impact is difficult to assess. Although it is likely to be significant, it may not be perhaps quite as great as some commentators have recently suggested.

In relation to fiscal policy, the somewhat expansionary stance this year will provide some support to domestic activity. It will partly offset the slowing of domestic demand, albeit within the limits of prudence and without an excessive deterioration in the underlying budgetary position. It will be particularly important to reduce the rate of increase in current spending to what can be financed by more moderate revenue growth, while continuing to focus public capital resources on improving the country's infrastructure, in line with the National Development Plan.

As regards domestic demand this year, the most notable adjustment relates to the construction sector. Its weight in overall output growth is set to decline to a more sustainable level due to a sizable reduction in residential construction output. This had reached levels in recent years that were well beyond the economy's medium-term requirements. The moderation in output growth and, in particular, the adjustment in the labour-intensive construction sector suggest that employment growth is set to decelerate significantly this year. While employment gains in other sectors of the economy are likely to more than offset the decline in construction sector employment, the overall increase in employment is likely to be quite modest. Employment growth seems set to fall short of the increase in labour supply and, as a consequence, some limited rise in the unemployment rate, perhaps to an average of about 5½ per cent, is in prospect this year. Less robust output and employment growth

will, however, contribute to an easing in inflationary pressures in the domestic economy. The average HICP inflation rate is expected to fall to around 2½ per cent this year, and perhaps further to about 2 per cent next year, bringing inflation in Ireland broadly into line with the euro area average.

Following substantial price increases over an extended time-period, house prices have declined reflecting an easing of demand. As prices have eased, housing output has also fallen back from recent record highs, adjusting to meet the new demand conditions. As a result, the supply of new houses is projected to decline to a level in line with the medium-term requirements of the economy, or possibly even somewhat below it. This combination of housing output and price developments has resulted in a significant and welcome deceleration in credit growth since mid-2006.

Turning to the medium-term, the economy has the potential to grow by around 4 per cent, a healthy rate of expansion by the standards of other developed economies. Assuming no adverse external developments and a broad levelling off in housing output, growth should recover in 2009, approaching its medium-term potential. As I have already stated, however, this outcome is contingent on the maintenance of a strong competitive position. This will require a sensible approach to pay determination and continuous improvements in productivity in both the private and public sectors of the economy.

I would like to particularly stress the important role of productivity for the future of the economy. In the long run, only productivity improvements can bring sustainable increases in the standard of living for individuals. If we try to compensate ourselves for terms of trade losses, such as those caused by oil price increases, then the results will be damaging. We know that this is the case from past experience. It took us many years to recover from inappropriate responses to similar developments in the past. Policies that promote productivity and competitiveness can, on the other hand, help the economy to ride out the effects of adverse developments and of lower growth in the global economy. They will also serve to increase the medium-term performance of the economy, protect employment and allow for sustainable increases in living standards.

Population ageing and pensions

I will now turn to the issue of pensions and ageing. While it is obviously good news on an individual level that life expectancy is increasing, population ageing more generally poses significant macroeconomic and fiscal challenges for most developed countries, including Ireland, during the decades ahead. The projected increase in the old-age dependency ratio will have negative implications for economic growth, while simultaneously placing a significant burden on public finances and on the sustainability of privately funded occupational and private pensions.

Population ageing will place considerable pressure on the public finances by driving up age-related expenditure. In the European context, the most acute fiscal pressures are faced by those countries where – unlike in Ireland – occupational pensions are mainly funded on a pay-as-you-go basis within public social insurance systems. A number of European countries have already adopted pension reforms aimed at controlling the projected increase in public pension expenditure. These include a considerable restructuring of contribution or benefit rules, increasing the effective retirement age and linking pension benefits in an actuarially fair way to life expectancy. In some cases, where these types of reforms have proved to be insufficient, more systemic reforms have been adopted, changing the financing structure of pension provision with increased reliance upon funded pension arrangements.

In the Irish case, the flat rate structure of the basic state pension, together with our current relatively favorable demographic structure, has so far resulted in a much smaller fiscal burden from age-related expenditure. Nevertheless, on the basis of current policies, age-related public expenditure in Ireland is set to increase significantly in the decades ahead.

Total pension expenditure by the state is set to increase from 4.6 per cent of GDP in 2005 to 7.9 per cent in 2030 and further to 11.1 per cent of GDP in 2050, according to the latest Department of Finance estimates.

As you will be aware, some pension reforms have already been adopted in Ireland. The most notable has been the establishment of the National Pensions Reserve Fund (NPRF). In addition, the parameters of the public service occupational scheme have been adjusted, with an increase in the minimum retirement age for new entrants. While the projected pension-related burden represents a significant challenge, careful planning will help to counteract the long-term pressures emanating from population ageing. In this regard, the Government's recently published Green Paper on Pensions presents a range of measures that might be undertaken to address future pension expenditure pressures. The four options considered were – a gradual increase in the current social welfare pension combined with a longer working life, enhancements to the current voluntary pension system, the adoption of a soft mandatory pension savings scheme and a fully mandatory pension savings scheme. Another issue worth considering is whether tax incentives or direct contributions by the Exchequer, as in the SSIA scheme, are the better approach. As you will also be aware, the National Pensions Review, published by the Pensions Board in 2006, provides a further set of recommendations.

Ireland has the advantage of starting from a healthy fiscal position, with one of the lowest debt-to-GDP ratios in the EU. Furthermore, Ireland's demographic profile is expected to remain favourable for some time. The country has a window of opportunity to move towards a more sustainable position. It is important, however, that considerable practical progress is made in good time in dealing with a problem, which, while not imminent, is nevertheless unavoidable and needs to be addressed sooner rather than later.

There are two key issues that need to be addressed.

First, measures are urgently required to bring funding into line with the cost of state pensions. Without this, the long term funding gap for the state pension system that already exists will be exacerbated.

Second, private occupational and personal pension coverage is particularly low among low-income workers and this must be addressed. While 800,000 people are covered by occupational pension schemes and about EUR90 billion worth of assets are under management, at present nearly half of Irish workers are not covered by occupational or private pension schemes. As a result, these workers face a substantial fall in living standards when they reach retirement.

The challenge for the pensions industry itself is to mobilise private savings and to deliver investment returns that can provide adequate pensions when they fall due. An important factor in this is to ensure that pension products are sold in as transparent a way as possible. In recent times, a much wider range of investment outlets for pension funds has become available, but recent experience indicates that the risks associated with new and innovative products need to be prudently assessed.

Conclusions

In conclusion, therefore, while both the international and domestic economies are in somewhat of a down phase at the moment, this has followed a protracted period of strong economic growth. A very welcome feature of this has been the rapid economic progress of regions of the world that did not enjoy the substantial improvements in living standards experienced by OECD countries since the second world war. Improved living standards and levels of health care have led to very significant increases in life expectancy in both developing and developed countries. The pensions industry and national exchequers worldwide are faced with the challenge of coping with these profound changes. With our

relatively young population, Ireland is facing these pressures somewhat later than most other advanced countries.

An important response, both to these longer-term challenges as well as the shorter-term difficulties caused by a weaker external climate and adjustments domestically, will be to continue to improve our productivity performance. There can be no doubt that we will be in a better position to cope with challenges such as population ageing and with changes in economic circumstances generally in a situation in which our economic performance continues to remain robust.

As I have already mentioned, it is important that we face the longer-term challenges of ageing without undue delay. Estimates suggest, for example, that, from a position at present where there are six people at work to every retired person, by mid-century this ratio will fall to two people at work to every pensioner. The various discussion papers, including the recent Green Paper, set out the various options for us to choose as a nation. It is important that we move ahead soon to deal with these issues, so that it will not be necessary to take more drastic action at some stage in the future.