John Hurley: Current state of the Irish economy

Opening statement by Mr John Hurley, Governor of the Central Bank and Financial Services Authority of Ireland, to the Joint Committee on Finance and the Public Service, Dublin, 15 July 2008.

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Good afternoon Chairman and members of the Joint Committee and thank you for the invitation to speak with you today on the current state of the economy and the banking/financial services sectors. I am accompanied by Tony Grimes, the Director General of the Central Bank and Tom O'Connell, Assistant Director General, Economics.

Earlier this year, I outlined to the Committee our unitary organisational structure and I emphasised, in particular, how the Central Bank and Financial Regulator work closely together in response to the market turbulence. I don't intend today to describe those arrangements again except to say that the structure continues to work very well and there continues to be the closest cooperation.

It is worth reminding ourselves that we have a very different economy now as compared to 20 to 25 years ago. Since then, Ireland has transformed itself from being a country with a relatively low standard of living to one where average income per head is now well above the EU average. Not only are living standards much higher, employment has grown rapidly and we have seen strong development in manufacturing, business and financial services sectors, helped by the fact that we have been hugely successful in attracting foreign investment. Clearly, the economic situation has changed significantly, but in terms of where we are starting from, the position is very different from the 1980s.

As you know, we published our Annual Report last week and, in my statement today, I will outline the rationale behind our latest forecasts for economic growth. In our earlier forecasts, it was always emphasised that there were many downside risks and vulnerabilities that could push growth lower. These risks related to the potential for interaction between global financial market turbulence, rising global energy and food prices and the slowing of activity within the economy, which was already underway.

In recent months, almost all of these downside risks have materialised and this has led to a greater-than-expected slowdown in growth and higher-than-anticipated inflation.

Notwithstanding the more challenging short-term outlook, we continue to believe that growth in the economy should gradually recover and inflation moderate. However, this recovery is not guaranteed and the evolution of the economy will be very much influenced by how we respond to the current challenges we face. As a country we have benefited considerably from the prudent, stability-focussed policy approach we have followed in recent decades. This has helped to deliver domestic economic stability, has contributed significantly to attracting foreign investment and has greatly facilitated growth. To ensure a sustainable recovery, it is very important that we maintain this approach and focus on key policy areas under our control. These include the public finances, the efficiency and effectiveness of public spending, particularly in relation to increasing the productive capacity of the economy, and overall competitiveness.

The updated assessment

While the emergence of a slowdown in the economy was not unanticipated, the loss of momentum has been greater than expected this year. This has arisen from a sharper-than-expected adjustment in the housing sector alongside a deterioration in the international environment. Our current forecasts are that both GNP and GDP growth will remain positive this year, albeit significantly less than 1 per cent. It will be the end of July before we finalise our forecasts, but a ballpark estimate, at this point in time, would be around 0.5 per cent growth this year and about 2 per cent in 2009.

In common with other developed economies, Ireland is facing significant inflationary pressures arising from very elevated levels of energy and other commodity prices. We are all conscious of the experiences of the 1970s, when the response to the oil price increases of the time resulted in persistently high inflation. This undermined growth and employment in the economy and was especially damaging to those on fixed incomes. While the current situation is not identical, there are some similarities. It is important to accept that economic conditions here have weakened and we cannot compensate ourselves on an economy-wide basis for commodity price increases over which we have no control. As we know from past experience, if we attempt to do so, recovery inevitably becomes delayed. Ireland's competitiveness position has weakened in recent years because wage and broader cost inflation has been higher than in our main trading partners. It is vital for our growth prospects to ensure that our competitiveness position improves rather than deteriorates further.

Based on the potential for future growth in productivity and the labour force, the medium-term outlook for the economy remains favourable and growth will return to stronger levels, if the appropriate corrective action is taken. Growth should pick up next year on the basis of a bottoming out in domestic housing output and some improvement in the external environment.

Residential housing market

The housing market weakened significantly during 2007 with sharp declines in both output and prices. Most economic commentators had envisaged an adjustment in the housing market because, for a number of years, housing output was well above the sustainable rate taking account of underlying housing needs. Housing investment peaked at around 13 per cent of GDP in 2006, which was well in excess of international norms. This is likely to reduce to about 7½ per cent of GDP in 2008, which represents a very substantial scaling back of activity. The significant weakening in the housing sector is going to detract considerably from growth this year.

Housing output should broadly stabilise during the course of next year, but clearly risks are to the downside. In general, however, the declines in both output and prices represent a movement towards a more sustainable position in the long term. Unfortunately the adjustment process is a difficult, if unavoidable, one.

The external environment

Two fairly distinct sets of events are driving global economic developments at the moment. Firstly, housing market adjustments are taking place in a number of the major developed economies alongside associated difficulties in financial markets. Secondly, a sharp rise in commodity prices is placing upward pressure on global inflation and causing a transfer of income from countries importing these commodities to those producing them. The combination of these events is having a negative impact on output growth globally. Unfortunately, this slowdown is affecting the US and UK economies disproportionately, two of our major trading partners. Economic activity has remained stronger in the euro area, although an easing in the growth rate is expected in the short-term before a recovery towards its potential growth rate of about 2 per cent. The risks to the growth outlook are probably on the downside, however, in all of these economies.

Another negative outcome of these events is, of course, the sharp upward pressure on headline inflation rates globally. Central banks are very focussed on this issue and are particularly concerned that the rise in commodity prices does not spread out into higher inflation generally. In order to counter these risks within the euro area, the ECB Governing

Council decided to raise its interest rates at its last meeting. Price stability is a vital foundation for sound economic performance and prosperity over the longer term and preserves the purchasing power of incomes and savings. Inflation, in contrast, creates uncertainty for savers and investors and undermines confidence in an economy in a way that ultimately damages the welfare of its citizens.

I would like to turn now to financial market developments. Over the past year, there has been a generalised disruption in normal money market operations between banks. This resulted mainly from uncertainty regarding the extent of losses on complex financial instruments linked to sub-prime mortgages in the US. Central banks responded quickly to counteract these adverse conditions in money markets. The ECB, in particular, was in a position to take strong action in the light of the pre-existing arrangements whereby banks had an extensive range of collateral that could be used to access central bank liquidity. These arrangements effectively addressed the problems at the short-end of the money market. However, with questions of transparency and asset valuation remaining, term interest rates continue to be elevated with higher than normal spreads remaining between longer-term rates and official rates. This will only change when confidence is restored among financial market participants.

Domestic banking sector

The Irish financial sector is not immune to these international financial developments which are persisting for longer than expected. Term funding is not as readily available on wholesale markets and this has increased the need for banks to concentrate on liquidity management. Internationally, share prices of financials have fallen significantly and Irish shares have also suffered. It is important, however, to point out that Irish financial institutions have negligible exposures to impaired US sub-prime and related structured credit products, and loan arrears remain historically low. Accordingly, the banking sector here has not experienced the write-down of assets that has required several other international banks to raise additional capital. In line with the results of previous exercises, the preliminary results of our latest macroeconomic stress tests on the banking sector, which are designed to test the financial position of banks in the face of a serious economic downturn, suggest that the banking sector's financial buffers remain strong. This strength is an essential prerequisite for the more challenging times that have arisen.

A recovery to medium-term potential growth

Growth should pick up somewhat next year as the fall in domestic housing output levels off. Thereafter, growth in the Irish economy could begin to return towards its long run sustainable potential rate of close to 4 per cent. However, this recovery is not guaranteed and, as I have said earlier, will be influenced by how we respond to the current challenges we face. To ensure a sustainable recovery in growth back towards potential, it is important to focus on some key areas under our own control. These include the public finances, the efficiency and effectiveness of public spending, particularly in relation to increasing the productive capacity of the economy, and overall competitiveness.

The slowdown in economic activity is impacting significantly on the fiscal position. Exchequer data indicate a sizeable decline in tax revenue in the first half of 2008, primarily reflecting a marked slowdown in property related taxes, but also indicative of a slowdown in consumer spending. On the expenditure side, the weakening of the labour market is increasing social expenditure. This points to significant deterioration in the fiscal deficit for 2008 relative to earlier projections. I note that the Department of Finance has revised its estimate for the full year General Government Balance to a deficit of about 2¾ per cent of GDP. Our own internal estimates are broadly in line with this assessment.

The slowing of growth coupled with the risks facing the economy presents significant issues for fiscal policy. On the basis of current trends, it will be a major challenge to remain within the terms of the Stability and Growth Pact next year. It should be emphasised, however, that the targets set under the Stability and Growth Pact represent a prudent approach to the management of the public finances.

Within these constraints, it will be necessary to carefully manage the allocation of scarce public funds and to focus on measures to increase the efficiency and effectiveness of government spending, both current and capital. A particular priority within the capital programme should be the maintenance of expenditure on key infrastructural projects, which can enhance productivity and improve the potential for the economy to grow in the future.

Policies that promote productivity and competitiveness can help the economy to weather the effects of adverse developments and of lower growth in the global economy. They also serve to increase the medium-term performance of the economy, protect employment and allow for sustainable increases in living standards. For these reasons, in addition to my earlier remarks about the need to improve competitiveness, boosting productivity growth and promoting flexibility in response to short-term shocks are particularly important. In addition to enhancing the efficiency of public spending and continuing to address the country's infrastructure deficit, a number of other measures can be identified which would promote this goal. These include greater competition in the more sheltered sectors of the economy, continuing to encourage innovation and R&D activity and enhancing the skill level of the labour force.

To conclude, we are now in a more challenging environment. This makes it particularly important to ensure that policy remains focussed on sound economic management and that timely decisions are taken to redress the unfolding situation. As I have said earlier, we have benefited considerably from following such an approach.

It has underpinned domestic economic stability, helped us to attract substantial foreign investment and greatly facilitated growth. It is vital for our prospects for a sustainable recovery in growth that we continue to follow such a path.