John Hurley: Recent economic developments in Ireland and the outlook for the economy

Opening statement by Mr John Hurley, Governor of the Central Bank and Financial Services Authority of Ireland, at the presentation of the Annual Report 2008, Dublin, 14 July 2009.

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Introduction

You are all very welcome to this press briefing to mark the publication of the Annual Report of the Central Bank and Financial Services Authority of Ireland.

I am joined today by my colleagues Tony Grimes (Director General), Brian Halpin (Deputy Director General) and Tom O'Connell (Assistant Director General, Economics).

The Annual Report 2008, which as you know is my last as Governor, documents our activities and presents our annual accounts. Actions that were taken in response to the unprecedented crisis in both international financial markets and particularly the domestic financial system dominated our activities in 2008 and 2009-to-date. Notwithstanding this, significant projects across the Bank's main functional areas, many of which were committed to under the Bank's strategic plan, were either advanced or completed during the year. Our annual accounts show that the Central Bank's profit for the year amounted to €364.2 million. After transfers to reserves, surplus income of €290.1 million has been paid to the Exchequer this year. The Bank's balance-sheet assets as at December 2008 amounted to €116.1 billion, a significant increase on 2007 due to substantially higher liquidity support by the Bank, on behalf of the Eurosystem, to credit institutions located in Ireland.

In my statement today, I will review economic and financial market developments, both here and abroad, and outline the significant actions that have already been taken by policymakers here to restore the health of the banking system; to put the public finances on a sound footing; to restore competitiveness; and to reform our regulatory system. While we remain in a very difficult and challenging environment, these responses will promote recovery. Nonetheless, recovery is likely to be gradual and is dependent on policy remaining focussed on dealing with the issues that I have outlined.

International developments

Since the publication of our previous Annual Report this time last year, the turmoil in financial markets has developed into a full-blown crisis and policy-makers everywhere have taken unprecedented steps to restore stability to their banking systems so as to limit the damage to the real economy. The manner in which the financial turmoil intensified significantly across the world last autumn following the bankruptcy of Lehman Brothers has been extensively documented. History shows us that downturns in economic activity that are preceded by problems in the banking sector tend to be longer in duration and, partly because of this, more severe than those caused by other factors. This is proving to be the case both here and abroad.

Since last September, deteriorating financial market conditions and intense strains on the financial sector led to sharp declines in economic sentiment internationally. Trade and financial channels, meanwhile, transmitted the resulting weakness in demand across the globe. As a result, we have experienced one of the steepest and most synchronised global downturns for many decades, with economic activity contracting sharply in both the final quarter of 2008 and the first quarter of 2009. Following a contraction of around 1½ per cent this year, the IMF now expects global growth of 2½ per cent in 2010, somewhat higher than their previous projection of just under 2 per cent. Nevertheless, by historical standards this will be a modest performance and, given the nature and scale of the crisis we have experienced, the recovery is likely to be gradual, extended and uneven across regions. The IMF, meanwhile, see the risks to their growth outlook as still being tilted on the downside. The fact that some recovery may be in prospect over the next year or so primarily reflects the unprecedented response of policy-makers to the crisis.

There has been an improvement in investor sentiment over the last number of months, with equity markets recovering somewhat, sovereign and financial credit default swap (CDS) spreads narrowing and the unsecured money market showing tentative signs of improvement. However, financial markets remain quite fragile reflecting caution over the prospects of an early economic recovery.

Turning to the euro area, the Eurosystem has responded to the crisis in several very significant ways. The Governing Council of the ECB has cut the main refinancing rate by a cumulative 325 basis points since last October bringing it to its lowest level on record at 1 per cent. This has had a very significant effect in lowering borrowing costs for households and firms across the region, including here in Ireland. A range of innovative non-conventional policy measures have also been adopted, particularly in terms of liquidity provision. Under the Eurosystem's revised operational framework including the full allotment policy, banks can access unlimited liquidity against suitable collateral at a fixed rate for up to 12 months. In addition, this month the Eurosystem has started a programme that will see it purchase up to €60 billion of covered bonds issued by banks in the euro area; this will help an important market sector, and again will be of benefit to banks in Ireland and support credit provision here. Looking ahead, as I have already said, the pace of global recovery is expected to be gradual and downside risks to the global outlook remain. Against this backdrop monetary policy must continue to provide support to the real economy for as long as is necessary, and policy rates should only be increased once there are clear signs that a sustainable recovery has begun.

Irish economic developments and policy issues

Given the highly open nature of the Irish economy and the character of economic growth in the years preceding 2007, Ireland was both exposed and vulnerable to the global financial and economic shocks that have emerged.

After more than a decade of very strong growth, domestic economic activity turned down sharply over the course of 2008. Economic growth had become quite unbalanced in the past few years as building and construction activity had reached unsustainable levels with property prices increasing beyond their fundamental levels. The current economic downturn reflects the interaction of a series of negative influences, both domestic and external, which have reinforced each other and, cumulatively, have had a significant dampening effect on activity.

As has been the case elsewhere, the pace of deterioration in economic activity has worsened since last autumn. The exceptionally elevated stress in financial markets that followed the collapse in Lehman Brothers triggered a sharp fall in consumer and business sentiment across the globe. This prompted a marked heightening of precautionary behaviour on the part of households and firms. In Ireland, this was reflected in consumers reining back spending even further and firms responding to the changed economic environment by cutting production and acting quickly to lower costs. With exports weakening, this has accelerated the fall-off in demand and has been reflected in a sharp rise in unemployment.

While we are still finalising our next quarterly forecasts, it now looks as if GDP will contract by -8.3 per cent this year (a small improvement on the figure published in the Annual Report). Next year the level of contraction is likely to be around 3 per cent for the year as a whole with some gradual recovery emerging later in the year but unlikely to take hold until 2011. The contraction in activity has already led to a significant rise in unemployment, which will not begin to reverse until the recovery gains some momentum. Reflecting this, unemployment is forecast to average around 13 per cent this year and 15 per cent in 2010. One consequence of the downturn in growth, however, has been a sharp turnaround in inflation. The consumer price index is forecast to fall by around 4 per cent this year and to be broadly flat next year (the HICP index, which does not include mortgage interest payments, is projected to fall by close to 1½ per cent this year with a further modest fall in 2010).

While major initiatives have been taken to stabilise the financial sector, and I will comment on these shortly, we also need to restore stability in other areas and chart a path that will in time ensure a sustainable recovery in economic growth. In particular, the importance of reversing the deterioration in cost competitiveness and in fiscal imbalances cannot be overstated.

With regard to competitiveness in recent years, economy-wide productivity gains have been very modest and labour cost increases have been relatively high compared with our main trading partners. This has led to a substantial erosion of the country's competitiveness. This deterioration is now being addressed and many firms have taken action to reduce their costs, with a view to regaining competitiveness and protecting output and employment. While this has undoubtedly been painful, it nevertheless reflects encouraging evidence of the flexibility and realism that is needed if the economy is to maintain the maximum possible number of jobs in the short term while placing Ireland in a favourable position to benefit from an eventual recovery in world demand. This type of flexibility must embrace all sectors of the economy.

On the fiscal side, the deterioration in the public finances is a cause for serious concern. The Government has agreed with the European Commission to correct our Excessive Deficit position by 2013 and it is crucial that these targets are met. The Government's introduction of a public sector pension levy and the Supplementary Budget are steps that have been taken to this end. Bringing the public finances back into balance is necessary to restore macroeconomic stability and to ensure international confidence in the economy on which, as a small open economy, we are so dependent.

As the bulk of the fiscal problem is of a structural or underlying nature, a cyclical recovery in economic growth cannot be relied on to restore order to the public finances. Experience, both here and overseas, suggests that the best way to restore fiscal balance is to place more emphasis on reducing expenditure rather than increasing taxation. Therefore, while some broadening of the tax base is necessary, it is desirable that the primary focus of fiscal-consolidation measures should be on reductions in public spending. The Commission on Taxation and the Special Group on Public Service Numbers and Expenditure Programmes will help identify measures that will improve the budgetary situation in coming years. Painful as they are, these measures are necessary to restore confidence, to deal with financing concerns and to underpin the medium-term growth potential of the economy.

The banking sector

Internationally, the functioning of the financial system has improved somewhat in recent months, largely as a result of government and central bank support. Nonetheless, vulnerabilities remain and financial conditions are tight. Against this background, funding conditions remain very challenging for Irish banks and this is reflected in their significant recourse to the Eurosystem, which is of particular value to the country at this time. Domestically, the contraction in the real economy and a continuing weak property market have meant that banks have incurred substantial loan impairments. In addition, earnings are likely to remain relatively subdued in the near term because of higher loan provisions, increased funding costs, the pass-through of lower ECB policy rates and competition for deposits. Overall, our banking system, similar to those elsewhere, continues to face significant challenges. However, the inherent problems that need to be addressed are much clearer now, and significant actions are being taken to help the system recover.

The Government through the various steps that have been taken has shown its commitment to do whatever is necessary to support financial stability. Our approach has broadly followed a similar path to others. The introduction of a state guarantee for bank liabilities was taken to stabilise the funding situation. Under this scheme, the authorities significantly increased their engagement with each covered institution and this permitted the authorities here to move quickly to recapitalise the main domestic banks in order to ensure their viability, to support the supply of credit to the real economy, and to address market participants' requirements for banks to maintain higher core Tier 1 capital ratios than before the crisis. During this time, it was necessary to take Anglo Irish Bank into public ownership to protect the stability of the wider financial system. Most recently, the authorities have addressed banks' non-performing assets through the decision to establish the National Asset Management Agency (NAMA) and have decided to put in place a new regulatory system.

Irish banks have substantial exposures to land and development loans, which creates uncertainty about their capital positions, and ultimately affects their ability to provide credit to the real economy. NAMA will remove these problem assets from banks' balance sheets, thereby renewing confidence in the Irish banking system, and creating the conditions whereby credit can flow in sufficient volumes to impact positively on the domestic economy. The pricing of these assets is a key issue which must balance restoring the role of the banking sector in the real economy with value for the taxpayer. When the current crisis comes to an end, the structure and shape of the banking system, both here and abroad, is likely to be very different. In Ireland, the successful operation of NAMA is likely to be an important catalyst in this respect as the banks that emerge may well be smaller. This should allow for a more focussed and consolidated banking sector.

Foremost among the lessons to be learned from our experience during this crisis is that regulation needed to be significantly enhanced in response to the turmoil that we have seen. I welcome the Government decision to establish a unified central bank and regulatory structure which will be responsible for both the supervision of individual firms and the stability of the wider financial system. The transition to these new arrangements is at an advanced stage – a high-level implementation group is already working on the fine details, including preparatory work on the relevant legislation. The recruitment process to fill key senior positions in the new structure is well underway. This is not a debate that is unique to Ireland. Significant reforms have been announced very recently in Europe, the US and UK. In particular, the reforms at European level with the creation of a European Systemic Risk Board mirror what is being implemented here.

Within this new structure, the system of regulation will be different in a number of ways. This will arise both from changes in the global regulatory environment and in the manner in which regulation is implemented in Ireland. The international regulations dealing with capital requirements, liquidity, provisioning and accounting standards under which banks everywhere operate will be revised, in significant part, to address issues that have arisen with respect to capital adequacy and liquidity. Within this framework, there will be more focus on banks' business models, strategies and risks while also raising the profile of corporate governance issues. Regulators will be on-site attending a selection of credit, treasury, audit and board meetings while also requiring significantly broader and more timely information. Regulating for consumer protection by way of codes of practice and conduct of business will continue to be a priority.

A key element in the successful implementation of this new approach will be up-skilling of staff. As part of this, the process of recruiting specialists with significant industry experience to supplement our existing skills is well underway. In summary, this new regulatory system will result in more focussed oversight of the financial sector and will enhance Ireland's reputation as an international financial services centre.

Conclusion

The crisis that we have experienced since last autumn is the most serious to have hit the global financial sector since the Great Depression. It has combined with a number of domestic vulnerabilities to create a particularly difficult situation for this country. In the course of this statement, I have dealt with the various actions that have been taken to restore the health of the banking system, to put the public finances on a sound footing, to restore competitiveness and to reform our regulatory system. These actions have been significant and necessary and it is imperative that we persevere with them.

My colleagues and I are happy to take any questions now.