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TheOutlook

A quarterly analysis of trends in the Irish economy

Export surge offsets weak domestic spending

- Exports have been stronger than expected
- Domestic spending still falling
- First BoP surplus likely since 1999

The Irish recession ended nine months to a year ago, depending on which national income measure one uses, and GDP rose by a cumulative 1.6% over the first nine months of 2010. The public at large do not perceive the recession as over however, partly due to the modest nature of the recovery, which has not been strong enough as yet to generate employment growth, and partly to the composition of the upturn, which has been solely due to the external sector. An export-led recovery was widely predicted but the combination of strong growth in global demand, a weaker euro and substantial gains in Irish competitiveness have generated much stronger growth in exports than expected, and we forecast that trend to continue this year, with exports projected to grow by 9% in volume terms.

That, and a pick up in inventories is expected to propel Irish GDP growth into positive territory for this year, at 1.6%, offsetting another fall in domestic spending, albeit a much smaller decline than seen in recent years. Capital spending has plunged over that period and although there are signs of stabilisation in house-building, we expect a further fall in overall investment spending in 2011. Consumption too may decline by 1% as household disposable income is likely to fall further, although the behaviour of the savings ratio represents a major uncertainty following a sharp rise since 2007; the positive impacts on consumer sentiment of stabilisation in the public finances and some fall in the unemployment rate may be offset by the higher tax burden (the average tax rate has risen by over 5 percentage points in the last three years, back to 2005 levels), an absence of net job creation and ongoing uncertainty about the final cost of capital support for the State-owned banks.

The shift away from domestic demand to external demand means that the economy is now in better balance than it has been for some time. Moreover the recent BoP data implies that the surpluses now being run by the household and corporate sectors are offsetting the public sector deficit, although it has required a long and very painful retrenchment to bring this about. The result may be that Ireland will run a BoP surplus in 2011, the first since 1999.

Dr. Dan McLaughlin.

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Irish GDP

Economy returns to growth

GDP rose 1.6% in the first nine months of 2010…

The Irish economy, as measured by real seasonally adjusted GDP, expanded by 0.5% in the third quarter of 2010 according to the latest CSO release, following a revised 1% contraction in Q2 and 2.1% growth in the first quarter. On a GNP basis, which better reflects the income of Irish residents, the economy grew by 1.1% in Q3, following a 0.1% rise in Q2 so on either metric one can say that the recession in Ireland is over, having ended nine months or even a year ago.

On the quarterly figures GDP rose by a cumulative 1.6% in the first nine months of 2010 and we expect a further expansion in the final quarter, although this will not be enough to leave the average growth rate for the year in positive territory, barring data revisions, and we have pencilled in zero growth for 2010. This represents a marked improvement on the 7.6% contraction recorded in 2009, but GNP in 2010 is expected to contract again, by 2.5%, following a 10.7% fall the previous year.

The general public does not perceive that the recession has ended, partly due to the slow pace of recovery which has yet to lead to employment growth, and partly to the nature of the upturn, which has been driven by exports as domestic demand is still falling.

…but domestic demand is still falling…

This was evident in the Q3 data, with domestic demand falling by 3.7% in the quarter. Capital spending remains the main culprit, plunging an annual 31% with building and construction down 32% and spending on machinery and equipment declining by 27%. The latter is extremely volatile and strongly influenced by aircraft orders, but has now fallen for three consecutive years so one might expect some stabilisation in 2011, particularly given the global upturn, and we expect a flat reading for the year. Building and construction is expected to decline further, however, despite some signs of stabilisation in house-building, given the fall in capital spending by the public sector, and we forecast a 10% contraction this year. Consequently, capital spending as a whole is forecast to fall again in 2011, by 6.5%, following an estimated 26% decline in 2010, which would leave its share of real GDP down at 11.3% against a cyclical high of 25.8% in 2005.

Government spending may have fallen by around 5% last year and we expect a 2% decline in 2011, although of much more significance is the trend in personal consumption as the latter accounts for around half of GDP. Consumption fell precipitously in late 2008 and early 2009, and is still declining, albeit at a much slower pace. Nevertheless, the value of consumer spending probably declined by 1% in 2010, and it is difficult to envisage a pick up this year. Employment may continue to fall for the first half of the year and average earnings are likely to decline again, by 1% after a 2% fall last year, with disposable income also pressurised by a rise in tax rates. A key uncertainty surrounds the savings ratio, however, which has risen very steeply over the last three years, driven by economic uncertainty, deleveraging and the rise in unemployment. The recent falls in the unemployment rate may help to improve consumer sentiment, as will the stabilisation of the public finances, and we have assumed that the savings ratio stops rising as a result, although further increases represent a clear downside risk to any forecast of consumer spending.

…albeit at a slower pace.

The net result of the above projections is that domestic demand is again forecast to contract in 2011, albeit by 2.0% against a 6% fall in 2010. Fortunately, two other factors looks set to more than offset the decline in domestic spending, with the result that we expect GDP to record positive growth in 2011.

The first is the inventory cycle, in that the two years to the middle of 2010 saw a steep and prolonged decline in stocks, which one would expect to come to a halt at some stage. In the event inventories rose in the third quarter of 2010 and we now expect a modest stock-build this year, which will provide a positive impetus for GDP.

Exports likely to continue to drive the recovery…

The second is the external sector, which has been the key factor in the economic recovery to date, and exports look set to again provide the main positive contribution to GDP this year. Exports were widely expected to drive the upturn but the pace of growth has certainly surprised to the upside; the volume of exports accelerated to an annual growth
of over 13% in the third quarter of 2010 with a 17% rise in the value of merchandise exports resulting in a record quarterly trade surplus of €10bn. Moreover, the available trade data implies that exports strengthened further in the final quarter of last year, and we estimate 10% volume growth in 2010 as a whole. Ireland has made substantial gains in competitiveness on the standard unit labour cost measure, and the weaker trend in the euro has also helped firms take advantage of the strength of global demand so we forecast a 9% rise in the volume of exports for 2011.

Exports accounted for 95% of real GDP in 2010 (the import share was 77%) so a 1% swing in exports now effectively gives a 1% swing in GDP, highlighting how the external sector has come to dwarf domestic demand. Our own 2011 forecast means that net exports boost GDP by 3 percentage points, thus offsetting the fall in domestic demand to give an overall rise in GDP of 1.6%, which is in line with the latest Government forecast but slightly ahead of the Reuters consensus (1.3%). GNP is also likely to record positive growth, albeit only 1%, with a further rise in multinational profits offsetting higher returns on Irish investments abroad.

…giving rise to the first BoP surplus since 1999.

The rebalancing of the Irish economy, away from construction and consumption-led demand and towards the external sector, is also evident in the balance of payments data, which in Q3, 2010 recorded the first meaningful quarterly surplus since 2003. Recently published data for 2009 shows that the household and corporate sectors were running sizeable surpluses, therefore partly offsetting the public sector deficit, and the latest BoP data implies that this process has continued to reduce the need to finance imbalances in the economy from abroad. We therefore expect Ireland to record a BoP surplus in 2011, equivalent to 1% of GDP, the first since 1999.

Irish real GDP (% change)

	2009	2010 (e)	2011 (f)
Personal Consumption	-7.0	-1.0	-1.0
Government Consumption	-4.4	-4.8	-2.0
Capital Formation	-31.0	-26.2	-6.6
- Building & Construction	-34.9	-31.0	-10.0
- Machinery & Equipment	-19.3	-15.0	0.0
Stocks (% of GDP)	-1.3	0.0	0.1
Exports	-4.1	10.0	9.0
Imports	-9.7	6.2	7.0
GDP	-7.6	0.0	1.6
GNP	-10.7	-2.5	1.0

Inflation

Positive inflation likely in 2011

The annual inflation rate has turned positive…

The annual inflation rate in Ireland, as measured by the CPI, turned positive last August, after eighteen months of deflation, but there is very little evidence of upward price pressures emerging. The index has actually fallen marginally since July, although the annual inflation rate has picked up, reflecting base effects, and will probably end the year well over 1%. This will still leave the average inflation rate for 2010 in negative territory, however, at around -0.9% from -4.5% in 2009.

Mortgage costs play a key role in the volatility of Irish CPI inflation, with a weight of 6.7% in the index, and it was this component that accounted for a substantial part of the base effects for the first half of 2010. That impact was compounded by an upward drift in mortgage costs as the year unfolded, with Irish banks attempting to pass on higher funding costs. Energy prices have also risen relative to 2009 and the steep fall in food prices seen over the last eighteen months has also come to a halt. Against this, the weak state of consumer demand has kept downward pressure on most other high-street prices.

…but little price pressures evident.

The latter factor is unlikely to change materially in 2011, and the annual inflation rate is likely to remain relatively subdued in the absence of a major move up in energy prices. A weaker euro against sterling may be an additional inflationary factor, and the timing of an ECB rate change, if any, will play a significant part (we expect a rise in the final quarter). On that basis we expect CPI inflation to average 1.4% in 2011, which is in line with the current consensus.

The HICP index, the standard EU measure of inflation, does not include mortgage costs and so tends to be much less volatile than the CPI. The annual HICP inflation rate turned negative in March 2009 and was still in deflationary territory in November 2010, at -0.8%, against a euro figure of 1.9%. We expect this Irish inflation measure to turn positive in the coming months, however, boosted by higher energy and food prices, and forecast an average figure of 0.8% for 2011, again in line with the consensus.

Finally, it is worth noting that a broader measure of inflation, the GDP deflator, rose over the first nine months of the year by a cumulative 2.5%, although the annual rate was still in negative territory in Q3, at -0.5%.

CPI Inflation (annual change, %)

	2010	2011 (f)
Q1	-3.4	1.3
Q2	-1.4	1.5
Q3	0.2	1.2
Q4	0.9 (e)	2.0
Annual	-0.9 (e)	1.4
HICP	-1.5 (e)	0.8

The unemployment rate peaked last July

The unemployment rate probably peaked last July…

The Irish seasonally adjusted unemployment rate is prone to revision but the latest vintage of data points to a cycle peak last July, at 13.7%, followed by a steady decline to 13.3% in the final quarter of 2010, and a similar average for the year as a whole. There is some evidence that the demand for labour is no longer falling at a precipitous pace (the level of redundancies averaged 3,800 per month in Q4 2010, from over 7,000 a month in the first half of 2009) but as yet no clear indication that employment has stabilised, so the decline in the unemployment rate owes more to changes in labour supply rather than any pickup in demand.

Indeed, the employment data as revealed in the latest Quarterly National Household Survey was disappointing as seasonally adjusted employment fell by over 23,000 or 1.3% in Q3, following an 8,600 decline in Q2 (0.5%). The latter figure had lent support to the view that employment would stabilise in the second half of 2010 but the most recent figures do not support this, with job losses still much in evidence in construction, manufacturing and financial services, with modest job creation only visible in a few industries, notably education.

…but owes more to falling labour supply.

The pace of job loss is slowing on an annual basis, to 71,000 or 3.7% in Q3 from 79,000 (4.1%) in Q2, but it is still likely that employment fell by over 4% on average in 2010, following an 8.2% plunge in 2009. The supply of labour has also fallen sharply, however, and at a more rapid pace in the third quarter of 2010, with a 2.4% annual decline recorded from 2.3% in Q2, and we expect that a further acceleration took place in the fourth quarter, given the trend in the Live Register and the unemployment rate. The participation rate has fallen steadily over the past two years, notably among the 15-24 age groups, and emigration has picked up.

We expect employment to stabilise by mid-2011 but this still implies a further fall in the annual average, and the labour force is also likely to contract further, with net immigration rising to around 60,000 a year, thus largely offsetting any natural increase in the population. The unemployment rate may continue to inch downward as a result, averaging 13% this year, highlighting that the flipside of export-led high productivity growth is limited job creation.

Labour Market (annual averages '000)

	2009	2010 (e)	2011 (f)
Employment	1929	1848	1828
Labour Force	2187	2131	2100
Unemployed	254	283	272
(% of labour force)	*11.8*	*13.3*	*13.0*

Exchequer Finances

2010 emerged on target

The 2010 Budget emerged on target…

The 2010 exchequer deficit emerged at €18.7bn which was virtually identical to the original Budget target, a rare feat in terms of the recent Irish fiscal performance – the past decade had seen substantial overshoots and undershoots with a median annual forecasting error of €1.5bn. The revenue and spending outcomes were significantly different than originally projected, however, with the current Budget deficit emerging €1.1bn better than expected, offset by a similar overshoot on the capital side.

Current revenue came in some €1bn ahead of target, including €700m in tax receipts and the balance in additional non-tax revenue largely stemming from the deposit guarantee schemes. Corporation tax, in particular, was much stronger than expected, €764m above projections, and this alongside additional revenue from excise duty offset a €254m shortfall in income tax. Debt expenditure was also lower than planned but this was offset by extra day-to-day spending leaving total current spending only marginally behind target. On the capital side the exchequer faced unplanned spending relating to NAMA. EU support for Greece (€346m) and direct support for the Educational Building Society and Irish Nationwide Building Society (€725m) with the result that the capital deficit emerged at €6.2bn against an original target of €5.1bn.

The deficit figure of €18.7bn amounts to 11.9% of estimated GDP and compares with a deficit of €24.6bn in 2009. However, the General Government deficit was much higher in 2010, at €50.1bn, reflecting the cost of capital support for Anglo Irish Bank and Irish Nationwide Building Society.

…with a €17.7bn deficit projected for 2011.

The 2011 Budget is predicated on real GDP growth of 1.7% and projects an exchequer deficit of €17.7bn, following another fiscal adjustment package involving €3.9bn in spending cuts (split equally between capital and current expenditure), €1.4bn in higher taxes, and €0.6bn in other measures. Despite these cuts the capital deficit is projected at €6.2bn, broadly unchanged from the 2010 outcome, as it includes borrowing of €3.1bn to fund part of the promissory notes used as capital for the State-owned banks. This transfer is excluded from the General Government deficit, which with other adjustments is forecast at €15.2bn, or 9.4% of GDP.

Exchequer Finances (€bn)

	2010 Budget	2010 Outcome	2011 Budget
Current Expenditure	47.1	47.0	48.4
- Voted	40.2	40.5	41.7
- Non-voted	6.9	6.5	6.7
Revenue	33.4	34.4	36.9
- Tax	31.1	31.8	34.9
- Other	2.4	2.7	2.0
Current Budget Balance	-13.7	-12.6	-11.5
Capital Budget Balance	-5.1	-6.2	-6.2
Exchequer Balance	-18.8	-18.7	-17.7
General Govt Balance	-18.7	-50.1	-15.2
(% of GDP)	(-11.6)	(-31.8)	(-9.4)

Funding the Exchequer Deficit

Gross funding of €22.3bn in 2011

The IMF/EU loan removes the need for market funding…

The NTMA, which manages Ireland's sovereign debt, issued €19.9bn of Government bonds in the first nine months of 2010 at an average yield of around 4.7% which was broadly unchanged from the average yield in 2009. The Agency then announced it had completed its funding for the year but this did not prevent a rapid rise in the risk premium on Irish debt; the 10-year yield soared to over 9% in late November, putting the spread against German debt at over 650 basis points.

The Irish Government then decided to accept an EU/IMF loan package at an average interest rate of 5.8% rather than attempt to fund in the market, which obviously removes the need for the NTMA to issue this year. A substantial fall in market yields might prompt the agency to issue short paper on an opportunistic basis but Irish yields are still trading at extremely high levels, with the 10-year benchmark around 9%, and over 600 basis points to bunds.

The Irish Government has repeatedly made the point that the State has no immediate need to fund, and this was confirmed in the release of the end-year exchequer balance. The NTMA raised a net €19.1bn in the bond market and an additional €3.4bn from National Savings schemes (marketed to the public) therefore comfortably exceeding this exchequer deficit of €18.7bn. The Agency had entered 2010 with cash balances of €21.8bn and the above net funding had augmented that total but the Agency ran down its commercial paper issuance with the result that cash balances fell by a net €6.1bn leaving an end-2010 cash balance total of €15.7bn.

…with a gross requirement of €22.3bn this year.

The 2011 Budget projected a €17.7bn deficit, which alongside scheduled redemption of €4.6bn (in November) implies a gross funding requirement of €22.3bn, and perhaps a €20bn call on the EU/IMF loan or the market assuming over €2bn is garnered through National Savings Schemes. The latter source could be much higher of course, and the demand for Irish Government bonds from domestic pension funds may well rise under proposed pension law changes. Hence the implied call on buyers of Irish bonds does not seem excessive, but the market price of Irish debt and the CDS spread indicates that investors are still adding a high risk premium.

The Irish debt ratio has certainly risen sharply over the last few years, from under 25% in 2007 to an estimated 94.2% in 2010, but on the Government's projections is forecast to stabilise at 102% in 2012/13 before falling again. The jump in the debt burden is in part due to the capital cost of supporting the State-owned banks (which amounted to €31.5bn in 2010) and investors see the banking sector as representing substantial further contingent liabilities for the State, thus representing further upside costs on the debt front. On that basis a substantial fall in Irish sovereign yields would require greater investor confidence as to the final bank losses.

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