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TheOutlook

A quarterly analysis of trends in the Irish economy

External environment to weigh on exports

- 1% growth now seen for 2011 following weak Q3 data
- Similar expansion expected in 2012

The scale of the reported fall in third quarter GDP implies that even with a modest rebound in the fourth quarter Irish growth in 2011 was 1% at best. This is stronger than the consensus view held in the early part of last year but forecasts had moved higher in the wake of upside growth surprises in the first two quarters, now revised down. The composition of that growth has been as expected however, with net exports providing the main stimulus and offsetting further falls in domestic spending.

The importance of exports in the Irish economy highlights that the risks to growth in 2012 may well be more to the external side, given the ongoing uncertainty in the euro sovereign debt market and the prospect of weak growth at best in the euro area and the UK. The current strength of the US economy (Ireland's largest single export market), the gain in Irish competitiveness and the fall in the euro, particularly against sterling, may provide some offsetting support, although we now expect the external sector to provide a smaller stimulus to the economy than in the past few years. Against that, the fall in domestic demand may ease; the increase in Foreign Direct Investment in 2011 may translate into a rise in spending on machinery and equipment and the headwinds facing the consumer may become less intense – employment is expected to fall further but wages may stop falling in aggregate and inflation is also likely to slow, so reducing the expected fall in real household incomes.

The recent ECB shift to easier monetary policy will also support most mortgage holders, and although there is some debate on whether rates will fall further, it is universally felt that rates will not rise for some time. Fiscal policy, in contrast, will again have a contractionary impact and the scale of the fiscal problem is illustrated by the fact that the State will still have to borrow some €19bn in 2012, or over €15bn excluding banking related expenditure. The Government would like to return to the market at some stage over the next eighteen months but this will probably depend more on investor sentiment towards euro debt as a whole and most if not all the funding will come from the EU/IMF, which makes sense anyway from a financial perspective in the wake of the reduction in the interest rate paid on EU funds.

Dr. Dan McLaughlin

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Irish GDP

Recent data prompts downward revision to forecasts

Big fall in investment in third quarter…

Irish GDP growth had surprised to the upside in both the first and second quarters but surprised to the downside in Q3; the consensus was expecting a 0.5% contraction so the 1.9% reported fall was something of a shock, with GNP declining by 2.2%. The figures for the first half of the year were also revised down, leaving the annual change in GDP in the third quarter at -0.1% with GNP 4.2% below the same period in 2010.

The main factor behind the third quarter fall in output was a 20.9% plunge in capital spending, including an extraordinary 28% decline in spending on machinery and equipment. The latter is particularly volatile on a quarterly basis (Q1 saw a 28% rise) partly due to aircraft orders, which in this case fell from over €1bn in Q2 to just €54m. Nevertheless, spending on machinery ex aircraft was still down an annual 8.7% and we are revising down our 2011 estimate for total spending on machinery and equipment and now expect a 10% fall. Building and Construction also fell substantially in Q3, and by over 21% on an annual basis, with the result that we are also revising down our estimates for that component in 2011, to -20% from -15%. As a result, we now expect capital spending in total to have fallen by over 16% last year, so reducing GDP by some 2 percentage points.

Consumer spending and government consumption also fell in the third quarter, both by 1.3%, and the former was down 3.9% on an annual basis. The final quarter may see a modest rise in personal consumption but for 2011 as a whole consumption probably fell by 3% so reducing GDP by 1.6 percentage points. Households probably increased their precautionary savings and certainly repaid some debt but inflation and job losses proved the main negative for consumer spending last year; employment fell by an estimated 2.4% while inflation picked up to 2.7% (against a 0.9% fall in prices in 2010) so substantially outstripping wages which fell marginally on the year. As a result real disposable income declined having risen modestly in 2010.

…and export growth has slowed…

The fall in domestic demand in the third quarter was partially offset by a positive impetus to GDP from inventories and another substantial contribution from the external sector; exports rose by 0.8% while imports fell by 1.5%. The former exceeded real GDP in the third quarter while imports amounted to 74%, so swings in net trade can and do dwarf the other GDP components. Exports have slowed, however, with the annual increase easing to 2.4% in Q3 from 10.6% a year earlier and we now expect 2011 export growth of 3.6% in volume terms from 6.3% in 2010. It now looks likely that imports fell in 2011, albeit marginally, so our estimate of the contribution to GDP from net trade is broadly unchanged from our previous 'Outlook' against a downward revision to domestic demand. Consequently, we now expect GDP to have risen by 1% last year, down from our previous 1.5% estimate, albeit still above the consensus forecast in the early part of the year. In the absence of revisions this implies a modest recovery in GDP in the final quarter of 2011, and the annual growth figure will benefit anyway as GDP contracted by 1.5% in the final quarter of 2010.

…and demand from Europe is likely to be weaker…

The outlook for 2012 is clouded by the uncertainty surrounding the euro sovereign debt issue which appears to have taken some toll on business and consumer confidence in the region. Most European governments are also pursuing contractionary fiscal policies so the consensus forecast for euro growth has moved down significantly of late. The same can be said for the UK, so growth in some of Ireland's main export markets looks likely to be weaker than in the past two years. In contrast, the US economy has picked up some momentum of late and as the largest single destination for Irish exports may provide some offset to the dimmer prospects elsewhere. Moreover, Ireland's recent competitive gains and the nature of its export mix may provide additional support to the external sector, as will the fall in the euro against sterling, although we still expect export growth to slow somewhat in 2012, to 3%.

...domestic demand to fall again but at slower pace.

On the domestic side, we envisage a further 1% fall in consumer spending but this will be at a slower pace than in 2011; employment is likely to fall further but wage growth turned positive on an annual basis in the third quarter of last year (the latest available data) so total wage income may be broadly flat. In addition, inflation is expected to slow, even with the recent 2% increase in VAT, helped by falling mortgage costs and a decline in annual energy inflation so limiting the decline in real disposable income. 2011 saw a substantial pick up in Foreign Direct Investment according to the BoP data and at some point we would expect this to translate into higher capital spending on machinery and equipment. Consequently, we project a 5% rise in this component in 2012 although the risk is that firms postpone investment in the face of European and global uncertainties. Construction spending is expected to decline again, albeit at a slower pace, so capital formation as a whole is projected to fall by some 5%.

Government spending too is forecast to fall so the net result is very similar to the position in 2011 – a decline in domestic spending offset by a positive contribution from net exports. Indeed, our GDP forecast for 2012, at 1%, is identical to the expected 2011 outturn, although GNP is expected to rise after contracting by over 2% last year. The risks to the forecast are more external than internal, given the importance of Irish exports in the GDP figure, and so any projection for 2012 is tentative against the current uncertain European outlook and in the absence of data on how Irish GDP fared in the final quarter of 2011.

Irish Real GDP (% change)

	2010	2011 (e)	2012 (f)
Personal Consumption	-0.8	-3.0	-1.0
Government Consumption	-3.8	-3.5	-2.0
Capital Formation	-24.9	-16.5	-4.5
- Building & Construction	-30.3	-20.0	-10.0
- Machinery & Equipment	-14.5	-10.0	5.0
Stocks (% of GDP)	-0.6	0.4	0.4
Exports	6.3	3.6	3.0
Imports	2.7	-0.2	1.0
GDP	-0.4	1.0	1.0
GNP	0.3	-2.2	1.0

Inflation

Expected to slow this year

Pick up in 2011 largely due to mortgages and energy…

Irish inflation, as measured by the CPI, picked up through 2011, and probably ended the year around 3.0% from 1.3% twelve months earlier. The acceleration was largely due to two factors unrelated to Irish domestic spending - energy and mortgage interest. The former rose by some 14% in the year to November, so contributing 1.2 percentage points to overall CPI inflation, while mortgage interest rose by 18%, adding 1.1%. If one excludes these factors prices were subdued, as one might expect in an environment of declining employment, falling wages and declining retail sales. Food price inflation did pick up, albeit strongly influenced by base effects, but to only 1.6%, while prices fell in five of the twelve CPI component groups.

…which may act to dampen inflation this year.

Mortgage interest inflation also peaked in the first half of 2011 and has been slowing since and that process is likely to become more pronounced in 2012 given the policy reversal by the ECB, with rates falling in November and December and the prospect of a further cut in the coming months. The path of energy prices is more uncertain, but in the absence of an oil price spike the first half of 2012 should see a deceleration in annual energy inflation due to base effects alone. Ireland's size and openness also means that the path of the currency, notably against sterling, also plays a role in the Irish price level and the recent fall in the euro may provide some offsetting upward pressure on inflation, albeit limited by weak domestic spending which may mean retailers have to absorb some or all of any rise in import prices. Similarly, it is unclear how much of January's 2% increase in the top rate of VAT will be passed on and the impact on inflation may be smaller than anticipated.

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Overall, we expect the annual rate of CPI inflation to fall sharply in the first half of 2012, and for a more modest pace of deceleration to take it below 2% in the second half with an annual average of 2.0%. The path of the HICP is likely to be much more stable, ranging between 1.5% and 2% through the year, with an annual average of 1.6%.

CPI Inflation (annual change, %)

	2011	2012 (f)
Q1	2.3	2.4
Q2	2.9	1.9
Q3	2.6	1.6
Q4	2.9	1.3
Annual	2.7	1.8
HICP	1.2	1.6

The Labour Market

Employment yet to stabilise

Large employment fall in Q3…

The scale of the fall in q3 GDP was not the only downside surprise in the quarter – employment fell by over 20,000 or 1.1%. The past year had seen a marked deceleration in the pace of job losses, with the decline in the second quarter of 2011 at just 0.1%, which had prompted the view that the employment cycle may have bottomed. In the event, the Q2 data was revised down slightly to a 0.2% fall, and the third quarter decline proved the largest since the final quarter of 2009. Employment did rise modestly on a seasonally adjusted basis in wholesale, retail, hotels and restaurants, perhaps reflecting the pick up in tourism, and in construction, curiously enough, but this was offset by falls in agriculture, financial services, manufacturing and education and health.

The supply of labour has also been on a downward trend and the third quarter saw an 18,000 fall. Consequently, the rise in unemployment was marginal, from 300,000 to 303,000, pushing up the unemployment rate to 14.4% from 14.2% in Q2. The monthly unemployment rate estimates since then show little change over the fourth quarter, with the rate ending 2011 at 14.3% from 14.7% a year earlier.

The labour force in the third quarter had declined to a seasonally adjusted 2.104m from a cyclical peak of 2.248m in the first quarter of 2008 and had it remained at that level, the unemployment level would now be 454,000 (against the actual 303,000) and the unemployment rate over 20%.

…and unemployment rate unlikely to decline much in 2012.

The supply of labour responds to market developments, of course, be it via a fall in participation or, in Ireland's case, emigration. The participation rate is now 60.4 from a peak of 64.8, with a marked decline in the younger age group. Net emigration has risen, initially from non-Irish nationals leaving after losing their jobs but of late this has changed with more Irish nationals leaving – 40,000 Irish nationals lost their jobs in the year to the third quarter, but the rise in Irish nationals unemployed was just 20,000.

For 2011 as a whole, we now expect an average fall in employment of 44,000 or 2.4%, with the numbers unemployed averaging 301,000 or 14.3% of the labour force. The latest data and the downward revision to our GDP forecast have also resulted in a more negative projection for employment in 2012, which we now expect to fall by 20,000 or 1%. This may well be matched by a similar decline in the labour force, however, so leaving the unemployment rate unchanged at 14.3%.

Labour Market (annual averages '000)

	2010	2011 (e)	2012 (f)
Employment	1848	1804	1784
Labour Force	2130	2105	2085
Unemployed	292	301	301
(% of labour force)	*13.6*	*14.3*	*14.3*

Exchequer Finances

On target despite tax undershoot

General Government deficit at 9.8% of GDP…

Tax receipts were projected to rise by 9.9% in 2011, to €34.9bn, but in the event emerged at €34.0bn or 2.5% adrift of the Budget target. The shortfall only began to emerge in the final few months of the year and was largely due to a €500m undershoot in VAT, reflecting weaker than expected consumer spending (corporation tax was also behind profile by a similar amount but over half of this was due to timing factors, subsequently unwound in early January). Despite this, total revenue came in broadly on target thanks to a substantial overshoot in non-tax receipts, primarily due to monies from the bank guarantee scheme. Current spending emerged some €400m below profile with the result that the current budget deficit was €11.2bn against an €11.5bn Budget target and as such well below the 2010 figure of €12.6bn.

The 2011 Budget had projected a capital deficit of €6.1bn but this figure had made no provision for any additional funds for the banking sector which in the event emerged at €7.6bn, although the Exchequer also received an unbudgeted €1bn in capital receipts from the sale of Bank of Ireland shares. The capital deficit therefore emerged well above the original target, at €13.7bn, resulting in a total Exchequer deficit (EBR) of €24.9bn equivalent to 16.1% of GDP. The General Government deficit, the fiscal standard measure across the EU, excludes a number of banking related transactions and this came in at an estimated €15.2bn or 9.8% of GDP, against a revised target of 10.1% but an original Budget projection of 9.4%. The IMF concentrates on the primary balance, and that target was also comfortably met.

…with another contractionary budget required for the 8.6% target in 2012.

The 2012 Budget is predicated on real GDP growth of 1.3% and a 2.5% rise in nominal GDP, to a forecast €159bn. On unchanged policies the General Government deficit was set to rise to €16.2bn or over 10% of GDP, so the achievement of an 8.6% deficit target required further fiscal adjustments on top of the €21bn already enacted since 2008. The Minister for Finance chose to raise an additional €1bn in revenue, largely through higher VAT and excise duties, and cut spending by €2.2bn, including €1.4bn on the current side, to give total Budget adjustments of €3.2bn, although the deflationary impact of the measures was expected to reduce tax revenue by €0.8bn. The Department of Finance believes that the Irish deficit is largely structural and that the structural deficit will fall modestly in 2012 to 8.0% of GDP from 8.6% last year, with the structural primary deficit declining from 5.3% to 3.8% of GDP. The risks to the Budget outlook appear to be on the downside, particularly in terms of the spending related tax receipts, although the figures are predicated on a 1.3% fall in real consumer spending.

Exchequer Finances (€bn)

	2011 Budget	2011 Actual	2012 Budget
Current Expenditure	48.4	48.0	49.5
- Voted	41.7	41.4	40.5
- Non-voted	6.7	6.6	9.0
Revenue	36.9	36.8	38.3
- Tax	34.9	34.0	35.8
- Other	2.0	2.8	2.5
Current Budget Balance	-11.5	-11.2	-11.2
Capital Budget Balance	-6.1	-13.7	-7.7
Exchequer Balance	-17.7	-24.9	-18.9
General Government Balance	-15.2	-15.2	-13.7
(% of GDP)	*-9.4%*	*-9.8%*	*-8.6%*

€24bn funding projected for 2012

€2.1bn overfunding in 2011…

Under the terms of the EU/IMF agreement, Ireland can borrow up to €62.5bn from these official sources, with another €5bn pledged in bilateral loans from a number of countries. In 2011, the Exchequer drew down a €0.5bn loan from the UK and some €34bn from the EU/IMF, with €13.9bn coming from the Euro Financial Stabilisation scheme, €7.6bn from the EFSF and €12.6bn from the IMF. Some €4.8bn of this was used to repay maturing bond debt with another €4.1bn in repayment of short dated commercial paper. The State also raises regular funding from the National Savings Schemes, and this amounted to €1.4bn in 2011 with the result that total net funding amounted to €27bn, compared to a funding requirement (EBR) of €24.9bn. This €2.1bn overfunding boosted the NTMA,s cash balances to €17.8bn from €15.7bn at the end of 2010.

Ireland's General Government debt amounted to €144bn at end 2010 and we estimate that it had risen to €168bn by the end of 2011, which is 108% of GDP from 92.5% the previous year. In 2012, the debt total may rise to €184bn equivalent to 114% of GDP and the Department of Finance expects the debt ratio to peak at 118% in 2013, before declining from these levels as Ireland is forecast to run a primary surplus from that period, with nominal GDP growth also expected to pick up.

…with €24bn required in 2012.

In terms of funding in 2012, the EBR is forecast at €18.9bn and bond redemptions amount to €5.5m (due in early March) giving a gross funding requirement of over €24bn, or some €23bn assuming a similar inflow from the National Savings Schemes than in 2011. Ireland can now access EU loans at around the cost of funds, so from a strictly financial viewpoint, it would make sense to source this requirement from official sources, even if the market was to open to Ireland at some stage in 2012. That is unlikely at present and may depend more on sentiment to the euro debt generally than to any specific Irish development, although the Government has indicated it would like to return to the markets this year. If so, it would likely take the form of Treasury Bills rather than longer dated debt, so most, if not all, the funding is likely to come from official sources. Ireland can still draw some €28bn under the EU/IMF deal so the implication is that the Exchequer is funded well into 2013 on unchanged cash balances, or beyond should they choose to run down these balances, currently just under €18bn.

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