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TheOutlook

A quarterly analysis of trends in the Irish economy

Irish economy contracts in face of three shocks

- GDP likely to fall again in 2009
- Falling inflation and sharply lower rates may offer some respite

The Irish economy has been hit by three shocks, one well-flagged but the other two unexpected at least in their degree of severity. The first was the housing correction, which precipitated a 30% fall in house completions over the first half of the year, and an 18% fall in total construction output. The second shock was the oil spike over the first half of 2008, which kept inflation high and prevented the type of easing in monetary policy normally seen in a cyclical slowdown. Indeed, interest rates had actually risen substantially as a consequence of a third shock – the global credit crunch. Of course Ireland is not unique in this regard, as it now appears that global growth is slowing sharply, with the US, UK and the Eurozone all in recession. The net result is that the Irish economy will contract by 1.6% this year, its first decline in national income in 25 years, with net exports providing the only substantial support to activity.

The outlook for 2009 is surrounded by more uncertainty than usual, given the degree of dislocation seen in financial and credit markets, but a further decline in Irish output seems the most realistic assessment at this juncture. A further sharp fall in construction spending looks inevitable given forward indicators of housebuilding, and household incomes will be squeezed by lower wage growth, falling employment and a higher tax burden. There are two positives however, which may eventually help to stabilise activity and ultimately restore some confidence.

The first is inflation, which was likely to drift lower but may fall sharply now in the wake of the recent plunge in commodity prices, including oil. The second is interest rates, as there appears little reason now for the ECB not to cut rates aggressively in the face of falling eurozone output. Rates fell to 2% in the last cyclical downturn and this appears a reasonable target this time round, with Irish inflation also likely to fall to around that level by mid-2009, on the assumption that oil prices do not rebound aggressively. Under normal circumstances the combination of falling inflation and lower interest rates is a recipe for recovery, although market events of late confirm that this cycle is very far removed from anything experienced in recent memory.

Dr. Dan McLaughlin

Irish GDP

Economy to contract by 1.6% this year

Steep falls in housebuilding help to push economy into negative growth…

The Irish economy, as measured by GDP, contracted by an annual 1% in the first half of 2008, and output will probably fall at a faster pace in H2, leaving average growth for the year at minus 1.6%. This would be the first negative growth reading since 1983, and is all the more remarkable given that the economy grew by 6% in 2007 and by 5.5% as recently as the fourth quarter of last year.

A prime factor behind this rapid deterioration was the scale of the fall seen in the construction sector, which contracted by 15% in the year to the second quarter, following a 20% fall in Q1. Spending on non-residential construction did rise modestly, and outlays on home improvements increased by 18%, but this was dwarfed by another 30% fall in housebuilding. We now know that house completions fell by 35% in the third quarter, so another substantial fall in construction output is inevitable in Q3, with further declines seen in Q4 and in 2009.

…oil price spike and credit crunch also material influence…

The only saving grace, albeit partial, is that residential constructions share of GDP is falling rapidly, so any given percentage fall will have a lesser impact on national income – housebuilding accounted for 9.3% of GDP in 2007 but had fallen to 6.5% by the second quarter of 2008, and is likely to end the year well below 5%.

Unfortunately, the impact of the housing correction on activity has been compounded by two further shocks to the economy – the credit crunch and an oil price spike. The former pushed up the effective cost of borrowing, prompted a tightening of credit standards and helped to precipitate a sharper global slowdown than appeared likely earlier in the year – the US economy now appears to be in recession, as is the UK and the euro area. Business spending has plunged against this backdrop with Irish spending on machinery and equipment falling by over 30% in Q2.

The rise in effective borrowing costs also hit consumer confidence, and households real spending power was also depressed by the surge in oil prices over the first half of the year, which helped keep inflation high. Moreover, the ECB eventually responded by raising rates in July, despite the fact that activity was clearly slowing sharply across the euro area. The net result is that Irish retail sales have fallen precipitously as has consumer spending overall: personal consumption declined by 1.4% in Q2, having risen by 3.6% in the first quarter and by 6.3% in 2007.

…net exports provide some support…

Unemployment has picked up at a rapid clip and this too will weigh on consumer sentiment, so we expect consumer spending to fall over the second half of 2008, leaving the average change for the year at zero. Government spending is set to rise by around 4%, but this will not prevent domestic demand (the sum of consumption plus investment plus government spending) falling by 4.5% in 2008. This weakness in Irish spending is also dampening demand for foreign goods as well, and imports fell by over 1% in the year to the second quarter. Exports are still rising however, perhaps reflecting the composition of trade, as Irish merchandise exports are dominated by chemicals and pharmaceuticals, which may prove more resilient than other more discretionary items. Consequently, the external sector is forecast to provide a net stimulus to growth this year, so limiting the fall in GDP to 1.6%, with a similar figure expected for GNP.

The outlook for 2009 is more uncertain than normal, given the turbulence in financial and credit markets but a further decline in Irish GDP looks the more likely outcome, particularly over the first half of the year. The construction sector is set to contract sharply again, and employment is forecast to fall, which will depress household income and hence consumption. The 2009 Budget will also add to the squeeze on personal incomes, and capital spending by the public sector will fall relative to 2008, albeit still remaining relatively high at over 4.5% of GDP.

…although rate cuts and lower inflation will eventually support spending.

There are two positives, however, which are likely to offer support and eventually steer the economy to a recovery. The first is inflation, which looks set to fall sharply, helped by the recent plunge in oil prices. The second is interest rates, as the ECB may now cut rates aggressively in the face of falling eurozone output and decelerating inflation – we expect a repo rate of 2% by mid-2009, from the current 3.75%. Interbank rates too are likely to drop lower, although a greater degree of uncertainty surrounds this area. Overall though, we doubt if these factors will be enough to prevent the average growth rate for the year from being negative, and we forecast a 1% decline in GDP, with GNP also falling at the same pace.

Irish Economy Forecasts

GDP % change	2006	2007	2008(f)	2009(f)
Personal Consumption	7.1	6.3	0	0
Government Consumption	4.8	6	4	1
Capital Formation	4	1.2	-17.5	-11.9
Stocks (1% of GDP)	0.8	-0.1	0.7	0.7
Exports	5.7	6.8	2	1.5
Imports	6.3	4.1	-1	-0.5
GDP	5.7	6	-1.6	-1
GNP	6.3	4.1	-1.5	-1

Inflation

Inflation set to fall

CPI inflation has proved stubbornly high…

Lower inflation is one of the few positives that is likely to materialise in the Irish economy over the coming year, although it has to be said that inflation has proved stubbornly high for longer than most envisaged, including ourselves. CPI inflation has been above 4% for two years now, underpinned by rising mortgage rates, a spike in food price inflation from late 2007 and the oil price surge, but the conditions appear to be in place for a sharp fall, both here and across the European economy.

One factor is food, as last year's steep monthly increases (3.4% in the fourth quarter alone) will soon fall out of the 12-month comparison. Indeed, food price inflation peaked in March at 9.3% and had fallen to 6.1% in September, helped by four consecutive monthly falls. This phenomenon will also be a feature of the price of fuel, particularly in the first half of 2009, but the recent plunge in oil prices offers an additional disinflationary influence, albeit partially offset by the Budgetary decision to raise the excise duty on petrol by 8 cents a litre. Indeed, the tax increases announced might have added at least 0.5% to the CPI, although staggered over a number of months, and hence dampen the pace at which inflation was likely to fall, but the decline in oil prices has already more than offset the excise change.

…but looks set to fall…

A third factor is mortgage interest payments which have risen again in recent months, reflecting the impact of the credit crunch on wholesale money market rates and the ECB's quarter point rate rise in July. Although tracker mortgages (which are linked to the repo rate) are rarer now, they were very popular over recent years, and so many borrowers will now benefit from the half point rate reduction announced in mid-October. Moreover, we expect mortgage interest to fall sharply in 2009, on the basis that substantial repo rate cuts are likely.

…to an average 2.2% in 2009.

Consequently, we expect CPI inflation to fall to around 2% by mid-2009 and to average 2.2% for the year as a whole, although this is predicated on oil prices staying around current levels. Inflation is measured using the standard European norm, the HICP, and is currently lower in Ireland (3.2%) than the euro average (3.6%), implying perhaps that the euro's appreciation against sterling is finally having an impact on Irish prices. Again inflation on this measure is also expected to decline primarily due to the unwinding of food and energy spikes, and is forecast to average 2.3% in 2009, from 3.3% this year.

Inflation (CPI, % change)

	2008	2009
Quarter 1	4.7	3.1
Quarter 2	4.7	2.3
Quarter 3	4.3	2.1
Quarter 4	4.2	2.1
Year	4.5	2.2

Interest Rates

ECB to continue to ease

Monetary policy was unusual this cycle…

One of the many unusual features of this economic cycle has been the stance of monetary policy in the euro area. Economic growth peaked in terms of momentum in the first half of 2006, and the ensuing slowdown became more pronounced from late 2007 with eurozone GDP actually falling in the second quarter of this year. This cyclical downturn would normally have led to monetary easing as indeed it did in the US, but the ECB actually tightened policy further, raising rates by a quarter point in July, to 4.25%. At that time there had already been a significant de-facto tightening anyway, via elevated interbank rates, as the credit crunch was by then almost a year old.

The ECB argued that an official rate rise was needed in order to anchor inflation expectations and prevent wage inflation from accelerating, although accepting that the pick up in headline inflation was primarily due to higher food and energy costs.

…but rates now look set to fall.

The ECB's October meeting hinted at a change of tack, as it had become clear that economic growth was not recovering as the Bank had expected. A rate cut in November therefore looked on the cards, but in the event rates were cut by half a point earlier than planned in a co-ordinated attempt by central banks to shore up confidence amid a plunge in equity markets and paralysis in credit markets.

The consensus view now is that euro growth may be close to zero next year and that inflation will fall very sharply, helped by the plunge in oil prices. On that basis, we may see a very rapid reduction in ECB rates in the coming months, and we now expect the repo rate to fall to 2% by the first half of 2009.This may have a positive effect on sentiment and consumer spending as the Irish economy is more geared to variable interest rates than in some other European economies, where fixed rate borrowing is more the norm. Total mortgage debt in Ireland rose by €100bn in the six years to 2007 and some €60bn of this was via tracker rates, linked directly to the ECB repo. If rates were to fall to 2%, implying a tracker rate of around 3%, this would save existing borrowers €1bn a year in repayments.

Exchequer Finances

Deficit higher than planned

The 2008 deficit forecast at 5.5% of GDP…

Fiscal policy in Ireland in recent years has been characterised by a dichotomy between planned budget targets and outturns. In some cases tax revenue has substantially exceeded projections, leaving the Government with much higher than anticipated current budget surpluses and indeed overall fiscal surpluses. In other cases, tax receipts have surprised to the downside, and this was certainly the case in 2008.

The 2008 Budget was predicated on 3% GDP growth, but the Department of Finance now expects output to decline by 1.3%, with tax receipts now projected to fall by over 10% and to emerge €6.5bn behind target. As a consequence, the current budget balance is now projected to move into deficit for the first time since the mid-1990's, which alongside a large but planned capital deficit will leave the General Government deficit at 5.5% of GDP, from the original 0.9% forecast.

…and the 2009 Budget raised €2bn in taxes.

The Department of Finance expects GDP growth to be negative again in 2009, so the Government sought to raise an additional €2bn in receipts when framing the 2009 Budget. This was achieved through a raft of measures, including higher excise duties, a rise in the standard rate of VAT and an increase in capital gains tax, with the key feature being the introduction of a levy of 1% on all incomes up to €100,000 and 2% on anything above. The net impact was a projected current budget deficit of €4.7bn and a capital deficit of €8.7bn, giving an Exchequer Borrowing Requirement of €13.4bn. The General Government deficit is projected at €12.2bn or 6.5% of GDP.

Net voted spending is projected to rise by 3.2% and net capital spending is forecast to fall by over 6% although at €8.7bn it is still 4.6% of GDP and therefore relatively high in a European context. The net effect of the Budget though is to reduce household disposable income and a notable feature is the number of new taxes announced which can of course be raised next year if the situation requires. Whether that option will be exercised or not is an open question, as the outlook for 2009 looks even more uncertain at this juncture than normal.

Exchequer Finances (Euro bn)

	2007	2008 (e)	2009 (f)
Current Spending	40.9	45.1	48.2
- Voted	37	40.9	42.2
- Non-Voted	3	4.1	6
Revenue	47.9	43.2	43.5
- Total	47.2	40.9	42.2
- Other	0.7	0.8	0.7
Current Budget Balance	7	-1.9	-4.7
Capital Balance	-8.6	-9.6	-8.7
Exchequer Balance	-1.6	-11.5	-13.4
General Government Balance	0.9	-10.4	-12.2
(% of GDP)	0.4	-5.5	-6.5

The Irish Labour Market

Unemployment to exceed 7%

Employment growth slowed sharply in Q2…

Trends in the Irish labour market are best captured by the Quarterly Household Survey which captures developments in employment and labour supply, including the influence of migration. This data showed that the demand for labour held up surprisingly well in the first quarter (employment rose by an annual 54,000) but that employment growth slowed sharply in Q2 with a net gain of only 7,000 in the total at work. The construction sector lost 27,000 jobs and manufacturing another 9,000 with the general economic slowdown more evident in the service sector, resulting in job losses in Hotels (3,000) and Transport (3,000). Other service sectors showed continued employment gains, notably in Wholesale and Retail (17,000), Financial (9,000) and Health (11,000) although at a much slower pace than in the previous year.

It seems clear from a range of more recent economic releases that employment probably fell in the second half of the year, and we now expect zero job creation on average in 2008, with an average 30,000 fall projected in 2009. Labour force growth has slowed in response to the deterioration in demand but unemployment has risen and is set to average 5.7% this year and over 7% next, hence moving the Irish economy away from full employment for the first time in a decade. The latter is equivalent to an unemployment figure of 167,000.

…and Live Register points to higher unemployment.

The monthly claimant count (Live Register) provides a more timely guide to labour market trends, and that supports the case of a marked deterioration – the numbers signing rose by 80,000 in the twelve months to September. Some 45,000 of those are claiming benefit which implies they had a recorded job and have lost it, while the balance are claiming allowances which are paid to those who have never had paid employment.

Labour Market (annual average '000)

	2007	2008 (e)	2009 (f)
Employment	2,117	2,120	2,090
Labour Force	2,218	2,247	2,257
Unemployment	101	127	167
Rate (%)	4.5	5.8	7.4

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