Comment

The pace of decline in economic activity has moderated significantly since last Spring. The economy appears to be close to the trough of the downturn in output terms, although some weakness will persist into the first half of this year, and there are likely to be further employment losses. Recovery, when it emerges, is likely to be gradual and modest. Unwinding the imbalances created during the boom years will continue to be a drag on economic activity for some time, suggesting that a broadly based recovery will take some time to emerge. A solid start has been made, especially in budgetary measures, but recovery will also be contingent on making further progress in overcoming the budgetary and broader economic and financial challenges that Ireland faces. A reversal in wage competitiveness losses will also be key: given the declining price level during 2009 this necessarily entails some nominal wage reductions, as are already being implemented in parts of both public and private sectors.

Although data for the final quarter of 2009 is not yet available, aggregate income in the economy is estimated to have declined by around 11 per cent last year in GNP terms, following a decline of just under 3 per cent in 2008. Carryover effects, and the likelihood that weakness in economic activity may continue into the first half of this year suggests that a further annual average contraction of around 2 per cent is in prospect for 2010 as a whole. However, compared to the corresponding period of 2009, positive growth, on an annual basis, is expected to return from the second half of this year, and on a full-year basis in 2011. Growth next year is likely to be moderate, however, perhaps in the range of 2½ to 3 per cent. Part of the steep decline in GNP reflected an increase in net factor income outflows as output at foreign-owned firms — and, therefore their profit repatriations — remained resilient. Meanwhile, outward flows of interest payments increased and the inward flow of earnings from Irish companies located abroad fell. The decline in GDP, the calculation of which was not affected by factor flows, was less steep (7 per cent in 2009).

The return to positive growth will come about as the external impetus to activity begins to outweigh the moderating, but still negative, impact of domestic factors. In the initial stages, the recovery in the Irish economy will be influenced by the strength and sustainability of the recovery in the global economy. To date, the global economy has recovered more strongly in the second-half of 2009 than had previously been expected and, reflecting this, there have been ongoing upward revisions to global growth forecasts for 2010. While this is a positive development, the recovery across the major industrialised economies remains somewhat fragile and uneven. Moreover, there are concerns as to the extent to which the emerging global recovery is dependent on a sizeable fiscal and monetary stimulus and other temporary factors. Notwithstanding this, however, the consensus of the main international forecasting agencies is that, following a sharp contraction in 2009, activity is projected to expand moderately in Ireland's main export markets this year.

Against this background, exports are forecast to grow modestly in 2010. While overall export performance has been better than expected during the downturn, the outcome varied considerably across sectors, with both the weakness of economic activity in the UK and the fall in the value of sterling creating a very challenging environment for firms focussed on that market. More generally, the strengthening in the value of the euro underlines the crucial objective of improving competitiveness in order to underpin export performance.

While the overall outlook for domestic demand remains subdued, there is likely to be a considerable difference in performance across the various components. The contraction in consumer spending is set to gradually come to an end, but the outlook for investment remains unfavourable, as the ongoing adjustment in the construction sector continues. With respect to consumer spending, the trend in key indicators points towards some stabilisation. Although there is a reasonable prospect of a return to growth at some point during 2010, for the year as a whole, consumer spending is set to fall. With household incomes remaining under pressure, consumer confidence improved but still subdued and households keen to repay debt, the eventual recovery in consumer spending is likely to be slow and gradual. Labour market trends reinforce this view, with the deceleration in the rise in the unemployment rate more a reflection of a pick-up in outward migration and reduced labour force participation, rather than evidence of an underlying improvement in employment trends. Emigration and lower labour force participation may also tend to limit the rise in the unemployment rate this year. Despite a prospective decline in employment of around 3¾ per cent, the unemployment rate may now increase more modestly to average 13½ per cent.

Overall, the near-term outlook remains challenging. Nevertheless, in terms of medium-term potential, the economy retains some important strengths — such as a significant degree of flexibility and a highly-skilled and educated labour force. Building on these strengths and continuing to bolster the flexibility and adaptability of the economy will help ensure a return to reasonable rates of growth in the medium-term. The long-term growth potential of the Irish economy remains relatively favourable by the standards of a developed European economy. However, our ability to realise this potential will depend on overcoming the current challenges we now face.

These challenges relate to the ongoing management of the public finances, further consolidating the stabilisation of the banking sector and improving the competitiveness of the economy. There has been considerable progress in relation to the stabilisation of the public finances since the last Quarterly Bulletin. The measures adopted in the Budget are aimed at capping the General Government Deficit at 11.6 per cent of GDP in 2010. In addition to the revenue effects of earlier tax increases, this is to be achieved by relying heavily on reductions in expenditure. This approach is in line with international evidence that this is the best method of tackling excessive budgetary deficits. It also reflects the lessons from Ireland's own experience in tackling the fiscal situation in the late 1970s and early 1980s. Overall, the expenditure reduction measures in the Budget amount to about €4 billion, although the net impact, allowing for subsequent lower taxation receipts, is somewhat lower at about €3.2 billion. Recognising that a significant part of the fiscal deficit is structural and not cyclical, the Government has also signalled the intention to achieve further consolidation measures amounting to €6.5 billion over the four years 2011 to 2014 inclusive to bring the deficit below the 3 per cent Stability and Growth Pact limit. It is essential that the medium-term consolidation strategy which has been set out for the progressive reduction of the deficit in coming years is realised.

The scale of the necessary adjustment reflects the fact that public spending grew rapidly during the boom years financed by strong receipts related to the property and construction sectors. There is now a clear need to very rapidly adjust both revenue and expenditure patterns to a more sustainable model. On the taxation side, this requires a broader tax base that is more stable and reliable over time. As part of the adjustments to date, there have been increases in marginal income tax rates. While the rise in these rates so far would not put Ireland out of line with many other advanced economies, there are limits to how high such rates can go without introducing negative disincentive effects. There is scope for further broadening of the tax base, however, through, for example, limiting exemptions from income tax and, introducing a system of property taxation, which is a common feature of many developed economies. Even allowing for possible changes to the taxation system, however, much of the burden of further adjustment is likely to have to fall on the expenditure side and, in this respect, the 'Report of the Special Group on Public Service

Numbers and Expenditure Programmes' provides a valuable framework. In particular, reform of the provision of public services should play a central role. This means the introduction of greater flexibility in terms of operating procedures and redeployment of resources so that service provision can be maintained, insofar as possible, while lowering costs. On the revenue side, in the interests of raising receipts and managing demand for the provision of services, it is important to move further in the direction of the 'user pays principle'.

Turning to the banking sector, despite some improvement in global financial market conditions, the operating environment for Irish banks remains very challenging. The financial crisis manifested itself in a number of ways including tighter funding conditions for Irish banks, a sharp rise in incurred and prospective loan losses, and a weakening (especially during the first half of 2009) of international perceptions regarding the Irish banking system. All of these have potentially significant direct and indirect effects on the real economy. In response, the Government has introduced a range of support measures including the guarantee of eligible liabilities, significant capital injections into the largest domestic banks and the establishment of the National Asset Management Agency (NAMA).

Economic prospects make it clear that some further loan losses can be expected even after the crystallization of losses on the transfer to NAMA of loans related to land and property development. It is clear, therefore, that the banking system will require further injections of capital this year and, to the extent that this capital cannot be raised in private markets, the Government has announced its commitment to providing sufficient capital to ensure the banks are adequately capitalised. The exact amount of extra capital that might be required from the State will depend on a number of factors including the valuation of NAMA assets, prospective losses on non-NAMA portfolios and the appetite of private investors. Overall, the transfer of assets during 2010 will have a positive impact in reducing market uncertainty and easing the funding conditions facing Irish institutions.

The measures introduced by the Government to support the financial system reflect the need to minimise the risk of damage to the real economy, by creating the conditions that would enable banks to expand lending to creditworthy borrowers, while at the same time ensuring adequate capital and liquidity buffers to protect the stability of the banking system. Ensuring an adequate supply of funding to Irish enterprises, including small and medium-sized enterprises and potential house buyers, is a prerequisite for recovery. It is important to avoid a negative feedback loop from arising between the financial sector and the real economy by strengthening the banking sector sufficiently to facilitate an adequate supply of credit. This has to work in tandem, however, with the appropriate policies being adopted in other spheres, in particular in relation to the public finances and restoring competitiveness, in order to establish a solidly based recovery in growth.

While significant progress on the first two policy issues is required to provide a stable background for economic growth, it is the improvement of the country's competitiveness position that will be the key to returning the economy to sustainable growth over the medium term. Although there may be considerable headwinds to any global recovery, the current rebound in world trade is, however, a positive development and latching on to strengthening external demand, combined with a restoration of confidence domestically, offers the best option for a sustained upturn in output growth. For this reason, competitiveness is central to recovery. There were sustained losses in competitiveness through most of the second part of the last decade as domestic prices and wages were driven up by strong demand. Irish inflation exceeded that of the euro area in every year, bar one, between 1998 and 2007. Productivity growth was strong in the early part of the last decade but it fell back subsequently, raising the costs of production in Ireland relative to other countries.

There has been a downward movement in prices in Ireland in recent times, both in absolute terms and relative to the situation in most other countries. This reflects some compression of profit margins but also declines in nominal wages in some sectors. This will improve our competitiveness position this year. For employees, the impact of the decline in nominal wages has been cushioned by the decline in prices although, in some sectors, including the public sector and the financial services sectors, declines in the real purchasing power of wages have occurred. In some other sectors, the position is less clear. It is important for the overall competitiveness of the economy, however, that wage restraint becomes the norm and that nominal wage developments reflect the fact that prices have fallen and that productivity growth is currently weak and has been so for some time. Such a development would help to improve not only the direct wage costs of firms in the traded sector but also the costs that they bear through their purchasing of goods and services in the economy. In achieving this objective, existing employment and future job creation prospects will be enhanced. The Annual Competitiveness Report of the National Competitiveness Council also draws attention to the fact that administered prices have continued to rise, professional fees remain very high in Ireland and that greater competition and regulation is needed in a range of sectors, such as health care, health insurance, utilities and public transport.

Some historical perspective is useful in assessing the current situation. Real living standards in the economy are still high by international standards and are much higher than they were a generation ago. GNP per capita (adjusted for purchasing power) rose from under 70 per cent of the EU average in the 1980s to over 110 per cent in the boom years. Although this indicator has been falling quite sharply over the last two years, it will level off at somewhere in the region of 90 to 95 per cent of the EU average. The employment rate in the economy, the proportion of the population aged 15 and over that is working is about 62 per cent, is also well above the corresponding rate of 52 per cent in 1990, despite the recent rise in unemployment. As already noted, the underlying strengths that the economy developed over the last twenty years, such as the high level of education and increased flexibility, have not been undone and, with careful policy choices and determined action, the economy can return to a moderate growth rate that will gradually reduce unemployment and improve living standards over time. Progress, on this occasion, however, has to be based on solid growth in activities that are, for the most part, internationally traded and that are linked to the underlying strengths of the economy and not, as in the recent past, reflective of unbalanced domestic developments that are vulnerable to sudden correction.