Comment

Hopes are rising that the downturn in the broader international and European economies may have reached a turning point. However, Ireland's recovery from recession will be slower than elsewhere. The Bank's latest forecasts suggest that, while the pace of decline in economic activity is moderating, the weakness in Irish economic activity is set to persist into the first-half of 2010. The fallout from the unwinding of the large domestic imbalances created during the earlier boom will continue to restrain economic activity and significant headwinds to recovery remain in place. These are projected to ease only gradually, and recovery, when it emerges, will at first most likely be modest. The outlook remains subject to considerable uncertainty.

Following a decline in GDP of 3 per cent last year, a further decline of around 8 percent seems likely in 2009. While there is the prospect of stabilisation followed by a return to modest growth during the course of next year, GDP for 2010 as a whole is projected to be about 2¼ per cent lower than in 2009.

This outlook is contingent on the sustainability of the incipient recovery in growth in our main trading partners, which should help support growth in Irish exports. However, domestic demand is likely to remain weak until 2011 at the earliest.

Given this background, and bearing in mind that employment tends to lag behind output, the outlook for the labour market remains unfavourable. Based on the expectation of some fall in labour force participation and outward migration, the unemployment rate is projected to average over 14 per cent in 2010. Reflecting weak labour demand, wages will tend to fall in the private sector, at least in nominal terms. This should help to reverse some of the substantial deterioration in competitiveness relative to our main trading partners that has occurred since the early years of this decade. The recent appreciation in the value of the euro against both the US dollar and sterling underlines the importance of continuing with measures to improve competitiveness so as to ensure that our exports will benefit from the emerging international upturn.

The contraction in economic activity since 2007 has been exceptionally severe. While the initial downturn in activity was driven by the sharp decline in the construction sector, this has broadened out into a marked weakening of domestic demand that was significantly amplified by the impact of global financial market turbulence, the collapse of world trade and severe recession in all our main trading partners. Although a large part of our current problems stem from the character of economic growth in the years preceding 2007, given the highly open nature of the economy, Ireland could not have escaped the impact of the global downturn which has resulted in output falls in most of our main trading partners.

The trend in key monthly indicators, along with the evidence from sentiment surveys, suggests that the most intense phase of economic contraction occurred in the fourth quarter of 2008 and the first quarter of 2009. At that time, significant domestic economic weakness was being exacerbated by the fall-out from exceptionally elevated stresses in domestic and international financial markets, in the aftermath of the failure of Lehman Brothers, and also by a highly synchronised contraction in demand and output across the global economy. Since then, however, evidence from a host of indicators suggests that, in recent quarters, while the economy is continuing to contract, the pace of decline has moderated from the rapid pace evident between last Autumn and this Spring. Retail sales, which declined sharply earlier in the year, have shown some signs of improvement in recent months, though still remain very weak. Similarly, in the labour market, the monthly rise in unemployment, having grown extremely rapidly, has slowed relative to the rate of increase in the first quarter. In addition, sentiment surveys also indicate that, while activity is still contracting, the pace of decline is easing.

Taken together, this could be interpreted as the beginning of a gradual move towards the stabilisation of economic activity, though at very weak levels. However, the outlook for the Irish economy still remains difficult and challenging. Output in 2010, as measured by GDP, will be about 14 per cent below that in 2007, an exceptionally severe contraction by international standards and unprecedented in Ireland since the National Accounts began to be compiled on a regular basis over half a century ago. The fall in output, which has not yet ended, is bringing about a significant reduction in living standards. It is now evident that spending and living standards had leaped to unsustainable levels at the height of the boom. Allied to the ongoing rebalancing of activity within the economy, which also has to run its course, domestic sources of demand can be expected to remain weak for a prolonged period. This will tend to hold back any recovery in labour markets.

Given the prospective weakness of domestic demand, tentative signs of recovery in the international economy are to be welcomed and, if sustained, will provide some support to economic activity. Externally-led growth represents the most likely source of recovery for the Irish economy. However, to ensure that we in Ireland can benefit from a global recovery, competitiveness needs to be restored in the economy as a whole.

The sharp and sudden set-back which has been experienced should not, however, be allowed to obscure the solid strengths and tangible economic achievements of recent years. Before the excesses and imbalances of the early and mid-2000s, the Irish economy had reached an advanced level of productivity and performance which stands comparison with any other country. The underlying strengths which helped ensure this performance are still present. Building on these strengths, and restoring the flexibility and adaptability of an economy with a strong skills base, will help speed a return to growth in the medium term. Our ability to realise this potential depends heavily on the effectiveness with which we address the current challenges.

The economic and financial environment of recent years has posed unprecedented challenges for budgetary and broader economic and financial policy. In the face of these challenges, the policy requirements are clear — to consolidate the stabilization and return to health of the banking sector so that it underpins growth, to restore order to the public finances and to regain competitiveness.

Reflecting the scale and nature of the downturn in economic activity, and the consequences of flawed lending strategies which have necessitated heavy provisions for loan losses, Irish banks have faced particularly difficult challenges over the past year, not least with regard to their funding and adverse market perceptions. In response, a series of Government actions taken over the past year have been designed to help ensure the conditions in which banks can both continue lending to credit-worthy borrowers while meeting required capital and liquidity standards. In particular, the Government guarantee scheme helped reassure bank depositors and ensure banks' continued access to other loanable funds. The injection of risk capital by Government partially offset loan losses and helped the biggest banks maintain adequate Tier One capital ratios, a key measure of their solvency on which providers of loanable funds increasingly focus.

In order to further consolidate banks' soundness, and remove some of the uncertainty about the eventual impact of loan losses on their exposure to land and development loans and certain associated loans, the Government has introduced legislation to set up the National Asset Management Agency (NAMA). It is estimated that NAMA will purchase land, property development and property investment loans with an estimated book value of €77 billion at a 'long-term economic value' of €54 billion. The Government has indicated that the purpose of NAMA is to ensure that bank balance sheets are strengthened and uncertainty over bad debts is reduced. This should help ensure a revived flow of credit on a commercial basis to individuals, households and businesses. The Government has also signalled that the Agency will have a commercial mandate and will have the objective of maximising over time the income and capital value of the assets entrusted to it. It is likely that some institutions will require additional capital in order to absorb the losses arising from the transfer of their impaired assets to NAMA and in order to maintain appropriate levels of capital. To the extent that sufficient capital cannot be raised independently or generated internally, the Government has said it remains committed to providing such banks and building societies with an appropriate level of capital.

With respect to the public finances, the contraction in the economy has had a very significant impact on the fiscal position both in terms of increased spending and sharply reduced tax receipts. This latter effect has been amplified considerably by the increased reliance during the boom years on taxes that are highly sensitive to economic conditions, particularly asset market conditions such as property market values and transactions. With the collapse in revenues, it is now necessary to strike a new balance between expenditure and taxation. The scale of the increase in public spending during the boom period adds to the scale of the needed adjustment. Significant efforts have been made in this regard, over the past year, in the form of the series of sizeable consolidation measures adopted and signalled for future years. Nonetheless, many more critical decisions remain to be made. Most pressing among these is the requirement to adjust the level of public expenditure, the need to create a more stable and reliable tax base and the need to bring expenditure broadly into line over time with the restructured revenue base. This unavoidable process of adjustment will involve difficult choices, both in terms of revenue and expenditure decisions emphasising the importance of reducing the cost of providing public services and finding ways of delivering these services more efficiently.

Debt considerations also emphasise the need to restore balance. The deterioration in the fiscal deficit in recent years, the rise in the level of public debt and the costs and uncertainties associated with support for the banking sector have transformed the long-term fiscal position. Allied to the uncertainties with regard to the future growth potential of the economy, this argues for a high degree of prudence in fiscal planning and also for framing budgetary policy on the basis of modest recovery scenarios.

Turning to the situation at present, the latest data point to the likelihood of some overshooting in the General Government Deficit this year from the target of 10¾ per cent of GDP set out in the Supplementary Budget. This mainly reflects a likely shortfall on the revenue side. This means that the outcome for 2009 will be further than budgeted from the target of 3 per cent of GDP planned for 2013 (as announced in the April Supplementary Budget). The natural goal is to achieve needed fiscal adjustment without threatening medium-term recovery and with the minimum of hardship. Taking account of recent tax rate increases, and the fall in many consumer prices over the past year, this may be possible with greater reliance on expenditure adjustments at this time. A focus on containing expenditure would also accord with the lessons from Ireland’s experiences in the 1980s, and also from international evidence, that carefully targeted and prioritised expenditure-based consolidation measures are generally more effective in the medium-term than over-reliance on tax based solutions.

In this respect, the recent ‘Report of the Special Group on Public Service Numbers and Expenditure Programmes’ provides a valuable framework. While raising a number of clearly difficult and sensitive policy options, very significant savings are required to ensure that Ireland moves towards meeting its Stability and Growth Pact obligations in time. Decisive action of this magnitude would also send a clear signal to international investors with beneficial effects on the cost of Government borrowing and on the funding costs of banks.

The Bank welcomes the recent publication of the ‘Commission on Taxation Report’ which provides valuable analysis of taxation reforms.

There is a pressing need to broaden the tax base in Ireland particularly given the need to keep tax rates low, a factor that has been integral to Ireland's attractiveness as a location for foreign direct investment. Furthermore, it is now clear that fiscal policy became too reliant on tax categories which have proven to be unstable, much of which related to the housing market. The Bank notes the economic and fiscal merits of a property tax, which could provide a stable source of revenue while not affecting labour market incentives and whose design should be both equitable and practical. Furthermore, it is important that the "user pays principle" becomes further ingrained in Irish society and, in this context, the proposals for a carbon tax and for water charges appear reasonable, while again not impacting on the labour market and also promoting intergenerational equity and economic efficiency.

The speed and extent of economic recovery will also depend on how quickly competitiveness can be restored. Pay costs are a key element here, especially for ensuring that employment in Ireland benefits from the global recovery. Economy-wide productivity gains have been relatively modest in recent years, while average wage rates have increased rapidly by comparison with our main trading partners, especially when exchange rate movements of the euro against sterling and the US dollar are factored in. It is this deterioration in international wage competitiveness that points to the desirability for wage restraint at this point if the decline in employment is to be reversed. Falling prices over the past year cushion the impact of nominal wage falls for those at work, while helping to ensure that more jobs are retained or created. A strategy to restore competitiveness must encompass action on a number of fronts including pay and non-pay costs, infrastructure improvements which support productivity growth, the enhancement of competition in sheltered sectors, continuing to encourage innovation and R&D activity and enhancing the skill levels of the labour force.

A recent puzzle in this area has been the divergence between the signal from a large body of survey evidence, which suggests that many firms have taken action to reduce their costs including the negotiation of reductions in wage rates, and the most recent official earnings data for manufacturing which points to an acceleration in average hourly earnings in industry. One possible explanation relates to compositional shifts in employment, as a result of layoffs being concentrated amongst lower paid workers, placing upward pressure on average wages per employee. Moreover, caution is also warranted by the fact that this data relates only to a small subset of employment and, in addition, that sectoral wage data tend to be quite volatile and prone to significant revisions.

More generally, the recent 'Annual Competitiveness Report' by the National Competitiveness Council (NCC) has drawn attention to the fact that, over the past year, administered prices have continued to increase quite rapidly, despite price and wage reductions in other areas of the economy. In this context, it would be important that the sheltered sectors of the economy are subjected to greater competition and regulation, notably in the areas of health care, health insurance, education, utilities and public transport. Similarly, professional fees in a number of selected services sectors remain very high in Ireland, a point also stressed by the NCC and the Competition Authority.

While there are very substantial challenges facing the economy at present, the economy has time and time again proven to be highly resilient and flexible. Moreover, in spite of a very turbulent economic environment, many of the strengths of the Irish economy remain in place, not least in terms of a highly educated and adaptable workforce, a relatively flexible economy and a significant comparative advantage in high productivity modern sectors. If we follow the appropriate policy path, the economy has the potential to grow solidly again in the medium-term.

International and Euro area Economy

Global economic conditions have improved in recent months and it now appears that, following a deep recession, world economic activity has started to increase once again. The decline in global output in the final quarter of 2008 and the first three months of 2009 was particularly sharp as the turmoil in financial markets spread to the real economy. Against the backdrop of significant uncertainty, tightening credit conditions and a sharp decline in confidence levels, the manufacturing sector was particularly hard hit and global trade fell significantly. In subsequent months, however, demand and production levels have started to pick up once again, driven by the significant policy response. Policymakers have taken wide-ranging measures to stabilise the financial system, while interest rates have been cut to extremely low levels and substantial stimulus packages have been put in place to provide support to demand. These measures have helped to bring about a stabilisation of economic activity in the advanced economies and a return to growth in many emerging economies.

Despite this improvement in economic conditions, the outlook is still for a very gradual global recovery. A number of factors are expected to weigh on economic activity levels for some considerable time. Unemployment in Europe and the US is already at a high level and, given that recovery in the labour market tends to lag the rest of the economy, is expected to increase further. The magnitude of the global downturn has also resulted in the emergence of significant excess capacity, which it will take some time to work through, while balance sheet adjustment, with some deleveraging, will be an ongoing process for households, firms and the financial sector alike. Conditions in financial markets have generally improved since earlier in the year, but many markets remain affected, and the significant policy support that has played a key role in stabilising output levels will gradually have to be withdrawn. This expectation of a gradual recovery is embodied in the International Monetary Fund's (IMF) latest projections. Following a contraction of around 1 per cent in world GDP this year, the IMF has forecast global growth of about 3 per cent in 2010. Such a rate of expansion would be well below the levels recorded prior to the downturn; global growth averaged close to 5 per cent over the period 2005 to 2007.

Reflecting the impact of base effects from energy prices, inflation rates have turned negative in a number of economies. However, this is expected to be a temporary phenomenon and, as these base effects unwind, inflation should turn positive once again. Looking past these transitory developments, it appears that inflationary pressures will remain low. This reflects the presence of significant negative output gaps, and the expectation of a gradual recovery in global growth. Such a view is consistent with recent developments in core inflation rates — excluding the more volatile energy and food components — which have been moderating in recent months.