Banc Ceannais na hÉireann
Central Bank of Ireland
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Box C: QB 4 – December 2023

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Interpreting Mixed Signals on the Recent Performance of the Irish Economy and the Revised Short-Term Outlook

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The Irish economy is characterised by the presence of large foreign-owned multinational enterprises (MNEs) alongside other firms whose activity is domestically oriented. As a result, headline macroeconomic statistics in Ireland sometimes present diverging signals as to the condition of the economy. This arises because the global factors that affect output in the MNE-dominated parts of the economy often differ from the drivers of activity in the domestic-facing economy. Such effects have been evident during 2023.

For the first three quarters of the year – the most recent period for which a full set of macroeconomic and labour market statistics are available – CSO data indicate that GDP contracted by 1.3 per cent compared to the same period in 2022. This was driven by a pronounced fall in net exports in the MNE-dominated sector of the economy. Over the same period, modified domestic demand (MDD) increased by 0.9 per cent. Meanwhile, labour market data – which are probably the most salient indicators of domestic economic conditions – also point to continued economic expansion in Q3 with employment increasing by 4.1 per cent. These differences in the realised data for the economy up to the third quarter of 2023 are also reflected in the projections published in this *Bulletin*. Against this background, this Box (1) explains the reasons for the negative GDP (and related net export) outturn for the economy in 2023 compared to the performance of domestic demand and employment and (2) describes the main drivers of the revised short-term outlook for economic activity contained in this *Bulletin*.

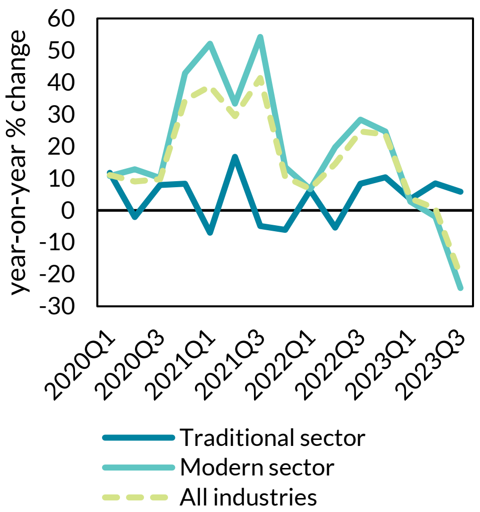
The somewhat divergent performance of the MNE-dominated and domestic-facing sectors of the economy is evident in a number of indicators. Figure 1 shows the year-on-year change in industrial production (3-month moving average) for the *modern* and *traditional* sectors as defined by the CSO.[1] The *modern* sector consists of the MNE-dominated parts of the economy including chemicals and pharmaceuticals, medical devices and computer, electronic and optical equipment. The *traditional* sector covers all other industries including the more domestically-oriented parts of the economy. Growth in industrial production in the *traditional* sector has remained steady and positive during 2023. The average volume of industrial production in the three months to September 2023 compared to the same period in 2022 is up by 5.9 per cent. In contrast, production in the *modern* sector declined by 24.3 per cent over the same period, resulting in overall production being 20.4 per cent lower in the three months to September 2023 compared to the same period in 2022. Figure 2 shows the contribution of the different headline expenditure components to the year-on-year change in GDP. Following an exceptionally large positive contribution to GDP in 2022, net exports have declined over the last two quarters, pushing overall annual GDP growth into negative territory.

The extent of decline in activity in the MNE-dominated sectors compared to domestic activity is further illustrated in Figure 3. The contribution of the domestic sectors to overall output (gross value added) growth has moderated but remained positive up to Q3 2023, whereas output in the foreign-dominated sector turned negative in the quarter – mirroring the decline in exports.

[1] See: https://www.cso.ie/en/releasesandpublications/ep/p-ipt/industrialproductionandturnoverseptember2023/

Output in MNE-dominated sectors falls sharply while activity in domestic sectors continues to grow

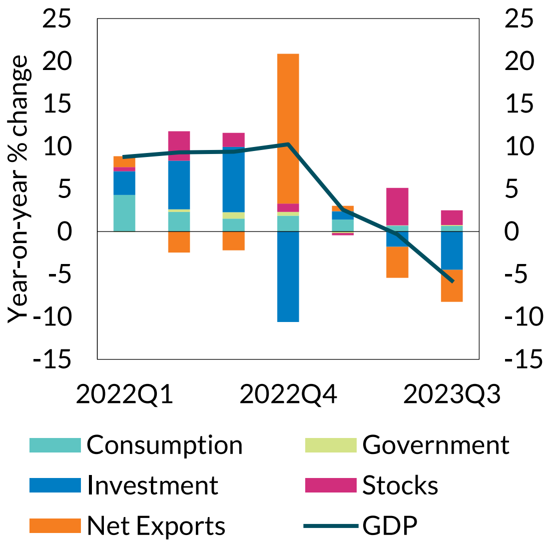
Figure 1: Industrial production, modern and traditional sectors, 3-m rolling average, year-on-year change



Source: CSO.

Following a large increase in 2022, net exports turn negative in 2023, lowering overall GDP

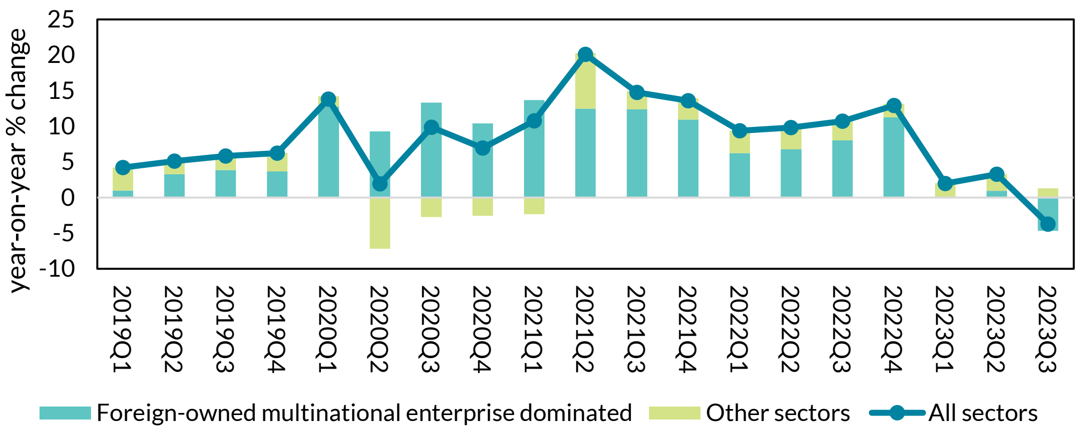
Figure 2: Contribution to year-on-year change in GDP



Source: CSO.

Pronounced slowdown in MNE-dominated sectors during 2023. Domestic sector output increases in first three quarters, but at a slower pace than in 2022

Figure 3: Contributions to y-on-y change in GVA, foreign-dominated and other sectors

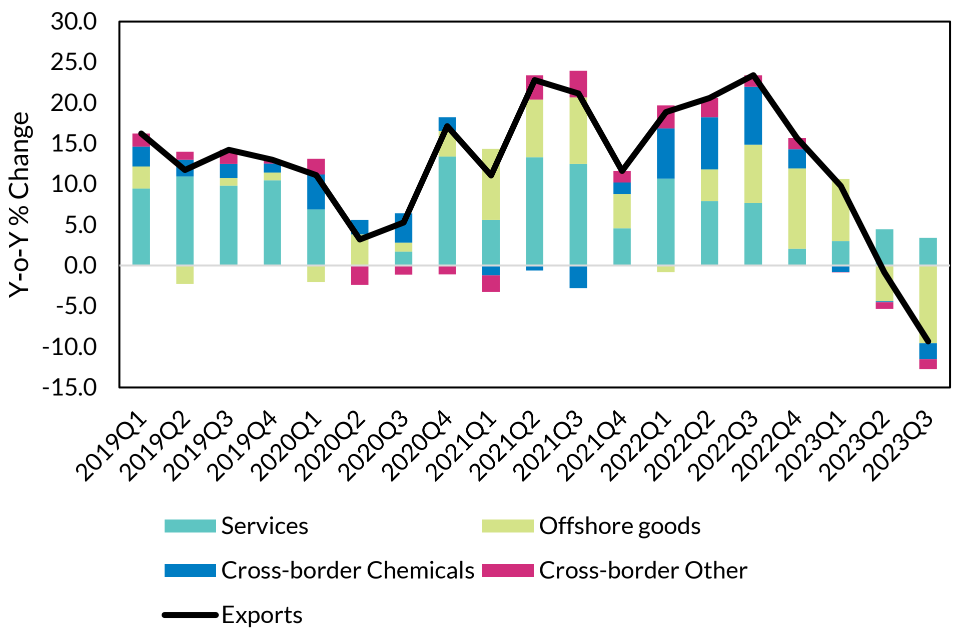


Source: CSO.

The reduction in net exports in 2023 is in turn concentrated in goods trade while services exports have continued to grow in 2023. The figure for overall goods exports published in the National Accounts includes goods physically produced in Ireland and goods produced abroad on behalf of Irish-resident MNEs, also known as contract manufacturing (CM).[2] The latter do not directly affect the employment or incomes of Irish residents. In 2023, the value of both components of overall goods exports has declined relative to 2022 with a particularly sharp drop in contract manufacturing or offshore exports. Figure 4 shows the contribution to the change in the value of overall exports of each of its components up to Q3 2023. On a year-on-year basis in Q3 2023, contract manufacturing (offshore goods) exports declined by almost 50 per cent, making by far the largest contribution to the overall decline in goods exports in the quarter.

Sharp reduction in exports produced abroad while cross-border goods exports manufactured in Ireland also decline in 2023

Figure 4: Contributions to year-on-year change in the value of overall exports



Source: CSO.

The decline in cross-border physical exports produced in Ireland is concentrated in two sectors: pharmaceuticals and ICT manufacturing. The decline in pharmaceutical exports

[2] See https://www.cso.ie/en/interactivezone/statisticsexplained/nationalaccountsexplained/contractmanufacturing/

follows a very large increase in 2022, boosted by the manufacture of Covid-related vaccines and treatments in Ireland. While the value of pharmaceutical exports over the first nine months of 2023 are 5.5 per cent lower than in 2022, exports are 29 per cent above the level for the same period in 2021. Consequently, and with the general prospects for the pharmaceutical sector remaining positive, once the exceptional pandemic-related export performance during 2022 drops out of annual comparisons, the outlook for growth in 2024 and beyond is favourable.

Exports of ICT goods, in particular semiconductors, are sharply down over the first three quarters of 2023 compared to 2022. China accounts for almost 70 per cent of all exports of semiconductors from Ireland. The drop in exports in 2023 is due mainly to a reduction in exports to that market, as well as lower exports of semiconductors to the US. The reduction in semiconductor exports to China and the US could be the result of a deterioration in the performance of individual firms in the sector, a cyclical weakening in demand for these goods globally or structural changes. In relation to firm performance, the semiconductor manufacturing sector in Ireland is highly concentrated with a small number of firms accounting for the majority of exports. A deterioration in the performance of an individual firm or firms, for example as reflected in a loss of market share, could negatively affect aggregate exports. In terms of potential structural factors and as noted in our September 2023 *Quarterly Bulletin*, the Biden Administration announced in October 2022 new restrictions on exports to China of certain ICT manufacturing goods.[3] The restrictions cover exports from US-based firms but they also apply to any company worldwide that uses US semiconductor technology in its production processes. Since US-owned multinational enterprises account for a significant share of exports from this sector in Ireland, it is possible that the restrictions are one factor behind the weakness in Ireland-China ICT goods exports to date in 2023.

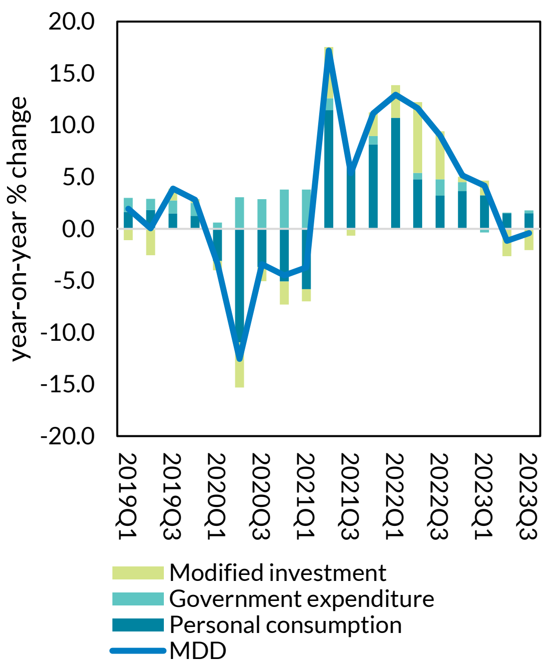
Looking ahead, our projections assume a recovery in cross-border physical exports from 2024. Following the correction in 2023 after the exceptional growth in 2022, pharma exports are projected to grow again over the forecast horizon reflecting the generally favourable medium-term prospects for this sector globally. The outlook for ICT manufacturing is more uncertain and a repeat of the weakness observed in 2023 would pose a risk to our overall export projections. Our forecast for overall exports, both goods and services, is weaker than at the

[3] These goods include advanced integrated circuits (ICs), computers and components containing advanced ICs, semiconductor manufacturing equipment and related software and technology.

time of our last *Bulletin* in September due to downward revisions to economic growth for Ireland's key trading partners over recent months.

Consumption growth still positive in 2023 but weaker modified investment lowers MDD

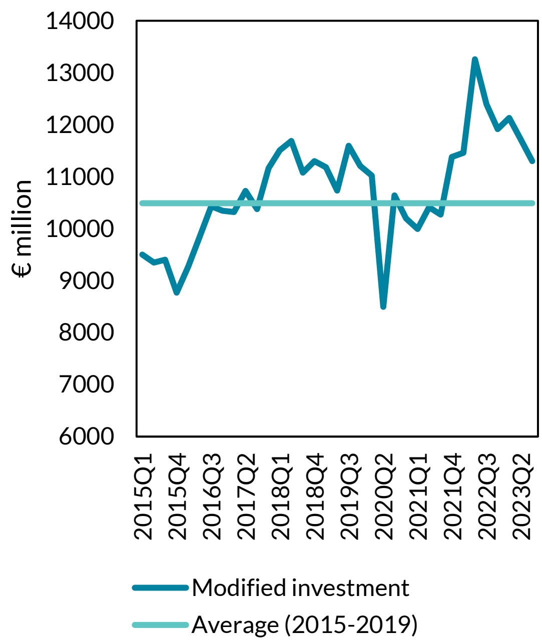
Figure 5: Modified investment, constant prices, seasonally adjusted



Source: CSO.

Modified investment increased sharply in 2022. Levels remain high in 2023 but have reduced

Figure 6: Contribution to year-on-year change in MDD



Source: CSO.

Turning to domestic demand, there are signs that activity has also slowed in this part of the economy during 2023 but the evidence is somewhat mixed and the extent of the slowdown is significantly less than observed in MNE-dominated activity. Growth in MDD was negative year-on-year in Q2 and Q3 2023. Personal consumption has continued to grow up to Q3 but was offset by a decline in modified investment (Figure 5). Part of the weakness in the latter can be attributed to a slowdown in investment activity from very high levels recorded in 2022. Modified investment in 2022 increased to its highest level since before the 2008 financial crisis, in part driven a number of large-scale firm specific investments in the MNE sector. As shown in Figure 6, the level of modified investment remains high in 2023 but has declined from the levels recorded in 2022. While the reduction in modified investment has acted as a drag on

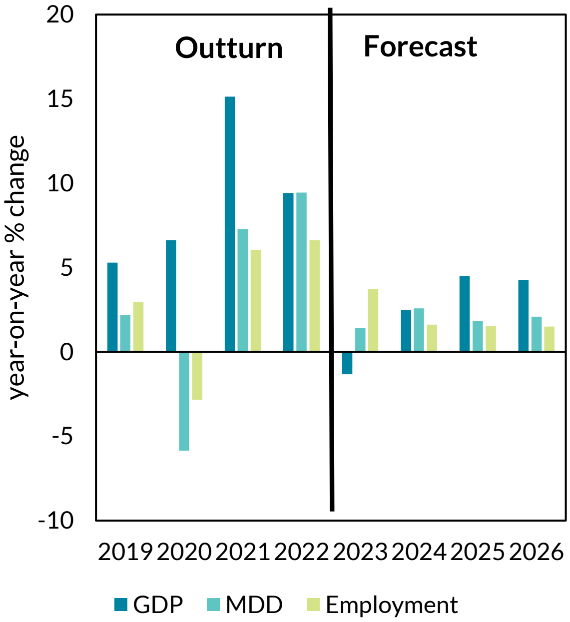
overall MDD in 2023, other indicators point to continued growth in domestic activity, but at a reduced pace (see *Recent Developments* section).

Putting these elements together, Figure 7 show the overall forecasts for GDP, MDD and employment in this *Quarterly Bulletin* and Figure 8 shows the revisions to these forecasts compared to our September projections. Reflecting the weak outturn for the first three quarters of the year, 2023 GDP has been revised down substantially from QB3 and is projected to contract for the year as a whole by -1.3 per cent. GDP growth is forecast to resume in 2024 and 2025 but the pace of growth has been revised down slightly based on the weaker external demand assumptions in this *Bulletin* compared to our September forecasts. These assumptions incorporate the ongoing impact of the transmission of tighter monetary policy to Ireland's key trading partners.[4]

[4] See Box C of QB 2 2023 (June 2023) for analysis of the transmission channels and estimated impact on the Irish economy of the monetary policy tightening implemented by the ECB between July 2022 and June 2023.

Pace of growth in economic activity forecast to slow from 2023 following strong post-pandemic recovery

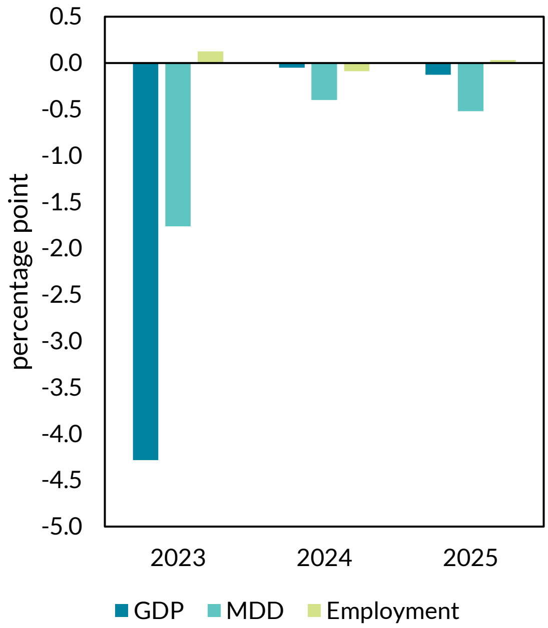
Figure 7: Outturn (2019-2022) and forecasts (2023-2026) for GDP, MDD and Employment, annual % change



Source: CSO (outturn data) and Central Bank of Ireland (forecasts)

MDD revised down in 2023 but by less than revision to GDP as domestic activity is still expected to grow this year

Figure 8: Revisions to GDP, MDD and employment, QB 4 versus QB 3



Source: CSO.
Note: The first projections for 2026 are published in this *Bulletin* (QB4 2023), hence no revision is shown for this year in Figure 8.

Turning to MDD, this has also been revised down for 2023 as a result of the weakness in modified investment but the revision is significantly smaller than for GDP and MDD is still expected to grow this year, in contrast to the projected decline in GDP. A slowdown in MDD growth is to be expected given the pace of the post-pandemic recovery observed in 2021 and 2022 (Figure 7). As the savings rate in the household sector and the investment rate in the company sector have returned to more normal levels, this is being reflected in a moderation in the pace of overall MDD in 2023 and for the remainder of our forecast horizon. Consistent with the projection for domestic demand, the pace of employment growth is expected to moderate. With the economy already at full employment in 2023, domestic capacity constraints – particularly in the housing market – are expected to place a limiting constraint on economic growth out to 2026.

Summing up, data for the first three quarters of 2023 point to a complex and mixed pattern of growth in the Irish economy. Activity in the MNE-dominated sector of the economy has contracted sharply, partly reflecting a reduction in pharmaceutical trade after exceptional levels of activity in 2022. Given the favourable prospects for this sector globally, exports should recover from 2024 onwards. Exports of semiconductors have fallen in 2023 and if this is driven by longer-term structural factors rather than a temporary cyclical downturn, the outturn for overall exports could be weaker than outlined in the *Bulletin*. In addition to these sector specific issues in pharma and ICT manufacturing sectors, the outlook for exports is somewhat weaker than in previous projections as tighter monetary policy reduces global growth prospects.

For the domestic economy, developments in 2023 have been more favourable than implied by the negative outturn for GDP. Growth in MDD has moderated but this largely reflects a return to a reduced pace of growth following the strong post-pandemic recovery. The reversion to a lower growth path for MDD in 2024 and 2025 is influenced by the transmission of higher interest rates as well as the impact of capacity constraints, in particular in the labour market and in housing, which are expected to limit the pace of expansion in activity over the coming years.