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TheOutlook

A quarterly analysis of trends in the Irish economy

Marginally positive growth expected this year

- Imports stronger than expected
- First rise in domestic spending since late 2007

The Irish recovery is universally expected to be driven by external trade and that was certainly the case in the first quarter, when exports rose by 7.1%, twice the pace of imports. Export growth slowed in the second quarter however to 1.6% and import growth accelerated by 4.5%, so contributing to a fall in GDP of 1.2%, albeit still leaving output 1% above the low recorded in the final quarter of 2009. The trade pattern evident earlier in the year may have resumed again in the third quarter – merchandise exports rose to a 9-year high in the month of July – and we still expect the external sector to drive Irish GDP growth into positive territory in 2010. We have revised up our import projection, however, and as a consequence GDP growth is now expected to be 0.5% against our previous 1%.

The second quarter contraction in GDP was a surprise given the strength of retail sales and the other monthly indicators, but domestic spending did increase in the quarter, for the first time in over two years. This reflected a substantial increase in business spending on machinery and equipment and a modest rise in non-residential construction, although capital spending as a whole is still likely to fall sharply in 2010, to 13% of GDP or half its share at the cycle peak in 2005. This is extremely low by Irish historical standards and only a small further decline is expected in 2011, particularly as house completions have shown signs of bottoming in recent months.

The pace of job losses has slowed of late and the unemployment rate may be at or near a cyclical peak, and if this proves the case may prompt some reduction in the household savings ratio in 2011, and therefore a modest rise in consumer spending. Consumption may fall this year, however, by around 1% following a 7% decline in 2009.

Irish inflation has moved back into positive territory, as we expected, and the 2010 Budget has also remained on target – indeed it may emerge slightly below the official projection although slightly higher as a percentage of GDP as the latter may be lower in nominal terms than the Government anticipated. The General Government deficit, the EU standard fiscal measure, is likely to be around €49bn, or 32% of GDP, as it will probably include the capital sums injected into the State owned banks. Clarity on this figure has been welcomed by investors, but 10% of the total or around €3bn will probably be added to next years' borrowing requirement, prompting a revision to the previous 5-year fiscal plan. The 2011 Budget is now likely to involve a larger fiscal adjustment and we have revised down our 2011 GDP forecast to 2.5%, which is marginally below the current consensus. A sharp fall in the headline deficit will achieve little however if it simultaneously reduces GDP and hence leaves the deficit ratio little changed.

Dr. Dan McLaughlin

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Irish GDP

Surprise fall in Q2 GDP

Q2 fall still leaves GDP 1% off cycle low…

The Irish economy, as measured by seasonally adjusted GDP, contracted by 1.2% in the second quarter, following a revised 2.2% rise in Q1. The data still leaves GDP 1% above the low in the final quarter of 2009, but the unexpected fall in Q2 will no doubt prompt a revision to the consensus outlook for the year as a whole. The strength of the PMI readings from the spring onwards and the surge in retail sales in Q1 (up 6.6% in volume terms) had convinced most analysts, including ourselves, that the economy had continued to advance, so the scale of the reported decline was a major surprise.

The CSO report revealed a fall in consumer spending, albeit a marginal 0.2%, and as a consequence we are revising down our consumption forecast for 2010 – we now expect a 1% contraction, against our previous flat reading. Employment may fall by 3.5% on average this year, which alongside a decline in average pay implies a substantial fall in aggregate earnings, although offset to some degree by higher transfers and a lower aggregate tax take. The price of consumption goods and services will also fall providing some support, but the ongoing decline in real consumer spending implies a further rise in the savings ratio. This rose from a cycle low of 3.6% in 2007 to 5.2% in 2008, the last official figure, and we suspect it rose again last year to around 10.5% with our forecast assuming a further increase in 2010 to 11.0%.

…business spending rose in the second quarter…

Government consumption also fell in volume terms in Q2, by 0.8%, after a revised marginal increase in Q1 and we are revising our forecast for the year as a whole, with a smaller fall (2.0%) than previously projected now pencilled in. Domestic demand as a whole rose in Q2, however, for the first time since late 2007, driven by an unexpected surge in business spending on machinery and equipment. This component of capital spending rose by an unadjusted 16% in the quarter and although the CSO does not provide an adjusted breakdown, the seasonal factors are unlikely to be that significant. The figure was strongly influenced by aircraft orders, which are very volatile on a quarterly basis, and we are not revising our forecast for business spending for the year as whole, and still envisage a 7% fall.

…but capital spending still set to fall this year…

Building and construction spending, the other component of capital formation, also recorded an unadjusted rise in Q2, albeit marginal, thanks to a pick up in home improvements and in non-residential construction. Consequently we now expect a smaller decline than previously thought for 2010, although at 26% it is still formidable. As a consequence capital spending as a whole is now forecast to fall by 21% this year which will bring its share of GDP down to 13.3% or half that recorded in the cycle peak at 2005. This is extremely low by Irish historical standards and we expect a rise in business spending next year, although construction spending may record a further albeit modest fall. House completions appear to have stabilised in the past few months but the year-over-year percentage falls in house building will remain substantial until the second half of 2011.

The GDP decline in Q2 was also driven by another large fall in stocks (reducing GDP by 0.8 percentage points). Indeed the latest fall is the seventh consecutive quarterly decline, bringing the cumulative total to over €3.2bn. Consequently we expect the fall to end soon.

…imports rose sharply, outpacing exports…

The Irish recovery is universally expected to be export-led particularly as net trade had provided the only positive contribution to GDP during the recession, and this was certainly the case in the first quarter, with exports growing by 7.1% or twice the pace of imports. The former now accounts for over 90% of GDP, so any material change in net trade tends to dwarf domestic demand. This proved the case in Q2; exports slowed, rising by 1.6% in the quarter, while import growth accelerated to 4.5%, no doubt boosted by a strong retail sales, notably cars, and the pick up in business spending. As a consequence, net trade reduced GDP by 1.8 percentage points and offset the 1.4% contribution from domestic demand.

…prompting a downward revision to our forecast…

The July data points to a resumption of the Q1 pattern, however, with industrial production recording a strong rise and seasonally adjusted exports at a nine year high on the month. For the year as a whole, we are revising up our export forecast to 8% but the rise in imports is now seen at 5% against the previous forecast of 1.5%. The net result is that GDP is now forecast to rise by 0.5% in 2010, from the previous 1% although we have not changed our GNP projection, which still envisages a 1.5% decline.

This forecast implies a return to positive annual growth by the fourth quarter and we still expect stronger growth in 2011, albeit now at 2.5% from our previous 3% forecast, although uncertainties abound both domestically and internationally. The former includes the scale of the fiscal adjustment planned for 2011, to be announced in early December, and political uncertainty has also grown of late.

…2.5% growth seen next year.

The latest data does point to a marked deceleration in the pace of Irish job losses, however, and we expect a marginal rise in employment next year, which alongside a small fall in the savings ratio may generate some consumption growth. Similarly we expect an increase in business spending and a further positive contribution to GDP from net exports, although the most significant factor may well be the inventory cycle, with an end to de-stocking. In other words firms will meet any increase in demand through production rather than running down their stocks.

Irish GDP (% change)

	2009	2010 (estimate)	2011 (forecast)
Personal Consumption	-7.0	-1.0	1.0
Government Consumption	-4.4	-2.0	-3.0
Capital Formation	-31.0	-21.0	-2.5
- Building and Construction	-35.0	-26.0	-9.0
- Machinery and Equipment	-19.0	-7.0	10.0
Stocks (% of GDP)	-1.3	-0.3	0.2
Exports	-4.1	8.0	6.5
Imports	-9.7	5.0	5.0
GDP	-7.6	0.5	2.5
GNP	-10.7	-1.5	2.0

Inflation

Annual inflation turns positive

Annual CPI Inflation turns positive…

We had expected a return to positive annual inflation (as measured by the CPI) in September this year and in the event it emerged one month early, with a 0.2% reading in August, the first positive inflation rate since December 2008. Indeed, the monthly increase in the index in August was much stronger than anyone anticipated, and as a consequence we are now revising our forecasts for 2010 with an end-year projection in excess of 2% and an annual average for this year at -0.7%. On a HICP basis inflation remains in negative territory, at -1.2%, but again we still expect a return to a positive reading by year-end, with an annual average of -1.3%.

Research on the determinants of Irish inflation tends to emphasise world prices and the exchange rate as the key drivers, and in that respect the deflation seen of late may owe as much to the euro's advance against sterling in the two years to 2009 as to Ireland's output gap, which the Department of Finance puts at around 7%. Similarly, the recent rise in prices has no doubt been strongly influenced by the fall in the euro against sterling, and indeed by the general fall in the Irish trade-weighted exchange rate which the Central Bank puts at 8% since the high in autumn 2009.

The CPI has risen by 1.9% since the January 2010 low and the August data showed that eight of the twelve component groups had risen over the previous three months. Higher mortgage costs has been the main catalyst behind the upward move, rising by some 10% in the three months to August and adding 0.7% to the overall CPI. Food prices have also stabilised after a persistent fall from early 2009 and energy prices are also higher than they were last autumn, albeit having fallen marginally in recent months.

Any forecast for Irish CPI inflation in 2011 will be strongly influenced by assumptions about the ECB tightening cycle, given the weight of mortgage interest in the CPI (6.7%) and we have pencilled in the first rise in the final quarter. On that basis, inflation is set to average 2.1% next year on our forecast, with a higher rate expected by year end.

…HICP inflation likely to follow.

The HICP measure excludes mortgage interest and so is much less volatile. The index fell by a cumulative 1.2% in the final four months of 2009 and in the absence of a sudden plunge in oil prices we feel that the base effects will push the annual inflation rate into positive territory by year end. For 2011 we expect an average of 1.2% in the absence of a significant move in the exchange rate or oil prices.

CPI Inflation (% change)

	2009	2010 (e)	2011(f)
Quarter 1	-1.5	-3.4	2.2
Quarter 2	-4.5	-1.4	2.0
Quarter 3	-6.1	0.3	1.7
Quarter 4	-5.8	1.7	2.3
Year	-4.5	-0.7	2.1
HICP	-1.7	-1.3	1.2

The Irish Labour Market

Unemployment rate may be at or near peak

Pace of job loss slows...

Irish employment fell again on a seasonally adjusted basis in the second quarter (it rose marginally on an unadjusted basis) bringing the total decline in this cycle to 276,000 or 12.9%. The pace of decline has slowed of late, however, and Q2 recorded a 7,600 fall, or 0.4%, from 15,000 in Q1 (0.8%) and over 76,000 in the first quarter of 2009 (3.7%). The monthly flow of redundancies has also fallen and the second half of the year may see some stability in the employment figures. The sectoral breakdown offers some support for that view, with employment rising on a seasonally adjusted basis in 7 of the 14 categories, although most of the former were in sectors dominated by public sector jobs. Construction continues to shed labour, as does manufacturing, with employment also falling in financial services.

The pace of decline in the labour force has also slowed, with a seasonally adjusted fall of under 4,000 (0.2%) in Q2, with the numbers unemployed rising to a new cycle high of 285,000 (13.2% of the labour force) from 278,000 in Q1 (12.9%). The numbers out of work for over a year has also risen substantially, and this long-term unemployment rate is now 5.9% from 1.5% two years earlier.

…migrant outflow confirmed.

The participation rate has fallen steadily from a cycle peak of 64.2% to the current 61.1%, with the change most evident in the 15-24 age group, with more young people opting to stay on at school and to enter third-level education. The flow of migration, which has been a huge influence on the supply of labour in Ireland, has also reversed course and the scale of that change was captured in the latest population estimates; immigration slowed to 31,000 in the year to April 2010, from 57,000 twelve months earlier and over 100,000 in 2007. Some 42,000 left the country in that year, but this had risen to 65,000 by April 2009, and the outflow to April 2010 was virtually identical. The composition of that emigration has changed however, with the largest proportion now Irish nationals. The net migration outflow of 35,000 was the highest since 1989 but was still offset by a 46,000 natural increase in the population, bringing the total to 4.47million, a rise of 0.3%.

The Q2 data has prompted us to revise our forecasts marginally, with the average fall in employment now reduced to 3.5% in 2010, offset by a smaller decline than originally envisaged in the labour force, to leave the average unemployment rate at 13.4%. This assumes that the current unemployment rate (13.7%) is at or near the peak, and we expect marginally positive employment growth in 2011, and a slow fall in the unemployment rate next year.

Labour Market (annual average '000)

	2009	2010(e)	2011(f)
Employment	1929	1862	1865
Labour Force	2187	2150	2145
Unemployed	259	288	280
(%)	*11.8*	*13.4*	*13.1*

Exchequer Finances

Budget remains on target

Tax in line and spending below profile…

The 2010 Budget projected a rise in the current budget deficit to €13.7bn from €11.4bn in 2009, offset by a sharp reduction in the capital deficit, which was forecast to fall to €5.1bn from €13.3bn, thus leaving an overall Exchequer Borrowing Requirement (EBR) of €18.8bn from €24.6bn. Tax receipts had fallen by 15.6% in 2009 and a further fall of 6.0% was projected for 2010, predicated on a contraction in both nominal and real GDP.

The Department of Finance publishes a monthly tax and spending profile and with data now available to end September the Budget looks on target, with a possibility of an undershoot of the forecast deficit. Tax receipts are running just 0.2% behind profile, largely due to a shortfall in income tax, which has been broadly offset by overshoots in corporation tax, VAT and excise duty. Spending is running 2.5% behind profile, solely due to the capital side, and the Minister for Finance now accepts that this is unlikely to pick up to target by year-end. In addition we expect non-tax receipts to emerge ahead of projections and debt interest to come in below the Budget forecast so giving a modestly lower deficit than originally planned.

From an EU perspective it is not the deficit per se that matters but the ratio to GDP and although real growth may be marginally positive this year and so ahead of the original Budget assumption, nominal GDP is likely to emerge below the Budget forecast. As a consequence we expect the EBR to emerge at 11.7% of GDP, and so marginally above the Budget projection despite a better outcome in terms of the cash deficit.

…but General Government deficit will be much higher than planned.

The EU measures fiscal policy in terms of the General Government balance, and in Ireland's case this year's figure is likely to include the cost of financial support for the three banks now in State ownership. This is now expected to amount to some €31bn in 2010 which in addition to the EBR above brings the General Government deficit to around €49bn or almost 32% of GDP. Only 10% of the cost of the bank recapitalisation will be funded each year but the 2011 deficit is therefore likely to be higher than projected in last year's 5-year fiscal plan. Consequently, the Minister is now scheduled to announce a new 4-year plan, outlining the measures required to bring the deficit down to 3% of GDP by 2014.

Exchequer Finances (€bn)

	2009	2010	2010
	Actual	Budget	Forecast
Current Expenditure	45.2	47.1	47.0
- Voted	40.2	40.2	40.3
- Non-voted	5.0	6.9	6.7
Revenue	33.9	33.4	33.7
- Tax	33.0	31.0	31.1
- Other	0.9	2.4	2.6
Current Budget Balance	-11.4	-13.7	-13.3
Capital Budget Balance	-13.3	-5.1	-4.9
Exchequer Balance	-24.6	-18.8	-18.2
General Government Balance	-23.4	-18.7	-48.9
(% of GDP)	*14.3%*	*11.6%*	*31.6%*

Funding the Deficit

Fully funded till mid-2011

Funding completed for this year…

The NTMA, the agency which manages Irish sovereign debt, planned to raise €20bn in 2010 and had achieved this target by mid-August. The €1.5bn of bonds issued at the regular monthly auction in September brought the total to €19.9bn or €22.4bn if funds raised through the National Savings (marketed to retail investors) are included. If one takes account of redemptions and some repayment of commercial paper the Agency raised a net €16.2bn in the first nine months of the year, against an exchequer deficit of €13.4bn over the same period. Consequently its cash balances increased by €2.8bn on top of the €21.8bn it was carrying at end-2009, bringing the total to €24.6bn so the deficit is fully funded until well into 2011. Consequently the Agency has called a halt to issuance in the near-term, and has cancelled the two remaining scheduled auctions. The average cost of bond issuance this year is 4.68% which is broadly in line with the average for 2009.

…and greater clarity now on bank recapitalisations…

The 10-year spread over bunds rose to around 450 basis points in September, with absolute yield levels at a high of 6.7% and this increase in the risk premium reflected in part market concerns about the cost of recapitalising the banking sector, particularly as related to the banks in public ownership. NAMA was also perceived to have moved at a slower pace than many expected, so adding to the uncertainty. The Irish authorities moved to provide greater clarity on these issues with a series of announcements on September 30th. NAMA is now set to complete the transfer of assets in a final tranche by year-end with the final haircuts for each institution now clearly indicated. In light of the latter the Central bank announced revised capital requirements for a number of institutions, including INBS, Anglo Irish bank and AIB. The latter will receive additional equity capital from the National Pension Reserve Fund, and as such off-balance sheet, but the banks in State ownership will require a total of €31bn or €9.1bn in addition to the sum provided to date, As a consequence, the General Government Debt, which stood at €105bn in 2009, or 66% of GDP, is likely to end 2010 at around €154bn or some 99% of GDP. The net position is much lower, as it includes the cash balances at the NTMA (€24.6bn) and the assets of the National Pension Reserve Fund (€24.1bn at end-June).

…with a funding target of €25bn likely for 2011.

The Government's current medium term projections for the public finances envisage an €18bn deficit in 2011, and €4.4bn is due in bond redemptions. The capital provided for the State owned banks is in the form of a promissory note, with some 10% likely to be funded each year. On that basis €3bn may be added to the funding target giving a total funding requirement of around €25bn in 2011.

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