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TheOutlook

A quarterly analysis of trends in the Irish economy

Modest but volatile growth expected this year

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- The recovery has been slow and uneven
- That pattern may continue in 2012
- Export growth to offset another fall in domestic demand

The Irish economy returned to growth in 2011, at least as measured by annual GDP, but the pace of recovery has been slow and uneven: GDP is now seen to have bottomed in the final quarter of 2009, but has risen by just 1% over the past eight quarters, with bouts of solid expansion followed by periods of contraction. GNP has been more volatile still, rising by 4.8% through 2010 but ending 2011 down 7.1%. The stop-start nature of the recovery and the dichotomy between the depressed domestic sector and a more robust export sector have no doubt been factors behind the fragile nature of business and consumer confidence, and the near term outlook is for a continuation of that trend.

Export growth, the main positive in the economy, slowed through 2011 and the current recessions in the euro zone and the UK represent a clear downside risk in 2012, although the US is expected to expand at a reasonable pace. We expect exports to continue to grow but at a slower pace than last year, which alongside sluggish imports means that net external trade will again provide the main stimulus to Irish GDP. Business spending may rise modestly but domestic demand overall is expected to decline further, with falls expected in Government consumption, construction and consumer spending. The latter may be less pronounced than seen last year, however, as employment and wages may stabilise. Indeed employment actually rose in the final quarter of 2011 for the first time in four years, although we do not expect a significant decline in the unemployment rate this year. Inflation is expected to be lower than in 2011 but the projected fall may not be as steep as previously envisaged, given the rise in oil prices in the first quarter of the year. The net result is that we expect another year of very modest growth but against a volatile quarterly pattern, with GDP forecast to rise by 0.6%, which is broadly in line with the current consensus.

The economy is now in broad balance as income exceeds spending in both the household and corporate sectors, with these surpluses offsetting the public sector deficit. The latter appears to be comfortably on target in relation to the 2012 Budget and, indeed, underlying tax revenue is well ahead of projections. This sits uneasily with some of the recent economic data, which has been on the weak side, and adds a further degree of uncertainty to the near term outlook.

Irish GDP

Another modest rise expected this year, around volatile quarterly pattern

Return to growth in 2011…

The Irish economy, as measured by real GDP, returned to growth in 2011, expanding by 0.7% following three consecutive years of contraction. The expansion was largely export-led; the volume of service exports grew by some 5% thereby outpacing merchandise exports and producing a 4.1% growth in total exports. Imports fell by 0.7%, reflecting a further contraction in domestic demand with the result that net external trade contributed 4.5 percentage points to GDP growth. Inventories also rose, adding a further 0.3 percentage points while the biggest negative contributor (1.4%) came from consumer spending. Government spending also fell, as did capital spending, with a 10.6% decline in that component taking capital spending's share of real GDP down to 10.5% against a cycle peak of some 26% in 2005 and a long-run average of 21%. Real spending on housing construction fell by 28% and house building now accounts for just 1% of GDP from a cycle peak of over 11% with building and construction as a whole now under 6% from over 20% in 2006.

GDP also rose in nominal terms last year, albeit by a marginal 0.3% taking the figure to €156.4bn and as such a little above that assumed by the Government. GNP which adjusts for international flows of profit, dividends and interest fell by 3.4% in nominal terms to €123.9bn and also declined in volume terms by 2.5%, following a modest 0.3% increase in 2010.

…but the economy contracted in H2.

The quarterly pattern of growth is subject to much revision and the latest vintage shows that the economy slowed through 2011, with a 2.2% expansion in the first half of the year followed by a 1.1% contraction in Q3 and a further fall in the final quarter of 0.2%. The deterioration in performance was largely due to a slowdown in export growth through the year, ending in a 1% fall in Q4. This mainly occurred on the merchandise side and in part reflects specific factors in the pharmaceutical industry (branded drugs going off patent), sluggish growth in the IT sector and the deceleration in the pace of world growth. The uncertain global outlook also represents a clear risk to any export forecast for 2012 particularly as the euro zone, which accounts for some 40% of Irish merchandise exports is expected to contract. The US accounts for 23% of exports and is expected to grow by over 2% however and some 16% of exports go to the UK, which is forecast to expand modestly, although it too has contracted over the past six months. As a result, we are projecting slower export growth this year and have pencilled in a 2.5% rise.

We also expect imports to grow, albeit marginally, reflecting the expansion in exports (which boosts the imports of components) and an increase in business investment, but offset by a further fall in consumption. Spending on machinery and equipment rose sharply in the final quarter of the year and its unusually low share of GDP also argues for a cyclical upturn, particularly as retained profits by multinationals also rose significantly last year. Consequently we forecast a 5% rise in that component. The impact on investment as a whole will be offset by a further projected decline in building and construction, however, so leading to a forecast 1% decrease in capital spending.

Domestic demand may fall again but offset by net exports…

Government consumption is expected to fall further as is personal consumption, although the latter did rebound a little in the final quarter of 2011. Indeed the Q4 data was unusual in that domestic demand grew and net exports declined, so reversing the general trend. We doubt that this will continue in 2012, however, as it is difficult to see a more sustained recovery in consumption near term. The Irish consumer is deleveraging, wages may be flat at best and the expected decline in inflation may not be as sharp as initially thought, given the rise in oil prices in the first quarter. Against that, aggregate disposable income may receive some support from employment, which we now expect to be flat on an annual basis, a view given some support by a surprise rise in the numbers at work in the final quarter of 2011. Consequently we forecast a smaller (1%) decline in real personal consumption this year, which means that domestic demand as a whole is set to fall by 1.5% following a 4.1% decline in 2011. This may be offset by the positive contribution implied by the external trade projections, so yielding a 0.6% increase in annual GDP in 2012. This is in line with the latest consensus view but the fact that net exports are again the main driver of growth highlights the risks to the forecast stemming from a steeper than expected contraction in euro zone GDP or a broader based slowdown in global growth. Business and consumer confidence in Ireland also remains fragile, although the upside surprise in tax receipts year to date may help to reassure as well as indicating that activity may be a little firmer than some of the monthly indicators would suggest.

…the BoP has moved into surplus.

The growth in Irish exports last year helped to boost the income earned on foreign direct investment in Ireland, against a decline in the income earned on Irish investments abroad, notably on debt instruments, with the result that the deficit on net income flows increased to over €32bn from €27.4bn in 2010. This explains why the GNP performance was much weaker than recorded by GDP. That net income deficit was offset in Balance of Payment terms by an increase in the merchandise trade surplus and a reduction in the deficit on trade in services, to leave a surplus of €123m against €765m in 2010. This was smaller than most forecasters envisaged (and no doubt will be revised), but the implication is that the economy remains in broad balance, with surpluses in the household and corporate sectors offsetting the deficit in the public sector. For 2012 we expect a BoP surplus of around €1bn, or 0.7% of GDP, with a higher trade deficit and another reduction in the services deficit offsetting an income deficit. The latter is expected to be smaller than seen in 2011, so GNP may rise at a faster pace than GDP, and we forecast a 1% increase.

Real GDP (% change)

	2010	2011	2012 (f)
Personal Consumption	-0.8	-2.7	-1.0
Government Consumption	-3.8	-3.7	-4.0
Capital Formation	-24.9	-10.6	-1.0
- Building & Construction	-33.1	-15.6	-5.0
- Machinery & Equipment	-14.5	-2.6	5.0
Stocks (% of GDP)	-0.6	0.3	0.1
Exports	6.3	4.1	2.5
Imports	2.7	-0.7	0.5
GDP	-0.4	0.7	0.6
GNP	0.3	-2.5	1.0

Inflation

Oil price rise prompts forecast revision

Traditional models of Irish inflation tended to emphasise the role of global prices and the exchange rate, given Ireland's size and openness to foreign trade, with less weight given to domestic demand. The scale of the Irish recession clearly showed that domestic factors can be very important, however, particularly as wages also fell in 2010 and 2011, thereby reducing cost pressures and adversely impacting demand.

Core inflation likely to remain subdued…

Consumer spending in Ireland did pick up modestly in the final quarter of 2011 but we still expect it to decline on an annual average basis in 2012, which is likely to keep domestically generated inflating pressure at a low level, particularly as wage inflation may be flat to marginally positive at best. The euro's decline against sterling does represent the potential for some upward move in Irish prices but this is unlikely to be significant in our view in the absence of an upside surprise in consumer spending, so dissuading retailers from passing on any increase in import prices.

Core inflation is thereby likely to remain subdued so the likely path of overall inflation will be determined by the most volatile components of the Irish CPI, mortgage interest and energy.

…and mortgage interest is dampening headline inflation…

The former increased sharply in the first half of 2011, reflecting higher ECB rates and an increase in the cost of funds for Irish banks, but has fallen back of late, with the annual change turning negative in March, helped by the recent cuts in the ECB repo rate. Mortgage inflation may therefore represent a significant deflationary influence on the CPI, even in the absence of any further ECB rate reductions.

The path of energy inflation is likely to be much more volatile and it now accounts for over 11% of the index, under revised weights from 7.8%. The annual energy inflation rate did slow through 2011, ending the year at 8.9% from a peak of some 15% in March but has remained in a 9%-10% range since, reflecting a combination of higher wholesale fuel costs, a rise in VAT and an increase in excise duty, and as such inflation has not fallen as fast as initially thought. Oil prices have fallen back a little of late and in the absence of another significant upward move we still expect annual energy inflation to slow through 2012 so providing an additional deflationary influence, albeit a volatile one.

…but volatile energy prices less supportive than expected.

Consequently, we still believe that Irish CPI will slow in the latter half of the year from the current 2.2% but the higher than expected q1 outturn means that the annual average may be around 1.9% for 2012. The HICP measure excludes mortgage payments and so is less volatile, although energy will still be a key factor there. We expect HICP inflation to average 1.8% this year, again easing from the current 2.2%.

CPI Inflation (annual change, %)

	2011	2012 (e)
Q1	2.3	2.2
Q2	2.9	2.1
Q3	2.6	1.9
Q4	2.9	1.6
Annual	2.6	1.9
HICP	1.1	1.8

The Labour Market

Surprise rise in employment in final quarter of 2011

Employment rose in the final quarter of 2011…

Irish employment peaked at a seasonally adjusted 2.14 million in the final quarter of 2007 and by the third quarter of last year had declined by 16% or 342,000. The pace of that decline had slowed appreciably in the first half of last year but the third quarter saw an initial 20,000 fall, or over 1%, so dashing hopes that the cycle may be at a turning point. Consequently, the 10,000 rise (or 0.6%) in seasonally adjusted employment in the fourth quarter of 2011 was a major surprise, and the third quarter decline was revised down to 14,000 or 0.8%. The Q4 rise, the first in four years, therefore does provide some concrete support for the view that the labour market is finally turning.

The job gains in Q4 ranged across a number of industries, including manufacturing (6,000), hotels and restaurants (4,000) and the financial sector (4,000) offsetting job losses elsewhere, including the retail sector (-2,000), transport (-3,000) and education (-2,000) with the pattern implying that the demand for labour is responding to the growth in exports, including service exports, and the recent revival in tourism.

…although unemployment remains stubbornly high…

The supply of labour has also contracted sharply in recent years, partly due to a fall in the participation rate and partly to net emigration. The labour force also rose in the fourth quarter of last year on a seasonably adjusted basis, however, with the result that the unemployment rate was unchanged at 14.6% from Q3. The quarterly figures also indicate that there may be a change to the pattern of migration; the initial outflows at the onset of the recession tended to be non-Irish nationals leaving after losing employment but the number and proportion of Irish nationals emigrating now seems to be picking up.

The upside employment surprise in Q4 also means that the average fall in employment in 2011, at 38,000 or 2.1%, was slightly smaller than we expected, although the decline in the labour force is also less than we anticipated, so leaving the unemployment rate broadly in line with our estimate at 14.4%.

…and likely to stay high this year.

For 2012 we are reluctant to predict a rise in employment given our expectation of very modest GDP growth. Consequently we expect employment on an average annual basis to be unchanged from 2011. Similarly we expect the labour force to remain unchanged with the result that the numbers unemployed will average just over 300,000 over the year, giving an unemployment rate of 14.4%.

Labour Market (annual averages '000)

	2010	2011	2012 (f)
Employment	1848	1810	1810
Labour Force	2130	2114	2114
Unemployed	292	304	304
(% of labour force)	*13.6*	*14.4*	*14.4*

Exchequer Finance

Revenue well ahead of target

GDP may be weaker than projected in the Budget…

The 2012 Budget projected a current deficit of €11.2bn, identical to the 2011 outturn, but a much smaller capital deficit of €7.7bn (against €13.7bn last year) to give a projected Exchequer Borrowing Requirement (EBR) of €18.9bn, down from €24.9bn in 2011. The General Government balance was forecast at €13.7bn, or 8.6% of projected GDP, predicated on a 2.5% rise in the latter, including a 1.3% increase in real terms. That real GDP forecast now looks high relative to the consensus (currently at 0.5%) and is likely to be revised down.

Tax revenue is running well ahead of profile, nonetheless, emerging over €800m, or 10% above target in the first quarter of the year, although there are some special factors at work. Corporation tax, for example, includes €250m which was delayed from 2011, while some €200m of receipts were reclassified as income tax instead of social insurance contributions (which are captured as an offset to gross spending). This still implies that underlying tax receipts are €350m ahead of profile, or some 4.5%, and 10% above the corresponding period of 2011, against a full year Budget target of 5.3%.

…but revenue is well ahead of target…

Income tax receipts are particularly strong on an underlying basis, boosted by the full-year effects of the tax increases in the 2011 Budget, while VAT is also over €10m ahead of profile and has grown at a 5.9% annual pace, against a 2.6% forecast for the year as a whole. The strength of revenue growth is surprising given the available data on the economy, as it implies stronger growth than indicated by retail sales and industrial production. On that basis, caution is warranted on drawing too many conclusions about the end-year outturn at this stage.

The Budget projected a 3.1% rise in current spending, with a significant increase in debt servicing offsetting a 2.2% fall in day-to-day current spending. The latter is running well ahead of target, however, exceeding profile by €533m in the first quarter, although the Government believes that short term factors are at work and the target will be met. The Government has also announced that it will not be paying the €3.06bn due to IRBC on the promissory note, but instead has met the payment via a Government bond. This reduces the capital deficit but has no impact on the General Government deficit.

Exchequer Finances (€bn)

	2011	2012 Budget	2012 Forecast
Current Expenditure	48.0	49.5	49.5
- Voted	41.4	40.5	40.5
- Non-voted	6.6	9.0	9.0
Revenue	36.8	38.3	38.3
- Tax	2.8	2.5	2.5
- Other	34.0	35.8	35.8
Current Budget Balance	-11.2	-11.2	-11.2
Capital Balance	-13.7	-7.7	-4.6
Exchequer Balance	-24.9	-18.9	-15.8
General Government Balance	-20.5	-13.7	-13.1
(% of GDP)	*(-13.1%)*	*(-8.6%)*	*(-8.2%)*

Funding the Exchequer Deficit

€45bn to date drawn down under the EU/IMF programme

The NTMA manages Ireland's sovereign debt and borrowed €34.5bn under the EU/IMF programme in 2011, raising another €1.4bn via National Savings Schemes. That total funding exceeded the exchequer deficit (€24.9bn) and debt repayments (€4.8bn in bonds and €4.1bn in commercial paper) by €2.1bn, so boosting cash balances to €17.8bn at end-December.

Cash balances increase to €18.7bn…

In the first quarter, the Agency drew down another €10.5bn under the programme (including some €1bn in bilateral loans from the UK and Denmark) which, alongside National Savings inflows, brought the sum to €11bn. This was used to repay maturing debt (€5.6bn in bonds and €0.7bn in CP) and to cover the €4.3bn exchequer deficit, with the result that cash balances increased by a further €0.9bn to €18.7bn, leaving the NTMA extremely liquid.

…and over €22bn is still available…

To date, Ireland has borrowed €15.8bn from the IMF, €9.4bn from the EFSF and €18.3bn from the ESM and €1.5bn in bilateral loans, giving a total of €45bn. The original programme involved funds of €67.5bn, implying that Ireland can borrow a further €22.5bn and has total resources available of over €41bn given the cash balances. This would more than cover the expected deficits and debt redemptions to the end of 2013, although the NTMA would no doubt like to return to the market well before that point.

…market sentiment remains positive.

That will depend upon investor sentiment towards the euro in general which is out of Ireland's hands, and on sentiment towards Irish debt. That remains reasonably positive given the broad stability of late in Irish bond yields and despite the potential uncertainty caused by the upcoming referendum on the EU Fiscal Compact. The fact that the deficit year to date appears comfortably on target is also a positive, but Ireland's deficit and debt figures make it vulnerable in the absence of a more robust economic recovery. The debt figure at end 2011 is now put at €169bn, or over 108% of GDP, and in 2012 is likely to rise to around €187bn or 118% of the current GDP projection. Against that, the market component of that debt is much lower: the level of outstanding government bonds is now just under €80bn, with perhaps half held by the ECB, the Irish banks and Irish pension and insurance companies, all of which could be viewed as long term holders.

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