

7. IRELAND

Export-driven recovery weighed by continuing household deleveraging and fiscal consolidation

Irish economy returns to timid growth

Ireland's economy saw an unprecedented collapse between 2007 and 2010, with GDP falling by 10% in real terms and 18% in nominal terms. The decline was led by the collapse in gross fixed capital formation (down 52% over the period in real terms). Although export gains were strong over the period despite the sharp decline in global demand, the interlinkages between the sovereign and banking sectors in the wake of the 2008 credit crunch saw borrowing costs jump to unsustainable levels by late 2010. This precipitated joint EU-IMF support to provide sovereign financing, allowing time to implement a policy programme aimed at restoring confidence in the Irish banking sector and public finances.

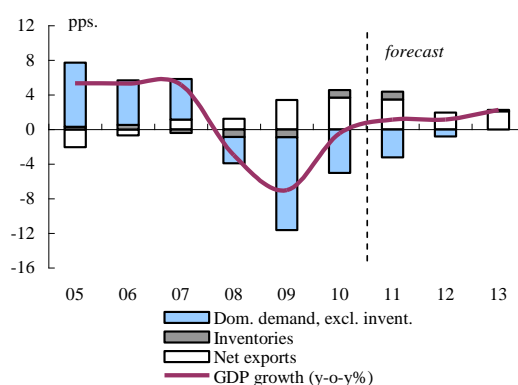
Since the programme was agreed in November 2010, Ireland's economy has continued to adjust broadly in line with expectations underpinning the EU-IMF programme. Domestic demand will contract again in 2011. However, this will be more than offset by a growth contribution from net exports of over 3 pps. of GDP, giving a headline growth figure of 1.1% for 2011 as a whole. This divergent economic development will continue in 2012. External demand will support growth with the domestic economy continuing to shrink, as exports continue to have only a limited impact on the labour market. Overall growth is projected at 1.1% in 2012. Moving to the medium term, growth is expected to pick up to 2.3% in 2013 as the non-traded sectors of the economy return to growth and the labour market begins to improve. Despite the slight upward revision to real growth in 2011, the deflator has been revised noticeably downward from 0.6% to -1.0%. This is due to the negative terms-of-trade developments in the first half of 2011 stemming from high energy prices as well as export price weakness. However these developments are expected to unwind in 2012.

Domestic economy will remain weak

Growth in the first half of 2011 was strong, with GDP increasing by 1.3% y-o-y, a tentative sign of economic stabilisation. Although quarterly output in Ireland is highly volatile, this was the first time since GDP peaked in 2007 that output expanded for two successive quarters. Although net exports

and stock-building were the dominant contributions to growth in the second quarter, domestic demand showed positive signs too, growing by 0.8% q-o-q.

Graph II.7.1: Ireland - GDP growth and contributions



Still, private consumption is set to decline by 2.4% in 2011, with government consumption falling by slightly more. The contraction is being driven by continued high private saving due to both precautionary motives and the need for households to repair their balance sheets. Private consumption is set to fall again in 2012 (by 1.1%) as the effects of deleveraging and continued fiscal consolidation continue. Over the forecast horizon, public consumption is set to decline as consolidation continues. However, the annual profile is somewhat uneven as the provision of government guarantees to the banking sector affects.

Investment is set to decline again in 2011 with a positive contribution from machinery and equipment investment being outweighed by the continuing (but expected) contraction in construction output. Continuing the 2011 recovery, machinery and equipment investment is set to grow again in 2012 (despite credit constraints) as re-tooling is overdue after the large contraction since 2008. This will broadly offset a further fall in construction output in 2012 with the net contribution to growth from gross fixed capital formation essentially flat for the year. Following a strong increase in inventories in the first half of 2011, the contribution from stock-building has been revised upward to 0.9 pp. of GDP this year. Given the slowdown in external demand growth,

stock-building is forecast to have a zero contribution to growth in 2012.

From 2013 on, domestic demand is set to provide a small but positive contribution to growth, for the first since 2007, on the back of a return to employment growth and a further decline in private savings.

Exports stay solid

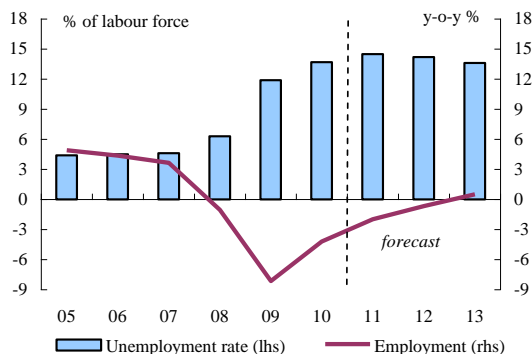
Ireland's export performance has remained strong this year on the back of strong demand in the pharmaceutical and agri-food sector, as well as gains from competitiveness improvements in recent years. Real exports grew by 5.5% in the first half of 2011 compared to the same period in 2010. Despite the global slowdown in the second half of the year, export growth for the year as a whole is set to average 4.5% in 2011. Due to the a-cyclical composition of exports (in particular pharmaceuticals), the impact of the current slowdown in global demand is set to be relatively limited in Ireland with export growth slowing to 3.8% in 2012, with a small terms of trade improvement expected too. A recovery in global trade combined with continuing labour cost improvements compared to trading partners should see exports return to robust growth approaching 5% in the medium term. Imports will continue to be held back by subdued domestic demand and net export growth is set to contribute substantially to medium-term economic activity.

Weak employment outlook over forecast horizon

Despite the timid economic upturn, the labour market is showing little sign of recovery. Employment contracted by 2.1% in the year to the second quarter and the monthly measure of unemployment has risen gradually through the year to 14.3% in September. Job growth has restarted in some export-oriented sectors but this is not likely to offset the continuing contraction in construction and public service employment this year or next. The rebalancing need is compounded by the skillsets of the considerable number of long-term unemployed (54% of total) who originate disproportionately from the construction and manufacturing sectors. Employment is set to fall by 1.9% in 2011 with a further reduction in 2012 of 0.6%. Net outward migration is set to continue over the forecast horizon, dampening unemployment growth, although strong natural

increase will keep population growth positive. Unemployment is set to average 14.4% this year, with a gradual decline to 14.3% in 2012 and 13.6% in 2013. Over the medium term, the uniquely high propensity to migrate makes estimates of unemployment outcomes in Ireland difficult.

Graph II.7.2: Ireland - Labour-market developments



Headline average hourly earnings remained flat year-on-year to the second quarter. However, labour cost compression is continuing at the non-wage margin (for example reductions in bonuses and benefits-in-kind). Hourly labour costs fell by 3.5% in the year to the second quarter of 2011, in contrast to an increase of 3.6% in the euro area. Wage developments are expected to be very moderate in 2011-12, thereby helping to further recover past competitiveness losses and facilitating sectoral adjustment.

Inflation turns slightly positive

During the domestic boom, Ireland suffered significant losses in competitiveness, as reflected in a strong rise in unit labour costs from 2002 to 2008. Irish price levels grew to be among the highest in the euro area. Since early 2008, Irish inflation has been below the euro area average and a cumulative contraction of 3% in the HICP took place in 2009 and 2010. While inflation will return to positive territory this year and next, it should remain subdued in the absence of strong demand pressures. Inflation of 1.1% in 2011 will be driven by external energy and administered service increases, while core inflationary pressures remain very weak. Inflation of 0.7% is now expected for 2012 although this will largely be driven by administered prices. In the medium term, core inflation in Ireland is likely to remain below the euro area average.

Current account bounces back

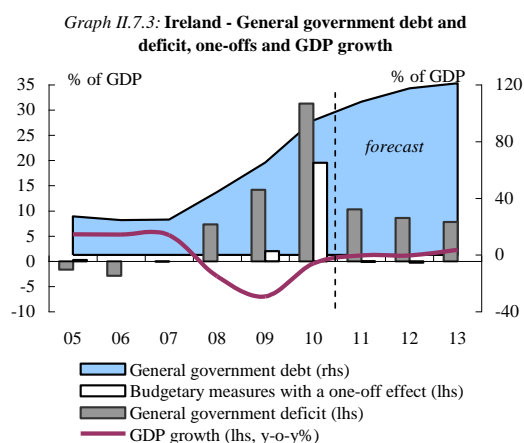
Ireland's external position is rebalancing and an unexpected current-account surplus of 0.5% of GDP was recorded in 2010, the first surplus since 1999. However this was followed by a deficit of 1.1% of GDP in the first half of 2011 as corporate profit outflows to foreign affiliates surged on the back of the strong export performance. This trend often weakens in the second half of the year and another small surplus of 0.7% is forecast for 2011. Over the medium term this trend is expected to intensify with growth being export-led while domestic demand remains weak as household deleveraging and fiscal consolidation continue.

Pace of credit contraction slows

The contraction in bank credit has stabilised. On a year-on-year basis, credit advanced to households and to non-financial corporations contracted by 4.0% and 2.7% respectively in August. The credit contraction to households seems to be steadily recovering from its trough of 5.3% in December 2010. Credit to non-financial corporations has been volatile. Looking forward, credit expansion is not expected to be strong in the short to medium term in the context of banks deleveraging and limited credit demand.

Consolidation continues

The government deficit ratio to GDP reached a record 31.3% in 2010, including one-off banking sector support measures of 20% of GDP. As compared to the spring 2011 forecast the deficit is down by 1.1 pps. of GDP due to the revisions to the public finance data and nominal GDP.



The government deficit is estimated at 10.3% of GDP in 2011. Despite permanent fiscal

consolidation measures of 3¼% of GDP, the structural deficit is estimated to decline by only ½ pp. of GDP over 2010. The difference stems from negative potential growth and closing output gap, as well as negative domestic demand developments – the main source of tax revenue and job creation. Lower tax revenue and some overruns in mainly social spending are estimated at 0.3% of GDP as compared to the spring 2011 forecast. However, these are more than offset by higher-than-expected non-tax revenue – fees on the bank guarantees (0.4% of GDP) and interests on the bonds injected as convertible contingent capital into the domestic banks (0.1% of GDP). The sale of the spectrum licenses announced in the 2011 budget is likely to take place in 2012 (one-off revenue of 0.3% of GDP), but the Jobs Initiative announced in May 2011 has a deficit-improving effect of 0.1% of GDP. The Jobs Initiative is budgetary neutral over the period 2011-14, while having a deficit-increasing effect of 0.1% of GDP in 2012 and 2013, and positive effect of similar size in 2011 and 2014. It includes a temporary levy on pension funds yielding almost 0.3% of GDP annually, which compensates for temporary reductions in some tourism-related VAT rates and social security contributions on low wages. Interest rate margin reduction on EU loans provided as part of the EU-IMF programme is estimated to produce savings of 0.2% of GDP. One-off banking support measures (including possible capital injection in the credit union sector) of 11% of GDP in 2011 are considered as financial transactions in the forecast until their statistical treatment is confirmed by Eurostat.

The deficit ratio is projected to decrease to 8.6% of GDP in 2012 and 7.8% in 2013 taking into account broad consolidation measures of 2½% of GDP and almost 2%, respectively, as agreed under the financial assistance programme. The forecast includes savings from the interest rate margin reduction (½% of GDP annually). The deficit in 2012 is improved by higher bank guarantee fees (0.2% of GDP), higher Central Bank's profits (0.2% of GDP) and return on the convertible bonds in the banks (0.2% of GDP). Overall, the positive effects on the 2012 deficit outweigh negative effects of the weaker growth on revenue and unemployment-related expenditure (1% of GDP). The temporary non-tax revenue, which help reduce the forecast deficit in 2012 are projected to recede in 2013.

From a level of 25% in 2007, the debt-to-GDP ratio is projected to peak at around 121% of GDP in 2013 before declining. This reflects the large primary deficits, banking sector support measures and rising debt servicing costs. Debt projections also include the impact of the participation in the capital of the ESM as planned on the cut-off date of the forecast. Precautionary cash balances are assumed at 7½% of GDP by end 2013.

Risks remain balanced

Over the medium term, growth is expected to pick up to 2.3% in 2013 as net export growth continues to make a positive contribution and domestic demand stabilises as the household saving ratio begins to fall.

Lower growth stemming from weaker-than-expected global demand in 2012 is a very real risk, as exports comprise a large share of Irish GDP. However, the composition of Irish exports and their relatively non-cyclical relationship with global demand would offset this to some extent. Although growth has returned, a pick-up in employment is likely to lag considerably, which has particularly pressing policy challenges. On the upside, precautionary savings are high giving scope for a reduction and the Irish household sector is likely to find considerable relief in 2012 given its exposure to short-term interest rates.

Table II.7.1:

Main features of country forecast - IRELAND

	2010			92-07	Annual percentage change					
	bn EUR	Curr. prices	% GDP		2008	2009	2010	2011	2012	2013
GDP	156.0	100.0	6.6	6.6	-3.0	-7.0	-0.4	1.1	1.1	2.3
Private consumption	79.6	51.0	5.6	5.6	-1.4	-7.2	-0.9	-2.4	-1.1	0.5
Public consumption	29.3	18.8	5.3	5.3	1.2	-3.7	-3.1	-3.6	-1.0	-2.1
Gross fixed capital formation	18.0	11.5	7.9	7.9	-10.1	-28.8	-25.1	-10.5	0.6	4.2
of which : equipment	6.1	3.9	8.8	8.8	-12.4	-23.5	-16.9	8.3	15.0	8.0
Exports (goods and services)	157.7	101.1	11.6	11.6	-1.1	-4.2	6.3	4.5	3.8	4.3
Imports (goods and services)	127.9	82.0	11.0	11.0	-3.0	-9.3	2.7	1.6	2.6	3.1
GNI (GDP deflator)	129.3	82.9	6.2	6.2	-3.0	-10.7	-0.8	-1.5	-0.8	0.9
Contribution to GDP growth :										
Domestic demand			5.3	5.3	-3.0	-10.7	-5.0	-3.1	-0.7	0.3
Inventories			0.0	0.0	-0.9	-0.9	0.9	0.9	0.0	0.0
Net exports			1.7	1.7	1.2	3.4	3.7	3.3	1.8	2.0
Employment			3.8	3.8	-1.1	-8.1	-4.2	-1.9	-0.6	0.6
Unemployment rate (a)			8.0	8.0	6.3	11.9	13.7	14.4	14.3	13.6
Compensation of employees/head			5.3	5.3	5.4	-1.2	-3.2	-0.1	0.4	0.9
Unit labour costs whole economy			2.5	2.5	7.5	-2.4	-6.9	-3.1	-1.2	-0.8
Real unit labour costs			-1.1	-1.1	10.1	1.7	-4.6	-2.1	-1.9	-2.0
Saving rate of households (b)			-	-	11.1	14.7	13.4	14.9	12.8	11.4
GDP deflator			3.7	3.7	-2.3	-4.1	-2.4	-1.0	0.7	1.3
Harmonised index of consumer prices			-	-	3.1	-1.7	-1.6	1.1	0.7	1.2
Terms of trade of goods			-0.5	-0.5	-5.5	6.1	-3.4	-4.9	0.8	0.0
Merchandise trade balance (c)			19.4	19.4	13.2	20.2	23.4	23.7	25.0	25.9
Current-account balance (c)			0.4	0.4	-5.6	-2.9	0.5	0.7	1.5	1.8
Net lending(+) or borrowing(-) vis-à-vis ROW (c)			0.9	0.9	-5.6	-3.7	0.1	0.4	1.4	1.5
General government balance (c)			0.6	0.6	-7.3	-14.2	-31.3	-10.3	-8.6	-7.8
Cyclically-adjusted budget balance (c)			0.0	0.0	-7.2	-11.9	-29.3	-9.1	-8.0	-8.1
Structural budget balance (c)			-	-	-7.2	-9.8	-9.7	-9.1	-8.3	-8.1
General government gross debt (c)			52.3	52.3	44.3	65.2	94.9	108.1	117.5	121.1

(a) Eurostat definition. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.