

# Irish Economic Outlook

## Dire recession nears the end: difficult recovery to begin

The dramatic decline in the Irish economy continued into the second quarter of this year, the fifth consecutive quarter of decline. The damage wreaked by this recession has been immense, whether seen through the collapse in house building, the surge in unemployment, the decimation of Government tax revenue, or the sharp decline in consumer demand.

The more positive news is that the pace of decline has eased in the second quarter. A number of indicators of activity, whether soft (consumer confidence, PMI surveys, global economic prospects) or hard (unemployment, tax revenue, retail sales), show continued weakness, although the pace of decline has eased considerably.

The cause of Ireland's economic decline is evidenced by the sheer scale of the collapse of private sector demand. In 2006, at the height of the boom, the Irish private sector was a net borrower to the tune of EUR10bn. In 2009 the private sector will be a net saver of EUR20bn a year. This represents a withdrawal of EUR30bn from the economy annually because of less spending on housing and consumer goods, and less capital investment by businesses. High Government borrowing is a direct mirror of this saving. While the spreads on Irish Government debt have risen sharply over the past year, the massive level of domestic savings will make the funding of this deficit easier.

The economic recovery will come from two sources. First, foreign demand for Irish produce will pick up as the global economy recovers. The initial signs here are encouraging. While global exports have been in freefall since Christmas, Irish exports have defied gravity. Second, as domestic confidence returns, the enormous rate of private saving will begin to fall. Consumer spending will bottom out this year and begin to grow slowly around the turn of the year. A pick-up in housing activity will take longer, with the residential sector to remain subdued for an extended period.

However, as long as Irish consumers and businesses remain in retrenchment mode, then overly aggressive measures to reduce government borrowing could be counter-productive. The budgetary measures taken in October and April were necessary, as the deficit was heading for 15% and financial market turmoil meant that there was a genuine (if remote) fear that funding could dry up. However, the Government should refrain from further significant taxation increases, although continue to reform the public and local private service sectors.

### Today's key points

- Domestic demand to contract by 13.6%, with the continued decline in construction and consumer spending the main culprits.
- GDP to decline by 7% in 2009, with the resilient performance of exports offsetting the domestic decline.
- Exports from Irish-based Multinationals have defied gravity so far in 2009, showing that Ireland's competitiveness as an exporting nation has been greatly underestimated.
- As domestic confidence returns, the enormous rate of private saving will begin to fall. The slowdown in the rate of increase of unemployment will be an important element to this change in confidence.
- Overly aggressive measures to reduce government borrowing could be counter-productive as long as domestic savings remain high.

Table 1. Macro-economic Forecast

	2008	2009	2010
GDP	-3.0%	-7.0%	-1.0%
Domestic Demand	-4.7%	-13.6%	-3.8%
Exports	-1.0%	0.2%	4.0%
Imports	-2.1%	-7.2%	2.0%
Personal Expenditure	-1.0%	-8.0%	-2.5%
Public Expenditure	2.6%	-1.0%	0.0%
Investment	-15.5%	-35.0%	-12.0%
Unemployment (avg)	6.4%	11.8%	14.3%
Consumer Inflation (HICP, avg)	3.1%	-2.0%	0.0%

Source: Danske Markets

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# Historic economic decline nears end

## Construction sector remains moribund

The proximate cause of the current downturn is the decline in the construction sector, with virtually every indicator of activity still moving in the wrong direction. On the residential side, construction activity is running at levels consistent with 15,000-20,000 houses this year, down from a peak of 93,000.

The big question is how large the accumulated overhang of unsold stock is, and how fast will it be burned off with construction at such low levels. While there is no reliable estimate of the size of the unsold housing stock, there are some pointers on new occupancy. New connections to the national electricity grid will be 30,000-35,000 in 2009, much higher than house completions, as houses built in 2008 and earlier are connected. Electricity connections usually occur when a property is finally occupied, although some construction companies could be connecting unsold houses to protect against mould.

The discrepancy between completions and connections is a sign that reduced construction activity is clearing some of the overhang of unsold houses. Longer term, favourable demographics are expected to drive annual housing demand of 40,000, well above the current level of activity. However sentiment indicators suggest that confidence remains at a very low level and that construction activity is still falling. Putting the two together suggests that the stock of unsold housing remains large and growth in construction remains a distant prospect.

In terms of non-residential, the fall off in demand for commercial property occurred much later than residential. Commercial construction activity peaked at the end of 2008 – although as current projects are completed, this level of activity is likely to decline sharply. The public capital programme has also been pared back by 5% in the April Budget, and will face further cuts in the coming years. Given that tender prices have fallen by close to 20% over the past two years to 2000 levels, this cut need not necessarily result in a fall off in the volume of public construction activity.

## Labour market deterioration slows

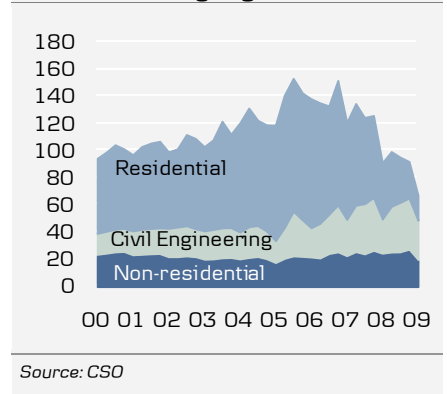
The rapid deterioration in the labour market over the past year has been one of the most dramatic features of the downturn. This turned particularly acute at the start of the year, with an increase of almost one percentage point in the unemployment rate in January alone. Irish unemployment has doubled from 5.9% in June 2008 to 11.9% in June 2009. Employment has decreased by 157,000, a fall of over 7%.

The contraction in construction is the main culprit. Almost half of the decline in employment to February (73,000) was accounted for by the construction industry alone. Given the continued rise in the Live Register since February, job losses in construction are now likely to exceed 100,000. Given future construction needs, this drop of 100,000 is permanent, although job losses are likely to continue and overshoot the long-term level.

The propagation of the sharp decline in the construction industry to the rest of the economy is also evident. In particular, there has been a sharp fall in employment in retail/wholesale (30,000), industry (20,000) and professional (6,000). There is also a significant gender imbalance, with unemployment for men reaching 15%, compared with 8% for women.

It is also notable that unemployment among immigrants from eastern Europe is now running at 20% – double the rate for Irish nationals. At the peak of the boom total employment was growing at 100,000 a year – 70,000 of which were through net inward immigration. The first signs of the anticipated re-emergence of emigration are now evident. This is entirely confined to nationals of eastern European countries, with net emigration of 25,000 over the past year, or one in eight of this grouping. For every one eastern European worker who has joined the dole queue, almost two have emigrated. Despite this outflow, the total population living in Ireland continues to expand due to Ireland's favourable demographic profile.

Chart 1. Contraction in residential construction on-going



## Irish exports defy gravity

One of the quieter stories of the recession has been the performance of Irish exports. While global trade has been in virtual freefall, Ireland has been virtually alone among non-oil exporting countries in increasing its goods exports. This is also mirrored in Ireland's industrial output data, which also shows little change on 2008's volume levels.

In part, this short-term resilience reflects good luck. Ireland has built up a large pharmaceuticals industry that is close to recession-proof and which now accounts for well over half of total goods exports. However, chance alone can't explain this very strong performance. The Swiss economy has suffered a significant decline in exports, despite also having a large pharmaceuticals base. Rather, the strong performance by Ireland in 2009 reflects the underlying strength of Ireland's exporting sector, which remains highly competitive.

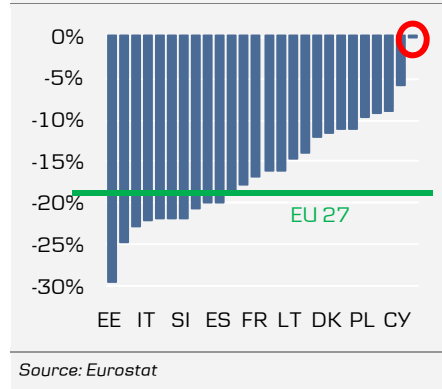
What is true is that a large current account deficit emerged in 2005. The emergence and growth of this deficit was presented as proof that high costs were constraining exports. This, in our view, was a misreading. Ireland's current account deficit was never about a lack of exports, but rather an excess of imports. Buoyed by soaring sentiment, import spending – by consumers, government and the construction industry – surged. The import demands of the construction industry alone rose by EUR8bn from 2000 to 2007, equivalent to over 4% of GDP.

At its height, the Irish current account deficit at 5% was less than half that of many Mediterranean countries (e.g. Spain 10%, Greece 14%) and was not an outlier compared with other wealthy western economies (e.g. US 6%, New Zealand 9% and Australia 6%). Given the scale of this surge in imports, the current account deficit of 5% simply wasn't large enough to provide evidence of an uncompetitive export sector.

Certainly, Ireland's cost base rose relatively quickly on the back of the property boom. However, the single most important cost to business – labour cost – was in a period of catch-up, after being relatively low in 2000. By 2008, Irish private sector pay was not out of line relative to our main trading partners according to the EU's AMECO dataset. Manufacturing wages in Ireland were still the lowest of all northern European economies, coming in 16% below the average. Pay in Irish services industries was in line with those of other northern European economies, though generous public services pay levels are the cause for this. Indigenous exporting firms have fared far worse, however, because of the weakness in sterling. While the real euro/sterling exchange rate has fallen since January, it still remains significantly above 2005 levels, leaving many exporters under pressure.

The demand for imports is now dropping rapidly as the savings rate surges. As a consequence, the current account deficit is set to dissipate in 2009. With the world economy set to recover faster than Ireland in the coming year, exports will continue to outstrip imports and a current account surplus will emerge in 2010. After the wave of wage reductions seen in the public and private sector in the first half of 2009, Ireland's wage competitiveness now significantly outstrips most other northern European economies.

Chart 2. Global production crumbles, Irish industrial production unchanged



### Cautious households drive savings up

Consumer spending remains very weak, due to the rapid rise in precautionary household's savings over the past year. Retail sales excluding cars have fallen 10% since its peak at the end of 2007. Including cars, the fall is double this. The figures for April show that there are tentative signs that the underlying rate of decline has slowed, although conditions remain difficult.

Where consumer spending goes from here is crucial for the whole economy, as household spending accounts for 57% of total domestic demand, and has a large effect on tax revenue and employment. The rises in taxes and fall in salary levels seen so far this year will have a dampening effect on Irish consumer spending over the next year. This is the unfortunate but inevitable consequence of having to tighten fiscal policy in the teeth of an already sharp economic contraction.

When will savings start to fall? Historically, it has been the rate of change in unemployment – not the level of unemployment – which guides the rate at which households feel they need to save. This is also the experience of Finland during its crisis in the early 1990s. In Finland, the savings rate was at its highest in 1992, when unemployment was rising at its fastest rate. The unemployment rate continued to rise until 1994, albeit at a slower pace – although in both 1993 and 1994 the savings rate plummeted.

This makes sense – the rate of increase in unemployment is a measure of people's fear of losing their job. Once unemployment starts to rise at a slower rate this fear starts to abate and precautionary saving starts to fall. As the peak in the rate of increase in Irish unemployment has now passed, the second half of the year is expected to see household savings peak and start to fall, which will be the catalyst for a stabilisation and subsequent recovery in consumer spending.

The other catalyst to a fall in precautionary savings in Finland in the early-1990s was the fall in interest rates. In the Finnish case, a very high interest rate environment persisted in the teeth of a sharp economic slowdown, a result of the German need for higher rates post-unification and the attempt by the Finns to defend an overvalued currency. Following the float of the markka in September 1992, interest rates tumbled. By the second half of the following year (equivalent to Ireland in late-2009), GDP had bottomed-out, household purchases of durables started to recover, residential investment had increased and even house prices had started to rise. Lower interest rates will also have their effect in Ireland, although this won't be evident until 2010.

### Prices continue to fall

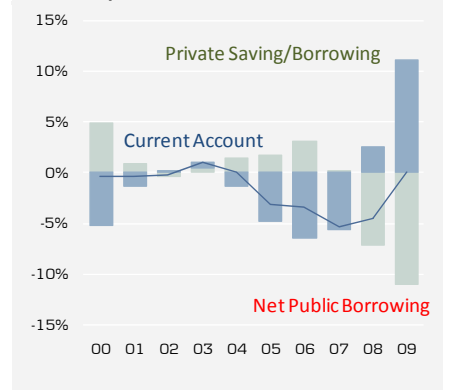
Inflation in Ireland continues to fall sharply, with the Consumer Price Index reaching a new low of minus 4.7% in May. This is mainly driven by lower mortgage costs, which have taken 3.5 percentage points off the annual interest rate over the past twelve months. This will ultimately be reversed, and represents a temporary respite from income falls and tax increases.

However, even excluding mortgage repayments, the Irish price level is falling at a faster rate than the rest of the eurozone. Irish consumer prices, as measured by the HICP, have fallen 1.7% to May 2009. This compares to a eurozone rate of 0% in May. After having become relatively expensive on the back of the property boom, Ireland has already regained a portion of its lost cost competitiveness. Consumer prices compared with the rest of the eurozone have now returned to levels last seen in February 2003 (see graph), although the sharpest rises in Irish prices were in the 2000-02 period.

What is particularly evident over the past twelve months has been a dramatic reduction in the cost to consumers of many durable and semi-durable goods. These categories have seen a sharp contraction in demand as consumers reign in spending and retailers have responded with aggressive price reductions. In all, industrial goods have fallen by 6% over 12 months, having risen modestly in the rest of Europe. On dealers' forecourts, the cost of cars has fallen by 5% in Ireland, again indicating the current intensity in competition due to the fall-off in demand.

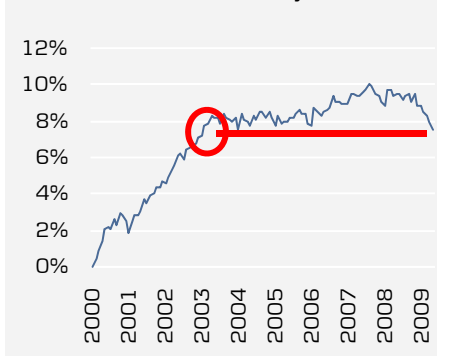
While there has also been a fall in the price of fast moving consumer goods, relative to the rest of Europe, this has not been as dramatic as with durable goods. This is surprising, as they benefit more from the weakness of sterling, as the UK is a major source for these goods. However, there are signs of an intensification in competition, in particular with Tesco

Chart 3. Massive private sector saving mirrors public deficit



Source: Danske Markets

Chart 4. Relative inflation falls back to levels last seen in February 2003



Source: CSO, Eurostat

changing its distribution model, the continued expansion of the discount retailers Aldi and Lidl, and an own-brand push instigated the convenience chain Spar.

## Government finances stabilise

The rapid deterioration in government finances has forced the Irish Government into a fiscal consolidation exercise at a time of great economic weakness. The underlying fiscal situation remains dire, although it has stabilised.

The progression of tax revenue to date has been in three distinct stages. In the first half of 2008 there were signs of weakness in tax revenue, though this was in line with a mild recession, with weakening housing taxes being offset by robust corporation and income taxes. However it was from summer 2008 to late-autumn that the collapse of housing-related revenue took hold and by November revenue was running at around 30% below expectations. By Christmas, the fall in housing-related tax revenue started to run out of steam. The tax raising measures in the October budget served to stabilise the position further.

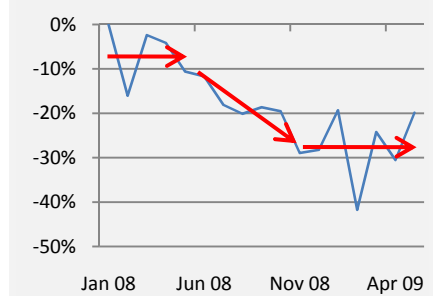
There have also been efforts to bring public spending under control, although the higher unemployment rate will continue to create its own demands. The government has effectively cut public sector pay by 7%, reduced universal social welfare payments and curbed the capital expenditure programme. Monthly revenue data is very volatile, although it looks likely that Ireland's deficit in 2009 will be between 10% and 12%. This would have been well in excess of 15% in the absence of corrective measures.

To date, the markets have not rewarded Ireland for its fiscal rigour in terms of a reduced cost of borrowing. The focus on the cost of refinancing the banking sector continues to dominate international commentary. This is despite the fact that the evidence of past financial crises suggests that it is the cost of day-to-day government spending, not bank bailouts that drives the increase in public debt. This is another reminder of a truth of human and market psychology – that uncertainty is disliked more than bad news.

As long as Irish consumers and businesses remain in retrenchment mode, then overly aggressive measures to reduce government borrowing could be deeply damaging. Irish private saving is likely to be equivalent to 12% this year. The size of private sector savings gives a sense of the potential 'bounce-back' once sentiment improves and savings reduce to perhaps half this level. Going forward, the government should refrain from further significant taxation increases until it is clear that private sector savings are in decline, and should instead focus its reform efforts on streamlining and modernising the public sector.

Going forward, the introduction of NAMA should have the effect in the medium term of improving credit flow in the economy. One policy area, however, where there has been less focus is improving the productivity of many locally-provided services, which is one of the key causes of the relatively high level of non-pay costs in Ireland. Examples of possible areas of reform include the regulation of legal services and reform of Ireland's payment culture of using a high volume of cash and cheques.

**Chart 5. Decline of tax revenues has stabilised**



Source: Derived from D/Finance

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