

## 7. IRELAND

### Adjusting for recovery

#### The global crisis came on top of a home-grown downturn

The global economic and financial crisis aggravated what started as a home-grown downturn and turned it into a protracted recession. After over a decade of strong economic growth that had been increasingly driven by domestic demand, a sharp adjustment from its 2006 peak began in the Irish housing market and subsequently spread to the wider economy. This development was amplified by the decline in global demand and especially by the recession in Ireland's main trading partners (euro area, US and UK). Similarly, the international financial crisis contributed to the deepening of the downturn, given the weight of the financial services sector in the Irish economy and banks' high dependence on foreign wholesale funding. The economy entered recession in 2008 and real GDP fell by 3% in 2008 and by a further 7.1% in 2009. The downturn has also produced a dramatic deterioration in the Irish public finances, with a large general government deficit emerging and feeding into a steep increase in the debt ratio from its low pre-crisis level.

#### Domestic demand is contracting heavily

A further, much less pronounced contraction in real GDP is expected in 2010, before positive growth should resume in 2011. The recession continues to be driven by contracting domestic demand. In 2009, declines in disposable income on the back of falling employment and, to a lesser extent, wages, together with a significant rise in precautionary savings, led to a historic decline in private consumption expenditure. As the pace of deterioration in the labour market has begun to slow, while consumer confidence started to pick up, a less sharp fall in private consumption is forecast for 2010. In 2011, with real disposable income expanding again, consumption growth should resume. Throughout the forecast period, the adjustment of households' balance sheets, following in particular their past over-investment in housing, is expected to continue to weigh on household spending.

Gross fixed capital formation declined by close to one third in 2009 and should contract further by nearly one fifth in 2010 before returning to moderate growth in 2011. The ongoing drastic

downsizing of the construction sector is expected to continue well into 2010, after which the cumulative fall in real construction investment since its 2006 peak would stand at close to 60%. On the back of subdued demand developments, equipment and machinery investment has also declined substantially, but is likely to pick up as prospects improve. Given the ongoing consolidation efforts, nominal public investment is expected to continue to fall.

Driven by the good performance of the – relatively acyclical – chemical and pharmaceutical sector, Ireland's exports only recorded a fairly moderate decline in 2009 compared to most euro-area peers. Given the strong decline in domestic demand, imports fell more steeply, implying a strong positive contribution of net external trade to GDP growth. Exports are set to expand again in 2010 and gather strength in 2011. These developments reflect the assumed global recovery and the incipient reversal of past competitiveness losses on the back of domestic price and wage adjustments, and also of a more favourable nominal effective exchange rate, especially due to developments vis-à-vis the USD. With imports recovering more slowly than exports in view of the subdued outlook for domestic demand, the contribution of net exports to growth is forecast to remain markedly positive over the forecast horizon, thereby contributing to the gradual narrowing of the current-account deficit.

As regards risks to the baseline scenario, net exports could suffer from a slower recovery in the main trading partners. At the same time, due to geographical trade patterns, a stronger-than-anticipated depreciation of the euro could boost Irish exports. Concerning the public finance forecast, in line with the usual no-policy-change assumption, the bulk (around 1.2% of GDP) of the consolidation effort for 2011 announced in the December 2009 stability programme update was not taken into account in the forecast as the underlying measures are still to be specified in the budget for 2011 (the exception is the announced retrenchment of public investment). Depending on the specific consolidation measures that are eventually implemented, a dampening effect on domestic demand cannot be excluded. Further, if the ongoing financial sector balance-sheet adjustment were to intensify due to worsening loan

quality in the context of the wider recession, subdued lending activity could in turn adversely affect real activity, inter alia through a dampening effect on investment. Finally, a faster-than-assumed pace of sectoral adjustment might provide support to consumption and investment demand.

### Employment falls strongly and net migration flows reverse

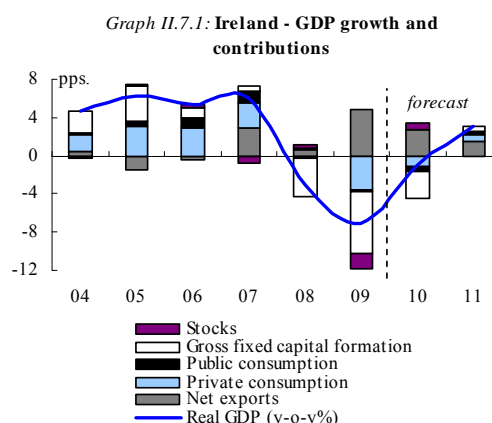
The pace of recovery will depend crucially on the speed at which imbalances accumulated in the past can be corrected. This includes the domestic rebalancing of economic activity from construction to more productive sectors, the recovery of competitiveness, the clean-up of household and corporate balance sheets and further consolidation of the public finances.

At the peak of the housing market cycle in 2006, the construction sector accounted for over 13% of total employment, compared to below 8% in the euro area. The ongoing downsizing of the housing market and the contraction in overall activity are reflected in a large decline in employment, which is set to continue well into 2010. In response to worsening labour-market conditions, the participation rate is falling. At the same time, after over a decade of significant inflows, net outward migration took place in 2009 and is expected to continue over the forecast period as Irish and immigrant workers seek job opportunities abroad. Still, the unemployment rate should rise further and peak at 13¾% in 2010, with young and low-skilled workers being hardest hit. With domestic demand still subdued and given the capital-intensive production in key export sectors, only a very moderate increase in employment is forecast for 2011 despite the return to positive economic growth.

### Downward price and wage adjustment is underway to help regain competitiveness

Over the past few years, Ireland suffered significant losses in competitiveness, as reflected in a strong rise in unit labour costs since 2002. The Irish price level was among the highest in the euro area in recent years and a downward adjustment of prices is underway. HICP inflation averaged -1.7% in 2009 and is forecast to be negative again in 2010 before turning mildly positive in 2011. Led by the strong retrenchment in the public sector, there also appears to have been a reduction in nominal wages in the private sector in 2009, which

is projected to continue in 2010. Such changes in relative prices would further support resource reallocation towards the tradable sector and help to recover past competitiveness losses. In turn, this would strengthen the potential growth contribution of the external sector. After productivity stagnated in 2008, an apparent pick-up is now in progress, which mainly reflects the ongoing labour shedding.



Regaining competitiveness will be important also given that balance-sheet adjustments are likely to continue to weigh on domestic demand over the next few years. After the steep increase in 2009, the household saving rate is set to see a moderate decline over the forecast horizon as confidence improves. This reflects not only precautionary motives but also the need to reduce indebtedness, given that household debt as a share of GDP doubled between 2001 and 2007 in the context of the housing boom. Corporate demand for investment credit is projected to also remain moderate in the short term, while bank deleveraging in the aftermath of the financial sector crisis might weigh on credit supply. The government measures to support the financial sector should facilitate an orderly restructuring process. In particular, in addition to guarantees and capital injections, a bad bank – the National Asset Management Agency (NAMA) – has been set up to purchase impaired assets from banks operating in Ireland in order to revive commercial banking.

### Underlying deficit ratio broadly stabilises owing to fiscal consolidation

The crisis has taken a heavy toll on Ireland's public finances. Notwithstanding significant deficit-reducing measures taken since mid-2008, the government deficit widened further in 2009

because underlying budgetary trends continue to be very negative. The deficit ratio reached 14.3% of GDP, but, excluding net deficit-increasing one-offs of around 2% of GDP largely linked to a capital injection into Anglo Irish Bank, it would be around 12.3%. Despite a series of tax-increasing measures, tax revenue is falling more sharply than nominal GDP, reflecting the severe adjustment in tax-rich domestic demand. At the same time, it takes some time to bring expenditure into line with revenue developments, also in view of the increase in social spending and debt-servicing costs.

In 2010, the deficit is expected to improve to 11.7% of GDP. The ongoing adverse underlying budgetary trends are contained by a significant consolidation package of 2½% of GDP. Together with the full-year effect of measures taken in the course of 2009, the net deficit-reducing effect of the measures amounts to 4¼% of GDP. Moreover, the fiscal position is improved by a one-off amounting to 0.6% of GDP in 2010.

In 2011, the deficit ratio is projected to increase to just above 12% of GDP on a no-policy-change basis (and zero one-offs). Relatively sluggish employment and consumption growth is forecast to lead to only a moderate tax revenue increase. Comparatively moderate spending growth is

forecast on a no-policy-change basis, also in view of the further cuts to public investment.

The combination of large primary deficits, rising interest expenditure and, until 2010, falling nominal GDP, leads in the forecast to a rise in the debt ratio to around 87% of GDP by 2011 on a no-policy-change basis.

In line with the 19 October 2009 preliminary view of Eurostat,<sup>(71)</sup> the bonds (around 30% of GDP) expected to be issued by the Special Purpose Vehicle associated with NAMA to finance the purchase of loan books from certain financial institutions are not recorded as government debt, while the majority of those bonds are guaranteed by the Irish State. On 30 March 2010, the authorities announced the transfer of a first tranche of loans to NAMA and the likely need for further capital injections into some banks. An effect of such capital injections on public finance developments within the forecast horizon cannot be excluded. However, in the absence of detailed information on the nature and size of these operations, the forecast does not include any impact.

<sup>(71)</sup> See [http://epp.eurostat.ec.europa.eu/portal/page/portal/government\\_finance\\_statistics/documents/Irish\\_letter\\_19\\_10\\_2009.pdf](http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/documents/Irish_letter_19_10_2009.pdf).

Table II.7.1:

**Main features of country forecast - IRELAND**

2008				Annual percentage change						
	bn EUR	Curr. prices	% GDP	92-05	2006	2007	2008	2009	2010	2011
GDP		181.8	100.0	6.9	5.4	6.0	-3.0	-7.1	-0.9	3.0
Private consumption		91.0	50.1	5.4	6.5	5.6	-0.7	-7.2	-2.4	1.4
Public consumption		33.1	18.2	4.7	6.3	7.7	1.5	-1.3	-2.7	2.0
Gross fixed capital formation		39.5	21.7	8.6	3.9	2.4	-15.5	-29.7	-17.6	4.2
of which : equipment		8.6	4.7	9.4	1.9	23.4	-11.1	-25.0	-4.9	6.5
Exports (goods and services)		151.9	83.5	12.3	5.1	8.6	-1.0	-2.3	2.0	4.3
Imports (goods and services)		133.0	73.2	11.5	6.5	5.6	-2.1	-9.3	-1.3	3.5
GNI (GDP deflator)		155.9	85.7	6.4	6.9	4.3	-2.9	-11.9	-2.8	2.4
Contribution to GDP growth :	Domestic demand			5.3	5.0	4.4	-4.1	-10.4	-4.4	1.6
	Inventories			0.0	0.4	-0.8	0.2	-1.6	0.7	0.0
	Net exports			1.9	-0.4	2.9	0.7	4.9	2.8	1.4
Employment				3.7	4.3	3.7	-1.1	-8.2	-3.5	0.4
Unemployment rate (a)				8.5	4.5	4.6	6.3	11.9	13.8	13.4
Compensation of employees/head				5.3	4.5	4.5	3.9	-1.6	-2.5	0.8
Unit labour costs whole economy				2.2	3.5	2.2	5.9	-2.7	-5.0	-1.7
Real unit labour costs				-1.5	0.0	0.9	7.2	0.5	-3.4	-2.5
Savings rate of households (b)				-	-	8.2	10.0	12.1	11.1	10.9
GDP deflator				3.7	3.5	1.3	-1.2	-3.2	-1.7	0.8
Harmonised index of consumer prices				-	2.7	2.9	3.1	-1.7	-1.3	0.8
Terms of trade of goods				-0.2	-1.1	-6.5	-2.8	0.8	-0.2	-0.2
Trade balance (c)				20.8	14.2	10.4	13.1	20.0	23.1	23.6
Current account balance (c)				0.9	-4.1	-5.3	-5.2	-2.9	-0.9	-0.6
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				1.7	-4.0	-5.3	-5.2	-2.8	-0.9	-0.6
General government balance (c)				0.5	3.0	0.1	-7.3	-14.3	-11.7	-12.1
Cyclically-adjusted budget balance (c)				0.4	2.1	-1.6	-7.0	-11.4	-8.7	-10.2
Structural budget balance (c)				-	2.1	-1.6	-7.0	-9.4	-9.3	-10.2
General government gross debt (c)				56.4	24.9	25.0	43.9	64.0	77.3	87.3

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