

# Technical Update of Current Year Macro-Economic Forecasts

## Department of Finance

**SUMMARY:** Following eight consecutive quarters of contraction, the latest GDP data show an increase in economic activity during the first quarter of this year, thus signalling the beginning of Ireland's emergence from the deepest recession ever recorded here. More recent statistics, including soft data, point to a continuation of growth in the second quarter also, so that the economic outlook for this year in GDP terms is somewhat better than projected last December. For the year as a whole, an average GDP growth rate of the order of 1 per cent is now anticipated.

The exporting sector – especially parts of the multinational sector – has been the driving force behind the recent expansion of activity. Excluding the profits generated from multinational exports means that GNP is likely to decline by around  $\frac{3}{4}$  per cent for 2010 as a whole.

On the assumption that international activity gains momentum and that further competitiveness improvements are achieved, a strengthening of activity can reasonably be expected next year and beyond. The Budget-day forecast of GDP growth of  $3\frac{1}{4}$  per cent in 2011 remains achievable. A more detailed macroeconomic assessment covering 2011-2014, taking account of latest developments and providing an updated risk assessment, will be set out by the Department of Finance in the Pre-Budget Outlook, to be published in the Autumn.

### 1. External developments

#### 1.1 External demand

Global economic activity is strengthening but, crucially, the pace of recovery is uneven across regions. Even within our main export markets, there are notable differences: the outlook for GDP growth in the US appears reasonably solid, while activity remains more muted in key markets such as the UK and the euro area.

**Table 1: Growth in our main trading partners**

	Autumn 2009		Spring 2010	
	2010	2011	2010	2011
US	2.2	2.0	2.8	2.5
UK	0.9	1.9	1.2	2.1
euro area	0.7	1.5	0.9	1.5
world	3.1	3.5	4.0	4.0

Source: EU Commission.

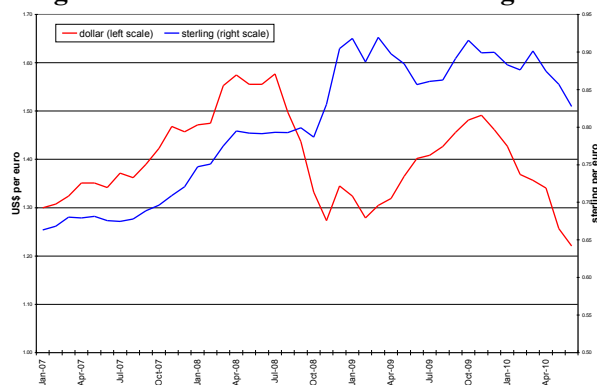
Notwithstanding these points, projections for growth in our main export markets have been slightly revised upwards since the December Budget (see table 1).

#### 1.2 Exchange rate developments

From the point of view of the external sector, recent exchange rate developments have also been favourable. Growth differentials between the euro area and the US, together with financial market concerns regarding public deficit and debt-dynamics in the euro area, have resulted in a marked depreciation of the euro-dollar exchange rate (figure 1). There has also been a significant

depreciation of the euro vis-à-vis sterling: in June this rate averaged €1 = stg£0.83, a depreciation of 8 per cent since December of last year. This will be particularly beneficial to firms in more traditional sectors, as well as to parts of the retailing sector.

**Figure 1: euro-dollar and euro-sterling rates**



Source: Central Bank of Ireland.

#### 1.3 Export performance and outlook

First quarter national accounts data point to a solid export performance in the opening months of this year. Exports of goods increased at an annual rate of 2.4 per cent, with particularly strong growth recorded in the chemicals and pharmaceuticals sub-sectors. For services exports, the annual growth rate was 9.5 per cent in the first quarter. The ongoing improvement in competitiveness and the relative improvement in external demand should continue to underpin export growth over

the remainder of the year. An annual average increase of 4½ per cent is assumed for the year.

## 2. Domestic Demand

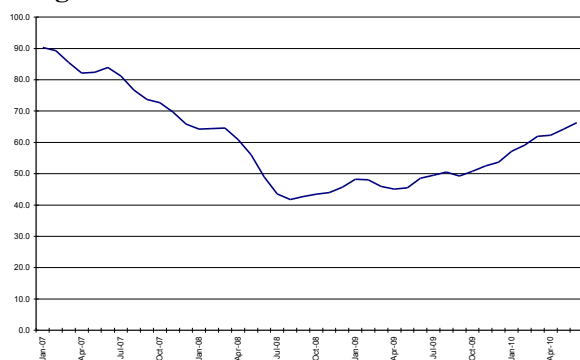
While the outlook for the external sector has improved somewhat, domestic demand looks set to remain weak this year.

### 2.1 Household spending

Recently published national accounts figures point towards a stabilisation in the level of consumer spending, with the level of outlays essentially flat between the final quarter of last year and the first quarter of this year.

While household disposable incomes remain under pressure from *inter alia* falling employment and wage reductions, consumer confidence has improved in recent months (see figure 2). This has prompted households to reduce savings from disposable income, thus supporting consumer spending.

**Figure 2: consumer confidence**



Source: ESRI / KBC

More recent data (including retail sales and car sales figures) point to a continuation of trends evident in the early part of the year, and for the year as a whole, consumer spending is now forecast to contract by ½ per cent.

### 2.2 Government consumption

Purchases of goods and services by the public authorities are forecast to decline by 3 per cent this year, in line with the Budget day projection.

### 2.3 Investment

Investment in building and construction continues to be a major source of weakness, with spending on all types of construction down significantly in the first quarter. Spending on machinery and equipment has also been weak, in part due to prevailing economic uncertainty. For 2010 as a

whole, investment spending is forecast to decline by 22 per cent.

### 2.4 Imports

In the first quarter of the year, imports of goods and services fell by 2.1 per cent, and are projected to decline by ¼ per cent for the year as a whole in line with the assumed decline in final demand.

## 3. Aggregate demand

In overall terms, economic activity in the opening months of this year has been stronger than assumed last December, and GDP growth of around 1 per cent for this year is now possible, with growth being driven by the exporting sectors. This composition of growth has important implications. Firstly, the employment content of such growth is typically lower than domestically-driven growth, with the result that no significant improvement is anticipated in the labour market until next year. Secondly, export-driven growth is less tax-intensive; thus stronger-than-expected real growth has not yet resulted in positive spill-overs for the public finances. Finally, excluding the profits generated from multinational exports means that GNP is likely to decline by around ¾ per cent for 2010 as a whole.

**Table 2: Revised forecasts for 2010, % change**

	Budget day	Current
Consumption	-3.0	-½
Government	-3.0	-3
Investment	-19.2	-22
Exports	0.4	4½
Imports	-2.8	-¼
<b>GDP</b>	<b>-1.3</b>	<b>1</b>
<b>GNP</b>	<b>-1.7</b>	<b>-¾</b>
CPI	-0.8	-1
HICP	-1.2	-1½
Employment	-3.4	-4
Unemployment rate, %	13.2	13½

## 4. Labour market

Notwithstanding some stabilisation in the level of activity, conditions in the labour market remain on the weak side. On an annual basis, the level of employment fell by 5.5 per cent in the first quarter, with jobs losses most severe in the construction sector. For the year as a whole, employment is now projected to decline by 4 per cent this year. Unemployment has risen in the first half of the year, reaching 13.4 per cent in June, and evidence suggests that the increase in unemployment would have been larger but for the decline in labour

supply. As the economic recovery gains traction, and as competitiveness improves, conditions in the labour market can be expected to improve over the course of next year.

## **5. Inflation**

While consumer prices continue to fall, the pace of decline is slowing. Indeed, modest annual price increases are anticipated towards the end of the year, on foot of technical base effects, higher oil prices and currency-related price pressures. Nevertheless, for the year as a whole consumer prices are forecast to fall by 1 per cent this year (and to decline by 1½ per cent on an EU harmonised basis, compared with an increase of 1.5 per cent in the euro area).

A more comprehensive measure of price changes in the economy is the GDP deflator. Quarterly national accounts figures show a sharp annual decline in this deflator in the opening three months of the year. As a result, this price measure is now likely to fall more rapidly than initially assumed, affecting the growth rate of nominal GDP. This is a significant factor in explaining why, notwithstanding the upward revision to the volume of GDP growth, tax revenue forecasts are unchanged (see below).

## **6. Risks**

The central forecast outlined above is, as always, subject to considerable uncertainty. Stronger world growth or a more rapid adjustment in domestic competitiveness could result in a more rapid rate of expansion. Alternatively, weaker activity in our main export markets or a failure of competitiveness to adjust appropriately could hinder our prospects, as could a renewed bout of financial market turbulence.

## **7. Public Finances**

Latest data show that the public finances are stabilising. Taxation revenue is broadly in line with profile, and the Budget day projection for the full year remains valid (a year-on-year decline of 6 per cent). However, income tax receipts in recent months were weaker than expected, and this points to ongoing weakness in the labour market in terms of both employment and earnings.

Spending at end-June was slightly below profile – largely due to timing issues. Capital spending was well down on the mid-year target, but is expected to catch up later in the year, so that the overall

planned spend of around 5 per cent of GNP will be met this year.

As a result, the Budget target for borrowing this year – which is of the order of €20 billion (when account is taken of some refinancing of existing debt) – remains valid. It is also important to note that, at the mid-year point, the NTMA has raised over 80 per cent of the funding requirements for 2010, so that we are in a comfortable position with regard to funding this year.

## **8. Medium term outlook**

The projections covering the period 2011-2014 are unchanged from Budget day. For next year, growth is assumed to gain momentum, on foot of an improving external environment, and a stabilisation of domestic demand. A GDP growth rate of 3¼ per cent is assumed. An average annual GDP growth rate of 4 per cent is projected over the period 2011-2014. This is based on an assumed trend growth rate of 2½ - 3 per cent per annum, together with the assumption that, in the short-term, growth in excess of trend can be achieved as under-utilised resources (especially labour) are brought back into productive use (i.e. the output gap closes over the forecast horizon).

A more considered assessment of the medium term outlook, including the risks associated with such a view, will be contained in the Pre-Budget Outlook which will be published in the Autumn.

*Department of Finance*  
*7 July 2010*