ECONOMIC UPDATE

PH BUSINESS CONSULTING

25 JUNE 2009

SUMMARY

- While the Irish economy may be showing some tentative signs of bottoming out there is no meaningful uplift in activity on the horizon.
- We are in danger of entering a protracted period of "growth recession" i.e. where levels of growth achieved are not sufficient to generate growth in sustainable employment.
- Against this economic backdrop the General Government Deficit as a % of GDP is in danger of remaining stubbornly high despite corrective policies.
- Real GDP is expected to decline by just over 10% this year and by 1% next year. The economy is suffering from deficient demand due to the collapse in consumer and investment expenditure.
- The situation is being compounded by the Governments fiscal policy which is pro cyclical. Personal taxation is being increased at a time when demand is extremely weak. Globally fiscal stimulus packages are being introduced to combat the possibility of a 1930's type depression. The opposite is happening here in Ireland.
- There is no question that order must be restored to the public finances. However, both the manner and the timescale in which this is to be achieved must be reviewed as a matter of urgency.
- The target General Government Deficit of 3% of GDP by 2013 is unachievable. A more realistic timescale would be 2015 or beyond.

SUMMARY

- The economy cannot afford to sustain the public sector pay and pensions bill both in terms of its absolute size and the rates of increase it has exhibited in recent years.
- Spending on Central Fund Services is projected to increase by about 90% over the period 2009 – 2013 ("Macroeconomic and Fiscal Framework 2009 – 2013") as government debt increases. This will further reduce the size of the "spending pot".
- Failure to tackle the pay and pensions issue will result in additional cuts in social welfare expenditure, more increases in taxation and reduced capital spending as the government attempts to restore order to the public finances.
- This would have disastrous consequences resulting in a even weaker economy than otherwise would be the case and the public finances exhibiting little or no improvement.
- In fact we are in real danger of being pushed from deep recession into full scale depression unless we see a significant change in policy.
- We are seeing failures on the demand side of the economy (i.e. insufficient private spending to make use of available productive capacity) and this requires a good old fashioned response – a demand side stimulus. The time to act is now.
- As Keynes pointed out in the long run we are all dead.

SUMMARY

- The issue for policymakers is how to achieve this capacity within the existing budgetary constraints and the available spending pot.
- The public sector pay bill must reflect the changed conditions in the labour market that now prevail compared to those underlying the 2002 Benchmarking Body pay recommendations.
- Wages are falling in the private sector and this will help our competitive position but if wages remain rigid in the sheltered sectors of the economy progress on this front will be hindered.
- In fact restoration of our competitive position could be a very long and drawn out process as wage levels decline slowly.
- Unless we see meaningful progress, our EMU status may ultimately be jeopardised. The doomsday scenario is exit from EMU, a substantial devaluation (e.g. 25% from current levels with sterling) and restoration of the one for one link with Sterling. We would then back to the pre 1979 exchange rate regime!

SOME RECENT ECONOMIC INDICATORS

- The number of persons signing on the Live Register rose to 397,000 in May of this year. This is an increase of 195,000 or 96.7% in twelve months. The standardised rate of unemployment rose to 11.8%. The number on the Live Register is likely move closer to 500,000 during the course of 2009.
- The volume of retail sales fell by 17.0% in April 2009 compared to April 2008. If motor trades are excluded the volume decline is 7.1% over this period. In the first quarter of 2009 the volume of retail sales declined by 21.4% compared to the first quarter of 2008 and by 7.3% when motor trades are excluded.
- The total number of new cars licensed during May 2009 fell 60.2% on levels in May 2008.
- The volume of output in building and construction fell by 35.3% in the first quarter of 2009 compared to the same period in 2008
- Production for traditional manufacturing industries was 14.9% lower in April 2009 compared to April 2008.
- In the five months ending May 2009, VAT receipts were 21.2% lower on the corresponding period last year.
- The KBC/ESRI index of consumer expectations (Consumer Sentiment Survey for May 2009) stood at 23.8 in May 2009 compared to 32.6 in May 2008. The three month moving average for the period ending may 2009 stood at 24.7 compared to 41.9 compared to the corresponding period in the previous year. This index is based on consumer perceptions of their future financial situation, the economic outlook and employment expectations. The Irish consumer remains pessimistic about the future outlook and expenditure looks set to remain very weak.

ECONOMIC PROSPECTS ARE GRIM

- Consumer expenditure accounts for roughly 50% of Irish GDP. It is a crucial component of our economy's engine of growth. Consumer spending has fallen dramatically with little prospect of a pick up in sight. Fear for the future underlies an unwillingness to spend. The situation is being compounded by the Governments tax increases in recent budgets and the promise of more tax increases to come. At a time of deep recession budgetary measures are further deflating demand. Policies that fuelled the fire during the boom are now extinguishing it as a very cold winter approaches. Investment expenditure has collapsed and exports remain weak. An export led economic recovery of the magnitude required to lift the economy is unlikely without a dramatic improvement in our competitive position. Our membership of the Euro zone removes the policy option of a substantial devaluation and restoring competitiveness will be a lengthy process in its absence.
- Real GDP is expected to decline by just over 10% this year and 1% in 2010. On the basis of unchanged policies it is difficult to see any meaningful recovery over the medium term i.e. levels of growth that are consistent with growth in sustainable employment.

ECONOMIC PROSPECTS ARE GRIM

- The bubble economy has come to an end. We have had negative growth in 2008 and will see double digit negative growth this year and a further decline is on the cards in 2010. The likihood is that Ireland may be on the verge of what is known as a “growth recession” i.e. where the economy grows but this growth is sluggish and is so slow that it is not sufficient to maintain pace with the economy’s expanding capacity (e.g. Japan in the 1990’s). In fact any growth recorded could be so far below potential that we may experience a growth depression which could last well into the second half of the next decade.

SIGNIFIGANT TAX INCREASES ARE PLANNED IN THE NEXT TWO YEARS

- The objective of reducing the General Government deficit to 3% of GDP by 2013 (Appendix 1) is unrealistic and therefore unattainable. Attempts to achieve this objective will have a very significant deflationary impact on the economy which is already in deep trouble.
- There is no engine of growth to improve economic performance for the foreseeable future. Against this background, it does not make any sense to continue to pursue pro-cyclical fiscal policies which only serve to make a bad situation worse.
- The current situation is one where the demand side of the economy has collapsed due to dramatic declines in both investment and consumer expenditure. Increasing the burden of taxation (Appendix 2) is not the way forward under these circumstances. The April supplementary budget implemented taxation and other measures designed to raise an additional €1.8bn in revenues in 2009 and €3.6bn in a full year. It is planned to raise an additional €1.75bn in 2010 and €1.5bn in 2011. The combined full year impact of the 2010 and 2011 measures is estimated to be €4.6bn and including the 2009 measures a staggering €8.2bn or virtually 5% of 2009 GDP.
- The economy cannot sustain the burden these measures will impose and in fact it could turn a deep recession into a full scale depression.

REDEFINE THE FISCAL TARGETS NOW

- Right across the globe policymakers are implementing fiscal stimulus packages to combat the deep global recession and avoid a 1930's type depression. Our policymakers are doing the exact opposite. The macroeconomic projections contained in the "Macroeconomic and Fiscal Framework 2009 – 2013" are very optimistic for 2012 and 2013. GDP growth of 4.2% and 4% is projected for each of these years respectively. These growth rates are unlikely to materialise if policies remain unchanged. Unidentified annual budgetary adjustments of €4bn in 2012 and €3bn in 2013 underlie the achievement of the target General Government Deficit of 3% of GDP in 2013.
- Given the weak state of the economy, we are in danger of falling into the trap of running stubbornly high budget deficits despite the fact that severe corrective actions will be taken (e.g. in 2010 the deficit is projected to be 10.75% of GDP unchanged from the 2009 target despite measures designed to deliver an additional €4bn in that year). The recently issued IMF report on Ireland projects the deficit at 11.8% of GDP in 2009 and 12.7% of GDP in 2010. This is a more realist assessment of the fiscal mess (serious internal imbalance) in which we find ourselves.
- We need a more realistic time scale to achieve the stated objective of a General Government Deficit of 3% of GDP. Given that the deficit is projected to be 10.75% of GDP or over next year, it would make sense to adopt a new five year planning period 2010 (base year) to 2015 with the objective of approaching the 3% target in 2015 with clearly established milestones along the way.

REDEFINE THE FISCAL TARGETS NOW

- There is no doubt that our levels of borrowing are unsustainable and pose a serious threat to our membership of the Euro zone. However, the time horizon envisaged to achieve stated objectives and more importantly the manner in which those objectives are to be achieved is in need of a major overhaul.

DEVELOPMENTS IN PUBLIC SECTOR PAY MUST REFLECT CURRENT LABOUR MARKET CONDITIONS

- Our economic problems are complex and deep rooted (see Appendix 3). There is no quick fix. However, redefining the fiscal targets and the manner in which they are to be achieved is one option that can be used to help ease the pain of adjustment.
- In his 2009 budget speech, the Minister of Finance stated that the public sector payroll amounted to €20bn. Using 2008 figures, Net Exchequer Pay and Pensions accounted for 47% of Net current spending (Gross pay and pensions was 37% of gross current spending). Year on year net pay and pension increases averaged 8.6% per annum over the six year period 2003 to 2008. The cumulative cost of the recommended levels of pay increases in the Benchmarking Body report (June 2002) was €1.2bn in a full year with the average increase being 8.9% (***Source: "Analysis of Exchequer Pay and Pensions Bill 2003 – 2008", July 2008***).
- Clearly the absolute size of the pay and pensions bill, its large share of the overall net current expenditure and large rates of increase annually are critical issues. The increases in the first benchmarking report reflected acutely tight labour market conditions that prevailed at that time. Conditions in the labour market have now altered radically. The economy cannot sustain a pay bill of this magnitude nor these large rates of increase. Developments in the Exchequer pay and pensions bill need to reflect the changed labour market conditions that currently prevail and will continue to prevail for a considerable period of time.

APPENDIX 1: GENERAL GOVERNMENT DEFICIT (GGD) 2009 - 2013

	2009	2010	2011	2012	2013
GGD (€bn)	€18.4	€18.1	€14.9	€10.4	€5.9
% GDP	10.75	10.75	8.5	5.5	3.0

Source: Macroeconomic and Fiscal Framework 2009 -2013

APPENDIX 2: TAX REVENUES (€bn) 2009 - 2011

	2009	2010	2011
Tax Revenue	€34.4	€35.4	€39.0
% Increase		+2.9	+10.2

Source: Macroeconomic and Fiscal Framework 2009 - 2013

APPENDIX 3: IRISH ECONOMIC PROBLEMS

- The heavy burden of both Irish corporate and personal debt.
- The collapse of the public finances.
- The collapse of the Irish Banking Sector.
- The persistent and protracted erosion of Irish competitiveness in evidence since the turn of this century which was never addressed and is now being compounded by a strong Euro.
- The erosion of real wealth due to the collapse of the Irish stock market and falling property prices.
- The sharp decline in both consumer and business confidence.
- The potential for political instability and industrial unrest.
- The likelihood that international investors and financial markets increasingly doubt our capability to remain in Economic and Monetary Union.
- The current deep downturn in global economic activity.

For a full and detailed explanation of all these points see " Economic Outlook 2009 – 2013, PH BUSINESS CONSULTING, February 2009 on www.phalpin.com