

## **ECONOMIC OUTLOOK**

**2009 – 2013**

***NO RECOVERY IN SIGHT***

***REAL GDP SET TO DECLINE BY OVER 7.0% IN 2009***

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## SUMMARY

Real GDP is expected to decline by over 7.0% in 2009 primarily due to a significant decline in consumer expenditure and a collapse in investment spending. Export performance will also weaken considerably.

No growth is anticipated in 2010 and a pick up in economic activity is not expected over the medium term on the basis of current economic policies. There is no "engine of growth".

Ireland faces a series of serious interrelated economic problems which impair our capability to benefit from any upturn internationally when it occurs. These problems are:

1. The heavy burden of both Irish corporate and personal debt: The ratio of Private Sector Credit to GDP stood at 211% at the end of 2008. Both businesses and households must restore order to their balance sheets and this will prove to be a very lengthy process. Under these circumstances lower interest rates will not be a driver of growth.
2. The collapse of the public finances: Restoration of order to the public finances will have a massive deflationary impact on the economy in coming years. At a time when fiscal stimulus packages are being used to attempt to kick start growth globally we in Ireland are entering a phase of major contraction. This is the price to be paid for the pursuit of pro cyclical policies during the boom years.
3. The collapse of the Irish banking sector: The banking sector capability to lend will be curtailed by the need to address its funding mix, its capital position, improve asset quality and a risk adverse mindset in the current economic climate.
4. Erosion of competitiveness: Our loss of competitiveness in evidence since the turn of the century has been compounded by the appreciation of the Euro against Sterling the currency of our main trading partner. Our lack of competitiveness will impair export performance, deter FDI, further encourage MNC's to relocate to lower cost and more competitive economies and hinder indigenous SME's who are key to the performance of the domestic economy.
5. Erosion of real wealth: The collapse of the stock market and the property market has eroded a significant amount of wealth in Ireland. We have had a meltdown in the price of financial and real assets The "real wealth" effect will adversely impact consumer and investment expenditure for a considerable period of time.
6. Sharp decline in consumer and business confidence: The fear of and rising unemployment itself will impact very adversely on consumer confidence.

Business confidence will also remain weak and this will put a break on new business investment.

7. Potential for political instability and industrial unrest: Should this materialise Ireland's reputation will be very badly damaged internationally and this could act as a deterrent to foreign investment alongside creating uncertainty and disruption for domestic business. The collapse in partnership talks (February 3<sup>rd</sup>) will be a cause of serious concern in this respect.
8. Doubts about Ireland's capability to remain in Economic and Monetary Union: As conditions here deteriorate even further the markets may seriously question our ability to remain within the Euro area. The differential between Irish ten year bonds and the German equivalent is currently 2.3% for the first time since the 1990's. This will prove very disruptive to economic performance.
9. Current deep downturn in global economic activity: The international recession will act as a constraint on Irish exports. A deep recession is anticipated in the UK our main trading partner. We cannot rely on export growth to pull us out of recession.

Our problems are deep rooted and there is no quick fix. Irish policymakers need to respond and put an integrated strategic plan in place to address meaningfully and with impact the complex and deep rooted economic problems we face.

## 1: INTRODUCTION

After the Great Crash of 1929, came the Great Depression which lasted for ten years. GNP in the United States in 1933 was approximately one third less than the level prevailing in 1929. The physical volume of production in the United States did not recover to 1929 levels until 1937 and it took until 1941 for the dollar value of production to reach 1929 levels. At the end of the 1930's one person in five was still out of work in the United States.<sup>1</sup>

The current economic downturn being experienced across the globe is both deep and severe. Across the world, banks, investment banks and insurance companies have collapsed. Governments have invested directly in many banks and have provided guarantees for deposits in order to try to keep the financial system functioning. Some financial institutions have been taken over at a fraction of their previous value and others nationalised. One of the main causes of this global financial turmoil was the sub-prime mortgage crisis in the United States. There was a sharp increase in global financial liquidity arising from very large external surpluses in some countries, low interest rates (cheap money), increased financial leverage and the development of complex financial products. Clearly we are living in extraordinary times.

Globally the authorities have responded to the economic crisis through fiscal stimulus packages (e.g. Barack Obama's \$825bn stimulus package in the US) and sharp reductions in official interest rates (e.g. to historically low levels in the UK). There is the possibility that official interest rates in both the US and the UK could fall close to zero as the authorities try to stimulate economic growth. The European Central Bank will prove to be more cautious than their Anglo Saxon counterparts.<sup>2</sup> The actions taken in both the US and UK will prove to be effective over time and economic growth will recover.

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<sup>1</sup> John Kenneth Galbraith: "The Great Crash 1929", Ch 10

<sup>2</sup> "The Vital Role of Money in the ECB Monetary Policy" ([www.phalpin.com](http://www.phalpin.com)) – P.Halpin, November 2006

## 2: Irish Economic Problems

The Irish economy will not be in a position to take advantage of this and recovery is not envisaged over the time period under consideration. The main reasons for this are:

1. The heavy burden of both Irish corporate and personal debt.<sup>3</sup>
2. The collapse of the Public Finances.
3. The collapse of the Irish Banking Sector.
4. 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.<sup>4</sup>
5. The erosion of real wealth due to the collapse of the Irish stock market and falling property prices.
6. The sharp decline in both consumer and business confidence.
7. The potential for political instability and industrial unrest.
8. The likelihood that international investors and financial markets increasingly doubt our capability to remain in Economic and Monetary Union.
9. Current deep downturn in global economic activity.

### 2.1: Indebtedness of the Private Sector

Private Sector Credit (PSC) stood at €376.8m or 198% of GDP at the end of 2007 i.e. virtually double the level of GDP in that year. By December 2008, PSC stood at €392.8m and almost double the level of PSC outstanding at the end of 2004 (€199.6m). Given the contraction of GDP in 2008 and continued growth in PSC, the ratio of PSC to GDP is estimated to have risen to about 211% (see Table 1). PSC is therefore, not only high relative to income levels (the ratio of PSC to GDP was 70% in 1995) but it has also grown at an extraordinary pace in recent years.

**Table 1: Ratio of PSC to GDP/GNP: 2004 – 2008**

	2004	2005	2006	2007	2008 (est.)
<b>% GDP</b>	<b>134</b>	<b>160</b>	<b>179</b>	<b>198</b>	<b>211</b>
<b>% GNP</b>	<b>158</b>	<b>188</b>	<b>208</b>	<b>234</b>	<b>253</b>

*Source: CSO, Central Bank & Financial Services Authority of Ireland*

<sup>3</sup> See "Ireland's Mounting Debt Problem" ([www.phalpin.com](http://www.phalpin.com)) – P.Halpin, August 2006

<sup>4</sup> See "Competitiveness and the Irish Economy" – P. Halpin, IMI Centre for Management Research, September 2003

The level of indebtedness of the private sector in Ireland is also extremely high compared to other Euro Area economies. In table 2 Ireland's debt to GDP ratio relative to Euro area debt to GDP ratios for Non – Financial Corporations and households is presented for the years 2002, 2005 and 2007.

**Table 2: Ratio of Irish to Euro Area Debt/GDP Levels (%)**

	2002	2005	2007
<b>Non – Financial Corporations</b>	<b>103</b>	<b>156</b>	<b>188</b>
<b>Households</b>	<b>100</b>	<b>141</b>	<b>153</b>

*Source: European Central Bank, Eurostat, European commission*

- At end 2007 Irish Non – Financial Corporation's debt to GDP ratio was 88% higher than the Euro area average and 53% in the case of households.
- At end 2002 the debt to GDP levels for both Non – Financial Corporations and households were in line with the Euro area average.
- The Irish corporate sector is more heavily geared on this measure compared to households.

The consequence of such a massive level of debt is that both the personal and business sectors must commence the process of restoring order to their respective balance sheets and this will prove to be a lengthy process. Both will seek opportunities to reduce their levels of debt to more acceptable levels in the current difficult economic climate. Under these circumstances, lower interest rates are unlikely to stimulate borrowing for investment projects by business and the consumer will remain subdued. Lower interest rates will help alleviate the cost of servicing existing debt but will not prove to be a driver of growth as may be the case in other economies with lower levels of gearing.

## 2.2: The Public Finances

The fiscal position is extremely weak. The Budget in October estimated a deficit of €11.5bn (Exchequer Balance) for 2008. The actual outturn at end December 2008 was €12.7bn and represents variance of €1.2bn from the Budgetary figure. The shortfall in tax revenues compared to that projected at the time of the budget was €1.6bn. A variance of this magnitude over such a short period of time is extraordinary and a cause of grave concern.<sup>5</sup> Tax revenues at the end of 2008 were about €6.5bn or 13.7 % below the outturn for 2007.

<sup>5</sup> This comment is based on the writer's experience as a commentator on budgets since 1981

The budget projected tax revenues of €42.8bn in 2009, an increase of €0.4bn or 1% above the projected outturn for 2008. Therefore the Government were already about €1.9bn behind plan for tax revenues on day one of 2009. On top of this the authorities now expect real GDP to fall by 4% compared to a decline of under 1% anticipated in the budgetary figures. The budget targeted a deficit of €12.2bn or 6.5% of GDP for 2009. Unemployment will be considerably higher this year than the level projected in the budgetary numbers with a resultant overrun on social welfare expenditure. The corrective measures announced on February 3<sup>rd</sup> aim to achieve savings of €1.8bn in 2009 and €3.1bn in 2010. In spite of these measures the deficit is likely to be over 10% of GDP this year.

The European Commission estimates (January 2009) that the budget deficit will be as high as 13% of GDP in 2010 (on the basis of unchanged policies). The marked deterioration in the Irish public finances in recent years can be seen from the European Commission's figures presented in Table 3.

**Table 3: General Government Balance 2006 – 2010 (% GDP)**

	2006	2007	2008	2009 (f)	2010 (f)
<b>General government balance</b>	<b>3.0</b>	<b>0.2</b>	<b>-6.3</b>	<b>-11.0</b>	<b>-13.0</b>

*Source: European Commission Interim Forecast, January 2009.*

We have gone from a budgetary surplus of 3% of GDP in 2006 to a deficit of over 6% of GDP in 2008.

Restoration of order to the public finances will have a massive deflationary impact on the economy in coming years. In order to achieve a deficit below 3% of GDP by 2013 the Government estimates adjustments (expenditure and taxation) of about €15bn will be required over the period 2010 - 2013. This equates to well over 8% of GDP. This is an enormous amount of money to take out of the economy in the midst of a deep global economic downturn and a domestic economic crisis. At this stage the Government should be stimulating the economy. We are not in a position to do so and this is the price to be paid for the pursuit of pro cyclical fiscal policy during the boom years.

### **2.3: Collapse of the Irish Banking Sector.**

The share prices of AIB, Bank of Ireland, Anglo Irish Bank and Irish Life and Permanent have collapsed. Their total market capitalisation on the 19<sup>th</sup> of January 2009 was about €1.3bn down from close to €60bn two years ago. This represents a

huge erosion of shareholder wealth. The state has nationalised Anglo Irish Bank and plans to recapitalise both AIB and Bank of Ireland. The implications of these events are far reaching. It is highly unlikely that the banks will recommence lending on a large scale for the following reasons:

- The banks must address their funding mix as a matter of urgency. This entails a reduction in wholesale funding and strong focus on building up personal deposits. Until the funding mix is resolved this will act as a constraint on the banking sector's capability to lend.
- The economy is extremely weak and good lending propositions will be limited.
- Cleaning up the balance sheet and improving asset quality will be the order of the day and in this environment the mindset will be risk adverse.

It will take a long time for the banking sector to resolve its difficulties and this will act as a major constraint on economic recovery over the medium term. A decision by the authorities to house all the banking sectors "toxic loans" under one roof (i.e. adopt the "bad bank" model) could (if taken alongside other appropriate measures) put the banks in a better position to start lending again.

## **2.4: Erosion of National Competitiveness**

The erosion of the Irish competitive position has been persistent since the turn of this century and has never been addressed in a meaningful strategic manner. We do not have and have never had a unique competitive advantage. The global downturn and the strength of the Euro especially against Sterling (appreciated by over 25% over the twelve months ending December 2008)<sup>6</sup> seriously exposed our competitive weakness as witnessed by high profile announcements of job losses in recent months (e.g. Dell).

Ireland was ranked 22<sup>nd</sup> on the most recent Global Competitiveness Index, published by the World Economic Forum.<sup>7</sup> Our ranking in the areas of infrastructure (53<sup>rd</sup>), macroeconomic stability (47<sup>th</sup>), technological readiness (24<sup>th</sup>) and market size (48<sup>th</sup>) were particularly poor.

Our lack of competitiveness will impair export performance, deter FDI, encourage MNC's to relocate to lower cost and more competitive economies and hinder indigenous SME's who are key to the performance of the domestic economy.

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<sup>6</sup> Using monthly average exchange rates – Central Bank & Financial Services Authority of Ireland

<sup>7</sup> The Global Competitiveness Report 2008 – 2009, World Economic Forum

## 2.5: Erosion of real wealth

The Irish stock market (overall index) fell by over 66% in 2008 with the financial index down by over 91%. Overall market capitalisation which stood at €93.3bn at end December 2007 had crashed to €32.3bn by end December 2008. At the end of 2006 it had stood at €119.3bn.<sup>8</sup>

Figures from Sherry Fitzgerald show that the average price of a second hand residential property fell by 18% in Ireland in 2008. From a peak in June 2006 they estimate that the Dublin market has fallen by 30% in nominal terms and for Dublin houses valued at over €1m by between 40 – 50%.<sup>9</sup> Thus we have had a meltdown in the price of financial and real assets. It is still not clear that either the equity or property markets have bottomed out yet. Thus there has been a huge erosion of real wealth and the future for markets is still highly uncertain. This will have a negative impact on consumer spending for a considerable period of time arising from the “real wealth effect” of collapsing asset prices.<sup>10</sup>

## 2.6: Sharp decline in consumer and business confidence

The number of persons on the Live Register rose by 146,000 or 81% in the twelve months ending January 2009. The standardised rate of unemployment rose from 4.9% in January 2008 to 9.2% in January 2009.<sup>11</sup> It is expected that the rate of unemployment could rise to 12%. This would mean an additional 130,000 people signing on the Live Register. Both fear of and rising unemployment itself will impact very adversely on consumer confidence. It would also have a severe deflationary impact<sup>12</sup>

The volume of retail sales fell by 8.1% in the twelve months to November 2008. This was the largest annual volume decline in retail sales since February 1984 and when motor trades are excluded the decline is the largest since April 1975.<sup>13</sup> The rate of decline in the volume of retail sales has been accelerating since February 2008 (when the volume of sales fell by 0.2% over the twelve month period).<sup>14</sup> VAT receipts in January 2009 were 15.6% below January of the previous year. The outlook for retail sales in 2009 is bleak given the consumers reluctance to spend.

<sup>8</sup> Source: [www.ise.ie](http://www.ise.ie) 20.1.2009

<sup>9</sup> Source: [www.sherryfitz.ie](http://www.sherryfitz.ie) , Statement by Marian Finnegan, Chief Economist, 5.1.2009

<sup>10</sup> Consumer spending accounted for just over 49% of GDP in 2008

<sup>11</sup> Source: [www.cso.ie](http://www.cso.ie) , Live Register, 4.2.2009

<sup>12</sup> Using some basic assumptions and doing a crude calculation suggest it could reduce consumer expenditure by over €2bn in a full year

<sup>13</sup> Source: [www.cso.ie](http://www.cso.ie) , Retail Sales Index, 23.1.2009

<sup>14</sup> Source: [www.cso.ie](http://www.cso.ie) , Retail Sales Index, 23.1.2009

The number of new private cars licensed for the first time in 2008 decreased by 19% on the same figure for 2007 and the number of new goods vehicles licensed for the first time fell by 31.7% over the same period.<sup>15</sup> The decline in new private cars licensed over the three month period ending December 2008 was 52% when compared to the corresponding period in 2007. The decline in the number of new goods vehicles sold over the same period was 50%. The prospects for the Irish motor industry are gloomy for 2009.

The KBC/ESRI monthly index of consumer expectations which focuses on how consumers view prospects over the next twelve months stood at 25.3 in January 2009 compared to 50.4 in January 2008. The three month moving average stood at 27.7 in the period ending January 2009 compared to 49.6 in the corresponding period the previous year.<sup>16</sup> These are at very low levels and reflect the high degree of uncertainty facing Irish consumers going into 2009. Against this background business confidence is also weak and this will put a break on new business investment for a long time to come.

## **2.7: Potential for political instability and industrial unrest**

For those old enough to remember, the 1970's and 1980's were periods of political instability and industrial unrest which did little for our reputation internationally. The economy was in the doldrums, unemployment high, the public finances in a mess and we had a massive balance of payments deficit.

Our economy is in trouble again, the public finances are in a mess, we have a balance of payments deficit (approx 6.5% of GDP in 2008)<sup>17</sup> and unemployment is rising rapidly. The conditions now exist for both a period of political instability and industrial unrest. Should this materialise Ireland's reputation will be very badly damaged internationally and this will be another factor to deter foreign investment alongside creating uncertainty and disruption for domestic business. The recent collapse in partnership talks will only add to the uncertainty and is a cause of serious concern in this respect.

## **2.8: Doubts about Ireland's capability to remain in EMU**

There can be no doubt that given recent developments we would have been in serious trouble had we not been members of the Euro area (e.g. as was the case

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<sup>15</sup> Source: [www.cso.ie](http://www.cso.ie), Vehicles Licensed for the first time 2008, 30.1.09

<sup>16</sup> KBC/ESRI Consumer Sentiment Index, January 2009

<sup>17</sup> Central Bank and financial Services authority of Ireland, Quarterly Bulletin January 2009

with Iceland). If we had a freely floating Irish Pound it would have been hammered on the foreign exchange markets and short term interest rates would have risen

sharply towards levels last seen in the currency crisis of 1992/93. However as conditions here deteriorate even further the markets may seriously question our ability to remain within the Euro area (especially against a background of Sterling weakness). Our Government debt to GDP ratio will increase sharply in coming years albeit from low levels (see table 4 below)

**Table 4: Government Debt/GDP (%)**

	2006	2007	2008	2009 (f)	2010 (f)
<b>Debt/GDP</b>	<b>24.7</b>	<b>24.8</b>	<b>40.8</b>	<b>54.8</b>	<b>68.2</b>

*Source: European Commission, Interim Forecasts, January 2009*

We are already beginning to see a significant gap emerge between the yield on Irish and German ten year bonds. At the time of writing the differential between Irish ten year bonds and the German equivalent is about 2.3%, a level not seen since the 1990's.<sup>18</sup> In the case of Greece it is 2.5%. As the Government goes to the markets to fund increased borrowing this differential may continue to widen as questions about our capability to remain in the Euro area gain momentum (the market logic is likely to be that devaluation would help restore competitiveness and hence boost economic growth and reduce unemployment). This will prove very disruptive to economic performance.

## 2.9: Current deep downturn in global economic activity

There is a recession internationally and this will act as a constraint on Irish exports performance. The IMF project world output to grow by a mere 0.5% in 2009 compared to growth of 3.4% and 5.2% in 2008 and 2007 respectively (lowest growth rate since World War Two).<sup>19</sup> Growth prospects are particularly weak in the economies of our main trading partners (see table 5).

**Table 5: Real GDP (annual % change)**

	2007	2008	2009(f)	2010 (f)
<b>Euro area</b>	<b>2.7</b>	<b>0.9</b>	<b>-1.9</b>	<b>0.4</b>
<b>UK</b>	<b>3.0</b>	<b>0.7</b>	<b>-2.8</b>	<b>0.2</b>
<b>US</b>	<b>2.0</b>	<b>1.2</b>	<b>-1.6</b>	<b>1.7</b>
<b>Japan</b>	<b>2.4</b>	<b>-0.1</b>	<b>-2.4</b>	<b>-0.2</b>

*Source: European Commission Interim Forecasts, January 2009*

<sup>18</sup> Source: Financial Times, 29.1.2009

<sup>19</sup> IMF World Economic Outlook Update, 28.1.2009

Our loss of competitiveness compounds the impact of the global recession on our export performance going forward. Against this background, we cannot rely on export growth to pull us out of recession.

### **3: Conclusion**

On the basis of unchanged policies real GDP is likely to decline by about 7.5% in 2009 as a result of a sharp downturn in consumer expenditure and a collapse in investment. The risks to this forecast are perceived to be on the downside. At best the economy is expected to exhibit zero growth in 2010 and may remain weak for a number of years thereafter.

Our problems are deep rooted and there is no quick fix. Given the excesses of the past, a protracted period of adjustment is in prospect. We are members of a fixed exchange rate regime and therefore the burden of adjustment will fall on income and employment and this process has now begun. Following the reunification boom in Germany real incomes remained unchanged for virtually a decade as industry sought to address the issue of competitiveness. As already stated loss of competitiveness is one of the most serious economic problems that we face in Ireland. Competitiveness needs to be considered in a broad context and not just focus on price competitiveness alone. We need measures to restore competitiveness including the development of a unique value proposition to attract FDI to Ireland and create sustainable competitive advantage as we move forward.

Irish policy makers need to respond and put an integrated strategic plan in place to address meaningfully and with impact, the complex and deep rooted economic problems we face. Confidence and stability must be restored to the banking sector.

Policymakers have responded globally and the mistakes of the 1930's are not being repeated and therefore a global depression should be averted. We need to be in a position to take advantage of any global upturn when it occurs.

## **SOME QUOTES**

**“Owners of capital will stimulate the working class to buy more and more of expensive goods, houses and technology, pushing them to take more and more expensive credits, until their debt becomes unbearable. The unpaid debt will lead to the bankruptcy of banks, which will have to be nationalised” (Karl Marx).**

**“One of the uses of depression is the exposure of what auditors fail to find” (John Kenneth Galbraith).**