



An Chomhairle Náisiúnta Eacnamaíoch agus Shóisialta
National Economic & Social Council

Ireland's Economic Recovery: An Analysis and Exploration

NESC Secretariat Papers

PAPER NO.1

Ireland's Economic Recovery: An Analysis and Exploration

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July 2011

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Acknowledgements

The authors would like to acknowledge all those who contributed to the development of this paper. This includes the Council's members who have taken the time to consider and provide feedback on the paper. Officials of the Department of Finance provided written comments on drafts of the paper. We are also grateful to our colleagues in the Secretariat for their help in shaping and finalising this paper. We would like to thank Libby Carton and Aidan Maguire at Carton LeVert for designing and typesetting the paper. Finally, we are indebted to Gaye Malone and Paula Hennelly who have with their usual patience and diligence expertly managed the production of this paper.

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Abbreviations

CACs

Collective Action
Clauses

CPI

Consumer Price Index

CSO

Central Statistics
Office

CRO

Credit Review Office

ECB

European Central
Bank

EHECS

Earnings Hours and
Employment Costs
Survey

EFSF

European Financial
Stability Facility

EFSM

European Financial
Stabilisation
Mechanism

ESM

European Stability
Mechanism

ESRI

Economic and Social
Research Institute

EU

European Union

FDI

Foreign Direct
Investment

GDP

Gross Domestic
Product

GNI

Gross National
Income

GNP

Gross National
Product

HCI

Harmonised
Competitiveness
Index

HICP

Harmonised Index of
Consumer Prices

ICT

Information and
Communications
Technology

IDA

Industrial
Development
Agency

ILO

International Labour
Office

IMF

International
Monetary Fund

ISME

Irish Small and
Medium Enterprises
Association

MNCs

Multinational
Corporations

NAMA

National Asset
Management Agency

NCC

National
Competitiveness
Council

NESC

National Economic
and Social Council

NPRF

National Pensions
Reserve Fund

NTMA

National Treasury
Management Agency

OECD

Organisation
for Economic
Co-operation and
Development

QNHS

Quarterly National
Household Survey

R&D

Research and
Development

RDI

Research,
Development and
Innovation

PCAR

Prudential Capital
Assessment Review

SILC

Survey of Income and
Living Conditions

SMEs

Small and Medium
Enterprises

SPU

Stability Programme
Update

VAT

Value Added Tax

Executive Summary

In 2009 the NESC Council, in its report *Ireland's Five-Part Crisis: Towards an Integrated Response*, identified that the current crisis has five parts: fiscal, banking, economic, social and reputational. The banking and fiscal challenges have largely overwhelmed analysis of the economic, social and reputational aspects. This NESC Secretariat paper brings attention back to the economy.

The Irish economy has experienced a dramatic reversal. Examined on any measure there has been unprecedented change. In most cases, indicators have returned to levels last seen in the early to middle part of the previous decade. Income measures per head are down almost 15 per cent, though household incomes have fallen less.

The exceptionally large contraction of the Irish economy has been driven by domestic demand rather than exports. The cumulative fall in the real volume of goods and services exports from Ireland between 2007 and 2009 was 5.2 per cent. Exports of goods and services then increased by 6.3 per cent in volume terms in 2010 and by 8.1 per cent in value terms. However, between 2007 and 2010, domestic demand declined in volume terms by over one-fifth, which is a huge decline. This was dominated by the fall in investment in building and construction which fell by 57 per cent in volume terms between 2007 and 2010.

Ireland experienced the largest fall in employment in the OECD, with numbers employed down over 13 per cent between 2007 and 2010. Ireland's unemployment rate was around 4 per cent in 2007; in 2011 it is over 14 per cent.

The change in public finances and the indebtedness of the Irish economy has also been severe. The sharp fall in the economy and the property market led to a fall between 2007 and 2010 of 23.5 per cent in total general government revenue. Prior to the crisis, government debt was 25 per cent of GDP. It is projected to peak at 118 per cent of GDP in 2013 when its nominal value will be close to €200 billion. The cost of rescuing Ireland's banks has added substantially to government debt. The total capital investment in the banks has been €46.3 billion.

Economies do recover from these types of set backs. The evidence shows that while there are long term negative impacts—in particular on level of output, employment and house prices—growth does recover. Advanced economies—such as Finland and Sweden in the 1990s have experienced similar deep crisis extending over a number of years. In those countries, in the decade after the crisis, real growth of GDP per capita was lower by just 1 per cent than prior to the crisis.

Four years into this crisis there are signs that the Irish economy is recovering.

- ◆ **Exports:** Exports of goods and services increased by 6.3 per cent in volume terms in 2010 and by 8.1 per cent in value terms. This includes strong contributions from domestic firms in sectors such as food and machinery. Food exports increased by 11.3 per cent in value terms; this included an increase of 28.5 per cent in the value of dairy exports.
- ◆ **Investment:** There was a strong recovery in investment and job creation by IDA companies as the level of new job creation in 2010—10,900—was on par with that achieved before the onset of recession.
- ◆ **Costs:** Between 2008 and 2010 there was a fall of 8 per cent, on an economy-wide basis, in relative compensation per employee and there have been reductions in other costs, including property, energy, computer services and accountancy.
- ◆ **Balance of Payments:** Ireland's balance of payments deficit has largely been eliminated. In 2010 there was a modest surplus in the current account of the balance of payments of 0.6 per cent of GNP. This is a significant indicator of economic resilience.
- ◆ **Jobs:** Employment fell by 0.5 per cent in the first quarter of 2011. This was the smallest quarterly decline in employment since the first quarter of 2008. Employment is expected to fall by 1.6 per cent in 2011 with a weak recovery of employment in 2012 based on Department of Finance projections.
- ◆ **Wealth:** Excluding housing assets, the net financial worth (financial assets less liabilities) of households has increased substantially since the start of 2009, with an increase of 70 per cent from the first quarter of 2009 to reach €99 billion in the fourth quarter of 2010.

In addition, there are signs that the public finances are improving. The deficit has been stabilised. Measures taken since 2008 to boost revenue and cut expenditure have yielded estimated cumulative annual adjustments by 2010 of close to €15 billion, while a further €6 billion in adjustments were introduced in Budget 2011.

However, the strength and sustainability of the recovery continues to depend on developments in two areas: Ireland's debt dynamics and the unfolding European context. In broad terms, the debt-dynamics depend on the relationship between fiscal balance, interest rates and growth. The question of how Ireland might stabilise its debt—and, in this context, the relationship between Ireland and Europe—has naturally been the subject of intense debate.

Over the past three years, that debate has included a range of issues such as the speed of fiscal correction, the incidence of expenditure reductions and tax increases, and the nature and role of the European Union. While underlying views still differ on these issues, it is important to note that events have undoubtedly narrowed the range of feasible positions: Ireland is not able at present to access bond markets for finance and is now part of an EU/IMF programme. There is very limited space for manoeuvre and it is our belief that the space is becoming more constrained by developments in Europe. In this sense, the trade-off, as debated in the early days of the crisis, has shifted in a way that requires fresh analysis.

We believe that these events are creating some degree of, as yet unspoken, convergence. We believe that this convergence is captured by the idea of ‘working the EU/IMF deal’. It seems to us that few can now disagree with the need in Ireland to both close the gap between Irish expenditure and tax and the need to create sustainable growth. In addition, few would now doubt that these national efforts need to be accompanied by ongoing and committed efforts to find solutions to the systemic problems in the euro area and the EU.

This convergence on ‘working the deal,’ rather than debating whether the deal can work allows us to concentrate on plans and actions that might, in spite of confined space for immediate action, unify Irish actors around projects of economic and social development. The paper discusses five connected elements necessary for ‘working the deal.’ In summary these are:

- ◆ **First**, continue fiscal adjustment and reform. Achieving a balance between revenue and expenditure is an important target and intermediate step towards stabilising debt.
- ◆ **Second**, work relentlessly to revive sustainable growth. This is necessary if Ireland is to create a positive debt-dynamic. There needs to be a concerted focus on exports. Exports have performed strongly, growing by 8 per cent in value terms and 6 per cent in volume terms in 2010, but it is possible to achieve higher growth rates; for example, the value of German exports of goods increased by almost 16 per cent in 2010. In addition, domestic demand requires fresh analysis and innovative responses and the paper suggests an agenda for further work on domestic demand. Finally, Ireland needs to rebuild the tax base. However, taxes should not constrain economic growth and activity. More revenue should be generated through taxes such as well-designed property tax and water charges.
- ◆ **Third**, make social solidarity a core concern to ensure fairness and unity of purpose. In adjusting public expenditure, it is necessary to identify innovative ways of cutting costs and maintaining standards. This requires engagement of local problem-solving to ensure that expenditure is reduced in a way that does not undermine the services provided to citizens.
- ◆ **Fourth**, address developmental constraints which have the potential to undermine the long term recovery of the economy and society. One such constraint is the availability of finance to support business investment. Taking forward the idea of a Strategic Investment Bank as mentioned in the Programme for Government, is a key step in this regard. It could support projects that deepen and strengthen Ireland’s economic and social development in a sustainable way.
- ◆ **Fifth**, work to promote a more comprehensive EU and international financial resolution. The Irish Government and the policy community need to be active contributors to the ongoing analysis of policy developments in European Union and the euro area. This is increasingly recognised as necessary to stabilise the euro and provide a context for Irish recovery.

Introduction

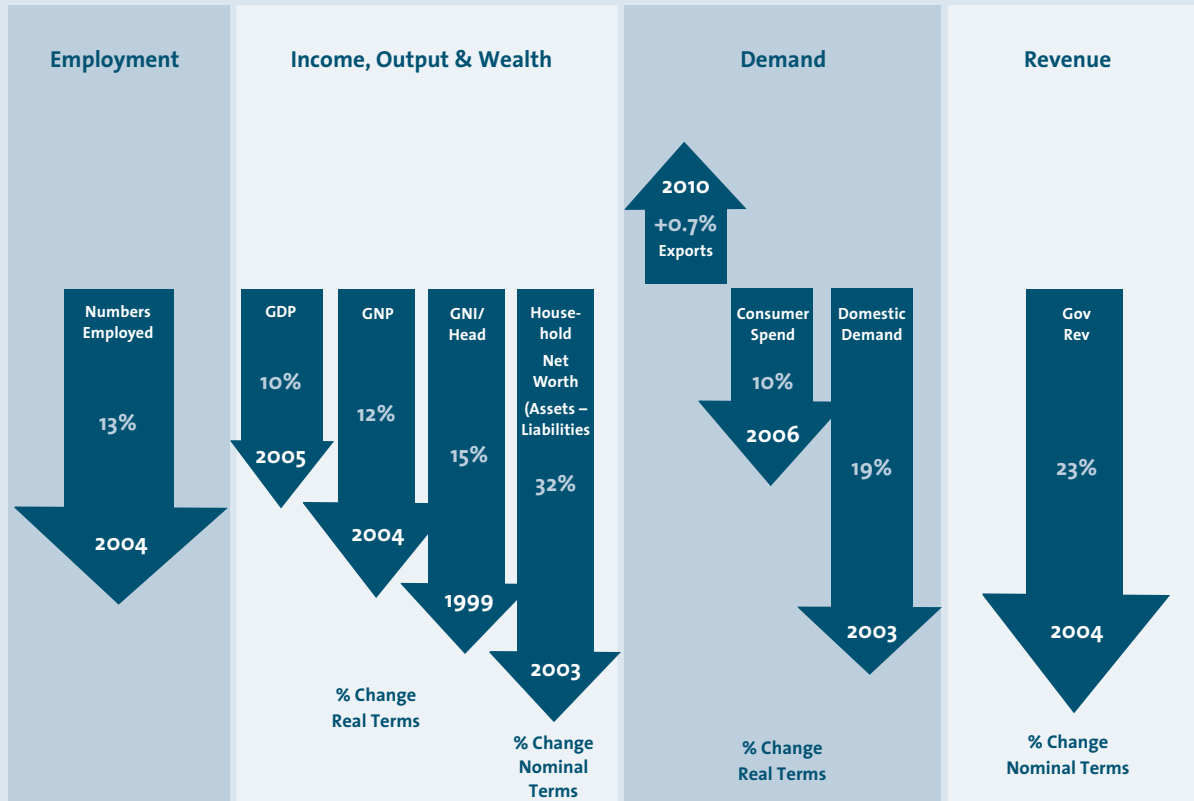
This NESC Secretariat paper examines the recovery of the Irish economy. There are two Chapters. Chapter 1 assesses the performance of the Irish economy, the impact of economic crises, international experiences and the outlook for the economy. Chapter 2 focuses on actions that can be taken nationally in what continues to be a very uncertain European context.

The core messages of the paper are:

- ◆ There are signs that the Irish economy is recovering. However future performance is deeply dependent on developments in two areas: debt dynamics and Europe;
- ◆ Events are creating a degree of, as yet unspoken, convergence captured by the idea of working the (EU/IMF) deal rather than debating if it can work;
- ◆ There are five connected elements necessary for 'working the deal':
 1. Continued fiscal adjustment and reform;
 2. Work relentlessly to revive sustainable growth;
 3. Make solidarity a core focus to ensure fairness and unity of purpose;
 4. Pursue developmental opportunities;
 5. Work to promote a more comprehensive EU and international financial resolution.

Chapter 1 of the paper assesses the performance of the economy since the onset of the crisis. It shows the severity of the contraction (Figure o.o). Examined on any measure there has been unprecedented change; numbers employed are down over 13 per cent; government revenue is down by almost a quarter. In most cases the indicators have returned to levels last seen in the early to middle part of the previous decade. The crisis has also resulted in a dramatic increase in national debt. Debt as a percentage of Gross Domestic Produce (GDP) has increased from 25 per cent in 2007 to 95 per cent in 2010 and is projected to increase further up until 2013.

Figure 0.0 Change Between 2007 and 2010—Various Indicators: Percentage Change and Year when Indicator last at 2010 Level



However, Chapter 1 of the paper also acknowledges improvements in economic activity and growth. Growth is taking place fuelled by exports—particularly pharmaceuticals, medical equipment, food, computer services and business services—inward investment and improvements in cost competitiveness. There are also signs that the public finances are improving. Chapter 1 also reviews countries which have experienced deep recession over a number of years.

Chapter 2 of the paper argues that the future of the economy is dependent on developments in two related areas: debt dynamics and Europe. The paper highlights the dynamics of debt stabilisation and identifies the factors which interact to either stabilise and reduce or increase the level of national debt. In addition, the paper highlights that the debt dynamic is unfolding in the context of significant developments in international finance which are highlighting the need for more comprehensive solutions. These solutions need to reflect the challenges faced by particular countries and systemic problems in the euro area and the EU. Chapter 2 identifies five strategies that would enhance the prospects of a stronger, earlier and more sustainable recovery of the Irish economy.

1

Assessing Recent Irish Economic Performance: 2007–2011

1.1 Introduction

Chapter 1 of this paper reviews trends in key economic indicators. It focuses on the extent to which the recession reversed the gains of earlier years and the current situation of the economy. It begins with an examination of developments in national income and output, both in aggregate and per head of population. It then examines exports, foreign direct investment, the balance of payments, output developments by sector, employment and unemployment, household income and earnings, cost competitiveness, credit, and the public finances. Chapter 1 also discusses the impact of economic crises, and the experience of severe economic crises in earlier periods and finally considers the outlook for the economy and the public finances in the coming years.

Chapter 1 also provides evidence, based on a number of case studies undertaken by the Secretariat in 2010, of how both indigenous and foreign-owned companies have been experiencing and responding to the challenges.

1.2 Economic Growth

1.2.1 National Output and Income

Ireland's GDP fell by 10.1 per cent between 2007 and 2010 so that the level of GDP in 2010 had fallen back to its 2005 level. The fall in Gross National Product (GNP) has been higher at 12.1 per cent and GNP in 2010 had returned to approximately its 2004 level. Gross National Income (GNI) also incorporates the impact of EU subsidies and taxes. The decline in GNI between 2007 and 2010 was 12.2 per cent, approximately the same as GNP.

Ireland's population has grown strongly over the past decade with an increase of over 730,00 between 2001 and 2011. Given the increase in population, the decline in economic output is greater when the various macro measures (GDP, GNP and GNI) are expressed per head of population terms. GNP per head and GNI per head are key measures of real income per head of population. Between 2007 and 2010, GNP per head fell by 14.7 per cent while there was a similar fall in GNI per head. This brought GNP and GNI per head back to their levels of 2000. This implies that the gains in living standards—as proxied by these macro measures—made over the past decade have been lost. On the other hand, it means that the gains in living standards made during the period of exceptionally strong growth of the Celtic Tiger era (1994 to 2000) are essentially intact. This does not imply that national wellbeing is at the same level as 2000; both the level of unemployment and the level of debt

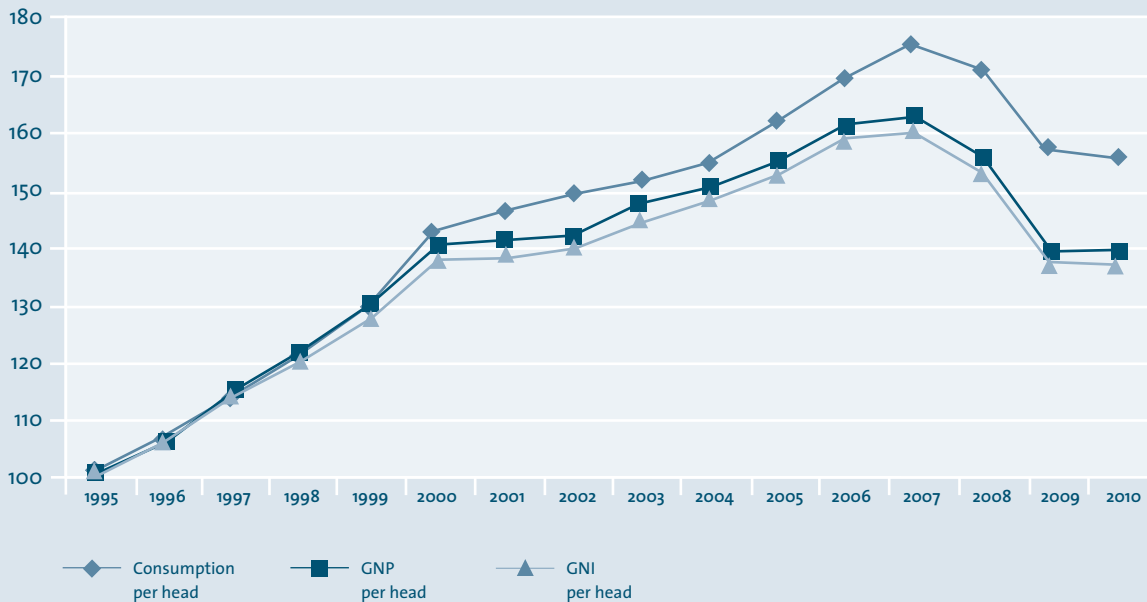
are now far higher than in 2000. At the same time, economic expansion over the past decade means that the gains in living standards achieved during the 1990s are now experienced by a much larger population.

A more tangible measure of living standards is real consumption per head of population (Figure 1.1). This measure declined by 11.3 per cent between 2007 and 2010, considerably less than the decline in GNP or GNI per capita. This was despite a sharp increase in personal savings. This was possible because household income has not fallen by as much as GNP. The trend in household income is examined in Section 1.4 below which explains why household income has fallen by less than GNP. Real consumption per head of population in 2010 was at approximately the same level as it was in 2004.

1.2.2 International Comparisons

The fall in Ireland's GDP in the current crisis has been the second highest in the Organisation for Economic Co-operation and Development (OECD), with only Estonia having a larger fall in GDP. In the EU only the Baltic States experienced sharper declines¹. Ireland's GDP fell by almost 10 per cent between 2007 and 2009 while GDP of the euro area fell by just 3.7 per cent. Economic recovery got under way in other countries during 2010 while Ireland's economy declined by 0.4 per cent in GDP terms; in GNP terms, the Irish economy increased by 0.3 per cent in 2010 (Figure 1.2).

Figure 1.1 Trend in Aggregate Measures of Living Standards, 1995–2010
1995=100



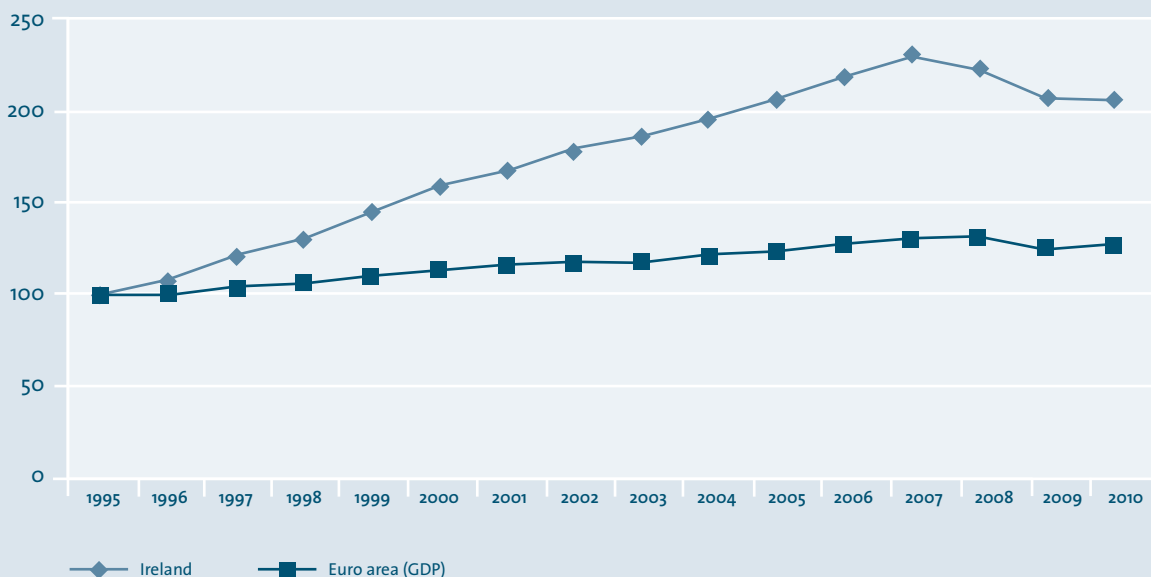
Source NESC calculations using CSO data.

¹ Estonia is now a member of the OECD while the other two Baltic states (Latvia and Lithuania) are not yet members.

On a quarterly basis, GNP increased in each quarter of 2010 while GDP declined in the second and fourth quarter, based on seasonally adjusted data. Quarterly GNP growth was boosted by an increase in investment income from abroad. This income includes the profits of companies with head offices in Ireland less dividends paid abroad by these companies. The profits of Irish multinationals such as Cement Roadstone Holdings (CRH) are included in Ireland's investment income. A particular factor that boosted investment income in 2010 was the movement of the legal head offices of a number of UK companies to Ireland. The profits of these companies less dividends paid abroad are part of in Irish GNP even though there is very limited economic activity in Ireland. Under double taxation agreements they are not liable for Irish corporation tax. This qualifies the recovery in quarterly GNP growth that occurred during 2010.

In the first quarter of 2011, GDP increased by 1.3 per cent while GNP fell by 4.3 per cent. Quarterly changes in GDP and GNP are volatile and subject to substantial revisions so should not be given too much weight. Annual changes give a better indication of underlying trends although also affected by revisions. On an annual basis, GDP in the first quarter of 2011 was marginally higher (0.1 per cent) than the first quarter of 2010 while GNP was 0.9 per cent lower.

Figure 1.2 Index of GDP in Ireland and the Euro Area, 2000–2010
2000=100



Source European Commission, AMECO database

The sharper decline in the Irish economy than that experienced in most other countries is driven by the exceptionally sharp fall in the construction sector in Ireland. Both output and employment in construction in Ireland more than halved since 2007; sectoral trends are discussed further in Section 1.2.7. By contrast, Ireland's exports during the crisis have been more resilient. Ireland's export performance is examined in Section 1.2.3.

From the late 1980s, Ireland had made steady progress in catching up with average EU living standards (Figure 1.3). By 2002, Ireland's income per head had reached the EU (15) average while by 2007, Ireland's gross national income per capita was 14 per cent above the EU (15) average. By that stage, Ireland's income was among the highest in the EU, at around the same level as Denmark's. The sharp decline in the Irish economy has meant that by 2010 Ireland had fallen back to a situation where gross national income per capita was around 8 per cent below the EU (15) average, similar to the situation in 1998. Ireland's income per head in 2010 was 3.4 per cent above the EU (27) average.² Ireland's gross national income per capita in 2010 was just above the levels of Spain and Italy and around 14 per cent below the UK.

Figure 1.3 Gross National Income Per Capita in Ireland, Denmark, Spain and the UK, 1995–2010, EU (15)=100



Source European Commission, AMECO database

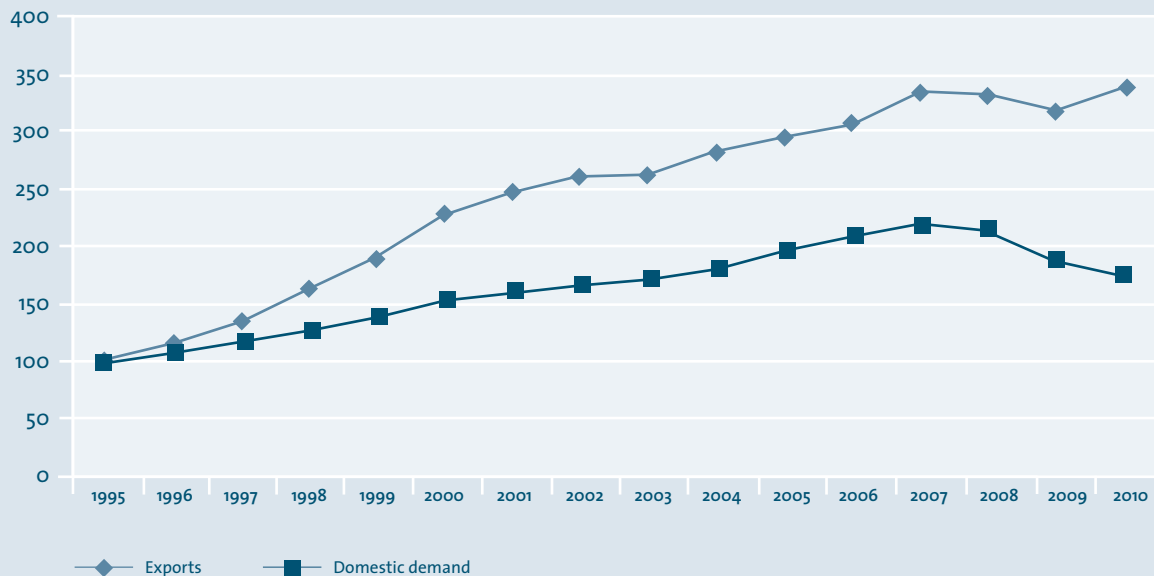
1.2.3 Exports

A simple disaggregation of the decline in the economy is to consider the division between the trend in exports and domestic demand. The exceptionally large contraction of the Irish economy has been driven by domestic demand rather than exports; developments in domestic demand are discussed in Section 1.2.5.

Ireland's exports have proved relatively resilient during the current global downturn. The volume of goods and services exports in 2010 was 0.7 per cent above the level of 2007. During 2010, Ireland's exports returned to growth: total goods and services exports increased by 6.3 per cent in 2010 in volume terms and 8.1 per cent in value term.

² The EU (27) includes lower-income member states so income per head is lower than the EU (15).

Figure 1.4 Trend in Real Volume of Exports and Domestic Demand, 1995–2010
1995=100



Source CSO, National Income and Expenditure.

The cumulative fall in the real volume of goods and services exports from Ireland between 2007 and 2009 was 5.2 per cent. Larger falls in exports occurred in all other EU (15) member states with the exception of Luxembourg where exports fell by 2.1 per cent. In fact, almost all EU (15) countries experienced double-digit falls in exports in this period. During 2010, there was a return to export growth across the global economy and Ireland participated in this recovery.

Internationally comparative data from the European Commission's AMECO database indicates that the volume of Irish exports of goods and services increased by 9.4 per cent in 2010. This was below the EU (15) average of 10.2 per cent³. The largest increase in export volume in the EU (15) in 2010 was in Germany, where exports increased by over 12 per cent. In value terms the increase in Irish goods and services in exports in 2010 was the lowest in the EU (15). Over the extended period from 2007 to 2010, the increase in the value of Irish exports was the second highest in the EU (15), based on AMECO data.

The question arises as to what lies behind Irish export growth in recent years. Both goods and services exports have contributed to this growth. The contribution of goods exports is first examined.

³ The most recently published CSO data shows a lower increase in the volume of Irish goods and services exports for 2010 of 6.3 per cent.

Goods Exports

Chemicals and pharmaceuticals have dominated the recent growth of Irish goods exports and have come to represent a remarkably high share of the value of goods exports (almost 59 per cent in 2010). During 2009 there was a widespread fall in trade among developed economies but Irish exports of chemicals and pharmaceuticals continued to grow with an increase of 7.3 per cent in value terms in 2009. This increase helped to limit the fall in Irish goods exports in 2009 to 2.8 per cent in value terms. By contrast, there were large double-digit declines in exports across the global economy with German exports, for example, falling by 18.3 per cent in 2009⁴.

The very strong performance of the chemical and pharmaceutical sector masks some very dramatic declines in other sectors. The cumulative decline in Irish goods exports between 2007 and 2009 was 6.3 per cent. However, when exports of chemicals and pharmaceuticals are excluded, the cumulative decline in Irish goods exports in this period was 21.4 per cent, which was higher than the comparable decline in German exports (18.9 per cent). There was a particularly large fall in Irish exports of machinery and transport equipment of 37.7 per cent; this category includes computers and so was severely affected by the closure of Dell in 2009. The value of food exports declined by 17.5 per cent in this period, and there was a large fall in the value of dairy exports of 24.6 per cent. Miscellaneous manufacturing exports increased by 8.3 per cent in this period. This reflected increased exports of professional and scientific equipment (including medical devices) and software products. There was also an increase in exports of 'other commodities' of 29.3 per cent. The major factor here was increased exports from the Shannon free trade zone.

There has been a broadly based recovery in goods exports in 2010. The Central Statistics Office (CSO) trade figures indicate that the value of goods exports increased by just over 6 per cent in 2010.⁵ By the end of the year, however, the annual increase was higher; the value of goods exports in the final quarter of 2010 was 17 per cent higher than in the final quarter of 2009. All of the main categories of goods exports increased in value with the notable exception of machinery and transport equipment. Food exports increased by 11.3 per cent in value terms; this included an increase of 28.5 per cent in the value of dairy exports. Drinks exports increased by almost 10 per cent and exports of metal products increased by over 20 per cent. Chemicals and pharmaceuticals increased by 9.2 per cent while miscellaneous manufacturing exports increased by 14.1 per cent (see Table 1.1). There was a substantial fall in the value of machinery and equipment exports, including computers and communications equipment, of almost one-fifth.

⁴ When drawing international comparisons in this paragraph and the next paragraph, Eurostat external trade data is used. This differs slightly from the CSO data for Ireland presented in Table 1.1.

⁵ When the trade figures are incorporated into the balance of payments and the national income accounts, the CSO makes certain adjustments. The national accounts data show an increase in the value of goods exports in 2010 of 6.8 per cent and a volume increase of 5.6 per cent.

Table 1.1 Value of Goods Exports by Sector, 2007–2010

	2010 €million	2010 % of Total	2007–2009 % change	2010 % change
Food	6980.5	7.8	-17.5	11.3
– Meat	2409.6	2.7	-8.3	10.3
– Dairy	1431.7	1.6	-24.6	28.5
– Miscellaneous Foods	1462.2	1.6	-24.2	6.9
Drinks and tobacco	1193.9	1.3	-23.3	10.6
– Drinks	1106.7	1.2	-24.1	9.9
Crude materials	1446	1.6	-36.8	48.8
Mineral fuels etc.	1027.2	1.1	-13.4	72.7
Animal and vegetable oils	26.6	0.0	-27.5	33.0
Chemicals and pharmaceuticals	52414.1	58.6	11.4	9.2
Manufactured goods classified by material	1449.3	1.6	-31.6	16.6
– Textiles	158.9	0.2	-29.9	12.5
– Non-metallic mineral products	251.3	0.3	-30.8	15.0
– Metals and metal products	652.0	0.7	-29.9	20.5
Machinery and Transport	10999.5	12.3	-37.7	-19.0
– Office machines	4515.5	5.0	-48.8	-29.9
– Communications	829.2	0.9	-29.2	-17.2
– Electrical machinery	3078.4	3.4	-30.4	-7.7
– Other transport	240.7	0.3	189.0	-66.0
– Other machinery and equipment	2335.7	2.6	-24.4	11.3
Miscellaneous manufactured articles (8)	10514.1	11.8	8.3	14.4
– Professional equipment	3270.8	3.7	42.7	8.7
Other commodities	2711.5	3.0	29.3	10.0
Total (including unclassified)	89240.2	100.0	-5.6	5.9

Source CSO, External Trade

Durkan and O’Sullivan (2011) analysed the growth of exports in 2010 in terms of modern (i.e. chemicals and parts of machinery and transport equipment and miscellaneous) and more traditional exports. They estimated that modern exports increased by 4 per cent in 2010 while traditional exports showed a considerably larger increase of 12.5 per cent. The fall in computer exports depressed the growth of modern exports during 2010.

The growth of Irish goods exports in 2010 was lower than in other EU countries, but at this stage there is considerable variation in estimates of growth in goods exports during 2010 across different statistical sources⁶. European Commission AMECO data for

6 Comprehensive information on goods trade across different countries is provided by Eurostat’s External Trade Statistics. These indicate that Irish goods exports increased by 1.8 per cent in volume terms and 6.0 per cent in value terms in 2010. The CSO’s External Trade statistics show an increase in goods exports of 3.6 per cent in volume terms and 5.9 per cent in value terms in 2010. The European Commission’s AMECO database uses a national accounts approach. The AMECO database shows an increase in Irish goods exports of 8.8 per cent in volume terms and 9.0 per cent in value terms in 2010. The national equivalent to the AMECO estimate is available from the CSO’s Quarterly National Accounts. This shows an increase in goods exports of 5.6 per cent in volume terms and 6.8 per cent in value terms for 2010. The estimates quoted here are those available in July 2011. Subsequent revisions should reduce the gap between these estimates and bring more clarity to Ireland’s relative export performance in 2010.

2010 would indicate that the increase in Irish goods exports in volume terms of 8.8 per cent was below the EU (15) average of 12.7 per cent. German exports of goods increased by almost 16 per cent in 2010 while exports of goods from Sweden increased by over 14 per cent. The increase in Irish goods exports in 2010 in value terms based on the AMECO data was 9.0 per cent, which was the lowest in the EU (15). The fall in computer exports is one reason why the increase in Irish goods exports in 2010 was lower than other EU countries. In addition, most countries experienced large falls in exports in 2009 so their 2010 performance included a rebound from these falls. However, these figures also illustrate the scope for an acceleration of Irish export growth.

Irish export growth has continued in 2011. In the first quarter of 2011, the value of Irish goods exports showed an annual increase of 8.5 per cent compared to the first quarter of 2010. The value of food exports in the first quarter of 2011 was almost 16.8 per cent higher than the first quarter of 2010 while chemical exports increased by 13.5 per cent in this period. Total machinery and equipment exports increased by 3.2 per cent in value terms in the first quarter of 2011 compared to the first quarter of 2010. This suggests that falling machinery and equipment exports may not depress export growth in 2011 in the way that this has occurred in earlier years. Exports of professional and scientific apparatus were 16.7 per cent higher in the first quarter of 2011 compared to the same quarter of 2010.

Services Exports

Services exports have been a key influence on Ireland's relatively strong export performance. Between 2007 and 2009, the nominal value of services exports fell by just 0.8 per cent, based on the European Commission AMECO database. This was a considerably better performance than in the EU generally: the average fall in services exports in the EU (15) was 5.5 per cent. There was a particularly strong performance in terms of Irish exports of computer services with an increase of 12.3 per cent between 2007 and 2009 (CSO data). Business services proved resilient with only a slight decline between 2007 and 2009. Tourism and travel exports, a key indigenous sector, declined by almost 21 per cent in this period.

There has been strong growth of services exports in 2010: the value of services exports increased by 10.0 per cent (see Box 1.1 for an example from the indigenous sector). Almost all services categories contributed to this strong performance (Table 1.2). Exports of computer services rose by 15.7 per cent while business services exports grew by 6.9 per cent. Exports of financial services increased by 3.2 per cent. One significant exception to the export recovery in this period was tourism and travel, which continued to decline in 2010 (by 12.3 per cent). However, overseas trips to Ireland increased by 8.6 per cent in the first quarter of 2011 compared to the same quarter of 2010.

In volume terms the increase in Irish services exports in 2010 at 9.9 per cent was the largest increase in services exports in the EU (15) and was a multiple of the average EU (15) increase of 3.7 per cent⁷. In value terms the increase in Irish services exports (9.9 per cent) in 2010 was the fourth highest in the EU (15).

The recovery of Irish exports that is under way is obviously a welcome development. In view of the constraints on Ireland's domestic demand at present, it is worth considering

⁷ This is based on AMECO data. The most recent CSO data indicates that the increase in the volume of Irish services exports in 2010 was 7.1 per cent. This would still leave Irish services exports as having the highest growth in the EU (15) in 2010 in volume terms.

Table 1.2 Exports of Services, 2007–2010

	2010 (€billions)	2010 % of Total	2007–2009 % change	2010 % change
Transport	3.6	4.9	4.7	18.4
Tourism and travel	3.1	4.2	-20.8	-12.3
Communications	0.5	0.7	-17.4	28.6
Insurance	7.8	10.5	-17.0	6.5
Financial services	6.0	8.1	-22.1	3.2
Computer services	28.2	38.2	12.1	15.7
Royalties/licences	1.7	2.3	40.6	39.4
Business services	22.3	30.2	1.6	6.9
Other services not elsewhere stated	0.6	0.9	-16.9	8.5
Services	73.8	100.0	-1.2	10.0

Source CSO, Balance of Payments, June 2011

Box 1.1 Service Exports: An Indigenous Success

Abtran

Abtran is an Irish-owned services company, established in 1997, which currently employs in excess of 1,000 staff across multiple business sites. The Cork-based company is an example of the type of company that is contributing to the rapid growth in the internationally traded services sectors of the economy. The company has experienced rapid growth in business volume – its turnover in 2009 was €30.4 million, with pre-tax profits of €2.6 million, and the company experienced 10 per cent growth in 2010. Abtran's current three-year cycle plan anticipates that revenue will approach €80m by 2014.

The company specialises in high value-added business process outsourcing, which entails research, design, testing, implementation and continuous improvement of business processes for clients such as financial services (banking and insurance), utilities, media, telecoms and public services. The company invests heavily in services innovation, and operates a Learning and Innovation Centre, which provides laboratory-type facilities for the design and validation of innovative business processes.

The company has established itself as the largest indigenous business process outsourcer (BPO) in the Irish market, and is rapidly expanding into export markets. It currently generates 35 per cent of its revenues from exports, but has ambitions to become a more significant player in the global BPO market. The company's high value-added strategy allows it to compete successfully against competitors from lower-cost economies such as India.

the possibility of achieving further acceleration of export growth. Between 1993 and 2000, Irish exports of goods and services grew by an annual average of almost 18 per cent. Stronger export growth can in turn help domestic demand, both in terms of multiplier effects and improving confidence.

1.2.4 Foreign Direct Investment

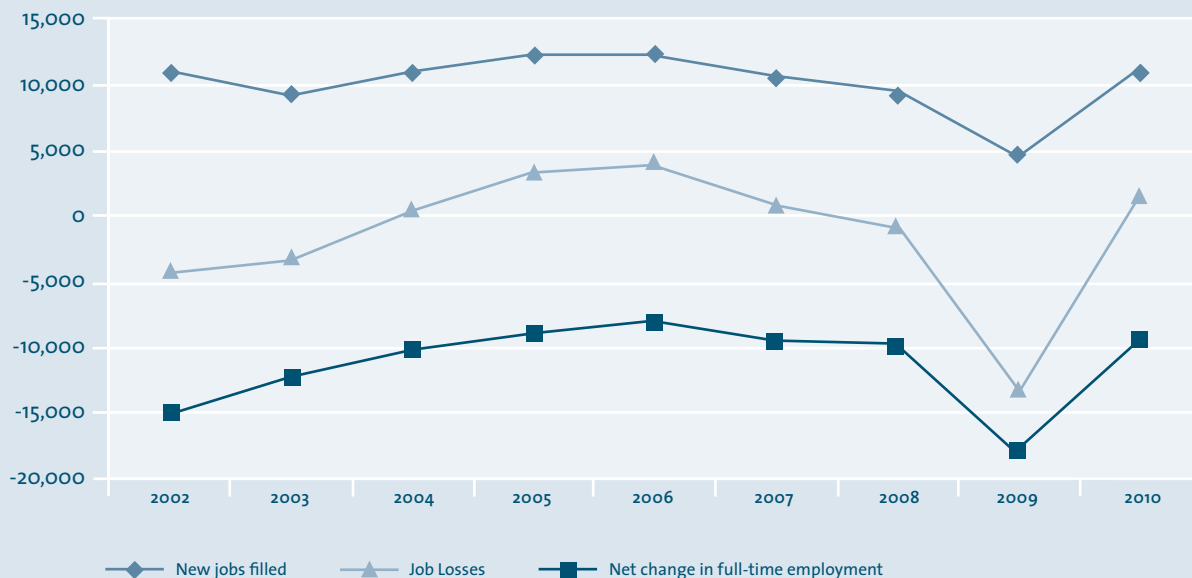
The resilience of Ireland's exports is underpinned by continuing success in the attraction of foreign direct investment (FDI). This section focuses on the recent performance of FDI. However, indigenous companies also play an important role in exports and this is discussed in Box 1.2.

In 2008, Ireland attracted more FDI, relative to the size of its population, than any other OECD country. Only Singapore attracted more investment on a per capita basis (National Competitiveness Council, 2010). The IBM 2010 business location survey found that Ireland in 2009 had more job creation based on FDI, relative to the size of the population, than any other country (IBM Global Business Services, 2010). Hungary was ranked as number two on this measure, followed by Singapore. Ireland was placed as tenth highest in terms of the absolute number of jobs created in business services and was placed at number nine in terms of the absolute number of jobs created in standalone Research and Development (R&D) centres. The significance of Dublin as an investment location emerges in the IBM survey: Dublin was ranked as fifteenth in terms of the number of new investment projects in 2009.

Over the seven years 2002–2008, the average annual level of new job creation in IDA Ireland companies was around 10,700. The recession led to a sharp fall in the level of new job creation in 2009 when only 4,615 new jobs were created. In 2010, there was a strong recovery in investment and job creation by IDA companies and the level of new job creation rose to 10,900. This meant a return to the type of job creation experienced before the onset of recession. Even in good times, job losses were a feature of IDA Ireland companies. Over the period 2002 to 2008, the average annual rate of job loss was close to the level of new jobs created, leaving little net change in employment in IDA companies. The rate of job losses accelerated in 2009 to reach around 18,000, so that there was a net loss of employment in IDA companies of around 13,400. In 2010 the number of job losses was considerably lower at 9,545. The net gain in employment in IDA companies in 2010 was 1,350, the strongest performance since 2006 (Figure 1.5).

In 2010, of 126 IDA-supported investments by foreign Multinational Corporations (MNCs), 79 (63 per cent) were investments by existing IDA client companies. Of these, just over half (42) were expansion projects, while the remainder (37) were classified as RDI (research, development and innovation) projects. These figures suggest that there is a considerable degree of upgrading occurring within existing MNCs in Ireland. As of 2010, IDA-supported companies employed approximately 139,000 people directly. The job-creation statistics for 2010 show an overall net gain of 1 per cent in numbers employed in IDA-supported companies. However, this figure masks a quite significant flux of 15 per cent—which reflects an increase equivalent to 8 per cent offset by job losses of 7 per cent. A similar trend can be observed in Irish-owned firms: in 2010, employment in Enterprise Ireland client companies was 137,241. A total of 8,193 new jobs were created by client companies with a net decline of 5,355, suggesting a total annual flux of almost 10 per cent.

Figure 1.5 Job Creation, Job Losses and Net Change in Employment in IDA Ireland Companies, 2002–2010



Source IDA Ireland Annual Report 2009 and IDA Press Release, 4 January 2011

This flux is occurring at a number of levels: within firms, through the upgrading of existing operations; within sectors, through the growth of certain companies concurrent with the decline of others in the sector; and across sectors, in the context of structural change in the economy. Company-level examples of flux can be seen as companies upgrade their operations from lower-end to higher value-added activities that typically require new capital investment coupled with upskilling of the workforce or displacement of lower-skilled workers with higher skilled workers.

One illustration of such flux comes from an indigenous engineering company, interviewed by the Secretariat. In response to a major downturn in its business, following the collapse of the construction sector, the company has been upgrading its operations from low-tech fabrication to high-tech engineering. The workforce has declined from a peak of 320 in 2007 to just above 100 in 2010. The company is aiming to restore employment levels but is depending on the success of a new venture into the renewable energy sector. The jobs that the company hopes to create will require different skills sets, and many of the previous incumbents will not have the requisite qualifications or experience. Where once the workforce consisted largely of steel fabricators, welders and metal engineers, the company hopes in the future to employ mechanical and electrical engineers and information and communications technology (ICT) technicians. There are many similar examples among established multinational firms in Ireland. Recent job announcements by the enterprise support agencies illustrate how companies in sectors such as ICT and pharmaceuticals are actively upgrading their operations to higher value-added, innovation-driven activities and recruiting highly-skilled staff, while in some cases experiencing a reduction in the numbers employed in lower-skilled manufacturing jobs.

Box 1.2 Exporting and the Role of the Indigenous Sector

The current context of export growth and depressed domestic demand again raises issues concerning the respective roles of the indigenous sector and foreign direct investment in Ireland's economic development. Issues such as:

- ◆ To what degree are indigenous enterprises in a position to take advantage of export market growth?
- ◆ Did indigenous enterprises perform well during the earlier growth period?

This text box examines key features of the performance of Irish-owned and foreign-owned businesses respectively in manufacturing and internationally traded services, drawing mainly on Forfás data (summarised in Table 1.3). Ireland's remarkable success in attracting foreign direct investment is documented in the main text. The proposition that Ireland has a weak indigenous enterprise sector is based, in particular, on the export performance of Irish-owned businesses (see for example the Enterprise Strategy Group, 2004)

The Forfás data (Table 1.3) show that the overwhelming share of the value of Irish exports is generated by foreign-owned companies. In 2009, just 10 per cent of the value of exports by manufacturing and internationally traded services companies was from Irish-owned enterprises. However, these figures refer to the gross value of export sales. Because of lower import content and profit outflows, a higher share of the sales of indigenous companies is spent on wages and other purchases in the Irish economy. Direct expenditure in the Irish economy represents around 63 per cent of the sales of Irish-owned companies in manufacturing and international services compared to 16 per cent for foreign-owned companies. It is possible to apply these shares of Irish economy expenditure to the export figures to generate adjusted export figures that reflect the weight of spending generated in the Irish economy. When exports are adjusted in this way, the share of exports generated by indigenous companies rises to 28 per cent. These Forfás figures on exports refer to companies supported by the enterprise agencies at some stage. When account is taken of other exports, including tourism, this would bring the share of 'adjusted' export earnings for indigenous enterprises to somewhere over 30 per cent.

Ireland's export boom during the 1990s was dominated by foreign-owned enterprises. Total exports by Irish-owned enterprises grew by an annual average rate of 5.5 per cent in nominal terms between 1990 and 2002, compared to a corresponding rate of 15.9 per cent for foreign-owned companies (Enterprise Strategy Group, 2004). There was, however, strong growth among Irish-owned companies in the exports of internationally traded services, with annual growth of almost 18 per cent in this period.

The past decade has seen slower export growth by both Irish- and foreign-owned companies. Total exports by Irish-owned companies in both manufacturing and international services grew by an annual average rate of just 2.6 per cent in nominal terms between 2000 and 2009, while exports by foreign-owned companies grew by an annual rate of 5.1 per cent. The relatively slow growth of indigenous exports was due to weak growth in manufacturing exports with indigenous manufacturing exports showing annual growth of just 0.9 per cent over this period. By contrast, exports of international services showed much more substantial growth for both Irish- owned (annual growth of 8.7 per cent over this period) and foreign-owned companies (annual growth of 8.3 per cent).

When compared with foreign companies located in Ireland—though this is not an entirely fair comparison—Irish-owned enterprises have a relatively low export orientation. In 2008, Irish-owned companies in manufacturing exported 41 per cent of their output compared

to over 91 per cent for foreign-owned manufacturers, according to the Census of Industrial Production. There is also a much higher reliance on the UK market. In the case of Irish-owned manufacturers, 41.3 per cent of their exports went to the UK in 2008 compared to 12.3 for foreign-owned manufacturers. The Irish and UK markets together represented over three-quarters of the output of Irish-owned manufacturers in 2008 compared to just under one-fifth for foreign-owned manufacturers.

Around half of total employment in manufacturing and internationally traded services in 2010 was in Irish-owned companies. This share increased slightly over the past decade. Total employment in manufacturing (and other industry) fell sharply over the past decade with a total fall of 23 per cent between 2001 and 2010. The fall was higher for foreign-owned manufacturing companies (25 per cent) than for Irish-owned companies (22 per cent). Employment in international services increased by over one-fifth in the same period. There was a remarkably strong increase in employment in indigenous enterprises in international services over the 2001 to 2010 period with an increase of 37 per cent, considerably higher than the corresponding increase in employment by foreign-owned companies in this period (12 per cent). The increase was also higher in absolute terms for Irish-owned companies. The level of employment in international services in 2010 was higher in foreign-owned companies (65,600), while there were 50,900 people employed in Irish-owned companies.

From 2007 to 2010, the fall in employment in foreign-owned enterprises (11 per cent) was less than the decline in Irish-owned enterprises (15 per cent) and also less than the decline in national employment (Table 1.4). Hence, in this period, foreign-owned companies helped to stabilise the economy (Barry & Bergin, 2010). The smaller fall in employment in foreign-owned companies in this period arose from these companies experiencing a smaller decline in manufacturing employment. However, the fall in employment in international services employment in this period was smaller in Irish-owned companies (1 per cent) than in foreign-owned companies (6 per cent).

During 2010 there was a modest (0.2 per cent) expansion of employment in foreign-owned companies due to an increase in services employment in these companies of 3.6 per cent. Employment in Irish-owned companies fell by 1.2 per cent in 2010 with both manufacturing and international services employment falling in these companies. Total employment in agency-supported companies fell by 1 per cent in 2010. This was an improvement on the previous year, when employment fell by almost 10 per cent.

Recorded productivity levels are considerably higher for foreign-owned enterprises. Table 1.3 indicates that value added per employee in Irish-owned enterprises in 2009 was just one-fifth the level of foreign-owned enterprises. This simple comparison is subject to limitations. It is influenced by major differences in sectoral composition; the value added of foreign-owned enterprises is also influenced by their ability to use intangible assets (such as brands and patents) created elsewhere in the corporation. Earnings are also higher in foreign-owned companies but the difference is much less stark. Payroll costs per employee in Irish-owned enterprises in 2009 were roughly 80 per cent of the level of foreign-owned enterprises. This difference was mostly due to manufacturing. For international services, payroll costs per employee in Irish-owned enterprises were just 4 per cent below foreign-owned enterprises.

To conclude, there continues to be significant structural differences between Irish and foreign-owned enterprises. However, this should not obscure the economic importance of both FDI and indigenous enterprise. Comparisons of the gross value of export earnings understate the significance of indigenous enterprise. There has been a strong performance by Irish-owned enterprises in international services over the past decade, with employment growing faster than in foreign-owned enterprises.

Table 1.3 Manufacturing and Internationally-traded Services: Key Characteristics, 2009/2010

	Irish-owned companies	Foreign-owned companies	Total	Irish Share (% of total)
Employment (2010)				
Manufacturing	104,549	88,966	193,616	54.0
Internationally traded services	50,861	65,561	116,422	43.7
Total	155,410	154,628	310,038	50.1
Sales (2009) (€billion):				
Manufacturing	23.0	65.7	88.7	25.9
Internationally-traded services	6.9	54.1	60.9	11.3
Total	29.9	119.7	149.6	20.0
Exports (2009) (€billion)				
Manufacturing	8.2	62.6	70.8	13.2
Internationally traded services	3.3	51.9	55.2	6.3
Total	11.5	114.4	126.0	10.1
Adjusted Exports (2009) (€billion)				
Manufacturing	5.5	8.8	14.3	38.6
Internationally traded services	1.6	9.4	11.0	14.5
Total	7.1	18.2	25.3	28.1

Source Forfás (2011), *Annual Employment Survey 2010*; Forfás (2010), *Annual Survey of Business Impact 2009* and NESC calculations. All figures are for 2009 except for the employment figures, which refer to 2010. A small level of employment in primary production (2,738) is included in the figure for manufacturing.

1.2.5 Domestic Demand

There are three components to domestic demand: personal consumption, investment and public consumption. Between 2007 and 2010, domestic demand declined in volume terms by 19.0 per cent, which is a huge decline.

Investment

The fall in domestic demand is driven by the dramatic fall in investment, which fell by almost 52 per cent in volume terms between 2007 and 2010 (Figure 1.6). There are two components to investment: building and construction; and machinery and equipment. Building and construction investment fell in volume terms by almost 57 per cent between 2007 and 2010, while investment in machinery and equipment fell by around 39 per cent. Building and construction investment is of particular significance for the Irish economy as this investment has a low import content and much of it is employment intensive.

Table 1.4 Employment in Manufacturing and Internationally Traded Services, 2001–2010

	2001–2010 % change	2007–2010 % change	2010 % change
Manufacturing & Other Industry			
Irish-owned companies	-22.2	-20.1	-2.8
Foreign-owned companies	-24.7	-14.9	-2.2
All companies	-23.4	-17.8	-2.5
Internationally Traded Services			
Irish-owned companies	36.9	-1.0	-0.8
Foreign-owned companies	11.9	-5.8	3.6
All companies	21.6	-3.8	1.6
All Sectors			
Irish-owned companies	-9.9	-15.1	-2.2
Foreign-owned companies	-12.6	-11.2	0.2
All companies	11.3	-13.2	-1.0

Source Forfas (2011) Annual Employment Survey

Figure 1.6 Trend in Real Volume of Personal Consumption, Investment and Public Consumption 1995–2010, 1995=100


Source CSO, National Income and Expenditure, June 2011

Notwithstanding substantial cuts in government capital spending, public investment has fallen but not to the same extent as private investment. Public capital investment, broadly defined to include investment by state commercial companies, fell by 12.1 per cent in nominal terms between 2007 and 2010. If the economy-wide price deflator for investment is applied to this change, this would represent an increase in volume terms of 12.1 per cent. However, between 2008 and 2010, public capital investment fell by 17 per cent in nominal terms and by 4.2 per cent in volume terms.

More detailed information on the composition of construction investment is available from the DKM review of construction, prepared annually for the Department of Environment, Heritage and Local Government (DKM, 2010). There are some differences in methodology from the national accounts estimates on which Table 1.5 is based. It is estimated by the DKM that the total volume of new construction investment fell by 67 per cent between 2007 and 2010, while repair and maintenance fell by 32 per cent over the same period (Table 1.6).

Table 1.5 Change in Volume of Investment, 2007–2010

	2008 % Change	2009 % Change	2010 % Change	2007–2010 % Change
Building and construction:	-9.4	-31.6	-30.3	-56.8
– Housing	-13.2	-36.9	-35.6	-64.7
– Other building and construction	5.2	-22.7	-26.5	-40.2
– Transfer Costs	-47.0	-56.0	-19.3	-81.2
Machinery and equipment	-10.9	-20.4	-14.5	-39.3
Total	-10.2	-28.7	-24.9	-51.9

Source CSO, National Income and Expenditure, June 2011

The DKM estimates show that the most dramatic fall in construction investment was in new private housing with an estimated fall in the real volume of investment of 90 per cent between 2007 and 2010; in terms of nominal investment, there was a fall of €16.3 billion for new housing alone. The fall in new social housing was much less, with a fall of 15 per cent in volume terms. By 2010, the value of social housing investment was around 70 per cent of private housing investment. Private residential repair and maintenance is estimated to have fallen by 38 per cent in volume terms.

There was also a huge fall in private non-residential construction of an estimated 85 per cent between 2007 and 2010. This refers to new construction in areas such as offices, shops and farms. This type of investment was not as large as residential investment so the fall in investment in nominal terms of €5.3 billion was not as significant as the fall in residential investment.

The DKM estimates of infrastructure investment, both ‘productive’ and ‘social’, indicate that the level of new investment in volume terms in 2010 was higher than it had been in 2007. It has, however, fallen in real terms since 2008, with an estimated decline in the region of 15 per cent. Social infrastructure includes investment in education, health and other facilities. The volume of new construction investment in both health and education in 2010 was above the level of 2008.

It is the dramatic swings in the level of investment in housing and construction that have driven the Irish economy in recent years. The construction boom became increasingly dependent on an unsustainable level of credit creation. Kelly has pointed out that bank lending relative to GNP more than tripled in the 11 years to 2008 (Kelly, 2009). The growth in credit outstripped banks’ domestic deposits and depended on a huge rise in foreign borrowing. The net indebtedness of Irish banks to the rest of the world increased from 10 per cent of GDP at the end of 2003 to 60 per cent of GDP by 2008 (Honohan, 2009). The investment boom boosted government revenue and expenditure. The subsequent sharp fall in investment plunged the economy into recession and increased unemployment. Tax revenue fell sharply, creating the crisis in the public finances.

Table 1.6 Changes in Construction by Sector, 2007–2010

	2007–2010 % Change in Volume	2007–2010 Change in €billions	2010 €billions	2010 % of Total Value
Residential construction				
– New private housing	-89.8	-16.3	1.0	8.6
– New social housing	-15.4	-0.4	0.7	5.5
– Private repair and maintenance	-38.5	-2.4	2.3	19.6
– Public repair and maintenance	64.3	0.1	0.4	3.5
Total residential	-74.3	-19.0	4.4	37.2
New private non-residential construction	-85.4	-5.3	0.6	4.9
New productive infrastructure	2.4	-0.8	3.8	32.6
New social infrastructure	5.5	-0.6	1.3	11.1
Non-residential repair and maintenance	-29.6	-1.2	1.7	14.2
Total new construction	-67.5	-23.3	7.4	62.7
Total repair and maintenance	-32.1	-3.6	4.4	37.3
Total construction	-58.5	-26.9	11.7	100.0

Source DKM (2010), Construction Review 2009 and Outlook 2010–2012.

Personal Consumption

The largest component of domestic demand is private consumer spending. The volume of personal consumption fell by 9.3 per cent between 2007 and 2010; the 2010 level of consumption was close to the level of 2006. The fall was concentrated in 2009 when personal consumption fell by 7.6 per cent. In 2010, the fall was 0.8 per cent.

The volume of retail sales fell by 18.6 per cent between 2007 and 2010. This, however, was driven by the volatile motor trade where volume fell by over half between 2007 and 2009 before recovering by 17 per cent in 2010. Excluding the motor trade, the volume of retail sales fell by 11.0 per cent between 2007 and 2010.

The total volume of retail sales showed a small increase of 1.0 per cent in 2010 following a huge fall of 14 per cent in 2009. When the volatile motor trade is excluded, retail sales fell by 1.7 per cent in 2010 compared to a fall of 6.8 per cent in 2009. Retail sales (excluding the motor trade) increased in the first quarter of 2010 but declined in the second half of the year. The fall in retail sales in the second half of 2010 is consistent with a decline in the KBC/ESRI Consumer Sentiment Index in this period. The Consumer Sentiment Index is a survey-based measure of consumers' perceptions of their current and future financial and economic situation.

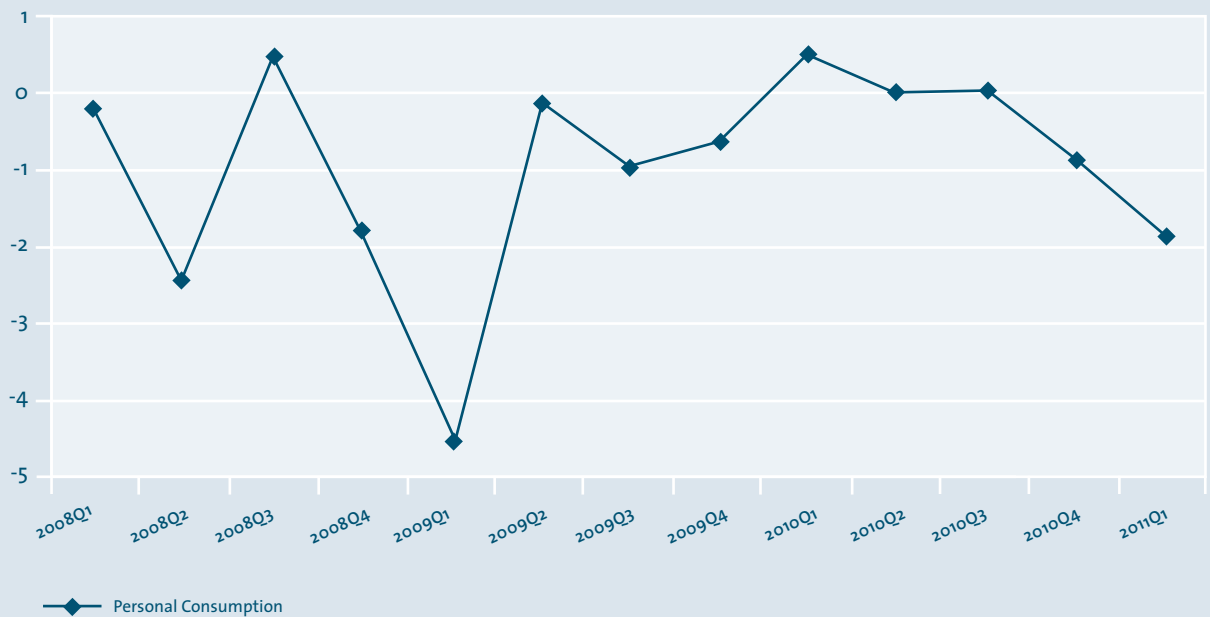
Total retail sales in the first quarter of 2011 were 2.3 per cent lower in volume terms than the final quarter of 2010. Retail sales (excluding the motor trade) were marginally higher (0.1 per cent) in the first quarter of 2011 compared to the final quarter of 2010, seasonally adjusted. However, trends in the first quarter were affected by the bad weather in December, which had the effect of switching some sales from December to January, so allowing for this would indicate a continuing decline. Retail sales excluding the motor trade have fallen in each month since January 2011.

Public Consumption

Public consumption refers to current public spending on goods and services including the public-service pay bill.⁸ Public consumption has to date fallen by less than the other components of domestic demand with a fall of 7.7 per cent between 2007 and 2010. In 2010 public consumption fell by 3.8 per cent, which exceeded the fall in private consumption in that year of 0.8 per cent. Under the government's projections as set out in the *Stability Programme Update (SPU)* of April 2011, this element of demand is expected to decline in each year to 2015.

⁸ Direct government payments including social welfare payments and interest expenditure are not included in public consumption.

Figure 1.7 Quarterly Percentage Change in the Real Volume of Personal Consumption, Q1 2008–Q1 2011



Source CSO, Quarterly National Accounts, June 2011

Role of Exports and Domestic Demand

Previous experience shows that substantial and sustainable employment growth depends on achieving growth in both exports and domestic demand (Table 1.7). Ireland's most successful period of employment growth, between 1993 and 2000, involved a combination of exceptionally strong growth in exports (annual growth of 17.7 per cent) and domestic demand (8 per cent). The subsequent period (2000 to 2007) involved a slowdown in both export growth and domestic demand but the slowdown in export growth was more pronounced. While the growth of domestic demand was at a similar rate to export growth in this period, the growth of domestic demand came to rely excessively on unsustainable credit as discussed above.

1.2.6 Balance of Payments

The sharp rise in investment during the economic boom led to the emergence of a deficit in the current account of the balance of payments. Other peripheral members of the euro area also experienced a rise in deficits in the current account of the balance of payments (NESC, 2010a). With the collapse of investment in conjunction with the recovery in exports, Ireland's balance of payments deficit has largely been eliminated (Figure 1.8). In 2010 there was a small surplus in the current account of the balance of payments of 0.6 per cent of GNP and the SPU projects a rising current account surplus in the coming years.

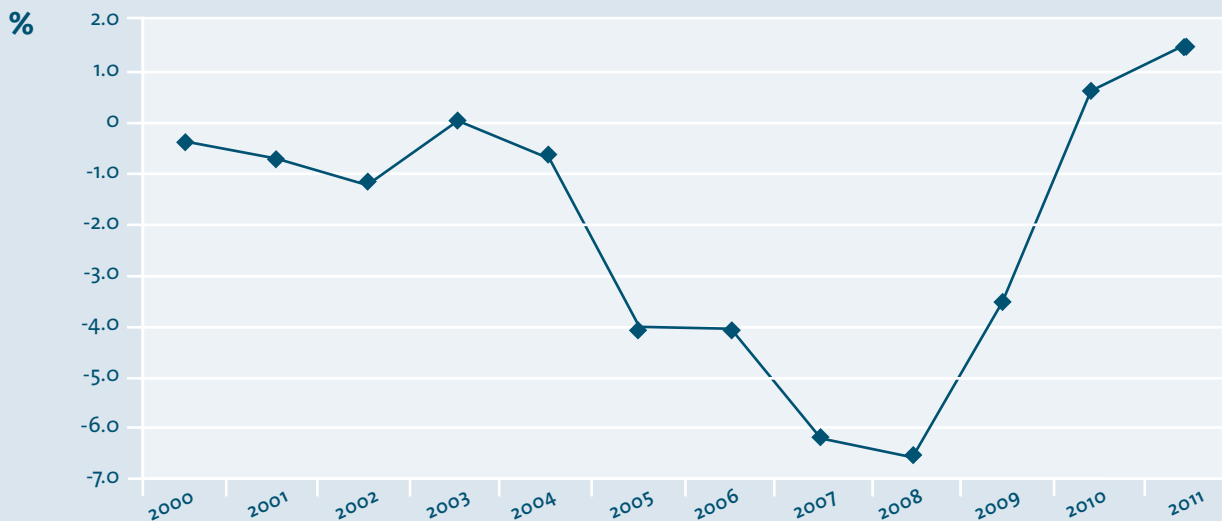
Table 1.7 Exports and Domestic Demand Annual Percentage Change, 1960–2010

	Exports	Domestic demand
1960–1980	8.4	4.7
1980–1987	8.2	0.2
1987–1993	9.5	2.5
1993–2000	17.7	8.0
2000–2007	5.6	5.2
2007–2010	0.2	-6.8

Source Calculated from European Commission AMECO database and CSO, National Income and Expenditure, June 2010.

The current account of a country's balance of payments can be viewed as the combination of the government's financial balance (i.e., the government deficit or surplus) and the private sector's financial balance (i.e. private savings less private investment). A large government financial deficit and a balance of payments current account moving into surplus means that there is a large private sector financial surplus similar in size to the government's deficit. With the current account in surplus, it means that the country as a whole is not engaged in net foreign borrowing to sustain its income. The State is undertaking a high level of borrowing and this is mostly foreign borrowing. At the same time, the private sector is either repaying debts or acquiring assets (including, for example, through pension funds) at a similar rate to the rise in the State's foreign borrowing. The elimination of the deficit in the country's balance of payments is a significant indicator of economic resilience.

Figure 1.8 Balance of Payments, Current Account, Percentage of GNP 2000–2011



Source CSO, Balance of Payments. 2011 forecast from the Department of Finance (2011)

1.2.7 Output by Sector

Construction

Developments in construction investment have been discussed in Section 1.2.5.⁹ Value added in construction was €4.4 billion or 3.1 per cent of GDP in 2010. The sector peaked as a share of GNP in 2006 when it represented 10.4 per cent of GDP (€16.2 billion). It peaked in volume terms in 2007 and since then has had by far the largest decline in real value added of any sector of the economy. Real value added in this industry fell by 52.5 per cent between 2007 and 2010. Construction output has continued to fall in 2011.

Services

Services value added represented around two-thirds of GDP in 2010. Output of services declined by 7.9 per cent between 2007 and 2010, less than the total decline in GDP in this period (10.1 per cent). Three categories of services output are identified by the CSO in the national accounts: distribution, transport and communications; public administration and defence; and other services. Within services, the largest fall in output has been in distribution, transport and communications with a fall of 15.3 per cent between 2007 and 2010. The output of 'other services', which covers the larger part of both private and public services, fell by 5.9 per cent between 2007 and 2010, while public administration output fell by 2.5 per cent in this period. Services output fell by 2.3 per cent in 2010 in volume terms. In the first quarter of 2011, services output increased by 0.7 per cent. This was the first quarterly increase in services output since the third quarter of 2008. There is further discussion of developments in services in Section 1.3 below on employment and unemployment.

Manufacturing

In examining trends in manufacturing, it is helpful to consider 'modern' and 'traditional' manufacturing separately. The breakdown of modern manufacturing and other industrial sectors as defined by the CSO is shown in Table 1.8. Modern manufacturing consists of the very high value-added sectors that are predominantly foreign-owned. Modern manufacturing represents around 57 per cent of industrial value added (excluding construction). Its share of employment, however, is considerably lower at around one-third. The traditional sectors refer to all other industrial sectors.

Since the onset of the recession, the decline in manufacturing output has been less steep than the decline in output of the economy as a whole. Between 2007 and 2009, manufacturing output fell by 3.4 per cent. There was no overall decline in the 'modern' sector of manufacturing with a slight increase in output of 0.7 per cent. Output in traditional manufacturing fell by 9.3 per cent, also less than the economy-wide decline in output.

The resilience of output in manufacturing between 2007 and 2009 is due to the pharmaceutical sector. Between 2007 and 2009, the output of this sector

⁹ Value added in construction is not the same as investment. Construction investment is a measure of total expenditure on construction. This measure does not make deductions for inputs purchased so construction investment is greater than the value added within the sector itself.

increased by over 15 per cent. There is evidence that the pharmaceutical sector has remained resilient due to a number of factors. First, the sector is predominantly export-focused; therefore the domestic recession is of minor consequence to this sector. In addition, there is evidence that the pharmaceutical sector in Ireland has been offsetting the erosion in its cost competitiveness by an increasing focus on productivity improvement and efficiencies gained through lean manufacturing and a focus on cost reduction. There were 28,200 people employed in pharmaceuticals in 2009, which represented around 13 per cent of manufacturing employment. Employment in pharmaceuticals declined by 8.3 per cent between 2007 and 2009.

Table 1.8 Gross Value Added and Employment in Modern Manufacturing

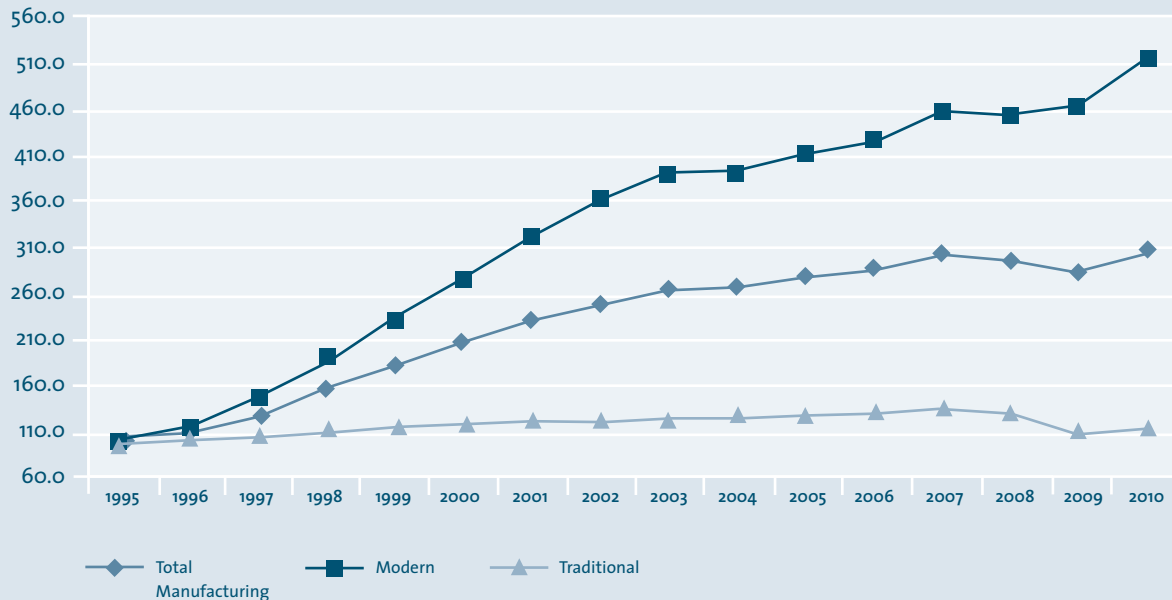
	Gross Value Added 2005 (% of total)	Employment 2010 Q 4 (numbers employed, 000s)	Employment 2010 Q 4 (% of total)
Modern Sectors	56.8	64.6	32.3
Chemicals and chemical products			
Basic pharmaceutical products	42.9	42.3	21.1
Reproduction of recorded media, and Medical and dental instruments			
Computers, electronic and optical products, and Electrical equipment	14.1	22.3	11.1
All Other Sectors ('Traditional')	43.2	135.4	67.7
Total Industry, excl. construction	100.0	200.1	100.0

Source CSO (2011), Industrial Production and Turnover

By contrast, the output of all of the other sectors within modern manufacturing fell sharply with the output of computers down by 34.5 per cent and electrical equipment by 41.7 per cent. In traditional manufacturing, there were large declines in output in almost every sector. Output in the food sector fell by 6.2 per cent between 2007 and 2009. Output in the dairy industry was stable over this period¹⁰ but there was a sharp decline in meat output of 22.5 per cent. Output fell by over 50 per cent in two traditional sectors (wood and wood products, and non-metallic minerals); both of these are very reliant on the construction sector. Output of machinery and transport equipment fell by just over 30 per cent.

¹⁰ However, the value of turnover for the dairy sector fell by 13.5 per cent between 2007 and 2009 as a result of lower prices.

Figure 1.9 Output in Manufacturing, 1995–2010
1995=100



Source CSO (2011), Industrial Production Volume and Turnover Indices

A recovery in manufacturing output began in 2010 with an increase in manufacturing output of 8.3 per cent. As in earlier years, there was a large increase in the output of chemicals and pharmaceuticals (18.6 per cent) but an encouraging feature of 2010 is that the growth of output was broadly based. Output for the combined modern sectors increased by 10.7 per cent. Output of electronic and optical products (excluding computers and components) increased by 16.4 per cent in this period, while ‘other manufacturing’, which includes medical instruments, increased by 20.6 per cent. Some sectors of modern manufacturing had sharp falls in output for this period: computers (-45.0 per cent) and electrical equipment (-14.4 per cent).

Output also recovered in traditional manufacturing with an increase in output of 1.9 per cent in 2010. This growth rate was depressed by negative carryover effects of falling output in 2009.¹¹ A better picture of the real recovery in output during 2010 is captured by focusing on the increase in output in the final quarter of 2010 compared to the final quarter of 2009. Traditional manufacturing output in the final quarter of 2010 was 4.3 per cent higher than the corresponding quarter of

¹¹ Carryover effects between two years can be defined as the annual change in a variable in a year if the variable in question remained at the same level as the final quarter of the preceding year. It captures the effects in annual terms of changes that have already taken place. When substantial quarterly falls take place in a variable in one year (such as 2009), this will lead to a negative annual growth rate in the following year (2010). This will occur even if no further quarterly changes take place in the year in question (here, 2010). If there had been *no change* in traditional manufacturing output in 2010, the carryover effects of earlier changes in 2009 would have resulted in an annual fall in traditional manufacturing output of 1.9 per cent between 2009 and 2010. Actual increases in traditional manufacturing output in 2010 more than offset the fall that would have occurred due to these negative carryover effects.

2009. Traditional manufacturing sectors in which output in the final quarter of 2010 had increased from the final quarter of 2009 were as follows: food, drinks, clothing, leather, basic metals, metal products, other machinery equipment and transport equipment.

One of the case studies carried out was at Keenan's and this highlights that key to this recovery has been a continued commitment to innovation. This is evident in the company's investment in R&D in areas such as nutrition, but also investment in customer databases and IT algorithms, which allows the company to continually refine the service they offer customers.

Agriculture

In terms of real (constant price) value added, the agricultural sector has fallen by less than GDP. Gross value added in constant prices for agriculture, forestry and fishing declined by 2.3 per cent between 2007 and 2010. However, income in the agricultural sector has been exceptionally volatile over the last few years.¹² There were large declines in 'entrepreneurial income' (i.e. income after payment of interest, rent and wages) of the agricultural sector in 2008 (18.5 per cent) and 2009 (35.0 per cent), followed by a very strong recovery in 2010 when income rose by around 45 per cent. The estimated nominal value of aggregate agricultural income in 2010 was still 23.3 per cent below its level of 2007. Average family farm income increased by around 50 per cent in nominal terms in 2010, following substantial declines in 2008 and 2009. The nominal value of average family farm income in 2010 was around €18,000, excluding other sources of farm household income; this was 8.6 per cent below its nominal value in 2007.

The strong volatility of agricultural income in recent years has been driven mostly by price and cost movements. The major influence on the fall in agricultural income in 2008 was rising input and overhead costs, particularly increases in the costs of fertiliser and feedstuffs. The major factor in the huge fall in agricultural income in 2009 was the fall in the value of milk output of 32.4 per cent (€527 million). This was mainly due to the fall in milk prices. The impact of dairy price movements is also evident in the volatility in the value of dairy exports shown in Table 1.1 above.

The biggest influence on the strong increase in agricultural income in 2010 was the recovery of global dairy markets. The value of milk output in 2010 rose by almost 40 per cent (€439 million), while volume increased by 7.4 per cent. The value of crops output rose by 6.0 per cent (€82 million) while the value of livestock increased by 2.3 per cent (€53 million). Total agricultural output rose by 12.2 per cent in value terms and by 2.4 per cent in volume terms in 2010. A fall in interest payments of 15.6 per cent was an additional factor that boosted income of the sector in 2010. Notwithstanding the recovery in 2010, farm income is still very heavily reliant on direct payments from the EU.

¹² Income in agriculture is more volatile than real value added both because of output price movements and the trend in input costs. On the other hand, subsidies help to stabilise agricultural income. The level of direct payments exceeded the level of entrepreneurial agricultural income in the years 2008 to 2010.

Farm households benefitted from employment opportunities during the boom years but since 2007 there has been a significant decline in employment of farmers and spouses in other occupations. In 2007, 58 per cent of either farm operators or spouses had off-farm employment, while by 2010 this had fallen to 49 per cent.

1.3 Employment and Unemployment

Employment

Ireland's economic crisis has led to a huge fall in the level of employment. Total employment peaked in the final quarter of 2007 and then fell by around 15 per cent (324,000 people) in the period to the first quarter of 2011. The largest decline in employment was in 2009 with a fall of 8.1 per cent in that year. The fall in employment in 2010 was lower with a fall of 4.2 per cent. By the first quarter of 2011 the level of employment at around 1.8 million had returned to approximately its level at the start of 2004. Employment in 2010 was around 650,000 above the level of 1993.

The available evidence indicates that employment is continuing to fall in 2011 but at a slower rate. There was a quarterly fall in employment in the first quarter of 2011 compared to the final quarter of 2010 of 0.5 per cent on a seasonally adjusted basis. This was the smallest quarterly fall in employment since the first quarter of 2008. This quarterly fall in employment was driven by a fall in accommodation and food service employment of 10.2 per cent. Of the fourteen employment sectors shown by the CSO in the Quarterly National Household Survey (QNHS), employment increased in six sectors in the first quarter of 2011 including professional and scientific services and financial services (see Table 1.9).

The fall of employment in Ireland in this crisis was the largest experienced in the OECD. A relatively large fall in employment in Ireland would be expected in view of the fall in output. However, a notable feature of this recession is that in most OECD countries, the fall in hours worked was less than the fall in output. This implies that productivity on an hourly basis fell in most OECD countries. By contrast, Ireland had among the largest increases in hourly productivity during 2008 and 2009. In addition, in many European countries the fall in labour input took the form of cuts in working hours more than cuts in employment. These two features have meant lower employment declines in many countries than would have been expected. Germany is a particularly striking example. Despite a fall in GDP of 4.9 per cent in 2009, total employment did not decline; Germany experienced a modest fall in employment in 2010 (0.4 per cent) (OECD, 2010). The experience of other European countries in sustaining employment in the face of falling output raises the question as to whether there is scope for Ireland to learn from this experience. This issue is considered in the forthcoming NESC study on unemployment and active labour market policies.

The exceptionally large fall in employment in Ireland since 2007 was driven by the huge decline in the construction sector (Table 1.9). Employment in this sector has fallen by close to 60 per cent since the final quarter of 2007 and represents approximately half of the total fall in employment. Industrial employment

(excluding construction) also experienced a large fall in this period of 16.1 per cent. There was an unusually large fall in employment in agriculture. The CSO has indicated that recorded agricultural employment has been influenced by the introduction of an updated sample.¹³

The change in the structure of employment in the economy is an influence on the rise of hourly productivity noted above. The disproportionate fall in construction employment has the effect of increasing the share of higher-productivity sectors in the economy. This in itself would boost average economy-wide productivity, even without an increase in productivity in any given sector. This has implications for unit wage costs, as discussed below (Section 1.5). In the years prior to the economic downturn, structural change in the economy had the opposite effect: the relative increase in the share of lower-productivity sectors in the economy had the effect of depressing productivity growth (Sexton, 2007).

Total services employment fell by around 6 per cent from the end of 2007 to the first quarter of 2011, considerably less than the fall in economy-wide employment. There is considerable diversity in employment trends across service sectors. In absolute terms the most significant fall has been in retail and wholesale trade, with a fall in numbers employed of over 51,000 (16.3 per cent). The loss of employment in this sector was equivalent to just over half of the net loss of services employment. In percentage terms the largest fall in services employment was in administrative and support services (24.1 per cent), which represented 19,800 in terms of the fall in numbers employed. There was also a major fall in employment in accommodation and food service with a fall in employment of almost 23 per cent or 30,500 in terms of numbers employed from the final quarter of 2007 to the first quarter of 2011.

Employment in financial services declined by less than other major services areas with a fall of 3.4 per cent between the final quarter of 2007 and the first quarter of 2011. The level of employment in information and communication services at the start of 2011 was at approximately the same level as at the end of 2007. The resilience of employment in this area is a reflection of the strong growth of services exports.

Some sectors within services have experienced an increase in employment since 2007: public administration and defence (an increase of 3.3 per cent between the final quarter of 2007 and the first quarter of 2011); health and social-work activity (an increase of 5.3 per cent), education (an increase of 7.5 per cent) and other service activities (an increase of 4.5 per cent). These areas (excluding other service activities) of services employment growth are dominated by public-service employment. However, health and education also include private employment.

Public-service employment is not identified as a category within the Quarterly National Household Survey (QNHS). The CSO collects data on public-sector employment in a separate Earnings Hours and Employment Costs Survey (EHECS); this survey is available from the first quarter of 2008. This survey shows that notwithstanding the rise in health and education employment as shown by the QNHS, employment in the public sector is falling. According to this survey, employment in the public sector

¹³ The CSO intends to revisit this issue when the results of the Census of Agriculture 2010 and the Census of Population 2011 become available.

Table 1.9 Employment by Sector, Seasonally adjusted, Q4 2007 and Q1 2011

	2007 Q4	2011 Q1	% Change 2007 Q4 to 2011 Q1	Change 000s 2007 Q4 to 2011 Q1	Quarterly % Change from 2010 Q4 to 2011 Q1
Agriculture, forestry and fishing	114.5	85.2	-25.6	-29.3	0.1
Industry	284.2	235.2	-17.2	-49.0	-1.2
Construction	262.3	108.1	-58.8	-154.2	-1.1
Wholesale and retail trade	313.7	262.7	-16.3	-51.0	-1.9
Transportation and storage	97.8	93.8	-4.1	-4.0	-2.1
Accommodation and food service	133.8	103.3	-22.8	-30.5	-10.2
Information and communication	70.8	69.8	-1.4	-1.0	-0.6
Professional, scientific, technical	112.8	102.3	-9.3	-10.5	4.5
Administrative & support services	82.1	62.3	-24.1	-19.8	4.2
Public administration and defence	103.6	107	3.3	3.4	2.4
Education	138	148.4	7.5	10.4	-0.7
Health and social work activities	220.8	232.4	5.3	11.6	-0.6
Financial and real estate	104	100.5	-3.4	-3.5	2.8
Other services	101.6	104.1	2.5	2.5	4.5
Total services	1479.0	1386.6	-6.2	-92.4	-0.4
Total employment	2,140.7	1,816.9	-15.1	-323.8	-0.5

Source CSO, Quarterly National Household Survey, June 2011

excluding semi-state bodies (mainly commercial bodies) declined by 2.2 per cent (8,000 people) between the first quarter of 2008 and the first quarter of 2011. The recruitment of 5,000 temporary staff to work on the 2011 Census had the effect of boosting public service employment in the first quarter of 2011. When these staff are excluded, public service staff (excluding semi-states) fell by 3.7 per cent (13,200 people) between the first quarter of 2008 and the first quarter of 2011.

Information on public-service employment is also published by the Department of Finance. The data it published differs from the CSO as the Department of Finance data is based on whole-time equivalents while the CSO data is based on numbers employed. The Department of Finance figures show a smaller fall in public-service employment than the CSO: these figures indicate that employment in the public service, based on whole-time equivalents, fell by 0.7 per cent between the end of 2007 and the end of 2010.

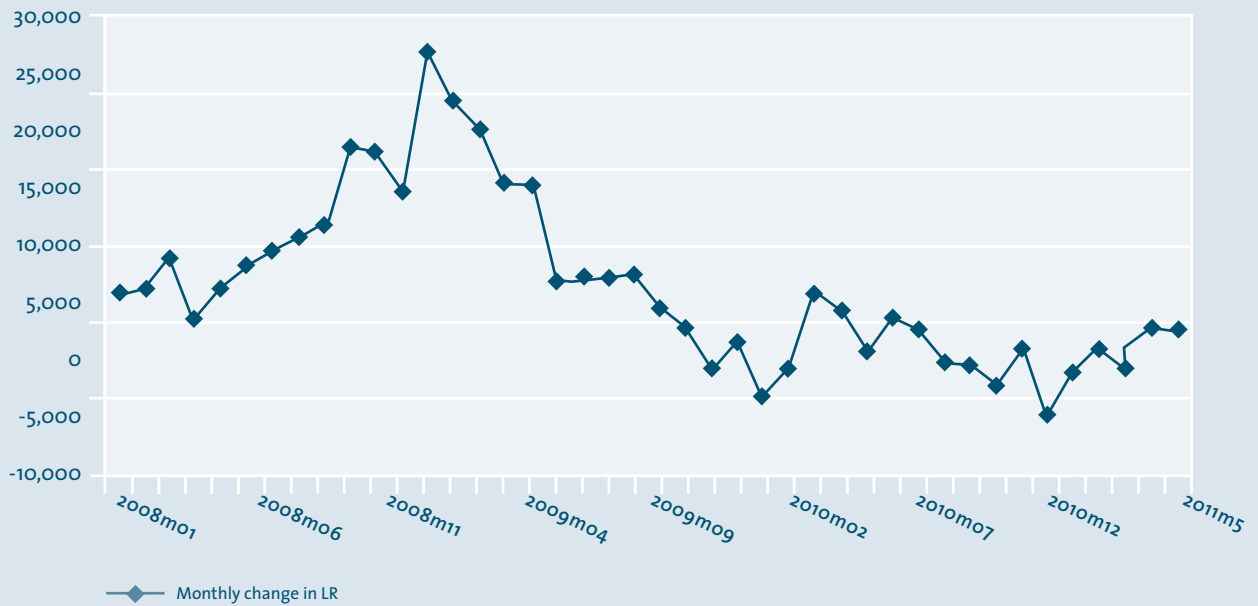
The fall in employment has been disproportionately high among non-Irish nationals. Employment of non-Irish nationals by 41.3 per cent from a peak of 345,800 in the final quarter of 2007 to 202,900 in the first quarter of 2011. The fall in employment among Irish nationals over the same period was just under 9 per cent (not seasonally adjusted).

Figure 1.10 Unemployment Rate in Ireland and the Euro area 1995–2012



Source European Commission, AMECO database

Figure 1.11 Monthly Change in the Live Register, Seasonally Adjusted January 2008–June 2011



Source CSO, Live Register, June 2011.

Figure 1.12 Quarterly Percentage Change in Employment
by Quarter, Q1 2008–Q1 2011



Source CSO, Quarterly National Household Survey, June 2011.

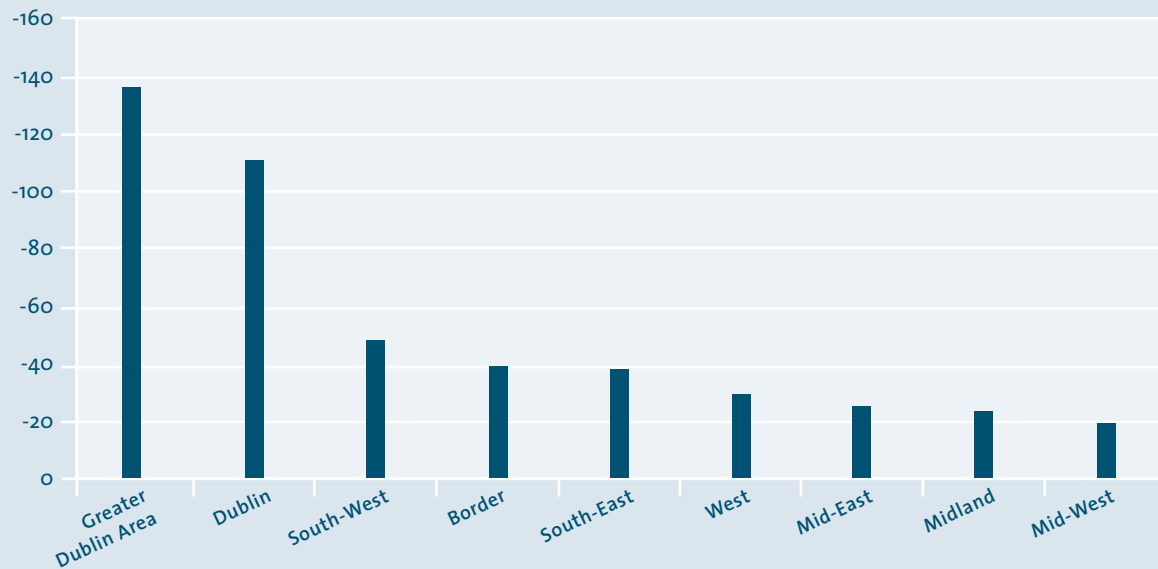
Unemployment

Prior to the economic crisis, Ireland’s unemployment rate was around 4 per cent while in 2011 it is over 14 per cent. This is the highest level of unemployment since 1994. There has been a dramatic increase in the numbers on the Live Register. The monthly increase peaked in January 2009 when the register increased by 27,000 (seasonally adjusted) in a single month. Since then the Live Register has grown at a considerably lower rate (Figure 1.11). The numbers on the Register (seasonally adjusted) reached a peak of 448,100 in August 2010. There were almost 460,000 people on the Live Register in June 2011 (not seasonally adjusted).

Not everyone on the Live Register is unemployed. The Live Register includes casual and part-time workers who are entitled to sign on for jobseeker’s benefit or allowance. In June 2011 there were almost 86,000 casual and part-time workers on the Live Register, representing 18.7 per cent of the total. The primary measures of unemployment is derived from the QNHS based on the International Labour Office (ILO) classification. According to the ILO classification people are considered to be unemployed if they are not engaged in paid employment, are available for employment and have taken specific steps to secure employment in the past four weeks. On this basis the level of unemployment was 295,700 or 14.0 per cent in the first quarter of 2011. The QNHS indicates that there has been relatively little change in the number of people unemployed (not seasonally adjusted) from the second quarter of 2010 to the first quarter of 2011.

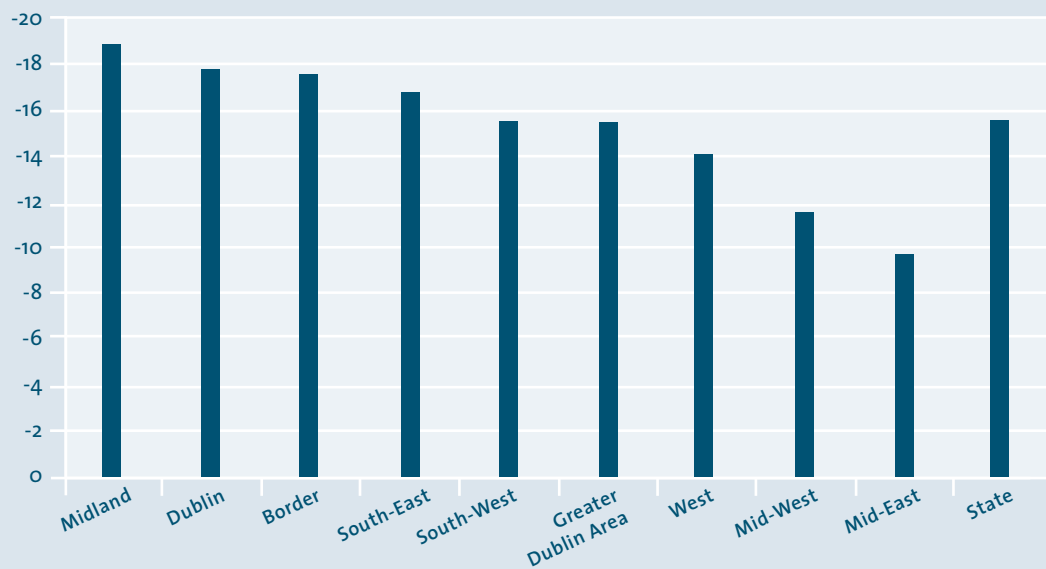
The long-term unemployment rate has increased from 5.3 per cent in the first quarter of 2010 to 7.8 per cent in the first quarter of 2011. Of the 295,700 people unemployed in the first quarter of 2011, over half (55 per cent) were classified as long-term unemployed. This compares to a figure of 41 per cent in the first quarter of 2010 and 22 per cent in the first quarter of 2009.

Figure 1.13 Change in Employment by Region in o00s, Q4 2007–Q1 2011

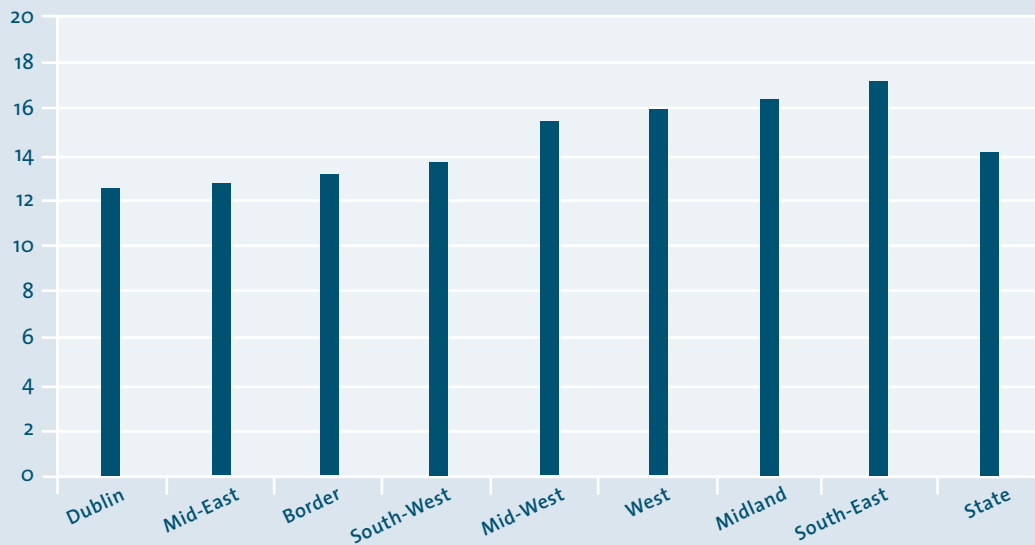


Source CSO, Quarterly National Household Survey, June 2011.

Figure 1.14 Percentage Change in Employment by Region, Q4 2007–Q1 2011



Source CSO, Quarterly National Household Survey, June 2011.

Figure 1.15 Unemployment Rate by Region, Q1 2011

Source CSO, Quarterly National Household Survey, June 2011.

Regional Employment

All regions have had substantial falls in employment (Figure 1.13 to Figure 1.14). In absolute terms, by far the largest fall in employment took place in the Greater Dublin Area with a fall in employment of around 137,000 from the final quarter of 2007 to the first quarter of 2011; this represented almost 41 per cent of the decline in national employment. The larger part of this fall took place in Dublin itself (around 112,000). In percentage terms, the largest fall in employment over this period was in the Midland region (19.0 per cent), followed by Dublin (17.8 per cent) and the Border (17.6 per cent). The Mid-East region, which surrounds Dublin, had the smallest fall in employment over this period (9.8 per cent). If the Mid-East and Dublin are viewed as one region, the fall in employment (15.5 per cent) was in line with the national average (15.6 per cent). Unemployment has increased sharply in all regions; see Figure 1.15. In the first quarter of 2011, the highest rate of unemployment was in the South-East (17.2 per cent) followed by the Midland region (16.4 per cent) and the Mid-West region (15.5 per cent). The lowest rates of unemployment were in Dublin (12.5 per cent), the Mid-East (12.7 per cent) and the Border (13.1 per cent).

Jobless Growth

The Irish economy is expected to show a modest recovery in GDP terms in 2011. The prospect of economic recovery raises the concern that a recovery in terms of GDP or GNP will not lead to much employment growth. This was a concern in Ireland in the 1980s and early 1990s and was the subject of a NESC report (NESC, 1993). The long-run trend in GDP, employment, and productivity as measured by GDP per worker is shown in Table 1.10. These figures would seem to confirm the first half of the 1980s as a period of jobless growth; between 1980 and 1987, GDP grew by an annual average of 2.5 per cent while employment declined by an annual average of 0.8 per cent. However, this

Table 1.10 Annual Percentage Change in GDP, Employment and GDP per worker, 1960–2010

	GDP	Employment	GDP/worker
1960-1980	4.5	0.5	4.0
1980-1987	2.5	-0.8	3.4
1987-1993	4.3	0.9	3.4
1993-2000	9.1	5.1	3.8
2000-2007	5.0	3.3	1.7
2007-2010	-3.5	-4.5	1.1

Source Secretariat calculations based on European Commission, AMECO database and CSO (2011), National Income and Expenditure.

overstates real economic growth in the period. There was negligible growth in terms of GNP with average annual growth of 0.5 per cent; the GDP that occurred was mainly due to growth in manufacturing exports in a limited number of sectors. The weak employment growth experienced, is better viewed as a result of inadequate economic growth rather than ‘jobless growth’.

Economic growth returned from 1987 and the average annual rate of GDP growth between 1987 and 1993 was 4.3 per cent. Annual employment growth of less than 1 per cent in this period could be viewed as disappointing. However, the annual rate of productivity was 3.4 per cent, which was in line with the long-term average since 1960. With long-term annual productivity growth in the region of 3.5 to 4 per cent, it is necessary to achieve GDP growth of this order of magnitude to stabilise employment. Against this background, the rate of annual employment growth between 1987 and 1993 (0.9 per cent) is what might be expected.

The period between 1993 and 2000 (the Celtic Tiger era) can be clearly seen as distinctive in Table 1.10. This period was distinguished by exceptionally strong growth of both GDP and employment. Productivity was comparable to earlier periods (somewhat faster than in the period since 1980). The fact that GDP growth was exceptionally strong and well above productivity growth resulted in unprecedented employment growth in this period.

From an examination of post-war trends in Irish economic growth and employment growth over the post-war period, Kennedy reached this conclusion:

A review of trends of Irish experience throughout the post-war period does not support the popular notion of jobless growth. Rather that experience suggests that Ireland, as a laggard in the application of new technology, has the potential for a strong growth in productivity (in the region of 3 per cent per annum), so that employment is unlikely to grow unless the growth rate of output is above this. The experience also shows, however, that once the growth of output was raised above the underlying trend rate of productivity growth, it was translated mainly into increased employment. In other words, changes in output growth are strongly related to changes in employment growth (Kennedy, 1998: 35).

Productivity continues to grow in the Irish economy so it is still necessary to achieve some threshold of economic growth in order to stabilise employment. As the economy has reached higher levels of productivity and income, somewhat slower productivity growth can be expected compared to the long-run average experienced since the 1960s. Over the period 2011 to 2014, the projected productivity growth in the economic outlook of the Department of Finance (2011) is an annual growth rate of 1.7 per cent (based on GDP per worker), so average GDP growth of this order of magnitude is now required to stabilise employment. GDP growth is expected to be greater than this in the coming years with the Department of Finance projecting annual GDP growth of 2.5 per cent over this period.

1.4 Household Income and Earnings

The macro-level measures of income overstate the real fall in income as experienced by households. Information is available on disposable (after tax) income per household from the CSO's Survey of Income and Living Conditions (SILC). The SILC data also show that disposable household income peaked in 2008 and then fell by 6.3 per cent in nominal terms in 2009 (4.7 per cent real).¹⁴ The net change in disposable income per household from 2007 to 2009, according to the SILC data, was 4.2 per cent in nominal terms (5.6 per cent in real). The change in total household income depends on the change in the number of households as well as the change in income per household. But allowing for potential household growth, the fall in total household income over the period 2007 to 2009 would be far less than the fall in nominal GNP of 19.1 per cent.¹⁵

The question arises as to how the fall in household income has been significantly lower than the fall in GNP. There are two key factors. First, the non-agricultural labour share of GNP increased from 48.2 per cent in 2007 to 55.7 per cent in 2009¹⁶; in this period, the fall in profits (in both the financial and non-financial sectors) has been far higher than the fall in wage and household income. Second, it is due to the influence of the automatic stabilisers of public expenditure. The increase in transfer payments (in particular the social welfare payments that people receive when losing employment) partly shelters households from the decline in GNP; of course this effect is also reflected in the rise in the government deficit.

There has been a large increase in household savings (Figure 1.16). The CSO estimates that household savings increased from €3.6 billion in 2008 to over €11 billion in 2009. Savings as a percentage of disposable income increased from 3.9 per cent in 2008 to 12.3 per cent in 2009. This rise in savings was a major influence on the fall in consumer spending. Consumer spending fell by €10.2 billion in 2009 or 11.3 per cent in nominal terms. This is far more than the fall in net disposable household income, which fell by €2.3 billion or 2.3 per cent in 2009.

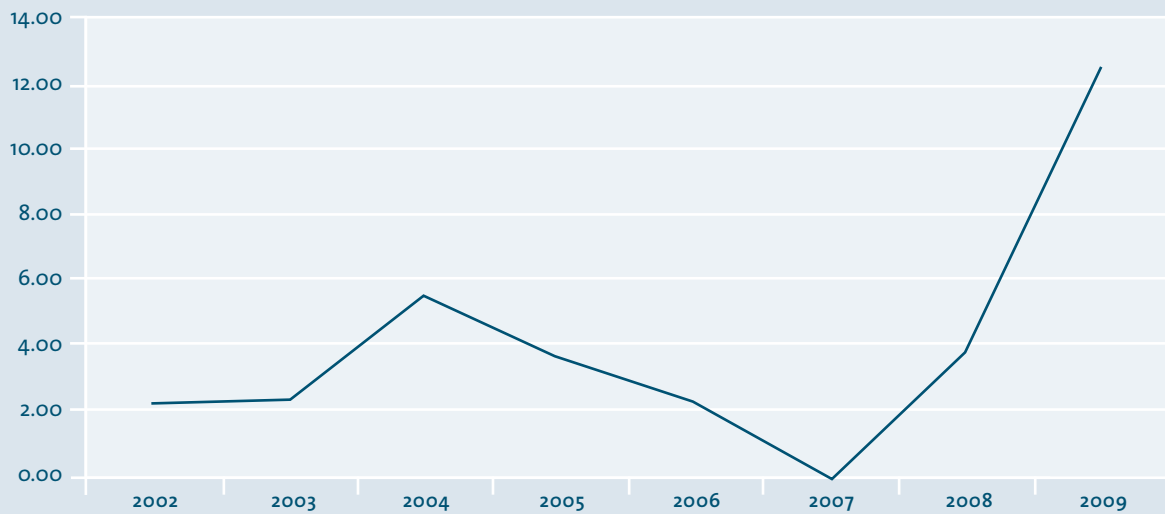
¹⁴ Based on the Harmonised Index of Consumer Prices (HICP) measure of inflation.

¹⁵ Information on total net disposable (after tax) income of households is available from the CSO's Institutional Sector Accounts up to 2009. This shows that total net disposable income of households actually increased in nominal terms over the period 2007 to 2009 by 3 per cent; it peaked in 2008 and then fell by 2.3 per cent in nominal terms in 2009. There are a number of dimensions to the definition of household income in the Institutional Sector Accounts that affect its change over this period. One factor that boosted the disposable income of households in 2009 was the fall in interest payments. Two other less obvious factors affected the change in household disposable income as defined in the CSO's institutional accounts. First, pension contributions are not counted as part of household disposable income as they are regarded as a 'social contribution'. Hence, a fall in pension contributions has the effect of increasing disposable income. Second, in 2009 the sharp fall in capital gains taxes had the effect of boosting disposable income. At the same time the fall in actual capital gains is not counted as a fall in disposable income as capital gains are not part of income.

¹⁶ For 2010 the non-agricultural labour share of GNP was 53.6 per cent.

Household savings is defined as the difference between net (after tax) household income and personal consumer spending. Household savings can be used to accumulate assets (typically bank deposits) or to repay debts. Savings data refer to the flow of new savings, which is distinct from both the accumulated stock of bank deposits and the stock of household debt. Households in aggregate at present have both a rate of current savings and a high stock of debt. Some savings are being used to repay debt.

Figure 1.16 Household Savings as a Percentage of Disposable Income, 2002–2009



Source CSO (2010), Institutional Sector Accounts: Non-Financial

1.4.1 Earnings

The CSO introduced a new earnings series from 2008 while a number of existing series were phased out from around that time. We focus here on trends from 2008. The trend in average weekly earnings by sector from the first quarter of 2008 to the first quarter of 2011 is shown in Table 1.11. The economy-wide annual fall in gross nominal wages over this period was 4.2 per cent. There was an annual increase in economy-wide hourly earnings in this period of 2.6 per cent. The largest falls in weekly earnings were in arts and entertainment (17.7 per cent), accommodation and food service (16.9 per cent) and financial services (13.4 per cent). Average weekly earnings in manufacturing over this period showed a small reduction of 1.1 per cent.

CSO data indicate that the cumulative change in earnings in the private sector (6.2 per cent) was greater than in the public sector (3.7 per cent) between the first quarter of 2008 and the first quarter of 2011. However, CSO data exclude the public-service pension levy. For an employee on average public-sector earnings this was around 6 per cent of gross earnings. If this is taken into account, the fall in public-sector gross earnings would be higher than the fall in the private-sector. The

comparison of the decline in earnings in the public and private sectors is sensitive to the choice of initial date. Public-sector earnings peaked in the final quarter of 2009. From the final quarter of 2009 to the first quarter of 2011, gross public-sector earnings (excluding the pension levy) fell by 9.8 per cent; the inclusion of the pension levy would bring the decline to around 15 per cent. The decline in private-sector earnings over the same period was 4.5 per cent.

The nominal fall in wages over this period was partly offset by a fall in consumer prices at the same time. The annual fall in average consumer prices based on the Harmonised Index of Consumer Prices (HICP) from the first quarter of 2008 to the first quarter of 2011 was 1.5 per cent, while there was a larger fall in the Consumer Price Index measure (CPI) of 2.7 per cent, reflecting the fall in mortgage payments. These indices indicate that between the first quarter of 2008 and the first quarter of 2011, the real value of average gross wages in the private sector (i.e. the value of wages after taking account of the fall in prices) fell by 4.7 per cent using the HICP or 3.6 per cent using the CPI. The HICP has increased on an annual basis since January 2011, while the CPI has shown annual increases since August 2010.¹⁷ On the other hand, there have also been substantial tax increases in this period so that the fall in after-tax pay has been higher than the fall in gross earnings.

1.4.2 Household financial assets and liabilities

A key feature of the years prior to the downturn was a large rise in the financial liabilities of households, primarily mortgages. In the first quarter of 2002, the stock of household debt was roughly equal to the level of annual household income; i.e. the ratio of household debt to household disposable income was approximately 100 per cent. By the third quarter of 2007, household debt had risen to more than double the level of household disposable income (230 per cent) (Cussen and Phelan, 2010). Household financial liabilities reached a peak of €212 billion in the fourth quarter of 2008 and have since fallen by around €18 billion (8.5 per cent) to reach €194 billion in the fourth quarter of 2010 (Figure 1.17). Notwithstanding the fall in debt, the level of household debt relative to income is high by historic standards. It is argued by Cussen and Phelan that consumption will remain sluggish until debt is reduced to a level that can comfortably be serviced out of current income. The process of debt reduction contributes to the high levels of household savings noted above.

The rise in household liabilities during the boom was paralleled by a rise in household assets, both financial and housing assets. The net worth of Irish households (assets less liabilities) peaked in the fourth quarter of 2006 at a value of €647 billion. It then fell by 32 per cent to reach €440 billion in the second quarter of 2010; this meant a return to the levels of 2003. The dominant factor in the fall in the net worth of Irish households has been the fall in house prices (Cussen and Phelan, 2010).

If housing assets are excluded, the net financial worth (financial assets less liabilities) of households has increased substantially since the start of 2009, with an increase of 70 per cent from the first quarter of 2009 to reach €99 billion in the fourth quarter of 2010. This reflects households both reducing their liabilities (repaying loans) and increasing their financial assets. Financial assets can be increased both by acquiring

¹⁷ Both the CPI and HICP indices are published monthly. An annual increase in the monthly index means that the monthly value of the CPI is higher than the corresponding value one year earlier.

Table 1.11 Average Gross Weekly Earnings by Sector, Q1 2008 to Q1 2011

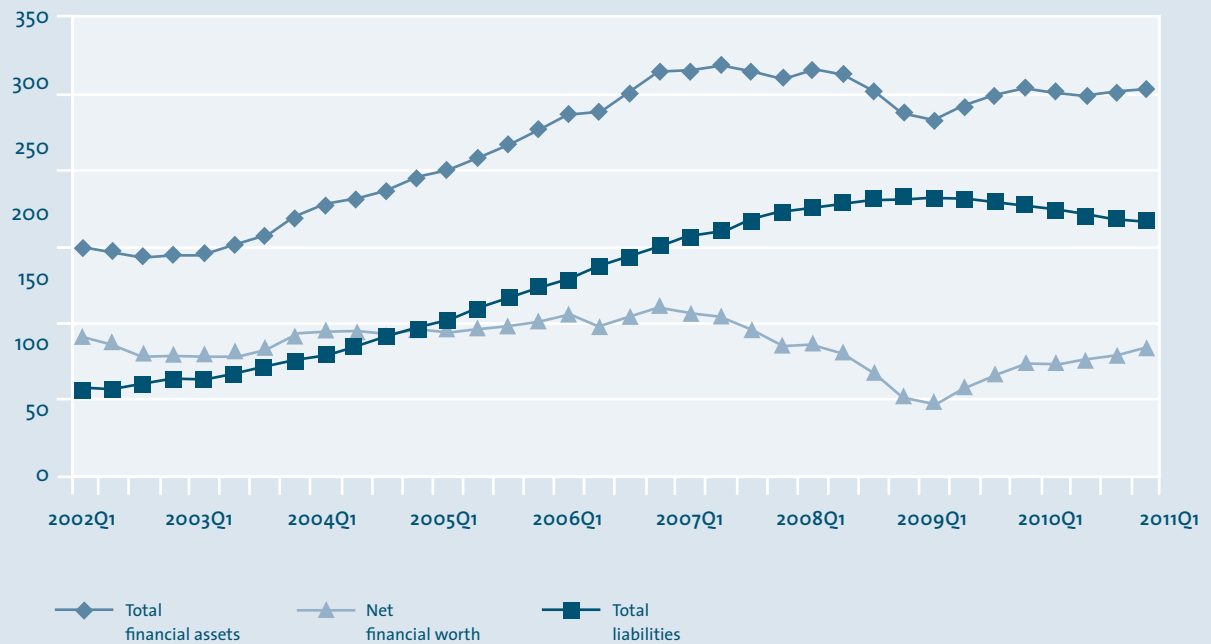
	2011 Q1	Percentage change Q1 2008 to Q1 2011	Percentage change Q1 2010 to Q1 2011
All economic sectors	€674.56	-4.2	-1.3
Private sector	€602.85	-6.2	-1.8
Public sector	€871.09	-3.7	-1.2
Industry:	€792.09	-1.0	-0.8
Mining and quarrying	€950.41	4.7	15.5
Manufacturing	€764.12	-1.1	-0.9
Utilities	€1,063.36	-7.1	-4.4
Construction	€646.68	-10.4	-10.9
Services			
– Wholesale and retail	€494.40	-2.5	2.3
– Transportation and storage	€703.41	-6.4	3.2
– Accommodation and food service	€288.62	-16.9	-9.4
– Information and communication	€990.47	-0.8	7.0
– Professional and technical	€740.77	-8.7	-13.7
– Administrative services	€491.32	-3.3	-0.4
– Public administration	€866.74	-9.9	-5.8
– Education	€796.34	-5.1	-1.4
– Health and social work	€705.01	-0.9	-0.1
– Financial Services	€973.02	-13.4	-3.5
– Arts and entertainment etc.	€398.81	-17.7	-11.9
HICP		-1.5	0.8
CPI		-2.7	2.3

Source CSO, Earnings, Hours and Employment Costs Survey

assets such as bank deposits or through revaluation of assets. During 2009 the increase in households' financial net worth was mainly due to an increase in financial assets. During 2010 the increase in financial net worth has come about mainly through a fall in liabilities.

Deposits represent by far the largest element of households' financial assets (42 per cent). This is followed by pension funds (24 per cent), life insurance funds (16 per cent) and shares and other equity (16 per cent). The value of pension-fund assets peaked in the first quarter of 2008. The value of pension assets has since fallen by around 4 per cent to reach €71 billion in the final quarter of 2010.

Figure 1.17 Financial Assets and Liabilities of Irish Households, Q1 2002–Q4 2010, €billions



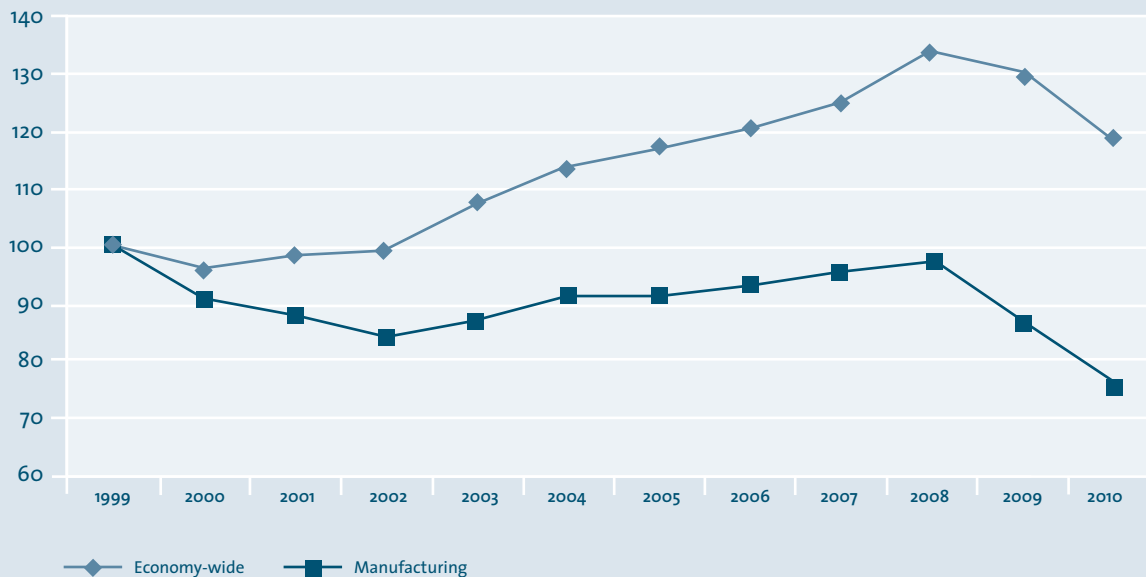
Source Central Bank of Ireland, Quarterly Financial Accounts, Quarter 4, 2010

1.5 Cost Competitiveness

There is no perfect measure that incorporates all of the complexities involved in cost competitiveness. However, a range of measures show that Ireland experienced a substantial loss of cost competitiveness in the past decade up to 2008, while since then there has been a recovery of cost competitiveness.

Perhaps the most comprehensive measure of cost competitiveness is relative unit labour costs in common currency terms. This incorporates the effect of exchange-rate changes and relative movements in wage costs and productivity. For the Irish manufacturing sector, relative unit labour costs have fallen by 25 per cent since 1999 relative to the average for Ireland’s main trading partners (Figure 1.18). However, the trend in unit labour costs in manufacturing is dominated by the high-productivity multinational sector (in particular, pharmaceuticals) so this gives a misleading impression. On an economy-wide basis, relative unit labour costs increased by 33 per cent between 1999 and 2008, signifying a loss of cost competitiveness. Between 2008 and 2010 there was a fall of 11 per cent, signifying a recovery of cost competitiveness. Box 1.3 describes the changes at leading foreign-owned pharmaceutical company.

Figure 1.18 Irish Unit Labour Costs Relative to Main Trading Partners in Common Currency Terms, 1999–2010
1999=100



Source European Commission, AMECO database and Central Bank of Ireland, Quarterly Bulletin, April 2011. The economy-wide index (from AMECO) is measured relative to 35 industrial countries. The manufacturing index is measured relative to the following main trading partners: the UK, the US, Germany, France, Italy, Belgium, the Netherlands, Spain and Singapore.

Box 1.3 Cost Competitiveness

As part of this project the Secretariat visited a pharmaceutical plant that employs 500 people. Labour accounts for 50 per cent of its costs. The company's cost competitiveness was eroded relative to its sister plants in Holland, France and Germany.

A productivity improvement system, implemented over the past five years, has allowed the company to regain much of its competitiveness. Since the system was introduced, the company doubled its production volumes while reducing headcount by one third. This was done in partnership with unions at the plant, including the introduction of a successful gainsharing model and an employee engagement strategy that supports an ongoing lean/six-sigma approach to continuous improvement.

Changing government policy around managing healthcare costs, particularly in the US, is intensifying the demand for lower costs in the industry. Where once the industry prioritised quality 'at any price', it is now recognising that costs, including labour costs, need to be controlled effectively to sustain long-term competitiveness. In Ireland, most sites introduced a pay freeze in 2010, and the majority are now embarked on significant lean/six sigma initiatives.

The trend in unit labour costs is influenced by structural change in the economy. An increase in the relative share of higher-productivity activities reduces unit wage costs, even if there is no change in actual relative wage levels. O'Brien examines the impact of structural change on Ireland's unit wage costs both within manufacturing and for the economy as a whole (O'Brien, 2011). The standard measure shows a fall in relative unit labour costs in manufacturing of 23 per cent between 2007 and 2010. A key influence on this was the increased share of the chemicals sector in manufacturing output. If the value of sectors within manufacturing is held constant (i.e. abstracting from the effects of structural change) then the fall in relative unit labour costs in manufacturing is much less dramatic, with a fall of about 9.6 per cent over the same period.

The analysis by O'Brien goes on to examine the impact of structural change across the economy as a whole on unit labour costs. The fall in the construction sector has meant that this lower-productivity sector has become a relatively smaller share of the economy while the higher-productivity manufacturing sector is now relatively larger. Between 2007 and 2010 the standard measure of relative unit labour costs for the economy-wide business sector fell by 17.5 per cent. An adjusted measure of unit labour costs is computed based on (i) holding output shares constant across broad business sectors; and (ii) holding output shares constant within the manufacturing sector. This adjusted measure shows a fall in relative unit labour costs in the business sector of 6.4 per cent. This shows a lower improvement in cost competitiveness than the standard measure but still represents a gain in cost competitiveness.

The impact of structural change is mainly manifested through productivity change so its impact is also mostly avoided if one compares compensation levels of employees; i.e. labour costs not adjusted for productivity. The trend in average compensation per employee in Ireland in common currency terms (relative to 35 industrial countries) shows a decline in relative Irish labour costs of 7.8 per cent between 2008 and 2010. Average compensation per employee in Ireland in common currency terms relative to the EU (15) fell by 3.8 per cent between 2008 and 2010.¹⁸ The smaller decline relative to the EU (15) reflects a greater weighting for the UK and no weighting for the US.

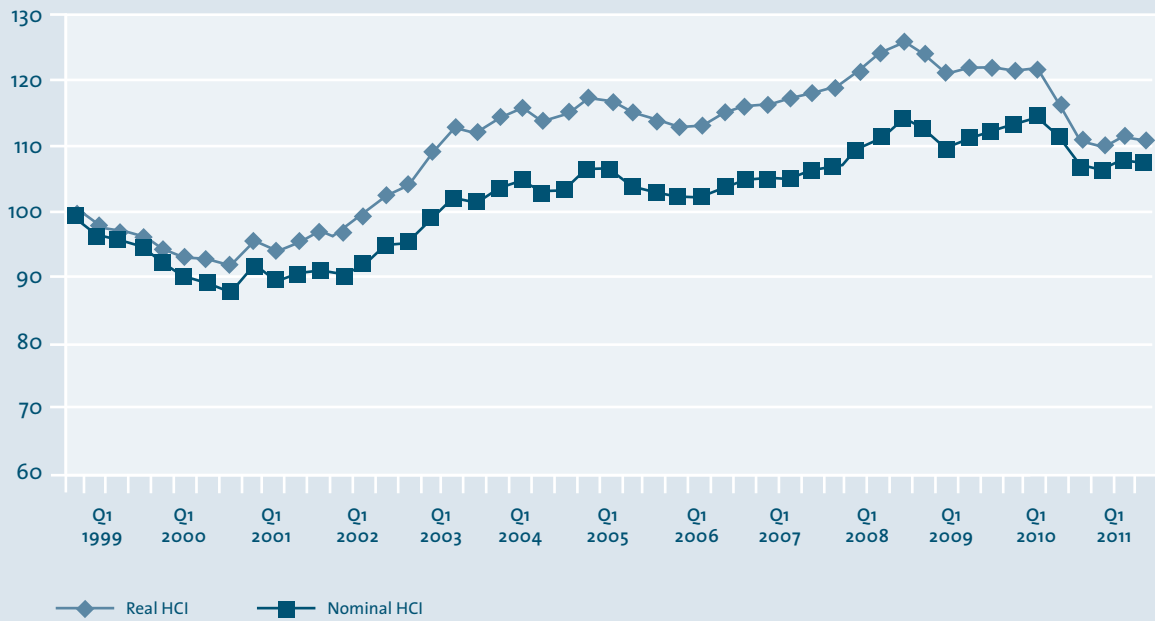
Another widely used measure of cost competitiveness is the Central Bank's Harmonised Competitiveness Indicator (HCI). This captures the movement in the average euro exchange rate, weighted in accordance with Ireland's trade pattern. When it is deflated by consumer prices, it also captures relative price movements. When measured in real (price-deflated) terms, it is a measure of Ireland's real exchange rate. A limitation of this measure is that consumer prices are not a direct measure of costs for internationally trading firms. This measure, however, gives some indication of general cost-competitiveness pressure in the economy.

Between the first quarter of 1999 and the second quarter of 2008, the nominal HCI increased by 14.1 per cent; this meant an appreciation of the nominal value of the

¹⁸ This is based on data from the European Commission's AMECO database. The comparisons of average compensation per employee used in this paragraph are all constructed using double export weights.

euro against the currencies of Ireland’s trading partners (Figure 1.19). As a result of faster inflation in Ireland, the increase in the real HCI was higher at 26.4 per cent over the same period. This indicates a substantial loss of cost competitiveness. Since 2008, the HCI has declined in both nominal and real terms. In nominal terms, the HCI fell by 5.1 per cent between the second quarter of 2008 and first quarter of 2011, while in real terms it fell by 12.1 per cent. This means that both the fall in the value of the euro and below, average inflation in Ireland contributed to a recovery of cost competitiveness. A stronger euro, particularly against the dollar, in the first part of 2011, meant an increase in the HCI on a monthly basis: the nominal HCI increased by 3.7 per cent from December 2011 to April 2011. The net increase in the real HCI since the first quarter of 1999 and the first quarter of 2011 was 11.0 per cent.

Figure 1.19 Harmonised Competitiveness Indicators in Real and Nominal Terms for the Irish Economy, Q1 1999–Q1 2011, First Quarter of 1999=100



Source Central Bank of Ireland, Harmonised Competitiveness Indicators for Ireland

Outside the multinational sector, Ireland's most significant trading partner continues to be the UK, and UK firms also have a very substantial presence in Ireland's domestic market. Hence, for indigenous firms, cost competitiveness relative to the UK is of particular significance. This is very strongly influenced by exchange-rate movements. The movement of sterling in recent years has created competitiveness pressures for indigenous firms. There was a very large depreciation in sterling after 2007: between January 2007 and January 2009, the euro increased by 38.4 per cent against sterling to reach a euro/sterling exchange rate of 0.92 in January 2009. During 2010 the euro weakened against sterling with a fall in the euro/sterling exchange rate of 5.7 per cent between January 2009 and January 2010. The early months of 2011 have seen an increase in the value of the euro against sterling, with an increase of 4.1 per cent between December 2010 and April 2011. The huge impact of the depreciation of sterling (since 2007) on labour costs measured in common currency terms is illustrated in Figure 1.20. When measured in euro terms, average compensation costs per employee in Ireland are now higher than in the UK.

Figure 1.20 Nominal Compensation per Employee in Ireland and UK, 2000 to 2010, Euros



Source European Commission, AMECO database

1.5.1 General Business Costs

A comprehensive range of costs relevant to doing business in Ireland are monitored by the National Competitiveness Council (NCC). The 2011 NCC report on costs shows significant falls in a number of business costs and improvements in Ireland's cost competitiveness. In addition to the decline in unit labour costs discussed above, there have also been reductions in other costs, including property, energy and business services. Notwithstanding the fall in prices, the NCC found that some business inputs remain relatively expensive in Ireland including property costs and legal fees.

The CSO is publishing a Services Producer Index on an experimental basis. This index measures the price of services produced domestically for other businesses. The services covered include: road freight; sea and coastal transport; air transport; computer programming and consultancy; legal, accounting, public relations and business management consultancy; architecture, engineering and technical testing. This index increased by 9.3 per cent from 2006 to the first quarter of 2008. It then fell by 8.9 per cent in the period to the first quarter of 2011. Of the 12 components that comprise the index, costs fell in 10 of these components¹⁹. The NCC reports shows that business services costs continued increasing in other EU countries.

One barrier to the reduction in property costs is the presence of upward-only review clauses in lease agreements. Rental costs have fallen for new leases but the presence of upward-only review clauses insulates landlords to some degree from the radical change in the economic environment. Lower rental costs would help the general cost-adjustment process in the economy and also help stimulate domestic businesses such as retail and restaurants. Addressing this issue would affect property rights and there are constitutional issues to be considered. The Programme for Government (2011) has a commitment to legislate to ban upward-only rent reviews for existing leases.

1.5.2 Comparison of Salary and Price Levels

The National Competitiveness Council (National Competitiveness Council, 2010) reports on a range of international comparisons of Irish salary levels. It found that in 2009, Irish salaries, across a range of job categories of most relevance to internationally competing firms²⁰ were broadly similar to the euro-area average. They were generally higher than in the US for most comparable positions and were also higher than the UK. Irish salary levels in these categories of most relevance to firms competing internationally were significantly lower than the most expensive countries, including Denmark and Germany.

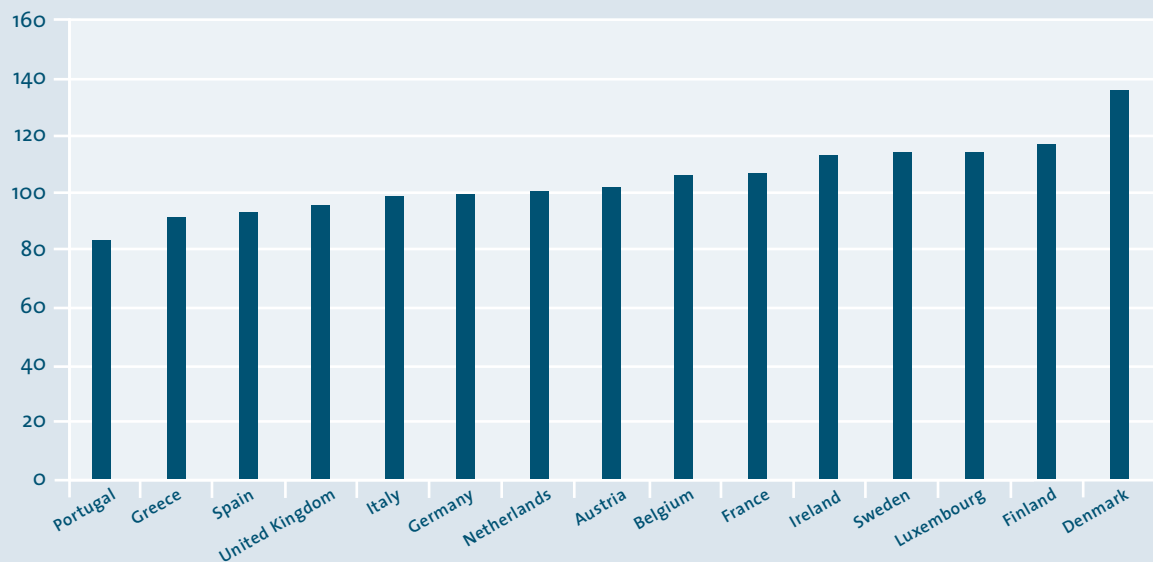
¹⁹ Legal services were an exception to the general fall in business services, as noted by the NCC, with costs in 2010 12 per cent higher than 2006. This however was based on responses from just 18 companies.

²⁰ These categories included skilled and unskilled production operative, systems analyst, senior IT manager, head of finance in financial services etc.

Notwithstanding the fall in consumer prices, the level of consumer prices in Ireland continues to be relatively high (Figure 1.21). In 2010 the average level of consumer prices was 12.7 per cent above the EU (15) average. This was a significant improvement on the situation in 2008 when Irish prices were 23.7 per cent above the EU (15) average. In the case of consumer goods, Irish prices in 2010 were 10.3 per cent above average while in the case of services the gap was higher with Irish prices 14.9 per cent above the EU (15) average. Irish prices in 2010 were on average the fifth highest in the EU with Denmark, Finland, Luxembourg and Sweden having higher prices. In 2009 Irish prices had been the second highest in the EU.

For government services, in 2009, the implicit price in Ireland was 26.9 per cent above the EU (15) average. This was the third highest in the EU after Denmark and Luxembourg.

Figure 1.21 Consumer Prices Relative to the EU (15), 2010
EU (15)=100



Source Eurostat website(July 2011). Based on household final consumer expenditure

A comprehensive and convincing analysis of how Ireland has become among the most expensive countries in terms of consumer prices in the EU is still to be developed. It is probable that rapid growth of the Irish economy, excessive credit creation, weak competition in some sectors, movements in the value of the euro, infrastructural deficits, small-scale, high indirect taxes and commercial rents, and the actual level of wages and salaries in some parts of the labour market, have all contributed (NESC, 2009). It is important to find ways of continuing to secure relative falls in Irish consumer prices.

1.6 Credit

1.6.1 Trends in Credit

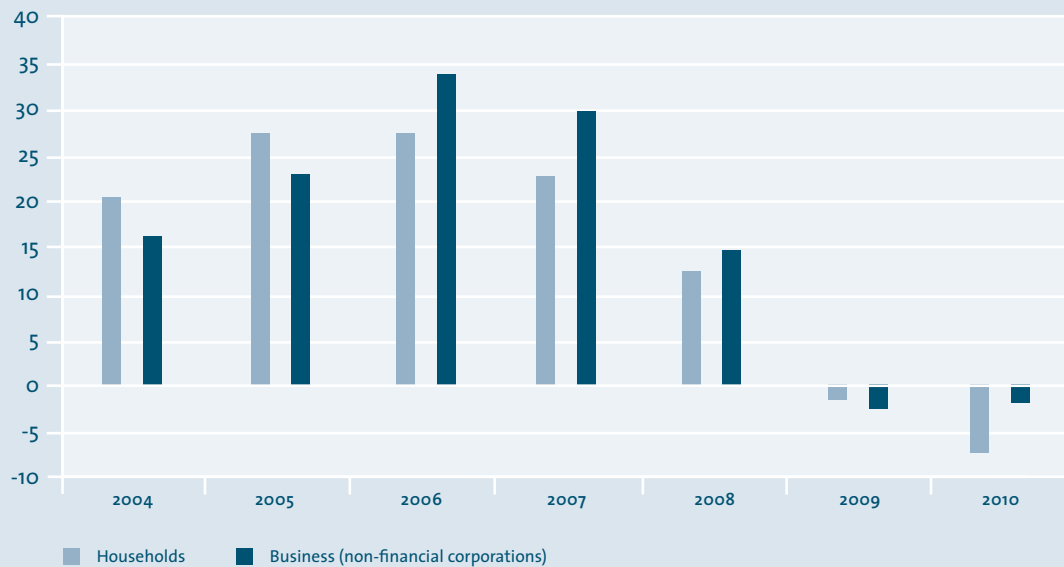
Credit has been a key feature of Ireland's economic boom and subsequent downturn. It grew rapidly in the years up to the downturn: the largest increase in credit took place in 2006 when there was an underlying increase in lending (i.e. new loans less repayments) to Irish households and business (non-financial corporations) in that year alone of €64.5 billion.²¹ Credit has fallen since 2009; i.e. new loans to households and businesses have been less than repayments (Figure 1.22). Loans to households have fallen by more than lending to businesses: in 2010 outstanding loans to households fell by €7.5 billion while loans to business fell by €1.9 billion. The annual rate of decline of lending to households in May 2011 (i.e. April 2011 compared to April 2010) was 4.8 per cent, while the corresponding rate for business was 2.6 per cent.

In terms of business lending, there has been a marked difference in the trend in short-term and long-term lending. Short term (less than one year) lending to business has actually increased during the downturn, while there has been a sharp fall in longer-term lending, although the pace of decline has eased. In May 2011, there was an annual increase in short term lending to business of 8.2 per cent. Lending for one to five years fell by 7.2 per cent, while lending for over five years fell by 6.3 per cent.

In recognition of the economic significance of lending to small and medium enterprises (SMEs), the Central Bank initiated a new survey to monitor trends in this type of lending in 2010. Information from this survey is available from the first quarter of 2010 to the first quarter of 2011. The survey shows lending to SMEs (excluding financial intermediaries) fell by €6.9 billion or 12.2 per cent over the year to the first quarter of 2011. Lending to 'core' SMEs (i.e. excluding property related lending) fell by €3.6 billion or 9.7 per cent over the same period. In the first quarter of 2011 the decline in core lending was €49 million, considerably lower than the average decline in the previous three quarters of €1 billion.

²¹ Trends in the level of credit in the economy reflect underlying credit transactions (new loans and repayments) and other effects, including valuation changes and loan transfers to other institutions including NAMA. The figures on credit, quoted in this section, are based on Central Bank figures on underlying credit transactions; i.e. adjustments have been made to remove the influence of other factors on credit, such as transfers to NAMA.

Figure 1.22 Annual Change in Credit Extended to the Irish Private Sector, 2004–2010, € billion



Source Central Bank of Ireland, Credit, Money and Banking Statistics

The fall in lending in SMEs arises from the fact that repayments exceeded the level of new lending. The average quarterly level of new lending to SMEs (excluding financial intermediaries) over the period from the first quarter of 2010 to the first quarter of 2011 was €764 million while there was new lending of €794 in the first quarter of 2011. The average level of new lending to core SMEs in the period since the first quarter of 2010 was €570 million and there was lending of €565 million in the first quarter of 2011. Core SME lending in the first quarter of 2011 was 3.4 per cent below the first quarter of 2010. The highest level of new SME lending in the first quarter of 2011 was for the property sector (€184 million). Apart from property, the highest level of new lending was for agriculture (€141 million) followed by the wholesale/retail trade (€113 million) and manufacturing (€54 million).

1.6.2 Credit Supply

The fall in credit has been driven by a fall in demand for credit. However, the question arises as to whether changes in the supply of credit are acting as an independent constraint on the growth of viable businesses. There is considerable survey information of relevance to this question, although information gaps remain.

Mazar's Surveys

A series of reports on bank lending to SMEs were prepared by Mazar's for the Department of Finance. The second Mazar's report was published in December 2009 and covers the period March 2009 to September 2009. This report was based on information from both banks and enterprises; the enterprise information was gathered through a representative sample of SMEs across all sectors of the economy. According to banks, around 14 per cent of SME loan applications were declined (an approval rate of 86 per cent). However, enterprises themselves reported a substantially higher rate of decline of credit applications of 28 per cent. A key reason for the gap in responses is a difference in perception as to what constitutes an application for credit. Initial credit inquiries are dealt with informally by managers and some credit requests are declined before a formal application is made. Banks generally do not record informal credit requests and the decline rates for credit as reported by banks are based on formal credit applications. Mazar's also considered that there were weaknesses in the data gathered on the enterprise side due to the limitations of telephone-based surveys.

A third Mazar's report was published in April 2010 and covered the period September 2009 to December 2009. The third report found little change in the approval rate for loans as perceived by banks, which was 87 per cent. The third Mazar's report did not include an enterprise survey. The report found a continuing deterioration in SME credit quality. A key indicator of this is that as of December 2009, 35 per cent of SMEs were operating outside of their repayment obligations.

CSO Lending Survey

The CSO published the results of a lending survey for 2007 and 2010. The survey covers enterprise in the non-financial market sectors that employ between 10 and 249 people. The survey found a substantial fall in the share of enterprises applying for finance: in 2007, 37 per cent of enterprises applied for loan finance, while in 2010 just 31 per cent of enterprises applied for finance. The enterprises that applied for finance experienced a sharp fall in their success rate in obtaining finance:

Enterprises that applied for loan finance had a success rate of 90 per cent in 2007 compared to 50 per cent in 2010 (CSO, 2011:1).

All sectors experienced a substantial decline in their success rates for new loans. The largest decline was for construction with a fall from 90 per cent in 2007 to 29 per cent in 2010. The highest loan success rate in 2010 was for services; this sector had a success rate of 56 per cent in 2010, down from 81.3 per cent in 2007.

Table 1.12 Success Rates of All SME Loans by Sector, 2007 and 2010

	Successful		Partially successful		Unsuccessful		Total	
	2007	2010	2007	2010	2007	2010	2007	2010
Industry	81.8	55.0	7.8	13.3	10.4	31.7	100	100
Construction	90.0	28.8	1.7	20.3	8.3	50.8	100	100
Selected services	93.6	53.1	3.4	17.7	3.0	29.2	100	100
ICT services	81.3	56.0	12.5	36.0	6.3	8.0	100	100
Professional, scientific and technical services	84.6	52.1	1.9	14.6	13.5	33.3	100	100
All enterprises	89.5	49.9	4.1	18.2	6.4	31.9	100	100

Source CSO (2011), Access to Finance: 2007 and 2010

ISME Bankwatch Survey

A quarterly survey of SMEs' experience in dealing with banks on credit matters is produced by the Irish Small and Medium Enterprises (ISME) association. These surveys show an improvement in the credit situation in 2010, with the rate of unsuccessful credit applications falling from 55 per cent in March 2010 to 32 per cent in December 2010. The June 2011 survey showed deterioration with the rate of unsuccessful applications rising to 54 per cent. The ISME surveys provide more recent information than Mazar's and the CSO but are not as statistically representative or comprehensive.

Credit Review Office

The Credit Review Office (CRO) was established by the Minister for Finance to review credit decisions by banks with regard to SMEs. Its remit covers National Asset Management Agency (NAMA) banks that are currently lending to SMEs; at present this means Bank of Ireland and AIB. Any borrower within the remit of the CRO has the right to appeal their credit decisions to the CRO. Initially the CRO could consider unsuccessful credit applications with a value of up to €250,000. With effect from July 2011, this has been increased to €500,000. Decisions are not binding on banks. However, in all cases where the CRO sided with the borrower, the banks have co-operated and provided the credit. The CRO publishes quarterly reports. The fourth quarterly report (May 2011) shows that to date there have been a small number of appeals (76 in total), with decisions made on 51 cases. In 40 per cent of these decisions, the bank's decision was upheld, while in 45 per cent of cases the bank's decisions was disputed or the bank subsequently provided credit. The CRO considers that its impact is larger than implied by the small number of applications made; it argues that the right of appeal in itself shapes the behaviour of banks.

The CRO monitors lending activity to SMEs in the banks under its remit. Banks provide monthly figures on their lending activity to the CRO and the Department of Finance but this information is not published as it is market sensitive. The

CRO publishes information on the loan approval rates of the two main banks for SME loans. As with the earlier Mazar's surveys, these are based on formal credit applications. The CRO reported loan approval rates of 87 to 89 per cent in each month since April 2010. In March 2011, the loan approval rate was 87 per cent.

Under legislation on recapitalisation of the banks, Bank of Ireland and AIB are required to sanction €3 billion each in new or restructured lending to SMEs per year for two years; the start date for this target was April 2010. The CRO reported that for the year from April 2010 to March 2011 the combined new or restructured lending by the two main banks for SMEs was €8.1 billion. This means that for the two banks taken together, the target was exceeded. However, the CRO points out that a 'high proportion' of these loans are being made to restructure existing debts rather than supporting new business activity. Quarterly meetings take place between the banks, the Credit Review Office and the Department of Finance to monitor progress on bank lending.

It is an achievement that the target for new lending has been exceeded but this does not in itself resolve the credit problem. The fourth quarterly CRO report elaborates on the core problem. The report points out that many of the SMEs in difficulty face not only liquidity problems but are also technically insolvent. Some of these businesses could be viable. The CRO points out that examinership can be too expensive. Hence, it is argued that a new process is needed to allow businesses to demonstrate viability. This could involve debt/equity swaps or debt write-off and restructuring. The CRO regards it as inevitable that the banks will have to use some of their capital to write off SME loans. It advocates that banks should use some of their capital to save viable SMEs. However, the CRO argues that:

It is my view that this will require some form of government initiative as some of this lending will be beyond the prudent cash flow lending criteria now obligatory in banking and expected by the regulator (CRO, 2011: 3).

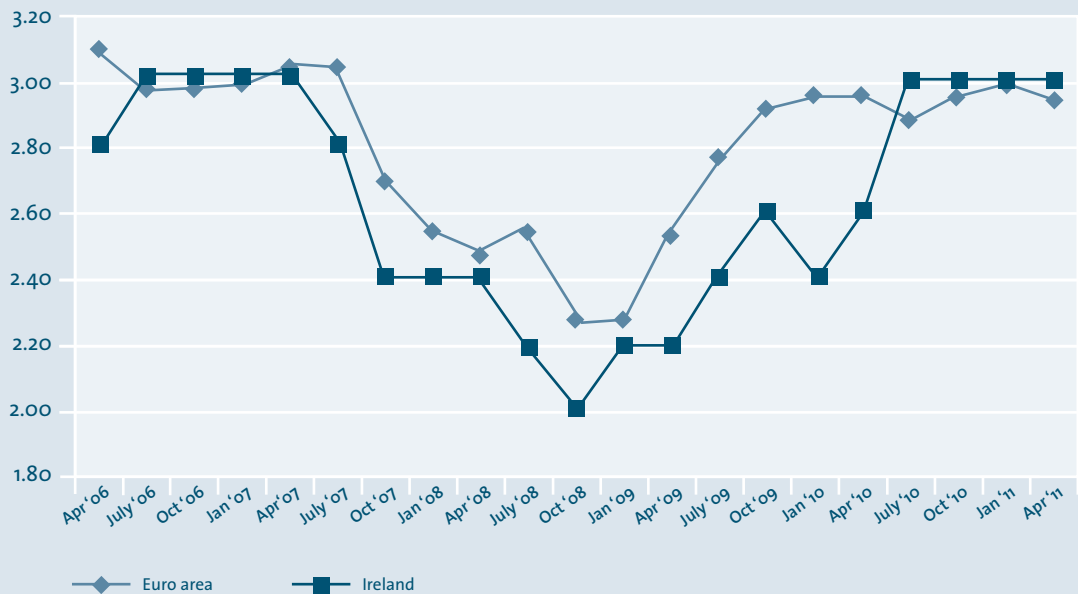
This highlights a difficult challenge: to find a way of assisting those SMEs that may be technically insolvent but could be viable with appropriate support, while not wasting scarce bank capital that has been provided by the State.

Euro Area Bank Lending Survey

The European Central Bank (ECB) conducts a quarterly bank survey of credit market conditions across the euro area, including Ireland. The survey covers bank lending to both businesses and households. Issues covered include changes in credit standards, terms and conditions of credit, and the demand for credit. The survey covers banks' own assessments of these matters. Banks are asked to rank their perception of changes in the variables concerned on a five-point scale. The supply of credit is measured by the question on changes in credit conditions. A ranking of three indicates no change in credit standards compared to the previous quarter while any response below three indicates a tightening of standards. Response over three indicates a loosening of standards.

The ECB surveys show that credit standards in Ireland tightened considerably in Ireland in 2007 and 2008 (Figure 1.23). The average response regarding loans to enterprises fell from 3.0 in the January 2007 survey to a low of 2.0 in the survey of October 2008. The results show that a similar tightening of lending standards took place in the euro area in 2007 and 2008 as a whole but it was more severe

Figure 1.23 Changes in Credit Standards for Lending to Enterprises over the Past Three Months: Ireland and the Euro Area, April 2006–April 2011



Source Central Bank of Ireland, Euro Area Bank Lending Survey, April 2011

in Ireland. Since July 2010, the survey shows that credit standards in Ireland have been unchanged.

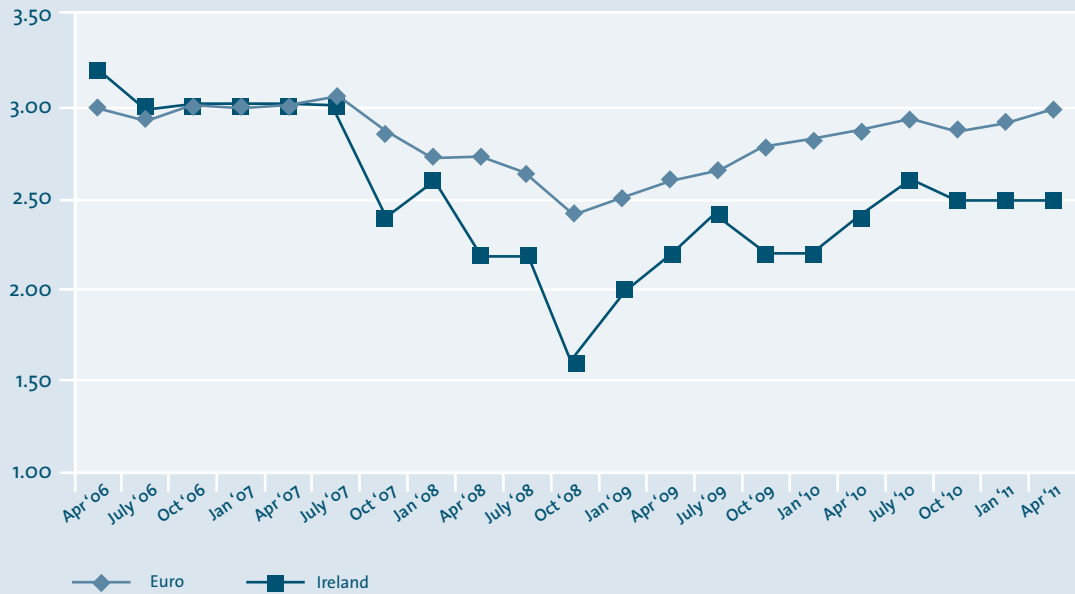
The ECB survey monitors changes in terms and conditions by seeking information with regard to the change in price margins on loans and a range of other conditions including collateral requirements and size of loan. Since 2007 there has been a deterioration in the terms and conditions of credit to business in Ireland, both in terms of price margins and other terms and conditions. This has generally been more pronounced in Ireland than the euro area; the example of collateral requirements is shown in Figure 1.24. The April 2011 survey found more restrictive price and non-price terms and conditions including higher loan margins, more restrictive covenants and reduced loan maturities. Actual interest rates charged have fallen since 2008 as a result of reductions in ECB rates.

The ECB survey shows a sharp fall in the demand for credit in Ireland from 2008 up to the first half of 2010. Demand for credit was unchanged in the first quarter of 2011.

Central Bank Review of SME Lending Strategies

The Central Bank published a review of the banks' SME lending strategies in January 2011; this review was undertaken as one of the Central Bank's 'prudential themes' (Central Bank, 2011). The review covered six banks with the primary focus on AIB, Bank of Ireland and Ulster Bank as these are the largest and most active lenders for SMEs. The review assessed the quality of the banks' SME strategies and plans, and the business plans for their implementation.

Figure 1.24 Changes in Collateral Requirements over the Past Three Months for Loans to Enterprises: Ireland and the Euro Area, April 2006–April 2011



Source Central Bank of Ireland, Euro Area Bank Lending Survey, April 2011

The review found that lending strategy has not in all cases been a top priority for banks and that not all plans contained all the elements that would be expected in a comprehensive plan. No evidence was found that banks were reducing credit standards in order to meet their targets on SME lending as required by the recapitalisation legislation, and the review considered that this was encouraging. It pointed to the additional challenge of making credit decisions in an environment in which so many SMEs are under financial pressure and noted that this challenge was exacerbated by the banks' centralised lending systems. The review considered that 'the banks have a significant retraining challenge to ensure that their staff possesses the requisite credit skills in order to execute their SME plans' (page 5). The review emphasised the importance of banks understanding and measuring the risk impact of their proposed lending policies as part of the approval process. It also emphasised the importance of a high-quality credit review process and expressed concern that some banks had undertaken limited numbers of credit reviews in the last two years. The main findings from the review were issued to all domestic credit institutions.

1.6.3 International Experience

The international experience of the role of credit in economic recoveries is examined in a recent International Monetary Fund (IMF) paper (Abiad *et al.*, 2011). Notwithstanding the widely accepted importance of bank credit, they point out that there are many cases of economic recoveries without credit growth. They refer to these episodes as ‘creditless recoveries’, which they define as economic recoveries in which the real growth rate of bank credit is zero or negative in the first three years of recovery. They show that such creditless recoveries represent around one in five of all economic recoveries. They are more common in low-income and emerging economies but represent an estimated 10 per cent of recoveries in advanced economies. Creditless recoveries are substantially weaker than normal economic recoveries: Abiad *et al.* estimate that output growth is on average one-third lower in these recoveries compared to normal recoveries and in many cases creditless recoveries are followed by stagnant growth.

Creditless recoveries could occur either because credit is not required for the recovery or because it is not available. Abiad *et al.* seek to identify whether or not creditless recoveries are the result of problems with the availability or accessibility of credit (what they refer to as impaired financial intermediation). They adopt two approaches to addressing this question.

First, they examine the circumstances in which creditless recoveries occur. If creditless recoveries are the result of impaired financial intermediation, they would be more likely to occur following events that disrupt the credit system. They find strong evidence that this is indeed the case. Creditless recoveries are twice as likely to occur following a credit boom and more than twice as likely to occur when there is a banking crisis. Where a downturn is preceded by both a banking crisis and a credit boom, ‘the subsequent recovery would almost certainly be creditless’ (Abiad *et al.*, 2011: 4).

The second approach adopted is to examine the performance of different sectors. Some sectors are normally more credit-dependent than others. If constraints on credit cause creditless recoveries, this effect would be most evident in credit-dependent industries. The industrial sectors identified in this study as most reliant on external credit were electrical machinery, professional goods and plastic products. They find that the more credit-dependent sectors have relatively lower growth in creditless recoveries than less credit-dependent sectors: during creditless recoveries, the growth rate of highly credit-dependent industries is 1.5 percentage points lower than in normal recoveries, while for low-dependent industries, the growth rate is only 0.4 percentage points lower.

Both the macro and micro-level evidence of Abiad *et al.* indicates that creditless recoveries are the result of constraints on the allocation of credit. These constraints could arise for different reasons. Most obviously, they could arise from a weak banking system that is unable to provide sufficient credit. Abiad *et al.*, note that even where there is a healthy banking system, an excessive debt burden in the private sector could limit the growth of credit. The required response in this case is more complex; they note that it would involve policies to facilitate deleveraging or possibly debt-restructuring.

1.6.4 Credit and Recovery: Conclusion

The Irish economy appears to be entering a tentative export-led recovery. International experience suggests that there is a significant probability that this recovery could be 'creditless'; i.e. the economy could recover while there would be a continuing real fall in credit or zero credit growth. This arises because Ireland has experienced both an exceptionally strong credit boom and a major banking crisis, precisely the conditions in which creditless recoveries are most likely to occur. These recoveries are on average substantially weaker than normal recoveries and there is evidence that the absence of credit growth in these relatively weak recoveries arises from problems with the availability of credit rather than because credit is not required. Credit constraints can arise both from problems within the banking system and from an over-indebted private sector; previous debts may inhibit the private sector from accessing credit for potentially profitable investments (Abiad *et al.*, 2011). The fourth quarterly report of the CRO referred to above indicates that the legacy of previous debt is a constraint on new lending in Ireland. The problem is that credit may not be available for worthwhile investments not on account of the merits of the investment itself but because previous debt calls into the question the capacity to take on new debt. For potentially viable businesses, the solution could involve debt equity swaps or writing down of debt followed by new lending.

Central Bank data indicates that there was gross new lending to 'core' SMEs (i.e. SMEs outside property-related sectors) of around €700 million in the first three quarters of 2010. According to the CRO, the credit situation improved during 2010. Nonetheless, there is information that points to the provision of credit being a real concern for the Irish economy. Short-term credit for business continued to increase during the downturn, while there was a sharp contraction of long-term business credit. The decline in long-term credit could constrain new long-term investment. The euro area Bank Lending Survey shows that credit standards became considerably more demanding in 2007 and 2008. This survey also shows that the terms and conditions under which credit is made available to business continue to deteriorate. A review of SME lending policies by the Central Bank found that banks needed to improve their SME strategies and plans and to strengthen the skills of staff engaged in SME lending.

1.7 Public Finances

The sharp fall in the economy and the property market led to a dramatic fall in revenue. As a result of the cyclically sensitive structure of tax, the underlying fall in revenue exceeded the decline in the economy.

The government responded to the crisis in the public finances with substantial measures to reduce expenditure and increase revenue. Substantial tax increases moderated the actual fall in revenue. The actual fall in total general government revenue between 2007 and 2010 was 23.5 per cent while nominal GNP fell by 21.5 per cent over this period (Figure 1.24). The level of total revenue in 2010 was close to the level of 2004. The measures taken since 2008 to boost revenue and cut expenditure have yielded estimated cumulative annual savings by 2010 in the

Figure 1.25 Index of Total Expenditure, Revenue and GNP, 2001-2011
 2001=100



Source European Commission, General Government database. The expenditure spike in 2010 is due to the promissory notes issued to banks

region of €15 billion, while a further €6 billion²² in savings was introduced in Budget 2011. Following a repeated series of fiscal interventions—the period from October 2008 to April 2009 had three separate announcements of major budgetary adjustments—the deficit was eventually stabilised. Excluding special support for the banks, the general government deficit was 11.9 per cent of GDP in 2010. The UK government deficit in 2010 was 10.4 per cent of GDP while the US deficit was 11.2 per cent of GDP. The euro area average deficit in 2010 was 6.0 per cent of GDP. Ireland's deficit is projected to fall to 10.0 per cent of GDP in 2011.

Tax revenue in 2010 was 3.9 per cent lower than in 2009. This follows much larger declines in 2008 (14 per cent) and 2009 (19 per cent). Tax revenue in 2010 was €703 million (2.3 per cent) higher than projected in Budget 2010. This was mainly due to corporation tax revenue, which was well ahead of expectations (by €764 million or 24.2 per cent). Revenue from excise duties was €164 million (3.6 per cent) ahead of projections while VAT was 0.1 per cent ahead of its projected level. Income tax was below expectations by €254 million (2.2 per cent).

The exchequer returns for the first half of 2011 indicate the public finances for 2011 are close to target. The exchequer deficit for the first half of the year was €10.8 billion. Revenue for the first half of 2011 was 0.7 per cent behind target (€115 million). The main shortfalls were for corporate tax (7.6 per cent or €116 million below target) and VAT (2.6 per cent, €34 million below target). The level of VAT revenue for the first half of 2011 was 0.9 per cent lower than the same period of

²² The €6 billion figure for 2011 includes revenue from asset sales of €485 million.

2010. Income tax revenue was marginally ahead of expectations (0.2 per cent, €11 million). Expenditure for the first half of 2011 was 1.5 per cent below target (€343 million). Current expenditure was 1.1 per cent (€219 million) below target while capital expenditure was 8.4 per cent (€124 million) below target.

Table 1.13 General Government Current and Capital Expenditure, 2007 and 2010

	2007 €billion	2010 €billion	2007–2010 Change in €billion	2007–2010 % Change
Current spending	58.8	65.2	6.4	10.9
Compensation of employees	19.0	18.1	-0.9	-4.7
Social transfers in cash	19.7	24.4	4.7	23.9
Interest	2.0	5.0	3.0	150.0
Other current expenditure	18.1	17.7	-0.4	-2.2
Capital spending	10.8	38.0	27.2	251.9
Gross fixed capital formation	8.9	6.0	-2.9	-32.6
Other capital expenditure	1.9	32.0	30.1	1584.2

Source European Commission general government database. General government covers both central and local government.

Notwithstanding the major cuts that have occurred, current expenditure in 2010 in money terms was higher than before the crisis (Table 1.13). This is due to increases in expenditure on social transfer payments (i.e. social welfare and other social payments) between 2007 and 2010 of €4.7 billion (23.9 per cent) and on interest of €3 billion (150 per cent). Total current expenditure in 2011 is expected to show a small fall of 0.9 per cent. Government investment spending ('gross fixed capital formation') fell by €2.9 billion between 2007 and 2010, a fall of around one-third in nominal terms.²³ A further fall in investment spending is expected in 2011 so that from 2007 to 2011, government investment spending is set to fall by 47.2 per cent in nominal terms. The fall in volume terms will be less, due to price reductions. Other capital expenditure increased hugely in 2010 due to the issuing of promissory notes for Anglo Irish Bank and Irish Nationwide.²⁴

It was announced in the *National Recovery Plan 2011–2014* that further adjustments of €15 billion would be introduced in the years 2011 to 2014 in order to achieve the target of reducing the deficit to 3 per cent of GDP by 2014; of these €15 billion adjustments, €6 billion was introduced in the 2011 budget. Ireland's target date to achieve a deficit

²³ This does not include spending by commercial state companies or investment in bank recapitalisation.

²⁴ A promissory note is a written promise to pay a sum of money in the future. In the case of the promissory notes for Anglo Irish Bank and Irish Nationwide, the payments will be made from 2011 to 2025. These promissory notes were issued in 2010 and the commitment made is classified as a form of capital expenditure for 2010. It resulted in a very high government deficit in 2010.

of 3 per cent under the Stability and Growth Pact has been extended to 2015, and this target date has been adopted in the new Programme for Government. The EU/IMF programme endorsed the planned €15 billion fiscal adjustment over four years. It is inevitable that cuts of this magnitude will have a negative effect on domestic demand and hence employment during this period.

The potential impact on the economy of prospective fiscal cuts of €15 billion (equivalent to 11.7 per cent of GNP in 2011) over four years was examined in a report by Euroframe, using the ERSI's model of the Irish economy (Euroframe, 2010). It was estimated that these cuts would reduce GDP by a cumulative 4 per cent over four years and would be sufficient to bring the deficit close to the 3 per cent target by the middle of this decade. It was estimated that the balance of payments surplus would increase by around 5 per cent of GDP. This arises from a substantial fall in imports and a reallocation of resources to the export sector. The Euroframe report explains that the effects on the domestic economy are not greater because of the openness of the economy and the associated relatively low multiplier.

At the end of 2010, Ireland's gross general government debt (the official EU measure) was 94.9 per cent of GDP (115.5 per cent of GNP). The sustainability of Ireland's public debt is examined in Section 1.8 below.

The cost of rescuing Ireland's banks has added substantially to the government debt burden in the public finances. The total capital investment in the banks to date (May 2011) has been €46.3 billion. If the State invests a further €19 billion following the 2011 Prudential Capital Assessment Review (PCAR), this would bring the total State investment to date to €65.3 billion or approximately 42 per cent of GDP (51 per cent of GNP). The IMF (IMF, 2011a) notes that only two banking crises in the last four decades are estimated to have had a larger gross recapitalisation cost: Argentina in 1980 and Indonesia in 1997.

Of the capital investment that has taken place to date, around €35 billion or 27.7 per cent of GNP has been to cover the losses for Anglo Irish Bank and Irish Nationwide. In the case of these banks, the losses are so great that there is no prospect of a return to the State on this investment. In the case of the provision of capital to other financial institutions, some of the capital should be recovered over time. Hence the net cost of recapitalisation will be less than the gross cost of €65.3 billion. There are also risks to the State arising from NAMA. Substantial discounts, however, were applied to the loans transferred to NAMA so the agency could break even and thus not add to the net costs to the State.

The annual cost of the bank rescue is the cost of servicing the debt needed for capital investment in the banks. It has been estimated by Honohan that the additional debt servicing costs resulting from the additional borrowing to fill the gap in the banks' finances represents around one-eighth of the fiscal adjustment over the coming years (Honohan, 2011). This bolsters the overall argument for the need to focus on factors beyond bank capitalisation and financing.²⁵

²⁵ The estimated capital requirements for the banks are now somewhat higher than when Honohan produced this estimate. It is also worth noting that the annual costs in cash terms over the next decade will be higher than the interest costs on the capital required for investment in the banks. The State issued promissory notes with a combined value of €31 billion to Anglo Irish Bank, Irish Nationwide and EBS. To cover the principal and interest on these, the State is required to make cash payments of €3.1 billion during each year from 2011 to 2023. This money will be borrowed by the exchequer and interest will also have to be paid on this borrowing. By 2023 the annual interest cost on this borrowed money will be €2.1 billion.

1.8 Impact of Economic Crises

The Irish economy has experienced a severe economic and financial crisis, with a huge social impact. The question arises as to what will be the enduring impact of this crisis. Some insight on this question can be gained by considering the experience of severe shocks in earlier periods. The decline in the Irish economy in the first half of the 1980s was less severe than the current downturn. There were two years of falling GNP: the largest fall was 1.9 per cent in 1983. The impact of Ireland's crisis in the 1980s was prolonged. There was an extended period of weak economic performance with huge social effects. GNP growth was below 2 per cent in each year from 1981 to 1986 and there were six years of either falling employment or negligible employment growth. Unemployment remained in double digits throughout the 1980s and well into the 1990s; it was not until 1997 that unemployment fell below 10 per cent.

Reinhart and Reinhart have examined the experience of severe crises in both advanced and emerging economies (Reinhart & Reinhart, 2010). They considered two major global disruptions—the 1929 stock market crash, the oil crisis of 1973—and 15 country-specific dramatic financial crises. The 15 country-specific crises were as follows: five advanced countries (Spain 1977; Norway 1987; Finland 1991; Sweden 1991 and Japan 1992); five Asian countries (Indonesia, Korea, Malaysia, Philippines, Thailand); and five other emerging economies (Chile 1981; Mexico 1994; Columbia 1998; Argentina 2001; and Turkey 2001).

They found that crises have significant enduring effects. Their main results can be summarised as follows.

- ◆ First, real growth of GDP per capita was lower in the decade following the crisis compared to the decade prior to the crisis. In the case of the five advanced country cases, the median rate of growth of GDP per capita was one percentage point lower in the decade following the crisis. The impact was greater in the case of the Asian economies with a fall in the median growth rate of 2.8 percentage points. Across all 15 country shocks, the fall in the median growth rate was 0.6 percentage points. The fall in growth rates includes the impact of negative growth during the period of decline and is a simple comparison of each period, without taking account of other influences;
- ◆ Second, there was an enduring impact on unemployment. This was most pronounced in the case of the advanced countries. The median rate of unemployment was five percentage points higher in the post-crisis decade (compared to the decade before the crisis); in 10 of the 15 cases the unemployment rate never returned to its pre-crisis level (by end of 2009);
- ◆ Third, financial crises have a significant impact on house prices. Median house prices in real terms were 15 to 20 per cent lower in the post-crisis period, with cumulative real declines of up to 55 per cent;
- ◆ Fourth, a build-up of debt and subsequent deleveraging were common themes across the crises. The median increase in the ratio of domestic credit to GDP in the pre-crisis decade was 38 per cent, while it fell by a similar amount in the decade following the crisis. Reinhart and Reinhart infer from this that 'if deleveraging of private debt follows the tracks of previous crises as well, credit restraint will dampen employment and growth for some time to come' (Reinhart & Reinhart, 2010: 4).

The medium term output performance following 88 banking crises over the past four decades is analysed in the IMF *World Economic Outlook* of October 2009. This analysis found that the output costs of banking crises are considerable. Seven years after the crisis, output was on average 10 per cent below the pre-crisis trend with considerable variation around this average. The analysis also found that medium term growth rates tended to eventually return to the pre-crisis growth rate.

During the 1980s, deep financial crises were widespread across Latin America. That decade is widely regarded as a ‘lost decade’ for the continent. Output growth per capita averaged a minus 0.6 per year in the 1980s—as measured by the average of the seven largest economies within the region—with huge negative social effects (Fraga, 2005). The plan devised by the US Treasury in 1989—which became known as the Brady plan—provided some debt relief for Mexico and similar agreements were subsequently introduced in other countries. The Brady plan is regarded as being successful in stabilising the debt situation and facilitating a resumption of economic growth. Financial crises, however, continued to be significant in Latin America in subsequent decades.

Under the Brady plan, creditors in effect were given two options. They could exchange their loans for new Brady bonds or they could provide additional loans. Most choose to accept bonds. The market value of the bonds offered was at or slightly above the secondary market value of the original loans. Creditors could choose between bonds that maintained the principal value of their loans but had longer maturities and below market interest rates or bonds that discounted the principal but paid market interest rates. Brady bonds were more secure than the loans that they replaced. This was because they were underpinned by the collateral of zero-coupon US Treasury Bonds. This meant that the creditors could claim the value of the Treasury bond in the event of a default. The countries issuing the Brady bonds purchased the Treasury bonds using money lent to them for this purpose. The Brady plan provided the countries concerned with debt relief while their creditors gained more secure and marketable assets. Brady plans subsequent to the original plan for Mexico provided creditors with a wider choice of options.

While the impact of past crises has been significant, it is also clear that economies can recover even from severe crises. The growth rates of GDP per capita—in the decades before and after the crises—of the five advanced countries identified by Reinhart and Reinhart are presented in Table 1.14 below. The growth rates in this table are calculated

Table 1.14 Annual Percentage Change in Real GDP Per Capita before and after Severe Financial Crises in Five Advanced Countries

	Pre-crisis decade	Post-crisis decade	Year of crisis
Finland	3.2	3.5	1991
Sweden	1.9	2.7	1991
Norway	3.4	3.0	1987
Spain	4.3	2.9	1977
Japan	4.0	0.7	1992

Source Calculated from European Commission, AMECO database

from the end of the period of crisis-induced decline.²⁶ It is clear that in four of these five cases, countries returned to strong growth of per capita income in the post-crisis decade. In the case of Finland and Sweden the growth rate in the post-crisis decade was somewhat higher than the pre-crisis decade. This includes some catch-up from lost ground during the years of decline. Growth rates for Spain and Norway were lower in the post-crisis decade but both countries experienced strong, sustained growth in GDP per capita. Of the five advanced countries that experienced severe crises as identified by Reinhart and Reinhart, it was only in Japan that there was a period of extended low growth following a financial crisis. Among the advanced countries, the largest declines in GDP per capita were in Finland and Sweden. The decline in Finland was similar to the decline in the Irish economy during the period 2007 to 2010.

Figure 1.26 GDP Per Capita Following Economic Crises in Finland, Ireland and Sweden, Year 1=100

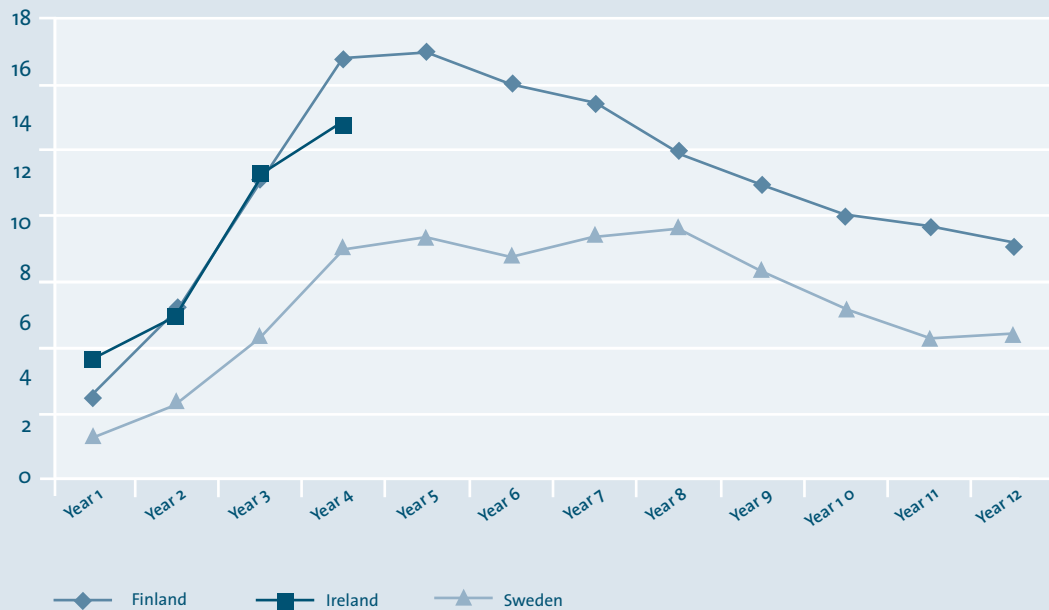


Source European Commission, AMECO database

Figure 1.25 shows the path of GDP per capita in these initial years of Ireland's decline alongside the decline and subsequent recovery in Finland and Sweden. Neither Finland nor Sweden experienced as severe a public debt problem as Ireland. The general government debt to GDP ratio in Finland was 14.1 per cent in 1991 and it peaked at 57 per cent in 1996; Sweden's general government debt to GDP ratio was 41.2 per cent in 1990 and it also peaked in 1996 at 72.9 per cent.

²⁶ This differs slightly from Reinhart and Reinhart (2010), who include growth rates from the year following the initial onset of the crisis. Thus the growth rates reported by Reinhart and Reinhart are an average of the years of decline and subsequent recovery while those reported in Table 1.11 just capture the years of recovery.

Figure 1.27 Unemployment Rates Following Economic Crises in Finland, Ireland and Sweden



Source European Commission, AMECO database

The trend in unemployment rates in Ireland during its crisis and the path of unemployment following the crises in Finland and Sweden are presented in Figure 1.26. The post-crisis experience of unemployment confirms that economic recovery does indeed reduce unemployment. However, it is also clear that even robust economic recovery is not necessarily enough to restore full employment. This points to the importance of dedicated labour market policies that go beyond policies to promote economic recovery. Active labour market policy is the subject of a forthcoming NESC study.

1.9 Economic outlook

1.9.1 Government Economic Outlook

The government's economic outlook for the period to 2015 from the *Stability Programme Update (SPU)* (Department of Finance 2011) is set out in Table 1.15. The outlook envisages an export-led recovery. The government's outlook for 2011 and 2012 has been revised downwards from that published a few months earlier in Budget 2011. There is expected to be modest GDP growth of just 0.8 per cent in 2011. From 2013, GDP is expected to grow at an annual rate of 3 per cent. Employment is expected to fall by 1.6 per cent in 2011 with a weak recovery of employment in 2012. Unemployment is expected to be 14.4 per cent in 2011 while it falls slowly in subsequent years.

In one respect the *SPU* has been revised upwards compared to the outlook of Budget 2011. Export growth is now expected to be somewhat stronger than earlier forecast. The volume of goods and services exports is now expected to increase by

Table 1.15 Economic Outlook: Stability Programme Update, 2011–2015

	Annual Percentage Change, unless otherwise indicated				
	2011	2012	2013	2014	2015
GDP real	0.8	2.5	3.0	3.0	3.0
GNP real	0.3	2.0	2.5	2.5	2.6
Private consumption	-1.8	0.0	1.0	1.3	1.4
Public consumption	-3.0	-2.3	-2.2	-2.2	-2.0
Investment	-11.5	1.0	4.4	5.1	5.5
Exports	6.8	5.7	5.0	4.5	4.1
Balance of Payments (current account, % of GNP)	1.4	2.6	3.7	4.7	5.2
Employment	-1.6	0.5	1.2	1.8	2.0
Unemployment (%)	14.4	13.7	12.7	11.5	10.1
Inflation (HICP)	1.0	0.9	1.5	1.7	1.8

Source Department of Finance (2011)

6.8 per cent in 2011 with average annual growth of 5.4 per cent in the following two years. The external economic outlook has improved somewhat since Budget 2011.

The downward revision to the economic outlook is due to a weaker outlook for consumer spending. In the *SPU*, consumer spending is expected to fall in 2011 by 1.8 per cent and an annual increase is not expected until 2013. The projected fall in consumer spending in 2011 is based on falling disposable income, rising inflation due to oil and commodity prices and expected growth in interest rates. A substantial fall in investment is expected in 2011 followed by a tentative recovery in 2012. In view of the public finance situation, the real volume of public consumption is projected to decline in each year to 2015.

The growth of domestic demand and overall economic growth will be depressed in the coming years by the very large fiscal cuts of €15 billion planned for the period from 2011 to 2015. The growth projections of Budget 2011 imply that the economy would have grown at a considerably faster rate if there had not been any need for large-scale fiscal adjustment. Growth scenarios published earlier by the ESRI indicate that this would certainly be possible for the Irish economy; for example, one scenario considered by Bergin *et al.* envisaged that if there were no further fiscal cuts beyond 2010, the Irish economy would grow at an annual rate in excess of 5 per cent (Bergin *et al.*, 2009). In Section 1.8, the experience of other economies in recovering from severe economic crises was discussed. This shows the capacity of economies to experience strong recovery following even severe crises.

There are risks that growth could be lower than the economic outlook of the *SPU*. Failure to resolve the financial market turbulence would adversely affect recovery in both the European and Irish economies. Global economic growth could be weaker than assumed which would weaken Ireland's export recovery. There is an additional risk for the Irish economy that growth could be weakened by vicious circles between the real economy, the banking system and the public finances. The low level of confidence in Irish banks makes it difficult for them to attract normal funding. This in turn makes it more difficult for the banking system to support an economic recovery. Lack of progress on economic recovery would in turn increase the problems of the banking system. The problems of the banking system have adversely affected the State's fiscal capacity, which in turn affects the State's capacity to guarantee the banking system. Necessary fiscal correction will reduce economic growth over the next few years. The legacy of debt in the economy may depress spending by more than assumed in the economic outlook of Budget 2011. The uncertain financial environment can adversely affect the confidence of both investors and consumers.

There are, however, significant 'circuit breakers' in place to prevent potential vicious circles from obstructing an economic recovery. First, the EU/IMF package means that there is secure funding in place to meet the State's current borrowing needs; this provides protection from the adverse bond market conditions. Second, the ongoing support of the ECB and Irish Central Bank means that the difficulties that Irish banks have in raising funds do not translate into corresponding reductions in credit. The export growth achieved by the Irish economy in a difficult environment in 2010 is an indication of the resilience of the economy.

It is possible that economic growth could turn out to be higher than the *SPU* projections. Export growth could be higher than assumed, boosted by the measures to promote competitiveness in the Programme for Government and the EU/IMF programme. Export growth in 2010 was higher than had been projected in the 2010 budget and by most forecasters.

The short-term economic outlook presented in the ESRI *Quarterly Economic Commentary* of spring 2011 is more optimistic than that presented in the *SPU* (Durkan & O'Sullivan, 2011). The ESRI projects GDP growth of 2 per cent in 2011 (*SPU*: 0.8 per cent) and GNP growth of 0.5 per cent (*SPU*: 0.3 per cent). The ESRI's employment outlook is broadly similar to the *SPU*. The primary difference with the ESRI's outlook concerns consumer spending. The ESRI expects a modest increase in consumer spending to occur during 2011 so that on average the annual level of spending for 2011 would be the same as 2010, rather than a fall as envisaged in the *SPU*. The ESRI expects consumption to return to annual growth in 2012. The recovery in consumer spending is based on a fall in the personal savings ratio from 13.8 per cent of personal income in 2010 to 9 per cent in 2012.

1.9.2 Analysis of Debt Sustainability

The Rise in Ireland's Debt Burden

Ireland's economic outlook is overshadowed by concerns about the sustainability of the public and private sector debt burden in Ireland. Ireland's debt problems began with private debt. However, with the onset of the economic crisis the

Table 1.16 Key State Financial Assets and Liabilities, end 2010

	€ billion	% of GDP	% of GNP
General Government Debt (A):	148.1	94.9	115.5
– Government securities etc.	116.5		
– Anglo Irish Bank promissory note	25.3		
– Irish Nationwide promissory note	5.3		
– EBS promissory note	0.3		
– EBS/INBS special investment share	0.7		
Total State Financial Assets (B)	40.6	26.0	31.6
– Cash balances (C)	16.2		
– Non-bank National Pension Reserve Fund (NPRF) (D)	15.0		
– Total non-bank financial assets (E)	31.2		
– NPRF investment in banks (F)	9.4		
Net Government Debt (general government debt less non-bank financial assets) (A) minus (E)	116.9	74.9	91.2

Source National Treasury Management Agency (2011), 'Information Note on Ireland's Debt', www.ntma.ie.

government deficit became very high and the ratio of debt to GDP/GNP has increased dramatically. In 2007 Ireland's debt to GDP ratio was 25 per cent of GDP (29.1 per cent of GNP). Since then it has more than tripled to reach an estimated 94.9 per cent of GDP (115.5 per cent of GNP) at the end of 2010. At the end of 2010 the nominal value of outstanding state debt was €148.1 billion.

These debt figures do not take account of the State's financial assets. An overview of key State financial assets and liabilities is provided in Table 1.16. At the end of 2010 the State had substantial financial assets with a value of €40.6 billion. Cash balances held by the National Treasury Management Agency (NTMA) were €16.2 billion, while there were assets valued at €24.4 billion in the National Pensions Reserve Fund (NPRF). Of the NPRF assets, its investments in Bank of Ireland and AIB were given a value of €9.4 billion. If NPRF bank investments are excluded—the real value of which is hard to know at this stage—total State financial assets were €31.2 billion at the end of 2010. The NTMA defines net government debt as gross debt less non-bank financial assets. On this basis, net debt at the end of 2010 was €116.9 billion (74.9 per cent of GDP; 91.2 per cent of GNP), considerably lower than gross debt as referred to above.

It is intended that €10 billion of NPRF assets will be used for bank recapitalisation during 2011. After this the NPRF will have assets of around €5 billion plus its bank investments. The NTMA indicates that cash balances will fluctuate but that it is intended to maintain a substantial level of cash balances; the level of cash balances at the end of 2011 will be around the same as at the end of 2010. This enhances the State's financial flexibility and means that net debt will continue to be lower

than gross debt. This financial flexibility, however, comes at a cost: the State is maintaining its cash balances by borrowing money through the EU/IMF agreement, while earning a considerably lower rate of interest on its deposits.

The information on assets and liabilities presented in Table 1.16 does not represent a comprehensive State balance sheet. There are significant State assets and liabilities in NAMA. At the end of 2010, NAMA had assets of €30.7 billion in the form of loans acquired from banks and liabilities of the same amount (bonds issued by NAMA to the banks). The State also has substantial commercial assets through its ownership of commercial state companies, as well as infrastructure and property assets. The State also has large pension liabilities, both for future social welfare pensions and public-service pensions.

In 2010, Ireland's debt to GDP ratio was the fourth highest in the EU. The member states with higher debt to GDP ratios were Greece (142.8 per cent), Italy (119.0 per cent) and Belgium (96.8 per cent). The EU (15) average was 82.9 per cent while the euro area average was 85.4 per cent. Italy's debt to GDP ratio has exceeded 100 per cent in every year since 1992, while Belgium's ratio was consistently above 100 per cent from 1983 to 2002.

The Need to Stabilise the Debt Burden

There are strong arguments for seeking to stabilise the debt burden relative to GDP/GNP as soon as possible. First, a rising debt burden implies that a rising share of national income is pre-empted to pay debt service and thus not available for other policy priorities. Second, the higher the level at which the debt burden is stabilised, the higher the share of tax required to service any given level of service provision. Third, Ireland can only return to normal bond market financing in a situation in which the debt burden is either stabilised or clearly on the way to stabilisation.

Analysis of Debt Dynamics

The challenge of stabilising and ultimately reducing the debt burden can be illuminated by considering the key variables that drive the debt to GDP ratio. These variables are the interest rate on the debt, the nominal growth rate of GDP and the primary or non-interest budget balance. In the situation where the interest rate on the debt exceeds the nominal growth rate of GDP, as is the case at present in Ireland, the debt to GDP ratio will increase, other things being equal. If an increase in the debt to GDP ratio is to be avoided in this situation, then it is necessary to offset this effect with a sufficiently large primary (non-interest) budget surplus. It can be shown that the size of the primary surplus required to stabilise the debt ratio in this situation is defined by the difference between the interest rate and the nominal growth rate of the economy times the debt to GDP ratio. If, on the other hand, the growth rate of GDP exceeds the interest rate on the debt, then other things being equal the debt to GDP ratio will fall. In this context, a primary deficit is consistent with a falling debt to GDP ratio, provided it is not excessively large.

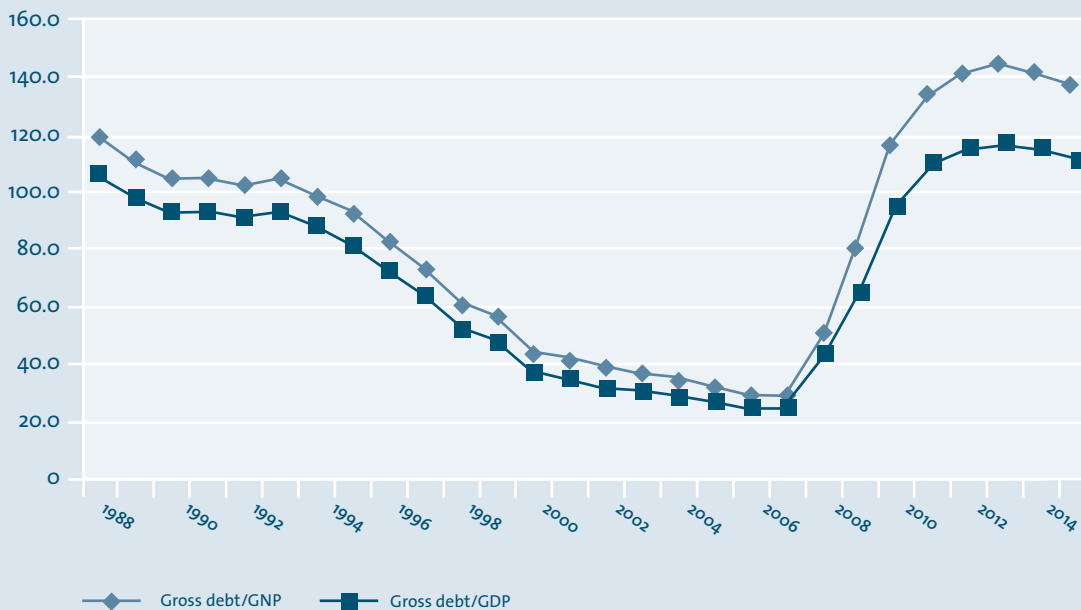
With this approach it is possible to decompose the growth in the debt to GDP ratio into three components as follows:

- i) The primary or non-interest balance as a percentage of GDP;
- ii) The 'snowball' effect, which is based on the difference between the interest rate and nominal GDP growth rate, adjusted for the size of the debt;

- iii) The stock-flow adjustment: this is a residual term to capture other factors that affect the stock of debt that are not captured by the other two dynamics. This can include factors such as changes in debt valuation and capital injections in banks where these are not included as regular expenditure. The accumulation and running down of cash balances by the NTMA is also reflected in the stock-flow adjustment figure. Normally, stock-flow adjustments are of minor importance but in recent years they have been significant.

From the 1990s up to 2007 Ireland experienced strong economic growth that exceeded the interest rate on the debt. In conjunction with a primary budget surplus this has meant substantial fall in the ratio of debt to GDP and GNP from 1994 (Figure 1.27). However, with the onset of the economic crisis these dynamics were reversed. The primary budget balance moved into a deficit of 5.9 per cent of GDP in 2008. This rose to 28.8 per cent of GDP in 2010, including the one-off promissory note for Anglo Irish Bank. In addition to GDP falling, a very large gap emerged between the interest rate and the growth rate of GDP.

Figure 1.28 Debt to GNP/GDP Ratio, 1987–2015



Source Historical data from IMF World Economic Outlook Database; projections are from Department of Finance (2011). Debt/GNP ratios are NESG calculations.

Stabilising the Debt to GDP Ratio

In the projections for the public finances as set out in the *Stability Programme Update* of April 2011, it is envisaged that the interest rate will continue to exceed the nominal growth rate of GDP in the period to 2015 (Table 1.17). In this scenario, stabilising the debt to GDP ratio requires a primary budget surplus that is sufficiently large to offset the impact of the differential between the interest rate and the nominal growth of GDP. In these projections, this condition is satisfied in 2014: in that year there is a projected primary surplus of 1.7 per cent of GDP and the debt to GDP ratio falls in that year; this leaves 2013 as the peak year for the debt to GDP ratio. In that year the nominal value of the outstanding debt is €198.1 billion, while the debt to GDP ratio is 118 per cent of GDP (144 per cent of GNP). The debt to GDP ratio falls to 111 per cent of GDP in 2015 (142 per cent of GNP)²⁷.

Table 1.17 Public Debt Developments, 2010–2015

	2010	2011	2012	2013	2014	2015
Nominal GDP growth rate	-2.9	1.4	3.1	4.0	4.3	4.6
Nominal interest rate	4.8	4.0	4.4	5.5	5.6	5.6
Nominal GDP growth rate less interest rate	7.7	2.6	1.3	1.5	1.3	1.0
Primary balance	-28.8	-6.2	-3.9	-1.1	1.7	3.4
General government debt (€billions)	148.1	173.0	187.4	198.1	202.2	203.6
General government debt (% of GDP)	95	111	116	118	116	111
General government debt (% of GNP)	116	134	141	144	142	137
General government balance (% of GDP)	-32.0	-10.0	-8.6	-7.2	-4.7	-2.8

Source Department of Finance (2011). The debt/GNP ratios are NESCAW calculations and take account of the revisions to GNP published in CSO (2011), National Income and Expenditure. Nominal debt figures are taken from National Treasury Management Agency, 'Information Note on Ireland's Debt', 10 May 2011, www.ntma.ie.

The annual change in the debt to GDP ratio and a decomposition of the contribution of the three main factors to this change is shown in Table 1.18 below. In the years to 2013, both the primary (non-interest) balance (which is in deficit) and snowball effect increase the debt to GDP ratio. The stock-flow adjustment factor also adds around six percentage points to the debt ratio in 2011. The main factor here is the borrowing undertaken to provide additional capital for the banks.²⁸ The primary

²⁷ The projections for the public finances in the SPU predate the publication of the CSO's most recent estimates for GDP and GNP. The revised GDP figures for 2010 would reduce the initial debt to GDP ratio for 2010 by 1.3 percentage points. Hence if the economy and the public finances were to evolve in accordance with the SPU projections, the debt to GDP ratio would peak at 1.3 percentage points lower than shown in the projections in Table 1.17. The preliminary results of the 2011 Census found that the population was around 100,000 higher than previously estimated. If confirmed by the final Census results, this would likely lead to an upward revision to the estimated level of employment and hence GDP and GNP. This would further reduce the debt/GDP and debt/GNP ratios.

²⁸ This capital is viewed as an investment. It is not included in the general government deficit or the primary balance. However, it does add to the debt and hence is included as a stock-flow adjustment.

Table 1.18 Analysis of Growth of the Debt to GDP Ratio, 2011–2012

	2011	2012	2013	2014	2015
Change in debt/GDP ratio	14.6	5.6	1.9	-2.6	-4.3
Contributions to change in debt ratio:					
– Primary balance	6.2	3.9	1.1	-1.7	-3.4
– Snowball effect	2.4	1.4	1.7	1.5	1.1
– Stock-flow adjustment	5.9	0.3	-0.8	-2.3	-2.0

Source NESCE calculations based on Department of Finance (2011)

balance moves into surplus in 2014 and hence contributes to a reduction in the debt ratio in that year; the primary surplus in 2014 is sufficiently large to offset the snowball effect. In addition the stock-flow adjustment effect also contributes to a reduction in the debt ratio in 2014 and 2015.²⁹

The government's projections in the *SPU* take account of the findings of the PCAR exercise undertaken on the Central Bank on the capital requirements of Ireland's banks. The PCAR determined that the banks required an additional €24 billion in capital in order to be prudently capitalised. The *SPU* projections assume that €10 billion of this capital is provided from the NPRF and €10 billion is provided through the exchequer. The remaining capital requirement is to be met by the banks' own efforts to raise capital primarily through imposing losses on subordinated bond holders.³⁰

The European Commission and the IMF have also published projections on the Irish economy and Irish public finances. There are small differences in the economic projections but the economic projections of the government in the *SPU*, the European Commission and the IMF are now all broadly similar. In its review of Ireland's EU/IMF programme of May 2011, the IMF projects the debt to GDP ratio to peak at 120 per cent of GDP in 2013. This is five percentage points lower than its initial projections, due to lower assumed bank recapitalisation (IMF, 2011a).

²⁹ One reason why the stock-flow adjustment term reduces debt in 2014 and 2015 arises from differences between interest payments in cash terms and interest payments as charged to the general government deficit.

³⁰ A bank's capital is the difference between its assets and liabilities. When losses are imposed on holders of subordinated bonds in a bank, this reduces the bank's liabilities and hence increases its capital.

In its initial paper on the EU/IMF programme, the IMF regards Ireland's capacity to repay the IMF as 'satisfactory' and refers to the IMF's exposure to Ireland as 'high but manageable' by the end of the programme (IMF, 2010: 30). However, it also states that the 'risks to the programme remain high' for the following reasons. Economic growth could be weaker than its projections of a moderate recovery. 'A prolonged period of deep recession could weaken loan repayment capacity of households and businesses and increase bank losses beyond current projections, leading the economy into a negative spiral'. There are the related risks that the fiscal situation could deteriorate and of a 'disorderly disruption of financial pressures.' It also points to the political risks of insufficient political will and public support to deliver the programme.

In its review in May 2011, the IMF's view was that risks had increased in some respects while declining in others. It emphasised, in particular, the risk of an inability to regain access to market funding:

This has been the clearest set-back since program approval, where despite strong policy implementation in both the financial and fiscal areas, the availability of cash and program financing, and the resolution of political uncertainty, ratings have been downgraded to the bottom tier of investment grade, spreads have widened, and access to markets has not been regained. A continued inability to regain market access for the sovereign, and hence for the banks, would impede growth, and, if prolonged, would result in a rising share of official financing in total public debt that could itself lead to wider spreads and undermine the ability to regain market access. In this context, deepening financial stress for other euro area periphery countries presents a critical yet largely exogenous risk that needs to be addressed through a more comprehensive European plan (IMF, 2011a).

On the publication of the report, Ajai Chorpá elaborated on what would be involved in a comprehensive European plan that would support Ireland's efforts:

First, Ireland needs to deliver the necessary policy action.

Second, European partners need to make clear that for countries currently with programs there will be the right amount of financing on the right terms and for the right duration to foster success. The priority here is to put into effect quickly an EFSF upgrade that can deal more flexibly with the crisis we face today. In addition, continued availability of ECB liquidity support for countries that are addressing their banking system problems is critical. In Ireland's case, the effectiveness of deleveraging and enabling banks to regain market-based funding would be supported by medium-term availability of Eurosystem financing.

Third, all euro zone countries need to support a comprehensive approach with accelerated repair and reform of financial systems through rigorous and transparent stress tests (Chorpá, 2011).

Chorpa argued that putting in place a consistent and comprehensive approach was urgent not just for the crisis countries but for all countries in the euro zone. Furthermore, ‘as a result of the crisis, Europe needs more integration, not less’ (Chorpa, 2011).

The rate of economic growth achieved has a crucial impact on the evolution of the debt burden. This effect operates both through its impact on the primary balance and the snowball effect. If moderate economic growth can be realised in the years ahead this will reduce the snowball effect and also help in the realisation of a primary budget surplus. The outlook for economic growth and interest rates also indicates that the achievement of a primary budget surplus is essential to stabilising the debt to GDP ratio.

Comparison to the 1980s

Ireland had an earlier public debt crisis in the 1980s from which a successful recovery was made. It is of interest to compare the current debt problems to this earlier experience (Figure 1.28).

If Ireland’s debt to GDP ratio evolves along the lines envisaged in the *SPU*, the debt to GDP ratio will rise to somewhat above its level of the 1980s with the debt to GNP ratio set to rise well above the level of the 1980s.

A significant indicator of the sustainability of the public finances is the interest burden as a share of GDP or GNP. Under the government’s projections in the *SPU* and those of the IMF and the European Commission, the interest burden on government debt will remain well below the levels reached in the first part of the 1980s. Ireland’s interest burden reached 9.4 per cent of GDP (10.5 per cent of GNP) in 1985. By 2007 this had fallen to just 1 per cent of GDP (1.2 per cent of GNP). With the economic crisis, it rose to 3.2 per cent of GDP in 2010 (4.0 per cent of GNP). In the *SPU*, projections expenditure on interest rises to 6.3 per cent of GDP in 2014 (7.8 per cent of GNP). In terms of the share of GNP, the 2014 level of interest expenditure will be one-quarter below its peak level of 1985. These interest rate projections pre-date the European Council agreement in July 2011 to reduce the interest rate on Ireland’s EU loans. This will further reduce the interest rate on Ireland’s national debt relative to the 1980s.

Expenditure on interest as a share of GDP/GNP is projected to remain well below the levels of the 1980s despite the debt to GDP/GNP ratios rising to higher levels. This is possible as interest rates on the debt are projected to be lower than the levels of the 1980s. Interest expenditure will still have a high opportunity cost. One indication of this is that in 2013, debt service will represent more than two and a half times government investment based on the *SPU* projections.³¹

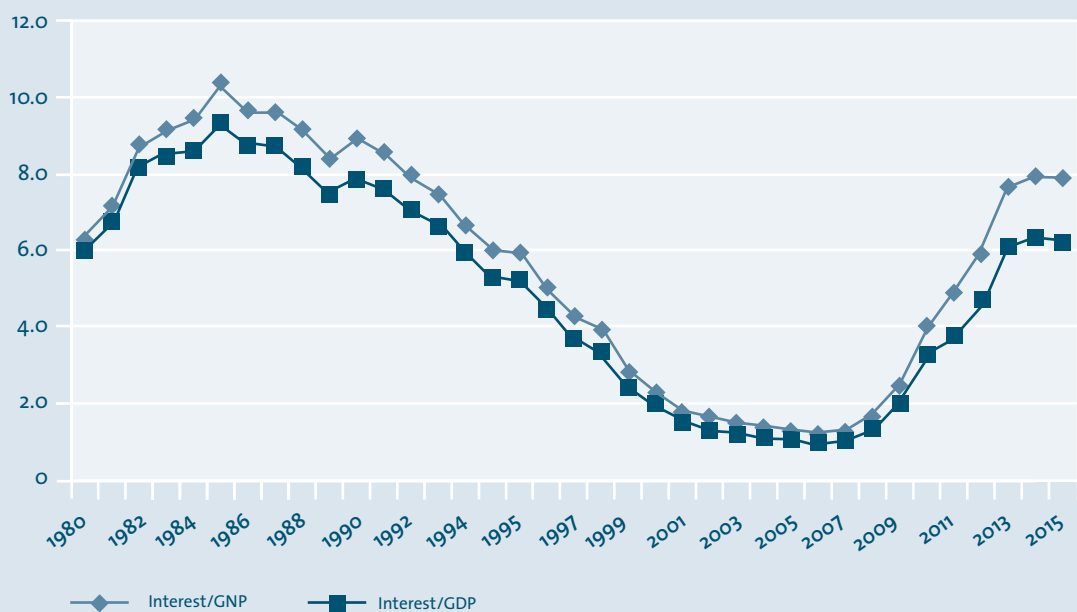
The average interest rate on the national debt at present benefits from the fact that most of the current debt was raised at interest rates that are lower than those currently available to Ireland. This effect will continue in the coming years but the projected interest payments also depend on the assumptions used. The interest rates used in these projections are considerably lower than the interest

³¹ Gross fixed capital formation for the general government sector is projected to be 2.3 per cent of GDP in 2013, while interest expenditure is projected to be 6.1 per cent of GDP.

rates available from the financial markets at present. However, if market interest rates on Irish government bonds remain at high levels, interest rates comparable to those used in the projections could be available from EU sources.

Economic recovery played a major role in enabling Ireland to emerge from its earlier debt crisis in the 1980s. The Irish economy does not now have the same potential for growth as it had in the 1980s. The problem of a high private debt burden on individuals and businesses did not exist in the 1980s. Neither did the banking problem. Ireland's success in making rapid progress in catching up with average EU (15) living standards cannot be repeated.³² The projections for Ireland's recovery in the coming years do not assume a return to the growth performance of the 1980s or 1990s. In the *SPU*, nominal GDP is assumed to grow by an annual average rate of 3.4 per cent between 2010 and 2015, compared to an annual average of 8.2 per cent between 1986 and 1990. Between 1995 and 2000, the annual rate of nominal GDP growth was 14.6 per cent. The projections in the *SPU* show that the achievement of more modest economic growth than was achieved in the 1980s or 1990s would

Figure 1.29 Interest on Government Debt as a Percentage of GDP and GNP 1980–2015



Source CSO, National Income and Expenditure and Department of Finance (2011), for projections from 2010 to 2015

³² There is, however, still scope for Ireland to move towards the average living standards of the richer members of the EU (15).

The evidence presented here shows that provided a moderate economic recovery occurs, there is a reasonable prospect that the debt ratio could be stabilised in a few years, but at a high level. There is a risk that with a stable but high debt ratio there could still be difficulties in returning to financial markets, as noted by Mc Hale (McHale, 2011). New arrangements are being put in place to provide financial support for euro area members after 2013.

European Stability Mechanism

The EU/IMF agreement addresses the State's current funding needs. The State intends to return to bond markets as soon as market conditions permit; the State however has sufficient financing available to it from the EU/IMF agreement and its own financial resources to cover its funding needs until the end of 2013. The March 2011 European Council ratified the establishment of a new European Stability Mechanism (ESM), which will become operational by mid 2013. The establishment of the ESM requires a minor Treaty change. It will replace the existing European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF) in providing financial assistance to euro area member states. Financial assistance will be subject to strict policy conditionality. The ESM will have a lending capacity of €500 billion. The adequacy of this lending capacity will be reviewed on a regular basis. Euro area member states will provide €80 billion in cash to be paid in over five annual instalments and will also provide loan guarantees so that the ESM can borrow additional money.

The ESM makes provision for negotiation with creditors. Member states seeking to avail of the ESM will be subject to debt sustainability analysis. If this analysis reveals that a macro-economic programme cannot realistically restore public debt sustainability, then,

The beneficiary Member State will be required to engage in active negotiations in good faith with its creditors to secure their direct involvement in restoring debt sustainability. The granting of the financial assistance will be contingent on the Member State having a credible plan and demonstrating sufficient commitment to ensure adequate and proportionate private sector involvement (European Council, 2011).

This provision will only come into effect after 2013. However, at that stage it will apply both to new and existing bonds. This means that if a member wishes to avail of the ESM but is deemed to have an unsustainable fiscal situation, then it may be required to restructure debt or to impose losses on bond holders. New bonds issued by euro area governments after 2013 will have 'collective action clauses' (CACs). These clauses will facilitate negotiations between states and creditors by enabling collective decisions to be taken by creditors on key debt-restructuring matters. It was originally proposed that when loans are made by the ESM, it would have preferred creditor status to other creditors, with the exception of the IMF. This had been a significant concern for potential investors. It was decided at a meeting of the eurozone finance ministers in June 2011 to change this condition: bonds issued by the ESM will not enjoy preferred creditor status.

The arrangements in the ESM have added to the pressure in bond markets of the peripheral euro area member states. Following the first announcement of CACs at the European Council meeting of 28–29 October 2010, there was an immediate increase in the bond yields of Ireland, Portugal and Spain (de Grauwe, 2011). Fears that a country may require access to the ESM can become self-fulfilling: if the financial markets will not provide finance, a country is left with essentially no choice but to seek access to the ESM, even if only to refinance existing debts.

In its report on the first and second reviews of Ireland's programme, the IMF raised concerns about the impact of the ESM on market access. On the publication of the report, Chorpa commented on the ESM as follows:

Finally, looking at these issues through the lens of investors, they're understandably concerned about the implications of the advent of the European Stability Mechanism, the ESM, which starts operations in 2013. Against this background it is an uphill battle to bring back private creditors to countries that are now out of markets. This returns me to my earlier point about the need for additional financing at appropriate terms. Specifically, the magnitude and terms of the financing need to be such that private creditors are convinced that the debt burden will be sustainable even in adverse scenarios and, hence, debt restructuring is off the table (Chorpa, 2011).

Chorpa's comment points to the critical importance of the conditions under which the ESM will operate. With appropriate conditions the ESM would support debt sustainability and hence the confidence of investors. This would improve market access for euro members and reduce the need to avail of the ESM.

A number of proposals have been made by McHale on the design of the ESM. First, greater clarity could be provided as to how the debt sustainability test will be applied. Second, he proposes that the growth potential of an economy for the purposes of assessing debt sustainability would be based on the growth that would occur with a neutral fiscal stance. Third, clarity to investors in bonds could be provided by setting a ceiling on the extent of losses that could be imposed on bond holders.

Other Policy Reforms

A range of reforms are being developed to strengthen economic governance at EU level. A 'European semester' commenced in 2011. This is a new policy-coordination cycle that is designed to harmonise both fiscal and structural reform policies of member states in line with agreed EU policy objectives. The Commission has published a series of legislative proposals to further strengthen economic governance. These provide for a stronger Stability and Growth Pact, including provision for financial penalties for lack of compliance. It is also proposed to introduce a regulation on macroeconomic imbalances; these imbalances (for example current account imbalances) would be monitored and there would be sanctions for repeated failure to address such imbalances. There is a proposed directive that would set minimum requirements for national fiscal frameworks. In

addition to these reforms, the euro area member states plus six others have agreed on a new pact on economic policy co-ordination, the 'Euro Plus Pact'. This Pact has a particular focus on competitiveness. Participating member states are required to present specific measures (to be chosen by the member state) to achieve the goals of fostering competitiveness and employment, and supporting the sustainability of the public finances and financial stability.

The European Commission has published a consultation paper on a new crisis management framework for financial institutions (European Commission, 2011). This considers new resolution powers for addressing failing financial institutions including statutory powers to impose losses on senior bond holders. It would take several years for any new arrangements to come into operation. The IMF has also proposed that 'the introduction of a pan European bank resolution framework with an EU-wide fiscal backstop would help decouple sovereign and banking risks' (IMF, 2011b: 6).

Ireland's debt burden has been substantially increased by the burden of bank debt. Information from the Central Bank shows that the structure of Irish bank bonds as of 18 February 2011 was as follows:

- ◆ guaranteed senior bonds: €20.9 billion;
- ◆ unguaranteed but secured senior bonds: €19.1 billion;
- ◆ unguaranteed, unsecured bonds: €16.4 billion;
- ◆ subordinated bonds: €6.9 billion.

'Guaranteed' here means guaranteed by the Irish state. A secured bond is one in which the creditor has a claim on a specific asset in the case of default on the bond. This reduces the scope to impose losses on the holders of these bonds since the claim remains on the assets. Taken together, subordinated bonds and unsecured, unguaranteed bonds represented €23.3 billion of Irish bank bonds in February 2011.

Many experts consider that it is likely that at some stage losses will be imposed on senior bond holders in European banks. These include Buiters *et al.*, who note that 'restructuring senior unsecured debt is part of the standard IMF post-crisis package in emerging markets' (Buiters *et al.*, 2011). At EU level the principle of imposing losses on bank bond holders has been considered, but not before 2013.

1.10 Conclusions to Chapter I

There has been a sharp contraction in the size of the Irish economy since 2007. The level of employment fell by around 13 per cent from 2007 to 2010, which brought the level of employment back to its level of 2004. There has been a huge increase in the rate of unemployment from around 4 per cent in 2007 to its current level of over 14 per cent. Real gross national income per head of population, fell by around 15 per cent between 2007 and 2010; the decline in real GNI per head has returned to its level of 2000. Income of households has fallen by less than GNI or other measures of national income.

The decline in the economy was driven by the sharp fall in construction output and employment; construction output fell by more than 50 per cent between 2007 and 2010 while employment in construction fell by almost 60 per cent. Total employment in services fell by 6.2 per cent from the final quarter of 2007 to the first quarter of 2011. There was considerable variation within this, with a particularly large fall in employment in retail and wholesale of 16.3 per cent over the same period. Most categories of goods exports and tourism declined substantially between 2007 and 2009; pharmaceutical exports continued to increase and services exports held up well. A broadly based export recovery occurred during 2010.

Despite the decline in the economy, Ireland remains a relatively high-income economy although no longer one of the highest-income EU countries. While GNI per head has returned to its level of 2000, this essentially leaves intact the real income gains achieved during the high-growth Celtic Tiger phase of the 1990s. The level of private and public debt, however, is now far higher than it was in 1999. Irish income in 2010, as measured by gross national income per head, is around 8 per cent below the EU (15) average; in 1987 Irish income had been only around two-thirds of the EU (15) average.

Ireland's income levels are underpinned by a sophisticated economy that is highly export-oriented. Relative to the size of its population, Ireland experienced a higher rate of job creation from FDI in 2009 than any other economy in the world. Amidst the current difficulties, there are some indications of improvements in the real economy that can provide a basis for recovery in subsequent years. These include the following:

- ◆ There has been a broadly based improvement in exports of both goods and services since 2010. Export sectors that have shown increased exports during 2010 include pharmaceuticals, medical equipment, food, computer services and business services;
- ◆ The level of job creation in IDA Ireland companies in 2010 at almost 11,000 was comparable to that achieved in pre-recession years of the past decade and more than twice as high as in 2009;
- ◆ Manufacturing output expanded in both modern and traditional manufacturing in 2010;
- ◆ There has been an improvement in cost competitiveness in many key areas, including labour costs, property and business costs generally;
- ◆ Following two years of decline, agricultural income recovered in 2010 and further growth is expected in agricultural income and food exports;
- ◆ Tax revenue in 2010 was €703 million (2.3 per cent) higher than expected, mainly due to higher than expected corporation tax (€764 million or 24.2 per cent ahead of expectations). The exchequer returns for the first half of 2011 were close to target;
- ◆ The current account of the balance of payments moved into a small surplus in 2010 (0.6 per cent of GNP);

- ◆ The net financial wealth of households, excluding housing assets, increased by 70 per cent from the first quarter of 2009 to the fourth quarter of 2010.

Notwithstanding some positive indicators from the real economy, the level of employment and domestic demand is still falling. The level of unemployment is very high and on present trends will remain high for an extended period, even with an economic recovery; the government's *Stability Programme Update* envisages that the rate of unemployment would fall to 10 per cent in 2015. The level of consumer prices in Ireland in 2010 was almost 13 per cent higher than the EU (15) average and, as Forfás has shown, many key business costs remain relatively high in Ireland including property, broadband and legal costs. Domestic demand has not yet begun to recover. There is a high debt burden for both government and households while the measures taken to address the banking sector have not yet established sufficient confidence in the sector. The government's projections envisage the debt to GNP ratio peaking at over 140 per cent of GNP.

The achievement of economic growth along the lines envisaged in the Government's projections would make a critical contribution in terms of securing some increase in employment and restoring balance to the public finances. It would be highly desirable to achieve faster economic growth in order to achieve more progress of increasing employment and reducing unemployment. Strong employment depends on a recovery in domestic demand. However, with significant constraints on domestic demand at present, in conjunction with expansion in the global economy, the best opportunities for economic growth initially lie in export growth. Ireland's exports experienced a recovery from 2010 but there is scope for Ireland to further improve its export growth.

This raises the question as to what policies could contribute to an acceleration of export growth. While there has been some restoration of cost competitiveness, securing further progress on cost competitiveness across a range of areas is a key mechanism through which export growth can be maximised. One barrier to the reduction in property costs is the presence of upward-only review clauses in lease agreements. The new Programme for Government (2011) contains a commitment to bring in legislation to ban upward-only rent review of existing leases.

An effectively functioning banking system is essential to maximising growth opportunities, so action in restoring the viability of the banking system is critical. However, in downsizing the banks, assets should not be disposed of at 'fire sale' prices. This increases bank losses and the costs to the State of rescuing the banks.

There are reasons to believe that the current difficulties can be overcome. With regard to the external environment, the current financial market instability cannot continue indefinitely: whether it takes further modest intervention or large initiatives, in one way or another the problems must be resolved. In regard to the Irish economy, the expansion of Irish exports demonstrates the capacity for growth in unfavourable circumstances. Decisive action on the public finances can be expected to contribute in time to stronger confidence when it becomes clear that the public finances are under control. Investment in housing, at least in urban centres, will recover when people feel more confident about their employment and when it becomes clear that prices have stopped falling.

2

National Action in an Unsettled European Context

2.1 Introduction

There are five parts to Ireland's current crisis. The banking and fiscal challenges have largely overwhelmed analysis of the economic, social and reputational aspects. This paper brings attention back to the economy.

Chapter 1 illustrated the damage—to employment, domestic demand and investment—but also the resilience of the economy. It suggests that there is a basis for hope. This is evident in the levels of exports, especially the growth in 2010, which occurred in pharmaceuticals, medical equipment, food, computer services and business services. Inward investment has regained pre-recession levels, signifying continuing confidence in the underlying skills and capabilities of Irish people. Competitiveness has also improved significantly.

Chapter 1 brought attention back to the interdependence between the parts of the crisis. In particular, it highlights the relationship between debt, public finances and economic growth. Understanding this dynamic was critical to how economic recovery was achieved in the 1980s and it can once again provide an important basis upon which to create broad engagement with the challenge of rebuilding Ireland's economy. An understanding of the debt-growth dynamic can assist policy to work in a more coherent manner during the crisis. It also provides a means of communicating in a more effective way with the wider range of stakeholders whose patience, commitment and innovation is so very necessary for Ireland to work its way back to financial, economic and social stability.

Chapter 1 highlights that this debt dynamic is unfolding in the context of significant European developments. It noted that there is growing recognition of the complexity of the financing problem and the need to develop more comprehensive European solutions.

It is natural that these developments, ideas and associated policy responses are the subject of intense debate. Over the past three years, that debate has included a range of issues, including bank resolution, the speed of fiscal correction (with advocates of both slower and faster adjustment), the incidence of expenditure reductions and tax increases, employment protection, the EU's response to the public finance and banking problems within the Union and the euro area and the feasibility of the adjustment path outlined in the EU-IMF Programme of Financial Support. While underlying views still differ on these issues, it is important to note that, on some of them, events have narrowed the range of feasible positions. Two events in particular: Ireland is not able at present to assess bond markets for finance; and, is now part of an EU/IMF programme. There is very limited space for manoeuvre and it is our belief that the space is becoming more constrained by developments in Europe. In this sense, the trade off, as debated in the early days of the crisis, has shifted in a way that requires fresh analysis.

We believe that these events are creating some degree of, as yet unspoken, convergence. On the one hand, those who emphasise the burden of accumulated debt and the importance of an early stabilisation of the debt/GDP ratio—and, consequently, strict adherence to the terms of the Programme of Financial Support—largely now recognise the advantages that would flow from a more comprehensive EU resolution of the public finance and banking problems that reflect systemic problems in the euro area and the EU. But, for a number of reasons they tend to focus on domestic adherence to fiscal correction more than on an enhanced international financial and political resolution. On the other hand, those who emphasise the negative feedback loops from fiscal adjustment to growth, largely now recognise that Ireland must at some point close the gap between revenue and expenditure, and indeed has little option but to adhere, in the current context, to the terms of the EU-IMF Programme of Financial Support. But, also for a number of reasons, they tend to highlight the need for a more comprehensive EU response more than the unavoidable fiscal adjustment process.

We believe that this convergence is captured by the idea of 'working the EU/IMF deal'. This convergence on 'working the deal', rather than debating whether the deal can work allows us to concentrate on plans and actions that might, in spite of confined space for immediate action, unify Irish actors around projects of economic and social development.

The remainder of this paper outlines five connected elements necessary for working the deal. It is structured as follows:

- ◆ 2.2 Continue Fiscal Adjustment and Reform;
- ◆ 2.3 Work Relentlessly to Revive Sustainable Growth;
- ◆ 2.4 Make Solidarity a Core Focus to Ensure Fairness and Unity of Purpose;
- ◆ 2.5 Pursue Developmental Opportunities;
- ◆ 2.6 Work to Promote a More Comprehensive EU and International Financial Resolution.

2.2 Continue Fiscal Adjustment and Reform

Achieving a balance between revenue and expenditure is an important principle. Its usefulness as a target is first, that it is a necessary step in stabilising the debt to GDP ratio; and second, that the variables that determine the balance are largely ones over which Irish people and the government have a significant degree of control. Once in balance, this means that day-to-day activities are not adding to national debt. (Box 2.1 provides an overview of debt dynamics).

The primary balance is the first step towards stabilising debt. However, this does not mean debt is stabilising because if interest rates on past debt are higher than the growth rate, then national debt as a proportion of GDP will still be rising. In this sense, the primary balance is a necessary step but it is not sufficient. It is a useful intermediate target. Bringing this into balance by 2013 is a challenging target but it is achievable. It is also a useful target because the factors that impact on it—level of expenditure and taxation—are largely within the control of Irish stakeholders. Indeed, though not technically identical, it is an early reminder of a central long-run requirement: Ireland must raise sufficient tax to cover the level of expenditure we require.

Box 2.1 Dynamics of Debt Stabilisation

The dynamics of debt accumulation or stabilisation is a standard part of economic theory. It describes the conditions under which a government can stabilise the fiscal deficit and the overall national debt. The factors which influence the stabilisation of the debt to GDP ratio are:

- ◆ **Primary Balance:** The difference between revenue and expenditure, excluding interest, as a percentage of GDP;
- ◆ **Snowball Effect:** The difference between the interest rate and nominal growth rate of GDP, adjusted for the size of the debt;
- ◆ **Stock Flow Adjustment:** Includes factors such as changes in debt valuation and capital injections in banks where these are not included as regular expenditure.

The combination of these elements drives the debt to GDP ratio as shown here.



In mathematical terms:

$$\Delta nd = o \quad \text{when} \quad t - g = (i - y) nd$$

Where

nd is national debt as % of GDP

t is government revenue as % of GDP

g is government expenditure, as % of GDP, excluding interest on past debt

i is interest rate on past debt;

y is the nominal growth rate of GDP.

The underlying dynamics of debt accumulation are such that the higher the level at which the debt burden is stabilised, the higher the share of tax required to service any given level of service provision. In addition, a rising debt burden implies that a rising share of national income is pre-empted to service debt and thus not available for other policy priorities. It is also evident that if progress is not made in stabilising and then reducing the debt to GDP ratio, then Ireland will at some stage not be able to obtain the funding needed to finance its deficit.

The interest rate on Ireland's sovereign debt is expected to exceed the nominal growth rate over the next few years. In this context, stabilising the debt to GDP ratio requires this to be offset by a sufficiently large primary (non-interest) surplus. It can be shown that the balance required is defined as the gap between the nominal interest rate and the nominal growth rate times the debt to GDP ratio.

In addition, the stock-flow adjustment is normally a small item. It includes debt-revaluations and capital injections, such as those currently being provided to the banks. The investment in the banks substantially increases the level at which debt is stabilised but not the timing of the stabilisation.

The second step is to focus on getting a surplus of sufficient size that it can be used to reduce the debt. Finally, more rapid progress can be made when there is both a primary surplus and the nominal growth of GDP exceeds the nominal interest rate.

2.3 Work Relentlessly to Revive Sustainable Growth

Ireland needs to ensure a return to positive economic growth, which will reduce the gap between the interest rate and the growth rate. Ireland's economy is expected to achieve moderate GDP growth over the next few years. Current forecasts expect a primary surplus of 2.7 per cent of GDP in 2014. At that point, nominal GDP growth is expected to have reached 4.3 per cent, while interest rates are expected to be 5.6 per cent. Given the gap between the growth rate and interest rate, this primary surplus is sufficiently large to reduce the debt to GDP ratio by two percentage points, to reach 116 per cent of GDP in 2014 (Table 2.1).

This section looks at three issues that determine future growth prospects:

- ◆ Re-building the Tax Base;
- ◆ Exports;
- ◆ Domestic Demand.

2.3.1 Re-building the tax base

The dynamics of debt stabilisation/accumulation are dependent on important interaction effects between the components of the equation outlined in Box 2.1 above. Mindful of these interaction effects this section argues that taxes should not constrain economic growth and activity. Figure 2.1 provides an overview of the different forms of estimated government revenue in 2011. The dominant sources of revenue are income tax and VAT which combined account for two-thirds of revenue in 2011. Corporation tax accounts for 12 per cent of estimated revenue. There is also non-tax revenue of €2.6 billion. These come from various sources, such as a surplus from the Central Bank and the National Lottery.

Table 2.1 Gap between Interest and Growth Rates—Current Forecasts

	2010	2011	2012	2013	2014
Nominal interest rate	4.8	4.0	4.4	5.5	5.6
Nominal growth rate	-2.9	1.4	3.1	4.0	4.3
Difference	-7.7	2.6	1.3	1.5	1.3

Figure 2.1 Projected Taxation³³ Receipts, 2011 (€m)



Source Estimates of Receipts and Expenditure for the Year ending December 2011, Department of Finance, 2011. Revenue for business rates are derived from CSO National Income and Expenditure (June 2010), which provides a preliminary estimate for 2009. Rates for PRSI are from estimates for the Department of Social Protection.

The primary balance will be improved by increasing revenue from any of these sources. In the 1980s, the challenge in relation to tax focused on reducing the high tax burden facing individuals, households and companies. In 2011, the overall challenge is to find ways to rebuild the tax base so that there is sustainable and equitable sharing of the tax burden. The debt-growth relationship means that improvements in revenue must be taken in a way that imposes the least possible harm to the prospects for economic activity. In some cases—such as property tax and domestic water charges—the logic is compelling: if Ireland puts a priority on the level of employment, reducing emigration, increasing output and growth, then it must raise additional revenue more through these channels rather than through taxes that dampen activity and employment. This highlights the importance of the interaction effect between the primary balance and growth. In addition, there are further reasons—related to housing and environmental sustainability—to adopt well designed property taxes, which should include an intergenerational effect, and water charges. We seem to have gone past the point where these taxes can be approached as matters of taste, tradition or ideology or at least arrived at the point where the implications of choices should be acknowledged.

³³ PRSI is not normally treated as a taxation receipt but is included here. Business rates are also included though rates are paid directly to local authorities and as such are not part of central government revenue.

In other cases—such as capital gains, wealth taxes or excises—economic modelling would be necessary to ascertain the likely balance between the range of effects across consumption, employment, business activity and revenue.

2.3.2 Export Growth

Exports, more so than other ways of boosting growth, can have more open-ended potential, at least for a small economy. It is not unrealistic for a small open economy to expect to grow exports at a rate of 10 per cent or more per year. CSO data indicates that the volume of exports grew by 6.3 per cent in 2010. Irish exports have been resilient but given the limited scope to boost domestic demand—private or public consumption or investment—at least in the short term there is a need to increase export growth. Second, foreign direct investment is a major factor in underpinning export performance. An important policy consideration in this context is the corporate tax rate and the tax base. This is not discussed further in this paper, though it is important to recognise the potentially significant impact on economic growth.

There needs to be a concerted focus on exports. This must engage more companies in more sectors into thinking about export opportunities for a greater number of products and services, and in more countries. The domestic market can provide a fertile location for testing new ideas, and the public sector, through its procurement process, can be an important stimulus in this regard. The crucial nature of exports is reflected in current policy and there is evidence that more government departments are engaging in work to help identify opportunities.

The crucial nature of exports is reflected in current policy and there is evidence that more government departments are engaging in work to help identify opportunities. A key example of this is *Trading and Investing in a Smart Economy* report. This was produced by a high level group with members from four government departments and six different enterprise agencies.

2.3.3 Domestic Demand

In addition, recovery of the economy will depend on growth in domestic demand. The sectors that cater to domestic demand tend to be more labour intensive and therefore more likely to create significant numbers of jobs and improve well-being.

Domestic demand is spending on consumption (by households and the State) and investment (by companies, households and the State). Some domestic demand goes on imports; it has most impact on the economy when it is allocated to domestic products and services and investments such as home improvements. For this to happen people need to have money and sufficient confidence about future earnings to be willing to spend it.

Increasing domestic demand during a crisis is extremely difficult. There are a number of views on how to achieve this. A 'wait and it will come' view focuses on export-led growth and assumes that as this continues it will create employment growth in exporting companies and domestic firms supplying goods and services. This will in turn boost confidence and create further domestic demand. A second

‘act and it will happen’ view highlights that if individuals and households start to spend this will boost domestic demand and this combined with export led growth will secure the future of the Irish economy.

The ‘wait and it will come’ view suggests a relationship between export-led growth and employment creation—both directly in the firms and indirectly—that is stronger than the evidence suggests. Indeed, much of the export-led growth, in particular in the pharmaceutical/chemical sector, is associated with small decreases in employment. The ‘act and it will happen view’ relies too much on the headline increase in the savings rate of 13.8 per cent (ESRI QEC) and the level of wealth. The savings rate is a product of increased savings **and** increased repayments. The wealth, while significant—in the final quarter of 2010, Irish households held almost €124 billion on deposit—is not evenly distributed and aggregate data are likely to conceal very fundamental differences among individuals.

A third view is therefore necessary. This view does not undermine the importance of continuing to rely on export-led growth or to encourage consumers to act. It focuses on identifying and exploring the complexities. This ‘understand and unlock’ view suggests that we need to understand why Ireland has:

- ◆ Weak Domestic Demand
- ◆ High Prices
- ◆ High Savings Rate
- ◆ High Levels of Deposits

Chapter 1 of this paper shows that consumer prices in Ireland are too high. Consumer prices were 12.7 per cent above the EU (15) average in 2010 which was an improvement over 2008 when the difference was 23.7 per cent. There are also number of specific business costs—wastewater services, legal services, property, broadband and waste disposal—which have not adjusted sufficiently. The creation of a more stable and community-wide system of funding for local government would allow a reduction in the burden of municipal services on businesses.

The Programme for Government contains a number of initiatives to help stimulate domestic demand, including a reduction in VAT from 13.5 to 12 per cent, doubling the funding for the retrofitting programme, a public-sector retrofit programme, changes in retail and reform of public-sector procurement. An analysis of these issues, and how they vary across households, could help inform how domestic demand might be stimulated further. It could help inform discussion about initiatives in relation to household debt; it could identify how further falls in Irish costs might be secured; and it could support the development of a property-based tax, which includes an intergenerational transfer effect. It might also help identify the role of new incentives in relation to home improvements. In relation to the latter, the case may be at least as compelling as the case for encouraging investment in imported cars through the scrappage scheme.

In addition, since the recession there has been a significant improvement in cost competitiveness though there are areas where costs remain high. The Programme for Government has committed to legislate to end ‘upward-only’ rent reviews. It also contains commitments to introduce a single business tax for micro-business, to further streamline regulation, to ban ‘hello money’, and to introduce a unique business identifier to reduce repetitive requests made to business. The EU/IMF programme includes a number of very specific and time-bound initiatives, such as the appointment of an Independent Regulator for the Legal Profession (Q3 2011); independent assessment of electricity and gas sectors (Q4 2011); elimination of restrictions on GPs (Q3 2011); and enforcement of the elimination of the 50 per cent mark-up for pharmacies (Q3 2011) and other reforms in competition law (Q3 2011).³⁴ The latter reforms include the introduction of legislation to empower judges to impose fines and other sanctions in competition cases in order to generate more credible deterrence (EU/IMF, 2010 14). The ability to impose civil fines is present in most other European countries and its absence in Ireland is a serious weakness in Irish competition policy. These proposals are endorsed by the Secretariat.

2.4 Make Solidarity a Core Focus to Ensure Fairness and Unity of Purpose

Measures taken must be based on social solidarity. Responses must be seen as sharing the burden of adjustment fairly and being capable of yielding a fair economy and society. Without this sense of fairness and solidarity, the focus on growth, for example, might not create the type of society or environment in which Irish people would like to live in years to come. It is important to highlight the need for intergenerational solidarity in light of the potentially disproportionate impact of the crisis on younger people. One way intergenerational solidarity could be advanced is to design a new property tax that takes into account the level of outstanding mortgage repayments.

The primary balance improves when government expenditure is cut. As with revenue, there are various ways that cost can be reduced. The debt-growth dynamic needs to be brought to bear on decision-making in relation to cost-cutting.

Expenditure cuts will have varying impacts on economic growth and activity and this needs to be carefully assessed. However, the Council has also argued that responding to the crisis by cutting costs (retrenchment) without carrying out reform is unlikely to deliver long-term solutions (NESC, 2009). Indeed, in its recent report, *Re-finding Success in Europe: the Challenge for Irish Institutions and Policy*, the Council argued it was unlikely that the country could address the fiscal challenge if it was approached narrowly as just a fiscal issue. NESC argued:

it does not seem possible to achieve the necessary fiscal adjustment without in-depth knowledge of how well different programmes work, how the welfare system can be made more developmental, and which taxes are most supportive of economic growth, employment and sustainability—including awareness of international best practice on these issues (NESC, 2010 b: 222).

³⁴ This includes a commitment to carry out a study on the economic impact of eliminating the cap on the size of retail premises, with a view to enhancing competition and lowering prices for consumers (EU/IMF, 2010 14).

There is a need to reduce expenditure. Government expenditure is used to provide necessary services for the citizens of the state. The range of those services and the quality and standard does not necessarily have to be curtailed or undermined because of the financial pressures. The NESC Council is currently examining public services in its project *The Role of Standards in the Provision of Quality Human Services*. It is uncovering systems that are being used in a range of services to maintain quality and standards within a context of significantly reduced budgets. The evidence to date suggests that the ability to combine retrenchment with reform exists in many parts of the public service. This is not to minimise the challenge of operating with very significant reductions in budgets; however, it does show that it is possible. The argument that there is not enough time to combine reform with retrenchment needs to be counterbalanced by the dangers of expediency and decisions that could severely hamper the country's long-term potential to recover. This highlights again the interaction effect between the primary balance and growth and activity. The tendency to overlook this interaction was observed in the 1980s when the overwhelming focus on expenditure cuts reduced the medium-term capacity of the state to provide, for example, adequate health care. In adjusting public expenditure it is necessary to identify new and innovative ways of cutting costs and maintaining standards. This requires engagement of local problem-solving to ensure that expenditure is reduced in a way that does not undermine the services provided to citizens.

2.5 Address Developmental Constraints

Ireland needs to address developmental constraints which have the potential to undermine the long term recovery of the economy and society. One such constraint is the availability of finance to support business investment. Taking forward the idea of a Strategic Investment Bank as mentioned in the Programme for Government, is a key step in this regard. It could support projects that deepen and strengthen Ireland's economic and social development in a sustainable way.

There is an underlying problem in the availability of credit for medium and long-term business investment. The Programme for Government recognises the need for further responses and identifies a number of measures including a temporary partial credit guarantee scheme and a €100 million micro-finance start-up fund.

However, there needs to be a dedicated institutional response, such as an independent Investment Taskforce with significant involvement and leadership from business people, to ensure the issue is effectively addressed. This taskforce should help design a new process to allow businesses, some of which may be technically insolvent, to demonstrate viability.

There are a number of factors that support this conclusion:

- ◆ The level of credit is contracting and it is noteworthy that credit for long-term projects is contracting faster;
- ◆ International research shows that restrictions to the flow of credit can have a significant impact on the strength of recovery and subsequent growth rates;

- ◆ Investment by businesses is critical for growth. The report highlights the contribution of indigenous business but also the continuing underlying weaknesses in terms of scale and international reach;
- ◆ The weak track record of existing banks, even before the crisis, in lending to non-building/property related businesses;
- ◆ Existing banks do not have in place the correct systems of localised assessment and support that are appropriate to current business conditions;
- ◆ Changes in banking to date have not resulted in a marked and demonstrable change in the supports available to business;
- ◆ Given the scale of the crisis and the level of unemployment, there is little justification for delays. A definite and radical institutional response is required which can deliver immediate improvements;
- ◆ The public sector, through agencies such as the IDA and Enterprise Ireland has considerable experience in working with companies to support very significant investments.

The level of credit is contracting. Credit has fallen since 2009; i.e. new loans to businesses have been less than repayments during that time. A contraction in credit is most damaging if activities or sectors with strong potential to grow and improve productivity are being constrained. It is noteworthy that credit for long-term projects is contracting faster. The decline in long-term credit could constrain new long-term investment. It is also worth noting that this may disproportionately affect companies at an earlier stage of development as they tend to have larger relative requirements for external capital.

There have been improvements in the quality of information available on credit. The Central Bank now publishes information on underlying credit transactions. However, there continue to be key gaps in the information available on credit. In particular, comprehensive information and regular information is required in relation to lending patterns. We support the proposal of the CRO that all interested parties would share in the commissioning of a quarterly survey of the demand and supply of credit to SMEs.

2.6 Work to Promote a More Comprehensive EU and International Financial Resolution

The IMF recognise the possibility that sovereign states will continue to be unable to regain market access and that more a comprehensive European plan is required. This depends, first, on Ireland delivering on the terms of the EU/IMF programme. Second, it requires that European partners need to make clear that for countries currently with programs there will be the right amount of financing on the right terms and for the right duration to foster success.

In this context, it is important that rigorous discussion take place in Ireland in relation to international financial developments and in particular the conditions under which the European Stability Mechanism will operate. This should help to to maximise the probability of enhancing Ireland's international financing arrangements in the medium and long term.

This should include contributions on issues such as the following:

- ◆ Design of the European Stability Mechanism;
- ◆ Barriers to bond markets access for small states;
- ◆ Treatment of creditors including creditor status within the European Stability Mechanism;
- ◆ Interest rates;
- ◆ New financing arrangements, such as a Eurobond and 'Brady bond';³⁵
- ◆ Long term sovereign debt.

³⁵ Brady bonds are discussed in Section 1.8

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