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Ireland's Economic Recovery: An Analysis and Exploration

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by Noel Cahill, Larry O'Connell, Rory O'Donnell and Cathal O'Regan

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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.

