QUARTERLY REVIEW
ECONOMIC TRENDS

IBEC

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Supplementary Budget lays out path to stability

The Irish economy is in the depths of the steepest recession on record. Financial, fiscal and currency crises resulting in the urgent need to take harsh remedial action are hitting it simultaneously. Maintaining economic activity and retaining employment are a necessary adjunct to direct fiscal action to stabilise public finances. Given Ireland's very favourable debt/GDP ratio, the stringent corrective measures announced in the supplementary Budget ought to dispel any market concerns about Ireland's ability to honour its debts. The judgements of rating agencies have been premature in that their assessment did not take account of the considerable adjustment measures now taken.

An overriding requirement of the supplementary Budget was that government demonstrate that it is taking effective action to stabilise the General Government deficit, which was heading for a truly unsustainable 12.75% of GDP and to have a credible programme of further corrective action that would reduce the deficit below 3% of GDP by 2013. The latest assessment of the fragile state of the Irish economy was argument enough for abandoning a target to reduce the deficit to 9.5% of GDP, which had been proposed in the January Addendum to the Irish Stability Programme Update. This would have required such corrective measures that the economy would have been driven into a deep and prolonged recession.

Sensibly, the Government chose the more economically sound option of doing sufficient to reverse the escalating rise in the deficit and at the same time announcing further adjustment measures to bring balance to the finances by 2013. In a departure from normal Budget formulation, accompanying documents to the Financial statement set out a profile of taxation and spending adjustments for 2010 and 2011 amounting to a further €9.4 billion on a full-year basis. The policy decisions underlying the expenditure reductions are already in train and will entail further reductions in pay costs, numbers and the full range of expenditure programmes. There is no provision for additional social spending other than that dictated by demography and unemployment. Savings on day-to-day spending will be made through more targeted welfare provision and reductions in public service costs and numbers.

We had argued for an adjustment package that was balanced more on the side of expenditure cuts than on revenue raising. The balance in 2009 was skewed firmly on the side of raising revenue. That was understandable in 2009, given the urgency of such corrective action. The Budget papers suggest that this balance of adjustment will not shift in favour of expenditure cuts until 2011 and then only to the proportion of 54%. We would urge that in the planning process out beyond 2010, every effort should be made to shift the correction to expenditure. All international evidence points to the efficacy of focusing more on expenditure.

Nevertheless, these harsh measures should go a significant way down the path of eliminating the structural deficit, which has emerged as the economy and the Exchequer rebalances from its overdependence on the construction sector and the associated tax yield. The sharp global downturn has also had a very negative impact on the Irish economy which has been more exposed than many countries because of the very open nature of the economy. A global recovery in 2010 or 2011 will give a strong boost to Ireland's exporting potential, which is the driving force behind growth and high living standards. This would boost economic activity and the automatic stabilisers that are greatly exacerbating the deficit levels in 2009 and 2010 will begin to have a positive influence on the deficit. In the later years of 2012 and 2013 the deficit position will depend on the strength of the cyclical upturn and the Government has declared that it will take measures to ensure that the deficit falls below 3% of GDP by the end of 2013.

IBEC fully recognises that these measures are harsh, will cause pain to all of Irish society and will make operating businesses more difficult. There is no alternative; Ireland has to restore its financial stability and its high international reputation as a globally trading economy. This supplementary Budget and the programme of correction outlined for the next four years will go a long way to achieving that. As social partners we support it and we call upon all other social partners to support it.

We have pointed out to Government that sustaining economic activity – and hence employment levels - is also a critical factor in maintaining fiscal stability. Prior to the supplementary Budget, we had argued for the reallocation of funds from the National Development Plan to provide substantial temporary enterprise supports for viable businesses that were suffering from the global downturn and the strength of the exchange rate, especially against sterling. The announcement of a €50 million per annum Enterprise Stabilisation Fund will not make the difference needed. IBEC will continue to seek a meaningful enhancement of this fund to ensure that viable businesses do not go out of business for want of some short-term assistance.

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Irish economic context

Budget introduces corrective measures...

Economic growth as measured by GDP averaged 5.5% in the five years to 2007. In 2008, output fell by 2.3%. According to pre-supplementary Budget tables published by the Department of Finance, GDP was set to fall by 6.75% in 2009; following the Budget the Government expects GDP to fall by 7.7%. This is a more benign scenario than we envisage (see tables 1 and 2). Our own pre-Budget assessment was that GDP would fall by 7.7%; on a post-Budget basis we think GDP will fall by over 9%.

In the supplementary Budget, it was crucial that the Government demonstrate that it is taking effective action to stabilise the Exchequer finances and in particular that it had the capacity to reduce the general government deficit. In ten out of the eleven years to 2007, the general government balance was in surplus; in 2008, it plunged to a deficit amounting to 6.3% of GDP. This deficit, which under Stability and Growth Pact rules should not exceed 3% of GDP, is well above this limit as indeed it is in several European Member States. Prior to the Budget the Government estimated that the general government deficit was set to increase to 12.75% of GDP in 2009, well above what was anticipated in the October Budget and above the 9.5% deficit envisaged in the Addendum to the Irish Stability Programme Update published in January this year. The government sensibly chose not to introduce adjustments to meet the 9.5% target. This would have required such corrective action that the economy would have been driven into a deep and lasting recession.

Instead, it sought to make adjustments in a spending and taxation package amounting to some €3.26 billion in 2009 and equivalent to €5.4 billion in a full year. In our view, this was at the limit of what the economy could bear without severe damage and much in line with our submission to government.

We believe that the Budget did succeed in demonstrating to international investors that the government has arrested the deteriorating trend in government finances and that it does have a credible plan to make significant corrective progress over the next four years. It added to this credibility by announcing plans for dealing with toxic assets by establishing a National Asset Management Agency.

...but balance between expenditure and tax increases is inappropriate

That said we do have reservations regarding the proposed measures and their impact on the economy. As we noted earlier, the estimates upon which the government's action is based are in our view optimistic. In the first instance, we doubt that GDP for 2009 will come in at €171 billion. This represents a fall in nominal terms of 7.7% from 2008 levels. We think GDP in nominal terms is likely to be closer to €165 billion. As the Government has also forecast a volume fall of 7.7% the implicit price deflator of GDP is zero, whereas most commentators including the Central Bank anticipate deflation of over 1%. Add to this that the impact of the Budget is likely to reduce GDP by more than the 1% envisaged by the government, nominal GDP could easily be more than 2% lower. This would result in a deficit of over 11% of GDP, but, significantly, one on a downward trajectory.

The balance between expenditure cuts and taxation increases was inappropriate. We had accepted in our pre-supplementary Budget submission that a mixture of spending reductions and tax increases would be needed to bridge the gulf between expenditure and revenue. We argued strongly that the balance of any adjustment package should be centred around one-third revenue raising and two-thirds expenditure cuts. We cited the evidence that firmly demonstrated that expenditure cuts led to economic recovery and tax increases exacerbated the problems of an economy in recession. However, the government's budgetary stance concentrated the greater part of its corrective action on taxation increases. The €3.26 billion adjustment was reached by expenditure cuts of €1.46 billion or 45% of the adjustment package, leaving 55% of the adjustment to tax increases, 86% of which were levied directly on incomes.

While we accepted the need for urgent action with an element of smash and grab in 2009 to arrest the deteriorating

Government Macroeconomic Prospects

	2009	2010	2011	2012	2013
Personal consumption	-7.8	-3.7	1.1	2.4	2.6
Public consumption	-0.4	0.0	0.0	0.0	0.0
Investment	-27.0	-16.0	7.4	9.9	10.0
Exports of G&S	-6.1	-3.1	3.0	4.0	3.9
Imports of G&S	-10.1	-6.1	2.1	2.7	3.2
GDP	-7.7	-2.9	2.7	4.2	4.0
GNP	-8.0	-2.8	2.5	4.0	3.8
Inflation (HICP)	-1.4	0.5	1.9	1.8	1.8
Inflation (CPI)	-3.9	0.3	2.0	2.0	2.0
Employment % change	-7.8	-4.6	0.5	2.2	2.4
Unemployment %	12.6	15.5	15.0	13.5	11.8

Table 1

IBEC forecasts: adjusted for April Budget

Annual % change

	2008	2009	2010	2011	2012	2013
Consumer spending	-0.8	-8.7	-5.0	2.0	3.0	3.0
Government spending	2.1	-0.5	-1.0	0.0	0.0	1.0
Investment	-19.9	-30.7	-18.6	5.4	9.2	12.8
Exports	-0.4	-4.8	-1.5	3.5	5.0	6.0
Imports	-4.4	-9.0	-4.5	4.1	4.8	6.6
GDP	-2.3	-9.2	-3.8	2.1	3.7	4.4
GNP	-3.1	-9.5	-4.0	2.3	3.8	4.6

Table 2

situation, the weight of further adjustment in 2010 and 2011 is also focused too much on tax revenue increases rather than expenditure cuts.

Table 3 below gives an outline of the further correction adjustments for 2010 and 2011. In a departure for Budget formulation multi-annual plans are contained in the budgetary projections. On a full-year basis these adjustments amount to €4.7 billion in 2010 and €4.6 billion in 2011, only marginally less than the estimated full-year adjustment package for 2009 contained in the supplementary Budget. In 2010, the full-year increase in taxation will be €2.5 billion or 53% of the total package; in 2011, the full-year increase in taxation will be €2.1 billion or 46%.

Additional annual measures to be delivered in 2010 & 2011

€ million	2010		2011	
	First year	Full year	First year	Full year
Taxation	1,750	2,500	1,500	2,100
Current expenditure	1,500	1,500	1,500	1,500
Capital expenditure	750	750	1,000	1,000
Total	4,000	4,750	4,000	4,600

Table 3

In a Macroeconomic and Fiscal Framework accompanying the Financial Statement, the government says that policy decisions underlying the expenditure reductions are already in train. This is welcome. The expenditure cutbacks will include pay costs, numbers and programmes. Social spending changes will be dictated by demography and unemployment; there will be more targeted welfare provision and further reductions in public service costs and numbers. Planning for the identification and delivery of these savings will begin now, which is much earlier in the process of budgetary formation than in the past. The Special Group on Public Service Numbers and Expenditure Programmes will also inform expenditure decisions.

On the taxation side, the Commission on Taxation will inform tax revenue decisions. It is clear from Table 3 that further substantial increase in tax revenue are planned with options to raise such revenues including the introduction of a carbon tax, a form of property tax and further significant base broadening through the elimination of unnecessary reliefs and a review of all areas of tax exempt incomes. We would hope, following the Commission on Taxation report, that the crude revenue raising by increased levies contained in this supplementary Budget would be eliminated in favour of a more appropriate income tax regime which would take account of the needs to maintain a competitive environment for high income activity. The government stated that further adjustments may be needed in 2012 and 2013 to ensure that the General government deficit will be below 3% of GDP by the end of 2013.

While it is encouraging that planning expenditure reductions are taking place now for future years, it is not at all clear that the Government is willing to target sufficiently expenditure reductions which international experience suggests is the most expeditious way to solve large deficit problems and regain economic momentum.

Post-Budget economic outlook

There is still a very large amount of uncertainty surrounding any economic forecasts. In table 1 we present the main forecasts from the Department of Finance contained in the supplementary Budget. In table 2 we present IBEC's post-Budget forecasts. The Department of Finance have moved a lot closer to our view of the economy than in the recent past. We are still somewhat less sanguine about economic developments in the near term and our point of departure for 2009 was a little more negative than the Department's. We believe that the very substantial tax increases levied on incomes will result in a larger negative impact on consumer spending, resulting in a fall of 13.3% over the 2009-2010 period, compared with 11.2% in the Department's forecasts. Regardless of the exact magnitude, the fall is unprecedented and will result in more retail job losses and excess commercial space for some years. Rising unemployment and uncertainty are likely to encourage savings or paying down debt. In addition, wages across large sections of the economy will be frozen at 2008 levels or indeed will fall. In IBEC's Business Sentiment Survey for the first quarter of 2009, 64% of companies said they would be implementing a pay freeze in the next three months and a further 15% said this was under consideration. Furthermore, 20% of companies said they would implement pay reductions and a further 25% said reductions were under consideration.

The impact on employment will be severe. The latest Live Register figures show that unemployment has risen to 11%. There is already solid evidence that the fall in employment is now rapidly spreading out from the construction sector to all other sectors. Data from the National Household Survey recorded an annual decline in employment in the last quarter of 2008 of 86,900 or 4.1%. The decline now goes much wider than the construction sector. In the last quarter of 2007, gross job losses were running at an annual 9,800, with the greater amount being in construction and the remainder in manufacturing. Job gains in other sectors of the economy easily offset these losses so that overall employment increased by an annual 66,800. In the last quarter of 2008, however gross job losses were an annual 101,300. Some 45,900 were in construction - the other 55,400 were spread across the private sector. The wholesale and retail sector shed over 18,000 jobs, manufacturing over 12,000, financial and business services almost 12,000, and hotels and restaurants 11,000. The public sector recorded employment gains of the order of 10,000. We expect total employment now to fall by close to 8% in 2009 and by a further 3.7% in 2010 and not show any significant growth until 2013. Unemployment is likely to average 12% in 2009 and over 14% in 2010, and will remain in double figures until 2014.

The rebalancing of the construction sector will continue. We now believe that housing output will fall by some 50% in 2009 and a further 30% in 2010. Commercial buildings are also in significant oversupply and output in that sector seems set to decline by 50% over the next two years. The crisis in the state finances requires that elements of the National Development Plan have to be abandoned or postponed, making it impossible for the government to maintain public capital spending at 5% of GNP after 2009. The Government has indicated that the Exchequer capital allocation will fall to 4% of GNP, but makes the point that lower tender prices mean that a large part of the programme will still be delivered. Total investment, nevertheless, will be a significant downside drag on the economy, falling by some 30% in 2009 and by 19% in 2010. However, we expect that building and construction activity will bottom out in 2010 and a modest growth of the order of 5% is possible in 2011 after four consecutive years of decline amounting in total to a fall of about 60%.

The loss of competitiveness has weakened the strong contribution of net exports to economic growth over the past five years. The global recession will result in exports of goods and services falling by close to 5% in 2009 and with only a mild recovery in global demand anticipated for 2010, exports of goods and services are likely to fall a little further. In 2011, provided global demand continues to pick up, exports of goods and services should start to grow again. Indeed we expect investment and exports to be the main positive features in 2011 and both should gain some impetus out to 2013.

Labour force forecast

000's annual average

	2008	2009	2010	2011	2012	2013
Agriculture	119	119	118	118	118	118
Industry	541	440	415	415	414	413
Services	1444	1378	1333	1323	1333	1359
Total at Work	2104	1938	1867	1857	1865	1890
Unemployed	137	265	309	286	278	258
% Unemployed	6.1	12.0	14.2	13.4	13.0	12.0
Labour Force	2241	2202	2176	2143	2143	2148

Table 4

Inflation forecasts

2009	Quarter	Year	Annual
March	-2.1	-2.6	-4.8
June	-2.5	-6.3	
September	-0.1	-6.8	
December	-0.1	-4.6	
2010			
March	0.4	-2.2	-0.1
June	0.5	0.8	
September	0.4	1.2	
December	0.0	1.3	

Table 5

More focus needed on the real economy

To date the government has almost entirely focussed on the crisis in the financial sector and more recently turned its attention to the rapidly deteriorating public finances.

IBEC does not dispute that correction of the public finances is a main priority. However, all the measures taken and proposed to date will do little to address the fundamental loss of competitiveness manifested in higher costs and prices. We outlined in A Programme for Enterprise Development and Sustainability the need for substantial temporary short–term measures to address particular problems relating to the sterling devaluation and the difficulty companies are experiencing in obtaining credit. Such support is essential if we are to minimise the loss of jobs over the next two years. The response in the supplementary Budget of an Enterprise Stabilisation Fund of €100 million over two years falls very far short of the mark.

More fundamentally, we believe that Ireland's lost competitiveness during this decade amounts to close to 15% relative to our main trading partners. Ireland's wage and cost levels are seriously out of line with trading partners. This must be corrected rapidly if Ireland is to restore its competitive position. Failure to do so will result in sub-optimal growth and will undo much of the progress of the last 15 years, with a return to permanently high levels of unemployment. Government is already seeking to reduce the cost of service providers to the public sector; it should also ensure that it reduces its own service costs and prices by a similar quantum.

As a very open economy Ireland needs to make adjustments to income levels over the next two years if business is to be competitively placed to take part in the global upturn. We estimate that wage levels require a downward correction of the order of 10%. Many companies are already taking such action; society needs to be convinced of the necessity to achieve wage reductions on an economy-wide basis. Successful implementation of such policy would reduce price levels in Ireland, which would help alleviate the impact on real living standards and would help restore employment levels through more rapid growth of exports. We recognise that income correction could impart a further deflationary impact on the economy in the short term but should bring about a more solid and sustainable recovery in subsequent years.

Investment

Annual % change

	2007	2008	2009	2010	2011	2012	2013
Building & construction	-1.9	-21.6	-32.6	-20.0	5.3	8.9	13.9
Plant & machinery	13.5	-14.0	-25.0	-15.0	5.0	10.0	10.0
Total	1.2	-19.9	-30.9	-18.6	5.4	9.2	12.8

Table 6

Supplementary Budget

Taxation measures

The cumulative tax measures of €3.6 billion in a full year, and €1.8 billion for the remaining months of 2009, were at the upper limit of what was expected. In the current budget iteration the balance of the adjustment has been firmly on the taxation side and this flies in the face of conventional wisdom and indeed Ireland's own bitter experience of fiscal consolidation from the 1980s. Middle income families have been hit severely and the marginal income tax burden has increased dramatically in the space of the past six months. While the increase in the income levy was largely as expected the substantial increase in the employee PRSI ceiling and the doubling of the health levy constitute a more painful than anticipated increase in the labour tax burden. The increase in the PRSI ceiling of over €23,000 also raises significant issues of equity between private and public sector workers. Over half of all public servants do not pay full rate PRSI and are therefore largely insulated from this tax increase.

The income tax/PRSI changes were as follows:

- 2% income levy to apply on earnings between €15,028 and €75,036; 4% on income between €75,037 and €174,980; 6% on all income over €174,980
- Health levy of 4% on income between €26,000 and €75,036; 5% health levy on all income over €75,036
- Substantial increase in the employee PRSI ceiling from €52,000 to €75,036

All workers will experience a marked reduction in their take-home pay as a result of the new tax measures. The loss will range from about 2% for a minimum wage income household to 9% at the upper income levels. The net impact of the Budget on some middle income earners will be even greater in cases where mortgage interest relief and early childcare supplement changes apply. Income tax increases of this scale in a single budget are unprecedented in Ireland and have resulted in the effective income tax rates moving up a number of places in the OECD league tables. For workers on average industrial earnings, the income tax burden remains low in international terms but for middle-income earners and high-skilled workers on above average earnings, Ireland has very quickly become a less attractive place to live and work. The marginal tax rate on incomes of €50,000 or so has increased to 53% from 43% before the October Budget. In international terms, Ireland is no longer a low tax destination for high skilled mobile workers and this has significant implications for Government's strategy to develop the 'Smart Economy'. The income tax burden has been increased to a level whereby any further hikes in subsequent budgets would seriously damage both the incentive to work and Ireland's ability to attract mobile labour.

The rates of capital gains (CGT) and capital acquisition tax (CAT) have been increased from 22% to 25% and the thresholds for CAT have been reduced by 20%. It has also been signalled that further increases in these taxes are likely in future budgets. Ireland's low rate of CGT has promoted a strong culture of entrepreneurship during the past decade or so and further increases in this tax risk undermining that. The reduction in the CAT thresholds are in line with recent trends in property and wealth values over the past year and is therefore unlikely to have a material impact. Tax increases on insurance policies and savings will also further erode household incomes but will be much less damaging to economic activity than the increased taxes on labour.

Impact of Budget changes on a married couple, two children (under 5), taxed under PAYE on full rate PRSI

Gross income	Net loss	Loss as % of net income
20,000	-1,044	-3.3%
40,000	-2,200	-5.3%
75,000	-4,092	-6.6%
100,000	-5,611	-7.4%
200,000	-10,642	-8.2%

Table 7

Impact of Budget changes on a single person, no children, taxed under PAYE on full rate PRSI

Gross income	Net loss	Loss as % of net income
20,000	-200	1.1%
40,000	-1,200	-3.7%
75,000	-3,092	-6.0%
100,000	-4,611	-7.1%
200,000	-9,642	-8.0%

Table 8

The increase in excise on diesel is a significant additional cost for business. Transport costs in Ireland are already considerably higher than the EU average and this increase will further damage the competitiveness of Irish business and exporters in particular. The increase of 25 cents for 20 cigarettes was the lower end of what was expected. The absence of increases in VAT or excise on alcohol will mean that the inflationary impact of the Budget will be negligible and on a post-Budget basis the Government forecasts the CPI will fall by 3.9% in 2009.

The abolition of mortgage interest relief for mortgages over seven years is an additional hit to many middle-income families, while the Minister indicated that mortgage interest relief may be abolished entirely in the coming years. The reduction in investor mortgage interest relief from 100% of interest payments to 75% will undoubtedly further reduce investor activity in the Irish residential market. At this stage, however, this change merely underlines the policy failures of the past in relation to the tax supports provided to property investors.

The Minister has set out the expected tax increases due in 2010 and 2011. Full-year tax increases of €2.5 billion are forecast for 2010 and €2.1 billion for 2011. He indicated that future tax changes may include a property tax; a carbon tax; taxing of child benefit; restriction of tax reliefs; and further broadening of the tax base. Following the extreme increases in taxes on labour in this Budget, any further income tax increases will be strongly opposed by IBEC. The concern remains that the Government's economic and fiscal framework remains overly optimistic on the short-term outlook and fiscal adjustments required in future years might be greater than those outlined.

Measures to stimulate the economy

IBEC welcomes the Minister's recognition of the increased importance globally of intellectual property and his proposal to introduce a scheme of tax relief for the acquisition of intangible assets, including IP, as a means of supporting the Smart Economy. The details of the scheme will be published in the legislation giving effect to the Budget provisions.

A very modest Enterprise Stability Fund of €50 million in 2009 and €50 million in 2010, is to be administered by Enterprise Ireland. Assistance will be provided to companies that were not in difficulty before 1 July 2008, but are now suffering as a result of the international crisis. Companies must have sound business models and be viable in the medium term. The scale of the funding provided is entirely inadequate and will do little to stem the loss of jobs from Ireland's under-pressure enterprise base. The lack of ambition in this measure is a clear indication of the degree to which Government continues to ignore the difficulties facing the real economy. It is astounding that the Budget did so little to support enterprise and employment but yet the Minister was able to allocate an additional €100 million in 2009 and €150 million in a full year to water down the terms of the recently introduced public sector pension levy.

Expenditure measures

As with the overall balance between tax and expenditure adjustments, the changes to public expenditure were poorly calibrated. The Budget has not done nearly enough to address the unsustainable levels of current expenditure and has introduced excessive cuts to capital expenditure. This balance applies to the adjustments in 2009 and for 2010 and 2011 also. In seeking to focus so strongly on capital expenditure rather than current expenditure cuts the Budget has again ignored best practice for fiscal consolidation.

The substantial reduction in capital investment will result in significant job losses and further contraction in economic activity. For 2009, the reduction in capital expenditure will mainly apply to local and regional roads, while spending on national roads remains largely intact in order to facilitate the completion of the inter-urban motorway network by end 2010. Some public transport projects are also to be deferred and rescheduled. Government has committed to maintaining capital investment at 4% of GNP over the 2009 to 2013 period and while this is a substantial investment level by international standards, in money terms it is a major pull-back on previous commitments.

The banking sector

The most noteworthy announcement in relation to the banking sector was the establishment of a National Asset Management Agency (NAMA) to deal with the land and development loans in the Irish banks. The book value of loans to be transferred to NAMA is an estimated €80 to €90 billion. However, the crucial point is that the loans will be acquired by NAMA at a 'significant discount' to reflect the loss in value. Transferring the loans over to NAMA will, nonetheless, result in a substantial increase in national debt, since the loans will be transferred to NAMA in exchange for government bonds. NAMA will operate on a commercial basis to maximise the income accruing from the assets, to be used to repay the additional national debt. Moreover, if NAMA ends up making a loss, a levy, presumably on the banks, will be applied to recoup the shortfall. If, after the losses from the write-down of the assets have 'crystallised', further recapitalisation of the banks is necessary, Government will do so in exchange for ordinary shares in the banks.

This is a complex technical operation, around which there is no consensus among experts. However, removing the impaired loans from the banks' books is essential for recovery in the Irish financial sector and the prevention of a Japanese-style 'lost decade' in the real economy. Creating a 'bad bank' is one option and the Government's chosen approach. Experience from Finland and Sweden shows that when properly operated, a 'bad bank' can achieve good returns on the assets and a good deal for the tax payers. Government should seek expertise from individuals involved in the Finnish and Swedish asset management agencies. The UK has opted for a combination of nationalisation and an insurance scheme aimed at capping the losses to the bank, which shifts more of the risk to the tax payer. Full-scale nationalisation is the option of last resort. While some Irish commentators argue that the entire banking sector should at this point be nationalised, this is not without its problems. The eventual fiscal cost may be high if the banks are not quickly cleaned up and resold to investors.

If the valuation process of the troubled assets is done well, NAMA should ultimately be able to present a good deal to the Irish tax payers. To date, however, we have very little detail on how the asset valuation process will operate. Transparency will be vital to achieve political acceptability. NAMA must not be perceived as a vehicle to bailing out either banks or developers, but a vital step in restoring health to the banks and the economy. The Budget documents indicate that the size of the total loan book transferred from each institution will be made public, but more must be done in informing the public of the asset valuation process. Finally, having the spectre of a potential future levy hanging over the banks will not be conducive to help the banks move on, so getting the asset price valuation right the first time around will be crucial.

Restoring Ireland's competitiveness

It was obvious for a number of years that Ireland's competitiveness had become seriously eroded. The difficulties facing the traded sectors of the economy were ignored by policy makers, however, in the face of buoyant employment growth and tax revenue arising from the overheating domestic economy. As ECB President Trichet recently pointed out, it is clear that Government and others mistook this bubble for a structural improvement in the Irish economy. All policy actors now accept that economic recovery can only be achieved through a restoration of competitiveness and reinvigoration of net trade, resulting from growth in the exports of goods and services. This section sets out how best to address Ireland's current competitiveness difficulties.

Germany experienced a bout of weak competitiveness in the mid 1990s. In the run-up to monetary union currency devaluation was not desirable. The path to recovery therefore involved an extended period of minimal nominal wage growth and productivity improvements which ultimately resulted in significant real unit labour cost reductions. Stronger wage growth in other countries meant that an effective nominal pay freeze was sufficient for Germany to restore its competitive position. Nevertheless the adjustment took a decade to complete and resulted in a significant erosion of real living standards. Per capita GDP in Germany was 113% of the EU average in 1992 but had fallen to 101% by 2002. It subsequently improved somewhat but much of the benefits of recovery have been temporarily stifled by the current global economic downturn.

The challenge facing Ireland is daunting. Firstly, there is no currency devaluation option. Secondly, the poor short-term international economic outlook and the prospect of global deflation mean that the German option of a nominal wage freeze is unlikely to yield sufficient benefits. Thirdly, the Irish economy is much more open and suffers or gains more with changes in competitiveness. IBEC therefore proposes that the best course of action is a short and sharp adjustment to wages and prices right across the economy in order to provide immediate improvements to competitiveness and place the country in a strong position to benefit from a recovery in world trade.

The case for a sharp reduction in nominal wages in Ireland is strong. Labour costs here have grown far more rapidly than in our main trading partners in recent years and are currently well above the EU 15 average (see table 9). The timing for such an adjustment is also right as consumer prices are set to fall by about 5% in 2009 and may decline further in 2010, thereby cushioning the impact of wage cuts on living standards.

At the core of Ireland's competitiveness difficulties is the trend in the cost of doing business here vis-à-vis that in two of our main trading partners – the UK and the US. In 2000, average labour costs in Ireland were 40% lower than those in the US and 17% cheaper than the UK. A combination of euro strength and high wage growth in Ireland resulted in a complete reversal of the competitive position by 2008 when average labour costs in Ireland were 11% above that in the US and 19% higher than in the UK. The competitive position against the UK has worsened considerably further in recent months as the value of sterling has continued to fall and is now 35% weaker than it was 18 months ago. Average labour costs in Ireland are currently 30% higher than those in our nearest neighbour. Such a competitive disadvantage is simply not sustainable in the medium term. The advantage provided to the manufacturing sector in the UK as a result of its recent competitive devaluation is such that it is difficult to envisage how the traditional manufacturing sector, in particular, can be sustained in the short term in Ireland without some support. Empirical data show that it takes about 12 months before the full impacts of currency movements are felt in the real economy. The window for action to address the problem is therefore rapidly closing. The 15% annual fall in output in the traditional sector in the first two months of 2009 demonstrates the difficulty.

Labour costs in selected industrialised countries (data relate to economy-wide earnings, include social security contributions)

€ per annum	2000	2008	% change 2000-2008
Ireland	30,343	46,577	53.5
France	35,036	44,156	26.0
Germany	37,909	43,571	14.9
United States	50,205	41,841	-16.7
EU-15	33,178	39,922	20.3
Euro-12	32,227	39,839	23.6
United Kingdom	36,435	38,954	6.9

Table 9

Source: European Commission AMECO database

A co-ordinated policy of wage reductions across both the public and private sectors would provide a significant boost to Ireland's competitive position. A nominal reduction of about 10% over a two year period and a further two year period of zero nominal wage growth would reduce Ireland's cost disadvantage by over 15%. This would effectively return Ireland's labour costs to the EU average. A reduction in wages would result in similar declines in both consumer prices and business costs, further reducing the cost of living and addressing Ireland's high cost of doing business. A policy of wage reduction could of course have significant downsides – it would involve considerable pain for households, particularly those with high debt levels; would further erode income tax revenues; and could lead to a damaging deflationary spiral. Irrespective of the policy pursued, however, it is inevitable that living standards will fall. A reduction in wages and prices would help preserve employment in the short term and would leave Ireland well positioned to benefit from improved export opportunities over the coming years.

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World economic context

The global crisis has been dubbed the Great Recession, in recognition of the fact that this is the most severe economic crisis since the Great Depression, but with some crucial differences. A forthcoming paper from economists Barry Eichengreen and Kevin O'Rourke shows that the decline in activity globally has been at least as severe as it was in 1929. Industrial output, trade and stock markets have all practically fallen off a cliff. This reflects the highly synchronised nature of the crisis in our modern globalised economy. The policy response, however, has been markedly different from that eighty years ago. Central banks have slashed interest rates and increased money supply, while governments have increased budget deficits, all in an effort to stimulate economic activity.

However, even with the stimulus from monetary and fiscal policy, a return to sustainable growth will only take place once stability has been restored in the financial system. The OECD in its March interim Economic Outlook stresses the higher-than-normal level of uncertainty which is attached to its projections in the current climate, particularly those relating to financial sector recovery and the effect of the sizable macroeconomic stimuli already in place or being implemented.

US

The US economy is in a deep recession. The OECD projects that GDP will fall by 4% in 2009. A subdued recovery may take hold in 2010, but growth for the year is projected to remain flat. Unemployment rising to 10.3% in 2010 and negative wealth effects from asset price falls will dampen consumer spending, a major component of US GDP. Economic activity is, however, receiving substantial stimulus from both monetary and fiscal policy. The Fed has slashed interest rates down to 0.25% and is engaging in quantitative easing. On the fiscal side, the American Recovery and Reinvestment Act includes discretionary measures estimated at 2.1% and 2.4% of GDP over 2009 and 2010, respectively. The budget deficit is projected at 11.9% by 2010, requiring an ambitious fiscal consolidation programme once the crisis has passed and recovery has taken hold.

Euro area

The euro area has followed the US into a deep recession, with GDP projected to fall by 4.1% in 2009 and a further 0.3% in 2010. Though the ECB has cut interest rates to 1.25%, it is lagging behind the Fed and the Bank of England. The ECB will, however, announce details of a quantitative easing programme in its May meeting. The measures may take the form of asset purchase, perhaps corporate bonds or even national debt. This should help support economic activity in the region. Of the euro area economies, Germany has been one of the most badly hit. The German economy, heavily reliant on exports of investment goods, is feeling the brunt of the collapse in world trade. GDP is projected to fall by 5% in 2009, with a slow recovery in 2010 with growth of just 0.2%.

UK

The UK economy is projected to decline by 3.7% in 2009 and by 0.2% in 2010. A combination of financial sector troubles, falling house prices and a weak global economy will make recovery difficult. Bank of England has provided substantial monetary stimulus by slashing interest rates to 0.5% and most recently by embarking on quantitative easing. Even though the government's fiscal stimulus has been relatively modest at 1.4% of GDP, the deficit is projected to reach 10.5% next year. This is driven mainly by automatic stabilisers and contraction in revenue-rich sectors. The scope for further stimulus is therefore limited; moreover, given the size of the deficit a credible fiscal consolidation plan is in order.

Real GDP growth – selected countries

Annual % change	2008	2009	2010
Euro area	0.7	-4.1	-0.3
UK	0.7	-3.7	-0.2
Germany	1.0	-5.3	0.2
France	0.7	-3.3	-0.1
US	1.1	-4.0	0.0

Table 10

Unemployment rate – selected countries

Annual % change	2008	2009	2010
Euro area	7.5	10.1	11.7
UK	5.7	7.7	9.5
Germany	7.3	8.9	11.6
France	7.4	9.9	10.9
US	5.8	9.1	10.3

Table 11

Budget deficit – selected countries

As % of GDP	2008	2009	2010
Euro area	-1.8	-5.4	-7.0
UK	-4.4	-9.3	-10.5
Germany	-0.1	-4.5	-6.8
France	-3.4	-6.6	-8.3
US	-5.8	-10.2	-11.9

Table 12