QUARTERLY REVIEW

ECONOMIC TRENDS

IBEC

DECEMBER 2008

Policy priorities for economic recovery

International, domestic and exchange rate factors mean that the Irish economy is currently facing unprecedented challenges. The size of the economy is set to contract sharply during both 2009 and 2010 before a return to modest growth in 2011. The impact of this on Ireland's public finances will be stark and major adjustments to the level of public expenditure and the tax base will be required. Ultimately IBEC remains confident in the ability of the economy to re-emerge from these challenging times more innovative, competitive and prosperous. In order for this to be achieved, however, the correct policy decisions will need to be taken in the coming months and years. This document sets out what these policy priorities should be.

Economic outlook

- Volume of economic activity to fall by 2.4% in 2008, 4.0% in 2009 and 1.5% in 2010.
- Deflation likely to emerge in 2009 as the Consumer Price Index (CPI) will fall by 1.5%. This will result in the nominal value of economic output being about 11% lower in 2010 than it was in 2007.
- Without corrective action, General Government Deficit could reach 11% in 2009 and remain at 8% by 2011 and 6.5% by 2012. Consequently, debt as percentage of GDP could reach 60% by 2011.

Correcting the public finances

- Set target of reducing General Government Deficit to under 3% by 2012.
- This will require a combination of expenditure cuts (€5 bn) and taxation raising measures (€4 bn). Expenditure cuts should be implemented immediately, while tax base should be broadened over a four-year period.
- Structural deficit in public finances has emerged as a result of over-reliance on property related taxes.
- Additional annual taxes of €4 bn must be raised by 2012 in order to return tax revenue as percentage of GNP to about 37%, and to fill the gap from windfall property tax receipts.
- To achieve this the tax base must be broadened and new property and environmental taxes and user charges introduced to raise €4 bn.
- Public sector reform must involve reductions in the size of the public sector in line with that of the economy and also reductions in the unit cost of services delivered. At this juncture it does not appear possible to stabilise the public finances without an adjustment to nominal rates of public sector pay. IBEC also believes that from a social and economic perspective it is optimal to focus more on reducing the unit cost of public services rather than opting for excessive reductions in the volume of services delivered.
- Target of €5 bn reductions in total government expenditure by 2012.
- To achieve this:
  - A reduction of €3.5 bn is required immediately in current expenditure. This should come from a combination of nominal cuts in public service pay rates, a reduction in public service employee numbers and improved value for money in all aspects of public sector procurement;
  - Exchequer funding of capital investment programme to be cut by €1.5 bn but this is to be replaced using investment from National Pensions Reserve Fund.

Stimulus through investment

- Overriding policy priority must be to minimise job losses and help re-skill those who are out of work.
- National Development Plan needs to be entirely reappraised and re-launched.
- All projects to be reassessed on basis of changed economic circumstances, including demographic trends.
- New projects funded must prioritise:
  - Employment potential;
  - Competitiveness impact;
  - Maximising benefits for Irish enterprises;
  - Environmental impact.
- Reduction in Exchequer capital funding to be replaced by investment in revenue raising capital projects by National Treasury Management Agency. Potential projects include roads, public buildings and social housing.

Skills and education

- Provide enhanced social welfare payments through PRSI rebate scheme for unemployed who take up accredited training or education.
- Develop scheme for employers and employees to encourage part-time working and education initiatives as an alternative to redundancy.

Supports for enterprise

- Launch business viability fund to support enterprises exposed to sterling currency crisis and impacts of deteriorating credit conditions. While it is important to have a medium-term strategy to support new enterprises, it is vital that Government 'stops the bleeding' and uses direct grants and labour cost assistance to preserve our current employment and enterprise base.
- Develop suite of marketing and employment support grants for SMEs.
- Restructure the Business Expansion Scheme (BES) to allow greater number of businesses to participate. Increase allowable funding levels and support with major branding and promotion initiative.
- Establish loan guarantee scheme for SMEs.
- Develop range of supports to promote innovation in enterprise, using the R&D tax credit scheme as a model.
- Improve flexibility of R&D tax credit scheme in order to allow offset against other tax heads.
- Public sector should commit to paying all invoices within 10 days.
- Increased emphasis should be put on helping enterprises access EU funding programmes in areas such as R&D.

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World economic context

Economic conditions this autumn have changed at an extraordinarily rapid pace, both at home and internationally. The short-term world economic outlook is dominated by the global financial crisis. As recently as summer 2008 it was hoped that the real economy would escape relatively unscathed; the risks, admittedly, were firmly on the downside. The collapse of the Lehman Brothers investment bank in mid-September marked the starting point in a rapid escalation of the crisis, as financial distress spread across the globe. The world economy is now facing the worst recession since the Second World War.

Prior to the financial crisis, many argued that Europe and emerging economies had decoupled from the US economy. This view has been emphatically proven wrong by the events of autumn 2008, as country after country has fallen into recession. Ongoing financial turmoil makes forecasting an uncertain exercise, given the number of risk factors. The central assumption of the OECD Economic Outlook, published in late November 2008, is that the current financial panic will be fairly short-lived. Tight credit conditions and elevated risk spreads will remain until the end of 2009 when they say the situation will begin to normalise.

This is a benign view; the downside risks to the forecast are substantial. These include: a sharper housing downturn and increased mortgage defaults; further falls in commercial property prices and a widening of loan delinquencies in commercial property and other loan categories arising from weaker growth across the OECD; the collapse of highly-leveraged hedge funds; pressure on pension funds; and further failures of large financial institutions. Should the strain on the financial system persist longer than the OECD currently anticipates, the downturn in economic activity will be deeper and more protracted than that of the central projection.

International policy responses

An international crisis on this scale requires an international response. Leaders of the G-20 countries met on 15 November, stressing in their statement the immediate need to stabilise the international financial system. In addition, supportive monetary policy must be coupled with fiscal measures to stimulate domestic demand. Finally, an integrated financial system will require greater international cooperation among national regulators.

The Fed in the US was the first to act on monetary policy, beginning an aggressive interest rate cutting cycle as early as September 2007. When the crisis escalated in the autumn of 2008, the major central banks, including the Fed, ECB and Bank of England, responded with a coordinated surprise 0.5% cut in interest rates, followed by further cuts in subsequent months. With rapidly falling oil and commodity prices, inflation is no longer a source of concern. Stimulating economic activity to prevent a protracted slump along with preventing a deflationary cycle from taking root are now the main priorities.

Alongside interest rate cuts, central banks have provided the financial system with considerable liquidity. Most recently, the Fed has gone a step further by pursuing the last-resort policy of quantitative easing, or 'printing money'. In December, the Fed slashed interest rates from 1% to a target range of 0% to 0.25%. This is a record low. In practice, however, the effective funds rate was close to zero even before this dramatic move. Even before this latest move, the Fed had announced its intention to purchase $600 bn of mortgage-backed securities, and loan out a further $200 bn to encourage consumer borrowing. The likelihood that the Fed will move even further by buying long-term Treasury securities is strong.

The Fed's recent schemes, aimed at preventing deflation, have led to an explosive expansion of the monetary base. Conversely, the money multiplier is falling rapidly as banks are hoarding cash; hence the actual quantity of money is not increasing. While appropriate and necessary in current circumstances, the Fed's actions pose certain risks. Once the economy rebounds and the money multiplier normalises, inflation will become a serious threat again, unless the Fed acts promptly to withdraw the high-powered money it is now creating. At present, it is unclear to what extent the ECB will be willing or has the capacity to follow in the Fed's footsteps. The Bank of England will almost certainly adopt some form of quantitative easing.

As with monetary policy, the US was one of the first countries off the block with a fiscal stimulus. Households were given tax rebates worth $150 bn, or 1% of GDP, in the first half of 2008. The impact of the stimulus in an environment of record-high oil prices was, however, limited. The economy is deteriorating rapidly, with job losses in November recording the biggest increase since 1974. The need for additional stimulus is urgent. President-elect Obama's advisers have indicated that a massive economic stimulus package will be top priority, significantly larger in scale than the $175 bn proposed during the campaign. Early indications are of a package in the region of $500-700 bn. Emphasis is likely to be placed on investment in infrastructure, public services and 'green' technologies. Supporting employment will also be a key priority.

Response from Europe

On this side the of the Atlantic, the European Commission published on 26 November *A European Economic Recovery Plan*, a blueprint for a coordinated approach to restoring consumer and business confidence. The key element of the plan is a budgetary stimulus of €200 bn, or 1.5% of EU GDP. The Commission recognises that countries with stronger public finances are better placed to implement fiscal stimuli; countries starting out from a weaker budgetary position should instead focus on structural reforms. Finally, the incentives should be aligned with the EU's medium and long-term objectives.

The Commission advocates a mix of revenue and expenditure measures. The expenditure side should be targeted at households especially badly hit by the economic slowdown, such as temporary improvements in unemployment benefits.

To mitigate the effects of the banking sector turmoil, governments can offer temporary guarantees and loan subsidies, in particular for companies suffering from the current short-term lack of working capital. This is also an opportunity for offering well-designed incentives for speeding up the response to long-term challenges, such as climate change. On the revenue side, lower employer social contributions can support job retention and creation, while a reduction in income tax can support purchasing power, particularly for low wage earners and a temporary VAT cut can support consumption.

The proposals place strong emphasis on the EU's long-term strategy, stressing the need of the fiscal stimulus to be aligned with the Lisbon Strategy. The four priority areas are people; business; infrastructure and energy; and research and development. Measures to support employment include reinforcing labour market activation schemes, particularly for low-skilled workers, and supporting the demand for labour through reducing employers' social charges on lower incomes. There is a need to enhance the access to financing for business, particularly SMEs. The European Investment Bank has increased its lending to the SME sector by €10 bn, to €30 bn. Moreover, member states should reduce the administrative burden on business in order to encourage entrepreneurship. Infrastructural investments should be accelerated, particularly in the areas of environmentally friendly transport, energy interconnectors, broadband and energy efficiency. Member states should also continue to invest in R&D and measures promoting the take-up of 'green' products should be explored.

The Commission's proposals recognise the need for countries to tailor the suite of measures to their own particular circumstances. Of the countries that have already announced measures, many are focussing on fast-tracking infrastructure projects and stimulating investment, rather than boosting consumption. The UK's £25 bn fiscal boost is one of the few exceptions. The headline-grabbing element of the package was the temporary reduction in VAT from 17.5% to 15.0%, in effect until the end of 2009. Crucially, the restriction of the income tax personal allowance and the new 45% rate of income tax, both affecting high earners, will not come into effect until 2010 and 2011, respectively. At this point the Chancellor expects the economy to be growing again.

International economies: difficult short-term outlook

On the face of it, the euro area is better placed to weather the economic storm than the US and the UK. House prices in the euro area, with a few notable exceptions such as Ireland and Spain, have increased at a more moderate pace than in the UK or the US. Consumers in the euro area are less indebted, and the savings rate has remained at close to 10%. Consumer spending may prove more resilient, particularly in the context of falling inflation. In contrast, the savings rate in the UK and US has fallen close to zero; households will need to build up their savings again and this will require a reduction in current consumption. Moreover, euro area countries have not been running the kind of substantial current account deficits that we have seen in the UK and US in recent years.

There are significant differences among the euro area economies; Italy and Spain are likely to see a more protracted downturn while Germany and France should recover more quickly. Overall, it is possible that the region will return to growth in 2010, when the US remains stagnant and UK output continues to fall. Table 1 shows forecasts up to 2010. Despite the relatively benign outlook for Europe, the risks for Europe are on the downside. Exports, in particular, have slowed rapidly in the most recent months, reflecting falling global demand.

GDP forecasts for main economies

GDP growth (% annual change)

	2008	2009	2010
Euro area	1.0	-1.0	0.5
Germany	1.3	-0.5	0.8
France	0.8	-0.5	0.8
Italy	-0.2	-1.5	0.0
Spain	1.3	-2.0	-0.5
UK	0.7	-1.5	-1.0
US	1.2	-2.0	0.0

Table 1

Source: Capital Economics December 2008

Though the outcome remains as yet unknown, the US economy has ultimately proved itself to be phenomenally flexible, while the euro area economies are constricted by more inflexible product and labour markets. Nor will the euro area economies benefit from a fiscal boost on the kind of scale that the Obama administration is likely to implement. The focus in Europe is much more strongly on the long-term sustainability of public finances, while the US will ramp up the deficit in the short term to cushion the economic downturn. With a rapidly ageing population, this may well be the right strategy for Europe; only time will tell.

The economic outlook at present is so uncertain because we are living through a bursting of global credit and asset bubbles on an unprecedented scale. The financial markets of tomorrow will look substantially different from those that have evolved over the last decade. Focus must again be placed on facilitating the production of goods and services, not the invention of ever-more sophisticated financial instruments. It is clear that the current institutional structure has failed to protect economies from the inherent volatility of a globalised financial system. Instead of reducing risk, financial innovation has spread and amplified it across the entire global financial system. Regulatory reform will be necessary, but should not be punitive so that the smooth functioning of financial markets is impeded for decades to come. To stifle the financial system would have a devastating impact on real economic activity. Regulators, however, will have to provide better incentives for banks to engage in rigorous risk management and reward systems based on long-term wealth generation.

Another risk at this point is that countries will turn their back on globalisation and instead embrace protectionist policies. The substantial benefits in terms of a real increase in living standards may be forgotten as countries absorb the current shocks. Globalisation can, as we have seen, increase volatility and inequality. The ensuing vulnerability has never been more evident than at present, when a financial crisis originating in the US mortgage market is rocking the entire global economy. The counterbalance to the negative aspects of globalisation, however, is not abandoning outward-oriented policies, but proper management by governments and international institutions. Achieving this in the coming months and years will be crucial for global economic recovery.

Another key driver of economic development in coming years will come from the energy and environment sectors. Climate change and energy security are the twin forces behind the shift towards a low-carbon economy. The EU has committed to reducing greenhouse gas emissions by 20% compared to 1990 levels and, subject to a comprehensive international climate change agreement, increasing the reduction effort to 30% of 1990 emissions. In addition, the target for the share of renewable energy is 20%. Reducing greenhouse gas emissions will bring considerable costs to companies, but also significant new business opportunities.

Irish economic context

A truly changed landscape

The global uncertainties surrounding the outcome of the financial crisis, the credit crunch and the success or otherwise of global efforts to stabilise the financial system and inject a coordinated fiscal stimulus to the economy makes projections over the next few years subject to huge risks. The numbers we present in Table 2 for the Irish economy are not so much a forecast but a stylised profile of the direction of the economy as we see it, around which we can confront the magnitude of the problems and the necessary response required from government.

The Irish economy has grown strongly in the last decade allowing living standards to rise and the Government to reduce its debt from the crippling levels that stifled the economy in the 1980s. In that sense the inevitable set back to our living standards, which we face over the next few years, will not be disastrous so long as appropriate corrective measures are taken.

A structural shift is under way

The economy is undergoing a significant structural shift as the much talked of, but little heeded, correction in the over-reliance on the construction sector is now taking place. The soft landing that was possible three years ago will now be a very hard landing, which will be deep and protracted. Construction activity, especially in the housing sector has slowed dramatically with an even greater slowdown about to take place in 2009. The financial crisis resulting in a restriction of credit for both businesses and consumers has greatly exacerbated a difficult adjustment. The loss of jobs in the construction sector alone will amount to around 140,000 by the end of the adjustment period; the knock-on to other sectors is now evident in connected activities. This combined with a fall in consumer confidence is already leading to job losses in retailing and manufacturing.

We estimate that the volume of GDP has fallen by 2.4% in 2008, will fall by 4% in 2009 and by a further 1.5% in 2010. In all the volume of activity in the economy in 2010 will be 8% lower than it was in 2007. Price deflation will also be a new phenomenon in the economy, as commodity prices tumble with the global recession, export prices fall as a result of global pressures and the relatively strong exchange rate of the euro exerts downward pressures on the price of imports of goods and services and some exports which are invoiced in dollars or sterling. We believe that the value of GDP in 2010 will be about 11% lower than in 2007. This will reduce the level of GDP to that of the latter half of 2005.

We do not think that the economy will start to pull out of this recession until 2011 and will lag the recovery in the global economy by at least a year. This is not only because of the magnitude of the construction sector correction but also the constraints placed upon the economy by the need to match the level of government spending with the lower level of economic activity. Provided appropriate measures in the next three years are taken to adjust public sector spending to the new reality, to raise productivity levels and to restore some of the lost competitiveness, the impetus to growth will revert to the traded sectors and it is possible for a more 'normal' trend growth to resume from the lower base reached in 2010. We think that economic growth in the period 2012-2015 could get back to a 3.5%-4% growth path, with a stronger catch-up

GNP and its components

Annual % change

	2007	2008	2009	2010	2011	2012	2013	2014	2015
Consumer spending	6.3	-1.0	-3.1	-2.6	0.1	0.9	2.5	3.0	3.3
Government spending	6.0	3.8	-1.0	-1.0	0.0	1.0	1.0	2.0	2.0
Investment	1.2	-21.6	-22.2	-5.6	3.2	7.3	8.0	8.9	8.7
Exports	6.8	2.0	1.0	2.0	2.5	2.5	4.0	4.5	4.0
Imports	4.1	-1.8	-2.0	1.3	1.8	2.4	3.7	4.3	3.5
GDP	6.0	-2.4	-4.0	-1.5	1.6	2.4	3.7	4.3	4.6
GNP	4.1	-2.1	-4.3	-1.7	1.4	2.2	3.9	4.3	4.7

Table 2

Vol change in GDP (%)

Figure 1

Value of GDP (€ million)

Figure 2

element in the last two years. Our scenario suggests that the level of GDP will not get back to 2007 levels until 2013. We graph the pattern of volume growth that we see developing over the next number of years and also the evolution of growth estimated by Government up to 2011 on which the 2009 Budget was cast last October. The divergence is stark. We also graph the level of growth in value terms, incorporating the impact of deflation, which will adversely affect tax revenues as well as the deficit and debt ratios. Our scenario postulates a significantly steeper decline and a much more protracted recovery period. Realistic policies can only be based on a realistic assessment of the economic situation, though this remains evolving.

The impact on employment

Not surprisingly, the construction sector was the first to manifest an employment slowdown and then a fall. The Quarterly National Household Survey recorded the first decline in seasonally adjusted construction employment in the first quarter of 2007. Between the first and final quarter of that year employment fell back 3.2%. The construction sector in 2008 has lost between 30,000 and 40,000 jobs and will lose close to 90,000 in 2009 as house building falls by a further 40% on top of a 36% fall in 2008. The impact of the construction contraction began to spread to industries and services closely related to the sector such as building materials and wood and legal, auctioneering and architectural services. The housing and commercial property overhang is likely to last for two years and we foresee no return to growth in that sector until 2011. We expect employment in the non-construction industrial sector to decline by 3% in 2008 and 2009 and continue to decline albeit at a slower pace up to 2013. Other sectors too will suffer fallout from the sharp decline in consumer confidence, which has been manifested by a very rapid fall in retail sales since the beginning of 2008. We believe that retail employment could fall by as much as 15% over the next two years. Business and financial services employment – a large source of employment growth in the last seven years – will also contract in the near term but

Labour force ('000)

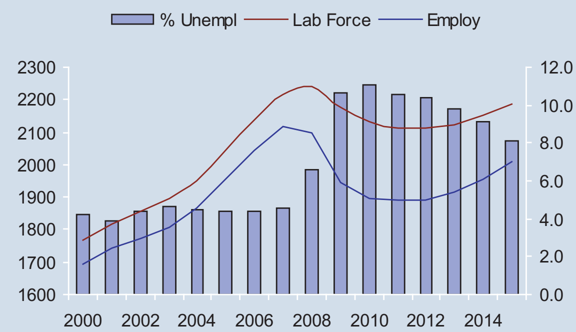

Figure 3

Labour force forecast

000's annual average

	2007	2008	2009	2010	2011	2012	2013	2014	2015
Agriculture	116	121	124	127	129	131	131	131	129
Industry	578	527	432	414	414	412	411	421	431
Services	1423	1448	1387	1355	1346	1349	1372	1406	1449
Total at Work	2117	2096	1944	1896	1889	1892	1914	1957	2009
Unemployed	101	147	232	236	222	219	208	196	177
% Unemployed	4.5	6.6	10.7	11.1	10.5	10.4	9.8	9.1	8.1
Labour Force	2217	2243	2176	2132	2111	2111	2122	2153	2186

Table 3

should rebound more strongly as global recovery gets under way. The public sector which again has been a source of significant employment increase is also likely to decline.

Although we expect the economy to resume growth in 2011, there will be a lagged response in employment as employers will be wary to undertake expansion until they have used all spare capacity and are sure that the upturn is enduring. There is a great deal of uncertainty concerning the behavioural pattern of migrant workers faced with redundancy. We believe a significant proportion of them will return to their homelands, which will reduce the numbers in the labour force. Our working assumption is that the labour force will undergo a marked downward shift in 2009 and 2010, falling by close to 6% and will not resume growth until 2013. We do not believe that employment levels will recover to current levels before 2015. This structural shift has implications for infrastructure planning in the medium term. Below we graph the employment scenario to 2015. The summary table is also given. Of course if there is a more robust return to global growth and credit is not unduly restrictive, a more speedy return to employment growth is possible.

Impact on Exchequer finances

The fall in the level of economic activity alongside price deflation is now wreaking havoc on Exchequer revenue, resulting in an explosion in the government deficits over the next five years.

The recent evolution of the public finances, with the reliance on unsustainable levels of revenue from the construction sector to finance excessive public expenditure increases - not least in public sector pay – allows the Government limited leeway for additional fiscal stimulus. We deal separately in the box on page 8 with the structural problems facing the public finances. The deficit on the General Government Balance (GGB), which under the rules of the Stability and Growth Pact should be close to balance over the business cycle, has been truly breached. We graph the Government's forecast of the evolution of the GGB out to 2011 contained in the October Budget. The basis on which the deficits are derived is unrealistic and the profiled deficit reduction is simply not achievable. We graph our own estimates for GGB based on more realistic assumptions for economic growth. On unchanged policies, the deficit balloons to almost 11% of GDP and we believe would be still over 6% of GDP by 2012. The debt ratio is likely to go over 60% compared with 25% in 2007.

It is true that Ireland is well placed to accommodate such large deficits because our overall debt to GDP ratio in 2007 was as low as 25%. The benefit of a low debt manifests itself in increased flexibility as low debt service costs do not divert tax revenue from the provision of essential goods and services. However, such large annual deficits will soon ratchet up the debt/GDP ratio, especially in times when falling volume growth in GDP is accompanied by deflation, which further depresses the value of GDP. The debt incurred by Government does not reduce with deflation but relatively increases. Apart from such an evolution being incompatible with the Stability and Growth Pact, allowing the deficit to grow in this way will push up debt service costs at a time when tax revenue is falling, thus making it harder for Government to make the necessary adjustments to public spending without seriously impairing the level of services. The last time the debt ratio was of such a magnitude in 1996, debt service costs accounted for 20% of net current expenditure and 20% of tax revenue in contrast to the low 5% enjoyed in 2007/08.

We believe that the Government must produce a strategy to ensure that the General Government Balance returns within the limits allowed in the Stability and Growth Pact in a realistic time frame. We believe that this cannot be feasibly done before 2012. However, this must be the realistic target of Government, firstly so that Ireland remains a solid member of the euro area and secondly to avoid returning to high debt servicing costs that so greatly reduce the flexibility of the economy.

Required correction in GGB

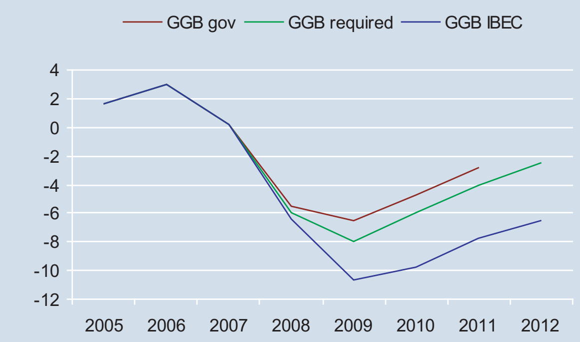

Figure 4

Impact on consumer spending

The fall in employment, recent high inflation brought on by high oil and food prices as well as high mortgage costs have severely dented consumer confidence. The impact on retail sales has been extraordinarily severe with volumes plunging since the end of 2007. Particularly badly hit have been those sectors most close to the housing sector. Sales of electrical equipment and hardware products have been particularly badly affected with annual falls reaching well into double figures. The grocery sector has also suffered falling sales in low single figures, as have the clothing and the footwear sectors. The continued depreciation of the sterling exchange rate has put added pressure onto retailers as significant trade has been diverted to Northern Ireland. Apart from depressing economic activity, this loss of sales will further reduce VAT revenues, adding to the difficulties of stabilising the public finances. Against this, some relief for consumers will be tangible, as interest rates in the euro area continue to fall and the banking sector seems ready to pass on the reductions in full. Commodity prices, led by energy prices, have also fallen sharply and inflation as measured by the consumer price index is likely to turn to deflation in 2009. The rapid fall in prices is now well in train and we expect the consumer price index to start falling in the first quarter of 2009. The effect will be felt most by those with house mortgages and all will notice the impact of reduced fuel prices. It will be imperative that any cost reductions are passed on, particularly in the area of public services and transport. Despite these mitigating influences, we expect consumer sentiment to remain weak and consumer spending is unlikely to contribute to domestic demand growth before 2012.

Impact of exchange rate

The recent weakening of the dollar and the sharp fall in sterling will seriously add to the competitive pressures of suppliers of goods and services on both the home and export markets. In particular the very sharp fall in the value of sterling – in Irish terms to its lowest level ever since the Irish pound split from sterling in 1979 – is taking us into uncharted waters and we urge that Government recognises this and introduces some amelioration to those businesses most exposed.

Exchange rates (monthly averages)

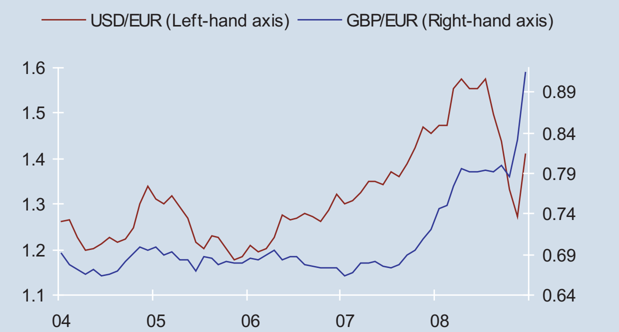

Figure 5

Inflation forecasts (consumer price index)

2008	Quarter	Year	Annual
March	1.6%	4.7%	4.1%
June	1.4%	4.7%	
September	0.5%	4.3%	
December	-2.1%	2.6%	
2009	**Quarter**	**Year**	**Annual**
March	-0.7%	-0.3%	-1.5%
June	0.2%	-1.7%	
September	0.1%	-2.6%	
December	0.1%	-1.5%	
2010	**Quarter**	**Year**	**Annual**
March	0.8%	0.9%	1.6%
June	0.7%	1.5%	
September	0.4%	2.0%	
December	0.1%	1.9%	

Table 4

Inflation outlook

The outlook for both global and domestic inflation has changed dramatically in recent months. Global recession has resulted in a collapse in commodity prices. Oil prices have moved from an all-time high of almost $150 per barrel in July to a four year low of about $45 by mid-December. Similar price falls have also been recorded in food commodities. Most developed economies are now facing a period of price deflation during 2009.

Domestically the Consumer Price Index (CPI) will be influenced by three main factors over the next year or so. Falling global commodity prices will result in much lower energy and food prices; the unprecedented cuts in ECB interest rates will substantially reduce the mortgage interest component of the CPI; and falling consumer spending will result in lower prices right across the retail sector. Retail fuel prices have already fallen considerably in recent months, with petrol pump prices down by about 30%. Electricity and gas prices are also likely to be reduced at some stage during 2009 in line with lower international energy prices. With the ECB base rate forecast to fall to 1.5% in 2009, the mortgage interest component of the CPI will drop by about 40% by the middle of the year. This will reduce the CPI by nearly 3 percentage points on average for 2009. There is already clear evidence that retailers are responding to the 5% fall in retail sales through very aggressive discounting. The CPI is now expected to turn negative in the first quarter of 2009 and is forecast to average -1.5% for the year.

Policy priorities for economic recovery

Vision for economic development

Ireland's economy faces two significant but not insurmountable challenges over the next five years or so. The first is to recover from the effects of a severe global economic recession and the second is to complete the transition from an excessive reliance on the construction sector. The policy actions needed to address both of these challenges are essentially the same – restoring competitiveness and promoting sustainable business activities. A radical overhaul of cost structures coupled with a leap forward in innovation capacity is needed in order to preserve prosperity and employment.

The Irish economy has benefited more than any other from increased globalisation over the past two decades. Ireland must continue to embrace globalisation and ensure that it creates a domestic policy environment which optimises the benefits. Building on previously recognised competitive advantages, Ireland must ensure that its cost level is brought back in line at least with other EU countries; real progress is made in developing innovative capacity; and that skills and education levels are improved. Ireland was successful in developing a strong traded enterprise sector in the 1990s despite the fact that the quality of infrastructure remained exceptionally weak. Excellent progress has been made in the past decade in strengthening our connectivity and further ambitious investment in the coming years will result in modern world-class infrastructure.

The most significant policy error of recent years has been the failure to control Ireland's cost base. Pay and business cost increases have been far in excess of those in our trading partners since the start of this decade and have not been matched by productivity growth. Economy-wide earnings in Ireland are now 15% above the euro area average while the public sector pay differential has widened even further. Strong productivity growth can help Ireland restore some competitiveness but an extended period of cost containment and in some cases cost reductions will also be required. Our future incomes policies must firstly be based on restoring lost competitiveness and secondly ensuring that in the medium term wage growth is predominantly determined by productivity performance.

In order to maximise the benefits of globalisation Ireland must pursue policies which help attract enterprise and the skilled workers which it needs. Effective taxation policies are central to both these objectives and IBEC strongly advocates a tax system which is competitive for mobile factors of production, such as corporations and labour, but is sufficiently broad to fund excellent public services.

Skills development must be at the centre of Government policy in the coming years. The challenge in helping those who have lost jobs in construction and other sectors to gain quality employment elsewhere in the economy is immense. Innovative approaches are required to encourage those both in work and out of work to enhance their education and skills levels. Improvements are required at all levels of the education system from pre-school to fourth level.

Favourable demographics will continue to provide Ireland with a significant competitive advantage over the next 20 years. A well educated, highly skilled, and cost competitive workforce is the key to restoring economic prosperity. Most new employment opportunities will emerge in the services sector, and in particular the internationally traded services sector. Manufacturing will also continue to provide high quality employment. The focus in manufacturing should not be on targeting certain sectors but on developing competence in specific activities. By producing high quality employees in engineering and science; finance; R&D; logistics and marketing, all sectors of manufacturing can have a bright future in Ireland.

A fully functioning and healthy banking system is essential to restoring economic prosperity. Failure to repair the current difficulties in the sector would be detrimental to businesses and households. It is essential that Government and the financial sector work together in order to bring about a return to normal credit conditions for enterprises and individuals.

Taxation and public expenditure

One of the most significant implications of the structural adjustment we are currently witnessing in the Irish economy is the need for corresponding adjustments in expenditure and taxation policies. Many countries are pursuing counter-cyclical fiscal policy at present and are not taking immediate actions to address their budget deficits. In Ireland's case, however, both large structural and cyclical budget deficits are emerging. While running a cyclical deficit is the correct course of action for Government to take during a recession, immediate action is required in order to address the structural deficit.

No other OECD country is currently experiencing such a rapid decline in either economic growth or tax revenues than Ireland. Budget 2009 estimated that tax revenues in 2008 would fall by about 7% to €42.4 bn. Following the publication of the November 2008 tax receipts, however, it is evident that the fall in tax revenue is much greater than that forecast by Government in October. It is now forecast that total tax receipts will be less than €41 bn and 13% down on the 2007 receipts. The Budget tax forecasts for the coming years are also overly optimistic. Given the headwinds facing all sectors of the economy in 2009 and the prospect of significant deflation, total tax revenue will decline much further than forecast. IBEC forecasts a further 10% fall in tax revenues in 2009, followed by a stabilisation in revenues in 2010 and about 8% growth in 2011. Even allowing for the tax increases announced in the Budget, total tax receipts by 2011 will remain about 15% lower than the 2007 level.

Actual and forecast tax revenues, 2006-2011

Figure 6

As discussed earlier, the structural deficit is largely related to the construction sector and the spin-off impacts it had on other domestic services and elements of the traditional manufacturing sector. A large portion of the tax revenues derived from this sector has been permanently lost.

Property related taxes in the form of capital gains tax, stamp duty and VAT accounted for about 18% or €8 bn of total tax revenue in 2007. Income taxes, corporation taxes and other taxes accruing from the sector and related activities are estimated at a further €5 bn. Total tax receipts from property and related sectors are therefore estimated at €13 bn or 30% of total tax revenue in 2007. Given medium-term demand levels of about half the level of construction activity recorded in 2007, coupled with the price adjustments which have occurred, it is estimated that about 50% of this revenue or 15% of total tax revenue will not re-emerge when the economy reverts to trend growth.

Table 5 demonstrates the degree to which tax revenue had become reliant on the property and construction sector in recent years and how this has sharply reduced in 2008. The windfall stamp duty and capital gains taxes are easily identified, but the sector has also made a substantial contribution to VAT (12.5% on new housing) income tax and corporation tax receipts in recent years.

Tax head receipts as % of total tax revenue

	2000	2006	2008	2011
Customs	0.8%	0.6%	0.7%	0.7%
Excise	15.8%	12.3%	14.2%	13.5%
Capital Gains Tax	2.9%	6.8%	3.5%	3.8%
Capital Acquisitions Tax	0.8%	0.8%	0.8%	0.8%
Stamps	4.1%	8.2%	3.8%	4.2%
Income Tax	33.7%	27.2%	32.1%	40.1%
Corporation Tax	14.4%	14.7%	12.4%	9.5%
VAT	27.6%	29.5%	32.5%	27.5%

Table 5

Tax revenue as a percentage of GNP has remained remarkably stable over the past decade and despite the fact that a number of tax rates were reduced in this time, total revenue in 2007 remained at 37.4% of GNP, just marginally lower than the 1997 figure of 37.6% (Figure 7). Reductions in income tax over this period were compensated for by increases in windfall property related taxes. The decision to reduce the tax burden on labour was a correct one and was instrumental in the reduction in unemployment and rapid growth in the size of the labour force. Revenue as a percentage of GNP will be 33.7% in 2008 and will decline further to 32.5% in 2009. Reform of the tax system is now clearly needed in order to ensure that revenues return to circa 37% of GNP as soon as trend growth resumes.

Reform of Ireland's tax structure must be done in a manner which optimises economic growth and competitiveness. The OECD has completed extensive research into how tax systems can be best structured in order to maximise growth. This work identifies that increases to taxes on labour and enterprise are the most damaging to economies, while increases to taxation on consumption and property are less harmful. Ireland currently has low taxation on property and this is clearly where Government must look to in order to replace lost tax revenues. In order to facilitate a swift recovery to economic prosperity and to ensure that a strong incentive to work remains, it is vital that no further increases are made to income taxes. Ireland's low tax policy for enterprise has proven vital in attracting high quality employment over the past decade or so and it is essential that this policy is maintained in the face of increasing competition to attract FDI.

Gross current expenditure and total government revenue as % of GNP

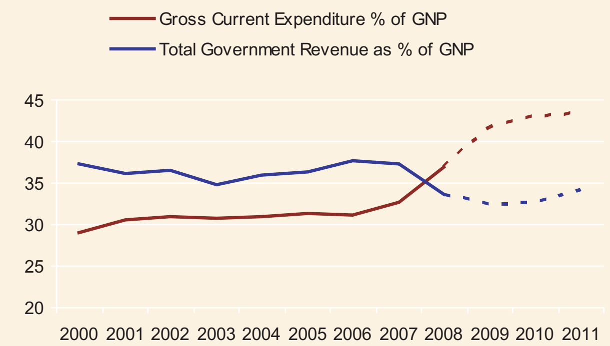

Figure 7

While Figure 7 illustrates the need to grow tax revenues to a sufficient level in the coming years, it also emphasises the challenge facing policy makers in order to curtail the growth of current expenditure. Current expenditure as a percentage of GNP had remained relatively stable over the 2001 to 2006 period, but excessive expenditure increases were allocated in both Budget 2007 and Budget 2008, at a time when it was already evident that economic growth was slowing. In the space of just three years current expenditure has grown from 31.2% of GNP in 2006 to a forecast 41.8% in 2009.

The structural adjustment which has occurred in the economy requires urgent reductions in current expenditure levels. Budget 2009 failed to address this issue sufficiently and it is now essential that immediate cuts in day-to-day expenditure are delivered. The size of the public sector grew in line with the size of the economy in recent years and it now must be reduced proportionately. The focus, however, must not solely be on cutting the size of the public sector but also on reducing the unit cost of what it delivers. In this way through increased productivity and administrative savings, front line services to the public can be maintained.

Investment

Despite the rapid deterioration in the public finances Government rightly remains committed to an ambitious investment programme. Exchequer spending on capital projects is forecast at 5.2% of GNP for 2009 or over €8.2 bn. Spending is also projected to remain at about 5% of GNP over the coming years. While other EU countries are embarking on enhanced government funded capital investment programmes as part of the EU recovery plan, it is unlikely that Ireland will participate. The high level of investment already committed to and the exceptionally weak state of the public finances mean that it is currently difficult for the Irish Government to increase further the scale of its investment programme. Instead Government should undertake a complete reconfiguration of the National Development Plan (NDP) in order to better align investment plans to the changed economic circumstances.

Reconfigure the NDP

The structural adjustment currently underway in the Irish economy and the likely implications for demographic trends mean that all investment projects planned under the NDP should be re-assessed. The outlook for the Irish economy has changed considerably since the NDP was originally planned in 2006 and project investment priorities have altered radically in the intervening period. Exchequer funding for the NDP may need to be reduced further but it is vital that the volume of activity does not decline. Government should consider using the National Pensions Reserve Fund to finance some capital projects with the potential to raise revenue for the fund in future years, such as roads, public buildings and social housing.

New plan to focus on jobs, competitiveness, enterprise supports and environment

In order to maximise value for money and stimulus to economic growth and competitiveness which can be derived from the NDP an immediate review of all aspects of the plan is required. The review should prioritise the following issues in the selection of new projects for investment:

- **Employment impact:** with the unemployment rate already at a ten-year high and rising rapidly, projects which support employment both in construction and in their long-term impact should be prioritised. More labour intensive capital projects have the potential to provide a greater stimulus to the domestic economy than projects with a greater reliance on foreign acquired skills and imported technology.
- **Competitiveness impact:** the restoration of competitiveness must remain at the core of all government policy and investment plans in the coming years. Competitiveness can be enhanced through projects which support productivity or help reduce unit costs. Particular emphasis should be placed on projects which will result in clearly identifiable reductions in the cost of doing business, e.g. completion of major inter-urban motorways to reduce transport costs, upgrading of electricity transmission network in order to reduce energy costs, and the roll-out of next generation broadband.
- **Support for enterprise:** the NDP must be used to improve the viability of Irish-based enterprises and employment. This can be done directly through support for R&D, workplace upskilling, marketing and dedicated initiatives for SMEs and start-ups. Indirect support through the NDP could take the form of investment in projects using **materials and technologies which can be predominantly supplied by Irish firms.** A commitment by Government to invest in specific projects over a sustained period of time would also provide firms with the certainty of reasonable medium-term demand levels for their products and services.
- **Environmental impact:** Ireland is well placed to develop a niche as a world leader in energy efficiency and renewable technologies. Excellent natural resources provide the potential for increased utilisation of renewable energy sources. An ambitious investment programme in supporting renewable energy projects and funding energy efficiency measures in businesses, homes and public buildings would have multiple economic and environmental benefits.

Skills and education

The quality of Ireland's workforce will be a central determinant of its potential economic growth rate. At present there are a series of weaknesses and challenges in relation to skills and education which need to be tackled. In international terms, the quality of outcomes from the Irish education system is not commensurate with the scale of resources provided. All of the sector's deficiencies cannot therefore be apportioned to a lack of sufficient resources although it is clear that some aspects of the system are under-funded.

Increased funding for third level

A substantial funding deficit exists at third level education. IBEC believes that removal of third level fees has done little to improve access to education for the less well-off and has resulted in a substantial funding shortfall for the sector. The re-introduction of third level fees should be subject to means testing and should be accompanied by a subsidised loan and/or deferred payment scheme. Re-introduction of fees should not result in any reduction in Government funding for the third level as it essential that the overall level of resources available is increased.

Major focus on upskilling

Providing every person in the labour market with the necessary skills to fully benefit from future employment opportunities is a major policy challenge. Over the past decade the number of people employed in the construction sector increased by well over 100,000. When the construction sector recovers from the current severe downturn and reverts to more sustainable output levels, total employment will remain at about 100,000 below its peak level. The **upskilling and retraining of those people who are unlikely to return to work in construction** must be prioritised. Similar targeted upskilling initiatives may also be needed for other sectors such as retail and hospitality.

Upskilling those at work must remain a key component of efforts to improve the overall quality of the Irish labour force. Implementation of the National Skills Strategy has increased relevance in light of the rapid deterioration in economic activity. A **mix of incentives for both employers and employees** is required in order to ensure that the strategy's targets are met. The current labour market circumstances also present the opportunity to implement a range of **innovative 'back to education' incentives** for employees and employers in cases where reduced hours workings are being considered. Reduced working time in conjunction with education and training initiatives should be supported as an alternative to redundancies.

Attracting mobile skills

The ESRI Medium-Term Review outlines that Ireland's future economic prosperity will be largely based on successful development of the internationally traded services sector. Prospects for this sector and the higher value added aspects of the manufacturing sector are heavily dependent on the supply of highly skilled workers. Numerous studies have recently identified the difficulties facing a range of knowledge-based sectors in the coming years due to a shortage of skilled employees in areas such as ICT, finance, R&D and the life sciences.

Globalisation has meant that skilled labour is becoming increasing mobile and many countries provide incentives in an effort to attract highly skilled labour from overseas. In order for the knowledge economy and the internationally traded services sector to develop successfully in Ireland **a dedicated scheme must be put in place in order to attract very highly skilled overseas employees with skills which are in short supply in the Irish labour market.** The introduction of such a scheme would enhance the ability of multinational companies located in Ireland to bid for key projects within the group or to introduce new high technology products or services, which require specific skills currently unavailable in Ireland. Changes to the remittance basis of taxation in Finance Bill 2009 have gone some way towards addressing the issue but the scheme needs to be much broader in order to have a material impact in attracting sufficient numbers of skilled workers. Countries such as Singapore provide excellent tax reliefs for posted foreign staff and hence are very successful in attracting mobile investment and labour.

Enterprise Environment

Venture capital initiative for indigenous enterprise

The indigenous traded enterprise sector has failed to benefit significantly from Ireland's recent economic prosperity. During the property boom years there was clearly a significant crowding-out effect, while indigenous firms also have difficulty competing with multinational firms for scarce skills. A great missed opportunity of recent years was the volume of Irish wealth attracted by property investments both at home and internationally. If only a portion of this funding had been invested in the traded enterprise sector, the Irish economy would currently be on a much sounder footing. Government must now deliver a policy framework which encourages investment in indigenous enterprise with the potential to generate sustainable employment and wealth. A conservative venture capital culture has limited the development of many Irish firms in recent years. The demise of property speculation now provides the opportunity for other sectors of the economy to maximise the potential of Ireland's still considerable wealth stock.

The existing Business Angels initiative should be greatly enhanced. It should be merged with the Business Expansion Scheme whereby investors would be given tax reliefs for investing in designated sectors of Irish enterprise. The initiative should be strongly branded, promoted and co-ordinated through a public enterprise support agency. In this way much greater investment funding could be directed to indigenous enterprise and the benefits of their future growth could be shared by other domestic investors.

Supporting innovation and R&D

The innovation capacity and productivity levels in indigenous enterprise remain weak. Insufficient numbers of firms are partaking in meaningful R&D activity, while innovation in the services sector is particularly low. Enterprise policy must focus to a greater degree on fostering an R&D culture in indigenous firms and increased emphasis must be placed on process development and services innovation. **The R&D tax credit scheme could be enhanced in order to support investment in services innovation.**

In order to maximise Ireland's attractiveness to multinationals, Government must ensure that enterprise supports and incentives match those of other countries also competing aggressively for FDI. The R&D tax credit scheme must be as beneficial and as flexible as that provided elsewhere. The scheme has a number of shortcomings and still ranks below similar schemes in other EU countries. The scheme also lacks flexibility in relation to the type of taxes against which expenditure can be offset against.

The public sector and enterprise

Government must ensure that regulatory and administrative burdens do not hinder Ireland's entrepreneurship culture. SMEs in particular bear the brunt of administrative reporting and regulatory requirements. Government should **accelerate the priorities identified by the High Level Group on Business Regulation** to ensure that these costs are reduced more rapidly.

Unnecessary and poorly designed legislation is also a considerable cost to business. Regulatory Impact Assessments (RIAs) have not been delivered as originally envisaged. Much new legislation is still introduced without fully quantifying the likely impacts on business efficiency and competitiveness. **Government must commit to full roll-out of the RIA process** and ensure that new legislation is delivered in a manner which minimises costs to business.

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In the current economic environment Government should help alleviate the impacts of the credit squeeze facing businesses by committing that **all public sector invoices will be paid within 10 days.**

Public sector reform

Significant progress has been achieved in recent years in relation to the reform of work practices and general modernisation of the public sector. The recent OECD report identifies further priorities for reform in the coming years in order to increase public sector effectiveness and efficiency. All of these developments have been welcome and necessary but much more radical reform is now required in light of the dramatically changed economic circumstances. **The main difficulty in relation to the public sector at present is the total cost of financing it.** It is now essential that both the size of the public sector moves in line with the total size of the economy and unit costs in the public sector are reduced substantially. Over the past decade average pay levels in the public sector have grown faster than those in the private sector and **in an international context average remuneration levels in Ireland's public sector are amongst the highest in the OECD**. On both affordability and equity grounds the status quo is not sustainable.

Research from the European Central Bank (ECB) confirms that average compensation in the Irish public sector increased at a faster pace than that in any other Euro area country in recent years (Table 6). The ECB data show that total remuneration costs for the Irish public sector increased by 132% between 1999 and 2006. This compares to an increase of just 27.5% in the Euro area. Average remuneration per worker grew by 67% over this period vis-à-vis 21.6% in the Euro area.

Euro area public sector pay trends, 1999-2006

(% growth in nominal remuneration, 1999-2006)

	Public sector remuneration bill	Average per public sector worker	Private sector remuneration bill	Average per private sector worker
Euro area	27.5	21.6	27.0	14.7
Ireland	131.7	67.0	84.7	42.2
Germany	0.5	8.3	9.0	7.5
Netherlands	37.6	24.8	27.8	26.2
Spain	56.0	22.1	57.8	12.2
France	27.1	20.4	31.8	23.0

Table 6

Source: European Central Bank (2007)

Public sector pay and pensions bill as % of tax revenue

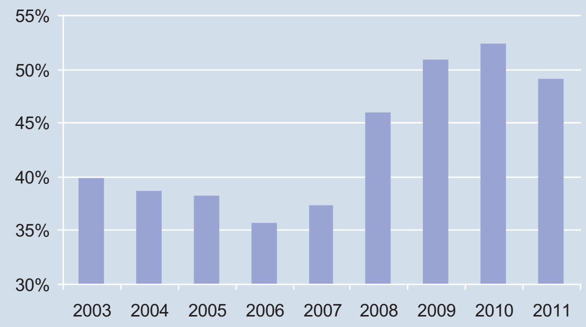

Figure 8

Separate data from Eurostat show that average public sector pay in Ireland is 24% higher than the average rates across Denmark, Germany, the Netherlands, Finland and the UK. An average teacher's salary in Ireland in 2004 was found to be over €48,000 – some 35% ahead of that in the UK and 25% higher than Germany. Health and social workers in Ireland earned an average of €46,000, which was nearly double average earnings for the sector in Finland and about 30% ahead of those in the UK.

Across a range of occupations from hospital consultants to teachers, remuneration levels in Ireland's public sector have moved radically out of sync with those in other countries. **The cost of the public service pay and pensions bill has jumped dramatically relative to total tax revenues in 2008. It has increased from 37% of tax revenue in 2007 to 46% in 2008.** Unless remedial action is taken in the coming months it will increase further to 51% in 2009. Future reform of the public sector must focus more on unit costs and pay levels. Taking into account the high level of public sector pay in Ireland relative to our trading partners, IBEC recommends a nominal reduction in pay levels in 2009. Excessive reductions in public sector employee numbers would be counter-productive in the current economic climate and would result in unnecessary damage to the quality and volume of front-line service provision. While it will do little to address the current Exchequer difficulties, public sector pension reform must also be delivered in order to ensure the medium-term sustainability of the public finances.