QUARTERLY REVIEW

# ECONOMIC TRENDS

IBEC

JULY 2009

## Better take the medicine now


There is now a little more certainty about the state of the global economy than there has been for well over a year. This in itself will tend to boost confidence and the pace of recovery. By the second quarter of the year most of the major international forecasting agencies have moved closer in their assessment of the depth of the recession and the likely timing, if not the strength, of the recovery phase. This is in sharp contrast to the almost continuous downgrading of forecasts that characterised the last two years as the statistical data deteriorated and it became evident how great the magnitude of the impact of the financial sector collapse would be on the global economy.

The same is true for Ireland. Indeed, it matters little whether the size of the fall in economic output in 2009 is 8% or 9%. Most commentators – domestic and international – are of the view that the economy will fall further in 2010 by the order of 2% to 4% and a recovery will only set in during the latter part of 2010 or the beginning of 2011. We must face the fact that the Irish economy is in a worse position than any other developed economy and therefore the necessary adjustments are more urgent and will be more painful.

The need to take strong and sustained corrective action is imperative for several reasons. Firstly, Ireland must quickly restore its battered international reputation and credibility as a sound investment location. Secondly, without demonstrable progress in rectifying the public finances the Irish government may find it increasingly difficult and more expensive to raise finance on badly shaken capital markets. Thirdly, the slower the rectification, the more Ireland's debt/GDP ratio rises, diverting scarce tax revenues away from necessary expenditure programmes to debt servicing. The need to continue to make provision for an ageing population, already disrupted by the financial sector bailout, requires a more speedy correction. Finally, if tackled rapidly, the prospect of returning to normality within four to five years is a far better option than to have a protracted correction, as in the 1980s, resulting in a lost decade of underperformance and unnecessarily high unemployment.

In the April Supplementary Budget, the Government took decisive action to stem the ballooning general government deficit, which was on course to hit over 15% of GDP, and contain it to an estimated 11%. It announced non-specific adjustments for 2010 and 2011 to cut current expenditure by €1.5 billion in each year and to cut capital spending by €0.75 billion in 2010 and by €1 billion in 2011. The tax increases in a full year represented 53% of the adjustment in 2010 and 46% in 2011. We expressed the view that the adjustment should have been more weighted in favour of expenditure cuts.

The report from the Special Group on Public Service Numbers and Expenditure Programmes, chaired by Colm McCarthy, provides the rigorous analysis for parliamentarians and the social partners to understand where the expenditure overruns from the Celtic tiger years occurred and identifies expenditure cuts and structural reforms that could deliver some €5 billion reductions in expenditure levels. If the reports that the Minister for Finance favours a higher level of expenditure cuts than were announced in the Supplementary Budget are true, then the McCarthy report provides the direction the Minister should take.

There can be no denying that the measures suggested in the McCarthy report are harsh – they need to be – and will require a great deal of perseverance and commitment in the face of widespread opposition. Part of the report identifies cuts to programmes that were built up over the last five years on unsustainable tax revenues that collapsed with the building industry and will not be reconstituted. These high levels of expenditure, in part based on uncompetitive pricing, need immediate redress. The reasons for some cuts need to be better explained to gain acceptance, especially in the areas of health, education and social welfare. The proposed cut in social welfare, for example, only restores the real 2008 value of social welfare benefits having allowed for the fall in prices; the 3% increase awarded in the 2009 Budget only sought to maintain benefits at the 2008 level when an increase in inflation of 2.5% was anticipated.

The economic crisis facing us demands reform in the delivery of public sector services which cannot survive under the present system because they are simply too costly. This provides the Government with a clear opportunity to embark on a programme of rationalisation and elimination of duplication. A more flexible and responsive workforce could truly contribute to the restoration of competitiveness of the Irish economy. The McCarthy report signposts the many examples where reorganisation would lead to delivery of the same high quality service with trimmed down resources. The Government must grasp the nettle of public sector reform, which is the only way to stabilise the public finances but it will take a determined and sustained effort over several years and must be supported by the social partners.

Further information:
David Croughan, chief economist. Email: david.croughan@ibec.ie • Fergal O'Brien, senior economist. Email: fergal.o'brien@ibec.ie
Reetta Suonperä, economic policy executive. Email: reetta.suonpera@ibec.ie • IBEC Agenda: http://agenda.ibec.ie

## Output

We outline, in Table 1, our view of the evolution of the economy over the next five years. The pace of the recovery will be dictated by the strength of the global upturn as well as our own ability to rectify the government finances, restore our lost competitiveness and the ability of the financial sector to service the needs of businesses and consumers.

The preliminary National Income and Expenditure Accounts, published at the end of June, provide the first official estimates of the performance of the economy in 2008. The Central Statistics Office estimated that GDP fell by 3% following a growth of 6% in 2007, and an average annual growth of 3.9% in the period 2002-2008. All of the components of demand – consumer spending, investment, exports and imports – fell with investment being by far the largest casualty, falling by 15.5%. The only growth came from an increase in government current spending of 2.6%.

The Quarterly National Accounts for the first quarter of 2009 were also published at the end of June. These clearly reveal that the construction sector peaked in the first quarter of 2007. Total investment, which includes investment in machinery and equipment as well as building and construction, fell steadily every quarter since and by the first quarter of 2009 was some 43% below the peak level in Q1 2007. The greatest quarterly fall occurred in the final quarter of 2008 when total investment fell by 15.8%, with a modest slowdown in the first quarter of 2009 to -13.2%. Other sectors of demand lagged the investment collapse. GDP, consumer spending and exports peaked in the fourth quarter of 2007 and fell by 9.3%, 9.6% and 4.5% respectively from the fourth quarter of 2007 to the first quarter of 2009. Imports and GNP peaked in the first quarter of 2008 and by the first quarter of 2009 had fallen by 11.7% and 12.0% respectively.

As the fall in investment was the driver of the recession, a small ray of hope can be seen from the deceleration in the pace of decline in seasonally adjusted data. The Ulster Bank Construction PMI report suggests further declines are likely as in June the index remained very negative, though less so than at the end of 2008. Investment is likely to remain a drag on the economy into 2010 and 2011, but with diminishing negative effects.

Our forecast for the outcome of 2009 is a GDP fall of 8.4%, a little less gloomy than the 9.2% forecast in April. The main difference is the better performance to date of the export sector on the back of a relatively better performance of manufacturing output, both of which are likely to fall by less than our previous estimate. Consumer spending we have left unchanged pencilling in a fall of 8.7%; so much, however, depends on confidence and the more certain commitment that the government will take steps to rectify the public finances, while painful, may provide a more certain background which might encourage spending decisions.

We believe GDP will fall by a further 2.9% in 2010 as the pace in the fall of investment spending slackens and becomes less of a drag on overall growth. The spending cuts and tax increases in 2010, aided by the McCarthy and the Commission on Taxation reports, are likely to make any growth in 2010 difficult. We expect that 2011 will provide the first signs of any real growth with little prospect for an increase in employment before 2012. By 2010, we expect that the value of GDP will be at around 2004 levels, with a recovery up to 2013 only restoring the value of GDP to 2006 levels. By 2010 the value of GDP will have fallen by 15%, which is a measure of the magnitude of the adjustments we must accommodate.

**GNP and its components**

| Annual % change | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|---|
| Consumer spending | 6.6 | 5.9 | -1.0 | -8.7 | -5.0 | 1.5 | 2.0 | 2.5 |
| Government spending | 5.8 | 6.9 | 2.6 | -1.0 | -1.0 | 0.0 | 0.0 | 1.0 |
| Investment | 4.0 | 2.3 | -15.5 | -31.9 | -10.0 | -1.3 | 3.8 | 8.7 |
| Exports | 5.1 | 8.6 | -1.0 | -4.0 | -1.5 | 2.5 | 2.5 | 4.0 |
| Imports | 6.5 | 5.6 | -2.1 | -9.5 | -4.0 | 3.0 | 3.0 | 3.8 |
| GDP | 5.4 | 6.0 | -3.0 | -8.4 | -2.9 | 0.7 | 1.7 | 3.6 |
| GNP | 6.3 | 4.4 | -2.8 | -9.2 | -3.1 | 0.9 | 1.7 | 3.2 |

Table 1

According to the Quarterly National Accounts, total industrial output (which includes construction) fell by an annual 10.5% in the first quarter of 2009; on a seasonally adjusted basis, however, there was a q-on-q increase of 4.6% in the first quarter following the largest fall of 11.9% recorded in the last quarter of 2008. Separate data from the Survey of Industrial Production record that manufacturing output in total has been more resilient than in many other countries. In the first quarter there was an annual fall of only 2% and in the first two months of the second quarter there was a small annual increase of less than 1%, which resulted in an annual decline of only 1.5% in the first five months of the year. At a broad sectoral level output of the modern sector increased by an annual 5.5% in the first quarter and in the first two months of the second quarter by 9.9%. This contrasts sharply with the fortunes of the traditional sectors where first quarter output fell by an annual 13.8% followed by a further fall of 13.5% in the first two months of the second quarter.

The overall solid modern sector performance, however, is driven almost exclusively by the very strong growth of the pharmaceuticals sector; output in the first five months of the year was up by an annual 18.7%, with first quarter growth of 17% accelerating in the first two months of the second quarter to 21%. This contrasts markedly with the output of the computer, electronic and optical products sector that recorded a first quarter annual decline of 22% and a further decline in the first two months of the second quarter of 19%.

The volume of output of traditional industries was generally very weak across all sectors. Wood output, related to construction, was down over 45% in the first five months of the year compared with the same period of 2008; output in the metals, plastics and engineering sectors was down by between 30% and 40%. Food sector output was down only 0.4% in the first five months of the year, with the output of the meat sector down by an annual 13% while dairy output was up 8.4%. However, this apparently good performance was only maintained under immense pricing pressures and loss of margin. While the volume of dairy output rose by 8.4%, the value of turnover in the first five months of 2009 was down by an annual 14%, implying a price reduction of over 20%. Bakery products too appear to have suffered price reductions of the order of 9%. While output in the beverages sector was maintained more or less at the level of 2008, the value of turnover fell by over 11% implying a price reduction of close to 12%. Many of these traditional sectors compete on markets where the fall in the value of sterling is putting immense pressures on margins.

## Investment

The investment sector of the economy continues to be the most rapidly contracting component of economic output. The fall in the volume of investment activity is set to double from a 16% decline in 2008 to a 32% fall in 2009. The impact of the credit crisis has meant that deterioration in the sector has spread from construction activity to the machinery and equipment sector.

The residential housing sector in Ireland remains in turmoil as house prices and housing activity levels continue to adjust rapidly downwards. A combination of deteriorating economic fundamentals and an expectation among potential house buyers that prices will fall further has resulted in exceptionally low transaction levels in the residential sector. The increase in unsold stock is beginning to ease, however, as new completions are falling rapidly. Nevertheless, the overhang on the market has increased substantially during the past two years and will take considerable time to shift. Unfortunately, accurate statistics are not available on unsold housing stock in Ireland but the consensus view is that at least two years of stock remain on the market. Given that normal economic conditions are unlikely to re-emerge until 2011, significant housing construction is unlikely to be experienced until 2014 or so. Even when residential construction activity does pick-up it is unlikely to exceed half of the peak activity level recorded in 2006. The potential structural unemployment implications of this present a major challenge for policy makers. For 2009, the number of house completions will be about 20,000 and will fall further to 15,000 in 2010.

The solitary bright spot in the investment sector of the economy is activity in the house improvements sector. Despite the very severe hit to disposable household income over the past year or so, home improvements expenditure has continued to grow. This is most likely because the lack of activity in house sales has meant that those wishing to trade up have been unable to do so and in many cases have decided to extend their existing houses as an alternative to moving. Home improvement investments increased 19% in the final quarter of 2008 and were 10% higher in the first quarter of this year. A 10% increase is pencilled in for the full year of 2009 and by 2010, the volume of home improvements activity will be greater than new house building.

### Investment

Annual % change

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|---|
| Building & construction | 5.6 | -0.8 | -15.5 | -34.0 | -11.7 | -3.6 | 1.4 | 8.2 |
| Plant & machinery | -1.4 | 13.9 | -15.4 | -25.0 | -5.0 | 5.0 | 10.0 | 10.0 |

Table 2

The “other building and construction sector” held up reasonably well in 2008 due to a strong pipeline of commercial property activity and good progress on the capital investment programme. Current conditions in the sector are exceptionally difficult, however, as all aspects of the commercial property sector have weakened considerably since autumn 2008. The Ulster Bank Purchasing Managers Index for June showed activity in the commercial sector at 39 - an improvement from the May reading of 32 but remaining very much in negative territory. (An observation below 50 indicates contracting activity.) Activity levels under the public capital investment programme will remain relatively strong during 2009 and 2010 as the National Roads Authority pushes all of its major inter-urban motorway projects towards completion by end 2010. No funding is currently available for new projects, however, and this very weak pipeline will likely result in a substantial fall in public capital programme construction related activity during 2011.

Machinery and equipment investment fell by 15% during 2008, primarily due to a very weak final quarter. The first quarter of 2009 continued in similar vein, as firm investment plans were reassessed and spending was 33% lower than in the first quarter of 2008. It is unlikely that any noticeable improvement will be seen until there is clear evidence of a recovery in the global economy. The reduced availability of funding for investment also remains a constraining factor.

The overall outlook for investment activity into 2010 and 2011 remains fairly subdued. None of the investment sub-sectors are expected to stage a meaningful recovery in 2010 and total investment volume will fall by a further 10%. The housing and commercial building construction sectors will most likely bottom out in 2010 but meaningful recovery will remain a number of years off, as stock overhangs will deter a pick-up in new activity.

## Employment

One of the most negative features of the recession is the increasingly rapid rate of employment decline, which we estimate will result in employment falling by 14 % from its peak in 2007 of 2.12 million to 1.83 million in 2010. The rate of employment slowdown was detectable on a seasonally adjusted basis from the second quarter of 2007. Employment - with mild fluctuations - had been growing on a quarterly basis at a consistent rate of around 1% per quarter. In the second quarter of 2007 this growth slipped to 0.8%, by the last quarter of 2007 to 0.3% and in the first quarter of 2008 employment stagnated. In the following four quarters from Q2 2008 to Q1 in 2009 inclusive, a rapidly increasing pace of decline set in with a quarterly decline of 1% in Q2 2008 gaining pace to record a quarterly decline of 3.5% in Q1 2009. According to the latest Quarterly National Household Survey, employment fell by 1.1% in 2008. We estimate that employment is likely to fall by 8% in 2009, by a further 5.4% in 2010 and stagnate in 2011 before resuming a modest growth of 1.2% in 2012, pushing up to a growth of over 2% in 2013. Our estimates out to 2015 suggest total employment will remain below 2 million.

**Employment**

000's annual average

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|
| Agriculture | 115 | 103 | 104 | 104 | 104 | 104 |
| Industry | 520 | 438 | 392 | 390 | 392 | 400 |
| Services | 1,465 | 1,390 | 1,331 | 1,332 | 1,354 | 1,390 |
| Total | 2,100 | 1,932 | 1,827 | 1,826 | 1,849 | 1,893 |
| Unemployed | 141 | 269 | 341 | 320 | 297 | 264 |
| % Unemployed | 6.3 | 12.2 | 15.7 | 14.9 | 13.8 | 12.2 |
| Labour Force | 2,241 | 2,201 | 2,168 | 2,146 | 2,146 | 2,157 |

Table 3

The fall in employment has been widespread across all sections of the private sector, with only banking up to the first quarter of 2009 escaping decline. The trend of decline started not surprisingly in the construction sector in Q2 2007. Up to Q1 2009, the sector had shed 90,000 jobs. The broad industrial sector including manufacturing has to date suffered a loss of 36,000 jobs and 13,000 have been lost in wholesaling and retailing, 12,000 in accommodation and food services and 12,000 in administration. No jobs have been lost in the public sector to date even though it accounts for 20% of total employment. Clearly, this will not continue given the need to trim public sector spending and the expenditure cuts recommended by the McCarthy report imply employment reductions. Without trying to second-guess the Government's response, our forecasts include employment reductions across the wide public sector of the order of 40,000 or about 7% of the total over the next five years.

According to the Quarterly National Household Survey data, the rate of unemployment, which had remained under 5% for 34 consecutive quarters, rose to 5.7% in Q2 2008 and increased steadily to 10.2% by the first quarter of 2009. Adjusted Live Register figures for the second quarter of 2009 estimated unemployment at 11.6%, with the month of June registering 11.9%. We expect unemployment to end the year at close to 14% and the average for the year will be 12.2%. The number unemployed will rise to 269,000 in 2009 (based on the ILO classification) having been 101,000 in 2007. Unemployment is likely to rise to 15.7% in 2010 and the numbers unemployed will approach 350,000. We think the labour force will decline by 1.8% in 2009, 1.5% in 2010 and 1% in 2011. The major factors dictating this fall will be a return to some outward migration as well as a reduced participation rate as some job seekers become discouraged and younger members of the labour force return to education.

## Prices and wages

Price deflation in Ireland continued up to June as prices fell by 0.3% in the month and recorded an annual decline of 5.4%. Excluding mortgage interest, the decline was 1.6%. Goods sector inflation fell by 5% and services sector inflation, which includes the impact of interest rate reductions, fell to 5.6%. Price falls up to June are widespread across most sectors of the economy; however, health recorded a 3.4% increase and education 4.5%. Energy prices rose in June because of oil prices shooting above $70 per barrel. We expect inflation to decline to 6% in the third quarter of 2009, moderating to 5.2% by year-end. Table 4 shows that, as base effects of the downward impetus move out of the inflation calculations, inflation in 2010 may be marginally above zero.

Companies and employees under pressure from the recession have shown a remarkable degree of flexibility and we expect wages across the economy to decline by at least 3% in 2009. This demonstrates a healthy flexible response to the country's serious economic crisis and along with the government's austere budgetary response is going some way to restore Ireland's international credibility. IBEC's Business Sentiment Survey for the second quarter of 2009 reveals that pay freezes have become the norm and a high percentage of companies have also implemented pay cuts. The survey data suggests that economy-wide wages in Ireland will fall by 3% in 2009. A number of companies plan further cuts over the coming months and downward pressure on wages will continue into 2010. With consumer prices falling by close to 4.5% in 2009 and remaining stable in 2010, Ireland has the opportunity to make great strides to restore much of the recent loss of competitiveness rapidly. A rapid improvement in competitiveness would allow for a much more rapid recovery in output and employment and enable Ireland to participate in the global recovery to the greatest extent.

| Inflation | | | |
|---|---|---|---|
| 2008 | Quarter | Year | Annual |
| March | 1.6% | 4.7% | 4.1% |
| June | 1.4% | 4.7% | |
| September | 0.5% | 4.3% | |
| December | -2.3% | 2.5% | |
| 2009 | | | |
| March | -1.8% | -1.5% | -4.3% |
| June | -1.8% | -4.5% | |
| September | -0.4% | -6.0% | |
| December | 0.0% | -5.2% | |
| 2010 | | | |
| March | 0.4% | -2.1% | 0.2% |
| June | 0.5% | 0.0% | |
| September | 0.6% | 1.2% | |
| December | 0.3% | 1.7% | |

Table 4

## Consumer spending

The Quarterly National Accounts register a sharp reduction in the level of consumer spending. Since the second quarter of 2008, consumer spending has recorded four successive quarters of annual declines, with the final quarter of 2008 recording a decline of 3.6%. The continuing high levels of job losses, higher taxation, and greater uncertainty resulted in consumer spending falling by an annual 9.1% in the first quarter of 2009; on a seasonally adjusted basis there was a quarterly fall of 6.2%.

Retail sales figures record that in the first five months of 2009, there was an annual fall of 19.8%, with sales in the two months April-May easing to a decline of 16.7%; in May the annual decline had decelerated to 15.4%. The deceleration in the decline in motor sales, from 47.9% in April to 39.8% in May, was the main reason for the slowdown in the fall of total retail sales. Initial recovery signs in core retail sales – i.e. excluding motor sales – were dashed by the acceleration in the decline in both April and May. In the two-month period core sales declined by an annual 9.1%, an increase in pace from the Q1 decline of 7.4%. The decline in supermarket sales in the April-May period represented a small acceleration in the pace of decline from the first quarter of -3.8%. Department store sales recorded a welcome slowdown in the annual decline from -10.3% in Q1 to -8.2% in April-May; there was also a deceleration in the decline in specialised food stores from 7.3% to 5.4% and the trend in pharmaceutical sales remained steady in April-May at -1.4%.

Most surprising has been the collapse in clothing and footwear sales where the rate of annual decline accelerated in April-May to 13.6% compared with a Q1 decline of 4.6%. The rate of decline in sales more directly associated with housing increased in the April-May period with annual declines in furniture of 35.9%, in hardware of 22.7% and in electrical sales of 22.7%. Therefore, the only bright light remains soft survey data. The KBC/ESRI consumer sentiment index moved up sharply in June from 45.5 to 53.4 and while the index measuring sentiment about current economic conditions fell back a little from 77.7 in May to 74.6 in June, the consumer expectations index moved up sharply from 23.8 to 39.1. It is too soon to point to a sustained easing of the negative trend in consumer spending as unemployment will continue to rise; further increases in taxation are likely; there will probably be further pay reductions; restrictions on consumer credit remain; and the cutbacks in government spending may well include reductions in social welfare payments.

Our profile for consumer spending is for a decline of 8.7% in 2009 and of 5% in 2010, with a return to modest growth in 2011.

## Exchequer finances

We said at the time of the Supplementary Budget that the Government had demonstrated a resolve to reverse the escalating rise in the exchequer deficit in 2009 and had set in place a series of tax increases and expenditure cuts that would result in a significant reduction in the deficit. We thought at the time that the Government's forecasts on which the public finances were based were overly optimistic, which could result in the target deficit being missed.

First half year returns reveal that total tax revenue was 17.3% lower than in the first half of 2008; this compares with a first quarter shortfall of 23.4%. It would have been surprising if the effects of the April Supplementary Budget had not made some favourable impact as the increased income levies clicked in at the beginning of May. Even since the Government produced its revised profile of tax revenue there has been a small slippage of 1.2% or €188 million in total revenue. Of more concern there was a slippage amounting to €315 million from the two largest tax heads of income tax and VAT. This was largely offset by an additional €118 million in corporation tax receipts which resulted from administrative changes rather than buoyancy.

It is imperative for the international credibility of the country and the implications this has on the cost of borrowing that the Government remains committed to and delivers on the targets of further tax and spending adjustments of €4.8 billion in 2010 and €4.6 billion in 2011. We continue to urge that a greater emphasis on current expenditure reductions is taken as international experience shows that this results in a more speedy return to the achievement of potential economic growth.

The McCarthy report, as well as the upcoming report from the Commission on Taxation should be useful in effecting a change in the balance of the adjustment.

## Trade and balance of payments

The Quarterly National Accounts and accompanying tables record a fall in the volume and value of exports of goods and services of 1% in 2009. The volume of goods exports fell by 0.8% and the volume of services exports fell by 1.4%. Compared with the collapse in exports of many countries, highly dependent on capital goods and motor cars, Irish exports with their heavy weighting of more recession-proofed pharmaceuticals have performed well in total. On the down side, services exports, which had grown in volume terms by 15% per annum in 2006 and 2007, fell back in 2008. Given the difficulties of the financial services sector, services exports are likely to remain under pressure in 2009 and 2010. First quarter data record that exports of goods and services fell by an annual 3% with exports of goods falling by 3.1% and services exports by 2.8%. For the year as a whole, we think that exports of goods and services will decline by 4% and by a further 1.5% in 2010 before resuming to modest growth in 2011 on the back of global recovery, now expected in the second half of 2010.

Imports of goods and services fell in volume terms by 2.1% in 2008, with imports of goods falling by 10.7% as demand in the Irish economy plummeted with the collapse of construction. The further deterioration of the rest of the economy in the second half of 2008 resulted in the volume of goods imports falling by an annual 24%; there was a further fall of 24.9% in Q1 2009. Services imports, however, remained stable in the first quarter of 2009 so that imports of goods and services combined fell by 11.7%. As we estimate that demand in the second half of the year will be less negative than the first half we estimate that for 2009 as a whole the volume of imports of goods and services will fall by 9.5% and by a further 4% in 2010.

Because of the very weak import performance, the current account of the balance of payments will reduce close to balance from a deficit equivalent to 6.1% of GNP in 2008 and move into surplus in 2010.

## Global economic update

The second quarter of 2009 has seen a slowing in the rate of economic contraction in all major economies. Indeed the most recent global economic assessments from both the OECD and the IMF include upward revisions to growth forecasts for a range of countries. The IMF update in early July forecast global economic growth of 2.5% in 2010 – an improvement of 0.6% from its April forecast. This most recent round of assessments was the first time since mid 2007 that growth forecasts were not revised downwards. Hardening evidence of turning points is now emerging. Nevertheless, considerable risks still exist and activity is likely to remain fragile for some time yet and vulnerable to aftershocks to the financial system. Now that economic forecasts have stabilised, a consensus is emerging on the ultimate scale of the economic crisis. At a global level, this is clearly the most severe economic decline since the Second World War. The social and economic consequences will be long lasting and the impact on the real levels of both household and public debt will be debilitating for many years to come. A striking feature of the recession has been the extent to which all countries have been impacted – it has provided clear evidence of the globalised nature of world economy.

Developments over recent months have also demonstrated the importance of rapid and effective policy responses to economic crises. In the absence of the decisions taken, the scale of economic contraction would clearly have been much worse. The challenge for policy makers now turns to exit strategies and the need to ensure that fledgling recovery is not strangled in the midst of a myriad of remaining risks to both the financial system and the real economy. Effective international co-operation will be essential in order to ensure that sustained global economic recovery remains.

Another pressing policy issue for Governments over the coming years will be the need to introduce substantial fiscal consolidation measures. The urgency for such measures will vary between countries and Governments will need to strike an appropriate balance between running the risk of choking off any emerging improvement in activity levels and the need to control debt levels. For small economies such as Ireland with rapidly growing public debt levels, the need for immediate measures was clearly signalled by widening sovereign debt spreads. For large economies, the urgency of fiscal consolidation measures is much less but all countries will ultimately have to address their public debt levels. When this is combined with the necessity in developed countries, in particular, for households to repair their balance sheets, it is difficult to envisage a return to the debt fuelled consumption trends of the past decade or so. The manner in which the global economy emerges from this recession will therefore be greatly influenced by debt levels and the process of correcting the related global imbalances will be exceptionally challenging.

### US

Business sentiment and consumer confidence levels have improved steadily in the US since spring. Most indicators remain in negative territory, however, and it is likely that the economy continued to contract in the second quarter of this year. The pace of deterioration in the US labour market slowed significantly from an average monthly fall in the non-farm payrolls of 690,000 in the first quarter of the year to 436,000 in the second quarter. Job losses of this level are exceptionally high in the context of previous US recessions, however, and the current pace of job losses is greater than that experienced in any recession since the 1970s. The US unemployment rate has now moved to a near 30 year high of 9.5% and the OECD expect unemployment to average 9.3% in 2009 and to go over 10% in 2010. Nevertheless, the more aggressive policy response in the US will mean that economic growth will return much more quickly than in

Europe. The IMF forecasts that the US economy will contract by 2.6% in 2009 and will record growth of 0.6% in 2010. The return of the non-manufacturing ISM purchasing managers index to positive territory in July, indicates that the US services sector has already started to expand. There are also signs that the US housing market has eventually bottomed-out. New housing starts in June increased for the second consecutive month to reach a seven-month high. Although they remain at a very low level in historical terms, the recent starts data suggest that the worst may now be over for the US housing sector.

In conclusion, it now appears that the US economy will pull out of recession over the next couple of quarters but the damage incurred to household balance sheets and the reduced access to debt as a means of supporting consumption will mean that recovery will be fairly anaemic. A range of difficulties remain for both the financial sector and the wider economy but at least the policy response to date has ensured that a catastrophic collapse has been avoided.

## Euro zone

The IMF July update revised up the cumulative forecasts for 2009 and 2010 for all of the major economic blocs with the exception of the euro zone. The 2009 forecast was lowered by 0.6% to -4.8%, while the 2010 growth estimate was revised up just 0.1% to -0.3%. The 2009 outlook for both Germany and Spain worsened considerably in the second quarter as the full impact of the collapse in global trade and the scale of the domestic housing related problems respectively, became evident.

Despite the fact that the origins of the crisis were primarily US based, the euro zone economy is set to experience a cumulative loss of output over double that likely to be recorded in the US. Ironically, the EU economy which had not experienced any element of a housing bubble over the past decade and which had done most in recent years to address its competitiveness problems is set to record one of the sharpest declines in GDP. The German economy is forecast to contract by 6.2% in 2009 and to decline by a further 0.6% in 2010.

Despite the fact that the euro zone economy is likely to take longer to experience a return to positive growth than the US, recent soft and hard data from the region show a slowdown in the pace of deterioration. A number of the business and consumer sentiment indicators from Germany have strengthened considerably in recent months. Encouragingly new export orders for manufacturing recorded a significant improvement in July. Indeed, given the progress that Germany has made in recent years in addressing its competitiveness problems it is best placed of all the euro zone economies to benefit from the pick-up in the global economy and world trade.

An interesting feature of the German economy during the crisis has been the relative resilience of both the labour market and consumer spending. Government supports to sustain employment have meant that firms have not shed jobs on a large scale. Public funding for short-term working schemes has helped preserve workers' earnings. Such supports can not be provided indefinitely, however, and despite the likely improvement in business activity levels, the schemes may ultimately result in the postponement of job losses rather than prevention.

France and Italy have not suffered to the same extent as Germany from the crisis, primarily due to a weaker reliance on global trade. Household debt levels are somewhere between the extreme highs of the UK and the low level pertaining in Germany. Competitiveness difficulties are set to continue to blight the Italian economy, while France is set to buck the euro zone trend and return to annual growth in 2010.

## UK

Recent economic indicators from the UK have surprised somewhat on the upside. In particular, the housing sector has shown some signs of stabilisation with house prices actually increasing in May and June. The Nationwide house price index is now showing a positive three-month moving average for the first time since end 2007. Retail sales have also held up reasonably well in the UK while the unemployment rate has not risen as quickly as that in many other economies. The unemployment rate is currently at 7.2% up from about 5.2% at end 2007. The number out of work will inevitably rise further over the coming quarters but the peak unemployment rate is set to compare favourably to both the US and the euro zone peaks.

**Real GDP growth - selected countries**

| Annual % change | 2008 | 2009 | 2010 |
|---|---|---|---|
| Euro area | 0.8 | -4.8 | -0.3 |
| UK | 0.7 | -4.2 | 0.2 |
| Germany | 1.3 | -6.2 | -0.6 |
| France | 0.3 | -3.0 | 0.4 |
| US | 1.1 | -2.6 | 0.8 |

Table 5

**Inflation - selected countries**

| Annual % change | 2008 | 2009 | 2010 |
|---|---|---|---|
| Euro area | 3.3 | 0.5 | 0.7 |
| UK | 3.6 | 1.9 | 1.2 |
| Germany | 2.8 | 0.3 | 0.4 |
| France | 3.2 | 0.3 | 0.7 |
| US | 3.8 | -0.6 | 1.0 |

Table 6

**Unemployment rate - selected countries**

| Annual % change | 2008 | 2009 | 2010 |
|---|---|---|---|
| Euro area | 7.5 | 10.0 | 12.0 |
| UK | 5.7 | 8.2 | 9.7 |
| Germany | 7.3 | 8.7 | 11.6 |
| France | 7.4 | 9.7 | 11.2 |
| US | 5.8 | 9.3 | 10.1 |

Table 7

IRISH BUSINESS AND EMPLOYERS CONFEDERATION

IBEC

Confederation House
84/86 Lower Baggot Street
Dublin 2
Tel: (01) 605 1500
Fax: (01) 638 1500

CORK
Knockrea House
Douglas Road, Cork
Tel: (0214) 295 511/2/3
Fax: (0214) 295 534

SOUTH EAST
Confederation House
Waterford Business Park
Cork Road, Waterford
Phone: (051) 331 260
Fax: (051) 331 261

MID-WEST
Gardner House, Bank Place
Charlotte Quay, Limerick
Tel: (061) 410 411/410 127/
410 654/412 838
Fax: (061) 412 205

WEST
Ross House
Victoria Place, Galway
Tel: (091) 561 109,
566 405, 566 368
Fax: (091) 561 005

NORTH WEST
11/12 Mill Court
The Diamond
Donegal Town
Co. Donegal
Tel: (074) 972 2474
Fax: (074) 972 2476

EUROPE
Irish Business Bureau
89 Avenue de Cortenbergh
Boite 2, 1000 Bruxelles, Belgium
Tel: (00-32-2) 512 33 33
Fax: (00-32-2) 512 13 53
Website: www.ibb.be

Further information on IBEC's services and activities can be found on the IBEC site at: www.ibec.ie

## Lessons from the Finnish crisis of the early 1990s

Finland in the early 1990s experienced an economic crisis with eerie similarities to Ireland's fall from grace. Lending, house prices, equities and construction all expanded rapidly in the late 1980s. The asset price bubbles were not sustainable and their ultimate deflation led to a banking crisis. GDP fell by 13% peak to trough and unemployment climbed to nearly 20%.

Yet Finland emerged from its economic depression to achieve one of the fastest growth rates among EU countries. From 1994 to 2000, GDP growth averaged nearly 5% per annum. The fall in the value of the Finnish markka of around 30% when the currency was floated in 1992 boosted competitiveness – temporarily. There is more to the Finnish story than devaluation of the currency. After the initial overshooting, the currency strengthened again and in 1996 was tied to the European Exchange Rate Mechanism, as a precursor to Finland joining the euro. More important for sustained improvement in competitiveness were wage moderation and strong productivity growth; the two combined led to falling unit costs.

After the crisis, Finland rapidly became one of the world's most ICT-intensive economies, but in many ways this process had started decades earlier. The Finnish science and technology policy has its roots in the 1960s. Initially, the focus was on macroeconomic policies, with the ultimate goal of securing employment and economic growth. In 1990 – prior to the onset of the crisis – the national innovation system was introduced. Microlevel policies, conditions conducive to knowledge development and innovation, became the focal point. The reorientation was not mere empty words: the government also increased public funding for R&D. This decision was courageous at a time of a large budget deficit, when expenditures were cut across almost the entire public sector.

The investment ultimately paid off and Finland went from an IT-laggard to a leader in the field. Nokia is by far the most well-known Finnish success story, but by no means the only one. Linux, the open source operating system, originated in Finland. Max Payne, the computer game that later became a Hollywood film, was developed by a Finnish company. The list goes on.

Nokia, of course, has had by far the most significant impact on the Finnish economy, accounting for 20% of exports and nearly 3% of GDP in 2002. In the early 1990s, however, it was a medium-sized, diversified conglomerate on the brink of bankruptcy, with interests ranging from rubber to forest products, but also to mobile phones. Under the guidance of Jorma Ollila, who became CEO in 1992, the company focussed its efforts on mobile communications. This did not happen in a vacuum and it is no accident that the two companies dominant in the 1990s in both mobile handsets and networks, Nokia and Ericsson, were Nordic. The Finnish telecommunications market was competitive from the outset, in contrast to the monopoly structure adopted in most other countries. Because it was open to foreign suppliers, Finland became a test market for the latest technologies. Foreign suppliers initially dominated the Finnish telecommunications equipment market, but during the 1970s and 1980s Finnish companies were advancing rapidly, with Nokia as the key player. A competitive and open Nordic market for mobile telephony, created in the 1970, was by the early 1980s the largest mobile communications market in the world. It is little surprise then that the Nordics were key players in the global upswing in mobile communications.

Perhaps the most important lesson for Ireland from the Finnish experience is that recovery is possible. It requires flexibility and determination, but it can be done. Secondly, the Finnish technology boom did not happen by accident, nor was it guided by a master plan. In some ways, it was a stroke of luck that long-term policies of setting technology and innovation at the heart of the Finnish system came to fruition just when needed. But perhaps it is not so surprising after all. Finland was poised and ready when the opportunity in mobile technologies came, and at the same time the economy had the spare capacity to take a new direction.

The Irish government recently set up a 28-strong innovation taskforce, tasked with bringing forward proposals on how to make the "smart economy" a reality. It is significant that the group will look at ways of enhancing linkages between institutions, agencies and the public and private sector – we know that companies rarely innovate alone. The group will also consider how legislation, educational policy, intellectual property, venture capital and immigration policy can be improved to support Ireland as an innovation hub – the kind of microlevel policies that Finland also focussed on.

Ireland must now build on its strengths and identify areas where to improve. The Finnish miracle did not happen overnight or in a vacuum. It was built on a solid foundation of long-term policies and with strong international links. Ireland has over the past decade put significant effort into its science and technology policies. We must continue to build on that platform. Granted, resources are scarce, so we must take a hard look at every single cent to ensure that it is spent efficiently. With determination and hard work we can come out of this crisis stronger and better. But most importantly, in all attempts to overcome the crisis in the public finances, we must not lose sight of the need to invest in those areas that hold the possibility of innovation and growth.