TSG 08/02

Tax Strategy Group

Emerging Economic Outlook

I. Introduction

The purpose of this paper is to update the Group on the emerging economic situation and the likely short-term evolution of the economy. Some of the forces shaping developments this year began to emerge last year and so key economic trends in 2007 are briefly outlined in section II. In section III, the Department's latest published forecasts are summarised. At the time, a number of risks to these forecasts were identified and it is now clear that many of these risks have in fact materialised. Section IV describes the key international and domestic economic developments since Budget time. The short-term outlook is summarised in section V.

II. Economic Performance in 2007

Preliminary figures show that GDP rose by 5.3 per cent last year, with GNP expanding by 4.5 per cent. The figures for the year as a whole should be interpreted with caution, however, as there was a sharp slowdown in the pace of expansion as the year progressed. Indeed, the data show that the level of activity at the end of the year was broadly similar to that at the beginning of the year; in other words, there was no growth within the year. This was mainly due to developments in the new house building sector, where the number of completions recorded a decline for the first time since 1993. The level of employment rose by 73,000 (3.6 per cent) last year, although by the end of the year employment in construction had begun to contract. The unemployment rate averaged 4.5 per cent, broadly unchanged from a year earlier. In relation to price developments, the rate of CPI inflation reached 4.9 per cent, its highest rate since 2001. The increase in mortgage interest rates, rising oil prices and higher food price inflation towards the end of the year were the main factors driving consumer prices higher. In terms of the public finances, a tax short-fall of €1.8 billion meant that a general government surplus of 0.3 per cent of GDP was recorded last year, compared to the initial forecast (i.e. in December 2006) of 1.2 per cent of GDP.

III. Latest Published Forecasts

The Budget 2008 forecasts for the main economic variables are shown in table 1 below. At the time, GDP was projected to expand by 3.0 per cent this year, slightly below the market consensus which, at the time, was for growth of 3¼ per cent. The more modest growth rate was based on the assumption of a fairly steep decline in new housing output as had been suggested by leading indicators such as new housing starts; for the year as a whole, new housing was projected at around 55,000 units, in line with the market consensus at the time. Growth was assumed to recover somewhat next year as the drag from new house building faded with a further pick-up assumed for the following year. This scenario was broadly consistent with the general view among economic commentators at the time.

Table 1: Budget forecasts, per cent change

	2008	**2009**	**2010**
GDP	3.0	3.5	4.1
GNP	2.8	3.3	3.9
HICP	2.4	2.0	1.8
Employment	1.1	1.3	1.5
Unemployment (per cent of labour force)	5.6	5.6	5.5
General Government Balance (per cent of GDP)	-0.9	-1.1	-1.0

Source: Stability Programme Update, Department of Finance.

IV. Latest Economic Developments

Crucially, a number of downside risks to the projections were outlined at Budget time, and it is now clear that many of these have in fact materialised. The main risks identified were the possibilities of:

- adverse exchange rate movements;
- further increases in oil prices;
- a sharper than assumed slowdown in the US economy;
- more prolonged financial market difficulties;
- a sharper than expected contraction of new house building.

IV.1 External developments…

The outlook for economic activity in our major trading partners has deteriorated in the first half of this year with, broadly speaking, three key forces weighing on short-term growth prospects. Firstly, international financial market difficulties have persisted for longer than initially hoped, and there is growing evidence of greater spill-over effects to the rest of the economy in some countries (most notably in the US). Secondly, weak housing investment in some countries (the US, UK and some euro area countries such as Spain) is restraining the pace of growth. Finally, rising prices for oil, food and some other commodities is dampening real income growth in most of our major trading partners.

On foot of these developments, projections for growth in our major trading partners have been revised downwards in recent months (see table 1). These developments have also been associated with major exchange rate shifts. Since the onset of the international financial market difficulties in August last year, the euro has appreciated by 16 per cent against the dollar and by 17 per cent against sterling.[1]

Table 1: Forecasts for GDP growth in our major trading partners

	october 2007		**april 2008**		**revision**	
	2008	2009	2008	2009	2008	2009
US	1.7	2.6	0.9	0.7	-0.8	-1.9
UK	2.2	2.5	1.7	1.6	-0.5	-0.9
euro area	2.2	2.1	1.7	1.5	-0.5	-0.6

Source: EU Commission.

IV.2 Domestic developments…

Conditions in the domestic economy have also deteriorated in the six months since the Budget was published. As outlined above, a decline in new house building to around 55,000 units this year was assumed at Budget time, in line with the prevailing consensus. This projection was made on the basis of prevailing indicators at the time. Since then, it has become apparent that a sharper than assumed decline in activity is underway, with completions this year likely to undershoot sustainable levels by a significant margin. For instance, new housing starts in the first four months of this year are down by over 60 per cent compared with the same period a year earlier. The consensus forecast among

[1] Average daily figures for April compared with similar for August last year.

economic commentators is currently for completions of around 48,000 units for the year as a whole, although this number includes some figures which are somewhat dated. DKM (who prepare forecasts for the Department of the Environment and who have a good insight) are projecting completions of 43,000 units, and while there is of course some uncertainty, it seems fair to conclude that completions will be in the region 40,000 – 45,000 units this year. This would constitute a decline of around 45 per cent compared to last year which, given the weight of this sector in overall economic activity, would constitute a substantial drag on the overall GDP growth rate this year, perhaps of the order 3 – 4 percentage points. In terms of commercial building, less information is readily available, although slowing demand in the economy more generally and higher funding costs may weigh on the prospects for this sub-sector.

The deterioration in the international climate may be compounding difficulties in the home-building sector. Two channels through which external developments could be transmitted to the sector are easily identifiable. Firstly, lower growth in our major trading partners together with adverse exchange rate developments may be weighing on the confidence of prospective purchasers (either for their own use of for rental purposes). Secondly, notwithstanding significant policy intervention, the functioning of international money markets has not yet returned to 'normal'. The associated rise in wholesale funding costs is now being passed on at the retail level in Ireland in the form of higher market interest rates, while access to credit also appears to have been tightened somewhat.

Table 2: Leading Indicators of New Housing Output

	period	**year-on-year, per cent**
New house completions	2008 M1-M4	- 27.5
New house registrations	2008 M1-M4	- 64.7
New house commencements	2008 Q1	- 52.4
New house prices	2008 Q1	- 8.6
Mortgage lending ^	2008 M3	+11.6

Source: Department of Environment, Central Bank and permanent tsb.
^ the 11.6 per cent annual growth rate was the slowest rate of increase since 1992.

Reflecting the labour-intensive nature of new house production, incoming data point to a potentially more difficult labour market environment than was initially assumed. For instance, live register data (which do not measure unemployment but do provide an indication of the health of the labour market) show a large increase in the claimant count number in the opening months of this year. The fact that employment in construction declined by 11 per cent year-on-year in the first quarter suggests that some of this claimant count increase reflects the sharper than expected decline in activity in the residential investment sector.

The impact of these developments may be spreading to other components of domestic demand. Consumer confidence has deteriorated as households have become more downbeat regarding their future prospects. Retail sales were noticeably soft in the first quarter suggesting that households may be reining in their spending. Purchases of cars – which could be regarded as partly discretionary – have been especially weak, although some of this may be related to taxation changes.

IV.3 Inflationary developments…

The more modest rate of demand growth has not yet resulted in any improvement in the inflation performance.[2] The annual rate of CPI inflation averaged 4.6 per cent in the first four months of the year. While there was some modest improvement in the services sector, price inflation in the goods sector has picked up noticeably. This, in turn, reflects the general rise in global commodity prices and, in particular, the rise in oil and food prices. The appreciation of the euro against the dollar has helped to offset some of the rise in global oil prices (oil is priced in dollars), but even in euro terms the wholesale price of oil remains close to historical highs. The primary driving forces behind higher food prices are weather-related shortfalls in supply (temporary), rising demand for higher 'value-added' foods from emerging countries (permanent), growing demand for bio-fuels (probably permanent) and perhaps speculative flows (temporary) reflecting a flight of funds from financial markets. The appreciation of the euro against sterling does not appear to have had any major impact on dampening goods prices at this stage; whether or not this reflects margin building remains is not yet clear. Over the remainder of the year some moderation in the rate of CPI inflation is expected, although it is clear at this stage that the Budget day forecast of 3.0 per cent will not be achieved. For next year, the current market consensus is for a moderation in the rate of inflation.

[2] Internationally the co-incidence of weak demand growth with rising price inflation has prompted concerns about 'stagflation', which has not been a feature of most developed economies since the 1980s.

On a harmonised basis, inflation averaged 3.4 per cent in the first four months of the year. Food and oil prices are also impacting on the inflation performance in the euro area, where HICP inflation has also averaged 3.4 per cent. In other words, harmonised inflation in Ireland has evolved in line with that in the euro area in the opening months of this year. Nevertheless, price levels in Ireland remain the highest in the euro area, with consumer prices on average being nearly 20 per cent higher than the average, undermining our competitiveness.

IV.4 Public finances …

For the year as a whole, tax revenue growth of 3½ per cent was projected at Budget time. This is now unlikely to be achieved as tax receipts to end-April were €736 million below profile.[3] The latest official forecast for the General Government Balance (GGB) in 2008, produced for the April 2008 Excessive Deficit Procedure (EDP) reporting, is the Budget day projection of a deficit of 0.9 per cent of GDP. A revised official GGB forecast will be produced for the October 2008 EDP. While spending in the year to end-April was €81 million ahead of profile, the tax short-fall that has now materialised will not be recouped (and in fact it is likely to be significantly worse). The Department is monitoring the situation and will review the position in the context of both the Budget Strategy Memorandum (scheduled to go to Government in June / July) and the half year Exchequer returns (2nd July).

V. Economic outlook 2008 – 2011

Forecasts covering the period 2008 – 2011 are currently being compiled in the context of the Budget Strategy Memorandum. The Budget time projection for this year will not now be attained, given the scale of the domestic and external shocks to which the economy has been exposed in recent months. It also appears increasingly likely that some of the adverse developments which have emerged this year may continue to restrain the pace of growth next year. For instance:

[3] It was assumed that receipts in the first half of the year would be weak, with receipts in the year to end-April assumed to be down by 1.3 per cent year-on-year. In fact, the actual tax revenue outturn in the year to end-April was down by 6.5 per cent year-on-year.

- **Housing market** – with prices continuing to decline and growing evidence of unsold stocks, developers are unlikely to raise output in the short-term, so that a further decline in output next year is becoming increasingly likely;
- **External demand** – the outlook for some of our major trading partners next year remains uncertain;
- **Credit markets** – global credit market conditions remain strained and it is difficult to predict when the situation will improve;
- **Commodity prices** – while the price of oil (Brent crude is currently above $120 (around €78) per barrel) and various foodstuffs are at elevated levels, further increases cannot be ruled out;
- **Exchange rates** – the euro-dollar bilateral exchange rate is currently trading at around €1 = $1.55 with the euro-sterling rate at around €1 = stg£0.80, implying competitiveness problems for Irish-based firms competing in these markets.

Table 3: Growth forecasts for 2008 / 2009

	2008		**2009**	
	GDP	**GNP**	**GDP**	**GNP**
at December 2007:				
Department of Finance	3.0	2.8	3.5	3.3
Consensus	3.25	3.0	4.0	4.0
now:				
Consensus	2.0	2.0	3.2	3.1

Source: Department of Finance and Reuters.

While no update has yet been published, table 3 shows how the market consensus for both this year and next has moved since Budget time. In summary, the consensus for GDP growth this year is now 2 per cent, a decline of 1¼ percentage points since Budget day. The consensus for next year is now for GDP growth of 3.2 per cent, ¾ percentage points below the expectation last December. Such rates of expansion would be well below the economy's trend rate of growth, resulting in a pick-up in unemployment. Moreover, given more recent developments (such as higher oil prices) the current consensus may be somewhat optimistic, and if growth was indeed lower next year this would have implications for the public finances.

Thereafter, in the absence of any further drag from residential investment and on the assumption of no further loss in competitiveness and the implementation of appropriate budgetary policies, the economy should return to its trend rate of growth, a point emphasised by the ESRI in its recent *Medium Term Review*.

The Group may wish to discuss the emerging economic outlook.

May 2008