Economic Trends and Outlook:

In recovery but more challenges ahead

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While the latest round of Covid restrictions will delay the recovery for some service industries, the short-to-medium term economic and labour market outlook is generally bright.

1. Introduction

The Irish economy has almost certainly exited the worst of the covid induced crisis and its recovery is now picking up steam. The strong countercyclical response taken by fiscal and monetary policy has broadly protected household incomes and the productive capacity of the economy. This in turn has enabled a sharp economic bounce-back. While the latest round of Covid restrictions will delay the recovery for some service industries, the short-to-medium term economic and labour market outlook is generally bright.

There are of course a range of threats to this outlook. Examples of important risks include: repeated and prolonged Covid related restrictions; a continuation of global supply constraints, rising inflation and a tightening of monetary policy in the euro area or in the US, further Brexit and trade uncertainty, and even potentially a slowdown in the Chinese economy.

Even so, our view is that rapid economic growth should manifest itself in 2022 through the release of pent-up consumer spending and through strong growth in domestic investment. The unemployment rate should be close to its pre-pandemic level by late 2022 with significant potential for wage growth in sectors experiencing labour shortages. The trajectory of price inflation is uncertain. Our view is that inflation is likely to dampen somewhat in the latter part of 2022 as base effects in energy prices work through the system, as supply chain issues ameliorate, and as spare capacity builds up.

However, policymakers will need to grapple with many significant long-term challenges in the years ahead such as changes to international trade and taxation, an ageing population, digitalisation and automation, the affordability of housing and childcare costs, labour market precariousness, and of course the economic transformation required to achieve the zero-carbon transition.

The zero carbon and digital transitions will cause significant changes in the architecture of the economy and in the composition of the labour market. Even so, these transitions nevertheless offer great opportunities for economic development. Policy will need to facilitate and ease these changes via just transition supports and via higher levels of per person investment in education and training including in digital literacy, via greater investment in green technologies and infrastructure, via measures to support the economy's innovative capacity, and via steps to eliminate barriers to labour force participation, for example the cost of childcare.

Finally, the pandemic has re-established the indispensability of public services and the welfare state. Meeting the costs of rising to these future challenges will require significant reform to the state's revenue raising capacities over the medium-term.

2. The World Economy

The IMF is projecting that the world economy will grow by 5.9% in 2021 and 4.9% in 2022, while the OECD projects growth of 6.9% and 4.7% respectively. Household consumption is projected to be the main driver of this growth. Such projections imply a strong bounce-back from the Covid-induced decline in GDP in 2020. That economic decline was particularly pronounced within advanced economies such as the United Kingdom and the euro area.

The economic resurgence in the advanced economies is now well underway and they have been growing rapidly now for over six months (see Table 1). The growth reflects the scale of the collapse in 2020 but also reflects the genuine strength of the rebound. The United States economy grew 12.2% and 4.9% on an annual basis in the 2nd and 3rd quarters of this year. Similarly, the euro area and the UK respectively grew by record amounts of 14.4% and 23.6% annually in the 2nd quarter, followed by 3.9% and 6.6% in the 3rd quarter.

The swift recovery is a consequence of the easing of restrictions and the release of pent-up demand that was enabled by successful vaccine rollouts, combined with the highly countercyclical fiscal and monetary policies that protected household incomes and businesses during the lockdowns.

The timing and strength of recovery will vary from sector to sector but will become increasingly broad-based as restrictions on face-to-face service industries are lifted. All major advanced economies will have surpassed their pre-pandemic GDP levels by early 2022. The large government deficits that have developed across the advanced economies will prove manageable given their temporary crisis response nature and given the highly supportive monetary policy commitments that have engendered hyper-low borrowing costs.

Table 1 Real economic growth rates (annual change, %), GDP unless stated

	20′ Q1	20′ Q2	20′ Q3	20′ Q4	21′ Q1	21′ Q2	21′ Q3
Euro area	-3.0	-14.5	-4.0	-4.4	-1.1	14.4	3.9
UK	-2.2	-21.4	-8.1	-7.1	-5.8	23.6	6.6
US	0.6	-9.1	-2.9	-2.3	0.5	12.2	4.9
China	-6.8	3.2	4.9	6.5	18.3	7.9	4.9
Ireland Rep.	6.5	1.4	10.8	4.5	11.7	21.1	11.4
Ireland (MDD)	-2.7	-12.2	-2.8	-2.2	-5.1	15.6	5.3

Note: Headline GDP data in Ireland is heavily distorted by the outsize activities of a small number of very large US multi-nationals. MDD or Modified Final Domestic Demand gives us a better understanding of the performance of the domestic facing economy.

Sources: Eurostat: GDP main aggregates, CSO: Quarterly National Accounts, Trading Economics: GDP data.

Labour markets are also well on the way to recovery although there is some evidence of scarring. The United States unemployment rate (UR) initially rocketed from 3.5% in February 2020 to 14.8% just two months later, while employment declined from 155.6 million to 133.4 million. There was a sharp decline in unemployment in subsequent months with the rate then falling relatively consistently over the last year. The unemployment rate was at 4.6% in October with 154 million employed. However, the labour force participation rate has declined from 63.4% on the eve of the pandemic to just 61.6% in October of this year. There is also evidence of persistent labour shortages in multiple sectors. Average hourly earnings rose by 4.9% year-on-year in October.

The euro area's seasonally adjusted unemployment rate was 7.3% in October. This was its lowest rate since April 2020. Youth unemployment was 15.9%. However, there is significant variation between EU countries with unemployment rates ranging from 2.9% and 3.3% in the Netherlands and Germany to 14.5% in Spain. Euro area employment grew 2.1% year-on-year in the 3rd quarter. UK unemployment was 4.3% in September while average weekly earnings were up 5.8% year-on-year.

Labour markets are well on the way to recovery but there are significant inflationary pressures

Significant inflationary pressures have been building in recent months (see Table 2). Rising global inflation relates to demand pressures, loose fiscal and monetary policy, labour shortages in certain sectors, base effects in energy and various commodities, as well as global supply chain issues related to availability of inputs and transport bottlenecks.

Global price increases are principally being driven by Covid related base effects, in particular rising energy costs. For example, annual energy price inflation is up 27.4% in the euro area in November, whereas price increases for all items excluding energy was just 2.5%. Overall, consumer price inflation is expected at 4.9% year-on-year. Prolonged higher inflation could prompt policymakers to trigger an earlier than expected tightening of monetary policy.

Price increases have been notably strong in the United States. US inflation moved above 2% in March and then above 5% in May. Annual energy costs rose by 30% in October which drove inflation to 6.2%, and its highest level in over 30 years. Core inflation in the US (which excludes food and energy) was 4.1%. The main upward pressure in the UK (4.2% in October and at its highest since December 2011) also came from energy prices, namely electricity (18.8%), gas (28.1%) and liquid fuels (69.1%). However, significant upward price pressures have been much less pronounced or almost absent in China (1.5%) and in Japan (0.1%).

The recent upward trends in price inflation have followed a decade of low price inflation in the euro area. The main issue for policy makers is to understand whether or not the recent higher price increases will be maintained. To an extent the price increases represent an unwinding of the lockdown induced fall in prices in 2020. The post-lockdown rebound in demand is likely to level out over the course of the next year or so, while supply chain issues should ameliorate. The future trajectory of energy prices is less certain, although some slowdown seems likely. Overall, the inflationary pressures are therefore most likely to be transitory although significant uncertainty remains.

We anticipate that consumer inflation in the euro area is likely to average 1.9%-to-2.0% over the medium term, i.e., the ECB target, and indeed 2% is close to the historical long-run average for Ireland, the UK and the United States. Guidance from the ECB suggests euro area monetary policy is unlikely to tighten until such time as the economic recovery is well embedded and employment is close to pre-pandemic levels.

Table 2 Consumer Prices (Annual Change, %), HICP Unless Stated

2021	Nov (2020)	Jun	Jul	Aug	Sept	Oct	Nov
Euro area	-0.3	1.9	2.2	3.0	3.4	4.1	4.9
UK	0.3	2.5	2.0	3.2	3.1	4.2	
US	1.2	5.4	5.4	5.3	5.4	6.2	
China	-0.5	1.1	1.0	0.8	0.7	1.5	
Ireland Rep.	-1.0	1.6	2.2	3.0	3.8	5.1	5.4

Notes: US (PCE), UK and China (CPI)

Sources: Eurostat: Inflation – Flash Estimate, Trading Economics, US Federal Reserve, Bank of England

3. Economic Trends in the Republic of Ireland

Headline real GDP growth remained robust throughout the pandemic due to a strong export performance (see Table 3). However, this particular indicator is heavily distorted by the activities of a small number of US multinationals. The real GNI* indicator, which is a more significant and useful indicator of activity in Ireland, declined by 3.5% in 2020.

Real modified domestic demand (MDD) grew by 5.3% year-on-year in the 3rd quarter of 2021 and was 2.4% higher than the same quarter of 2019. The two-year growth in MDD has been driven by government spending (+14.5%). Personal consumption (-0.6%) and modified or 'domestic' investment (-0.5) were marginally below their 3rd quarter of 2019 levels. Annual MDD fell for five consecutive quarters (Q1 2020 to Q1 2021 inclusive) with average annual declines of 5%, before finally turning positive (+15.6% year-on-year) in the 2nd quarter of 2021.

Personal consumption increased annually by a slightly disappointing, albeit still strong, 7.7% in the 3rd quarter. This followed robust annual growth of 19.3% in the 2nd quarter. Consumption had declined year-on-year in each of the five quarters prior to that as spending opportunities for services were restricted. Household saving soared to record levels during this period. The volume of retail sales for October was up 9% compared to the same month in 2019 but just 1.5% compared to 2020. This modest increase in retail sales was driven primarily by increased sales in bars.

Construction remains weak, with activity down year-on-year, and down 17.5% compared to the 3rd quarter of 2019. Overall, five of eleven sectors remain below their 2019 levels in real terms. Even so, the successful vaccination programme and consequent opening of the economy meant that consumption and domestic investment were on target to exceed their pre-covid levels by the end of 2021, although the latest round of restrictions may impede this recovery somewhat.

Table 3 Dashboard of Macroeconomic Indicators, Republic of Ireland

	2017	2018	2019	2020	21'Q3	Latest
Percentage volume change over previous year						
Gross Domestic Product	8.9	9.0	4.9	5.9	11.4	11.4 (Q3'21)
Modified Domestic Demand	3.2	4.6	1.7	-4.9	5.3	5.3 (Q3'21)
Personal Consumption	2.3	3.9	3.3	-10.4	7.7	7.7 (Q3'21)
Retail Sales	3.9	3.8	2.1	-2.3	1.5	1.5(M10'21)
Modified GNI (GNI*)	4.6	5.3	2.6	-3.5	-	-3.5 (2020)
Percentage annual average rate of change						
Employment	2.8	2.8	2.9	-2.8	9.8	9.8 (Q3'21)
Labour Productivity	3.7	5.6	3.1	-	-	3.1 (2019)
Average Hourly Earnings	1.7	2.9	3.5	4.8	3.8	3.8 (Q3'21)
Average Weekly Earnings	1.9	3.3	3.6	5.2	5.4	5.4 (Q3'21)
Inflation (CPI)	0.4	0.5	0.9	-0.3	2.9	5.3 (M11'21)
Percentage of annual GDP or quarterly GDP						
Government Balance (GGB)	-0.3	0.1	0.5	-4.9	-	-4.4 (H1'21)
Gov. Gross Debt (end year)	67.8	63.1	57.2	58.4		58.4 (2020)
Percentage of labour force						
Unemployment (Covid Adjusted)	6.7	5.8	5.0	19.4	10.9	6.9 (M11'21)
Long-term Unemployment	3.0	2.1	1.6	1.3	1.7	1.7 (Q3'21)

Notes: Half-year, ('H'), Quarterly ('Q'), monthly ('M') and other data is compared to same period of the previous year. Modified domestic demand (MDD) is non-seasonally adjusted 'Total domestic demand less the effects of the trade in aircraft by aircraft leasing companies and the imports of intellectual property'. Modified GNI is GNI adjusted for factor income of redomicilied companies, and depreciation of aircraft leasing, R&D service imports and trade in IP and depreciation on aircraft leasing. GGB is end-year figure as a % of annualised GDP or latest six month figure as % of six month GDP. Unemployment is Covid-adjusted.

Sources: CSO: Labour Productivity, National Income and Expenditure, Quarterly National Accounts, Retail Sales Index, Labour Force Survey, Earnings and Labour Cost, Consumer Price Index, Balance of International Payments, Government Finance Statistics, Monthly Unemployment.

The number of Pandemic Unemployment Payment (PUP) recipients fell to 53,000 by the first week in December

Photo by Brad Starkey on Unsplash

Inflationary pressures have been building in recent months. Irish CPI inflation was 3.7% in September, 5.1% in October and 5.3% in November. Inflation in November was the highest in over 20 years. However, the context is important. Inflation had been negative for the first 11 months of the pandemic and has only exceeded 2% in recent months.

The main factors contributing to CPI inflation in November were Transport costs (39% contribution), which mainly reflects higher prices for diesel, petrol and motor cars, Housing & Home Energy costs (36%) which mainly reflects higher rents and the cost of home heating oil, electricity and gas, and Restaurants & Hotels (12%). Overall, we can see that the bounce-back in energy costs is the main contributor to inflation. Notably, the last two years have seen a cumulative increase of 4.2% in the CPI and 4.3% in the HICP, annual averages of 2.1%. Residential property prices rose 12.4% in the year to September. Housing supply continues to fall well short of demand while the rise in discretionary household savings has likely added to property price pressures.

The number of Pandemic Unemployment Payment (PUP) recipients fell to 53,000 by the first week in December. This represents just 9% of the peak PUP numbers in early May 2020 (606,000). Dublin has had the relatively weakest recovery amongst this cohort with PUP recipients still at 12% of the peak number.

The Covid adjusted unemployment rate (CAUR) in November was down to 6.9%, or 180,000, on foot of annual employment growth in the 3rd quarter of 9.8% (+221,200) as the economy continues to open. Employment growth falls to 8.6% if we exclude absences from work. Hours worked was up 6% or 4.3 million hours worked per week.

The unemployment rate is now below 7% and there is already evidence of labour shortages in some sectors

Average weekly earnings increased 8.9% overall (Table 4) and 8.8% in the private sector between the 3rd quarter of 2019 and the 3rd quarter of 2021, with average hourly earnings up 7.6% and 7.5% respectively over the same time period. A very important caveat is that these figures are skewed upwards by the composition of jobs lost during the crisis. Lower paid and service sector workers are disproportionately likely to have lost employment. With that caveat in mind, hourly and weekly earnings (real and nominal) increased in almost all sectors over the two-year period. The sole exception was the transportation and storage sector.

Table 4 Weekly earnings earnings by sector, % change, 3rd quarter

2021	2019	2020	2021	2019 to 2021	2020 to 2021
HICP	102.1	101.1	104.1	2.0	3.0
CPI	103.8	102.9	105.9	2.0	2.9
	€	€	€	%	%
Industry	883.24	890.24	943.06	6.8	5.9
Construction	804.64	818.03	870.57	8.2	6.4
Wholesale/retail et al.	597.26	605.19	627.91	5.1	3.8
Transport/storage	833.22	780.66	769.55	-7.6	-1.4
Accommodation/food services	376.82	387.95	401.34	6.5	3.5
ICT	1241.45	1270.40	1342.98	8.2	5.7
Financial/insurance/real estate	1090.20	1119.87	1160.86	6.5	3.7
Professional/scientific/technical	948.00	906.67	1033.90	9.1	14.0
Administration & support	607.68	624.16	684.51	12.6	9.7
Public administration/defence	966.73	978.47	1006.37	4.1	2.9
Education	865.60	901.01	969.74	12.0	7.6
Human health & social work	727.10	758.21	804.58	10.7	6.1
Arts/entertainment/services	494.22	518.58	564.39	14.2	8.8
All sectors	**769.14**	**794.89**	**837.42**	**8.9**	**5.4**

Notes: CPI index is December 2011 = 100; HICP index is 2015 = 100

Sources: CSO: Earnings and Labour Cost Quarterly, Consumer Price Index

As is the case in other European countries, there is now evidence of labour shortages in areas like driving, software and construction. The economy-wide and the private sector job vacancy rates (JVR) of 1.5 and 1.6 are at their highest recorded levels since at least 2008.

Inflation is running at over 5%

Compensation of employees (COE) increased by 11.4% annually in the 3rd quarter and increased 5.6% compared to the previous quarter. Arts and entertainment saw the fastest increase in percentage terms (17.3%). Industry (excluding construction) was the only sector to experience a decline. The Employment Wage Subsidy Scheme (EWSS) accounted for 4% of COE during the quarter and over 10% in distribution, transport, hotels & restaurant (12.1%), and in arts & entertainment (19.2%). The distribution et al. sector accounted for almost 60% of the cost of the EWSS in the 3rd quarter.

The public finances have held up well given the difficult economic situation and the highly countercyclical response of government. In particular, tax receipts have been stronger than expected (9.4% above target) with income tax receipts and especially corporation tax receipts continuing to surprise to the upside. Tax receipts in the first

11 months of 2021 are €7.4 billion higher than the equivalent period in 2019. The exchequer recorded a deficit of €4.9 billion on a rolling basis over the 12 months to the end of November. While Ireland's public debt-per-person is amongst the highest in the world at close to €47,000, the 10-year bond yield was just 0.08% as of the 7th of December.

Economic Outlook

Growth

The economic recovery is picking up steam with rapid growth likely to manifest itself in 2022. Strong employment growth and the removal of once-off Covid-19 supports will see the deficit fall significantly in 2022, and then again in 2023, in both nominal as well as per cent of GDP terms.

Demand is likely to continue its strong expansion over the next year, notwithstanding the latest restrictions on services activity. The services and manufacturing PMIs both remain very strong overall, albeit they are down somewhat on the record levels seen earlier this year. This signals strong growth although rising Covid numbers will dampen demand somewhat in the short term. The construction PMI suggests solid near-term growth in commercial projects. Overall, domestic demand should grow by close to 8% in 2022. This strong projection assumes minimal economic disruption from Covid-related lockdowns.

Consumption will be driven by the unwinding of household savings and the realisation of pent-up demand as constraints on certain services are ended, while business investment will benefit from increased business confidence and reduced uncertainty. Even so, a cautious approach to removing targeted supports for weakened but viable businesses should be maintained.

One caveat is that the rising energy costs, if sustained, might reduce household expenditure on other goods and service, and might also be a drag on the level of business investment as input costs rise. Consumer confidence declined to a seven-month low in November reflecting concern over the surge in Covid infections and rising energy costs. On the other hand, the small and highly globalised nature of the Irish economy suggests that Ireland should benefit strongly from the expected demand-based recoveries in advanced economies, as well as the general bounce-back in the volume of world trade as economies increasingly open up.

The recovery should be much faster and more robust than previous recoveries from recession. Household incomes have largely held up, the economy's productive capacity has broadly been protected, and private sector debt is much lower than in the wake of previous crises.

Labour market

The labour market is undergoing a strong recovery and the unemployment rate will continue to fall for at least the next two years as employment continues to grow. The extent of structural damage to the labour market remains unclear but should be much less severe than after previous crises. The unemployment rate should be below 5.5% by the end of 2022, with the economy close to full employment by end 2023.

The general outlook for wage growth is also positive, albeit with the usual variation from sector to sector. High job vacancy rates, tight labour supply and high inflation should feed through into strong nominal wage growth for workers. However, average economy-wide wage growth will be lower as the composition of new jobs will skew towards lower value-added sectors.

Inflation

There is significant uncertainty about the future trajectory of price inflation in the months ahead. Crucially, recent inflation reflects a number of temporary factors such as the inevitable bounce back in energy prices and in consumer demand after their sharp fall in 2020. The pandemic also caused supply chain issues for the global economy, including raw material and component shortages and pressure on transport networks, and these issues are likely to persist until early-to-mid 2022 before starting to ease. Sustained inflationary pressures would fuel higher wage demands in order to counteract the increasing cost of living. Our view is that inflation will peak in the fourth quarter of 2021 before settling back to around 2% in the second half of 2022 and an average of close to 2% thereafter.

On the other hand, we expect both house prices and rents to continue their rapid rise. Housing supply will significantly lag demand for at least the next few years, and we anticipate that much of the glut of savings accumulated during the lockdowns will eventually pass through into higher house prices.

Risks, uncertainties and challenges

There are a number of risks to the recovery. A non-exhaustive list includes:

- Repeated and prolonged Covid related restrictions. This will remain an ongoing risk until such time as vaccinations are widely available in the global south;
- Ongoing global and domestic supply constraints;
- Rising international inflation and a consequent tightening of monetary policy in the euro area or in the US;
- Sustained higher inflation in Ireland relative to trading partners could result in a loss of competitiveness;

- Accumulated household savings not being used to support demand and being diverted to assets like housing. Savings have disproportionately been accumulated by higher income households with lower-than-average propensity to consume;
- Further Brexit related and other trade disruption,
- A potential slowdown in the Chinese economy.

Policymakers will need to grapple with many significant long-term challenges in the years ahead such as (A) responding to changes to international trade and taxation, potentially via a revised economic model, (B) supporting an ageing population, (C) adapting to digitalisation and automation, (D) improving the affordability of housing and childcare, (E) reducing labour market precariousness, (F) increasing labour productivity, and of course (G) managing the economic transformation required to achieve the zero carbon transition.

The zero carbon and digital transitions will cause significant changes in the architecture of the economy and in the composition of the labour market. Even so, these transitions nevertheless offer great opportunities for economic development.

Policy will need to facilitate and ease these changes via just transition supports to protect real incomes and via a range of investments: (1) higher levels of per person investment in education and training including in digital literacy, (2) greater investment in green technologies and infrastructure, (3) measures to support the economy's innovative capacity including reversing the chronically low annual under-spend on public R&D, and (4) via steps to eliminate barriers to labour force participation, for example the cost of childcare.

There is a strong case for using the opportunity represented by cheap borrowing to invest in education and skills and in infrastructure. However, meeting the costs of rising to these future challenges will require significant reform to the state's revenue raising capacities over the medium-term.


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