Full employment now, but enormous challenges ahead

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The economy is close to full employment - but there are many challenges ahead

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1. Introduction

The economy is at or close to capacity. We are now at record levels of employment and hours worked and we have a record female employment rate. The economy and labour market have rebounded well post-pandemic and have broadly withstood the range of negative external shocks of the last few years. The domestic economy has been supported by loose fiscal policy, and by pent-up demand and the unwinding of savings. Exports have been boosted by the strong international performances of pharmaceuticals and ICT.

The recent pace of employment growth is unsustainable and the outlook for the next year or so is more muted. In particular, tightening monetary policy and weak consumer and business confidence will dampen consumption and investment over the next year. Even so, we anticipate reasonably strong employment growth of close to 1.5% and Modified Domestic Demand (MDD) growth of close to 2.5% in 2024 as improvements in real household incomes act to support demand. There are however a number of caveats to this projection.

It assumes there is no further tightening of monetary policy; it assumes that fiscal policy will be stimulatory; that there will indeed be a return to real wage growth as price inflation fades away, and that the assumed growth in real disposable household income supports domestic demand via increased consumption. On this basis we anticipate that the labour market will remain tight and that the unemployment rate will remain close to, albeit slightly above 4%.

The Irish economy and society more generally are facing a series of enormous challenges over the medium-to-long term. These challenges include but are not limited to - ageing demographics and slowing growth; de-globalisation and changing industrial policy and FDI patterns; disruption from climate change, climate action and biodiversity loss; and technological disruption from automation, from Artificial Intelligence, and from many other innovations.

These challenges and changes will significantly alter the future composition of consumption patterns, of economic tasks, and of labour market opportunities and returns. We need to take a strategic approach to these challenges including through reforms to labour market policy, to industrial policy and to education and skills policy. Just transition principles will need to underpin our response to each of these challenges.

Budget 2024 represents an opportunity to begin to plan for these challenging mega trends. In particular, an expansionary budget makes little economic sense at this time and would be pro-cyclical. Particular caution is warranted around regressive tax cuts. Instead, taxes and social contributions will need to meaningfully increase over the medium-term in order that we have the resources necessary to deal with the range of coming challenges. In addition, we should move away from year-to-year tactical and political budget-making to a more considered and strategic multi-annual approach.

Budget 2024 should of course focus on ensuring income adequacy for poorer households in order to reverse the rise in poverty deprivation seen over the last year – but universal cost of living supports would be unnecessary and badly targeted.

The windfall and perhaps transitory corporation tax receipts should be saved into a series of funds to (A) help offset future ageing costs, to (B) ensure capital spending is protected and maintained over the economic cycle in order to address our many infrastructure deficits and in particular to invest in the green transition, and to (C) ensure sufficient and consistent funds are available to support public investment in housing in order to tackle the chronic market failure in that sector.

Finally, monetary policy should take care not to push the European economy into a recession and the ECB should now pause the cycle of monetary tightening. The impact of monetary policy takes place with a lag and inflation is likely to gradually creep down to its 2% target over the next 12 to 24 months.

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2. The World Economy

The Republic of Ireland's economic performance depends to a large extent on the performance of its major trading partners and the wider global economy. Most of our trading partner economies have generally held up well in recent years notwithstanding the range of shocks from Covid shutdowns, trade disruption, cost of living pressures and monetary tightening. Nevertheless, the near-term outlook for growth is relatively tepid for most if not all Western economies. More positively, the tightness of the labour markets in these countries and regions suggests that real wages will turn positive on average in the second half of 2023.

The US economy has weathered the range of recent crises and interest rate hikes surprisingly well, maintaining a reasonably good economic and labour market performance. The economy grew 2.4% year-on-year in the second quarter following growth of 1.7% in the first quarter and full year growth of 1.9% in 2022. The August unemployment rate was close to capacity at 3.8%, albeit this was up from 3.5% in July. The labour market remains somewhat tight, notwithstanding declining levels of job vacancies. The long-term unemployment rate is just 0.7%. However, the employment rate is below the pre-pandemic rates and below the 25-year average, suggesting there may be some degree of pandemic related scarring and labour market exiting.

Inflation is gradually coming under control. The PCE price index was at 3.3% annually in July, with core PCE also trending downwards at 4.2%, and with the trimmed CPI at 4.5%. The sustained tightness of the labour market means that real wages are now marginally increasing notwithstanding the relatively high inflation. Average hourly earnings rose 4.3% year-on-year in August.

The outlook for the US economy is for relatively modest growth over the next year. Tight monetary policy and weak confidence will likely slow demand. The US composite PMI declined to a barely positive 50.1 in September implying very modest growth in private sector activity amid sustained pressure from inflation and high interest rates. Loans to the private sector have been on a downward trend since January, albeit stabilising in August. Consumer confidence of 67.7 in September marked the second consecutive decline while the index itself is well below the long-term average. The Federal Reserve held interest rates steady at the 22-year high of 5.5% at its September meeting though it signalled the possibility of a further hike this year.

The Euro Area economy has also held up reasonably well and escaped recession last year despite being buffeted by a variety of shocks. However, growth is now slowing and the short-to-medium term outlook is weak with high inflation and the lagged effect of higher interest rates expected to increasingly dampen demand. The Euro Area grew 0.5% year-on-year in the second quarter following growth of 1.1% in the first quarter and full year growth of 3.3% in 2022. Employment growth has remained strong with employment increasing 1.3% year-on-year in the second quarter.

The Euro Area's labour market is very tight by its own historical standards. The seasonally adjusted unemployment rate remained at a record low of 6.4% in July with youth unemployment at a record low of 13.8%. Six EU countries including Germany, the Netherlands and Poland have unemployment rates at or below 4%. This is likely to be close to, or at, full capacity. Greece and Spain are now the only countries with double digit unemployment. The Euro Area's labour force participation rate was at a record high of 75.1% in July. The long-term unemployment rate of 2.3% is well below the 25-year average of 3.9% and close to a record low, albeit the rate is still notably higher than that of the US. Real wage growth in the Euro Area remains negative with wages increasing 4.6% year-on-year in the second quarter, or less than the rate of inflation.

Annual inflation in the Euro Area fell to 5.2% in August or less than half of the 10.6% rate in October 2022. However, core inflation, at 5.3% in August, is proving to be sticky. Core inflation has been stuck in a narrow range of 5% and 5.7% since October 2022. The ending of the Russia-Ukraine grain deal could put upward pressure on food prices and there is potential for further energy supply disruptions. Even so, the expected trend for price growth is downward albeit with uncertainty regarding the pace of decline.

An assessment by the European Central Bank (ECB) that core inflation will prove sticky would likely induce them to keep interest rates at their peak rate until well into 2024. If so, this would have damaging consequences for output and employment. Interest rates have already increased by 4.5% and the full impact on prices and demand has not yet been felt. The ECB should take care not to unduly tighten monetary policy as doing so risks generating a recession. A pause would be appropriate. Fiscal policy will become more restrictive as temporary cost of living measures are gradually withdrawn. Stagflation is now a realistic concern.

Overall, the Euro area's immediate economic outlook is fairly weak. The September composite PMI of 47.1 suggests negative growth in private sector activity over the short-term horizon. Consumer confidence is more negative than the historical average and was -17.8 in September. Respondents are pessimistic about household finances. Incomes are still declining and cost of living pressures are deepening for many households, notwithstanding that the economy-wide personal savings rate is above the long-run average.

The UK's economic performance has been somewhat similar to that of the Euro Area. It expanded 0.6% year-on-year in the second quarter, following 0.5% in the first quarter and full year growth of 4.1% in 2022. However, retail sales fell 1.4% year-on year in August marking the 17th consecutive month of decline. The unemployment rate is low by historical standards, at 4.3% in July, but has been on an upward trend over the last year. The employment rate, while lower than the pre-pandemic level, remains high by historical standards, albeit employment declined in the three months to June. A relatively tight labour market combined with high inflation is generating strong real wage growth. Wage growth accelerated to 8.5% in the three months to July.

The UK's short-term outlook is for either very weak growth or a mild recession. The composite PMI was 46.8 in September with consumer confidence at -21. Inflation remains high at 6.7% in August (6.2% for core inflation). This suggests that interest rates will remain elevated for some time. Indeed, the Bank of England may now have finished its cycle of monetary tightening. Tight monetary policy will put downward pressure on aggregate demand over the short-term.

Finally, the slowdown in the Chinese economy and the potential for a significant property crash is now a source of concern for the global economy. Chinese authorities are likely to respond to weak demand by loosening monetary policy and, ideally, by also gradually building out a stronger social safety net. High inflation and interest rates will continue to slow down lending and demand in the global economy.

3. Economic Trends in the Republic of Ireland

The Irish economy is performing reasonably well in many respects, most notably in terms of labour market outcomes, although the pace of growth appears to be moderating (see Table 3.1) while living standards have declined for most households over the last 18 months. GDP growth remains highly volatile from quarter to quarter as it depends on the performance and IP location decisions of a small number of large multinationals. Recent sluggish goods export figures point to a post-pandemic renormalisation of economic activity in pharmaceuticals and ICT. Goods exports had been growing at unsustainable rates (13 consecutive quarters of double-digit growth on a year-on-year basis) and some correction or slowdown was inevitable.

Table 3.1 Dashboard of Macroeconomic Indicators, Republic of Ireland

	2019	2020	2021	2022	23'Q2	Latest
Percentage volume change over previous year						
Gross Domestic Product	5.3	6.6	15.1	9.4	-0.7	-0.7 *(Q2'23)*
Modified Domestic Demand	2.2	-5.9	7.3	9.5	-0.3	-0.3 *(Q2'23)*
Personal Consumption	2.6	-9.9	8.4	9.4	2.4	2.4 *(Q2'23)*
Retail Sales	2.1	-2.3	8.7	-0.6	6.5	3.6 *(M8'23)*
GNI*	2.5	-3.6	13.9	6.7	-	6.7 *(2022)*
Percentage annual average rate of change						
Employment	2.9	-2.8	6.0	6.6	3.5	3.5 *(Q2'23)*
Productivity (Domestic)	1.3	17.3	5.5	-	-	0.9 (Q1'23)
Average Hourly Earnings	3.5	4.8	4.4	3.6	5.1	5.1 *(Q2'23)*
Average Weekly Earnings	3.6	5.2	4.7	3.4	4.3	4.3 *(Q2'23)*
Compensation of Employees	7.6	0.3	9.8	9.6	8.7	8.7 (Q2'23)
Actual Hours Worked (week)	2.9	-9.7	6.6	8.5	1.3	1.3 (Q2'23)
Inflation (CPI)	0.9	-0.3	2.4	7.8	6.6	6.3 *(M8'23)*
Percentage of annual GDP or quarterly GDP						
Government Balance (GGB)	0.5	-5.0	-1.6	1.6	-	1.4 (Q1'23)
Gov. Gross Debt (end year)	57.0	58.4	55.4	44.7	-	43.5 (Q1'23)
Percentage of labour force						
Unemployment *(Covid Adjusted)*	5.0	19.4	16.1	4.5	4.4	4.1 *(M8'23)*
Long-term Unemployment	1.6	1.3	1.8	1.3	1.2	1.2 *(Q2'23)*
Percentage						
Participation Rate (15+)	62.3	60.2	63.3	64.9	65.7	69.0 (Q2'23)
Savings Rate	10.8	25.6	24.6	20.6	-	12.0 (Q2'23)
Deprivation Rate	17.8	14.3	13.8	17.7	-	17.7 (2022)

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. *Unemployment* is Covid-adjusted for 2020 and 2021. *'Productivity'* refers to labour productivity in the domestic-dominated sectors.
Sources: CSO: *Labour Productivity, National Income and Expenditure, Quarterly National Accounts, Retail Sales Index, Labour Force Survey, Earnings and Labour Cost, Consumer Price Index, Government Finance Statistics, Monthly Unemployment, Household Saving, Survey on Income and Living Conditions.*

More domestically relevant indicators than GDP, such as Modified Domestic Demand (MDD) and consumption, suggest that the economy is continuing to expand on a quarter-to-quarter basis. Seasonally adjusted MDD increased modestly by 1% in Q2 (declining on an annual basis due to lower investment) while personal consumption grew 2.4% year-on-year. Pent-up demand has supported a strong post-pandemic recovery with the savings rate normalising from 32.5% in Q2 2020 to 12% in Q2 2023.

Seasonally adjusted consumption is at a record high and grew 0.9% quarter-on-quarter in Q2, Gross Value Added (GVA) in the domestic sectors grew by 1.5%. The volume of retail sales increased by 6.5% in Q2 and by 3.6% in the year to August - though by just 2.2% and 1% respectively when motor trades are excluded. The ESRI's nowcast model estimates that MDD grew 1.9% year-on-year in July and that annual MDD growth was 3.1% in Q3.

Most economic sectors grew year-on-year in Q2 (seasonally adjusted). Construction activity was a notable exception with activity marginally below that of Q2 2018 and Q2 2019 in real terms. Demand continues to greatly outstrip supply in the housing market with negative implications for regional labour supply and mobility, and for migration dynamics.

Inflationary pressure

The Consumer Price Index (CPI) rose by 6.3% between August 2022 and August 2023, whereas the alternative HICP measure rose by 4.9% in the year to August and 5% in the year to September. The HICP's moving 12 month rolling average was 6.9% in August. Cumulative price changes for selected time periods up to August 2023 are shown in Table 3.2. The CPI rose by 19.2% between January 2021 (just before the invasion of Ukraine) and August 2023, while the HICP rose by 18%.

Core inflation excludes volatile energy and unprocessed foods price inflation. Core CPI inflation was 6.4% in August while flash estimates suggest core HICP was 4.5% in September. Central banks tend to focus on core inflation and services inflation when deciding monetary policy as these tend to be more reflective of future inflation than the more volatile headline inflation. Changes in core CPI and core HICP are shown in Table 3.3.

Inflation remains high - and sticky

Table 3.2 Inflation (CPI and HICP), August 2023, % Change over Period

CPI	% change	HICP	% change
January 2021	19.21	January 2021	18.02
August 2021	15.57	August 2021	14.40
January 2022	13.51	January 2022	12.35
August 2022	6.33	August 2022	4.93
January 2023	5.31	January 2023	4.47
July 2023	0.67	July 2023	0.50

Note: CPI (All items) was 100.0 in December 2016; 101.5 in January 2021 and 121.0 in August 2023
Source: CSO: Consumer Price Index

Table 3.3 Core Inflation (CPI and HICP), August 2023, % Change over Period

CPI	% change	HICP	% change
January 2021	15.03	January 2021	13.50
August 2021	12.49	August 2021	11.20
January 2022	11.52	January 2022	10.13
August 2022	6.36	August 2022	4.73
January 2023	6.17	January 2023	5.11
July 2023	0.34	July 2023	0.17

The items contributing most to the 6.3 percentage point CPI increase in the 12 months to August 2023 were housing, water, electricity, gas and other fuels (3.02 points), restaurants and hotels (1.18 points), recreation and culture (0.90 points) and food and non-alcoholic beverages (0.89 points). Over 80% of inflation is now coming from services (as opposed to goods) with mortgage interest (up 46.4% year-on-year) contributing 1.42 points to inflation by itself (this also largely explains the difference in growth in the CPI and the HICP).

The rise in the cost of living and the failure of incomes (in particular social transfers and wages) to match price increases can be seen in the jump in the deprivation rate from 13.8% in 2021 to 17.7% in 2022 (see Table 3.1). While headline inflation is on a downward trajectory, core inflation has been somewhat sticky and has operated within a high and narrow band over the last year.

Strong labour market

The seasonally adjusted unemployment rate was 4.1% in August, or 111,500 persons and the lowest rate since 2001. This compares to 120,000 persons just prior to the pandemic and to a pandemic peak of 408,000 persons. Unemployment is down marginally from 115,600 in August 2022. The long-term unemployment rate was 1.2% in the second quarter of 2023, below its pre-pandemic level and marginally above the record low of 1.1% (Q3 2022).

The labour market remains close to capacity yet wages are still negative in real terms.

However, youth unemployment rose to 11.2% in August. This was the highest reading since September 2022. The job vacancy rate (JVR) of 1.3 is high by Irish standards and suggestive of a tight labour market with the economy-wide and private sector rates higher than both their pre-pandemic levels and historical norms. However, the sectoral JVRs have declined in recent quarters possibly indicating a softening in labour demand and normalising of employment growth. The unemployment rate ranges from 3.3% in the Mid-East region to 6% in the South-East region.

Total employment was a record 2.64 million in the second quarter of 2023 with employment up a robust 3.5% over the previous year. The employment rate for people aged 15 to 64 increased from 73.5% in Q2 2022 to 74.2% in Q2 2023. The female employment rate is at a record high of 70.5% while the male employment rate is at 78% (its Q2 peak was 80.6% in 2006). The participation rate increased from 65.2% to 65.7% in the year to Q2 2023 and was at a record 61% for females. Participation rates range from 69.1% in Dublin to 61.6% in the South-East region.

Total employment in Q2 had increased in all bar two sectors. Only *Industry* and *Agriculture, Forestry and Fishing* declined year-on-year. In absolute terms, employment grew by 88,400 since Q2 2022 with *Human Health & Social work* accounting for 18,600 net new employments, followed by *Public Admin & Defence* (14,300), and the heterogeneous *Other* category (9,600). The composition of employment has been shifting towards higher value and higher wage activities in recent years. This is exactly what we would expect given the tightness of the labour market and the greater choice available to workers.

Actual hours worked in the economy reached a record 84.1 million hours per week during the second quarter of 2023. This compares to 83 million hours in the same quarter of 2022 and 78.5 million in the second quarter of 2019. The sectors with the most hours worked were *Industry* (11.1 million), *Human Health & Social Work* (10.2 million) and *Wholesale & Retail & Vehicle Repair* (10.0 million).

One caveat to the positive labour market news is that the seasonally adjusted employee index fell by 0.1% in the month to July 2023. The largest decrease was observed in *Accommodation & Food Services* (-3.7%). Even so, the overall index has increased 2.4% compared to July 2022, with *Financial, Insurance & Real Estate* seeing the largest rise in the number of employees at +6.5%.

A longer-term perspective (Table 3.4) shows that the composition of employment by sector has changed significantly over the last 25 years. *Industry* (falling from a 20.3% share to 12.2%), *Agriculture, Forestry and Fishing* (from 8.7% to 3.8%) and *Wholesale/Retail & Vehicle Repair* (14.2% to 13%) have lost the largest shares of employment, whereas the largest gains in share have gone to *Human Health and Social Work* (from 7.8% to 13.3%), *ICT* (from 4.1% to 6.6%) and *Education* (5.9% to 8.1%).

The scale of compositional shifts in employment and the potential for shifts of a similar scale over the next generation illustrate the need for policymakers to be agile in terms of their labour market, industrial and education policies. Mega-trends such as ageing demographics, digitalisation and technology disruption, climate action and decarbonisation, and deglobalisation and changing global supply chains, will all meaningfully change labour market structures and dynamics.

The impact of these mega-trends may lead to relative growth in the caring economy, in health, in ICT and in construction in the years to come alongside relative losses in areas such as agriculture, agri-food, education, retail, vehicle repair and possibly in certain types of industry and professional services. The full nature and scale of the labour market changes are difficult to anticipate.

Table 3.4 Persons aged 15-89 in Employment, by sector (SA), thousands, 2nd quarter

All Q2	1998	2018	2022	2023	2023 (1998)
					% Share
Agriculture, forestry, fishing	136.8	105.3	105.5	98.8	3.8 (8.7)
Construction	105.8	144.6	167.3	170.2	6.5 (6.7)
Industry	321.0	278.4	325.2	321.2	12.2 (20.3)
Wholesale/retail, vehicle rep	224.3	300.5	325.6	341.9	13.0 (14.2)
Transport & storage	66.2	97.3	111.5	115.4	4.4 (4.2)
Accommodation, food serve	105.0	176.4	166.9	175.1	6.7 (6.6)
ICT	64.3	117.0	165.9	174.2	6.6 (4.1)
Fin/insurance, real estate	63.9	110.1	130.5	136.0	5.2 (4.0)
Professional, science/tech	72.5	139.1	165.7	174.5	6.6 (4.6)
Admin & support	51.0	103.4	106.5	111.6	4.2 (3.2)
Public admin & defence	66.8	103.3	127.4	141.7	5.4 (4.2)
Education	93.1	166.1	212.0	213.4	8.1 (5.9)
Human health & social work	123.3	284.5	330.6	349.1	13.3 (7.8)
Other or not stated	79.1	116.6	109.9	119.8	4.6 (5.0)
All sectors	1,580.3	2,248.2	2,541.9	2,629.3	100

Note: Seasonally adjusted. Rounding means that employment shares do not add up to 100. Construction employment peaked at 241,100 in Q2 2007. Thus, construction employment in Q2 2023 was at just 70.6% of its historical peak.

Sources: CSO: Labour Force Survey

Employee compensation increased 4.3% in the second quarter of 2023 relative to the previous year. Average weekly earnings increased 4.3% overall, (Table 3.5 and Table 3.6) and by 3.8% in the private sector in the twelve months to Q2 2023, with average hourly earnings up 5.1% and 4.5% respectively over the same time period.

Real wages should turn positive by the end of 2023.

We can see that wages fell far short of inflation for the vast majority of workers. Real weekly wages declined across the economy by 2.3% on a CPI comparison basis. Five sectors have experienced negative real wage growth (CPI comparison) since 2018 with the deficit most pronounced for workers in *Transport & Storage*. The *ICT* sector has had the fastest wage growth over the last five years.

Table 3.5 Weekly earnings by sector and type, % change, 2nd quarter

All Q2	2018	2022	2023	18-23	22-23
HICP	100.7	111.6	117.7	16.9	5.5
CPI	101.1	111.8	119.2	17.9	6.6
	€	€	€	%Δ	%Δ
Industry	887	993	1,050	18.4	5.7
Construction	773	921	910	17.7	-1.2
Wholesale/retail, vehicle repair	575	665	669	16.3	0.6
Transport & storage	808	873	888	9.9	1.7
Accommodation, food service	350	408	432	23.4	5.9
ICT	1,174	1,448	1,532	30.4	5.8
Financial/insurance/real estate	1,109	1,247	1,340	20.8	7.5
Professional, scientific/tech	915	1,075	1,114	21.7	3.6
Administration & support	548	692	712	29.9	2.9
Public admin & defence	969	1,020	1,112	14.8	9.0
Education	839	914	950	13.2	3.9
Human health & social work	718	812	855	19.1	5.3
Arts, entertainment & rec	513	625	627	22.2	0.3
Other services	451	557	573	27.1	2.9
All sectors	745	872	910	22.1	4.3

Notes: CPI index is December 2016 = 100; HICP index is 2015 = 100; The CSO advises that payments to public servants in Q4 2022 may have included backdated that impacts the annual percentage changes for public service employments.

Sources: CSO: Earnings and Labour Cost Quarterly, Consumer Price Index; Author calculations.

Table 3.6 Average weekly earnings by sector, % change, yearly averages, Q2

All Q2	2018	2022	2023	18-23	22-23
	€	€	€	%Δ	%Δ
Private	683.58	819.88	850.82	24.5	3.8
Public	962.16	1044.09	1107.20	15.1	6.0
All	745.09	871.93	909.77	22.1	4.3
HICP	100.7	111.6	117.7	16.9	5.5
CPI	101.1	111.8	119.2	17.9	6.6

Notes: CPI index is December 2016 = 100; HICP index is 2015 = 100; For public sector earnings see note under Table x.
Sources: CSO: Earnings and Labour Cost Quarterly, Consumer Price Index

Public finances and fiscal policy

The public finances continue to perform well assisted by the healthy state of the labour market. Income tax, VAT, and especially corporation tax receipts, have all been growing very strongly. Following a general government surplus of €8 billion in 2022, 1.6% of GDP or 3% of GNI*, the Department of Finance has projected a surplus of €10 billion in 2023 and €11.7 billion in 2024. These numbers will be revised down on Budget day.

The shift to a 15% corporation tax rate will likely further boost tax receipts in 2024. In addition, Ireland is expected to be just one of two Euro area countries to run a surplus in 2024 while Ireland's debt level expressed as a percentage of GNI* is below the Euro area average. Net debt was €185.4 billion at the end of 2022. However, the headline numbers are enormously flattered by the potentially transitory surge in corporation tax receipts. In addition, we should note that with the economy and labour market performing so strongly, the actual structural budget balance is somewhat worse than the headline budget balance.

The risks underlying reliance on an elevated corporation tax yield are well understood, with circa €12 billion in receipts potentially transitory in nature. Most of these windfall receipts should be saved and not used to finance ongoing current spending or tax cuts. The Department of Finance is proposing to use the transitory receipts to set-up a state savings vehicle in order to part pay for future ageing costs. There is certainly merit in this strategy. Once the fund is large enough the annual return on investment will effectively amount to a new revenue stream that reduces medium-to-long-term pressure to increase taxes. There is scope to do this and also to set up one or more infrastructure funds, e.g. to support the green transition over the next 20 years and to address the housing crisis. Regardless of how we use the transitory funds we will still need significant structural revenue increases over the medium-term to pay for future ageing and other costs.

A correct understanding of whether the economy is overheating, in recession, or somewhere else along the cycle, matters greatly for budgetary policy and for the appropriate fiscal stance taken by Government. If the economy is in a downswing then it makes sense for Government to stimulate the economy in a Keynesian fashion. The opposite is true if the economy is overheating. Unfortunately, Irish governments have a long and unhappy history of pro-cyclical budgets.

Our view is that the economy is close to or at capacity, albeit not necessarily overheating. If so, this would suggest there is little or no rationale for an expansionary budget. The budget – in its current form as set out in the Summer Economic Statement – will modestly add to overheating and to inflation, while the proposed income tax cuts will disproportionately benefit the better off.

The medium-to-long term fiscal position is much more challenging. Age related expenditure is projected to increase by 3.3% of GNI* by 2030 and will rise further in the following decades. Climate action will lead to diminished revenues from fossil fuels and to greater expenditure in a range of areas while the corporation tax yield is extremely vulnerable to evolving tax games and to decisions made in other countries.

Finally, Ireland's per capita public spending is already low relative to peer high-income EU countries. If we are to meet the challenges of the future such as ageing demographics, decarbonisation and digitalisation - we will need to increase public investment across a range of areas. Tax cuts in Budget 2024 are obviously problematic in this context particularly when we are so reliant on potentially transitory corporation tax receipts.

Sentiment

Sentiment indicators are consistent with fairly anaemic growth (see Table 3.7). The Consumer Sentiment Index was at 58.8 in September. This is well below the historical average of 82 and was the lowest reading since March. It implies a broadly negative perception of future economic activity and prospects and it stems from high inflation, high interest rates and pressure on the finances of lower income households.

The Construction PMI was negative in August at 44.9 amid a sharp drop in new orders. This was the weakest reading since December 2022. The August Manufacturing PMI had the first positive reading since February, although the PMI subsequently fell back in to negative territory in September (49.6) on account of subdued global demand. Finally, the Services PMI was at a broadly expansionary 55 in August, although this was the weakest reading since February. Each of the three PMIs are below their long-run average.

Table 3.7 Sentiment Indicators

PMI	Jul	Aug	Sept	13-year range	Long-run average
Services	56.7	55.0		13.9 - 66.9	57.0
Manufacturing	47.0	50.8	49.6	36.0 - 64.1	54.0
Construction	45.6	44.9		4.5 - 68.8	54.0
				27-year range	
Consumer Confidence	64.5	62.2	58.8	39.6 - 130.9	82.0

Note: A PMI in excess of 50 represents activity expansion compared to the previous month (growth), whereas a PMI below 50 represents contraction. The consumer sentiment index was 77.0 before the invasion of Ukraine in February 2022. Range is 11 years (2013 to 2023) for construction PMI.

Sources: AIB: Manufacturing and Services PMIs; BNP Paribas: Construction PMI; KBC/ILCU: Consumer Sentiment

Outlook

The Irish labour market is either at or close to capacity, at least in the absence of continued net inward migration. We anticipate that the tight labour market and a lagged 'catch-up' to a high but falling inflation rate will generate real annual wage growth in the final quarter of 2023 and then again in 2024. Nominal wage growth should range between 4.5% and 5% in 2024 depending on specific sectoral dynamics.

The rate of employment growth seen this year is not sustainable and was buoyed by pent-up demand and a normalisation of the savings rate. Even so, we anticipate reasonably strong employment growth of close to 1.5% next year as rising incomes support demand. However, this outcome is contingent on (A) no further tightening of monetary policy; (B) the assumption that fiscal policy will continue to be stimulatory; that (C) there is a return to real wage growth, and that (D) growth in real disposable household income translates into support for domestic demand. On this basis we anticipate the labour market will remain tight and that the unemployment rate will remain close to, albeit slightly above 4%.

The economy should continue to grow – but at a more modest rate

The economy should continue to grow over the next twelve months albeit at a modest rate. We anticipate that Modified Domestic Demand (MDD) will increase by close to 2.5% in 2024.

There are significant upside and downside risks to output. The high level of concentration in pharmaceuticals and ICT makes Irish exports inherently volatile and difficult to project. In general, the weak outlook for Ireland's trading partners will act as a headwind to net export growth and the robust pandemic era growth in pharmaceuticals is unlikely to be sustained.

The ECB's tight monetary policy stance will act as a headwind to investment (higher cost of credit) and to personal consumption (incentivises saving). There is still considerable uncertainty vis-à-vis the transmission of monetary policy onto demand in terms of lag and size of effect. A particular concern is that the higher cost of credit will act as a brake on investment in housing supply. This would constrain the economy's employment growth potential by acting as a constraint on labour mobility.

The muted PMIs and confidence indicators should temper expectations as they are consistent with modest growth this year and there are particular concerns about construction activity. Concerns about personal finances amidst cost of living pressures might also lead to excess precautionary saving. However, this is balanced by the likely return to real wage growth in late 2023 and in 2024 and a reduction in cost of living pressures for most wage earners.

Fiscal policy is likely to be expansionary, and procyclical given the current strength of the labour market. Even so, the public finances will remain very healthy in the short-term and in surplus in 2024 assuming no sudden reversal of corporation tax receipts.

Post-pandemic supply and demand mismatches have mostly washed out of the system, but 2nd and 3rd order effects arising from the invasion of Ukraine are keeping inflation at an elevated level. Our view is that inflation will fall gradually month-by-month over the next year provided there are no significant shocks to energy prices. However, this will still keep price growth and core price growth at a level above the ECB's 2% target for all of 2024, which may in turn induce the ECB to keep interest rates at their peak level for much of 2024. We anticipate that HICP inflation and HICP core inflation will average just over 3% next year following inflation of close to 5.5% in 2023.

Fiscal policy will ameliorate cost of living pressures in 2024 although a more targeted approach would be more effective at reducing poverty and deprivation rates.

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