Economic Trends and Outlook:

Better Days Ahead

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the pandemic has permanently changed the future trajectory of the global economy with the acceleration of digitalisation and remote working

Introduction

Covid-19 has caused unprecedented disruption to societies and economies across the globe, but the economy is now on the cusp of a rapid and sustained recovery. Even so, formidable challenges and transitions lie ahead.

We are now well almost one and a half years into the worst global pandemic in a century. Millions of people across the globe have lost their lives while tens of millions more lost their livelihoods.

The measures taken to contain the virus, while justified, have either interrupted or stopped entire sectors of economic activity both in Ireland and across the world. Indeed, the pandemic has permanently changed the future trajectory of the global economy with the acceleration of digitalisation and remote working. The pandemic has also brought the indispensability of public services and the welfare state into sharp focus. This insight may have implications for the future trajectory of fiscal policy.

The zero carbon transition will further transform the economy in the years ahead. This transition will entail significant disruption for certain sectors and regions but also great opportunity for the Irish economy as a whole.

The World Economy

The IMF estimates that the global economy contracted 3.2% year-on-year in 2020. There were significant differences between countries. These differences mainly depended on the structural composition of their economies and the associated economic vulnerability to the virus prevention measures. The United States economy contracted by 3.5% and there were especially sharp falls in output in advanced economies (-4.6% overall), and amongst the Republic of Ireland's key trading partners in the Euro area (-6.5%) and the United Kingdom (-9.8%).

Vaccine rollouts, eased restrictions, fiscal supports, and enormous pent-up demand as savings unwind, are set to drive a strong resurgence in most advanced economies over the next twelve to eighteen months. Recovery will vary from sector to sector but the significant fiscal supports will ameliorate the risk of long-term labour market scarring.

The IMF is projecting real GDP growth of 7% this year in the US and in the UK, followed by growth of just under 5% in both countries in 2022 (4.9% and 4.8% respectively). The IMF envisages more modest growth of 4.6% this year and 4.3% next year in the Euro area. The ECB projects Euro area growth of 4.6% in 2021, 4.7% in 2022 and 2.1% in 2023.

All major economies should have surpassed their pre-pandemic GDP levels by early-to-mid 2022. The US economy grew 0.5% and 12.2% on an annual basis in the first two quarters of this year. However, concerns are rising about the spread of the delta variant, about labour supply issues and about supply chain disruptions. Flash estimates show that the Euro area grew 13.7% in the second quarter compared to the previous year. Spain, France and Italy grew particularly robustly. While the extraordinary growth is partially an artefact of the size of the GDP collapse in quarter two 2020, its size suggests a very strong recovery is now well in train in the Euro area.

The outlook for the low and middle income economies is less benign in the short-run given the generally slower pace of vaccine rollouts and ongoing virus outbreaks. However, the large emerging economies should all experience growth this year given the weakness of the performance in 2020.

Annual inflation accelerated to 5.4% in the US in June. Annual inflation was 2.5% in the UK in June while HICP inflation in the euro area rose to 2.2% in July. Clearly price pressures have now become a factor in many countries. However, this price pressure primarily reflects the unwinding of downward price pressures in 2020, as well as temporary pandemic related bottlenecks and pent-up demand. The inflationary pressures are therefore most likely to be transitory.

The recovery has begun in the advanced economies but it will take a number of years before labour markets fully recover

Even so, the inherent uncertainty around these price developments, alongside rising inflation expectations, have increased the likelihood of an accelerated timeline for tightening monetary policy in North America and in Europe. As it stands, the ECB is signalling it will continue to maintain its net asset purchases under the pandemic emergency purchase programme until the coronavirus crisis phase has passed.

It will take a number of years before unemployment rates return to pre-crisis levels. The US unemployment rate increased from 3.5% in February 2020 to 14.8% in April 2020, representing over 25 million jobs lost. The unemployment rate was still well above pre-crisis levels at 5.9% in June of this year, with the downward trend slowing. Despite this, there is now evidence of labour market shortages in a number of low pay sectors. The official Euro area seasonally adjusted unemployment rate was 7.7% in June although this figure is an underestimate as it doesn't fully reflect ongoing furlough schemes. The UK unemployment rate was 4.8% in May although hours worked remain below pre-pandemic levels.

The large government deficits across advanced economies are manageable given their temporary nature, as well as the supportive monetary policy commitments of central banks, and the extremely low cost of borrowing that has followed from that support.

Table 1 Real GDP Growth Rates (annual change), %

	19' Q4	20' Q1	20' Q2	20' Q3	20' Q4	21' Q1	21' Q2
Euro area	1.0	-3.3	-14.6	-4.0	-4.6	-1.3	13.7
UK	1.2	-2.2	-21.4	-8.5	-7.3	-6.1	
US	2.6	0.6	-9.1	-2.9	-2.3	0.5	12.2
China	5.8	-6.8	3.2	4.9	6.5	18.3	7.9
Ireland Rep.	5.1	6.5	1.4	10.8	4.5	10.7	
Ireland (MDD)	2.0	-2.7	-12.2	-2.8	-2.2	-4.8	

Note: Headline GDP data in Ireland is distorted by the outsize activities of a small number of very large US multinationals. 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*.

Economic Trends in the Republic of Ireland

Despite the impact of the pandemic, Ireland's headline real GDP grew by an ostensibly robust 5.9% in 2020. The outsize impact of a small number of large multinationals continues to distort Ireland's headline data. In this case, the GDP growth is explained by the very strong export performance of the multinational dominated *ICT* and pharmaceutical sectors. Gross value added (GVA) in *manufacturing* grew 23%, while *ICT* grew by 13.8%.

On the other hand, the domestic economy and domestically facing sectors were much more negatively affected by the pandemic with the modified domestic demand (MDD) indicator declining by 4.9%, and the GNI* indicator declining by 3.5%. Overall, seven of the ten main economic sectors declined in 2020. GVA in *distribution, transport, hotels & restaurants* fell by 16.2%, GVA in *construction* declined by 9%, and GVA in *arts & entertainment* fell by 25.5%. The year-on-year decline in MDD continued in the first quarter of 2021, with MDD falling 4.8%.

Personal consumption fell 10.4% in 2020, as opportunities for spending were restricted and household saving soared to record levels. The resumption of lockdown caused a further decline in consumption in the first few months of 2021. However, more recent volume of retail sales data suggests that household spending has started to accelerate. The volume of retail sales (year-on-year) was up 10.6% in June.

Prior to the crisis the labour market was tightening on the back of almost eight years of sustained economic growth. Weekly and hourly earnings in the private sector both grew by 4% in the year to end-2019.

However, the labour market was very badly hit by the pandemic. Private sector pay fell significantly in 2020 although the main pandemic supports ameliorated the decline in

The Coronavirus recession had a disproportionate impact on the customer facing and domestic sectors

household income. Close to a third of the labour market was in receipt of some form of pandemic support during the second quarter of 2020. The headline unemployment rate only rose modestly during the year. However, this is highly misleading. Pandemic unemployment payment (PUP) recipients peaked at 600,000 in April/May 2020 before declining to 200,000 by late Summer and early Autumn. The second wave peak was over 350,000 in late November and the third wave peak was 486,000 in January 2021.

Table 2 Dashboard of Macroeconomic Indicators, Republic of Ireland

	2017	2018	2019	2020	21'Q1	Latest
	Percentage volume change over previous year					
Gross Domestic Product	8.9	9.0	4.9	5.9	10.7	10.7 *(Q1'21)*
Modified Domestic Demand	3.2	4.6	1.7	-4.9	-4.8	-4.8 *(Q1'21)*
Personal Consumption	2.3	3.9	3.3	-10.4	-11.8	-11.8 *(Q1'21)*
Retail Sales	3.9	3.8	2.1	-2.3	-0.7	10.6 *(M6'21)*
Modified GNI (GNI*)	4.6	5.3	2.6	-3.5	-	-3.5 *(2020)*
	Percentage volume change over previous year					
Employment	2.8	2.8	2.9	-2.8	-5.0	-5.0 *(Q1'21)*
Labour Productivity	3.7	5.6	3.1	-	-	3.1 (2019)
Average Hourly Earnings	1.7	2.9	3.5	4.8	5.5	8.6 *(Q1'21)*
Average Weekly Earnings	1.9	3.3	3.6	5.2	8.4	8.4 *(Q1'21)*
Inflation (CPI)	0.4	0.5	0.9	-0.3	-0.2	1.6 *(M6'21)*
	Percentage of annual GDP or quarterly GDP					
Mod. Investment (% GNI*)	19.7	20.2	18.0	18.4	-	18.4 *(2020)*
Mod. Current Account Balance	4.3	4.1	5.7	6.4	-	6.4 *(2020)*
Government Balance (GGB)	-0.3	0.1	0.5	-5.0	-6.7	-6.7 *(Q1'21)*
Gov. Gross Debt (end year)	67.0	63.0	57.4	59.5	60.5	60.5 *(Q1'21)*
	Percentage of labour force					
Unemployment (SA)	6.7	5.8	5.0	5.8	7.1	*6.5 (M7'21)*
Long-term Unemployment	3.0	2.1	1.6	1.3	1.7	*1.7 (Q1'21)*
	Percentage of households					
Deprivation	18.8	15.1	17,8	-	-	17.8 *(2019)*
At Risk of Poverty	15.7	14.0	12.8	-	-	12.8 *(2019)*
	Percentage					
Gini Coefficient	31.5	29.7	28.8	-	-	28.8 *(2019)*

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. *Modified current account* also adjusts for a number of globalisation effects related to multinationals. *Modified investment* is the investment component of MDD. *GGB* is end-year figure as a % of annualised GDP or latest nine month figure as % of nine month GDP. *Unemployment* is average for four quarters or latest quarter/month seasonally 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, Survey on Income and Living Conditions*

Actual hours worked in the economy fell by 9.5% during 2020. Service sectors were disproportionately affected with lower paid workers, young workers (aged 15-24) and part-time workers much more likely to lose their jobs. Workers from the *accommodation & food* sector had the largest number of weeks spent on PUP, followed by workers in *wholesale/retail*. Ostensibly, hourly and weekly wages increased in 2020. However, headline 2020 wage data is misleading as a measure of average wage growth due to a significant compositional bias in terms of employment losses and hours lost, with low paid workers much more likely to have lost employment or hours worked.

Economic Outlook

Swift recovery

The easing of lockdown marked the beginning of what is likely to be a prolonged economic expansion. The economy should grow by close to 8% this year and close to 6% in 2022. Modified domestic demand should grow by close to 3% this year and 7% next year. These rates are very high by historical standards and domestic demand should move above its pre-pandemic levels over the next year. The positive outlook assumes:

(A) Ongoing success in the vaccine rollout,

(B) A full or almost full opening of the economy and society, and

(C) A cautious approach to removing targeted supports for weakened but viable businesses.

Economic growth will be fuelled by the confluence of a number of factors:

- The domestic economy will benefit from the realisation of an unprecedented level of pent-up demand for activities constrained during the lockdown such as face-to-face services,
- Increased public investment and an expansionary stance from fiscal policy,
- Increased private investment as business confidence returns and economic uncertainty fades (SME saving rose significantly in 2020),
- The swift normalisation of the household savings rate from its current excessive and historically high level as households go out and spend,
- An increased demand for exports as Ireland's trading partners experience strong demand-based recoveries supported by the Biden stimulus, the EU recovery plan, and loose monetary policy.

An unfortunate side effect of the declining savings rate will be to push house prices even higher. Housing demand will continue to greatly outstrip housing supply until the middle of the decade, with housing affordability remaining a major issue in the absence

We are on the cusp of a prolonged economic expansion

of a fundamental public policy shift towards more public house building. Housing supply should be close to 21,000 units in 2021, roughly 60% of average annual housing demand.

There is much heated debate about how prices will evolve in the advanced economies over the coming months and years. Recent inflation reflects a number of special temporary factors such as, the inevitable bounce back in energy prices after their sharp fall in 2020, the return of the economy to normal, and pandemic related bottlenecks for certain goods.

The era of sub-1% inflation in Ireland is probably at an end, and growing demand will certainly fuel inflationary price and wage pressures. However, it is much too early to assert that we are about to enter an era of persistently high inflation. In any event, modestly higher average inflation would make it easier for central banks to fight future recessions and would reduce the real value of government debt burdens.

Table 3 Institutional Forecasts

2021	EU	CBI	DF	ESRI	IMF	OECD	2022	EU	CBI	DF	ESRI	IMF	OECD
GDP	7.4	8.3	8.8	11.1	4.2	4.2	**GDP**	5.1	5.4	5.1	6.9	4.8	5.1
MDD		3.4	2.6				MDD		5.6	7.4			
C	5.5	4.1	3.5	7.5		3.9	**C**	8.6	7.6	10.4	8.5		9.9
Gov Bal	-5.0	-5.4	-5.1	-4.1	-5.5	-4.0	**Gov Bal**	-2.9	-2.8	-3.4	-1.9	-2.8	-2.8
Unemp	10.7	17.6	16.3	16.3	6.8	7.7	**Unemp**	8.1	8.5	8.2	7.1	5.7	8.1
HICP	1.5	1.8	1.1	1.2	1.6	0.8	**HICP**	1.2	2.0	1.9	1.5	1.9	1.6
Comp	2.0	1.5	-0.1				**Comp**	1.8	4.9	-6.5			

Notes: **GDP** is annual growth in real Gross Domestic Product. **MDD** is annual growth in real Modified Domestic Demand. **C** is annual growth in personal consumption. **Gov Bal** is the Government Balance (Surplus/Deficit) measured as a % of GDP. **Unemp.** is the Unemployment rate measured as a % of the labour force. **HICP** is the Inflation rate measured in terms of annual percentage growth. **Comp.** Is the annual growth in Compensation per Employee and is a proxy for wage growth.

Sources: European Commission (EU, July), projections for C, Gov Bal and Comp are April; Central Bank of Ireland (CBI, July); Department of Finance (DF, July), projections for C, HICP and Comp are from April; Economic and Social Research Institute (ESRI, June), Inflation projection is for CPI rather than HICP; International Monetary Fund (IMF, April), projections for unemployment are not Covid-adjusted; Organisation for Economic Cooperation and Development (OECD, May), projections for unemployment are not Covid-adjusted.

Risks and uncertainties

Crucially, it would be a mistake to use previous recessions as a baseline or template for the expected pace of recovery. The Covid-19 recession was a policy induced freeze on supply. The dynamics are therefore qualitatively different from previous demand-side balance sheet recessions such as the 2008 great financial crash. In particular, a key difference is that household incomes have largely held up during the pandemic.

Previous recessions were characterised by an overleveraged private sector carrying very significant debt. On this occasion, the economy's productive capacity has broadly been protected, and there may be minimal scarring effects. The impact of unwinding the government's pandemic supports is uncertain. However, policy makers appear to have learned from previous crises and there will be gradual tapering of supports. The precise scale of private sector business failures will remain unclear for some months and could be severe. The debt crystallisation process for businesses will also need to be carefully managed from a policy perspective. However, the June economic stimulus and the relatively loose fiscal policy stance should ameliorate the potential for damage as the economy transitions away from lock down.

There are a number of other risks to the recovery. Most obviously, virus mutations could lead to further lockdowns and the global economy cannot fully recover until vaccinations are available in the global south. Also, savings have been concentrated in higher income households. It may be that the bounce-back in spending will be significantly more muted than we expect as higher income households have generally lower propensities to consume.

Finally, there is residual uncertainty over the long-term disruption to trade and supply chains caused by Brexit. The level of economic disruption caused by Brexit has been clouded by the impact of the pandemic and could be an impediment to recovery.

Labour market prospects

The extent of structural damage to the labour market remains unclear and it will take a number of years before unemployment and employment rates return to their pre-crisis levels. Almost a third of the labour force was either in receipt of the pandemic unemployment payment (PUP) or was benefiting from the employment wage subsidy scheme (EWSS) as recently as March. Given the unprecedented nature of the crisis, it is as yet unclear the extent to which there will be significant labour market scarring, or recession induced structural unemployment. However, it is clear that the shock will have long-lasting social, economic and political implications.

Nevertheless, scarring should not be anywhere near as severe as during the great financial crash. There is no equivalent sectoral collapse akin to the structural collapse in construction post-2008. Labour market conditions should rapidly improve with very strong employment growth over the next 18 months. We project employment growth of close to 11% in 2022. Even so, unemployment could still be elevated at current levels by the middle of 2022. We anticipate that it will be end-2023 before the labour market is fully or almost fully recovered to its pre-pandemic unemployment levels.

The relatively high projected unemployment rate does suggest a degree of labour market slack. However, this masks labour market tightness in a number of economic sectors so that the potential for wage growth could vary significantly depending on the sector. The US and UK experiences post-lockdown have been marked by tightness in a number of economic sectors, notably retail and accommodation & food services, with labour demand higher than supply. In addition, the strong growth in projected consumption and retail sales, and very strong PMIs and confidence indicators, which are proxies for expected domestic business conditions, suggests a strong environment for those businesses that do make it out of lockdown. This suggests there will be reasonable capacity to support wage increases.

The Department of Finance estimates the personal consumption deflator at 1.6% in 2021 and 2.8% in 2022. Supply constraints, commodity shortages, Brexit, and demand pressures will all continue to drive inflation. Nominal wages will need to increase by more than these levels if they are to translate into real wage growth. Headline average wage growth 'across the economy' is likely to be low or even negative as many of the new or restored jobs will be in low paid sectors and low value added sectors. However, potential wage growth for workers that retained existing jobs during the pandemic is reasonably positive overall in the short-to-medium term.

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Challenges ahead – investment not austerity

The public finances will be in deficit until at least 2026 and probably beyond. The annual deficit will be almost €20 billion in 2021. Even so, the cost of borrowing remains extremely low and much of the 2021 deficit represents once-off pandemic related costs. There was a budget surplus of 0.9% of GDP in the final pre-pandemic year of 2019. Interest rates are likely to remain very low thanks to the ECB's 'whatever it takes' support, and there will be no external pressure to turn to austerity policies. The per capita debt ratio is very high but carries an interest rate of just 1.5% meaning that the interest bill on the national debt is below €3.5 billion, less than half the record of almost €8 billion paid in 2013.

Fiscal and monetary policy should remain highly expansionary in the short-to-medium-term in order to ensure that the nascent economic recovery is not derailed. The return of the fiscal rules in 2023 and the unwinding of the ECB's financial supports will need to be carefully managed. In particular, there is a strong case for using the opportunity represented by cheap borrowing to invest in education and skills and in green infra-structure.

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. The key to fixing the public finances is to restore employment levels. The economy's growth potential remains strong and such growth, if realised, will gradually erode the debt burden over time.

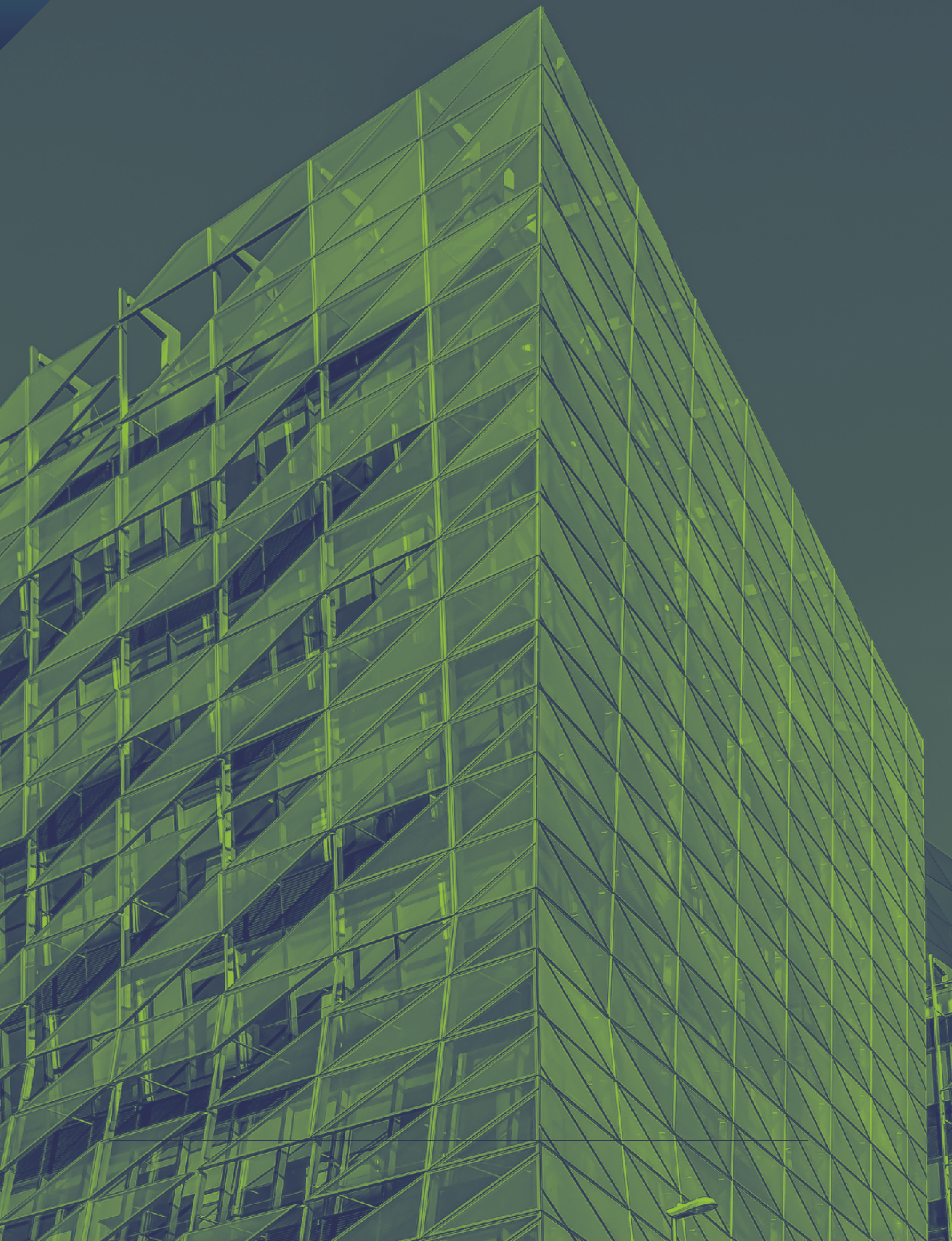
The formidable challenges lying ahead mean that there can be no return to the failed policies of austerity. The housing crisis can only be resolved via massive and direct state intervention amounting to billions of annual investment. The green and digital transitions are also going to require significant annual investment, while Ireland's chronic annual underinvestment in childcare, in public R&D and in per pupil spending on education will need to be reversed if we are to grow our economy sustainably into the future.

These spending pressures will come in the context of potentially declining corporation tax receipts and a potential crisis for Ireland's FDI model. The international tax reforms, if they happen, could be the catalyst to force Ireland to finally develop a more rounded economic model based on investment in people's skills, innovation and knowledge capacity, alongside a greater focus on public services, well-being, job quality, and liveable towns and cities.

Conclusion

Overall, 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.

We will need to adequately invest in people and in infrastructure if we are to successfully manage the green and digital transitions



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