Quarterly Economic Observer

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NERI Nevin Economic Research Institute

About NERI and this publication

The Nevin Economic Research Institute (NERI) has been established to provide information, analysis and economic policy alternatives. Named in honour of Dónal Nevin, scholar, trade unionist and socialist who gave a life of service to the common good, the Institute aims to undertake research that will be of relevance to the Trade Union movement and the general public across the island of Ireland.

This is the eleventh Quarterly Economic Observer (QEO) of the Institute. The purpose of the QEO is to provide regular, accessible and timely commentary so as to equip trade unions and others in articulating and advancing a new economic paradigm where the old has failed. The QEO complements the NERI Autumn 2014 Quarterly Economic Facts (QEF) which provides a set of statistical indicators to complement our analysis. Unless otherwise stated, the data cited in this Observer are the latest available as of mid-September 2014. The final draft of this document was completed on 21st September 2014.

This report has been prepared by staff of the Institute. We are grateful to external reviewers from the academic and research community who reviewed and commented on an earlier draft of this document. The analyses and views expressed in this publication are those of the NERI and do not necessarily reflect those of others including the Irish Congress of Trade Unions or the unions supporting the work of the Institute.

Further information about NERI may be obtained at our website **www.NERInstitute.net**

The Nevin Economic Research Institute

Quarterly Economic Observer

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Table of Contents

Executive Summary

This edition of NERI's Quarterly Economic Observer (QEO) provides an overview of recent economic trends (Section 2) and outlines NERI's current expectations for the economic outlook in Northern Ireland and the Republic of Ireland (Section 3). The QEO also outlines a strategic approach to fiscal policy in the Republic of Ireland and considers a range of fiscal policy options through the twin lens of equity and growth (Section 4).

Economic Outlook

The economic outlook for both parts of the island of Ireland remains positive and the outlook for the Republic of Ireland in particular has improved since the Summer QEO. The Republic's economy grew very strongly in the first half of the year. Comparing the first half of 2014 with the first half of 2013 there was an increase in real GDP of 5.8%. Although we expect the pace of growth to moderate in the second half of the year we are still projecting fairly strong growth in output for the remainder of 2014, and also for 2015 and 2016. Even so a number of concerns remain including high levels of private indebtedness, weak credit conditions and high levels of long-term and youth unemployment. The recovery remains fragile and the weak performance of the Euro area, and the threat of deflation, could begin to weigh on the Republic's economy.

Unemployment will continue to fall but is likely to remain in double digits until 2016. While employment growth was weaker than expected in the first half of the year we believe there is a high level of resource slack in the economy and see steady employment growth out to 2016. The recovery in employment has not been geographically uniform. In general employment is expanding in the east of the country and declining in the west of the country. In the year to June 2014 employment declined by 7,300 in the South-West region; by 5,400 in the Western region and by 2,900 in the Mid-West region.

As outlined in Section 3, our current projections for the Republic of Ireland include:

- GDP Growth in 2014, 2015 and 2016 of 5.0%, 3.0% and 2.9% respectively. The return to growth will mainly be driven by increasing investment and a strong export performance.
- A return to modest growth in personal consumption in 2014 after a decline in 2013 and a strong return to growth in investment.
- Continued improvement in employment with the unemployment rate falling to an average of 11.5% in 2014, 10.6% in 2015 and 9.8% in 2016.

The deficit figures are helped by the favourable revisions to GDP under ESA2010 along with the strong pace of the recovery both in employment and especially GDP growth. We now anticipate a deficit of 3.7% of GDP in 2014, and 2.1% of GDP in 2015.

Our outlook for Northern Ireland is generally positive and we continue to project that:

- Economic recovery will start to take hold with modest increases in employment and output.
- But that the pace of recovery will continue to lag that of the UK and the Republic.
- Uncertainty about the UK's position in the European Union may dampen the North's ability to attract investment over the next few years.

A Strategic Approach to Fiscal Policy in the Republic of Ireland

- Public debt levels in the Republic remain extremely high and by the end of 2013 were equivalent to 123.3% of GDP and 145.1% of GNP. The General Government Balance (GGB) recorded a deficit of 5.7% of GDP in 2013.
- While the public finances remain fragile they will continue to improve provided that monetary policy remains supportive and growth returns to the real economy. We estimate the public deficit will be close to 3.7% of GDP in 2014 and 2.1% of GDP in 2015.
- The debt-to-GDP ratio should decline steadily over the next few years supported by growth in nominal GDP and by extremely low interest rates.
- On the balance of evidence it appears Ireland's structural deficit is now close to zero, albeit still marginally in deficit. This implies there is minimal need for additional new Budgetary consolidation measures. It remains our analysis that the scale of the Budgetary adjustment in Budget 2015 should not exceed €800 million.
- Public policy must now focus on the real side of the economy – employment, real incomes and growth. Fiscal policy has a critical role to play in this regard and public investment is of particular importance.
- The public investment to GDP ratio is currently very low by European standards and by historic standards in the Republic of Ireland. Alongside this, the State's cost of borrowing is now at an historic low while the ability of the private sector to invest is being constrained by a lack of access to credit.
- The long-term rate-of-return to the Irish economy from prudently targeted public investment is very likely to exceed the current cost of borrowing. There is a strong case for the Government to borrow to fund a large-scale programme of public investment focussed on areas such as social housing, education and high speed broadband infrastructure.

- The State's very low cost of borrowing provides an opportunity for increased debt issuance to fund a large-scale programme of public investment. Public capital investment should be increased to average at least 3% of GDP over the next few years.
- Government revenue as a percentage of GDP in the Republic of Ireland is very low compared to Western European standards and also compared to the most competitive countries in the European Union. The Republic's debt burden is still high and there is no scope for reducing the overall level of taxation in the medium-term without causing damage to public services. Cuts to government revenue would have to be funded through offsetting cuts to public spending.
- Further cuts to public spending will put immense pressure on public services, public investment and social transfers. Primary (non-interest) public spending is already low by EU standards, and by modern historical standards in Ireland.
- Instead of cutting taxes a social emergency fund should be created and targeted at the most vulnerable people and communities in Irish society. Reversing cuts to mental health services should be a priority as should a programme of social housing and additional training and education supports for young people.

1 Introduction

The economic outlook for both parts of the island of Ireland remains positive and the outlook for the Republic of Ireland in particular has improved since the Summer QEO. The Republic's economy grew very strongly in the first half of the year and although we expect the pace of growth to moderate we are still projecting fairly robust growth in output for the remainder of 2014, and also for 2015 and 2016. While employment growth was weak in the first half of the year we believe there is a high level of resource slack in the economy and see steady employment growth out to 2016. Unemployment will continue to fall but is also likely to remain in double digits until 2016.

Recovery cannot be taken for granted and the economy retains a number of weaknesses inherited from the boom and bust. The pace of the recovery remains threatened by high levels of public, corporate and household indebtedness and by generally weak credit conditions. There are also a number of external risks to the generally strong growth outlook including deflationary fears in the Euro area, the possibility of structurally low investment becoming a reality in the advanced economies, and an absence of wage and income growth in the domestic economy.

Overall the economic outlook for Northern Ireland is mildly positive although uncertainty about the UK's position in the European Union may dampen the North's ability to attract investment over the next few years.

This edition of the *Quarterly Economic Observer (*QEO) is structured as follows. Recent economic trends in both parts of Ireland are reviewed in Section 2. Section 3 updates NERI's macroeconomic projections while in Section 4 we discuss a strategic approach to fiscal policy in the Republic of Ireland. Section 5 concludes.[1]

The Nevin Economic Research Institute (NERI) offers this report as a contribution to public debate on policy making and formation on the island of Ireland. We welcome feedback, comment and suggestions. The precise data used and the specifics of any proposal/projections are constantly subject to review as fresh information and data become available.

[1] The analysis here complements a number of recent and forthcoming NERI research papers. These are cited throughout the report and can be accessed on the NERI website.

2 Overview of Recent Economic Trends

This section of the Quarterly Economic Observer (QEO) examines recent trends in a number of key economic indicators in the Republic of Ireland and in Northern Ireland. The headline economic developments since 2007 are summarised in Table 2.1. The Republic of Ireland's employment rate increased from 58.8% in the second quarter of 2012 to 61.3% in the second quarter of 2014. The employment rate is now eight percentage points below its pre-crisis level. Overall the decline in the employment rate has been much more severe in the Republic of Ireland than in the Euro area as a whole. The UK's employment rate was 71.5% in the first quarter of 2014. This represents a return to the pre-crisis levels of 2007-2008.

Table 2.1 Key Economic Trends (2007-2013)

	2007	2008	2009	2010	2011	2012	2013
Total Employment (% of working-age population)							
ROI	69.2	67.6	61.9	59.6	58.9	58.8	60.5
NI	68.4	67.8	64.7	66.1	67.4	67.3	66.9
UK	71.5	71.5	69.9	69.9	69.5	70.1	70.8
Euro area	65.5	65.9	64.5	64.1	64.2	63.8	63.5
Unemployment (% of labour force)							
ROI	4.7	6.4	12.0	13.9	14.7	14.7	13.1
NI	4.0	4.5	6.5	7.1	7.2	7.5	7.6
UK	5.3	5.6	7.6	7.8	8.0	7.9	7.5
Euro area	7.5	7.6	9.6	10.1	10.1	11.3	12.0
Gross Domestic Product (% volume change over previous year) – *NI output refers to GVA*							
ROI	5.0	-2.2	-6.4	-1.1	2.2	0.2	-0.3
NI	8.8	-1.0	-3.2	1.8	0.4	1.2	N/A
UK	3.4	-0.8	-5.2	1.7	1.1	0.3	1.7
Euro area	3.0	0.4	-4.5	1.9	1.6	-0.7	-0.4

Sources: Labour market data are from Eurostat (2014a) Labour Force Survey Database (Updated 10 July 2014 for employment and 29 August 2014 for unemployment; Online reference code lfsi_emp_a and une_rt_a); GDP data for Republic of Ireland (ROI), United Kingdom (UK) and for the Euro area (Euro) are from Eurostat (2014b) National Accounts database (Updated 27 August 2014; Online reference code nama_gdp_k); Gross Value Added (GVA) data for Northern Ireland (NI) are taken from ONS Regional Trends Series (Office for National Statistics, 2013)

Notes: ROI, UK and Euro area labour market data for 2007-2013 refer to the whole year; NI labour market data are based on the average of the four quarters for each year with data taken from the Labour Force Survey
Total employment refers to all persons in employment (ILO definition) aged 15-64 as a proportion of all persons aged 15-64.
Unemployment is measured on the ILO definition basis and refers to persons aged 15-74.
n/a = not available

2.1 Recent trends in the World Economy

Overall the economic recovery across the advanced economies remains weak and uneven with growth moderating more than expected in the first quarter of 2014 (IMF, 2014a). Public and private debt levels remain very high in a number of countries and the process of balance sheet adjustment is dampening the pace of economic recovery.

Unemployment also remains high, particularly in the Euro area, and unutilised capacity (slack) continues to be sizable. The spare capacity in much of the Euro area suggests potential for above trend growth in the short to medium-term. However, the weakness of credit conditions, higher post-crisis levels of structural unemployment, declining labour force participation, and fragile public and private balance sheets are all operating as impediments to potential growth. On the other hand, a lessening of drag on output from fiscal tightening, supportive monetary policy, and further progress in the construction of a proper banking union for the Euro area will all improve prospects for recovery over the next two years. There are a number of risks. Further escalation of the crises in Ukraine and Syria/Iraq could lead to a supply-side shock in the form of higher energy prices. This would exert downward pressure on growth prospects for European economies.

Global growth was slower than expected in the first quarter of 2014, most notably in the US where real GDP declined by 2.1%. However, real output growth in the US did improve in the second quarter with seasonally adjusted real GDP increasing by 1.0% over the previous quarter while real GDP increased at an annual rate of 4.2% (BEA, 2014). Growth in the Euro area was sluggish in the first half of the year. Annual growth rates to date in 2014 are 1.0% in the first quarter and 0.7% in the second quarter. On a seasonally adjusted basis the Euro area experienced no volume growth at all in the second quarter of 2014 compared to the previous quarter (Eurostat, 2014c). This followed a first quarter where Euro area real GDP rose by just 0.2%. The Euro area's sluggish performance comes in the wake of a six quarter recession in 2012-2013 arising from the Euro area's sovereign debt crisis. There were declines in real economic activity in both 2012 (-0.7%) and 2013 (-0.4%). The European Union economy grew by a seasonally adjusted 0.2% in the second quarter of 2014 while seasonally adjusted real GDP declined in Japan, Germany and Italy in the second quarter of the year.

The UK had a relatively strong performance in the first half of 2014. Annual real GDP growth was 3.0% in the first quarter and 3.1% in the second quarter while seasonally adjusted real GDP growth was 0.8% in both of the first two quarters (ONS, 2014). Although UK GDP has now surpassed its pre-crisis peak, this milestone was achieved by the US and other advanced economies up to two years ago. There has also been a worrying trend of falling productivity in the UK. When GDP is adjusted for increases in population, GDP per capita remains some 5.1% below peak. Forecasters expect growth of up to 3% for the UK in 2014, falling to 2.6% in 2015 (NIESR, 2014).

Fiscal policy stimulus and strong credit growth supported an acceleration of growth in the first quarter in China (+2.0%) while geopolitical tensions have hampered growth in Russia and other parts of Central and Eastern Europe. The OECD's (2014a) Composite Leading Indicators (CLIs) point to stable growth momentum in the OECD area as a whole. The CLIs point to above trend growth momentum in the UK and India and to growth losing momentum in Germany and Brazil.

The deflationary trend in the Euro area has become more pronounced in recent months. The Euro area estimates for year on year inflation (HICP) were 0.4% in July and 0.4% in August. The index is essentially unchanged from the fourth quarter of 2013 and prices have fallen in half of the 18 Euro area countries in the period from March 2014. Deflationary concerns will keep monetary policy accommodative and interest rates low in the Euro area for some time to come. The European Central Bank (ECB) is projecting Euro area HICP inflation of 0.6% in 2014, 1.1% in 2015 and 1.4% in 2016 (ECB, 2014). The ECB has continued to reduce interest rates, has introduced a programme of Targeted Long Term Refinancing Operations (TLTROs), and announced at its September meeting that the Eurosystem will commence an Asset Backed Securities Purchase Programme (ABSPP) and a euro-denominated Covered Bond Purchase Programme (CBPP). If inflation remains very subdued the ECB is likely to take the significant step to engage in limited quantitative easing – pumping money into the economy directly by buying government bonds - in order to revive consumer spending and economic activity.

Inflation in the United States, and in the OECD area as a whole, was stable at 2.0% to 2.1% in the second quarter of 2014. The Federal Reserve (Fed) expects that inflation will increase only gradually as labour market slack and subdued wage growth keeps price pressures broadly contained. Inflation in the UK is close to the 2% target (1.9%) and the Bank of England projects that inflation will remain close to the target in the period ahead. Annual CPI inflation was 3.6% in Japan in June but this largely reflects a VAT hike implemented in April. Annual inflation to June was 1.5% if the VAT hike is excluded. CPI inflation was 2.3% in China in June. Overall the deflationary trend is to date a Euro area phenomenon rather than a global one and largely reflects exchange rate appreciation, with declines in energy and food prices also playing a role.

According to Eurostat (2014d) the Euro area seasonally adjusted unemployment rate was 11.5% in July 2014. This represents an improvement on the July 2013 figure of 11.9% but is still over 4 percentage points worse than the 2008 level. The stock of long-term unemployed has more than doubled from its pre-crisis level and accounted for over 6% of the total Euro area labour force by the end of 2013. In July 2014 the seasonally adjusted unemployment rate for the European Union as a whole was 10.2% or 24.85 million people. Youth (under 25s) unemployment in July was 23.2% in the Euro area and 21.7% in the European Union.

Performance has been much stronger in the United States with payroll employment exceeding the pre-crisis peak in May of this year. Job gains have averaged 230,000 a month in 2014. The unemployment rate fell to 6.2% in July 2014 from 7.3% in July 2013 and there is now an improvement of almost 4 percentage points from its high in 2009. Unemployment is now just 1 percentage point higher than the pre-crisis level and improvements in the labour market are likely to accelerate a normalisation of monetary policy in the United States (Federal Reserve, 2014). Inflationary pressures will increase as the economy reaches its potential level and rising wages and prices will be accompanied by a tightening of monetary policy. The tightening of monetary policy in the United States is likely to generate negative spillovers for a number of emerging market economies as capital flows start to return back to the United States and the cost of capital rises.

People unemployed in the UK in the three months ending June 2014 fell by over 146,000 bringing the overall rate down to 6.2% from 6.6% in the previous quarter. There was growth in self-employment of 0.1% compared to growth in total employment of 0.3%. While both full-time and part-time employment increased, all of the increase in part-time employment was within the self-employed category. House prices across the UK continued to grow although the London market may be beginning to ease.

2.2 Recent trends in the Republic of Ireland Economy

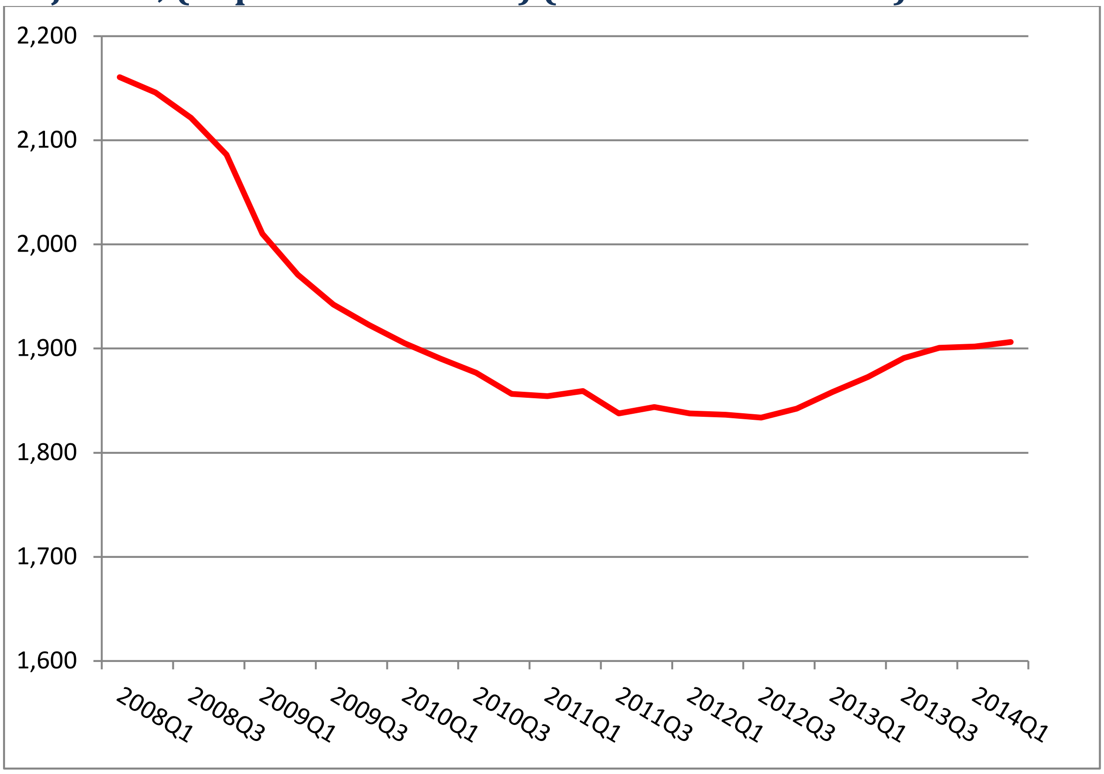
Data from the Quarterly National Household Survey (CSO, 2014a) suggests that the recovery is continuing in the Republic of Ireland labour market although worryingly the pace of this recovery appears to be slowing down. Total employment increased to 1,901,600 in the second quarter of 2014 representing a 31,600 (+1.7%) improvement on the previous year (see Chart 2.1). However, seasonally adjusted employment increased by just 1,200 (+0.1%) in the first quarter and by just 4,300 (+0.2%) in the second quarter. To put these numbers in context total employment fell by 245,700 between the second quarter of 2008 and the second quarter of 2014. More positively total Full Time Equivalent (FTE) employment is up by 2.4% on an annual basis. There were 2,156,100 people in the labour force in the second quarter of 2014 representing a decline of 14,500 over the year and a decline of 122,200 since the second quarter of 2008. The employment rate for persons aged 15-64 increased from 60.2% to 61.3% in the year to the second quarter of 2014, although this remains below the Euro area average which was 63.2% in the first quarter of 2014.

Annual employment growth was positive in 10 of the 14 economic sectors with declines in four sectors. The largest recorded increases in persons employed were in *accommodation and food service activities* (+8,000) and in *agriculture, forestry and fishing* (+6,400)[1] while the largest declines were in *other NACE activities* (-2,800) and *industry* (-2,700). *Administrative and support services* had the largest percentage increase at +6.2% while *other NACE activities* had the largest relative decline at -2.7%. In terms of broad occupational group the biggest annual employment gains were for *skilled trades* (+19,900) followed by *elementary* (+7,000), while the largest declines were in *sales and customer service* (-3,500) and in *professionals* (-3,500). In terms of age and gender cohorts employment has fallen on an annual basis for females aged 25-34 (-9,000) and for females aged 15-24 (-10,000). Employment has also fallen, albeit on a lesser scale, for males aged 25-34 (-1,800) and for males aged 15-24 (-1,300). Total youth employment fell by 11,300 between the second quarter of 2013 and the second quarter of 2014.

[1] The CSO urges particular caution in the interpretation of the trend in total employment in the agriculture, forestry and fishing sector. This caution is due to sampling changes.

The unemployment rate was 11.8% in the second quarter of 2014. This represents a steady improvement from 13.9% in Q2 2013 and 15.0% in Q2 2012.[2] The seasonally adjusted unemployment rate decreased from 12.0% to 11.5% during the second quarter. There are now 247,700 people unemployed (seasonally adjusted) compared to 293,500 in Q2 2013. The seasonally adjusted unemployment rate is 13.2% for males (157,500 people) and 9.4% for females (90,700 people), while the participation rate is 67.5% for males and 52.3% for females. Youth unemployment remains very high at 26.9% but has declined from 29.6% in Q2 2013 and 33.0% in Q2 2012. The long-term unemployment rate remains a serious concern and was 6.8% in Q2 2014, although this does represent a significant decline from 8.1% in Q2 2013 and from 9.2% in Q2 2012. There are now 146,500 long-term unemployed representing 57.6% of the total unemployed. The Live Register showed a seasonally adjusted standardised unemployment rate of 11.3% in July and 11.2% in August (CSO, 2014b). The August figure represented the 26th consecutive monthly drop and is a 3.9 percentage point improvement from the peak of 15.1% in early 2012.[3]

Chart 2.1 Quarterly Trends in Total Employment, Seasonally Adjusted, (Republic of Ireland) (000's of Individuals)



Source: CSO (2014a) Quarterly National Household Survey

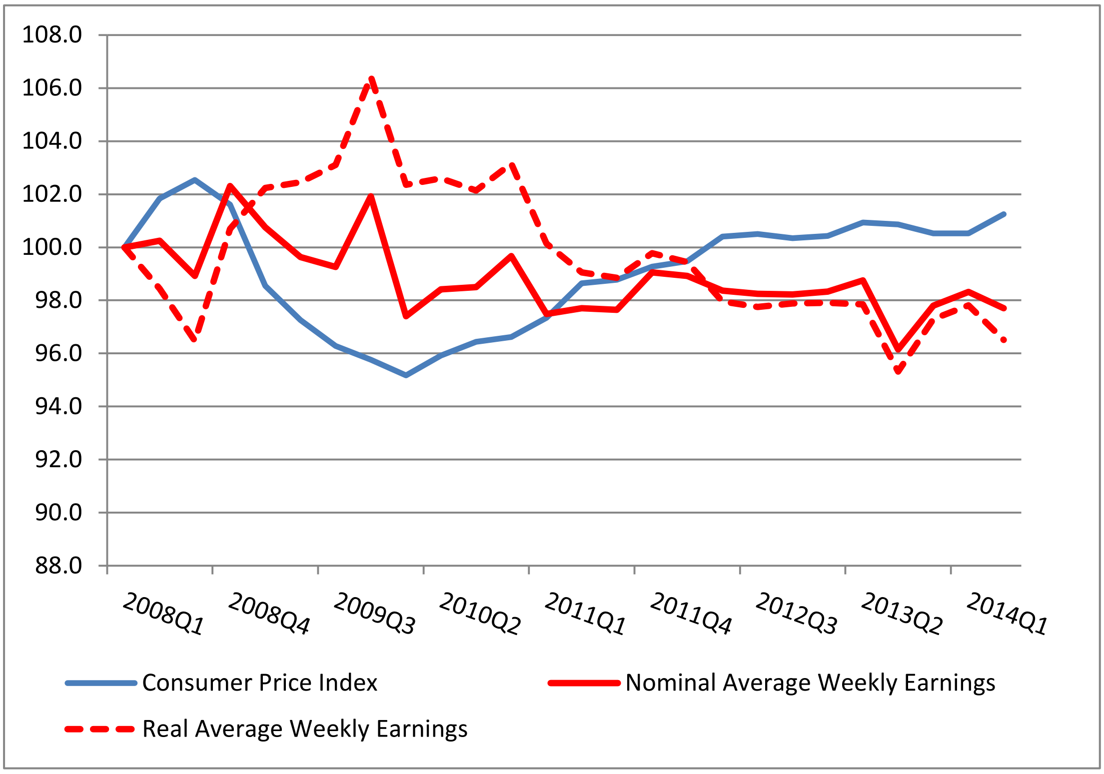
[2] Figures are based on ILO definitions of labour force status.
[3] See NERI's Quarterly Economic Facts for more details on recent labour market trends.

The recovery in total employment has not been geographically uniform and there are distinctive regional trends across the Republic's eight geographic (NUTS 3) regions. In general employment is expanding in the east of the country and declining in the west of the country. Total employment in the *Dublin* region increased by 21,300 in the year to Q2 2014 and increased by 10,700 in the *South-East* region and 9,600 in the *Mid-East* region. However, employment actually declined by 7,300 in the *South-West* region; by 5,400 in the *Western* region and by 2,900 in the *Mid-West* region. Total Full-Time Equivalent (FTE) employment also declined in the year to Q2 2014 in the *South-West*; *Mid-West* and *Western* regions. The unemployment rate fell in every region in the year to Q2 2014. The unemployment rate is lowest in *Dublin* (10.0%) and highest in the *South-East* (14.3%). There are also substantial differences between the regions in terms of labour force participation. The *Dublin* region has the highest participation rate at 63.0% while the *Border* region has the lowest at 55.0%.

Average weekly earnings fell by 1.1% in the year to Q2 2014 and fell by 0.6% from the previous quarter (CSO, 2014c). Weekly earnings were €688.15 in Q2 2014 compared to €695.53 in Q2 2013. However the average conceals substantial differences across sectors. The largest annual increases in average weekly earnings were in *construction* (+6.0%) and in *accommodation and food services* (+5.3%) while the largest declines were in *arts, entertainment, and recreation services* (-5.3%) and in *professional, scientific and technical* (-3.8%). Average hourly earnings fell by 1.7% over the previous year - from €22.01 in Q2 2013 to €21.63 in Q2 2014. Private sector average hourly earnings decreased 0.5% in the year to Q2 2014, while public sector hourly earnings fell by 3.1% in the same period. Average weekly hours increased marginally from 31.6 to 31.8 in the year to Q2 2014 while average hourly total labour costs decreased by 1.6% over the year to Q2 2014.

As shown in Chart 2.2 the decline in weekly earnings is at least being partially offset by low inflation (CSO, 2014d). As discussed in Section 4 and in McDonnell, (Forthcoming) the Irish economy continues to operate well below its long-run potential with an excess of unused resources. The large amount of spare capacity in the economy is contributing to the subdued wage and price inflation. Falling food and energy prices combined with the strength of the euro are also contributing to low inflation. The annual change in the CPI was 0.4% in the year to August 2014 while the HICP increased by 0.6% over the same period. The largest upward contribution to the CPI in the year to August 2014 was *restaurants & hotels*, while *food & non-alcoholic beverages* caused the largest downward contribution. The annual rate of inflation for services was 2.1% in the year to August, while goods inflation decreased by 1.6%. The annual change in the CPI has remained below 1.0% since March 2013 and below 2.0% since September 2012.

Chart 2.2 Trends in Earnings and Prices (Republic of Ireland)

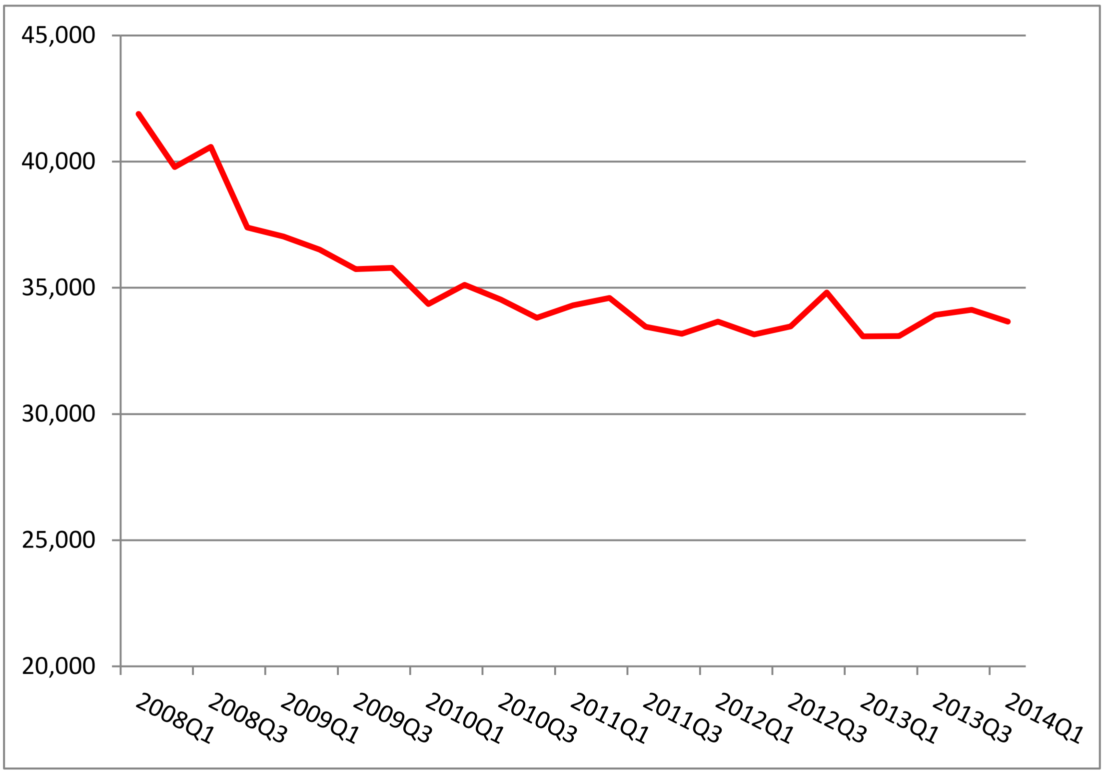


Source: CSO (2014c) Earnings and Labour Costs; CSO (2014d) Consumer Price Index

While GDP only increased by 0.2% in volume terms in 2013, GNP increased by a reasonably robust 3.2%. The subdued figure for real GDP is partially attributable to the expiration of important patents in the pharma-chem sector and the replacement of products by generic equivalents. On the other hand GNP growth was unaffected by this patent cliff effect. Domestic demand fell by 0.3% in real terms in 2013 as fiscal contraction and private sector deleveraging continue to weigh on growth (see Chart 2.3). Despite these influences a recovery in economic output appears to have finally taken hold although both real GDP and real GNP remain well below their respective peaks. The most recent CSO estimates indicate that real GDP grew by 1.5% on seasonally adjusted basis in the second quarter of 2014 and grew by 7.7% compared to the second quarter of 2013 (CSO, 2014e). The year-on-year change for the first half of the year is +5.8% for GDP and +6.0% for GNP. The CSO revised the National Accounts in July of this year to ensure compatibility with the latest European System of National Accounts (ESA 2010). The changes to the system of National Accounts - most importantly the inclusion of R&D expenditure as investment instead of intermediate consumption - raised the level of GDP in 2013 by 6.5%. The upward revisions to GDP and GNP are stock effects and do not imply changes to future growth rates although they do improve the debt to GDP ratio.

Capital formation (investment) remains low as a percentage of GDP by both EU standards and by Irish historical standards. This raises concerns for the productive capacity of the economy and for potential GDP growth. Corporate indebtedness and credit constraints on SMEs remain barriers to private sector investment while fiscal contraction has disproportionately targeted the public capital budget. The most recent CSO data indicates that the volume of investment declined by 2.4% in 2013. The poor headline numbers partially reflect the timing of aircraft purchases and investment in housing, in other building and construction, and in machinery and equipment all saw increases in 2013. However, capital formation increased by 18.0% in the second quarter of 2014 compared to twelve months previously and is up 11.3% in the first half of the year.

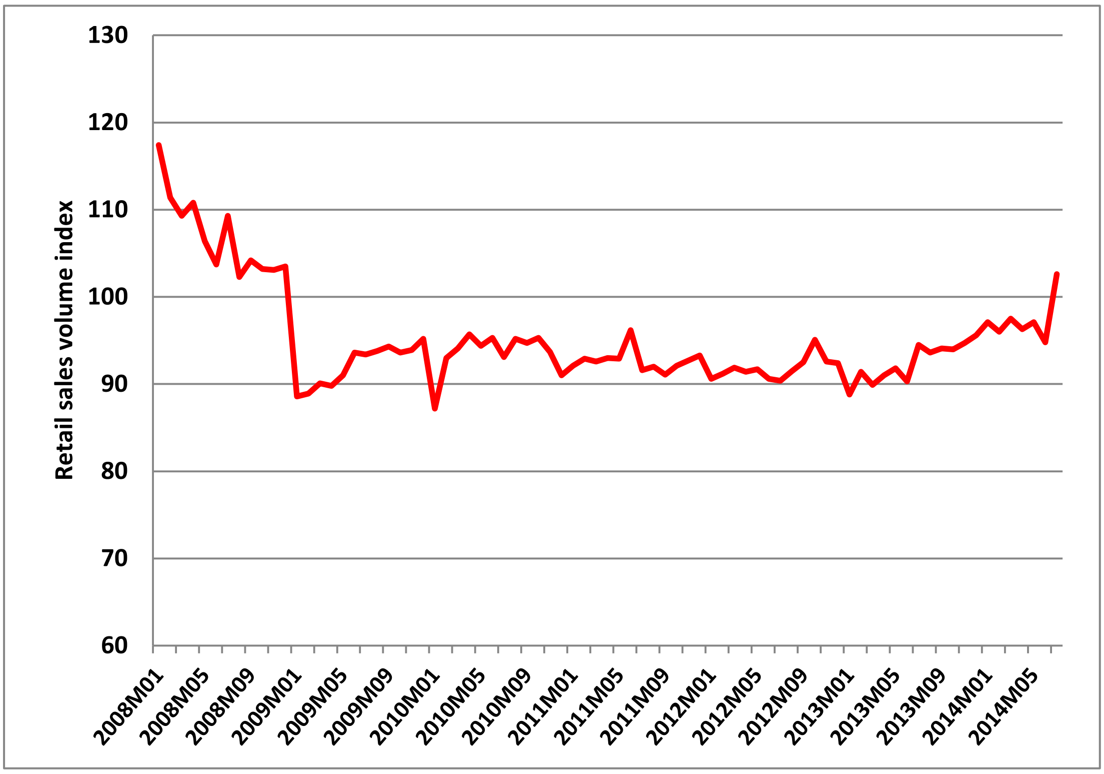
Chart 2.3 Trends in the Real Value of Domestic Demand (Republic of Ireland) (€million)



Source: CSO (2014e) Quarterly National Accounts

Private consumption declined by 0.8% in 2013 marking the third consecutive year of decline. However, personal consumption is up 1.2% on the previous year in the first half of 2014 while data from retail sales (CSO, 2014f) suggests a recovery in consumer spending may finally be taking place (see Chart 2.4). Seasonally adjusted total retail sales were up 8.6% in July in volume terms and +5.9% in value terms over the previous year, while core sales, which exclude motor trades, were up 3.1% in volume terms and 1.0% in value terms over the previous year. The July result is the ninth consecutive month of seasonally adjusted positive growth in retail sales in both volume and value terms. The *KBC Ireland/ESRI Consumer Sentiment Index* (ESRI, 2014a) reached its strongest level since January 2007 in July of this year (89.4) before declining marginally in August (87.1).

Chart 2.4 Monthly Trends in the Volume of Retail Sales (Republic of Ireland)



Source: CSO (2014f) Retail Sales Index

Notes: Volume of retail sales (seasonally adjusted). M01 = January; M05 = May; M09 = September

Net exports (0.6%) were the driver of GDP growth in 2013. Export volumes increased by 1.1% in 2013 while the volume of imports increased by 0.6% in 2013. Merchandise exports fell by 4.1% in volume terms while services exports were up 4.0%. The pharma patent cliff had a negative impact on exports last year although that effect appears to have played itself out. The current account had a surplus of €7.6 billion in 2013 although this figure is inflated by the phenomenon of PLCs domiciling in Ireland. The volume of exports was up 10.2% in the first half of 2014 compared to the first half of 2013 while imports were up 8.9%.

Seasonally adjusted production in the manufacturing industries was up 19.9% in July 2014 compared to the previous year while production in the modern sector (technology and chemicals) was up 31.2% and production in the traditional sector was up 6.5% (CSO, 2014g). Although a very volatile series the seasonally adjusted figures have shown growth in manufacturing production for seven consecutive months. The headline *Manufacturing Purchasing Manager's Index* (PMI) improved to 57.3 in August

2014 (Investec, 2014a). A score above 50 represents expansion in activity and the August result signifies the fastest rate of expansion since December 1999. The headline Services PMI (Investec, 2014b) also shows growth in business activity, improving to 62.4 in August and marking the second fastest expansion since February 2007.

Sentiment also appears strong in the construction sector. The Construction PMI (Ulster Bank, 2014) rose to 62.6 from 59.9 in the previous month and activity among Irish construction firms has now increased in each of the past 11 months. The PMI readings for housing activity (65.4) and commercial activity (64.6) are particularly strong although civil engineering activity (49.3) continues to lag.

The number of mortgage accounts for Principal Dwelling Houses (PDH) in arrears fell for the fourth consecutive quarter in Q2 2014 (CBI, 2014a). A total of 126,500 accounts (16.5% of PDH accounts) were in arrears at end Q2 2014, a decline of 4.7% relative to Q1 2014. PDH accounts in arrears for more than 90 days are also down from the previous quarter. However, there was deterioration in the proportion of Buy To Lets (BTLs) in arrears for more than 90 days. Irish residential prices rose by an annual rate of 13.4% in July (CSO, 2014h). This was the highest annual rate of change since April 2007.

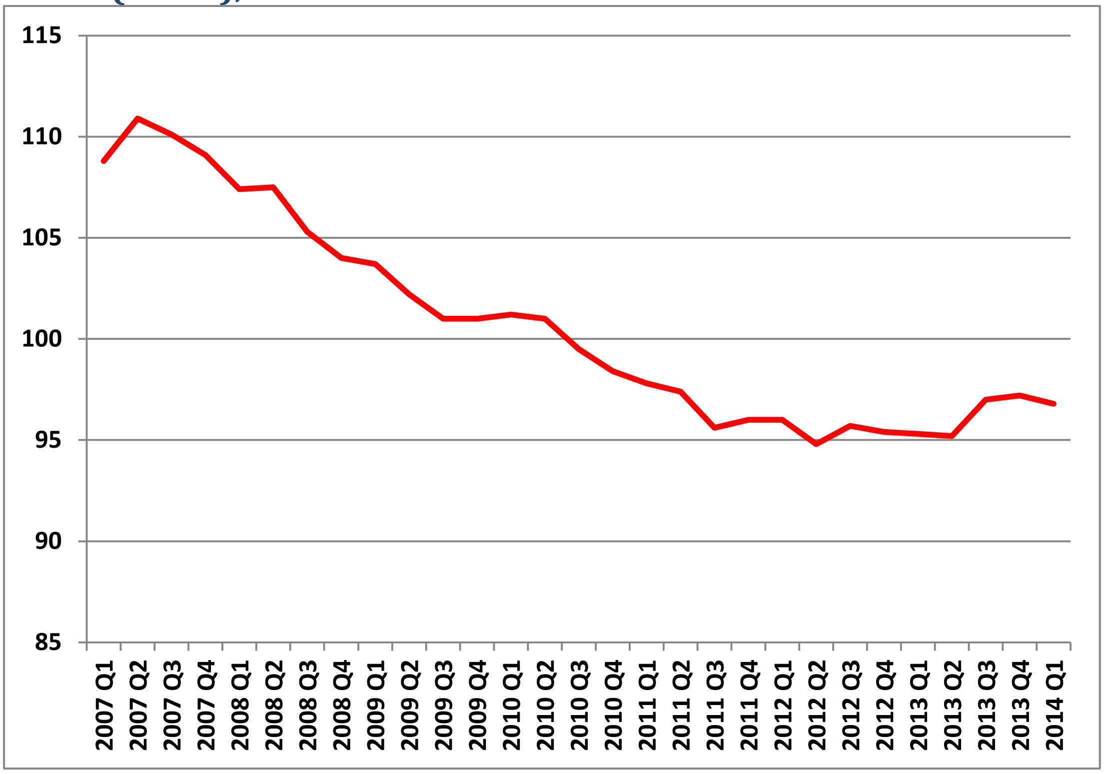
Household net worth rose by 0.9% during Q1 2014 marking the seventh consecutive quarterly increase (CBI, 2014b). Household net worth stood at €508.5 billion or €110,312 per capita, at end first quarter 2014. Household debt fell by €1.9 billion during Q1 2014 to stand at €164.3 billion and overall has fallen by 19.3% since Q3 2008. Household debt as a proportion of disposable income (a measure of debt sustainability) declined by 3 percentage points and is now 182.3%. The domestic economy (households, non-financial corporates and government) continues to be a net lender with the combined deleveraging by households and non-financial corporates outstripping the net borrowing of government.

The General Government Balance (GGB) was in deficit to the tune of €10.01 billion in 2013, or 5.7% of GDP (CSO, 2014i). This was within the Excessive Deficit Procedure ceiling of 7.5% and marks an improvement on the 2012 position of €13.91 billion or 8.1% of GDP. Public expenditure decreased from €72.87 billion to €70.80 billion while government revenue increased from €58.96 billion to €60.79 billion in 2013. An Exchequer deficit of €6.33 billion was recorded for end August 2014 (DOF, 2014a). This compares with a deficit of €7.32 billion for the same period last year and the outturn for end August is better than profile to the tune of €1.31 billion. The CSO estimates that at end of 2013 the gross debt of General Government stood at €215.5 billion or 123.3% of GDP, while net debt amounted to €160.75 billion or 92.0% of GDP. Gross debt was €215.05 billion at end March 2014. The borrowing costs for 10-year bonds have fallen from over 14 per cent in 2011 to below 1.7 per cent in early September 2014.

2.3 Recent trends in the Northern Ireland Economy

Official statistics for Northern Ireland suggest that the Northern Ireland economy still faces many challenges. The latest figures for the Northern Ireland Composite Economic Index (NICEI) show that the economy contracted by 0.4% in first quarter of 2014 (NISRA, 2014a). This disappointing result follows two consecutive quarters of positive growth the second half of 2013. While UK GDP has finally surpassed its pre-crisis peak, Chart 2.5 shows that Northern Ireland output is still 12.7% below its peak in Q2 2007. Gross Value Added is the equivalent of GDP for Northern Ireland (plus indirect taxes and less subsides) and the latest figures for 2012 indicated a real terms decline of 0.5% in that year. Northern Ireland contributes just over 2% of total output for the United Kingdom despite having 2.8% of the population.

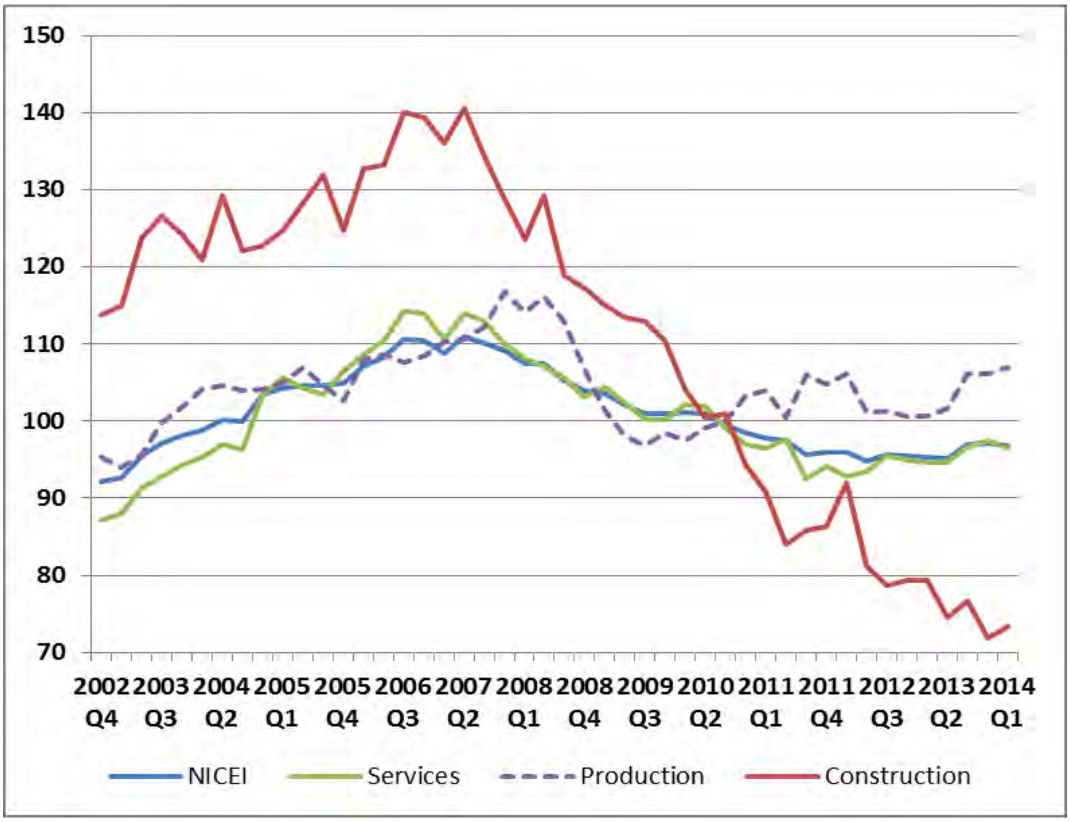
Chart 2.5 Trends in the Northern Ireland Composite Economic Index (NICEI), 2007-2014



Source: NISRA (2014a) NI Composite Economic Index

Chart 2.6 shows that the first quarter contraction in overall output was due to a decline in the services sector. The service sector contracted 1.1% in the first quarter contributing -0.6% to the overall index. The services sector is the largest in Northern Ireland and had shown signs of recovery and positive growth in the final three quarters of 2013. There was a modest increase in the production sector which complements positive data in the first three quarters of 2013. However the production sector is the only component of output likely to reach its pre-crisis peak within the next couple of years. While there has been a small increase in construction sector activity, the small quarterly increases in the last three years have not been able to arrest the consistent trend of decline in this sector. The first quarter data indicates that there is not as yet any sign of a sustained recovery in the service sector. As this is the target sector for government growth initiatives, its performance over the next few months will be carefully watched.

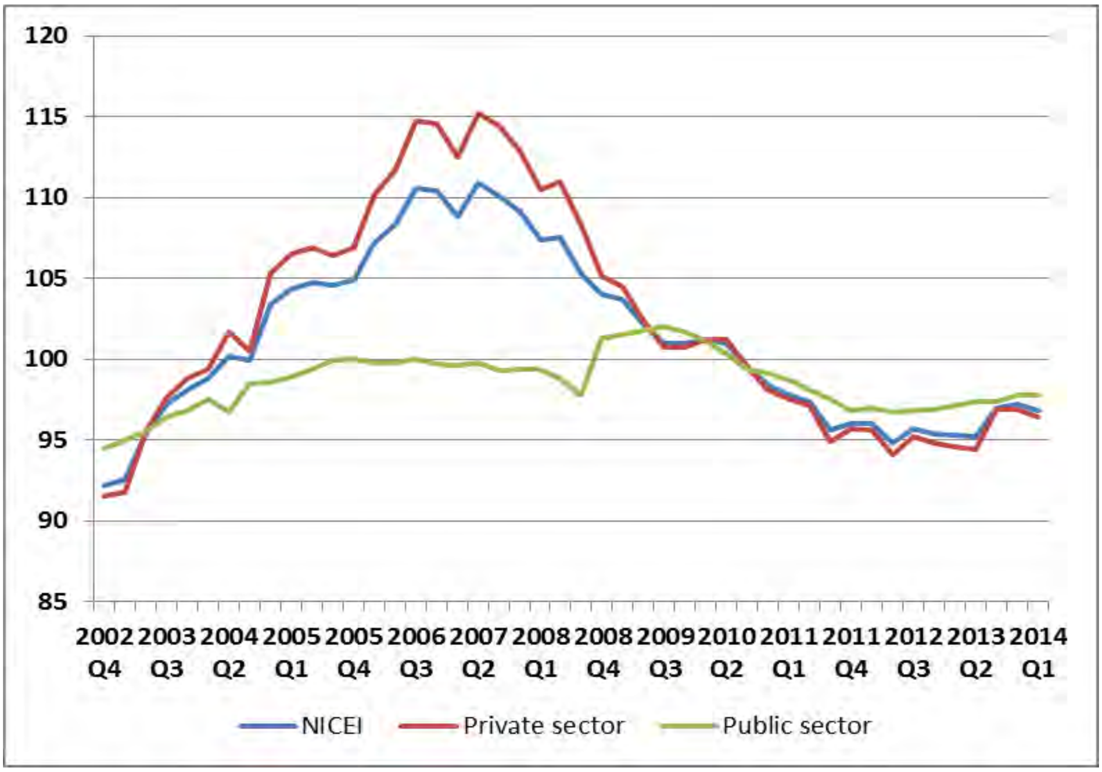
Chart 2.6 Sectoral changes in the Northern Ireland Composite Economic Index (NICEI), 2002-2014



Source: NISRA (2014a) NI Composite Economic Index

The public and private sectors are both on gradual downward trends (see Chart 2.7). Activity has been downward in the private sector since 2007-08 and in the public sector since 2009. The public sector remained flat in the first quarter of 2014 with the fall in overall output attributable to the contraction in the private sector. The contraction in the public sector can be attributed to the reductions in government expenditure as a part of the UK government's austerity programme. As Chart 2.7 shows the private sector has moved in much the same direction indicating that it has not filled the void left by retrenchment of the public sector. This is a concern, particularly in the context of potentially further reductions in public expenditure in the aftermath of the 2015 UK general election. If the private sector cannot at least match these reductions, then a further overall contraction in Northern Ireland output would follow.

Chart 2.7 Public and private sector performance in the Northern Ireland Composite Economic Index (NICEI), 2002-2014)



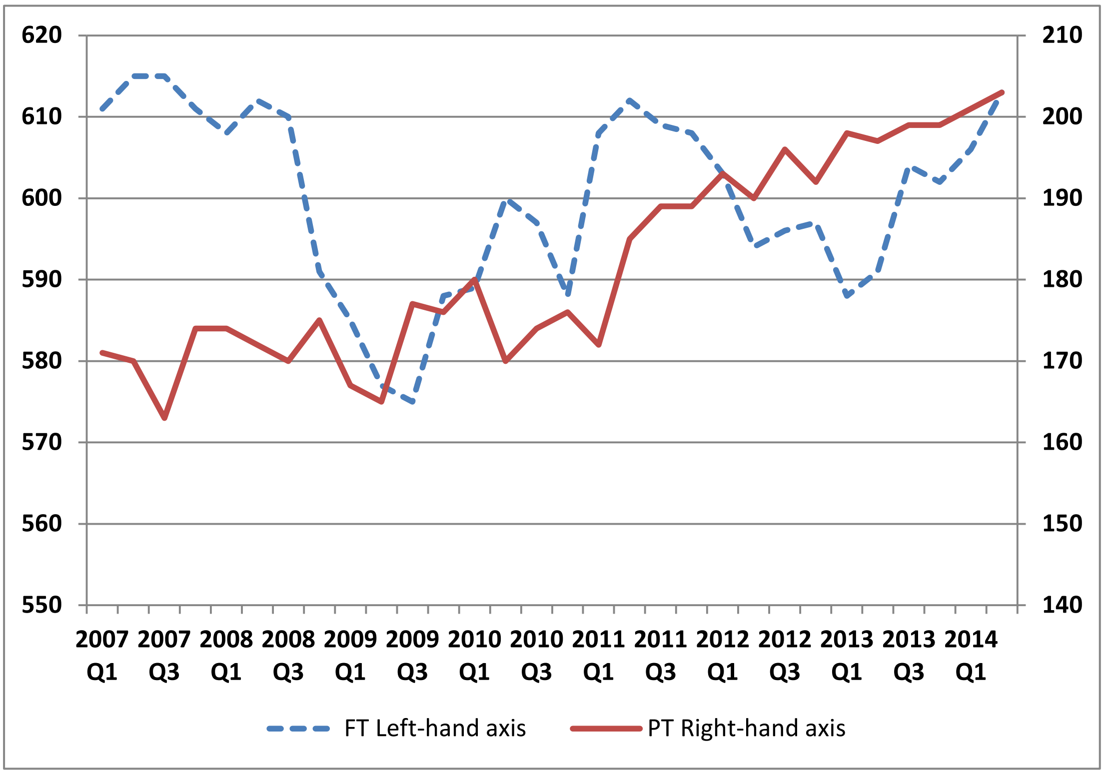
Source: NISRA (2014a) NI Composite Economic Index

The most up to date information we have on economic activity is survey data from the Purchasing Managers Index (PMI) for Northern Ireland. The PMI survey reports expectations and intentions of firms in various industries and sectors. The latest data for Northern Ireland in August (UlsterBank, 2014) indicate a continuing trend of increasing business confidence, employment expectations and new business. The construction industry is by far the most buoyant and confident sector, but these trends have yet to show any positive increase in Northern Ireland output. It may be that this is due to work carried out by NI construction firms outside of Northern Ireland. While all three sectors indicate modest increases in the prices they charge for their products, they also report increasing input costs particularly in the construction sector.

The Northern Ireland labour market has seen some positive changes in recent months (NISRA, 2014a). Unemployment in the three months to the end of July was 6.6% and this represents a fall of 0.3 percentage points from the previous quarter (February to April) and also a 0.3% decrease from the same period in 2013. However there was also an increase of 19,000 in those classified as economically inactive which reverses a recent trend of decline. There was also no increase in full-time employment and a small decrease in part-time employment. The percentage of employment that is full-time has fallen from 78.1% in May-July 2007 to 75.3% in May-July 2014 (see Chart 2.8). Youth unemployment increased from 19.2% to 20.0%. The overall number of young people unemployed remained unchanged at 20,000. This implies the number of young people in the labour force has contracted. The claimant count, which measures out-of-work benefits recipients showed decreases for the first half of the year - there is now an unbroken trend of 20 months of decline (NISRA, 2014c). The decreases however are less than those recorded within the United Kingdom and Northern Ireland still maintains the highest claimant count of any UK region at 5.9%. However the claimant count is a more accurate barometer of benefit eligibility than it is of overall unemployment.

The Northern Ireland jobs market has had some notable successes in the third quarter of 2014 with gains in the production and services sectors. The largest increases in jobs were in the pharmaceutical sector and business services sectors. Almost 350 jobs were created by the Craigavon based firm Almac. In the services sector, Baker & McKenzie plans to create 250 jobs in Belfast in legal services and back office functions, while consulting firm Deloitte has announced the creation of 350 jobs over the next five years. Electronic security firm Proofpoint announced the creation of 94 jobs in research & development and global operations in Belfast. There were also 140 jobs announced by SSE in its existing call centre in Belfast. On the downside, there are fears of significant job losses in the private medical group Threefivetwo as NHS outsourcing is scaled back, and within the public sector there are concerns for jobs at HM Revenue and Customs in Derry. Also, aeronautical manufacturing firm Bombardier announced the loss of 400 jobs in Belfast. Finally, uncertainty around the future of banking represents a significant concern in terms of potential jobs losses across Northern Ireland.

Chart 2.8 Full and part-time employment, Northern Ireland, 2007-2014 (000's of individuals)



Source: NISRA (2014b) Labour Force Survey

House prices in Northern Ireland increased by 4% in the second quarter of 2014 following a 3% increase in the first quarter. The annual increase from the second quarter of 2013 to 2014 was 10% while the volume of residential sales increased by 25% over the same period (NISRA, 2014d). House prices in Northern Ireland reached their peak in the third quarter of 2007 and the overall index is still 50% below peak level. Average property prices were 9.1 times the average salary in 2007, but as of 2013 the ratio had fallen to 4.2 times average salary. Growth in Northern Ireland house prices has been modest in comparison to other regions.

3 Future Economic Outlook

3.1 Introduction

In this section of the Autumn QEO we outline our basic assumptions for Ireland's main trading partners as well as our expectations for the economies of both parts of the island of Ireland. We also consider risks to the baseline forecast.

NERI projections for economic growth, the labour market and the public finances are projected for the Republic of Ireland out to 2016. Our expectation is that the economy will continue to operate below its potential level for the duration of the forecast period. Our projections for economic growth in the Republic have improved markedly since the Summer edition of the QEO. However, the pace of employment growth has slowed and we project that the unemployment rate, although falling in each of the next three years, will remain in double digits until 2016 and well in excess of pre-crisis levels.

For Northern Ireland we present a set of external projections for economic activity, employment growth and unemployment and consider the main risks to the Northern Ireland economy.

3.2 Macroeconomic Assumptions for the Global Economy

The value of exports from the Republic of Ireland was over 105% of GDP in 2013 (CSO, 2014e). As a small open economy the Republic's economic performance is highly dependent on the economic performance of its main trading partners. The most significant of these are the Euro area, the UK and the United States.

Euro area real GDP growth is expected to be somewhat subdued in 2014. Real GDP stagnated (0.0%) in the second quarter of 2014 (Eurostat, 2014c) following four quarters of modest growth and survey data suggests that growth momentum will remain sluggish in the third quarter. ECB staff projections see Euro area real GDP increasing by 0.9% in 2014, 1.6% in 2015 and 1.9% in 2016 (ECB, 2014a). Private sector forecasts are converging around growth of 0.9% in 2014 and 1.0% to 1.5% in 2015. Recovery is being hampered by weak credit growth to the private sector, legacy problems associated with the banking crisis, and ongoing deleveraging by the public and private (household and corporate) sectors. The elevated private sector debt burdens continue to weigh on consumption and investment and are barriers to credit growth. There is sizeable spare capacity in the economy and the currently high levels of unemployment (11.5% in July – Eurostat, 2014a) risk becoming increasingly structural with consequences for potential growth. The weakening growth momentum (and growth expectations) may dampen private investment and this too would have consequences for potential growth. In addition, the Euro area is experiencing a deflationary trend. Annual Euro area inflation (HICP) was just 0.4% in August (Eurostat, 2014e). This is well below the ECB's price stability mandate of just under 2% and partially reflects the strength of the Euro. Inflation is expected to remain low throughout 2014 but to then gradually increase in 2015 and 2016. If inflation does not meaningfully increase in the next six months we anticipate that the ECB will take further steps, potentially including quantitative easing. Finally, the slowdown in some emerging economies has implications for trade, capital flows and overall economic activity.

There are some signs of optimism. Exports will benefit from the recovery in parts of the global economy and from a fall in the value of the Euro. The Euro should depreciate against both the US Dollar and the UK Pound over the next twelve to eighteen months as monetary policy gradually tightens in both the US and the UK. The policy initiatives taken by the ECB in its September meeting clearly indicate that monetary policy will remain supportive of domestic demand for some time. Euro area domestic demand will also be supported by a reduction in the pace of fiscal tightening. Credit conditions should improve in 2015 following the results of the stress tests on Euro area banks and the ongoing construction of a banking union. Meanwhile low energy prices continue to support real disposable income and are helping to keep input costs down. Even so, the economic outlook for the euro area remains fragile with a number of downside risks including the prospect of an intensification of the Ukraine crisis and knock-on effects in terms of reduced trade, rising energy costs, and falling confidence.

Economic prospects appear much brighter in the UK and in the United States with both countries' recoveries expected to continue. The Bank of England (BOE) is projecting real GDP growth of 3.5% in 2014, 3.0% in 2015 and 2.6% in 2016 (BOE, 2014). The BOE is forecasting average CPI inflation of 1.8% over the period 2014-2016 and LFS unemployment falling from 5.9% in the fourth quarter of 2014 to 5.4% in the fourth quarter of 2016. In the United States, real GDP expanded at only a modest pace in the first half of the year. The Fed's forecast for real GDP growth in 2014 is now between 2.1% and 2.3%. The forecast is predicated on loosening fiscal policy, continued improvement in credit availability, increases in consumer and business confidence, and a pickup in international economic growth. NIESR (2014) is forecasting that the United States economy will grow by 1.9% in 2014 and 3.0% in 2015. Monetary policy will begin to tighten and interest rates rise in both countries over the next twelve months as labour market conditions continue to improve.

NIESR's latest global economic forecast is for the world economy to grow by 3.5% in 2014 and 3.7% in 2015. Key risks to recovery are identified as deflationary pressures in the Euro area, the Chinese financial system, and pressures on monetary policy.

3.3 Macroeconomic Projections for the Republic of Ireland

Gross Domestic Product

The National Accounts can give a skewed impression of the underlying health of the economy and caution is required when interpreting the headline GDP and GNP growth figures. GDP growth is particularly difficult to interpret as it tends to fluctuate along with the behaviour of a small number of multinationals. In particular the accounting practices and tax planning of multinationals distort the headline GDP figures. The patent expiry effect in the pharma sector is yet another example of how the GDP figures can be distorted by a small number of these firms. Fitzgerald (see ESRI, 2014b) identifies a number of sources of distortion in the National Accounts including the phenomenon of tax inversions or "re-domiciled PLCs" which affects the current account and distorts GNP upwards. Other examples include Ryanair's large-scale purchase of aircrafts and the future treatment of aircraft leasing in the national accounts, both of which have significant effects on the trade data.

With the above caveats in mind we are projecting real GDP growth will be a robust 5.0% in 2014 and a closer to trend 3.0% in 2015 (see Table 3.1). GDP increased by just 0.2% in 2013 although this figure was distorted downwards by the patent cliff effect in the pharma sector. Real GNP grew by 3.3% in 2013. It appears the patent cliff effect will have a much smaller impact on the 2014 growth figures, while the gradual recovery in the Republic's trading partners, increasing competitiveness and a depreciating Euro will support export growth in 2014 and in 2015. Net exports will make substantial positive contributions to growth in 2014 and 2015. We are forecasting that domestic demand will make its first positive contribution to real GDP growth in seven years. Investment will grow strongly from its historically weak base as a percentage of GDP, while improving household balance sheets, a stronger labour market, and increases in disposable income will all drive growth in personal consumption. Survey indicators of economic performance and sentiment have been robustly positive in 2014 and are strongly suggestive of continued expansion for the rest of 2014. The exchequer returns, labour market and retail sales data are also strongly suggestive of a domestic economy in recovery. GDP grew by a very robust 5.8% in the first half of 2014 compared to the first half of 2013 while value added increased in all sectors (CSO, 2014e).

Since the release of the Summer QEO we have seen substantial revisions to the National Accounts related to the new European System of National and Regional Accounts (ESA 2010) which replaces the previous ESA that had been in use since 1995. Most importantly Research and Development (R&D) is no longer treated as intermediate consumption under ESA 2010 but as capital formation. This leads to an upward adjustment in investment and the estimated stock of GDP. GDP has been revised upwards from €164.1 billion to €174.8 billion in 2013 to reflect these methodological changes. The move to ESA 2010 does not imply higher future growth rates but does make it easier to achieve the required fiscal targets under the Excessive Deficit Procedure (EDP)

Personal Consumption

Consumer spending fell in volume terms for the third consecutive year in 2013. Personal consumption was down 0.8% in real terms in 2013 – a fall of over 7% since 2008. The declining trend will finally reverse in 2014 and we are projecting growth in personal consumption of 1.2% in 2014 and 1.3% in 2015. Consumption increased 1.2% in the first half of 2014 compared to the first half of 2013.

Higher levels of employment and disposable income, combined with improving net household worth, will drive growth in domestic demand and personal consumption. However, stagnant wage growth will hamper the recovery in consumption. Average weekly earnings were down 1.1% in the year to Q2 2014 (CSO, 2014c). Job growth without wage and income growth will constrain growth in demand. On the other hand the low inflation environment is helping to preserve the value of real incomes. The introduction of water charges will dent personal consumption in 2015.

While the Retail Sales Index rose by 0.7% in volume terms in 2013 it fell by 0.2% in value terms (CSO, 2014f). Excluding motor trades the volume of sales increased by 0.8% and declined by 0.1% in value terms. The 2014 data has been broadly positive. The volume of retail sales increased by 8.2% in July 2014 when compared with June but decreased by 0.7% when motor trades are excluded. The volume of retail trades is up 8.6% in the year to end July and up 3.1% when motor trades are excluded. The *KBC/ESRI Consumer Sentiment Index* (ESRI, 2014a) was at 89.4 in July. This was the highest monthly value since January 2007. The trend has been broadly upward since the middle of 2013 although sentiment declined marginally in August. The improvement in consumer expectations and confidence suggests fairly strong growth in personal consumption this year.

Exchequer VAT and Excise returns have been very strong so far (DOF, 2014a). The end-August 2014 outturn is 3.7% ahead of profile for VAT and 5.2% ahead of profile for Excise duties. The end-August 2014 outturn is up 8.5% year on year for VAT and 5.8% year on year for Excise duties.

Household debt continues to decline and fell by €1.9 billion to €164.3 billion (€35,694 per capita) during the first quarter of 2014 (CBI, 2014b). Household debt has now fallen by 19.3% since the third quarter of 2008. In terms of debt sustainability household debt as a proportion of disposable income fell by 3 percentage points to 182.3%. This is the lowest level since 2006 but is still high by international standards. The decline reflects the reduction in household debt as well as a slight increase of €185 million in disposable income. The decline in the ratio of debt to disposable income should increasingly feed through into a declining savings rate and a higher level of consumption. The *Nationwide UK (Ireland)/ESRI Savings Index* (ESRI, 2014c) recorded a value of 97 in August 2014 down 1 point on the level recorded in August 2013. The Savings Index is a measure of overall sentiment towards saving. Finally, Household net worth rose by 2.9% during Q4 2013 and by 0.9% during Q1 2014, marking the seventh consecutive quarterly increase. The increase in net worth represents an increase in anticipated lifetime income and this should eventually translate into higher levels of annual consumption.

Table 3.1 Projections for Output, the Public Finances and the Labour Market, (Republic of Ireland)

	2013 values	2013	2014	2015	2016
National Income		*Percentage real change over previous year*			
Gross Domestic Product	€174.8bn	0.2	5.0	3.0	2.9
Personal Consumption	€83.3bn	-0.8	1.2	1.3	1.4
Investment	€26.5bn	-2.4	9.7	8.0	7.0
Government Consumption	€26.0bn	-0.5	2.1	0.0	0.0
Exports	€184.1bn	1.1	8.1	3.2	3.3
Imports	€147.7bn	0.6	6.9	2.7	2.9
Government Finances		*Percentage of GDP*			
General Government Balance	€10.01bn	-5.7	-3.7	-2.1	-1.4
Gross Debt	€215.5bn	123.3	116.6	113.3	109.4
Labour Force		*Percentage change over previous year*			
Employment	1,881,150	2.3	1.8	2.0	1.9
		Percentage of Labour Force			
Unemployment	282,200	13.0	11.5	10.6	9.8

Sources: 2013 data are from CSO (2014e) National Accounts, CSO (2014i) Government Finance Statistics, CSO (2014a) Quarterly National Household Survey, and NERI calculations.

Notes: 2014-2016 data are NERI projections and assume there will be neutral budgets for the remainder of the forecast period.

Investment (Gross Domestic Fixed Capital Formation)

Total investment in 2013 was just two thirds of total investment in 2007. Investment decreased by 2.4% in 2013 although the headline figure was depressed by the timing of aircraft purchases. The ESA 2010 revision saw the Republic's investment to GDP ratio increase from 11.2% to 15.2%. However, this remains one of the lowest ratios in the EU, well below the long-run historical average, and a constraint on the medium-term growth potential of the economy. Declining investment has become a trend across Europe. Even so, the Republic of Ireland's investment data has been very robust so far this year with capital formation up 11.3% in the first half of 2014 compared to the first half of 2013.

Investment is by far the most volatile component of GDP in terms of year-on-year changes with potential for fast growth rates. We are projecting that investment will grow by 9.7% in 2014 and by 8% in 2015. The fast rate of growth should be understood in the context of the historically low investment to GDP ratio. Deployment of some or all of the Ireland Strategic Investment Fund (ISIF) toward capital projects represents an upside risk to the 2015 and 2016 projections and something we have recommended on a number of occasions. Access to credit remains a constraint on investment, particularly for SMEs. On the other hand the need for balance sheet restructuring is declining and combined with ongoing debt restructuring should help spur investment. In addition, non-traditional sources of funding are being created including the establishment of the Strategic Banking Corporation of Ireland. The ECB's recent decisions to stimulate activity in the Euro area through asset purchases should place downward pressure on interest rates and on the cost of capital.

We anticipate that building and construction will drive the expansion in investment over the next two years. The excess of supply over demand in the Dublin housing market is feeding through into higher prices and this should eventually encourage higher levels of house completions The Construction PMI registered 61.4 in August (Ulster Bank, 2014) and is signalling a strong increase in housing activity and commercial activity although the PMI for civil engineering activity remains weak. The PMI registered its twelfth successive monthly increase in employment in August. On a seasonal basis the volume of output in building and construction increased by 2.1% in the first quarter of 2014, and by 4.1% in the second quarter of 2014. On an annual basis, the volume of output in building and construction increased by 10.1% in the second quarter of 2014. Expansion should also continue for machinery and equipment as investment responds to employment growth, an improved environment for exports, and solid growth of new orders.

Government Consumption

Government consumption is a policy instrument. According to the Department of Finance's Stability Programme Update (SPU) Government consumption is scheduled to decline by 0.9% in 2014 and by 1.6% in 2015 before stabilising in real terms in 2016 (DOF, 2014b). There are now strong indications that the Budget 2015 adjustment will be substantially less austere than was originally envisaged. In light of this apparent shift in policy we are modifying our forecast for government consumption in 2015. In addition, fees from the government's ELG scheme have significantly reduced as covered liabilities have matured and this has contributed to an increase in net government expenditure of +5.2% in the first half of 2014 compared to the first half of

2013. We now anticipate that government consumption will increase in real terms by 2.1% in 2014 and will remain flat in 2015.

Exports

Exports rose by 1.1% in volume terms in 2013. The somewhat disappointing performance of the export sector was partially attributable to the impact of the patent cliff and the fall in the measured volume of exports in the pharmaceutical sector. The patent cliff effect is expected to be greatly diminished in 2014 and will have negligible impact on employment. Exports are up by 10.2% in the first half of 2014 compared to the first half of 2013 and we are now projecting that exports will increase by 8.1% in 2014 before reverting much closer to trend at 3.2% in 2015. Exports will be boosted by the expected depreciation in the value of the Euro against the US Dollar and the UK Pound, as well as by continued recovery in the United States and the UK. However, the weak performance of the European economy will exert downward pressure on the demand for Irish exports. The Euro area accounted for 38.2% of goods exports in the first half of the year while the United States accounted for 22.2% and the UK accounted for 14%.

On an annual basis the value of goods exports increased by 6% in June 2014 compared to June 2013 (CSO, 2014j). By far the main driver was the growth in export of *Organic Chemicals* (+54%). The *Investec Manufacturing PMI* (57.3 in August) suggests an improvement in business conditions and confidence in the sector with output and new orders both up strongly. The headline Manufacturing PMI is at its highest level since December 1999. New export orders rose for the fourteenth month running in August. The UK was the main source of new business from abroad.

Services exports overtook goods exports for the first time in 2013 and in the medium-term growth in exports will be driven mainly by the services sector. Total service exports at €22.35 billion increased by €1.13 billion between Q1 2013 and Q1 2014. The *Investec Services PMI* at 62.4 is at its second highest level since February 2007 and has shown an expansion in new export orders from abroad for thirty seven consecutive months. The index for new exports is strongest in the *Transport, Travel,* *Tourism & Leisure* sector reflecting the improvement in the international economy and expansion in tourism exports. The United States was the main source of new business from abroad.

Imports

Services and merchandise exports both contain a large import component and the expected increase in exports will be reflected in higher levels of imports. Much of the import content into the Republic of Ireland is in the form of royalties and licenses. The accounting practices and transfer pricing of large-scale multinationals can make it difficult to interpret the import data and are a challenge to understanding the true value added of these firms. In general the use of transfer pricing to boost profits in the Republic leads to an understating of the true value of imports.

Imports rose by just 0.6% in volume terms in 2013 although this figure would be higher if we were to exclude the impact of aircraft purchases in the previous year. It is expected that imports of aircrafts will increase again in 2014. Imports grew strongly in the first half of 2014 and are up 8.9% on the first half of 2013. We are projecting that the volume of imports will increase by 6.9% in 2014 before moderating to 2.7% in 2015. Investment growth will feed through into higher levels of merchandise imports while the more modest growth in personal disposable income and consumption will boost tourism imports, other services imports and imports of motor vehicles.

Labour Market

Total employment grew by 2.3% in 2013. However, seasonally adjusted employment grew by just 5,300 jobs (0.3%) in the first half of 2014 and while employment is up 31,600 in annual terms, the vast bulk of these gains occurred during 2013. In spite of the weak first half figures we are projecting employment growth at a relatively healthy 1.8% in 2014 although this is less optimistic than our forecast from the Summer QEO. Employment growth will be driven by the anticipated improvements in domestic demand. In particular increased investment will boost employment growth in the construction sector. There is significant remaining slack in the economy and we are projecting strong employment growth in 2015 (2.0%) and 2016 (1.9%).

We are forecasting that the unemployment rate will average 11.5% in 2014, 10.6% in 2015 and 9.8% in 2016. These rates are well above the long-term average for the Republic's economy. According to the Quarterly National Household Survey the seasonally adjusted unemployment rate declined from 12% to 11.5% (254,500 persons) over the second quarter of 2014 while the Live Register recorded a standardised unemployment rate of 11.2% in August. An expected increase in the size of the labour force will mean that not all of the employment gains in 2015 and 2016 will be reflected in a reduced unemployment rate.

We expect the labour force participation rate to increase gradually in the medium-term although the high rate of long-term unemployment and the length of the recession may have caused permanent damage to the economy in the form of a higher rate of structural unemployment. Our unemployment and employment projections are broadly consistent with that of other forecasters in 2014 and relatively pessimistic in 2015. Table 3.2 shows a range of projections for unemployment in 2014 and 2015. The range of projections for 2014 is from 11.2% (European Commission) to 11.5% (NERI, Department of Finance and ESRI), while the range of projections for 2015 is from 9.8% (ESRI) to 10.6% (NERI).

Table 3.2 Range of Projections for Unemployment as a Per Cent of the Labour Force, (Republic of Ireland)

	2014	2015	2016	2017	2018
NERI (September)	11.5	10.6	9.8		
Department of Finance (April)	11.5	10.5	9.7	8.9	8.0
Central Bank of Ireland (July)	11.4	10.5	-	-	-
European Commission (May)	11.4	10.2	-	-	-
IMF (April)	11.2	10.5	-	-	
OECD (May)	11.4	10.4	-	-	-
ESRI (July)	11.5	9.8	-	-	-
Investec (August)	11.4	10.0	8.8	-	-

Sources: DOF: Ireland's Stability Programme April 2014 Update, (DOF 2014b); CBI: Quarterly Bulletin, (CBI 2014c); European Commission: Spring 2014 Forecasts, (EC, 2014); IMF: World Economic Outlook April 2014 (IMF 2014b); OECD: Economic Outlook, (OECD 2014b); ESRI: Quarterly Economic Commentary, Summer 2014 (ESRI, 2014b); Investec: Irish Economy Monitor, (Investec 2014c).

Labour market improvements have yet to translate into higher average weekly earnings and the high degree of slack in the economy and the low level of inflation suggest that upward pressure on wages will remain muted in 2014. However earnings growth is occurring in some sectors of the economy such as construction and average earnings will start to rise as the unemployment rate continues to fall.

Public Finances

The headline government deficit improved from 8.1% of GDP in 2012 to 5.7% in 2013. This was well within the Excessive Deficit Procedure (EDP) ceiling of 7.5%. In nominal terms the 2013 government deficit was €10.01 billion. Based on our estimates for economic growth, unemployment and employment creation we are projecting further improvement in the deficit in 2014 and in 2015. The reductions in the numbers unemployed mean reduced expenditure on social transfers. At the same time increased employment and higher average incomes will generate additional direct and indirect revenue flows.

The exchequer deficit up to end August 2014 was €6.3 billion, compared to €7.32 billion for the same period last year. This represents a year on year improvement to date of €989 million. The outturn exchequer deficit up to end August is €1.31 billion less than profile. We project that the exchequer borrowing requirement will fall to 3.7% of GDP in 2014 and to 2.1% of GDP in 2015. General government debt was 123.3% of GDP at the end of 2013 (€215.5 billion) and we estimate that gross debt will fall to 116.6% of GDP in 2014 and to 113.3% of GDP in 2015.[1] These estimates assume there will be a reduction in precautionary cash balances of the scale described in the April 2014 SPU and take into account the methodological shift from ESA 1995 to ESA 2010. The shift to ESA 2010 has facilitated the Government's ability to hit its EDP target of better than a 3% deficit in 2015. Our 2015 projection assumes the Government will announce a fiscally neutral budget in Budget 2015. If our projections for the public finances are borne out, Ireland will comfortably fall within the EDP ceilings for 2014 and 2015. Although the deficit projections are sensitive to growth and employment outcomes the risk of breaching the EDP ceiling in either year is low.

[1] Debt sustainability remains uncertain and vulnerable to an increase in the cost of borrowing. The Central Bank of Ireland should, at a minimum, not push forward its timetable for offloading the portfolio of floating bonds it acquired in a swap for Irish government promissory notes. Doing so would have negative consequences for the cost of borrowing and ultimately for employment and growth.

Risks to the Outlook

Macroeconomic projections come with a large degree of uncertainty and are best understood as baseline estimates. Table 3.3 compares NERI's projections to those of other agencies. Projections of GDP growth in 2014 vary between a low of 1.7% (European Commission and IMF) and a high of 5.0% (NERI), while the 2015 projections for GDP growth vary between 2.2% (OECD) and 3.7% (ESRI). These are substantial differences yet even this variation fails to catch the true range of feasible outcomes in 2014 and 2015. There is a wide range of risks to the baseline projections. Exchange rate movements always represent a source of uncertainty. The lack of clarity about the future United Kingdom (UK) governance structures and its place or otherwise in the European Union may begin to exert downward pressure on the UK Pound. This would damage growth in the Republic's exports.

Weaker than expected output growth in our trading partners would impact on the Irish economy's recovery. Deflationary concerns in the Euro area may presage a long period of Japanese style stagnation and this would weaken exports from the Republic. In addition, the slowdown in growth in emerging economies risks a knock on effect on growth in the advanced economies as demand for exports would fall. The concept of 'secular stagnation' (CEPR, 2014) has recently been developed. The idea is that four structural headwinds in the global economy will lead to a structural increase in the savings rate – a savings glut - and insufficient demand to sustain future economic growth. If secular stagnation is becoming a reality then the global outlook for consumption and investment may be substantially weaker than previously understood. Geopolitical tensions represent a further downside risk. The Ukraine imbroglio could escalate leading to a trade war with Russia and to an increase in energy costs. Such a supply side shock would be very damaging for the European Union economy. A deterioration or spread of the humanitarian disasters and conflicts in Syria and Iraq would also place upwards pressure on energy costs.

There are valid concerns about the ability of the domestic economy to generate sustained employment growth. For example credit access remains fragile and a setback in the Autumn bank stress tests would dent confidence and impact lending. Weak credit growth will delay recovery in investment. In addition, failure to properly construct the Euro area's nascent banking union risks perpetuating fragmentation in the European banking system. Such an outcome would have negative ramifications for the cost of capital and for investment levels. The outcome of the OECD's Base Erosion and Profit Shifting (BEPS) project (OECD, 2013) may change international corporate tax rules from 2016 onwards. The uncertainty generated in the interim may lead to a reduction in Foreign Direct Investment into the Republic over the next few years and this would have negative consequences for investment and growth. Finally, if there is higher than expected hysteresis (permanent damage from the recession) in the labour market it could manifest as slower than anticipated improvements in both the unemployment rate and employment growth. Hysteresis represents the damaging effect of past economic weakness on potential. The crisis and the recession have caused immense damage to the human capital of the work force and this damage has reduced the Republic of Ireland's growth potential.

Table 3.3 Range of Projections for Annual Change in Real GDP, (Republic of Ireland)

	2014	2015	2016	2017	2018
NERI (September)	5.0	3.0	2.9		
Department of Finance (April)	2.1	2.7	3.0	3.5	3.5
Central Bank of Ireland (July)	2.5	3.3	-	-	-
European Commission (May)	1.7	2.9	-	-	-
IMF (April)	1.7	2.5	-	-	-
OECD (May)	1.9	2.2	-	-	-
ESRI (July)	3.0	3.7	-	-	-
Investec (August)	2.5	2.8	2.5	-	-

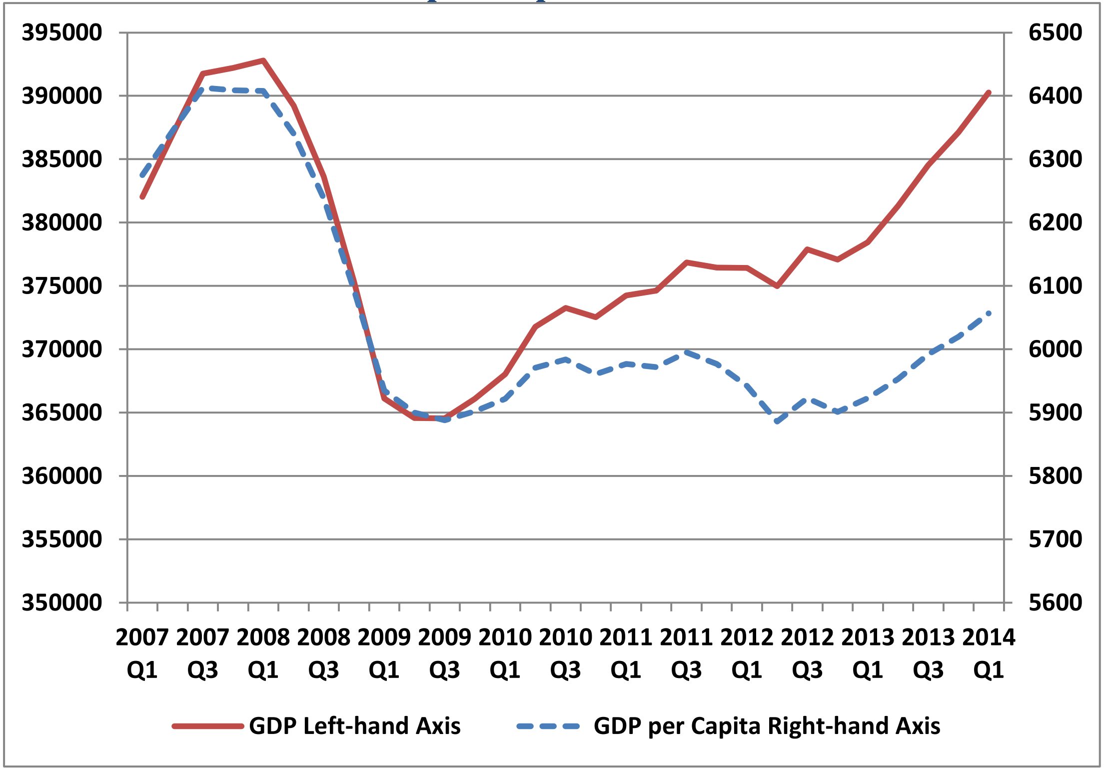
Sources: DOF: Ireland's Stability Programme April 2014 Update, (DOF 2014b); CBI: Quarterly Bulletin, (CBI 2014a); EC: Spring 2014 Forecasts, (EC 2014); IMF: World Economic Outlook April 2014 (IMF 2014b); OECD: Economic Outlook, (OECD 2014b); ESRI: Quarterly Economic Commentary, Summer 2014, (ESRI, 2014b); Investec: Irish Economy Monitor, (Investec 2014c).

3.4 Macroeconomic Outlook for Northern Ireland

Macroeconomic Outlook

Northern Ireland saw a contraction of output in the first quarter of 2014 and appears to be falling behind the UK. While the UK and Northern Ireland have seen significant employment growth, this does not seem to be translating into growth of the same magnitude. GDP growth in both the UK and Northern Ireland has been underwhelming compared with employment growth. This phenomenon has been referred to as the productivity puzzle (see Mac Flynn, 2013). One explanation may be that the type of employment being created is compositionally different to that being destroyed and that the newer jobs are of lower skill level (less productive) and consequently less well paid. Since 2007 the composition of employment has shifted from manufacturing and construction toward less productive areas like services and transport. The changing structure of the labour market may have serious implications for the Northern Ireland economy's growth potential.

Chart 3.1 UK GDP & GDP per Capita 2007 - 2014



Source: Office for National Statistics (2014) GDP Estimates
Notes: LH-Axis figures are £m and RH-Axis are £

Risks to the Outlook

The main risks to the Northern Ireland economy arise from the health of the UK economy and in particular the sustainability of GDP growth. At this stage in the recovery we would expect to see labour productivity and real wages increasing. This has not been the case. The severity and form of the recession may have delayed the return to productivity growth. However the longer this trend persists, the longer living standards will stagnate, with potential consequences for the long-term output potential of the UK economy. The composition of UK GDP growth raises sustainability concerns, GDP growth was lead primarily by higher consumer spending in 2013 and this was accompanied by a worrying increase in household debt. Early signals for 2014 suggested improvements in investment and exports and therefore more balanced and sustainable growth. However these trends have not advanced into the second quarter.

There are signs that manufacturing is losing ground to the services sector and that household debt is on the rise again (BOE, 2014). A return to domestic consumer-led services sector growth poses significant risks to growth sustainability.

The remaining risks to the Northern Ireland economy are political. While voters in Scotland may have rejected outright independence, the prospect of further devolution for Scotland, and in particular devolution of fiscal powers, creates uncertainty for Northern Ireland as it may open up a discussion on the allocation of government expenditure within the UK. The Barnett formula is certain to be discussed in the context of the devolution of more tax raising powers and the possibility of devolving some welfare expenditure among the regions. This is likely to impact on the debate on Welfare Reform within Northern Ireland. In addition, a decision on the devolution of Corporation Tax to Northern Ireland is likely to be made now that the uncertainty of the Scottish independence referendum has passed

Table 3.4 Overview of recent projections of Economic Activity and employment/unemployment (Northern Ireland)

	2013 (Outturn)	2014	2015	2016
Economic Activity	**n/a**			
Ernst & Young (GVA)		2.4	1.8	1.7
PWC (GVA)		1.9	2.0	-
Danske Bank (GVA)		2.3	2.4	-
Employment	**-0.4**			
Ernst & Young		1.8	1.1	0.5
Unemployment (%)	***7.6***			
Danske Bank		7.1	6.7	-
Ernst & Young		6.4	6.1	6.0

Sources: Ernst and Young: Economic Eye, Summer (2014); PWC: Northern Ireland Economic Outlook April (2014); Danske Bank Quarterly Economic Overview Q1 2014 (May 2014) Danske Bank (2014)

Note: Gross Value Added differs from GDP by the difference between taxes and government subsidies.

4 A Strategic Approach to Fiscal Policy in the Republic of Ireland[1]

4.1 Introduction

Concern about the Republic of Ireland's public finances has dominated economic and public policy since 2008. Public debt levels remain extremely high and by the end of 2013 were equivalent to 123.3% of GDP and to 145.1% of GNP. Meanwhile the public finances recorded a deficit of 5.7% of GDP in 2013 and we estimate that the public deficit will be close to 3.7% of GDP in 2014. Yet the debt-to-GDP ratio should decline steadily over the next few years supported by growth in nominal GDP and by extremely low interest rates, while there is likely to be a balanced budget by 2018 even under a no-change fiscal stance. While the public finances remain fragile they will continue to improve provided that monetary policy remains supportive and growth returns to the real economy.

The appropriate scale and composition of the Budget 2015 fiscal adjustment was extensively discussed in the Summer 2014 edition of the QEO (NERI, 2014). It remains our analysis that the scale of the discretionary adjustment should not exceed €800 million and that it should consist mainly of a revenue-based fiscal consolidation, alongside a programme of public investment, and a social emergency fund targeted at the most vulnerable people and communities in Irish society. There is no scope for a reduction in the overall level of taxation in Budget 2015.

Public policy must now focus on the real side of the economy – employment, real incomes and growth. Fiscal policy has a critical role to play in this regard and public investment is of particular importance. In this section of the QEO we consider the options available to sustainably increasing the Republic of Ireland's potential growth rate through fiscal policy. The public investment/GDP ratio is currently very low by European standards and by historic standards in Ireland. Alongside this the State's cost of borrowing is now at an historic low while the ability of the private sector to invest is being constrained by a lack of access to credit. The long-term rate-of-return to the Irish economy from prudently targeted public investment is very likely to exceed the current cost of borrowing. There is a strong case for either the Government itself or a government owned body to borrow (issue debt) to fund a large-scale programme of

[1] A strategic approach to fiscal policy in the Republic of Ireland is discussed in greater detail in a forthcoming NERI Working Paper (McDonnell, Forthcoming).

public investment focussed on areas such as social housing, education and high speed broadband infrastructure.

4.2 Overview of the Public Finances and Fiscal Policy

The Republic of Ireland recorded an end of 2013 debt-to-GDP ratio of 123.3% or €215.5 billion. This equates to an extremely high 145.1% of GNP.[2] The General Government Balance (GGB) was in deficit to the tune of €10.01 billion or 5.7% of GDP in 2013. The exchequer deficit up to end August 2014 was €6.3 billion, compared to €7.32 billion for the same period in 2013. This represents a year on year improvement to date of €989 million. Based on our current projections for growth and the exchequer finances we are forecasting a public deficit of 3.7% in 2014, 2.1% in 2015 and 1.4% in 2016. We anticipate the primary balance will be in surplus by 2015 and that there will be a balanced budget by 2018 under a 'no change' fiscal stance. The Government will comfortably fall within the Excessive Deficit Procedure (EDP) ceilings (i.e. maximum allowed deficits) of 5.1% of GDP in 2014 and 3.0% of GDP in 2015. The deficit projections are sensitive to growth and employment outcomes. Our estimates assume a fiscally neutral budget in 2015.

The breakdown of the public deficit into its cyclical and structural[3] components was discussed at length in the Summer QEO (NERI, 2014) where the case was made that most if not all of the remaining deficit is cyclical in nature. This suggests there is little need for additional fiscal consolidation. In other words the remaining deficit is caused by the functioning of the so called 'automatic stabilisers' as they fluctuate along with the cyclical upswings and downturns in the economy. As the economy improves we can expect expenditure to decline along with demand for unemployment and income related social benefits, and for government revenue to increase along with income and expenditure based tax contributions (personal taxes, social contributions, corporate taxes and indirect taxes). Excessive fiscal adjustment will do unnecessary damage to domestic demand and it is our analysis that the scale of the fiscal consolidation in Budget 2015 should not exceed €800 million.

[2] The gross debt figure is somewhat misleading as a barometer of debt sustainability as it is partially offset by significant cash reserves and other assets.
[3] The structural deficit or structural surplus is the remaining deficit or surplus when the economy is at its long-run equilibrium.

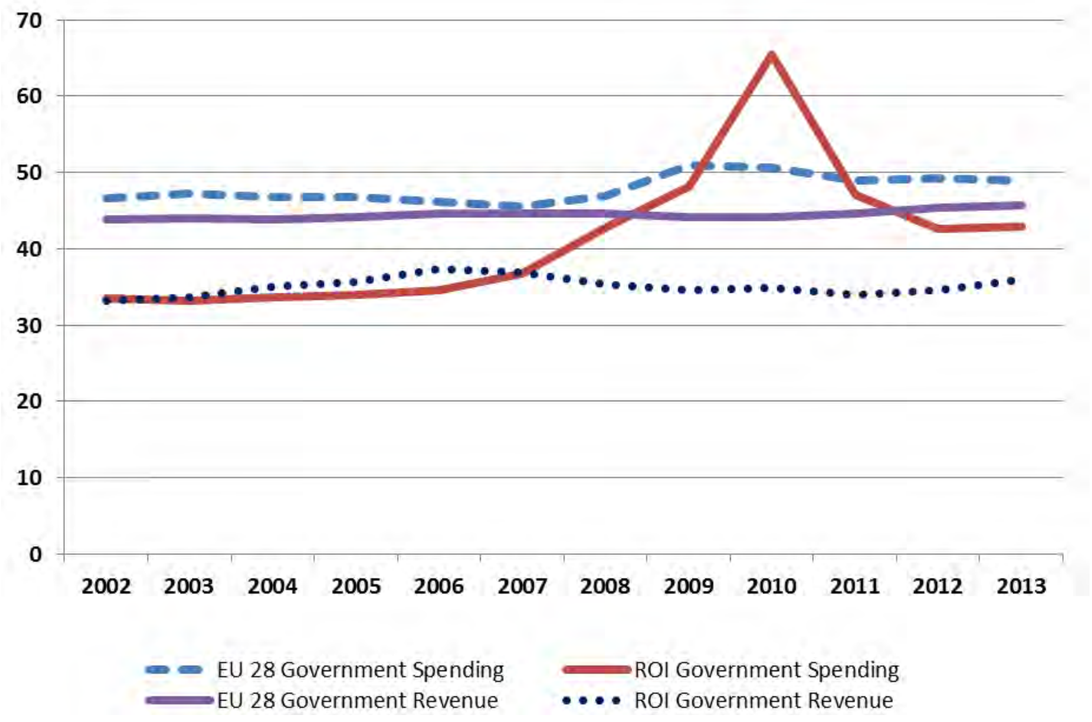
Table 4.1 Cumulative Fiscal Adjustments 2008-2015

	Total adjustment €bn (including 2015)	2008-2010 (€bn)	2011-2013 (€bn)	2014 (€bn)	2015 (€bn) (Signalled)
Revenue	**-11.5**	-5.6	-4.3	-0.9	-0.7
Expenditure	**-20.5**	-9.2	-8.4	-1.6	-1.3
of which					
Capital Expenditure	*-5.0*	*-1.6*	*-3.3*	*-0.1*	*0.0*
Current Expenditure	*-15.5*	*-7.6*	*-5.1*	*-1.5*	*-1.3*
Total adjustment	**-31.8**	-14.7	-12.6	-2.5	-2.0

Sources: Department of Finance budgetary documentation; Budget 2009 to Budget 2014 inclusive.
Notes: Figures may not sum due to rounding. Total adjustment includes €2.0 of additional measures currently projected for 2015 although it is not anticipated that the final adjustment will be this large.

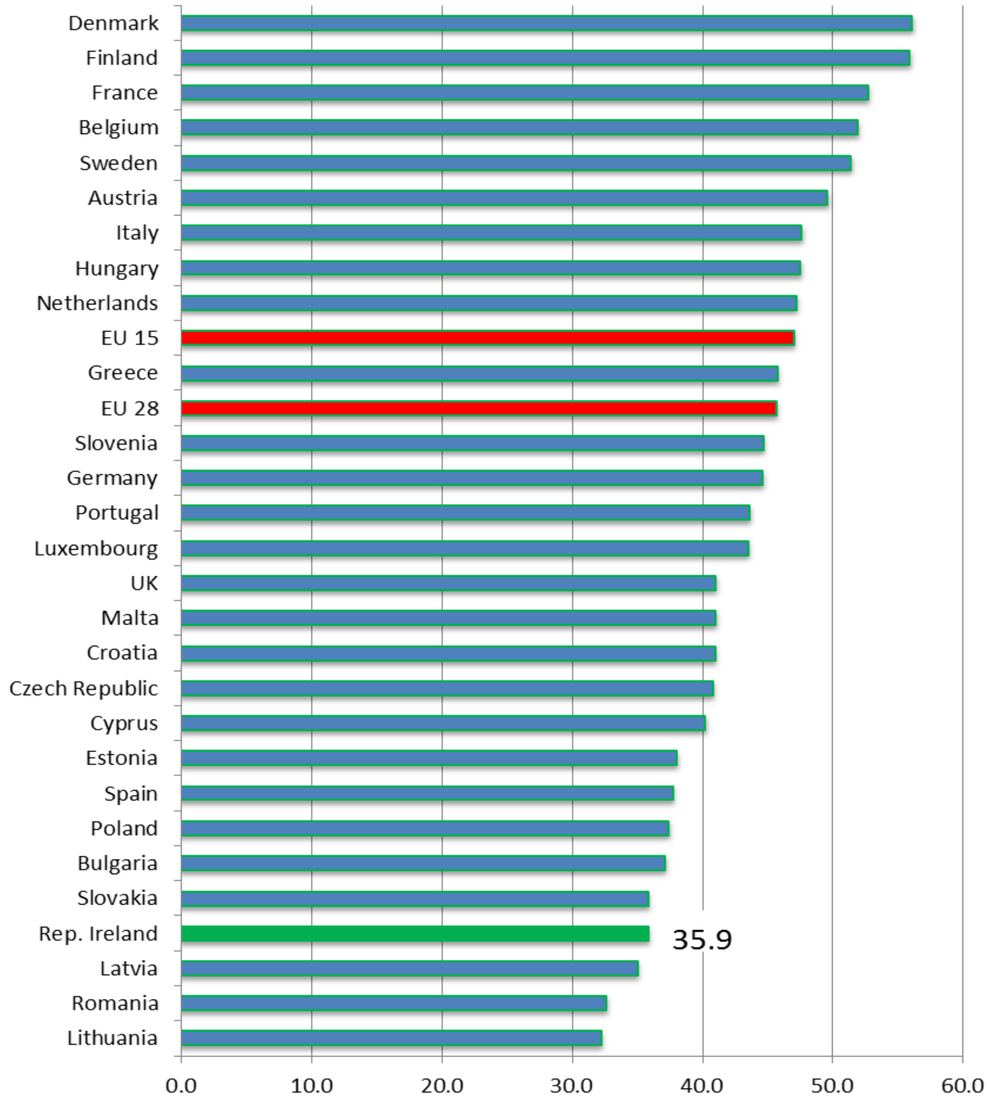
Fiscal policy has placed a heavy emphasis on cuts to public spending over tax increases since the start of the crisis (see Table 4.1). Public spending has to date accounted for 64% of the total fiscal consolidation effort. The data makes clear that Ireland is not a high tax economy. Chart 4.1 shows Ireland has low levels of public expenditure and low levels of government revenue when compared to the EU average. Government revenue as a percentage of GDP was fourth lowest in the EU in 2013 (see Chart 4.2), was the lowest amongst the higher income member states and was substantially lower than each of the ten most competitive EU countries (World Economic Forum, 2014).

Chart 4.1 Public Spending and Government Revenue, % GDP



Source: Eurostat (2014f) Government Finance Statistics

Chart 4.2 General Government Revenue as % of GDP, 2013



Source: Eurostat (2014f) Government Finance Statistics

The Republic of Ireland's low level of government revenue as a percentage of economic output is inconsistent with the provision of Western European levels of public investment, social transfers such as pensions, and public services such as education and health. Budgetary projections indicate that primary public spending (i.e. spending less interest payments on the national debt) as a percentage of output will soon reach historically low levels for modern Ireland. This has profound implications for the Republic's welfare state. The Irish Fiscal Advisory Council (IFAC, 2014) noted in its most recent fiscal assessment that current budgetary plans imply considerable pressures on government services, public investment and social payments. Tax cuts in

Budget 2015 imply even more pressure on the quality of public services and in the context of a still high public deficit should be considered deeply unwise.

4.3 Ireland's Growth Potential

In order to assess the appropriateness of a country's fiscal stance we must first estimate the country's potential economic output and the gap between this potential output and the country's actual output. Potential output, the output gap derived from it, and the Non-Accelerating Inflation Rate of Unemployment (NAIRU) are known as structural or 'potential' variables (Klär, 2013). The estimated output gap is a key input into the measurement of the structural balance. In turn the country's structural balance tells us whether a particular fiscal stance is sustainable. The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (EMU) has increased the focus on potential variables because the Treaty limits the maximum structural deficit allowable for the public finances. The Treaty does however allow for a certain amount of cyclical borrowing associated with the operation of the automatic stabilisers. While the public finances must record a cyclical surplus in economic upswings there is some space for running cyclical deficits in economic downturns.

Box 4.1 Deriving the Structural Balance

The General Government Balance (GGB) can be broken down into structural and cyclical components. Disentangling the structural and cyclical components requires us to:

(A) Estimate the economy's potential output and therefore the output gap; and

(B) Estimate the budget sensitivity parameter.

Budget sensitivity is a measure of the impact of upswings and downturns on the public finances.[4] For example a positive output gap of 3 per cent of potential output (a booming economy) and a budget sensitivity of 0.6 implies a budget surplus of 1.8 per cent of potential output is required in order to maintain a neutral structural balance (Klar, 2013). As we can directly observe the GGB it becomes straightforward to derive the structural balance provided we know the output gap and the budget sensitivity parameter.

A negative output gap (representing underutilisation of capital and labour) implies fiscal space for running budget deficits.

[4] The budget sensitivity parameter is derived by calculating the elasticities of the automatic stabilisers (e.g. tax receipts and welfare payments) with respect to cyclical fluctuations in the economy. The budget sensitivity may differ for each of the automatic stabilisers but will always take a value between 0 and 1.

Official estimates of potential variables have proven very unreliable. Multiple retrospective revisions have been the norm – even for particular years. In recent years the Commission has repeatedly revised downwards its estimate of Ireland's potential growth. Between 2008 and 2012 the structural unemployment (NAIRU) estimate for Ireland has been increased by a very substantial 8.2 percentage points. This suggests either the Commission believes structural unemployment has increased by over 170,000 in just four years or the Commission is conceding its previous estimates for the output gap were spectacularly wrong. The measurement problem is not just an Irish issue as other countries have also seen massive revisions, for example Spain.

Ireland undoubtedly has to work through coordination and retraining issues related to the redeployment of labour from the construction sector to other sectors of the economy. However, there is little systemic evidence of structural deterioration in the Irish labour market since 2008. Instead the multiple downward revisions for potential growth, potential output and the NAIRU should be interpreted as representing the Commission's belief that the structural balance was much worse than previously thought prior to the crisis and that the economy and labour market was operating well above its long-term potential. Indeed the revised estimates act as the crux of the Commission's argument that fiscal policies aimed at boosting aggregate demand in Ireland would be ineffective and that unemployment cannot be reduced except through structural reforms.

Can fiscal policy influence potential output?

Textbook macroeconomic theory decomposes potential growth into contributions from labour supply, human capital, physical capital and total factor productivity. Structural variables like potential output are thought to be relatively stable over the business cycle. Long-run equilibrium growth and employment are seen as determined only by supply-side dynamics influencing the capital stock, the labour force (including human capital), or productivity (e.g. technological and institutional change). Demand side effects are treated as having only transitory impacts while the path of potential output is seen as independent of short-run fluctuations in activity (Klär, 2013). If this argument is correct then Ireland's post 2008 downturn, like the boom before it, should only have a transitory impact on Ireland's potential output and long-run equilibrium unemployment rate. Actual output will trend towards potential output over time. Fiscal policy would be ineffective.

Yet it seems unreasonable to argue the business cycle has zero impact on potential output. A negative investment shock such as Ireland experienced will reduce the capital stock relative to what it might otherwise have been. Presumably this will have at least some impact on potential output. A positive investment shock can have the opposite effect. Similarly, permanent damage known as 'hysteresis shadows' or 'hysteresis effects' can develop in the labour market during a sustained downturn. We can think of hysteresis as being the permanent damage done to equilibrium output as a consequence of an extended downturn. Hysteresis effects in the labour market relate to erosions in the stock of human capital - skills, confidence, tacit knowledge and work habits are eroded as the duration of unemployment is prolonged. The 'learning-by-doing' so crucial to the development of human capital and economic growth becomes stalled. This has implications for the economy's productive capacity – and for the economy's long-run equilibrium. In other words, demand-side effects can have permanent impacts on the economy and on living standards. Actual unemployment may become structural if it is allowed to persist for long periods of time. The result is a fall in potential output and higher equilibrium levels of unemployment.

The damage done to the banking system and the high level of private debt also represents sources of hysteresis to the extent they are constraints on potentially productive investment. The basic argument is that hysteresis effects and investment shocks can translate short-run slack (underutilisation of resources) into permanently lower levels of potential output through channels such as higher structural unemployment and a smaller capital stock (Bouis, Cournède and Christensen, 2012).

We can think of economic output, and indeed the economy, as a system, with multiple (infinite) long-run equilibria. De Long and Summers (2012) estimate that each percentage point of negative output gap reduces the growth rate of potential GDP by 0.1 percentage point.[5] Potential GDP is permanently reduced unless policy responds to increase demand. Deterioration in human capital since 2008 arising from hysteresis effects may have pushed up Ireland's NAIRU (structural unemployment). This would actually make the scale of the Commission's potential output revisions somewhat more

[5] De Long and Summers (2012) find the hysteresis effect to be symmetric. Positive output gaps increase the level of potential output.

plausible. But if cyclical events and economic path dependency do in fact matter for long-run output and structural unemployment then it means there is indeed a role for activist policy. If fiscal policy is capable of altering the NAIRU then the economy has potentially more than one structural balance. In this context it might be best to think of Ireland's current rate of double-digit unemployment as a market failure capable of being influenced by both supply-side and demand side policies. In other words, activist fiscal policy can have long-term effects on potential output.

4.4 Growth Friendly Fiscal Policy

It is one thing to argue that activist demand-side measures can have a permanent impact on growth potential but it is quite another to identify the appropriate measures. Effective measures will be those that boost the amount of labour inputs employed and those that boost average labour productivity. The growth of employment will reflect labour force participation and labour force growth, while the growth of labour productivity will reflect the capital stock (human capital and physical capital) and technological progress. The efficacy of the various fiscal instruments is considered in greater depth in McDonnell (Forthcoming). McDonnell argues the case for higher levels of public capital investment as a per cent of GDP and for increased spending on R&D and on education. The case for increasing the Republic's current public investment to GDP ratio is also argued in Crafts (2014).

Research from the OECD (Cournéde, Goujard and Pina, 2013) has decomposed every possible fiscal measure into one of seventeen different categories. These seventeen 'fiscal instruments' were than ranked in terms of their welfare outcomes (economic growth and equity). The most damaging fiscal consolidation instruments are cuts to education and cuts to childcare and family supports. These types of cuts are particularly damaging to the formation of human capital and result in lower output per capita in the long-term. Cuts to public investment were also found to be damaging to welfare in the long-run. There is a strong case for increasing public spending in all of these areas. Increases in spending have to be paid for and of course are inconsistent with tax cuts.

The fiscal multiplier measures the spill-over impact on economic activity caused by discretionary adjustments in government spending or taxation. The size of the fiscal multiplier depends on the nature of the fiscal adjustment. In practice almost all studies show that discretionary fiscal consolidation is harmful for growth in the short-term although there may be substantial variation in the effects of different fiscal instruments. Recent Irish estimates of GDP impact multipliers (ESRI, 2013; O'Farrell, 2013) are shown in Table 4.2 for a selection of fiscal instruments. There is some disagreement about the ranking of the multipliers in terms of size although public investment and public sector employment appear to be associated with higher than average multipliers. In other words increases to investment and public sector employment appear to be the fiscal instruments most effective at stimulating economic activity as well as producing the most damaging outcomes when cut. International studies also tend to show that multipliers are highest for public investment and government consumption and somewhat lower for taxes and transfers (OECD, 2009; and Barrell, Holland and Hurst, 2012).

Table 4.2 Impact Multipliers for Ireland

Policy Instrument	ESRI	Impact Rank	O'Farrell	Impact Rank
Public sector employment	1.2	1st	1.38	2nd
Investment	0.6	2nd	1.76	1st
Income tax	0.4	3rd=	1.07	4th
Social Transfers	0.4	3rd=	1.06	5th
Public sector wage rates	0.3	5th	1.35	3rd

Sources: ESRI (2013d) Medium-Term Review 2013-2020; O'Farrell (2013) The Effects of Various Fiscal Measures

Notes: Estimates are for a fiscal shock equivalent to 0.6% of GDP and represent the percentage impact on real GDP; The ESRI results only take account of demand side impacts and do not consider the longer-term supply side benefits of increasing the productive infrastructure of the economy. The ESRI note that if the investment were in productive infrastructure this supply-side effect could dominate the short-term demand effects.

4.5 Investing in Growth

The Republic's investment/GDP ratio is very low by EU standards. High corporate indebtedness and the damage to the banking sector continue to act as constraints on private investment. The public investment/GDP ratio is also very low by EU standards and by historic standards in Ireland. Cuts to public capital expenditure are particularly damaging to welfare in the long-run as public investment in productive infrastructure has a positive effect on capital accumulation, productive capacity, and long-term output. The problem of low investment in the Republic has been identified on numerous occasions (Crafts, 2014; NERI, 2014; IFAC, 2014; IMF, 2014c) and public investment is currently expected to average just 1.5% of GDP over the period to 2018.

This is well below the current Euro area average. According to estimates from Kamps (2005) the growth optimising rate of public investment is 3% of GDP for an economy growing at an expected trend rate of 3% per annum. This suggests a required increase in public investment of well excess of €2 billion per annum over the next few years.
As noted in the Summer QEO depreciation of the public capital stock exceeded public capital expenditure in 2013. In other words the public capital stock actually declined in 2013. The shortfall in public investment has consequences for the economy's growth potential. Ireland's productive infrastructure already lags that of Western Europe in a number of key respects and infrastructure deficits are apparent in a number of areas including social housing, public transport, and broadband infrastructure and water services. The inability of the private sector to invest adds to the need for public investment.

The Irish government's cost of borrowing (ten year bonds) is now below 1.7%. This is a historically low level. At the same time the ability of the private sector to invest is constrained by over indebtedness and a lack of credit. The long-term rate-of-return (ROR) to the Irish economy from a public capital investment programme is likely to be well in excess of the Government's currently low cost of borrowing. In this context the case for borrowing to fund public investment becomes compelling. It would make sense for a private company to borrow to invest under these conditions and it equally makes sense for the Government to borrow to invest.

Financing investment can be centralised and leveraged through an independent Strategic Investment Bank or Strategic Investment Fund. The European Investment Bank, the European Bank for Reconstruction and Development, Germany's KfW, and the UK's Green Investment Bank all provide templates for such a vehicle. The creation of the Ireland Strategic Investment Fund (ISIF) is a welcome innovation in this context. To ensure the funds borrowed are actually used for investment in human and physical capital it is important they are transferred directly to a fund such as the ISIF. The goal should be to raise sufficient funds to increase the public investment ratio to an average of at least 3% of GDP over the next decade. This implies almost doubling the current public investment to GDP ratio.

Examples of appropriate areas of investment were described in the Summer QEO and include housing, education and telecoms/broadband. A large-scale programme of public housing has obvious social benefits but could also benefit the economy by facilitating labour mobility to regions that show greater job creation and by forestalling a housing bubble in the Greater Dublin area. Ireland ranks poorly in terms of broadband infrastructure relative to other Western European countries. Broadband is a General Purpose Technology (GPT) and facilitates innovation and growth in multiple economic sectors. Investment in this area is vital for regionally balanced job creation. Finally, investments in education and in R&D are crucial for innovation and for growth in human capital.

4.6 Tax Reform

Eurostat (2014g) data shows that Ireland is a low tax economy by European standards. Ireland's overall tax take in 2012, including Social Security Contributions (SSCs), was the sixth lowest in the EU as a proportion of GDP (28.7%). The weighted average for the EU was 39.4%. Employer social contributions are particularly low in Ireland, while Ireland also stands out for its low tax take from property and labour income. Government revenue (which includes non-tax and SSC income) was 35.9% in Ireland in 2013 – ten percentage points below the EU average.

The progressivity of the Irish tax system is often overstated. Collins (2014) points out that the Irish tax system's progressivity is often misleadingly focused only on income taxes, or income related taxes and that a full analysis of the progressivity of the tax system requires consideration of the impact of consumption taxes. Collins shows that consumption taxes are more regressive than direct taxes on income. Indirect tax contributions, as a percentage of gross income, tend to be higher for lower income groups. Eurostat data shows that Ireland has a comparatively high Implicit Tax Rate (ITR) on consumption compared to the EU but has low ITRs on labour and capital.

The State's capacity to maintain advanced economy levels of public services, public investment and social payments is contingent on sufficiently high levels of revenue being raised. But care is required when proposing specific revenue increases. Taxes influence behaviour in a variety of different ways and in so doing influence economic efficiency, employment, equity and growth. Theory and evidence (Johansson et al, 2008; Heady et al, 2009) both suggest taxes on property, wealth and passive income have minimal impact on long-run economic growth and have smaller employment effects than taxes on labour income and consumption. Taxes on property and wealth are also redistributive if properly designed and helpful to tax authorities in fighting tax evasion and criminal activity by revealing inconsistencies between income flows and wealth.

Reform is also needed in the area of tax expenditures, which are analogous to government spending programmes, can carry large fiscal costs, and tend to deliver larger benefits to higher income households. Reliefs allowing a tax deduction at the individual's marginal rate of income tax are more valuable to, and will disproportionately benefit, those with the highest income tax rates. Preferential tax treatment for certain asset categories and types of investment, for example, pensions and housing distorts investment decisions. This distortion erodes allocative efficiency in the economy, is damaging to growth, and provides mechanisms for tax avoidance. Favourable tax treatment for investing in housing assets relative to other forms of investment is likely to be particularly damaging to long-term growth because it distorts capital flows away from productive investments and toward non-productive investments in housing.

4.7 NERI Proposals

The NERI outlined its budgetary recommendations in the Summer Edition of this publication (NERI, 2014). We argued that net fiscal consolidation should not exceed €800 million and that consolidation should mainly be financed through revenue raising measures.

The proposed measures included the introduction of a wealth tax and reforms to Capital Acquisitions Tax; an increase in Employer's PRSI on the portion of income in excess of €100,000; additional curbs on tax expenditures, and additional staff for the Revenue Commissioners in order to improve tax compliance and clamp down on tax evasion and criminal activities. Alongside these measures we proposed that the incoming water charges should be equality proofed to ensure low income households do not fall into water poverty. Despite the encouraging second quarter growth figures we hold to our analysis that these measures remain individually and cumulatively appropriate.

In addition to the package of revenue measures we argued that €400 million of additional public spending should be allocated to protect vulnerable individuals, groups and communities. This additional funding would be reserved for a number of targeted social programmes including additional resources for community supports in deprived areas and additional resources for mental health services. A portion of this additional funding should be allocated to help address Ireland's social housing crisis. We also propose the reversal of the changes to the Jobseeker's Allowance Rates that were announced in Budget 2014 (see Box 4.2).

Finally, and for the reasons advanced earlier in this section, we are proposing that the level of public capital investment should be increased to an average of 3% of GDP over the next decade.

4.8 Conclusion

The public finances are stabilising and the era of fiscal consolidation should be coming to a close. Only a small net fiscal adjustment is appropriate for 2015. However, given Ireland's low revenue base there appears little room for a reduction in the overall level of taxation. Public policy must now focus on the real side of the economy – employment, real incomes and growth. Fiscal policy has a critical role to play in this regard and public investment is of particular importance. The public investment/GDP ratio is currently very low by European standards and by historic standards in Ireland. Alongside this the State's cost of borrowing is now at an historic low while the ability of the private sector to invest is being constrained by over indebtedness and a lack of access to credit. The long-term rate-of-return to the Irish economy from prudently targeted public investment is very likely to exceed the current cost of borrowing. There is a strong case for the Government to fund a large-scale programme of public investment focussed on areas such as social housing, education and high speed broadband infrastructure. Such investments would be self-financing and would increase the potential output of the economy.

Box 4.2 Budget 2014 and cuts to Jobseeker's Allowance for those under 26

Currently, there are 24 unemployed people for every job vacancy. This is a problem for everyone looking for employment, but makes it particularly difficult for young people who tend to have less work experience.

Budget 2014 reduced Jobseeker's Allowance (JA) to recipients less than 26 years of age. The adjusted rates are 30% lower for new entrants aged 22-24 and 23% lower for those aged 25. The new rates came into effect on 15 January 2014. The measure was presented as a way to "incentivise young jobseekers to avail of education and training opportunities and [to] try to avoid them becoming welfare dependent from a young age." The Department of Public Expenditure and Reform (2013) estimate that €32 million will be saved by the measure over the course of 2014.

JA rates prior to Budget 2014

Age	Basic Allowance (€)
18-21	100
22-24	144
25 and over	188

JA rates post Budget 2014

Age	Basic Allowance (€)
18-24	100
25	144
26 and over	188

Source: Department of Public Expenditure and Reform (2013)

A recent evaluation of FÁS/Solas training schemes shows that prior to the recent measure young people were willingly participating in training, with most still unable to find work upon finishing their course. The profile of people participating found the 15-24 cohort was over represented in the courses examined; at the time of the survey this age group represented 22 percent of the unemployed population, but 33 percent of the trainees partaking. Similar to other participants, young trainees are reported to be willingly participating in training. The report notes "the vast majority of those who registered with FÁS in the summer of 2011 did so of their own volition… only 11% of trainees were directed by the Department of Social Welfare."

The lack of jobs is a key issue. When evaluating the employment outcome following completion of the training, the survey sought to find out how many of those finishing the course had found a job "at some point" during the 12 month period since exiting the training. Even by this accommodating employment metric only 36 percent in the 15-24 had found employment; the lowest success rate amongst all the age cohorts. Many factors could be influencing this poor outcome—education level prior to commencing the training and length of time unemployed, for instance—but cutting Jobseeker's Allowance is unlikely to address any of the issues facing young people in the labour market. The absence of jobs, not motivation, is the central issue for young people looking for work.

5 Conclusion

Our outlook is for steady improvement in both of the economies on the island of Ireland. For the Republic we are projecting fairly robust GDP Growth in 2014, 2015 and 2016 of 5.0%, 3.0% and 2.9% respectively. The return to growth will mainly be driven by increasing investment and strong export performance. Although our base-line outlook for employment and growth in the Republic of Ireland is positive there are remaining concerns about the scale of private indebtedness, the generally weak credit conditions and the high levels of long-term unemployment and youth unemployment. Our growth projections are conditional on further improvement in the US and UK economies and on a recovery in the European economy.

Economic recovery appears to be gradually taking hold in Northern Ireland although political uncertainty continues to cast a cloud over the North's economic prospects. In particular, the uncertainty over the UK's position in the European Union will dampen the North's ability to attract investment over the next few years.

The public finances in the Republic of Ireland are stabilising and the era of fiscal consolidation should be coming to a close. Only a small net fiscal adjustment is appropriate for 2015. Despite the recent economic improvement, the debt-to-GDP ratio is still very high and the public finances remain vulnerable to a medium-term rise in interest rates. A cautious stance is therefore appropriate for Budget 2015. Given Ireland's low revenue base there appears little room for a reduction in the overall level of taxation. Instead, as we have argued in the QEO, there is a strong case for the Government to fund a large-scale programme of public investment focussed on areas such as social housing, education and high speed broadband infrastructure. Given the current cost of borrowing such investments would be self-financing in the long-term and would increase the potential output of the economy.

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7 Appendix

Appendix 7.1. Overview of recent economic trends – Republic of Ireland

	2009	2010	2011	2012	2013
Total Expenditure					
Consumption €m	83,565	82,447	82,969	82,467	83,334
Investment: private and public €m	33,082	26,106	24,841	26,923	26,541
Government current spending €m	29,650	26,437	26,111	25,922	25,956
Exports €m	146,363	157,811	167,086	182,506	184,056
Imports €m	-121,555	-129,023	-132,398	-147,079	-147,694
Domestic Demand €m	144,807	134,421	134,701	135,600	136,668
Total Income					
GDP €m	168,114	164,928	171,042	172,755	174,791
GNP €m	139,597	138,503	138,915	142,445	148,529
Income from Agriculture €m	2,064	2,586	3,202	3,019	3,027
Income non-Agriculture: Wages €m	74,683	69,440	69,465	69,519	71,854
Income non-Agriculture: Other €m	52,887	57,882	63,645	63,648	61,706
Employment					
Labour Force	2,242,400	2,196,700	2,173,700	2,165,800	2,182,100
Labour Force Participation Rate %	62.3%	61.0%	60.4%	60.2%	60.7%
Employment	1,953,600	1,886,100	1,845,600	1,841,300	1,899,300
Employment full-time	1,530,800	1,459,700	1,411,300	1,395,000	1,448,600
Employment part-time	422,700	426,400	434,300	446,300	450,700
Underemployment	112,900	112,500	140,800	147,600	139,300
Unemployment	288,900	310,600	328,100	324,500	282,900
Unemployment %	12.9%	14.1%	15.1%	15.0%	13.0%
Long-term Unemployment	80,600	152,600	191,700	193,000	165,100
Long-term Unemployment %	3.6%	6.9%	8.8%	8.9%	7.6%
Migration					
Immigration	73,700	41,800	53,300	52,700	55,900
Emigration	72,000	69,200	80,600	87,100	89,000
Net Migration	1,600	-27,500	-27,400	-34,400	-33,100

Appendix 7.1 (cont) Overview of recent economic trends – Republic of Ireland

	2009	2010	2011	2012	2013
Public Finances					
Total General Gov. spending €m	78,144	103,544	76,550	69,844	70,371
Total General Gov. revenue €m	55,963	55,149	55,331	56,623	58,866
General Gov. Balance €bn	-22.18	-48.40	-21.22	-13.22	-11.50
General Gov. Gross Debt €bn	104.5	144.2	169.2	192.5	202.9
General Gov. Gross Debt % GDP	64.4%	91.2%	104.1%	117.4%	123.7%
Earnings and Prices					
Average earnings € per week	699.10	693.70	687.67	691.93	677.13
Average earnings % change	0.3%	-0.8%	-0.9%	0.6%	-2.1%
Private sector av. earn. % change	3.6%	-2.4%	-2.5%	1.0%	-1.3%
Public sector av. earn. % change	-2.4%	-0.8%	0.7%	1.2%	-1.2%
Inflation CPI %	-4.5%	-1.0%	2.6%	1.7%	0.5%
Inflation HCPI %	-1.7%	-1.6%	1.1%	2.0%	0.5%
Inequality and Poverty					
Gini coefficient	29.3	31.4	31.1	31.2	n/a
Quintile ratio	4.3	4.8	4.9	5.0	n/a
Relative poverty %	14.1%	14.7%	16.0%	16.5%	n/a
Consistent poverty %	5.5%	6.3%	6.9%	7.7%	n/a
Deprivation rate %	17.1%	22.6%	24.5%	26.9%	n/a

Sources: CSO (2014e) Quarterly National Accounts; CSO (2014k) National Income and Expenditure; CSO (2014a) Quarterly National Household Survey; CSO (2014l) Population and Migration Estimates; CSO (2014c) Earnings and Labour Costs; CSO (2014d) Consumer Price Index; CSO (2014m) SILC Reports; and Eurostat online database.

Notes: Earnings and labour market data are for Q3 in all years.
Domestic Demand is Total Domestic Demand.
National accounts data reported at current market prices.

Appendix 7.2 Overview of recent economic trends– Northern Ireland

	2009	2010	2011	2012	2013
Total Expenditure					
Personal consumption £m	-	-	-	-	-
Investment: private and public €m*	8,833	9,353	7,332	-	-
Government consumption £m	-	-	-	-	-
Exports £m	5,270	5,438	5,910	5,627	5,987
Imports £m	5,152	5,417	5,774	5,690	5,807
Domestic Demand £m	-	-	-	-	-
Total Income					
GVA £m	28,447	28,945	29,063	29,410	-
GNP £m	-	-	-	-	-
Income from Agriculture £m	116	356	381	-	-
Income non-Agriculture: Wages £m	17,157	17,111	17,624	-	-
Income non-Agriculture: Other £m	11,175	11,477	11,058	-	-
Employment					
Labour Force	808,000	834,000	859,000	864,000	866,500
Labour Force Participation Rate	58.5%	59.9%	61.1%	61.0%	60.7%
Employment	750,500	773,500	794,000	797,500	795,000
Employment full-time	581,000	593,500	609,000	597,500	596,000
Employment part-time	171,250	175,000	184,000	193,000	198,000
Underemployment	25,500	27,000	32,000	41,500	43,000
Unemployment	52,500	59,500	62,000	65,000	65,000
Unemployment rate %	6.5%	7.1%	7.2%	7.5%	7.6%
Long-term Unemployment	17,500	26,000	27,500	33,000	35,000
Long-term as % of Unemployed	33.3%	43.7%	44.4%	50.8%	53.5%
Migration					
Immigration	25,261	24,544	23,724	23,255	23,100
Emigration	21,604	23,394	25,218	24,570	25,438
Net Migration	3,657	1,150	-1,494	-1,315	-2,338

Appendix 7.2 (cont) Overview of recent economic trends– Northern Ireland

	2009	2010	2011	2012	2013
Public Finances					
Total General Gov. spending £m	17,784	18,840	19,081	19,350	19,834
Total General Gov. revenue £m	-	-	-	-	
General Gov. Balance £m	-	-	-	-	
General Gov. Debt nominal £m	-	-	-	-	
General Gov. Debt % GDP	-	-	-	-	
Nominal earnings and Prices					
Average earnings £ per week	354.60	354.70	354.50	360.80	366.80
Average earnings % change	2.8%	0.0%	-0.1%	1.8%	1.7%
Private sector av. earn. % change	-	0.6%	0.1%	-2.3%	2.4%
Public sector av. earn. % change	-	6.5%	1.9%	5.4%	0.8%
Inflation CPI %	-	-	-	-	
Inflation HCPI %	-	-	-	-	
Inequality and Poverty					
Gini coefficient	-	-	-	-	-
Quintile ratio	-	-	-	-	-
Relative poverty %	20%	22%	20%	21%	19%
Consistent poverty %	19%	20%	20%	23%	20%
Deprivation rate %	-	-	-	-	-
-					

Sources: HMT (2014) Public Expenditure Analysis 2013; HMRC (2014) RTS; ONS (2013) Gross Value Added (Income Approach); NISRA (2014b) LFS Quarterly Supplement; NISRA (2014e) Northern Ireland Migration Flows; NISRA (2008-2013) Annual Survey of Hours and Earnings; Department of Social Development (2014) Poverty Bulletin

Notes: Where cells are blank the data are unavailable.
*Investment as Gross Fixed Capital Formation (estimated)

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