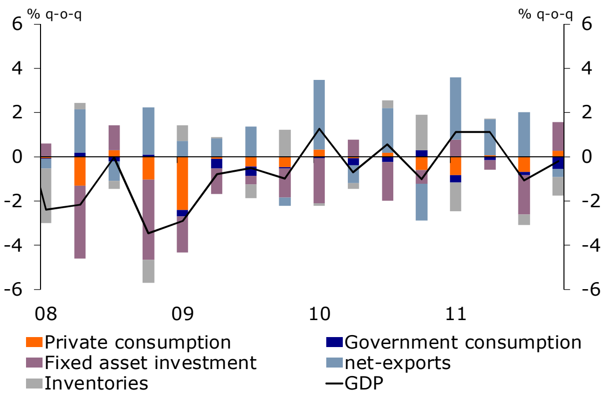
Macro Comment 12/25

Tim Legierse

Irish economy still struggling to recover

After an impressive start to the year, the Irish economy fell back into recession in the second half of 2011. With domestic demand expected to fall further and export growth held back by sluggish growth in global demand, the economy is expected to show only a modest recovery in 2012.

Figure 1: GDP and expenditure contributions



Source: Central Statistics Office Ireland

Irish gross domestic product (GDP) fell by 0.2% q-o-q in the last quarter of 2011. Following on a 1.1% contraction in the third quarter, this certainly removes a lot of the shine from the solid quarterly growth rates posted in the first half of the year. Still, after three years of falling economic activity, the 0.7% growth rate for the year is good news.

The outcome for 2011 is slightly worse than the 1% growth that the government expected. But this will probably not significantly alter the budget deficit for the year, which was well in line with the agreements made in the context of EU/IMF financial assistance. The disappointing second half of the year does make it harder to achieve the 1.3% GDP growth that underpins the 2012 budget. Average quarterly GDP growth will have to be 0.7% throughout the year to attain that figure. Given the likelihood of continued weakness in domestic demand and stagnation or modest growth in the main export markets, this is no small feat.

The expenditure breakdown shows a surprising shift compared to the rest of 2011 (figure 1). Domestic demand posted a moderate positive contribution to GDP growth, courtesy of a rise in private consumption and a very sharp rise in fixed asset investment. This more than made up for an accelerated drop in government consumption and inventory formation. Overall, domestic demand contributed 0.2%-points to growth, against an average subtraction of 1.8% per quarter in the three preceding quarters. Against that, after contributing an average 2.1%-points to quarterly GDP growth in the year to September, net-exports subtracted 0.4%-points in 11Q4. Exports declined for the first time this year on the back of falling GDP in the UK and the Eurozone. Lower imports partly mitigated the negative impact.

The available economic indicators for the first months of the year point to continued economic weakness. The manufacturing PMI was up in February, but at 49.7 still points at falling activity. The services PMI rebounded strongly, from 48.3 in January to 53.3 in February. But we would caution reading too much in one month’s data. Overall, there are no signs yet of a strong pickup in activity in either sector. On a more positive note, unemployment fell in February, after having stabilised in the second half of last year. Still, consumer confidence remains at very low levels. Households’ real disposable incomes will decline further this year due to downward pressure on wages, lower government transfers and higher taxes. At the same time, house prices are still on a steady downward path, further eroding household net wealth. As a result, the saving rate will remain high as households bring down debt to strengthen their balance sheets. We expect household spending to resume its downward trend in 2012. Therefore, domestically oriented businesses will see little reason to increase fixed investment. Government spending is expected to keep falling for the coming years.

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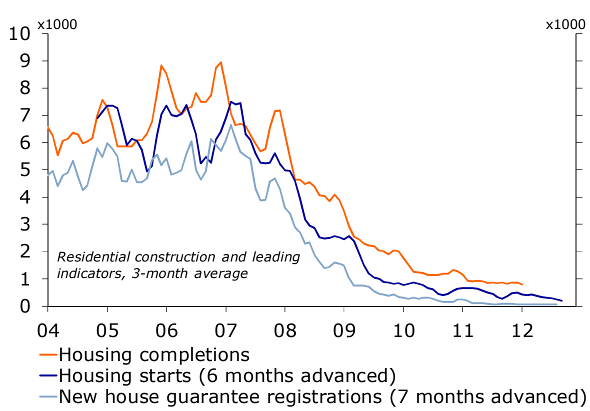
In all then, 2012 is unlikely to be the year of robust recovery. We expect domestic demand to fall further this year, making economic growth exclusively dependent on the export sector. We expect world trade growth to pick up some pace in the second half of the year, as emerging markets counter slowing economic growth with accommodative monetary and fiscal policy. We also anticipate economic growth to continue or resume in Ireland's main export markets (i.e. the US, the UK and Europe). The sharp adjustment in wages and costs over the past year and the relatively low value of the euro against the US dollar and the British pound will also support export growth.

In 2013, domestic demand is expected to act less of a drag on activity. Coupled with higher export growth, this should mean that GDP growth accelerates relative to this year. This year already, the negative effect of the sizeable correction in construction activity will probably have run its course. Housing starts and completions are currently reaching very low levels (figure 2). Even though it will take considerable time to return to higher levels of activity given the housing overhang still available, the fact that residential investment can hardly fall further means that an important drag on growth of the past couple of years will no longer hold back the recovery.

Our focus in this article has been on GDP. But an important feature of the Irish economy is the big difference between GDP and gross national product (GNP). Due to sizeable net foreign direct investment inflows since the 1990's, a large share of the firms operating in Ireland is foreign owned. The profits generated by these firms do not accrue to the Irish people and are not counted in gross national product. As such, GNP is a better measure for the income of Irish nationals. A notable development in the past years has been the sharper drop in GNP than GDP (figure 3). Export growth has been the only positive aspect of the economy over the past years. It is the modern manufacturing and services sectors, which are for a large part foreign owned, that export a lot. As a result, the positive impact of growing exports has only partially accrued to the Irish people. The divergence in GDP and GNP was particularly harsh in 2011. As a result, while the 0.7% *rise* in GDP looks good at first glance, the 2.5% *drop* in GNP gives a rather more pessimistic, and for the Irish people very painful, view on last year's economic development.

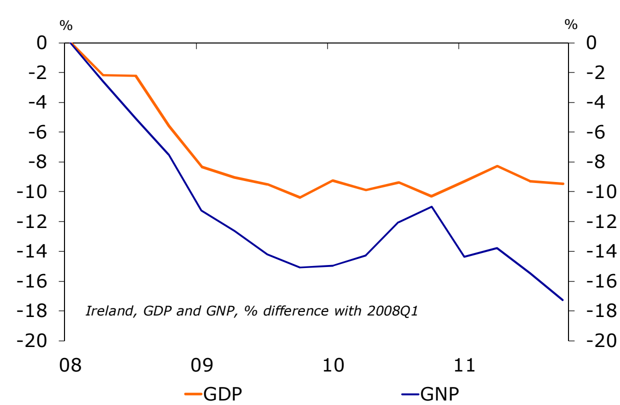
While we remain optimistic about the medium term prospects for the Irish economy, today's figures show that the road to better times ahead will be long and difficult.

Figure 2: Residential construction bottoming out



Source: Reuters EcoWin

Figure 3: GDP versus GNP



Source: Central Statistics Office Ireland

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Rabobank Economic Research Department

	Tel.	E-mail:
Chief economist	+31 30 21	
Wim Boonstra	66617	W.W.Boonstra@rn.rabobank.nl
International Economic Research		
Allard Bruinshoofd*	63272	W.A.Bruinshoofd@rn.rabobank.nl
Macro		
Shahin Kamalodin	31106	S.A.Kamalodin@rn.rabobank.nl
Tim Legierse	62677	T.Legierse@rn.rabobank.nl
Michiel Verduijn	30522	M.P.Verduijn@rn.rabobank.nl
Country Risk		
Erwin Blaauw	62648	E.R.Blaauw@rn.rabobank.nl
Fabian Briegel	64053	F.Briegel@rn.rabobank.nl
Jeroen van IJzerloo*	62406	J.IJzerloo@rn.rabobank.nl
Herwin Loman	31105	H.Loman@rn.rabobank.nl
Reintje Maasdam	31403	R.Maasdam@rn.rabobank.nl
Ashwin Matabadal	61601	A.R.K.Matabadal@rn.rabobank.nl
Reinier Meijer	31568	R.Meijer@rn.rabobank.nl
Anouk Ruhaak	64860	A.N.Ruhaak@rn.rabobank.nl
National Economic Research		
Hans Stegeman*	31407	H.W.Stegeman@rn.rabobank.nl
Macro		
Ruth van de Belt	60143	R.Belt@rn.rabobank.nl
Maarten van der Molen	64214	M.T.Molen@rn.rabobank.nl
Danijela Piljic	31104	D.Piljic@rn.rabobank.nl
Anke Struijs	31408	A.C.A.Struijs@rn.rabobank.nl
Theo Smid	67599	T.H.Smid@rn.rabobank.nl
Paul de Vries	30172	Vries.P@rn.rabobank.nl
Regional		
Rogier Aalders	31393	R.Aalders@rn.rabobank.nl
Cynthia Briesen	31411	C.C.Briesen@rn.rabobank.nl
Frits Oevering	64439	F.J.Oevering@rn.rabobank.nl
Anouk Smeltink-Mensen	66404	A.H.H.M.Smeltink@rn.rabobank.nl
Willem van der Velden*	62478	W.Velden@rn.rabobank.nl
Financial Sector Research		
Yvette Jörissen	64931	Y.M.Jorissen@rn.rabobank.nl
Dick Scherjon	31405	D.P.Scherjon@rn.rabobank.nl
August Sjauw-Koen-Fa	31406	A.R.Sjauw@rn.rabobank.nl
Nicole Smolders	79108	N.M.P.Smolders@rn.rabobank.nl
Leontine Treur	67084	L.Treur@rn.rabobank.nl
Bouke de Vries*	61195	Y.B.Vries@rn.rabobank.nl

**Head*