Irish economy in good shape

by Oliver Mangan

When assessing where the Irish economy stands after almost two years of the Covid-19 pandemic, it is best to use 2019 as the base for comparisons. Overall, the economy has come through the crisis in robust shape, although there are some sectors which have been badly impacted and are recovering more slowly.

Substantial fiscal support measures amounting to circa 20% of national income have played a key role in limiting the damage to the economy. Ireland has also benefitted from the favourable product mix in its large multi-national sector, with a large presence of pharma, medical, ICT and financial services companies, which have seen very strong export growth over the past two years.

The underlying strength of the economy is best exemplified by the data on tax receipts and the labour market. Tax revenues in 2021 were up by 15% on their 2019 level, i.e. before the pandemic struck. Notably, income tax receipts were over 16% higher.

This is consistent with the latest labour force data, which are for the third quarter of 2021. These show employment was up by 6.4% on the same period in 2019. Unlike in some other countries, the Irish labour force also continues to grow strongly, expanding by almost 7% in the past two years, reflecting rising participation rates and a continued increase in the number of non-Irish nationals in the workforce.

The official unemployment rate stood at 5.1% at end 2021, only slightly up on its end 2019 level of 4.8%. The rate including those on the Pandemic Unemployment Payment (PUP), stood at 7.5% in December, but this should fall rapidly with restrictions on activity lifted in January.

In terms of the domestic economy, the latest data shows modified final domestic demand was 3.3% higher in the third quarter of 2021 compared to the final quarter of 2019.

Consumer spending, though, had yet to return to end of 2019 level. While core retail sales (i.e. ex the auto sector) were 10% higher than two years ago, new car sales were down by 10% in 2021 on 2019 levels. Spending in some service sectors such as travel, hospitality and entertainment has also yet to recover.

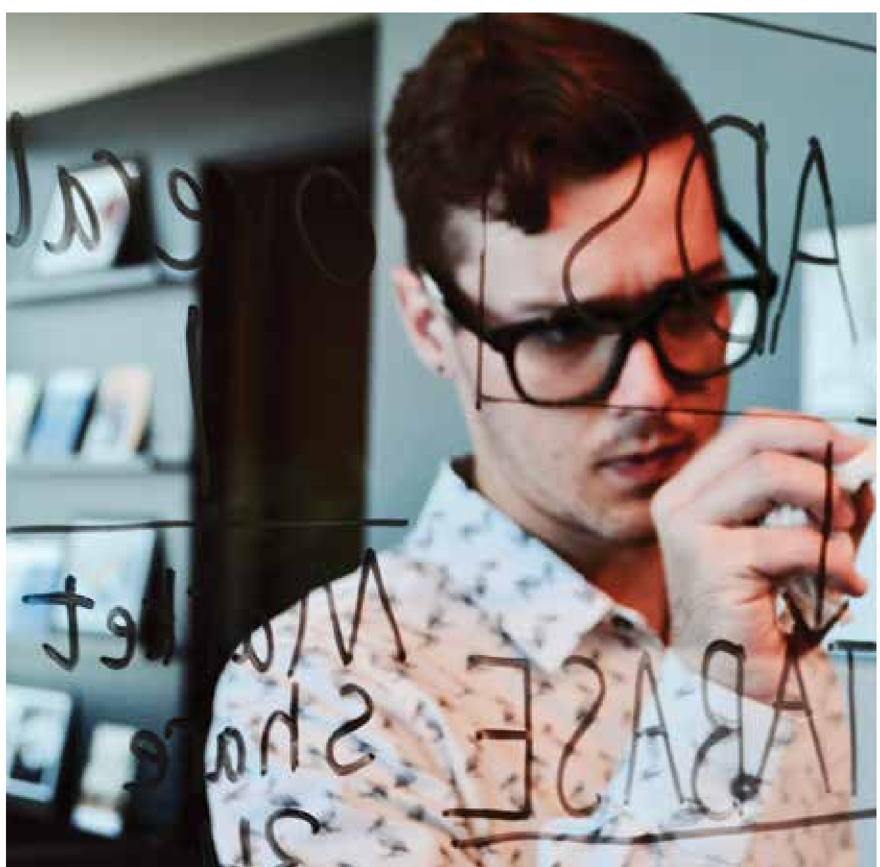
Meanwhile, housing output as measured by completions in 2021 were on a par with 2020 and 2019, at 20,500 units. However, overall construction output was still well down in the third quarter of last year on 2019 levels.

Again, this is reflected in labour market data, with construction employment still below 2019 levels.

The prospects for the Irish economy look very favourable with Covid-19 restrictions on activity now lifted and as the global economy continues to recover from the 2020 recession. The Central Bank is forecasting that Irish GDP will rise by 8.7% this year and 5.0% in 2023, with the domestic economy growing by 7.1% in 2022 and 5.2% next year.

It is predicting very strong growth in consumer spending in particular of 9.4% in 2022 and 6.5% in 2023.

The Irish economy is anticipated to be an outperformer over the next two years. While global growth is expected to remain strong, it is losing momentum. Both the OECD and IMF are projecting the world economy will expand by 4.5% in 2022 and circa 3.5% in 2023. This is down on growth of close to 6% in 2021.



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A slowing in global growth is no surprise as the initial surge in activity last year after economies re-opened with the lifting of Covid restrictions, abates. However, other factors are also at work. Supply bottlenecks have come more to the fore, with shortages of raw materials, key inputs and workers, as well as capacity constraints in transportation, resulting in delays and rising supplier delivery times. This has held back output in some industries, most notably the auto-sector.

The Return of Inflation

Meanwhile, rising inflation, which erodes real spending power, will also act to dampen growth. The combination of supply constraints alongside the release of pent-up demand and a rebound in commodity prices, especially in the energy sector, has caused inflation to surge over the past year. The Consumer Price Index (CPI) rate has risen to 7% in the US, 5.4% in the UK and 5% in the Eurozone, with the UK rate expected to rise to 6.5-7% in late spring. Irish inflation is at 5.5%.

The sharp rise in inflation was expected to prove temporary, but there is now an increased level of uncertainty regarding this assumption. What is clear is that the spike in inflation will persist for longer than previously envisaged. There have been marked upwards revisions to 2022 inflation forecasts in nearly all countries. An easing in supply chain disruptions is not expected to begin until around the second half of 2022. Oil prices have also surged again over the winter, while gas prices remain elevated.

The biggest medium-term inflation risk may well be the labour market, if a shortage of workers puts sustained upward pressure on wages. The unemployment rate has fallen to circa 4% in the US and UK and 7% in the Eurozone. The number of job vacancies has risen to very high levels in many economies.

Another headwind for growth will be a less accommodative stance to fiscal policy. The Biden administration is struggling to have further fiscal measures passed by Congress, while fiscal policy is set to be tightened in the UK from this spring as taxes start to rise. Governments Covid supports have also ended in most countries or are in the process of being wound down.

Higher interest rates on the way

Meanwhile, the concerns around tight labour markets and high inflation have seen some of the major central banks signal that significant rate hikes are in store in 2022-23. This will be an additional headwind to growth. The OECD warned in its latest Economic Outlook that inflation may prove persistent and continue to surprise to the upside. This could force central banks to tighten policy to a greater extent than anticipated, endangering the recovery in activity.

Rates are already rising in the UK, but most attention is focused on the US economy and the Fed, with the first of a series of rate hikes on the cards at its next policy meeting in March. The Fed is confident about the underlying strength of the economy, noting that indicators of economic activity have continued to improve and job gains have been solid in recent months.

Indeed, Fed Chair Powell has commented that the US economy is in a stronger position now compared to the last tightening cycle in 2018-19, including a far stronger labour market. At the same time, inflation is running well above its target, and much higher than the last time the Fed started to hike interest rates.

Crucially he advised that these differences are likely to have "important implications for the appropriate pace of policy adjustments". In other words, the pace of rate rises is likely to be faster than during the last tightening cycle. This suggests that the Fed has to play catch up, having greatly underestimated the rise in inflation and how quickly the jobs market would tighten in 2021. More frequent or bigger rate increases may be required than in the last cycle, when rates rose to 2.5%, to bring inflation back down close to target.

By contrast, the ECB continues to emphasise that despite the current surge in prices, it believes that the outlook for inflation over the medium term remains subdued. The core inflation rate in the Eurozone is much lower than elsewhere at circa 2.5%. Hence, the ECB has indicated that it believes conditions for rate hikes in the Eurozone are very unlikely to be in place this year. Markets are not as convinced and expect rates to be raised before the end of the year, with further hikes to come in 2023.

The information in this article is correct as at 10th February 2022

Oliver Mangan

Chief Economist, AIB