# Opening Statement – Oireachtas Committee on Budgetary Oversight

## Lea Hauser, Kieran McQuinn and Conor O'Toole, ESRI

## 06/03/2024

**Introduction**

Let me begin by thanking the Chair for the invitation to the ESRI to appear before the Committee. I am Dr. Kieran McQuinn, and I am joined by my colleagues Dr. Conor O'Toole and Lea Hauser. We are grateful for the opportunity to appear before the Committee today to provide our views on the present economic and fiscal situation and to discuss some key issues and risks which the medium-term fiscal strategy should consider.

**Economic outlook**

The pace of growth across most western economies in the last quarter of 2023 has been moderating. This has implications for the small and open nature of the Irish economy, compounded by the fact that the sectors responsible for the strong growth since the start of and during the pandemic are now experiencing a slowdown in growth rates.

These sectors are largely made up of export-oriented foreign companies that have been affected by the international trade slowdown. The latest data shows a divergence between the sectors dominated by foreign and domestic companies. While the domestic sectors have maintained a moderate pace of growth, certain sectors dominated by foreign companies have declined sharply in their growth rates. Modified investment[1] is slowing down too, primarily being driven by a fall-off in investment activity which, still contains certain activities of multinational firms. A crucial issue for the domestic economy over the next 12 to 18 months is the extent to which investment picks up again following the slowdown caused by the high interest rate environment. Recent research by Egan and McQuinn (2023)[2] highlights the contractionary impact of higher interest rates on residential investment across the Euro Area.

[1] As defined by the Central Statistics Office (CSO).

[2] Egan P. and K. McQuinn (2023) Monetary tightening in the Euro Area: Implications for residential investment, Economic and Social Research Institute (ESRI) working paper 767.

Consumption growth is plateauing with competing factors at play: the ongoing robust labour market performance is being offset by high interest rates, dwindling savings accumulated during the pandemic and ongoing cost of living pressures.

Inflation, although no longer growing sharply, is proving to be more persistent than expected. The gradual decline in energy prices and the subsequent second-round effects can already be observed, but inflation remains elevated. Therefore, estimates of core inflation and food prices should return in the direction of normality in the course of 2024.

Unemployment remained low in 2023 and the slight increase that occurred was partly due to a classification issue reported by the CSO. Although some headline indicators, such as GDP, international trade, and investment hint towards a slowdown in economic activity, employment is still growing in the Irish economy. This underlines the difference between the headline indicators and the actual performance of the domestic economy. Given these combining factors, we believe modified domestic demand (MDD) will grow, but at a modest pace in 2024.

Despite the current economic slowdown, newly published ECB data on household and consumer expectations show that Irish households are more positive in 2023 than in 2022 with regard to key economic indicators such as house price trends, inflation and economic growth expectations. For 2024, most respondents expect house prices to rise, but at a lower rate than what was expected for 2023. The same applies to inflation. Although almost all respondents expect inflation to rise in 2024, the extent is less pronounced.

**Concentration risks, overheating & the housing market**

Looking at the overall macroeconomic picture, the Irish economy has weathered challenges such as Covid-19 and inflation well and we believe that the macroeconomic outlook for 2024 points towards continued, modest growth.

As much of the recent growth in the domestic economy has been due to the performance of key multinational sectors, the influence and dependence on a small number of very large firms is again becoming more evident. In particular, the pharmaceutical and ICT sectors have seen significant growth in both value added and employment in recent years. As mentioned in several commentaries, the exceptional performance of these sectors makes the domestic economy vulnerable to a significant correction or contraction in either sector. Indeed, these dynamics have been evident in 2023 as a contraction in pharmaceutical exports contributed to the predicted decline in GDP. This concentration of risk is even more important in regard to corporation tax receipts as this has an impact on fiscal policy and the domestic economy. Numerous agencies as well as the Department of Finance have indicated a notable component of the corporation tax as windfall in nature suggesting they may not continue at the present level of receipts.

In this regard the announcement to establish the Future Ireland Fund and the Climate and Nature Fund in the recent budget is commendable. The deployment of a notable component of the windfall receipts to capital funding is prudent and ensures they do not feed into current spending. This is particularly important considering that the growth rate of corporate tax revenues has slowed in 2023. These funds are furthermore important as they have a countercyclical effect and represent an instrument that reduces dependence on the economic cycle and key multinational sectors in the future. The funds aim to address serious capital deficits and pressure that are impacting the Irish economy, in particular on the issues of climate change and planning for issues around population aging. It is evident that significant investment is needed in the Irish economy across a broad variety of headings.

Another area where the domestic economy is likely to face continued pressure over the medium-term is in the housing market. Despite reaching a 16-year high with 32,695 completed units in 2023, surpassing the milestone of 30,000 apartments for the first time, housing supply remains insufficient. Estimates by Bergin and Garcia-Rodriguez (2020) indicate that the structural demand for housing in the Irish economy is approximately 35,000 units per annum. It was pointed out that these numbers are underestimating the actual needs for housing regarding the higher immigration numbers than used in the projections. By the end of April 2023 Ireland measured the highest population growth since 2008, which underlines the argument that structural housing demand will be revised upwards. This means that the demand for housing will continue to exceed the supply over the medium-term.

Furthermore, looking at housing construction figures in comparison to other European countries, it becomes clear that Ireland was among the countries with the lowest investment in housing in the EU in 2022, only exceeding Greece, Poland, and Bosnia and Herzegovina. As a result, the rise in house prices and rents is likely to continue, albeit at a slower pace in the case of house prices, considering the data.

**Public finances:**

The developments in taxation revenues in 2023 reflect the overall trend in the Irish economy. While there has been an increase in tax receipts – mainly driven by income tax, VAT, and corporation taxes – the pace of growth in 2023 was somewhat less than the two previous years. Additionally, the State's debt position continues to improve, with debt ratios declining.

While growth is anticipated across several tax headings, the growing vulnerability of the public finances to concentration risks is particularly apparent, as the ICT[3] and pharma-related sectors continue to account for most corporation tax receipts. It is clear that the pressures on the public finances going forward will be significant. Growing demand for investment in both physical and social infrastructure coupled with the challenge of climate change means Government expenditure levels are set to increase on a sustained basis over the medium term.

**Concluding remarks**

The Irish domestic economy continues to grow, albeit at more modest rates than in recent years. At this point, we expect this moderate but sustained growth path is likely to continue in the present year and into 2025. While the internationalised sectors of the economy have provided a buffer to external shocks in recent years, there are growing risks to the concentration of activity in these sectors. In terms of public finances management, the growing needs of the economy in terms of both current and capital spending need to be balanced against the economy operating at close to full employment. Managing this balance is critical in the coming period. We look forward to any comments or questions that you may have.

[3] For reference, see: Conefrey, T., Keenan E., Michael O'Grady M. and D. Staunton (2022). The Role of the ICT Services Sector in the Irish Economy, Signed Article in Quarterly Bulletin: The Central Bank of Ireland, March.