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RECOVERY SCENARIOS FOR IRELAND

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EXECUTIVE SUMMARY

The Irish economy is facing extremely challenging times. It is in the throes of a deep recession, unemployment is rising rapidly and the Irish banking system is facing serious funding difficulties. As a consequence, by the end of 2010 output per head will have fallen back to its 2001 level. Nonetheless, our analysis suggests that the potential growth rate of the economy is around 3 per cent a year. Given the very severe recession that Ireland is currently experiencing, this means that when the world economy eventually recovers the Irish economy can be expected to experience a period of above average growth. On this basis, output per head could be restored to its 2007 level by the middle of the next decade. Consistent with this forecast, our estimates suggest that there will be a permanent loss of output of 10 per cent compared to where the economy might have been. This will represent a very painful permanent "scar" on the economy arising from the current recession.

The dramatic deterioration in the public finances in 2008 and the early months of 2009 exposed the scale of the structural deficit – the deficit in the public finances which would remain even after a world recovery unless fiscal action is taken to close it. This structural deficit largely reflects the legacy of unwise fiscal policies in recent years. The experience of Ireland in the 1980s and of many other countries since then, suggests the importance of taking early action to tackle such a fiscal crisis. The budgets of 2009 and the budget promised for 2010 are together likely to halve the size of the structural deficit to 3 to 4 per cent of GDP. This seems to us to be an appropriate fiscal policy response to the very serious public finance problems. However, it will be very important that there is no slippage in the main parameters of the budget planned for 2010.

Our assessment is that if the world economy recovers significant momentum by 2011, the Irish economy, as long as it regains competitiveness, can be expected to grow quite rapidly in the 2011-2015 period, recovering some of the lost ground of the current recession. Under these circumstances the economy could temporarily grow at an average of over 5 per cent a year to 2015. If this happened, the unemployment rate would be reduced from a peak of around 17 per cent in 2010 to between 6 and 7 per cent by 2015.

If the world recovery were delayed a year to 2012, we estimate that the permanent loss of output and income could be closer to 15 per cent, the turnaround in the unemployment rate would be further delayed and there would be higher emigration. This would also lead to a higher structural budget deficit in which case further tough budgetary action from 2011 onwards would be appropriate.

In addition to action on fiscal policy, the authorities have taken steps to help stabilise the banking sector. Our analysis suggests that the long-term cost to the State of the necessary additional action to deal with the problem may be small relative to the debts accruing as a result of borrowing to fund the normal activities of the government. However, even if the funding needs of the banking system are eventually largely repaid, the full resolution of this problem will take some considerable time. In the interim the very substantial overhang of debt needed to fund a solution to the banking problems will add to uncertainty and to the risks facing the economy.

The uncertainty arising from the crisis in the financial system would argue for continuing action to tackle the structural deficit over the period 2011-15. The objective should be to eliminate the structural deficit by 2015. While this will require the maintenance of a tight fiscal policy over the period, it will be a much less severe policy stance than we are currently experiencing. It would also be less severe than the prospective budgetary policy envisaged as being necessary by the Department of Finance for the period 2011-13 in its *Macro-Economic and Fiscal Framework: 2009-13*.

The analysis in this paper highlights the importance of improving the competitiveness of the Irish economy – this is essential if the economy is to return to full employment within a reasonable time scale. We envisage a major reduction in the level of costs, including labour costs, relative to the Euro Area over the period 2009-11. In this context, it is important that public policy should do all that it can to speed this essential adjustment. A revised partnership agreement which recognised the importance of reducing costs, broadly defined, would help in this regard.

The Irish economy faces a period of very high unemployment. It will be very important that public policy learns from past research in Ireland and elsewhere on how best to prevent the unemployed of today becoming the long-term unemployed of tomorrow. This problem will be particularly acute for those losing their jobs who have relatively low levels of education and skills. This suggests that priority needs to be given to labour market initiatives that will effectively tackle this skills deficit among many of the unemployed. In preparing for a recovery, the economy would also benefit from increased policy attention to measures to enhance productivity and innovation in the tradable sector of the economy.