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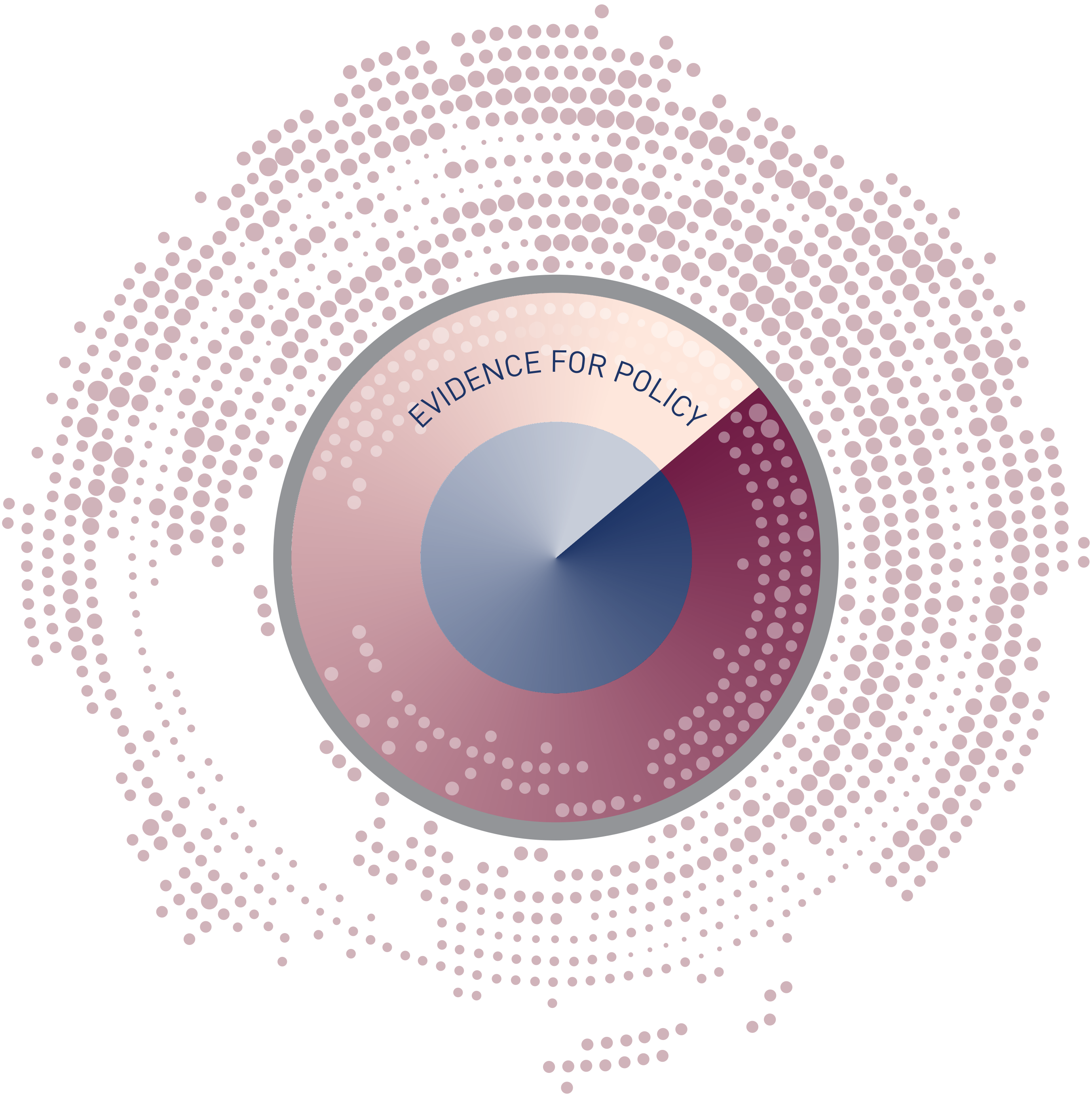
AUTUMN 2021

KIERAN MCQUINN, CONOR O'TOOLE, CATHAL COFFEY AND WENDY DISCH



ESRI ECONOMIC & SOCIAL RESEARCH INSTITUTE

QUARTERLY ECONOMIC COMMENTARY

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THE AUTHORS

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The Quarterly Economic Commentary has been accepted for publication by the Institute, which does not itself take institutional policy positions. It has been peer reviewed by ESRI research colleagues prior to publication. The authors are solely responsible for the content and the views expressed.

TABLE OF CONTENTS

SUMMARY TABLE

	2020	2021	2022
Output (Real Annual Growth %)			
Private Consumer Expenditure	-10.4	7.5	8.0
Public Net Current Expenditure	10.9	4.1	3.0
Investment	-23.0	-45.0	8.3
Exports	9.5	14.3	9.0
Imports	-7.4	-7.9	10.0
Gross Domestic Product (GDP)	5.9	12.6	7.1
Gross National Product (GNP)	3.4	10.5	6.1
Domestic Demand (excl. Stocks)	-15.3	-20.0	7.2
Of which: Modified Domestic Demand	*-4.2*	*7.1*	-
Labour Market			
Employment Levels ('000)	1,976	2,039	2,307
Unemployment Levels ('000)	455	395	176
Unemployment Rate (as % of Labour Force)	19.4	16.3	7.1
Public Finances			
General Government Balance (€bn)	-18.4	-14.7	-8.0
General Government Balance (% of GDP)	-4.9	-3.4	-1.7
Inflation (Annual Growth %)			
Inflation (CPI)	-0.3	2.3	2.5

Note: The employment level for 2020 is based on the COVID-adjusted level of employment at the end of each quarter published by the CSO along with the quarterly LFS. As a result, it represents a lower bound estimate for employment in 2020. The unemployment rate and level are based on the monthly unemployment and the COVID-adjusted monthly unemployment series published by the CSO.
Modified Domestic Demand refers to Modified Total Domestic Demand, which excludes large transactions of foreign corporations that do not have a large impact on the domestic economy. Definition available here: Total Domestic Demand and Modified Total Domestic Demand - CSO - Central Statistics Office.
Inflation is measured by the annual percentage change in CPI.

The Irish Economy – Overview

- The recent National Accounts confirm that the Irish economy in general has performed in a particularly robust manner in the present year despite the ongoing effects of the COVID-19 pandemic. It is clear that both domestic and foreign sources of growth have contributed to a strong performance in 2021.

- The continuing roll-out of vaccines along with the stated intention of the Government to relax all public health measures by October 22 means that the economy is on course for a return to near normal activity by the end of the year.

- Consequently, we believe the economy is set to register growth of 12.6 per cent in the present year. Unemployment is now set to fall to 9 per cent by the end of the year. Modified total domestic demand, which is a more accurate barometer of underlying economic activity, is set to grow by over 7 per cent. Furthermore, we believe the economy will continue to grow strongly in 2022 with GDP set to increase by 7 per cent.

- This robust performance will ease somewhat the pressure on the public finances. While the Government is still expected to run a deficit in the General Government Balance in 2021, the indications are that it is likely to be smaller than was previously thought. The significant reduction in unemployment will help to restore the public finances to a more sustainable long-term path as the economy slowly emerges from the pandemic.

- It is clear, however, that over the medium term the Government will have to face mounting fiscal challenges related to meeting climate change and housing targets as well as reforming the health sector. Prudent management of the public finances will be required to keep current expenditure growth in check while allowing for investment in critical areas.

- Inflationary pressures in the economy are beginning to pick up. While some of these effects are transitory (coming from so called base effects), global factors such as higher energy prices are also playing a role. Further inflationary risks, in particular in domestically non-traded goods and services, could materialise if the domestic economy recovers particularly rapidly.

The Domestic Economy

Output

Key Points

- *Irish economy set to grow significantly in 2021.*
- *Headline GDP is set to increase by 12.6 per cent while modified total domestic demand is forecast to increase by 7.2 per cent.*
- *Growth is broad-based with both domestic and foreign sources contributing positively.*
- *The economy is set to continue to grow strongly into 2022.*

By October 22 most of the public health measures put in place to deal with the COVID-19 pandemic are set to be lifted, with personal responsibility replacing official public health measures as the primary manner of dealing with the pandemic. This is in line with the gradual easing of public health measures which has been occurring since Q2 2021 and will greatly facilitate the economy returning to near normal activity over the coming months.

In this *Commentary* we assume that there is no further tightening of public health measures after October of this year. We also assume that the continued successful vaccination policy will enable the economy to return to normal by the end of this year.

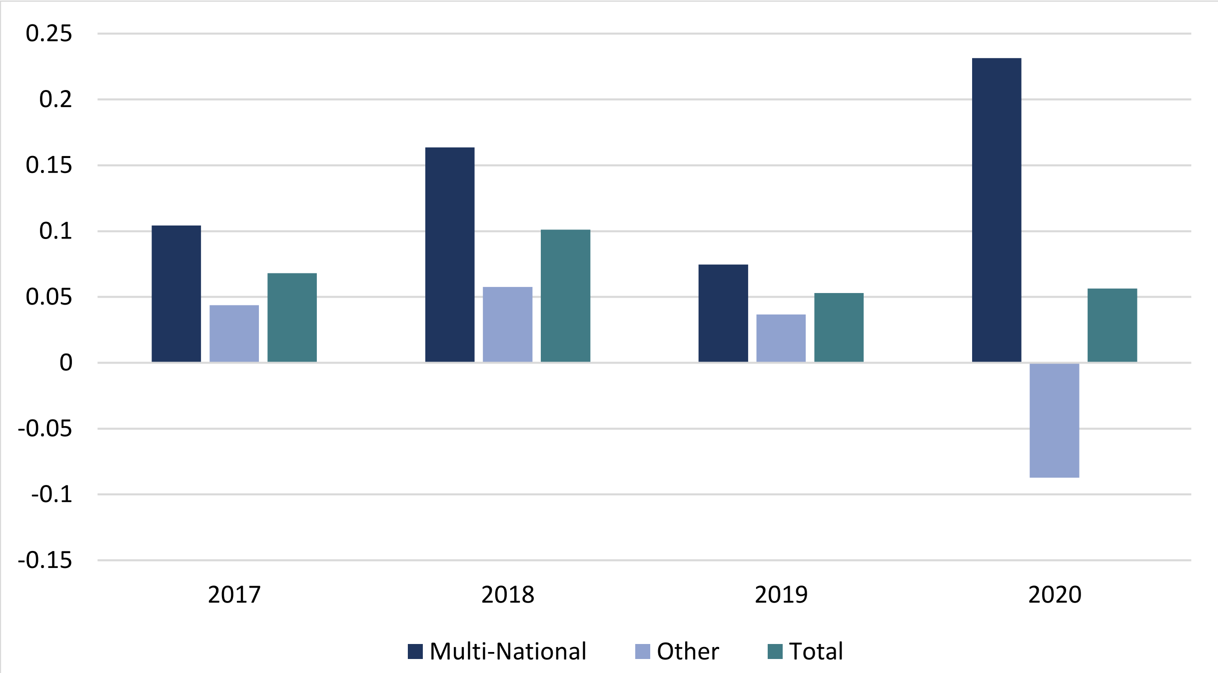
The contrast between the export sector and domestic sources of growth in 2020 has been noted in the *Commentary* (see O'Toole, 2020).[1] However, more evidence of the divergent nature of the economy's performance during the pandemic is evident from a comparison of foreign-owned multinationals and other enterprises for 2020. Figure 1 plots the increase in gross value added (GVA) for sectors where foreign-owned multinational enterprises are dominant and for the other sectors of the economy.

The substantial contribution of the foreign owned sector is obvious as the 'Other' sector registered a decline of nearly 9 per cent in gross value added in 2020; however this was more than compensated for by the sizeable increase in GVA for the foreign owned sector of 23 per cent. Within the multinational sector,

1 O' Toole C. (2020). 'The lockdown tale of two economies in Ireland: How big tech and pharma bucked the trend', Special Article, *Quarterly Economic Commentary*, Autumn.

Publishing, audio-visual and broadcasting observed growth of almost 21 per cent, Computer programming and information services increased by nearly 9 per cent, while Chemicals and chemical products grew by 24 per cent.

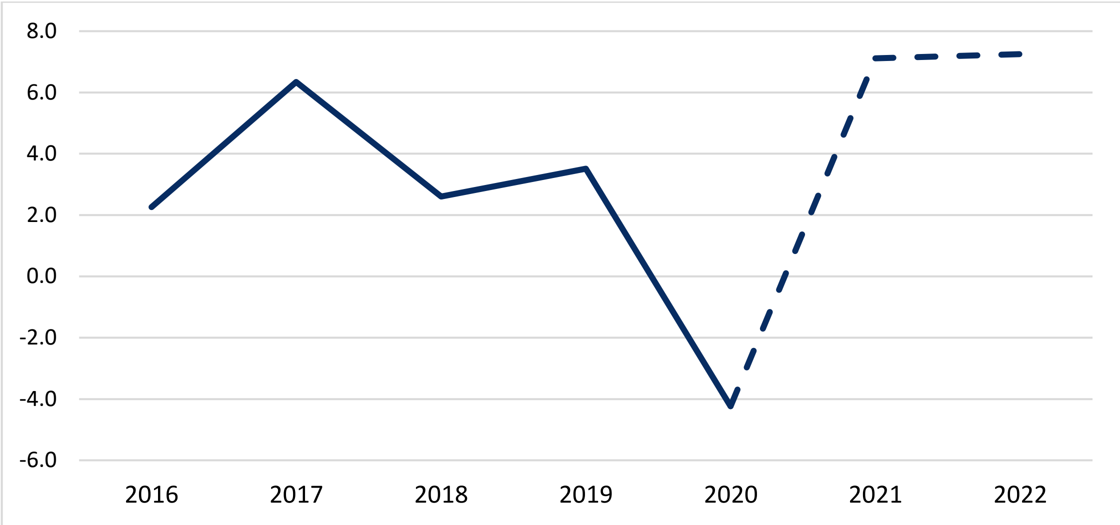
FIGURE 1 GROWTH RATE IN GROSS VALUE ADDED (GVA) OF MULTINATIONAL DOMINATED SECTORS, OTHER SECTORS AND TOTAL (%)



Source: *QEC* calculations and Central Statistics Office.

The expected performance of the economy in 2021 differs in that it is set to draw from both domestic and foreign sources of growth. As public health measures have eased through the year both consumption and underlying investment have experienced strong recoveries. Figure 2 presents our forecast of modified total domestic demand for 2021 and 2022 along with the actual changes in the series since 2016. The modified series excludes data on aircraft leasing, R&D service imports and trade in intellectual property (IP).

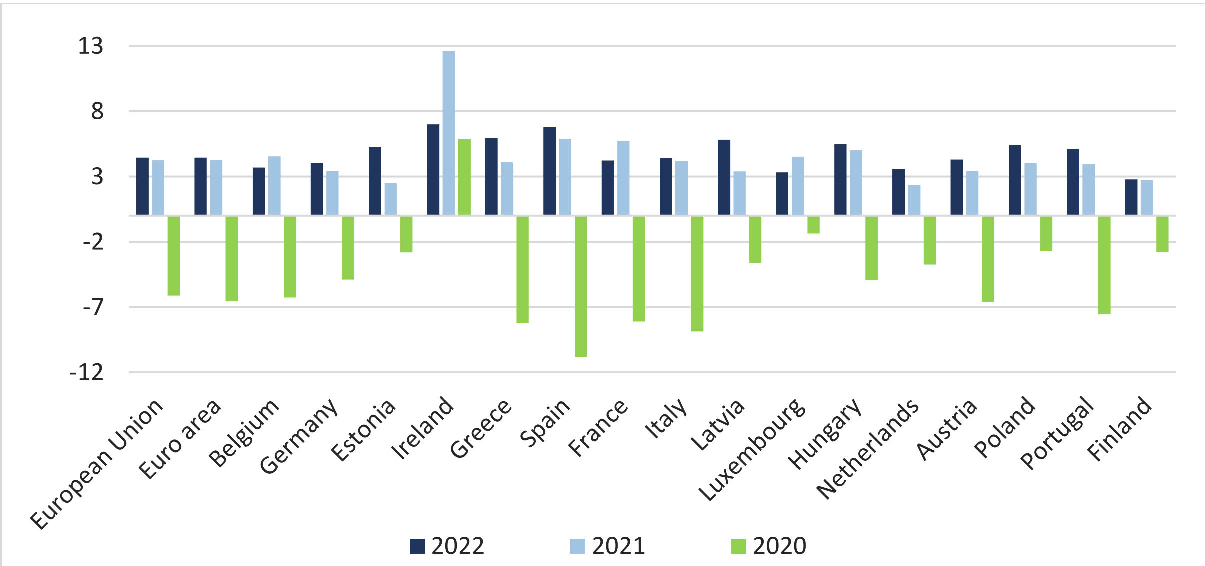
FIGURE 2 ACTUAL AND FORECAST (2021 AND 2022) RATES OF MODIFIED TOTAL DOMESTIC DEMAND (%)



Source: *QEC* calculations and Central Statistics Office.

The performance of the Irish economy vis-à-vis other European countries can be assessed from Figure 3 which compares the actual growth performance of a select set of European countries in 2020 and the EU Commission forecast for the same countries in 2021 and 2022. The Irish economy is an outlier in that it alone amongst all European countries witnessed positive growth in 2020 and it is also expected to experience one of the most robust recoveries in both 2021 and 2022. It is also worth noting that our forecast for modified total domestic demand in 2021 at 7.2 per cent is still somewhat greater than the growth rates envisaged for European countries in that year.

FIGURE 3 ACTUAL GDP GROWTH FOR 2020 AND EU FORECAST FOR 2021 AND 2022 (%)



Source: *QEC* calculations and EU Commission.

DEMAND

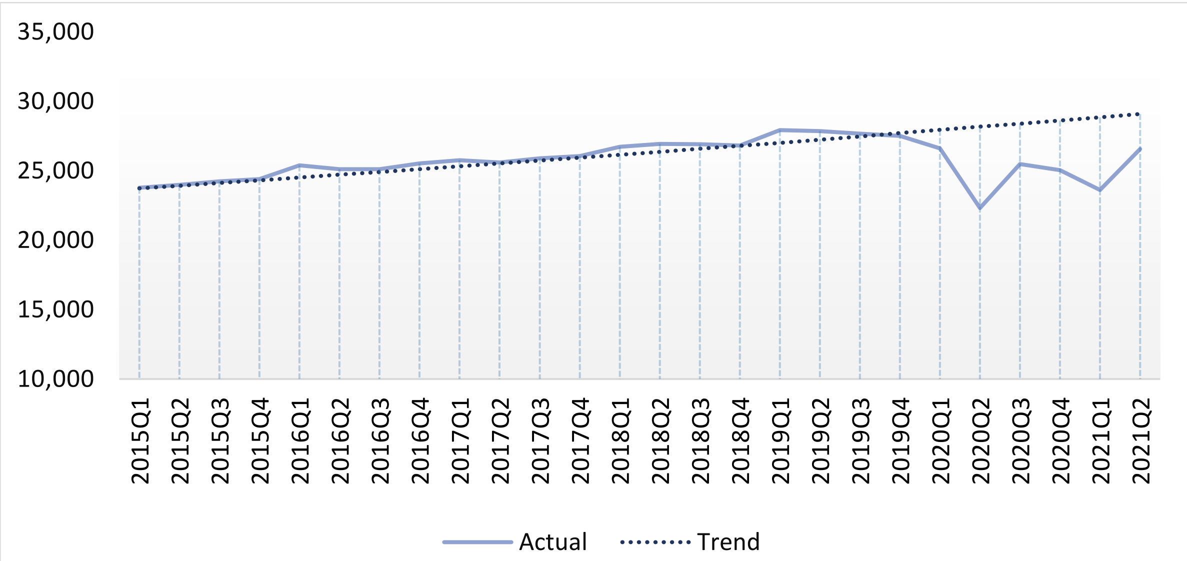
Key Points

- *The high savings ratio in Ireland alongside the sustained economic reopening are likely to lead to a rebound in consumption in 2021 and 2022.*
- *Consumption increased rapidly in Q2 2021 as the economy reopened and public health measures were eased.*
- *Expenditure patterns appear to be normalising with more spending allocated to accommodation, transport and restaurants.*

Household sector consumption

The second quarter of 2021 has seen a strong rebound in consumption expenditure in Ireland as households engaged with sectors of the economy that have reopened. As the economy and society were gradually reopened over the period April to June, a marked increase in the level of consumption was recorded. Figure 4 presents the quarterly level of consumption expenditure (in constant price € millions) for the period 2015-2021. The impact of the pandemic is evident with drops in consumption associated with periods of increased incidence of the disease and tightening of public health restrictions. To provide an indication of the impact of the pandemic on the overall level of household spending, a linear trend is included in Figure 4 which extrapolates the Q4 2019 level of consumption using the average quarter-on-quarter growth rate over the period 2015-2019 (approximately 0.8 per cent).

FIGURE 4 QUARTERLY PERSONAL CONSUMPTION ON GOODS AND SERVICES – CONSTANT MARKET PRICES AND SEASONALLY ADJUSTED – LEVELS

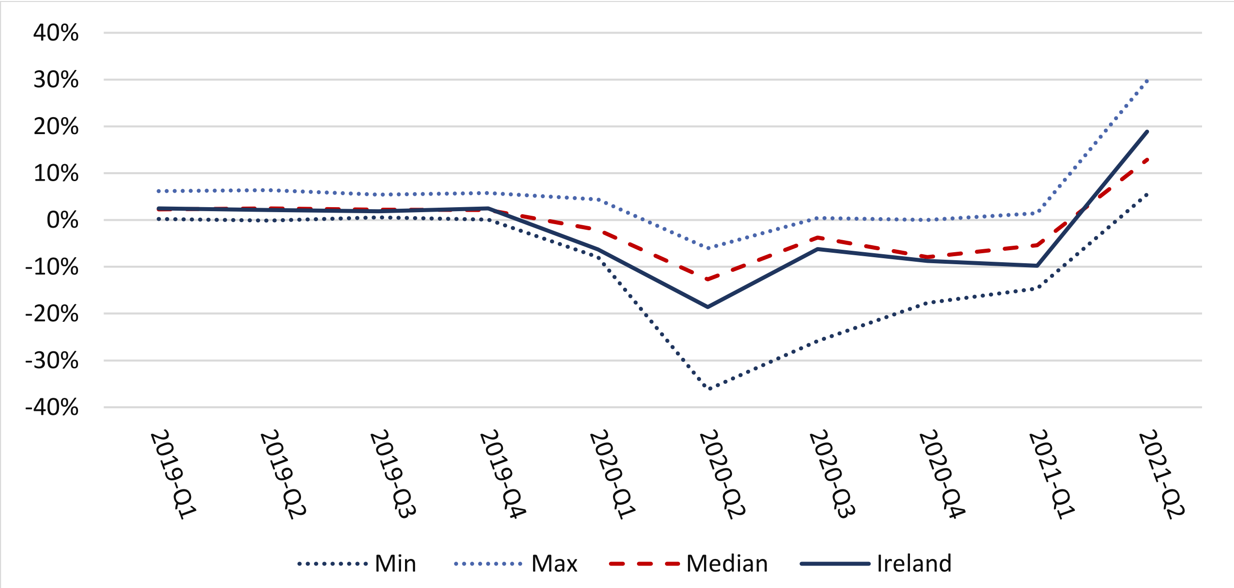


Source: Central Statistics Office and Authors' calculations.

It is clear that despite the robust recovery in Q2 2021, the level of household expenditure remains below what may have been expected to occur had the economy continued to grow in line with pre-COVID-19 trends.

The annual change in consumption in Ireland is presented in Figure 5 in a comparative European context. In general, through 2020, the drop in consumption was larger in Ireland than the median of other European countries, which likely reflects the variation in the stringency of public measures required to manage the pandemic. The recovery in Q2 2021, which equated to a 19 per cent year-on-year expansion in consumption, was larger in Ireland than the median of other European countries. However, this recovery stems from a lower base as the decline during the first onset of the pandemic in Q2 2020 was comparatively larger than the typical decline in other countries.

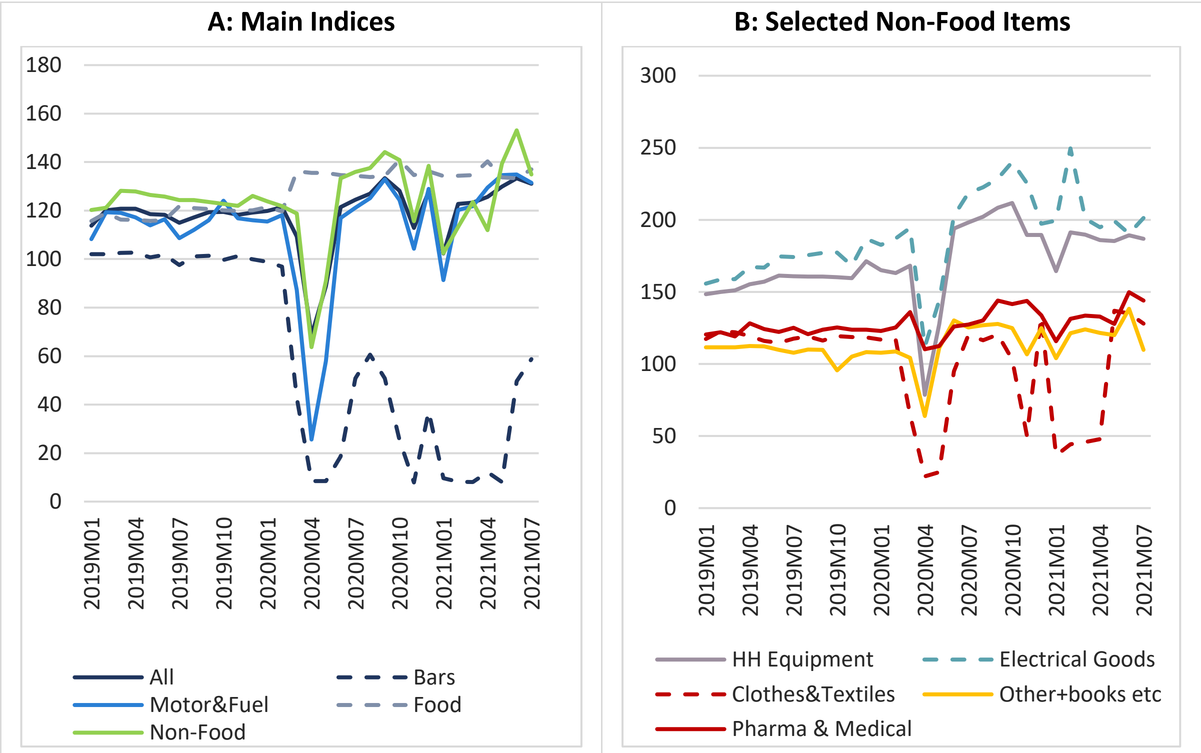
FIGURE 5 QUARTERLY PERSONAL CONSUMPTION ON GOODS AND SERVICES – GROWTH RATES – YEAR-ON-YEAR EUROPEAN COMPARISON



Source: Authors' calculations using Eurostat data.

The recovery in the second quarter of 2021 is apparent in the monthly retail sales data (Figure 6) with sustained increases in non-food retail sales activities throughout May and June. Focusing on the sub-indices in panel B of Figure 6, the increase in expenditure on items like clothing, textiles and footwear was particularly strong as retail outlets reopened following the easing of strict public health regulations in operation for the first three months of 2021. A strong increase in expenditure in bars is evident from June and July 2021 as the continued easing of restrictions on hospitality and accommodation services allowed businesses to reopen. A feature of the public health restrictions (Coffey et al., 2020)[2] is a likely deferral of expenditure while the potential consumption choices of households are constrained (i.e. spending is restricted on certain items given public health regulations). In the retail sales data (Figure 6), the drop of expenditure (month-on-month) between June and July (as seen in the overall non-food index in panel A) is likely to reflect the fact that many households may have undertaken deferred expenditure immediately after retail outlets were reopened. This would lead to a temporary uptick in expenditure, followed by a drop which is observed. This does not represent a slowing of the general recovery in household expenditure, rather just a timing issue relating to deferred expenditures.

FIGURE 6 RETAIL SALES INDEX – MAIN ITEMS



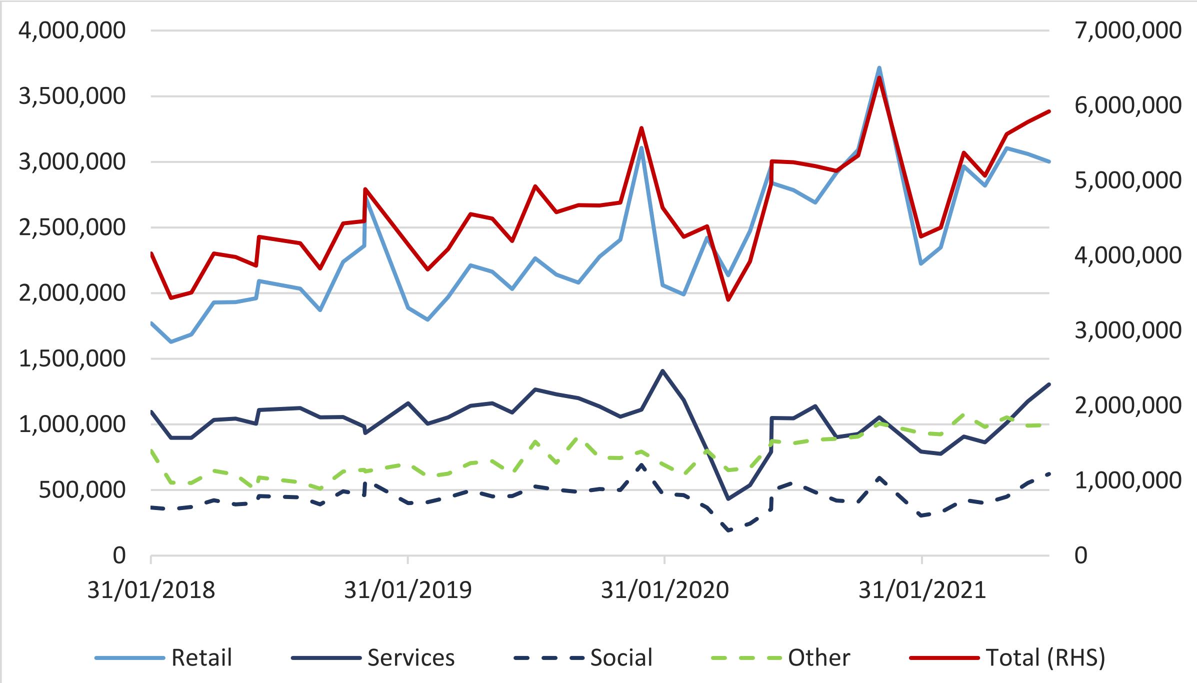
Source: Central Statistics Office, Base 2015=100.

The sustained increase in expenditure can also be seen in the Central Bank of Ireland credit and debit card statistics, as shown in Figure 7. While these data are in nominal values and not seasonally adjusted, a broader group of expenditure categories are available and comparable to the retail sales data, which provide additional insight. The change in the total expenditure on credit and debit cards has continued to grow throughout 2021 from the January low point. The month-on-month decline in retail expenditure is also evident in these data. However, other expenditure categories such as services expenditure (which includes

2 Coffey, C., K. Doorley, B. Roantree and C. O'Toole (2020). *The effect of the Covid-19 pandemic on consumption and indirect taxes in Ireland*, No BP2021/3, Papers, Economic and Social Research Institute (ESRI).

transport and accommodation) and social expenditure (dining, restaurants and entertainment) showed continued increases through April to July in line with the reopening of the economy. Expenditure on restaurants and dining has also increased in the most recent quarter. It is likely that households will continue to increase their expenditure on items previously unavailable due to the public health regulations as the economy and society continue to reopen.

FIGURE 7 TOTAL EXPENDITURE FROM PERSONAL CREDIT CARD + DEBIT CARD DATA (NOMINAL, €'000 BOTH AXES)

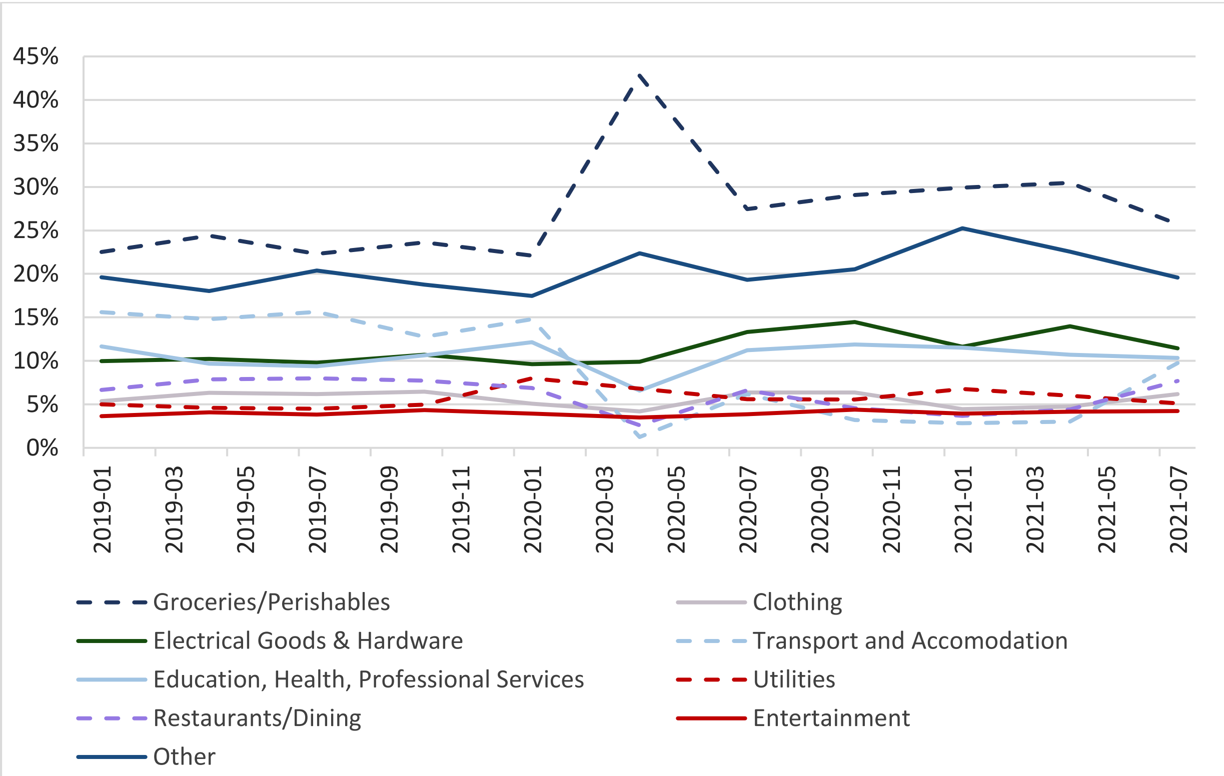


Source: Central Bank of Ireland.

One important aspect for understanding the nature of the recovery in household expenditure is the degree to which spending patterns have changed through the pandemic. If the basket of goods and services has shifted over time as a consequence of public health restrictions and other pandemic related effects, this may affect the targeting of demand and purchases (for example a greater share of spending allocated to consumption has been delayed, abandoned etc) as the economy returns to normal purchasing patterns. We examine this using data on the share of expenditures below.

Figure 8 presents data from the Central Bank of Ireland credit and debit card series. The data are the share of total expenditure by type of expenditure. The impact of the pandemic is very clear with a marked increase in the share of groceries/ perishables during the first lockdown period; as other types of goods and services were foregone, the share of these items increased. Transport and accommodation expenditure fell dramatically from approximately 15 per cent before the pandemic to 1 per cent. Towards the end of the period, expenditure on these items has recovered to 10 per cent of the total but it remains below the pre-pandemic levels by approximately one-third. The declining share of groceries, other expenditure and utilities highlights the continued normalisation of expenditure as the economy reopens. It is clear expenditure is returning in those categories which had declined due to the public health regulations. It is likely this will continue as public health regulations are unwound.

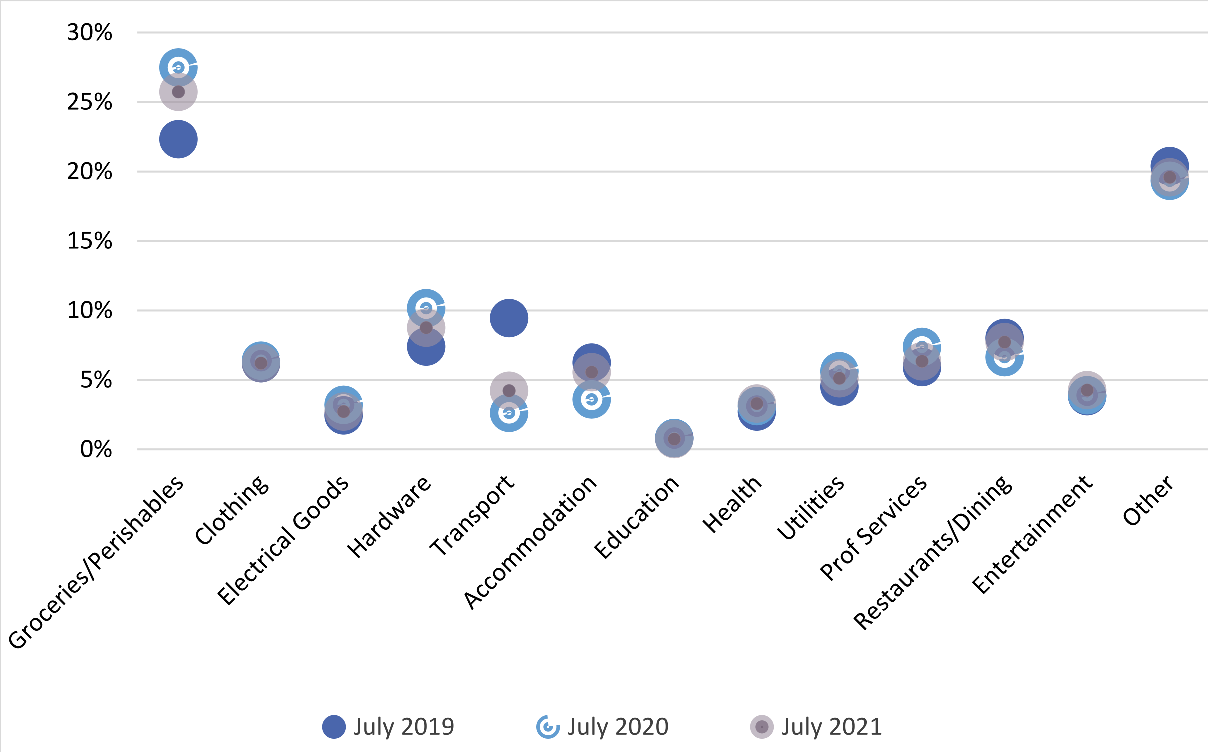
FIGURE 8 EXPENDITURE SHARES – CREDIT CARD (PERSONAL) + DEBIT CARD DATA



Source: Central Bank of Ireland.

To gain a more granular insight into the recovery trends, Figure 9 presents the share of expenditure by category in July 2019, 2020 and 2021. Expenditure remains well below pre-pandemic levels of transport, accommodation and other expenditure, while many of the other items have recovered.

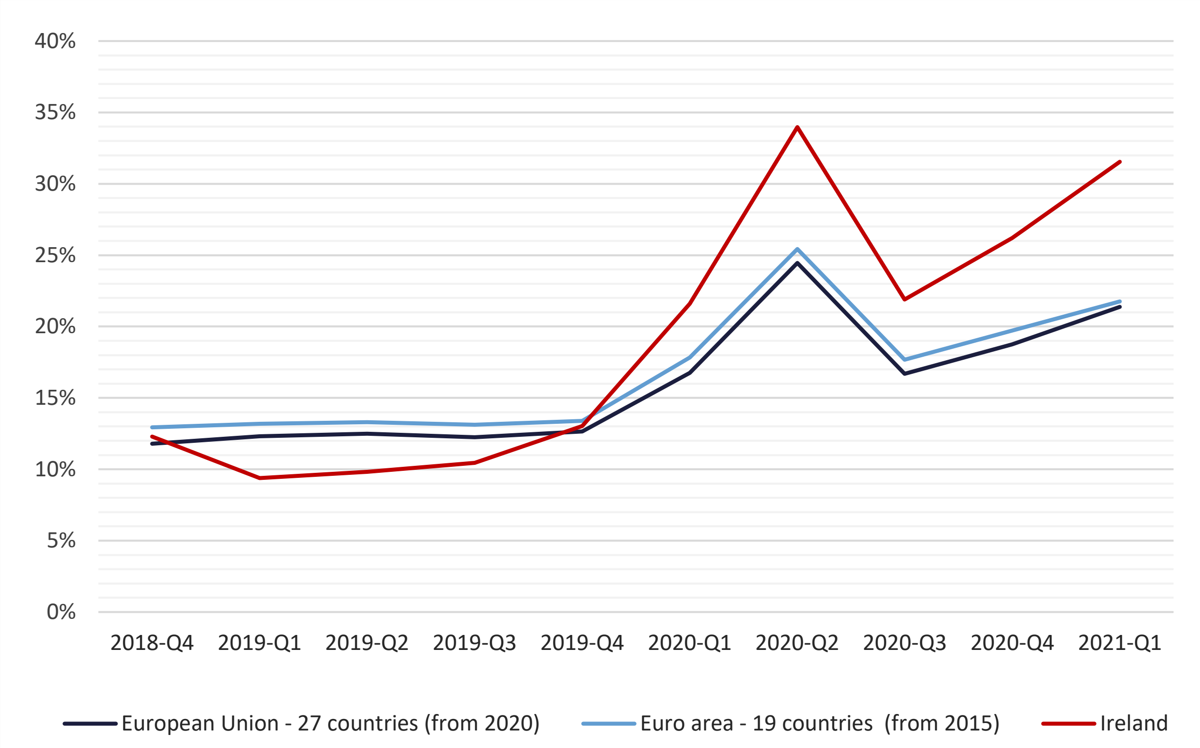
FIGURE 9 SHARE OF EXPENDITURE FROM CREDIT CARD (PERSONAL) + DEBIT CARD DATA



Source: Central Bank of Ireland.

While it is clear the domestic economy sustained a considerable economic shock through 2020 and into the first quarter of 2021, a notable feature of the pandemic in Ireland has been a marked increase in the savings ratio (the share of disposable income diverted into savings). Figure 10 presents the savings ratio for Ireland, the Euro Area and the European Union as a whole. It is clear the savings ratio in Ireland increased dramatically and remains well above the pre-pandemic level. This suggests that there is a large tranche of resources available to households to spend as the economy reopens.

FIGURE 10 SAVINGS RATIO – IRELAND AND EUROPEAN ECONOMIES – GROWTH RATES

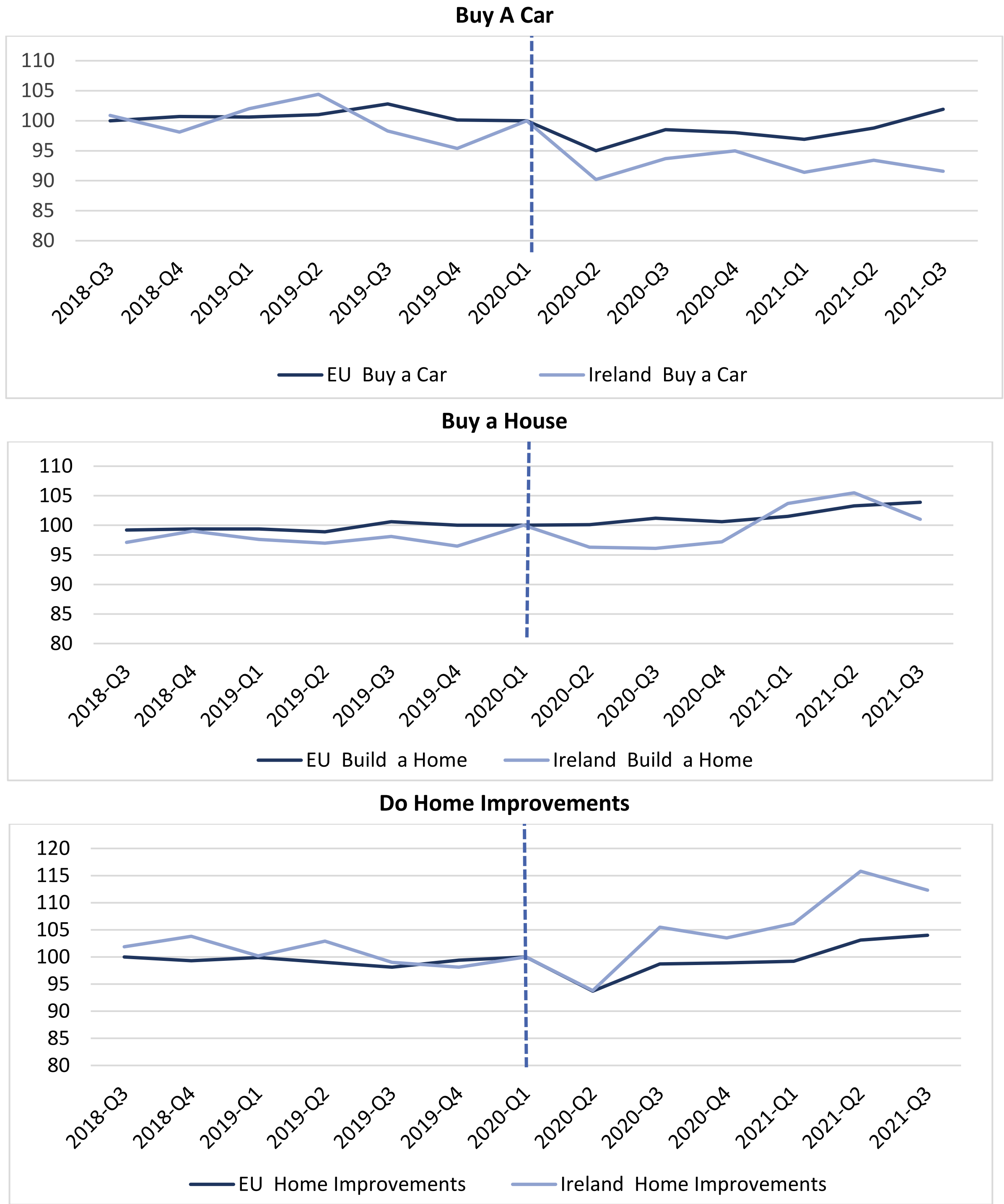


Source: Central Statistics Office.

How households use this expenditure is going to define the nature and composition of the economic rebound. For households with excess savings, the following choices are available: a) continue saving; b) increase expenditure on non-durable goods and services (such as holidays and recreation); c) purchase durables (such as cars); d) invest these funds for example into financial assets or housing (either through improvements or new purchases); or e) repay debt.

To gain some insight into the preferences of Irish households in this regard, we can draw on the European Commission Consumer Sentiment Survey which provides information on expectations of the propensity to make large purchases on a) cars and other motor vehicles; b) house purchase; and c) home improvements. The figures in index form (Q1 2021 = 100) are presented for Ireland and the EU for each item. It appears that Irish households are more likely to channel funds into house purchase and home improvements relative to car purchases since the onset of the pandemic. This is a likely usage for a portion of the built-up savings.

FIGURE 11 EXPENDITURE EXPECTATIONS (INDEX = 100, Q1 2020)

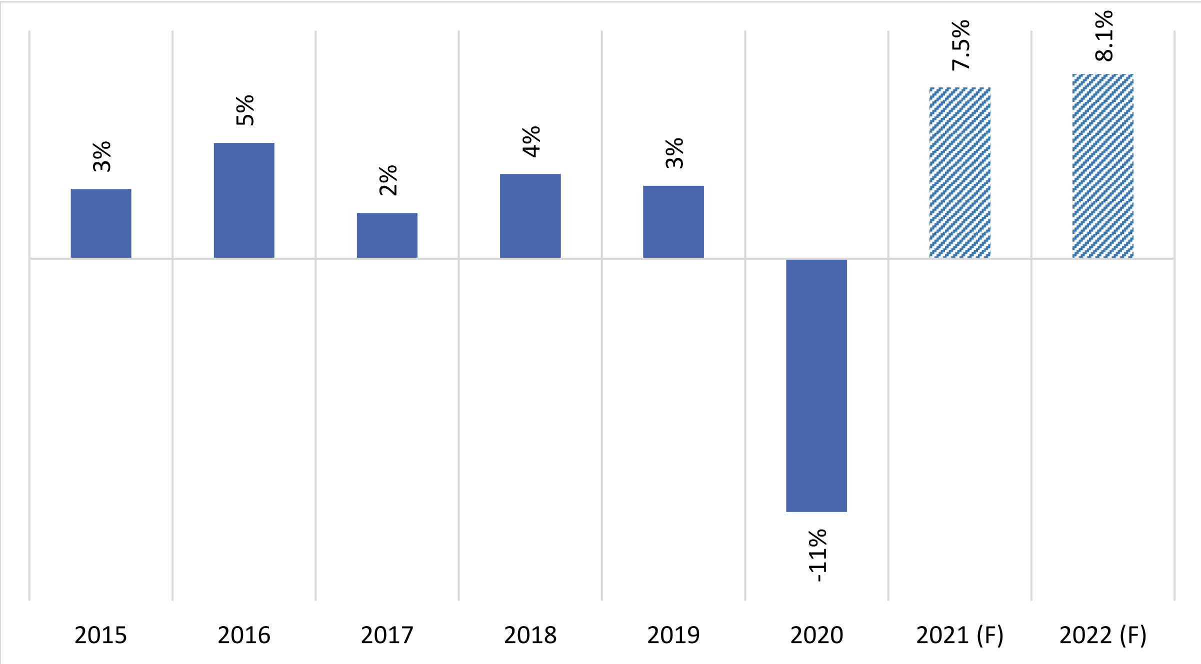


Source: Authors' calculations using European Commission index of positive, negative balances.

Consumption forecasts

Given the context outlined above, we expect a strong recovery in consumption for 2021 and into 2022. Two factors are particularly important. First, the continued improvement in the labour market and the more sustained reopening of the economy are allowing households to increase their expenditure on previously constrained goods and services. Second, the high savings ratios are likely to decline, even if they remain above pre-pandemic levels. This will allow a continued increase in expenditure across all goods and services. Indeed, in our baseline forecast we assume that the savings ratio does not fall to its pre-pandemic rate, which suggests that no unwinding of the excess savings accumulated during the pandemic is likely to occur by 2022.[3]

FIGURE 12 CONSUMPTION FORECASTS



Source: Central Statistics Office (to 2020); authors' forecasts.

3 In this context, an unwinding of savings balance would require households to dissave i.e. have a negative savings position (spending > income). We assume that the savings balance remains positive (income > spending) but that the ratio (income – spending)/income falls somewhat.

TRADED SECTOR

Key Points

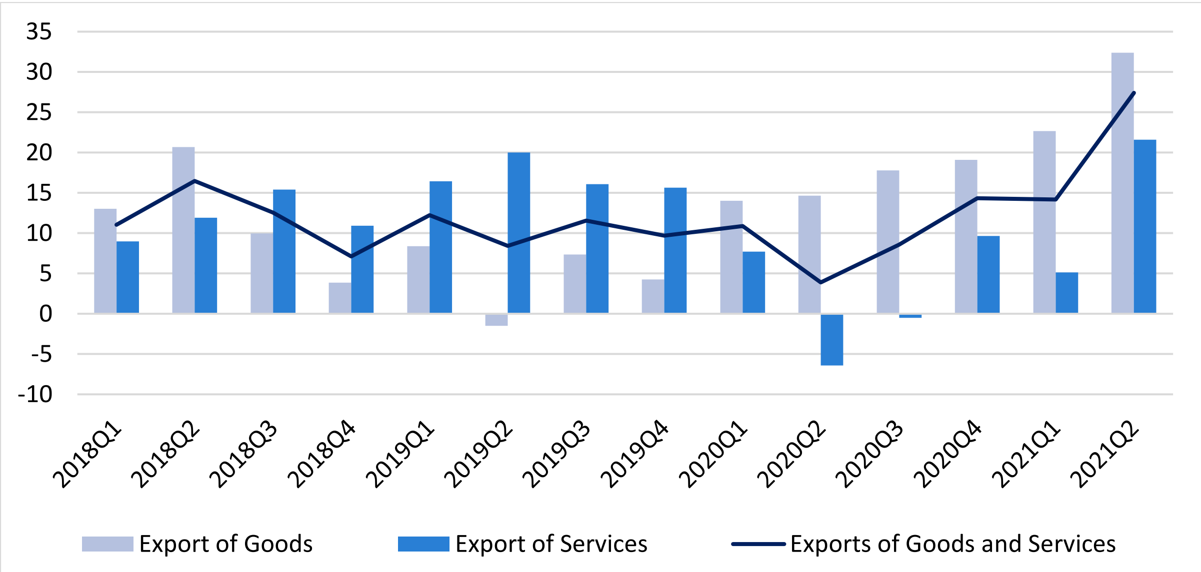
- *Exports grew by 6.4 per cent in Q2 2021 compared to Q1 2021 on a seasonally adjusted basis.*
- *Service exports grew by 7.5 per cent in the period.*
- *Compared to Q1 2021, imports grew by 5.4 per cent in Q2 2021.*
- *Irish trade with the UK continues to benefit from asymmetries in Customs checks.*
- *Irish net exports were €55.4 billion in Q2 2021.*

Import and export activity

The strong performance of the Irish traded sector has continued into Q2 2021, as seasonally-adjusted exports increased 6.4 per cent relative to Q1. Meanwhile, seasonally-adjusted imports grew by 5.4 per cent in the same period. These changes led to an 8.2 per cent growth in net exports from Q1 2021, resulting in total net exports of €55.4 billion. Compared to Q2 2020, exports were up 27.4 per cent in the second quarter of this year.

Figure 13 shows the annual growth in Irish exports by quarter. In Q2 2021, goods and services exports increased 32.4 and 21.6 per cent per annum respectively.

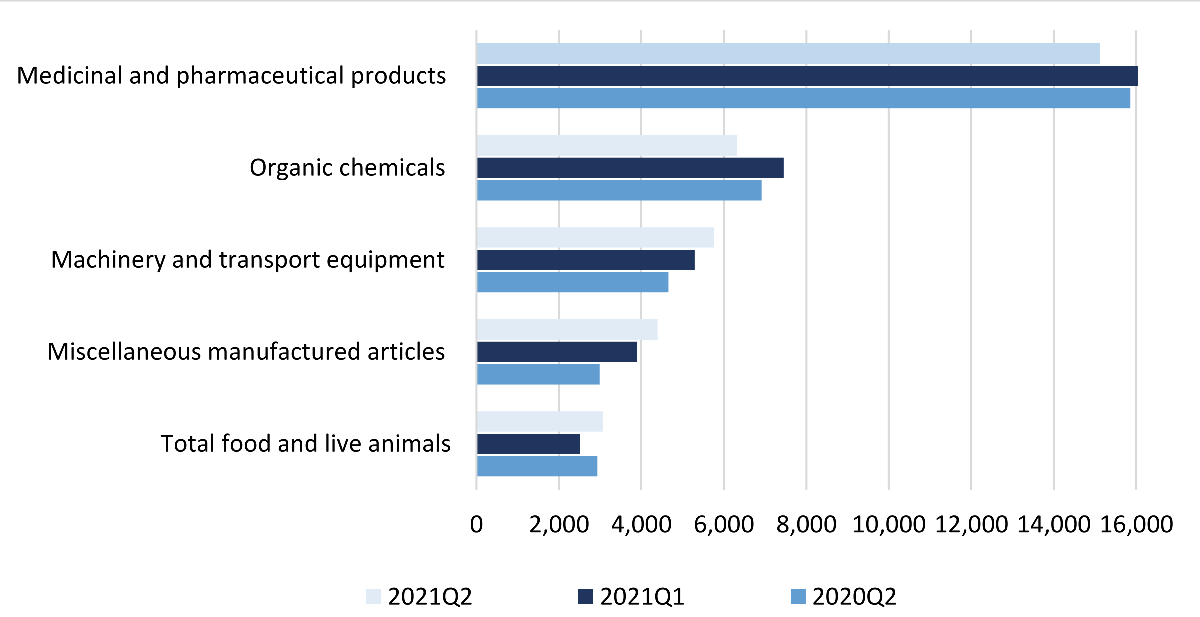
FIGURE 13 SEASONALLY-ADJUSTED EXPORTS: YEAR-ON-YEAR GROWTH (VOLUME, %)



Source: Central Statistics Office, Quarterly National Accounts.

Medical and pharmaceutical products accounted for just under 40 per cent of Irish goods exports in Q2 2021 in terms of value. Nevertheless, a decline of 6.2 per cent in these exports occurred in Q2 2021 compared to Q1 2021. Figure 14 shows that while medicinal products and organic chemicals declined compared to Q1 2021, exports in other groups have been on the rise. Growth across a variety of export groups is encouraging as it signals that the recovery is not isolated to a small number of multinational corporations in one or two sectors, but rather is being experienced by enterprises across the economy. For example, the value of Food and live animal exports increased by 22.9 per cent compared to Q1 2021 and by 4.8 per cent annually. Machinery and transport equipment exports grew by 8.9 per cent from Q1 2021 and by 23.7 per cent from Q2 2020.

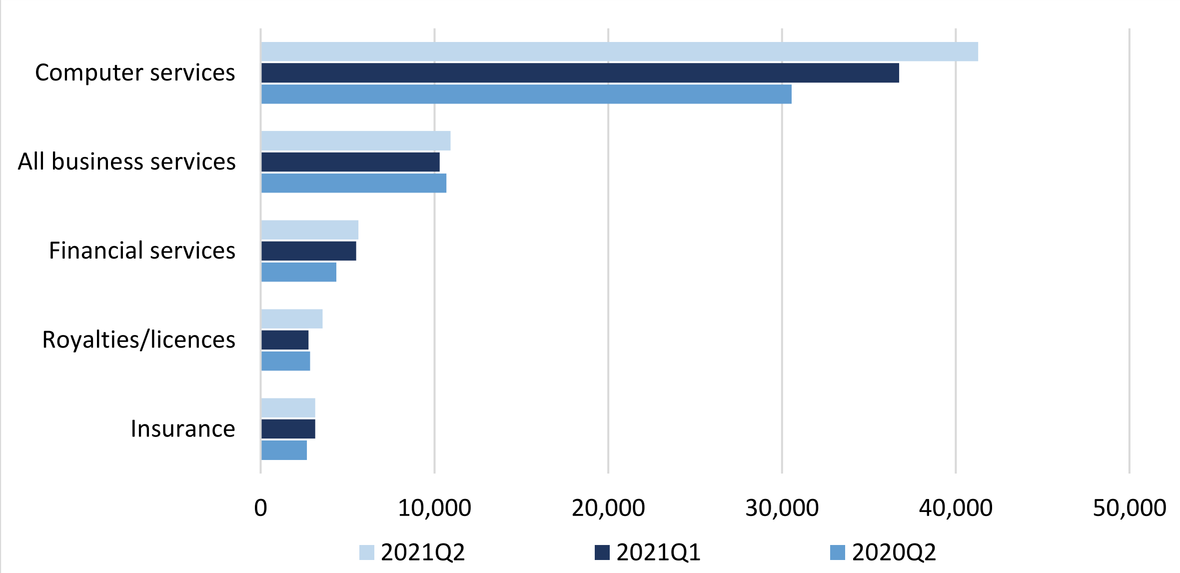
FIGURE 14 GOODS EXPORTS BY COMMODITY GROUP (VALUE, € MILLION)



Source: Central Statistics Office, Value of Merchandise Trade.

Service exports increased significantly in the second quarter of 2021. Computer services, which accounted for 60 per cent of the value of total service exports in Q2 2021, grew by 35.1 per cent in the year to Q2 2021 and by 12.4 per cent compared to Q1 2021. As shown in Figure 15, the prominent components of service exports increased from Q1 2021 as well as from Q2 2020, apart from insurance which remained unchanged between Q1 and Q2 2021.

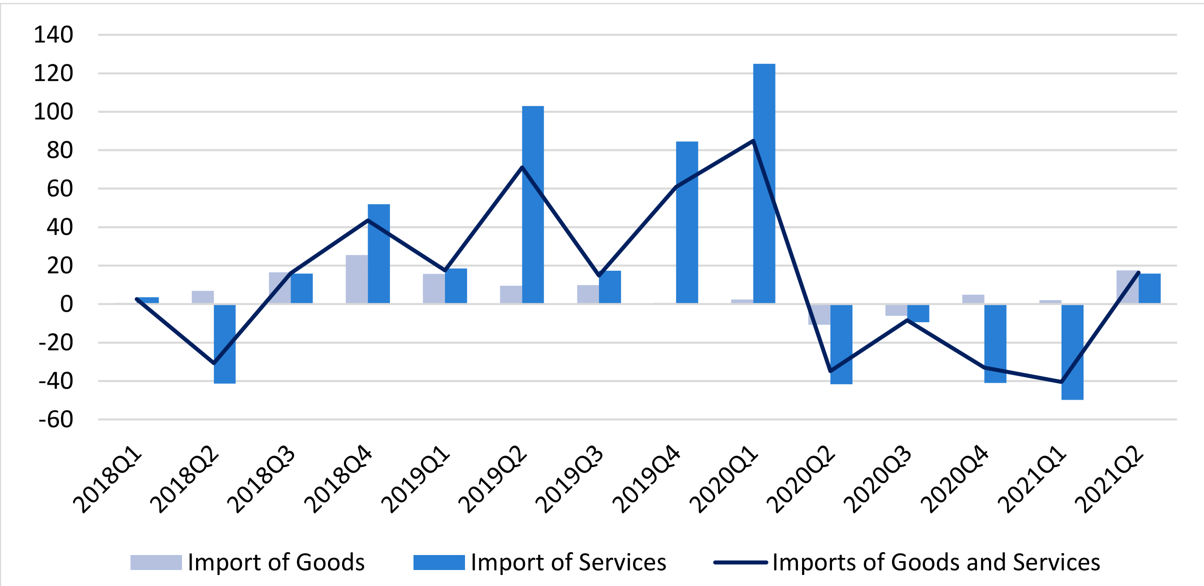
FIGURE 15 SERVICE EXPORTS BY COMPONENT (VALUE, € MILLION)



Source: Central Statistics Office, Current Account: Merchandise and Services.

Figure 16 shows that Q2 2021 registered positive annual import growth for the first time in five quarters. Compared to Q2 2020, imports grew 16.4 per cent, with goods and services increasing 17.5 and 15.9 per cent respectively. While the substantial losses that occurred in Q2 2020 are contributing to the high year-on-year growth seen in Q2 2021, the overall performance of imports in Q2 2021 is indicative of the return to normal economic activity in Ireland as restrictions ease, consumption rebounds, and businesses adjust to new trade rules imposed by Brexit.

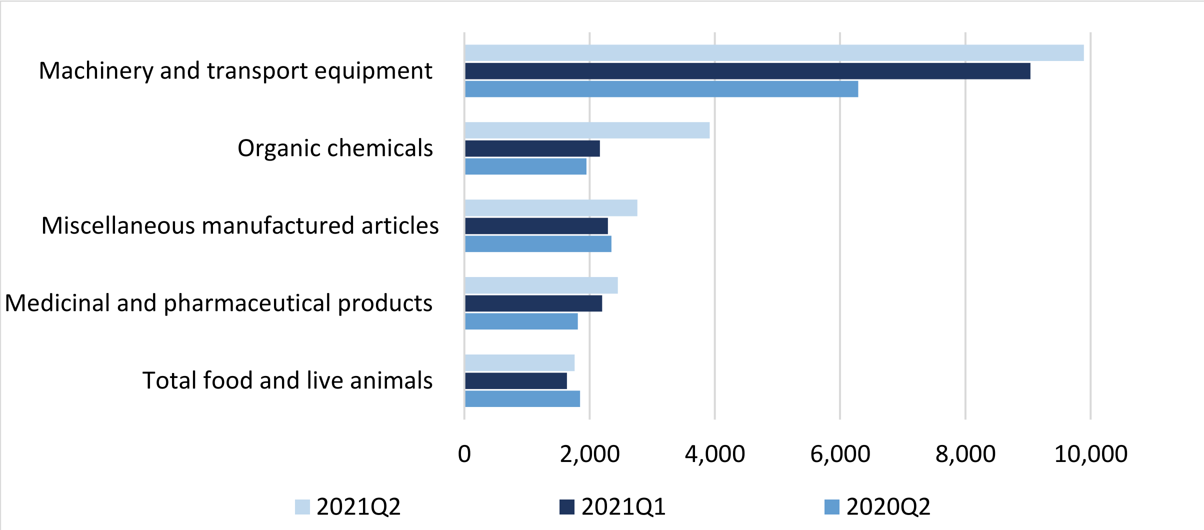
FIGURE 16 SEASONALLY-ADJUSTED IMPORTS: YEAR-ON-YEAR GROWTH (VOLUME, %)



Source: Central Statistics Office, Quarterly National Accounts.

Figure 17 shows goods imports by commodity group. Machinery and transport equipment accounted for just under 40 per cent of goods imports in terms of value in Q2 2021. Imports of machinery and transport equipment increased substantially in Q2 2021, by 9.5 per cent compared to Q1 2021 and by 57.2 per cent compared to Q2 2020. Organic chemicals and miscellaneous articles both grew by 81 per cent and 20 per cent respectively compared to Q1 2021. The significant increases in imports, particularly in transport equipment and manufactured articles, is likely related to declining uncertainty in market conditions as plans to reopen the economy materialised in Q2 2021.

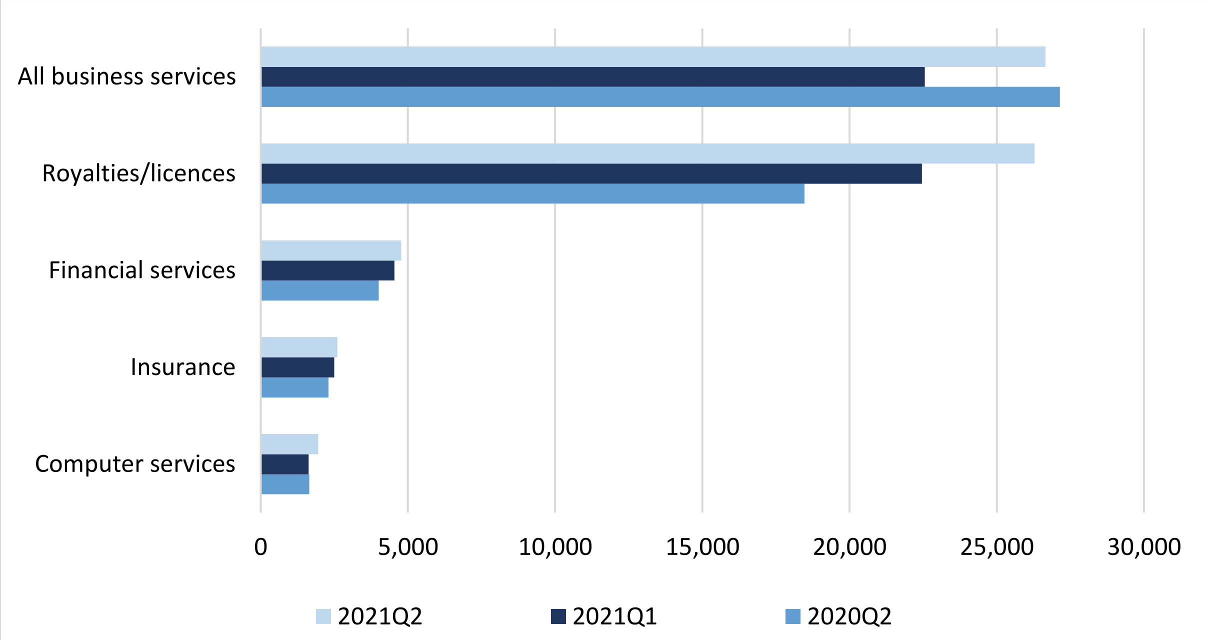
FIGURE 17 GOODS IMPORTS BY COMMODITY GROUP (VALUE, € MILLION)



Source: Central Statistics Office, Value of Merchandise Trade.

Overall service imports grew by 15.0 per cent from Q1 2021 and by 15.5 per cent compared to Q2 2020. Service imports by commodity group are shown in Figure 18. Business services and Royalties and licenses each account for roughly 40 per cent of all service imports. Business services, which include services such as research and development, and operational leasing, grew by 18.2 per cent compared to Q1 2021 and contracted 1.8 per cent compared to Q2 2020. Royalties and licenses increased quarter-on-quarter (17.0 per cent) and year-on-year (42.3 per cent). Both computer and financial services increased by 19 per cent annually while insurance services grew by 13.4 per cent from Q2 2020.

FIGURE 18 SERVICE IMPORTS BY COMMODITY GROUP (VALUE, € MILLION)



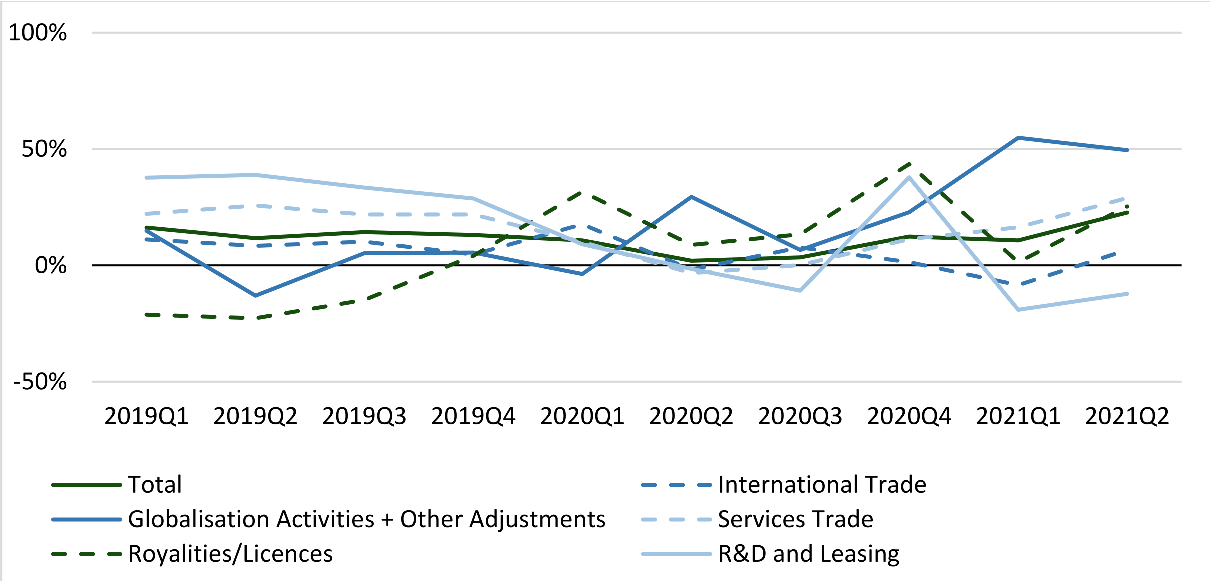
Source: Central Statistics Office, Current Account: Merchandise and Services.

Components of export growth

While much of the growth occurring in trade is rooted in actual cross-border goods and service flows, it is important to highlight the contribution of certain Globalisation Activities undertaken by multinational companies (such as contract manufacturing) to these trends. Figure 19 provides a breakdown of current account exports by activities that are considered to be cross-border trade versus multinational accounting operations or other corporate management strategies. International trade and services trade are mainly reflective of trade that is directly related to cross-border activities or the flow of real goods and services. However other trade pertaining to multinational activity often does not relate to real goods and services; we therefore entitle this trade as 'Globalisation Activities' which refers to trade related to merchanting, goods for processing, and other conceptual adjustments. These activities, along with Research and Development (R&D) and leasing and Royalties and licensing are strongly tied to multinational accounting or corporate management activity, and therefore should be assessed separately from other trade activities. Throughout the pandemic, Globalisation Activities have been performing strongly and contributing to Ireland's impressive export growth. In Q2 2021, these activities grew by 49.5 per cent per annum, while growth in Royalties and licensing exports also contributed significantly to overall growth (increasing 25.3 per cent per annum). R&D and leasing was the only component to experience declines, contracting 12.3 per cent in the same period.

It is noticeable that services and international trade have been performing strongly as the economy recovers from the COVID-19 pandemic. Services trade exports have been increasing since Q2 2020, experiencing growth of 28.9 per cent per annum in Q2 2021. International trade exports increased by 6.7 per cent per annum over the same period. This indicates that the positive growth in Ireland is not exclusive to multinational activity, and is being experienced in the domestic economy as well.

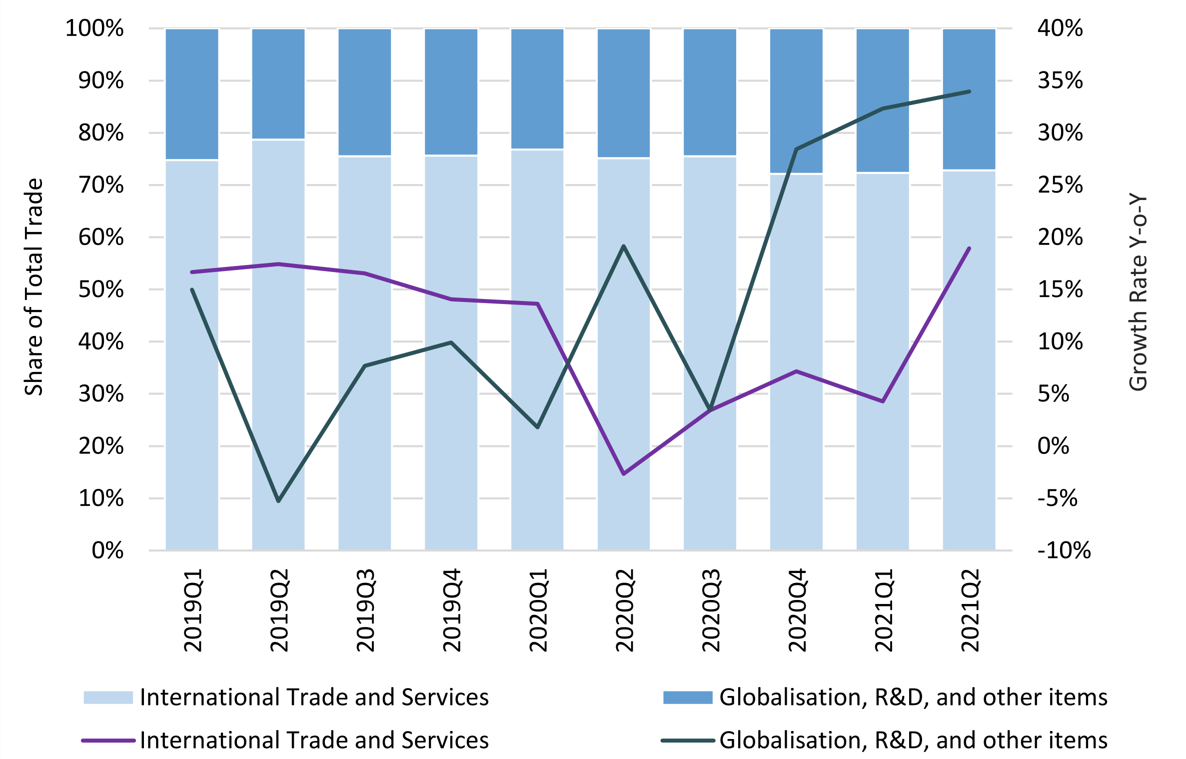
FIGURE 19 EXPORT GROWTH BY COMPONENT (Y-o-Y %) – CURRENT PRICES



Source: *QEC* calculations using data from the Central Statistics Office, Current Account Trade Data.
Note: Globalisation Activities and other adjustments refers to Merchanting; Goods for processing; and Other conceptual adjustments. R&D and Leasing refers to the following CSO accounts: Business services: research and development (inclusive of IP related R&D) and Business services: operational leasing. Business services other than research and development are included in the Services Trade.

Despite the boost stemming from multinational activity, International and Services Trade are still the primary components of Ireland's trade exports. In Q2 2021, they contributed to 72.8 per cent of total exports. Figure 20 shows the share of International and services trade exports compared with the shares of the following: Globalisation Activities and adjustments; R&D and leasing; and Royalties and licensing. Since Q1 2019, such items have accounted for roughly one-quarter of total exports. The corresponding annual growth rates in Figure 20 highlight the volatility of these components as opposed to the relatively more predictable performance of International trade and services exports. While the latter did decline steeply at the onset of the pandemic in Q2 2020, it has since experienced positive growth. In Q2 2021, International trade and services exports grew by 18.9 per cent compared to Q2 2020, while Globalisation, R&D, and Other Items exports grew by 34.0 per cent. While trade related to multinational activity is robust, it is encouraging to note that exports from domestic activities are performing strongly as trade recovers from the pandemic.

FIGURE 20 EXPORT GROWTH BY COMPONENT (SHARE OF EXPORTS (LHS) AND Y-O-Y % (RHS))



Source: *QEC* calculations using data from the Central Statistics Office.
Note: Globalisation, R&D, and other items refers to the following accounts described in Figure 19: Globalisation activities and other adjustments; Royalties/Licensing; and R&D and leasing.

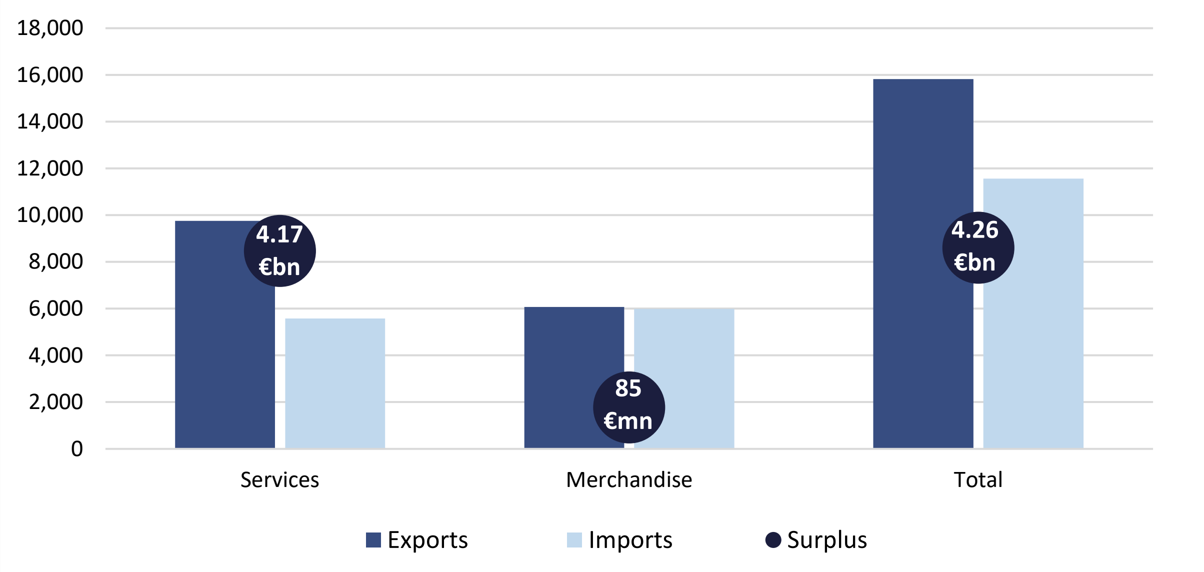
Brexit and trade

Irish trade, given the traditional linkages, is strongly affected by the unfolding of the Trade and Cooperation Agreement signed between the UK and the EU on 30 December 2020. While the negotiations between the UK and the EU managed to avoid the implementation of tariffs, many non-tariff barriers such as licensing, labelling and rules related to health and food safety have been implemented and will continue to be rolled out. The trade data presented in this *Commentary* reflect the asymmetry in Customs checks on cross-border trade between the EU and UK. Since January 2021, goods from the UK to the EU must comply with new procedures and import requirements of EU Member States. Meanwhile, imports from the EU to the UK have not been met with the same stringency, as full Customs checks in the UK are not set to apply until 2022.[4] This imbalance in Customs checks benefitted Irish trade in Q1 2021, resulting in an overall trade surplus of approximately €4.9 billion, whereas the trade surplus in Q1 2020 was approximately €2.8 billion in comparison. Merchandise trade has been the largest contributor to the total surplus. In Q2 2020, Ireland's merchandise trade surplus with the UK was -€751 million compared to €85 million in Q2 2021.

4 For more information see: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1004070/2021_July_BordersOPModel_Publishing__2_.pdf.

Figure 21 shows the trade relationship between the UK and Ireland in Q2 2021, in which a continued trade surplus of €4.3 billion was recorded. While this marks a decline of 12.7 per cent from Q1 2021, the trade surplus rose by 58.9 per cent from Q2 2020.

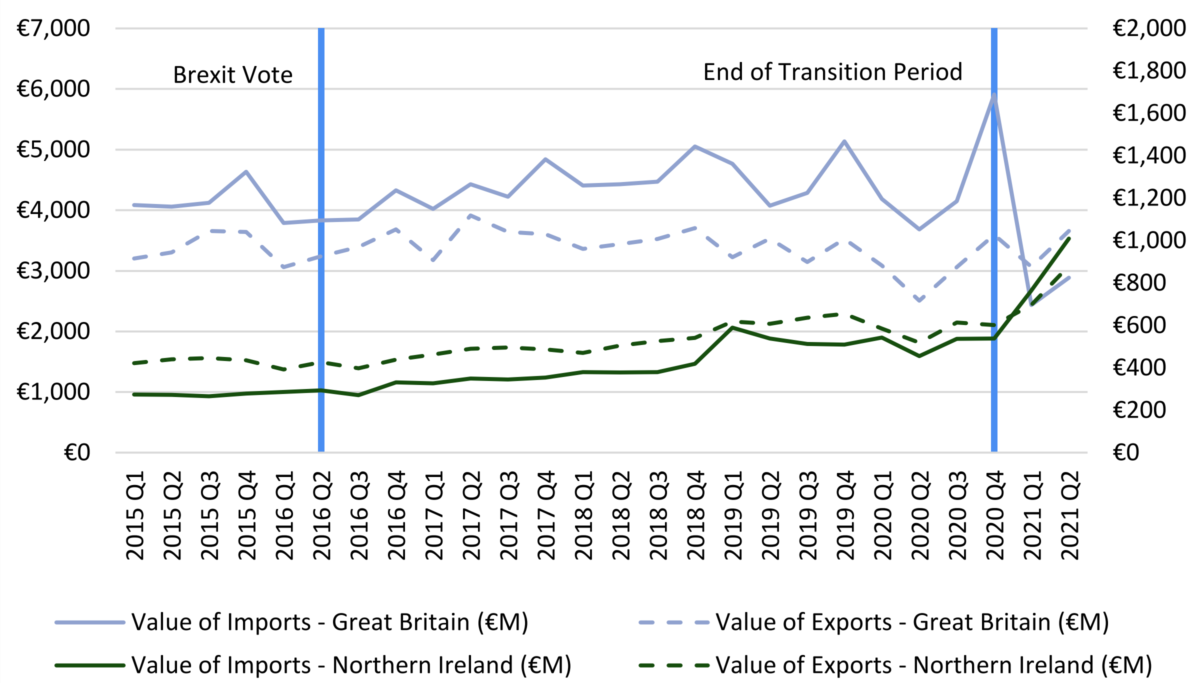
FIGURE 21 IRELAND TRADE WITH THE UK IN Q2 2021 (VALUE, € MILLION)



Source: Central Statistics Office, Current Account with the UK: Merchandise and Services.

Monthly goods trade data offer an insight into the progression of the Trade and Cooperation Agreement's effect on Irish and UK trade. As the transition period came to a close, Q1 2021 marked a major shift in trade with the UK as the value of imports from Great Britain (GB) fell nearly by 60 per cent from Q4 2020 to Q1 2021, while imports from Northern Ireland increased by 42 per cent in the same period (Figure 22). However Q2 2021 shows some adjustment to the initial changes. The value of imports from GB rose by 18.6 per cent from Q1 to Q2 2021, although they remain 21.6 per cent less than their value in Q2 2020. Exports to GB also increased by 19 per cent in Q2 2021 after their initial decline in the first quarter. The value of trade between Ireland and Northern Ireland also increased in Q2 2021. The value of imports grew by 32 per cent between Q1 2021 and Q2 2021 while exports grew by 26.4 per cent in the same period.

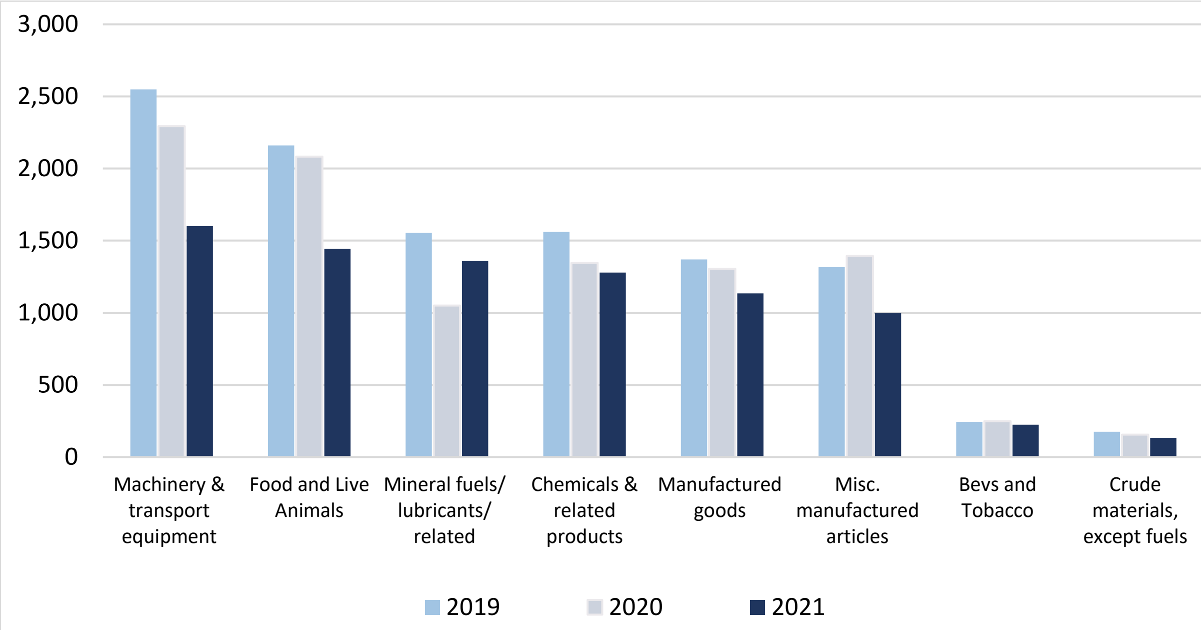
FIGURE 22 IRELAND TOTAL MERCHANDISE TRADE WITH GREAT BRITAIN (LHS) AND NORTHERN IRELAND (RHS) (VALUE, € MILLION)



Source: *QEC* calculations using Central Statistics Office data.

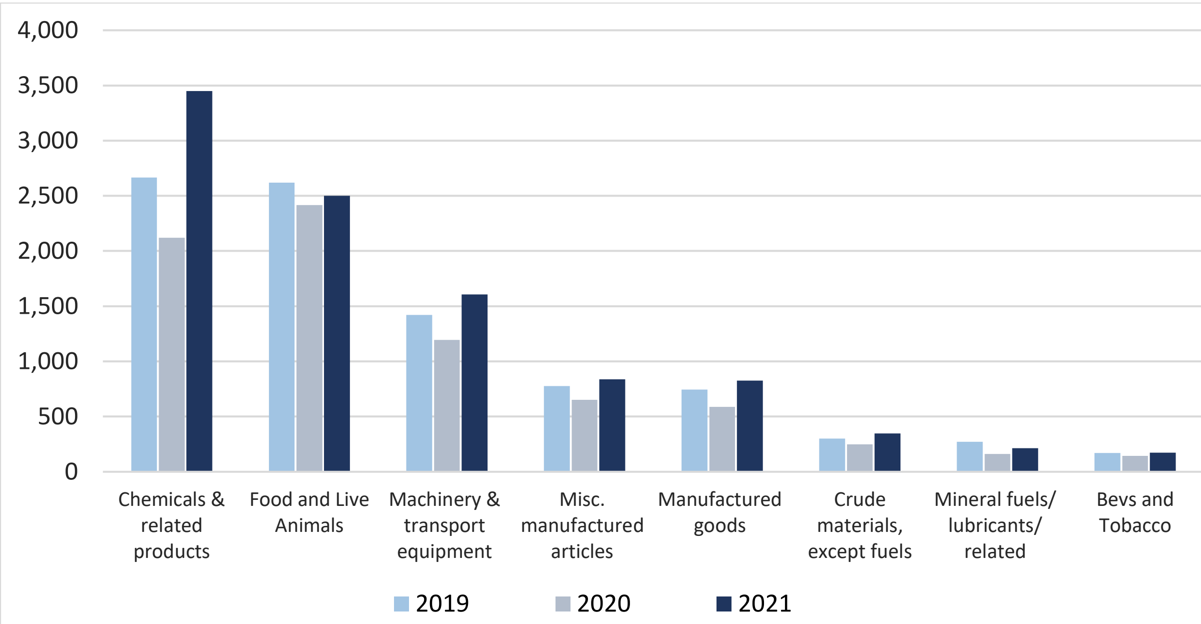
Due to the disruptions in trade in 2020, it may be more illustrative to compare trade with the UK to its levels in 2019. Figure 23 shows the value of imports to Ireland from the UK from January to July in 2019, 2020, and 2021. Between 2019 and 2021 imports declined in each commodity group. Machinery and transport equipment and Food and live animals registered the largest declines, at 37.2 and 33.3 per cent, respectively. Meanwhile, as shown in Figure 24, all export categories from Ireland to the UK have experienced an increase between 2020 and 2021. Just two of the pictured commodity groups (Beverages and tobacco and Food and live animals) have lower levels in 2021 when compared with 2019 while all others have increased. The total value of Chemicals and related products has experienced the greatest increase (29.3 per cent from 2019 to 2021 or €781.1 million).

FIGURE 23 IMPORTS FROM THE UK BY COMMODITY GROUP (NON-SEASONALLY ADJUSTED, JANUARY-JULY) (€ MILLION)



Source: Central Statistics Office, Value of Merchandise Trade.

FIGURE 24 EXPORTS TO THE UK BY COMMODITY GROUP (NON-SEASONALLY ADJUSTED JANUARY-JULY) (€ MILLION)



Source: Central Statistics Office, Value of Merchandise Trade.

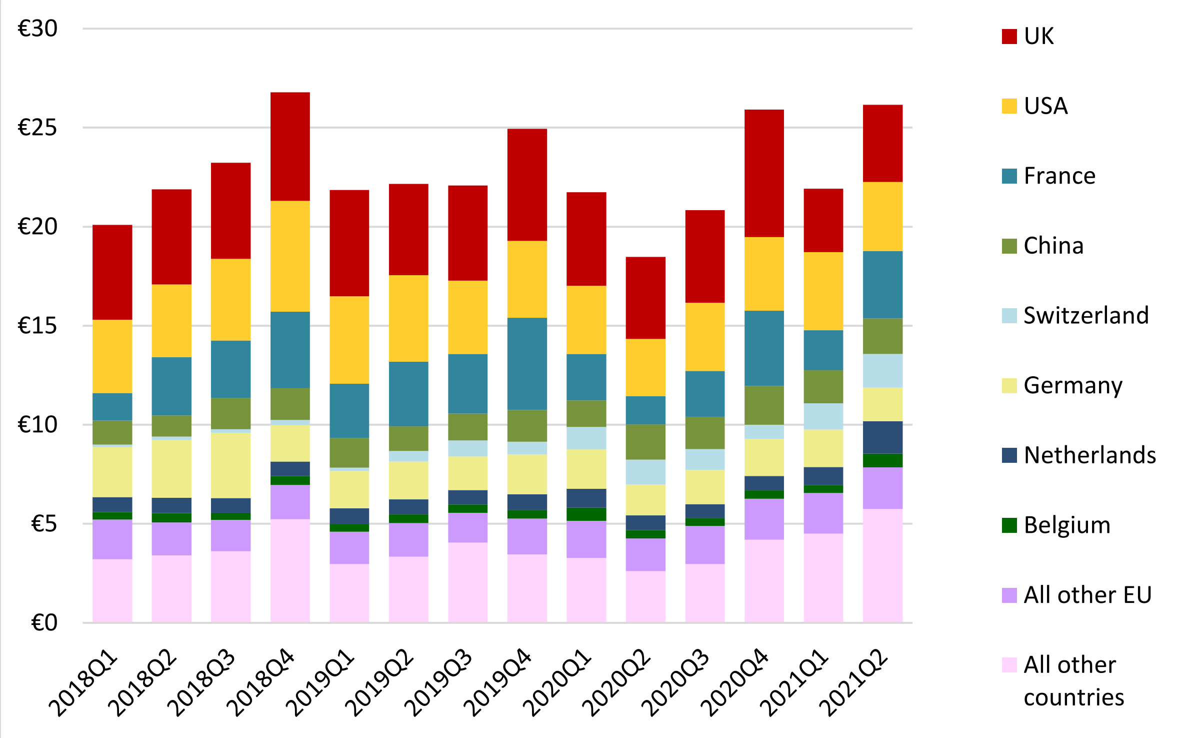
While many of the effects of the trade deal have proven beneficial for the Irish trade surplus, the implementation of more checks on goods moving from the EU into the UK is likely to slow down some aspects of Irish trade. However, given the impact of COVID-19 on supply chains and trade relationships, many checks that would have affected trade in the latter half of 2021 will now be implemented in 2022. Health certificates and sanitary checks initially planned for 1 October 2021 have been delayed until January and July 2022.[5] The ongoing changes to procedures between the UK and the EU will continue to influence trade performance in Ireland.

While the most pressing concerns for Irish trade are undoubtedly those related to Northern Ireland and Great Britain, it is important to gauge the effects of Brexit and the pandemic on Ireland's other key trading partners. One such effect is the increased diversity in Irish imports. Between Q1 2017 and Q4 2020, imports from all other countries (non-EU) averaged 15 per cent of total Irish imports. In the first half of 2021, the share has increased to 21 per cent. This is accompanied by a decline in the UK's share of imports by 8 per cent. While perhaps a temporary reaction to Brexit, it will be important to pay attention to the future of Ireland's trade relationships as states recover from the pandemic and trade protocols between the UK and the EU continue to unfold.

In Q2 2021, France and the US each accounted for 13 per cent of total imports, the second and third largest share behind the UK (Figure 25). Yet imports from France have been increasing recently, while imports from the US have slowed. In Q2 2021, imports from France increased 67 per cent (€1.36 billion) compared to Q1 2021. Imports from the US declined 12 per cent (€0.46 billion) in the same period.

5 Further information related to UK procedures and delays can be found here: Government sets out pragmatic new timetable for introducing border controls – GOV.UK (www.gov.uk).

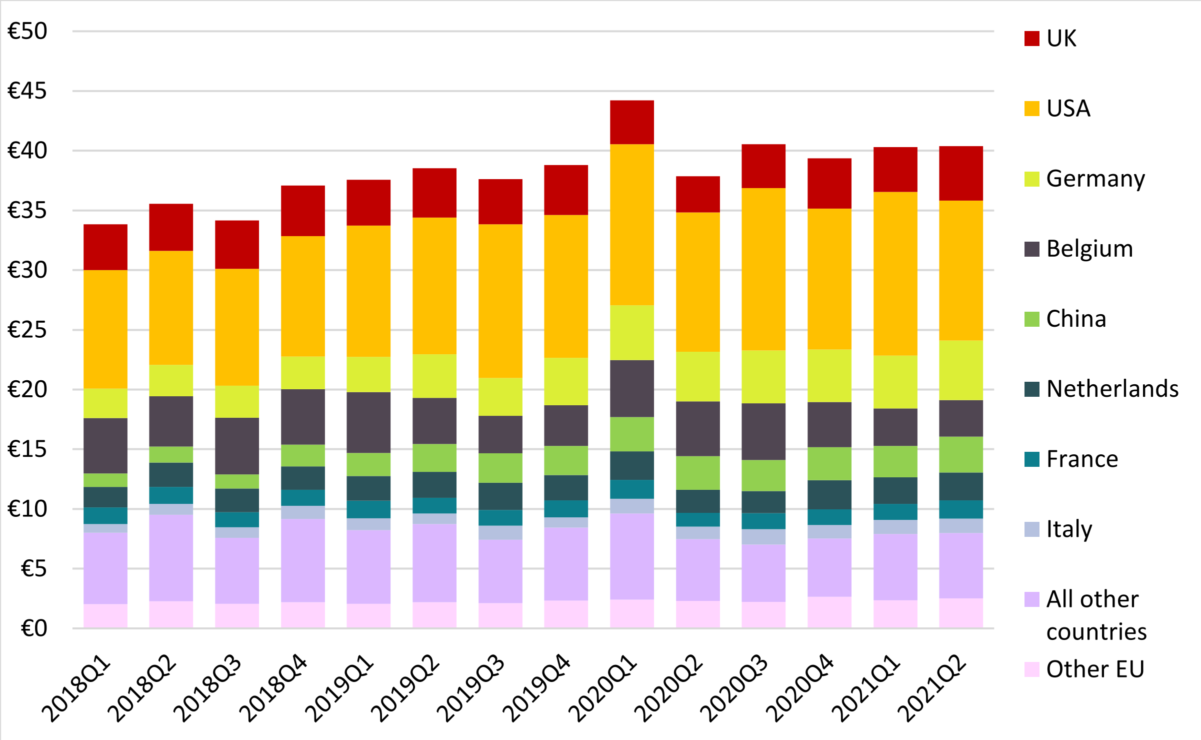
FIGURE 25 IRELAND'S MERCHANDISE IMPORTS BY KEY TRADING PARTNER (VALUE, € BILLION)



Source: *QEC* calculations using Central Statistics Office data.

Figure 26 shows the total value of Ireland's exports to its ten largest trading partners between Q1 2018 and Q2 2021. The US accounted for 30 per cent of all Irish exports in Q2 2021 (€11.7 billion). The value of exports to the US declined by approximately 15 per cent between Q1 and Q2 2021, while remaining largely unchanged from Q2 2020. Belgium was the only main trading partner to experience a decline in receiving Irish exports from Q2 2020 to Q2 2021 (down by 33 per cent). The countries with the greatest annual growth in their import of Irish merchandise exports were the UK (50 per cent), France (32 per cent), the Netherlands (22 per cent), and Germany (20 per cent).

FIGURE 26 IRELAND'S MERCHANDISE EXPORTS BY KEY TRADING PARTNER (VALUE, € BILLION)



Source: *QEC* calculations using Central Statistics Office data.

As most of Ireland's key trading partners resume normal economic activity and vaccination take-up continues, further gains in the traded sector are expected. While exports have registered exceptional growth in the first half of the year, we do expect a modest slowdown in exports throughout the rest of the year. Despite this slowdown, we expect exports to increase by 14.3 per cent overall in 2021. We do expect an overall decline of 7.9 per cent in imports for the year, largely due to the significant decline in imports in Q1 2021. We expect the traded sector to stabilise and continue performing well in 2022, with exports and imports anticipated to grow by 9.0 and 10.0 per cent, respectively.

INVESTMENT

Key Points

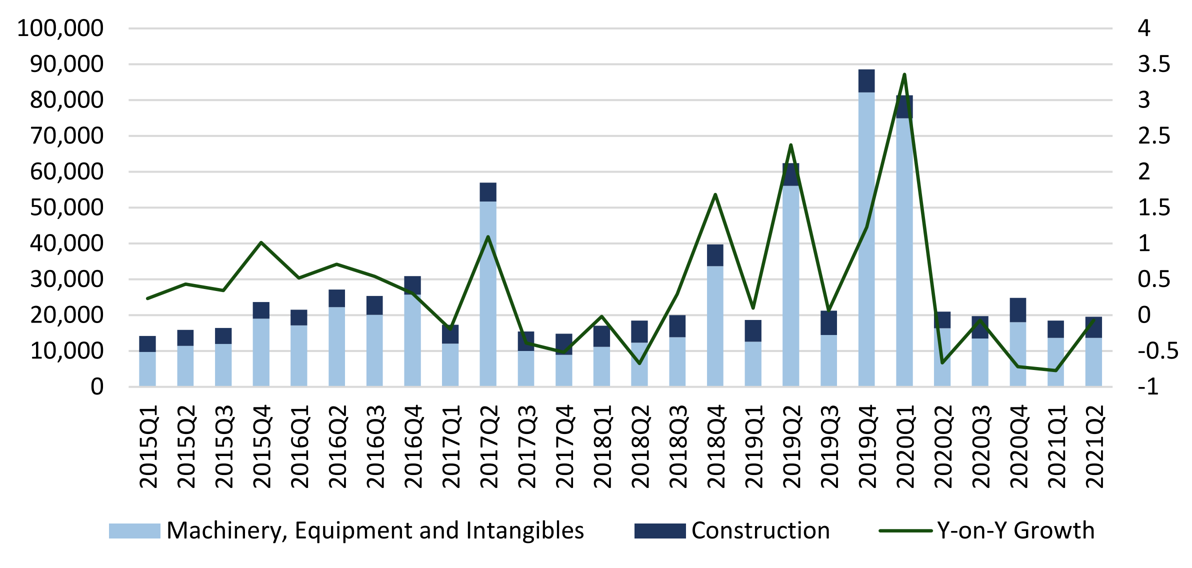
- *Headline investment levels are likely to drop dramatically in 2021 due to multinational activities.*
- *In terms of underlying activity, a pick-up in business sentiment and a continued reopening of economic activity should spur investment activity towards the end of 2021 and into 2022.*
- *Construction activity is rebounding sharply following the reopening of the sector to full activity in early Q2 2021.*

Investment overview

One of the most volatile aspects of the Irish economy is capital investment. Considerable attention has been focused in recent years on documenting the distorting impacts of multinational investments in intangible assets (in particular those relating to research and development activities) and machinery investment in aircraft leasing. Both of these elements have been removed from the Central Statistics Office (CSO) modified investment series to attempt to provide a more stable dataset to understand trends in capital formation.

However, these effects continue to influence the National Accounts to a considerable degree. Figure 27 presents the overall trend in investment activity including construction and all machinery and intangibles investment. Extremely large value investments in 2019 and early 2020 have an impact on the 2021 levels with the annualised change in investment in the first quarter of 2021 dropping by nearly 80 per cent. As a result, we expect a large annual decrease in headline investment for 2021. These fluctuations also make it difficult to identify the effects of the pandemic on investment activity by Irish-owned enterprises and SMEs.

FIGURE 27 GROSS FIXED CAPITAL FORMATION GROWTH, LEVEL (€ MILLION) – OVERALL CONSTANT PRICES AND SEASONALLY ADJUSTED



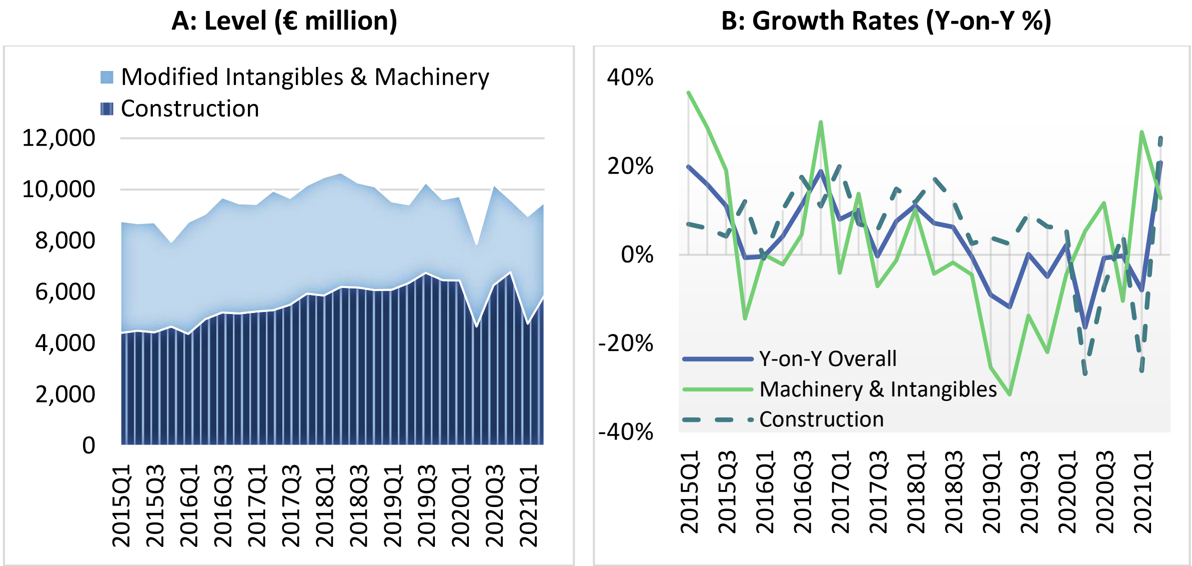
Sources: Central Statistics Office and *QEC* analysis.

To get a less distorted picture of investment flows, Figure 28 presents the level (panel A) and annualised growth rate (panel B) for the CSO's modified investment series which excludes aircraft leasing and IP investment activity. These data provide an investment path that one might expect given the nature of the public health restrictions (i.e. investment decreases as restrictions increase etc). Notable declines in investment were recorded in the Q2 2020 and Q1 2021 periods, in which severe public health limitations were in operation across many sectors of the economy. For example, Q1 and Q2 of 2021 were characterised by a 7 per cent decline followed by a 20 per cent increase compared to the first two periods of 2020.

Focusing on the separate trends in construction and machinery and intangibles however highlights differential growth paths: construction is much more closely linked to the public health restrictions which restricted the sector's activity while the investment in machinery and intangible investment appears to be inversely correlated with the restrictions (increases in Q2 2020 and Q1 2021 are notable in this regard).

These trends are likely to be influenced by the continued importance of activities of large multinationals even in the modified investment series. Domestic enterprises are much more likely to alter their investment plans in line with the reopening of the economy and the degree of uncertainty surrounding the public health outlook. Indeed, recent research by Kren et al. (2021)[6] show that a notable share of SMEs in Ireland undertook investment in public health measures in 2020. These businesses are likely to re-engage with new investments once the outlook becomes sufficiently certain.

FIGURE 28 GROSS FIXED CAPITAL FORMATION GROWTH, LEVEL AND GROWTH RATE (€ MILLION, %) – MODIFIED AND SEASONALLY ADJUSTED

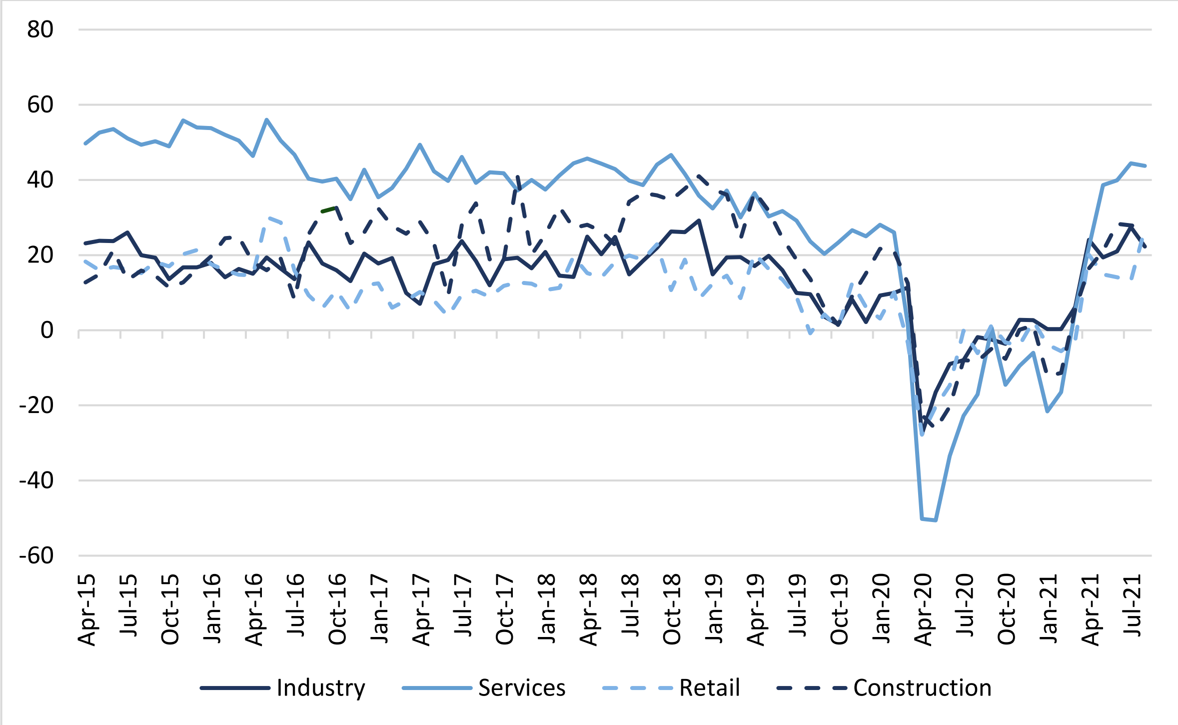


Sources: Central Statistics Office and *QEC* analysis.

To gain more insight into the degree to which businesses are being affected by uncertainty, we draw on the European Commission Business Confidence Indicators. Composite overall confidence indicators are presented below for enterprises in the industrial, service, retail and construction sectors. It is clear that a very marked pick-up in confidence has occurred since April 2021 when the roll-out of the vaccination programme indicated the future potential loosening of public health measures. It is likely this confidence will lead to a rebound in investment by many businesses as the economy recovers.

6 Kren, J., M. Lawless, F. McCann, J. McQuinn and C. O'Toole (2021). 'New Survey Evidence on COVID-19 and Irish SMEs: Measuring the Impact and Policy Response', *The Economic and Social Review*, *52*(2, Summer), 107-138.

FIGURE 29 EUROPEAN COMMISSION BUSINESS CONFIDENCE INDICATOR – ALL SECTORS

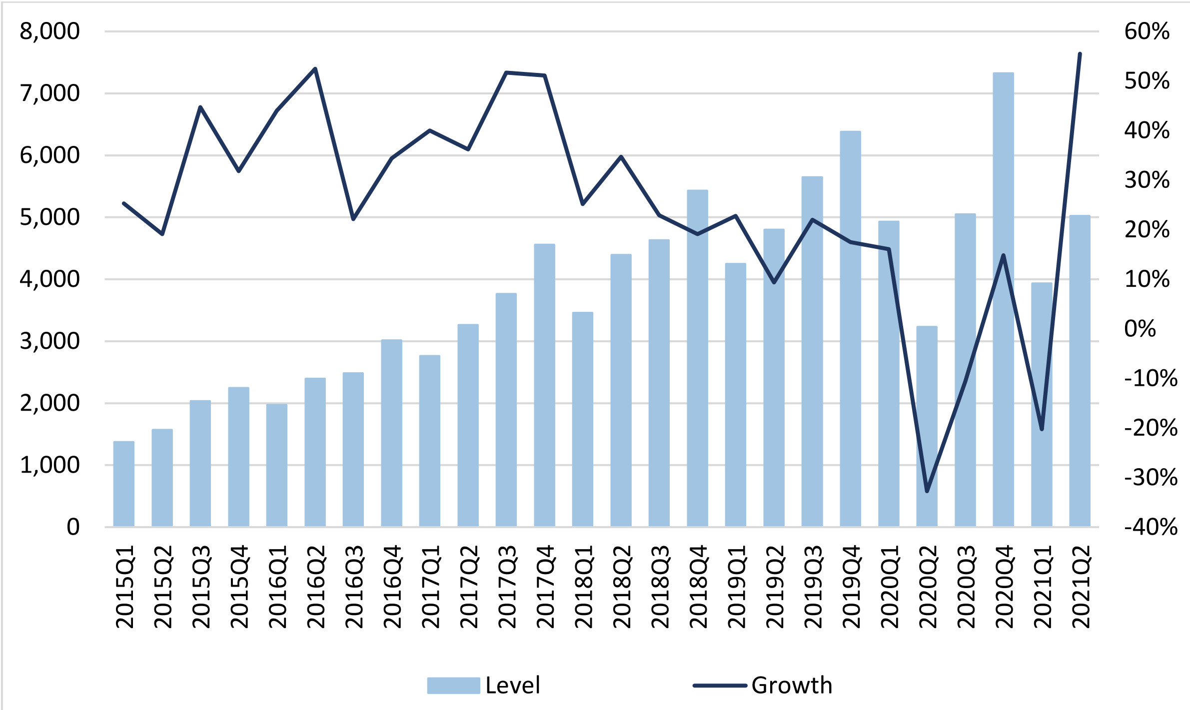


Sources: European Commission.

Construction outlook

Construction output in Ireland has displayed considerable volatility since the onset of the pandemic due to the direct impact of required public health measures on the sector's operations. In line with the limitations on the sector in Q2 2020 and Q1 2021, large drops in housing completions were recorded in these quarters. However output rebounded towards the end of 2020 and in Q2 2021 when measures were eased. In total, 20,353 dwelling completions were reported by the CSO, which is marginally down on 2019 (21,075).

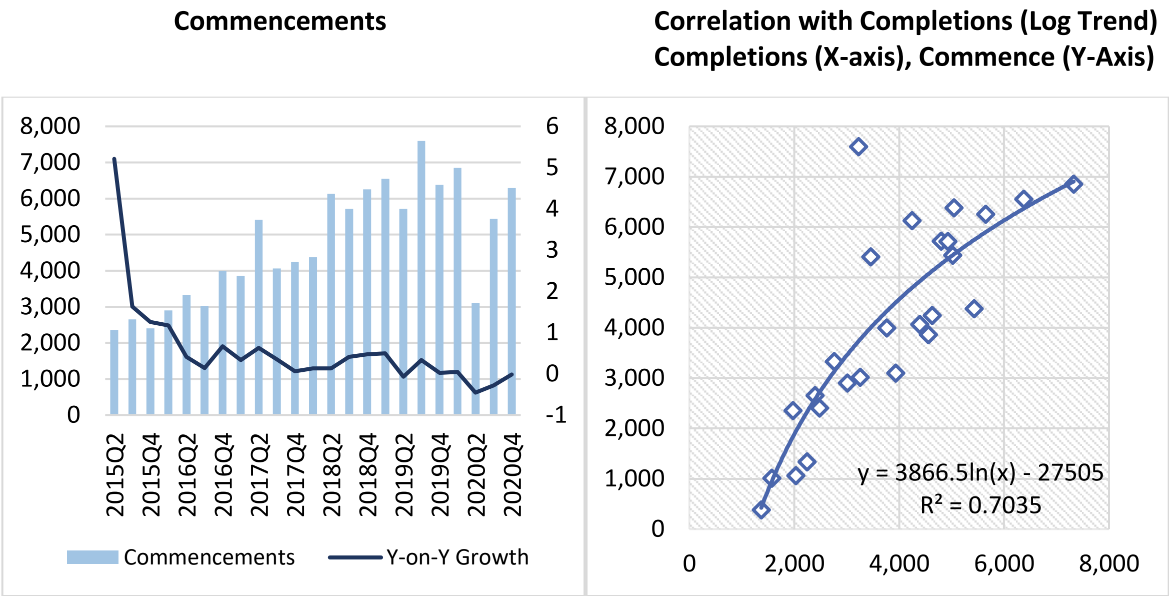
FIGURE 30 HOUSING COMPLETIONS (ESB CONNECTIONS) – LEVEL OF COMPLETION (LHS) AND GROWTH (Y-O-Y, RHS)



Sources: Central Statistics Office.

A useful leading indicator of housing completions is the level of residential commencements. These data have a high correlation with completions, with a time lead of three quarters (this assumes approximately nine months between commencement and completion). To demonstrate this, a scatterplot of commencements (t+3) with completions (t) shows a close trending relationship (Figure 31). While commencements dropped in the second quarter of 2020, they rebounded sharply towards the end of the year which provides a good basis for output growth in 2021 and beyond.

FIGURE 31 LEVEL OF COMMENCEMENTS AND SCATTERPLOT OF COMPLETIONS (T) AND COMMENCEMENTS (T+3)

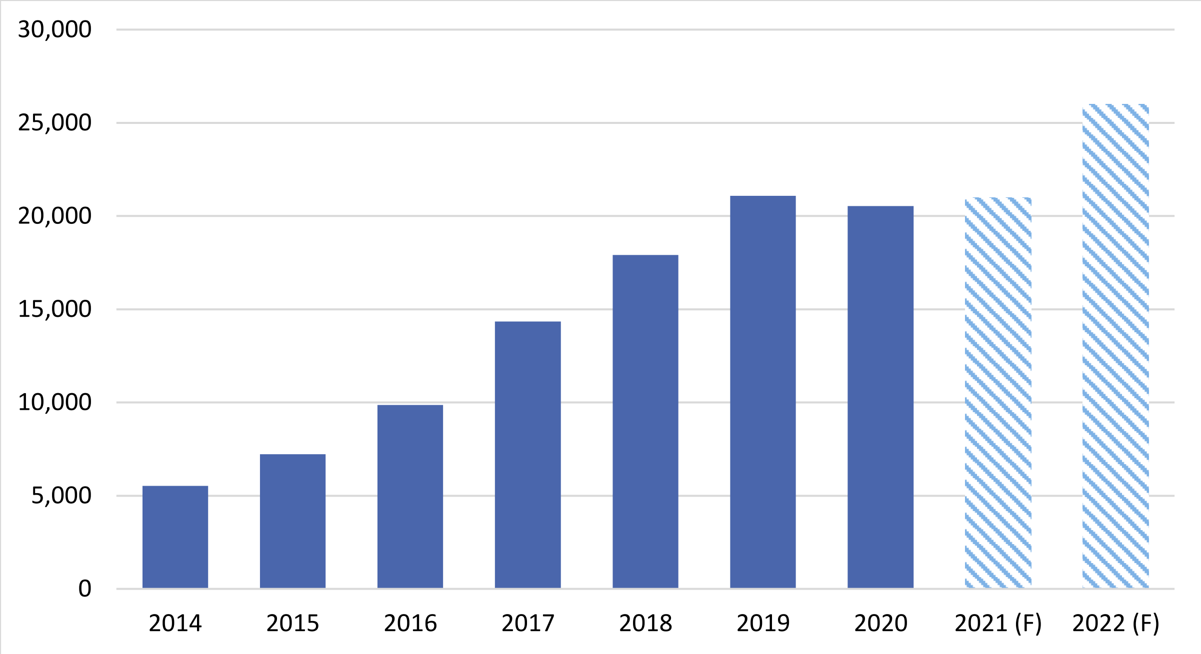


Sources: Authors' calculations using Central Statistics Office and Department of Housing data.

On the back of the rebound in construction activity in Q2 2021 and the continued and sustained economic growth outlook, we expect an outturn of close to 21,000 units in 2021. We expect supply to increase further in 2022 with a completions level of just over 26,000 units (Figure 32). An increase in construction activity over the coming years is also likely to be facilitated by recently announced policy measures.[7]

[7] The Housing For All policy initiative announced in September 2021 commits the Government to increasing housing supply over the next ten years.

FIGURE 32 ANNUAL HOUSING COMPLETIONS (2021-2022 FORECASTS) – TO 2020 – ACTUAL



Sources: Central Statistics Office and *QEC* Forecasts.

Forecasts

For 2021, we expect an overall drop of investment of approximately -45.5 per cent which is due to the carry-over effects of the large multinational capital formation flows in 2020. However, underlying this figure, we would expect domestic investment in machinery and equipment to rebound as the economic recovery becomes more ingrained, the risk of further public health restrictions recedes and construction activity in particular picks up. We see these factors as feeding through into a more sustainable recovery in investment for 2022. Overall, we expect annual average growth in investment of -45.5 per cent in 2021 and 8.3 per cent in 2022.

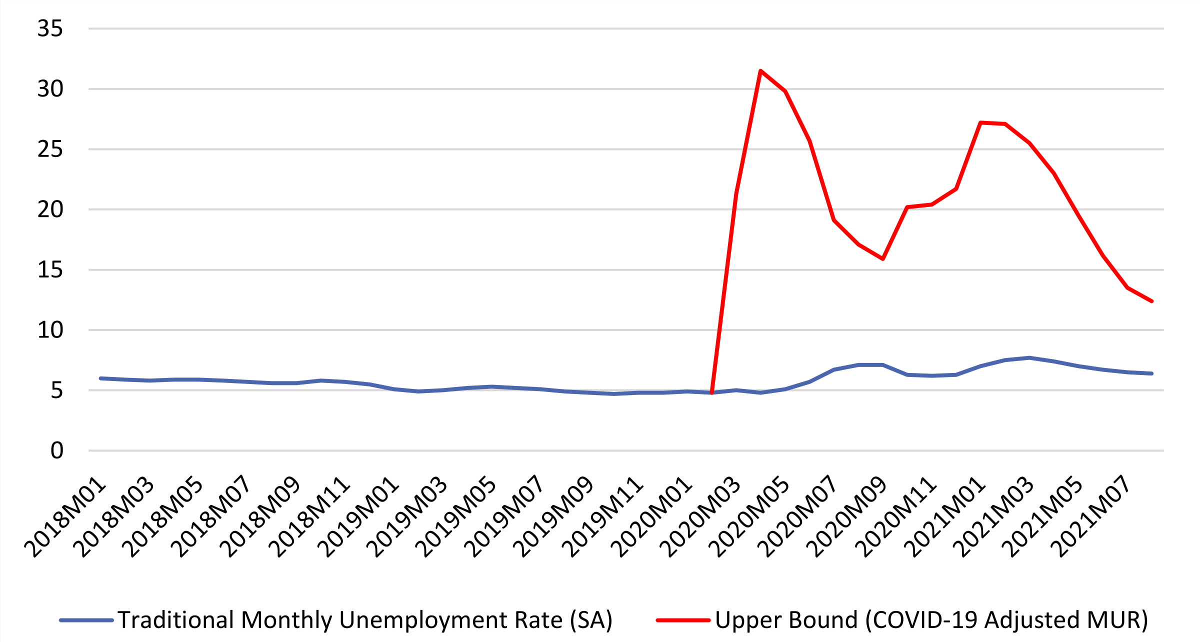
LABOUR MARKET

Key Points

- *The unemployment rate was 12.4 per cent in August 2021.*
- *Approximately 143,600 people were on the Pandemic Unemployment Payment (PUP) on 29 August 2021.*
- *Employers received Employment Wage Subsidy Scheme (EWSS) payments for approximately 319,400 qualifying employees in August 2021.*
- *Unemployment rate in Q4 2021 will fall to 9.0 per cent.*
- *Average unemployment rate for 2022 is set to be 7.1 per cent.*

The impact of the COVID-19 pandemic on the Irish labour market has been unprecedented in recent times in both scale and the level of fluctuation. The substantial variation in the unemployment rate since early 2020 reflects the impact of the tightening and loosening of public health restrictions. The unemployment rate in February 2020 was 4.8 per cent. The COVID-adjusted unemployment rate peaked at 31.5 per cent in April 2020. From this peak, the unemployment rate declined during the summer of 2020 with the loosening of restrictions and the economic rebound. As more stringent public health restrictions were reintroduced, the unemployment rate increased from 15.9 per cent in September 2020 to 27.2 per cent in January 2021. Since January 2021 the unemployment rate has declined to 12.4 per cent in August 2021. The average monthly unemployment rate for 2020 was approximately 19.4 per cent while the average for the first eight months of 2021 is 20.6 per cent. Figure 33 shows both the traditional and the COVID-19 adjusted monthly unemployment rate from January 2018 to August 2021.

FIGURE 33 UNEMPLOYMENT RATE BY MONTH (%)



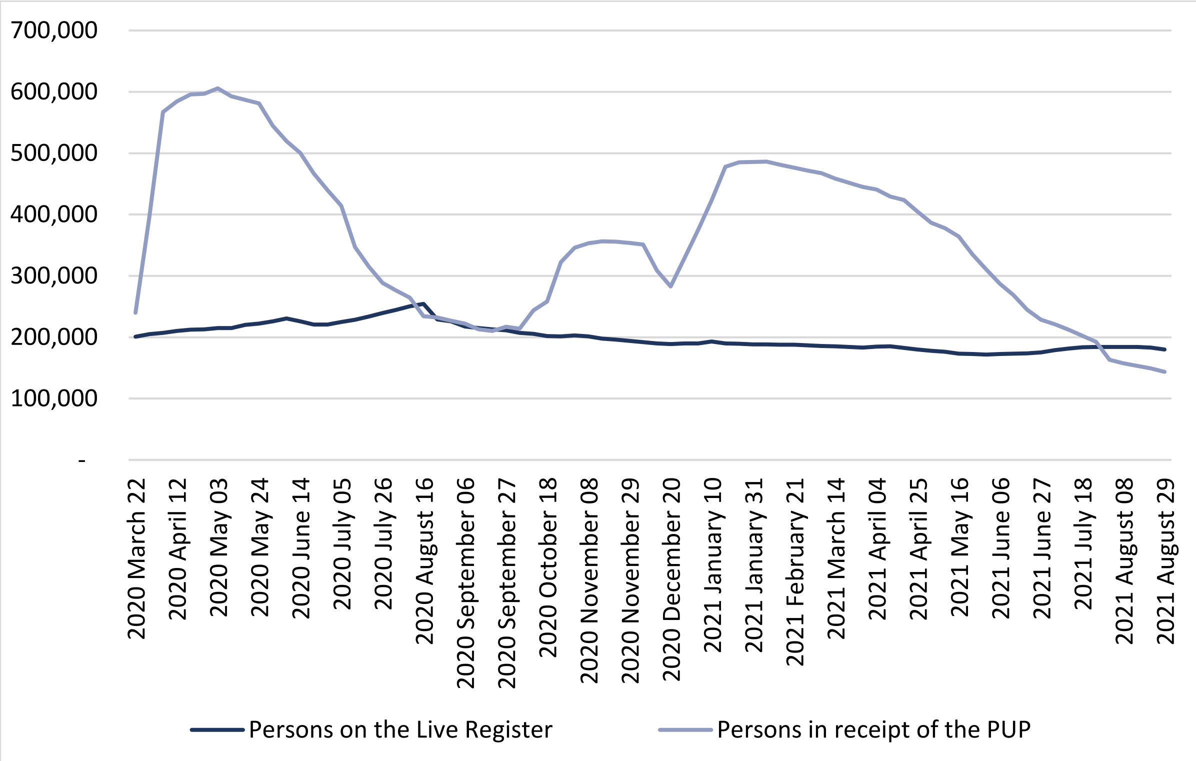
Sources: Seasonally-Adjusted Monthly Unemployment Rate Series and the COVID-19 Adjusted Monthly Unemployment Rate Series. Central Statistics Office.

In response to the pandemic the government established the pandemic unemployment payment (PUP) which aimed to provide a short-term, emergency income support to affected households. The PUP closed to new applicants from 8 July 2021 and the weekly payment will be tapered down by €50 in September 2021, November 2021 and February 2022. From 26 October 2021 those receiving a payment of €203 will move to Jobseeker's Benefit if eligible.[8] Individuals transferring from the PUP to Jobseeker's Benefit will likely be reflected in an increase in the traditional monthly unemployment rate. Figure 34 shows the number of individuals in receipt of the PUP or on the Live Register by week from March 2020 to August 2021. Three peaks are evident in the number of people on the PUP and these peaks coincide with the implementation of the strictest public health measures over the last 12 months. The first peak occurred in early May 2020 when the number of individuals in receipt of the PUP was just under 605,700. Restrictions were eased and by the end of September 2020 there were just over 210,000 people in receipt of the PUP. More stringent public health restrictions were brought in during October 2020 due to an increase in the number of COVID-19 infections. This resulted in the second peak occurring in mid-November 2020 when approximately 356,300 people were in receipt of the PUP. The re-introduction of restrictions in December 2020 was followed by the third peak in the number of PUP claimants in early February 2021 when just under 486,400 were in receipt of the PUP. Since February 2021 the number of individuals in receipt of

8 For more information see: https://www.citizensinformation.ie/en/social_welfare/social_welfare_payments/unemployed_people/covid19_pandemic_unemployment_payment.html.

the PUP has reduced, and as of 29 August 2021, approximately 143,600 individuals were claiming the PUP. This marks a fall of over 462,000 in the number of PUP recipients from its overall peak in May 2020.

FIGURE 34 NUMBER OF PEOPLE ON THE PUP AND LIVE REGISTER BY WEEK



Source: Central Statistics Office.

Table 1 shows a breakdown of PUP recipients by sector. Of those on the PUP on 29 August 2021, 28.4 per cent were from the Accommodation and food sector, 22.9 per cent were from the Wholesale and retail trade/repair of motor vehicles sector, and 12.0 per cent were from the Construction sector. These three sectors alone account for 63.4 per cent of PUP recipients, and while this highlights the unequal and long-lasting impact the pandemic has had on certain sectors, there has been a large reduction in the number of people from these sectors on the PUP. For example, the number of PUP claimants from the Accommodation and food sector has fallen by approximately 103,000 from the May 2020 peak in PUP claimants. The number of claimants from the Wholesale and retail trade/repair of motor vehicles sector and from the Construction sector have fallen by approximately 71,000 and 72,000 respectively over the same period.[9]

[9] These are based on the sectoral breakdown published by the Department of Social Protection and are available at: https://www.gov.ie/en/publication/f4c60c-covid-19-statistics/.

TABLE 1 BREAKDOWN OF PUP RECIPIENTS BY SECTOR AS OF 29 AUGUST 2021

	Number ('000)	Percentage
Agriculture, forestry and fishing; Mining and quarrying	2.0	1.4
Manufacturing	8.4	5.8
Electricity, gas supply; Water supply, sewerage and waste management	0.6	0.4
Construction	12.0	8.3
Wholesale and retail trade; Repair of motor vehicles and motorcycles	22.9	16.0
Transportation and storage	6.1	4.2
Accommodation and food service activities	28.4	19.8
Information and communication activities	3.9	2.7
Financial and insurance activities	3.7	2.6
Real estate activities	2.2	1.6
Professional, scientific and technical activities	6.8	4.8
Administrative and support service activities	16.8	11.7
Public administration and defence; Compulsory social security	2.7	1.9
Education	5.9	4.1
Human health and social work activities	5.5	3.8
Arts, entertainment and recreation	4.7	3.3
Other sectors e.g. hairdressing and beauty salons	7.3	5.1
Unclassified or unknown	3.6	2.5
Total	143.6	100.0

Source: Payments Awarded for COVID-19 Pandemic Unemployment Payment and Enhanced Illness Benefit – Statistics. Published on 1 September 2021 by Department of Social Protection.
Note: Figures refer to those on the PUP as of 29 August 2021 who received a PUP payment on 31 August 2021.

The level and composition of those employed has also been affected by the pandemic. According to the Labour Force Survey there were an estimated 2,230,600 people employed in Q1 2021. This figure does not represent the full impact of the COVID-19 pandemic on the Irish labour market as it has been determined using strict classification criteria set by the ILO.[10] To address this problem, a COVID-19 adjusted estimate of employment has been produced. The CSO estimates that 1,785,923 persons aged 15 and over were in employment in March 2021 (the end of Q1 2021).[11]

Many of those still working are being supported by a wage subsidy scheme. These schemes allow employees, whose employers were negatively impacted by the

10 For more information on the ILO classification guidelines see: https://www.cso.ie/en/releasesandpublications/in/lfs/informationnote-implicationsofcovid-19onthelabourforcesurvey-quarter22020update/.

11 For more information see: https://www.cso.ie/en/releasesandpublications/ep/p-lfs/labourforcesurveyquarter12021/.

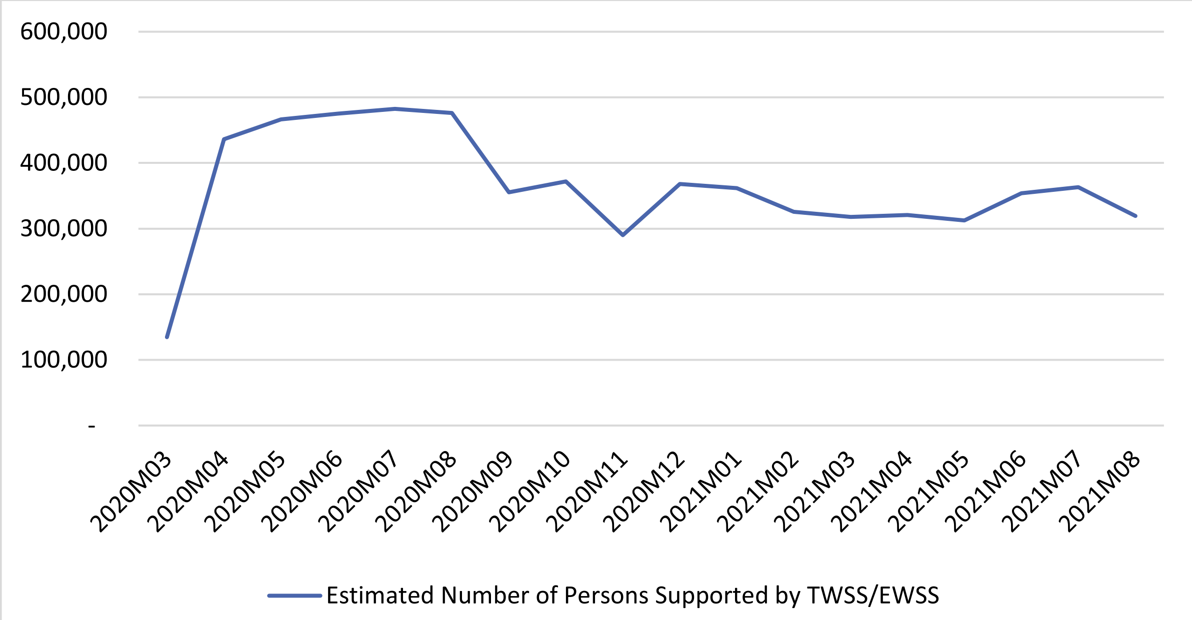
pandemic, to be supported directly through their employer's payroll system. The Temporary Wage Subsidy Scheme (TWSS) was announced by the government on 24 March 2020 with Revenue making the first payments under the scheme four days later. The scheme ran until 31 August 2020. While the TWSS was active 66,600 employers received subsidy payments of approximately €2.8 billion in respect of 664,500 employees. Approximately 255,800 other employees who were not directly supported by the TWSS were indirectly supported through their employer's participation in the scheme. While the TWSS was active, approximately 116,100 people regained employment and transitioned from the PUP to the TWSS. Approximately 22,000 individuals supported by the TWSS lost their jobs and transitioned from the scheme to the PUP. Approximately 260,900 individuals moved from the TWSS to non-TWSS employment.[12] This shows the significant role that wage subsidy schemes played in helping individuals retain/regain their jobs during the pandemic.

The Employment Wage Subsidy Scheme (EWSS) replaced the TWSS from 1 September 2020 although the TWSS and the EWSS operated in parallel throughout July and August 2020. The EWSS provides a subsidy to qualifying employers based on the number of eligible employees on their payroll. Under previous plans the EWSS was due to expire on 30 June 2021 but on June 1 it was extended until 31 December 2021. By 9 September 2021 subsidies to the value of €4.7 billion had been paid to 51,300 employers for 653,300 employees. EWSS payments were made for 319,400 employees in August 2021. This is down from approximately 346,300 employees in January 2021. Figure 35 shows the number of individuals supported by the TWSS or EWSS from March 2020 to August 2021.

Another impact of the pandemic on the labour market has been that employer Pay Related Social Insurance (PRSI) has been forgone due to the reduced rate on wages paid that are eligible for EWSS support. These receipts have also been impacted by the fact that under the TWSS, employer PRSI did not apply to the subsidy and was reduced from 10.5 per cent to 0.5 per cent for top-up payments. PRSI forgone under TWSS could not be directly calculated by Revenue but was estimated to be around €460 million. PSRI forgone under the EWSS to 9 September 2021 was calculated by Revenue to be €747 million.

12 For more details see: https://www.revenue.ie/en/corporate/documents/statistics/registrations/a-year-of-covid-19-tax-supports.pdf.

FIGURE 35 NUMBER OF EMPLOYEES ON WAGE SUBSIDY SCHEMES BY MONTH

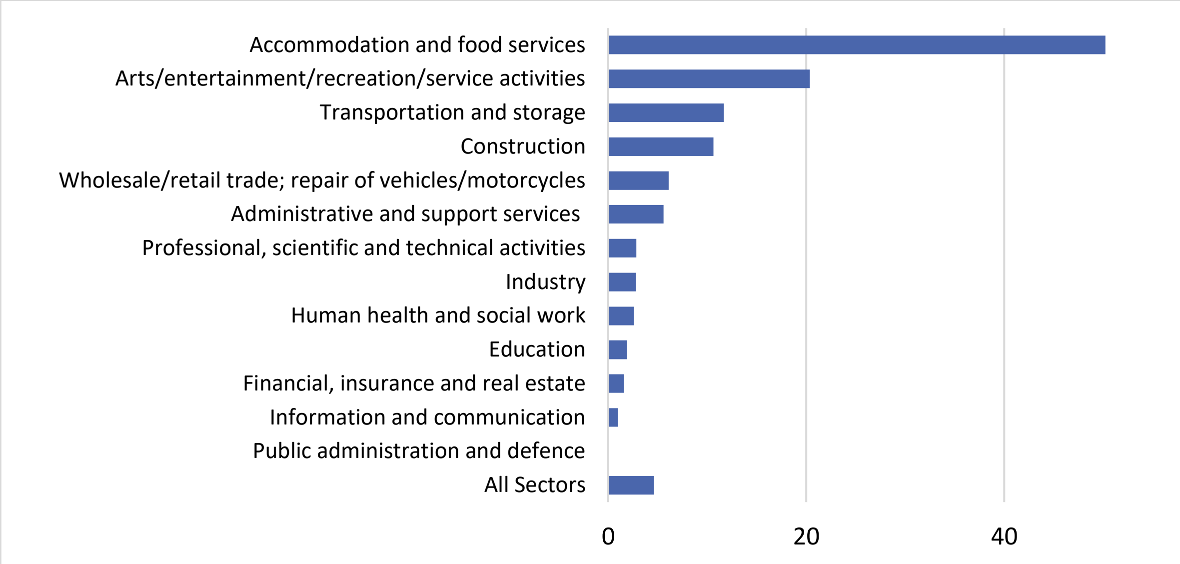


Source: Central Statistics Office and Revenue Commissioners.

While 17.0 per cent of active employments were directly supported by the EWSS overall in Q2 2021, the proportion of total employments per sector supported by the EWSS varied significantly across the sectors. The highest was in the Accommodation and food services sector (76.0 per cent) and the Arts, entertainment, recreation and other service activities sector (45.8 per cent). Public administration and defence sector had the lowest proportion at 0.2 per cent. In Q2 2021, EWSS payments accounted for 4.6 per cent of total earnings across all sectors. In the Accommodation and food services sector EWSS payments accounted for 50.2 per cent of total earnings, while it represented 20.4 per cent and 11.7 per cent of the total earnings in the Arts, entertainment, recreation and other services sector and the Construction sector respectively.[13] Figure 36 shows the EWSS subsidy payments as a percentage of total earnings across the sectors.

[13] For more information see: https://www.cso.ie/en/releasesandpublications/br/b-lfs/labourmarketinsightbulletinseries8q22021/.

FIGURE 36 EWSS SUBSIDY PAYMENTS AS PERCENTAGE OF TOTAL EARNINGS



Source: Central Statistics Office.

In Q2 2021, average weekly earnings across all employments increased by 5.0 per cent compared to Q2 2020, while they decreased by 3.8 per cent compared to Q1 2021. However, these figures may be affected by a compositional effect due to the significant changes in the number of those in employment across these quarters. For this reason, the CSO has also produced an analysis of earnings based on data relating to workers that were employed in both of the quarters being compared. Under this approach, average weekly earnings in Q2 2021 increased by 1.5 per cent compared to Q1 2021, while they increased by 12.9 per cent compared to Q2 2020. However these results must be interpreted with caution, as Q2 2020 results are likely to have been impacted by the stringency of the public health restrictions in place at the time, while the CSO has indicated that the Q2 2021 results have been negatively impacted by lower than usual response rates.[14]

The average monthly unemployment rate for 2020 was 19.4 per cent. Given the strong increase expected in domestic sources of growth in the latter half of the year, we expect that the unemployment rate in Q4 2021 will be approximately 9.0 per cent with the average unemployment rate for 2021 overall being 16.3 per cent. Owing to some scarring effects in the economy after the pandemic, we believe it is unlikely that the unemployment rate will approach its pre-COVID low of 4.8 per cent until 2023 at the earliest. Unemployment is expected to average 7.1 per cent for 2022, we expect continued growth in consumption and exports, and we do not expect any significant job losses stemming from the ending of the wage subsidy scheme.

[14] For more information see: https://www.cso.ie/en/releasesandpublications/br/b-lfs/labourmarketinsightbulletinseries8q22021/.

MONETARY, FINANCIAL AND INFLATION OUTLOOK

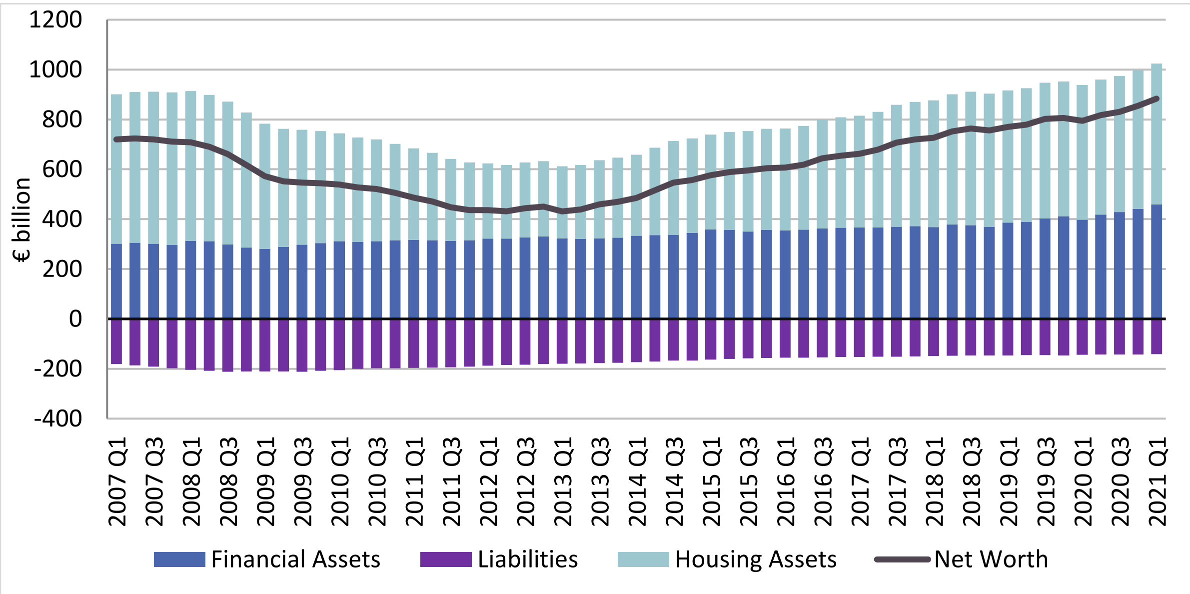
Key Points

- *Household net worth increased considerably as lending and consumption slowed throughout the pandemic.*
- *New mortgage lending for both first time buyers and movers has met or exceeded pre-pandemic levels as lending recovered in Q1 2021.*
- *The reopening of the economy has seen temporary spikes in prices.*
- *We forecast overall inflation to reach 2.3 per cent in 2021.*

Household credit and mortgage market

During the COVID-19 pandemic and its related lockdowns, aggregate household savings increased due to limited spending, significant government supports, and increased uncertainty about the future. While government supports have mitigated the impact of the pandemic on individual households, a full recovery is likely to be uneven across households as supports unwind. Figure 37 shows the net worth of Irish households as a reflection of housing and financial assets less liabilities. Net worth has been on the rise since Q1 2020. The average net worth of households in 2020 was 4.4 per cent above the 2019 average, and Q1 2021 saw an additional 3.3 per cent growth compared to Q4 2020, as both housing and financial assets increased. Consumption in Q2 2021 shows signs of a return to a more normalised savings picture as the economy reopens and households resume normal activities.

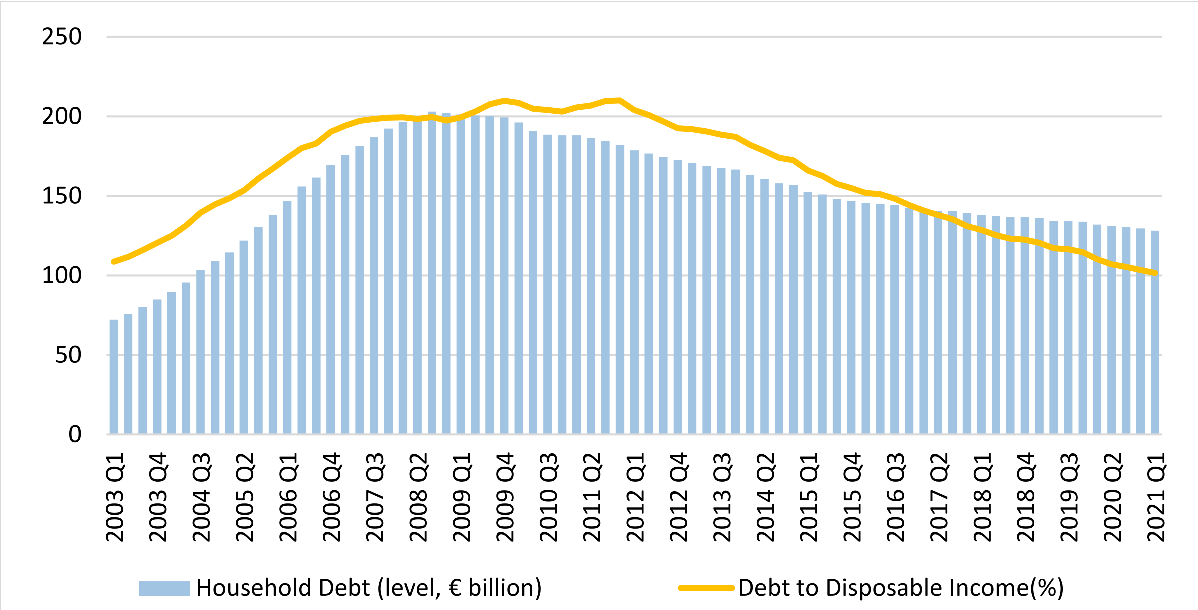
FIGURE 37 HOUSEHOLD NET WORTH



Source: Central Bank of Ireland, Quarterly Financial Accounts.

The rise in savings has been mirrored by a subsequent decline in household debt, shown in Figure 38. The debt-to-income ratio reflects the indebtedness of households, in terms of their ability to pay back the principal of their debt. Average debt levels in 2020 remained 2.8 per cent lower than in 2019. While the increase in disposable income has contributed to the further decline in debt-to-income levels amongst households, this ratio has also been significantly affected by a declining demand for credit at the onset of the pandemic. The overall decline in debt-to-income ratios is beneficial in terms of lowering the vulnerabilities of the household sector to macro-financial risks.

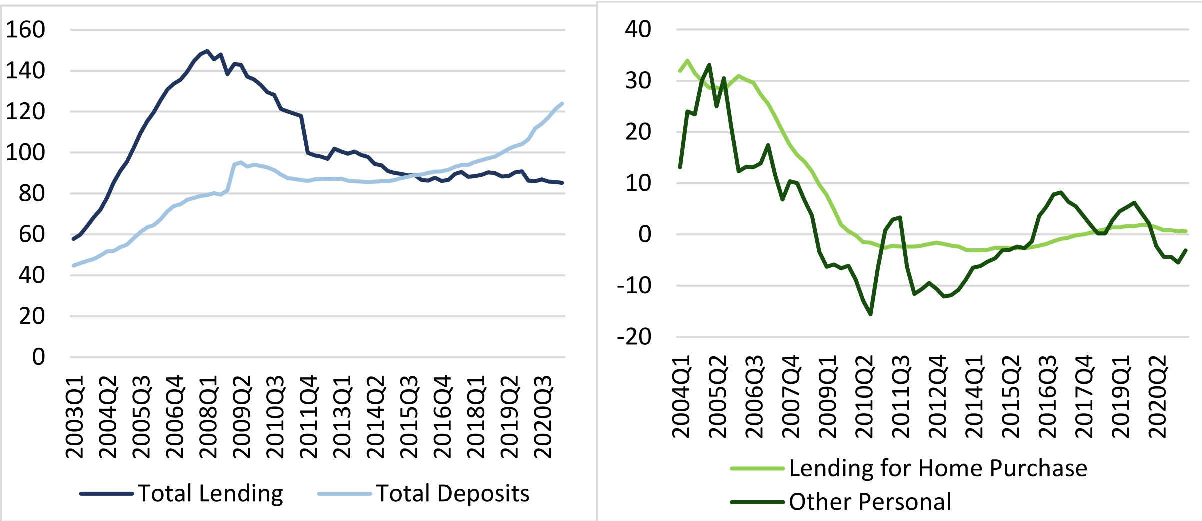
FIGURE 38 HOUSEHOLD DEBT



Source: Central Bank of Ireland, Quarterly Financial Accounts.

While large levels of credit can threaten the financial stability of the economy, an absence of lending may prohibit households from optimising their consumption patterns. Prior to the pandemic, deposits had surpassed lending, creating a gap between deposits and lending. However, the effects of the pandemic led to an acceleration in this gap, as savings increased and households halted borrowing (Figure 39). The total balance of loans has yet to reach pre-pandemic levels, as new lending has been outstripped by payments. In Q2 2021, the drop-off in personal lending was sharper (-3.1 per cent) than in the mortgage (lending for house purchase) market.

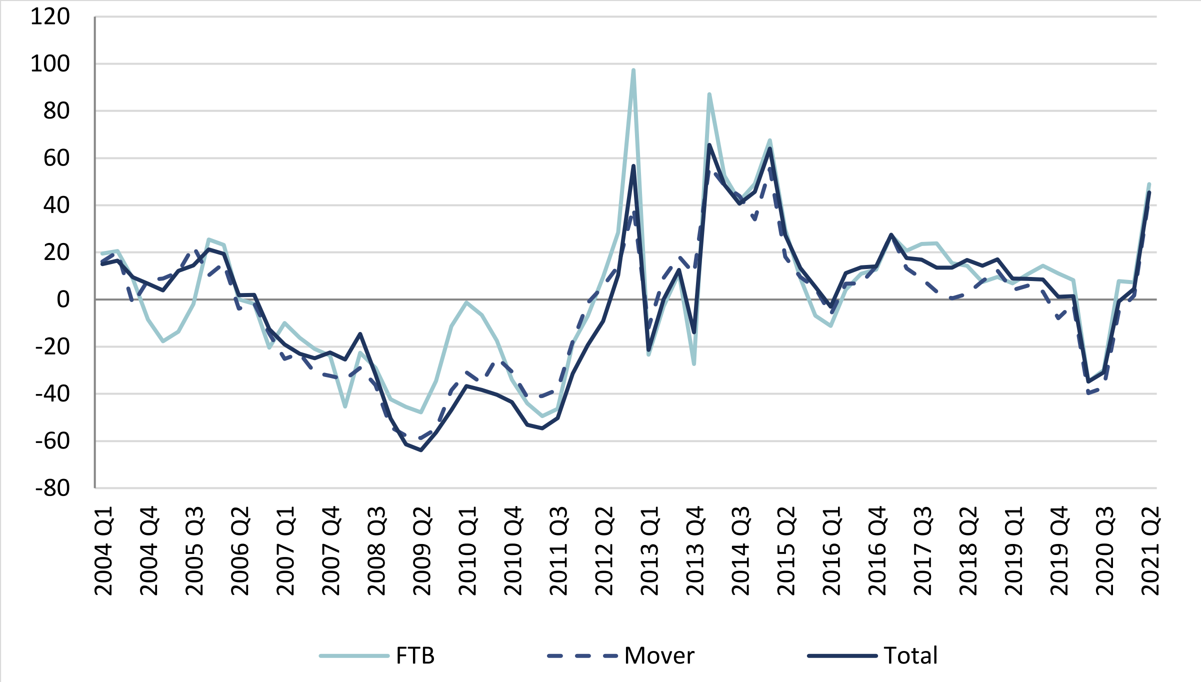
FIGURE 39 TOTAL LENDING AND DEPOSITS (LHS) AND GROWTH RATES OF CREDIT TO HOUSEHOLDS YEAR-ON-YEAR (%) (RHS)



Source: Central Bank of Ireland, Credit, Money and Banking Statistics.
Note: Data are taken from Central Bank of Ireland data release A.18, Growth rates series codes 777 and 1,252.

Following the first set of public health measures announced in Q2 2020, new mortgage lending fell by 35 and 40 per cent per annum for first time buyers and movers, respectively (Figure 40). Q3 2020 saw further declines of over 30 per cent year-on-year for both groups. Yet while movers continued to forgo house purchases, mortgages to first time buyers began increasing as early as Q4 2020. The most recent figures show mortgage lending growth of over 49 and 44 per cent for first time buyers and movers, respectively. The total number of FTB purchases reached 4,895 in Q1 2021, 11 per cent above its pre-pandemic level in Q1 2020. Mover purchases are now equal to their Q1 2020 volume. As mentioned, survey data from the European Commission Consumer Sentiment Survey suggest that households in Ireland have an increasing likelihood of purchasing housing. We can therefore expect that the savings accumulated by households during the pandemic are likely to contribute to house purchases and stimulate mortgage lending.

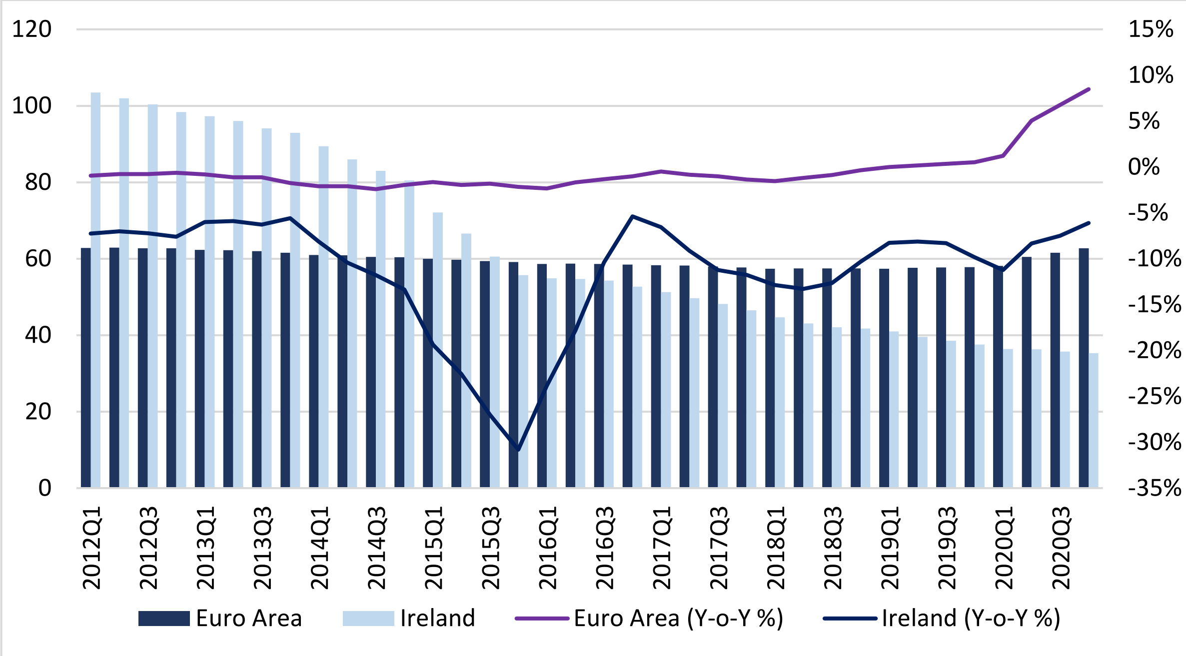
FIGURE 40 NEW MORTGAGE LENDING VOLUME GROWTH (%)



Source: Banking and Payments Federation Ireland.

However, even with the recent pick-up in new mortgage lending, credit levels amongst Irish households continue to fall as repayments outstrip new borrowings. Figure 41 compares the credit levels and growth rates to households and non-profit institutions serving households (NPISH) in the Euro Area and Ireland. Credit levels amongst Irish households have declined since the aftermath of the GFC. Credit amongst Irish households exceeded the Euro Area median by 78 per cent in 2010. The debt build-up preceding the financial crash resulted in dramatic deleveraging by households. By 2015, credit levels amongst Irish households were on a par with their Euro Area counterparts, however the continued deleveraging in the Irish market since then means that Irish households' credit levels are now below those of the Euro Area. In 2020, average credit in the Euro Area exceeded credit levels in Ireland by 70 per cent.

FIGURE 41 CREDIT TO HOUSEHOLDS AND NPISHS FROM ALL SECTORS, (% OF GDP)



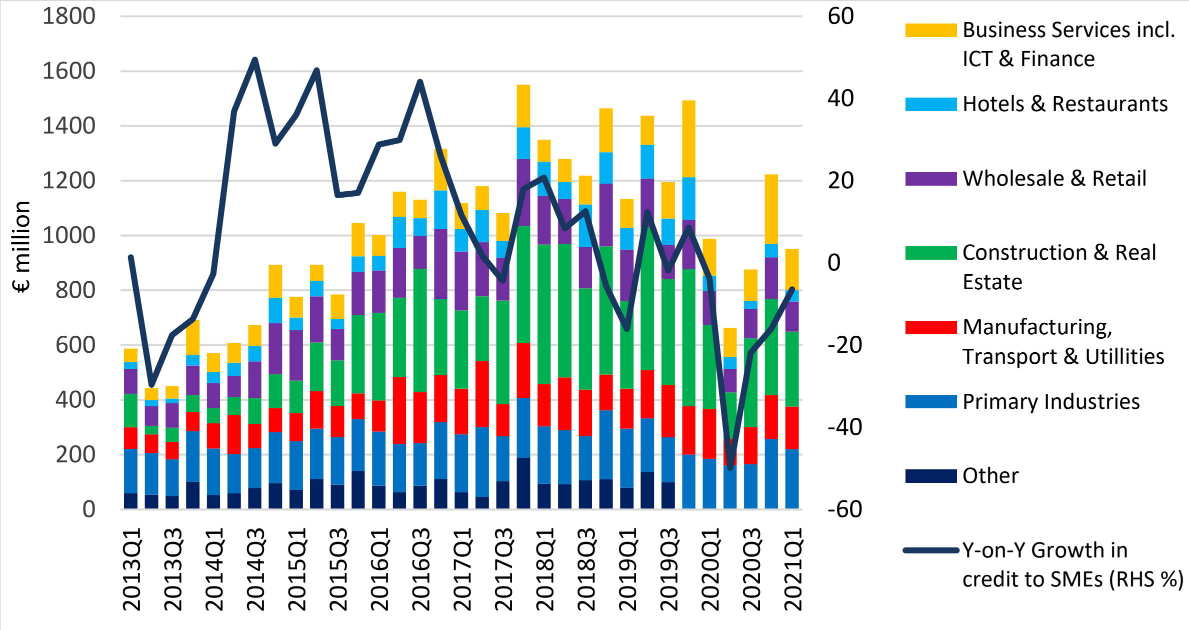
Source: Bank for International Settlements.

Trends in SME credit

Much like the effect of the pandemic on households, the recovery for businesses is likely to be uneven. Irish SMEs have experienced a particularly sharp fall in lending since the beginning of 2020. Total lending to SMEs in 2020 decreased 23.2 per cent compared with lending in 2019. Q1 2021 witnessed further declines in lending, dropping 23.2 per cent from Q4 2020 to just €1.05 billion in total. However, the effects of public health restrictions on different sectors have varied considerably, with some sectors more capable of adapting to remote work or less likely to experience public health-related closures. Such sectors include business services and primary industries, which were the only two sectors to increase new lending to SMEs in Q1 2021 compared to Q1 2020. Meanwhile, lending to all other sectors remains below its Q1 2020 level (Figure 42).

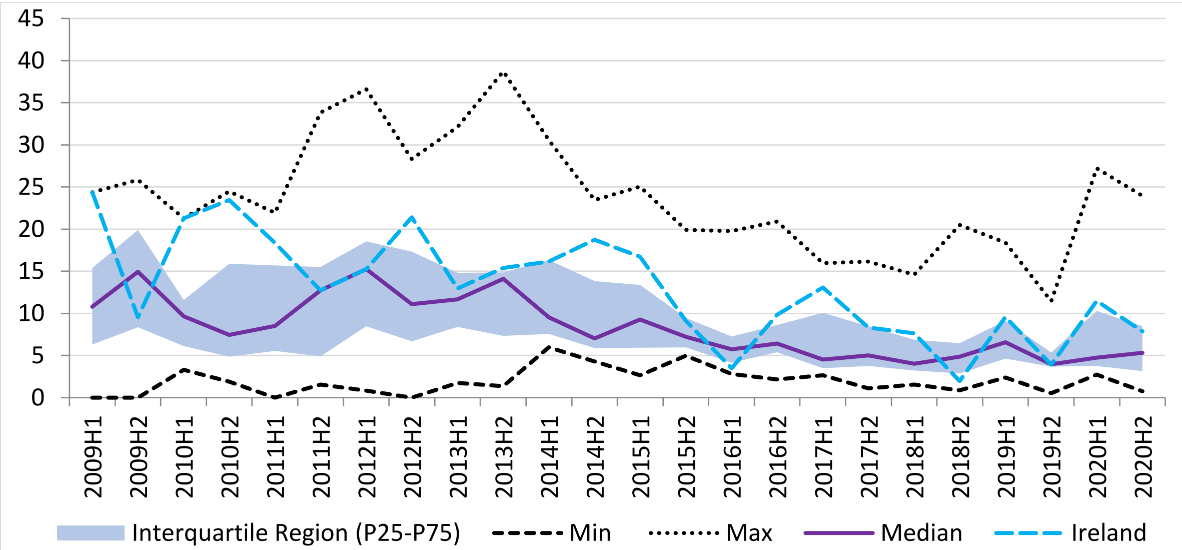
While monitoring overall lending trends can be informative, it does not provide much insight into the demand for credit. To better understand SME demand for credit, we present loan application and rejections data from the ECB survey of SMEs (Figure 43). We present the data for Ireland as well as the median value for other European countries for which data were available. Credit supply conditions appear tighter in Ireland with rejection rates of 7.9 per cent, compared to the median level in the other EU countries of 5.3 per cent. This is a marked increase compared to the first half of 2020, in which the rate of rejection in Ireland was more than twice that of the EU median.

FIGURE 42 NEW LENDING TO SMES BY SECTOR (TOTAL LENDING AND ANNUAL CHANGE, %)



Source: Central Bank of Ireland, Credit Advanced to Irish Resident Small and Medium Sized Enterprises.

FIGURE 43 ECB BANK LOAN REJECTION RATES, EURO AREA COMPARISON (%)



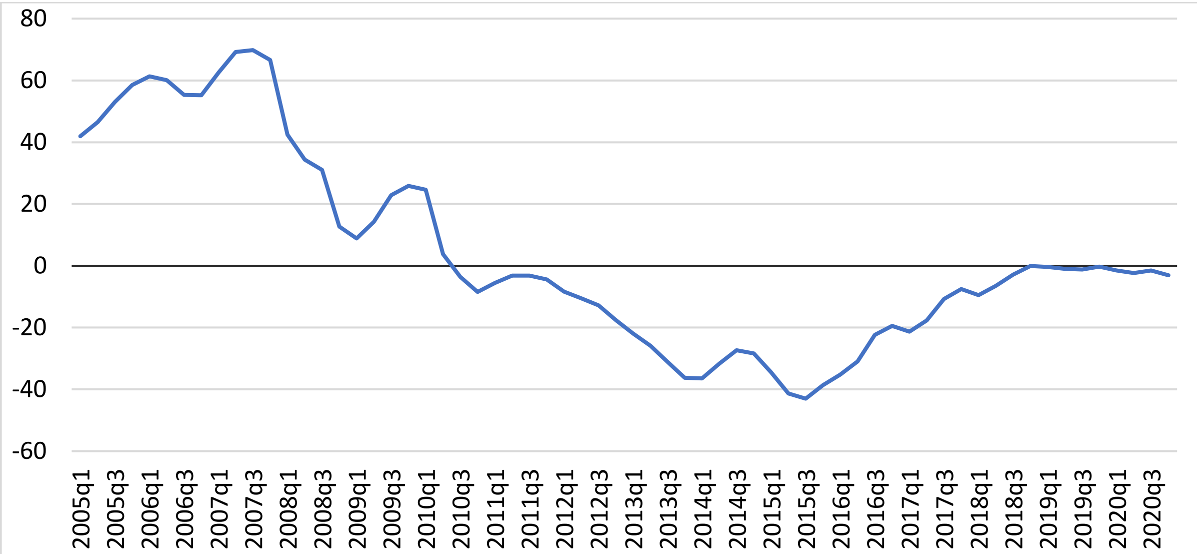
Source: European Central Bank, Survey on Access to Finance of Enterprises (rejected bank loan applications).
Notes: Countries included are: AT, BE, EE, ES, FI, FR, IE, IT, LT, NL, PT, SI. These countries are selected due to data availability.

Credit-to-GDP

While lending to households and SMEs has been trending downward, it is important to assess the relationship between the actual and trend level of the credit-to-GDP ratio, as measured by the credit gap. When the gap is positive, the current level of the ratio is greater than trend and when the gap is negative the current level of the ratio is less than trend. If the gap becomes significantly large, this may suggest that the current level of credit in the economy is unsustainable.

Due to a number of methodological issues with the standard approach to calculating the credit gap in the Irish context, the Central Bank has constructed an alternative measure of the credit gap using a model-based approach, using GNI*[15] in place of GDP.[16] The credit gap has remained negative since Q2 2010 (Figure 44). With the halt in lending through much of the pandemic, the credit gap declined to -3.1 in Q4 2020. While the gap is historically low, monitoring the credit gap is imperative in assessing the sustainability of credit levels in Ireland.

FIGURE 44 CENTRAL BANK MODEL BASED ESTIMATE OF CREDIT GAP (%)



Source: Central Bank of Ireland.

Interest rates and the cost of credit

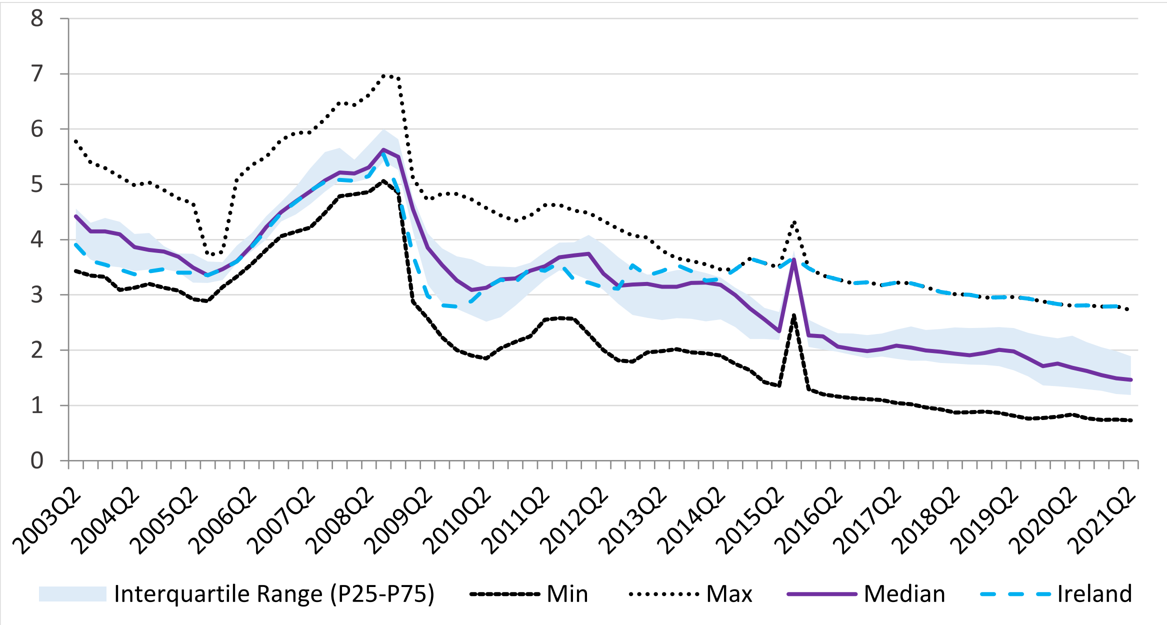
While many factors influence credit levels, one important contributor in Ireland is the cost of finance. Figure 45 shows the relatively high cost of finance for Irish households compared to other Euro Area countries. Ireland has had the highest interest rates on home purchases since Q3 2015 and domestic rates have exceeded the EU wide median since Q4 2012. The average annual interest rate on new home loans in Ireland was 2.7 per cent in Q2 2021 compared to just 1.5 per cent in the Euro Area. The comparatively high rates of borrowing within Ireland exacerbate the affordability challenges faced by households wishing to purchase a home. A number of factors are likely to impact the interest rate level in Ireland including market competition, the cost of capital for banks and the underlying collateral recovery risk. It is likely that the recent announcements of market exit by Ulster

15 This measurement for domestic economic activity attempts to strip away the distortionary effects of in order to give a more reliable measure for trends in the underlying Irish economy.

16 For more on this approach see: O'Brien, E., M. O'Brien and S. Velasco (2018). 'Measuring and mitigating cyclical systemic risk in Ireland: The application of the countercyclical capital buffer' Central Bank of Ireland *Financial Stability Notes*, 4.

Bank and KBC have weakened competitive dynamics in the retail banking market. However, some recent non-bank entrants may provide competition going forward.

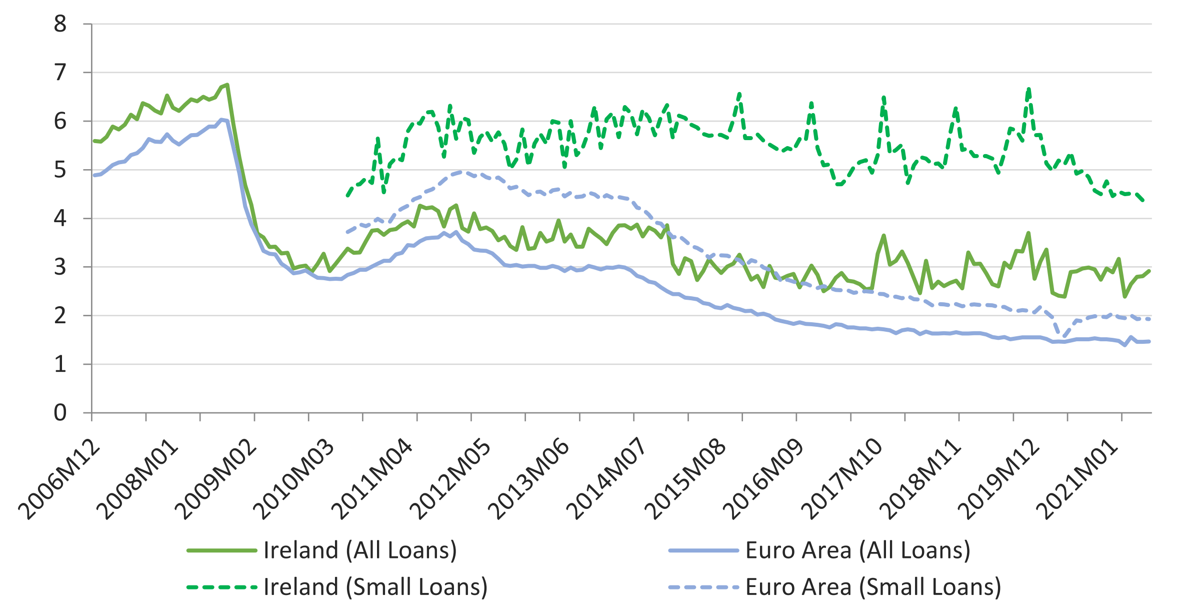
FIGURE 45 INTEREST RATES ON NEW HOME PURCHASES, EURO AREA COMPARISON (%)



Source: European Central Bank, MFI Interest Rate Statistics.
Notes: Countries included are: AT, BE, EE, ES, FI, FR, IE, IT, LT, NL, PT, SI, SK. These countries are selected due to data availability. Data differ between this chart presented and the text as the ECB comparison data include restructured mortgages whereas the new business SVR is only for new drawdowns.

Interest rates on loans to corporations in Ireland have also remained higher than the Euro Area average. Figure 46 presents the interest rate on new business loans in Ireland and the Euro Area across two series: 1) depicts all loans to corporations and 2) covers small loans worth less than €250,000. As of July 2021, there was a 1.5 and 2.5 percentage point difference between Ireland and the Eurozone on all loans and small loans, respectively. In 2020, the average interest rate paid by Irish corporations in need of small loans was 5.0 per cent, compared to just 1.9 per cent for Euro Area businesses. This difference reflects the relatively high cost of credit for Irish SMEs.

FIGURE 46 INTEREST RATES TO CORPORATIONS, EURO AREA COMPARISON (%)

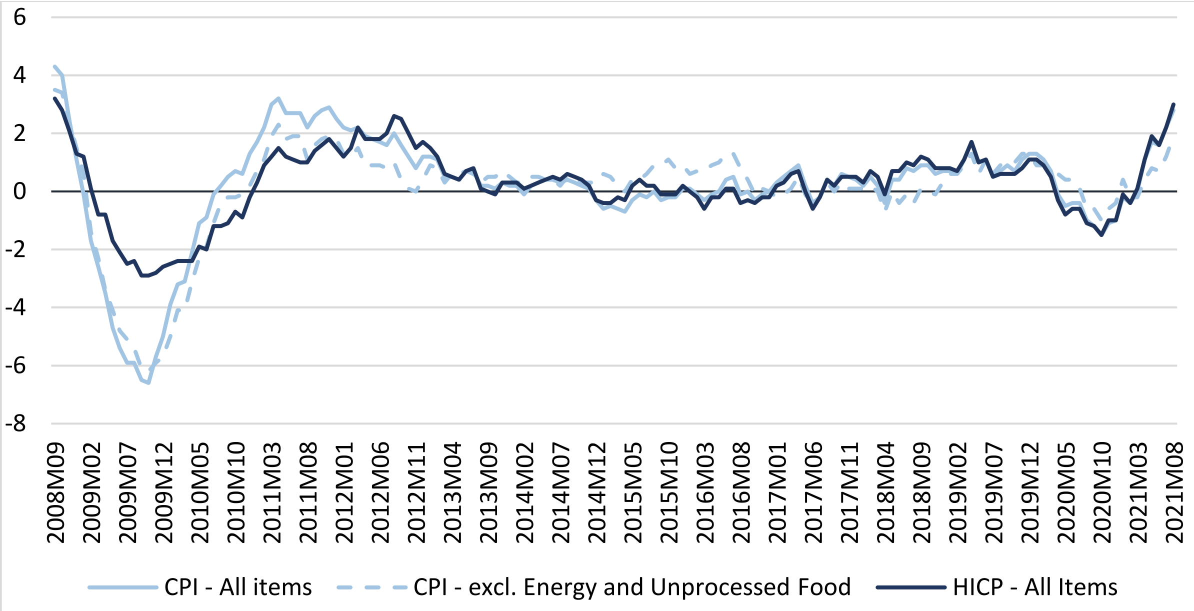


Source: European Central Bank, MFI data. 'Small loans' refers to loans worth less than €250,000.

Inflation outlook

As economies have resumed most normal activities in the second half of 2021, consumption and unemployment levels have rebounded slightly faster than anticipated. The surge in demand for consumer goods comes as manufacturing and other sectors are just resuming normal output, contributing to upward pressure on prices as supply struggles to meet demand. The CPI and HICP experienced annual increases of 2.8 and 3 per cent in August, respectively (Figure 47). While this is above the target of 2 per cent, the rise is largely counteracting the deflation that occurred in 2020 and early 2021 due to the various different public health measures that were adopted. For example, both the CPI and HICP experienced declines in each quarter from Q2 2020 to Q1 2021.

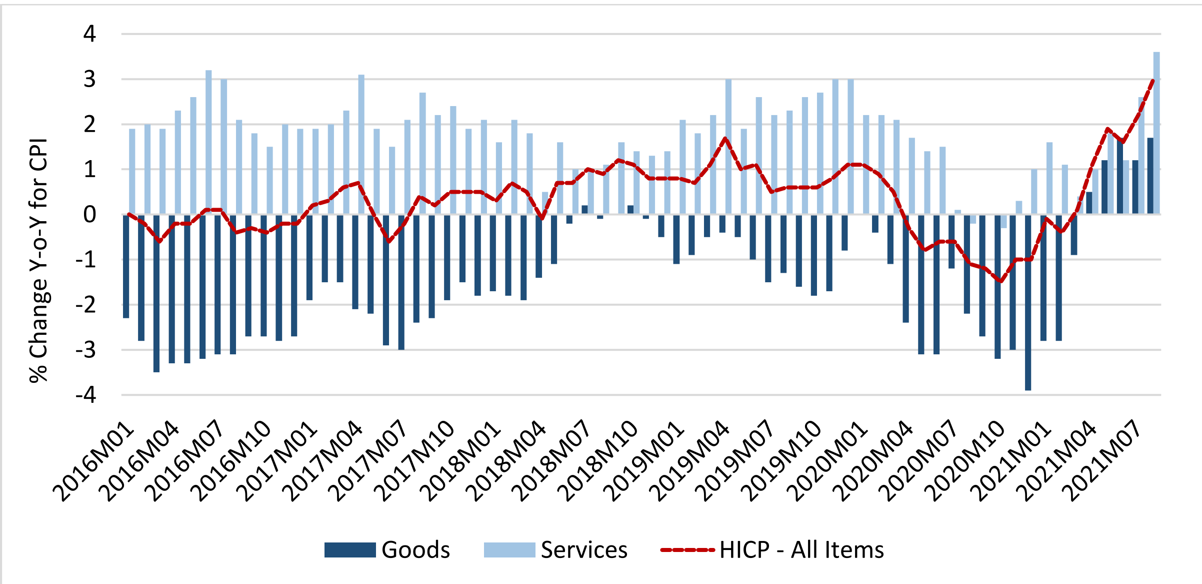
FIGURE 47 ANNUAL GROWTH IN INFLATION (%)



Source: Central Statistics Office.

The demand for services has been particularly strong since the easing of restrictions in Q2 2021. In July and August, prices of services jumped 2.6 and 3.6 per cent, respectively. While there is no doubt a surge in demand, as consumers are enjoying services that were not available during lockdown, the large jump is also related to the deflation that occurred in Q3 2020.

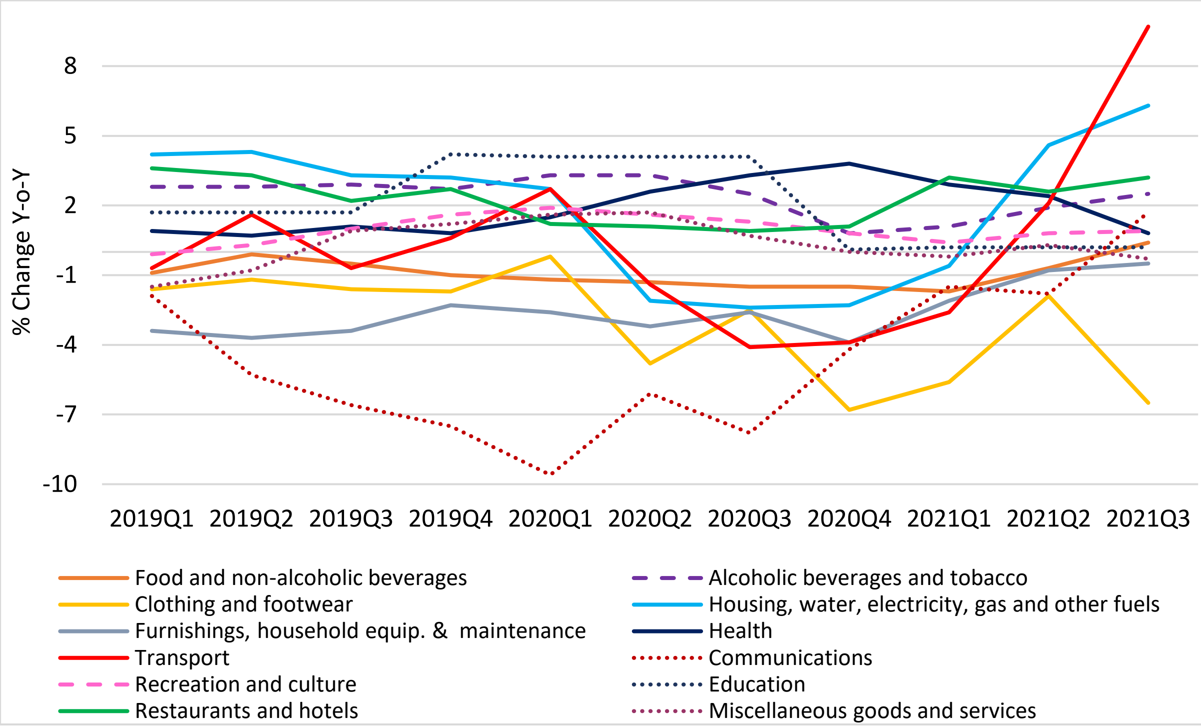
FIGURE 48 DECOMPOSITION OF ANNUAL CPI GROWTH INTO GOODS AND SERVICES GROWTH (%)



Source: Central Statistics Office.

Price changes across commodities also reveal the effects of easing restrictions. Transport costs registered the largest increases in recent price movements, growing 9.7 per cent in Q3 2021 in response to the 4.7 per cent decline in transport costs that occurred in Q3 2020 (Figure 49). Clothing and footwear experienced the greatest decrease in prices, at 6.5 per cent. Communication-related goods have also experienced consistent price growth since Q3 2020. Housing, Water, Electricity, Gas and Other Fuels rose significantly in August 2021 (6.3 per cent), as the cost of utility prices increased.

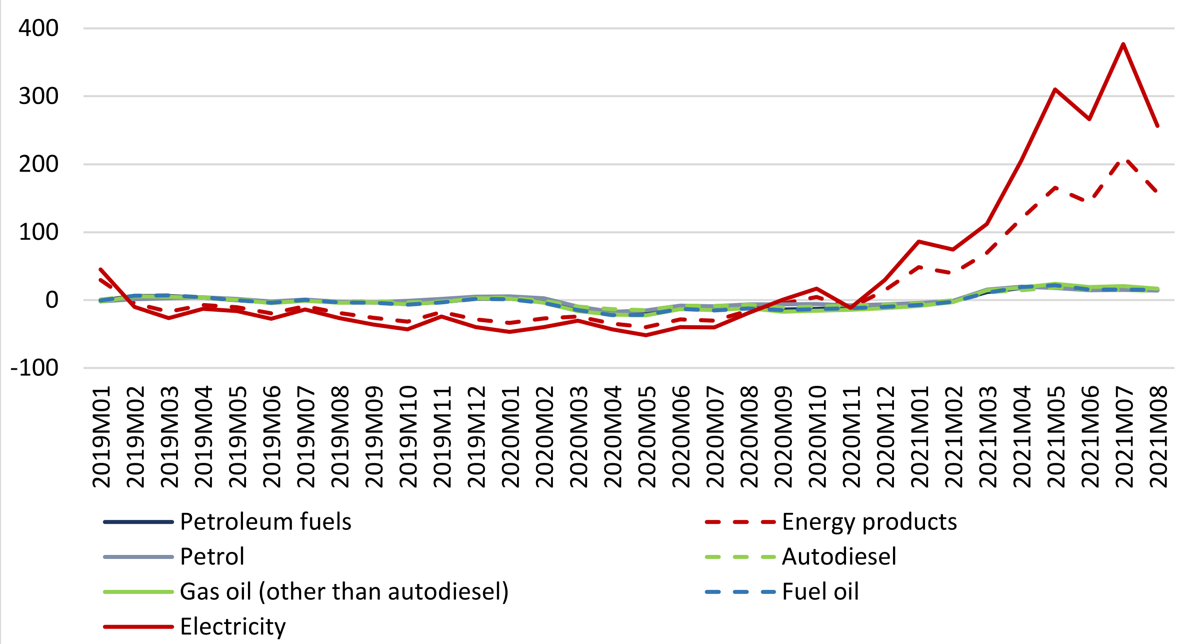
FIGURE 49 CONSUMER PRICE INDEX BY COMMODITY (%)



Source: Central Statistics Office.

While the CPI demonstrates how prices are behaving in the overall economy, it is also revealing to examine wholesale prices which often reflect changes in pricing much more quickly than the CPI. Figure 50 shows the wholesale prices of energy items. As is clear from the chart, 2021 has been accompanied by substantial changes in the energy market. The price of electricity and energy products in particular have been growing rapidly since December 2020. The price of energy products has increased over 100 per cent annually from April to August 2021. The growth in electricity prices has been even more rapid. As of August 2021, electricity prices had increased over 250 per cent per annum. While some declines in energy prices occurred in 2020, the latest increases have far surpassed pre-pandemic price levels. Prices in petroleum fuels, petrol, autodiesel, gas oil and fuel oil have all also experienced increases since March 2021 but have so far remained close to their pre-pandemic levels.

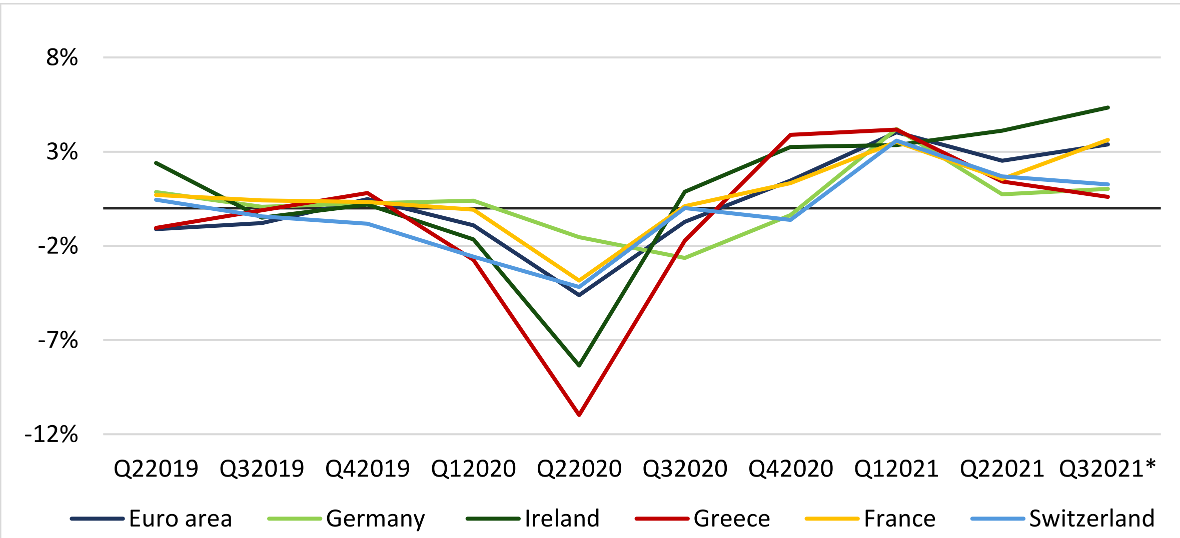
FIGURE 50 ANNUAL CHANGE IN WHOLESALE PRICE INDEX BY ENERGY TYPE (%)



Source: Central Statistics Office, Wholesale Price Index.

The rise in utility costs and other goods is not unique to Ireland. As inflation depends on the global supply and demand of goods and services, it is important to benchmark Ireland's rise in prices against that of other countries. Energy prices increased globally in Q2 2021. The Euro Area experienced an increase in prices of 3.4 per cent in Q3 2021, the fourth consecutive quarter to experience price increases. In Ireland, the increase was 5.3 per cent in the same period (Figure 51).

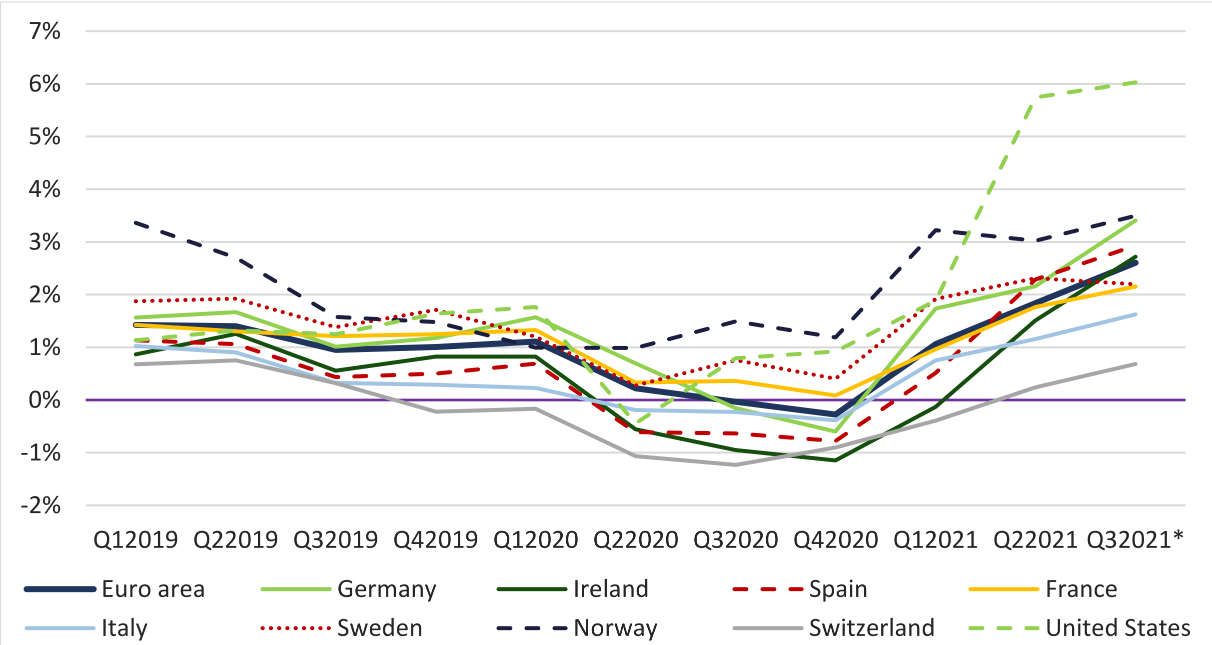
FIGURE 51 ELECTRICITY, GAS AND OTHER FUELS, CROSS COUNTRY COMPARISON (Q-ON-Q %)



Source: Eurostat HICP.
Note: Q3 2021 refers to data through August 2021. 2015=100.

The Harmonised Index of Consumer Prices (HICP) measures the prices of goods and services over time. Figure 52 shows the HICP for a selection of countries between Q1 2019 and Q3 2021. Increases in prices are evident in the chart, with several countries exceeding 2 per cent inflation by Q3 2021. By August of 2021, prices had increased 2.7 per cent in Ireland and 2.6 per cent in the Euro Area compared to the same period last year. While much of the spike in 2021 is reflective of the negative growth in prices in 2020, factors such as the volatility in energy prices, increased consumption and supply chain disruptions may contribute to further increase throughout the remainder of 2021.

FIGURE 52 HARMONISED INDEX OF CONSUMER PRICES (HICP) (ANNUAL GROWTH %), CROSS COUNTRY COMPARISON



Source: Eurostat HICP.
Note: Q3 2021 refers to data through August 2021. 2015=100.

The ECB's medium-term target of a 2 per cent inflation rate means that short-term fluctuations below or above this average should be permitted without spurring strong reactions. In clarifying the ECB's reaction to the recent spikes in inflation, Isabel Schnabel remarked;

> *Contrary to some predictions, our baseline scenario foresees inflation in the Euro Area to weaken significantly as of the start of next year before falling below our target of 2 per cent again. This is because the*

> *inflation rate is currently significantly affected by statistical effects. Put simply, inflation is so high now because it was so low last year.*[17]

For the remainder of 2021, the surge in consumption that first took place after the lifting of restrictions is likely to continue as households unwind their savings and businesses resume normal economic activity. This will contribute to further increases in prices, and we therefore expect overall inflation to be 2.3 per cent in 2021. However, as saving rates return to their long-term averages, consumption is expected to gradually decelerate in 2022. Therefore, the spike in prices that we expect to see by Q4 2021 will likely ease throughout 2022. Much like the expectations set out by the ECB, we anticipate a weakening of inflation as the new year unfolds, resulting in overall inflation of 2.5 per cent in 2022. However, any sustained easing of the inflation rate could be compromised by a continuation of global price pressures for energy products as well as a faster than expected recovery in the domestic economy.

[17] Schnabel, I. (2021). 'New narratives on monetary policy – the spectre of inflation', speech at Frankfurt am Main, 13 September. Full speech available here: New narratives on monetary policy – the spectre of inflation (europa.eu).

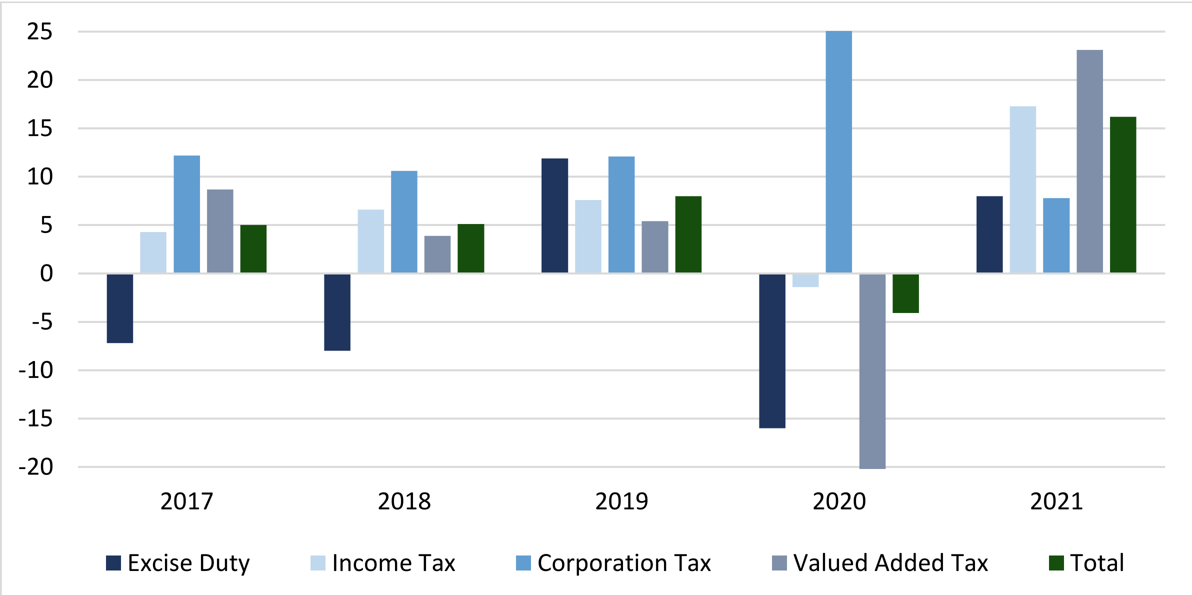
PUBLIC FINANCES

Key Points

- *Greater than expected growth easing difficulties in the public finances.*
- *Strong underlying growth underpinning increases in taxation receipts.*
- *Deficit in 2021 somewhat lower than expected.*

As can be seen from Figure 53, the pace of economic growth in 2021 has resulted in most taxation items experiencing strong growth.

FIGURE 53 GROWTH RATE AND LEVELS FOR MAIN TAXATION ITEMS: JANUARY TO MAY 2019-2021



Source: *QEC* calculations.

Items such as VAT, income tax and excise duties largely rebounded from their declines in 2020 and registered large growth, while corporation taxes, which had grown by 27 per cent for the same period in 2020 also grew robustly.[18]

Inevitably much of these increases are due to the significant recovery in economic activity resulting from the easing of public health restrictions through Q2 2021 and Q3 2021. However, some of the increases may also be due to underlying economic growth or growth which would have occurred anyway between 2020 and 2021 if the pandemic had not occurred. In the following Box, McQuinn quantifies the amount of tax increases due to the two different sources of growth.

18 In 2020 about €2 billion in tax warehousing took place so taxation receipts for the year are artificially low to that extent.

BOX A DECOMPOSING INCREASES IN IRISH TAXATION LEVELS IN 2021 BETWEEN THE RECOVERY AND UNDERLYING ECONOMIC GROWTH

In this Box we conduct a counterfactual exercise to assess how actual taxation receipts in 2021 compare with the level they would have been in 2020 if there had not been a pandemic. While there has been strong growth in receipts across most taxation categories between 2021 and 2020, this is affected by the significant decline in receipts in 2020 due to the adoption of the public health measures.

It is informative, therefore, to assess how much of the increase in receipts between 2021 and 2020 is due to underlying growth in the economy between these two years as opposed to how much of the increase is due to the recovery after the sharp decline in 2020 levels. The relationship between tax receipts and underlying economic activity has been of particular interest in an Irish context since the great financial crisis (GFC) of 2007/2008 and has been examined in Deli et al. (2017) and Addison-Smyth and McQuinn (2016; 2010).

To arrive at the counterfactual level for 2020 we calculate the average growth rate for each tax heading over the period 2016-2019. This deliberately excludes 2015 when there was an exceptional increase in corporation tax receipts which was associated with significant distortionary transactions in the Irish National Accounts. Table A.1 summarises the average growth rates for each category.

TABLE A.1 ANNUAL AVERAGE GROWTH RATE IN IRISH TAXATION CATEGORIES: 2016-2019 (JANUARY-AUGUST)

Component	%
Customs	1.5
Excise duty	3.6
Capital Gains Tax	17.3
Capital Acquisitions Tax	10.3
Stamps	7.0
Income	5.7
Corporation Tax	10.1
VAT	5.5
Total	6.0

Source: *QEC* estimates.

From the table it is evident that most categories have experienced significant increases over the period as the economy has grown at a highly robust rate. Income taxation receipts have, on average, grown at a considerable rate of 6 per cent per annum between 2016 and 2019.

We now apply these growth rates to the actual 2019 taxation levels and generate a counterfactual set of figures for the 2020 taxation categories. Table A.2 illustrates the actual and counterfactual series for each category.

TABLE A.2 COMPARISON OF ACTUAL AND COUNTERFACTUAL 2020 IRISH TAXATION CATEGORIES (JANUARY-AUGUST)

Component	Actual 2020 (€ billion)	Counterfactual 2020 (€ billion)	% difference
Customs	0.17	0.22	24.8
Excise duty	3.34	4.06	17.7
Capital Gains Tax	0.28	0.31	9.4
Capital Acquisitions Tax	0.14	0.17	19.0
Stamps	0.87	0.92	5.5
Income	13.89	14.88	6.7
Corporation Tax	6.48	5.43	-19.3
VAT	7.79	10.44	25.4
Total	32.95	36.40	9.5

Source: *QEC* estimates.

The counterfactual level in 2020 is somewhat larger than the actual level in all cases with the exception of corporation tax. Corporation tax experienced a significant increase in 2020; this reflected the fact that some multinationals in the Irish jurisdiction performed quite robustly during the pandemic.

In Table 3 we compare the counterfactual level of the different tax categories in 2020 with the actual amount in 2021. This enables us to identify how much of the tax increase between the two years is due to the underlying growth in the economy as opposed to the increase that is due to the low levels in 2020.

TABLE A.3 COMPARISON OF COUNTERFACTUAL 2020 AND ACTUAL 2021 IRISH TAXATION CATEGORIES (JANUARY-AUGUST)

Component	A	B	C	B v C	A v C
	2020 Counterfactual (€ billion)	2020 Actual (€ billion)	2021 Actual (€ billion)	% Difference	% Difference
Customs	0.22	0.17	0.31	88.6	41.8
Excise duty	4.06	3.34	3.62	8.3	-10.9
Capital Gains Tax	0.31	0.28	0.27	-2.5	-11.7
Capital Acquisitions Tax	0.17	0.14	0.19	41.9	15.0
Stamps	0.92	0.87	0.99	14.4	8.1
Income	14.88	13.89	16.52	18.9	11.0
Corporation Tax	5.43	6.48	7.00	8.1	29.0
VAT	10.44	7.79	9.82	26.0	-6.0
Total	36.40	32.95	38.72	17.5	6.4

Source: *QEC* estimates.

From the table, the significant increase in the actual tax levels between 2020 and 2021 is evident with overall tax levels up 17.5 per cent between the two years. All items with the exception of Capital Gains Tax register a strong increase.

When we examine the difference between the actual 2021 level and the counterfactual level for 2020, the increase is now 6.4 per cent. Income tax, which is up by almost 19 per cent between the two actual levels is still up by over 11 per cent between the actual 2021 and the 2020 counterfactual level. Interestingly, VAT levels registered negative growth between the actual 2021 and counterfactual 2020 level. This taxation item would be one of the main items impacted by the public health measures.

This illustrates that while a large portion of the increase in tax revenues between the two years is undoubtably due to the low base in 2020 because of the COVID pandemic, it also indicates that there was underlying growth in taxation levels between the two years as well. This correlates with the exceptionally strong growth rates observed in general across the economy in 2021 when compared with 2020.

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This Box was prepared by Kieran McQuinn

Table 2 presents the forecasts for different taxation items for 2021 along with the actual rates of growth for the same period in 2020.

TABLE 2 FORECAST OF KEY TAXATION AGGREGATES IN 2021 (%)

Tax	2020 actual growth (%)	2021 forecast growth (%)
Income	-1.0	13.0
VAT	-17.8	20.0
Corporation	8.7	3.5
Excise	-8.3	6.0
Total	-3.6	11.5

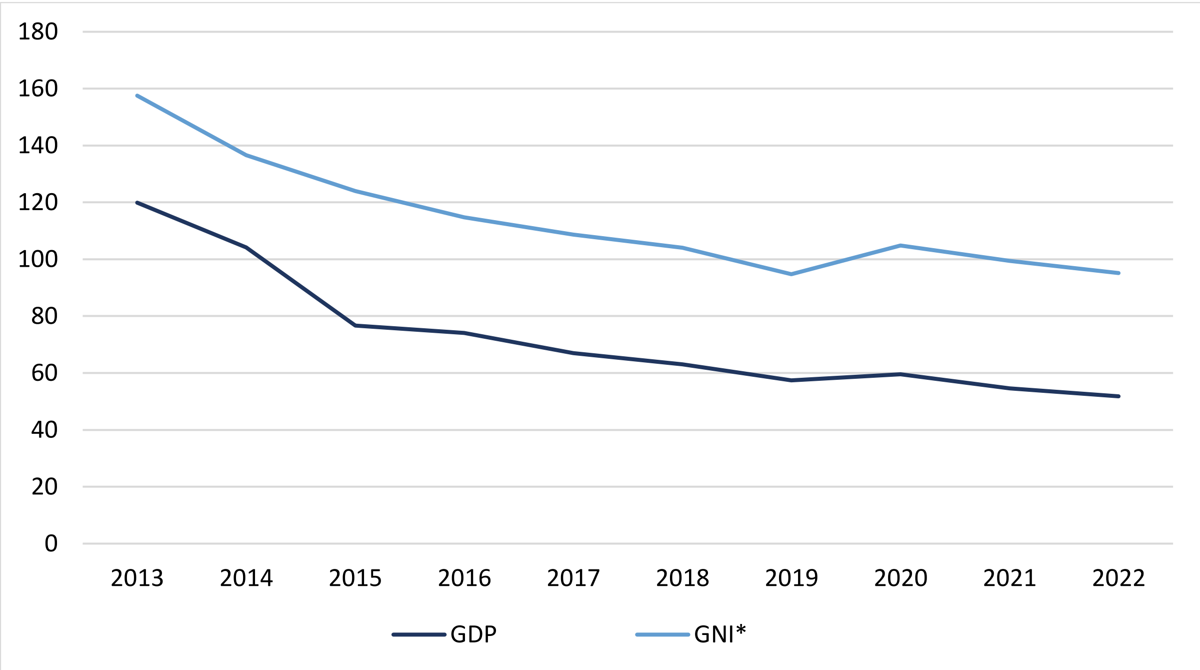
Source: Department of Finance and *QEC*.

The budgetary situation in 2021 is further eased due to the pace of the economic recovery as expenditure does not need to increase as much had been previously forecast. This is particularly the case due to developments in the labour market. With the easing of public health measures, the unemployment rate has been declining quickly, resulting in less expenditure in areas such as the Pandemic Unemployment Payment (PUP).

Between the increase in taxation receipts and the slower pace of increase in expenditure, we now believe that there will be a deficit on the General Government Balance (GGB) of 3.4 per cent in 2021. This is down somewhat from our previous forecast. We also believe that the improvement in the public finances will continue into 2022 as the unemployment rate declines further. This will result in a deficit on the GGB of 1.7 per cent at the end of 2022.

Given the faster pace of economic growth, we summarise the resulting implications for our forecasts of the debt-to-output ratios in Figure 54. At the end of 2020, the debt-to-GDP ratio stood at 59.5 per cent while debt-to-GNI* increased to almost 105 per cent. In 2019, the debt-to-GNI* ratio had fallen to 95 per cent. In 2021 both ratios will actually decline to 54.6 and 99.5 respectively; and in 2022, we believe the pace of recovery in the domestic economy will cause those ratios to decline further to 51.8 per cent of GDP and 95.2 per cent of GNI*.

FIGURE 54 DEBT-TO-GDP AND GNI* RATIOS (%)



Source: *QEC* calculations.

Given these forecasts, in Box B the sustainability of Ireland’s present debt position is assessed when compared with other European countries.

BOX B IS IRELAND A HIGH DEBT COUNTRY?

The pandemic has resulted in a renewed focus on the role of fiscal policy both in a domestic and international context. The formal suspension in the European Union of the fiscal rules framework, introduced as part of the Stability and Growth Pact (SGP) in 2011, has enabled Member States to increase substantially their levels of public sector borrowing. Ireland, like most Western economies, has increased its borrowing significantly over the last two years as it addressed the swift economic downturn prompted both by the onset of COVID-19 and the public health measures adopted to contain the spread of the virus. Inevitably, some concerns have been expressed in a domestic context as to how sustainable this increase is and whether it could necessitate a period of fiscal retrenchment in order to put the Irish public finances back on a sustainable footing.

In addressing this point a number of commentators have referred to Ireland as a 'high debt country' amongst Western economies. While the standard debt-to-GDP ratio, which is typically used in assessments of sovereign debt, stands at a relatively low 59 per cent in 2020, many dismiss the ratio on the basis of the well-known difficulties with GDP in an Irish context and instead point to the debt-to-GNI* measure, which, in 2020, stood at just under 105 per cent. GNI* is the measure proposed by a special working group which advised the Central Statistics Office to arrive at a measure of output which reflected more accurately underlying activity in the Irish economy (see Lane, 2017, for more details).

However, there are issues with both approaches; debt-to-output indicators are mainly used in comparison with similar ratios from other jurisdictions.[19] Comparing debt-to-GDP with other countries from an Irish perspective may provide a somewhat false sense of security given the well-established volatility of Irish GDP. However, using debt-to-GNI* is problematic in that it is difficult to benchmark the ratio against comparable indicators for other countries. It does not make sense to compare debt-to-GNI* for Ireland with debt-to-GDP for other countries as they are two different output measures, and while Ireland's difficulties with interpreting its National Accounts are quite significant, they are by no means unique in this regard. Therefore, differences may emerge between GDP and GNI* for other countries as well.[20]

In assessing whether Ireland is a high debt country we use an alternative measure of fiscal sustainability – the ratio of gross government debt to taxation revenues. This we believe is a much better indicator of the capability of an economy to meet its debt requirements in terms of its total revenue take (note Allen-Coghlan and McQuinn (2021) following Furman and Summers (2020) estimated the real interest payments-to-GDP ratio as an alternative measure of debt sustainability). While not totally immune to multinational related distortions, taxation receipts are less susceptible to the issues which have afflicted GDP estimates.[21]

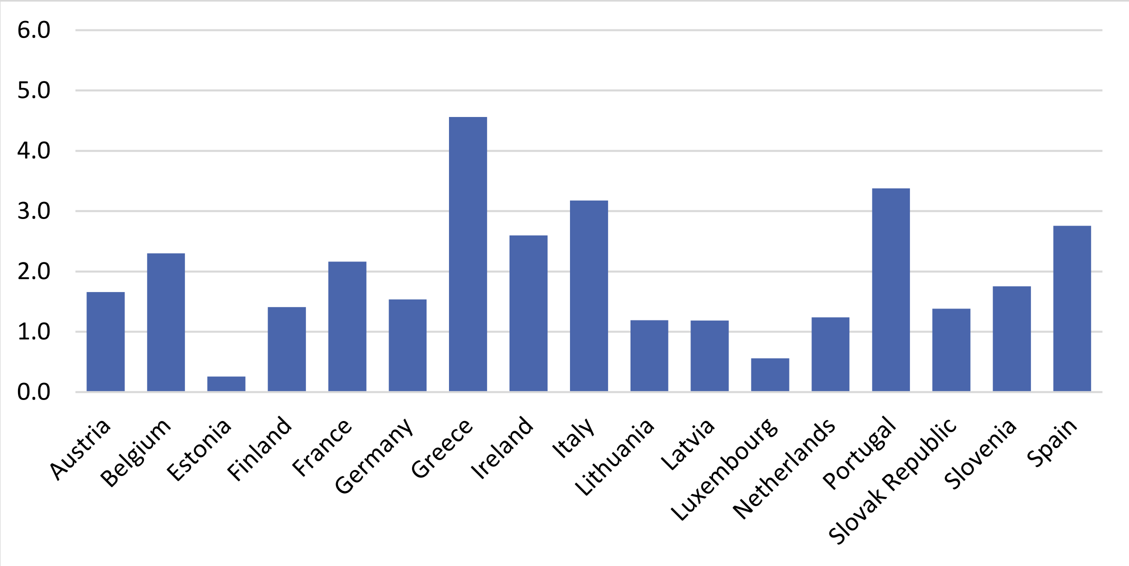
19 While Reinhart and Rogoff (2010) did identify 90 per cent as a crucial turning point in the debt-to-GDP ratio, the usefulness of the ratio for a particular country is usefully in terms of its relative ranking with other countries. Additionally, the original Reinhart and Rogoff (2010) work was subject to significant criticism (see Herndon, Ash and Polin, 2014, for example).

20 One option may be to use cross-country comparisons of Net National Income which are typically less distorted by multinationals.

21 Corporation tax receipts have often increased when investment in intangible assets has risen sharply.

Figure B.1 presents this ratio for 17 Euro Area countries for 2019 (the most recent date for which actual data are available).

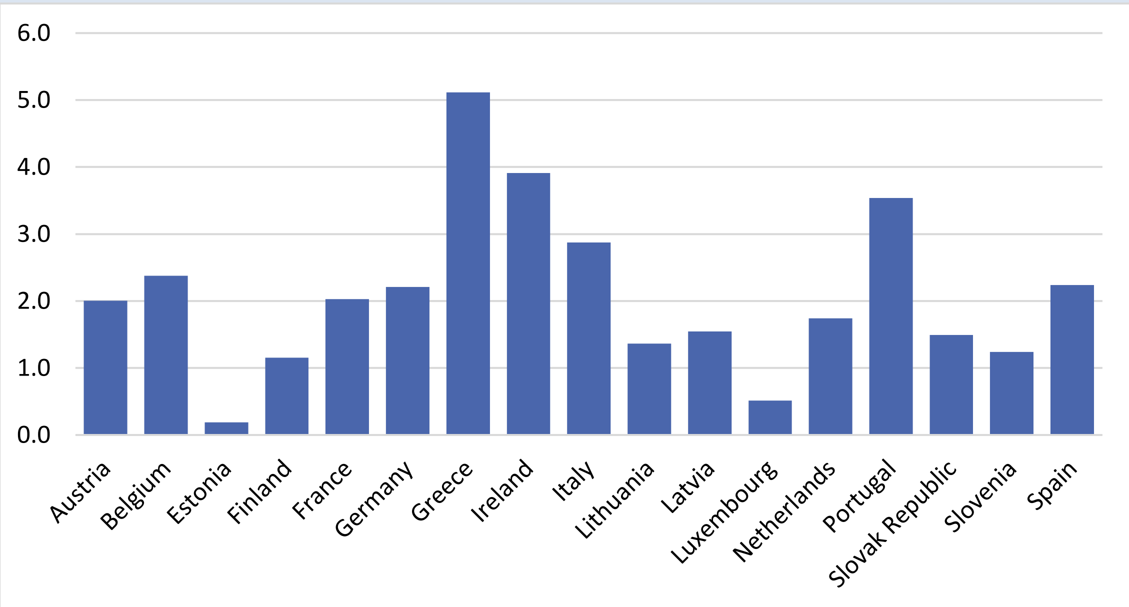
FIGURE B.1 RATIO OF GROSS PUBLIC DEBT TO TOTAL GOVERNMENT TAXATION REVENUES (2019)



Source: OECD, Eurostat and *QEC* calculations.

From the graph while the figure for the Irish ratio is not the highest amongst the countries included, it is, at 2.6, at the higher end of the distribution suggesting Ireland is one of the more indebted countries in Europe. However, care must be taken when assessing a static or one-off observation such as this. For example, consider the same graph for data in 2011:

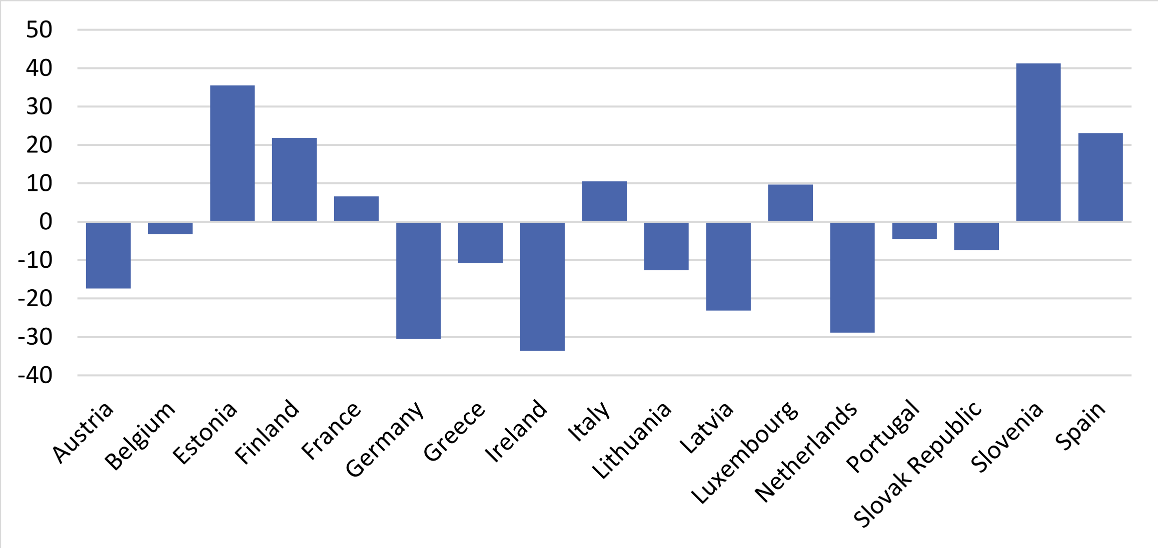
FIGURE B.2 RATIO OF GROSS PUBLIC DEBT TO TOTAL GOVERNMENT TAXATION REVENUES (2011)



Source: OECD, Eurostat and *QEC* calculations.

In this instance the ratio stood at almost 4 as the Irish economy was in the immediate aftermath of the great financial crisis (GFC), which had a particularly acute impact on the domestic economy. In Figure B.3 the percentage change in the ratio between 2011 and 2019 is plotted.

FIGURE B.3 CHANGE (%) IN THE RATIO OF GROSS PUBLIC DEBT TO TOTAL GOVERNMENT TAXATION REVENUES (2011-2019)

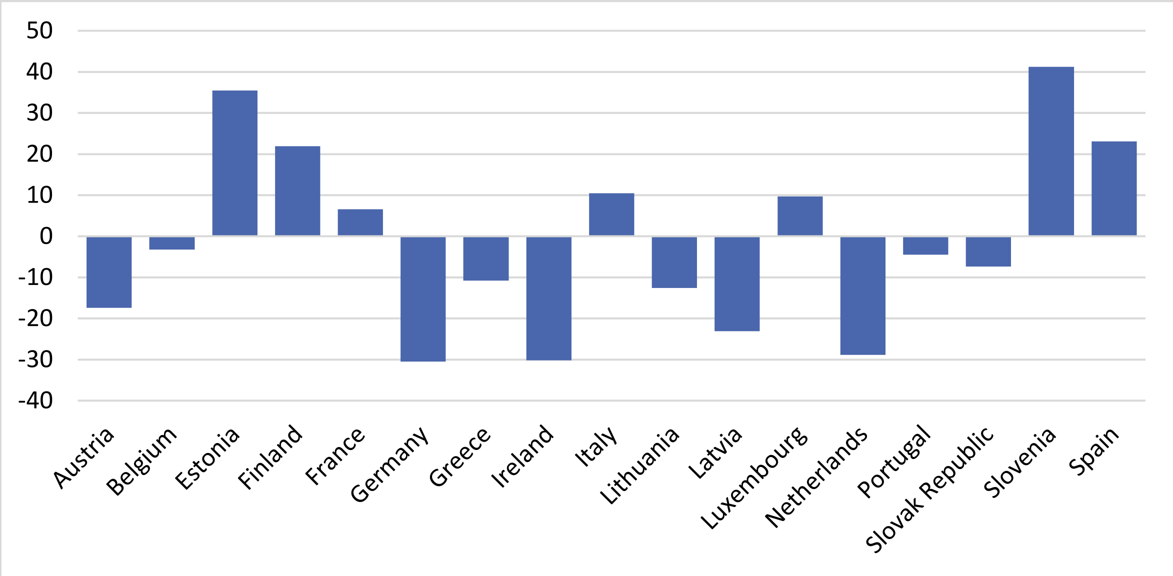


Source: OECD, Eurostat and *QEC* calculations.

It can clearly be seen that the Irish economy has registered the largest decrease in the ratio over the period. Only Germany and the Netherlands have registered comparable declines in the ratio, while Slovenia, Estonia and Spain have all experienced increases in relative indebtedness.

One potential concern with using the taxation base is the volatility around corporation tax receipts. As a sensitivity analysis, we replicate Figure B.3 using an alternative corporation tax receipts series for Ireland. In particular, instead of the actual growth rates in corporation tax receipts in 2015 and 2018 of 40 per cent and 24 per cent respectively, we apply rates of 10 per cent increases for the two years in question. This results in corporation tax receipts in 2020 being 35 per cent less than they actually were. The revised change in the ratio of debt-to-taxation receipts is plotted in Figure B.4.

FIGURE B.4 CHANGE (%) IN THE RATIO OF GROSS PUBLIC DEBT TO TOTAL GOVERNMENT TAXATION REVENUES (2011-2019)

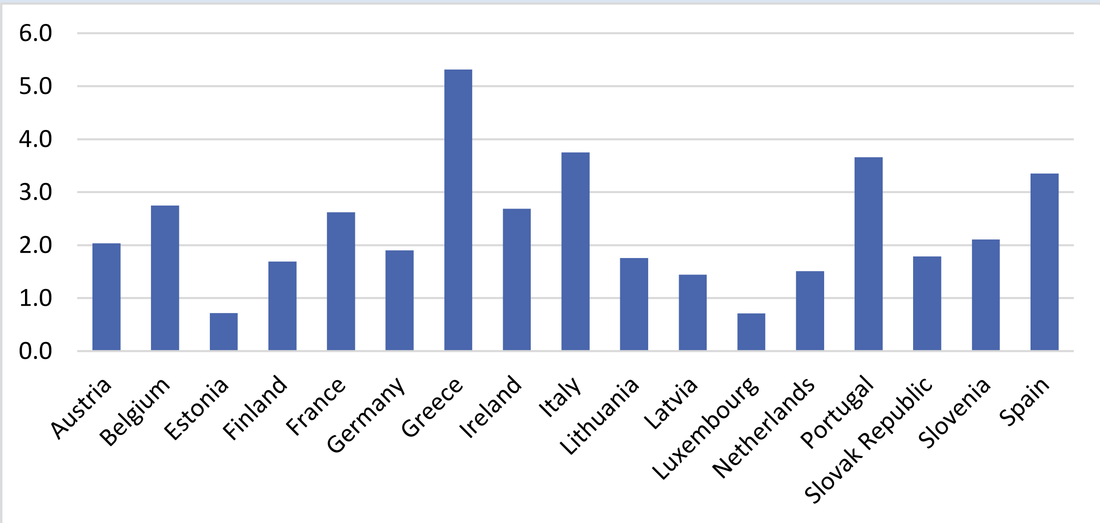


Source: OECD, Eurostat and *QEC* calculations.

The ratio now falls by just over 30 per cent as opposed to the 33 per cent decline using the actual corporation tax data.

Therefore, it is fair to say that in terms of the dynamics of the debt ratio, the Irish economy has performed particularly well over the past ten years with a marked decline in the debt burden over the period. Despite the pandemic, it would also appear that the Irish economy is set to experience a further improvement in terms of its relative ranking across Europe vis-à-vis its debt position. In Figure B.5, the ratio is plotted for 2022 using forecasts for debt levels and Government total revenues from Eurostat.[22]

FIGURE B.5 RATIO OF GROSS PUBLIC DEBT-TO-TOTAL GOVERNMENT TAXATION REVENUES (2022)



Source: OECD, Eurostat and *QEC* calculations.

By the end of 2022 Irish debt levels are set to be very much in the middle of the 17 countries reported, with the Irish ratio just above the average rate. This reflects the underlying strength of the Irish economy as it has performed much better than other countries throughout the COVID-19 crisis. The Irish economy, alone amongst European countries, experienced a positive growth rate in 2020 for example.

Therefore, incorporating the past and future likely trends in Irish fiscal performance in any examination of the current fiscal position provides a different assessment to one based purely on analysis of the most recent annual data.

A final point to note in discussing the current Irish fiscal position is to understand why the Irish fiscal position was in such an elevated position back in 2011. The deterioration in the ratio of debt-to-taxation receipts between 2008 and 2011 was of course mainly due to a macroprudential or banking crisis where Irish taxation revenues and financial institutions became over-reliant on an overvalued residential and commercial property market. While elements of fiscal policy in the run-up to the GFC of 2007/2008 could be criticised, it was not fiscal policy itself which led to the difficulties which were subsequently endured. This is in stark contrast to the fiscal difficulties experienced in the Irish State in the 1980s which, as discussed by McQuinn (2021), were very much due to poor policy decisions in a fiscal context.

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This Box was prepared by Kieran McQuinn.

[22] The Irish forecasts are taken from the current *Quarterly Economic Commentary*.

General Assessment of the Irish Economy

The Irish economy looks set to register significant growth in 2021 with both domestic and foreign sources of growth likely to result in output increasing by over 12.5 per cent. While there was a marked contrast between the two different components of growth last year, with exports, in particular, resulting in the economy experiencing growth of almost 6 per cent in 2020, all sectors of the economy look set to register sizeable increases in activity this year. Modified domestic demand, which is a more accurate measure of how domestic sectors of the economy are performing, is set to increase by over 7 per cent in 2021. Unemployment is now set to fall to 9 per cent by the end of the present year.

The removal of all major Government public health restrictions by October 22, coupled with the successful vaccination programme being rolled out, means that a return to normal economic activity should continue as the year progresses. Furthermore, we believe the economy will continue to grow strongly through 2022 as the recovery takes hold. This growth performance is set to be characterised by a balanced mix of domestic and foreign sources. Foreign-led growth will be enhanced by the recovery being observed in global economies; however some elements of Irish-UK trade may be adversely impacted by Brexit-related changes in trade conditions which are likely to unfold between the UK and the European Union. Unemployment will continue to fall into the new year, and by the end of 2022 the unemployment rate will fall back to just under 6 per cent.

On the domestic side, the high savings ratio of households should drop back providing a boost to consumption expenditure throughout the year. Coupled with continued improvement in labour market conditions, this should allow for a broad-based recovery in domestically non-traded sectors once public health restrictions remain limited.

While there are still sectors of the Irish economy which are set to suffer from long-term scarring effects caused by COVID-19, the resilience of the Irish economy through the COVID pandemic is quite remarkable. This resilience is based on two inter-related factors; the strength of certain aspects of the export sector and the relatively robust performance of the Irish economy prior to the pandemic.

The strength of the economy’s performance through the pandemic will in itself present certain challenges. Like most economies, the Irish economy has experienced a significant supply-side shock as a result of the pandemic; however, unlike most other countries, the demand-side implications have been relatively muted in the Irish context. This has led to inflationary pressures in the economy as the supply side adjusts in the aftermath of the COVID shock, demand rebounds in line with the economic reopening and global energy prices have increased markedly. For Ireland, many of these pressures are particularly evident in the residential property market where both house prices and rents have increased quite significantly since the start of 2021.

These inflationary pressures have been experienced in many advanced economies as public health measures have increased and decreased over time. At present, international commentators and central banks are attributing these pressures to pandemic-specific adjustments (such as base effects or temporary market imbalances), however the longer the period of inflation lasts the more likely it is to feed through into wage expectations. From a monetary policy perspective, if the Eurozone inflation rate remains above the ECB target rate for a protracted period, this may increase the pressure to unwind accommodative monetary policy measures which to date have lowered financing costs and eased financial market conditions.

In Ireland, the speed of the economic recovery, and in particular how quickly households unwind excess savings, will also likely feed through into the inflation rate, in particular into non-traded goods and services. While at present our expectation is that inflationary pressures will abate throughout 2022, a rapid increase in consumption, further international supply chain disruptions, and higher international energy prices in a global recovery all risk feeding through into inflation.

The improvement in economic activity and in the labour market will ease the pressure somewhat on the public finances. A key element of restoring the public finances to a more sustainable footing will be done by the economy itself as unemployment levels fall, the automatic stabilisers will kick in and social welfare expenditure levels will fall. Due to greater than expected increases in taxation receipts and less than expected increases in expenditure, we now believe the General Government Balance (GGB) in 2021 will be 3.4 per cent. We expect the GGB to fall further in 2022 to 1.7 per cent. The rate in 2022 would be well within the range set out under the European Union’s fiscal rules.

However, over the medium term there will be a number of significant fiscal challenges. The increased Government expenditure in areas such as housing, climate change and healthcare will necessitate extra revenue to be raised by the

State going forward. McQuinn (2021)[23] outlined that running a small but sustainable deficit over the medium term, as opposed to say a balanced budget, is possible. Similarly, recent research by Kakoulidou and Roantree (2021)[24] has examined options for increasing tax revenue in the domestic economy. It is clear that some optimal combination of these policies will be required going forward if the State is to successfully meet the requirement for future investment. For example, relying purely on increasing taxes to meet the investment challenges could have implications for the competitiveness of the domestic economy. Therefore, any combination of policies must maintain competitiveness of the economy while ensuring that the public finances are kept on a sustainable basis. The need for greater investment is coming when the economy will be experiencing strong rates of growth. It is important, therefore, that restraint be demonstrated in terms of current expenditure in order to reduce the possibility of overheating in the domestic economy.

One issue which this *Commentary* has consistently noted is the requirement to increase the supply of housing to deal with considerable bottlenecks in provision, in particular for social and affordable housing. The recent government 'Housing for All' strategy commits to increases in investment in housing which, if delivered, should contribute to raising housing output. Welcome developments include the move to long-term, multi-annual housing budgets and other supply-side activities, such as boosting the role of the Land Development Agency (LDA). If the housing needs of the country are to be met it will require collaboration between both the public and private sector to finance the continued delivery requirements.

However, challenges remain in terms of ensuring that public capital is targeted and operationalised towards facilitating the construction sector's capacity to increase output. The deployment of public capital in construction therefore must minimise capacity pressures and ensure value for money. Indeed, the required increase in new housing output is occurring at a time when increasing focus on housing retrofit to boost climate emissions reduction will be needed. This is likely to add to the existing capacity pressures in the sector. From a public policy perspective, these competing demands are likely to require choices to be made over the prioritisation of investments.

The *Commentary* also examines the issue of financial intermediation and the provision of credit in the Irish economy. Despite the economic growth in the country over the last number of years, the degree of competition has arguably

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23 McQuinn K. (2021). 'With "g" greater than "r", should we be borrowing to increase Irish housing supply?', Special Article, *Quarterly Economic Commentary* (*QEC*), Summer, Economic and Social Research Institute (ESRI).

24 Kakoulidou T. and B. Roantree (2021). *Options for raising tax revenue in Ireland*, Budget Perspectives paper, Economic and Social Research Institute (ESRI).

weakened amongst domestic retail banks with the announced high-profile market exits. There is some evidence that alternative providers of finance in the domestic economy are emerging.[25] This ties in with the issues raised in Duffy et al. (2016)[26] which foresaw a credit constraint emerging in the Irish economy where credit provision was dependent purely on the traditional financial sector. It is likely that finance providers other than traditional retail banks are going to play a more prominent role in funding the Irish economy over time.

An issue which the *Commentary* will be devoting more attention to in the future is the issue of climate change. It is evident that there is a considerable challenge for the international community and the domestic economy in meeting the climate change targets which have been outlined. The Irish economy is now on a legally binding path to net-zero emissions no later than 2050 and to a 50 per cent reduction in emissions by the end of this decade. As recently outlined by Pisani-Ferry (2021),[27] the scale of adjustment and challenges which this will present for economies in general are substantial and while there will also be opportunities for growth in the adoption of green technologies, the scale of investment required to meet the emissions targets will be sizeable (as noted above for housing). It is clear that much greater focus and attention on the economic costs of meeting these challenges is required.

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25 https://www.centralbank.ie/statistics/statistical-publications/behind-the-data/the-role-of-non-bank-lenders-in-financing-irish-smes.

26 Duffy D., D. Foley, N. McInerney and K. McQuinn (2016). 'Demographic Change, Long-Run Housing Demand and the Related Challenges for the Irish Banking Sector', in *Ireland's Economic Outlook: Perspectives and Policy Challenges*, Economic and Social Research Institute (ESRI).

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