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European Economics Daily: Ireland - Still positive

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European News: Tsipras to visit Merkel next Monday

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• Tsipras to visit Merkel. Greek Prime Minister Tsipras has accepted an invitation from Chancellor Merkel to meet in Berlin next Monday (March 23). In related news, German Finance Minister Schäuble criticised the Greek government at an event in Berlin yesterday. According to Mr Schäuble, the Greek government had "destroyed all trust" and would be betraying the Greek people by constantly looking for scapegoats in Berlin, Brussels and the rest of Europe.

Focus: Ireland - Still positive

Bottom line: The decline in the Euro exchange rate is likely to be particularly beneficial for Irish economic growth because it is unusually open and conducts the majority of its trade with non-Euro area economies. Real GDP rose by 4.8% in 2014 and we expect a similar rate of growth in 2015. Such rapid growth is prompting concerns of a second Irish bubble but, while the rate of expansion is strong, the level of output remains depressed relative to before the crisis. In our view, the Irish economy has the scope to grow rapidly for some time without overheating. A decline in support for mainstream parties poses the main risk to our positive outlook.

Constructive on Ireland's prospects

In 2011, we argued that Ireland had made significant progress in reducing its 'country-specific' bond risk premium and that the main risks to its continued progress were external rather than domestic (see "Ireland: Main risks now external, not domestic", European Weekly Analyst, November 3, 2011). Although we argued that the external risks were estill substantial, our central case was that the economy would recover, that the Budget deficit would be brought under control and that Ireland was unlikely to require a second bailout.

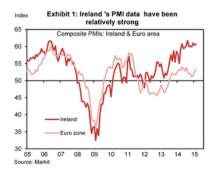
Our relatively constructive outlook for the Irish economy and its public finances was based on two assessments:

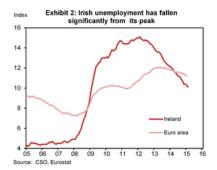
- We argued that the post-crisis adjustment to Ireland's fiscal and current account imbalances was more complete than many had recognised. Aided by the unusual flexibility
 of nominal wages and prices in Ireland, the real exchange rate adjustment required to correct Ireland's external imbalances already appeared complete by 2011. We
 argued that this was contributing to a stabilisation in economic output which, in turn, would aid in the reduction of the government deficit.
- With Ireland having been through a successful fiscal consolidation in the late 1980s, we argued that there was sufficient political will among the major political parties to sustain the fiscal adjustment programme set out by the EU-IMF.

From gradual to rapid recovery

The improvement in Ireland's economic performance between 2011 and 2013 was steady rather than spectacular but, in the past 18 months, the economy has shifted into a higher gear. Real GDP rose 4.8% in 2014 and business surveys are consistent with growth at least this strong at the start of 2015 (Exhibit 1).

Reflecting the strength of the turnaround in economic output, Ireland's labour market is also recovering rapidly: unemployment fell to 10.1% in February, 5 percentage points (pp) below the peak reached in early 2012 and 1pp below Euro area unemployment (Exhibit 2). Employment rose 1.8% in 2014 and has risen a little over 5% from the trough.





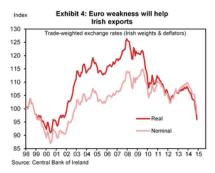
The composition of growth has appeared relatively healthy. Real GDP growth in 2014 was driven by an 11.7% rise in investment spending and a 12.6% rise in the export of goods and services (Exhibit 3). Ireland's current account balance has swung from a deficit worth 6% of GDP in 2008 to a surplus of 6% of GDP in 2014.

The strength of exports growth in 2014 pre-dates an expected boost from the recent weakening in the Euro. The Euro's trade-weighted exchange rate has declined by 15% since mid-2014, a development that is likely to be particularly beneficial for Irish growth because its economy is unusually open and it conducts the majority of its trade with non-Euro area economies. Ireland's trade share (the average of exports and imports) was equal to 101% of GDP in 2014 and trade with non-EMU countries was worth 69% of GDP (with the US and UK – two economies where we expect relatively strong growth -- both accounting for a little under 25% each).* For the Euro area as a whole, the (non-EMU) trade share is around one-quarter of Ireland's.

Exhibit 4 displays a measure of the real trade-weighted exchange rate calculated by the Central Bank of Ireland, which takes account both of changes in the Euro exchange rate (with weights that reflect Irish trade shares) and of relative CPI inflation differentials against Ireland's trading partners both within and outside of the Euro area.** Ireland's real effective exchange rate fell significantly between 2008 and 2011, driven by the relative weakness of wage and price developments in Ireland. More recently, Ireland's real TVVI has fallen significantly further, but this time driven by nominal exchange rate weakness. Ireland's real TVVI has now returned to the levels last witnessed in the late-1990s/early-2000s.

3/17/2015 GS 360



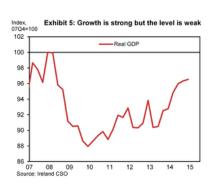


Rapid growth, but from a deep trough

The recent rapid rates of economic growth are prompting concerns in some quarters of a second Irish bubble. But, such was the depth of the decline during the crisis that, notwithstanding the strength of growth in recent years, the level of Irish economic output remains 4% below the pre-crisis peak (Exhibit 5). Although unemployment is much lower than it was at its peak, it remains significantly higher than most estimates of its equilibrium level (around 5%) and unit labour cost inflation remains negative.

A similar point can be made about Ireland's housing market: while Irish house prices have risen 25% from their trough, they remain close to 40% below their pre-crisis peak (Exhibit 6). While price gains have been larger than 25% in some segments of the Dublin market, the national market appears a long way from a second bubble.

In our view, the Irish economy has the scope to grow rapidly for some time without there being a significant risk of overheating.





The main risks to benign outlook are political

We argued in previous research that the most important *domestic* risk to our positive views on the Irish economy was presented by the high level of mortgage arrears in Ireland's banking sector but that we expected the combination of rising house prices and falling unemployment to drive an improvement in loan-loss dynamics ("Ireland: Improving loan-loss dynamics", *European Economics Daily*, May 15, 2014). In the past 18 months, the value of mortgages in arrears by more than 90 days has fallen from 10.7% to 8.2% of GDP and, while progress in this area remains slow, we no longer view problem mortgages as representing the most important domestic risk.

The biggest risk now, in our view, is provided by political developments in Ireland (in this respect, Ireland is similar to many other European economies). Opinion polls suggest that the combined support for the two government parties (Fine Gael and Labour) has fallen from 56% at the time of the 2011 election to just 31% today, while the combined support for the three large 'mainstream' parties (Fine Gael, Labour and Fianna Fail) has fallen from 73% to 49%. Some opinion polls suggest that Sinn Fein -- whose economic policies focus on a rejection of austerity and are similar in many respects to those of Syriza in Greece and Podemos in Spain -- are now the post popular party in the country.

Given the strength of growth and the decline in unemployment in recent years, the unpopularity of the government may come as a surprise to many external observers. Part of this unpopularity can be explained by the government's perceived mishandling of some specific policy initiatives (notably the introduction of water charges). However, in our view, a more important explanation is provided by the ongoing weakness in the levels of many key economic indicators: while *growth* in output, employment and incomes has been impressive in the past 18 months, each remains weaker in *level* terms than before the crisis. If output, employment and incomes continue to grow rapidly during 2015 – driving their levels back towards where they stood before the crisis -- we would expect the mainstream parties to recover some support ahead of the election that is due in 2016.

The likely make-up of the government after the next election remains highly uncertain at this stage. Ireland's Taoiseach (Prime Minister) Enda Kenny recently ruled out the possibility of forming a coalition with Fianna Fail. However, it may be that this is the only combination of 'mainstream' parties that could form a stable government.

- * Exports (goods and services, measured on a shipments basis) were worth 112% of GDP in 2015. However, a large share of the value added in these exports is imported in the form of intermediate goods and services. Exports measured on a value added basis must be worth less than GDP by definition.
- ** Because this measure takes account of trade both within and outside of the Euro area, it is not comparable to a standard Euro area TWI.

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