The Leadership Exchange

PwC Quarterly Economic Digest - Q4 2024

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Contents

Introducing the Quarterly Economic Digest

We are pleased to present the first issue of our new Quarterly Economic Digest. The Digest will focus on the Irish economy but with a view to global indicators and events.

Each quarter, we will discuss economic output, inflation, the labour market and the fiscal outlook. We will include a range of forecasts, providing different perspectives on Ireland’s economy. Each issue of the Digest will also focus on a special topic (e.g. housing) and include a crash course in behavioural economics. We hope that you find the QED interesting and informative and we welcome your comments and questions.

1. The Rundown

We present our first Digest at a time when Ireland's economy is performing remarkably well. While GDP growth figures are not flattering, modified domestic demand-a more appropriate measure of Ireland's economic output-is set to grow by around 2.5% in 2024 and there is a broad consensus among forecasters that this growth should continue into 2025 and 2026. Inflation has been tamed and is now close to the target rate of 2%, while real wages are increasing. The labour market has proved robust to monetary policy tightening, with a seasonally adjusted unemployment rate of just 4.3% reported in September. Ireland's fiscal position is positive, with surpluses forecasted for the 2024-2026 period.

Overall, these indicators are very positive and leave the Irish economy the envy of much of the world. Over the long term, there are many encouraging factors underlying this success, including Ireland's highly educated, English speaking workforce; our ability to attract foreign direct investment, especially from the US; and particularly strong growth in the technology and pharmaceutical sectors.

However, there are downside risks and vulnerabilities that must be considered. As a small, open economy, Ireland's continued prosperity is dependent on robust international demand for Irish goods and services. The outcome of the US presidential election in November may lead to an increase in protectionist trade policies by the US. Increased tariffs and other barriers to trade would impact the global economy significantly.

Conflict in Ukraine and the Middle East, which runs the risk of escalation, is not only causing

The Economy at a Glance

Economic Output
Although Ireland looks set to experience a technical recession again in 2024, Ireland's economic performance is understated by GDP. Modified domestic demand is set to increase by around 2.5% in 2024.

Inflation
Headline inflation has been tamed and forecast to fall close to the 2% target in 2024. Services inflation remains stubbornly high.

Labour Market
More people are working in the State than ever before, and the economy is approaching full employment with an unemployment rate of just 4.3%.

Fiscal Outlook
Ireland is set to record a general government surplus in 2024, aided by the EU Court of Justice ruling and windfall corporation tax receipts.

great suffering in those countries directly affected but could have significant implications for prices globally - not least the cost of food and energy. As a country on the end of fossil fuel supply chains, Ireland is particularly vulnerable. Ireland’s general government balance is in surplus primarily due to windfall corporation taxes and a once-off transfer resulting from the EU Court of Justice’s ruling. The Department of Finance estimates that without these windfalls, Ireland would be running a deficit. The Central Bank has highlighted that these windfall revenues are not linked to the underlying economy. Given the narrowness of Ireland’s tax base and concentration of corporation tax revenues in just a handful of corporations, this is a significant risk.

As featured in our Topic in Focus section, the housing deficit is a significant risk to Ireland’s continued economic prosperity. Housing supply must increase dramatically in order to keep pace with demand. The Central Bank estimates that 52,000 units are required each year to 2050. High housing costs have widespread implications for individuals, who defer starting families, for businesses who must pay higher wages to attract workers, and for the State which must try to close the affordability gap. All of this impacts Ireland’s competitiveness, with implications for our economic model over the long term.

Given the above, it is essential for our long run prosperity that policies to secure cheap, green energy are implemented, that our housing stock is rapidly expanded, and that windfall revenues are set aside for investment in critical infrastructure that will pay a return to the taxpayer over the long run.

Ciarán Nevin
Senior Economist

2. Economic Output

Ireland experienced a technical recession in 2023 and is likely to do so again in 2024 but GDP growth is set to return in 2025.

Ireland's GDP fell by 5.5% in 2023, meaning that the economy experienced a technical recession. This was primarily driven by a fall in exports and restructuring among multinational enterprises (MNEs). Forecasts suggest that GDP will decline slightly in 2024 before returning to growth in the region of 2.5% to 4.6% in 2025 (see Figure 1).

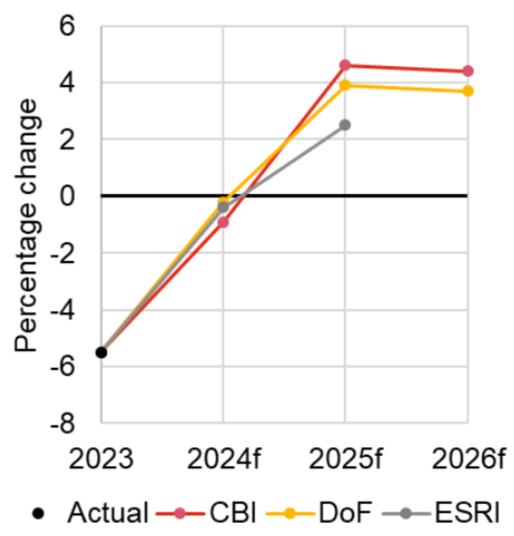
Where once GDP overstated Ireland's economic performance, it now understates the strength of the real economy.

While GDP is the global standard measure of economic output, the true health of Ireland's economy is better understood by observing modified domestic demand (MDD), which strips out distortionary activity such as investment in imported intellectual property and aircraft leasing. As Figure 2 shows, Ireland's economy continues to perform well, with MDD growth of 2.6% in 2023 and forecasted growth of between 2.3 and 3.1% per annum to 2026. The Department of Finance forecasts that MDD will grow at close to 3% per annum out to the end of the decade. PwC's Restructuring Update Q3 2024 finds that insolvencies have increased by 35% year on year, with a particular spike in the retail sector. However, this may be part of a readjustment to normal economic conditions, post pandemic. The Update notes that the insolvency rate is still below the 20-year average.

The US is outperforming the euro area and the UK and this looks set to continue.

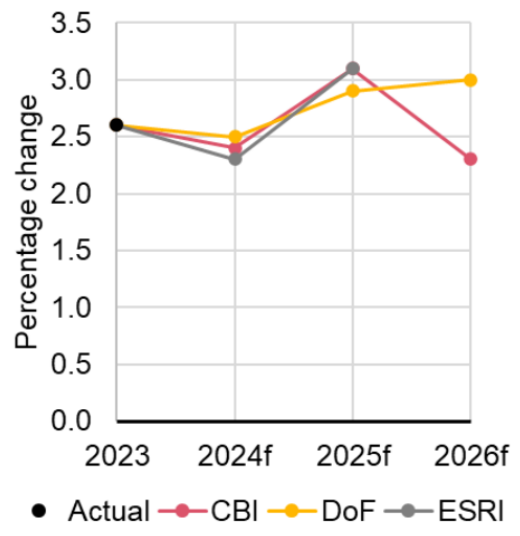
The US economy is performing well and the Federal Reserve projects GDP growth of 2% per annum out to 2026. Ireland's strong economic

Figure 1. GDP growth forecasts



Sources: CBI, CSO, DoF, ESRI

Figure 2. MDD growth forecasts



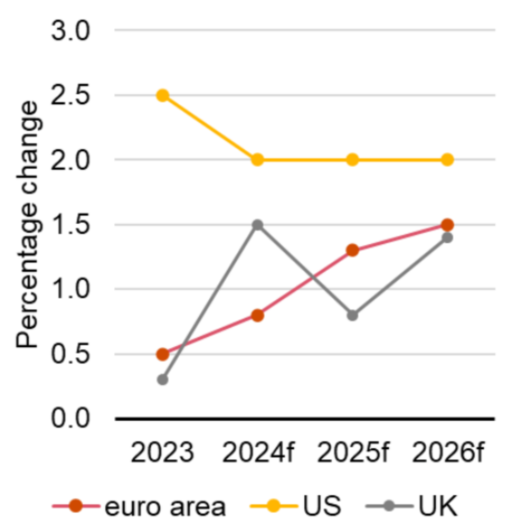
Sources: CBI, CSO, DoF, ESRI

performance contrasts starkly with that of the euro area average: ECB staff projections suggest euro area GDP growth of just 0.8% in 2024, rising to 1.5% by 2026. The Bank of England expects that the UK economy will grow at a slightly faster rate of 1.5% in 2024 but that it will lag behind the US and euro area in 2025 and 2026.

As a small, highly globalised economy, Ireland is vulnerable to global shocks but domestic factors offer reassurance.

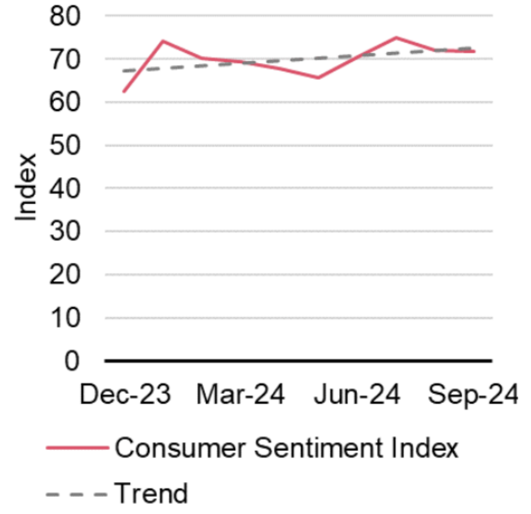
While the outlook for Ireland is positive, as a small, open economy, Ireland's prosperity is particularly sensitive to global events. The results of the US election in November may be enormously consequential to Ireland's economy, with the potential for heightened geopolitical tensions, increased barriers to global trade, and a return to high levels of inflation. Ongoing conflict in Ukraine and the Middle East places pressure on global supply chains and runs the risk of escalation, while extreme weather events could increase food prices. A global slowdown would lead to a decrease in demand for Irish exports. Given this uncertainty, setting aside funding for countercyclical spending, such as through the Infrastructure, Climate and Nature Fund is prudent. Looking domestically, interest rate normalisation (see Section 2), wage growth (see Section 3) and increased consumer sentiment (see Figure 4) will likely contribute to growth in consumption and economic output.

Figure 3. Global GDP growth forecasts



Sources: BoE, ECB, FRB

Figure 4. Irish consumer sentiment



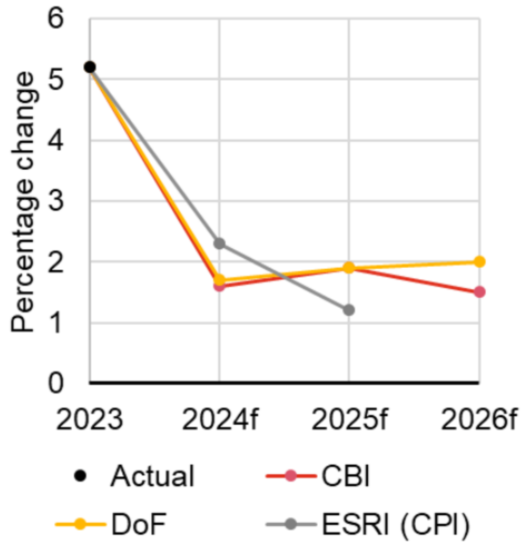
Source: Irish League of Credit Unions

3. Inflation

Headline inflation has been tamed but services inflation remains stubbornly high.

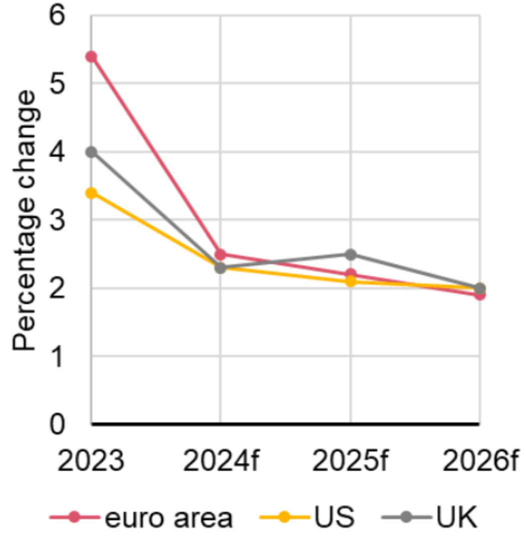
Inflation has dominated economic commentary over the past two years but that is changing. In Ireland, inflation has declined significantly. Various forecasts show the headline inflation rate in Ireland tracking close to the 2% target rate, as shown in Figure 5. While headline inflation is broadly on target, inflation in the services sector has remained stubbornly high. The Department of Finance notes that core services inflation remains very elevated, with a rate of inflation in excess of 4% for 12 of the last 15 months.

Figure 5. Inflation forecasts for Ireland



Sources: CBI, CSO, DoF, ESRI

Figure 6. Global inflation forecasts



Sources: BoE, ECB, FRB

As inflation has eased globally, the focus has shifted to economic growth, productivity and jobs.

Headline inflation has eased in the euro area, the US, and the UK in 2024 and is expected to remain close to the target out to 2026 (see Figure 6). With inflationary pressures easing, attention has shifted to economic growth, productivity, and employment. This is particularly pressing in the euro area and UK, where performance has been sluggish. Monetary policy has loosened globally, with the European Central Bank, the Federal Reserve, and the Bank of England all cutting rates this year. While it is not expected that interest rates will fall to the levels seen in the aftermath of the Global Financial Crisis, they are expected to decline further into 2025 before stabilising, as shown in Table 1.

Table1. Interest rate projections

	Current Rate	2025 Forecast	2026 Forecast
ECB	3.5	2.5	2.5
FRB	4.8	3.1	3.1
BoE	5	3.3	3.0

Sources: BoE, ECB, FRB, S&P Global

Fiscal stimulus and wage growth may put further upward pressure on prices.

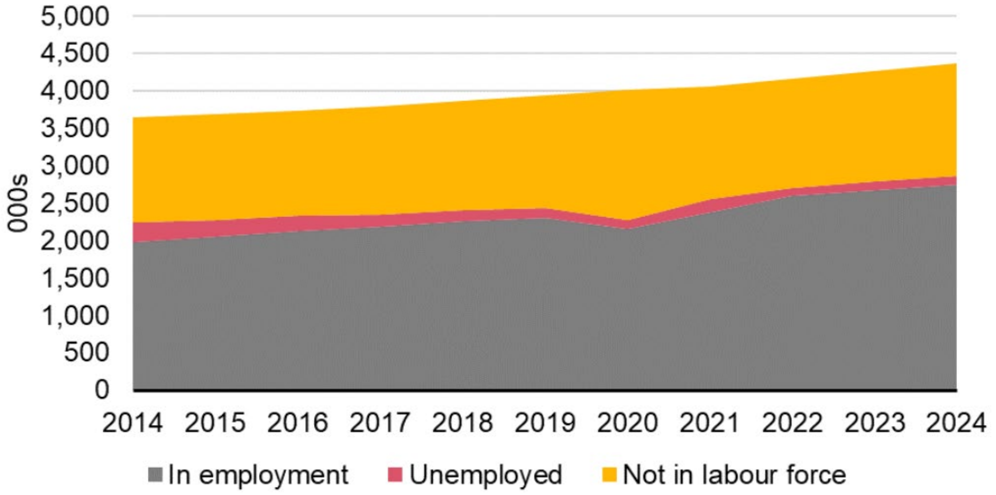
Wage growth and the high level of fiscal stimulus resulting from Budget 2025 could have an inflationary impact, as could geopolitical tensions and supply chain issues. This is important to note in the context that Ireland does not set its own monetary policy, which is determined for the euro area as a whole. As discussed in Section 6, housing and infrastructure constraints across the country are increasing costs and wage demands, which poses a challenge for competitiveness in the long run.

4. Labour Market

There are one million more people working in Ireland than in the year 2000.

With more people working in the State than at any point in its history, Ireland's labour market is in good health. There are one million more people working in Ireland today than at the turn of the millennium. This is a particularly striking statistic given the occurrence of a global financial crisis and a pandemic in the intervening years. As Figure 7 shows, the labour market has rebounded strongly since the pandemic and continues to grow. In September the unemployment rate stood at just 4.3%: the economy is approaching full employment.

Figure 7. Persons aged 15+ by employment status

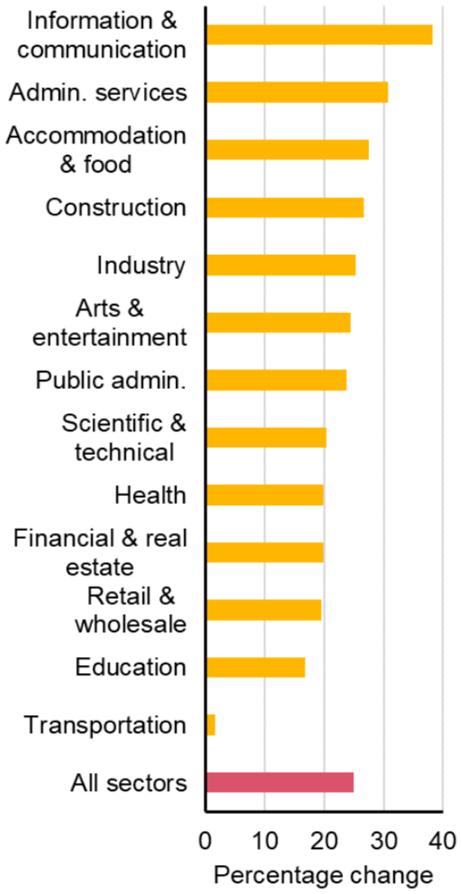


Sources: CSO

A tight labour market puts upward pressure on earnings, which will lead to real income gains for households as inflation eases.

This tightness in the labour market has contributed to the increase in earnings shown in Figure 8. Since 2019, average hourly earnings have increased by 25%. This increase in earnings has not been uniform, however. At the top end, those working in the information and communication sector, which includes big tech, have seen their earnings increase by 38%. Conversely, the earnings of those working in transportation have increased by less than 2%.

Figure 8. Percentage change in average hourly earnings by sector, since 2019

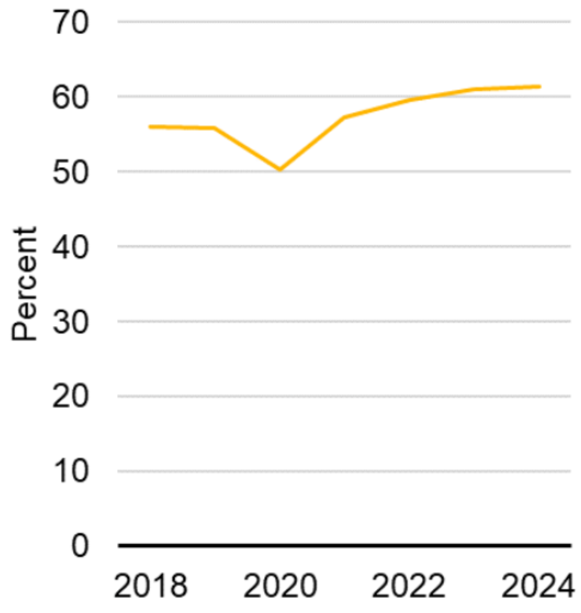


Sources: CSO

Wider access to childcare and public transport could increase labour force participation and living standards.

Increased earnings, in real terms, have the potential to encourage greater numbers into the workforce. However, as Figure 7 shows, the share of the population that is not in the workforce has remained relatively flat over the past decade. An outlier in this regard is the female labour force participation rate, which has increased in recent years, and now stands at a record high of 61% (see Figure 9). People remain outside the workforce for a variety of reasons including, for example, education but some would choose to enter the workforce under the right conditions. The availability of cost effective childcare and high quality public transport, for example, can help to bring more people into the workforce and increase household income.

Figure 9. Female labour force participation rate



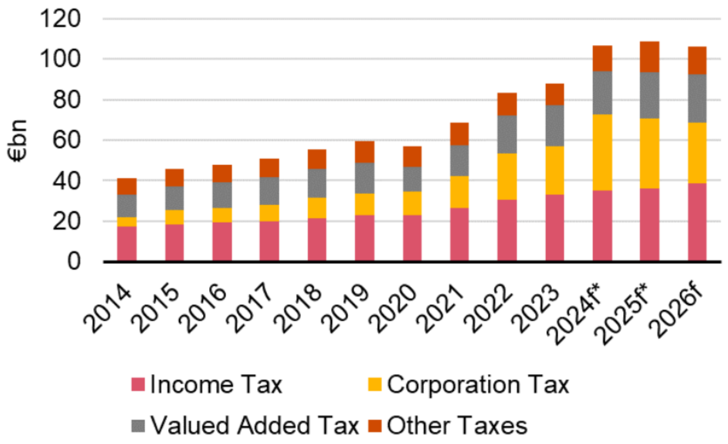
Sources: CSO

5. Fiscal Outlook

Windfall corporation tax receipts see the Government running a surplus.

As Budget 2025 coverage outlined, the State is in a relatively strong fiscal position. The general government balance - the difference between revenue and expenditure - is in surplus. That surplus is projected to amount to almost €24 billion in 2024, including windfall corporation tax income and the funds resulting from the ruling of the European Union's Court of Justice. As Figure 10 shows, tax revenues have grown dramatically since the beginning of the pandemic. The Department of Finance expects revenues to level off out to 2026. All else equal, it is likely that corporation tax receipts will increase further with the introduction of BEPS Pillar 2.

Figure 10. Government revenues by tax category



Source: DoF
Note: *2024 and 2025 figures include the effects of the EU's Court of Justice ruling.

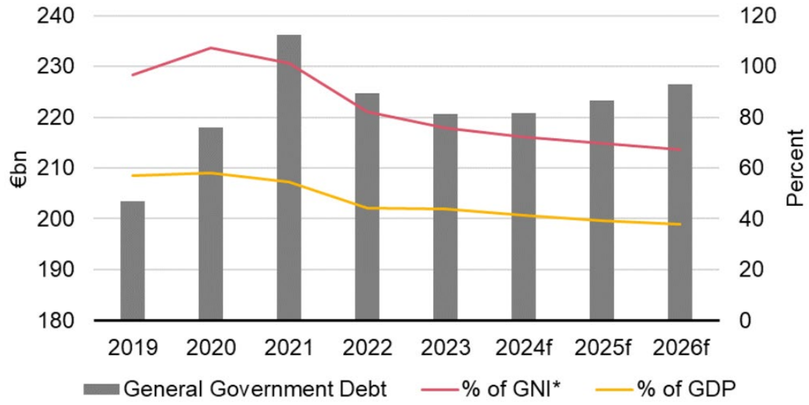
When windfall revenues are excluded, there is an underlying fiscal deficit.

The Department of Finance estimates that if the one-off transfer of funds and the windfall corporation tax receipts are excluded, an underlying fiscal deficit of around €6 billion would result, with a deficit of a similar magnitude next year. The Central Bank notes that excess corporation tax flows, which cannot be explained by developments in the real economy, could be subject to a sudden reversal. Given this, it is prudent that these funds are not used for current expenditure but instead used to fund investment into the future, through mechanisms such as the Infrastructure, Climate and Nature Fund.

Government debt as a share of economic output continues to fall in Ireland, in contrast to the EU as a whole.

General government debt increased during the pandemic but has been falling as a share of economic output since 2020 (see Figure 11). Debt as a share of modified gross national income (GNI*) is expected to fall from 75.9% in 2023 to 69.1% in 2024. Falling debt ratios are a result of both economic growth and primary surpluses, and it is expected that they will continue to decline. By contrast the debt ratio of the EU as a whole has been increasing since the end of 2023. The NTMA reports that the average yield on bonds issued in 2024 is 2.7%, with an average maturity of 11.6 years. General government interest payments are expected to amount to 2.6% of government revenues in 2024.

Figure 11. General government debt and debt to output ratios



Source: NTMA

6. Topic in Focus: Housing

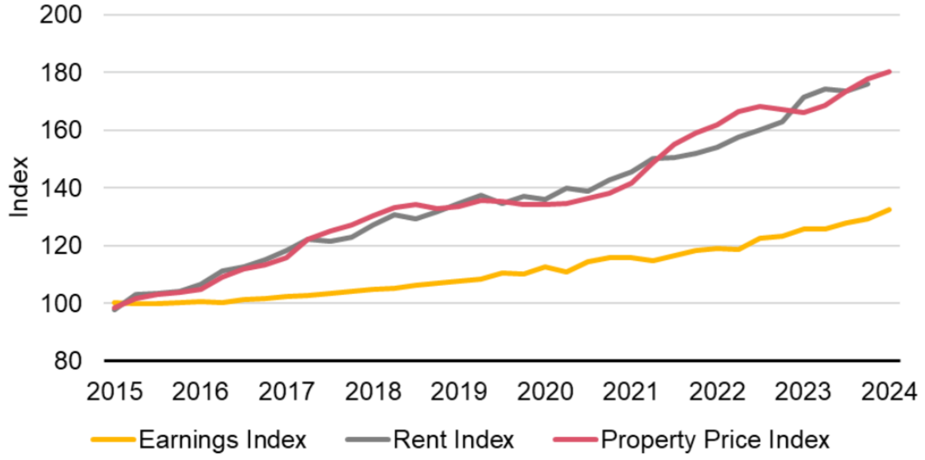
Earnings growth has not been keeping pace with the cost of housing.

While average hourly earnings have increased by 25% from 2019 to 2024, as discussed in Section 4, the gap between earnings and housing costs has been widening for years. Recent real wage growth is due to a combination of increased wage demands caused by inflation and a tight labour market. Unemployment remains low at 4.3% and inflation is tracking close to the 2% target rate. However, with ever increasing housing costs, many remain locked out of the housing market. Figure 12 shows how rents and property prices have followed a similar pattern over the past decade, growing at a faster rate than earnings.

Strong demand for scarce housing is pushing purchase prices 5% above asking prices.

Despite the gap between growth in earnings and growth in property price and rents, strong competition for housing persists across the country. Myhome.ie notes in its Q2 2024 property report that house prices are on average being settled at 5% above asking prices. This continued competition for housing is due to an imbalance between supply and demand. Increased rental costs are being driven by new rental properties rather than existing rental properties. RTB analysis finds that while Dublin still currently has the highest average rent, counties Leitrim and Longford experienced the highest growth in rent at 22.6% and 22.5% respectively since Q1 2023.

Figure 12. Residential property prices and rents continue to rise



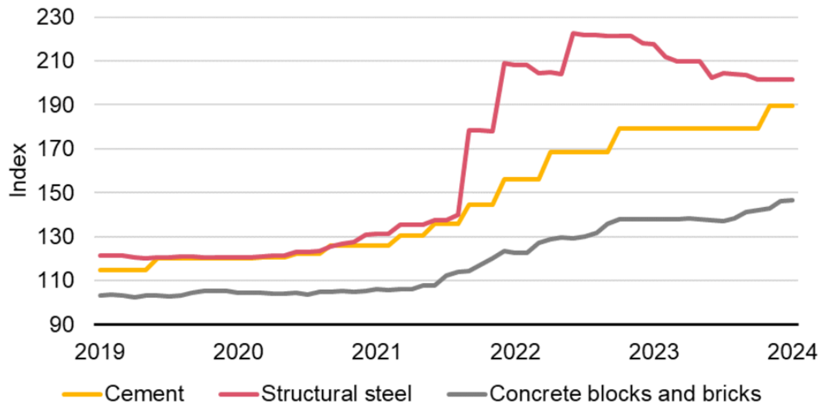
Sources: CSO and RTB. Base year 2015 = 100

This increased growth in rental prices outside of Dublin is a consequence of continued remote working and a lower supply of housing outside of built up areas.

Supply of housing not meeting demand requirements

The stock of available housing for sale in Ireland has decreased since 2015, while the population has increased significantly and is forecast to continue to grow. The Central Bank of Ireland estimates that 52,000 homes will need to be built per year out to 2050. This is an increase of 20,000 units per annum relative to the 2023 figures. In the 12 months to July 2024, 12% of property purchases were by non-occupiers, potentially contributing supply to the rental property market.

Figure 13. Wholesale price index for building and construction materials



Source: CSO. Base year 2015 = 100

Increasing input costs in the construction sector requires a focus on increasing productivity in order to make housing more affordable.

One factor contributing to the increased cost of house prices is the input costs for building new homes. The wholesale price of cement, concrete blocks and structural steel increased substantially during the pandemic, as shown in Figure 13. Earnings in the construction sector increased by 27%, above the average for all sectors at 25% (see Figure 8). With the construction industry suffering from under-investment and lower productivity since the financial crisis, public policy should seek to crowd-in productive investment in this sector. Zoning and permit reform can also reduce the cost of development land. Should the supply of housing not increase to meet demand over the coming years, house prices and rents will continue to rise.

Housing costs have wide ranging consequences for households and the economy as a whole.

If a greater share of household income must be spent on housing, this reduces consumption in other areas of the economy as demand for goods and services falls. These effects can ripple through the economy. Increasing housing costs also reduces the capacity of households to invest, such as in the home retrofitting that is required to make the transition to net zero. Additional government spending may also be required in order to bridge the gap between what households can pay for housing and the cost. Increasing housing costs also lead to increased wage demands, with implications for the cost of doing business and global competitiveness. As such, policy that increases the productivity of the housing sector will have widespread and long term benefits.

7. Behavioural Issues

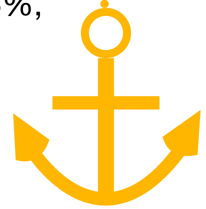


Figure 14. The anchoring effect

Each quarter we take the opportunity to keep our biases in check.

Cognitive biases are systematic errors in the way individuals reason with the world around them due to subjective perceptions of reality. In this section we explore the what, where, when and why of a different bias each quarter.

The anchoring effect influences everything from purchasing decisions to the public perception of government spending.

The anchoring effect is a cognitive bias that describes the human tendency to rely too heavily on the first piece of information encountered (the “anchor”) when making decisions. Once an anchor is set, we tend to bias towards interpreting other information around this anchor. The anchoring bias can greatly affect everything from purchasing decisions to the public perception of government spending.

Our minds need a starting point to enable comparison and analysis.

The anchoring effect occurs because our minds are wired to seek a starting point for making comparisons or estimates, and we often subconsciously set this reference point (or “anchor”) ourselves. This can happen in various situations, such as negotiating the price of a car, estimating the value of a house, or deciding how much to tip at a restaurant.

Whether you’re buying a house or a coffee, the anchor will influence how you feel about your purchase.

For example, consider the process of purchasing a home. In Section 6, you’ll have seen that house prices are being settled at 5% above asking price. Knowing this can set an anchor for your expectations. If you then purchase a house for just 3% above the asking price, you may feel like you’ve gotten a good deal. Similarly, in a restaurant, the suggested tipping amounts on your bill serve as anchors that can influence how much you decide to tip. If the suggested tips are 15%, 20%, and 25%, you might tip more than you would have if no suggestions were provided.

Before making a decision, question the assumptions that informed the anchor, to make sure it is a reasonable one.

To overcome the anchoring effect, ensure you are objective in your thinking and reasoning. Where a decision involves comparison and the anchoring effect could be in play, assess the individual criteria of the subject in question, gather information and evidence to support your thinking.

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Appendix

Sources

Bank of England
Central Bank of Ireland
Central Statistics Office
Irish League of Credit Unions
Department of Finance
Economic and Social Research Institute
European Central Bank
Eurostat
Federal Reserve Bank
MyHome.ie
National Treasury Management Agency
Residential Tenancies Board
S&P Global

Glossary

BoE	Bank of England
CBI	Central Bank of Ireland
CSO	Central Statistics Office
DoF	Department of Finance
ECB	European Central Bank
ESRI	Economic and Social Research Institute
FRB	Federal Reserve Bank
GDP	Gross domestic product
GVA	Gross value added
HICP	Harmonized Index of Consumer Prices
ILCU	Irish League of Credit Unions
IPP	Intellectual property products
MDD	Modified domestic demand
NTMA	National Treasury Management Agency
RTB	Residential Tenancies Board