Economic Trends and Outlook: April 2021 Update

NERI Report Series, No.6

Tom McDonnell

NEVIN ECONOMIC RESEARCH INSTITUTE

The IMF estimates that the global economy contracted 3.3% year-on-year in 2020

1. World Economy

We are now one year into the worst global pandemic in a century. Thus far, almost 3 million people have lost their lives while many millions more have lost their livelihoods. There has been unprecedented disruption to societies and economies alongside a sharp rise in extreme poverty within emerging economies as jobs have been lost and income levels have fallen. Lost hours of education and lower levels of investment could structurally shift global output levels downwards in the future.

The IMF estimates that the global economy contracted 3.3% year-on-year in 2020 with the US economy contracting 3.5%. There were sharp falls in output in advanced economies (-4.7% overall), and especially amongst the Republic of Ireland's key trading partners in the Euro area (-6.6%) and the United Kingdom (-9.9%). Spain experienced a double digit fall in output in 2020 reflecting its vulnerability to the downturn in tourism.

The onset of the pandemic caused Europe and the US to experience unprecedented year-on-year falls in output in the second quarter of 2020 including -14.6% in the Euro area and -21.4% in the UK. In contrast, China exited recession in the second quarter as the pandemic had peaked earlier in that country. Its economy actually grew on an annualised basis (+2.3%) compared to 2019. Even so, this was China's slowest rate of growth in over four decades.

The volume of world trade fell by an IMF estimated 8.5% while the contraction in global demand put significant downward pressure on energy prices. This exacerbated the scale of the economic and fiscal crisis within energy producing countries.

Yet the outlook is now hopeful. The vaccine rollouts are gathering pace in many countries and fiscal and monetary policy continue to buttress national and regional economies. Business sentiment and business expectations are now improving beyond the near-time horizon.

The Chinese and US economies are already well on their way to recovery while the EU and the UK should return to their pre-crisis output levels in mid-2022. Even so, it will take a number of years before unemployment rates return to pre-crisis levels. A number of advanced economies including Germany, the US and the UK were close to full employment just prior to the crisis. It is as yet unclear the extent to which there will be a negative medium-or-long-term impact on labour force participation levels.

Overall, the recovery from the economic crisis, at least for high-income countries, should be much quicker and much more robust than the recovery from the great financial crash and other recent recessions. Further infection waves may give the recovery a stop-start aspect. However, the outlook for emerging countries is significantly less favourable due to the relative weakness of the economic supports available and the slower pace of vaccine rollout.

Table 1 Real GDP Growth Rates (annual change), %

	19' Q4	20' Q1	20' Q2	20'Q3	20'Q4
Euro area	1.0	-3.3	-14.6	-4.2	-4.9
United Kingdom	1.2	-2.2	-21.4	-8.5	-7.3
United States	2.3	0.3	-9.0	-2.8	-2.4
China	6.0	-6.8	3.2	4.9	6.5
Ireland Rep.	5.9	5.8	-2.6	8.7	1.5
Ireland Rep. (MDD)	2.9	-1.8	-15.5	-1.9	-3.1

Note: Headline GDP data in Ireland is distorted by the outsize activities of a small number of very large US multinationals. MDD or Modified Domestic Demand gives us a better understanding of the performance of the domestic facing economy.

Sources: Eurostat: *GDP main aggregates*, CSO: *Quarterly National Accounts*, Trading Economics: *GDP data*.

The enormous drop in domestic demand in March-April 2020 was followed by a modest and partial recovery in the majority of European countries in the third quarter. The latest wave of the pandemic has since reversed some of that tentative recovery. Unsurprisingly, the most severe declines have been for activities with an inherent face-to-face or communal dimension such as arts, entertainment, hotels and restaurants.

The outlook is now hopeful – but the pandemic has undone years of progress in the global fight against extreme poverty

The recovery will vary from region to region and from sector to sector. Global manufacturing has already returned to pre-crisis levels. For example, industrial production in the EU in December 2020 was just 0.4% below the same month of the previous year.

On the other hand, face-to-face sectors will take longer to fully recover. The EU's volume of retail trade was 5.4% lower in January 2021 than it was in January 2020. There was also a large compositional shift away from bricks and mortar with 'mail orders and internet' up 40% over the previous year.

The possible reversal of the enormous lockdown enforced build-up of household savings offers the prospect of a strong and generalised consumption-based recovery across the advanced economies. However, not all of these savings are likely to be unwound in the short-run given the increased labour market and income uncertainty that may emerge post-crisis and the lower propensity to consume of the groups most insulated and better able to save during the crisis. Significant fiscal support will be needed to ensure that permanent labour market damage is minimised.

Price inflation in the Euro area was positive in January (0.9%) having been negative for much of 2020 on account of low energy prices and weak consumer demand. The Biden administration's fiscal stimulus has generated a somewhat overblown debate about a possible return to high levels of inflation in the US. Such an outcome seems unlikely in the case of the Euro area. The increase in inflation in early 2021 reflects the unwinding of the downward price pressures that characterised 2020. Our baseline projection is that Euro area prices will hover between 1% and 2% over the short-to-medium term.

The pandemic may have damaged long-run productivity by costing hours of education and reducing levels of investment

Labour markets

Labour markets everywhere have been severely affected by the crisis. The US unemployment rate swiftly transitioned from full employment in February (3.5%) to a peak unemployment rate of 14.8% in April, with over 25 million jobs lost in those two months. Over half of the net job losses were recovered by August but employment was still 8 million below its pre-crisis level as of March 2021. The unemployment rate was 6% in March and the downward trend is likely to continue through 2021-22.

The headline or 'official' fall in employment was less pronounced in the Euro area and in the UK. The smaller decline reflects the use of job retention and related schemes aimed at preventing redundancies, for example the Temporary Wage and Subsidy Scheme (TWSS) was created in Ireland for just this purpose. As a result total hours worked fell much faster than did total employment.

Even so, the Euro area unemployment rate had risen to 8.2% in the fourth quarter of 2020 and employment was 1.9% below the level in the fourth quarter of 2019. The unemployment rate should continue to rise in the middle part of 2021 as policymakers' transition away from job retention schemes and insolvencies increase. Unemployment should then begin to fall towards the end of 2021 although recovery could be delayed until 2022 depending on the extent of business failures.

A similar situation arose in the UK where the employment rate fell by just 0.5 percentage points between February and May of 2020, whereas average weekly hours worked fell from an average of over 32 in 2019 to 25.8 in May 2020. Total hours in the second quarter of 2020 were down almost 20% over the previous year. The unemployment rate was a relatively low 5.1% in January 2021. However, the government's job retention scheme was supporting about 4 million jobs, or about one in five employees. Unemployment is likely to increase as the retention scheme and the forbearance towards businesses are phased out. Labour market conditions should improve over the latter parts of 2021 and again in 2022.

Outlook and policy

Swift and decisive emergency policy responses from governments and central banks prevented a collapse in output and employment and a prolonged depression. Even so, the Euro area economy contracted 6.6% in 2020. The latest ECB, European Commission and IMF projections for the Euro area suggest GDP growth of between 3.8% and 4.4% in 2021 followed by growth of between 3.8% and 4.1% in 2022. The UK had a sharper decline of 9.9% in 2020 but is likely to compensate for this with an earlier recovery given its faster vaccine rollout. Nevertheless, projected UK growth of close to 5% in 2021, and again in 2022, would mean that the UK economy, similar to the Euro area economy, would only return to pre-crisis levels by the second half of 2022.

The recovery in the European economies will be assisted by an unwinding of the unprecedented levels of household savings. This will boost consumption. In addition, the Next Generation EU instrument will provide a boost to public capital investment over 2021-24. If properly targeted the instrument could help undo much of the damage done to the human capital base by the crisis as well as assisting with economies necessary digital and climate transitions.

The economy recovery should be much swifter and more robust than previous economic recoveries

The US economy's recovery has already begun and it is expected to grow by 6 or 7% in 2021 given the enormous fiscal support provided by the Biden administration and the fast pace of vaccine rollout. The US recession was also less severe in output terms than the European recessions. Pre-crisis output recovery should be achieved by the second half of 2021.

There was a sharp deterioration in the public finances across advanced economies in 2020. The deterioration arose from temporary labour market, business and income supports, from additional health spending and from a diminished tax base. The scale of the deficits will reduce over the course of 2021-23. The large deficits are manageable given their temporary nature, as well as the supportive monetary policy commitments of central banks and extremely low cost of borrowing that has followed from that support.

Governments should postpone fiscal tightening until 2023 at the earliest and this tightening should protect the vulnerable and take account of the increase in economic inequality arising from the crisis.

Overall, the baseline outlook is weak for the first half of 2021. However, the vaccine rollout and the easing of restrictions will unlock significant pent up demand as consumer and business confidence returns. Crucially, this assumes no cliff-edge removal of the pandemic related fiscal supports and a continuation of supportive monetary policy. Investment-based fiscal supports will then strengthen the recovery over the course of late 2021 and into 2022.

Finally, policy will need to work to counteract the decline in productivity growth experienced by advanced economies since the 1990s. In particular, the post-2008 policy mistakes of decreasing investment in R&D, in education and in infrastructure will need to be reversed. Just as governments protected their economies productive capacity during the crisis, they should focus their post-crisis budgetary policies on measures to improve the economy's innovative capacity and productive capital stock – both physical and human – while also emphasising poverty elimination measures and policies to manage a just transition to a zero carbon economy.

Fiscal and monetary policy must remain supportive – fiscal retrenchment should not occur before 2023

2. Republic of Ireland

The Republic of Ireland's (henceforth Ireland) economy was performing relatively strongly on the eve of the pandemic. However, the strength of the economy and the prospect of overheating were often overplayed by commentators. Ireland's unemployment rate was higher than in countries like the US, the UK and Germany (ranking 16th best in the EU) and the employment rate was well below the top performing countries. As for overheating, there was no evidence of inflationary pressures in the economy, new dwelling completions were well below projected medium-term demand, and the household savings rate was well above its long-run average.

Even so, the direction of travel was unquestionably positive in most, albeit not all, economic dimensions. Employment growth averaged a robust 3% per annum between 2013 and 2019 and the non-seasonally adjusted unemployment rate had fallen to 4.5% in quarter four 2019. Every region bar the South-East had an unemployment rate under 5%. Annual weekly and annual hourly wage growth were both well above 3% in 2019. Minimal price inflation meant that real wage growth was in excess of 2%.

The improving labour market conditions were matched by increasing demand. Modified domestic demand averaged real annual growth of 4.2% between 2014 and 2019. Despite the evident progress, 17.8% of households were experiencing deprivation in 2019 and there were ongoing deficiencies in a number of areas, for example, childcare costs, chronic undersupply of housing, and spiralling rental costs.

The pandemic economy

In any event the economy swiftly exited from its eight year long cyclical upswing with the onset of the first lockdown in mid-March 2020.

The pandemic and ensuing policy response generated the greatest shock to the Irish labour market in the history of the State. The unemployment rate (Covid-adjusted) reached an all-time high of 30.5% by April. The rate then steadily declined month-on-month and fell to a pandemic low of 15.7% in September. The third lockdown pushed the rate up to 25.1% in January and it was 24.2% in March. The government quickly responded to the economic crisis with the introduction of a temporary wage subsidy scheme and various business supports in order to preserve productive capacity and with enhanced income supports to preserve living standards.

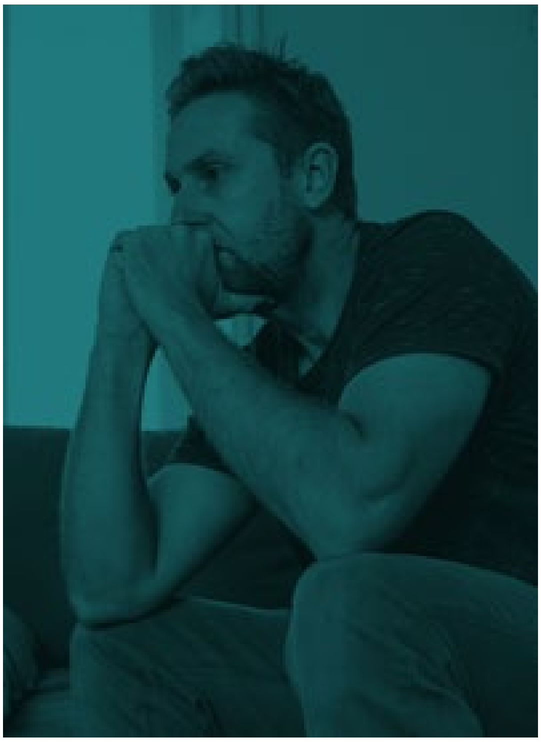

Table 2 Dashboard of Macroeconomic Indicators, Republic of Ireland

	2017	2018	2019	2020	20'Q4	Latest
Percentage volume change over previous year						
Gross Domestic Product	9.1	8.5	5.6	3.4	1.5	1.5 *(Q4'20)*
Modified Domestic Demand	3.5	4.3	3.3	-5.4	-3.1	-3.1 *(Q4'20)*
Personal Consumption	2.4	2.8	3.2	-9.0	-7.6	-7.6 *(Q4'20)*
Retail Sales	3.9	3.8	2.1	-2.3	3.7	-3.2 *(M2'21)*
Modified GNI (GNI*)	4.6	6.8	1.7	-	-	1.7 *(2019)*
Percentage annual average rate of change						
Employment	2.9	2.9	2.9	-1.2	2.2	-2.3 *(Q4'20)*
Labour Productivity	3.1	4.2	-	-	-	4.2 (2018)
Average Hourly Earnings	1.7	2.9	3.5	4.8	5.5	5.5 *(Q4'20)*
Average Weekly Earnings	1.9	3.3	3.6	5.1	7.5	7.5 *(Q4'20)*
Inflation (CPI)	0.4	0.5	0.9	-0.3	-1.2	0.0 *(M3'21)*
Percentage of annual GDP or quarterly GDP						
Mod. Investment (% GNI*)	20.0	20.9	20.5	-	-	20.5 *(2019)*
Current Account Balance	0.5	6.0	-11.3	4.6	7.5	7.5 *(Q4'20)*
Government Balance (GGB)	-0.3	0.1	0.4	-5.4	-	-6.2 *(Q1-3'20)*
Gov. Gross Debt (end year)	67.8	63.6	58.8	-	-	62.0 *(Q3'20)*
Percentage of labour force						
Unemployment (SA)	6.7	5.7	5.0	5.7	5.7	5.8 *(M3'21)*
Long-term Unemployment	3.0	2.1	1.6	1.3	1.5	1.5 *(Q4'20)*
Percentage of households						
Deprivation	18.8	15.1	17,8	-	-	17.8 *(2019)*
At Risk of Poverty	15.7	14.0	12.8	-	-	12.8 *(2019)*
Percentage						
Gini Coefficient	31.5	29.7	28.8	-	-	28.8 *(2019)*

Notes: Half-year, ('H'), Quarterly ('Q'), monthly ('M') and other data is compared to same period of the previous year. *Modified domestic demand* (MDD) is non-seasonally adjusted '*Total domestic demand less the effects of the trade in aircraft by aircraft leasing companies and the imports of intellectual property*'. *Modified GNI* is GNI adjusted for factor income of redomicilied companies, and depreciation of aircraft leasing, R&D service imports and trade in IP and depreciation on aircraft leasing. *Modified investment* is the investment component of MDD. *GGB* is end-year figure as a % of annualised GDP or latest nine month figure as % of nine month GDP. *Unemployment* is average for four quarters or latest quarter/month seasonally adjusted.

Sources: CSO: *Labour Productivity*, *National Income and Expenditure*, *Quarterly National Accounts, Retail Sales Index, Labour Force Survey, Earnings and Labour Cost, Consumer Price Index, Balance of International Payments, Government Finance Statistics, Monthly Unemployment, Survey on Income and Living Conditions*

Employment fell from an average of 2.32 million in 2019 to a Covid-adjusted 1.97 million in 2020, a decline of almost 15%. The employment rate fell from 70.2% in 2019 to a Covid-adjusted 57.5% in 2020. Actual hours worked per week fell from 77.4 million in quarter four 2019 to 70.8 million in quarter four 2020. This was a decline of 6.6 million hours or 8.5%. Hours fell in nine of the fourteen main economic sectors. The largest absolute (2.7

million hours) and relative (-53%) fall was in *accommodation and food services* but other sectors, most notably *arts and entertainment*, also experienced severe declines. According to analysis from the CSO, the profile of those laid off work since end-March 2020 suggests 10% are unemployed, 11.7% do not want a job (e.g. in education or caring responsibilities), and 76% are available for work but not seeking work. This may imply that about three quarters of workers are expecting to return to previous employment.

There were over 443,000 recipients of the Pandemic Unemployment Payment (PUP) in late March. This compares to a third wave peak of over 482,000 in late January. PUP recipients peaked at over 605,000 in April/May 2020 before declining down to around 210,000 by late Summer and early Autumn. *Accommodation and food services* had the largest number of recipients followed by *Wholesale/retail*. The fiscal cost was about €5 billion in 2020. The PUP now has four payment levels with half of recipients on the maximum of €350.

While the PUP was crucial for preserving income levels, the Temporary Wage Subsidy Scheme (TWSS) was the main labour market strategy for preserving productive capacity and maintaining the employer/employee link. The TWSS was in place from late March until the end of August and cost €2.9 billion. TWSS numbers peaked at over 450,000 in May and again in July. The replacement Employment Wage Subsidy Scheme (EWSS) will help facilitate a swifter post lockdown recovery. The EWSS is an employer subsidy and one that 28% of employers claimed in January 2021 in respect of over 352,000 employees. *Wholesale/retail* (17% of total), *Construction* (15%) and *Accommodation/food* (14%) made up the largest numbers of employers in mid-February, with almost 310,000 employees covered. The EWSS had cost €2.6 billion by early March 2021.

A record 1.2 million workers were in receipt of State income supports in May 2020

The severest job losses are disproportionately concentrated amongst lower skilled workers, young workers and part-time workers. Absolute unemployment increased more for males but the relative increase was higher for females.

Private sector pay has fallen significantly since the onset of the crisis. IBEC estimate gross private sector pay fell from €6 billion in February to €4.5 billion in May but that much of the income gap was filled by the TWSS and PUP. On the other hand, headline data for average weekly and hourly earnings suggests significant wage growth, for example average hourly earnings in accommodation and food services increased an implausible 14% between 2019 and 2020. Unfortunately, this is just an artefact of the skewed distribution of jobs and hours lost which has disproportionately affected workers in low paid service jobs. The economy-wide growth of private sector earnings of 6.3% (hourly) and 8.5% (weekly) reflects these differential outcomes for low paid and other workers and represents economic weakness rather than strength.

There is likely to be lingering damage to the labour market when the economic supports are removed. We anticipate the unemployment rate will still be well in excess of pre-crisis levels by the middle of 2022 (circa 8%) and pre-crisis employment levels will not be restored before 2023.

Consumer price inflation turned negative year-on-year in April 2020 reflecting the pandemic related collapse in demand as well as a fall in energy prices. The CPI remained negative until March of this year, albeit it was just at 0.0%. The unwinding of the disinflationary forces prevalent in 2020, as well as a modest Brexit effect, should generate some inflationary pressures in 2021. Inflation is likely to remain well below 2% until at least 2023.

The public finances were pushed sharply into deficit in 2020 having been in surplus in 2019. The 2020 deficit was just under €20 billion or 4.8% of GDP. On the expenditure side there were increased healthcare costs related to the pandemic and increased costs arising from the fall in employment and the range of new and temporary supports associated with the lockdown. On the revenue side there was a sharp fall in receipts related to lower consumption levels (i.e. VAT and Excise). Income tax receipts fell just 1%, whereas PRSI receipts fell 8.3%. The greater progressivity of the income tax tells us that job losses were concentrated at the lower end of the income distribution.

The ongoing need for higher levels of healthcare expenditure and the assumed continuance of the temporary supports until at least the end of quarter three suggests a significant albeit smaller deficit in 2021 in the region of €15 to €18 billion. On the other hand, the public finances should exhibit significant improvement in 2022 as the temporary economic supports are ended, household and business spending increases and the labour market strengthens. Despite the large deficits, the ECB's highly supportive monetary policy and bond buying programmes will prevent any significant rise in the cost of government borrowing.

Ireland's headline GDP grew by close to 3.4% in 2020 despite the economic lockdown. This ostensibly places Ireland as a positive outlier amongst advanced economies. This creates a misleading picture. The headline data is distorted by the very strong export performance of firms in the pharmaceutical and IT sectors. In contrast, domestic demand fell sharply in 2020. Modified domestic demand (MDD), a measure that strips our intangibles and aircraft leasing, fell by 5.4% in 2020 including a dramatic lockdown induced year-on-year fall of 15.5% in the second quarter. The building and construction index fell 6.5% in volume terms in 2020. The enormous contraction of domestic demand was very much in line with that of other advanced European economies. MDD contracted 3.1% in quarter four relative to the same period of 2019. Personal consumption was down 9% year-on-year in 2020 following a spectacular year-on-year decline of 21.4% in the second quarter. There were smaller annual declines of 5.2% and 7.6% in the third and fourth quarters respectively as the lockdown eased. We anticipate a partial recovery in consumer spending in 2021 followed by a rapid increase in 2022 as pent-up demand is realised.

Consumption fell by 9% in 2020

Outlook

The short-run outlook for 2021 is still uncertain as it depends on the diffusion of the virus and the severity and duration of lockdown. Assuming the vaccination programme continues to speed up we will be able to progress down the lockdown levels and have most activity restored by quarter three. The transition away from the temporary economic supports represents another uncertainty as it as yet unclear how much damage has been done to the business sector and the likely extent of associated insolvency.

Our view is that the gradual easing of lockdown will mark the beginning of a prolonged economic expansion. The economy should be growing robustly on an annualised basis by the end of 2021. This assumes: (A) a successful vaccine rollout, (B) a full or almost full opening of society, and (C) retention of targeted supports for weakened but viable businesses. The economy should grow by more than 4% in 2021 and 5% in 2022.

The projected expansion is based on (1) the realisation of an unprecedented level of pent-up demand for activities currently constrained by the lockdown, primarily services. We expect the household savings rate to normalise from its current excessive and historically high level. (2) Increased public investment from domestic fiscal policy and from the EU's National Recovery Plan. (3) Increased private investment as economic uncertainty fades and the construction lockdown ends. (4) Increased demand for exports as trading partners experience strong demand based recoveries. The Biden stimulus and the EU's NRRP will significantly boost the US and EU economies in 2021 and 2022 respectively.

It is important not to use previous recessions as forming a baseline for the pace of recovery. The Covid recession is a policy induced freeze on economic activity. The dynamics are qualitatively different from previous demand-side balance sheet recessions experienced since the 1970s. Government intervention has broadly protected productive capacity so that labour market scarring (recession induced structural unemployment) should be somewhat ameliorated. Scarring/hysteresis should not be as severe as the great financial crisis as there is no equivalent sectoral collapse akin to the structural collapse in construction post-2008.

In addition, the policy response (monetary, fiscal, labour market) appears to have learned from previous crises and is likely to remain expansionary. Fiscal and monetary support will not be indefinite, notwithstanding the low interest environment, but will persist until 2023 at the earliest. This is very different from the post-2008 response. The budget was in surplus of 0.9% of GDP in 2019 and the 2020 deficit is not out of line with the EU average. Per capita debt is very high but carries an interest rate of just 1.6%. This all suggests Ireland is unlikely to be singled out by markets.

The public finances will remain in deficit until at least 2024. Even so, strong employment growth and the removal of once-off supports will see the deficit improve significantly from 2022 onwards, both in nominal and percentage of GDP terms. The key to fixing the public finances is to restore employment levels.

The Irish government can and should seek to avail of the low interest environment in order to fund a multi-billion stimulus programme based on investment in infrastructure and measures to support the zero carbon transition. Our view is that the Irish state's revenue base will eventually need to be broadened. Corporation tax receipts are likely to structurally shift downwards over the medium-term given international policy momentum. The impact of the Biden/OECD reforms is also likely to reduce Ireland's attractiveness as a location for foreign investment.

Household incomes have largely held up – a key difference from previous crises. However, the unwinding of government supports remains a risk. The scale of business insolvency is difficult to predict and a badly managed debt crystallisation process (e.g. payment of back taxes and rent arrears) could push a meaningful number of firms over the edge. Also, savings may be concentrated in high income households. The commensurately lower propensity to consume may lead to a slower rebound in spending.

Labour market conditions should quickly improve once the restrictions are lifted. Even so, we anticipate unemployment levels will still be elevated at around 8% of the labour force (circa 200,000) by the middle of 2022. We expect it will be end-2023 before the labour market is fully or almost fully recovered. The extent of structural damage to the labour market remains unclear but we anticipate scarring will be much less than previous crises.

Wage and employment growth will vary from sector to sector but average headline wage growth in 2021-22 will be low and perhaps negative as many of the newly restored jobs will be in low paid sectors. Wage increases for existing jobs should be in the region of 2%. Price inflation will resume in the next few months. However, we see inflation remaining below 2% in 2021-22 despite strong upward pressure from restored demand.

The extent of labour market scarring is unclear but there will be a much stronger and quicker recovery than after the great financial crash

NEVIN ECONOMIC RESEARCH INSTITUTE

31/32 Parnell Square, Dublin 1, Ireland
Phone: +353 1 8897722

45-47 Donegall Street, Belfast BT1 2FG, Northern Ireland
Phone: +44 (0)28 9024 6214

info@NERInstitute.net

www.NERInstitute.net

@NERI_research