2017 Promises to be a most interesting year

In this article economist, Jim Power, takes stock of 2016 and examines the external factors affecting Ireland's economy for 2017.

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Overview of 2016

While we do not yet have full data for 2016, the data we do have suggest that Ireland delivered an impressive growth performance. In the first nine months of the year, gross domestic product (GDP) was 4.7% higher than the equivalent period in 2015. Personal consumption expanded by 3.2%; investment expanded by 4.2%; exports of goods & services expanded by 2.1% and imports of goods & services expanded by 2%. Employment topped 2 million for the first time since 2008; the unemployment rate ended the year at 7.2%, down from 8.9% a year earlier; the Exchequer borrowing requirement came in at €1 billion, which is equivalent to an estimated 0.9% of GDP; and total tax revenues were 5% or €2.26 billion ahead of 2015.

The personal sector made a solid contribution to growth. Retail sales, which capture spending on goods (equivalent to around 40% of total consumer spending) expanded quite strongly, albeit with a couple of important caveats. Car sales made a very strong contribution, and the gap between the value and volume measures has clear implications for consumer-facing businesses.

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Firstly, the value of retail sales expanded by 3.8% and the volume of sales expanded by 5.9%. When the motor trade is excluded, the underlying level of activity is less strong. The value of sales expanded by 2.1% and the volume of sales expanded by 4.3%. New car registrations expanded by 17.5% last year. Secondly, the gap between the value and volume metric is still wide suggesting that price compression is still a key feature of the retail landscape. This means that margins for retailers are still tight in the face of a consumer who is still under financial strain and is consequently very price sensitive.

For 2016 as a whole, it is estimated that GDP expanded by 4.2%, so all in all it was a year of further solid progress for the Irish economy.

The Outlook for 2017.

The economic momentum going into 2017 is strong, but there are considerable domestic and external challenges on the immediate horizon, that will require careful management. Brexit is clearly the key international risk. The post-Brexit trading relationship between the UK and the EU is the obvious longer-term issue, but sterling is the more immediate one. While sterling strengthened towards the end of 2016, it remains vulnerable to Brexit-induced uncertainty. For Irish exporters to the UK and for UK tourism into Ireland this is an obvious challenge.

Brexit

On January 17th, Prime Minister May delivered what is arguably her most comprehensive assessment of what the post-Brexit future might look like for the UK. The Prime Minister is quite clear that the UK will leave the EU. She is also quite clear in her desire to create a new and equal partnership between the UK and the EU. She ruled out the possibility of partial membership of the EU or a 'half-in, half-out' situation. She does not want the type of model adopted by other countries, presumably meaning countries such as Norway and Switzerland, who have a ccess to the single European market, but at a price.

She is adamant that the UK will not be part of the Single European market (SEM), but that it will be able to do a trade deal with the EU. She does not envisage that the UK will remain a full member of the Customs Union, as this would mean having to apply the EU's Common External Tariff, and would prevent the UK from being able to independently negotiate a trade deal with non-EU countries.

The Prime Minister intends to have the negotiations concluded by the time the 2-year Article 50 process has ended. At that stage, there would be a phased process of implementation of new arrangements. The aim is to avoid a 'cliff edge' at the end of the 2-year period and give business enough time to plan and prepare for any new arrangements.

The Prime Minister went out of her way to convince her EU partners that the UK decision to leave the EU is not borne out of a desire to become more distant from the member countries, but rather to maintain close relations with the EU. However, she also wants to build closer relationships with the rest of the world, free from the shackles of the EU.

In contrast to Donald Trump, who has used a lot of protectionist rhetoric to date, her vision is of a Britain that will remain outward looking and whose people will desire to 'travel to, study in, trade with countries not just in Europe but beyond the borders of our continent'.

It is unlikely that EU members will actually take this assertion at face value or that her speech will smooth troubled waters. The instinct in the EU remains one of negativity in relation to the UK decision and this will make the negotiations over the next couple of years very difficult and potentially fractious. Regardless of how important the UK is to the EU; the reality is that a relatively painless exit for the UK is not something that too many EU leaders would be enamoured with.

While the Prime Minister has laid out quite clearly what she wants to achieve, it is important to remember that much of this could well be at odds with what the EU will want to achieve. The period of negotiation will be difficult; compromises will have to be made; but from an Irish perspective it has to be hoped that the Prime Minister will achieve her objective of creating a free trade relationship between the UK and the EU. This will prove very difficult.

The Prime Minister was also categoric in her suggestion that no deal would be better than a bad deal for the UK, suggesting that if a 'good' deal cannot be agreed, the UK would be willing to rely on World Trade Organisation (WTO) rules. This would not be good news for the Irish agri-food sector in particular. Furthermore, she threatened that in such an eventuality, the UK could change its economic model, with a sharp cut in the corporation tax rate a distinct possibility in order to attract foreign direct investment (FDI).

Economic outlook

The external economic environment as we move into 2017 looks reasonably positive. The US economy is doing well; the UK economy is still showing good momentum; China is starting to recover again; and the moribund Euro Zone economy showed some signs of improvement towards the end of last year. US interest rates will rise further during 2017, but we are not likely to see an increase in ECB rates. However, towards the end of the year it is conceivable that the possibility of a change in the ECB's historically low interest rate stance could be increasingly discussed. Higher ECB rates most likely to be a story for 2018, rather than 2017.

While there is cause for optimism as we move into 2017, policy makers will need to manage the challenges very carefully.

Apart from Brexit, the key risks to the Irish economic outlook include:

- Growing wage pressures in the public sector;
- The housing crisis;
- Pressure to increase expenditure on public services; and
- Weak domestic political leadership.

Ireland cannot allow the cost competitiveness of the economy and the fiscal situation be undermined at a time when the recovery is facing immense challenges, not least from Brexit. Careful, prudent control of wage costs and the public finances is essential. When all of these factors are weighed up, GDP growth of around 3.3% looks realistic for 2017. However, international political developments will need to be monitored very closely.

Economic Growth Forecast

(Average)	2016f	2017f
GDP	+4.2%	+3.3%
GNP	+7.5%	+3.0%
Consumer Expenditure	+3.3%	+2.7%
Government Consumption	+5.9%	+2.5%
Investment	+15.8%	+7.5%
Exports Goods & Services	+3.6%	+4.5%
Imports Goods & Services	+5.9%	+5.1%
Unemployment Rate (%)	8.0%	6.5%
Employment (000s)	2,035	2,085
Inflation (HICP)	-0.1%	+1.0%