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PowerTalks

Tackling inflation in 2023





Jim Power's outlook on the Irish and Global Economy

The International Background and Outlook

2022 proved once again that there can be no certainties in the world of economics and finance. The Russian invasion of Ukraine in February had a dramatic impact on the global economy. Unfortunately, as we move into 2023, its impact continues to be felt. We can confidently predict that the year ahead will be characterised by intense uncertainty.

The key global themes in 2023 are likely to include:

- The ongoing war in Ukraine.
- Energy concerns.
- The fight against inflation.
- Further monetary tightening by the global central banking system.
- The vulnerability of real estate markets, particularly residential property prices.
- The uncertainty about the global economic outlook.
- Global geo-political tensions.
- Covid-19.

While the global economy remained quite resilient in the face of intense headwinds during 2022, there will likely be a significant slowdown in global economic activity in the first half of 2023.

THE GLOBAL ECONOMIC & INTEREST RATE BACKGROUND

Inflation and interest rates dominated global economic developments during 2022. Inflation surged as the year progressed and central bankers moved away from a relaxed stance at the beginning of the year to a much more conventional monetary policy approach later in the year.

Once central bankers realised that the Ukraine war had fundamentally changed the landscape and that inflation threatened to become embedded, they moved aggressively on the interest rate front. Central bankers recognised the adage that the persistence of inflation increases with the rate of inflation.

Having increased consistently to reach highs last seen more than three decades ago, data released in December showed that headline inflationary pressures showed tentative signs of easing towards the end of the year. The annual rate of inflation in the UK eased to 10.7 per cent in November from 11.1 per cent in October, which was the highest rate since October 1981; the annual rate in the Euro Zone eased to 10 per cent in November, down from a record high of 10.6 per cent in October; and the annual rate in the US eased to 7.1 per cent in November, down from 7.7 per cent the previous month. Data released in early January showed a further decline in headline inflation in December, with the German rate easing to 9.6 per cent from 11.3 per cent and the French rate easing to 5.9 per cent, from 6.2 per cent.

The easing of the headline rate reflects the decline in global oil and other energy prices, rather than an easing of domestically driven inflationary pressures in areas like services. Natural gas prices in the first week of January declined to levels not seen since before Russia invaded Ukraine as unseasonably warm weather reduced demand. The outlook for inflation in 2023 is uncertain. The hope is that energy prices will remain at least at current levels and hopefully fall further, which would lead to a considerable base effect on the annual rate of inflation. However, central bankers will be keeping a close eye on second-round effects in areas such as services and of course wage pressures. Core inflation rather than headline inflation will dominate the attention of central bankers.

In December, the US Federal Reserve, the Bank of England, and the ECB delivered 0.5 per cent rate increases, rather than the 0.75 per cent increases of previous months. Between December 2021 and December 2022, the Bank of England increased rates nine times taking the base rate from 0.1 per cent to 3.5 per cent; between July and December the ECB increased interest rates four times, taking the key rate from zero to 2.5 per cent; and between March and December the Federal Reserve increased rates seven times, taking the Federal Funds rate from a target range of 0 to 0.25 per cent to a target range of 4.25 per cent to 4.5 per cent.

Looking ahead to 2023, it seems certain that interest rates will increase further.

The Federal Reserve statement after the rate increase in December made it clear that the monetary tightening has further to run in 2023. It warned that 'ongoing increases' in interest rates would be 'appropriate' in order to ensure that the Federal Reserve is restraining the economy enough to bring inflation under control. Alongside the interest rate decision, the monetary authority also published details of how Federal Reserve officials see interest rates going from here. The median

estimate is for a Federal Funds rate of 5.1 per cent by the end of 2023, but the rate is expected to decline to 4.1 per cent in 2024 and 3.1 per cent in 2025. These are just projections and of course anything can happen in the environment of intense economic and political uncertainty that prevails now.

The prevailing tone of the Federal Reserve is that the US economy will have to be squeezed further to bring inflation under control. The official forecast for GDP is for growth of just 0.5 per cent in 2023 and 1.6 per cent in 2024. By US standards, this would represent a very slow level of economic activity.

The Bank of England took the Base Rate up to 3.5 per cent in December, but the general tone was a bit more relaxed than previously, with two members of the Monetary Policy Committee (MPC) voting for no change. However, the reality is that UK inflation is still too high and demand in the economy is still quite resilient, so further tightening in the early months of 2023 looks likely. The markets are currently of the view that rates will reach 4.5 per cent.

The ECB also increased its key rate by 0.5 per cent in December, taking it up to 2.5 per cent. It too warned of further interest rate increases to come. Specifically, it stated that 'interest rates will still have to rise significantly at a steady pace to reach levels that are sufficiently restrictive to ensure a timely return of inflation' and that 'inflation remains far too high.' The ECB looks set to deliver at least 1 per cent in further tightening in the first half of 2023.

As we move into 2023, we remain in a rising interest rate environment and the path and magnitude of rate increases from here will be determined by the trajectory of inflation, the performance of wages and labour markets, and the general health of the economy.

One of the surprising features over the past year has been the resilience of labour markets in the face of higher interest rates and significant global economic pressures.

The US unemployment rate is at a historically low level of 3.7 per cent of the labour force; the UK rate is at 3.7 per cent; the Irish rate is at 4.4 per cent; the German rate is at 5.6 per cent; and the Euro Zone rate is at a record low of 6.5 per cent. Labour shortages and upward pressure on wages remained a marked feature of the business environment during 2022. In an environment of skills shortages there is a tendency for companies to hoard workers. However, there is a limit to how long this could continue if global economic activity slows as anticipated in the early months of 2023. It seems likely that unemployment everywhere should edge up in the first half of 2023, but for some businesses, holding on to skilled staff is a choice that will have to be given consideration.

The risks to the global economy are significant in the first half of 2023. Rising interest rates, persistent core inflation, the continuation of the Ukraine war and fragile business and consumer confidence are likely to combine to generate a much weaker US, UK and Euro Zone economic environment. China will also have to be watched carefully as its economy is under ongoing significant pressure from the pandemic and the problems in the property and construction sector.

The bottom line is that intense uncertainty prevails, and this looks set to continue until the Ukraine situation becomes clearer. That could take some time.

The Irish Economic Background And Outlook

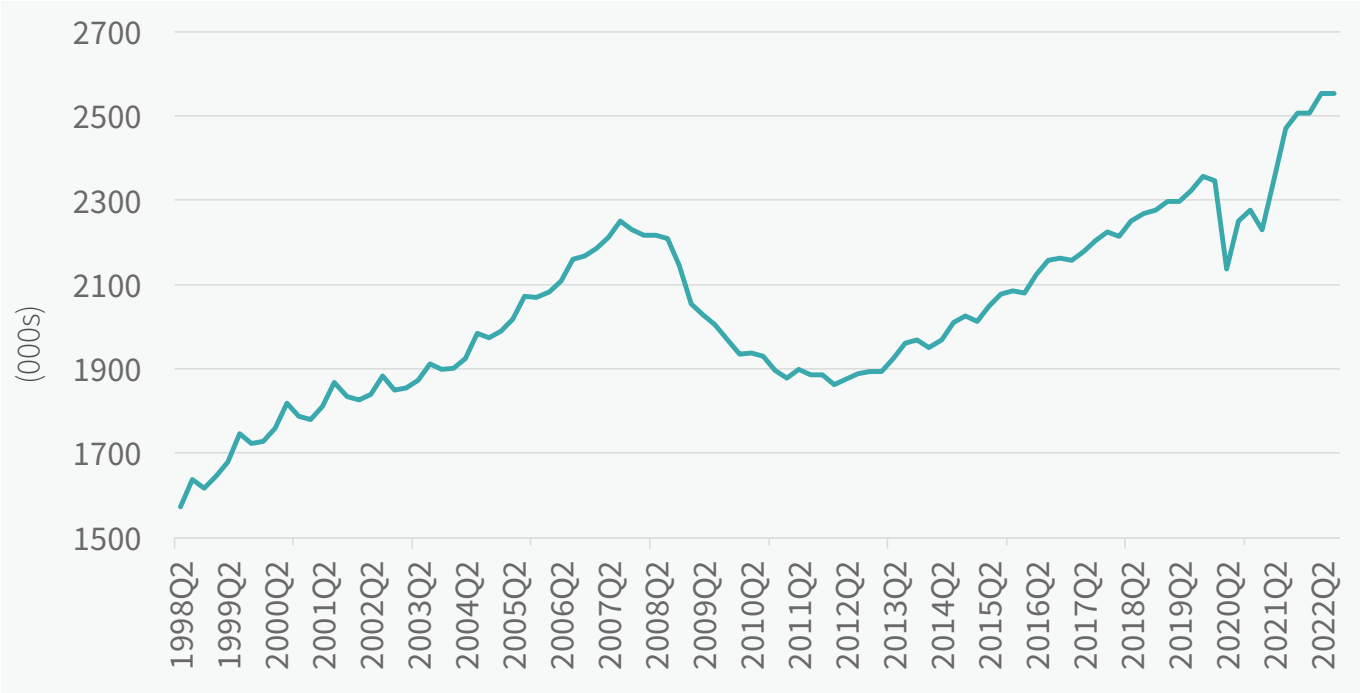
Despite the global economic difficulties, elevated inflationary pressures and an aggressive upturn in the global interest rate cycle, the Irish economy had a solid year in 2022. It was supported by a strong multi-national performance; exceptionally strong export growth; buoyant tax revenues that facilitated a very expansionary budget in September; and a strong labour market.

Not surprisingly against a background of intense global uncertainty, rising interest rates and intense cost-of-living pressures, consumer confidence declined during the year, and consumer spending weakened. Business confidence also declined and there was anecdotal evidence of a more cautious approach to business investment as the year progressed. However, in overall terms the Irish economy proved very resilient and delivered another impressive performance.

THE LABOUR MARKET

The labour market performed very strongly in 2022. Employment levels reached a record high of 2.55 million in September and the unemployment rate ended the year at just 4.4 per cent of the labour force. Recruitment and retention of staff and upward pressure on wages characterised the labour market during 2022.

Figure 1: Employment



Source: CSO

EXTERNAL TRADE

The external trade performance was strong in 2022. In the first 10 months of the year, merchandise exports were 28.8 per cent ahead of the equivalent period in 2021. Exports of food and live animals expanded by 22.4 per cent (6.9 per cent of total exports); Chemicals and related products increased by 34.1 per cent (64.9 per cent of total exports); and machinery and transport equipment increased by 13.5 per cent (13.2 per cent of total exports). While the agri-food sector is performing strongly, the foreign-owned component of the industrial base continues to be the main driver of buoyant exports.

Export sales to all the main regions was up strongly. There was no visible Brexit impact, with Ireland's trade with the UK performing strongly.

Table 1: Ireland's Merchandise Export Partners (Jan-Oct 2022)

REGION	€m (Jan-Oct)	% OF TOTAL	% Change 2022/2021
EU-27	67,845	38.40%	32.50%
United States	53,641	30.40%	23.00%
Great Britain	14,592	8.30%	25.90%
Northern Ireland	4,078	2.30%	33.80%
Rest of World	36,311	20.60%	31.60%
Total	176,466	100.00%	28.80%

Source: CSO

INFLATION

A strong and steady escalation in the cost of living dominated economic and political discourse during 2022. The annual inflation rate averaged 7.8 per cent in the first 11 months of the year. The annual rate peaked at 9.2 per cent in October, but it eased to 8.9 per cent in November. Supply chain difficulties due to Covid created considerable price pressures initially, but the war in Ukraine exacerbated the pressures, particularly in energy-related and food-related components of inflation.

In the year to November, of the 8.9 per cent overall increase; housing, water, electricity, and gas accounted for 4.46 per cent; transport accounted for 1.09 per cent, restaurants and hotels accounted for 1.15 per cent; and food and non-alcoholic beverages accounted for 1.28 per cent.

The reduction in global energy prices in recent months, particularly oil and gas, should result in a decline in the annual rate of inflation in the first half of 2023, but inflationary pressures are still strong in sectors such as accommodation & food and other services.

Table 2: Irish Inflation by Component

COMPONENT	YEAR-YEAR CHANGE (NOVEMBER 2022)
Overall Consumer Price Inflation	8.9%
Food	11.7%
Clothing & Footwear	1.9%
Private Rents	11.0%
Electricity	63.5%
Natural Gas	94.3%
Home Heating Oil	57.1%
Petrol	5.6%
Diesel	24.8%
Restaurants	6.4%
Accommodation	17.8%
Motor Insurance	-10.7%
Communications	0.2%
Health	2.1%
Motor Cars	10.1%

Source: CSO

THE PUBLIC FINANCES

The buoyancy of tax revenues was the key feature of the public finances in 2022. In Budget 2023, the Government allocated €11.3 billion in once-off budgetary measures and in core budgetary measures. The absolute size of the package was significant but did not have any impact on Irish bond yields. This is in marked contrast to the financial market meltdown that followed the UK mini budget, which culminated in the Prime Minister losing her job. The main reason for the two different responses was the fact that the UK would have to borrow to finance its fiscal largesse, whereas Ireland is able to fund the fiscal package from a budget surplus on the back of buoyant tax revenues.

The end-December Exchequer returns show that an Exchequer surplus of €5 billion was delivered in 2022, compared to a deficit of €7.4 billion in 2021. This turn around of €12.4 billion is due to buoyant tax revenues and the decline in Covid-related public expenditure.

For the full year:

- Overall tax revenues totalled €83.1 billion which is 21.5 per cent or €14.7 billion higher than 2021. This is the highest level of tax revenues ever collected.
- Corporation tax receipts totalled €22.6 billion, which is €7.3 billion or 47.8 per cent higher than 2021. This buoyancy reflects the strong profitability of many of the multi-nationals operating in Ireland. Corporation taxes accounted for 27.2 per cent of total tax revenues in 2022 and it has overtaken VAT as the second largest tax generator, behind Income tax.
- Income tax came in at €30.7 billion, which is 15.2 per cent or €4.1 billion ahead of 2021. The strength of income tax receipts reflects the very progressive nature of the Irish income tax system, and the high quality of employment in the economy. It is indicative of a very buoyant labour market, where retention, recruitment and increased labour costs are still significant challenges for some employers, despite the international head winds that are building steadily and the tentative signs of slower activity that we are seeing in the Irish economy. Income tax accounted for 37 per cent of total tax revenues in 2022.
- VAT receipts totalled €18.6 billion, which is up 20.5 per cent or €3.2 billion on 2021. This reflects the improvement in consumer spending. VAT accounted for 22.4 per cent of total tax revenues in 2022.

Table 3: Tax Revenues (2022)

TAX CATEGORY	€m	YEAR-ON-YEAR CHANGE (%)	YEAR-ON-YEAR CHANGE (€m)
Income Tax	30,728	+15.2%	+€4,061
VAT	18,601	+20.5%	+€3,160
Corporation Tax	22,643	+47.8%	+€7,318
Excise	5,441	-6.8%	-€398
Stamps	1,824	+23.0%	+€341
Capital Gains Tax	1,747	+6.4%	+€106
Capital Acquisitions Tax	605	+4.1%	+€24
Customs	636	+21.0%	+€110
Motor Tax	904	-0.3%	-€3
Total	83,130	+21.5%	+€14,720

Source: Department of Finance Fiscal Monitor, 4 Jan 2023.

The Exchequer surplus came in at €5 billion in 2022 and this equates to a General Government Surplus of €5.2 billion, equivalent to 2 per cent of Gross National Income (GNI). However, the Department of Finance is applying a justifiably cautious interpretation to the strong tax revenue buoyancy. The Department adjusts the Exchequer figures for its assessment of transitory

corporation tax receipts and estimates that when this is done, the underlying General Government Balance (GGB) is estimated to have been in deficit to the tune of €5.2 billion.

It is impossible to accurately estimate how much of the corporation tax revenue buoyancy is transitory, but it is important to recognise that a sizeable portion could be. The Department of Finance is obviously worried that the current government and its successor could just spend the windfall taxes for political reasons, and then if a correction were to occur in corporation tax receipts, the country could be left with a significant hole in the public finances. In the run up to the 2008 crash, the government spent aggressively on the back of buoyant construction and property-related tax revenues, and when this source of revenue proved dramatically transitory, the country was left with a serious fiscal problem. The lesson is that engaging in excessive expenditure on the back of a tax base that could prove transitory is not prudent. The Department of Finance is justifiably concerned.

POPULATION

Census 2022 shows that the population of Ireland stood at 5.12 million in April 2022. This is up by 7.6 per cent from Census 2016. Every county in the country experienced growth in population. In the six-year period between Census 2016 and Census 2022, there was net inward migration of 190,000. This is the highest population recorded in a census since 1841.

AGRICULTURE

Although farmers endured a strong increase in input costs during 2022, due to energy and fertiliser, farming had a good year. The CSO estimates that the Operating Surplus for farmers increased by 30 per cent, following an increase of 17.6 per cent in 2021. The value of farm output increased by 26 per cent in 2022.

FOREIGN DIRECT INVESTMENT

Despite the global economic headwinds and forthcoming changes to the global corporation tax regime, the IDA had another successful year in 2022. Employment in IDA supported companies increased by 32,426 gross new jobs; 8,407 jobs were lost; and 24,019 net new jobs were created. 242 new investments were delivered in 2022, with 167 coming from North America; 54 from Europe; and 21 from 'growth markets.' Total employment reached 3091,475.

In October 2022, the sectoral breakdown of IDA supported jobs was as follows:

Table 4: Sectoral Breakdown of IDA Supported Jobs

SECTOR	EMPLOYMENT OCT. 2022	% TOTAL	% CHANGE ON 2021
ICT	116,192	38.5%	+6.0%
Modern Manufacturing	105,199	34.9%	+8.0%
Traditional Manufacturing	23,658	7.8%	+5.6%
Business, Financial & Other Services	56,426	18.7%	+9.0%
Total	301,475	100.0%	+9.0%

Source: IDA, 12 December 2022

IDA supported companies have a strong footprint across the regions. IDA-supported companies had expenditure of €30.7 billion in 2022, with payroll accounting for €19.6 billion. The strong FDI footprint has provided an important anchor for the Irish economy since the beginning of 2020.

Table 5: Regional Breakdown of IDA Supported Employment (October 2022)

REGION	EMPLOYMENT	% OF TOTAL
Dublin	137,822	45.7%
South-West	52,228	17.3%
West	31,490	10.5%
Mid-West	26,004	8.6%
Mid-East	21,861	7.3%
South-East	15,520	5.2%
Border	8,885	2.9%
Midlands	7,665	2.5%
Total	301,475	100.0%

Source: IDA, 12 December 2022.

In mid-December 2022, the European Union had a significant breakthrough in relation to the OECD/G20 global tax deal agreed in October 2021. Hungary dropped its veto on Pillar 2 of the tax deal. Pillar 2 allows for the introduction of a minimum corporation tax rate of 15 per cent for multinationals and domestic groups or companies with a combined annual turnover of at least €750 million. The 27 EU member states have now agreed to transpose the directive into the national law of member states by the end of 2023. The EU is determined to be a front-runner in applying the global tax deal.

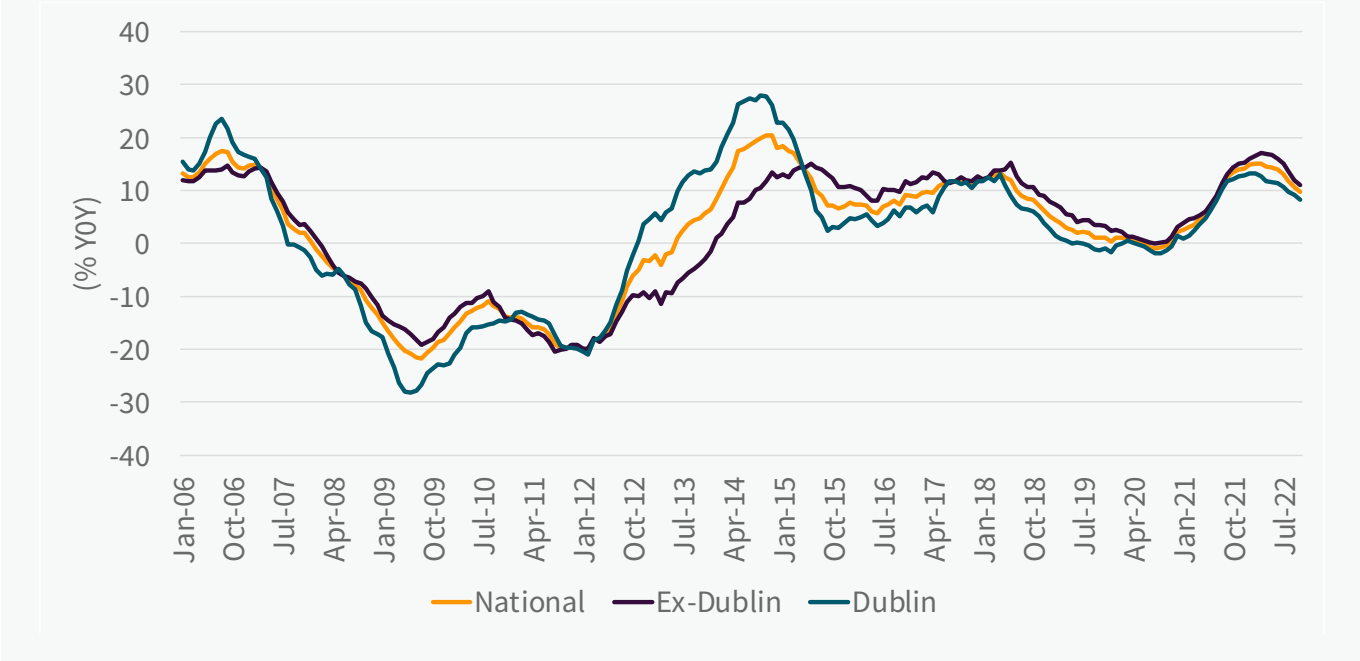
The impact of the global tax changes is not likely to be significant as Ireland will still offer an extremely competitive tax rate in a global context. However, it should serve to focus more attention on the imperative to concentrate on other aspects of national competitiveness, other than corporate tax structure. This national competitiveness agenda should include housing; public services such as health and education; physical and remote connectivity; the personal tax burden and the quality of the labour force. Ireland has a distinct FDI advantage given that it is now the only native English-speaking country in the EU (excluding Malta). However, it will be important to maintain an environment that is as competitive and pro-business as possible.

HOUSE PRICES

Against a background of rising interest rates and considerable economic uncertainty, there have been clear indications that house price inflation is decelerating. In the year to October, national average residential property prices increased by 9.8 per cent, with prices in Dublin rising by 8.3 per cent and prices outside Dublin rising by 11 per cent. This is down from a peak growth rate of 15.1 per cent in national average prices in March 2022; a peak growth rate of 13.2 per cent in Dublin in February 2022; and a peak growth rate of 17.1 per cent in the Rest of Ireland in March 2022.

In October, the national Residential Property Price Index (RPPI) showed that national average residential property prices were 2.9 per cent above the highest level recorded at the peak of the economic boom in April 2007. Dublin residential property prices are 5.7 per cent lower than their February 2007 peak, while residential property prices in the Rest of Ireland are 1.8 per cent higher than their May 2007 peak.

Figure 2: Residential Property Inflation (Year-on-Year)



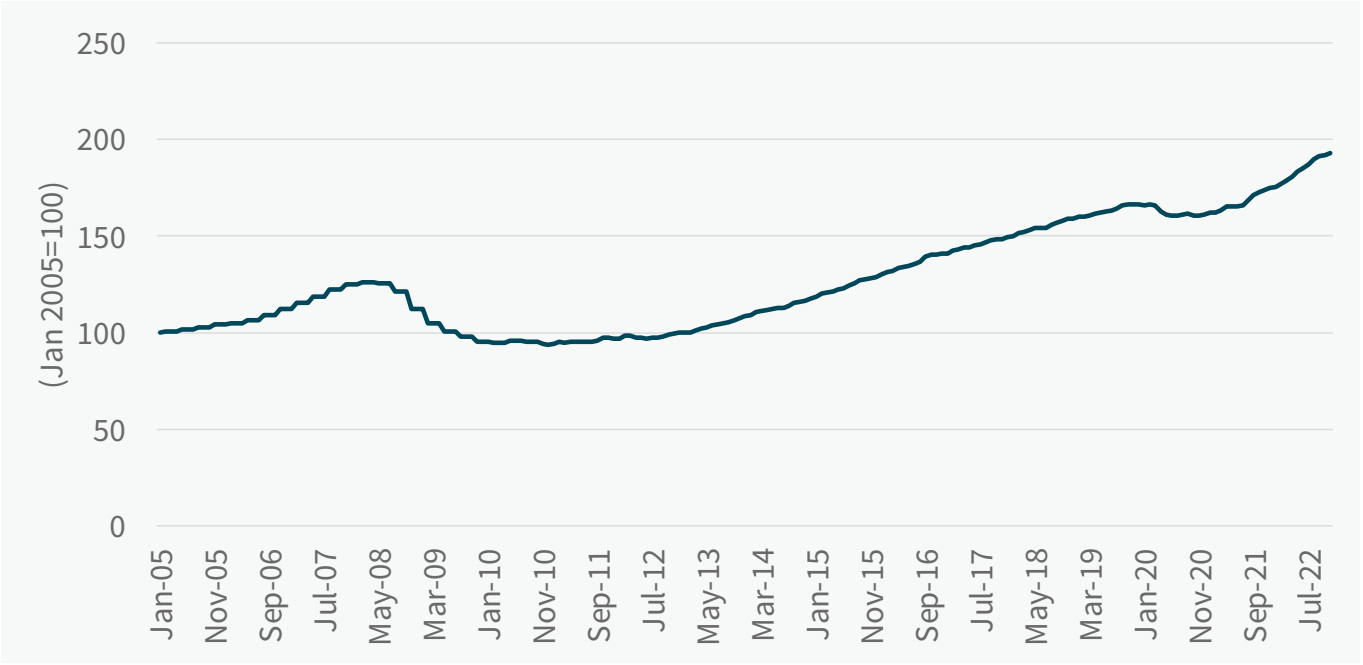
Source: CSO

THE RENTAL MARKET

Pressure on the cost of private rents continues to intensify. CSO data show that rents increased by 11 per cent in the year to November. Between June 2012 and November 2022, average private rents increased by 98.8 per cent.

Inadequate supply and strong demand are higher pushing the rental market, not least from those who are unable to borrow enough to purchase a residential property and from a growing labour force and overall population growth.

Figure 3: CSO Private Rents



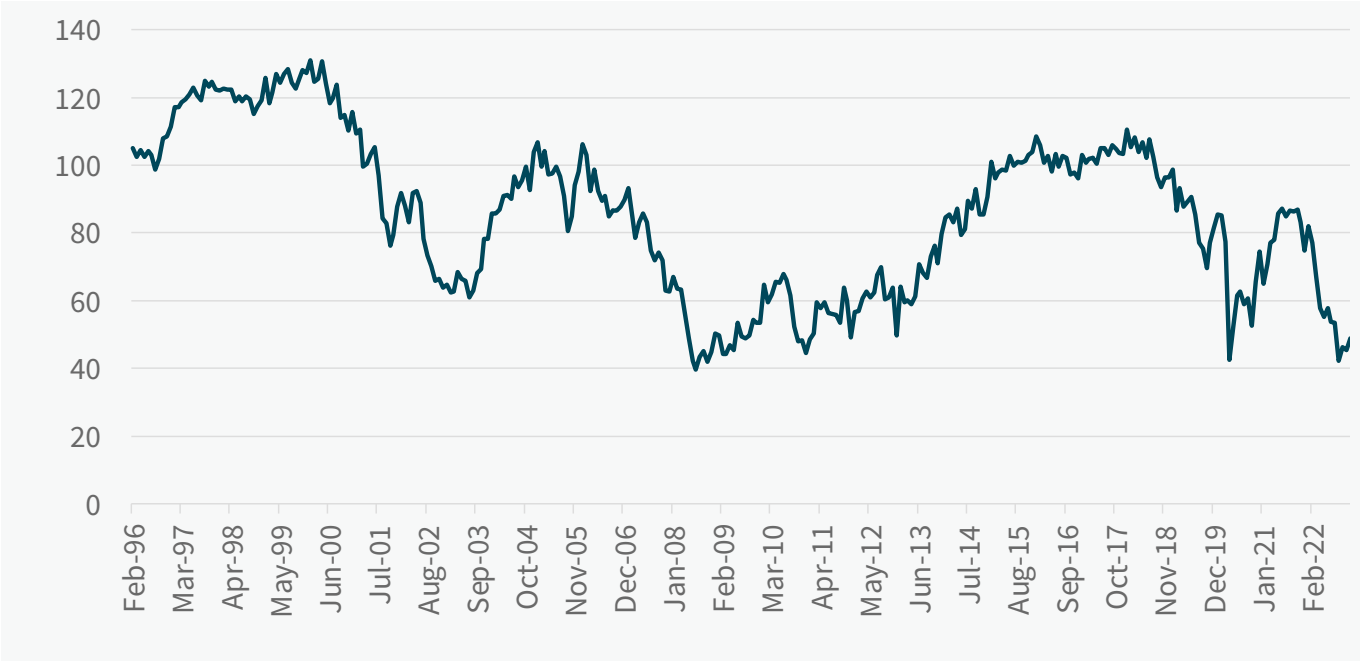
Source: CSO

THE CONSUMER

Not surprisingly against a background of intense global uncertainty, rising interest rates and the cost-of-living pressures, consumer confidence fell sharply as the year progressed. In September sentiment fell to lows last seen in March 2020 and the second half of 2008. It recovered modestly in the final quarter, helped by the very expansionary budget package of €11.3 billion in Budget 2023 on 27th September.

The decline in sentiment resulted in a weaking of consumer spending. In the three-month period August-October 2022 the volume of retail sales was 4.3 per cent lower than the equivalent quarter in 2021. The value of sales was 4.8 per cent higher, reflecting the escalation in consumer prices.

Figure 4: Consumer Confidence



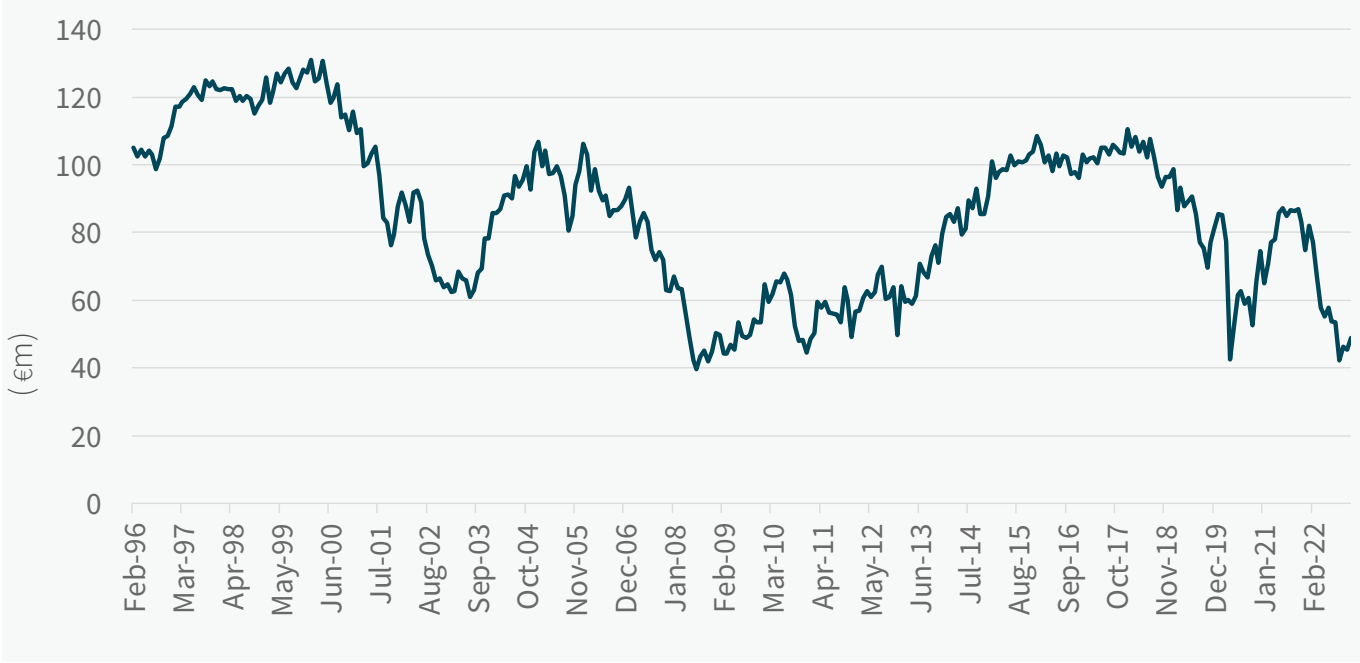
Source: KBC Bank Ireland/ESRI

THE ECONOMIC OUTLOOK

Despite the resilience of the Irish economy in 2022, it seems inevitable that growth will slow over the coming months, but the slowdown is likely to be limited to certain sectors. The sectors that are most dependent on discretionary spending look most vulnerable, with hospitality, personal services and non-essential retail looking most exposed. Thankfully, the Irish economy is facing the current difficulties from a position of considerable strength on some important fronts, including the FDI base; the strong labour market; the strong export platform; and a record level of household savings. The record budget package of €11.3 billion in Budget 2023 will also provide support for the economy.

Household savings reached a record high of €149.3 billion in October 2022. During the two years of the pandemic there was an unanticipated increase in personal savings as many workers continued to earn but could not spend due to restrictions. During 2022, savings were more precautionary in nature as global and domestic uncertainty intensified. This level of savings will provide a solid anchor for the personal sector during what promises to be a more challenging year in 2023.

Figure 5: Household Deposits



Source: Central Bank of Ireland.

While there is considerable uncertainty about the economic growth outlook, the outlook for inflation is even more uncertain. Following projected annual inflation of 8.5 per cent in 2022, average inflation is projected to moderate to 7.1 per cent in 2023 and 2.4 per cent in 2024. Unfortunately, this will be determined by factors that are outside of Ireland's control, but the recent significant downward trend in global energy, oil and shipping costs does give cause for optimism.

In 2023, the key positives for the economy include:

- A solid level of economic momentum in 2022.
- A record level of employment and a low rate of unemployment.
- A record level of household savings of €149.3 billion and a solid aggregate personal sector balance sheet.
- A stable banking system, albeit there is now a much less competitive concentrated banking system.
- A strong fiscal position on the back of buoyant tax revenues, although there is an elevated level of outstanding government debt. Government debt stood at 101 per cent of Gross National Income (GNI) at the end of 2021. It is expected to fall to 86 per cent of GNIat the end of 2022 due to strong economic growth and a budget surplus. Debt is high, but manageable, provided economic growth continues and tax revenues hold up.

- The export base of the economy is strong, particularly the Chemical and Pharmaceutical sector.
- The FDI base of the economy is strong and is still expanding.

The key threats and challenges in 2023 include:

- A very uncertain external environment.
- Rising interest rates.
- Cost-of-ling pressures.
- Higher costs of doing business, particularly for the SME sector.
- The pressures on the global technology sector.
- The housing market is the single biggest economic, social, and political challenge facing the country. The lack of housing and the high house prices and rents are now seriously undermining the competitiveness of the economy. It is likely that Irish house prices could decline over the coming year against a background of slower growth, rising interest rates, affordability, and a vulnerable global real estate outlook.
- Addressing the climate change agenda. It will be necessary to turn ambitious targets into real action and progress.
- The global geo-political environment is very uncertain. Ireland could also face massive political change in 2025.

There are significant challenges and uncertainties ahead, which will inevitably undermine Irish growth. However, Ireland is still in a good place facing into a very uncertain year.

The views expressed in this article reflect those of Jim Power and are for informational purposes only. They do not represent the views of Aviva. Jim Power's views may change.



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