

MACRO-BACKGROUND FOR IRISH TOURISM

The Global Backdrop

This time last year there was considerable doubt concerning global recovery prospects. There was a risk that the magnitude of the shock to the global economic and financial system was so severe that it would take some years of stimulus measures to restore growth. Thankfully the global economy has come back from the abyss and is in a much better place today than this time last year. It is clear that the unprecedented monetary and fiscal stimulus has worked.

The emerging world is growing strongly again, but in the developed world, the recovery is more modest and is not without its risks over the coming year. In the US the consumer is still very justifiably in a cautious frame of mind, and recovery in consumer spending will be slow. The US economy has shed 8.4 million jobs since January 2008 and considerable personal wealth destruction has occurred. The balance sheet of the US personal sector was in a very poor state of health coming into the recession, with alarmingly low levels of savings and high levels of personal debt. The personal sector is now paying down debt and the savings rate is climbing. This balance sheet repair is fundamentally positive, but will dampen the consumer contribution to economic recovery.

The Euro Zone economy technically emerged from recession in the third quarter of 2009, when GDP expanded by 0.4%. The rate of expansion in the final quarter of 2009 slowed sharply to just 0.1 per cent.

Looking across the Euro Zone's main economies, the general picture is still one of weakness, despite the fact that the recession has technically ended:

- Having expanded by 0.7 per cent in the third quarter of 2009, German GDP ground to a halt and was flat in the final quarter. Consumer spending and investment remain very weak, but exports are holding up well, reflecting the strong competitive position of the German exporting sector;
- The French economy is recovering more quickly than the others. GDP expanded by 0.6 per cent in the final quarter of 2009, up from growth of 0.2 per cent in the previous quarter.
- Having expanded by 0.5 per cent in the third quarter of 2009, Italian GDP contracted by 0.3 per cent in the fourth quarter. Consumer spending and investment remain very weak, while the export performance is being undermined by a lack of competitiveness;
- The Spanish economy has not yet emerged from recession. GDP contracted by 0.1 per cent in the fourth quarter, having contracted by 0.3 per cent in the previous quarter;

It is clear that domestic demand remains weak across the Euro Zone. The unemployment rate remains stubbornly high at 9.9 per cent of the labour force, while fiscal deficits continue to widen. Looking out over the coming year, it is difficult to be confident that anything other than a modest economic recovery will be seen.

Fiscal policy will have to be tightened as efforts will have to be made to control high deficits in many member countries. Prospects for France and Germany look reasonably good, but Italy, Portugal, Greece and Spain will continue to be a source of immense concern.

The Euro Zone economy is projected to grow by 1 per cent in 2010.

The UK economy emerged from recession in the final quarter of 2009. GDP expanded by 0.3 per cent, following a contraction of 0.3 per cent in the third quarter. Prospects for 2010 are challenging. Growth in the early part of the year will be dampened by the increase in VAT rates and the ending of the car scrappage scheme. Industrial production fell by 0.4 per cent in January, and activity levels are still 14 per cent below the pre-recession levels. The biggest challenge for the UK economy is undoubtedly addressing the massive fiscal deficit. Based on the borrowing levels for the early weeks of 2010, it is possible that the deficit this year could be equivalent to 12.8 per cent of GDP, which would represent a higher deficit than Greece. However, the level of outstanding debt at some 60 per cent of GDP is much lower than that of Greece and Italy. Nevertheless, the incoming UK government will have to put a credible deficit reduction plan in place as quickly as possible. The markets are currently worried that this might be difficult in the event of a hung parliament, and this is currently spooking the markets and particularly sterling. The UK economy is expected to expand by 1.3 per cent in 2010, but the risks currently appear to be on the downside.

Global Economic Forecast

	2008	2009e	2010f
World Economy	3.0%	-0.8%	3.9%
Euro Zone	0.6%	-3.9%	1.0%
United States	0.4%	-2.5%	2.7%
United Kingdom	0.5%	-4.8%	1.3%
Germany	1.2%	-4.8%	1.5%
France	0.3%	-2.3%	1.4%
Japan	-1.2%	-5.3%	1.7%
China	9.6%	8.7%	10.0%
India	7.3%	5.6%	7.7%

*e=estimate f=forecast
Source: IMF, January 2010*

Interest Rates

European official interest rates remain at historic lows of 1 per cent and there is no immediate pressure to tighten. The Euro Zone economy is recovering at a slow pace; there is still considerable excess capacity across the Zone, and inflationary pressures are muted. There will have to be a strong emphasis on fiscal correction over the next couple of years in the Euro Area, so official rate rises are not likely in 2010, but there would appear to be some limited upside potential in 2011. US rates may rise before the end of 2010, but there is no immediate threat to UK rates.

Exchange Rates

The dollar has appreciated by almost 11 per cent against the euro over the past six months. The appreciation of the dollar reflects a more favourable market outlook for the US than the Euro Zone economy. For US tourists travelling to Ireland, this does represent a positive development. For UK tourists travelling to Ireland the situation is much more difficult. Sterling has lost over 32 per cent of its value against the euro since the end of 2007. Earlier in 2010, sterling strengthened modestly as the Greek situation undermined confidence in the euro, but over the past month sterling has come under renewed pressure. The markets are worried by opinion polls pointing towards the possibility of a hung parliament in the aftermath of the upcoming general election. Given the immediate requirement to address the UK fiscal deficit, such an election outcome would be the worst possible scenario. Consequently, sterling looks set to remain weak at least until the election is out of the way.

The Irish Economy

2009 was a very difficult year for the Irish economy and it will go down in history as the sharpest ever annual contraction in Irish economic activity – at least since records began. In the first nine months of 2009, GDP declined by 8.1 per cent and the more meaningful measure of economic activity, gross national product (GNP) declined by 12.1 per cent. In the first nine months of the year, consumer spending declined by 7.8 per cent, investment declined by 31.9 per cent, exports of goods & services declined by 2.7 per cent and imports of goods & services declined by 9.9 per cent.

Looking ahead to 2010 it is difficult to be terribly confident that the economic environment might get markedly better. The housing side of the economy is still falling in terms of both prices and building levels, consumer confidence and spending will continue to be undermined by wage cuts in the public and private sector, further job losses, further cuts in government expenditure, and the inevitability of further increases in the personal tax burden. On the positive side, the external economic environment is getting gradually but steadily better and this will undoubtedly give some boost to the export performance. Statistically it appears likely that the technical recession will end in the second half of 2010, but recovery will be challenging. The major challenge for Irish policy makers is to ensure that as the external economic environment improves, the Irish economy will be in a position to exploit the recovery.

Two key areas will need to be addressed in this context – the public finances and the competitiveness of the economy.

In relation to the public finances, Ireland had to borrow €24.6 billion in 2009, equivalent to around 11.5 per cent of GDP. Although the borrowing requirement for the full year was slightly better than expected due to a stronger than expected tax take towards the end of the year, a borrowing requirement of almost €25 billion is inordinately large in an Irish context and is not sustainable. Future budgetary policy has got to work aggressively towards reducing this borrowing total as quickly and as aggressively as possible. Postponing the fiscal adjustment process is not an option because interest payments on Ireland's national debt is rising steadily and will increasingly soak up a significant part of the annual tax take.

The total tax take in 2009 came in at just €33 billion, which is the same tax take as in 2004. Net voted current spending totaled €27 billion in 2004, but in 2009 it totaled €40 billion. So while the tax take is back at 2004 levels, net voted current spending has increased by over 48 per cent in the interim period. The collapse in tax revenues and the failure to manage spending appropriately is the nub of the fiscal crisis in which Ireland now finds itself.

A fundamental reform of taxation and spending is required. The most economically efficient tax system is one based on relatively low marginal rates, but spread broadly. This will require measures such as more workers being taken back into the tax net, the introduction of a property tax, user charges for water, and the abolition of many remaining tax reliefs. The menu has been presented by the Commission on Taxation. On the spending side, a menu of choice has also been presented in the 'Report of the Special Group on Public Service Numbers and Expenditure Programmes' in July 2009. Many of the measures suggested will have to be given serious consideration over the coming months.

The only way to solve a fiscal crisis or an unemployment crisis is through generating economic activity. Over the coming year the external environment is likely to be better, but we also need to continue to address the broad competitiveness agenda. Quite simply, the cost of doing business and the cost of living in Ireland will have to be reduced considerably further. This competitiveness restoration process will have to include wages, local authority charges, commercial rates, professional fees, commercial rents and the cost of consumer goods and services. This process did commence in 2009 but more is needed. It is also essential that policymakers seek to create an environment where jobs are preserved and created. Ireland simply has to get real about its structural economic and financial problems and create the basis for high quality and sustainable economic growth.

IRISH ECONOMIC FORECAST

Average	2008	2009f	2010f	2011f
GDP	-3.0%	-7.3%	-1.7%	3.1%
GNP	-2.8%	-9.0%	-3.0%	2.5%
Consumption	-1.0%	-7.8%	-3.0%	2.0%
Investment	-15.5%	-38.0%	-20.0%	5.0%
Government	2.6%	-1.0%	-1.0%	-1.0%
Exports	-1.0%	0.5%	2.5%	5.0%
Imports	-2.1%	-8.0%	-4.0%	4.0%
Consumer Price Inflation	4.5%	-4.5%	1.0%	2.5%
Unemployment (average)	6.3%	12.5%	14.0%	14.0%
House Completions	51,724	24,000	12,000	15,000

The crisis situation in Greece highlights the dangers for a small country in a monetary union that does not keep its public finances under control. Thankfully, Ireland is currently not featuring too prominently in international discussions on the Greek crisis. Spain, Portugal and Italy are now more frequently mentioned and thankfully one 'I' has dropped out of the P.I.G.S acronym. We need to ensure that it remains that way.

Ireland is not featuring purely because of what Brian Lenihan has achieved over the past year. International observers, and particularly international bond markets, believe that a country which has increased taxes, cut government spending and public sector pay is serious about addressing its problems. The attitude of international markets is very important, given the amount of money that Ireland is borrowing and will continue to borrow over the next three years at least. On Friday last, Greece had to pay 324 basis points over Germany to borrow 10-year money: Ireland had to pay 140 basis points over Germany. This time last year we had to pay almost three times that differential.

It is absolutely essential for the well-being of Ireland that Government does not succumb to the pressures currently being exerted by public sector unions. Any reversal of the measures introduced in last December's budget would quickly propel Ireland up alongside Greece as the sick man of Europe. We cannot risk that and instead we need to continue to press ahead with at least another 3 tough budgets to keep the budgetary correction on course. Any slippage would be disastrous for Ireland. The imperative is to maintain the confidence of international markets and keep Ireland pointed in the direction of recovery. The challenges ahead are still immense, not least in relation to the NAMA process, and the biggest enemy at this juncture would be complacency. We must recognise that Ireland is in a better place today than a year ago, but the challenges are still immense, but tackling them head on will eventually be in the best interests of every Irish citizen.

Issues for Tourism Sector

The following are the key issues for a tourism sector that will continue to operate in a challenging marketplace over the coming year:

- Global recovery is happening, but there are certain fragilities and imbalances that will constrain consumer spending and travel in Ireland's key source markets;
- Exchange rate developments are mixed. The strengthening of the dollar is good news, but the ongoing pressures on sterling will ensure that Ireland will remain an expensive market for UK tourists;
- Domestic consumer dynamics are still difficult and discretionary spending is still under pressure, ensuring that domestic tourists will remain extremely price sensitive;
- There is currently massive uncertainty about the future of the hotel sector. It is estimated that banks have already taken *effective ownership* of up to 100 hotels and are effectively subsidizing their operation. It is probable that NAMA will ultimately take control of many hotels, and it is not clear what the fate of these hotels will be. There is also considerable uncertainty about the fate of the 'zombie' hotels that have been funded by non-Irish banks. Overriding all of this is of course the fact that there is significant over capacity in the hotel sector, and there is huge uncertainty concerning how the market can eventually achieve equilibrium;
- The lack availability of rental cars poses a major threat to incoming tourism and it appears that the relevant Government departments are either unaware or are failing to understand the magnitude of and the implications of this situation;
- The whole Irish economy, including the tourism sector, will need to become more competitive in terms of price and quality.