Economic Insights

ISSUE: 01 | JUNE 2020

A SUDDEN SHOCK
This time is different, but to what extent?

DOMESTIC CONSUMPTION
A global shock, locally felt, everywhere.

AN EXPORT ECONOMY
Headwinds for all of our trading partners.

Executive summary

Dear reader,

KPMG is pleased to publish the first in a series of papers analysing Ireland's economy. This comes at a clear period of unprecedented economic and social change. The IMF is projecting a 3.0% fall in global GDP in 2020 and the worst recession since the 1930s.

Domestically, we have been living with the crisis and related restrictions for the past three months. Aggregate and household demand for products and services involving face-to-face contact has fallen significantly. Unemployment is at record levels, reducing disposable income. Many firms are closed and are facing cashflow issues, and the public finances are under strain.

Since mid May the Government has gradually re-opened parts of the economy. Many retail stores are operating and travel restrictions have been relaxed. The publication of a Draft Programme for Government by Fianna Fáil, Fine Gael, and the Green Party on 15 June is timely. It outlines several 'Missions' that the prospective government would pursue: key standout objectives include the document's focus on a jobs-led recovery, developing a Green New Deal, and supporting regional sustainability.

The Draft Programme sets a target of creating 200,000 new jobs by 2025. This will be achieved by, amongst other enablers, bringing forward capital investment projects, decarbonising the economy, and financing the growth of SMEs. The Programme earmarks the development of a Recovery Fund and a National Economic Plan over the coming months as tools to support a return to growth.

In this article, we review the underlying structure of Ireland's economy, identifying reasons to be positive. We believe that Ireland can and will recover from this crisis. Our workforce is productive and agile, our enterprises are dynamic and innovative, and our society is cohesive and driven.

With the right strategies and collective action, we will overcome the current challenges together.

Regards

Seamus Hand
Managing Partner

Content

Headline indicators

WHILE THERE ARE CLEAR HEADWINDS IN 2020, THE IRISH ECONOMY CAN RETURN TO GROWTH IN 2021 AND BEYOND.

Irish Economic Outlook

MODIFIED DOMESTIC DEMAND

2019	2020	2021
3.0%	-15.0%	8.5%

GDP

2019	2020	2021
5.5%	-10.5%	6.0%

INVESTMENT (% OF GDP)

2019	2020	2021
43.5%	21.5%	22.0%

UNEMPLOYMENT RATE

2019	2020	2021
5.0%	14.0%	10.0%

DEBT TO GDP RATIO

2019	2020	2021
59.0%	69.0%	68.5%

IRELAND 2019 GDP BREAKDOWN

GDP = C + I + G + [X – M]

GDP	C	I	G	X	M
Gross Domestic Product	**Consumption**	**Investment**	**Government Expenditure**	**Exports**	**Imports**
€347bn	€112bn (32%)	€151bn (44%)	€35bn (10%)	€440bn	€390bn
	See page 6	*See page 7*	*See page 8*	(14%) *See page 9*	

Sources: CSO, Department of Finance (April 2020)

A sudden shock

THIS TIME IS DIFFERENT, BUT TO WHAT EXTENT?

The Covid-19 health emergency has led to a significant economic crisis, unseen since World War II. Mandated social distancing, combined with voluntary aversion behaviour, has caused sharp falls in discretionary consumption and some declines in non-discretionary consumption, as well as a fall in business and household investment.

While 2020 shares some characteristics with other recent recessions, most notably the presence of a sudden shock, it differs in one clear way: plummeting aggregate demand can rebound due to strong fundamentals domestically. At the same time, how we consume goods and services will change. Global recovery is dependent on vaccine development.

WE CAN LEARN LESSONS FROM THE LAST CRISIS.

Our most recent global recession – still in our collective memory – impacted countries differently according to the economic foundations of each country. It took Ireland >25 quarters to recover from the financial crash, whereas our 5 main trading partners recovered in ~10 quarters.

While policy tools varied, there was a general consensus that fiscal austerity would support recovery. In 2020, the narrative has changed. The European Commission and national governments are broadly aligned that significant public investment may be a more appropriate approach.

WE WILL RECOVER; HOW AND WHEN IS UNCLEAR.

Throughout the crisis, key talking points have been around the shape of the recovery. Economists and policy-makers are understandably unclear what the path to recovery will be. These will depend on:

1. The size of the contraction from Q4 2019 to the trough – dependent on the structure of the economy
2. The length of time it takes to reach the lowest point of the curve – dependent on the effects of, and adherence to, social distancing
3. The length of time, if any, during which the curve remains flat – impacted by development of a vaccine
4. The length of the recovery from the trough to Q4 2019 levels of output – dependent on the economy's capacity to adapt and respond.

As of mid June, Ireland's economy has begun to re-open and yet the fullness of the economic impact may not be felt for a number of months. The *Draft Programme for Government* commits the parties to developing recovery plans from July.

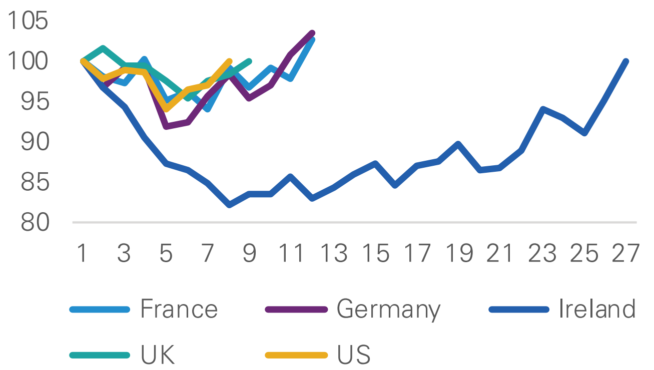
As with all countries, the re-emergence of the virus in a 'second wave' is a concern. Positively, we are now better equipped to deal with such a situation.

THE CURRENT CRISIS IN CONTEXT

Risk factor	.com	2008	2020
Demand shock			
Supply shock			
Financial shock			
Underlying strength			
Indebtedness			

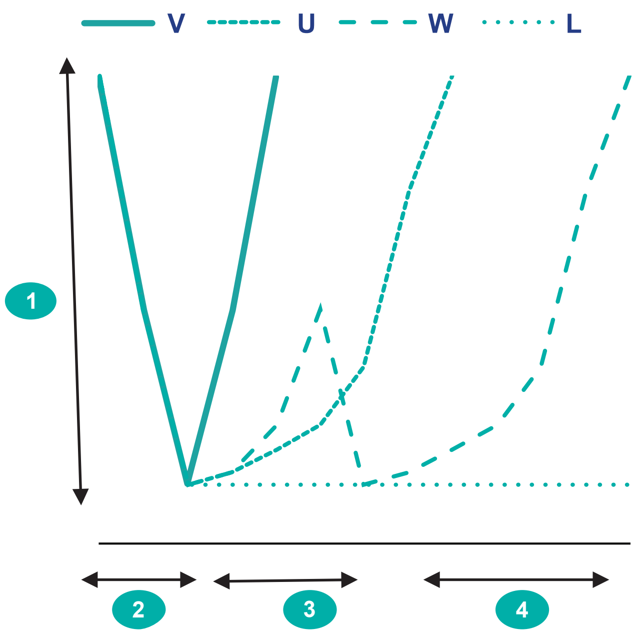
Source: KPMG analysis

RECOVERIES FROM THE LAST RECESSION (2007 Q4 = 100



Source: KPMG analysis, OECD; note: numbers refer to quarters

POTENTIAL SHAPES OF RECOVERY



Source: KPMG analysis

Domestic consumption

A GLOBAL SHOCK, LOCALLY FELT, EVERYWHERE.

The nature of the current crisis means that countries in which economic output is predominantly dependent on domestic demand and face-to-face contact have suffered most in the short-term.

Consumption in Ireland typically accounts for 1/3 of our economic welfare. Going into 2020, the domestically-focused economy was growing at a slower rate than the economy on an aggregate level. Residents of Ireland were optimistic. Since Q1, sentiment fell sharply. Concerns around income, job security, and future opportunities are widespread.

The agreement on a Draft Programme for Government may mitigate some of these concerns. Commitments to a jobs-led recovery and to the growth of domestic enterprises may encourage consumption across the economy.

DEMAND HAS BEEN STABLE FOR MANY GOODS/ SERVICES.

Travel and social distancing restrictions have halted in-shop expenditure on many goods and services that would have been bought otherwise, in particular on recreation and outings, non-essential household goods, and clothing. Firms that closed, but which have an online presence and can operate social distancing rules, may have been able to mitigate the extent of harm caused.

On the whole, mitigating lost sales has not been possible in accommodation, food, and related sectors. Over recent months, we continued to spend on housing costs, food, household fuel, and communications.

The lifting of restrictions enables a share of pent-up demand for tangible products to be met, where possible. With 70% of Ireland's SMEs having a website, and 33% selling online, there is clear capacity to grow in the recovery.

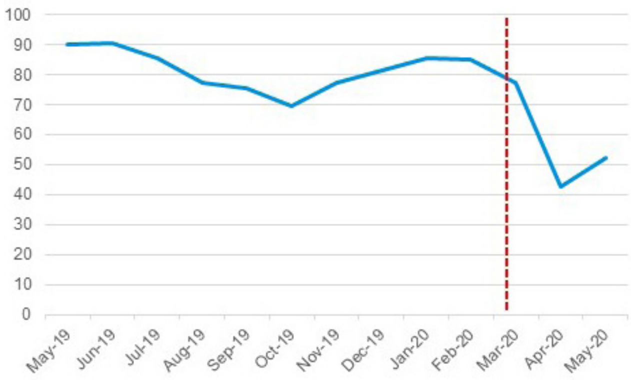
IN TIME, HOLIDAY DOMESTICALLY TO SUPPORT GROWTH.

International non-essential travel broadly halted in Q1, continuing into Q2. Foreign visits to Ireland and trips by Irish residents internationally disappeared. At this point, the outturn for global tourism later in 2020 does not appear positive.

Holidaymakers may instead remain in-country, where possible. For residents of Ireland, making domestic trips could help boost the economy, particularly in regions more dependent on tourism. A trend was already emerging in 2019, with domestic trips up 14% y-o-y.

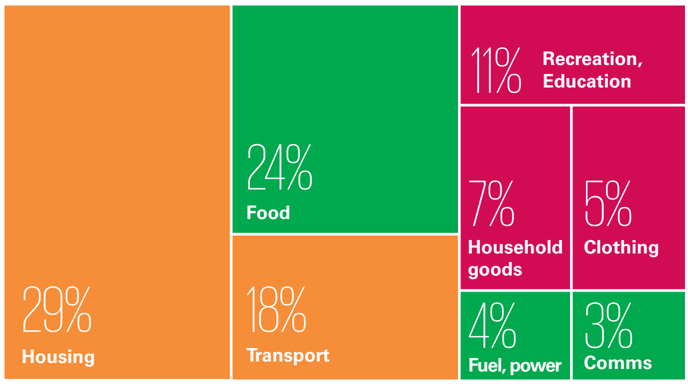
Irish tourists abroad typically spend 1.8 times that of their international counterparts visiting Ireland. Allowing for the nature and timing of government Covid guidance, if each Irish resident substitutes his/her overseas vacation for a domestic one, this would moderate the fall-off in visitor numbers

SENTIMENT INDICES



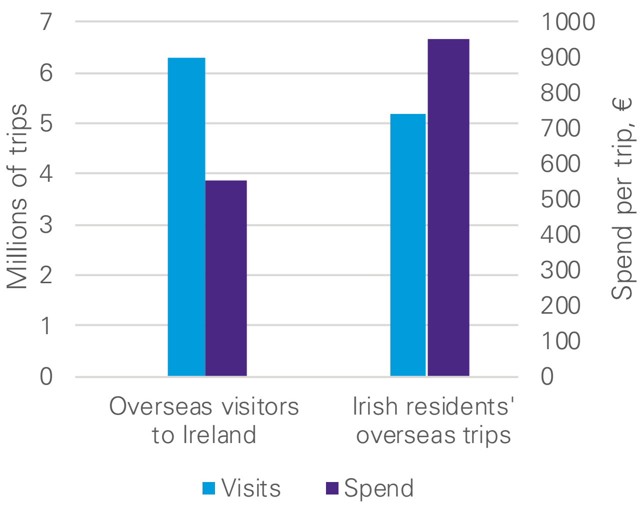
Source: KBC Bank: red line refers to social distancing measures

CONSUMPTION OF PERSONAL INCOME



Source: CSO; note: refers to 2018, excludes miscellaneous purchases, colours reflect impact on spend during the period of restrictions

TRIPS AND SPEND IN Q1 AND Q2 2019



Sources: CSO

Private sector investment

IRELAND IS A LEADER AT ATTRACTING FDI.
Ireland is a clear success story for attracting global foreign direct investment for several decades. Even during the height of the last recession, Ireland was performing well relative to its competitors. Since 2010, inward FDI flows have almost doubled, supporting the last recovery. In the period 2015-2019, the IDA met all its targets, attracting 1,200 investments that created >110,000 jobs.

To return to growth following the current crisis, a continued focus on attracting FDI can be expected. This, however, comes with a caveat that globalisation may slow or retreat over the coming years, if investors turn attention to domestic markets.

M&A ACTIVITY HAS BEEN STRONG GLOBALLY.
At present, corporates and private equity players alike are prioritising the liquidity position and management of their firms. Substantial levels of private equity dry powder are available for opportunities as they arise, and well-capitalised corporates will be similarly positioned once credit markets and valuations stabilise.

Tech firms that provide solutions to the physical and geographical disruption caused by Covid-19 are particularly well-positioned to seize opportunities, as the pandemic has put remote working, video streaming and global internet communications at the forefront of our day-to-day lives.

In other sectors, a period of consolidation in pursuit of scale may follow so they are better positioned to withstand the period of uncertainty ahead. Combinations may be explored in a transparent way with similar sized companies, with stock used as acquisition currency.

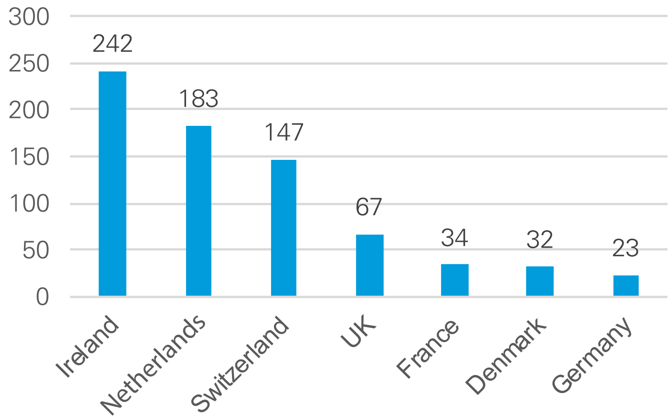
INVESTMENT FOCUSED ON GROWTH SECTORS.
Recent years have seen record levels of M&A activity, albeit in 2019 dealmakers had to weather increased volatility in equity markets, decreasing valuations, and macroeconomic and political uncertainty.

In the near term, organic and inorganic investment will be focused on high-quality assets in perceived Covid-resilient sectors. Technology and telecom firms that provide solutions to the physical disruption caused by Covid-19 are well positioned to seize opportunities.

Global M&A activity in the life sciences, pharma and MedTech sectors hit an all-time high in 2019, and clearly these sectors are vital in the current circumstances and will continue to attract investment. From an Irish perspective, this is a positive story as together, the technology, telecom, pharma & life science sectors account for 20% of employment within the Irish workforce.

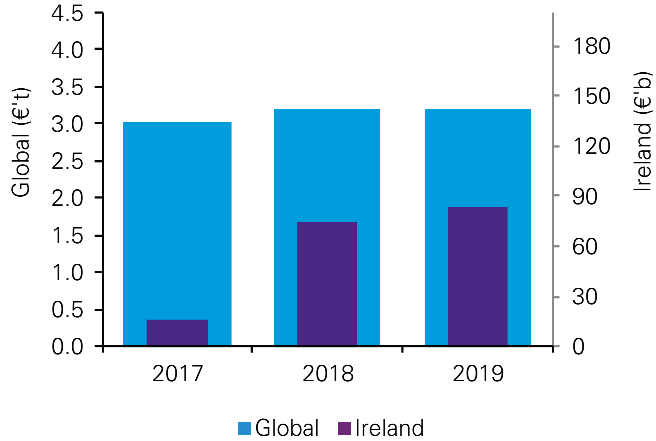
There is, there is general consensus that a key driver of the global recovery will be the Green Economy. We can expect climate-focused stimulus plans and conditional rescue package.

FOREIGN DIRECT INVESTMENT, % OF GDP



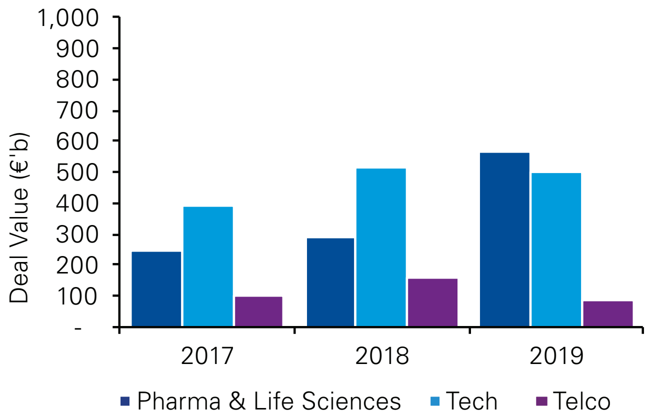
Source: IMF, OECD; countries selected are competitors and/or key trading partners

GLOBAL AND DOMESTIC M&A DEAL VALUES



Sources: Mergermarket

GLOBAL M&A SECTOR ACTIVITY



Sources: Mergermarket

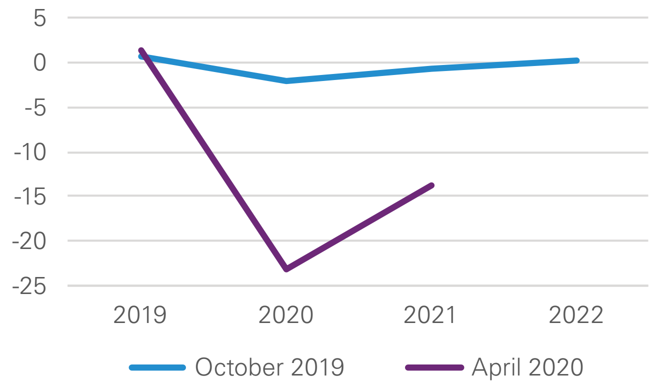
The role of government

ALL GOVERNMENTS ARE UNDER FISCAL PRESSURE.
While the current crisis is macro in nature, it is having profound effects on governments' public finances. Countries with existing debt burdens and running deficits will be most acutely hit.

Domestically, Ireland entered 2020 with healthy public finances. The crisis has already resulted in significant costs for the Exchequer, while tax revenue will fall. In April, a total deficit of over €23 billion was projected for 2020 by the Department of Finance. Since, the Minister has indicated that the deficit will be greater - we can expect an update in the Department's *Summer Economic Statement* in late June.

Under the *Draft Programme for Government*, a roadmap for balancing the Exchequer finances will be announced at Budget time.

FORECASTED GENERAL GOVERNMENT BALANCE (€BN)

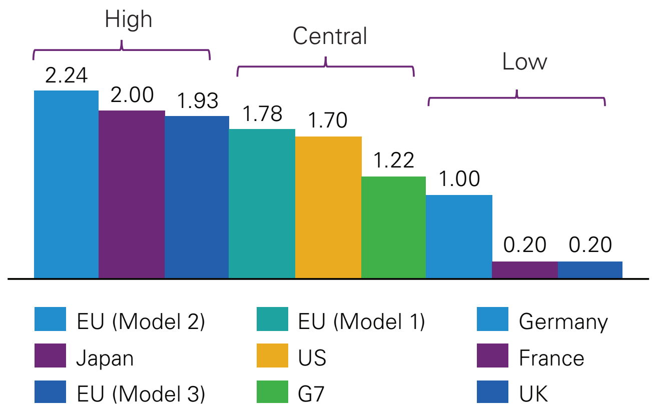


Sources: Department of Finance

COUNTER-CYCLICAL POLICIES WILL BE WIDESPREAD.
Beyond the short-term, there is broad political consensus across the globe that stimulus plans will be used to achieve economic growth. Central banks will meet the deflationary demand shock with inflationary quantitative easing. Together, external policy choices and the actions of multi-lateral agencies can be expected to benefit Ireland.

Policy-makers will have choices around how much to invest, in which sectors and schemes, and where. These will need to be targeted to maximise economic returns, employment generation, and broader social benefits. Before investing, policymakers should be aware that returns vary by region, economic structure, and investment type. In recoveries, investments in human and social capital can be as, if not more, beneficial than investments in capital infrastructures.

MULTIPLIERS OF PUBLIC INVESTMENT, PER € INVESTED



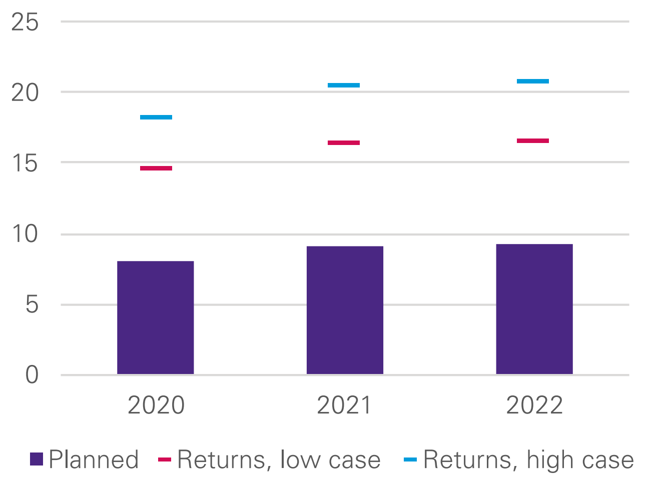
Source: ABD et. al (2016), Baum et al. (2012), Deleidi, et al. (2020)

EXISTING INFRASTRUCTURE PLANS CAN BE BOLSTERED.
The *Draft Programme for Government* states that a National Economic Plan will be published in October. The shape and size of this Plan, and how it aligns with Project Ireland 2040 is not yet determined.

The *Draft Programme* also states that the Plan will focus on jobs-intensive infrastructure, in order to maximise the economic returns of capital investments. Under existing capital plans, the State has earmarked €26 billion for capital investment in 2020-2022. The economic returns of the planned investment could sum to between €47 billion and €56 billion over the three years, using low and high multipliers.

The challenge for the new government is to balance the short-term liquidity demands with long term investment priorities so that the country can emerge from the crisis well-positioned to embrace growth opportunities.

CAPITAL PLANS AND POTENTIAL ECONOMIC RETURNS (€BN)



Sources: Department of Finance, KPMG analysis based on multiplier ranges

An export economy

HEADWINDS FOR ALL OF OUR TRADING PARTNERS.
Globally, economic growth was weakening since 2018. The slowing Chinese economy, escalating trade tensions, Brexit uncertainty, and tighter global liquidity conditions were acting as a drag on prosperity. In April, the IMF projected that global GDP will fall by 3.0% relative to 2019. Few countries will be untouched.

Ireland, as a highly open and interconnected global economy, suffers when the world stutters. All our top 10 export markets bar China are expected to see a contraction in GDP this year. The IMF predicts all will return to positive growth in 2021.

IMPACTS ON EXPORT SECTORS WILL VARY.
The crisis has resulted in a fall in aggregate demand for exports from Ireland, with sentiment amongst manufacturers and service-producers having fallen significantly.

Exports are projected to fall by a total of 7.7% in 2020, with tourism being the most severely affected sector. Contract manufacturing and mechanical and electrical engineering will suffer too, as global manufacturing declines.

By 2021, exports are expected to rebound, growing by 7.5%. This will support recovery, though exports will not reach 2019 levels until 2022 at the earliest.

WE PRODUCE WHAT THE WORLD NEEDS.
While aggregate exports are falling, there is positive news. The structural nature of our exports means we have a degree of relative security.

Ireland has greatest number of MedTech employees per capita in the world and is the 5th largest exporter of pharmaceutical products by value globally. Of the exports to our top 10 trading partners, over 1/3 our exports related to pharmaceutical, MedTech, and related products.

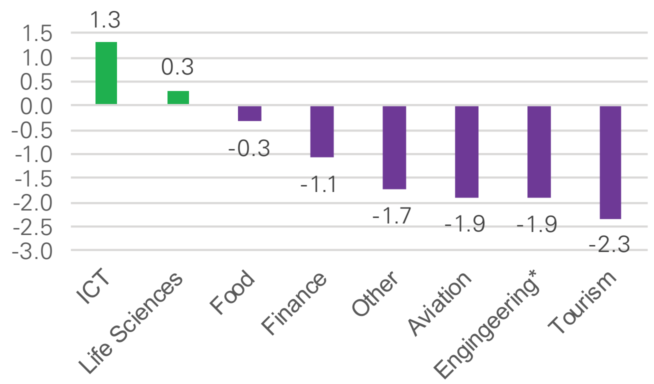
These sectors are experiencing high demand, given the crisis is firstly a health emergency. In the medium and long term, these sectors will be in a position to respond to the health needs of ageing populations in advanced economies.

IRELAND'S TOP 10 TRADING PARTNERS, 2019

#	Country	2020 GDP growth %	% Exports
1	US	-5.9	30.8
2	Belgium	-6.9	10.4
3	UK	-6.5	10.3
4	Germany	-7.0	8.8
5	Netherlands	-7.5	5.7
6	China	1.2	5.4
7	Switzerland	-6.0	3.7
8	France	-7.2	3.5
9	Italy	-9.1	2.5
10	Japan	-5.2	1.8

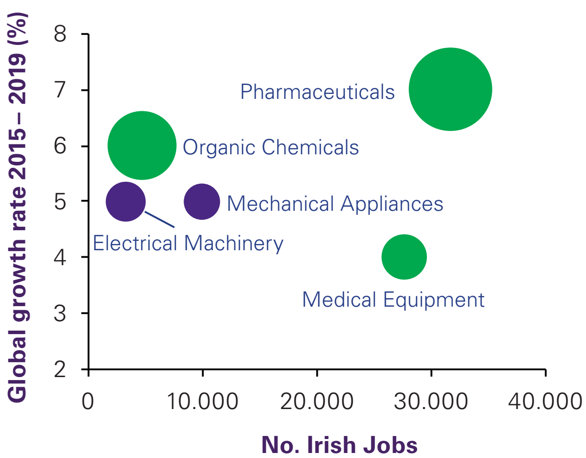
Source: OECD, CSO

FORECASTED % Y-O-Y CHANGE IN EXPORTS, 2020



*Source: Department of Finance; *includes contract manufacturing*

IRELAND'S TOP 5 PRODUCT GROUPS BY EXPORT VALUE



Source: CSO; note: size of bubble represents relative strength, green refers to pharma and related products.

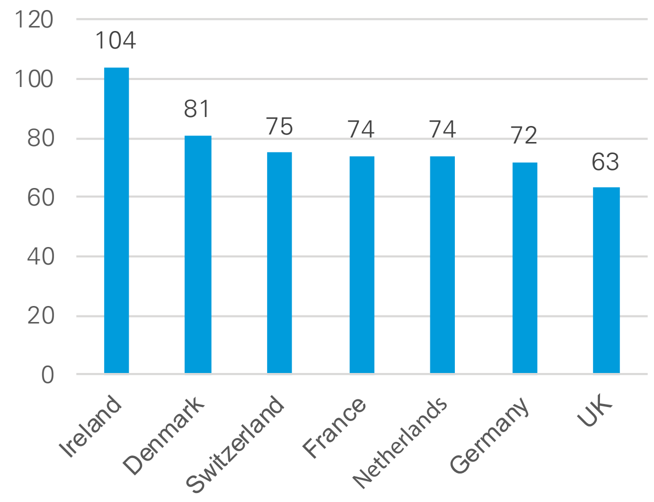
Productivity and growth

A PRODUCTIVE ECONOMY AT ITS CORE.
Throughout history, prosperity has been driven by productivity, where output increases at a faster rate than the rate of growth of the number of hours worked. This has lifted billions of people out of poverty.

With the current crisis shutting many manufacturing and service providers, both productivity and prosperity may flatline globally. The challenge is that productivity growth requires demand to increase, which is unlikely in the short-term.

Ireland is a productivity success story. The OECD reported in 2019 that Irish workers are amongst the most productive in the world, generating close to $100 of economic value for each hour worked, growth of 198% since 2000. Our strong level of aggregate productivity can both enable domestic recovery and attract FDI relative to peer economies.

COMPARATIVE LEVELS OF PRODUCTIVITY, $/HOUR



Sources: OECD, refers to 2019; countries selected are competitors and/or key trading partners

DIVERGENT IMPACTS ACROSS SECTORS.
A key driver of Ireland's productivity is the strength of many of our highly productive sectors – ICT, MedTech, and Pharmaceuticals. With demand for these sectors increasing, productivity may in fact increase.

At the same time, the nature of the restrictions severely impacted the labour market in less productive sectors – e.g. accommodation, food, wholesale and retail. As many of these products and services are experiential, the social impact could be viewed as being greater than the productivity and output loss.

RECOVERY WILL COME, WITH PRODUCTIVITY A DRIVER.
The Department of Finance is projecting that productivity in Ireland will grow by 7.6% in 2020. This is double-edged – while the headline is positive, it is driven by the magnitude of job losses in less productive sectors being compensated by stability in highly productive sectors.

A clear risk is that employment opportunities do not recover in more at-risk and less productive sectors than in sectors than can weather current challenges. Employees in more secure sectors, who will have saved during lockdown, can use their pent-up consumption demand to support employees in less secure sectors during the recovery – increasing productivity.

The *Draft Programme for Government* recognises the risks of an unbalanced recovery. To mitigate this and to increase SMEs' productivity, policies will include the development of Regional Technology and Clustering Programme. Such approaches will be vital for the country to achieve broad-based growth.

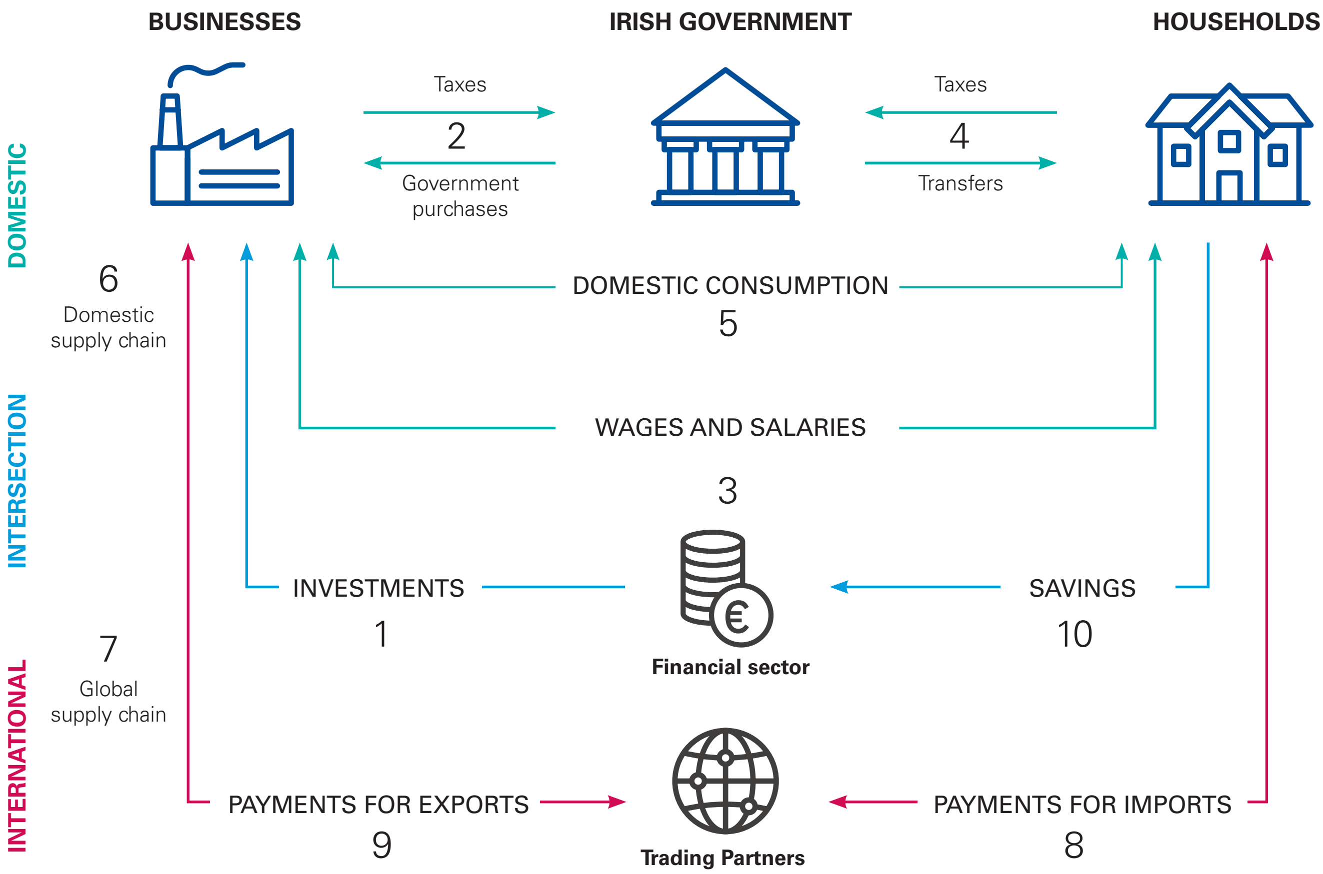
EMPLOYMENT AND ECONOMIC OUTPUT BY SECTOR

Source: CSO, Department of Finance; note: size of boxes refer to economic output as a share of total; colour refers to total employment, where darkest navy is ~300,000 employees.

The path to recovery

THE PATH TO RECOVERY REMAINS UNCERTAIN, THOUGH SIGNIFICANT STEPS HAVE BEEN TAKEN AT CREATING THE RIGHT RECOVERY ENVIRONMENT. MORE ACTIONS ARE NEEDED, AND WILL BE TAKEN BY ALL ACTORS IN THE ECONOMY.

Steps Q3/Q4	Where we are, Q1/Q2 2020	Where we want to be
1	Financial market liquidity	ECB restores market functioning
2	Tax payments decline	Cash crunch minimised by household spend and taxes
3	Layoffs, furlough	Workplaces continue to pay wages
4	Tax payments decline	Fiscal stimulus by governments
5	Shop closures, delivery restrictions, travel bans, etc	Relaxation of social distancing restrictions and behaviour
6	Worldwide supply chain disruptions	Production restarts
7	Negative global demand shock	Relaxation of travel/trade restrictions
8	Negative domestic demand shock	Domestic demand recovers
9	Worldwide supply chain disruption	Global demand recovers
10	Negative wealth effect	Households with capacity to save do so



Source: KPMG Economics, Baldwin (2020)

Key messages

DOMESTIC CONSUMPTION

1. **Our collapsed demand will recover** – entering the crisis, domestic demand was strong; we can expect a bounce as restrictions are lifted.
2. **We can buy local, more often** – with outturns for international demand for some goods and services uncertain, buying local will act as a crutch
3. **We should holiday domestically** – if we all substitute foreign holidays with domestic trips, we can mitigate economic losses in regions dependent on tourism.

PRIVATE SECTOR INVESTMENT

1. **We are a leader at attracting FDI** - as our core domestic strengths remain, we can expect relative stability
2. **Irish deal activity has been in the right sectors** – M&A activity over recent years has been strong in ICT, life sciences and pharmaceutical, and renewables; all will be hot sectors in 2020 and beyond.
3. **Our strengths in R&D can support a step-change** – the new economy will be driven by R&D, AI, automation, and robotics. Expect 'tech' to permeate all sectors.

THE ROLE OF GOVERNMENT

1. **Expect more government activity** – we can expect greater levels of government activity in the private sector across the economy; short-term wage subsidy schemes and broader sectoral rescue plans have already been announced
2. **Capital investment may increase** – existing capital plans will support growth, though these may need to be bolstered - this has been flagged in the *Draft Programme for Government*.
3. **Pan-European cooperation will be vital** - with support from France and Germany, the European Commission has announced a stimulus plan amounting to €750 billion, which Member States will sign off on in July.

EXPORTS AND MARKETS

1. **We should aim to sell more internationally** – to build on our existing fundamental strength as an export nation, we will sell more ICT, pharma, MedTech, and agri-food on global markets
2. **China's global footprint will increase** – at the time of writing, China looks like being the only major economy to grow in 2020, and geopolitical change will increase its foothold in both advanced and emerging economies
3. **Identify emerging trends** – We should identify emerging trends - take stock of historic and future trends, and invest to get ahead of the pack

About us

FIRM-WIDE BUSINESS PLANNING SUPPORT.
KPMG can provide firm-wide business planning support. Working with clients across our service lines to ensure our clients are able to mitigate harm during the current and evolving crisis. We have published a range of pieces providing the latest and best advice to enable firms to overcome current challenges.

LEADING STRATEGY AND ECONOMIC ADVISORS.
Our Strategy team works with public and private sector clients across industries to adapt to change and to create value. Developing coherent and robust strategies at a time like this is vital. We specialise in deal and growth strategy, enterprise wide transformation and operational excellence, impact modelling, and econometrics.

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Produced by: KPMG's Creative Services. Publication Date: May 2020 (6239)