DÁIL ÉIREANN

AN COMHCHOISTE UM AIRGEADAS, CAITEACHAS POIBLÍ AND ATHCHÓIRIÚ

JOINT COMMITTEE ON FINANCE, PUBLIC EXPENDITURE AND REFORM

Dé Máirt, 7 Deireadh Fómhair 2014

Tuesday, 7 October 2014

The Joint Committee met at 3 p.m.

MEMBERS PRESENT:

Deputy Richard Boyd Barrett,	Senator Sean D. Barrett,
Deputy Catherine Byrne,*	Senator Thomas Byrne,
Deputy Joe Carey,*	Senator Paul Coghlan,
Deputy Ciara Conway,	Senator Michael D'Arcy,
Deputy Michael Creed,	Senator Aideen Hayden.
Deputy Jim Daly,*	
Deputy Pearse Doherty,	
Deputy Regina Doherty,	
Deputy Timmy Dooley,	
Deputy Alan Farrell,	
Deputy Ciarán Lynch,	
Deputy Michael McGrath,	
Deputy Kieran O'Donnell,	
Deputy Pat Rabbitte,	

* In the absence of Deputies Heather Humphreys, Simon Harris and Dara Murphy, respectively.

In attendance: Deputy Peter Mathews.

DEPUTY LIAM TWOMEY IN THE CHAIR.

Election of Chairman

Clerk to the Committee: The first item of business on the agenda is the nomination and election of a Chairman. As clerk to the committee, I received notification on 29 September from Deputy Ciarán Lynch, item No. 1006, of his resignation as Chairman of the Joint Committee on Finance, Public Expenditure and Reform. Pursuant to Standing Order 91, I now invite nominations for the position of Chairman.

Deputy Regina Doherty: I nominate Deputy Liam Twomey.

Deputy Joe Carey: I second that proposal.

Clerk to the Committee: As there are no other nominations, I declare Deputy Liam Twomey to be Chairman of the Joint Committee on Finance, Public Expenditure and Reform and call on him to take the Chair.

Deputy Liam Twomey took the Chair.

Chairman: It is a great honour for me to fill the role of Chairman of the committee. I thank committee members for their nomination and support. I look forward to working with them in a genuine spirit of partnership and co-operation. With the experience and enthusiasm of all members, as shown to date, I am confident that this will continue to be a highly productive committee that discharges its functions in an efficient and enlightened way.

I thank Deputy Ciarán Lynch for the great work he did as Chairman and hope he will continue to work with us on the committee. We had a good and fruitful relationship. I wish him the very best in his difficult challenge at the banking inquiry. I welcome Deputy Ciara Conway who is taking over from Deputy Aodhán Ó Ríordáin.

I will try to be as fair and impartial as I can. I believe in maintaining a strong, united and non-partisan approach where all members can contribute and believe their efforts are worthwhile. This will help to ensure the best results and added value to the parliamentary committee process.

Election of Vice Chairman

Chairman: As the position of Vice Chairman is now vacant, Standing Orders provide that, as soon as may be after the election of the Chairman, the committee shall select one of its members to be Vice Chairman. I therefore call for nominations.

Deputy Ciarán Lynch: I nominate Senator Aideen Hayden.

Senator Paul Coghlan: I second that nomination.

Chairman: As there are no other nominations, I declare Senator Aideen Hayden to be Vice Chairman.

Deputy Kieran O'Donnell: I wish the Chairman and the Vice Chairman well in assuming their roles. I commend the outgoing Chairman, Deputy Ciarán Lynch, on the fantastic work he has done on the committee and wish him well in his work at the banking inquiry. I also thank

the outgoing Vice Chairman. This is a constructive committee which deals with a wide range of issues and I have no doubt that the Chairman will command it with the normal authority.

Deputy Ciarán Lynch: I thank the members of the committee for their warm comments and thank all those who were members of the committee in the past two years. This time two years ago when I became Chairman, I was an unknown quantity. I had not worked with many members previously. It was a steep, interesting and most enjoyable learning curve. I am not departing from the committee completely and would like to maintain involvement and continue the work we have done together. This is the committee which settled on doing a number of things and we did them quite well. Much of it comes down to the role played by the secretariat and the Vice Chairman who supported me during that period. I know that Deputy Liam Twomey will prove to be an effective Chairman and I wish him the best of success. He will have a busy cycle, with the budget about to be landed on us. However, it is something we do every year. I thank every member for the learning I received from the committee. I had chaired other committees, but this was one of the most challenging roles I had taken on. We might not have agreed at all times, but I hope I treated members as fairly as I was able to do. I hope we accomplished a number of things in the past two years. I wish the incoming Chairman and the committee the best of success in the future.

Senator Aideen Hayden: I thank Deputy Ciarán Lynch for the excellent role he played in chairing the committee. It is an interesting, vibrant and cohesive committee and I echo his words about the secretariat. The new Chairman and the previous one worked well together. With the secretariat, the committee has completed an incredible amount of work in the past 12 months.

Deputy Peter Mathews: I would like to be excused, now that I have fulfilled my role in representing the Opposition. As Deputy Pearse Doherty is present, it is fair for me to go to the Chamber to deal with the business of the day.

The joint committee went into private session at 3.10 p.m. and resumed in public session at 4.05 p.m.

Budget 2015: Department of Finance

Chairman: I welcome from the Department of Finance Mr. John McCarthy, chief economist and assistant secretary; Ms Mary Dalton, assistant principal officer; Ms Laura Weymes, assistant principal officer; and Mr. Shane Enright, assistant principal officer. The format of the meeting will be that Mr. McCarthy will make some opening remarks which will be followed by a question and answer session. I remind members, witnesses and those in the Visitors Gallery that all mobile phones must be switched off, as they interfere with the broadcasting of the proceedings.

By virtue of section 17(2)(*l*) of the Defamation Act 2009, witnesses are protected by absolute privilege in respect of their evidence to the joint committee. If, however, they are directed by it to cease giving evidence on a particular matter and continue to do so, they will be entitled thereafter only to qualified privilege in respect of their evidence. They are directed that only evidence connected with the subject matter of these proceedings is to be given and asked to respect the parliamentary practice to the effect that, where possible, they should not criticise or make charges against any person or an entity by name or in such a way as to make him, her or

it identifiable. Members are reminded of the long-standing ruling of the Chair to the effect that they should not comment on, criticise or make charges against a person outside the Houses or an official either by name or in such a way as to make him or her identifiable.

Mr. John McCarthy: I thank the joint committee for the invitation to discuss with it the economic outlook in advance of the budget. As the Chairman mentioned, I am the chief economist in the Department. I am accompanied by colleagues on the forecasting team. They are Ms Laura Weymes who looks after the labour market side; Mr. Shane Enright who looks after the domestic side, and Ms Mary Dalton who monitors international trends and inflation.

By way of background, for the information of the committee, Regulation 473 of May 2013, one of the two pieces of legislation known as the "two-pack", introduced a common budgetary timeline. Specifically, it requires all non-programme euro area member states to submit draft budgetary plans to the European Commission and the Eurogroup by 15 October each year. It further specifies that the economic forecasts on which the draft budgetary plan is based should be either produced by an institution independent of the Government or by a finance ministry and endorsed by an independent body. In Ireland, as in the majority of euro area member states, we have gone down the endorsement route and the endorsement function has been assigned to the Irish Fiscal Advisory Council, IFAC. In order to make the process operational, a memorandum of understanding between the Department and the IFAC has been signed. This is available on the websites of both institutions.

In the context of budget 2015, the endorsement process has been under way since mid-September. In the past few weeks my colleagues and I have been engaged in in-depth discussions with both the secretariat of the council and council members on the latest economic trends and the likely outlook. I can report that the council has concluded that the Department's forecasts are within the endorsable range. In other words, they have endorsed the forecasts as of today and a letter of endorsement will be placed on the websites of both institutions this afternoon.

We have provided the committee with a copy of the presentation provided for the council last week as part of the endorsement process. It is a fairly large document, It comprises 50 slides and is technical in places. I propose to present a more concise version to the committee. Of course, we will take questions on both presentations. We circulated the first presentation yesterday and the more concise version today.

I stress that the numbers we are presenting to the committee are based on the technical assumption that there will be no policy change. This is purely a technical assumption that was needed in order that both the Department and the council could agree on an appropriate macroeconomic forecast. It does not represent Government policy. In fact, the forecasts that will be presented on budget day may change from the numbers we present today to take into account any budgetary measures. As the Minister has outlined in his letter to the clerk of the joint committee, we are not in a position to discuss the fiscal situation nor the implications of the economic numbers for policy. We did not discuss these with IFAC and we have no mandate to do that.

To kick off, I propose that the team quickly run through the presentation, which comprises 14 or 15 slides. Ms Mary Dalton will start the presentation, outlining the latest international developments, and will say something about the inflation outlook. Mr. Shane Enright will present on the domestic situation and Ms Laura Weymes will discuss the labour market outlook. I will then summarise what all this means for the outlook and talk about the actual forecast and what it means for this year and next. We will happily take questions thereafter.

Ms Mary Dalton: To begin with, we will look at some of the international developments with regard to our key trading partners. The USA, the UK and the euro area account for approximately two thirds of Irish exports, and performance has been relatively mixed in the year to date in respect of these trading partners. I will begin with the USA. The economy contracted in the first quarter of 2014, which was mainly on account of temporary factors, including bad weather. Since then, it has rebounded, and it grew by 1.1% in the second quarter of this year. However, it is not expected that the contraction in the first quarter will be made up throughout the remainder of the year. On that basis, forecasts for the USA for 2014 have been revised down somewhat, but remain as we expected at the time of our stability programme update for 2015 in April.

Moving to the UK, economic growth remains robust, largely driven by private consumption, a pick-up in investment and an overall positive contribution from net exports. In quarter 2, growth increased by 0.9%, and high-frequency indicators also indicate healthy growth here. On that basis, forecasts for the UK have been revised upwards for this year and slightly upwards for next year.

The euro area presents a slightly different story. It might look as though we are missing a value at the end of the chart on the slide, but in fact growth was flat in quarter 2 of 2014. This situation was driven by developments in the three largest member states. There was a contraction in Germany and in Italy in the second quarter, while France had zero growth. Some of the risks we highlighted in April have materialised in terms of geopolitical tensions and a lower rate of growth of inflation in the euro area. On that basis, the forecast has been revised downwards for the euro area. The forecasts we have used to feed into our own budget 2015 forecast are those of the OECD which were published last month. These forecasts are in line with the IMF World Economic Outlook forecasts which were published earlier this afternoon.

To move on to developments with regard to inflation, the harmonised index of consumer prices, or HICP, is the comparable measure of consumer prices across member states. The chart on the slide compares the annual rate of inflation in Ireland with the euro area. The annual rate of HICP inflation in the euro area was 0.3% in September, representing the twelfth month in a row for which the annual rate of inflation was under 1%. While some of this may be attributable to temporary factors such as reductions in oil prices, the weak economic recovery is also clearly a factor which is dampening price dynamics. While low inflation may serve to protect real incomes, if actual inflation persistently undershoots expected inflation, it can be problematic for two reasons. First, in terms of aggregate demand, if individuals in households and companies expect that they will get better value in future, they will hold off on personal consumption and investment. Second, it pushes up the real interest rate, which increases the real debt burden. Another point to highlight in relation to the chart is that since July the annual HICP inflation rate in Ireland has gone above the euro area average, although it remains far below the rates in our other key trading partners, the USA and the UK.

In the next slide, I take the Irish HICP inflation and break it down in more detail. The black dotted line is the same line that was on the previous chart. In this chart, we strip out the more volatile elements of inflation, including energy and unprocessed food, and are left with core inflation, which we generally tend to focus on as it provides us with a better picture of the underlying price dynamics in the economy. When one strips out the more volatile elements, the rate of inflation was 1% in August, which was mainly driven by services, particularly private rents and licensed premises. Goods continue to act as a drag on inflation, mainly due to falls in the price of clothes and non-energy industrial goods. My colleague Mr. Enright will take the

committee through the real economy.

Mr. Shane Enright: I will take the members through a number of slides which touch on developments in domestic demand as well as exports in the first half of this year. As the members can see, the slide on the screen shows growth in retail sales over the last 12 months. It has been positive for all but one of the months in the period. I have broken down the contributions to the strength of retail sales to show the effect of the motor trade and that of core retail sales, which is everything else. For the first seven months of the year, retail sales were up approximately 7% over the same period last year. Approximately half of that effect comes from core retail sales and the other half from strength in the motor trade. We heard today that the number of vehicles licensed to the end of September is up around 30% compared to the same period in 2013. From looking at the numbers, it seems the 142 effect is stronger than the 132 effect was last year. Car sales are still well below the levels we saw in 2007. A view as to the equilibrium numbers of new car sales is important for making GDP forecasts, tax forecasts and excise forecasts over the next number of years. Our view is that the equilibrium number of car sales is probably still higher than the number that will be recorded this year, despite the growth we have seen over last year's levels.

The next slides shows strength in investment over the course of the last number of quarters. I will break this down into the two most economically relevant components in terms of performance of the public finances and the labour market. The light green bar on the slide shows year-on-year growth in core machinery and equipment. That has been in very strong territory since the start of 2013. It reflects business investment in items such as plant, machinery and vehicles and demonstrates renewed confidence at firm level about prospects and investing to replenish capital stock. The year-on-year growth rate has fallen back a bit but is still in strong and positive territory, at nearly 22% in quarter 2. The other aggregate I have highlighted there is building and construction activity on an expenditure basis. In year-on-year terms, it has grown by approximately 10% in the first half of the year. While that is encouraging, it is from a very low base. The contraction in building and construction activity between 2006 and 2012 was of the order of three quarters. Strong growth is still off quite a low base compared to where we were in the past.

Turning to the external side, we have had a very strong rebound in goods exports in the first half of the year, up 16% in the second quarter.

Deputy Pearse Doherty: Can Mr. Enright clarify, in relation to the last two slides, whether we are looking at year-on-year or quarter-on-quarter changes?

Mr. Shane Enright: Apologies. The legend on the left should have specified that it is year on year. Unless we say otherwise, all of the numbers are year on year.

Mr. John McCarthy: The reason is that as the quarterly figures are very volatile, it is better, from an Irish perspective, to look at the year-on-year position.

Mr. Shane Enright: There was a weakness throughout 2012 and particularly in 2013 on the goods exports side. It was primarily due to the impact of the patent cliff in the pharmaceuticals sector. It impacted on production in and exports from Ireland. We referred to this during our last appearance before the committee. It appears that the effect of this has now faded and one can see from the monthly series that exports of pharmaceutical and chemical products are back in modest positive territory again. Overall, some of the strength in exports in the first half of the year is reflective of the statistical treatment of the production of goods on a contract basis by

plants abroad under contract to Irish firms. However, the exports story, if one includes services also, is that the figures for goods and services are up 13% in the second quarter in year-on-year terms.

Deputy Pat Rabbitte: Why are retail sales below the line?

Mr. Shane Enright: Essentially, the total at the top of the bar represents the effect of the motor trade and everything else on the year-on-year rate. In every period except one - October 2013 - the impact of both was positive.

Deputy Pat Rabbitte: What did that mean in October 2013? Did the rate of consumption collapse or did retail sales collapse? How is it a negative?

Mr. Shane Enright: In October 2013 there was a negative year-on-year figure for core retail sales. The Deputy will recall that in October 2012 there was what was known as the Saorview effect, with very large purchases of televisions-----

Deputy Timmy Dooley: That was Deputy Pat Rabbitte's responsibility at the time. Well done. He moved the markets. He can include it in his CV.

Mr. Shane Enright: If memory serves, the negative base effect in September and October 2013 pulled down the headline.

Turning to the outlook - I appreciate that we are providing the committee with many numbers - these are the endorsed macroeconomic forecasts as agreed with the Fiscal Advisory Council as of last week. The 2013 numbers represent the outturn as reflected by the Central Statistics Office and the figures for 2014 and 2015 are obviously our estimates. I will outline some of the changes since the stability programme update, SPU, in April. We have essentially doubled our forecast export growth rate from just over 4% to just over 8% for 2014. This is due to the very strong performance of exports in the first half of the year and the carryover impact for the remainder of this year. That, in turn, accounts for the bulk of the upward revision of this year's GDP headline growth rate from 2.1% at SPU time to 4.7% today.

The figure for personal consumption has been revised upwards for next year by a little. That is due to the assumptions underpinning this forecast Mr. John McCarthy mentioned, the technical assumptions of a neutral budget. The SPU assumed a quantum of consolidation which we are no longer assuming. We anticipate that the knock-on effect of more positive household income will increase private consumption growth by more than we would have anticipated previously. That is one of the main reasons for the upward revision of GDP next year also. The harmonised index of consumer prices, HICP, has also been revised upwards very slightly.

My colleague Ms Weymes will discuss developments in the labour market and the outlook for it.

Ms Laura Weymes: With regard to ongoing trends, there is evidence of seven consecutive quarters of employment growth, with employment growing by 1.7% in the second quarter. What this means in level terms relative to the first half of 2013 is that the figures now indicate that there were 37,000 more jobs in the first half of the year relative to the same period last year. This employment growth has been relatively broadly based. In year-on-year terms, ten of the 14 sectors designated by the CSO are posting growth. In terms of trends, on the live register side, there has been acceleration in the pace of contraction of the live register, particularly during the summer months of this year. In the last two quarters to the end of September the rate

of reduction was running, in annualised terms, at approximately 35,500. Consistent with this, there has been a fall in the standardised unemployment rate from its peak in February 2012 by four percentage points to rest at 11.1% in September.

The next slide focuses on the outlook. Relative to the SPU, the last formal set of projections, we now have two further quarters of Quarterly National Household Survey data. These point to a slight easing off in the pace of growth in H1 of this year relative to the second half of last year, 2% in H1 this year relative to 3.2% last year. This has prompted a slight downward revision in our estimate for employment growth in 2014. We have reduced the figure from 2.2% in the last set of projections to 1.8% in full year terms this year.

In terms of sectoral composition, reflecting the composition of employment and the strong focus on services, services are growing at a rate of approximately 1.7% and account for three quarters of the employment figure. Much of the momentum is coming from the full-time private services sector.

With regard to what we have seen in the labour force which has a bearing for the bottom line unemployment rate level, trends in the first half of 2014 differed slightly from our outlook at the time of the SPU. Labour force volumes have been contracting on a quarterly basis in each of the quarters this year; therefore, even with a strong second half, we would still profile a very soft labour force full year figure. We have it slightly at a negative figure for 2014 and recovering in 2015. To be clear on the migration assumptions underpinning this, we are still profiling outward migration, although with a slighly lesser arc than would have been assumed at the time of the last projections. This is probably a reflection of the responsiveness of Irish labour supply to overall labour market and economic conditions. There will be considerably stronger labour force growth in 2015, consistent with an unemployment rate falling to just over 10%.

The next slide elaborates on the drivers of the change in the labour market outlook. To focus on the chart on the left hand side of the slide, the labour force is principally driven by three factors - participation rates, the natural rate of population increase and the path for migration. The last two components are suppressed into the blue bar which we have labelled "the demographic effect". After a negative contribution last year, this is exerting positive momentum in 2014. There has been a slight falling back in participation rates on a full year basis for 2014, accounting for the negative contribution. This, again, will turn positive in 2015.

The chart on the right-hand side splits the drivers of the unemployment rate and what is contributing to the change in the rate between the labour force and employment growth. The falling labour force this year has helped to reduce the unemployment rate, although the main story from the chart is that employment growth continues to be the dominant source of momentum in terms of exerting downward pressure on the unemployment rate.

Mr. John McCarthy: I realise there is a great deal to take in. I will try to summarise the key points. It is fair to say that the data flow in the past year or so has been encouraging for the most part. There is clear evidence that recovery is gaining momentum. Recovery is being led by the external sectors. We have seen strong trading partner growth, most notably, as Ms Dalton said, in the US and the UK. The one cloud on the horizon is the euro area, where activity essentially stalled in the second quarter of this year. The figures cast doubt on previous assumptions that a turning point in the euro area business or economic cycle had been reached. It is fair to say that soft data on quarter three in the euro area have not been particularly encouraging. There is a clear downside risk in the euro area. As was mentioned earlier, today the IMF revised downwards its forecasts for GDP growth this year in the euro area. What is more important

than the external side, where there has been a reasonable performance in the past number of years, is that there is now concrete evidence that recovery is broadening. We are seeing domestic demand make a positive contribution to growth for the first time since 2007. The committee will be aware that domestic demand has fallen quite dramatically. It fell by more than one fifth from peak to trough, but this year it will make a positive contribution. People will feel it in their pockets. There is more employment. Domestic demand is more employment- and tax-rich, so a clear turning point has been reached. That is a positive.

In overall terms, when all data are put together, we see GDP growth of 4.7% for this year, with positive contributions from both net exports and domestic demand. We see GDP growing by just over 3.6% next year, again with a positive contribution from both domestic demand and net exports. I stress the point I made earlier that the forecasts for next year are based on no policy change. Should measures be announced in the budget, we will have to adjust the figures on budget day.

In this final slide, we show the risks to the projections. My view is that the distribution of risk around the central scenario is probably tilted to the downside at this stage. Most of the risks are on the external front. Ms Dalton mentioned geopolitical risks, which appear to have intensified in the past six months. The euro area continues to surprise on the downside. The legacy effects of the crisis, with high levels of public and private debt, fragmented financial markets and the need for further consolidation in some areas, will continue to have an impact on the euro area economy.

There is a big concern about the current low rate of inflation in the euro area, so risks associated with low inflation have come to the fore in the past year or so. The latest inflation figure is 0.3%. My own view is that the probability of outright deflation, which members will recall is a persistent phenomenon, is probably low, but a prolonged period of fairly low inflation is certainly not an implausible baseline scenario. A period of what Christine Lagarde referred to as "lowflation" would be problematic. It raises the real interest rate and it is a *de facto* tightening of monetary policy. It raises the real debt burden and incentivises households and bodies in the public sector to deleverage further, and it also makes relative price adjustment more difficult within the euro area. Vulnerable countries need to improve competitiveness relative to the core, and if the core is running a low rate of inflation, that becomes more problematic for the periphery. It complicates the adjustment in the euro area.

A risk that we have included in the slide of which we are certainly conscious and to which the IMF alluded today in its World Economic Outlook is a concern that many economists would have regarding the financial markets and the so-called underpricing of risk. They are discussing a monetary policy with very low rates of interest which incentivises investors to move to peripheral economy debt and emerging economy debt. That could change rapidly, particularly if there were a change in the monetary policy stance in the US. These are the main downside risks that I see.

There are some upside risks in the domestic market, the key risk being a stronger export performance than we have assumed. There is also a risk that the current low rate of investment normalises more rapidly. In an advanced economy one would allocate about a fifth of GDP to capital formation and investment. The figure in Ireland is much lower than that. We have had under-investment relative to GDP for a number of years. At some stage the figure will need to normalise, and there is the potential for this to happen quite quickly, which will boost domestic demand and so forth. There are upside risks, but on balance the distribution of risk is probably tilted to the downside, given some of the external factors at play.

We will try to answer questions from members.

Deputy Michael McGrath: I welcome Mr. McCarthy and his colleagues from the Department of Finance. The presentation was very informative and largely positive for the economy, which is good news.

Clearly the significant improvement in exports seems to be the main driver of growth in GDP. To what extent do net exports contribute to the increase in the growth forecast for 2014? At present, the Department is forecasting growth of 4.7%; is that correct?

Mr. John McCarthy: It is.

Deputy Michael McGrath: That figure is up from 2.1% last April. That is a very dramatic escalation in growth.

Mr. John McCarthy: It is.

Deputy Michael McGrath: It has happened very quickly. We are not really seeing the impact of this on the street. I assume it is largely driven by net exports.

Mr. John McCarthy: There are two components. There has been a 4.7% increase in GDP this year. The positive contribution from domestic demand is just over 3% and the contribution from net exports is 1.5%. These are ballpark figures. I can get the exact figures, but that is the order of magnitude.

Deputy Michael McGrath: It is domestic demand that is driving it?

Mr. John McCarthy: It is domestic demand. The reason for that is mainly on the investment front. We have seen a very strong recovery in investment. During the first half of the year, investment was up by 11% relative to the same period last year. The investment cycle is leading the way. We are seeing a positive contribution from consumption, which is the largest component of domestic demand. In the first half of the year this was up by more than 1%. That is having a very positive effect on overall domestic demand.

Deputy Michael McGrath: Generally, what percentage does domestic demand account for in terms of GDP?

Mr. John McCarthy: It is about three quarters.

Deputy Michael McGrath: Clearly its weighting is more significant as a driver of GDP.

Mr. John McCarthy: Absolutely. It is much more employment-rich and tax-rich as well. I can give the Deputy the exact figure now.

Deputy Michael McGrath: Please do.

Mr. John McCarthy: With regard to domestic demand in 2013, overall GDP was €175 billion, of which personal consumption was just over €83 billion, Government consumption was about €26 billion and investment or capital formation was €26.5 billion.

Deputy Michael McGrath: What about net exports?

Mr. John McCarthy: Exports account for the remainder, apart from stocks, which make up a very small proportion of the figure.

Deputy Michael McGrath: What are the 2014 growth forecasts for the United Kingdom, the euro area and the United States, which collectively account for approximately two thirds of our exports?

Mr. John McCarthy: It is more than two thirds.

Deputy Michael McGrath: Is the growth forecast for the euro area largely flat?

Ms Mary Dalton: The forecast for the euro area is 0.8% for this year and 1.1% for next year. The equivalent figures for the United Kingdom are 3.1% this year and 2.8% next year. We are projecting growth of 2.1% this year and 3.1% next year in the United States.

Mr. John McCarthy: If one amalgamates the three regions, weighted by their share in Irish exports, GDP in our major trading partners, which is essentially these three regions, will grow by approximately 1.5% this year, accelerating to 2% next year. This weighted figure may be more appropriate if the Deputy would like to have a simple statistic.

Deputy Michael McGrath: Collectively, the euro area, United Kingdom and United States economies will grow by between 1% and 1.5% this year. Irish export growth is much greater than that. What is driving the expansion of exports? While I acknowledge that Ireland has regained significant competitiveness in the past five or six years, what is causing the spurt in exports, especially given that the economies to which we primarily export are not exactly racing ahead?

Mr. John McCarthy: A couple of issues arise. The GDP numbers feed into the export model. That is a proxy, however, because what drives Irish exports are imports from the three regions to which we referred. As imports will always be stronger than the GDP, imports are stronger than GDP for all three regions. That would explain some of the increase. The other variable that feeds into our export model is a measure of competitiveness. The measure we use is what is known as a real effective exchange rate. This takes the nominal exchange rate and deflates it by relative price or relative cost developments. This year and next year, I do not foresee much improvement in relative prices *vis-à-vis* the euro area, for instance, because the harmonised index of consumer prices, HICP, in the euro area will probably be 0.4% or 0.5%, whereas it will probably be approximately 0.5%.

While there is not much improvement taking place on the relative price front, what we are seeing is an improvement in the exchange rate. What we do in terms of producing a forecast for the exchange rate is very much in line with what is done by the European Commission, the European Central Bank, the IMF and so forth. We hold the exchange rate constant at the end of September, project it forward on an unchanged basis and see what this means for next year relative to this year. We anticipate a depreciation of the exchange rate of the order of 3%. This will have an impact on competitiveness and, in turn, spur exports. These two variables explicitly come into our export model and both are moving in the right direction. However, Irish exports are difficult to model because they are fairly concentrated in a small number of sectors that are doing very well and are independent of competitiveness. These include information technology, which experienced growth of 40% last year, and aircraft leasing, which is also doing very well. In addition, we no longer have the patent cliff effect on the merchandise side.

A new phenomenon has also become evident in the past couple of quarters. The Deputy may have read some of the coverage of the Central Bank quarterly bulletin published last week, or today's letter from the Irish Fiscal Advisory Council, IFAC. The bulletin and the IFAC's

letter draw attention to a phenomenon known as contract manufacturing, where an Irish entity contracts production out to a third country. This means production will take place in country A and the products, once produced, will be exported into country B. Such exports are classified under the new methodology as Irish exports, which is very unusual. It is almost impossible to model in the short term because it involves firm-specific types of issues. People may not have concerns in this regard but they find it difficult to understand. It is a relatively new phenomenon and we do not know whether it is cyclical or structural. It certainly had a major impact on exports in the first half of the year.

One has, therefore, a number of factors, namely, the gradual recovery internationally, the improvement in competitiveness, some sector-specific issues and the lag effect in respect of strong foreign direct investment. With regard to the strong inflows of foreign direct investment in recent years, once an announcement is made, it takes a year or two for the investment to take place. One then sees the exports subsequently. A combination of all of these factors is driving the very strong export performance.

Deputy Michael McGrath: The slide shows that exports are expected to increase by 8.3% in 2014. Is this figure by volume or value?

Mr. John McCarthy: It is by volume.

Deputy Michael McGrath: It is not distorted by foreign exchange rates; it is absolute volume.

Mr. John McCarthy: That is the real growth rate in exports. To put it in context, the volume of exports in the first half of 2014 increased by 10% compared to the figure in the first half of 2013. The 8% figure is solidly grounded.

Deputy Michael McGrath: There has been a recovery in retail sales, which are a good measure of the performance of the domestic economy and current levels of disposal income. Part of the increase is related to a significant rise in motor sales. What is the year-on-year increase in retail sales by volume and value as at the end of September? Is it the case that they increased by between 2% and 3% over the year?

Mr. John McCarthy: As we do not yet have figures for September, I will use the figures for July and August as a proxy for the full third quarter. Core retail sales, which excludes cars, increased by 3.5% in the quarter compared to the same period last year.

Deputy Michael McGrath: Is that measured by volume?

Mr. John McCarthy: Yes. One issue we should have perhaps alluded to is that overall consumption is composed of the consumption of goods and services, whereas retail sales, for the most part, only refers to the consumption of goods - that is, the purchase of widgets, cars and so forth - and does not include expenditure in restaurants, cinemas and so forth. The consumption of services has been weaker than the consumption of goods. The Deputy will note that retail sales have increased by between 6% and 7%. One does not see such an increase coming through in the overall consumption figure produced by the Central Statistics Office in the quarterly accounts because the consumption of services is essentially flat and accounts for roughly half of the overall consumption figure.

Deputy Kieran O'Donnell: The Department anticipates a growth rate of 4.5% this year. Is it correct that this figure is split roughly between exports and domestic consumption at 1.5%

and 3%, respectively?

Mr. John McCarthy: The anticipated growth rate is 4.7%. Exports in this context refers to net exports, which is gross exports minus imports.

Deputy Kieran O'Donnell: That is what I mean. Is the split then 1.7% and 3%?

Mr. John McCarthy: We provided ballpark figures, but I also have exact figures. Net exports will account for 1.3% of the overall figure and domestic demand will account for another 3.7%. This gives a total of 5%, but it should be noted that stocks work in the opposite direction.

Deputy Kieran O'Donnell: That explains the figure of 4.7%.

Mr. John McCarthy: Yes.

Deputy Kieran O'Donnell: While the public perception is that growth is being very much driven by exports, the figures show that it is primarily being driven by domestic demand. To drill down into the figures, investment has increased by 11% in the first six months of 2014 and consumption by 1.2%. How does the investment figure break down?

Mr. John McCarthy: We are projecting that overall investment will increase by 14.5% for the year as a whole. We break down the figure into three components, the first of which is building and construction, which we expect to grow by 9%. This segment is broken down further in that one has new house building as well as repairs, which refers to upgrades of a house, extensions and so forth.

Deputy Kieran O'Donnell: Does Mr. McCarthy have a breakdown for construction between new house build and commercial-----

Mr. John McCarthy: We do.

Deputy Kieran O'Donnell: What is it, roughly?

Mr. John McCarthy: We deal separately with what we refer to as core machinery equipment. This is because there is a very volatile element included in machinery and equipment called purchases of aircraft, which can distort things. We prefer to look at the core to get an idea of what is happening on an underlying basis. It also does not really affect the GDP figures because all aircraft are imported; therefore, it does not affect aggregate demand in the short term, which we expect to increase by 30% this year. The figures which are very strong have been running at about 40% in the past 18 months. The economic interpretation is that we have had years of under-investment relative to GDP.

Deputy Kieran O'Donnell: This is aircraft.

Mr. John McCarthy: No, it is excluding aircraft. There have been years of under-investment relative to overall GDP. We had a situation at one stage where the purchase of new capital assets - investment - was only just sufficient to cover the depreciation of existing capital stock, which is virtually unheard of in an advanced economy outside wartime. Investment fell to extremely low levels, but we are now seeing domestic demand recovering, more certainty and capacity utilisation beginning to creep up, while firms are trying to rebuild their productive capacity. In the past 18 months investment in core machinery and equipment has been running at 35% to 40%. On that basis and on the basis of the figures we have for the first half of the year, we believe the figure will be close to 30% for the year.

Deputy Kieran O'Donnell: Will Mr. McCarthy indicate what the figures were last year? What increases are we seeing? Has there been a 9% increase? What would the comparative figures be for 2013?

Mr. John McCarthy: For overall building and construction.

Deputy Kieran O'Donnell: No, just to give me an indication, roughly by how much did the figure for construction go up by in 2013? To go on from this, are construction and machinery the two investment components?

Mr. John McCarthy: There is a third. Let me answer the Deputy's first question first. For 2013, the volume of house building-----

Deputy Kieran O'Donnell: By how much did the figure for investment go up overall in 2013?

Mr. John McCarthy: The figure for capital formation actually fell by 2.4%.

Deputy Kieran O'Donnell: What does Mr. McCarthy expect the overall investment figure to be for the year?

Mr. John McCarthy: For this year I expect a figure of 14.5%.

Deputy Kieran O'Donnell: The figure has gone up by nearly 16.5%, is that right? Based on that reduction, the level of construction was down.

Mr. John McCarthy: Yes.

Deputy Kieran O'Donnell: For the first half of 2014, we have seen a phoenix-like rise in construction and the other areas of investment, which is feeding into growth. Am I correct?

Mr. John McCarthy: Overall, the level of construction was actually up by 14% last year, but the level of house building was down; therefore, other components such as extensions and commercial building more than compensated for it.

Deputy Kieran O'Donnell: Therefore, we are not seeing an enormous jump in the construction sector, but we are seeing it in investment in machinery and other areas. Mr. McCarthy is effectively saying that in the commercial economy, in terms of job creation and the SME sector, reinvestment is taking place.

Mr. John McCarthy: Absolutely.

Deputy Kieran O'Donnell: Looking at the figure of 30% to 40%, how much of it and how much of the 9% figure for construction has to do with Government investment? This is based on a model which is driven by job creation, with added value; therefore, we are not worried about the growth in construction, which is relatively moderate and holding its place. Am I correct in my analysis?

Mr. John McCarthy: The Deputy is right on the construction side. There are various obstacles to ramping up housing supply in the short term, for instance. The price elasticity supply is low and probably lower than historical norms, given capacity constraints.

Deputy Kieran O'Donnell: On the investment about which Mr. McCarthy is talking, a 14% increase overall for the year, is it all private investment? How much of it is State invest-

ment?

Mr. John McCarthy: Some of it would be. I do not have a breakdown.

Mr. Shane Enright: The assumption is that the contribution in terms of the capital spend is actually flat year to year. The growth is coming from private investment.

Mr. John McCarthy: The third point Deputy Kieran O'Donnell made was about the other component of investment. It is composed of two elements, one of which is aircraft and very volatile. The other is a new element - investment in research and development. The Deputy may remember that in July the CSO made methodological changes which boosted the level of GDP by a dramatic amount, €10.5 billion. Three quarters of this shift in the level of GDP was due to the capitalisation of research and development spending. It used to be treated as intermediate consumption, in other words, it was an input into production. We subtracted it from GDP and it is now included above the line.

Deputy Kieran O'Donnell: What has it added to the growth rate?

Mr. John McCarthy: It does not affect the growth rates because it shifts the level up, but it does not really affect the growth rate from one year to the next.

Deputy Kieran O'Donnell: Materially, it does not have that impact.

Mr. John McCarthy: Exactly. However, we do expect this residual component to grow by 11% for the year.

Deputy Kieran O'Donnell: If I am to analyse it, the construction sector is not seeing a huge increase from last year. In the SME and research and development sectors there is substantial growth, particularly in investment in new plant machinery and so forth, while the figure for the manufacturing sector is going up by 30% to 40%. We are looking at the figure for research and development going up by 11%.

I wish to address the issue of the patent cliff. Officials from the Department of Finance were before the committee last year. It is my opinion that GDP was understated at that point. No one could tell me why, but my instinct told me it was understated and this view is also held by others. Is there any possibility that GDP was understated last year? Contracted exporting was discussed. Does this mean that in the case of a foreign country there is manufacturing taking place here, the sales from that manufacturing would be regarded as exports from the other country rather than from here? What impact will this have on us into the future?

Mr. John McCarthy: I believe the Deputy is talking about the reverse of what we have. I do not believe there is too much of it happening. It is difficult to make out from the data. In theory, it certainly is possible, but I do not think there is too much going on.

Deputy Kieran O'Donnell: Will Mr. McCarthy deal with the patent cliff issue? It is a source of puzzlement.

Mr. John McCarthy: I think the Deputy is right; it did depress GDP. We have conducted some research and published it on our website on the impact of the------

Deputy Kieran O'Donnell: The fact is that GNP was up significantly, which would have fed into domestic demand.

Mr. John McCarthy: I think the Deputy is right. The broad pharmaceutical-chemical sector operates in a vacuum in the economy. It does not have many links with other sectors. While we did see a reduction in value added and exports, it did not really spill over into lower employment figures. There was some, but it was not like having a large widget factory closing down, which would have had a big impact. As sub-supply into the sector was fairly small, the multiplier effects were weak. It did affect the headline figure, but I think the Deputy is asking whether it overstates the impact. I think that is the case. That is why, for instance, GNP last year is probably a better indicator of what actually went on.

Deputy Pearse Doherty: When we are talking about the figures for GNP and nominal GDP, what would the figures look like if it were not for the revision that took place in EU rules?

Mr. John McCarthy: They would be roughly €10 billion lower.

Deputy Pearse Doherty: I was going to ask about the pharma cliff, but the issue has been touched on. This is a major issue, the unpredictability of which we have discussed. How confident are the delegates that they have now got it right in relation to that sector of the economy?

Mr. John McCarthy: That is a good question. We have trawled through the company accounts of many of the pharmaceutical firms in Ireland because it is such an important issue as the Deputy mentioned. Our view is that the blockbuster drugs that are losing patent protection this year and next have much lower global sales than the blockbuster drugs that lost patent protection in 2012 and 2013. Very few of those are actually manufactured in Ireland. Our best educated guess is the impact of this shift from branded drug production to generic drug production because of patent expiry is probably behind us. I cannot say that definitively because that would involve a firm-specific, micro-level analysis but that would be the best view. If one looks at trade data for the first half of the year - division 5 in terms of the SITC classification - there is an increase in the exports from the broad pharma-chem sector. We are confident but one can never be sure.

Deputy Pearse Doherty: Is this the first time this exercise of looking at the accounts was undertaken or was it done in previous years?

Mr. John McCarthy: It is the first time we did it because it was such an important issue.

Deputy Pearse Doherty: That is fair enough. That is why it would not have been picked up in previous years?

Mr. John McCarthy: Yes.

Deputy Pearse Doherty: Referring to our trading partners - obviously two of them are healthy in terms of growth - what would be the impact of percentage decreases in the growth estimation of the UK or the US? Has that been calculated?

Mr. John McCarthy: Yes. We have included a sensitivity analysis in our stability programme. We use the ESRI HERMES model. Various shocks are simulated. We do not do it for specific countries. The impact of lower global GDP is simulated. It is broader than the UK and the US. It shows that the elasticity of Irish GDP to world GDP is 1. If there was a 1% reduction in world growth, that more or less feeds through 1:1 to a lower Irish growth. The reason for that is seen in the export channel and, to a lesser extent, in the inward investment channel.

Deputy Pearse Doherty: Mr. McCarthy mentioned the potential of stagnant or low infla-

tion and the impact that could have on Ireland's debt burden. Is upward inflation expected next year? Figures of 0.5% and 1.0% mentioned.

Mr. John McCarthy: It is 0.5% this year which is unchanged relative to the stability programme update, SPU. It is 0.1% for next year.

Deputy Pearse Doherty: Is it 1% or 0.1%?

Mr. John McCarthy: It is 1%. It used to be 0.9% in the stability programme. It is now 1%.

Deputy Pearse Doherty: What are the factors that will drive that? Is it lack of an adjustment in domestic demand?

Mr. John McCarthy: There are two factors driving it. One is external, the other internal. What drives Irish inflation for the most part is external factors. Inflation in Ireland is a function of the exchange rate and price developments elsewhere. Ireland imports world inflation, so to speak. We have seen a depreciation of the exchange rate against both the dollar and sterling since about the second quarter of this year. Everything else being equal, that will push up import prices in Ireland. We have incorporated that into our model. The second factor underpinning the upward revision is the strength of domestic demand. There is more demand-pull inflation. I do not think it will take off because there is still a lot of slack and spare capacity in the economy, the outward gap is still negative and there is still an unemployment gap. However, there is an improvement in domestic demand which is stronger than we had expected. That will, everything else being equal, lead to stronger inflationary pressures.

Deputy Pearse Doherty: On retail sales, what sectors are improving? Where is the figure of 3.6% in the last month, year on year, coming from? I am talking about sectors apart from motor trades.

Mr. Shane Enright: We have talked about the motor trade contribution. The monthly figures are quite volatile but it is possible to identify broad patterns through the year. They are sectors associated with durable goods and construction. Sales of things like paint and white goods are generally up. The other trend we can see is bar sales are flatter or falling depending on the period examined. Also, the grocery sector is down slightly in year-on-year terms as consumers are prioritising value over volume in that sector. The sectors doing best are in the durable goods side rather than services or grocery.

Deputy Pearse Doherty: There was reference to exports in the first half of the year. There has been an increase. In terms of that being maintained until the end of the year, will the type of figures seen in the first half of the year be carried through? Will there be a further increase or a flattening out at the current level?

Mr. John McCarthy: Implicit in our numbers is some moderation in the second half of the year. When one looks at the figures for the first half of the year, they are up 10% year over year. We are projecting 8.3% for the year as a whole. Implied in that would be export growth of the order of 6% in the second half of the year. In terms of the evidence that supports that, we have some weaknesses that became evident over the summer. For instance, the figures contained in the merchandise trade data, which are published every month, are down 10% year over year in July. Interestingly, there has been a very large increase -12% - in imports in July. Therefore, the contribution of net exports may be weak over the summer. That is one of the factors underpinning an assumed deceleration in the second half of the year. The other issue would be related to trading partner growth. In Q2, and to a lesser extent in Q1, our exports were able to decouple

somewhat from what was going on in the euro area. It is difficult to make the assumption that you can get a permanent decoupling. We have implied in the numbers that the weakness in the euro area will have some impact on the export numbers. It is still strong growth in the order of 6%. However, it is not the sort of figures we saw in the first half of the year.

Deputy Pearse Doherty: Is that a conservative and cautious approach? Is there a greater weight on the negative potential risks than on the positives?

Mr. John McCarthy: Yes and no. That is the economist in me. If one looks at the July data, it was a poor month. However, a few of the Deputy's colleagues have mentioned the contracted production issue. This is a very difficult concept to forecast. It is probably confined to four or five firms. It is firm specific. It is a very unusual phenomenon. We do not know if this is a cyclical issue or a one-off. We do not know if it will evaporate or whether it is a structural issue. In terms of forecasting that, we have taken the view it is better to err on the side of prudence. That is justified on the basis - if one considers how this operates - this does not generate one additional job. The jobs are generated in country A which is producing the widgets or whatever is being produced. It does not have any impact on the employment levels in Ireland.

Deputy Pearse Doherty: I would like to tease that issue out given the time and it could have such an impact. However, in relation to employment growth, and looking at the year-on-year figures - the graph looks really healthy and it is great to see the live register numbers coming down - one of the concerns is this mythical 60,000 jobs created last year. I know there was revision of the calculations based on the census. It is unlikely that those jobs were actually created. They were probably underestimated previously. If we look at the national household survey for the end of last year and the number of people in employment compared to the end of the second quarter, we see a growth in employment of about 7,000 in six months. Is that type of growth an issue of concern? The figures for the end of quarter two showed that 1.909 million people were employed, while at the end of quarter four the figure was 1.901 million. Those figures are from the national household survey.

Mr. John McCarthy: Those figures are not seasonally adjusted. The more appropriate figures would be the seasonally adjusted ones. If one is looking at unadjusted figures, the more appropriate metric is to compare year-on-year. In the first half of this year, the level of employment was up by 2% relative to last year. In terms of actual numbers of jobs, Ms Weymes might help me out there.

Ms Laura Weymes: Six thousand.

Mr. John McCarthy: Up about 6,000.

Deputy Pearse Doherty: Yes, but that is the point I am making. Six thousand net jobs - or 6,500, according to the figures we have - were created in the first six months of this year. If we are to believe what happened last year, 60,000 jobs were created in a year, yet only 6,500 were created in the first six months of this year. Is it the case that the 60,000 did not exist and the figure was a result of the way the calculations were done, or are we seeing a sizeable slowing down of job creation?

Mr. John McCarthy: I am quite confident about last year's headline figure. There was an issue; the Deputy mentioned the incorporation of the census data. The CSO says that that affected the composition or the sectoral breakdown of employment. It had previously underestimated the number of people in agriculture, so it was adjusting over the year to correct for that.

However, the CSO was quite happy to stand over the overall figure. I am not casting doubt on the figures, but the strong employment growth last year relative to the weak GDP figure gave rise to a phenomenon whereby productivity fell by about 2.5% last year. That has only ever happened twice in 50 years, so it was a very unusual phenomenon. This was not so much on a GNP basis; it can be explained based on the patent cliff that Deputy O'Donnell mentioned.

For this year, we have incorporated a downward revision to our employment number. At the time of the stability programme we were projecting 2.25% employment growth; we have brought that back to 1.8%. The reason is that a base effect will kick in in the second half of this year. This is related to the Deputy's earlier point. Because employment growth in the second half of last year was so strong, it is difficult to get year-on-year growth in the second half of this year. Therefore, we have brought down employment growth to 1.8%. A number of pieces of evidence support continued employment growth this year. Ms Weymes mentioned the live register, which is an imperfect measure of the labour market. However, the pace of reduction in the live register actually accelerated over the summer. The number of people on the live register is now falling at 9.5%, compared to about 8% earlier on in the year. The unemployment rate is down to 11.1%, which is absolutely too high, but we are in a better position than we were two or three years ago.

I will not mention the fiscal side, but if one looks at the income tax data to the end of September, it is up by 8.8%, while PRSI is up by over 5%. On balance and in the round, most of the evidence would support reasonable employment growth this year.

Deputy Pearse Doherty: Can I ask one more question?

Chairman: No. I have let this go five minutes over, so I am trying to keep it under control. I call Deputy Rabbitte.

Deputy Pat Rabbitte: I have two brief questions. If the construction projection of 9% growth is realised, to what proportion of the workforce does that bring the number of people employed in construction?

Mr. John McCarthy: We do have the figure; maybe the Deputy could ask his second question while we find it.

Deputy Pat Rabbitte: My second question is purely academic-----

Mr. John McCarthy: Sorry; my colleague tells me the figure is 245,000.

Deputy Pat Rabbitte: What percentage of the workforce is that?

Mr. John McCarthy: Total employment is 1.9 million.

Deputy Pat Rabbitte: I presume it is only about 5% or 6%, is it?

Ms Laura Weymes: I am sorry; I have called the wrong line.

Deputy Pat Rabbitte: Yes; it must be about 5% or 6%.

Ms Laura Weymes: It is 106,000 for this year, 2014.

Mr. John McCarthy: It is 106,000.

Ms Laura Weymes: With growth of just under 4.5% in construction employment, which

would be consistent with the investment projections.

Deputy Pat Rabbitte: Does that bring it to 4.5%, or is it 4.5% now? If the 9% growth happens, does it bring it closer to 5%?

Ms Laura Weymes: No. The 9% is consistent with the 4.5% growth in construction employment levels.

Mr. John McCarthy: The share is about 6%.

Ms Laura Weymes: Industry, including building, is 20%.

Mr. John McCarthy: It is about 5% or 6% of total employment.

Deputy Pat Rabbitte: With regard to the discussion we have just had about the revision of inflation, does Mr. McCarthy have a view on what is the ideal?

Mr. John McCarthy: What the ideal rate of inflation is?

Deputy Pat Rabbitte: Yes.

Mr. John McCarthy: I do. From a euro area perspective, price stability is defined as "inflation close to but not exceeding 2%". I suppose that would be the ideal. However, from an Irish perspective, we still have a situation in which price levels, rather than the rates of change, are still in excess of the European average, which is affecting competitiveness. We therefore need to run an inflation rate below that of our European colleagues for some time to come. Something of the order of 1% to 1.5% would not be an unreasonable rate of inflation in Ireland for the next couple of years.

Deputy Pat Rabbitte: Would Mr. McCarthy say that notwithstanding the size of the national debt?

Mr. John McCarthy: The debt position is obviously very high. Reducing that will involve increases in nominal GDP - in other words, the debt ratio. Ideally, we would like to increase the denominator much more rapidly, but one can achieve that both through improvements on the real side and also on the price side. In other words, it is the nominal rate of growth. If we are getting real growth of 4.7% or 3.5%, averaging at just over 4%, and one layers in 1.5% inflation on top of that, one is looking at nominal GDP growth of the order of 5% to 5.5%. That would be sufficient to comply with the EU fiscal rules whereby we are required to reduce debt ratio at a particular rate, namely one twentieth of the difference between the current level and 60% on an annual basis. If we were to achieve 1.5% inflation, once the real growth rate is sufficiently strong, we could then comply with the debt correction rule.

Senator Aideen Hayden: Can Mr. McCarthy go forward a couple of slides to the one showing GDP and GNP?

Mr. John McCarthy: Yes.

Senator Aideen Hayden: First, I just want to make a general comment. It never ceases to amuse me how people talk about the health of an economy in relation to new car sales. To the best of my knowledge, not a single component of the average imported car is manufactured in this country, so how it is supposedly helping the Irish economy is a mystery to me. I presume it is supposed to indicate the robustness of an economy.

Mr. John McCarthy: Yes; it is a bellwether indicator. If people are more confident, they spend on cars.

Senator Aideen Hayden: They could just as easily have foreign holidays or maybe something that is manufactured in Ireland.

Mr. John McCarthy: The Senator is absolutely correct. The margin of propensity to import cars is one, so we do not get any jobs, except for the secondary activity on the forecourt.

Senator Aideen Hayden: Other than the person who stands out in the forecourt selling it. Fundamentally, there is not a single car manufactured in Ireland to the best of my knowledge.

Mr. John McCarthy: We do get a large dividend on the public finances for it.

Senator Aideen Hayden: That is good to know. I am glad there is some benefit. Mr. McCarthy mentioned tax, GDP impacts and excise, if I remember correctly. In terms of Government consumption, on the list, he noted that it would drop in 2014 from 4.8% to 1%. Am I correct?

Mr. John McCarthy: Yes.

Senator Aideen Hayden: Why? What is behind that?

Mr. John McCarthy: This is largely a statistical effect relating to the Haddington Road agreement which came into effect in mid-2013. Government consumption is largely comprised of wages and salaries of Government employees. Essentially, the output value is measured as equal to the inputs. In the case of Government consumption, under the Haddington Road agreement hours worked increased - we are so advised by the CSO and it measures it at about 5% - compared to previous arrangements. That mechanically pushes up the volume of Government consumption because public service workers are working longer. The price of Government consumption has fallen by an equivalent amount because the workers are working more for the same or slightly less pay in some cases. That explains this statistical effect.

Senator Aideen Hayden: Am I right in assuming that the Government's share of the economy is falling?

Mr. John McCarthy: Yes, in 2015, slightly.

Mr. Shane Enright: That is just the Government consumption - the purchase of goods and services by Government - which is about one third of overall Government spending in the economy because, for instance, social welfare is not included in Government consumption, as it is not a purchase of a service-----

Senator Aideen Hayden: I would not have expected that to be.

Mr. Shane Enright: -----nor pensions and things like that. So the expenditure ratio - Government expenditure as a percentage of GDP - is not moving that much.

Senator Aideen Hayden: Are you saying that the Haddington Road agreement has been responsible for reducing Government consumption from 4.8% to 1%?

Mr. John McCarthy: It is not just the Haddington Road agreement. There are other factors in play.

Senator Aideen Hayden: It seems to be the principal factor.

Mr. Shane Enright: To get into the specifics, there is the eligible liabilities guarantee scheme which is the banks paying the Government for a service. This reduces Government consumption. Again, this is the statistical treatment. As that scheme expires - it is due to expire completely between 2011 and 2015 - that also has an effect on Government consumption in terms of pushing it up slightly.

Senator Aideen Hayden: Government consumption seems very low, but there we are. Mr. McCarthy mentioned why he was predicting a lower growth rate for 2015 down from 4.7% to 3.6%. Would he recap that?

Mr. John McCarthy: One of the principal reasons is an anticipated moderation in export growth. We do not see a continuation of some of the sector-specific issues that can be seen this year. If one looks at the figures, the rate of exports goes from 8.3% to 4.8%. Exports are the single largest component of GDP. They are in excess of 100% of GDP. Small changes on the exports figure can have a big impact on the overall figure. If I could use this opportunity to revert to Deputy O'Donnell's question earlier, if one looks at the figures on domestic demand contributions, stocks and net exports and so forth, one can see the answer to Senator Hayden's question. There is a smaller contribution from net exports. Deputy O'Donnell referred to the contributions this year. It is 3.6% from domestic demand plus 1.25% from net exports and a minor adjustment on stocks. The main reason for the slow-down for next year is the 0.5% smaller contribution from net exports and that is primarily due to the fall off in actual exports.

Senator Aideen Hayden: Mr. McCarthy mentioned in regard to the 4.7% that the bulk of it was comprised of growth in domestic demand as opposed to the healthy exports which are clearly there. Therefore, the domestic economy's recovery is more relevant than the export market to the improvement in domestic demand. In relation to our eurozone partners and their impact on our growth, to what extent does Mr. McCarthy feel that the improvement in domestic demand may be to some extent due to the success of lowering of the European Central Bank rates, given that, for the sake of argument, 75% of our mortgage market is tracker-based? To what extent are people feeling the benefit of the greater bang to the buck in their pocket? Rather than being a negative, it has to some extent been a positive for us in this economy.

Mr. John McCarthy: I am subject to correction, but I think the market in tracker mortgages is about 50%. However, I am not an expert in that area. The Senator is right about the reduction in interest rates having a favourable impact on a large part of the household sector by boosting their disposable income and that is feeding through into consumption. There is another channel through which it is having a positive impact. The reduction in interest rates and the unconventional measures now being seen - the purchase of private sector assets, asset-backed securities, covered bonds and so forth - are increasing the money supply and leading to a depreciation of the euro exchange rate. That will have an impact on the exporting side of the economy. There is a more positive impact on the real economy from the accommodative monetary policy stance that is being adopted by the ECB.

Senator Aideen Hayden: I was very interested in a number of Mr. McCarthy's responses on the construction sector. I noticed in the charts that it seemed particularly volatile over Q2 and Q3 of 2013 and Q2 of 2014. What does he think is contributing to that volatility?

Mr. John McCarthy: The nature of the sector is that it is a volatile sector anyway. Typically, investment is the most volatile component of GDP and building and construction would

be included in the investment component. It is highly cyclical around a long-term trend. The cycle displays larger amplitude - in other words, it is much more volatile than the regular economic cycle. The wavelength of the cycle is much longer. Therefore, it is possible to get longer peaks and troughs. Construction is a type of microcosm of that. Volatility within the sector is to be expected. What has probably been seen over the last couple of years is an over-correction in the construction sector. In the housing sector, Ireland went from producing 92,000 units per annum, which was completely unsustainable, to producing 8,000 units, which we now see is also unsustainable, as there are price increases in the sector. This is certainly the case in parts of the country where shortages are an issue. There are some obstacles in the sector that might help improve supply in the short-term. However, there are some policies underway to correct that. I will not dismiss it by saying it is normal. However, there is more volatility in some sectors than others.

Senator Aideen Hayden: Particularly as we are looking towards construction as an area that will feed demand and therefore feed into the growth for next year, it would be important to note that it is a particularly volatile sector.

Mr. John McCarthy: Yes. In equilibrium, in an advanced economy, normally 10% or 11% of GDP is spent on construction.

Senator Aideen Hayden: We are at about 6%.

Mr. John McCarthy: Yes; the Senator is right, we are below the norm.

Chairman: Is it as high as the EU average of 10%?

Senator Aideen Hayden: Yes, but it depends on the GNP-GDP figure.

Mr. John McCarthy: The historical norm means that it would be in and around that percentage. That is not just for housing but construction more broadly.

Senator Aideen Hayden: I thank the delegates.

Chairman: Let us return to what Mr. McCarthy mentioned, that four companies are the main contributors.

Mr. John McCarthy: It is a handful. I do not know if it is four in particular.

Chairman: Can we be briefed more on the matter? It is interesting that a rate would be based on such a small handful of companies.

Mr. John McCarthy: We have had the issue of a small number of companies having a disproportionate impact on GDP for some time. Earlier one of the members mentioned the impact of the pharmaceuticals, patent cliff and so forth. One can see that this arises from time to time. Ireland is so small that a handful of multinational companies can have a disproportionate impact on GDP. Mr. Enright may have the figure to hand, but something like 50 companies account for about two thirds of gross value added in the economy.

Mr. Shane Enright: Of turnover.

Mr. John McCarthy: Yes. That complicates things for those of us who are trying to understand how the economy works.

I return to the Chairman's specific point. We are in a situation where methodological chang-

es have been incorporated in the past while which bring contracted manufacturing to the fore. We do not know how many companies are involved, but we suspect it is a handful and they are having a big impact. A number of economists, as well as the Central Bank's report last week, have taken the view that such activity overstates the level of GDP. We cannot go into firm specific developments, as we do not have the information from the CSO. As there are legal impediments to our accessing the data, we simply cannot do so, but our suspicion is that a very small number of companies engage in this type of activity. It is virtually impossible to forecast the figure because it would mean getting into firm specific developments. It is not like other companies where accounts might be easily visible and so forth. It is, therefore, very difficult to get a handle on the matter. Unfortunately, I cannot give any more information because I simply do not have it.

Chairman: That is fine.

Deputy Kieran O'Donnell: I wish to ask a broad question. With the projected growth rates for the economy, when will more be taken in than will be spent? We must meet the 3% target by the end of 2015. Let us, therefore, consider the projected growth rates. When will we balance the books?

Senator Aideen Hayden: Does it include repayments on the debt?

Deputy Kieran O'Donnell: Correct. We were in surplus prior to paying interest. Am I correct in that assertion?

Mr. John McCarthy: There is a primary surplus.

Deputy Kieran O'Donnell: There is a primary surplus also. Am I more or less correct?

Mr. John McCarthy: It was either last year or this year that we would move towards a primary surplus.

Deputy Kieran O'Donnell: When?

Mr. John McCarthy: I am prohibited from discussing the implications for the public finances. We will publish forecasts, to 2018, as part of the budgetary process in order that the Deputy can see when we might move to a balanced budget position.

Deputy Kieran O'Donnell: Mr. McCarthy has told me that he expects it will happen before 2018.

Mr. John McCarthy: No, I am not saying that; I am saying by 2018 the Deputy will see how close we are to having a balanced budget.

Chairman: There may be a little extra.

Mr. John McCarthy: It could be in excess or below, but one would be able to make a better call.

Deputy Kieran O'Donnell: What would be a sustainable growth rate for an economy?

Mr. John McCarthy: That question is back in my space but very difficult to answer. On what would be a sustainable growth rate of an economy, it is a question of what happens on the supply side. In other words, it is related to the endowment of capital and labour in the economy. It is a matter of how fast the labour force can grow, how fast productivity can grow and so forth.

The Deputy's question is very difficult to answer from an Irish perspective, given the openness of the economy. In other words, an economy that is growing strongly can suck in labour from abroad in two ways. Irish people who have emigrated would come back and a lot of eastern Europeans who have settled here would bring their families into the country. The concept is very difficult. Sometimes when we meet investors and so forth we can say that potentially the sustainable growth rate in the United States is of the order of 2.5%, or perhaps 3%. What is the sustainable growth rate in Massachusetts? If it was to suffer a shock, be it positive or negative, people would leave or come in. It is very difficult to predict the figures on a regional basis. Having said that, I will give the Deputy a figure, but it carries health warnings. My own view is that the potential growth rate of the economy is somewhere in the order of 3%, perhaps a little higher, but it is evenly broken down between growth in labour supply and productivity. Please remember that my forecast carries health warnings.

Deputy Kieran O'Donnell: Is that figure based on the construction sector accounting for no more than 10% of GDP?

Mr. John McCarthy: That is in line with the historical norm.

Deputy Kieran O'Donnell: Let us look at the figures. We have seen huge growth in investment this year, but it has not filtered down into a massive growth in consumption. Obviously, companies are investing and jobs are being created. Also, we are coming from a very low base in 2013 in terms of investment.

Mr. John McCarthy: Yes.

Deputy Kieran O'Donnell: The figure for 2015 is probably more sustainable because the figure for 2014 has been healthy. Is it fair to say we will still have a deficit in 2014 and 2015? What does the Department expect the deficit to be by the end of 2014 and 2015? We have had very healthy growth in the economy, but there are still very high debt levels.

Mr. John McCarthy: We will make the deficit figures public this day next week.

Deputy Kieran O'Donnell: What is the most recent figure published?

Mr. John McCarthy: The most recent figure was published in the stability programme in which a deficit of 4.8% for this year was stated.

Deputy Kieran O'Donnell: What is the value of the deficit?

Mr. John McCarthy: Does the Deputy mean in money terms?

Deputy Kieran O'Donnell: Yes.

Mr. Shane Enright: It is €8 billion.

Mr. John McCarthy: That is within the ceiling set.

Deputy Kieran O'Donnell: I accept that. I caution that while the economy is doing very well, we still have a deficit of €8 billion. What are the most recent projections for 2015?

Mr. John McCarthy: The projected figure is 2.9% or just over €5 billion. I think the Minister said the figure would start with a three. As he is on record as saying this, I am not betraying anyone.

Senator Aideen Hayden: Mr. McCarthy is correct. There has been a rumour that we might reach a figure of 2.9% this year. I said this because I wanted to see if the officials would smile.

Mr. John McCarthy: I always smile.

Chairman: As the Minister is never wrong, we will have to leave it at 3%.

Mr. John McCarthy: The Government is committed to correcting the excessive deficit figure by next year and that is the official line.

Chairman: I wish to look briefly at the labour market side. The figures indicate there was real growth in the number of people in employment last year. What is the figure?

Mr. John McCarthy: It may be over 60,000.

Ms Laura Weymes: It is between 45,000 and 50,000.

Chairman: It is 45,000 to 50,000. What is it this year?

Ms Laura Weymes: It is 34,500 for 2014.

Chairman: The labour growth forecast figures go into the negative for this year. How am I reading that?

Ms Laura Weymes: Is the Chairman asking why the labour force growth has been revised downwards?

Chairman: If we have 34,000 extra jobs.

Ms Laura Weymes: The three factors driving the labour force are migration, participation, and the natural population increase. We have not had much downward revision on the migration. We are using the CSO's April migration and population estimates.

Chairman: They say that the same number of people are migrating outwards.

Ms Laura Weymes: The figure is 21,500 outwards.

Mr. John McCarthy: It has slowed a bit. It was running at 35,000 in 2012-2013

Deputy Kieran O'Donnell: That is the net figure.

Mr. John McCarthy: That is the net figure, yes. There was net outward migration of just over 21,000 in the year to April 2014. The level of outward migration is slowing in net terms.

Ms Laura Weymes: It is very marginal relative to what we would have estimated in our last forecast. We have only come down from about 23,000. Much of the effect is through the participation rate, to answer the Chairman's question, which we are profiling to fall this year relative to last year. It is difficult to square in that typically the participation rate is cyclical and tends to respond to overall output levels, but we have reason to believe there is a lag in the response of the participation rate to the improved labour market conditions.

Mr. John McCarthy: The participation rate is the number of people of working age who participate in the labour force. If my wife stays at home, she is neither employed nor unemployed. Her participation rate is zero. That fluctuates with the economic cycle. It tends to pick up when employment demand or labour demand is strong, and *vice versa*.

Deputy Kieran O'Donnell: Is that a function of the fact that the percentage of short-term unemployed is falling while the long-term unemployed, for whom it is more difficult to re-enter the workforce, are becoming a higher percentage of the overall number unemployed? Is that a contributing factor? The people who are short-term unemployed are taking up jobs and are being re-employed much more quickly whereas it is more difficult for people who are long-term unemployed to re-enter the workforce. Hence the participation rate-----

Ms Laura Weymes: It is the net effect, the combination of the short-term and the long-term, because the participation rate is in aggregate.

Deputy Kieran O'Donnell: There must be a reason the participation rate is falling.

Ms Laura Weymes: We surmise it might reflect the composition of employment rather than unemployment. We are seeing a shift from more part-time employment into a more consolidated full-time basis and so, as people work longer hours and make that shift into full-time, they are not registering as an increase in employment volumes. That would be one of the explanatory factors why the participation rate is not picking up at the pace we might have expected.

Deputy Kieran O'Donnell: Instead of three or four part-time jobs coming on stream, one full-time job does. Is that what Ms Weymes is saying?

Mr. John McCarthy: Full-time equivalent is running faster than overall employment growth.

Chairman: That is the cause of these figures, because people are not leaving the country, unemployment is dropping and yet the workforce is not growing.

Mr. John McCarthy: That is because participation rates-----

Chairman: Participation rates are the ones that matter.

Mr. John McCarthy: It is unusual at this stage in the economic cycle. One would normally expect the participation rate to pick up.

Chairman: It is unusual.

Mr. John McCarthy: It could have been a one-off. It was evident in the second quarter figures. I do not think it was evident in the first quarter. Last year participation had increased, so perhaps it is an anomaly.

Chairman: It is an important figure for next year. If investment is improving and the economy is improving and that gets stuck, we have a problem. I thank Mr. McCarthy and the other officials from the Department of Finance for briefing the committee. It has been a worthwhile discussion and it has been very informative from our point of view.

The joint committee adjourned at 5.45 p.m. until 3 p.m. on Wednesday, 22 October 2014.