AIB Economic Outlook

May 2024

For the life you're after

AIB Group Plc

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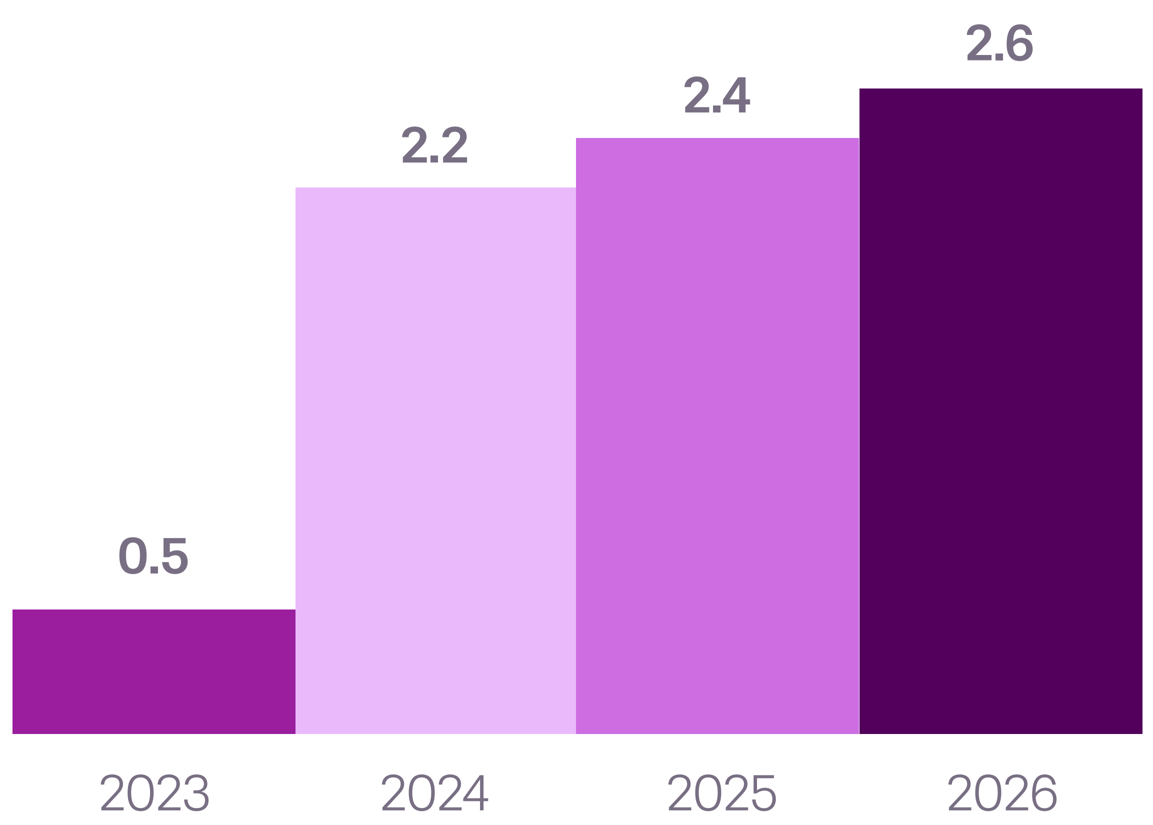
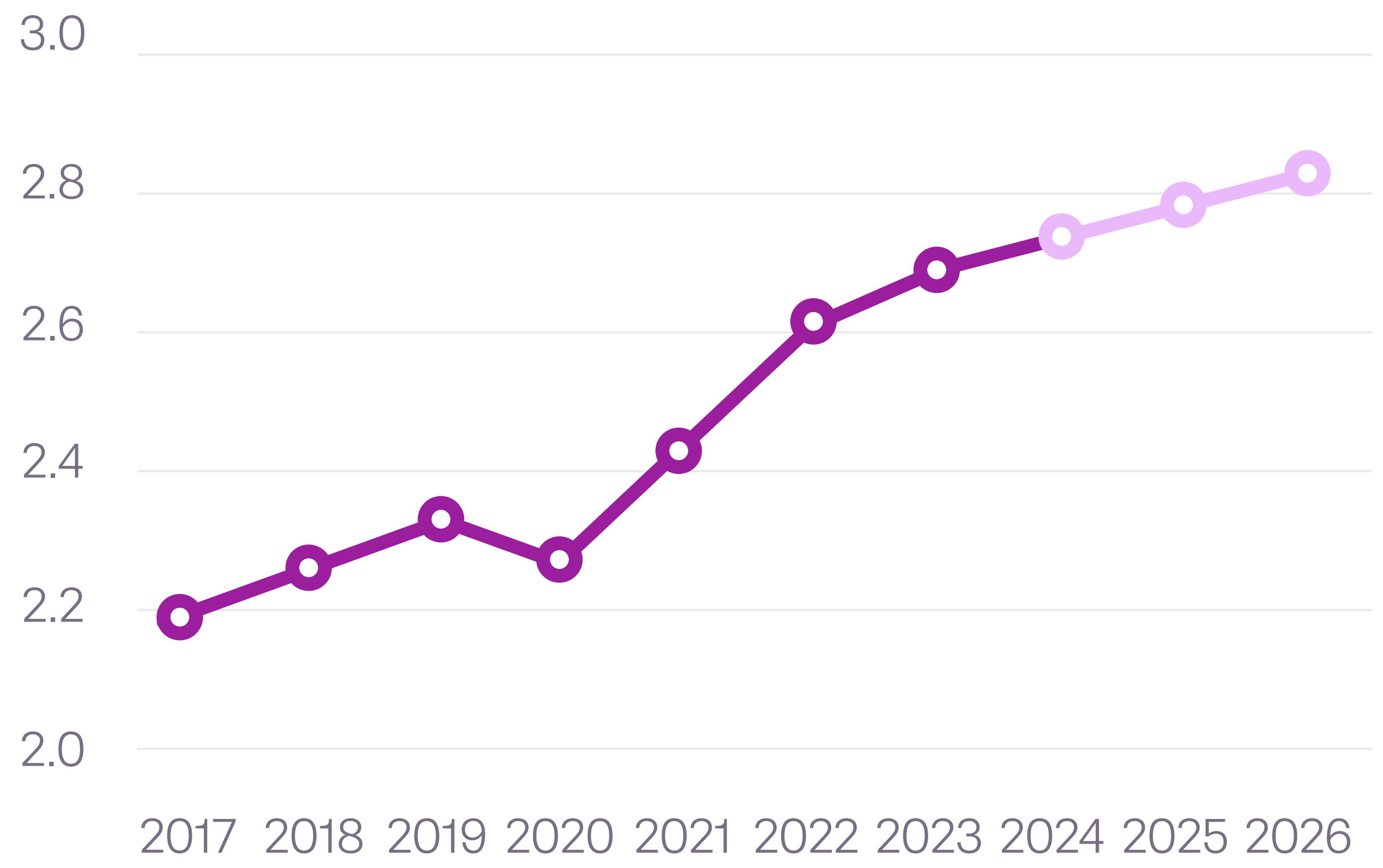
Economic Growth Forecasts*

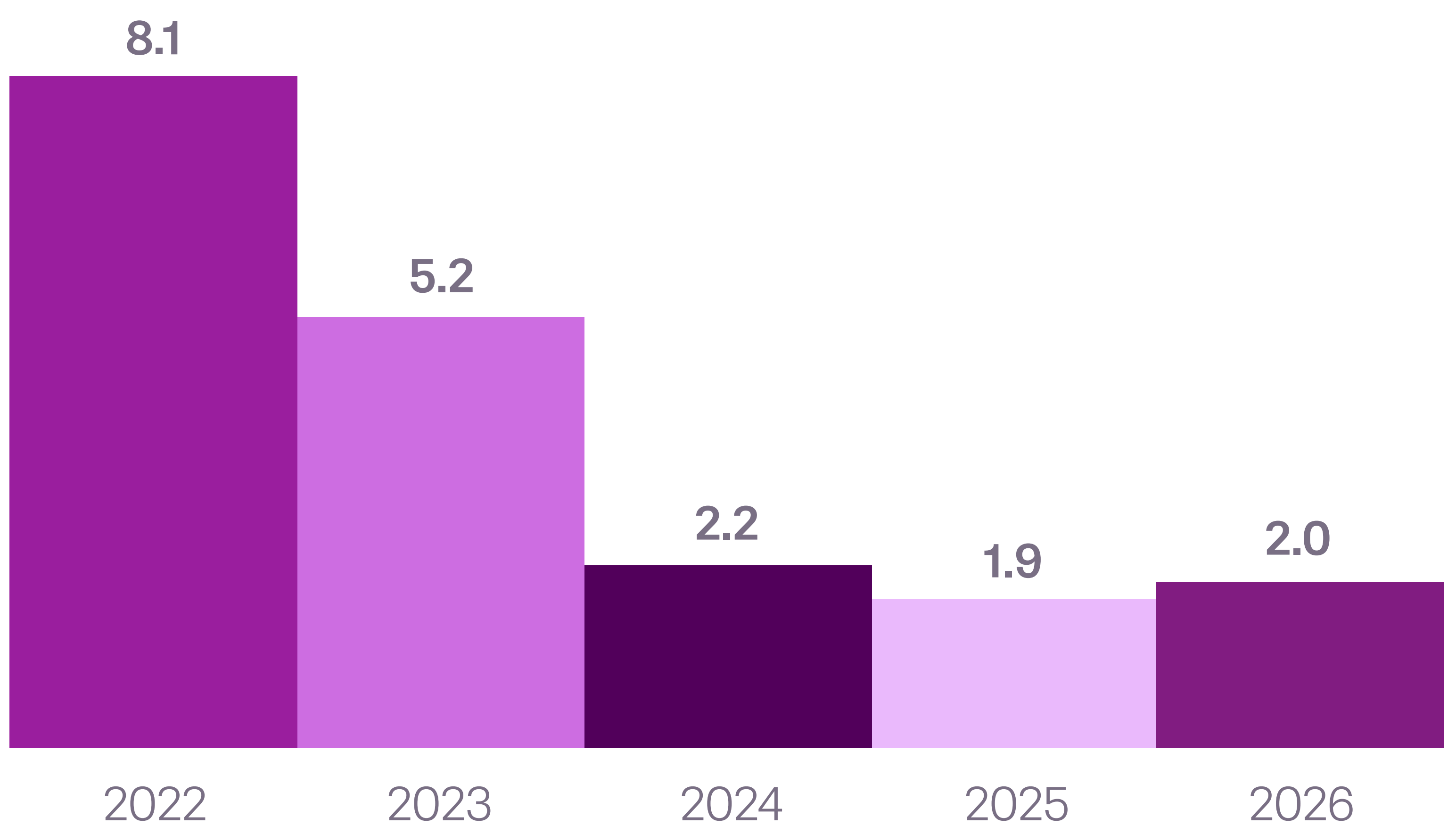


*Based on Modified Final Domestic Demand

Employment Forecasts (Millions)



Inflation Forecasts*



*Based on Harmonised Index of Consumer Prices

Macro Outlook

Global Backdrop - steady if unspectacular

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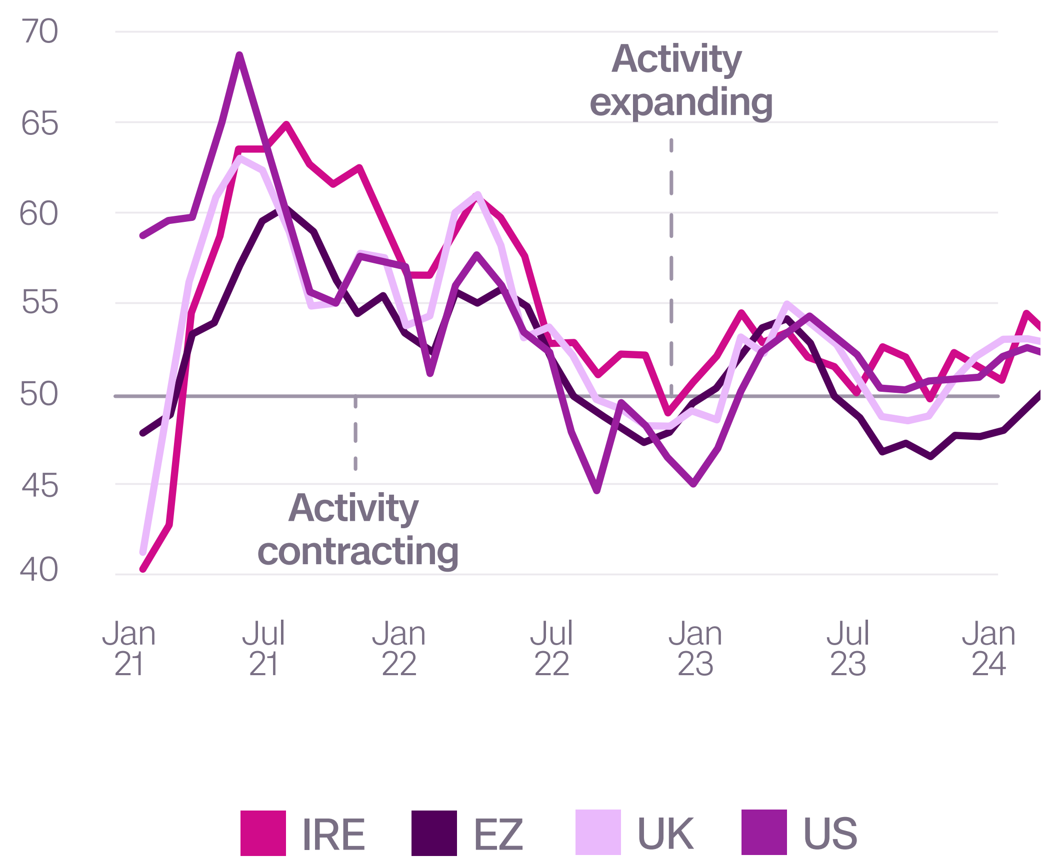
Ireland's key trading partners continue to grow at a steady, if unspectacular pace. The US economy has outperformed the UK and Eurozone of late, but European economies are showing signs of accelerating growth in 2024.

Composite PMIs for Ireland and key trading partners

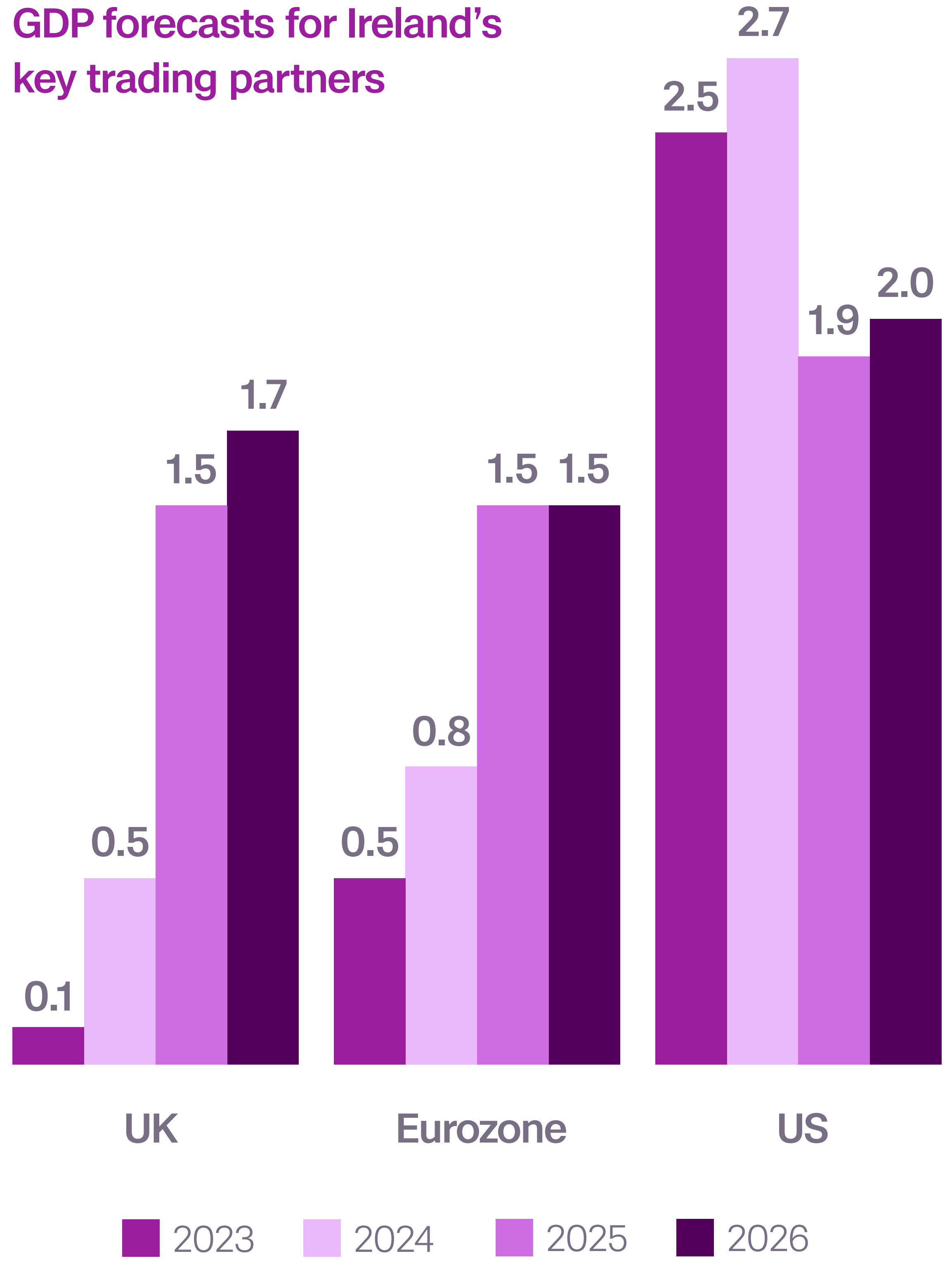


Source: S&P Global/Refinitiv

The global economy has demonstrated remarkable resilience in the face of multiple shocks in recent years, from Covid-19 to the current geopolitical events in Ukraine and the Middle East, interspersed by a rapid escalation in inflation and interest rates. Economic data have largely come in ahead of expectations so far in 2024, inflation continues to ease, and central banks are now contemplating rate cuts. Labour markets and wage growth are strong, but global growth remains at historically weak levels, and is expected to remain so in the near term according to the IMF. In this context, those ever present geopolitical risks could still knock some economies off course.

Amongst Ireland's key trading partners, the US has by far outperformed its peers in recent times, with GDP growth of 2.5% in 2023, compared to just 0.1% and 0.5% in the UK and Eurozone, respectively. Nevertheless, there are signs of life in the UK and Eurozone economies, with both surveys and hard data pointing to an upturn in growth in 2024, alongside tentative signs that the US boom is finally starting to fade.

GDP forecasts for Ireland's key trading partners



Source: IMF

Irish Outlook - moderate growth expected

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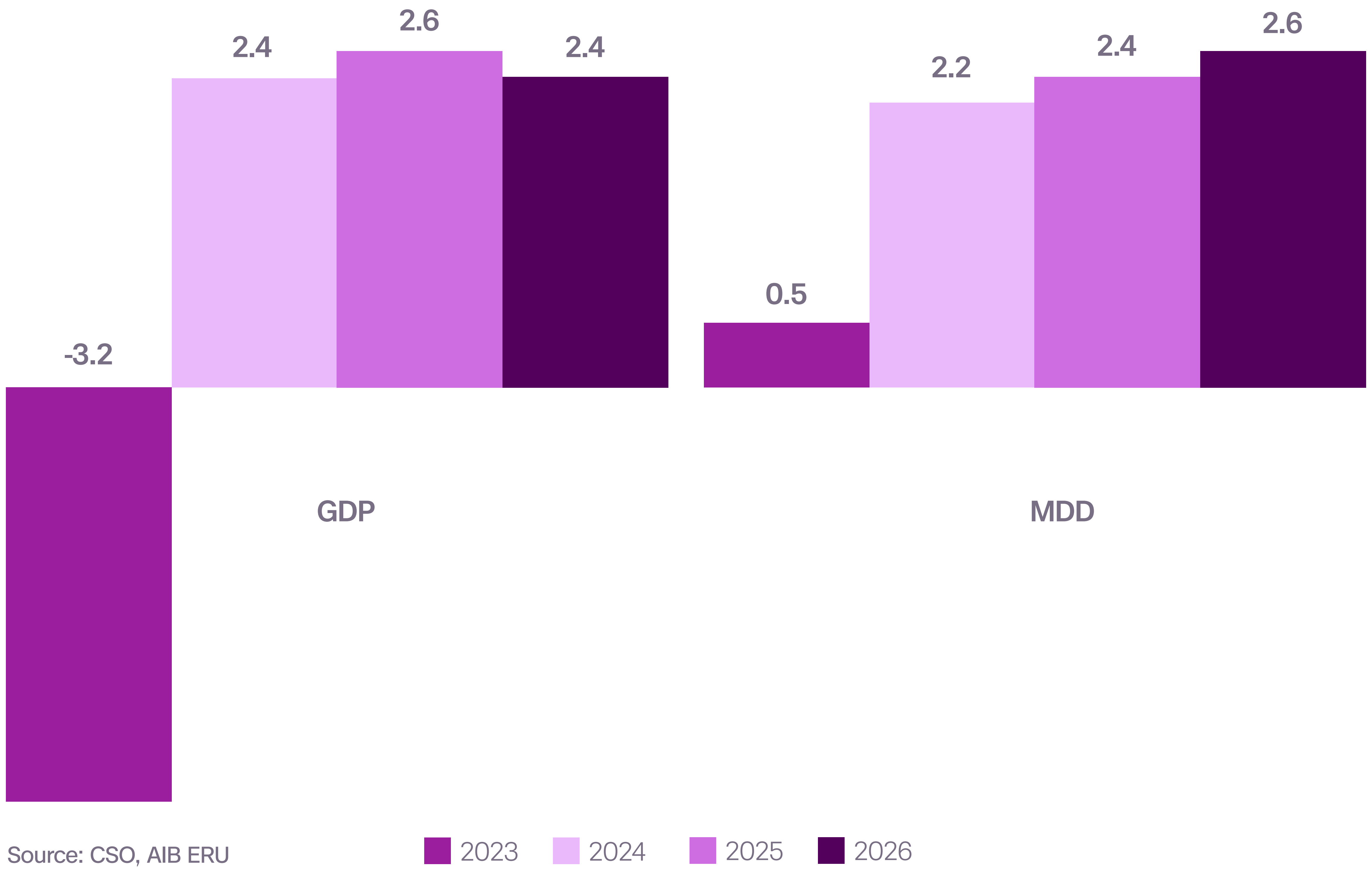
In Ireland, we expect a more moderate pace of economic growth in the near term, with both GDP and modified domestic demand (MDD) growing at 2-3% per annum following several years of rapid growth.

Following a GDP fall in 2023 due to a downturn in the pharmaceuticals sector, Ireland's industrial output and goods exports are expected to bounce back in 2024 and 2025. The domestic economy will also continue to expand at a robust pace, underpinned by employment growth and a renewed rise in real wages as inflation normalises. However, with the economy and labour market reaching full capacity, we expect more moderate growth in the coming years.

Irish Growth Forecasts



Source: CSO, AIB ERU

Lead indicators such as AIB's Purchasing Manager Indices (PMIs) suggest domestic growth has sustained a moderate pace in recent months. Retail sales continue to grow at a decent pace, while exchequer tax returns point to a healthy domestic picture so far in 2024. On the external side, trade data also signal goods exports have picked up following a downturn in 2023, particularly in the pharmaceuticals sector.

On the investment side, the IDA has indicated that there is a more "challenging international environment" expected in 2024. Direct FDI employment was little changed in 2023, following several years of rapid growth. The immediate focus is now on retaining Ireland's competitive advantage in the medical, pharma and tech sectors in the near term. In this context, the announcement of new international headquarters in Ireland by nascent AI companies is a welcome signal that Ireland remains an attractive location for inward investment in the tech sector. Nonetheless, infrastructure constraints could blunt Ireland's competitive advantage in the more resource-intensive pharmaceuticals and manufacturing sectors.

The Irish economy is not immune to the downside risks still facing the global economy. Furthermore, the persistence of an increasing number of domestic capacity constraints is expected to have a restraining impact on the economy. These constraints are primarily in relation to housing, transport, social and utilities infrastructure. However, private sector balance sheets are characterised by low debt levels and high savings. As a result, while growth is expected to moderate in 2024 and beyond with risks tilted to the downside, the public and private sectors have built up resilience. We discuss the key risks to the outlook later in this report.

Taken together, these indicators for the Irish economy suggest GDP and modified final domestic demand (MDD), a less volatile gauge of domestic activity, may have bounced back early in 2024.

Our forecast is for Irish GDP to rise by 2.4% in 2024. This would be a significant bounce back in growth following the 3.2% fall in 2023, and reflects the recovery underway in the international pharmaceuticals sector, which will boost exports once again in 2024. On the domestic side of the economy, we see MDD rising by 2.2% in 2024, driven by a 2.4% rise in consumer spending and 2.2% rise in modified investment. Further out, we expect GDP to rise by 2.6% in 2025 and 2.4% in 2026. MDD is forecast to rise by 2.4% in 2025 and 2.6% in 2026.

Inflation - back to normal rates, but risks remain

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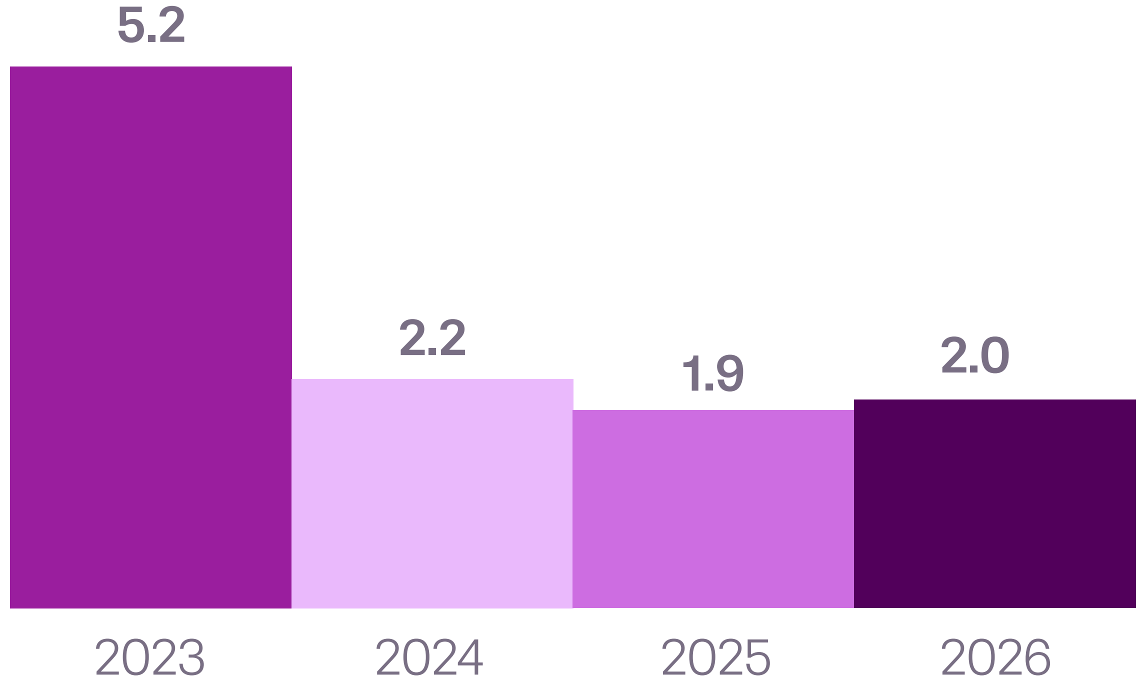
Inflation has returned to the normal range and we expect it to remain there in the near term. However, Ireland remains exposed to movements in international commodity prices and domestic price pressures in capacity-constrained sectors.

Irish inflation has been in rapid decline over the course of the past year as the sharp price rises in 2022 and 2023 drop out of the annual rate. The annual HICP inflation* rate declined to 1.6% by April 2024, but core inflation, which excludes food and energy, is proving stickier, driven by still high inflation in some services sectors. Additionally, the base effects of earlier energy price declines should be largely washed though the data by the second half of 2024, with potential for fresh inflationary pressures if global energy prices rise once again. However, lead indicators such as producer prices and PMI surveys point to muted inflationary pressures at present, which should feed through to consumer inflation at a lag of several months.

We see HICP inflation falling to 2.2% in 2024, and averaging 1.9% and 2% in 2025 and 2026, respectively. However, the risks are tilted to the upside on inflation due to current geopolitical tensions impacting supply chains and the potential for increases in oil prices.

HICP Inflation



Source: CSO, AIB ERU

Brent Crude Oil ($/barrel)

Source: Refinitiv

*HICP inflation is the harmonised measure used in Eurozone countries and targeted by the European Central Bank.

Risks to the outlook for Ireland - downsides outweigh the upsides at present

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Geopolitical risks remain front and centre, and could dampen the outlook for global economic growth this year. On the upside, Irish households maintain an exceptionally high level of pandemic-era savings. These savings could drive stronger growth in consumer spending than expected.

While risks to the outlook are more balanced than a year ago, the weak trajectory for UK and Eurozone growth and its more direct exposure to geopolitical risks means the outlook is less certain. The primary geopolitical risks which could spill over to economies, particularly in Europe, remain the war in Ukraine, alongside conflicts in the Middle East. The direct impacts are via higher commodity prices and supply chain disruption which could quickly feed through to higher inflation. Indeed, recent European PMI surveys point to lengthening delivery times for firms and rising input prices directly related to the diversion of trade from the key Red Sea route. Indirect impacts could also dampen growth as evidenced by the sharp decline in consumer and business sentiment in Europe following the Russian invasion of Ukraine in 2022. For now, the conflict in the Middle East has not impacted on the global economy to a significant extent.

Global geopolitical risk index

Source: Caldara and Iacoviello. This reflects automated text-search results of the electronic archives of newspapers reporting geopolitical events

Another downside risk relates to monetary policy. With growth particularly weak in the Eurozone, there remains a risk that the ECB waits too long to initiate its rate-cutting cycle over concerns of lingering inflation. Higher-for-longer interest rates could also expose weaknesses in the global financial system and tight credit conditions may precipitate stresses at a sectoral level.

In terms of upside risks, precautionary savings remain at relatively high levels in many economies, particularly Ireland, and could underpin stronger domestic spending in 2024, if geopolitical risks do not materialise. Our central assumption is that Irish households continue to maintain savings close to current historically high levels, but a brightening economic outlook might spur stronger consumer spending than we anticipate in the coming years. In conclusion, given the openness of the Irish economy, the risks remain tilted to the downside on our outlook.

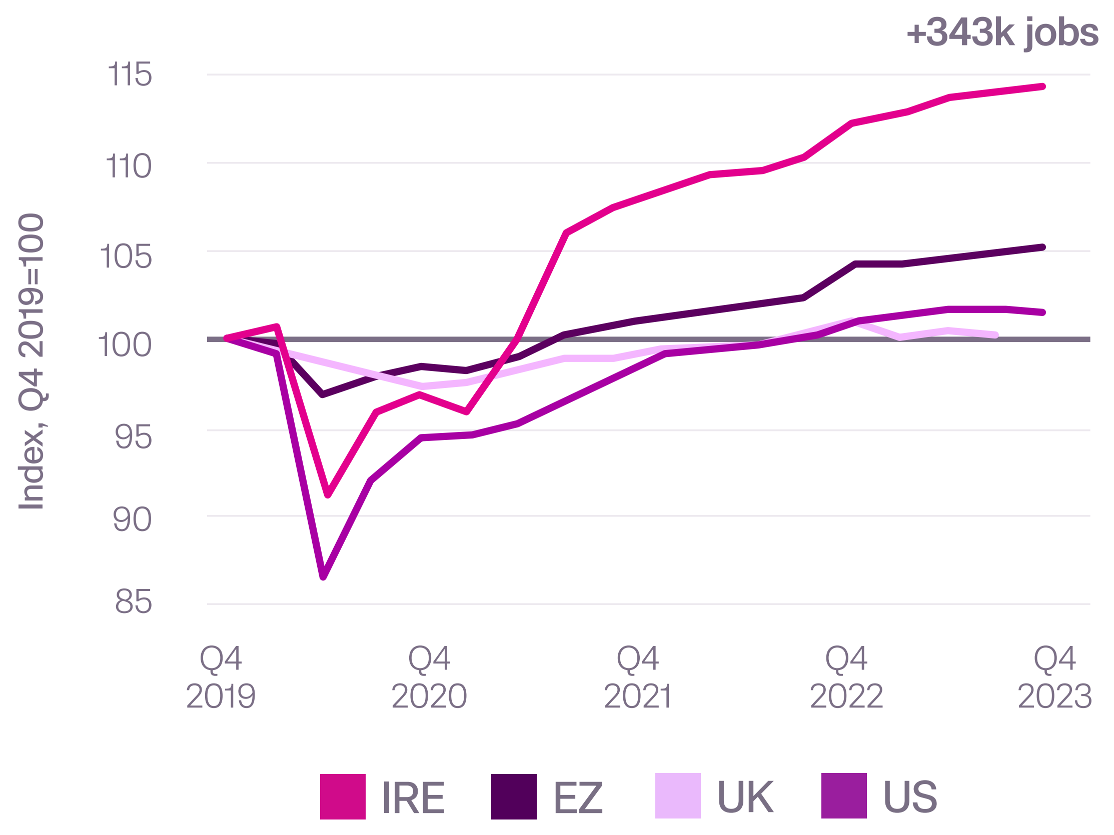
Labour Market Outlook

Labour Market Outlook

We expect continued robust growth in the labour market, with unemployment remaining close to current low levels and employment topping 2.8 million people by 2026.

The growth in the labour markets highlights the exceptional performance of the Irish economy in recent years. Since the beginning of 2020, employment has grown by nearly 340,000, or 14%, to a record high of 2.7 million people. This compares to a trough of 1.87 million in 2012 post the global financial crisis. In an international context the performance of Ireland's labour market is exceptional, far outstripping peers in European and US economies. While the labour market has experienced capacity constraints, particularly in sectors such as healthcare and construction, the growth in employment has been underpinned by two key trends.

Ireland's jobs growth vs. peers since 2020



Source: Refinitiv

First, Ireland's strong population growth has boosted the labour force in recent years, with a sharp rise in in 2022 and 2023, in particular. Second, the female participation rate (those in work and active job-seekers) has surged following the pandemic, rising to 60.4% of the working age population in Q4 2023 from 56.4% in Q4 2019. On the back of this, female employment was up 4% in the year to end-2023, compared to growth of 2.9% in male employment. Indeed, if lower pre-Covid female participation rates had sustained, we estimate there would be 95,000 fewer women in the workforce today. This shift in female participation could reflect flexible work patterns, including remote work, which has enabled more people to join the workforce, which would be one of the few positive economic outcomes from the pandemic.

However, there are signs that this exceptional growth is beginning to cool as Ireland's economy and labour market near full capacity. The latest job openings data from sources such as recruitment website Indeed suggest waning employer demand, while PMI surveys point to more modest growth in private sector employment. Moreover, the exceptional growth in the labour force is unlikely to continue at the same pace as the rise in female participation levels off, while inward migration has eased following the rise associated with the war in Ukraine in 2022 and 2023. Following a 3.5% rise in 2023, we see employment growth averaging 2.8% in 2026 and 1.7% in 2025, with total employment topping 1.8 million people by 2025. We expect the unemployment rate to average 4.5% in 2024 and 4.4% in 2025.

Female Labour Force Participation Rate

Source: CSO

Theme in focus

Central banks to embark on rate cuts this year

Where will rates land in the long term?

Central banks to embark on rate cuts this year

Following an aggressive hiking cycle throughout 2022 and 2023, rates at the major central banks have been on hold since the third quarter of 2023. As inflation continues to normalise, all are on the cusp of cutting interest rates in the coming months. However, there remains uncertainty on the trajectory of these cuts and the landing zone for interest rates in the long term.

The recent central bank meetings have seen differences in the outlook for rate cuts this year. The European Central Bank (ECB) guided a rate cut in June, while the Bank of England has indicated that it could begin cutting during the summer. However, the US Federal Reserve stated that rates will have to remain at current levels for longer than previously envisaged and may not cut until September 2024. The reason for the divergence is varying degrees of confidence that inflation is on a sustained downward trajectory in each of the economies. As of mid-May, markets are pricing in around 60 basis points (bps) of rate cuts by the ECB, 40bps by the Bank of England, and 35 bps by the US Fed, but these market prices have been volatile in reaction to incoming macro-economic data.

Where will rates land in the long term?

Longer-term there remains uncertainty on where interest rates will finally bottom out. Indeed, there has been increasing debate amongst central banks and academics as to whether the natural rate of interest (r*) has risen. The natural rate of interest is defined as the real rate of interest (including for 2% long term inflation) that is neither expansionary nor contractionary for the economy. In the decades before the pandemic, there was a downward trend in most estimates of r*. This reflected a higher propensity to save, as rising life expectancy incentivised individuals to put more away for retirement. The "global savings glut" in developing Asian and oil-producing countries also likely pushed r* lower. Meanwhile, increased preference for safe assets and lower productivity post the Global Financial Crisis (GFC) drove r* lower in the decade immediately prior to the pandemic, with many economies operating with negative interest rates.

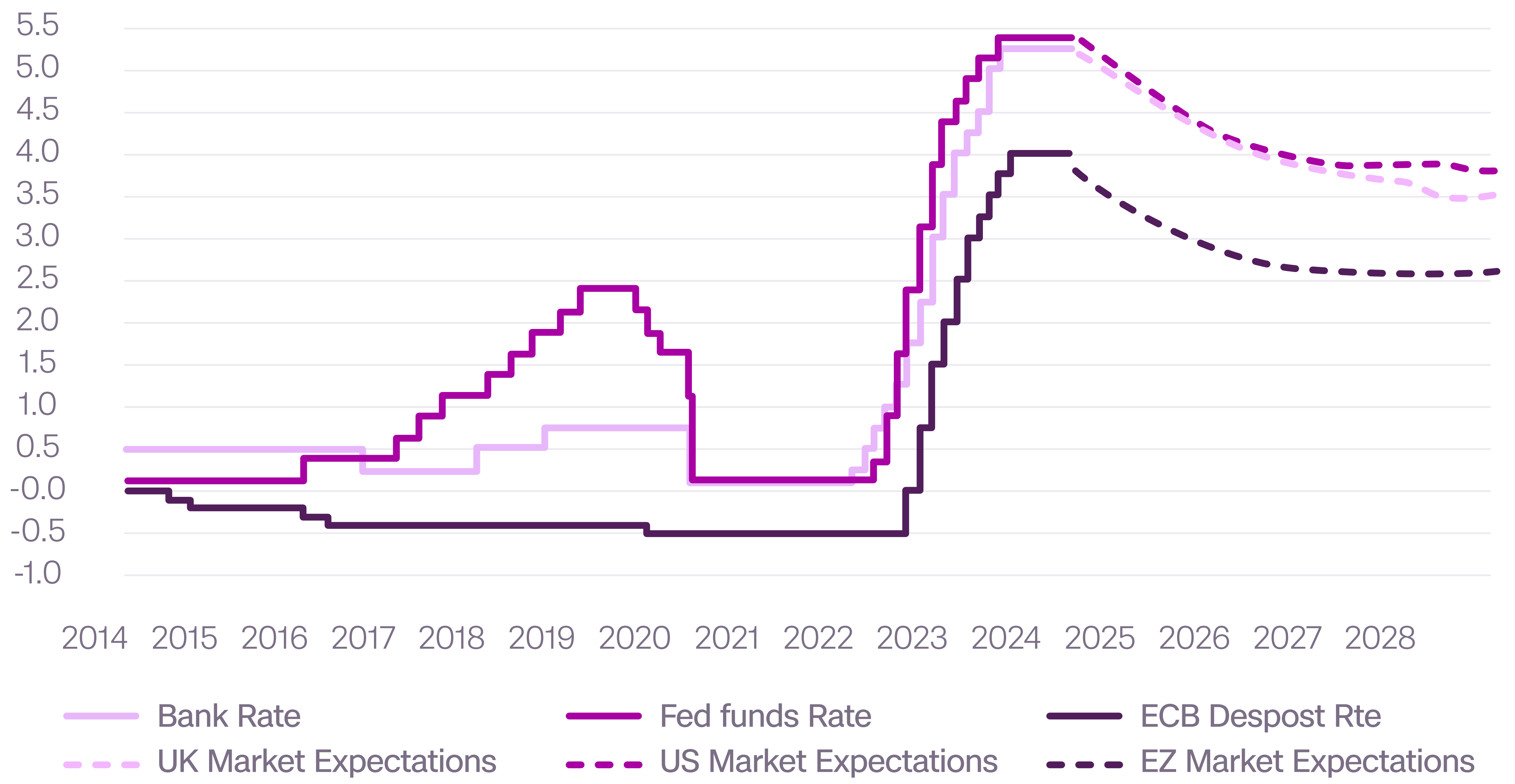
It should be noted that there is a large degree of uncertainty in estimating r*. However, several measures suggest it has recently increased relative to pre-pandemic levels. Furthermore, a number of structural developments, including shifting demographics, decarbonising the economy, increased focus on digitalisation and de-globalisation may see the balance between savings and investment tip towards the latter, which could push r*up.

Central bankers have also stated that the natural rate of interest may have risen post the pandemic. This indicates that policy rates will likely settle above the near-zero rates which prevailed following the GFC. Markets appear to be of a similar view at present, based on interest rate futures contracts.

In the Eurozone, futures pricing is for the deposit rate to decline to around 2.5% by the middle of 2026. This is broadly in-line with statistical estimates which shows r* at 0.5%, consistent with a policy rate of 2.5%. In the US, there is some divergence between market pricing, statistical measures of r*, and the Fed's own projections of where interest rates will eventually land. Statistical estimates of r* suggest a policy rate of just 2.75%, which is close to the Fed's projection for long-term rates of around 2.6%. However, market expectations (see chart below) suggests the Fed funds rate will fall to a 3.75-4.00% range by end year 2026. Markets see a somewhat similar path for UK rates, with current pricing indicating that official rates in the UK will fall to circa 3.5% in the first half of 2027.

Thus, while there is some disagreement as to where exactly long-term interest rates will land, they are likely to be higher than the ultra-low "rates" of the 2010s.

Official interest rates - market expectations



Source: Refinitiv

[1]Quo vadis, r*? The natural rate of interest after the pandemic, BIS (March 2024) – available at: Quo vadis, r*? The natural rate of interest after the pandemic (bis.org)

Appendix

Detailed Forecast Tables

Irish macroeconomic forecasts (% change)

	2023	2024	2025	2026
Consumer Spending	3.1	2.4	2.8	2.5
Government Spending	1.7	1.5	0.5	1.8
Investment	2.9	4.6	4.6	4.5
Exports	-4.8	3.5	3.3	3.5
Imports	0.4	2.8	3.2	3.6
GDP	**-3.2**	**2.4**	**2.6**	**2.4**
Modified Domestic Demand	**0.5**	**2.2**	**2.4**	**2.6**
HICP Inflation	**5.2**	**2.2**	**1.9**	**2.0**

Irish labour market forecasts

	2023	2024	2025	2026
Unemployment rate	4.3	4.5	4.4	4.4
Employment Growth	3.5	1.8	1.7	1.7
Employment ('000)	2,685	2,733	2,779	2,821
Earnings Growth	3.8	3.1	3.0	3.0

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