



The Outlook

A quarterly analysis of trends in the Irish economy

Economy to contract by 7%

- Negative carry-over from 2008 biases 2009 down
- 2010 may be flat, given global recovery

The Irish economy contracted by 2.3% in 2008, only the third year in the past fifty that GDP has fallen. Unfortunately, a fourth looks inevitable in 2009, given the fall in output in the final quarter of last year: GDP slumped by an annual 7.5% in Q4 and the carry-over effects of this alone imply a sharp decline in average growth for the year, prompting us to revise our forecast to -7%.

Most western economies are in recession and world trade is falling, so exacerbating the global downturn. Despite this, Irish exports held up remarkably well last year, as did industrial production, and the external sector provided the only significant stimulus to the economy, a feat we expect to see repeated this year. Domestic spending was and is likely to remain extremely weak, however, falling by 6% last year and a forecast 11% in 2009. House building is the main culprit, declining by 35% in 2008 and a forecast 45% this year, although non-residential construction and business spending have also slowed sharply of late. Indeed investment spending in total is forecast to fall to under 17% of GDP in 2009, from a cyclical peak of over 27% in 2005. Within that total, the resources devoted to house building have already fallen sharply, to only 4% of GDP in the final quarter of 2008 from a peak of 11.5% in 2005.

Unemployment has risen rapidly, and the unemployment rate is forecast to average 11.8% this year, reflecting a 7% fall in employment and a modest decline in the labour supply – there is no clear evidence to date that there has been a substantial exodus of migrant labour. Households are seeking to increase savings against the bleak domestic and international backdrop and this trend alongside a fall in disposable income in 2009 will result in a 7.5% decline in the volume of consumer spending, following a 0.8% fall last year.

The conditions that normally precipitate an end to recession – the passage of time, low interest rates and falling inflation – are now present internationally, and in Ireland's case prices look likely to fall (we expect CPI inflation of -2.7%) which will offer some support to real incomes. The impaired nature of the global banking system adds an additional layer of uncertainty, however, regarding the timing and strength of a recovery. There are a few more positive signs from the US of late, it can be said, and global equity and commodity markets may have bottomed but it is too early yet to conclude unequivocally that the cycle is turning. Global supply does appear to have been cut far more than warranted by demand, nonetheless, and we may see an upturn in activity before year end. If so, Irish GDP may show flat growth in 2010, albeit driven by exports rather than domestic demand.

Dr. Dan McLaughlin

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Irish GDP

Economy to contract by 7%

A sharp fall in GDP in Q4 means a negative carry-over effect...

The Irish economy, as measured by GDP, contracted by 2.3% in 2008, following growth of 6.0% in 2007 and an average annual rise of 5.6% over the previous five years. GDP is set to decline again in 2009, and the scale of that contraction is likely to be substantial, given the dismal final quarter of 2008 – GDP fell by 7.5%. Indeed, the negative carry-over effect of that figure means that growth in 2009 would average -5% even if there was no further deterioration during the year. The following year is now more likely to see positive growth, on the assumption that the global economic cycle begins to turn over the next nine months.

The plunge in house building was the main catalyst behind the downturn in 2008: residential construction fell by some 35% on average, and by an extraordinary 50% in the final quarter. The fall in house completions reduced GDP by 3 percentage points in 2008, and by 3.9 percentage points in Q4 alone, and is again likely to be a significant negative for the economy in 2009. Data available to end-February shows house completions running 47% down on the previous year, and we expect a broadly similar pattern over the remaining months of 2009. This is a larger percentage decline than in 2008 but house building's share of GDP has also fallen, to an average 6.1% last year and only 4.2% in Q4, so the impact on GDP is marginally less negative than in 2008.

Spending on home improvements rose in 2008, by 12.9%, but other non-residential construction fell, and looks set to decline more sharply in 2009 given the proposed reduction in public sector capital investment. As a result, we expect a 25% decline in total construction spending, from 20% last year.

The other component of capital formation – business spending on machinery and equipment – tends to be much more volatile on a quarterly basis, partly due to the influence of large ticket items such as aircraft. Business spending rose by an annual 15.7% in the third quarter of 2008, for example, but then plunged 47.5% in the fourth quarter, to leave the annual average change at -20%. Again, the weakness of that Q4 figure implies a steep fall in the average business spending figure for this year, even with some improvement in the final quarter, and we have pencilled in a 25% decline for 2009.

...and construction and consumer spending will again be negative...

Consumer spending in Ireland accounts for just under half of GDP and started to fall in volume terms on an annual basis in the second quarter of 2008, ending the year down by 4%. The average decline for the year was much more modest, at -0.8% however, given the positive first quarter, and spending rose by 2.2% in value terms. The latter figure implies that the savings ratio rose modestly in 2008, a supposition in line with previous experience of Irish households' response to rising unemployment, although the scale of the recent revisions to the savings data makes any comment in this area subject to large caveats. We do know that employment fell by 0.6% in 2008, and average wage growth was around 3% in our view, which alongside a sharp rise in transfers gives an estimated 4% rise in disposable income, thereby implying that the savings ratio rose to 5.8% from 4% in 2007.

Another rise in the savings ratio can be expected this year given the surge in unemployment, although this time disposable income is likely to fall in nominal terms, due to a combination of falling employment, zero wage growth, and a sharp decline in rental income, although again higher transfers will provide some offset. On the positive side, interest rates are at historically low levels, which will boost disposable income for borrowers, and CPI inflation is likely to average -2.7%, so supporting real incomes. Nevertheless, we still expect a 7.5% fall in real consumer spending this year, given the scale of the fall in employment and the swingeing tax increases in the recent Supplementary Budget.

Domestic demand (the sum of consumer spending, capital formation and government spending) fell by 6% last year, and our forecast incorporates a 10% plunge in 2009. The external sector is again likely to provide some positive offset, however, so leading to a smaller decline in overall output.

...so GDP will fall by 7% on average...

Exports did decline in 2008, but only marginally so, with a rise in service exports and strong growth from pharmaceuticals and medical devices limiting the fall to 0.4% in total exports in volume terms. As a consequence, Irish industrial production also held up much better than elsewhere in 2008, declining by only 1.3%.

Merchandise imports fell at a double-digit pace last year, in contrast, led by computer equipment, aircraft and road vehicles, although service imports did increase, which helped limit the fall in the volume of total imports to 4.4%. As a result, the external sector's contribution to real GDP rose by €5bn in 2008, thereby partly offsetting a €10bn decline in domestic demand. We expect this pattern to be maintained over the course of this year, and forecast a 10% decline in imports and a 5% fall in exports. This results in a 7% decline in GDP in 2009, which alongside a marginal fall in net profit outflows also leaves GNP growth at -7%, from -3.1% in 2008.

...but may return to flat growth in 2010.

The first quarter GDP figures may prove the worst of the year and the annual growth figure in the final quarter will be flattered by a positive base effect, as last year's dire Q4 number falls out of the annual comparison. This augurs well for an end to negative growth in 2010, again driven by net exports, although clearly this requires some recovery in the global economy. The prospects of that happening are unclear at this juncture although there are a few signs emerging from the US that a cyclical turning point is perhaps near. It is also certainly true that US production and indeed global industrial output, has fallen much faster than spending over the past six months, implying that we could see a sharp rebound in production given the low level of inventories. The return of positive growth in the US offers the best hope for the Irish economy, as domestic demand is likely to remain depressed in 2010.

Irish Economy Forecasts

	2007	2008	2009(f)	2010(f)
Personal Consumption	6.3	-0.8	-7.5	-3.0
Government Consumption	6.0	2.1	-1.0	-2.0
Capital Formation	1.2	19.9	-25.0	-14.0
Stocks (% of GDP)	-0.1	0.2	0.5	0.6
Exports	6.8	-0.4	-5.0	2.0
Imports	4.1	-4.4	-10.0	-4.0
GDP	6.0	-2.3	-7.0	0.0
GNP	4.1	-3.1	-7.0	0.0

Inflation

Prices to fall by over 2.5% this year

Lower mortgage interest is driving the CPI down...

Having averaged close to 5% over the first half of 2008, inflation fell sharply over the final six months of the year and by December stood at just 1.1%. It has fallen further over the opening couple of months of 2009 and in February prices were 1.7% lower than in February last year. Inflation on the EU harmonized measure has also fallen steadily since mid-2008, to just 0.1% in February from almost 4% last June.

The difference between the national and EU harmonized inflation rates is largely accounted for by housing costs, and mortgage interest repayments in particular, which are included in the former but not in the latter. Mortgage interest repayments have fallen dramatically as the ECB has lowered its key interest rate in response to the rapid deterioration in the euro area economy. The latter has been cut by 3% (including the 25bps reduction to 1.25% on April 2) since the autumn, with the result that mortgage interest repayments are now almost 26% lower than a year ago. Given its weight in the CPI – just over 6.5% - this decline in mortgage costs fully accounts for 1.7% decline in the CPI over the past year.

The second half of last year also saw an unwinding of the previous run-up in oil and other non-energy - notably food - prices, with Brent crude for example falling from a peak of almost \$150 p/b in June to \$37p/b in late December, though it has since risen by about \$10p/b. Mainly as a result, energy cost inflation is now negative, with prices in February almost 4% lower than in February 2008. Food price inflation has also decelerated sharply and stood at less than 1% in February, from almost 9% a year earlier. Disinflation is also evident outside of mortgages, energy and food, with inflation excluding these three categories falling from over 2% to under 1% over the past year, presumably reflecting the sharp reduction in economic activity over this period.

Looking ahead, overall inflation is likely to fall deeper into negative territory over the next few months, averaging around -4% in Q2, as the annual decline in mortgage interest costs increases even further, partly on foot of the latest decline in the ECB interest rate, and energy prices fall further on foot of the reduction in domestic electricity and gas charges from May 1st, though the pace of decline will be reduced somewhat by higher petrol prices.

...with inflation set to average -2.7% in 2009.

Assuming ECB interest rates bottom at 1% and oil prices remain broadly unchanged at around current levels, the annual rate of decline in both mortgage and energy costs will ease back sharply over the second half of the year. This in turn should mean that the annual rate of decline in the overall CPI should also begin to fall back over this period, even if inflation outside of these two areas decelerates further, which is almost certain given the weakness of domestic demand and considering that the recent rise in the euro/sterling exchange rate will still be working to dampen down prices. Overall, we expect the CPI to fall by 2.7% on average in 2009, while HICP inflation is forecast to average -1%, from 3.1% in 2008.

Inflation (CPI, % change)

	2008 (actual)	2009 (f)
Quarter 1	4.7	-1.4
Quarter 2	4.7	-4.2
Quarter 3	4.3	-3.5
Quarter 4	2.5	-1.6
Year	4.1	-2.7

Balance of Payments

Deficit narrows in 2008

The Deficit has risen in recent years...

In recent years Ireland has run a deficit on the current account of the Balance of Payments, in contrast to the mid and late 1990s when surpluses were the norm. The change became pronounced from 2005 when the deficit jumped from under €1bn to €5.7bn, and then proceeded to rise to over €10bn in 2007, before declining again last year to €8.4bn, the latter equivalent to 4.5% of GDP.

The trend deterioration reflected a number of factors. One was a fall in the merchandise trade surplus, which although still very large at over €26bn last year compares with a high of €35bn in 2002, reflecting a fall in the value of merchandise exports. The latter is predominantly a price effect, however, as the volume of visible exports has risen by 20% since 2000. This is twice the rise in the volume of imports over the same period, and the price of both has fallen, with export prices falling faster than import prices.

A second factor has been the growth of service exports, which in 2008 amounted to €68bn, compared with €81bn for merchandise exports, and hence amounting to 46% of total exports, against 20% in 2000. Service imports have risen strongly, too, but the deficit on services has shrunk from over €13bn a year in the early part of the decade to under €3bn in 2007 and €4.8bn in 2008.

...but narrowed in 2008, to 4.5% of GDP.

The combined total of the visible trade surplus and service deficit amounted to €21bn last year and has not greatly changed in recent years. Net factor outflows have continued to grow, however, amounting to over €28bn in 2008, from less than €15bn in 2000. The pace of deterioration has certainly slowed (which is key for GNP growth relative to GDP) reflecting a pick up in the growth of income earned by Irish residents on investments abroad, but the absolute size of the multinational profit outflows is such that the net balance is still on the increase. Finally, we have transfers which have shifted from a modest surplus to a €1.3bn deficit in 2008, reflecting a decline in Ireland's net receipts from the EU, and higher worker remittances paid abroad.

From a broader macro perspective the current account balance can be seen as a reflection of any imbalance between saving and investment in the economy. In that sense the deterioration in recent years can be attributed to a rise in investment relative to savings, with the household component of the latter falling. Investment as a percentage of GDP fell sharply in 2008, however, and looks set to decline further this year, which implies that the BoP deficit may decline further near term.

Balance of Payments (Euro bn)

	2006	2007	2008
Merchandise	25.0	22.5	26.3
Services	-6.8	-2.9	-4.8
Income	-24.0	-28.6	-28.4
Transfers	-0.5	-1.3	-1.3
Current Account	-6.3	-10.3	-8.4
(% of GDP)	-3.6	-5.4	4.5

Exchequer Finances

2009 Deficit now forecast at 10.75% of GDP

**The Government has been forced to
revise the fiscal outlook...**

The Irish Government brought forward the 2009 Budget to last October (it is normally in early December) in order to address the unfolding deterioration in Exchequer finances. The Minister for Finance announced a tax package at that time designed to raise €2bn (or €1.6bn net of the deflationary impact on activity) largely via an income levy and higher indirect taxes alongside a sharp reduction in the growth of current expenditure. This was expected to yield a General Government deficit of €12.2bn in 2009, equivalent to 6.5% of GDP, against an expected outcome of €10.4bn in 2008.

In the event the Irish economy (and indeed the global economy) deteriorated remarkably quickly in the final months of last year, with the result that the fiscal outcome proved far worse than anticipated; tax revenue fell by 13.7% in 2008, pushing the current budget into deficit for the first time since 1996, and leading to a General Government deficit of some €12bn.

As a result of this change in the near term outlook, the authorities produced a revised projection in January for the Exchequer finances from 2009 to 2013, incorporating a projected General Government deficit of €19bn for this year in the absence of corrective action. The Government then announced expenditure cuts, largely on the current budget and involving higher pension contributors for the public sector, designed to cut spending by €2.1bn in a full year and €1.5bn in 2009. This brought the forecast deficit to around €17bn, or under 10% of GDP.

**...and now expects to borrow
€20bn in 2009.**

The January figures were predicated on a 4.0% decline in GDP and unfortunately this now looks optimistic, as did the 9.3% projected fall in tax receipts, given the 23% fall in the first quarter. Consequently, the Government announced a new round of fiscal measures on April 7th, this time involving a sharp rise in income taxes (€1.8bn), some further current spending cuts (€0.9bn) and a €0.6bn reduction in capital spending. As a result, the Minister for Finance now expects the General Government balance to emerge at €18bn and that the Exchequer Borrowing Requirement will be just over €20bn.

Exchequer Finances (Euro bn)

	Actual 2008	Initial Budget 2009	Latest Budget 2009
Current Spending	44.7	48.2	46.4
- Voted	40.8	42.2	40.5
- Non-Voted	3.9	6.0	5.9
Revenue	41.6	43.5	35.3
- Total	40.8	42.8	34.4
- Other	0.8	0.7	0.9
Current Budget Balance	-3.1	-4.7	-11.1
Capital Balance	-9.6	-8.7	-9.2
Exchequer Balance	-12.7	-13.4	-20.4
General Government Balance	-11.8	-12.2	-18.4
(% of GDP)	-6.3	-6.5	-10.8

The Irish Labour Market

Employment to fall by over 7%

No evidence of large migrant exodus...

The speed at which the Irish economy deteriorated in 2008 surprised most observers and this is particularly true in relation to the labour market. Employment fell by 87,000 or 4.1% in the year to the fourth quarter, having risen by 67,000 twelve months earlier, a rise of 3.2%. This swing in the jobs market was predominantly driven by the construction sector, with employment falling by 46,000 in Q4, 2008. Other sectors began to shed workers as the year unfolded, however, as consumer spending retrenched; the numbers employed in wholesale and retail fell by 18,000 in the fourth quarter, with manufacturing shedding 12,000 workers, hotels 11,000 and financial services 12,000. Indeed, the only sectors which saw employment growth were education (6,000), health (4,000) and transport (1,000).

The huge job gains seen earlier in the decade had attracted into Ireland large numbers of migrant workers and this begged the question of what these migrants would do in the event of a downturn. On the evidence to date, it would appear that there has certainly not been a mass exodus. The labour force did fall in the year to Q4 2008, but modestly so, by 17,000 or 0.8%, and the numbers of non-Irish nationals fell marginally from the previous year, to 349,000 from 355,000.

The combination of a steep fall in employment and a modest decline in the labour force resulted in a sharp rise in the numbers unemployed, to 171,000 in Q4, a 70,000 rise on the year. This increase also pushed the unemployment rate up to 7.7% from 4.5%, the latter having remained broadly unchanged for the previous five years.

...so large jobs fall will result in an unemployment rate averaging 11.8%.

The available data for 2009 implies that employment has fallen at an even faster pace in recent months. Notified redundancies, which even in the boom years averaged 2,000 a month, have risen to around 6,500 a month of late and the CSO estimates that the unemployment rate in March rose to 11%, or to an average of 10.3% in the first quarter. The latter implies an unemployment figure of 225,000, and therefore an annual employment fall of 145,000 assuming that the labour force continued to decline at a modest pace. On that basis, the average fall in employment in 2009 is now likely to be over 7% or 152,000 on the assumption that the pace of lay-offs slows. A further fall in the labour force is likely in response to this unprecedented decline in jobs, but the scale is uncertain, given the large migrant component - we expect an average fall of around 30,000. If so, this would leave the average unemployment rate for the year at 11.8%, with the end-year figure in excess of 13%.

Labour Market (annual average '000)

	2007	2008	2009(f)
Employment	2117	2114	1953
Labour Force	2218	2241	2213
Unemployment	101	137	260
Unemployment Rate (%)	4.5	6.1	11.8

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