



# The Outlook

A quarterly analysis of trends in the Irish economy

## GDP probably grew in first quarter

- Data points to export-led expansion this year
- Consumer spending stabilising after substantial fall last year

The consensus view in Ireland is that the economy will return to growth in the second half of the year, although it is thought this will not be sufficient to offset a first half decline, leaving annual GDP growth for 2010 in negative territory, albeit marginally so. The latest data challenges this view, however, as industrial production has soared in the first two months of the year, with retail sales returning to positive annual growth in February, boosted by the car scrappage scheme. The implication, in the absence of significant data revisions, is that the economy grew in the first quarter, and substantially so, which if true, makes a positive GDP reading for the full year much more likely, and we retain our 1% growth forecast.

Irish exports fell marginally last year against a backdrop of a plunge in world trade and it is not unreasonable to expect a rise in exports in 2010 given the global recovery and a return to growth in Ireland's main markets. Consequently, the external sector is again likely to be the main driver of the Irish economy, offsetting another large forecast fall in capital spending, notably in building and construction.

The trend in the labour market remains a constraint for Irish households (we expect a further fall in employment and wages) but disposable income in the aggregate will be cushioned by government transfers, falling taxes in total and falling prices. The net result is that real disposable income may be flat this year following a sharp decline in 2009 and we expect consumer spending to stabilise, on the assumption that the savings ratio is broadly unchanged, following a steep increase last year.

Prices in Ireland are falling on an annual basis, unlike the trend in the euro area, but we expect this to change by the year end, although average inflation for 2010 is likely to remain negative, at -1.2%. The fall in employment has prompted net migration and a sharp reduction in the participation rate, and the resulting fall in the labour force may mean that the unemployment rate averages around the first quarter figure of 13.4% for the year as a whole.

Finally, a return to positive growth, if export led, may not have a huge impact on the exchequer's finances but we expect the Budget to emerge broadly on target by year-end. Similarly, a rise in Irish exports may also translate into strong multinational profits with the result that the income of Irish residents, as measured by GNP, may fall by 1%, despite the forecast 1% rise in GDP.

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## Irish GDP

## GDP to expand this year

**GDP has fallen by over 12%...**

The recently published National Accounts data for Q4 2009 incorporated some revisions to past releases and revealed that the Irish economy, as measured by seasonally adjusted real GDP, has recorded flat or negative growth for eight consecutive quarters, with a cumulative decline in output of 12.5%. The fall in GNP, which measures the income of Irish residents, has been even larger, at some 17%, marking this recession as unusually long and steep relative to Irish historical experience and our euro peers (GDP there fell by 4.1%).

One factor in this Irish underperformance is the scale of the decline in capital spending. In 2009 as a whole, for example, capital formation plunged by some 30% thereby reducing GDP by 6.6 percentage points and taking investment's share of GDP down to 17% from a cycle high of over 27% in 2005. Business spending on machinery and equipment tends to be one of the most volatile components of demand and fell some 16% on average last year, albeit rising by an annual 2% in the final quarter following a 25% fall in Q3. The trend in building and construction output has been more consistently negative, declining by 34% in 2009 and at a similar annual pace through the year. Within this category housebuilding fell by 48%, and by Q4 accounted for only 2.5% of real GDP, from a cyclical high of 12%.

Personal consumption was the other main catalyst behind the fall in Irish output, with a 7.2% decline last year reducing GDP by 3.5 percentage points. Aggregate wage income fell by around 10%, led by an 8% fall in employment, but transfers rose and total taxes on income fell, so reducing the fall in disposable income to an estimated 7%, although the absence of data on non-wage income makes any such estimate tentative. With that caveat it would appear that the 10% fall in nominal consumer spending, was much larger than the decline in disposable income, implying that the savings ratio rose very sharply – we estimate a rate of 11.0%, from 2.3% in 2007 (the last official figure).

**...with exports offering some support...**

Last year also saw an unusually large decline in inventories, amounting to €2.8bn in real terms, reducing GDP by another 1.5 percentage points. Consequently, the decline in GDP in 2009 might well have been in double digits but for a substantial contribution from the external sector; exports fell by 2.3% in volume terms but imports declined by 9.3%, with the result that net exports added 4.5 percentage points to GDP growth, limiting the total fall in GDP to 7.1%.

Service exports actually rose in volume terms in 2009 and even exceeded merchandise exports in the fourth quarter, highlighting how the composition of Irish exports has shifted away from the manufacturing of I.T. equipment, the staple of the 1990's. This is also evident in the merchandise export data, with organic chemicals and medical and pharmaceutical products accounting for over half the total merchandise exports in 2009. These sectors in Ireland are dominated by multinationals and the relatively strong performance of these companies was also reflected in a rise in multinational profits, in contrast to falling international profits from Irish companies, which helps to explain why GNP fell by more than GDP in 2009, declining by over 11%.

**...which is likely to be the case this year...**

This Irish export out-performance occurred against a backdrop of falling world trade, so it is not unreasonable to expect Irish exports to rise this year in light of the global recovery and a return to growth in Ireland's main trading partners. Moreover, January saw a substantial rise in merchandise exports and a surge in industrial production. Consequently, we have pencilled in a 3% volume rise in exports in 2010, which set against a further, albeit modest, fall in imports of 1% results in a positive contribution to GDP of over 3 percentage points.

The combination of stronger exports and rising industrial production also implies that inventories may no longer be falling. We have assumed a much more modest inventory decline in 2010 which has the affect of boosting GDP growth, so a rise for the year would be an upside surprise.

**Capital spending  
to fall again...**

Domestic demand is likely to fall again, however, particularly capital spending, as there is little to suggest anything other than another substantial decline in building and construction and we forecast a 25% contraction in 2010. Spending on machinery and equipment is also expected to fall on average over the year, but this time by 5%, on the basis that the global recovery and the rise in retained profits by multinationals in Ireland will prompt some capital investment as the year unfolds. The net result is that overall capital spending is forecast to fall by 20%, which will reduce GDP growth by 3.5 percentage points.

**...although consumption  
may be flat...**

The picture for consumer spending is less negative, as the data shows a marked moderation in the recent pace of decline; spending fell by only 0.3% in Q4, against 4.9% on the first quarter of 2009, and retail sales returned to positive annual growth in February, helped by the car scrappage scheme. The labour market trend remains a key constraint for households (we expect a 4% fall in employment and a 2% decline in wages) but government transfers, lower tax payments in total, and falling prices will soften the aggregate blow. We assume an unchanged savings ratio around 11%, so the forecast 2.5% fall in disposable income results in a similar fall in the value of consumer spending, although this is all due to falling prices, with real consumption unchanged.

**...GDP may have risen in  
first quarter and is  
forecast to grow in 2010.**

GDP is therefore facing a negative influence from domestic demand against positive contributions from the inventory cycle and net exports and these may prove more than an offset, leading to a 1% rise in GDP. This implies a return to positive quarterly growth at some stage (zero growth in each quarter would leave the annual growth rate in 2010 at -2%) and the monthly PMI's are supportive on that issue, with the manufacturing index rising to 53.0 in March and the services PMI at 49.6. The recent trend in these indices would therefore imply a positive GDP reading in Q2 but the published industrial production and retail sales data to February points to a high probability of a positive GDP figure in Q1, and a strong one at that. If that indeed materialises the consensus growth forecast for 2010 would be revised up substantially. Nonetheless, it is the recovery in the global economy which still offers the best prospect of an Irish upturn rather than any likely domestic development, and it may be 2011 before domestic demand picks up on a substantial basis; we expect GDP to rise by 3% next year, which is in line with the consensus view.

**Irish Economy Forecasts (% change)**

	<b>2009 (actual)</b>	<b>2010 (f)</b>	<b>2011(f)</b>
Personal Consumption	-7.2	0.0	2.0
Government Consumption	-1.2	-3.0	-1.0
Capital Formation	-29.7	-20	-5.0
- Building and Construction	-33.8	-25	-10
- Machinery and Equipment	-15.7	-5.0	5.0
Stocks (% of GDP)	-1.5	-0.2	0.3
Exports	-2.3	3.0	6.0
Imports	-9.3	-1.0	4.0
GDP	-7.1	1.0	3.0
GNP	-11.3	-1.0	2.5

## Inflation

## Irish price trend at odds with euro area

**Irish prices still falling on an annual basis...**

Ireland's status as a small, open economy means that academic research has tended to emphasise international price trends and the exchange rate as the main determinants of inflation in Ireland, as opposed to domestic economic conditions. However, the scale of the recession in Ireland, both in absolute terms and relative to the euro norm, implies that the size of the Irish output gap would put downward pressure on the Irish price level. Moreover, Ireland's effective exchange rate rose by 10% in the three years to end-2008, with the lagged effect adding a further disinflationary impetus.

Irish prices duly fell relative to the euro area in 2009 and, unlike the latter, deflation is still clearly evident. The annual inflation rate on the HICP measure, for example, was unchanged at -2.4% for the first three months of 2010, with only two of the twelve commodity groups showing annual price increases (transport and education). Food prices fell 7.8% in the twelve months to March so contributing -1.1 percentage points to the annual inflation rate, with clothing and footwear down 13.7% and contributing another -0.7 percentage points. The other significant contributors were housing (-0.5 percentage points) and restaurants and hotels (-0.4 percentage points) with rising energy costs the only main offset (transport added 0.7 percentage points).

**...although mortgage interest now much less of a factor.**

Higher energy costs may well push up the index again over the next few months and the recent rise in wholesale food prices implies that the unusually long period of falling retail food prices will soon come to an end. These factors alongside negative base effects may mean that HICP inflation will emerge as the year closes, although the average inflation rate for 2010 is very likely to remain negative, at -1.3%, following -1.7% in 2009.

The main difference between the HICP inflation measure and the Irish CPI is the latter's inclusion of mortgage interest, which adds a degree of volatility and largely explains why inflation on that measure was much weaker in 2009, averaging -4.5%. At one point last year mortgage interest had fallen by almost 50% on an annual basis, but the annual decline in March had slowed to only 16%, reflecting base effects and some upward movement in mortgage rates over the last few months. These base effects will remain a feature until August and by that stage we expect the annual CPI deflation rate to be under 1%, before turning positive by year-end. Again, though the average inflation rate for the year will be negative, at a forecast -1.2%.

**Inflation (CPI, % change)**

	<b>2009 (actual)</b>	<b>2010 (forecast)</b>
Quarter 1	-1.5	-3.4
Quarter 2	-4.5	-1.6
Quarter 3	-6.1	-0.5
Quarter 4	-5.8	0.6
Year	-4.5	-1.2
HICP	-1.7	-1.3

## The Irish Labour Market

## Unemployment rate may be stabilising

**Employment fell by over 8% in 2009...**

Irish employment began to decline in the third quarter of 2008 on a seasonally adjusted basis and by the final quarter of 2009 stood at 1.88 million, having fallen by 256,000 or 12%. The pace of decline slowed over the course of last year, however, from 73,000 in the first quarter (3.6%) to 23,000 in Q4 (1.2%). The pattern of notified redundancies is similar, averaging over 7,000 a month in Q2 2009 to under 6,000 in the first quarter of 2010.

The construction sector has borne the brunt of the downturn; employment peaked in that industry earlier than in the general economy but in the last eighteen months alone job losses in construction account for nearly half the total fall in employment. As a result, construction now accounts for 7.2% of total employment, from a cyclical peak of 13.7%, and further job losses in the sector are likely given the trend in the leading indicators of housebuilding. Other sectors such as manufacturing and the retail trade are also seen as shedding labour, and the public sector will not prove a source of job creation, given the fiscal position. Consequently, we expect total employment to fall by some 4% on average in 2010, following an 8.2% decline last year, with some stability emerging next year.

The supply of labour proved extremely responsive to demand during the boom years and the same can be said about the downturn; the labour force fell by 70,000 or 3.1% in the year to the fourth quarter of 2009. This was driven by a significant fall in the participation rate (it now stands at 61.2% from a cycle peak of 64.8%) which is now declining across all age cohorts, but particularly in the 15-19 and 20-24 age groups, no doubt due to more young people staying on in school or enrolling in third level courses.

**...but falling labour supply dampens unemployment rate rise.**

Migration is an additional factor, with the large net inflows common in recent years giving way to a net outflow. This amounted to 8,000 in the year to April 2009 but the figure for April 2010 may well have reached 50,000 or more.

Migrant labour has certainly been hit harder by job losses; non-Irish nationals in employment fell by over 16% in the year to Q4 2009, or by 50,000 against a 6.7% decline for Irish nationals. Moreover, of the former only 17,000 were classed as unemployed, with a 34,000 fall in non-nationals in the labour force.

The fall in the labour force has meant that the rise in the unemployment rate has been less steep than many expected, although the figures have recently been revised higher. The unemployment rate was unchanged at 13.4% from the first quarter and we expect that figure to be the average for the year, with a modest decline seen in 2011, reflecting a stabilisation in employment and some further modest falls in the labour force.

**Labour Market (annual average, '000)**

	2009	2010(f)	2011(f)
Employment	1929	1852	1852
Labour Force	2187	2138	2115
Unemployed	259	286	263
(%)	11.8	13.4	12.4

## Exchequer Finances

## Taxes modestly behind profile

**Taxes were 3.5% behind expectations in Q1...**

The 2010 Budget projected an Exchequer Borrowing Requirement (EBR) of €18.8bn, comprising a current budget shortfall of €13.7bn and a capital deficit of €5.1bn. Current spending was forecast to rise by some 4%, due to a substantial increase in debt service costs, with net voted spending (i.e. excluding debt payments) flat relative to 2009. Tax receipts were projected to fall by some 5%, but total revenue was expected to match the 2009 outturn, thanks to the fees paid by those banks covered by the Irish Government deposit guarantee. The result was a General Government deficit target of 11.6% of GDP, and as such similar to the 2009 outturn. The Department of Finance estimated the 2010 cyclically adjusted deficit to be broadly unchanged from the previous year, implying the Budget was neutral in terms of fiscal policy, despite incorporating a €4bn cut in expenditure (2.4% of GDP).

The Budget arithmetic was predicated on a 2.8% fall in nominal GDP in 2010, including a 1.3% volume decline. This was in line with the consensus at the time but the latter has now moved to around -0.5%, and the 2009 GDP outcome was also slightly better than anticipated by the government. The implication is that the deficit might now be expected to be lower than projected, although the exchequer figures for the first quarter are not overly encouraging in that regard.

The annual pace of decline in tax receipts is beginning to slow, to -15% at end-March from -19% at end-December, but revenue is emerging behind profile, albeit not dramatically, at €267m, or 3.5% of the end-March target. Capital taxes are running ahead but income tax is €105m behind profile, with corporation tax experiencing a similar shortfall. VAT is also adrift of the target (€54m), although the Department of Finance feels the original Budget target is still likely to be achieved, particularly as the economy is widely expected to pick up momentum as the year unfolds.

**...but Budget still broadly on target.**

On the spending side, the data shows current spending down 1.8% year-over-year, and behind profile, with net voted spending some 6% below the corresponding figure in 2009. Capital spending, too, is running behind profile although the Minister for Finance puts these spending shortfalls down to timing issues rather than to any more fundamental factors.

The EBR ended the first quarter at €3.9bn, against €3.7bn a year earlier and for the moment we are inclined to forecast an outturn in line with the Budget projection.

**Exchequer Finance (€bn)**

	2009 (Actual)	2010 (Budget)	2010 (Forecast)
Current Expenditure	45.2	47.1	47.1
- Voted	40.2	40.2	40.2
- Non-voted	5.0	6.9	6.9
Revenue	33.9	33.4	33.4
- Tax	33.0	31.0	31.0
- Other	0.9	2.4	2.4
Current Budget Balance	-11.4	-13.7	-13.7
Capital Balance	-13.3	-5.1	-5.1
Exchequer Balance	-24.6	-18.8	-18.8
General Government Balance	-19.3	-18.7	-18.7
(% of GDP)	11.7%	11.6%	11.6%

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**Funding the Exchequer Deficit**

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## Half funding target already achieved

**The NTMA has issued over €10bn this year to date...**

The 2010 exchequer deficit was forecast at €18.8bn by the Minister for Finance in the December budget, and the NTMA subsequently announced a bond issuance target of €20bn for the year, compared with the 2009 outturn of €33.7bn. The Agency envisaged eleven scheduled monthly bond auctions and syndicated issuance on an opportunistic basis.

In the event the demand for Irish Government debt has been strong, allowing the Agency to issue some €10bn of bonds in the first three months of the year (i.e. half the annual target). Over €700m has also been raised through the National Savings Schemes (from retail investors) giving a total funding figure of €9.3bn when account is taken of €1.7bn in commercial paper redemptions. This compares with an exchequer deficit of €3.9bn in Q1, so boosting the NTMA's cash balances by €5.3bn, bringing the total outstanding to €27.2bn.

This is a comfortable cushion for the Agency should market conditions prove less positive, although all of the available evidence points to a reduction in the perceived risk of holding Irish government debt. The 10-year spread over Germany, for example, has traded in a relatively narrow range around 145bps since the turn of the year, from a high of 284bps in the spring of 2009, implying that the market is clearly differentiating between Ireland and Greece, and indeed Ireland and Spain, as the 60bps spread there is half its level of a year ago. Similarly, the 5-year CDS spread for Ireland is now trading around 150bps, implying a 12.5% probability of default, against a 30% implied probability in February 2009.

**...and bank re-capitalisation has no significant funding implications for 2010.**

The Irish Government has introduced a new form of liability guarantee for Irish banks, allowing qualifying institutions to issue guaranteed debt with up to a 5-year maturity, and four institutions have issued at that tenor for a total of €7.5bn. Sums have also been raised at shorter maturities and a number of commercial paper and CD programmes have been opened in a variety of currencies.

Last year's EBR included €4bn for the re-capitalisation of Anglo Irish Bank, and this year's €20bn target excluded any additional funds for the banking sector, even though it was universally believed that additional capital would be required. The Minister for Finance did announce re-capitalisation plans in late March, following a transfer of the first tranche of loans to NAMA and the introduction of a new capital regime for the banking sector, but they do not carry any immediate significant implications for the funding total. If required, the Government intends to convert its existing preference shares in Bank of Ireland and Allied Irish Bank into equity (the original investment came from the National Pension Reserve Fund), but will supply fresh capital to two building societies, EBS and Irish Nationwide, by way of €100m equity in each, with the latter also receiving an additional €2.6bn Promissory Note. Anglo Irish Bank also received capital of €8.3bn via this Promissory Note route, which is payable over 10-15 years rather than as an upfront lump sum.

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