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Bank of Ireland Global Markets

TheOutlook

A quarterly analysis of trends in the Irish economy

Return to growth in 2010

- The global recovery should boost Irish exports
- Domestic demand likely to remain weak

The global recession is over and Ireland's main trading partners appear to have returned to growth in the third quarter, amid more upbeat forecasts for the world economy in the coming year. The Irish data has also tended to surprise to the upside of late, notably the labour market, in welcome contrast to the dismal readings common from last autumn.

We noted in our previous 'Outlook' that the worst may be over for the Irish economy and this may indeed prove to be the case: GDP stopped contracting in the second quarter, with consumer and business spending rising, although the plunge in activity over the previous nine months still meant that GDP contracted by 7.4% on an annual basis.

The recession in Ireland has seen a substantial rebalancing in the economy, away from domestic demand and towards exports. Housebuilding is falling by 50% a year and now accounts for only 3.3% of real GDP from 11.5% in 2005, with construction as a whole under 12.5%, virtually half its share of GDP at the peak of the boom. Households have cut discretionary spending in order to rebuild savings, which may exceed 12% of disposable income this year, from 2.3% in 2007. Exports, which have held up remarkably well amid an unprecedented plunge in global trade, amounted to 88% of GDP in the second quarter, from 79% in 2006.

Despite the second quarter data, it is too early to say that the recession in Ireland is over, although a positive quarterly growth reading is certainly possible in Q4 or the first quarter of 2010. This is likely to be driven by exports and business spending, rather than the consumer, and these are volatile in the short-term, although one would expect exports to pick up on a more consistent basis next year assuming that the global recovery maintains momentum. On that expectation, we are revising up our forecasts, with GDP growth now seen at 1% next year, from our previous flat reading. For 2009, GDP is expected to contract by 6.5% on average, from our previous 7% forecast, with the annual pace of decline slowing sharply in the fourth quarter, to -2.5%, from -8.4% in the first half of the year. Employment is likely to continue to fall in the near term, although the exodus of immigrant labour means that the unemployment rate is likely to average 13.3% next year and peak around 13.5%. The deflation cycle also appears to be at a turning point, and we expect the annual inflation rate to return to positive territory in the second half of 2010.

Dr. Dan McLaughlin

Irish GDP

Economy stops contracting in Q2

The economy had flat growth in Q2…

The Irish economy, as measured by GDP, stopped contracting in the second quarter according to the recently published National Accounts. The zero quarterly growth reading followed a revised 2.3% fall in Q1 and an extraordinary 5.6% plunge in the final quarter of 2008. As a consequence of the latter two readings, GDP on an annual basis was still substantially down in Q2, at -7.4%, but this compared with a -9.3% reading in Q1. The second quarter figure was also stronger than the consensus expectation and as a result the consensus forecast for this year and next has been revised up.

Domestic demand actually rose by a seasonally adjusted 1.3% in Q2, driven by a double-digit increase in spending on machinery and equipment. This was strongly influenced by the volatile aircraft component which resulted in a 5.7% increase in overall capital spending but is unlikely to be repeated in Q3. Consumer spending also rose, however, by 0.5% following an auto-related 5.2% plunge in Q1, and the bounce in domestic demand boosted imports, which rose by 1% in volume terms in the quarter. The latter outpaced the growth in exports, (0.2%) with the result that the external sector had a negative influence on GDP, reducing growth to zero in the quarter.

…although strong multinational profits resulted in a further fall in GNP…

Exports have performed relatively well over the past year nonetheless, particularly given the collapse in world trade following the Lehman demise in September 2008; the value of exports was unchanged in Q2 from a year earlier with a volume decline of 2.5%. This compares with an annual fall in the volume of imports of 7.1%, so the Irish economy has already experienced a substantial rebalancing, with exports accounting for 88% of real GDP in Q2 from 78% in early 2007. This also sits uneasily with the widely-held view that Ireland has lost competitiveness on a grand scale.

This relative export strength is also evident in multinational profits, which rose to €8.9bn in Q2 from €7.7bn a year earlier. Some €4.8bn of these profits were reinvested in Q2, following a €6.2bn reinvestment in Q1, so boosting FDI in Ireland, which rose to €13bn in the first half of the year. The fact that multinationals here outperformed indigenous companies also meant that GNP, which takes account of international profit and interest flows, fell further than GDP on an annual basis in Q2, by 11.6%, and also recorded a 0.5% seasonally adjusted fall in the quarter.

The global recession is now over and Ireland's main trading partners all appear to have recorded growth in Q3, so we expect Irish exports to benefit, picking up in the coming months and expanding more strongly in 2010. This export-led growth remains the most likely driver of an Irish recovery as some key components of domestic demand may remain weak. Consumer spending, for example, has been constrained by falling employment, flat to negative wage growth, a rise in the average tax rate and a rise in the savings ratio. It is difficult to be too precise on the latter, given the absence of timely Irish income data and the scale of recent revisions to past data, but it seems reasonably clear that the savings ratio this year is back in double digit territory (we estimate 12.5%), from 7% four years earlier and 2.3% in 2007, the last official figure published.

…the recovery will be export-led…

It is true that the fall in interest rates provides a substantial boost to mortgage borrowers, and consumer prices have also fallen, offering some support to real incomes. Consumer confidence too has risen from last year's lows, albeit still weak by historical standards, and the recent slowdown in the pace of unemployment growth is also likely to support sentiment. Nevertheless, it may be well into 2010 before we see a sustained quarterly increase in consumer spending, and we still expect a 3.6% fall on average next year, from a 7.5% contraction in 2009.

Residential construction is still falling at a 50% annual rate (implying around 25,000 completions this year from 52,000 in 2008) and this is unlikely to change in the near term although it has become less significant than it was; that component of spending fell to only 3.3% of GDP in the second quarter. Non-residential investment is also falling, and the growth in home improvements has slowed so construction spending in total looks set to decline again next year, by 20% following a 30% collapse in 2009.

Capital spending on machinery and equipment may well stop falling over the next year, particularly if the global recovery gathers and maintains momentum. That component tends to be very cyclical and strongly influenced by interest rates and growth expectations and has already fallen dramatically, so a rebound is likely at some stage.

…with 1% growth seen in 2010.

The global recovery and the second quarter data does mean that the end of the Irish recession is likely to be sooner than previously thought, and a positive quarterly GDP reading is certainly possible by the fourth quarter of this year, or by the first quarter of 2010. The trend evident in the monthly PMI indicators support this view; the services PMI has risen to 46.5% from a low of 31.8% in February, with the manufacturing equivalent rising to 46.6% in September from a February low of 33.2%, and the equivalent indicators in the major economies have risen or breached the 50 reading, implying an end to contraction. The money supply too, as measured by M1 has started to pick up and recorded positive annual growth in August, following double digit declines over the past year. We now expect GDP next year to rise by 1% on average, and to have returned to positive annual growth by the first quarter of 2010 at the least, with a similar rise for GNP. The published quarterly pattern also means that average GDP growth in 2009 is now forecast at -6.5%, from -7% with GNP at -9.5% from -10%. The annual fall in GDP may have slowed to -2.5% by the fourth quarter, from -8.4% in the first half of the year.

Irish Economy Forecasts

	2008	2009	2010(f)
Personal Consumption	-1.0	-7.5	-3.0
Government Consumption	2.6	0.0	-2.0
Capital Formation	-15.5	-25.9	-15.9
- Building and Construction	-15.5	-30.0	-20.0
- Machinery and Equipment	-15.5	-12.0	-5.0
Stocks (% of GDP)	0.2	0.0	0.8
Exports	-1.0	-3.0	4.0
Imports	-2.1	-9.5	-2.0
GDP	-3.0	-6.5	1.0
GNP	-2.8	-9.5	1.0

Deflation cycle at turning point

Prices in Ireland have fallen further than the euro norm…

Ireland's annual inflation rate, on the HICP measure, turned negative in March, three months earlier than in the euro area as a whole, and prices here have fallen faster; the euro inflation rate in September was a provisional -0.3%, against an Irish figure of -3.0%, the lowest in the zone.

The Irish economy has contracted more than the euro average and consumer spending here has been particularly weak, so one would expect more downward pressure on Irish prices. In addition, the euro has appreciated by some 40% against sterling over the past two years, and the UK accounts for one-third of Irish imports implying a further source of deflationary pressure on the Irish high street. This influence is evident in food prices, which have fallen by 6.0% in the past year in Ireland, against a 1.2% decline in the euro area. Similarly clothing and footwear prices have been much weaker in Ireland, declining by over 13% against a modest rise in the euro area. The Irish housing market has also experienced a bigger correction than the norm across Europe, with the result that rents there have fallen by some 16%, contributing to a much larger fall in Irish housing costs than seen on the continent.

The deflationary trend may now have bottomed in the euro area, and the consensus view is that prices may have started rising again on an annual basis by the final months of the year, in large part due to negative base effects (last year's plunge in oil prices falls out of the annual comparison). The same is likely to happen in Ireland, particularly as the rapid fall in food prices may also come to a halt. Consequently, we anticipate a return to positive annual inflation by the second half of 2010.

…but the deflation cycle may be turning.

The more widely quoted measure of Irish prices, the CPI, has recorded a much sharper fall in inflation, largely due to the influence of mortgage interest. This accounts for 7% of the index and has fallen by some 50% over the past year, thereby reducing the CPI by 3.5 percentage points. This explains why CPI inflation, at -6.5% in September, is much weaker than the HICP measure, but again the summer months may prove to be the cycle low, particularly as mortgage rates are unlikely to fall further. Indeed some lenders have raised rates of late, but even if the ECB repo remains unchanged for the next year, the impact of past mortgage cuts will drop out of the twelve month comparison. Therefore we expect CPI inflation to end this year around -4.0%, from the current -6.5%, and to average -0.2%, from -4.3% in 2009.

Inflation (CPI, % change)

	2009 (e)	2010 (f)
Quarter 1	-1.5	-2.4
Quarter 2	-4.5	-0.3
Quarter 3	-6.1	0.8
Quarter 4	-5.2	1.4
Year	-4.3	-0.2
HICP	-1.3	0.2

The Irish Labour Market

Employment fall prompts migrant outflow

The pace of job losses has slowed…

The deterioration in the Irish labour market has been more pronounced than experienced by most other developed economies: the unemployment rate in the second quarter of this year was a seasonally adjusted 11.6% from 5.5% a year earlier and 4.7% in the second quarter of 2007. Employment began to fall in the spring of 2008 and declined by 174,000 in the year to Q2 2009. This represents an 8.2% plunge and as such a steeper decline than the 7.4% contraction in GDP recorded over the same period.

The pace of job loss has slowed, however, to a seasonally adjusted 36,000 (1.8%) in the second quarter from 69,000 (3.4%) in Q1. The construction sector accounted for two-thirds of the Q2 decline, with some sectors recording positive employment growth, including education, financial services, transport and hotels and restaurants, albeit offset by further job losses in manufacturing, the wholesale and retail trade and agriculture.

The labour force began to decline with employment, albeit at a much slower pace; the annual fall in Q2 was 37,000 or 1.6%. Consequently, the numbers classified as unemployed have risen very sharply, to 265,000 in the second quarter, from 127,000 a year earlier and a cycle low below 100,000 in 2006. Again, though, the rise in unemployment has slowed, particularly in recent months: the unemployment rate rose by 2.3 percentage points during the first quarter to 10.8%, by 1.3 percentage points in Q2, to 12.1%, and by 0.5 percentage points in the third quarter. Indeed the unemployment rate was unchanged at 12.6% in September from the previous month, and the increase in the numbers claiming benefit (the Live Register) slowed to only 600, from a monthly average of 25,000 in the first quarter of 2009.

…and migrant outflows have dampened the unemployment rate.

This relative improvement in the unemployment trend largely reflects a substantial swing in migrant flows, however, with annual data to April 2009 showing a net 8,000 migrant outflow, the first negative figure since 1995. There was still a large immigration inflow in the year (57,000) but outflows rose to 65,000, the highest figure in twenty years. The pick-up in Irish nationals emigrating was marginal in relation to the past four years, and the largest emigrant group was from the EU accession states implying that some recent immigrants returned home.

The latest figures have prompted a substantial revision to consensus estimates for the unemployment outlook. We are also revising our forecasts, although not dramatically as we had anticipated a deceleration in the unemployment trend. For this year we still expect the unemployment rate, to average under 12% and to end the year around 13% but we have lowered next year's forecast to 13.3% from 13.7%, implying a peak around 13.5%.

This is predicated on employment falling by an average 70,000 in 2010, or by 3.6%, and a marginal acceleration in the pace of labour force contraction. Risks to the forecast may lie more with the latter, as a larger migrant outflow would mean the unemployment rate peaking out at lower levels than envisaged here.

Labour Market (annual average '000)

	2008	2009(e)	2010(f)
Employment	2,100	1,935	1,865
Labour Force	2,241	2,196	2,150
Unemployment	141	261	285
Unemployment Rate (%)	*6.3*	*11.9*	*13.3*

Exchequer Finances

Deficit forecast revised higher

Tax receipts slipped further behind target in September…

The Irish Government introduced a supplementary Budget in April in order to bring the exchequer finances back in line with the original target, having already announced expenditure cuts in February amounting to €2bn in a full year. The April measures largely centered on the personal sector with higher taxes on income introduced, alongside an increase in the Health Levy and higher social insurance contributions. The aim was to increase revenue by €1.8bn in 2009 and by €3.6bn in a full year, which with some additional spending cuts brought the Exchequer deficit forecast back to €20.4bn from an expectation of €23bn in the absence of corrective measures.

The revised Budget projections were predicated on a 7.7% average fall in real GDP in 2009, which is likely to be pessimistic, if anything, but in the event tax receipts now look as if they will undershoot the revised target following a weaker than expected outturn in September – the Government now expects tax receipts to come in some €2bn below the projected figure, following a €970m shortfall relative to profile over the first nine months of the year.

Corporation tax has been the only heading consistently ahead of target (although that figure slowed noticeably in September) and stamp duty is now running marginally ahead of profile, albeit 50% down on a year-over-year basis. VAT and income tax are now running well behind projections which is key as the two account for 70% of the total tax take; income tax to end September was €480m behind profile and down 9.4% on a year-over-year basis, with VAT €650m adrift (-21% year-over-year). The Government's revised target implies a final tax total of €32.4bn for 2009, or over 20% down on the 2008 outturn.

…and the Government has revised down its projection for the full year.

The Government's revised projection may prove to be too pessimistic, and there will be savings on the spending side, particularly as unemployment has risen by less than expected, which will prove to be more significant for the 2010 Budget – the Government had anticipated an average unemployment rate of 15.5% next year, whereas the current consensus forecast is for an end-year figure of 13.5%. The Department of Finance may also revise up its 2010 GDP forecast (it was envisaging a 2.9% fall) given the improved global backdrop but the December Budget is sure to include substantial spending reduction if the Government wishes to keep the General Government Deficit at 10.75% of GDP as projected in April, from a revised forecast of 12% in 2009. Indeed, the Minister for Finance had warned in April of a €4bn package of tax increases and spending cuts in 2010, but in recent months the message has shifted away from increasing the tax burden, with the bulk of the adjustment now seen to be on the expenditure side. Gross voted current spending (i.e. excluding debt interest) amounted to over €56bn in 2009 so a €4bn reduction amounts to a 7% cut, which given the composition of spending can only be reasonably achieved via reductions in the public sector numbers and/or pay, and cuts in social welfare payments, although a further cut in capital spending may be more palatable politically.

Exchequer Finance (€bn)

	2008	2009 Budget (Revised)	2009 (f)
Current Spending	44.7	46.4	46.0
- Voted	40.8	40.5	40.4
- Non-Voted	3.9	5.9	5.6
Revenue	41.6	35.3	33.7
- Tax	40.8	34.4	32.8
- Other	0.8	0.9	0.9
Current Budget Balance	-3.1	-11.1	-12.3
Capital Budget Balance	-9.6	-9.2	-9.0
Exchequer Balance	-12.7	-20.3	-21.3
General Government Balance	-13.3	-18.4	-19.5
(% of GDP)	*-7.1%*	*-10.8%*	*-11.8%*

Funding the Exchequer Deficit

NTMA starts pre-funding 2010 deficit

Market sentiment towards Ireland has improved…

The NTMA made steady progress in funding the 2009 Exchequer deficit through the year, helped by a reduction in risk aversion generally and by an improvement in market sentiment towards Ireland. This can be seen in the spread on Irish sovereign debt over Germany, which for 10-year bonds rose to 280 basis points in March 2009 before falling steadily to under 150 in late September, albeit moving marginally wider again in the past few weeks. The perceived risk of the Irish Government defaulting has also fallen substantially, as revealed by the CDS spread, as indeed it has for the main Irish financial institutions, with the two major banks issuing non-guaranteed term debt in recent weeks.

The NTMA had entered the year with a strong position, having built up balances of €22bn, largely through commercial paper. The projected exchequer deficit for 2009 was €20bn, which alongside a €5bn redemption gave a funding total of €25bn. The NTMA raised €16bn to end-September via three bond syndications, and another €8.2bn via a series of regular monthly auctions. This sum broadly matched the exchequer deficit and the scheduled redemption over the first nine months of the year and additional short term borrowings and funds from the National Savings Schemes (essentially retail deposits) boosted the NTMA's cash balances by an additional €3bn, bringing the total to €25bn.

…allowing some pre-funding of 2010 deficit.

The Government has now revised the 2009 deficit higher, by some €2bn, but the NTMA has already covered this and more via the syndicated issuance of a new 15-year bond, the 5.4% 2025, with €7bn supplied to the market. This brought total bond issuance year to date to €31.2bn and probably to €33.2bn by year-end, given that two regular monthly bond auctions are due in October and November.

Consequently, the authorities will have pre-funded €6.2bn of next years' issuance via the bond market, which allied to the positive cash position leaves the NTMA in a very strong position.

The 2010 Budget will be presented in early December and the official funding requirement will be revealed then, but we do know from the Government's medium term projections that a €20bn Exchequer Borrowing Requirement is planned. There are no substantial scheduled redemptions next year so the funding requirement in 2010 may well be around €20bn, implying required issuance of only €14bn given the pre-funding.

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