Bank of Ireland
Global Markets

The Irish Economy
An overview

March 2010

Produced by the Bank of Ireland Economic Research Unit

the treasury **specialists**©

Contents

GENERIC GRAPH KEY: (e) = estimate, (f) = forecast.

1. Irish Government making progress in stabilising public finances

(a) Firm action taken to address fiscal position

The Irish Government has taken decisive action to stabilise the public finances. During the last 18 months, the Irish Government has made savings (through spending cuts and tax increases) of c. €12bn, which is equivalent to c. 7.5% of GDP. In addition to the austerity measures that have been implemented, there is an on-going strategy to put the State's finances back on a sustainable footing in the medium term.

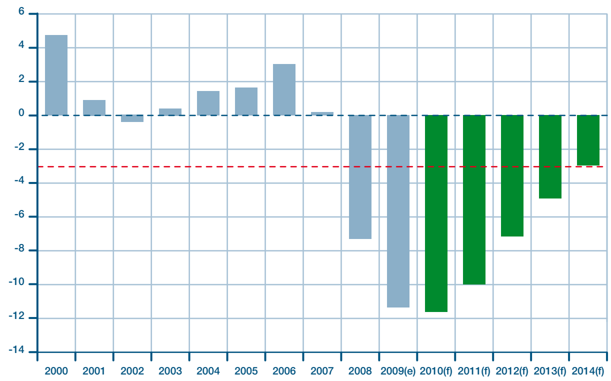
- Recession in Ireland damaged public finances, as tax receipts were overly dependent on consumption and construction taxes. Tax revenue from these sources had surged in the run up to 2008, as the economy grew strongly and the construction sector boomed
- However, by early 2009 tax revenues were declining at an average annual rate of around 25%, as Government spending continued to increase in excess of budgeted targets due in part to rising unemployment benefit claims
- The Government began their fiscal consolidation earlier than other European countries, starting to identify areas where savings could be made as early as the summer of 2008
- In early 2009, the Government implemented a pension levy on public servants, instituted a hiring freeze and cut some non-essential spending. The Government then carried out a supplementary budget in April 2009, which raised income taxes and cut spending further
- The 2010 Budget delivered in early December 2009 produced another round of spending cuts, amounting to €4.1bn, including €1bn on the capital side and cuts in public sector pay and social welfare rates. This Budget left taxation largely unchanged, however, with the exception of the introduction of a carbon tax
- These measures combined have stabilised the General Government Deficit at under 12% of GDP. While this is still an unacceptably high level for the medium term, it was crucial to stop the deterioration in the public finances in advance of an economic recovery
- There is a consolidation plan that should see the Government deficit cut to under 3% of GDP by 2014 and this plan has been approved by the European Commission
- The Irish Government has further capacity to cut back its capital spending (target c. 5% of GNP per annum), while still prioritising key infrastructure projects. While the fiscal position of Governments across Europe have deteriorated, other Governments do not have the same capacity as Ireland to cut capital spending and therefore reduce the overall General Government deficit
- The Government has also continued to affirm its commitment to supporting the Irish banking system through:
  - The setting up of the National Asset Management Agency (NAMA). The objective of NAMA is to help support the banking sector and restore the flow of credit to businesses and customers, while minimising the risk to the taxpayer
  - Irish Government Guarantee for certain bank liabilities; Credit Institutions (Eligible Liabilities Guarantee) Scheme 2009
  - Recapitalisation of Bank of Ireland and Allied Irish Bank; Government investment of €3.5bn in preference shares in both institutions in 2009

Irish Government Budget surplus/deficit as a % of GDP

	General	Current	Capital
2005	1.6	3.9	-4.2
2006	2.9	5.1	-3.8
2007	0.3	3.7	-4.5
2008	-7.2	-1.6	-5.2
2009	-11.3	-6.9	-8.1
2010(f)	-11.6	-8.5	-3.2

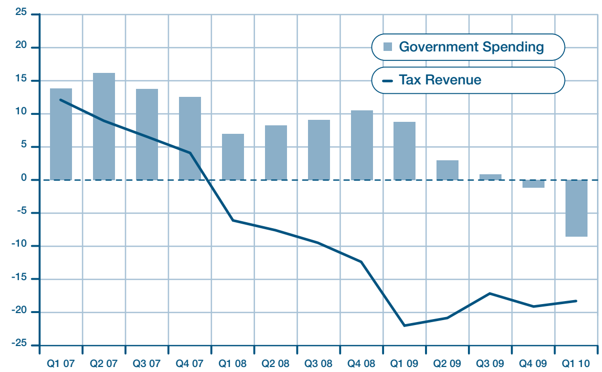
Source: Irish Department of Finance; General based on General Government Balance, Current and Capital based on Exchequer Balance

Public finances move into deficit



Graph shows: General Government Balance as a % of GDP. The red line represents Stability & Growth Pact 3% deficit limit
Source: Irish Department of Finance

Budget gap narrowing as tax shortfalls stabilise and Government spending falls



Graph shows: Irish tax revenue & voted current Government expenditure (% change year on year)
Source: Irish Department of Finance

(b) Government efforts viewed positively by international bond markets

The actions the Government have taken to stabilise the fiscal position have been welcomed internationally, and viewed positively by markets and Institutions such as the EU, IMF and OECD.

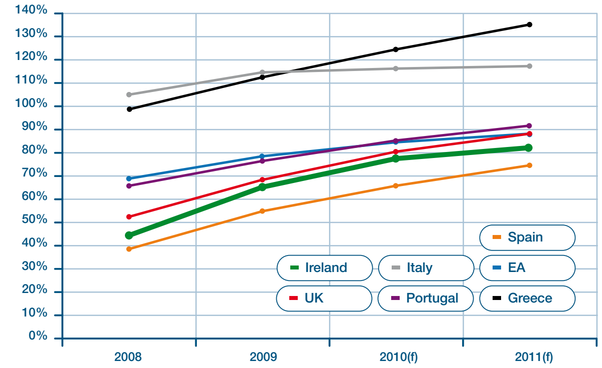
- The initial decline in Ireland's public finances, combined with the sharp recession, caused the cost of borrowing for the State to rise. Irish 10-year bond yields rose from a level broadly in line with 10-year German bunds in 2007 to 280 basis points above bunds in early 2009. However, this gap had fallen to c. 130 basis points by March 2010

- The Credit Default Swap (CDS) rate for Ireland (a measure of the risk of a default) also rose sharply last year to around 400 basis points (February 2009) but has now fallen back to about 120 basis points (March 2010)

- The Irish Sovereign has demonstrated access to international funding markets. The National Treasury Management Agency (NTMA) raised almost €35bn in 2009 and has already raised more than 50% of the €20bn planned borrowing requirement for 2010

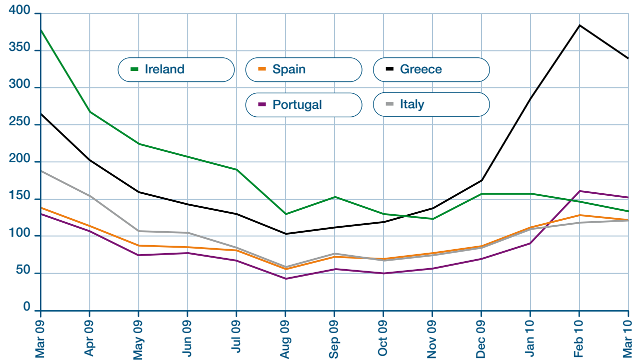
- While Ireland's debt to GDP ratio has increased substantially, it still compares favourably with the Euro Area average
  - Ireland's gross Government debt at end 2009 was €106bn, equivalent to an estimated 64.5% of GDP. However this takes no account of the cash balances held by the NTMA (€21.4bn at 31 December 2009) and the assets of the National Pension Reserve Fund (€22.3bn at 31 December 2009), which would result in a net debt ratio of 38%
  - Ireland's gross debt ratio is projected to rise to 78% of GDP in 2010 and to peak at 84% in 2012, still below the Euro Area average which is forecast to reach 88% in 2011

Irish Government Debt/GDP ratio - still in line with European peers



Graph shows: General Government Debt/GDP ratio comparison versus selected EU members
Source: EU Commission & Irish Department of Finance

Ireland's CDS levels have tightened, outperforming other peripherals



Graph shows: 5 year CDS spread of peripheral European sovereigns
Source: Bloomberg

- During recent months, international markets have become increasingly concerned regarding the fiscal position of peripheral Eurozone countries including Greece, Portugal and Spain. Irish debt has outperformed during this time, as investors have begun to differentiate between Ireland and other peripheral countries based on the actions taken by the Irish Government to tackle the fiscal challenges

Public finances have deteriorated across Europe

GDP Growth (%)	2008	2009	2010(f)	2011(f)
Ireland	-3.0	-7.1	-1.3	3.3
UK	0.6	-4.6	0.9	1.9
Germany	1.3	-5.0	1.2	1.7
France	0.4	-2.2	1.2	1.5
Spain	0.9	-3.7	-0.8	1.0
Portugal	0.0	-2.9	0.3	1.0
Italy	-1.0	-4.7	0.7	1.4
Greece	2.0	-1.1	-0.3	0.7

Public finances have deteriorated across Europe (continued)

General Government Balance (% of GDP)	2008	2009	2010(f)	2011(f)
Ireland	-7.2	-11.3	-11.6	-10.0
UK	-5.0	-12.1	-12.9	-11.1
Germany	0.0	-3.4	-5.0	-4.6
France	-3.4	-8.3	-8.2	-7.7
Spain	-4.1	-11.2	-10.1	-9.3
Portugal	-2.7	-8.0	-8.0	-8.7
Italy	-2.7	-5.3	-5.3	-5.1
Greece	-7.7	-12.7	-12.2	-12.8

General Government Debt (% of GDP)	2008	2009	2010(f)	2011(f)
Ireland	44.1	64.5	77.9	82.9
UK	52.0	68.6	80.3	88.2
Germany	65.9	73.1	76.7	79.7
France	67.4	76.1	82.5	87.6
Spain	39.7	54.3	66.3	74.0
Portugal	66.3	77.4	84.6	91.1
Italy	105.8	114.6	116.7	117.8
Greece	99.2	112.6	124.9	135.4

Table shows: GDP growth, General Government Budget Balance (GGB) and General Government Gross debt (GGD) as defined on a harmonised EU basis. GGB and GGD forecasts bar Ireland are from the latest EU commission forecast (November 2009) and these forecasts are calculated on an unchanged budgetary status from that period forward. Irish forecasts are from the Irish Department of Finance and include changes made in Budget 2010 (published December 2009).
Source: EU Commission, Eurostat, Irish Department of Finance, Reuters Consensus Forecasts

The actions taken by the Irish Government to stabilise the public finances have been well received internationally

"What I have seen coming from Ireland has been quite impressive in terms of adjusting to new circumstances without losing time and not hesitating to take the kind of bold and courageous decisions in order to put the economy back on its feet."

Jean Claude Trichet, ECB President, January 2010

"Policy adjustment in Ireland has already begun and indeed is well-advanced compared with some other countries… The government has taken several necessary and courageous measures to stabilise the public finances….There is evidence of a reduction in nominal wages. This shows a remarkable degree of flexibility by international standards, both in the private and public sectors."

Angel Gurría, OECD Secretary-General, November 2009

"The (Irish) authorities have responded in the right manner, on the two aspects that matter the most: the financial sector and fiscal consolidation."

Ashoka Mody, IMF Assistant Director, Mission Chief for Ireland, June 2009

2. Irish economy should move back towards growth in 2010

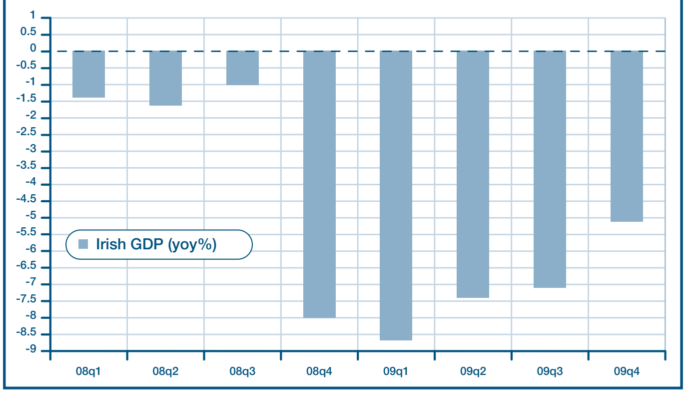
(a) Economy contracted by 7.1% in 2009 but survey data improving

The Irish economy shrank for 8 consecutive quarters through to the end of 2009. However, recent survey data indicates that the economy appears to be stabilising in 2010.

- Irish GDP declined by 2.3% in Q4 2009. The continuing fall in economic activity is mainly the result of the collapse in construction. Investment fell by 9.7% in Q4 following a 10.3% drop in Q3

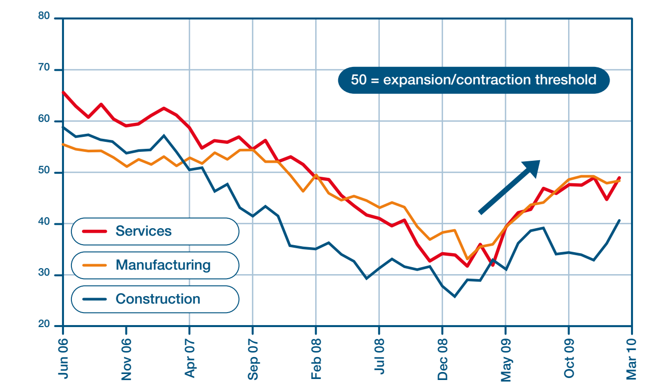
- Many Irish economic surveys appear to have bottomed and are recovering, while others are pointing to a slowdown in the pace of contraction. Purchasing Manager Indices (PMIs) for the services and manufacturing sectors have recovered to levels close to expansion, while construction continues to lag

Annual GDP declines appear to have bottomed



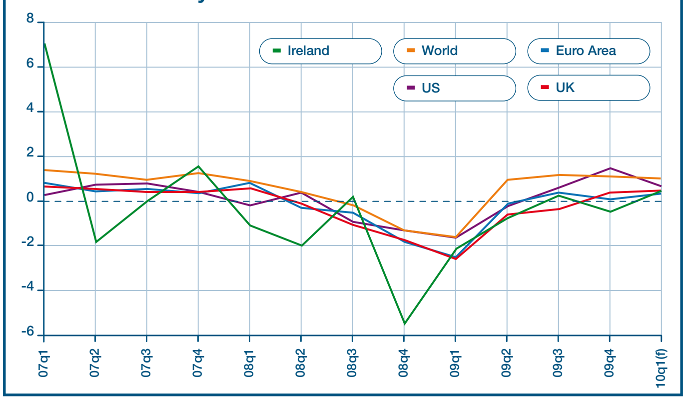
Graph shows: Irish GDP (year on year %)
Source: CSO

Irish PMIs suggest key sectors close to expansion



Graph shows: Irish Purchasing Managers Indices
Source: NCB, Ulster Bank & Markit

Global economy has moved out of recession



Graph shows: Annual GDP Growth Rates
Source: IMF, ONS, BEA, Eurostat & forecasts Reuters consensus & Bank of Ireland Economic Research Unit (ERU)

The external sector continues to be the main support for economic activity in Ireland, while the domestic economy remains weak. The global recovery should provide a further boost to Irish export performance this year.

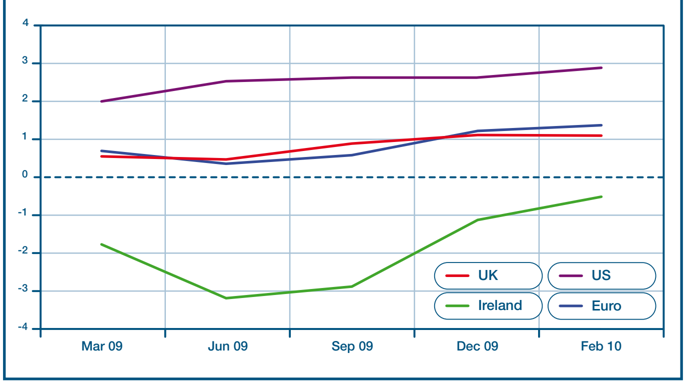
- Expectations about the near-term outlook for Ireland have improved, with the consensus forecasting a return to annual growth in the second half of 2010. The median consensus GDP forecast for 2011 is now 3% growth following a contraction of 0.5% this year

- The unemployment rate rose rapidly during the recession, from under 5% in early 2008 to over 13% by end-2009, but the rate of increase has slowed of late. The consensus now expects the unemployment rate to peak at around 13.5%, from 15.5% a year ago

- Irish exports have held up relatively well during the global downturn. The resilience of Irish export performance in part reflects the composition of our foreign trade, as chemicals and pharmaceutical products (usually less cyclical in terms of demand) account for c. 60% of Irish merchandise exports

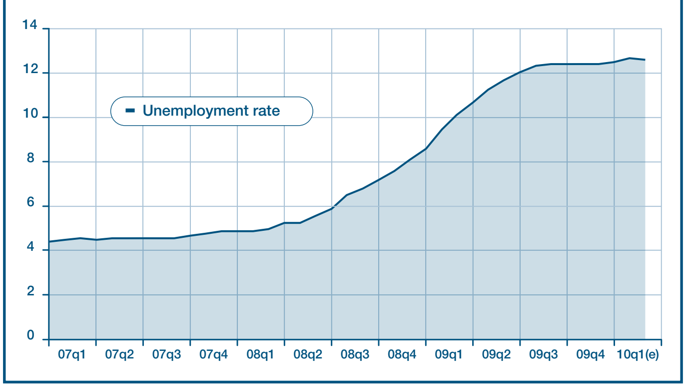
- The consensus view is that Irish exports will start to grow again this year, given the global recovery and in response to a fall in labour costs in Ireland, which is expected to boost competitiveness

Consensus forecasts for GDP growth trending higher



Graph shows: Consensus GDP forecasts for 2010
Source: IMF, ONS, BEA, Eurostat and forecasts Reuters consensus

Rate of unemployment growth has slowed recently



Graph shows: Irish unemployment rate based on Live Register
Source: CSO, estimate Bank of Ireland ERU

- However domestic demand has been very weak, initially driven by a plunge in construction output and a decline in business spending, followed by a substantial fall in consumer spending (-7.2% fall in volume terms in 2009)

- Consumer spending is expected to contract further in 2010, given pressures on household incomes and a substantial increase in the savings rate - the savings ratio may now be 11% - 12% from 2.3% in 2007

- Government spending should also fall by about 2.5% this year as the Government implements its plans to return the public finances to a more sustainable footing

The table above right highlights the Bank of Ireland Economic Research Unit forecasts for Irish economic growth (annual %)

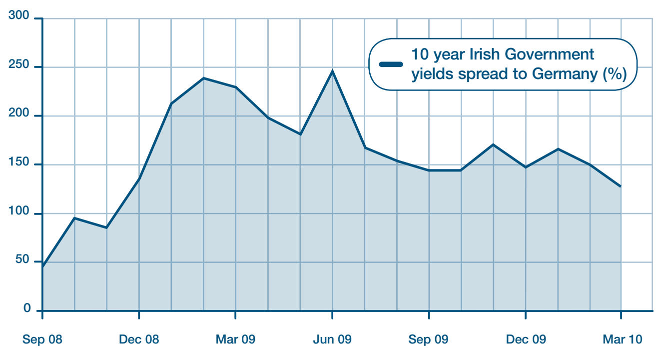
- Finally, amid signs of stabilisation in the Irish economy, the market's perception of Irish sovereign risk has improved in recent months: the 10-year yield spread over Germany has narrowed to under 130 basis points (March 2010) from a high of 280 basis points a year ago (March 2009)

Irish economy forecasts

	2008	2009	2010(f)
Personal Consumption	-1.0	-7.2	-2.0
Government Consumption	2.6	-1.2	-2.5
Capital Formation	-15.5	-29.7	-17.0
Exports	-1.0	-2.3	3.5
Imports	-2.1	-9.3	-2.0
GDP	-3.0	-7.1	1.0
GNP	-2.8	-11.3	-1.5

Source: Bank of Ireland ERU

Market perception of Irish risk has improved



Graph shows: Irish Government bond spreads over German bunds
Source: Bloomberg (19 March 2010)

(b) Export growth to provide economic stimulus

Exports will remain of vital importance to the Irish economy and will be the catalyst for economic recovery.

- Exports will drive any growth in GDP in 2010 as domestic demand will remain subdued. Exports are likely to average 90% of real GDP in 2009 from 80% in 2007

- The performance of the external component of Irish GDP has been resilient - the volume of exports fell by 1.2% in the year to Q4 2009, against a 7.5% fall in imports

- Ireland's export performance has also held up well when compared with other countries. The 1.2% fall in Irish exports in the year to Q4 2009 contrasts with a -5.2% fall in exports for the Euro Area as a whole

- The resilience of the external sector is mainly due to the composition of merchandise exports (chemicals and pharmaceuticals account for over 60% of the total) and partially due to the strength of service exports, including business services, insurance and capital services

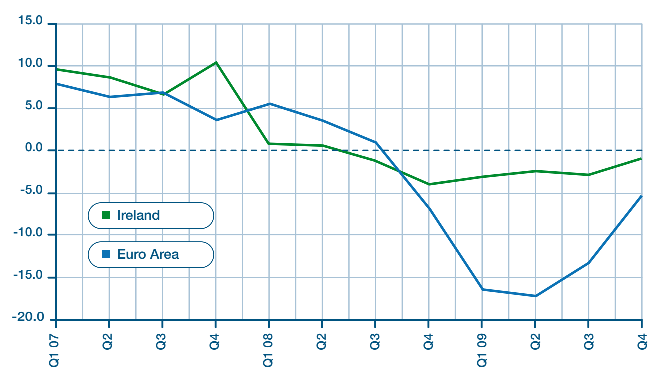
- Ireland is a very open economy and recovery in the global backdrop should be supportive of export performance. As recovery becomes more entrenched in Ireland's key trading partners - the US, UK and Eurozone - we expect healthy growth in Irish exports of c. 3.5% for 2010

Irish GDP component % weighting

GDP component	2007	2008	2009(f)
Personal Consumption	48%	52%	52%
Government spending	14%	16%	17%
Investment	26%	22%	16%
Exports	82%	84%	90%
Imports	-70%	-74%	-74%

Source: Bank of Ireland ERU

Irish exports performance holding up well

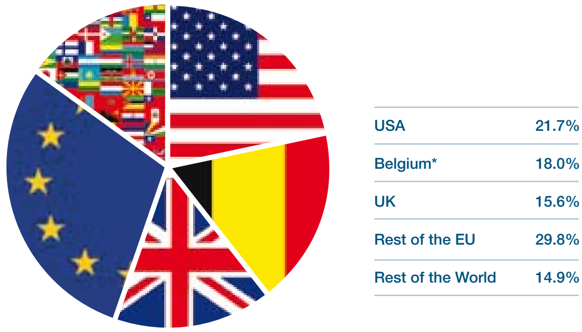


Source: Eurostat and CSO
Graph Shows: Exports of Goods and Services (Annual Growth in Volumes %)

- Imports into Ireland should continue to fall due to weak domestic demand, and we are forecasting a decline of 2% this year

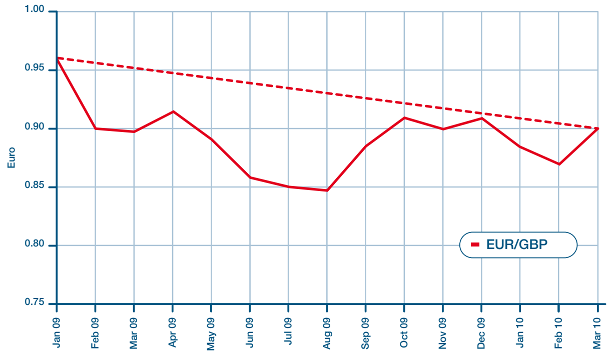
- The pull back of the euro relative to sterling, after a period of prolonged appreciation, is positive for domestic Irish businesses and exporters in particular. Irish multinational exports are less impacted by the euro/US dollar exchange rate, as all stages of the production process tend to be priced in US dollars (raw materials and final exports)

Distribution of Irish merchandise exports; US, UK and Eurozone key partners



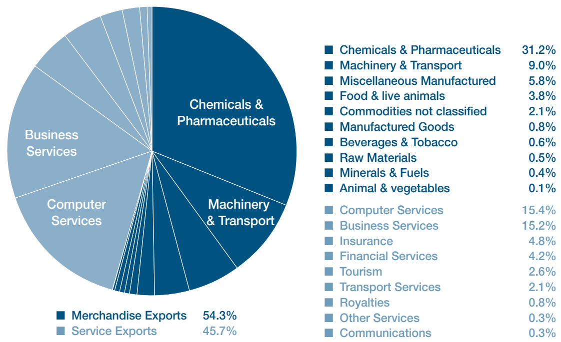
*Belgium is key distribution centre for pharmaceuticals
Source: CSO 2009 (based on 9 months data)

Depreciation of euro versus sterling has boosted competitiveness



Graph shows: Exchange rate between Ireland & UK
Source: Bloomberg

Composition of Irish exports; services, chemicals and pharma of increased importance



Source: CSO 2009 (based on 9 months data)

(c) Domestic economy to remain subdued

All components of domestic demand - consumer, business, construction and Government spending - are set to remain weak in 2010. Unemployment and uncertainty regarding job prospects has been a major negative driver of consumer spending. Furthermore, construction spending is unlikely to increase for some time, particularly as the Irish property market has yet to show any clear signs of stabilisation. Below, we address some of the key aspects of Ireland's domestic economy that will remain muted in 2010.

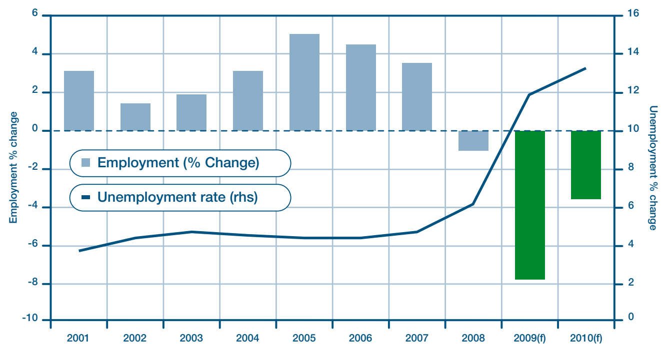
i. Increase in Irish unemployment slowing

- Monthly unemployment/Live Register data continues to point to an improvement in labour market conditions versus 12 months ago. While the Irish labour market remains under stress, the large flows onto the Live Register, and the associated sharp increases in unemployment, seem to be behind us

- Additions to the Live Register averaged over 11,000 people per month in 2009 with over 50,000 people joining in January and February of last year. So far in 2010, the net additions to the Live Register were 3,500 in the same period

- The unemployment rate was 13.1% at the end of 2009. We still expect the rate of unemployment to tick up slightly from this level over the course of the year. The Irish Government expects unemployment to average 13.2% in 2010 and to ease thereafter as economic growth resumes

Sharp increase in Irish unemployment slowing



Graph shows: % change in Irish employment and the unemployment rate
Source: CSO, forecasts Bank of Ireland ERU

- The slower pace in the unemployment trend owes little to employment growth, but largely reflects a sharper than expected decline in the supply of labour

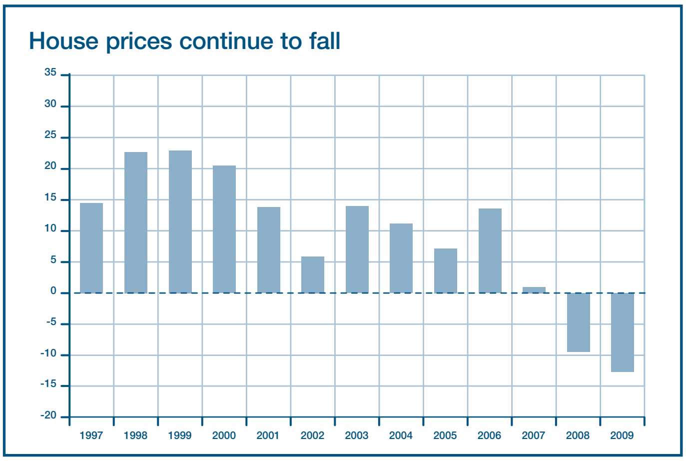
- The labour force fell by an annual 69,000 in Q4 2009, or by 3.1%, having fallen by 65,000 in Q3. The decline reflects lower participation (from young people, in particular, who are staying on longer in schools and colleges) and a pick up in outward migration. The participation rate fell to 61.2% in Q4 2009 from 62.9% a year earlier

- We expect job losses to continue in the Irish economy in 2010, although employment may fall at a slower pace. This is likely to trigger a further substantial fall in the labour supply

ii. House prices still falling but affordability improving

- House prices in Ireland do not appear to have bottomed yet. The Permanent TSB/ESRI index showed that, while the pace of house price declines had fallen in Q3 to an average of 1.2% from 1.6% in Q2, it re-accelerated again in Q4 to record an average fall of 2.8% in the quarter. According to this index, house prices fell by an average of 18.5% in 2009

- House price deflation and rent declines are likely to ease again in the months ahead, as the economic backdrop and sentiment improves. However, it may take some time before the excess supply in the market is cleared

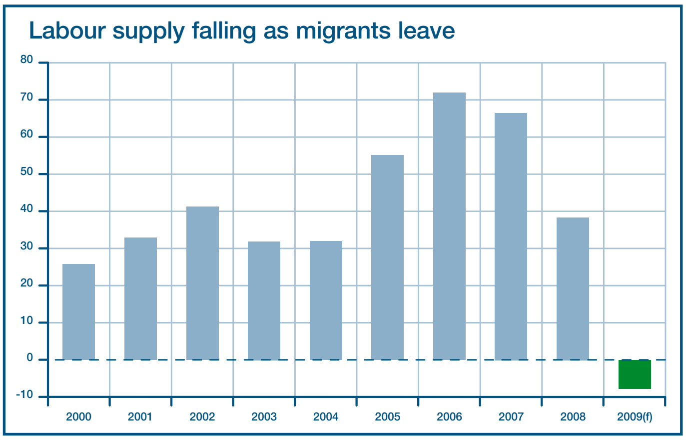


Graph shows: House price inflation (% end year)
Source: Permanent TSB/ESRI

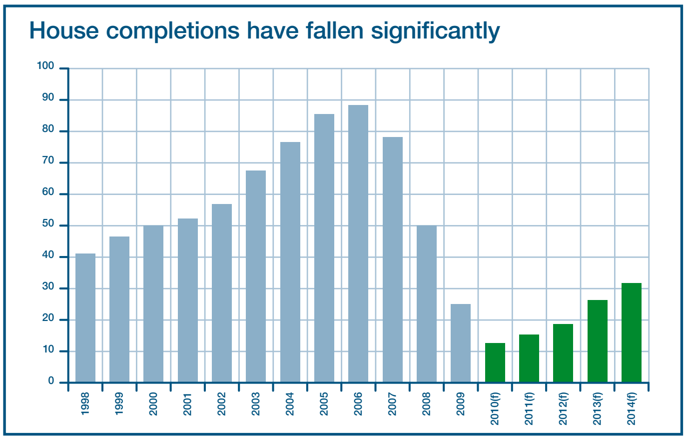
- c. 26,500 houses were completed in 2009 compared to over 50,000 in 2008, and a peak of almost 90,000 in 2006. We believe the number of completions will fall again in 2010 to about 16,000, which should represent a low for the cycle and adds just 1.1% to the housing stock this year

- However, there are some encouraging signs, notably the improvement in affordability. The average mortgage interest rate on new loans has fallen sharply in the past year, to c. 2.7% from 5.5%. These falls, along with declining house prices, have provided a substantial boost to affordability

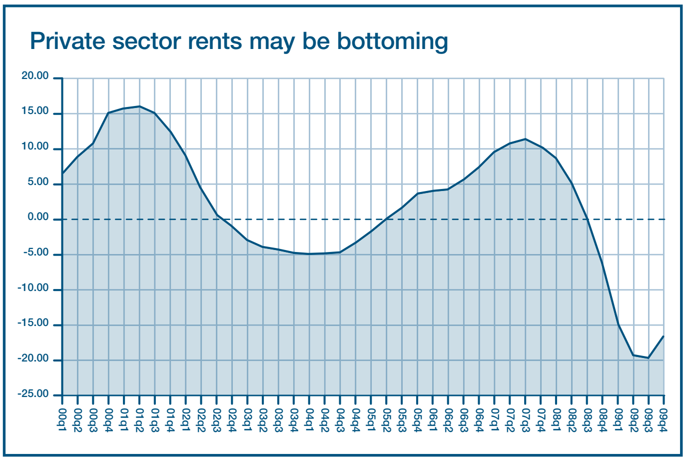
- The fall in rents appears to be bottoming. Private housing rents as measured in the CPI inflation index fell by just 0.7% in the three months to February 2010 compared to a fall of 2.4% in the three months to November 2009



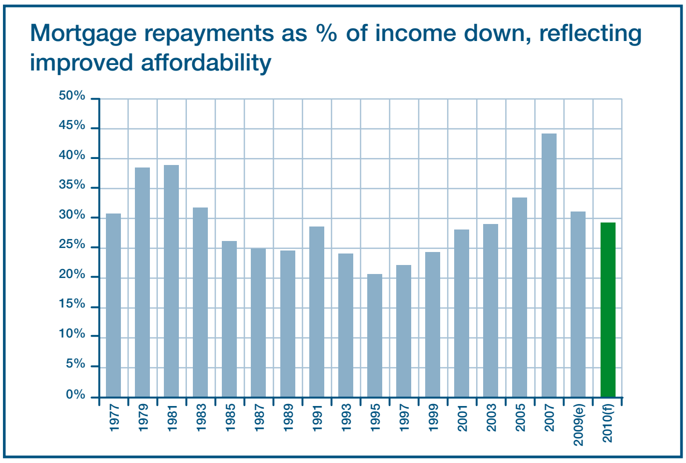
Graph shows: Irish net migration (000's)
Source: CSO



Graph shows: Irish house completions (000's)
Source: Irish Department of Finance & Irish Department of Environment



Graph shows: Private sector rent (% change)
Source: CSO



Graph shows Irish mortgage repayments as % of income
Source: Bank of Ireland ERU

iii. Deflation still running its course

- In contrast with the Euro Area, which had just a brief period of disinflation in 2009, Ireland continues to experience negative inflation rates. HICP inflation (the EU standard measure) was -2.4% in February 2010, the 12th consecutive month that the annual inflation rate in Ireland has been negative

- HICP inflation in Ireland was -1.7% last year compared to a Euro Area average of +0.3%. The divergence between Irish and European prices is broad-based across most goods and services

- We expect that HICP inflation will again be negative in Ireland for 2010 as a whole. Although prolonged deflation in not desirable for the domestic economy, it will help Ireland gain some competitiveness against our main trading partners - the US, UK and Euro Area - all of whom should record positive rates of inflation in 2010

- CPI inflation, which differs from HICP inflation mainly due to the inclusion of mortgage interest repayments, is forecast to decline by 0.6% this year after a 4.5% decline last year

- We expect that both measures will return to positive territory from the second half of the year onwards and that the average annual rate will turn positive again in 2011

Deflation continuing but positive inflation rates set to return in 2H 2010

	2009	2010(f)
Quarter 1	-1.5	-2.9
Quarter 2	-4.5	-0.8
Quarter 3	-6.1	0.3
Quarter 4	-5.8	1.3
Year (2009)	-4.5	-0.6
HICP	-1.7	-0.3

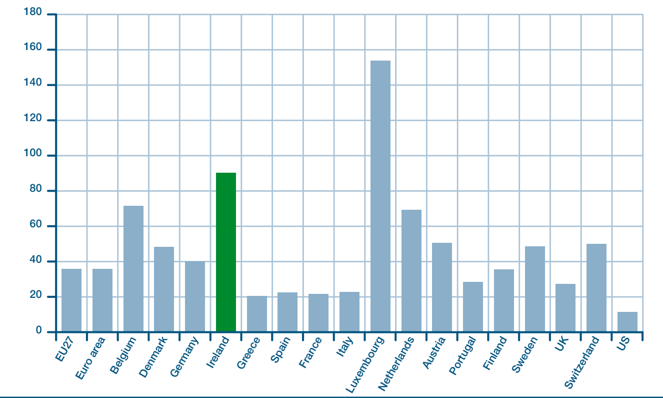
Graph shows: Inflation (CPI % change)
Source: CSO, forecasts Bank of Ireland ERU

(d) Key features of Irish economy - building blocks for sustainable growth

Moving forward from this difficult period, there are several key features of the Irish economy that should help underpin recovery and support sustainable growth over the medium term.

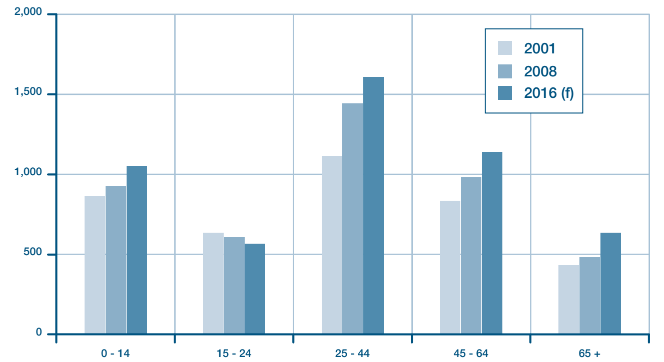
- Export-oriented economy with strong export partnerships with key markets
- Knowledge and experience in key sectors:
  Pharmaceuticals, chemicals, high-tech industries, business and financial services
- Ability to attract modern FDI
- Low corporate tax regime
- Pro-business environment
- Young population demographic compared to other European countries
- Well-educated flexible workforce, with unit labour costs falling relative to our European peers

Ireland has one of the most open economies in the world



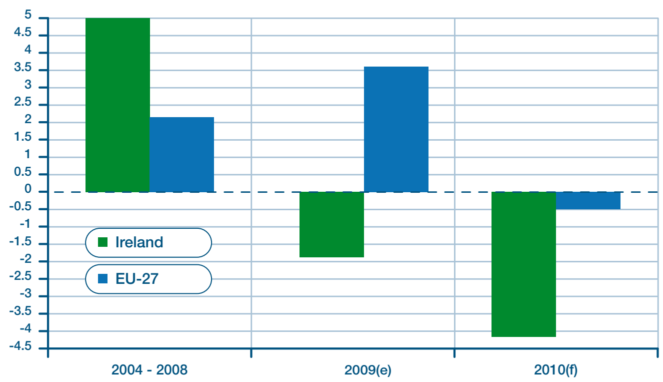
Graph shows: Ratio of exports to GDP
Source: Eurostat 2009

Strong demographic profile - 25 to 44 year age group is dominant cohort



Graph shows: Irish population by age cohorts (000's)
Source: CSO

Ireland's unit labour costs falling versus European peers



Graph shows: Whole economy unit labour costs
Source: EU Commission

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