Bank of Ireland
Global Markets

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In this Issue: 3% Growth this year, 4% next
• GDP • Inflation • Wage Trends
• Exchequer Finances • The Irish Labour Market

the outlook

Trends in the Irish Economy

3% Growth this year, 4% next

We now know that the Irish economy grew by 5.3% in 2007, exactly in line with the post-millennium trend. Growth dipped below potential in the second half of the year, however, and this pattern looks set to continue through 2008 and into 2009, with GDP set to expand by 3% this year and 4% next.

House completions look set to fall sharply...

Ireland has experienced cyclical slowdowns before (most recently 2003-2004) and no doubt will again but each cycle has a different driver. The prime factor behind this cyclical slowdown is falling residential construction, with house completions set to decline to 50,000 this year from over 78,000 in 2007, before recovering in 2009. This rapid supply response by the building sector is ultimately positive for the housing market but is negative for output, knocking 1.3% off GDP in 2008. State spending on non-residential construction which is projected to rise by over 10% will provide only a partial offset, with the result that construction output as a whole is forecast to decline by over 5%.

....contributing to a period of sub-trend growth.

Housing construction will fall from 9.2% of GDP to 7.7% on these forecasts, as the other components of GDP are set to grow, albeit at a more modest pace than of late. Consumer spending is forecast to increase by 4% in real terms, from 5.4% last year, in response to slower growth in household disposable income, in turn reflecting a deceleration in employment creation and a mild easing in wage growth; employment growth will average 40,000, with job losses in construction offset by further gains in the service sector, and earnings will rise by 4.7% from 5.3% in 2007. Exports are forecast to grow by 5%, following an 8.2% rise in 2007, with the slower pace of expansion reflecting the euro's appreciation and weaker growth in Ireland's major export markets. Last year saw some €19bn in FDI inflows into Ireland, equivalent to 10% of GDP, so this export forecast may be conservative.

The global economy has proved resilient, despite the weakness of the US economy, but this has also pushed up commodity prices, including food and energy, preventing a more rapid deceleration in inflation than one would normally see at this stage of the cycle. Despite this we still expect CPI inflation to fall, averaging 3.6% in 2008 from 4.9% last year. This will provide some support for real incomes, and we envisage a half point cut in ECB rates, although the recent spike in headline inflation clouds the timing issue.

The impact of the turbulence seen in financial markets since last August also adds to the uncertainty and provides a downside risk. The global supply of credit may also be curtailed for a time and, as a result, we now expect a less rapid recovery in 2009 with growth set to pick up to 4%. Any period of sub-trend growth is likely to adversely impact Government finances and 2008 is unlikely to be an exception; we expect a €1bn shortfall in tax receipts relative to Budget projections, giving rise to a €2.8bn General Government Deficit. The latter is equivalent to 1.4% of GDP, to put it in context, and as such in line with the EU average.

Dr. Dan McLaughlin
March 2008.

outlook

GDP

The Irish economy grew by 5.3% in 2007 according to the recently published estimate from the CSO, which is in line with the average annual growth since the year 2000. The rise in consumer spending, at 5.4%, was stronger than the post-millennium average (4.9%), as were exports (8.2% against a trend of 5.2%), but this was offset by weaker capital formation, with zero growth recorded against a trend of 5%. The latter component also included a fall in building and construction (a 3.3% decline), driven by a substantial reduction in house-building, with completions of 78,000 compared with some 88,000 in 2006.

Trend growth in 2007...

Construction spending on new housing fell by over 12% in 2007 according to the CSO and we forecast a 15% decline in 2008, which will reduce GDP by 1.3%. This may be partially offset by increased spending on improvements and a rise in non-residential investment (the 2008 Budget projected a 10% plus increase in voted capital) but building and construction output as a whole is forecast to decline by over 5%. Spending on machinery and equipment is expected to be flat, with the result that total capital formation is forecast to fall by some 4%.

...but falling residential construction will continue to dampen activity.

The decline in construction output is already leading to job losses in that sector, and although this will be more than offset by job creation in the services sector the net result will be slower overall employment growth in 2008. Employment grew by 67,000 in the year to the fourth quarter of 2007, nonetheless, so even if job growth slows to only some 20,000 by Q4 2008, this still leaves the annual average rise in employment at 40,000 for the year on our forecast.

Wage growth is also likely to slow somewhat in response to the softening in labour demand and we forecast a 4.7% rise in average earnings, from 5.3% in 2007. Sluggish tax growth on incomes will provide a partial offset but we expect nominal household income growth to slow to around 7.5% from an estimated 9% the previous year. Inflation, too, should slow, so providing more support for real incomes, although the recent spike in food prices means that the deceleration in inflation will not be as pronounced as we has previously envisaged. Households may also choose to save a greater share of this disposable income given the uncertain international backdrop and the rise in unemployment. Recent declines in housing and equity wealth will not help, although research has not found a strong link between wealth and Irish consumption. The trend in real disposable income is the main driver and so we project a 4% rise in real consumer spending, from 5.4% last year.

On the external side, there is much comment to the effect that Ireland has lost competitiveness, but this should be put in context; Irish unit labour costs in manufacturing fell by 40% relative to Ireland's main trading partners in the ten years to 2004, and by 2007 the figure was still 35%. Moreover, Irish manufacturing in 2007 had its best year since 2002, with output growth of 7.5%, including 3.7% in the indigenous sector. Last year also saw

outlook

FDI inflows amounting to €19bn equivalent to 10% of Irish GDP. One might expect some slowing in export growth in 2008, nonetheless, given the stronger euro and weaker growth in the US, the UK and the euro area; we forecast a 5% rise in export volumes, against a 4% increase in imports. The result is a positive contribution to economic growth from the external sector.

...leading to 3% growth in 2008...

The net result is that GDP growth in 2008 is forecast at 3%, with a similar rise in GNP. This is clearly below the recent trend and the economy's potential growth rate, so unemployment is set to rise; we forecast an average unemployment rate of 5.5% this year. The economy has experienced sub-trend growth before (more recently in 2003-2004) and no doubt will again. So the issue is how long the cyclical slowdown is likely to last and in this case there are two complicating factors, one relating to the strenght of commodity prices and the other to the credit crunch that hit financial markets last August. Ordinarily, we might expect ECB rates to fall substantially in response to a cyclical downturn in Europe, but in this case the fall may be limited to half a point, reflecting the persistence of above target inflation.

...and a mild recovery to 4% in 2009.

Furthermore, the credit crunch may dampen lending somewhat and so act as another brake on a quick rebound. Consequently, we expect a relatively slow recovery in 2009, with growth to average 4% and unemployment to stay around 5.5%. Consumer spending may well pick up some momentum, helped by a further decline in inflation, but the big cyclical swing is likely to be from the construction sector, as housing output will not fall forever - we expect house-building to recover to 55,000 from 50,000 this year. This contributes to a recovery in construction output of some 3% which therefore turns from a negative contributor to GDP to a positive.

Irish Economy Forecasts

GDP (% change)	2006	2007	2008(f)	2009(f)
Personal Consumption	5.7	5.4	4.0	4.5
Government Consumption	5.3	6.7	5.0	3.0
Capital Formation	3.1	0.2	-3.9	3.0
Stocks (% GDP)	0.8	-0.1	0.3	0.3
Exports	4.4	8.2	5.0	5.0
Imports	4.4	6.4	3.8	5.0
GDP	5.7	5.3	3.0	4.0
GNP	6.5	4.5	3.0	4.0

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Inflation

Inflation peaked in early 2007…

…but food prices now keeping CPI stubbornly high.

The headline inflation rate in Ireland, as measured by the CPI, reached a cyclical peak of 5.2% in January 2007, and spent the rest of that year in a 4.6%-5.1% range, yielding an average of 4.9% for 2007 as a whole. This was the highest reading since 2000 and we envisaged a deceleration in 2008, in large part due to a number of favourable base effects. Oil prices, for example, rose by over 50% in euro terms, pulling the annual inflation rate in the energy component up to over 10% last November, and this is unlikely to be repeated in 2008. Similarly, mortgage costs rose sharply in the first half of 2007, reflecting higher ECB rates, and so the annual inflation rate in this component would be expected to decelerate even if rates have peaked, let alone start to fall.

The evidence for the year to date is that these factors are indeed at work, but the benefit is being offset by accelerating inflation in other components. Food prices have risen sharply over the past year, boosting inflation across most of the developed world, and Ireland is no exception; food and non-alcoholic beverages rose by 2.2% in the first two months of 2008, taking the annual inflation rate in that category to 8.5%, from 1.1% twelve months earlier. The Irish rate of food inflation now exceeds the eurozone average, (5.8%), which is rather surprising given that the euro has appreciated by over 12% against sterling over the past six months and that around one-third of Irish imports come from the UK, with a much higher percentage in the food sector.

The spike in food prices largely explains why inflation rose again in February, to 4.8%, having fallen to 4.3% in January, with the implication that the average inflation rate for the year will now be higher that we had envisaged - we now forecast CPI inflation to average 3.6% in 2008, although with a steady deceleration through the year, to around 3% by December.

From an international perspective the HICP measure of inflation is a better gauge of Ireland's relative price performance as it is the standard used across the European Union. Inflation on that definition averaged 2.8% in 2007, against the euro area figure of 2.2%, and we expect an average of 3% for Ireland in 2008. This measure excludes mortgage costs, among other items, and so is not prone to the large cyclical swings seen in the CPI as a result of the interest rate cycle.

Inflation (CPI, % change)	2007	2008(e)
Quarter 1	5.0	4.5
Quarter 2	5.0	3.7
Quarter 3	4.8	3.2
Quarter 4	4.8	3.0
Year	4.9	3.6

Wage Trends

There is no official data on the trend in average earnings in the economy but quarterly figures are available for the main sectors, albeit not on a timely basis. From those published it appears that wage growth picked up in 2007, averaging 5.3%, from 4.9% in 2006.

Wage inflation accelerated in 2007…

The Public Sector is the single largest employer in the economy, with a workforce in excess of 360,000, equivalent to over 17% of total employment. Pay growth in the sector has slowed, following the substantial gains made in the latter part of 2004 as a result of a benchmarking award, with the annual rise in weekly earnings decelerating to 4% in the third quarter of 2007, from an average 5.1% in the first half of the year. Pay rates in other areas of the economy are more closely related to market forces and many have seen an acceleration. The annual growth in weekly earnings in the financial sector was 7.5% in the first half of 2007, which followed a rise of 6.9% in 2006. Earnings in industry also picked up in 2007, averaged 5% growth in the first half of the year, from 3.5% in 2006, although distribution did see a modest deceleration, to 4.3% in the third quarter from 5.8% in 2006. Pay also picked up sharply in construction, which is surprising given the output trend in that industry; weekly earnings rose by 6.9% in the year to the fourth quarter, to leave the average for 2007 at 6% from less than 2% in 2006.

…but is likely to slow below 5% this year.

The general trend is therefore indicative of a market where labour is scarce rather than plentiful, with estimated wage growth of 5.5% across the economy as a whole in the first half of 2007. A modest slowdown may have begun in the second half, but wage inflation probably averaged at least 5.3% for 2007 as a whole.

The trend is likely to be softer in 2008 however. The public sector has not received any special increases from the recent benchmarking award and wage inflation is likely to drift lower in those sectors open to market forces, given that employment growth is set to slow and unemployment to rise. Consequently, we expect wage growth for the economy at large to average 4.7% this year, which would be the weakest since 2003.

outlook

Exchequer Finances

2008 Budget was expansionary…

…and tax revenue is already behind target.

The 2008 Budget, delivered in December 2007, was predicated on real GDP growth of 3%, which is below the economy's potential growth rate and compares with growth in excess of 5% last year. Consequently, one might expect that the Government's fiscal position would have deteriorated on cyclical grounds, from the small General Government surplus recorded in 2007 (0.5% of GDP). In fact, the Minister for Finance chose to adopt an expansionary fiscal policy, with the result that the General Government deficit is forecast at 0.9% of GDP, instead of the 0.3% that would have occurred on cyclical grounds alone.

The 2008 Budget did incorporate a slowdown in the growth of voted current spending, to 9.3% from over 12% last year, but the Minister chose to maintain strong growth in capital spending - gross voted capital expenditure rose by over 10%. Tax receipts in contrast, are projected to rise by only 3.5%, which is below the forecast rise in nominal GDP (5.5%). This reflects an expectation that the housing market will continue to weaken (stamp duty is projected to fall by over 10%) and slow growth in employment and wages, bringing the forecast rise in income tax to only 2.4%.

This moderation in revenue growth still leaves the current Budget balance in strong surplus (€4.8bn), but this is more than offset by the projected capital deficit of €9.6bn, yielding an exchequer shortfall of €4.9bn, or €1.8bn in terms of the General Government deficit (which adjusts for items like payments to the National Pension Reserve Fund and the surplus in the Social Insurance Fund).

The risks to that Budget arithmetic lie to the downside, judging by developments in the first two months of the year. Income tax and stamp duty are in line with expectations, but capital taxes are over €260m behind the expected monthly profile, with other substantial shortfalls in VAT (€200m) and corporation tax (€100m). As a result total tax receipts are already over €500m behind expectations. The official view is that it is too early in the year to draw definite conclusions as to the trend in revenue relative to target, which is reasonable, but the authorities may have underestimated the impact of last year's plunge in the Irish equity market on capital taxes, for example. Consequently, we are inclined to pencil in a shortfall in tax revenue of some €1bn, implying that the General Government deficit will be €2.8bn, equivalent to 1.4% of GDP and hence comfortably within the 3% limit set down in the Growth and Stability Pact.

Exchequer Finances (Eur bn)	2007	2008 (budget)	2008 (f)
Current Spending	40.9	44.8	44.8
- Voted	37.0	40.4	40.4
- Non-Voted	3.9	4.4	4.4
Revenue	47.9	49.6	48.6
- Tax	47.2	48.9	47.9
- Other	0.7	0.7	0.7
Current Budget Balance	7.0	4.8	3.8
Capital Balance	-8.6	-9.6	-9.6
Exchequer Balance	-1.6	-4.9	-5.9
General Government Balance		-1.8	-2.8

The Irish Labour Market

Irish employment growth in this economic cycle peaked in the summer of 2005, (annual job creation was 101,000) and has been decelerating since, albeit at a very mild pace. Annual employment growth in the fourth quarter of 2007, for example, was 67,000 and as such only marginally softer than Q3 figure, although down from the 86,000 recorded twelve months earlier.

Employment growth set to slow further...

Employment fell in two categories in Q4, manufacturing and construction, the latter by some 6,000, which is the first decline in this cycle, although such a move had been anticipated by analysts for some time. These job losses were dwarfed by substantial gains in the service sector, notably in wholesale and retail (+24,000), the financial sector (21,000), health (11,000) and hotels (8,000).

...pushing the unemployment rate up to 5.5%.

Labour force growth, in contrast, accelerated in Q4, showing an annual increase of 78,000, with the result that the level of unemployment rose to 101,000 from 90,000 in Q4 2006. The unemployment rate therefore picked up, to 4.5% from 4.2% twelve months earlier. Immigration is now playing an even bigger role in terms of labour supply, accounting for some 50,000 of the 78,000 annual growth in the fourth quarter, which alongside data revisions took the migrant share of total employment to 15.6%. Ireland is still seeing domestically driven labour force growth, of course, with a natural rise of 13,000 augmented by another 15,000 stemming from the long-term upward trend in participation.

For 2008, we expect further job losses in construction and therefore slower growth in total employment, with the annual gain falling to some 20,000 by the fourth quarter. The annual average growth in employment will be much higher, at around 40,000, nonetheless, given the starting base. This is equivalent to a 1.9% rise in the total at work, compared to the 3.6% figure seen in 2007. Labour force growth is likely to slow, too, in part due to lower net migrant inflows and we project a 65,000 rise in the supply of labour in 2008. This leaves the level of unemployment at 125,000 or 5.5% of the labour force. An upturn in the unemployment rate is already evident in the recent data: the monthly Live Register, which measures the claimant count, has seen a sharp rise in January and February, perhaps reflecting a step-up in the pace of construction lay-offs, pushing the unemployment rate up to 5.2%.

Labour Market (annual average '000)

	2006	2007	2008 (f)
Employment	2,044	2,117	2,157
Labour Force	2,138	2,218	2,282
Unemployment	95	101	125
Rate (%)	*4.4*	*4.5*	*5.5*

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