Produced by the Economic Research Unit
August 2012

Bank of Ireland
Global Markets

# TheOutlook

A quarterly analysis of trends in the Irish economy

## Recovery stronger than previously reported

Group Chief Economist: Dan McLaughlin

- GDP 2.2% above cycle low
- 1% growth seen this year

The recovery in Irish economic activity is now seen to be stronger than initially reported, following the latest round of data revisions; real GDP is over 2% above the low recorded in the final quarter of 2009, and last year's growth is now put at 1.4%, double the first estimate. The recovery remains slow and uneven, however, and driven solely by the external sector, which may explain why few people consider that the recession has actually ended; consumer spending is some 10% below its pre-recession level, capital spending is down an extraordinary 50% while exports have risen by 8%.

That trend of falling domestic demand and rising net exports reversed in the first quarter of 2012, however, albeit largely due to a surge in imports, in turn reflecting a second consecutive quarterly increase in business spending on machinery and equipment. Consequently, we now expect a rise in the latter over the year as a whole, and for that to offset another fall in construction spending, to give the first increase in total capital spending, in the economy for five years.

Consumer spending fell again in the first quarter, and we expect a 1.5% decline over the year, although nominal household income may stabilise, given the prospect of unchanged employment and a small rise in average earnings albeit offset by lower transfers and a rise in the tax burden. As a consequence we still expect total domestic demand to fall in 2012, by 1.7%, before a modest pick up in 2013.

Exports had their best performance in the first quarter for fifteen months and grew by over 6% on an annual basis, supported by double digit growth in service exports. The global economy has slowed and Europe is in recession so the risks to the external sector are plain to see, but Irish competitiveness has improved substantially and the fall in the euro may also provide support, particularly the decline against sterling.

Overall, we now expect GDP to rise by 1% this year, an upward revision from our previous 0.6%, despite the 1.1% decline in the first quarter. The recent data revisions have also extended to the unemployment rate, which is now put at a new cycle high of 14.8% in recent months, and we forecast an average of 14.7% for 2012. Ireland looks on target to match or beat this year's fiscal targets, and the prospect of some reduction in the sovereign's debt burden has helped to push Irish bond yields down to pre-bailout levels, although we feel that there is a risk of disappointment as to the level of debt savings.

The economy is also now paying its way in the world and running a balance of payments surplus, unlike many of the other peripheral European economies, which means that the public sector deficit is now been offset by strong surpluses in both the household and corporate sectors.

Irish GDP — Page 2
GDP falls in Q1 but from higher base

Inflation — Page 4
ECB rate cut will push inflation down

The Labour Market — Page 5
Upward revisions to unemployment rate

Exchequer Finance — Page 6
Budget targets likely to be met or bettered

Funding the Exchequer Deficit — Page 7
Ireland returns to the bond market

Contact Us — Page 8

# GDP falls in Q1 but from higher base

The first quarter national accounts revealed a 1.1% fall in Irish GDP but substantial revisions to the past data meant that fall was from a stronger base than initially thought. The plunge in GDP in the eight quarters to end 2009 is now seen to be slightly less steep than originally reported, albeit still severe at 10.8%, while the recovery has been revised up, leaving first quarter GDP 2.2% above the trough of the cycle. Annual GDP growth in 2011 is now put at 1.4%, double the previous estimate, while the level of GDP at €159bn is €2.5bn higher than the figure released in March.

**Domestic demand rose in Q1, against previous trend…**

The revisions did not alter the broad pattern of the recovery, which has seen net exports as the main driver of growth, offset to a greater or less degree in each quarter by falls in domestic demand. That trend was not replicated in the first quarter of this year, however, as domestic demand rose and net exports made a negative contribution to GDP, albeit due to a 4.9% increase in imports, outpacing a 2.6% rise in exports. The demand for imports was boosted by an 11.6% surge in capital spending, the second consecutive quarterly rise, leaving the annual increase in the first quarter at 8.0%, with spending on machinery and equipment up by 25%. The latter was flattered by strong aircraft orders, which tend to be volatile on a quarterly basis, but the rise ex-aircraft was 6.2%. Building and construction spending fell in the quarter and by over 11% on an annual basis although spending on home improvement and renovation is rising and now exceeds the spend on new houses. Total capital spending accounted for only 10% of GDP in 2011, against a long run average of 21%, and the recent rise would lend support to the view that investment may have bottomed, particularly as 2011 saw another strong year for retained earnings in the multinational sector. On that basis we are revising our capital spending forecast and now expect a marginal rise in 2012 as a whole, with a 12% increase in outlays on machinery and equipment offsetting an 8% fall in building and construction.

**…but consumer spending still falling...**

The first quarter rise in domestic demand occurred despite a 2.1% fall in consumer spending. This followed a revised 1.8% increase in the final quarter of 2011 and perhaps indicates that consumers brought forward some purchases ahead of the well-flagged increase in VAT. Weekly earnings appear to have stabilised and may rise marginally this year and household incomes will also be supported by a stabilisation in employment, but total transfer payments may fall and tax paid is forecast to rise, leaving nominal personal disposable income broadly flat on last year. This represents an improvement following three consecutive years of decline but real incomes will fall given the projected rise in consumer prices. Consequently, we expect a 1.5% decline in real consumer spending in 2012 on the assumption of a broadly unchanged savings rate. Government spending is also projected to continue to decline (despite a surprise rise in Q1) giving an overall 1.7% fall in domestic demand, the fifth consecutive year of falling domestic spending.

**…service exports extremely buoyant…**

The 2.6% increase in Q1 exports was the strongest quarterly performance for fifteen months and reflected buoyancy in service exports, with annual growth of 11.9%, the best figure since late 2007. Ireland has regained competitiveness according to the standard unit labour cost metrics and the supply side changes are particularly evident in service exports, with the expansion of production out of Ireland from major global firms in business and computer services. The fall in the euro may also help more traditional Irish exporters, particularly the decline to a 3.5 year low against sterling. In sum, we have revised up our forecast for exports and imports, with 5% in the former against 3.5% in the latter and this boost from net exports offsets the fall in domestic demand, resulting in a 1% increase in GDP.

**…and we have revised up our growth forecast.**

This represents an upward revision from our previous forecast (0.6%) in large part due to the recent data revisions. GNP also fell in the first quarter, by 1.3% and we now expect GNP in 2012 to be flat. Ireland is now running a Balance of Payments surplus (now put at 1% of GDP in 2011), unlike most of the other peripheral euro zone economies, and we expect that surplus to rise in 2012 to €2.6bn or 1.6% of GDP

The export-led nature of Irish growth makes the economy vulnerable to external events, and the possibility of a weaker European economy than envisaged, including that of the UK, represents a clear risk to the projection. It also makes any forecast further into the future more tentative than usual, although we concur with the consensus view that 2013 may see a return to some growth in domestic demand, thus leading to an acceleration in GDP growth; we expect a 1.5% rise.

**Real GDP (% change)**

| | 2010 | 2011 | 2012 (e) | 2013 (f) |
|---|---|---|---|---|
| Personal Consumption | 1.0 | -2.4 | -1.5 | 0.5 |
| Government Consumption | -6.5 | -4.3 | -4.0 | -2.0 |
| Capital Formation | -22.6 | -12.6 | 1.0 | 7.5 |
| - Machinery & Equipment | -15.3 | -2.6 | 12.0 | 15.0 |
| - Construction | -30.1 | -15.8 | -8.0 | 0.0 |
| Stocks (% of GDP) | -0.4 | 0.1 | 0.0 | 0.0 |
| Exports | 6.2 | 5.1 | 5.0 | 5.0 |
| Imports | 3.6 | -0.3 | 3.5 | 4.0 |
| GDP | -0.8 | 1.4 | 1.0 | 1.5 |
| GNP | 0.9 | -2.5 | 0.0 | 1.0 |

Inflation

# ECB rate cut will push inflation down

**Inflation at 18-month low…**

Irish consumer prices, as measured by the CPI, rose by 1.4% in the three months to March, reflecting a rise in energy prices, which accounted for a third of the increase, and the impact of a rise in VAT. These factors prevented the widely expected decline in the annual inflation rate with the latter remaining broadly unchanged at 2.2%.

In contrast, the monthly index fell by 0.2% in the three months to June, with increases in only four of the twelve component groups, with the result that the annual inflation rate eased to 1.7%, the lowest figure in eighteen months. Moreover, in the absence of a further upward move in oil prices we expect a further deceleration in the annual inflation rate over the remainder of the year, to around 1% in the final quarter, and an average of 1.6%.

**…and mortgage payments now falling…**

Energy now accounts for over 11% of the Irish CPI and volatility in that component is the source of a significant part of the volatility in the overall index. Annual energy inflation slowed in June to 8.6% from over 13% six months earlier and although there may be a short-term increase we expect the energy inflation rate to slow in the latter part of the year, so keeping downward pressure on the overall index.

Mortgage interest provides another source of volatility for the Irish CPI and the combination of positive base effects (rates rose in the first half of 2011) and the ECB rate cuts has had a very significant impact; mortgage payments in June fell by 7% on the previous year, so reducing the CPI by 0.4 percentage points as opposed to adding 1.5 percentage points twelve months earlier. The mortgage component now includes more tracker rates, following a rebasing, and so should reflect the impact of the ECB's July rate cut over the next few months, although non tracker rates were generally not reduced.

**…weaker euro/sterling rate impact may be limited.**

Imports account for some 80% of Ireland's GDP and food and drink imports from the UK account for a significant share of that sector, so the euro/sterling rate can also have a more medium term impact on Irish inflation. Consequently, the recent fall in the single currency to a four-year low against sterling may put some upward pressure on Irish prices, particularly if consumer spending recovers some momentum, although we do not envisage that occurring this year.

The HICP measure of inflation excludes mortgage interest and any downward pressure there is likely to come from energy inflation. We expect the annual inflation rate to slow to around 1.5% over the coming months, and to average 1.7% for the year.

**CPI Inflation (annual change, %)**

| | 2011 | 2012 (f) |
|---|---|---|
| Q1 | 2.3 | 2.2 |
| Q2 | 2.9 | 1.8 |
| Q3 | 2.5 | 1.4 |
| Q4 | 2.7 | 1.0 |
| Annual | 2.6 | 1.6 |
| HICP | 1.1 | 1.7 |

The Labour Market

# Upward revisions to unemployment rate

**Employment may be stabilising…**

Employment in Ireland rose for the first time in four years on a seasonally adjusted basis in the final quarter of 2011, by 11,000 or 0.6%, raising the prospect of a cyclical turning point in the labour market. In the event employment fell again in the first quarter of 2012, albeit by 7,000 or 0.4%, so still providing some support for the view that the demand for labour may be at least stabilising. Employment is now below 1.8 million on an unadjusted basis, nonetheless, and as such back to levels last seen in 2003, having peaked at 2.15 million in the third quarter of 2007. The economy did return to growth in 2011 but that growth was solely driven to the external sector, with high productivity multinational exports to the fore. Consequently employment is unlikely to pick up appreciably until domestic demand returns to growth, and we expect a broadly flat employment picture this year, despite a forecast of 1% growth in GDP.

The recent labour data also shows a net rise in the labour force over the past two quarters, reversing the trend over the past four years, leaving the annual decline in the first quarter at just 5,000 or 0.2%. The Irish participation rate appears to be close to stabilising after a steady decline while net emigration may be lower than many expected. The census data for 2011 revealed that the population was over 90,000 more than estimated and the level of immigration may still be higher than some forecasters expected so reducing the net emigration figure.

**…but unemployment rate at new cyclical high.**

The open nature of the Irish labour market adds a degree of volatility to the labour force and contributes to the scale of revisions often seen in the monthly estimates for the unemployment rate. A few months ago the data pointed to a cyclical high in the unemployment rate of 14.6% in the autumn of 2011, followed by a modest fall in the earlier months of 2012, but the latest figures shows the unemployment rate at 14.7% in the first quarter, rising to 14.8% in June and July. Consequently we have changed our unemployment forecast for the year, and now expect an average of 14.7% from the previous 14.4%, on the view that the labour force will now rise marginally so pushing the average number unemployed to 311,000.

**Labour Market (annual averages '000)**

| | 2010 | 2011 | 2012 (f) |
|---|---|---|---|
| Employment | 1848 | 1809 | 1809 |
| Labour Force | 2139 | 2114 | 2120 |
| Unemployed | 292 | 304 | 311 |
| *(% of labour force)* | *13.6* | *14.4* | *14.7* |

Exchequer Finance

# Budget targets likely to be met or bettered

**Tax and spending above profile…**

Tax revenue in Ireland has been running ahead of profile year to date and emerged over €520m or 3.1% above expectations at end-June. The out-performance was largely due to strong corporation tax receipts (up 39% on an annual basis and €274m above profile) and buoyant income tax revenue (€215m above profile and 16.9% above the same month in 2011). The 2012 Budget incorporated a 2% rise in the top rate of VAT, to 23% and the Department of Finance projected a modest 2.6% increase in receipts as a result, despite the expectation of a fall in personal consumption, and that forecast appears broadly on track.

Spending is also above profile, however, by 1.8%, largely due to an overshoot on health expenditure, although the authorities still expect the Budget to emerge on target for the year as a whole. The exchequer deficit for 2012 was forecast at €18.9bn with a current budget shortfall of €11.2bn, as in 2011, but a much lower capital deficit of €7.7bn against €13.9bn the previous year, with the latter inflated by support for the banking sector.

**…but 8.6% deficit target to be met or beaten.**

The 2012 capital deficit forecast was also inflated by bank-related expenditure including a €3.1bn promissory note payment. In the event the Government issued a bond to IBRC which was then used in a repo transaction with Bank of Ireland to cover the cash payment. Consequently, the capital deficit will be some €3bn lower than actually forecast, although Government debt will still increase by a similar amount given the increase in bond issuance.

The promissory note is not included in the General Government deficit figure, which the Budget forecast at €13.7bn or 8.6% of projected GDP. We expect the deficit to emerge at €13.2bn or 8.2% of GDP. That outturn would still leave the Irish figure as the highest in the euro zone given current EU projections. Moreover the Department of Finance believes that the cyclical component is less than 1% of GDP, which if broadly accurate implies the need for further spending cuts and a broadening of the tax base as envisaged in the EU/IMF programme.

**Exchequer Finances (€bn)**

| | 2011 | 2012 Budget | 2012 Forecast |
|---|---|---|---|
| Current Expenditure | 48.0 | 49.5 | 49.7 |
| - Voted | 41.4 | 40.5 | 41.0 |
| - Non-voted | 6.6 | 9.0 | 8.8 |
| Revenue | 36.8 | 38.3 | 39.1 |
| - Tax | 34.0 | 35.8 | 36.4 |
| - Other | 2.8 | 2.5 | 2.7 |
| Current Budget Balance | -11.2 | -11.2 | -10.7 |
| Capital Balance | -13.7 | -7.7 | -4.7 |
| Exchequer Balance | -24.9 | -18.9 | -15.4 |
| General Government Balance | -20.5 | -13.7 | -13.2 |
| *(% of GDP)* | *(-13.1%)* | *(-8.6%)* | *(-8.2%)* |

Funding the Exchequer Deficit

# Ireland returns to the bond market

**The NTMA overfunded modestly in H1…**

The exchequer deficit amounted to €9.4bn in the first half of the year and a bond redemption of €5.6bn brought the gross funding requirement in the half-year to €15bn. The NTMA borrowed €4.7bn from the IMF, €9bn from the EU and secured €1.2bn in bilateral loans, largely from the UK, bringing total funding from official sources to €14.9bn. In addition, €0.8bn was raised via the various National Savings Schemes and with other minor adjustments this resulted in €1bn overfunding, so increasing cash balances to €18.8bn, from €17.8bn at end 2011.

That cushion alongside the residual €18bn undrawn balances from Ireland's €67.5bn loan programme means that the exchequer's forecast deficit and redemptions are funded well into 2014, so a key issue is whether Ireland will be able to fund the deficits beyond that point in the market at a sustainable rate, or will the authorities have to negotiate another official loan. The interest rate on the EU/IMF loans to date averages under 3.5% and the average maturity is around 10 years, which in better terms than Ireland is likely to secure in the market but at a cost of quarterly fiscal targets and other conditions.

The fact that Ireland has adhered to the current adjustment programme has helped to push Irish secondary yields down and the market received another fillip following the end-June euro summit which held out the prospect of actions to improve the sustainability of Irish debt.

**…and re-entered the bond market in July.**

The scale of any debt relief on the cost of State support for the Irish banking sector is unclear, and perhaps open to disappointment, but the NTMA took advantage of the July rally in Irish bonds by first raising €0.5bn in Treasury bills, at a yield of 1.8%, and then raising over €4bn by tapping the 5% 2020 and issuing a new bond, the 5.5% 2017. The Agency also offered switch terms into those bonds out of the existing 13's and 14's, thereby extended the maturity of the debt and reducing the 2014 funding requirement by €0.6bn. The average yield on the new bond issuance was around 6% which is not sustainable in the long run but can be seen as the first step by the Irish sovereign on a path which it hopes will lead to more normal market funding at a more sustainable rate. The timing of any additional funding will depend to some degree on external developments, however, particularly market sentiment towards the euro bond market in general. The NTMA has signalled that it will issue index linked debt and amortising bonds, designed to attract local pension fund interest, and this is likely to be less dependent on international sentiment.

## Contact Us

### Economic Research Unit (ERU)

To discuss any aspect of this report, contact your treasury specialist or our Economic Research UNIT (ERU):

Chief Economist, Bank of Ireland: Dr. Dan McLaughlin Tel: +353 (0) 766 244 267
Senior Economist: Michael Crowley e-mail: eru@boigm.com
Economist: Patrick Mullane

### Contact your treasury specialist

| | |
|---|---|
| Corporate Treasury | 1800 60 70 20 or 1800 30 30 03 |
| Business Banking Treasury | 1800 79 01 53 |
| Institutional Treasury | 1800 60 70 40 |
| Specialised Finance | +353 (0)1 790 0001 |
| UK Sales Team | 0800 039 0038 (within the UK) |
| US Sales Team | +1 203 391 5555 |

### Our Offices

**Dublin**

2 Burlington Plaza, Burlington Road, Dublin 4, Ireland
Tel +353 (0) 766 244 100

**London**

Bow Bells House, 1 Bread Street, London EC4P 4BP, UK
Tel +44 (0)20 3201 6000

**Belfast**

1 Donegall Square South, Belfast, BT1 5LR, UK
Tel +44 (0)28 9032 2778

**Stamford (US)**

300 First Stamford Place, Stamford CT 06902, US
Tel +1 203 869 7111

**Keep in touch with the markets, visit www.treasuryspecialists.com**

Market data supplied by Thomson Reuters

**Disclaimer**
This document has been prepared by the Economic Research Unit at Bank of Ireland Global Markets (“GM”) for information purposes only and GM is not soliciting any action based upon it. GM believes any information contained herein to be accurate but GM does not warrant its accuracy and accepts no responsibility, other than any responsibility it may owe to any party under the European Communities (Markets in Financial Instruments) Regulations 2007 as may be amended from time to time, and under the Financial Services Authority rules (where the client is resident in the UK), for any loss or damage caused by any act or omission taken as a result of the information contained in this document. No prices or rates mentioned are bids or offers by GM to purchase or sell any currencies, securities or financial instruments. Except as otherwise may be specifically agreed, GM has not acted nor will act as a fiduciary, financial or investment adviser with respect to any currency or derivative transaction that it has executed or will execute. Any decision made by a party after reading this document shall be on the basis of its own research and not be influenced or based on any view expressed by GM. This document does not address all risks. Any party should obtain independent professional advice before making any investment decision. Any expressions of opinion reflect current opinions as at 2nd August 2012. This publication is based on information available before this date. This document is property of GM. The content may not be reproduced, either in whole or in part, without the express written consent of a suitably authorised member of GM staff.
Bank of Ireland is regulated by the Central Bank of Ireland. In the UK, Bank of Ireland is authorised by the Central Bank of Ireland and authorised and subject to limited regulation by the Financial Services Authority. Details about the extent of our authorisation and regulation by the Financial Services Authority are available from us on request. Bank of Ireland incorporated in Ireland with limited liability. Registered Office - Head Office, 40 Mespil Road, Dublin 4, Ireland.Registered Number - C-1.