Produced by the Economic Research Unit
July 2011

Bank of Ireland
Global Markets

TheOutlook

A quarterly analysis of trends in the Irish economy

Modest growth this year, but consumption weaker than expected

- Strong growth in Q1, again driven by external trade
- Domestic demand still falling

The Irish economy grew by 5.1% in nominal terms in the first quarter of the year and by 1.3% in volume terms, taking the annual change in the latter into positive territory. Moreover, revisions to past data now show that the fall in GDP from 2008 to 2010 was somewhat less steep than previously thought and that the level of GDP last year was also higher than envisaged, at €156bn with a concomitant modest reduction in Ireland's debt ratio.

The new figures point to real GDP having bottomed in the final quarter of 2009, but the quarterly pattern since then has been volatile, with any advance followed by a contraction. That may remain the case this year, although we still expect a modest 0.5% rise in GDP for 2011 as a whole.

This forecast is unchanged from our previous quarterly 'Outlook' but we have changed the composition of that growth in the light of the Q1 data. Consumer spending has surprised to the downside with households cutting discretionary spending in response to a rise in prices, further falls in employment and another, albeit modest decline in average earnings, and we now expect a 2.5% fall in the volume of personal consumption against our previous 2%.

Against that, spending on machinery and equipment rose in the first quarter, and as a consequence we have revised our expectation of capital spending as a whole – we still expect a decline, driven by further steep contraction in construction, but the annual fall in business spending may now be much more modest, and represents a possible upside surprise.

This overall fall in domestic spending is likely to be offset by another strong contribution from the external sector, although we have trimmed both our export and import growth figures, with the former reflecting the deceleration in global growth evident in the first half of the year. The corollary to export-led growth is that multinational outflows are likely to rise and we envisage no growth in the GNP measure.

Employment is also generally driven by domestic demand, and so employment may fall again this year, albeit at a much slower pace, although the numbers unemployed may remain in a narrow 290,000 – 300,000 range given the fall in the labour force, with the unemployment rate averaging 14%. Finally, the Exchequer deficit appears to be broadly on track, with downside risks relating to VAT perhaps compensated by lower than projected spending and higher than anticipated non-tax receipts.

Dr. Dan McLaughlin

Irish GDP

Strong export-led growth in first quarter

Positive data revisions…

The recently published national accounts for the first quarter of 2011 incorporated revisions to past data. The result is that the Irish recession is now deemed to have been somewhat less steep than originally reported; real GDP fell by 3.0% in 2008 (from 3.5%), the contraction in 2009 is now put at 7.0% (-7.6%) and last year's initial 1% decline has been revised to -0.4%. As a consequence the peak to trough fall in GDP is now seen as 12.6% instead of 14.6%. The value of GDP has also been revised up with the 2010 figure at €156bn or €2.1bn above the original estimate. The new data also shows GNP growth in 2010 of 0.3%, following four consecutive quarters of rising income.

…and exports again drove GDP in Q1…

The latest figures have not altered the broad pattern of GDP last year with an advance in one quarter followed by a contraction in the next, and this trend continued into 2011, with a 1.3% rise in Q1 largely offsetting a 1.4% contraction in the final quarter of 2010, leaving the annual growth figure in the first quarter in marginally positive territory. The Q1 advance was driven by external trade; a 3.8% rise in the volume of exports dwarfed a marginal decline in imports, thus contributing 4 percentage points to GDP growth. The annual pace of export growth has slowed of late, however, reflecting in part base effects but perhaps also as a consequence of the deceleration in global GDP growth, and we have revised down our forecast for Irish exports in 2011 as a whole – we now expect a 6.0% increase, from over 8%. On the import side, the recent strong annual increase in value terms largely reflects higher import prices and we have also revised down our forecast for import growth to 4%. As a result net exports are expected to provide a positive contribution to GDP of 2.7 percentage points.

…but consumption was surprisingly weak…

Domestic demand plunged during the recession and the first quarter GDP figures showed a further decline, although this time personal consumption was the culprit, falling 1.9% and an annual 2.9%. Retail sales excluding autos had risen marginally in Q1 so the implication is that spending on services fell sharply. In addition, spending by Irish residents abroad (which is added to the consumption figure) is still falling while tourism to Ireland (which is subtracted) is now growing again. The household savings ratio in Ireland has risen sharply over the past three years (we estimate a 12% figure for 2010) but household disposable income has also been falling and we see that remaining the case in 2011. The pace of decline in average earnings has slowed (to 1.3% in Q1 from 2.5% in the previous quarter) but is still expected to be negative this year which alongside a further fall in employment gives a 3.0% decline in total wage income. This is less than half the figure recorded in 2010, but other factors will be more negative, including a rise in the total tax burden and a fall in transfers. Moreover, prices are now rising again, having fallen in 2009 and 2010. Consequently, we expect a 2.5% average fall in consumer spending in 2011 which will provide a 1.3% negative contribution to GDP growth.

…capital spending still falling but at slower pace…

Capital spending, including construction, plunged during the recession but the Q1 data revealed a modest 1.1% rise, in turn reflecting a 7.7% rise in spending on machinery and equipment, which offset a further fall in building and construction. The business spending data was flattered by a strong rise in the volatile aircraft orders component, albeit still marginally positive excluding that, but we still expect a negative reading for the year as a whole in part due to a substantial negative base effect in the second quarter. Similarly, we expect a further fall in building and construction, albeit at a slower pace than in 2010, although it is now much less significant in terms of GDP; housebuilding now accounts for less than 2% of real GDP. Overall we forecast a 10% fall in capital formation, which is marginally higher than our previous expectation and the past Q1 data on business spending does open the door to an upside surprise on that number.

…modest growth still expected this year.

Government spending also fell in the first quarter and we have pencilled in a 4% decline for 2011, with the result that domestic expenditure as a whole (consumption, capital formation and government spending) declines by 4.2%, against a 5.8% fall in 2010 and an extraordinary 15.1% plunge in 2009. The past couple of years has also seen a huge fall in inventories and one might expect this to come to a halt at some stage, although we now expect a flat inventory figure for 2011, having previously pencilled in a small increase. The net result is that GDP growth is still expected to be a modest 0.5% this year with the positive contribution from net exports offsetting a further drag from domestic demand.

Ireland ran a BoP surplus in 2010…

The data revisions also included a substantial change to the Balance of Payments (BoP), which now shows an Irish surplus in 2010, the first since 1999, amounting to €765m or 0.5% of GDP. This compares with deficits in excess of 5% of GDP in both 2007 and 2008, implying large sectoral imbalances in the economy at that time. The data for 2010 now implies a broad sectoral balance, with the deficit in the public sector offset by surpluses in both the household and corporate sectors.

…volatile profit outflows but flat GNP forecast this year.

The large swing in the BoP has been driven by a substantial increase in the merchandise trade surplus with the net outflow of factor payments broadly unchanged between 2007 and 2010. The quarterly flow of such payments is very volatile, nonetheless, particularly multi-national profits and this was very evident in the Q1 2011 figures; these profits rebounded sharply after an unusual weak fourth quarter figure which contributed to a jump in net factor outflows to over €8bn from €4.6bn the previous quarter. As a consequence, GNP fell by 4.3% leaving the annual change in negative territory at -0.9%. Following that, we now expect GNP to be flat this year.

Irish Real GDP (% change)

	2010	2011 (e)	2012 (f)
Personal Consumption	-0.8	-2.5	-0.5
Government Consumption	-3.8	-4.0	-3.0
Capital Formation	-24.9	-10.5	0.5
- Building & Construction	-30.3	-14.0	-5.0
- Machinery & Equipment	-14.5	-5.0	10.0
Stocks (% of GDP)	-0.6	0.0	0.3
Exports	6.3	6.0	6.0
Imports	2.7	4.0	5.0
GDP	-0.4	0.5	3.0
GNP	0.3	0.0	3.0

Inflation

Mortgage interest main driver

Higher mortgage costs have pushed inflation up…

The volatility in the Irish inflation rate, as measured by the CPI, is largely driven by mortgage interest, energy and to a lesser degree, food prices. Mortgage interest has a 6.7% weight in the index and generally means that Irish inflation somewhat paradoxically moves in the same direction as ECB interest rates, at least initially. Irish mortgage rates have risen independently of the ECB over the past year, however, with lenders attempting to pass on the higher cost of Irish funding, with the result that in the twelve months to May mortgage interest had risen by some 20% and contributed over 1.1 percentage points to the overall annual inflation rate of 2.7%.

The ECB raised rates in April, of course, and we expected a significant mortgage effect in the May index, given the prevalence of 'Tracker Mortgages' (i.e. linked to the repo rate) but in the event it did not materialise, implying that the June index will be impacted. The ECB raised rates again in July so the next few months will see a further mortgage effect.

Energy prices have also risen in the past year, by over 10% to May and this contributed another 0.9 percentage points to inflation, so if one excludes these two factors inflation would be in positive territory but only modestly so, particularly as food, which accounts for over 11% of the index, has risen by only 1% over the past year.

…and ECB tightening will be key influence this year.

The implication is that any near-term Irish inflation forecast will be strongly driven by expectations about oil prices and ECB monetary policy, and the consensus inflation figure for 2011 has risen of late, to 2.3% from 1.7% earlier in the year in response to higher oil prices and the reality of ECB tightening. Oil prices have fallen over the past month, however, which will offer some respite but the recent rate increase will help to push the annual inflation rate above 3.5% in the latter part of the year in the absence of a steeper fall in oil prices. Consequently, we expect CPI inflation to average 2.8% this year.

HICP inflation excludes mortgage interest which makes it less volatile, rising by 1.2% in the twelve months to May. Energy inflation was a significant factor here however, with modest price increases evident elsewhere, mainly in services. The Government has cut VAT on some personal services geared to the tourist market, but we doubt if this will be a material impact. We expect HICP inflation to average 1.3% this year from -1.6% in 2010.

CPI Inflation (annual change, %)

	2010	2011(e)
Q1	-3.4	2.3
Q2	-1.4	3.1
Q3	0.2	2.8
Q4	0.9	3.3
Annual	-1.0	2.8
HICP	-1.6	1.3

The Labour Market

14% unemployment for this year

Employment declining but at slower pace…

Irish monthly redundancies this year have fallen relative to 2010 and are significantly lower than 2009, implying a concomitant decline in the pace of job losses. GDP is also no longer declining, having risen marginally in the year to the first quarter, and the latest employment data is broadly consistent with these developments, showing a 0.5% fall in Q1, from 0.6% in the previous quarter and 0.8% a year earlier. Construction is still shredding labour, as is manufacturing, but the first quarter saw a significant increase in job losses in the hotel sector and in the wholesale and retail trades. The prospects for a return to employment growth this year are not bright, given the likely scale of GDP growth and its composition – an export-led recovery may boost output but domestic demand, which sustains most employment, is still expected to fall. Nonetheless, we expect a further deceleration in the pace of job losses through the year, although this still implies an average fall of 33,000 or 1.8% in 2011.

…and now matched by a fall in labour force….

The numbers unemployed have moved in a narrow 290k – 300k range since the second quarter of 2010, despite the fall in employment, reflecting a similar decline in the labour force. The participation rate has fallen significantly, notably in the younger age group, with more people staying on in school or enrolling in third level education. Migration has also played a significant role with a high proportion of non-Irish nationals that have lost their jobs leaving the country. The trend decline in the labour force did slow sharply in the final quarter of 2010 but has picked up again in the first quarter, and we expect this to continue. Consequently, our forecast fall of 30,000 in the labour force leaves the numbers unemployed at 295,000 for an average unemployment rate of 14%.

…data revisions produce lower unemployment rate.

The data on Irish employment and labour supply is published quarterly in the National Household Survey, but the CSO publishes a monthly estimate of the unemployment rate. This uses the trend in the monthly claimant count (the Live Register) to update estimates of the quarterly figures and as such subject to revisions on publication of the survey data. These revisions have been substantial of late, largely reflecting swings in the pace of labour force decline. The unemployment rate in the first quarter is now put at 14.1% for example, against an initial 14.7%. The latest monthly data gives a 14.1% reading for Q2, so the average year to date unemployment rate is now much lower than previously thought which will prompt revisions to annual forecasts, although the employment trend has emerged broadly as expected. Finally, the initial census figure for 2011 was higher than expected, at 4.58 million, which implies that net emigration may have been lower than previously estimated over the past few years.

Labour Market (annual averages '000)

	2010	2011(e)	2012(f)
Employment	1848	1815	1815
Labour Force	2139	2110	2100
Unemployed	292	295	285
(% of labour force)	*13.6*	*14.0*	*13.6*

Exchequer Finances

Half-year figures show Budget on target

The 2011 Budget was predicated on 1.7% real growth in the economy and flat consumer spending. That forecast now looks optimistic (the consensus expects growth of around 0.5%) and personal consumption is likely to fall by around 2.5%. Despite this, the evidence from the exchequer returns to end-June is that the Budget remains broadly on target, with the borrowing requirement (EBR) still likely to emerge around €18bn.

Tax receipts marginally behind profile…

Tax receipts at the half-year were €114m or 0.7% behind profile largely due to a €134m shortfall in VAT, which is 2.5% behind target. This no doubt reflects the weaker than expected trend in consumer spending, although inflation is also higher than forecast, supporting the nominal tax take. Corporation tax is also adrift of profile but this may owe more to timing issues and the downside risks relate more to VAT, given the weak trend in core retail sales.

…but spending also below target.

Spending is also running below profile, however, on the current and capital side, and emerged €342m or 1.5% under the target at the half-year. The net result was a current budget deficit of €7.2bn against a €8.1bn shortfall in the same period of 2010. The EBR as a whole was higher than the previous year, at €10.8bn against €8.9bn, but this reflects the impact of the €3bn funding of the Promissory Notes, paid by the State to Anglo Irish Bank and INBS.

The Government has stated that it expects the fiscal deficit to emerge around the Budget target and this seems a reasonable forecast at this point. The risks on the tax side are to the downside, but against that non-debt spending may well emerge below target, particularly on the capital side. In addition, non-tax receipts may also emerge ahead of Budget, notably in terms of the fees received from the banks for the State guarantee – this was projected at €800m for the year as a whole but by end-June had already reached €600m.

Exchequer Finances (€bn)

	2010	2011 Budget	2011 Forecast
Current Expenditure	47.0	48.4	48.6
- Voted	40.5	41.7	41.7
- Non-voted	6.5	6.7	6.9
Revenue	34.4	36.9	36.7
- Tax	31.8	34.9	34.4
- Other	2.7	2.0	2.3
Current Budget Balance	-12.6	-11.5	-11.9
Capital Budget Balance	-6.2	-6.1	-6.0
Exchequer Balance	-18.7	-17.7	-17.9
General Govt Balance	-49.9	-15.2	-15.4
(% of GDP)	-32.0	9.4%	9.9%

Funding the Exchequer Deficit

Loan package could fund State well into 2013

Light redemption profile in next few years…

The Irish Government has some €90bn in outstanding bonds at issue, with some 82% held abroad. That share fell through 2010, implying that residents absorbed a higher share of last year's issuance. The weighted average maturity of the debt is 7.4 years and the redemption schedule is relatively light over the next few years; €4.4bn matures in November this year, €5.6bn in March 2012 and €6bn in April 2013.

In addition, the State is still running large deficits, of course, with an EBR figure of around €18bn now expected this year, followed by a €15bn target for 2012. These figures imply that the State would need to borrow some €23bn in 2011 and €21bn in 2012, irrespective of any additional funds to cover further capital support for the banking sector. Similar figures presumably underpinned the Government's request for EU/IMF support, as the €67.5bn loan agreed last November includes 'up to €50bn to cover the financing of the State'. The figures imply that the loan envisaged Ireland returning to the markets as a borrower by the end of 2012 and indeed this remains the official view.

…and banking support may be less than envisaged.

That return to issuing debt instruments certainly looks some way off given the current yield on Irish debt. The 2-year bond is trading over 15%, with the 10-year benchmark over 12%. The risk premium has clearly risen sharply, with the 10-year spread moving at just under 100bp after selling off following the Portuguese downgrade. However, the Government may now be funded for a longer period than initially envisaged because the official EU/IMF package included €35bn earmarked for the banking sector, with half of that coming from the National Pensions Reserve Fund. It now appears that the banking sector will not need that amount and so any residual could be used by the Government to cover the Exchequer deficit well into 2013. The Irish Government drew down €22.2bn from the EU/IMF facility in the first half of the year, against an EBR of €10.8bn. The excess was used to repay €6bn in short-term debt and some €0.5bn on bond redemptions, with the balance augmented by €1bn in inflows to National Savings products. The net result was a €5.8bn increase in cash balances.

The Irish Government is also seeking to re-negotiate the interest rate on the EU portion of the loan. This is a variable rate, depending on the cost of funding, but the spread agreed last November may be reduced. The spread on the IMF loan is not up for negotiation.

Contacts

Bank of Ireland Global Markets

www.boi.ie/globalmarkets

Chief Executive: Austin Jennings
Head of Global Customer Business: Kevin Twomey

Colvill House, Talbot Street, Dublin 1, Ireland
Fax: +353 1 799 3035 Tel: +353 1 799 3000
e-mail: info@boigm.com

Economic Research Unit (ERU)

Chief Economist, Bank of Ireland: Dr. Dan McLaughlin
Senior Economist: Michael Crowley
Economist: Patrick Mullane

Tel: +353 1 609 3341
e-mail: eru@boigm.com
Listen to Daily Commentary on Freephone: 1800 60 70 60

Corporate & Institutional Sales — Freephone 1800 30 30 03

Head of Corporate & Institutional Sales: Aine McCleary	
Head of Corporate Sales: Liam Connolly	+353 1 790 0000
Head of Customer Group Funding: Paul Shanley	+353 1 609 3212
Institutions: Gavin Rylands	1800 60 70 40
Property & Specialised Finance: Ed Preston	+353 1 609 3277
Corporate Relationship Manager: Eamon McManamy	+353 1 609 3215

Retail Sales — Freephone 1800 790 153

Deputy Head Global Customer Group, Head of Retail Sales & Customer Group Operations: John Moclair
Business Development & Sales Management: Adrienne McNally
Head of Customer Group Operations: Osna O' Connor
Business Banking Sales: Leslie Cosgrave

Global Markets United Kingdom (UK)

Head of UK: Liam Whelan	0044 207 4299 111
Head of Specialised Treasury: Mark Doody	0044 207 4299 103
Head of Corporate Sales: Kai Fisher	0044 207 4299 109
Business Banking Sales: Sandra Perry	0044 207 4299 121

P.O. Box 62929, Bow Bells House, 1 Bread Street, London EC4P 4BF
Tel: +44 (0) 20 7429 9111
GB Treasury Sales Team Freephone: 0800 039 0038
Tel: +44 (0) 7429 9121; Treasury Sales Team: 0800 776 616

Global Markets United States (US)

Head of US: Darsh Mariyappa
Head of US Business Development: Joe Connolly
Head of US Sales: Garreth Boyle

300 First Stamford Place, Stamford, CT 06902, US
Tel: +1 203 391 5555
Fax: +1 203 391 5901

Global Products Team

Global Head of Structured Business: Brian Vaughan — Tel: +353 1 790 0040
Head of Structured Products Distribution: Barry McLoughlin — Tel: +353 1 790 0400

Marketing

Head of Marketing: Andrew Hearnden — Tel: +353 1 609 3302

Market data supplied by Thomson Reuters