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Bank of Ireland
Global Markets

TheOutlook

A quarterly analysis of trends in the Irish economy

Global upturn to support Irish recovery

- Domestic demand expected to fall again
- Export growth to provide economic stimulus

Most European economies returned to growth in the third quarter of 2009, as did the US, and Ireland too also recorded a modest expansion in GDP. As such, one could claim that the recession here is over, although the detail argues for a more cautious interpretation - the expansion was solely due to a sharp fall in imports relative to exports, following a further decline in domestic spending. Moreover, the real income of Irish residents, as measured by GNP, contracted by 1.4%.

It does seem clear that the economy is stabilising, nonetheless, as GDP fell by only 0.3% in the six months to September as against the extraordinary and unprecedented 7.5% plunge in the six months to March 2009. That period gave rise to some extremely pessimistic forecasts for 2010 and the better data of late has prompted some upward revisions. Most forecasters, including the Government, envisage a return to positive growth in the second half of this year, although this still leaves the average growth rate for 2010 in negative territory, around -1%. We still expect a positive reading of 1%, however, largely because we forecast a slightly stronger recovery in exports, given that Ireland's main markets are now growing again.

Most, if not all, forecasters agree that domestic spending is set to fall again this year, albeit at a slower pace than 2009. We expect a 2.0% contraction in consumer spending (-7.2% last year) and a 17% fall in capital spending, about half the 2009 pace of decline. Construction spending still looks extremely weak, with house-building now down to some 3% of GDP from a cyclical peak of over 12%.

The record low interest rate environment and falling consumer prices has provided some support for personal incomes, but households appear to have reduced spending by more than the fall in disposable incomes; the savings ratio may have risen to over 11% in 2009, against a decade average of 5.4%. We have not pencilled in a decline on the savings ratio this year, as employment is expected to fall further, albeit at a much slower pace than in 2009, but the apparent stabilisation in the unemployment rate may prompt some change in consumer behaviour. The deflation cycle also appears to have turned, however, and we expect inflation to turn positive again before year end. Finally, the fiscal position also appears to be stabilising after two consecutive years in which the outcome was substantially worse than expected, although uncertainties still abound, including the pace and durability of the global recovery and the timing of monetary tightening by the ECB.

Dr. Dan McLaughlin.

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Irish GDP

GDP rises in Q3, despite big fall in domestic demand

The economy has stabilised after a 7.5% fall in six months…

The Irish economy, as measured by GDP, contracted by 7.5% in the six months to March 2009, an extraordinary and unprecedented collapse in activity. Since then, the economy has moved to a more stable path, contracting by 0.3% in the following six months. Indeed, GDP actually recorded modest growth of 0.3% in Q3, albeit still leaving the annual rate of decline at 7.4%.

In a narrow technical sense one could state that the Irish recession ended in the second quarter, following the general experience elsewhere, although the composition of the Q3 data argues against that conclusion. The recorded expansion was solely due to a sharp fall in imports relative to exports, in turn reflecting a 2.7% fall in domestic demand, including a 9.9% plunge in capital spending. As a result, the modest rise in real income recorded essentially accrued to foreign multinationals with Irish resident incomes, as measured by GNP, continuing to fall, this time by 1.4% in the quarter, bringing the annual GNP contraction to 11.3%.

…Exports have held up well and will support growth this year…

The Q3 data does highlight the importance of the external sector in determining Irish output, with exports likely to average 86% of real GDP in 2009 from 79% in 2006. The resilience of the external sector (the volume of exports fell by 2.6% in the year to the third quarter, against an 11.9% fall in imports) is partly due to the composition of merchandise exports (chemicals and pharmaceuticals account for over 60% of the total) and partially to the strength of service exports, including business services, insurance and capital services. This performance appears to sit uneasily with the widely held view that Ireland has lost competitiveness, but measures of relative unit labour costs in manufacturing, which are dominated by the multinational influence, do not support that contention.

We expect the volume of exports to pick up as 2010 unfolds, reflecting stronger demand in Ireland's main markets, and have pencilled in a 3.5% rise for the year as a whole. Imports, in contrast, are expected to fall again, albeit by a less dramatic 2%, with the result that the external sector again provides the main support for the economy.

…but consumer spending and investment will fall again…

The outlook for domestic demand is less promising, however, and another year of contraction looks in store. The recession has seen a collapse in total capital spending, which we expect to decline to only 14% of GDP in 2010, from an estimated 17% last year and a cyclical peak of 27.4% in 2005. A key component of this trend is the precipitous fall in residential construction, with a 50% decline likely in 2009, following a 34% fall in 2008. The available proxies for housing starts imply only a modest change in this trend for 2010, and we expect a 42% fall. To compound the issue, spending on home improvements has now turned negative after double-digit growth in 2008, and non-residential construction is also now falling sharply, although we also expect this trend to flatten somewhat this year. Nonetheless, building and construction as a whole is still forecast to decline by over 22%, following a 36% decline last year. The other component of capital formation, spending on machinery and equipment, is extremely volatile on a quarterly basis (it rose 6% in the year to Q2 2009 and then fell 25% in Q3), but the global recovery may provide some incentive for multinational companies in particular, to boost investment as the year unfolds, although we still expect an average fall of 5% for 2010, following an estimated 14% fall last year.

…the savings ratio has risen…

Consumer spending is also expected to contract further in 2010, following a 10% average decline in cash terms in 2009, or 7.2% in volume terms. This was largely driven by a sharp fall in household disposable income, with an estimated 9% fall in aggregate wage earnings partly offset by a rise in transfer receipts and a fall in aggregate income tax payments, There also appears to have been a substantial increase in savings: we estimate that the savings ratio in 2009 rose to over 11% from a cycle low of 2.3% in 2007. This compares with an average of 5.4% over the previous decade, showing that Irish households reduced their discretionary spending to an unusual degree last year in the face of rising unemployment, while repaying credit card debt and reducing net mortgage debt outstanding.

The recent stabilisation in the unemployment rate, if maintained, may prompt a modest fall in the savings ratio this year, but our base case is that the savings ratio is broadly unchanged in 2010, with the trend in disposable income thereby driving consumption. Employment is expected to fall again, by an average 3.5%, and average earnings in the economy may also decline by 2%, but again higher transfers will provide some offset, so limiting the fall in disposable income to around 4%. Therefore, we have pencilled in a similar fall in personal consumption, incorporating a 2% price fall and a 2% decline in volume terms.

…an inventory rebound may also boost GDP.

Government spending is also expected to decline in volume terms (by 2.5%), with the result that domestic demand as a whole is forecast to contract by 5% this year, following an 11.5% fall in 2009. The past year has also seen an unusually large fall in inventories (of over €1bn) and we expect this to come to a halt given the global upturn, providing a positive contribution to growth, which alongside the net export stimulus is strong enough to produce positive growth for the year as a whole - we reiterate our 1% GDP growth projection, as made in our previous quarterly Outlook, following a 6.6% contraction in 2009. This modest growth, allied to its skewed nature, will again result in a decline in GNP, however, and we forecast a 1.5% fall, against an 11.2% decline last year.

Our GDP growth forecast is above the consensus, which still expects a modest contraction (-1.0%), as indeed does the Irish Government. The consensus has become less pessimistic in the light of the recent improvement in the data, however, as the current expectation compares with a forecast 3.5% contraction held at mid-2009. The monthly PMI indices have certainly trended higher, supporting a less bearish view, and both the services and manufacturing indices are now above 48 from cyclical lows of 31.8 and 33.2 respectively. This still implies a contraction, of course, but we expect these indicators to follow the European pattern and breach the 50 level in the next few months.

Irish Economy Forecasts

	2008	20009 (e)	2010 (f)
Personal Consumption	-1.0	-7.2	-2.0
Government Consumption	2.6	-1.2	-2.5
Capital Formation	-15.5	-28.7	-17.0
- Building & Construction	-15.5	-33.0	-21.6
- Machinery & Equipment	-15.5	-14.0	-5.0
Stocks (% of GDP)	0.2	-0.6	0.3
Exports	-1.0	-3.0	3.5
Imports	-2.1	-9.7	-2.0
GDP	-3.0	-6.6	1.0
GNP	-2.8	-11.2	-1.5

Inflation

Inflation likely to turn positive again this year

Irish prices have fallen further than the euro norm…

The euro area's experience of deflation lasted only five months in 2009, with the annual inflation rate turning positive again in November, having reached a low of -0.7% in July. In contrast, Ireland is still in the throes of deflation, with consumer prices falling by an annual 2.6% in December on the HICP measure, the tenth consecutive month of negative inflation. Consequently, the Irish average inflation rate for 2009 was substantially below that of the euro average, emerging at -1.7% against +0.3% in the euro area.

The divergence between the Irish price experience and her euro peers is evident across most of the components of the HICP, and is particularly acute in food, clothing and footwear, and housing. This partially reflects a sterling effect, with Ireland being far more exposed to the euro/sterling exchange rate than its continental neighbours. The nature of the Irish recession may also have played a part, with domestic demand much weaker here than in the euro area, notably in personal consumption.

The deflationary cycle may also have turned In Ireland, however, albeit at a more sluggish pace than likely in the euro area, although similar factors are at work: last year's large declines in food and energy prices will fall out of the annual comparison and these base effects will help push annual inflation rates higher in 2010. In Ireland's case, we expect inflation to turn positive again in the final quarter on the HICP definition, although the average for the year is still likely to be negative at -1.0%.

…but return to positive inflation likely as year unfolds.

The more widely quoted measure of Irish inflation, the CPI, reflects similar price pressures, but augmented by falling mortgage interest, which at one stage in 2009 reduced the annual inflation rate by 3.3%. This largely explains the divergence between the CPI and the HICP, with the former recording a cycle low of -6.6% in October with an average annual figure of -4.5%.

Again though, CPI inflation is likely to turn positive again in 2010, largely on base effects, even in the absence of an ECB rate move. We anticipate that inflation will move above negative territory by the final quarter, although the annual average will again be negative, this time at -1.2%.

Inflation (CPI, % change)

	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	-4.5	-0.6
HICP	-1.7	-0.3

The Irish Labour Market

Unemployment rate surprises to downside

The rise in the unemployment rate was less than expected…

The CSO produces a monthly estimate of the seasonally adjusted unemployment rate which is derived from the quarterly National Household Survey and augmented using the trend in the monthly Live Register, a claimant count. The latter had never fallen below 150,000 despite a long period of full employment in Ireland, and started to rise steadily from mid-2007, with the monthly increase averaging 25,000 in the first quarter of 2009. The monthly average rise slowed somewhat in Q2, to under 14,000, but the consensus at that time expected a figure in excess of 500,000 by year-end. The unemployment rate in June had also risen at a rapid clip, to 12.1% from 5.9% twelve months earlier, and again the consensus expected an end-year figure around 13.5% and a cyclical peak in excess of 15%.

In the event the third quarter saw a further deceleration in the Live Register trend, with a monthly average rise of 5,000, and the rise in Q4 was just 400 a month taking the end-year figure to 427,000. The result was that the unemployment rate ended 2009 at 12.5%.

Unfortunately, this change in trend owes little to employment and largely reflects a sharper than expected decline in the supply of labour – the labour force fell by an annual 65,000 in the third quarter of 2009, or by 2.9%, having fallen by 37,000 in Q2. 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; 61,000 non-nationals lost their jobs in the year to the third quarter with some 45,000 then leaving the country.

…albeit due to higher migration and falling participation.

The scale of job losses remains substantial with total employment falling by an annual 185,000 in Q3, or 8.8%, from 174,000 (8.2%) in Q2. The construction sector accounted for 80,000 of the decline, followed by manufacturing (41,000), wholesale and retail (31,000) and hotels and restaurants (9,000). A number of sectors are still creating jobs, particularly the health sector (13,000) and the financial sector (5,000). We expect job losses to remain a feature of the Irish economy in 2010, although employment may fall at a slower pace – we have pencilled in a 65,000 decline on average over the year, or 3.5%, from an 8% average decline in 2009. This is likely to precipitate a further substantial fall in the labour supply, however, with the result that the unemployment rate is forecast to average 12.9%, implying only a modest rise from the final quarter of 2009. If so, it may prove a boost to consumer confidence and a positive surprise for the authorities, who have based their spending projection on an average unemployment rate in 2010 of 13.2%.

Labour Market (Annual average, '000)

	2008	2009(e)	2010(f)
Employment	2100	1931	1865
Labour Force	2241	2185	2140
Unemployment	141	254	275
(%)	6.3	11.6	12.9

Exchequer Finances

Smaller deficit projected in 2010

The 2009 Budget was revised a number of times…

The 2009 Budget, delivered in October 2008, projected a General Government deficit of €12.2bn (6.5% of GDP) predicated on a marginal fall in real GDP and a 1% rise in tax receipts. By February 2009, however, tax revenue was falling by an annual 25%, prompting a series of policy adjustments, first on the spending side and then a more comprehensive revision to both expenditure and taxation via a Supplementary Budget in April. The latter included a €3.3bn fiscal adjustment (2% of GDP) and projected a General Government deficit of €18.4bn or 10.75% of GDP, a figure subsequently revised higher again by the government to €19.3bn. The Exchequer Borrowing Requirement (EBR), the more relevant fiscal measure for the bond market, had been originally projected at €13.4bn and was also revised up substantially, to €20.4bn in April and then €25.3bn.

In the event, the 2009 EBR emerged at €24.6bn, comprising an €11.4bn current budget deficit and a €13.3bn shortfall on the capital side, the latter inflated by a €4bn injection to Anglo Irish Bank (the 2010 annual payment to the National Pension Reserve Fund was also brought forward into 2009, adding another €1.5bn to the total). Tax revenue fell by 19% in the year, emerging at €33bn, from €40.8bn in 2008, with VAT down €2.7bn (21%) followed by income tax (€1.4bn or 10%) stamp duty (€0.9bn or 44%), capital taxes (€1bn or 55%) and excise duty (€0.7bn or 14%). Corporation tax was also well down on the 2008 figure (€1.2bn) but came in ahead of the April projection.

Current spending rose marginally in 2009, with higher debt payments and unemployment benefits offsetting cuts in other programmes, although the debt payments were substantially lower than projected in April. The combination of higher debt costs and a further increase in the numbers claiming benefit was also expected to boost exchequer spending again in 2010, and in the absence of corrective measures the General Government deficit was projected at €21.8bn or 13.5% of GDP.

…but a lower exchequer deficit is expected this year.

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 alone, however, with the exception of a carbon tax, although tax receipts are forecast to fall again in 2010 by some 5%, albeit offset by higher non-tax revenue (primarily the fee payable by the banks for the deposit guarantee) leaving projected revenue unchanged on the forecast 2009 outturn. The net result was a forecast current budget deficit of €13.7bn and a capital deficit of €5.1bn, giving an EBR of €18.8bn and a General Government deficit of a similar magnitude, equivalent to 11.6% of GDP.

Exchequer Finance (€bn)

	2009 (Outturn)	2010 Budget
Current Expenditure	45.2	47.1
- Voted	40.3	40.2
- Non-voted	5.0	6.9
Revenue	33.9	33.4
- Tax	33.0	31.1
- Other	-0.8	2.3
Current Budget	-11.4	-13.7
Capital Budget	-13.3	-5.1
Exchequer Balance	-24.6	-18.8
(% of GDP)	(-14.7)	(-11.6)
General Government Balance	-18.7	-18.7
(% of GDP)	(-11.1)	(-11.6)

Funding the Exchequer Deficit

Less supply this year

The NTMA issued €34bn in bonds in 2009…

The exchequer deficit for 2009 finally came in at €24.6bn, which was lower than the Government's €25.2bn prediction made in early December but virtually double the previous year's figure of €12.7bn. The Department of Finance estimates that Ireland's gross Government debt at end 2009 was €106bn, equivalent to 64.5% of GDP, although this takes no account of the cash balances held by the NTMA, the debt management agency, and the assets of the National Pension Reserve Fund, which would reduce the net debt ratio to 39.5% according to the Department.

The NTMA sold €34bn of medium and long dated bonds in 2009 (€29bn net of bond redemptions) and raised an additional €1.8bn via the National Savings Scheme (marketed to the retail investor), thereby comfortably over-funding. The Agency also introduced a regular auction of Treasury Bills, with maturity out to 1-year, although funds raised via this channel were offset by maturing commercial paper which together with some other short term debt repayment amounted to €6.3bn. Consequently the NTMA's total net funding for 2009 was €24.5b, and as such almost identical to the EBR, with the result that its cash balances at the end of the year were broadly unchanged, and amounted to €21.8bn.

This balance gives the NTMA some leeway in terms of the timing of bond issuance but in general the aim is to fund the projected EBR and any bond redemptions via medium and long term bond debt. Scheduled redemptions amount to €1.2bn in 2010 so the implication is that the NTMA will require bond issuance of just €20bn or around €18.5bn allowing for monies raised from the retail market. This is substantially lower than last year's total although it does not take account of any additional capital injection into Anglo Irish Bank (now fully stated owned) or indeed for any other Irish financial institutions which may need capital in 2010.

…and forecasts up to €20bn supply this year.

Nonetheless, the Government's firm action to address the fiscal position has reduced the implied probability of default; Ireland's 5-year CDS is currently trading around 160bps from a high of 395bps in February 2009. Similarly, the yield spread over bunds has fallen substantially over the past year, from over 280bps to 150bps. In part this move reflects the general reduction in risk aversion across markets, but Ireland has also outperformed some other high yielding euro sovereigns. The 10-year spread against Italy is trading around 77bps from a high of 150bps in early 2009, and the spread against Spain has come in to 88bps from 178bps. The most dramatic change is against Greece, which is now trading 105bps over Ireland from 71bps through. The NTMA has taken advantage of the better sentiment towards Ireland by issuing a €5bn new 10-year benchmark in recent days, so completing a quarter of the scheduled issuance.

Ireland's gross debt ratio is projected to rise to 78% of GDP in 2010 and to peak at 84% in 2012 according to the Department of Finance. This represents a rapid deterioration from 2007, when the ratio stood below 25%, but nevertheless still leaves Ireland below the forecast euro average over the period. Moreover, tax receipts in the month of December came in 19% above the same month in 2008, implying that the exchequer is entering the year with some prospect of the projected budget deficit emerging lower than expected, which would be a welcome change after two successive years to the downside.

Contacts

Bank of Ireland Global Markets

www.boi.ie/globalmarkets

Chief Executive: Austin Jennings
Head of Global Customer Group: 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

Contact	Phone
Deputy Head of Customer Group: John Moclair	
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

Contact	Phone
Head of Retail Sales & Customer Group Operations: Aine McCleary	
Business Development & Sales Management: Adrienne McNally	
Business Banking Sales: Leslie Cosgrave	1800 790 153
Branch Sales: Michelle O'Meara	+353 1 609 4330
Dealer Assistants: Osna O'Connor	+353 1 609 3509

Global Markets United Kingdom (UK)

Head of Global Markets London: Liam Whelan
Head of Business Development: Duncan Wilson
Head of London Treasury Sales: Sandra Perry

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

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