

AIB GLOBAL TREASURY SERVICES

Topic of the Day

THE IRISH ECONOMIC OUTLOOK

BY
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The Irish Economic Outlook – 23rd October '06

AIB Global Treasury, a division of AIB Capital Markets, today released its latest Outlook on the Irish Economy. In summary:-

Economy to Grow by 6% in 2006, Slowing Somewhat to 4.5% by 2008

Let's be very clear to start with that the Irish economy is continuing to perform remarkably well. Employment growth is likely to average 4.5% this year, after a 4.7% rise in 2005. GDP growth is forecast at 6% this year, up slightly from 5.5% in 2005.

Looking forward, it is likely that the growth rate of the Irish economy will slow somewhat in 2007 and 2008 as many of the factors currently boosting activity begin to wane. Growth in the global economy is expected to moderate, interest rates are rising and new housing output may soon start to decline, while the impact of maturing SSIA's and an expansionary fiscal policy is likely to become less pronounced by 2008.

We look for GDP growth to ease somewhat to 5.5% in 2007 and 4.5% in 2008. This implies continuing large net inward migration and a further rise in participation rates to meet continued strong growth in the demand for labour. Employment growth is expected to moderate but still average a robust 3.5% per annum over the next two years.

Construction Concerns

Although there has been much comment about the economy becoming lopsided and overly dependent on the construction sector, the fact is that GDP growth has been very well balanced to date in this decade. Indeed, in 2006, we expect domestic demand and exports to both rise by 6%. Within domestic demand, consumer spending, government consumption and fixed investment are forecast to rise by 6.5%, 4.5% and 5.0%, respectively. This can hardly be called lopsided growth.

It is true that the construction sector now accounts for a high share of both GDP and employment as a result of the surge in housing output in recent years. However, the pace of growth in housing activity is now slowing and housing output is likely to rise by about 6.5% this year, down from the double digit growth rates of recent years. The rise in construction employment has also slowed a lot. Nevertheless, despite the slower growth in housing activity, GDP growth is forecast to accelerate and employment is likely to rise by around 4.5% in 2006.

Looking forward, we do expect new housing output to decline from next year on, with a sharp deceleration also in house price inflation. The slowdown in housing should be offset to some extent by a pick up in non-residential construction activity, which has been very weak in recent years. It is also encouraging to see a marked pick up in Irish manufacturing activity and a rebound in service exports. Maintaining a strong export performance is very important for future economic growth prospects as construction slows down. Thus, a downturn in housing activity should not derail the economy. Instead, it is likely to see the economy move onto a more moderate growth trajectory over the next two years.

Growing Private Sector Indebtedness

Against the background of robust economic growth and the boom in the housing market, there continues to be an accompanying sharp rise in the ratio of personal sector debt to personal disposable income. The low interest rate environment, strong job creation and positive developments in real income have all supported this rise in debt. In a country where the aspiration to home ownership is the norm, the steady growth in the stream of aggregate income has, over time, encouraged a multiple of borrowing relative to income. The marked uptrend in the debt ratio looks set to be maintained in the years ahead. The ratio is forecast to reach 160% in 2006 and exceed 185% by 2008.

The vast bulk of personal debt is secured by property. Hence, the risks in relation to growing personal sector indebtedness are very much linked to the prospects for the housing market, where we expect a soft landing. Furthermore, there has also been a very sharp rise in household assets. Indeed, at end 2006, the outstanding level of residential mortgage debt will be equivalent to around 17% of the value of the housing stock, which is expected to be around €700 billion.

Inflationary Pressures to Abate

Inflation has picked up a lot this year, especially the headline CPI rate. Much of the rise, though, is due to increases in interest rates and house prices. The rise in the HICP rate has been much less pronounced. Nevertheless, there has been some deterioration in Ireland's underlying inflation performance compared to our main trading partners and this needs to be arrested.

In this regard, it is very important that Ireland keeps domestically induced inflation under control. The errors made at the start of this decade, when sharp hikes in indirect taxes and public service charges plus very large wage increases caused high inflation to become embedded in the economy, must be avoided on this occasion. It is crucial that the terms of the recently approved national pay deal are adhered to, in particular. We expect headline inflation to fall sharply to 3.5% and 2.4% in 2007 and 2008, respectively, from 4% in 2006, while the gap with eurozone inflation should narrow.

Prudent Budget Required

Ireland's fiscal position remains very sound. It is the case, though, that the strong fiscal position is dependent on the continuation of relatively strong economic growth and that the tax base is being bloated by a large intake of property taxes from a buoyant housing market, which could well decline. These factors need to be borne in mind in framing Budget 2007. It would be appropriate to maintain the general government budget in surplus, avoiding an excessively stimulatory pre-election budget.

There has been considerable speculation that the Government may overhaul the stamp duty regime. However, the Minister for Finance has appeared to rule this out. We would caution against making any major changes to stamp duty or other property related taxes and reliefs in the budget that would unsettle the property market or help sustain the current very high level of house price inflation. That said, there should be scope to introduce some modest changes in the budget, such as indexing stamp duty bands.

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Commenting on the report, John Beggs, Chief Economist said, . . .

"Ireland's overall economic performance remains very impressive. Strong GDP growth of around 6% has been accompanied by further robust growth in employment this year and, not surprisingly, in a continuing healthy government budget surplus.

It is worth pointing out that growth in the Irish economy is well balanced. The recent recovery in manufacturing activity and service exports is particularly welcome. Furthermore, the acceleration in GDP growth and continuing strong uptrend in employment this year has occurred against a backdrop where the rapid growth in housing output and construction employment has slowed considerably.

The outlook for 2007 and 2008 is for a continued impressive overall economic performance - real GDP is forecast to grow on average by 5% and employment by 3.5% in the next two years, despite a weakening of housing activity. Our inflation performance should also show a big improvement after the marked rise in CPI rates this year - indeed, most of this increase is due to much higher housing costs rather than broad-based price pressures.

Given the above scenario, the upcoming budget should aim to keep the general government balance in surplus and an excessively stimulatory pre-election giveaway budget should be avoided. Furthermore, the budget should not do anything that unsettles the property market or helps sustain the very high level of house price inflation.

The full report can be found on: www.aibeconomicresearch.com under latest Articles: Economic Reports: Irish Economic Quarterly October 2006

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