



The Irish Economy

Where Does it Stand and Where is it Going?

June 2008

IRISH ECONOMIC UPDATE

Introduction

The Irish economy has entered a challenging phase after a prolonged period of strong growth. In this report we examine the current state of the economy and how it is likely to perform in the next couple of years. We look at Irish economic growth prospects in the context of the much more difficult internal and external environment, as well as the likely developments in the property and labour markets, inflation and public finances. We also look at the medium term growth prospects for the economy.

In summary:

- **The Irish economy had already lost considerable momentum by the second half of 2007**, with GDP growth slowing to 3.7% year-on-year, down from close to 7% yoy in H1. Domestic spending slowed sharply, turning negative on a year-on-year basis in the final quarter of the year, led by declines in housing output and investment in machinery and equipment.
- **The data published for the opening months of 2008 point to a further weakening of domestic activity.** Housing output continues to contract, while growth in consumer spending has slowed sharply. Tax receipts have been very weak and the jobless total has spiked upwards.
- **A sharp decline in new housing output will greatly depress GDP growth in 2008 and 2009.** Housing completions are forecast to fall to 47,500 this year and 33,000 in 2009, down from 78,000 last year. With new housing investment and associated transfer costs accounting for 11% of GDP, the decline in housing will knock some 4% off GDP growth in 2008 and 1.8% off in 2009.
- **The economy is also facing other significant headwinds in 2008/2009**, including a marked slowdown in the global economy, a sharply higher exchange rate, tightening of credit conditions, increases in interest rates, rising unemployment, weakening confidence and fiscal tightening.
- **Domestic spending is forecast to contract by 1.7% this year and to be virtually flat in 2009**, as a result of the sharp fall in housing output along with much slower growth in consumer spending, government expenditure and non-residential investment.
- As in 2007, **net trade should again make a significant contribution to GDP growth in 2008-2009.** Given the weakness of domestic spending, import growth should slow. Export growth is expected to slow also, given the more difficult external environment. However, there appears to be a strong, structural uptrend in service exports, which should help underpin total exports.
- Service exports have risen at a double digit rate for the past five years and were up by over 17% yoy in Q4 2007. They now account for 44% of total exports. Thus, we look for solid export growth of 5.3% in 2008 and 5% in 2009, albeit down from 8.2% in 2007.
- Overall, net trade is expected to add some 2.8% to GDP growth in 2008 and 2.4% in 2009, having contributed 2.25% in 2007. **GDP growth, though, is forecast to slow sharply to 1.3% this year and 2.5% in 2009, from 5.3% in 2007.**

- The fact that GDP growth excluding housing averaged 6.2% in the last three years, during which time Ireland also enjoyed very robust job growth, indicates that the economy is more competitive than commonly assumed. However, exchange rate movements over the past year do pose considerable challenges for the traded sector and highlight the need for a moderation in wage and price inflation.
- **We see no reason not to expect a resumption of strong growth once the marked downward adjustment in housing activity is complete and the global economy regains momentum. Our forecast is for GDP growth to recover to 4% in 2010.**
- In terms of the housing market, new housebuilding activity should level out in 2010. House prices are likely to find a floor in 2009, helped by the considerable improvement in affordability generated by a 15-20% peak-to-trough house price fall in the 2007-2008 period.
- **The sharp slowdown in economic growth will hit the labour market hard.** We expect employment growth of 30,000 in 2008, down from 67,000 last year, with no job growth envisaged in 2009. A fall off in inward migration and a decline in participation rates will help curtail the rise in unemployment. However, we still expect the **jobless rate to pick up close to 6.5% in 2009.**
- Inflation is proving very sticky and the CPI rate looks set to average 4.6% this year, with the HICP rate picking up to 3.6%. Very sharp increases in food and energy prices are driving up inflation world wide, with increases in mortgage repayments adding to CPI inflation in Ireland as well.
- The appreciation of the euro and weakening domestic demand and labour market conditions should see inflationary pressures wane next year. **Provided the upward pressure on food and energy prices eases, CPI and HICP inflation rates should fall back to average around 3.5% and 3.0%, respectively, in 2009.**
- **Tough budgets are required in 2009 and 2010** to maintain the public finances in a healthy condition. Tax receipts this year are likely to undershoot target by some €2.5 billion, pointing to a budget deficit of 2.2% of GDP, which compares to a surplus of 3% of GDP in 2006.
- This deteriorating trend in the budget balance cannot continue and top priority must be given to reining in the runaway growth of current spending on services. Spending growth will have to be capped at 4% in 2009 and 4.5% in 2010 to maintain the budget deficit at around 2.5% of GDP.

In conclusion:

Very weak rates of growth in output and employment are in prospect in 2008 and 2009, reflecting, in particular, a sharp contraction in housing activity and a weaker global economy. It is important to keep the downturn in perspective, though, as it comes after a prolonged period of very robust growth stretching back to the early 1990s. The economy will still hold onto virtually all the substantial gains in output, employment and living standards achieved since 1993.

The strong performance of the economy leading up to this downturn, especially in the non-housing sectors, augurs well for a resumption of robust economic growth post the downturn. The fundamentals of the economy remain sound, also. Hence, we expect GDP growth to pick up to 4% in 2010 as the downturn in housing bottoms out and global growth improves.

Looking further out, we think that the economy can achieve an average growth rate of 4.5% in the period 2010-2014 led by strong growth in the services sectors, in particular business, financial and I.T. services, and helped by a renewed pick up in housebuilding activity.

The Recent Evidence on the Economy

The latest National Accounts data show that Irish GDP grew by 5.3% in real terms last year, right in the middle of the 4.3 - 6.4% range that it has occupied to date in this decade and close to the growth rates of 5.7% and 5.9% recorded in 2006 and 2005, respectively. The performance last year is all the more impressive, though, when one considers that a rundown of inventories depressed GDP growth by 0.8% in 2007.

However, there was a clear division between the performance of the economy in the first and second halves of the year. GDP growth averaged close to 7% yoy in H1 2007 before slowing to 3.7% in H2. The principal factor behind this slowdown was a sharp fall-off in fixed investment, which moved from a growth rate of 12.3% yoy in Q1 to a contraction of 12.3% in Q4 2007. Two factors were responsible. Housing output declined by over 20% yoy in H2 2007 as completions started to fall back, while investment in machinery and equipment fell by over 10% yoy.



Growth decelerated in other areas of the economy also in H2 2007. Consumer spending slowed towards the end of 2007, with the growth rate easing from an average of 5.8% yoy in the first three quarters of the year to 4.4% by Q4. The growth in government spending also slowed in H2 2007. On a positive note, exports performed strongly right throughout 2007. Overall, the economy had clearly lost considerable momentum by end 2007, especially in the domestic sector. Indeed, growth in total domestic spending turned negative on a year-on-year basis in Q4 2007 so growth in GDP was only sustained by a strong performance by net exports.

The data published for the opening five months of 2008 suggest that domestic spending has been very weak. Tax receipts have been depressed, declining by 8% yoy to end May. Property related taxes and VAT receipts have fallen, reflecting in particular the sharp downturn in housing activity. The weakening trend in retail sales evident in H2 2007 gathered momentum in the opening months of 2008. New car sales fell by 15.5% yoy in January-May 2008, while the growth in retail sales excluding the motor trade fell to less than 1% yoy in January-April 2008.

The contraction in housing activity has also continued in 2008. Housing registrations fell by 63% yoy to May and completions were down by 27% yoy to April. Not surprisingly, then, growth in mortgage lending had slowed to 11.4% yoy by April, down from 13.4% in December and 24.2% at end 2006.

Meanwhile, there has been a very sharp rise in the Live Register to date in 2008, indicative of a deteriorating jobs market. Redundancies also rose by 27% yoy in the five months to May. A marked decline in employment in the construction and manufacturing sectors was recorded for the December-February 2008 period in the latest labour force survey. Not surprisingly, then, the rise in the jobless total has been most pronounced amongst males.

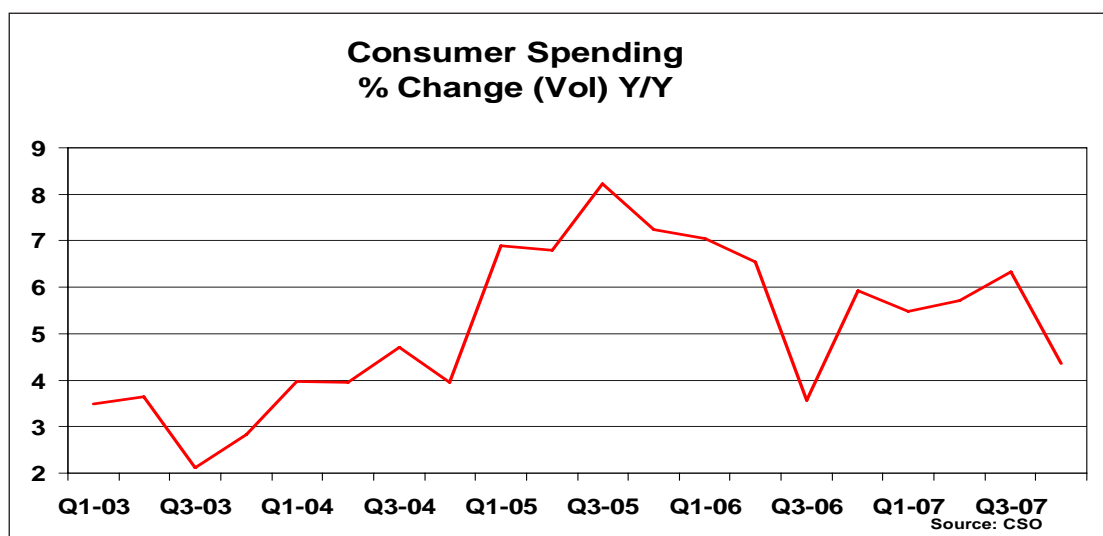
Manufacturing output was volatile in the first four months of 2008 but, overall, was broadly on a par with H2 2007 levels. There are no data available yet on external trade volumes in early 2008. However, the merchandise trade data show that exports held up well in value terms in the first three months of the year, increasing by 4.25% on Q4 2007 levels, with the trade surplus also rising sharply on its level in Q4 2007. We have no data at all yet on external trade in services in early 2008. Overall, then, after a weak finish to 2007, the evidence suggests that the domestic economy has lost further momentum in the opening months of 2008, with GDP growth continuing to be driven by net trade.

How Much Will Growth Slow By in 2008 and 2009?

The Irish economy is set to experience a marked deceleration in the pace of economic growth in 2008 and 2009. The main factor behind the slowdown in GDP growth is a sharp decline in new housing output. Judging by the trends in housing registrations and other data, housing completions could fall to 47,500 this year and 33,000 in 2009, from 78,000 in 2007. This represents a fall of almost 40% in housing output in 2008 and close to a 30% decline in 2009.

Investment in new housing accounted for 9.2% of GDP in 2007. An additional negative factor is that there are associated transfer costs (almost 2% of GDP) that move in a positively correlated way with housing. The scale of the decline in housing output and the fact that it accounts for such a large part of the economy implies that the downturn in the sector will weigh heavily on the overall growth of the economy in the next two years. We estimate that it will depress GDP growth by some 4% in 2008 and 1.8% in 2009.

Of course, the decline in housing output will have knock on consequences for other areas of the economy, in particular consumer spending. Indeed, growth in consumer spending is expected to weaken anyway in 2008 and 2009 due to subdued growth in employment, a waning of the SSIA impact, low consumer confidence and the tightening of credit conditions. The 2008 budget was also less generous than the previous two budgets in terms of the boost that it provided to disposable income via increases in social welfare payments and income tax reductions. Meanwhile, a very tight budget is in prospect for 2009.



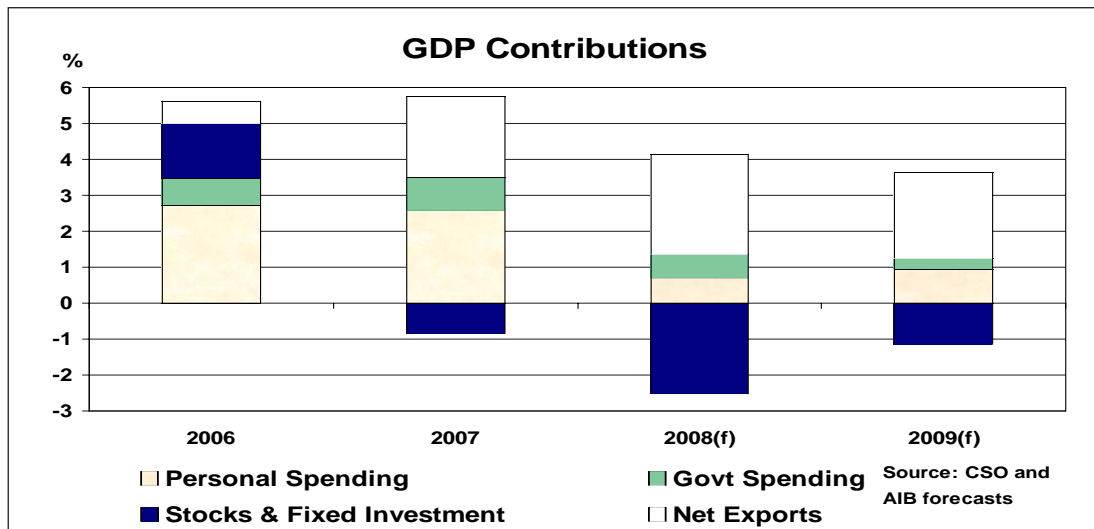
Consumer spending, though, will still be helped by modest growth in incomes. Employment is forecast to grow by around 1.4% in 2008, while wage growth should be of the order of 4%. Overall, we estimate that growth in personal disposable income will be close to 6% in 2008. However, we expect it to slow to just 4% next year given that the economy may not generate any net increase in employment.

However, we expect that the CPI inflation rate will fall to around 3.5% in 2009, which will provide a boost to real disposable income. Furthermore, household savings are also quite high, having being boosted by the SSIA scheme in recent years. The savings ratio is likely to rise further this year but it could decline in 2009 in the face of weak income growth.

Overall, growth in consumer spending will slow sharply in 2008 and 2009. The data for the opening months of this year have been very weak. New car sales fell by 15.5% yoy to May, although these may have been depressed by a change in car tax that takes effect in July. However, even excluding the motor trade sector, growth in the volume of retail sales fell to just 0.9% year-on-year in the first four months of 2008. It is worth pointing out, though, that spending on services accounts for almost 60% of consumer expenditure. Thus, in 2002 and 2003, when car sales fell sharply and growth in non-motor trade retail sales was very anaemic at 1%, consumer spending still rose by 4.2% and 3.0%, respectively. The indications, though, are that overall consumer spending has turned very sluggish and we expect it to grow by just 1.5% in 2008 and 2.0% in 2009.

Growth in current government spending is also set to slow this year and next, having increased by 5.3% in 2006 and 6.7% in 2007. This year's budget suggests growth in spending will slow to around 4.5%, while we expect a rise of just 2% in 2009, given the deteriorating trend in the public finances. Public capital spending, though, is set to rise strongly this year and next. The 2008 budget provided for a 21% increase in public capital expenditure this year, with a further significant rise of 16% planned for 2009 under the National Development Programme.

This will provide a boost to fixed investment. However, with the economy slowing down and credit conditions tightening, we expect a deceleration in the growth rate of both private non-residential construction and spending on machinery and equipment in 2008 and 2009. Indeed, the former is likely to decline next year. With new housing investment contracting sharply, it means a very marked decline in total fixed investment in the next two years. This is forecast to fall by 11.7% this year and a further 5.5% in 2009.

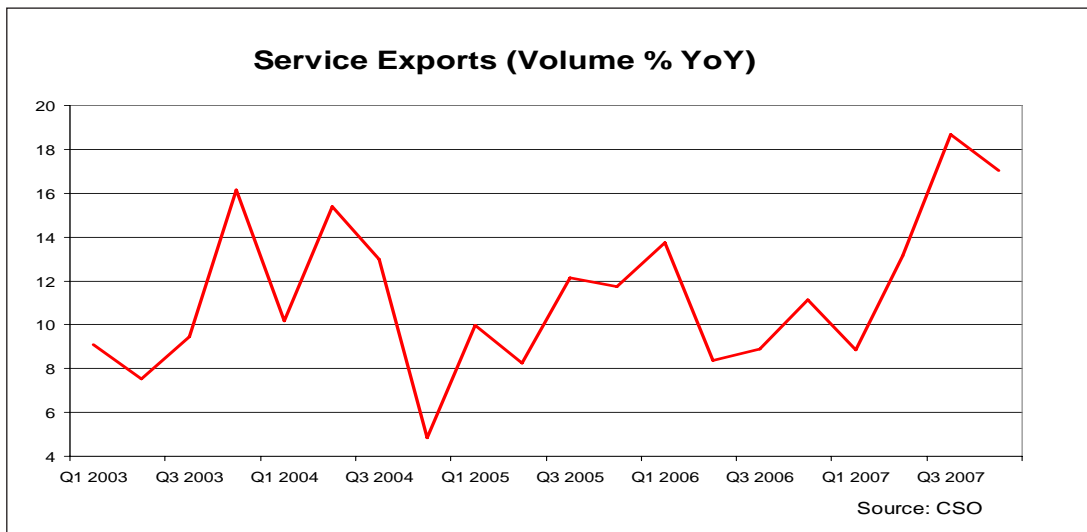


It is clear, then, that the economy is going to be relying on a significant contribution from net exports to sustain economic growth. The strong performance of external trade in 2007 is encouraging in this regard. Exports grew by 8.2% last year, their best performance in this decade, powered by a 14.5% rise in service exports. Goods exports rose by a more moderate 4%. Overall, net exports contributed 2.25% to Irish GDP growth last year.

The external environment, though, has turned much less favourable, with the US economy close to recession and growth in Europe slowing down. The euro has also appreciated markedly during

the past two years, especially against two of Ireland's main trading partners, the US and more recently the UK. Thus, exports in 2008 are unlikely to repeat their very strong performance of 2007. However, merchandise trade data for the opening three months of the year show that goods exports have held up reasonably well in early 2008.

Meanwhile, the volume of service exports has grown by more than 10% in each of the last five years, a trend that shows little sign of abating. The latest data, which are for Q4 2007, show service exports up by over 17% yoy. We expect the strong performance by service exports to continue as they seem to be on a long term, marked, structural uptrend.



Nonetheless, the appreciation of the exchange rate and the much weaker growth outlook for our main trading partners in 2008 and 2009 will weigh on Irish exports. Thus, we look for export growth to slow to around 5.3% this year and 5.0% in 2009, from 8.2% in 2007, with the strong underlying uptrend in service exports preventing an even greater deceleration in export growth.

The weakening economy points to slower growth in imports in 2008 and 2009, especially as they were boosted in 2007 by a substantial jump in imports of transport equipment in the earlier part of the year that may not recur in 2008/2009. Hence, net trade, as in 2007, is expected to make a significant contribution to GDP growth this year and next. We see net trade boosting GDP by around 2.8% in 2008 and 2.4% in 2009.

Overall, then, GDP growth is forecast to slow markedly to around 1.3% in 2008 and 2.5% in 2009, on the back of weaker growth in both exports and the three main components of domestic demand - household spending, current government expenditure and fixed investment, particularly housing. Indeed, we look for domestic spending to decline by 1.7% this year and rise by a meagre 0.1% in 2009, having averaged growth of 5.4% in the last four years. Hence, without net trade, GDP growth would be negative in 2008 and close to zero in 2009.

An average GDP growth rate of close to 2% for 2008/2009 would be the lowest recorded since the mid-1980s. However, this should be viewed in context, with the fall in housing output taking some 4% off GDP this year and around 1.8% off GDP in 2009, as well as the impact on growth of the much weaker external environment, general tightening of credit conditions and unfavourable exchange rate movements.

Even if our forecasts prove overly optimistic, the downturn in activity is unlikely to derail the economy completely. The economy will still hold onto virtually all the gains in output, employment and living standards achieved since 1993. These are very impressive gains, with

real GDP increasing by 167% and employment rising by over 75% in this period. Hence, though there were commentators who believed that the rapid growth of the Celtic Tiger era was something of a mirage that would not prove sustained, it is now clear that a remarkable and permanent rise in living standards has taken place in Ireland.

Economy Should See a Recovery by 2010

We see no reason not to expect a resumption of strong growth once the marked downward adjustment in housing activity is complete and the global economy regains momentum. It is worth noting in this regard that, excluding housing, the economy has grown in excess of 5% in each of the last three years, averaging 6.2%. Even in 2008, we expect that GDP growth excluding housing could amount to over 5%, boosted in particular by net exports and a large carryover from 2007, after GDP growth excluding housing amounted to 7.3% last year.

We expect that the downturn in housing output will bottom out in 2010, paving the way for a return to stronger economic growth. In these circumstances, fixed investment should no longer act as a major drag on the growth rate of the economy. We expect to see a marked improvement in growth in domestic spending in 2010, which is forecast to pick up to around 3%. The international environment should also have turned more favourable by that stage, allowing exports to grow by over 5%. Hence, we look for GDP growth to pick up to 4% in 2010. The ESRI is even more optimistic than us as it forecasts that GDP growth would pick up to 4.6% in 2010 in its recently published *Medium Term Review 2008-2015*.

IRISH ECONOMIC GROWTH FORECASTS 2006 - 2010					
(% Volume)	2006	2007	2008(f)	2009(f)	2010(f)
Consumer Expd	5.7	5.4	1.5	2.0	3.0
Government Expd	5.3	6.7	4.5	2.0	2.5
Fixed Investment	3.1	0.2	-11.7	-5.5	2.5
Domestic Spending	4.9	4.1	-1.7	0.1	2.8
Exports	4.4	8.2	5.3	5.0	5.3
Imports	4.4	6.4	2.3	2.8	4.0
GDP	5.7	5.3	1.3	2.5	4.0
GNP	6.5	4.5	1.0	2.2	4.0

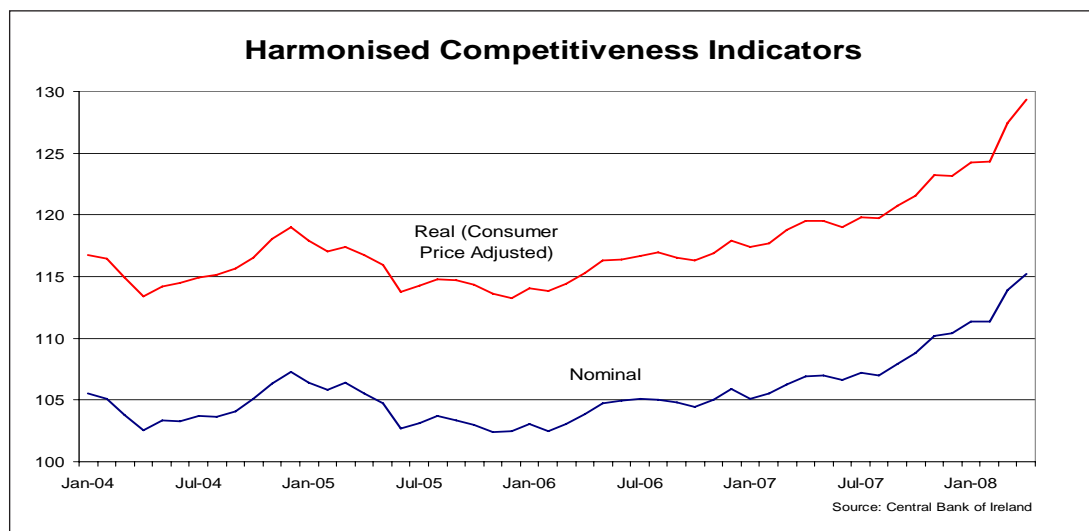
Source: CSO; AIB ERU Forecasts

Is Economy Suffering From a Major Loss of Competitiveness?

There are concerns that a marked deterioration in Irish competitiveness will constrain the ability of the economy to move back onto a robust growth path. The marked widening of the current account deficit in recent years, relatively high level of prices and wages in Ireland, and appreciation of the exchange rate are cited as evidence of a marked deterioration in the competitiveness of the Irish economy.

The economy did lose competitiveness early in the decade when Irish inflation was at very high levels. The marked appreciation of the euro against the dollar in recent years, and more recently against sterling, has made it an even more difficult operating environment for the traded sector of the economy. It is worth noting, though, that the Irish harmonised competitiveness indicator (HCI) published by the Irish Central Bank, was actually relatively stable from mid-2003 to mid-2007. The nominal Irish HCI (which approximates a trade-weighted exchange rate index) was confined to a range of 102-107 in this period.

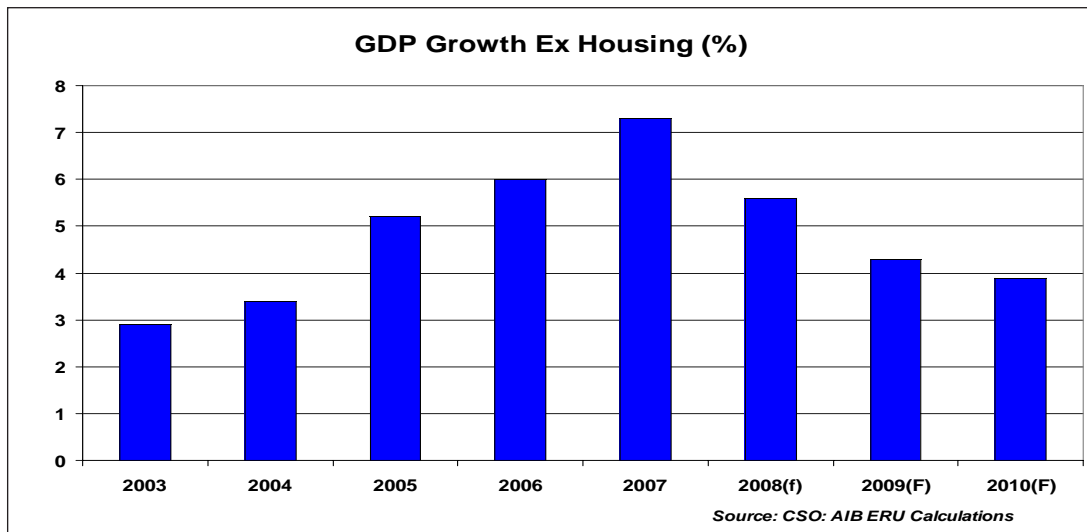
Since last summer, though, the index has risen steadily to 115.25 by April 2008, an increase of almost 8% on a year ago. Deflating the HCI for changes in consumer prices to give a real trade-weighted index does not alter this picture, with the index stable from mid-2003 until its significant rise on exchange rate movements since last summer.



One has to say that there has been little evidence of the loss of competitiveness impacting greatly on the labour market in recent years, where job growth has been robust and broad based, while unemployment has remained very low. Indeed, the large influx of foreign workers into the Irish economy in recent times and continued strong inflows of foreign direct investment are not consistent with an economy that has been beset by competitiveness problems.

Neither has there been much evidence that a loss of competitiveness is constraining the growth rate of the economy. Even excluding housing, the economy has grown strongly in recent years, with GDP excluding housing growing by 6% in 2006 and 7.3% 2007. Furthermore, there was a revival in manufacturing activity and a pick up in merchandise exports. Meanwhile, service exports have powered ahead in recent years and grew by over 15% in volume in 2007.

It is true that there has been a marked fall in the merchandise trade surplus, which has declined by €8.5bn since 2004. However, this partly reflects factors such as a surge in the bill for fuel imports, rising imports of machinery and equipment, and increased imports of materials for the booming construction sector. There has also been a decline in export earnings in some high-tech industries, notably in the ICT sector. However, this seems to reflect continuing downward pressure on prices for these goods, exacerbated by exchange rate movements, as well as a global shift in manufacturing production to low cost countries.



In contrast to the goods side, there has been a marked improvement in the balance of trade on services, where the deficit has declined by €6.25bn since 2004 (and €10bn since 2002). The economy is becoming more services orientated, notably on the external trade side, and services accounted for 43.5% of total export earnings in 2007, compared to just 21% in 2000.

Service export earnings have tripled since 2000 and by 2007 were equivalent to 35% of GDP. Three sectors dominate service exports; business, computer and financial/insurance. These are markets where products are knowledge intensive, helping to limit the effects of any loss in competitiveness on activity. Ireland's favourable low corporate tax regime is also no doubt important for these sectors.

The robust and sustained growth of service exports in recent years suggests that there is a strong structural uptrend to these exports, which may mean that they can withstand a cyclical downturn in the global economy. They have also provided the economy with a route to become less dependent on goods exports, where competition is based primarily on price.

This shift towards service industries may have made the economy less vulnerable to the ever increasingly competitive, global pricing environment. It is also interesting to note that the business/I.T./financial services sectors of the economy have seen rapid job growth in recent years and now account for a bigger share of the workforce than manufacturing or construction.

The country trade distribution of service exports is not that different from goods: in 2006, 19% of service exports went to the UK, 17% to the US and 36% to the eurozone. Thus, service exports could be impacted by the exchange rate movements of the past year, in particular the sharp rise of the euro against sterling. However, they have been able to withstand the marked fall of the dollar in recent years, with service exports to the US continuing to grow rapidly, despite the unfavourable exchange rate movements. This suggests that service exports to the UK may be able to continue growing despite the sharp fall of sterling.

Nonetheless, there can be no doubt that the sharp appreciation of the euro since last summer, especially against sterling, does make life a lot more difficult for those in the traded sector of the economy and has led to some loss of competitiveness. In its recent country report on Ireland, the OECD argues that unless wage and price inflation are reined in, the export sector will not be able to contribute to easing the adjustment process for the economy following the downturn in housing construction.

Other measures to improve long term competitiveness are important also. The OECD identifies boosting competition, upgrading infrastructure, generating more innovation and improving human capital as important policy challenges if strong economic growth is to be resumed.

How Long Will The Housing Downturn Last?

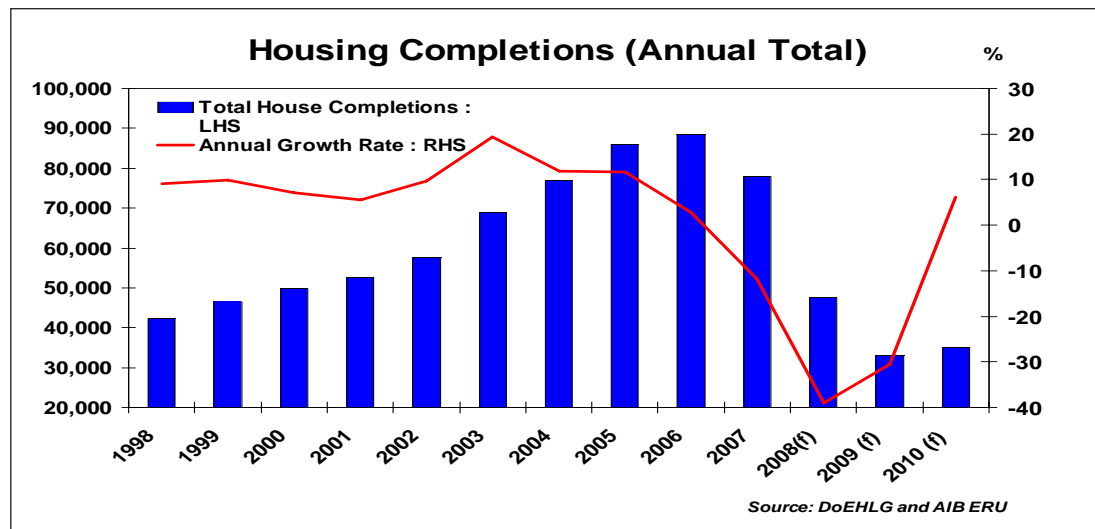
The sharp housing market downturn witnessed over the past year was precipitated by a rapid deterioration in affordability in 2006 which quickly resulted in a significant drop in demand in an over-supplied market. The deterioration in affordability reflected the fact that prices had risen too far too fast in 2006 while interest rates were also on an uptrend.

As a result, the short-term supply/demand balance got out of kilter. House builders had responded to the strong market conditions by boosting housing output. On our estimation, the number of completions in 2005/2006 significantly exceeded medium term demand levels. This situation was sustainable in a market in which prices were growing strongly - with demand being brought forward from future years on concerns about being left out of the market.

However, as soon as the price environment softened, the very high level of housing output in 2006 rapidly resulted in an over-supplied market which exacerbated the price downturn. House builders acted promptly to cut projected output levels in response to reduced demand.

Lead indicators of housing output began to decline in early 2007, with the pace of decline accelerating over the course of last year. House registrations fell by 43% in 2007. Meanwhile, commencements fell by 35% last year. These trends continued in the early months of 2008, with registrations down by 63% year-on-year to May and commencements declining by 52% year-on-year in Q1.

Due to the lags from registration to commencement to completion, this slowdown only began to be reflected in completion levels in H2 of last year. Completions (on a CSO adjusted basis) were broadly flat compared to 2006 levels in the first half of 2007. They then fell by over 21% year-on-year in H2-2007. Overall, completions totalled 78,027 in 2007, compared to 88,400 in 2006, a decline of 11.7%.

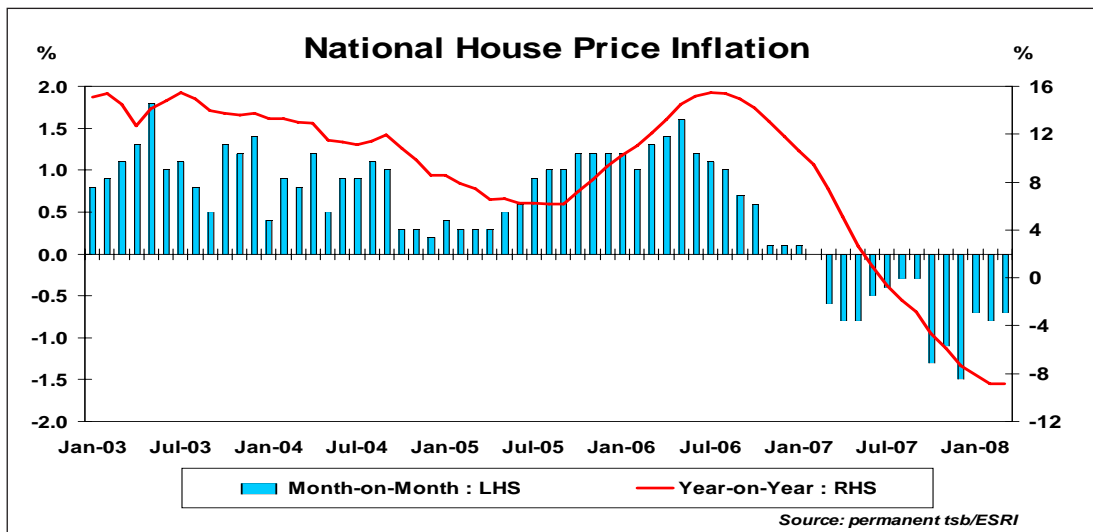


Completions continued to fall in early 2008, amounting to 19,000 in the year to April, a decline of over 27% yoy. Overall, the trend in registrations and commencements in 2007 suggests that the level of completions is on course to decline to somewhere around 47,500 units in 2008 (a fall of almost 40%). At this stage, the weak registrations and commencements data in early 2008 point to a further fall in completions in 2009, and we are pencilling in a level of 33,000, implying a further decline of almost 30% on 2008 levels. To put this correction in perspective, should completions fall to 33,000 in 2009, this would bring them back down to a level not seen since 1995-96.

The current supply overhang along with considerable negative market sentiment has been forcing prices lower. According to the permanent tsb/ESRI index, prices nationally fell for the

14th consecutive month in April, declining by 1.1% in the month. This follows average monthly declines of 0.75% in Q1 2008 and 1.3% in Q4 2007. These marked price falls mean that, nationally, prices in April were 9.2% below year earlier levels and 10.5% down from their peak level in January/February 2007. This represents a marked change from the 11.8% increase on a year-on-year basis recorded in December 2006.

At the beginning of this year, the first substantial break in the apparent unanimity amongst the major developers to hold firm on prices occurred. The positive response from buyers to these lower prices has subsequently seen other builders follow suit, such that significant price cuts are becoming quite common for new homes.



The permanent tsb/ESRI index is based on mortgage drawdowns and thus probably refers to sales agreed a number of months previously. It means that the price cuts for new homes in 2008 did not start to show up in this index until April, when they declined by 2.0% in the month. Thus, actual house prices have probably fallen more from their peak than suggested by the 10.5% decline shown in the April data, as this most likely refers to sales agreed at the very start of the year. At this stage, actual house prices in June 2008 could be close to 15% down from their peak levels in early 2007, after the marked falls in new house prices this year.

A cumulative 15% fall would bring house prices back to their level in the autumn of 2005. Effectively, such a fall in prices would represent an unwinding of the last surge in house prices, which took place from the autumn of 2005 to late 2006, and which was a major contributor to the overheating that developed in the housing market. If house prices have fallen by close to 15% from their peak, this would bring affordability back to early 2006 levels, which may be sufficient to regenerate interest in the housing market. Indeed, there has been some anecdotal evidence that market sentiment is stabilising, with some renewal of buyer interest and some upturn in home sales in recent months.

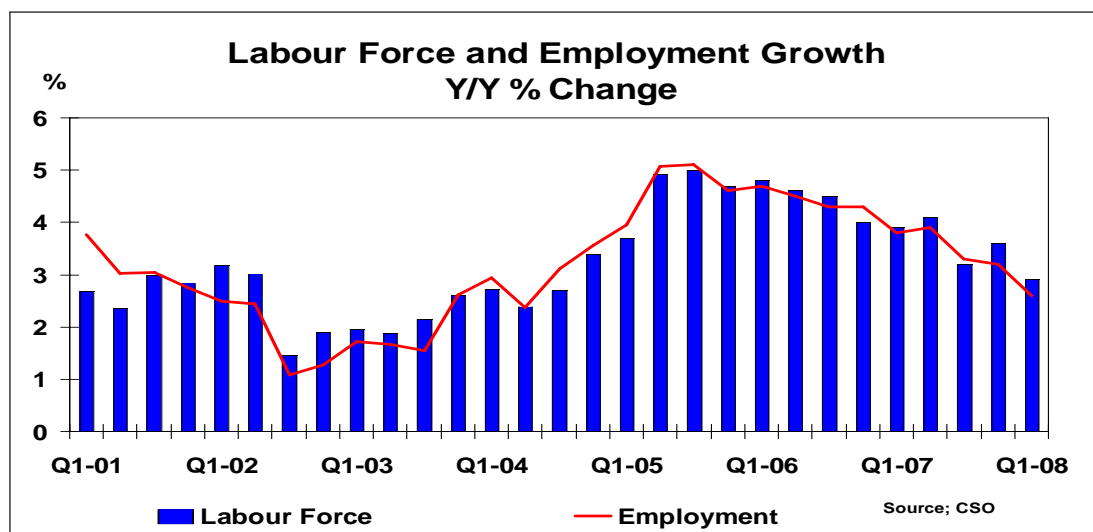
However, we await the results of the summer selling season to see whether there has been a sustained improvement in market activity in response to improved affordability conditions. The prospect of an ECB rate hike, though, is a new negative for affordability. Thus, even if prices are approaching a bottom, we are not anticipating any strong rebound; rather we anticipate that prices will remain relatively static at best in H2 2008 and rise only marginally in 2009.

Indeed, given the large overhang of property on the market, likelihood of an ECB rate hike, weakening economic and labour market conditions and tightening of credit conditions especially in the mortgage market, prices may continue to fall over the remainder of this year. It may take a price fall of close to 20% before the market finds a bottom. Even then, we would not anticipate any marked pick up in prices in 2009 given the subdued prospects for the economy next year. Thus, we do not expect any meaningful recovery in house prices until 2010.

How High Will The Unemployment Rate Go?

The latest Quarterly National Household Survey (QNHS) report, which is for Dec-Feb 2008, shows a further slowdown in labour force and employment growth around the turn of the year, with unemployment moving higher. The labour force grew by 2.9% yoy in the Dec-Feb 2008 period, down from 3.8% a year earlier and a peak rate of over 5% in early 2006. Meantime, employment growth eased to 2.6% yoy in the same period, also down from 3.8% a year earlier and a peak rate of over 5% reached in mid-2005. The unemployment rate stood at 4.8% seasonally adjusted in Dec-Feb 2008, up from 4.4% a year earlier.

Employment growth in the year to Dec-Feb 2008 was concentrated in three sectors; the wholesale/retail sector which added 21,100 jobs (+7.3% yoy), financial/business services which created 26,300 additional jobs (+9.7% yoy) and the health sector where there was a rise of 11,500 (+ 5.4% yoy) in employment. The construction and manufacturing sectors both suffered significant employment declines of 9,800 and 7,500, respectively, making the 53,800 or 2.6% yoy rise in total employment all the more impressive. Some of the workers who lost jobs in these two sectors may have returned to farming as there was a 7,000 rise (+6% yoy) in employment in agriculture.



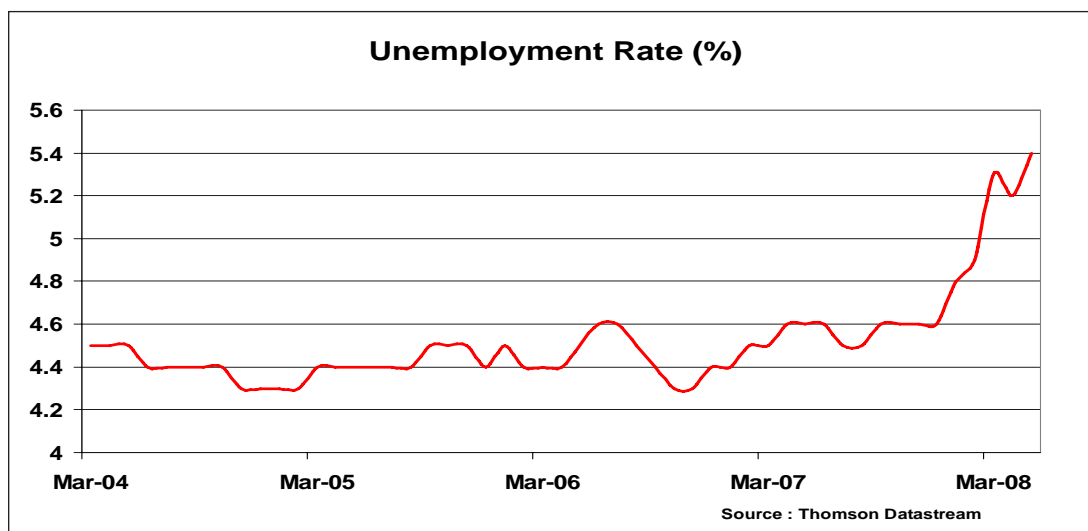
Meantime, only one-third or 18,400 of the 53,800 rise in jobs was in full-time employment, with 66% or 35,400 constituting part-time employment. Furthermore, 31,200 or 58% of the employment growth was in self employment. This suggests that recent job growth may have been of a lower quality than in previous years.

Net inward migration is estimated to have accounted for 80% or almost 50,000 of the 62,500 increase in the labour force in the year to Dec-Feb 2008, with rising participation rates accounting for another 7,000 of the increase. This implies that less than 6,000 of the increase in the labour force was due to indigenous population growth. Given these figures, it is not surprising then that non-Irish nationals accounted for 90% or 48,400 of the 53,800 rise in employment in the year to Dec-Feb 2008.

As noted above, the latest QNHS data show that the unemployment rate rose to 4.8% seasonally adjusted in Dec-Feb 2008 from 4.6% in the previous quarter and 4.4% a year earlier. The rise is modest enough at less than 9,000 for the twelve months to Dec-Feb 2008. This reflects the fact that there has been a slowdown in labour force growth as well as employment growth in recent times. Indeed, female unemployment has continued to decline with the rise in the jobless total more than accounted for by males, consistent with the marked fall in the numbers employed in construction and manufacturing.

There has been a much sharper increase in the Live Register than in unemployment as recorded in the QNHS in recent times. The Live Register rose to over 207,000 in May, up from 165,000 last October. Of course, the Live Register is not designed to measure unemployment. It includes part-time workers (those who work up to three days a week), seasonal and casual workers and people signing on for Social Welfare credits. The big jump in the Live Register is consistent with the large rise in part-time employment and modest uptrend in unemployment in the QNHS.

There is little doubt that the slowdown in employment growth will continue. The strong growth in jobs in the retail/wholesale trade is unlikely to be sustained given the much weaker pace of growth in consumer spending forecast for 2008-2009. Job growth also looks set to slow in financial/business service sectors given their more difficult operating environment. A tightening of fiscal policy points to sluggish growth in public sector employment. The construction sector can be expected to shed considerably more jobs given the sharp downturn in housing activity. It lost 10,000 jobs in the year to Dec-Feb 2008 and could have shed another 33,000 jobs by the end of next year. Employment is likely to continue contracting in the manufacturing sector also.



Overall, we expect employment growth to average 1.4% in 2008, or around 30,000 jobs. By end year, though, we expect employment growth to have slowed to around 0.5% yoy, implying job growth of around 10,000 compared to end 2007 levels. Turning to 2009, lay-offs in construction and manufacturing are likely to continue to act as a drag on job growth. The growth in public sector employment is expected to be sluggish. Growth in private services jobs should slow in a lagged response to the weakening in economic growth. Taking into consideration also that it will be starting from a very low base next year, employment growth may be close to zero in 2009.

Labour force growth has been decelerating for the past two years and can be expected to slow further in 2008/2009 via a marked fall-off in inward migration and a decline in the participation rate. In the year to April 2008, PPS numbers issued to nationals from the EU 10, Bulgaria and Romania declined by 37% yoy so inward migration seems to be slowing already. Meanwhile, the male labour force participation rate has declined since mid-2007, while the participation rate for the whole labour force fell in Q1 2008. As a result, we look for labour force growth to average 2.2% this year and 1.2% in 2009, down from 3.7% in 2007 and 4.6% in 2006. Nonetheless, this will not be sufficient to prevent a marked rise in unemployment.

The unemployment rate was remarkably stable in the period 2004-2007 at around 4.4-4.5%. It has now risen to above 5% and seems likely to average around 5.3% in 2008, up from 4.5% last year. Despite a continued slowing of labour force growth, a stagnant job market is likely to see the unemployment rate rise even more sharply next year to an average rate of 6.4%. Employment growth should pick up in 2010 as economic activity regains momentum but the unemployment rate is still likely to continue rising and average around 6.6% for that year.

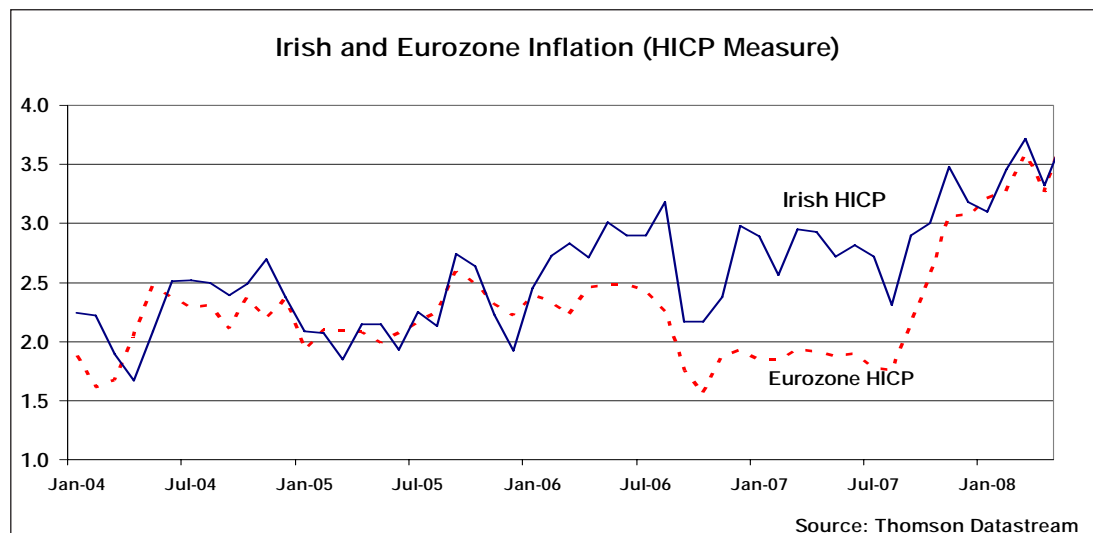
Will Inflation Come Down Anytime Soon?

Irish inflation as measured by the CPI looks set to average around 4.6% in 2008, the third consecutive year of high inflation following rates of 4% in 2006 and 4.9% in 2007. The data for the opening months of 2008 have been disappointing, with the headline CPI rate averaging 4.6% yoy in the January to May period. This is fuelling concerns that high inflation is becoming embedded in the economy and it has generated demands from trade unions for substantial wage increases in the current national pay talks.

Much of the high inflation in 2006 and 2007 was due to big increases in mortgage repayments. Hence, the HICP inflation measure, which excludes mortgages, averaged 2.7% in 2006 and 2.8% in 2007, well below the CPI rate. However, HICP inflation has picked up this year also. There have been sharp increases in food and energy prices since last summer, which has put upward pressure on both headline and underlying inflation rates. The annual rate of HICP inflation had picked up to 3.7% by May from 2.7% last summer. It now looks set to average 3.6% for the year as a whole, its highest level since 2003.

Food prices have increased sharply since the last summer, with the year-on-year rate of increase accelerating from 2.7% in September to 7.8% by May. The year-on-year rate of increase in energy prices stood at 9.2% in May, up from a low of 1.7% last August. Oil prices have surged even further ahead in recent weeks, which will keep inflation high in the months ahead. Mortgage rates also look set to rise with the ECB expected to increase rates in July.

Thus, the headline CPI inflation rate is expected to fluctuate around the 4.5% level over the second half of the year. The HICP rate is expected to remain at or above 3.5% over the balance of the year also. Hence, we do not expect any noticeable easing of inflation before end 2008.

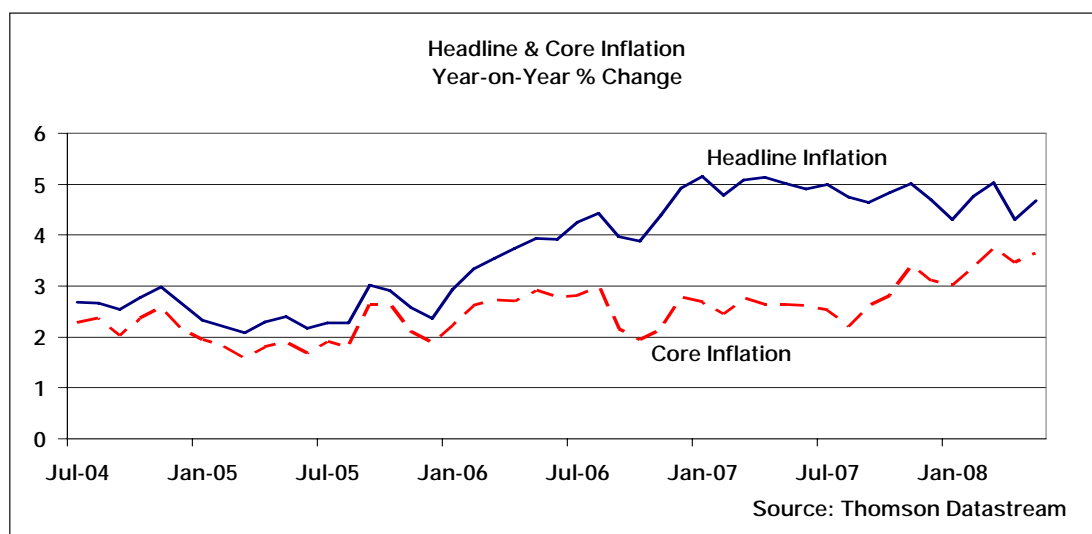


The bulk of the price rises in Ireland have come from external sources. Not surprisingly, then, inflation has picked up in other countries also. The rate of HICP inflation for the eurozone has more than doubled to 3.6% from 1.7% last August. Indeed, the Irish and eurozone inflation rates have been virtually identical in recent months. In the US, the CPI rate has picked up from a low of 1.9% last August to around 4% in recent months. In the UK, CPI inflation has jumped sharply to 3% and is expected to rise even further in the coming months. Thus, the recent rise in inflation is a global event and not just an Irish phenomenon.

That said, it is disappointing that food price inflation is running at 7.8% yoy in Ireland, well above the UK and eurozone rates of 6.6% and 6.4%, respectively. Given the marked appreciation of the euro against sterling, one would have expected a lower rate of food price

inflation in Ireland, given the sizeable food imports from the UK. More generally speaking, there is little evidence yet that the euro's strength is translating into lower consumer prices here.

Indeed, Irish goods price inflation as measured by the HICP, which should be most influenced by exchange rate movements, has accelerated from close to 0% a year ago to 4% yoy, while service sector inflation (excluding mortgages) has decelerated from 5.6% to 3.3% in the same period. This is actually a positive development. It suggests that, if upward pressure on food and energy prices abates and the currency's strength does start to impact on goods prices, Irish inflation will eventually fall. The slowdown in the pace of economic activity and rise in unemployment should also eventually result in an easing of inflationary pressures.



One constraint on headline inflation is the continuing rise in the mortgage component of the index, reflecting the lagged effects of the sharp rise in house prices in the past decade. The CPI uses a set of mortgages with varying ages. As time progresses, new mortgages are added to the set at current house prices and older mortgages, based on far lower house prices, drop out when they are repaid. Even though house prices have declined in the past year, the level of house prices and thus the size of mortgages are still much higher than a decade ago. Thus, the mortgage component of the CPI is continuing to rise. By our estimates, this is adding roughly 0.1% per quarter to headline inflation. Furthermore, mortgage rates look set to rise again.

Obviously, the trends in food and energy prices will have a major bearing on inflation going forward. These are hard to forecast but we make a working assumption that the uptrend in both the food and energy components of the CPI will moderate to around 2.7% and 4% yoy, respectively, by end 2009. We also assume unchanged exchange rates, an ECB refi rate of 4.25% and just a modest increase in indirect taxes in the 2009 budget.

On this basis, headline CPI inflation is forecast to average around 3.5% next year, down from 4.6% in 2008. The HICP rate, which excludes mortgages, is forecast to average 3.0% in 2009, down from 3.6% this year. We look for the HICP rate to ease further to 2.5% in 2010, with CPI inflation falling below 3%. Overall, then, we do not expect inflation to fall from its current high level until next year. It's going to be a slow process, with the CPI rate staying above 3% until towards the end of 2009. Even then, the risks are to the upside from energy and food prices.

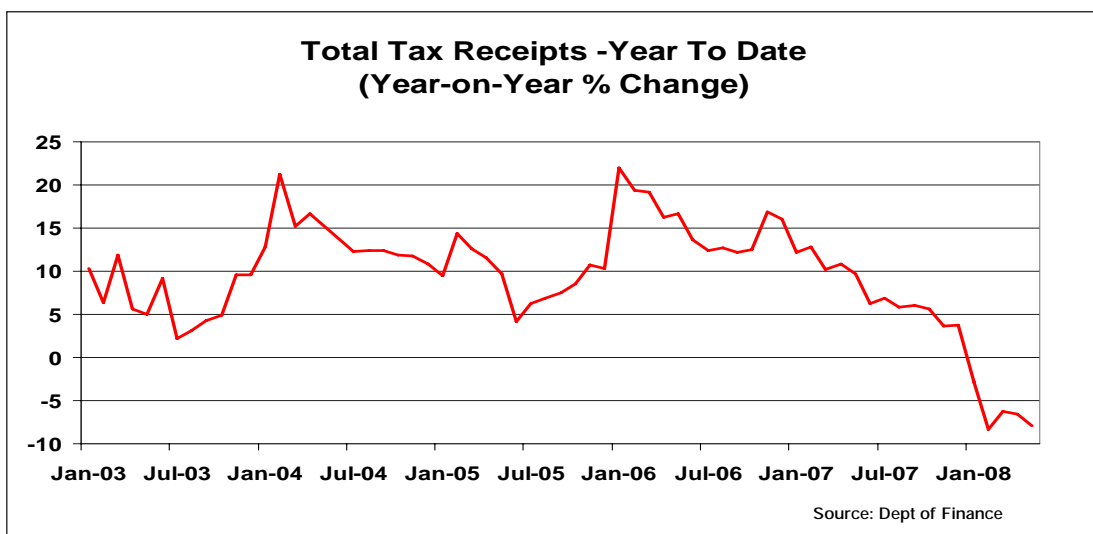
Getting back to a low inflation environment would be aided if importers and retailers pass on the benefits of the euro's strength to customers in lower prices, the government avoids excessive increases in indirect taxes and public service charges and the nation as a whole avoids a wage/cost spiral. The trend in food and energy prices and interest rates may be beyond Ireland's control but these factors are not, when it comes to reducing inflation.

Tough Budgets Ahead in 2009 and 2010

The was a marked reduction in the General Government budget *surplus* in 2007 to €554 million, or 0.3% of GDP, from €5.2 billion or 3% of GDP in 2006. While some of the decline in the budget surplus was due to an unexpected weakness in tax receipts, most of it was attributable to planned large increases in government spending last year. Significant growth in public spending was also provided for in this year's budget against a backdrop of projected sluggish growth in tax receipts, pushing the government finances into deficit. The 2008 budget set a target for a General Government budget *deficit* this year of €1,845 million, or 0.9% of GDP.

This would be only the second such General Government budget deficit recorded since 1997. As a result, the General Government debt to GDP ratio had fallen to just 25% by end 2007, one of the lowest in the EU. Furthermore, the current budget balance is projected to remain in significant surplus in 2008, with the projected budget deficit more than accounted for by capital borrowing (excluding pension pre-funding) of some 4% of GDP. Capital borrowing is very necessary to help fund improvements in the nation's still relatively underdeveloped public infrastructure. Overall, then, the Irish public finances remain in a very strong state.

However, the Exchequer returns for the opening five months of the year indicate that the government budget deficit outturn will be much larger than forecast. Tax receipts have been very weak, falling by 8% yoy to end May in 2008, leaving them €1,165m behind target.



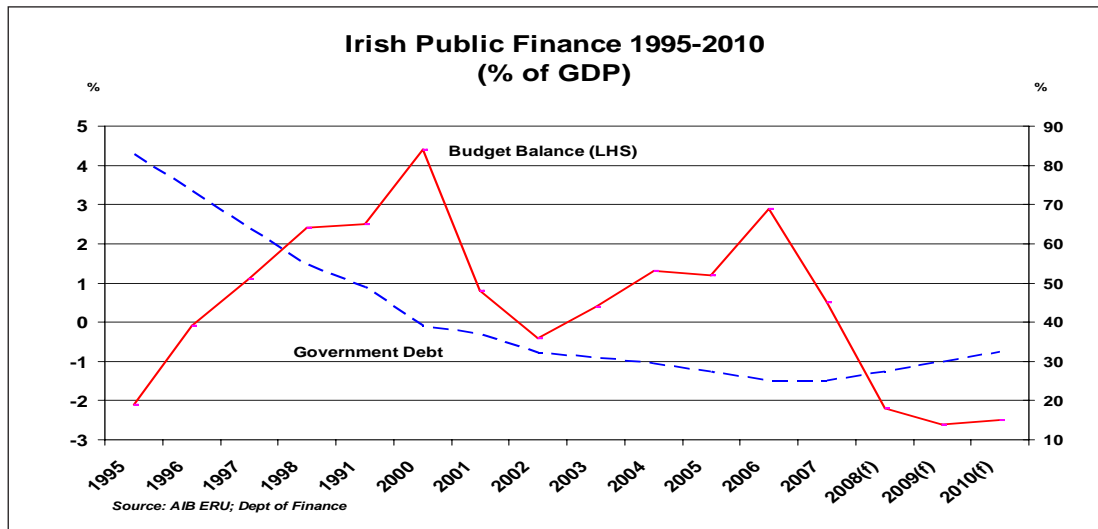
Indeed, it has been quite clear since early in the year that there will be a large undershoot in tax receipts in 2008. The downturn in the housing market is having a much bigger impact on property related tax revenues and VAT receipts, than originally anticipated. It also seems likely that economic growth in 2008 will be less than half the 3% rate forecast by the government at budget time, with consumer spending well below expectations.

Estimating the size of the shortfall in tax receipts is difficult given that: a substantial portion of tax revenues are collected late in the year; tax receipts may have been impacted by changes in car tax taking effect in July; and some signs of life in the housing market could yet give a lift to property tax receipts later in the year. At this stage it is unlikely that the tax take in 2008 will even match that in 2007. Tax receipts were €1,165 million behind schedule at end May even though three of the main tax heads - income, corporation and Excise duty- were close to target. For the year as a whole, total tax receipts could undershoot target by €2.5 billion.

On the current spending side, the government is finding it difficult to keep health expenditure within budget but any overruns should be small. Capital spending should be in line with target. Some savings could be made in areas such as debt interest payments. Thus, overall

Government expenditure may end the year close to target. At this stage, the eventual General Government budget deficit outturn for 2008 could be of the order of €4.15 billion, or 2.2% of GDP, some €2.3 billion above the original target.

The Minister for Finance has called the current budgetary situation manageable given the strong position of the public finances, such as the low debt/GDP ratio. However, the marked deterioration in the budget balance in 2007/2008 cannot be allowed to continue, not least because there is an EU cap of 3% of GDP on budget deficits for member states of the euro area.



The Irish Finance Minister will want to allow some room for forecasting errors in his next budget, given the difficulty in predicting tax receipts and the uncertainty surrounding what the actual size of the tax base will be post the correction in the housing market. Thus, it is unlikely that he will target a budget deficit much above 2.5% of GDP next year. This points to a very tight budget in 2009 especially as the tax take may continue to be depressed by weakness in housing activity. A tight budget also looks in store for 2010. Thus, we do not envisage much in the way of indexation of income tax credits and bands in the next two budgets. Meanwhile, there are likely to be some increases in indirect taxes and public service charges.

Our forecasts are for sluggish growth in tax revenues of around 1.5% in 2009, picking up to some 5% in 2010 as housing activity stabilises. This implies that, if the General Government deficit is to be kept to around 2.5% of GDP, growth in government spending needs to be contained to around 4% in 2009 and 4.5% in 2010. This is obviously going to prove a difficult task, with unemployment on the rise, upward pressure on public sector pay and demands for improved public services, especially in health and education.

An easy option would be to scale back capital spending as happened on the last occasion that economic growth slowed and pressure came on the public finances, in 2003 and 2004. However, the proposed increase in Exchequer financed capital expenditure in 2009-2010 is relatively small at 6% over the two years. While capital spending plans may now have to be reviewed, the government should ensure that any cutbacks have a limited impact on the future growth potential of the economy, which is still burdened by a considerable infrastructure deficit.

The key focus for the government must be to control the runaway growth in gross current supply services spending has jumped from €22 billion in 2000 to €53 billion this year, an increase of over 140% in the space of eight years. It now equates to 32% of GDP, up from 24.7% in 2000. There must be scope for improvements and efficiencies to be made in this area after such strong spending growth to date in this decade. Indeed, a recent OECD report on the Irish economy highlighted the need to get better value for money in the public sector.

APPENDIX 1:

What are the medium term economic growth prospects?

Our analysis shows that we expect GDP growth to pick up to 4% in 2010 as the downturn in housebuilding activity bottoms out and global growth regains momentum. Will this signal the beginning of another period of robust growth for the Irish economy?

The recently published *ESRI Medium Term Review 2008-2015* of the Irish economy forecasts that growth will indeed pick up again. It sees GDP growth averaging 3.8% in the 2010-2014 period, with GNP growth averaging 4%. Economic growth is cyclical and the ESRI sees the economy returning to a solid medium term growth path when the current downturn ends. It does not see the downturn doing lasting damage to the economy's long-term growth potential. The rate of productivity growth is forecast to average around 2.5% a year and employment is expected to grow by 1.2% per annum in the period 2010-2014.

In our view, the ESRI forecasts, if anything, err on the side of caution. The Irish economy has proved to be a phenomenal job creator over the past fifteen years and while employment growth will certainly moderate in the coming decade, we feel that it can exceed the ESRI's modest forecast. We expect employment growth to average around 2% in the 2010-2014 period, which would be half the rate of job growth achieved in the 2004-2007 period. As a result, we see GDP and GNP growth averaging 4.5% in the 2010-2014 period.

The services sector, in particular the business, financial and I.T. sectors, have taken over the baton from the manufacturing and housebuilding sectors as the main growth engine of the economy. As the ESRI points out, these sectors have become the key channel through which the robust growth in world trade is transmitted to the Irish economy. They are now a major part of the economy and employ more people than either manufacturing or construction. They are also sectors that have enjoyed rapid growth in recent years and there is no reason why this trend cannot be sustained in the coming decade.

It is important to note that our forecasts embody a more pronounced slowdown in GDP growth in 2009-2010 than the ESRI's, reflecting a much larger decline in housebuilding activity- we see

IRISH ECONOMIC GROWTH FORECASTS 2010 - 2014					
(% Volume)	2010	2011	2012	2013	2014
Consumer Expd	3.0	3.5	3.5	3.5	3.5
Government Expd	2.5	3.5	4.0	3.5	3.5
Fixed Investment	2.5	8.0	7.5	5.0	1.5
Domestic Spending	2.8	4.6	4.6	3.9	3.0
Exports	5.3	6.0	6.0	5.7	5.5
Imports	4.0	5.8	5.8	5.0	4.5
GDP	4.0	4.8	4.8	4.7	4.2
GNP	4.0	4.8	4.8	4.7	4.2

Source: AIB ERU Forecasts

house completions falling to 33,000 by 2009 compared to the ESRI's 45,000 forecast. As a result, we see housebuilding rebounding to its medium term demand level of 55,000 level by 2013 adding significantly to GDP in the 2011-2013 period. By contrast, the ESRI forecast has just a modest rise in house completions in this period, given its higher base. However, the ESRI make the point that if the downturn in activity proves to be more severe than they anticipate, then the economy should recover even more vigorously from 2010 on.

Excluding housing, we see GDP growth averaging 4.2% in the period 2010-2014. This is considerably slower than the rate of GDP growth excluding housing recorded by the economy in the last three years, which averaged 6.2%. Thus, we do not believe that our growth forecasts constitute an overly optimistic outlook for the Irish economy, especially given the flexibility of the labour market, notably its ability to boost supply via net inward migration. Furthermore, it would represent a continuation of Ireland's long track record of strong economic growth, stretching back as far back as the 1960s and 1970s, with the exception of the economic slump of the 1980-1986 period.

APPENDIX 2:

What is the State of the Commercial Property Market?

2007 was a strong year in terms of commercial building activity, particularly in the Dublin office sector and in the retail sector. However, the slowdown in Irish economic activity raises serious questions about the continued strength of the commercial property sector. Concern focuses on two, previously strongly performing, major sub-sectors of the diversified commercial property market - Dublin offices and retail.

In the Dublin office market, some 250,000 sq metres of new office space was completed in 2007, an increase of 130% on 2006 construction levels. There remains a relatively strong office pipeline with approaching 315,000 sq metres scheduled for completion this year, an increase of a further 24%. Meanwhile, 2007 was a record in terms of letting activity (with estimates of between 260,000 and 300,000 sq m let in the Dublin market). With demand outstripping supply, there was some slight decline in vacancy rates last year.

The financial services sector accounted for some 45% of the Dublin office take up last year. Thus, it is particularly encouraging that, given the global problems facing the financial services sector coupled with the downturn in Irish economic conditions, demand for office space appears to be holding up reasonably. Indeed, lettings in Dublin in Q1 were some 10% above their five year average for the quarter.

Tenants, though, are moving cautiously, are taking longer to make decisions and are looking for better value. Prime rents, which had been stable since autumn 2007, are now coming under pressure. Given the current economic climate, further slippage in rents could occur. However, funding pressures are likely to curtail new development which should help to relieve some of the pressure on rental levels.

In the retail sector, there has been a considerable growth in floor space over the past few years, helped by the high levels of rental growth in the sector. Total shopping centre space grew by over 10% last year alone. As a result, in terms of shopping centres, Ireland is now third in Europe in terms of space per capita. This high level of capacity reflects, in part, the fact that the shopping centre model is more prevalent in Ireland than elsewhere in Europe.



Further extension of shopping centre space is anticipated. Many of the major retailers have indicated that they intend opening new stores in the coming year. Meanwhile, overseas retailers continue to enter the Irish market. There remains considerable scope for retail brand expansion, with CB Richard Ellis estimating that only 35% of international retailers are currently represented in the Irish market (compared to 55% in the UK).

We are expecting that the rate of growth in consumer spending will slow to 1.5% this year and 2.0% in 2009 from 5.4% in 2007 and thus it seems inevitable that the pace of retail expansion will slow. However, Ireland should still have a relatively high rate of retail sales growth in a European context, with the sector also supported by Ireland's demographic profile.

However, the scope for further expansion of retail floor space is becoming more limited and the pace of growth in the sector needs to slow in order to prevent oversupply. Developers, though, appear to be more cautious about shopping centre development. Furthermore, the current more difficult funding conditions should also serve to inhibit speculative shopping centre development.

Against the background of the large amount of shopping centre space that has come on stream in recent years and the slowdown in consumer spending, retailers are likely to be more selective about location and there would appear to be limited potential for further strong rental growth in the sector.

While the prospects for the sector are undoubtedly deteriorating, there are as yet are no indications of any sharp downturn in commercial property activity. However, the current funding pressures are likely to curtail new building activity to some extent. This should help to limit the extent of downward pressures on rental levels and help prevent the emergence of significant oversupply in the sector. With the market becoming more challenging, though, rents are already beginning to decline in some sectors.

Reflecting the more challenging environment, data from Investment Property Databank (IPD) show that Q1 2008 was the worst in terms of commercial property returns since the IPD index began in 1995. Overall, the market recorded a return of -2.3% in the quarter. This reflects, in large part, a drop in capital values (of 3.3% on the quarter) driven by a sudden collapse in investor confidence triggered by financial market uncertainty. In addition, although still positive (at 0.7% qoq in Q1 2008) overall rental growth slowed sharply (from 1.5% qoq in q4 2007).

