



# The Irish Economy

## Sharp Adjustment To Continue In 2009

### Overview

---

**The Irish economy entered recession in 2008 for the first time in 25 years, led a marked decline in construction.** A further decline in GDP is on the cards in 2009, with housing remaining a major drag on overall activity. In line with the trend globally, it is shaping up to be a very severe downturn in the economy. GDP could contract by a cumulative 5.5% in 2008-09, before stabilising in 2010. **We do not expect the economy to regain significant momentum until 2011.**

This bleak outlook has obvious very negative implications for the labour market, with a substantial retrenchment in employment, particularly in the building industry, on the cards. We expect the jobless rate to rise to at least 10%. The public finances will remain under severe pressure, with the budget deficit set to rise to 10% of GDP.

**The downturn in housing activity is having a major impact on the economy.** The direct effect is to knock 3.7% and 3% off Irish GDP growth in 2008 and 2009, respectively. Other problems facing the Irish economy include the sharp appreciation of the euro against sterling, a marked tightening of fiscal policy and the sharp fall in consumer and business confidence. The high levels of private sector debt built up in recent years add to the vulnerability of the economy at a time of deleveraging and recession.

**The severe Irish recession has also to be viewed in a global context. The advanced economies of the world are experiencing the worst recession since World War 2** according to the IMF. The crisis in the banking sector and financial markets and associated deleveraging are having a major negative impact on real economic activity across the globe. Ireland is a very open economy and so is being hit hard by the sharp downturn in the world economy.

**The Irish economy is most unlikely to regain momentum until the global economy starts to swing upwards and activity levels stabilise in the housing market.** Central banks across the world are cutting rates aggressively and adopting a range of other measures to alleviate the worst effects of the credit crunch. Interest rates are heading for exceptionally low levels. Fiscal policy is also being loosened to help offset flagging private sector demand.

Meanwhile, **inflation is tumbling** globally following a collapse in commodity prices, most notably for oil. This will provide a significant boost to real disposable income, which combined with stimulatory macro economic policies should form the basis for an eventual revival in the world economy. With deleveraging expected to be a prolonged process, though, it could be 2011 before we see a fully fledged recovery by the global economy.

Looking to the domestic front, the housing sector is set for another sharp decline in output in 2009, taking completions down to very low levels. Hence, **we expect just a modest fall in housing output in 2010. Combined with some improvement in the global economy, this should allow activity levels to stabilise in the Irish economy in 2010**, with GDP growth expected to be around zero.

January 2009

IRISH ECONOMIC UPDATE

**We see a return to growth by the Irish economy from 2011 on**, as the world economy regains significant momentum and activity levels start to pick up in the domestic economy. **A key requirement in this regard is to ensure that the economy is in a position to take full advantage of the global upturn** as a recovery in Ireland will almost certainly be export led.

In this regard, the period 2009-2010 provides an ideal opportunity for the Irish economy to improve competitiveness, given that it will be characterised by a very sharp contraction in domestic demand, big rise in unemployment and very low inflation. **The focus must be on reducing Irish unit wage and non-wage costs to bring down production costs to more competitive levels.** The government should minimise increases in taxes as well as price rises for public services that add to production costs. Pay restraint will be vitally important in both the public and private sectors. Greater competition is also required in many sectors of the economy to help bring down prices.

It is going to be **very difficult to achieve any worthwhile reduction in the budget deficit until the economy is back on a firm growth path, which is unlikely to be until 2011.** It will also take a number of years to bring the budget deficit down from its likely peak of 10% of GDP in 2010 to below the 3% level, as required by EU rules. Recently revised forecasts from the Dept of Finance showing the budget deficit falling to 2.5% of GDP by 2013 are challenging but a prudent fiscal policy can get the budget deficit back down below the 3% of GDP level over the medium term.

The key to bringing the budget deficit under control is to secure a marked reduction in government spending as a percentage of GDP as the economy regains momentum. This does not imply a reduction in the overall level of spending. Instead, **growth in government spending needs to be kept well below the growth rate of nominal GDP and tax receipts, as the economy recovers.** This implies that budgetary policy will have to be kept very tight in the first half of the coming decade.

Housing activity is likely to be relatively subdued for quite some time, which combined with the need for a tight fiscal policy, implies that economic **growth is unlikely to return to the very strong levels witnessed in recent years. Instead, we see GNP growth averaging around 3.7% in the period 2011-2014**, with growth in domestic spending running at around 3%.

#### **In summary:**

- **The Irish economy is likely to contract by around 1.5% in GDP terms in 2008, with GNP falling by 2.7%.** National accounts data show that GDP fell by 0.6% year-on-year in Q1-Q3 2008, with GNP declining by 2%. Domestic spending fell sharply, declining by almost 5%, led by big declines in housing output and investment in machinery and equipment.
- **The data published for the closing months of 2008 point to a further weakening of activity.** Housing output continued to contract, while the decline in consumer spending gathered pace. Tax receipts were very weak and the jobless total continued to spike upwards.
- **The sharp decline in new housing output is weighing heavily on GDP growth.** Housing completions are estimated at around 51,000 in 2008, down from 78,000 in 2007. They are forecast to fall to 25,000 in 2009 and 20,000 in 2010. With total housing investment and associated transfer costs still accounting for 8.5% of GDP last year, the decline in housing activity knocked some 3.7% off GDP growth in 2008 and will knock close to 3% off in 2009.
- **The economy is also battling other very strong headwinds**, including severe recessions in all our major export markets, a sharply higher exchange rate against sterling, tightening of credit conditions, collapse in asset prices, rising unemployment, weakening business and consumer confidence and a marked tightening of fiscal policy.
- **Domestic spending is estimated to have contracted by over 5% last year and is forecast to decline by a further 7.3% in 2009 and 2.4% in 2010**, largely as a result of sharp falls in housing output and non-residential investment - total fixed investment is forecast to decline by

43% in the 2008-2010 period. Consumer spending is also expected to fall, with just sluggish growth in government spending.

- As in 2007-2008, **net trade should make a significant contribution to GDP growth in 2009-2010 despite the very unfavourable external environment.** Export growth slowed sharply over the past year as the global economy went into recession, but it has remained in positive territory to date. However, we do not expect exports to show any growth in 2009.
- Imports, though, are falling sharply in the face of the marked decline in domestic spending. Overall, net trade is estimated to have added some 2.6% to GDP growth in 2008, and is forecast to contribute 2.2% in 2009 and 1.9% in 2010.
- Overall, then, **we expect GDP to contract by 4% this year and be broadly unchanged in 2010.** The risks to this forecast are on the downside, particularly in relation to exports, which could well decline given the very difficult external environment.
- **Thus, we do not see the economy recovering until 2011, when we expect Irish GDP to rise by 3.5%.** Furthermore, a tight fiscal policy and subdued housing market are likely to act as constraints on growth in the first half of the coming decade.
- House prices are likely to find a floor in 2010, helped by the considerable improvement in affordability generated by a very large decline in house prices and a sharp fall in mortgage interest rates, as well as signs of a stabilisation in the economy.
- **The recession is hitting the labour market very hard.** Significant job losses are already evident in many sectors of the economy, especially construction and manufacturing. We expect to see many job losses also in the services sectors of the economy. **In total, the economy could shed 150,000 jobs in the 2008-2010 period,** implying a fall of 7% in employment.
- A turnaround in migration flows with net outward migration resuming, as well as a decline in participation rates, should result in a contraction in the labour force in 2009 and 2010. However, we still **expect the jobless rate to continue its sharp uptrend, rising to at least 10%.**
- The CPI rate averaged 4.1% in 2008, with the HICP rate (which excludes mortgages) averaging just over 3%. However, **inflation is now in sharp decline.** There has been a big fall in oil prices since the summer, with other commodity prices also in decline. Mortgage repayments are also now falling as a result of ECB rate cuts. The appreciation of the euro and weakening domestic demand and labour market conditions are also contributing to waning price pressures.
- **Very low inflation rates are in prospect for 2009 and 2010.** Indeed, the CPI is likely to decline by 2.5% on average in 2009 as a result of a steep fall in mortgage rates. We see the HICP rate averaging just zero per cent this year despite sharp hikes in indirect taxes and public service charges. CPI inflation is forecast to average 1% in 2010, with the HICP rate averaging 1.2%.
- **The public finances have gone badly off course in the past year.** The General Government budget deficit is put at around 6.3% of GDP in 2008. The budget deficit is likely to rise to around 9% of GDP in 2009 and 10% of GDP in 2010, way above the EU's 3% limit.
- **Fortunately, Government debt is low** at 30% of GDP in net terms at end 2008, or 20% of GDP if one includes the National Pension Reserve Fund. Thus, there is scope to run a large budget deficit, which is just as well, as getting the budget deficit back down to 3% of GDP will take a good number of years. This can be best achieved through continuing to keep a very tight rein on government spending as the economy recovers and tax receipts pick up.
- We do not see the budget deficit falling to 3% of GDP until 2014 and this is on the assumption that the economy picks up strength from 2011. **Thus, very tough budgets will be required in the first half of the next decade** in order to restore order to the public finances.

**IRISH MACRO ECONOMIC FORECASTS; JANUARY 2009**

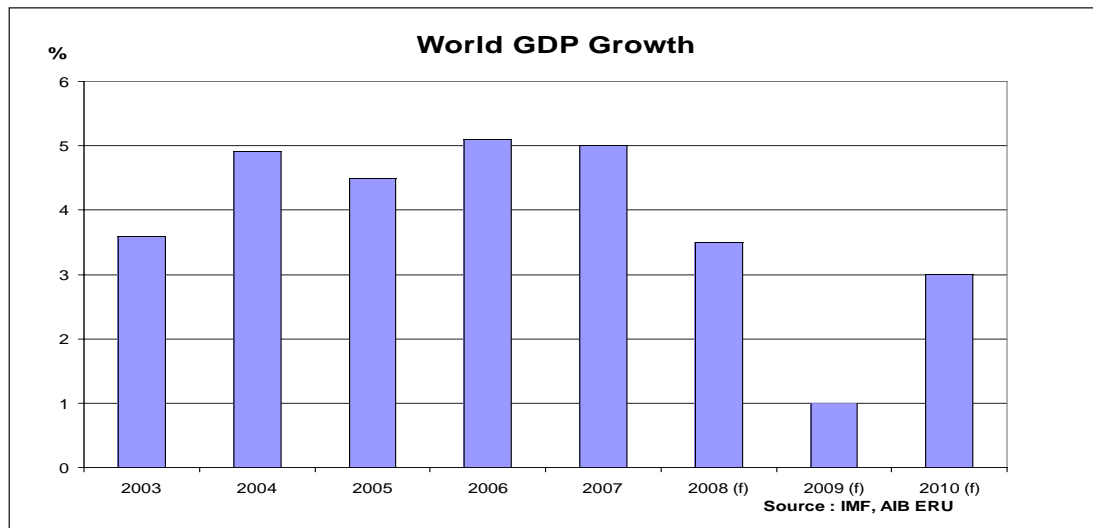
<i>Annual average % change unless otherwise stated</i>	<b>2007</b>	<b>2008(e)</b>	<b>2009(f)</b>	<b>2010 (f)</b>	<b>2011 (f)</b>
<b>Real GDP</b>	<b>6.0</b>	<b>-1.5</b>	<b>-4.0</b>	<b>0.0</b>	<b>3.5</b>
<b>Real GNP</b>	<b>4.1</b>	<b>-2.7</b>	<b>-3.5</b>	<b>-0.5</b>	<b>3.3</b>
<b>Domestic Expenditure</b>	4.7	-5.2	-7.3	-2.4	2.5
Personal Spending	6.3	-0.3	-2.5	-1.0	2.0
Government Spending	6.0	2.8	0.5	0.5	0.5
Fixed Investment	1.2	-18.5	-23.5	-9.0	6.0
Contribution of Stocks to GDP Growth	-0.9	0.6	-0.3	0.1	0.0
Total Exports	6.8	1.0	0.0	2.0	4.3
Total Imports	4.1	-2.7	-3.5	-0.2	3.3
Level of GDP (€bn, current prices)	190.6	186.8	179.3	182.0	192.0
Level of GNP (€bn, current prices)	161.2	157.2	151.7	153.2	161.6
<b>Industrial Production (Vol)</b>					
Total	7.2	0.5	-1.0	2.0	4.5
Modern	8.7	2.8	0.0	3.0	6.0
Other	3.7	-4.5	-3.0	-0.5	1.0
<b>Housing</b>					
Average House Price Inflation (end year)	-7.3	-10.0	-10.0	2.0	5.0
House Completions (CSO Basis '000)	78.0	51.0	25.0	20.0	25.0
<b>Labour Market</b>					
Labour Force Growth	3.7	1.4	-0.6	-0.9	0.5
Employment Growth	3.6	-0.2	-3.5	-2.2	0.8
Unemployment Rate (%)	4.6	6.3	9.0	10.0	9.7
Net Immigration (Year to April '000)	67.3	39.0	20.0	-20.0	-10.0
<b>Costs and Prices</b>					
CPI	4.9	4.1	-2.5	1.0	2.2
Irish HICP	2.8	3.1	0.0	1.2	2.0
Mfg Output Prices (Home Sales)	1.6	5.3	2.5	1.0	1.5
Earnings Growth (Whole Economy)	5.0	4.0	1.0	1.0	2.0
Unit Wage Costs (Whole Economy)	4.5	5.4	3.2	0.3	0.3
<b>External Account</b>					
Total Trade Balance* (% of GNP)	+12.2	+12.9	+14.3	+14.4	+13.4
Current Account Balance (% of GNP)	-6.4	-6.4	-4.2	-4.1	-5.0
<i>(* Goods and Services)</i>					
<b>Public Finances</b>					
General Gov. Balance (€ m)	554	-11,800	-16,000	-18,000	-16,000
General Gov. Balance (% GDP)	+0.2	-6.3	-9.0	-10.0	-8.4
General Gov Debt /GDP ratio (%)	24.8	40.6	52.7	62.3	68.0
<b>Private Sector Finances</b>					
Personal Disposable Income	10.4	5.8	0.0	-0.2	3.2
Personal Savings Ratio (%)	3.3	5.5	7.5	7.0	6.5

*Forecasts prepared by AIB's ERU, historical data sourced from CSO, Dept of Finance, DoE & permanent tsb*

## A Very Weak Global Economy

The global economy weakened rapidly over the course of 2008 with recession taking hold in the main developed economies over the course of the year. The combination of a sharp downturn in housing markets, financial sector deleveraging, dislocation in financial markets, sky-high commodity prices and sharp falls in consumer and business confidence all led to a rapid deterioration in economic conditions that has also translated into rising unemployment.

No part of the global economy has been spared. Even the very strongly growing Asian economies, like China and India, are slowing down. IMF forecasts for the world economy in 2009 make grim reading. They expect activity in developed economies to contract by 0.25%. This would be the first such annual contraction in GDP in the postwar period. Meanwhile, growth in emerging economies is forecast at 5% in 2009, a marked deceleration from the 8% growth rates of recent years. However, even these grim IMF forecasts look too optimistic to us. We see the world economy growing by 1% or less in 2009 compared to their 2.2% forecast, and a global growth rate of 5% for much of the past decade.



Conditions in financial markets remain very difficult and the problems in the financial sector are likely to restrain global growth for a prolonged period. Credit spreads have risen to extremely high levels, many credit markets remain closed, interbank markets continue to suffer from poor liquidity and high rates and bad debts are becoming a major concern. Banks are focusing on deleveraging through scaling back on the asset side of their balance sheets, which is greatly curtailing lending activity. Sovereign spreads are widening out for emerging, smaller and lower rated countries, while sharp falls in stock markets are adding to asset price deflation.

Governments and central banks have implemented a broad range of measures in recent months to help alleviate the acute stress in the banking and broader financial system and support economic activity. There have been numerous measures to address the problems in the financial sector including bank guarantee and recapitalisation programmes, purchasing of distressed assets, massive liquidity injections into money markets, sharp cuts in interest rates and announcements of major fiscal stimulus packages.

The strong policy responses of the authorities in many countries means that the risk of a systemic financial meltdown has been greatly reduced. However, the financial system is still malfunctioning, especially money and credit markets, while deleveraging is expected to last for a prolonged period. This greatly reduces the effectiveness of interest rate cuts in stimulating economic activity. It suggests that not only will developed economies endure a full blown recession in 2009 but any recovery in activity will be muted enough in 2010. Thus, this downturn is likely to resemble the severe global recessions of the mid-1970s and early 1980s .

GDP growth is set to be negative in 2009 in Ireland's three main export markets, namely the US, UK and eurozone, with just a sluggish recovery in activity in prospect in 2010. Indeed, the President of the World Bank has warned that there could be a contraction in world trade in 2009 for the first time in more than 25 years, certainly for advanced economies.

In the US, the downturn in activity turned into a deep recession in the latter stages of 2008. The sharp decline in housing activity has morphed into a contraction in consumer spending and business investment and a weakening of export growth, while the unemployment rate is rising rapidly. We expect US GDP to contract by 2% in 2009, with only a major fiscal stimulus package and a continuing significant contribution to growth from net trade preventing an even bigger decline in output. We expect a modest recovery in 2010 with GDP rising by 1% as the substantial easing of monetary policy takes effect, and the housing market stabilises.

It is a similar story in the UK, where there has been a sharp contraction in housing activity, business investment and manufacturing output in 2008. We expect a marked fall in household consumption in 2009 and 2010, reflecting the tightening of lending conditions, declines in household wealth, rising unemployment and a rebuilding of household savings. Fixed investment will also be hit hard in 2009 by the restrictive lending environment and weak economy. We look for UK GDP to contract by 2.25% in 2009. There has been a marked easing of monetary policy in the UK in recent months and interest rates are heading to very low levels. There also has been a marked depreciation of sterling in recent times. This should lay the foundations for a modest pick up in growth in 2010, when GDP is forecast to rise by 0.5%.

<b>GLOBAL ECONOMIC GROWTH FORECASTS 2007 - 2010</b>				
(% Volume)	2007	2008(e)	2009(f)	2010(f)
<b>World</b>	5.0	3.5	1.0	3.0
<b>US</b>	2.0	1.3	-2.0	1.0
<b>UK</b>	3.0	0.7	-2.25	0.5
<b>Eurozone</b>	2.6	1.1	-2.0	0.5

*Source: IMF; AIB ERU Forecasts*

Although the same imbalances were not as evident in the eurozone economy as elsewhere, the region has not escaped the effects of the global downturn and has been in recession since Q2 2008. The combination of the strength of the euro and weakening global demand has hit exports, a key engine of growth in the region. Investment spending, another key source of growth, is now in decline reflecting falling construction activity, tightening of credit conditions and weak business confidence. Consumer spending is being weighed down by weak income growth, poor consumer confidence and tighter credit conditions. Overall, we see eurozone GDP contracting by 2.0% in 2009 before rising by a modest 0.5% in 2010 as monetary easing impacts on activity.

One piece of good news is that the slide of the world economy into recession has reversed the marked uptrend in commodity prices, with sharp falls in oil prices in particular. These have fallen from a peak of close to \$150 a barrel last July to close on \$40 a barrel. The combination of declines in commodity prices and growing spare capacity in economies, especially in labour markets, will produce a sharp decline in inflation in 2009. Indeed, CPI rates are already in marked decline. The IMF sees CPI inflation averaging 1.4% next year in advanced economies, down from 3.6% in 2008. In many economies, inflation will have fallen to around zero by the summer, if the marked decline in oil prices proves sustained. This will provide a significant boost to real disposable income and combined with stimulatory macro-economic policies should help form the basis for an eventual recovery in economic activity.

## **2008 Saw First Fall In Irish GDP In 25 Years**

The recession in the Irish economy began as a downturn in the housing market in H2 2007 when housing investment shrunk by over 20% year-on-year. Investment in machinery and equipment also declined in this period. Nevertheless, the economy still registered robust growth, with GDP rising by 4.75% year-on-year in H2 2007, helped by the continuing strong uptrend in consumer and government spending, non-residential construction and exports.

In 2008, though, the downturn in housing activity gathered momentum, while there was a sharp slowdown in virtually every other sector of the economy in the face of a global recession, severe credit crunch and knock on effects from the sharp downturn in housing activity. The economy was also burdened with a rising exchange rate and increases in interest rates for much of the year, while fiscal policy was tightened. Sharp rises in commodity prices pushed inflation higher, squeezing real disposable income. All these factors contributed to a very difficult economic backdrop and there was a sharp rise in unemployment.

National Accounts data for the first three quarters of 2008 show that GDP declined by 0.6% and GNP by 2% on year earlier levels. Domestic spending took a big hit, contracting by almost 5% yoy. Fixed investment declined by 18%, reflecting further very sharp falls in housing and business investment. Growth in consumer spending slowed sharply in Q1 2008 and then turned negative in Q2 and Q3, while growth in government spending also slowed sharply.



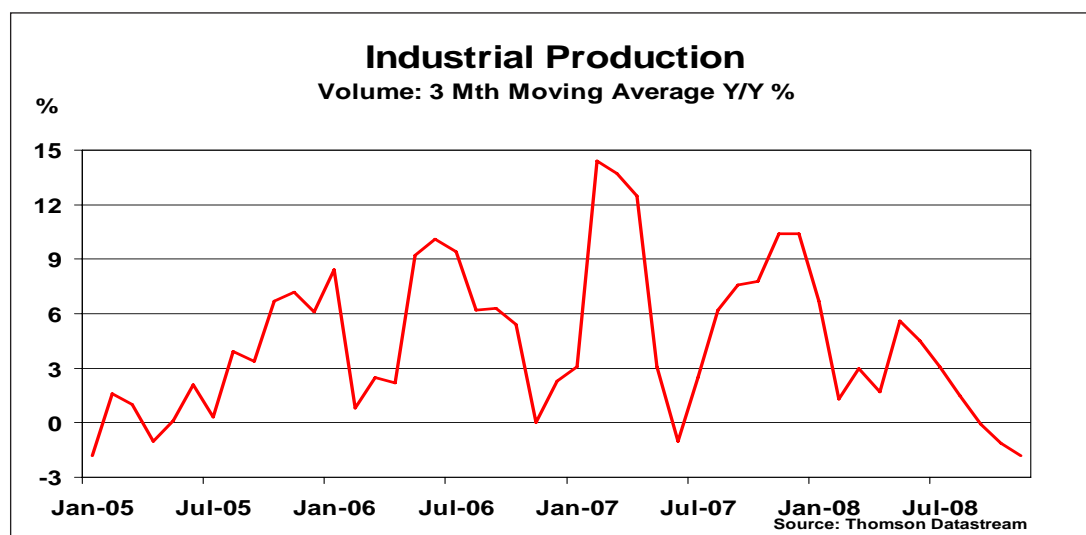
Meanwhile, export growth turned very sluggish in 2008, rising by just 1.2% yoy in the first three quarters of the year, down from growth of 6.8% in 2007. In particular, services exports, which had been increasing at a double digit rate since 2003, were flat in the period Q1-Q3 2008. Goods exports rose by 2.2% yoy, down from a growth rate of 3.7% in 2007.

Manufacturing output held up reasonably well in the first three quarters of the year given the difficult external environment, but its annual growth rate decelerated. Although output rose by 1.5% in Q3, the year-on-year growth rate fell to 0.8%, down from 3.5% in H1 2008 and 7.5% in 2007. Manufacturing activity has been underpinned by solid growth in the modern, high-tech sector, where output was up by 3.9% yoy in Q3. By contrast, output in traditional industries declined by 6.2% yoy in Q3 2008.

The data published to date for the closing months of 2008 suggest that the economy has lost even further momentum, with a consequent deepening of the recession. The weakening trend evident in retail sales continued to gather momentum, hit in particular by a rise in cross border shopping as sterling fell sharply in late 2008. New car sales were very weak in recent months. Tax receipts also became even more depressed, declining by 22% yoy in the final quarter of the year, having being down by 9.5% to end September.

The contraction in housing activity continued to gather pace in Q4 2008. Housing registrations were down by 66% last year. Housing completions, which were down by 25% yoy to end September, fell by 46% yoy in October/November. Not surprisingly, then, growth in mortgage lending has continued to decelerate, slowing to 6.7% yoy by November, from 8.5% in September and 13.4% at end 2007.

Industrial production data for October/November show a continuation of the weakening trend in the manufacturing sector, with a decline now evident in output in the modern, high-tech sector. This does not augur well for exports. There are only limited data available on external trade in Q4 2008. Merchandise trade data show that goods exports continued to hold up reasonably well in October. We have no data at all on external trade in services for Q4. Overall, though, the environment for exporters is becoming increasingly difficult with all of Ireland's main markets now in recession. Problems are particularly acute for those exporting to the UK or in competition with UK exporters, given the further marked decline in sterling.



Meanwhile, the rise in the Live Register accelerated over the course of the year, indicative of a deteriorating jobs market and worsening economy. The December figures show the Live Register total at 293,500, up by 49,000 on its September level and a rise of 121,000 since the start of the year. The unemployment rate rose to 8.3% in December, up from 6.9% in September and 4.7% at end 2007. Employment data are not yet available for Q4 but the Live Register figures point to an even bigger drop in job numbers than the 20,000 seasonally adjusted fall seen in the previous two quarters.

Not surprisingly, then, we believe that GDP and GNP declined sharply in Q4 2008. We estimate that GDP and GNP fell by 4.0% and 4.7%, respectively, on year earlier levels. We believe that domestic spending will be down 6.5% yoy, led by a decline of over 20% in fixed investment. For the year as a whole, this would imply a fall of 1.5% in GDP and 2.7% in GNP, and a fall of over 5% in domestic spending, which would confirm a deep recession in 2008, and represent the first decline in national output in a calendar year since 1983.

The main factor behind the contraction in GDP in 2008 was the sharp decline in new housing output. Housing activity in total accounted for 12% of GDP in 2007. Housing completions are estimated to have totalled around 51,000 last year, down from 78,000 in 2007. This represents a fall of some 35% in new housing output in 2008.

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 sharp downturn in the sector weighed heavily on the overall growth rate of the economy last year. We estimate that it depressed GDP growth by some 3.7% in 2008. Excluding housing, then, we estimate the rest of economy expanded by some 2.2% last year, but in reality this was mainly a carry over effect from 2007.

## Very Big Fall In GDP In Prospect For 2009

Turning to 2009, another sharp decline in housing activity is in prospect which again will weigh heavily on the overall growth rate of the economy. We see housing completions falling by over 50% to around 25,000 units. The decline in housing activity will knock almost 3% off GDP growth in 2009. Meanwhile, the non-housing sectors of the economy are facing into a very difficult year, so a very sizeable decline in GDP is on the cards for 2009.

The decline in housing output, of course, is having knock on consequences in other areas of the economy, in particular consumer spending, which is estimated to have declined by 0.3% in 2008. Consumer spending is facing a very difficult year in 2009 given sharply contracting employment, very low consumer confidence, the tightening of credit conditions and squeeze on incomes from a contractionary 2009 budget, which included the introduction of an income levy. Pay freezes and pay cuts are also becoming increasingly common across the economy. Overall, we do not expect any growth in personal disposable income in 2009. The personal savings ratio can be expected to rise in this very difficult environment. The continuing sharp fall in housing activity only adds to this very negative backdrop for consumer spending.

Although inflation is set to fall sharply as a result of cuts in mortgage rates, collapse in oil prices and currency strength, with the headline CPI rate turning negative, this will be swamped in terms of its impact on household spending by the whole host of negative factors detailed above. Thus, we expect consumer spending to fall by 2.5% in volume terms in 2009.

### IRISH ECONOMIC GROWTH FORECASTS 2007 - 2011

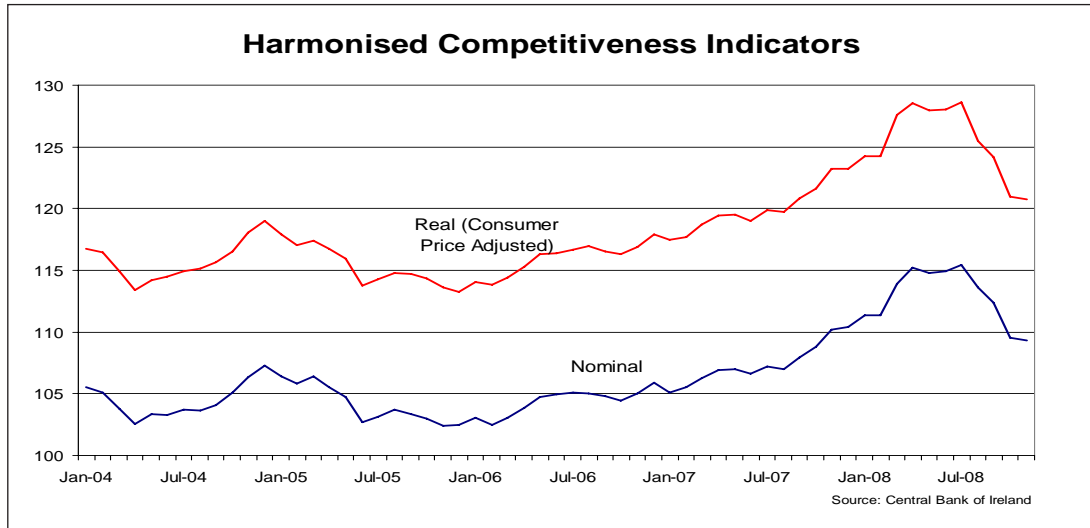
(% Volume)	2007	2008(e)	2009(f)	2010(f)	2011(f)
<b>Consumer Expd</b>	6.3	-0.3	-2.5	-1.0	2.0
<b>Government Expd</b>	6.0	2.8	0.5	0.5	0.5
<b>Fixed Investment</b>	1.2	-18.5	-23.5	-9.0	6.0
<b>Domestic Spending</b>	4.7	-5.2	-7.3	-2.4	2.5
<b>Exports</b>	6.8	1.0	0.0	2.0	4.3
<b>Imports</b>	4.1	-2.7	-3.5	-0.2	3.3
<b>GDP</b>	6.0	-1.5	-4.0	0.0	3.5
<b>GNP</b>	4.1	-2.7	-3.5	-0.5	3.3

*Source: CSO; AIB ERU Forecasts*

Meanwhile, growth in public spending is also set to slow sharply in 2009 as the government seeks to contain the rise in the Exchequer deficit. The 2009 budget suggests that growth in real current government spending will slow to around 0.5% from close to 3% in 2008. The growth in public capital spending is set to slow sharply in 2009 also after rising strongly in recent years. The budget provided for a 1.5% increase in total public capital expenditure in 2009, with a reduction in Exchequer financed capital spending offset by increases from other sources.

This will provide some support for fixed investment in 2009. However, with the economy in deep recession and a severe tightening of credit conditions, we expect a sharp fall in both private non-residential construction and spending on machinery and equipment in 2009. With new housing investment also contracting sharply, it means that a very marked decline of 23.5% is forecast for total fixed investment in 2009, after the fall of 18.5% in 2008.

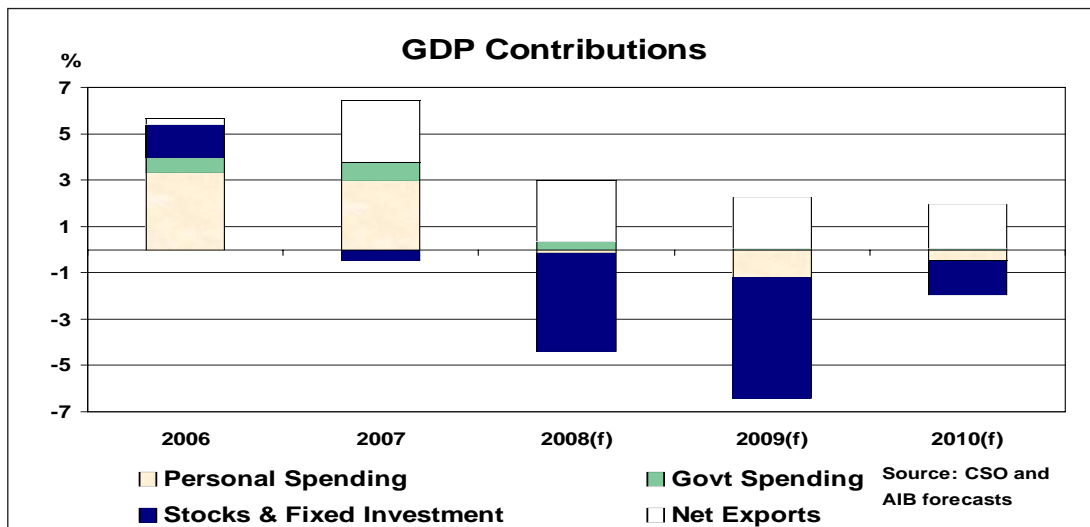
The external environment is very unfavourable for Ireland in 2009 with the US, UK and eurozone economies all in deep recession. Furthermore, the euro has appreciated by some 35% against sterling in the past eighteen months, putting that part of the Irish economy that competes directly with the UK, both at home and abroad in British and third country markets, at a major disadvantage.



However, as the chart above shows, Ireland did make gains on the competitiveness front during the second half of last year reflecting a weakening of the euro and relatively low Irish inflation. Nonetheless, it is going to be very difficult for Irish exports to register any volume growth this year given the unfavourable external environment and the renewed weakening of sterling. Hence, we look for Irish exports to be at best unchanged in volume terms in 2009.

The recession in the domestic economy and poor prospects for exports point to a contraction in imports in 2009. We are forecasting a decline of 3.5% in imports this year after a fall of 2.7% in 2008. Hence, net trade is expected to make a significant contribution to GDP growth in 2009. We see net trade boosting GDP by 2.2%, compared to 2.6% in both 2007 and 2008.

Overall, then, GDP growth is forecast to fall by a sharp 4% in 2009, on the back of zero growth in exports and a contraction in the two key components of domestic demand - household spending and fixed investment, particularly housing. Indeed, we look for domestic spending to decline by 7.3% in 2009 following the estimated fall of 5.2% in 2008. A 3.5% decline in GNP is forecast for 2009. The risks to our national accounts forecasts are very much on the downside, especially in relation to exports, given the worsening external environment.



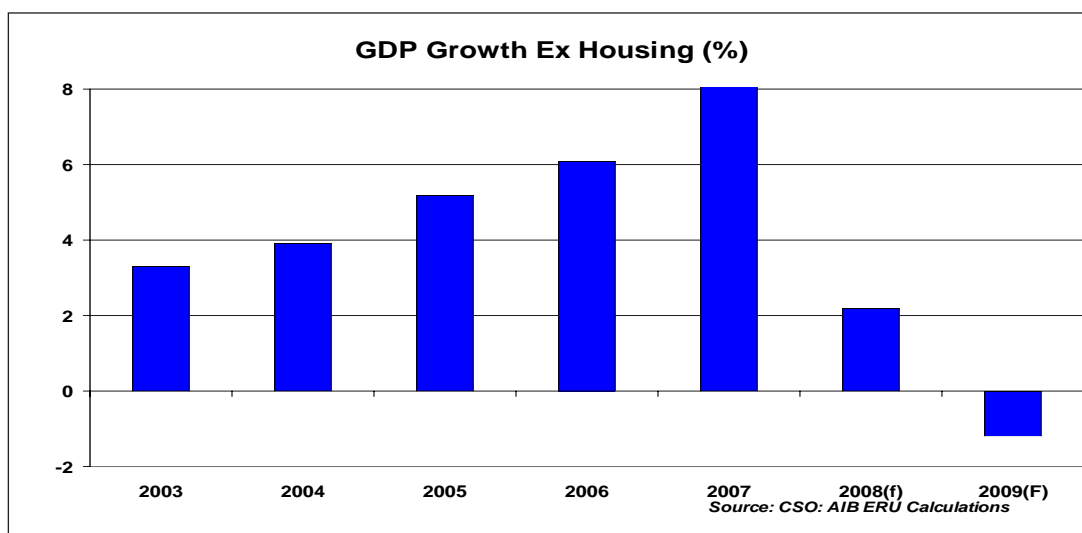
## Economy To Remain Weak In 2010

The global economy is expected to regain some momentum in 2010 as it responds to exceptionally low interest rates and as credit conditions start to improve. The OECD is forecasting that growth in the region will pick up to 1.6% in 2010, after a decline in output in 2009, with world trade growing by 5% after a meagre rise of 1.8% in 2009. Meanwhile, on the domestic front, we expect that the downturn in the housing market will ease, with completions declining by just 5,000 to 20,000 in 2010. Thus, the sector should no longer act as a heavy drag on the overall growth rate of the economy, and is forecast to knock just 0.6% off GDP in 2010.

We would expect that, as elsewhere, some signs of a recovery will begin to emerge in the Irish economy during 2010. However, the upturn in Irish activity is likely to prove sluggish in its early stages. First, the recovery in the world economy is not expected to be very strong. We suspect that while the credit crunch will ease, lending conditions will still remain relatively restrictive globally as balance sheet repair in the banking sector continues. Second, on the domestic front, fiscal policy can be expected to remain restrictive given the rise in the budget deficit to high levels. Third, both housebuilding and non-residential construction activity are likely to decline further in 2010. Unemployment can also be expected to continue rising.

Indeed, we do not see the conditions being in place by 2010 for a recovery in domestic spending, which instead seems likely to contract by a further 2.4%. Thus, whatever growth there is in the Irish economy will be generated by exports and be reliant on a pick up in the global economy. Overall, we are forecasting no change in GDP for 2010 as a whole, but growth should turn positive in the second half of the year. GNP is forecast to fall by 0.5% in 2010.

We expect to see a return to solid growth by the Irish economy once housing activity starts to recover and the global economy moves back on to a more robust growth path. It is worth noting in this regard that, excluding housing, the economy grew at an average rate of 6% in the four year period 2004-2007, with exports rising by 6.3%, buoyed by a strong performance by service exports.



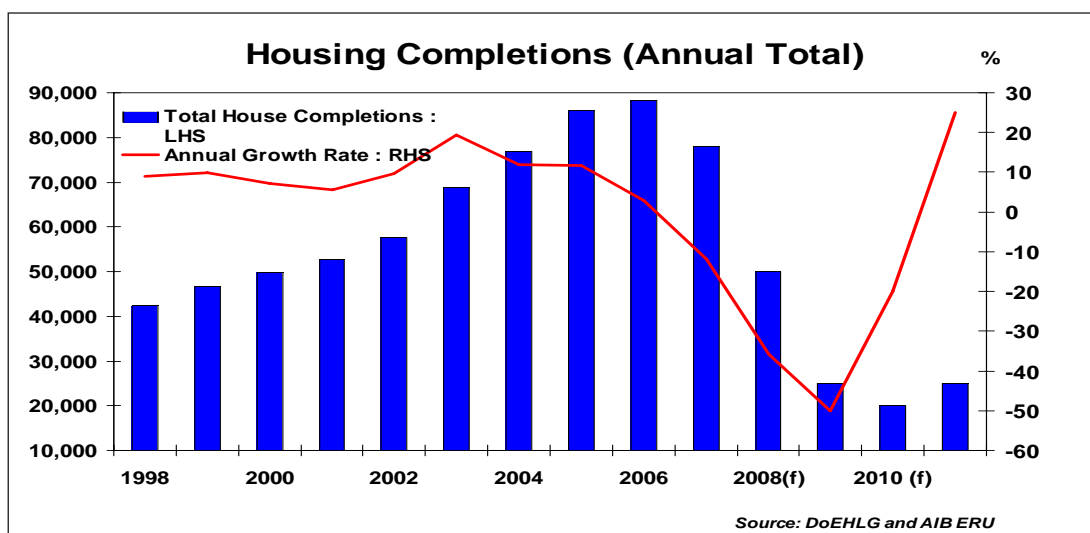
We expect some improvement in housing activity in 2011 and a return to strong economic growth by the global economy. The pick up in the international environment should allow exports to grow by over 4%. We expect to see a recovery in domestic spending, which should grow by around 2.5% in 2011 as fixed investment will no longer act as a drag on the growth rate of the economy. However, given the need for a continuing tight fiscal policy and with housing activity likely to stay relatively muted, we do not expect a return to the very strong growth rates of recent years. Instead, we look for GNP growth to pick up to 3.3% in 2011. Furthermore, we see GNP growth averaging around 3.7% in the period 2011-2014, with domestic spending growing by some 3%.

## Housing Downturn To Continue Into 2010

The sharp housing market downturn witnessed over the past two years was precipitated by a rapid deterioration in affordability which resulted in a significant drop in demand at a time of a very high supply of housing. The deterioration in affordability reflected the fact that prices had risen too far too fast by 2006, while interest rates were also on an uptrend.

The short-term supply/demand balance had also gotten out of kilter. House builders had responded to strong market conditions by greatly boosting housing output. On our estimation, the number of completions in the 2005-2007 period significantly exceeded medium term demand levels. The very high level of housing output in an over-supplied market exacerbated the price downturn, as did the general worsening of economic and labour market conditions.

House builders acted promptly to cut projected output levels in response to reduced demand. New house registrations fell by 43% in 2007 and a further 66% in 2008. Meanwhile, commencements fell by 35% in 2007 and an estimated 54% last year. Due to the lags from registration to commencement to completion, the slowdown in activity only began to be reflected in completion levels in H2 2007, when they fell by 21% year-on-year.



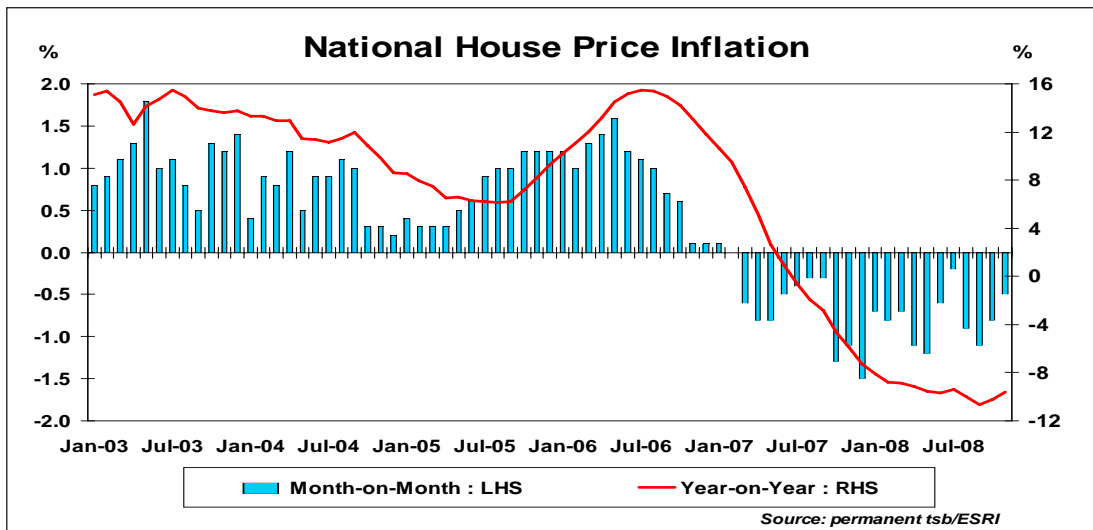
Completions totalled 78,027 in 2007, compared to 88,400 in 2006, a decline of 11.7%. They have continued to fall over the course of 2008 and are likely to amount to around 51,000 for the year, a decline of 35% on 2007. At this stage, the continuing weak registrations and commencements data through 2008 point to a further fall in completions in 2009, and we are pencilling in a level of 25,000, implying a further decline of over 50% on 2008 levels.

Given the supply overhang in the market, the poor prospects for both economic growth and the labour market over the next two years, and the marked tightening in mortgage lending conditions, a further decline in housing completions is likely in 2010. We are looking for house completions to fall to 20,000 in 2010, well below estimated medium term demand levels of around 40,000. To put this correction in perspective, should completions fall to 20,000 in 2010, this would bring them back down to a level not seen since the start of the 1990s.

The supply overhang and poor affordability conditions, along with very negative market sentiment, have been forcing house prices lower since the end of 2006. According to the permanent tsb/ESRI index, prices nationally fell for the 21st consecutive month in November 2008, declining by 0.5% in the month for a year-on-year decline of 9.6%. These marked price falls mean that, nationally, prices in November were over 15% down from their peak level in January 2007.

The permanent tsb/ESRI index is based on mortgage drawdowns and thus generally refers to sales agreed a number of months previously. It is also a three month moving average of house prices. It means that house prices have probably fallen more from their peak than suggested by the 15% decline shown in the November data, as this most likely refers to sales agreed in the summer. By the late spring, the index could be showing prices down by close to 20% from their peak, reflecting selling prices at end 2008, given the weakness of the market in H2 2008. Indeed, anecdotal evidence suggests that actual house prices could have fallen as much as a third, even though a decline on this scale is not being picked up in the published data.

The data, then, as reported by the permanent tsb/ESRI index appear not to be picking up the full extent of the market movements and are also lagging the market. As such, the index is likely to show prices falling right through 2009 on a month-on-month basis. This would take prices, using this index, to some 25% below their peak by the end of next year, bringing them back to levels not seen since late 2003.



Falling house prices obviously improve mortgage affordability. However, up until the autumn, much of this improvement was being offset by increases in mortgage rates, both due to increased wholesale funding costs as a result of the global credit crunch and hikes in official ECB interest rates. However, the past few months have seen a U-turn in ECB policy and it has cut rates aggressively. The benefits of these rate cuts, totalling 2.25%, have been generally passed on in full by lending institutions in Ireland to mortgage holders. Further policy easing is likely from the ECB and it is expected that its key refi rate will be reduced to 1.5% in the spring, a total reduction in official interest rates of 2.75%.

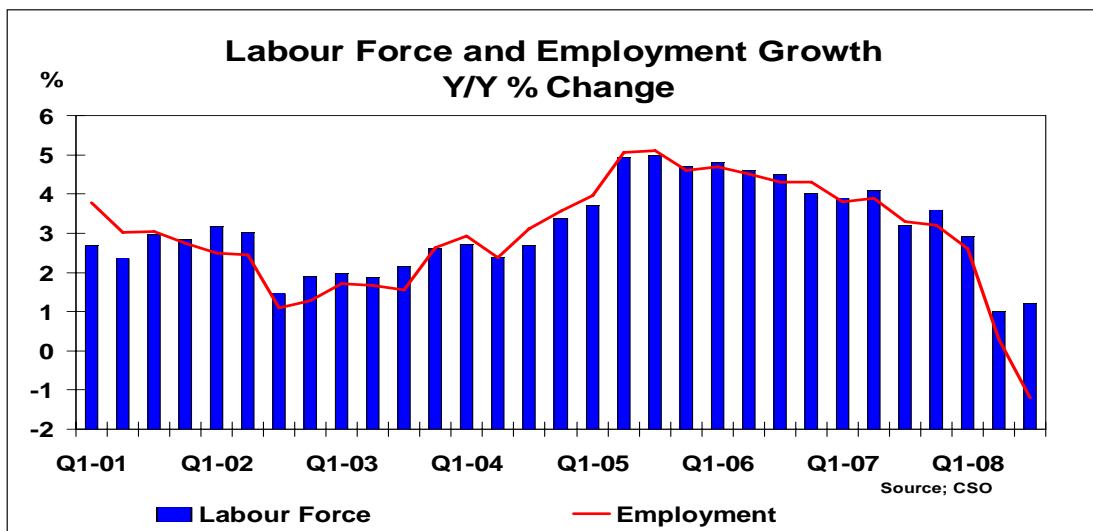
Based on the latest permanent tsb/house price data and taking into account the rate cuts to date, mortgage repayments for a two income couple (on a 35 year, 90% mortgage) now account for less than 14.5% of their net income, compared to 24% at the height of the housing boom in Q4 2006. Affordability levels are set to continue to improve as house prices and mortgage rates fall even further. Assuming that the ECB does cut rates to 1.5% and that most of this is passed on to mortgage holders, then mortgage repayments could fall to just 12% of disposable income over the course of 2009, the best affordability conditions since 1996.

In our view, this should set the stage for a stabilisation of house prices in 2010 and a recovery in the housing market in subsequent years, both in terms of activity levels and prices. However, the recovery is likely to be a modest affair given the overhang of property on the market. We do not expect a return to the buoyant market conditions of the past decade or so, with completions rising only slowly from very low levels. It is also likely to be a very long time before house prices return to the peak levels seen at end 2006.

## Jobs Under Threat Across The Economy

The latest Quarterly National Household Survey (QNHS) report, which is for the period Q3 2008, shows the first year-on-year fall in employment since 1991, with unemployment moving sharply higher. Employment fell by 1.2% year-on-year or 25,000 in Q3, a marked change from 2007, a year that saw employment grow by 3.7% or 80,000. There was an even bigger decline in full-time employment, which fell by 33,000 or almost 2% in the year to Q3 2008. On a seasonally adjusted basis, employment fell by 20,000, or almost 1%, in both Q2 and Q3 2008.

Meanwhile, the unemployment rate climbed to 8.3% in December, up from 6% in the June and 4.7% at end 2007. The QNHS put the number of unemployed at 161,000 in Q3, up from 107,000 in Q3 2007, a rise of 50%. More recent monthly data suggest that the trend in jobless numbers remains strongly upwards, with the Live Register total fast approaching 300,000.



The fall in employment in the year to Q3 2008 was concentrated in two sectors, construction and manufacturing. Construction shed 26,000 jobs (-9%) in the twelve month period, while manufacturing employment declined by 9,500 (-3%). Jobs are also beginning to be lost in the service sectors of the economy. The hotel/bar/restaurant trade shed 5,500 jobs (-4%), while employment also declined in the retail sector and in business and financial services. Job gains were mainly in areas dominated by the public sector, most notably health and education, which added 13,000 between them.

Labour force growth is also slowing rapidly. The labour force grew by 28,000 or 1.2% in the year to Q3 2008, down from a rise of 70,000 a year earlier. At its peak, the labour force was growing by over 100,000 a year, or in excess of 5%. But for this sharp slowdown in labour force growth, the rise in unemployment would be even more pronounced.

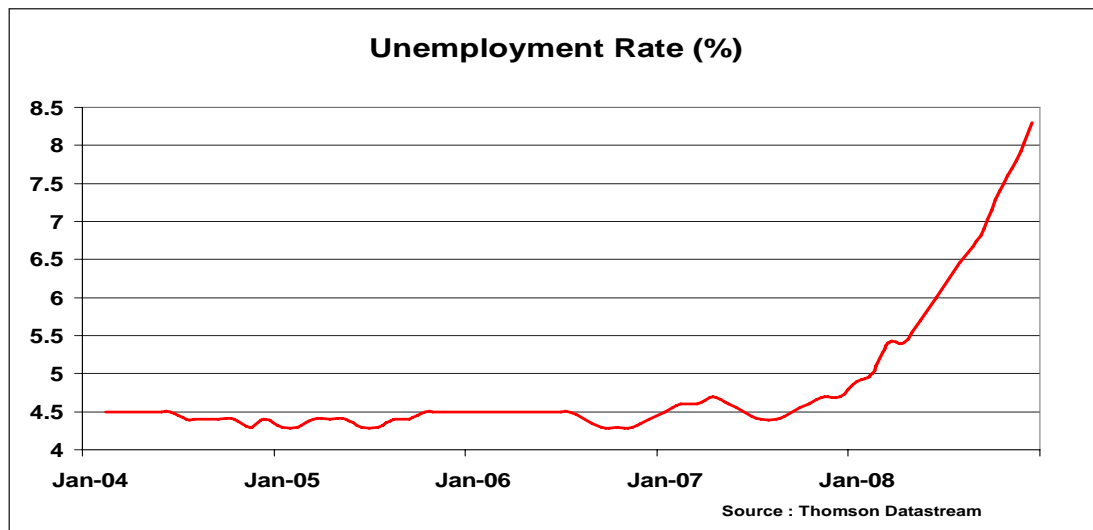
The slowdown in labour force growth reflects two factors. First, there has been a marked fall-off in net inward migration. There was an increase of 11,000 in the number of non-Irish nationals in the labour force in the year to Q3 2008. By contrast, an increase of over 60,000 in the non-Irish national labour force had been recorded in the year to Q3 2007. Second, the participation rate of the population in the labour force had been on a long term uptrend, especially for females. However, it is no longer rising, no doubt reflecting dwindling job opportunities, and, indeed, the participation rate edged lower in Q2 and Q3 2008.

There is little doubt that the trends evident in the latest QNHS are a harbinger of things to come and the data are going to get a lot worse with the economy now in deep recession. The economy is facing a substantial fall in employment and continued marked uptrend in the jobless total. Employment in construction has yet to feel the full force of the downturn in both residential and

non-residential building activity. The latest data show that there were 257,000 employed in the sector in Q3 2008, down just over 10% from its peak. With construction output likely to fall by close to 50% in this recession, the number employed in the sector is going to shrink considerably further.

The global recession and appreciation of the euro against other European currencies make for a very difficult backdrop for the export orientated manufacturing sector. The credit crunch and global recession is also likely to slow foreign direct investment. Thus, further sizeable job losses seem inevitable in manufacturing and, indeed, some have already been announced.

The services sector accounts for the vast bulk of employment in the economy. It is hard to be optimistic about job prospects in the retail trade with consumer spending in sharp decline. A further contraction in employment is likely in the hotel/restaurant sector also. Employment in financial and business services is also likely to shrink further, given the difficulties in these sectors, most notably in banking and in businesses associated with building activity.



The government is also trying to secure a reduction in the numbers employed in the public sector to help contain the sharp rise in the budget deficit. Thus, no matter where one looks, jobs are under threat in the economy. It is entirely possible that the economy could shed as many as 150,000 jobs in this recession, with the unemployment rate rising to 10%.

Overall, we expect that employment will have fallen by 55,000 or around 2.5% by end 2008 compared to end 2007 levels. Turning to 2009, the economy is likely to contract by 4%. Thus, we could see employment fall by a further 75,000 or 3.5% by end 2009, with a particularly severe contraction in employment in construction. The decline in employment is likely to extend into 2010 given the poor growth prospects for that year, and a further 20,000 jobs could be lost. Thus, employment could shrink by as much as 7% in this downturn, a huge fall.

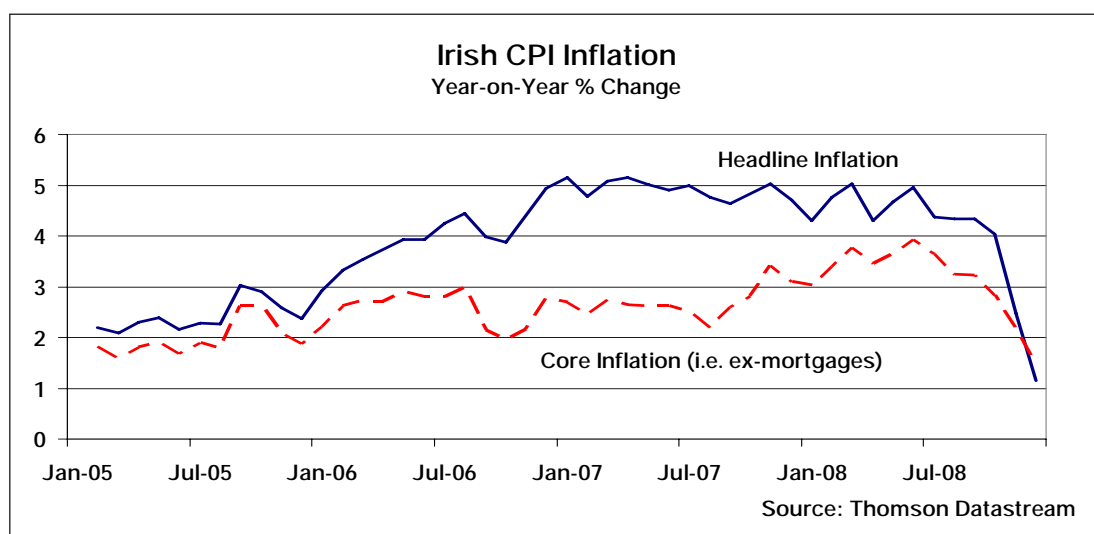
Labour force growth has been decelerating for the past two years and can be expected to contract in 2009 via a turnaround in migration flows and a decline in the participation rate. Net inward migration has already slowed sharply and the very poor prospects for the jobs market here suggest that outward migration is likely to resume with some migrants returning home or moving elsewhere in search of employment. Meanwhile, the male labour force participation rate has been in decline since mid-2007, while the participation rate for the whole labour force has fallen in the last two quarters. Thus, we look for the labour force to shrink by 1.5% over the next two years.

Nonetheless, this will not be sufficient to prevent a further marked rise in unemployment. The jobless rate had picked up to 8.3% by December 2008. Despite the expected contraction in the labour force, heavy job losses are likely to see the unemployment rate rising to an average of at least 9% in 2009 and 10% in 2010.

## Heading For Negative Inflation In 2009

Irish inflation as measured by the CPI averaged 4.1% in 2008, the third consecutive year of high inflation following rates of 4% in 2006 and 4.9% in 2007. However, both headline and core measures of Irish inflation went into sharp decline in the second half of 2008 on falls in mortgage rates, oil and food prices. Despite the sharp increases in indirect taxes and public service charges announced in the October budget, the CPI rate had fallen to 1.1% by end 2008.

Much of the high CPI inflation in 2006 and 2007 was due to big increases in mortgage repayments. Hence, the HICP inflation measure, which does not include mortgages, averaged 2.7% in 2006 and 2.8% in 2007, well below CPI inflation. However, HICP inflation did pick up in late 2007 and H1 2008 on the back of sharp increases in food and energy prices. The annual rate of HICP inflation peaked at 3.9% in June 2008.



Both the headline CPI rate and HICP rate fell sharply in the second half of 2008 as the factors which had been putting upward pressure on inflation unwound - the ECB cut rates aggressively in the final quarter of 2008, oil prices have collapsed since last July, while food prices also fell in H2 2008. As a result, the headline CPI rate fell from 5% in June to 1.1% by December. The HICP rate stood at 1.3% in December, down from 3.9% in June.

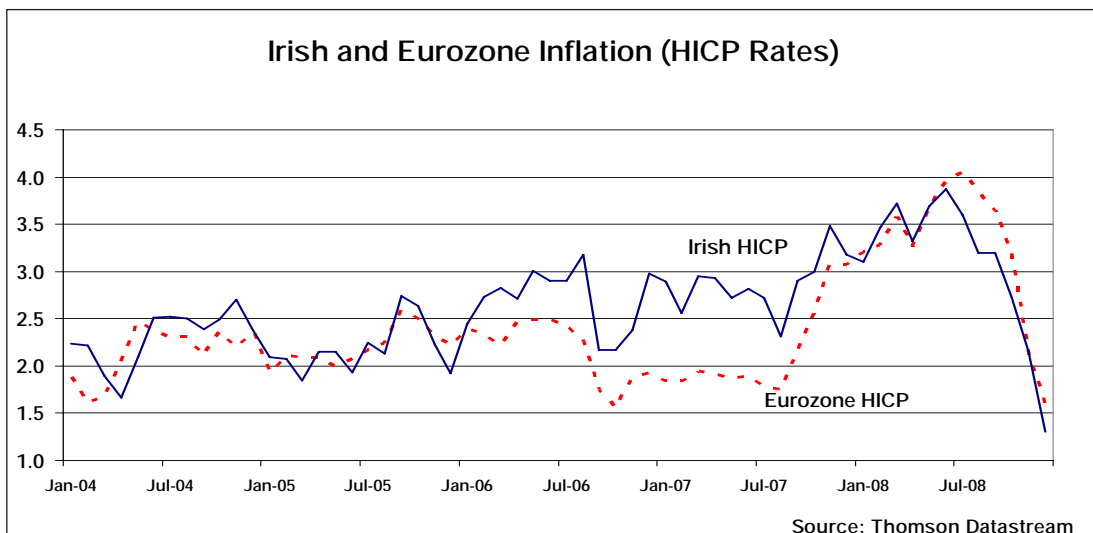
Inflation trends have been much more favourable in Ireland than in other countries in recent times. Inflation (measured on a comparable basis) peaked at 5.5% in the US and 5.2% in the UK, compared to 3.9% in Ireland. The latest data, which are for December, show Irish HICP inflation running at 1.3%, below the eurozone average of 1.6% and well below the UK rate of 3.1%, despite hikes in indirect taxes in Ireland and a cut in VAT in the UK. Indeed, Ireland had the fourth lowest inflation rate in the EU-27 in December and for 2008 as a whole.

Two factors seem to be contributing to the lower inflation in Ireland. Firstly, the downturn in the Irish economy has been particularly steep and it was one of the first EU economies to go into recession. Retailers also seem to be engaging in a lot of price discounting to entice shoppers to spend, especially given the strength of cross-border trade at present. There has also been a very sharp rise in unemployment, which is likely to dampen wage inflation.

Secondly, the strength of the exchange rate is also helping to depress prices. Exchange rate movements tend to have a greater impact on a small, open economy like Ireland than in bigger economies. In particular, the sharp rise of the euro against sterling should depress prices here given that a significant share of consumer goods are imported from the UK, and British multiples have a big presence in Ireland. It is also likely that prices here are being reduced to compete with the fall in prices in euro terms in Northern Ireland.

In this regard, clothing and footwear prices were down by 6.5% year-on-year in Ireland in December, with durable good prices down by 1.3%. The comparable year-on-year rates in the eurozone were +0.8% for clothing and +2.2% for durables. Food prices have fallen here since the summer and the annual rate of food price inflation in Ireland in December stood at 3.2%, compared to 10.4% in the UK.

One area of concern from an inflation point of view is the steep increases in indirect taxes and public service charges. It is estimated that the increases in indirect taxes in the 2009 budget could have boosted inflation by as much as 0.6%. Meanwhile, there have been significant increases also in administrative charges, notably in health and education. In total, the increases in these charges and indirect taxes could add 1% to Irish inflation.



Nonetheless, this factor is being overwhelmed by the forces pushing down inflation within the economy. It looks as if the ECB will reduce interest rates to at least 1.5% this year, pushing down mortgage rates even further. Rents are also in sharp decline. Oil prices have fallen by over two-thirds from their peak in July, while other commodity prices are also in decline. Food, clothing and durable goods prices are also falling against a backdrop of a very weak domestic and international economic environment.

Another important factor that should exert further downward pressure on prices in 2009 is the very sharp appreciation of the currency against sterling. The sterling-euro rate is currently above 90 pence, having been as high as 98 pence at end 2008, compared to a 65-70 pence range in the period 2003-2007. Sterling's fall should lead to big price drops on UK imports.

Headline inflation is now in rapid descent and should turn negative in February. By the summer, CPI inflation could be running at -3.5%. Our forecast is for headline CPI inflation to average around -2.5% in 2009. This negative CPI rate should not be interpreted as deflation as it does not represent a broad based fall in prices but rather is caused primarily by declines in mortgage repayments. Hence, it will prove temporary in nature.

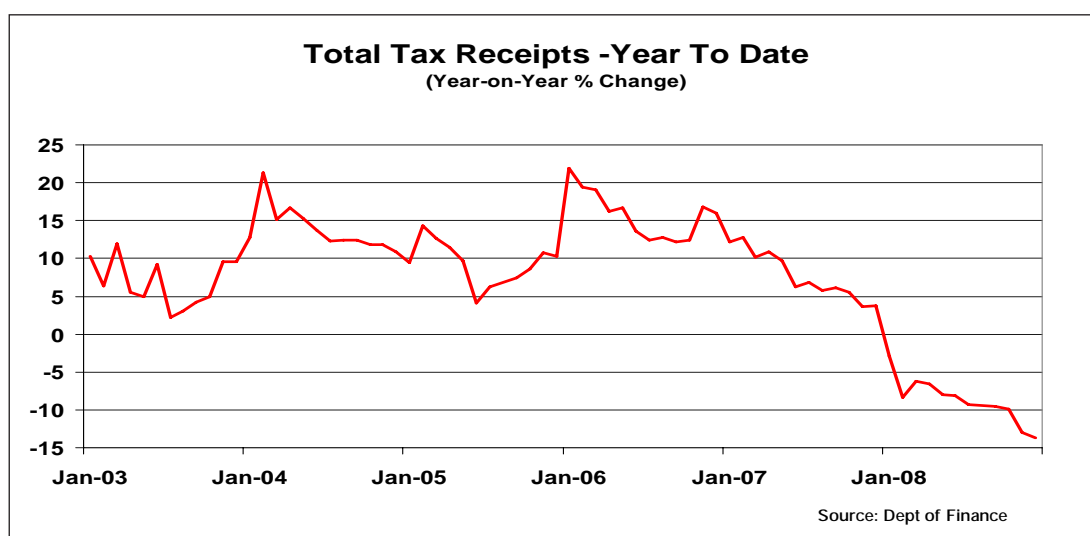
Nonetheless, the HICP rate, which excludes mortgages, should turn negative this summer before turning positive again later in the year. It should average around zero for 2009 as a whole, despite the hikes in indirect taxes and administrative charges. Indeed, if sterling was to fall back towards parity again, a negative average HICP rate could be on the cards for 2009.

We see the HICP rate picking up to just above 1% in 2010, allowing for some further increases in indirect taxes and administrative charges and assuming that oil prices are more stable. The headline CPI rate is likely to average around 1% in 2010 as the impact of the cuts in mortgage rates drops out of the annual rate, bringing headline inflation into line with the HICP.

## Public Finances Hit Rocky Ground

A General Government budget surplus in 2007 of €0.5 billion, or 0.2% of GDP, was transformed into a budget deficit of €11.8 billion or 6.3% of GDP in 2008. One reason for this dramatic turnaround was a collapse in tax receipts as the economy hit recession. Taxes undershot target by over €8 billion last year, leaving them 13.7% below their level in 2007. The other reason is the continued strong rise in public spending, which increased by some 10% in 2008.

The public finances will deteriorate further in 2009 as the recession deepens, despite a tough budget and some cutbacks in government spending. Tax receipts will continue to fall this year and are likely to undershoot the budget target by €4 billion or more. The budget deficit is likely to be in the region of 9% of GDP, or some €16 billion this year. With the economy remaining weak in 2010, the budget deficit could climb to €18 billion or 10% of GDP.



This implies that there would be three consecutive years in which the Irish budget deficit will be way above the 3% of GDP limit set out in the EU's Stability and Growth Pact. In our view, it is likely to be 2014, at the earliest, before the budget deficit is brought back down to 3% of GDP. This is assuming that the economy returns to a strong growth path from 2011, with a consequent marked jump in tax revenues.

Another key requirement in getting the budget deficit down is that growth in government spending is kept to very low levels over the next six years. This will prove a difficult task, with rising jobless numbers putting upward pressure on social welfare spending, increasing debt interest costs and strong public resistance to cutbacks in government spending.

However, it is clear that, in the absence of a draconian rise in taxation that would have serious negative consequences for economic activity, the only way to reduce the budget deficit is through restraining growth in public spending. In effect, total public spending will have to grow at a much slower pace than nominal GDP in the coming years to help close the budget gap. By our estimates, total government spending would need to grow by less than 3% per annum in the 2010-2014 period, with voted spending rising by around 2%, if the budget deficit is to get back down to the 3% of GDP limit set out in the EU's Stability and Growth Pact.

An easy option would be to scale back capital spending as occurred in the 2009 budget and, indeed, on the last occasion that economic growth slowed and pressure came on the public finances, back in 2003 and 2004. While capital spending plans need to be kept under review, 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 vast bulk of government spending is on the current side and the key focus for the government must be to control the runaway growth in gross current supply services spending. This has jumped from €22 billion in 2000 to a projected €55.5 billion in 2009, an increase of over 150% in the space of nine years. It is likely to equate to 37% of GDP in 2009, up from 25% in 2000.

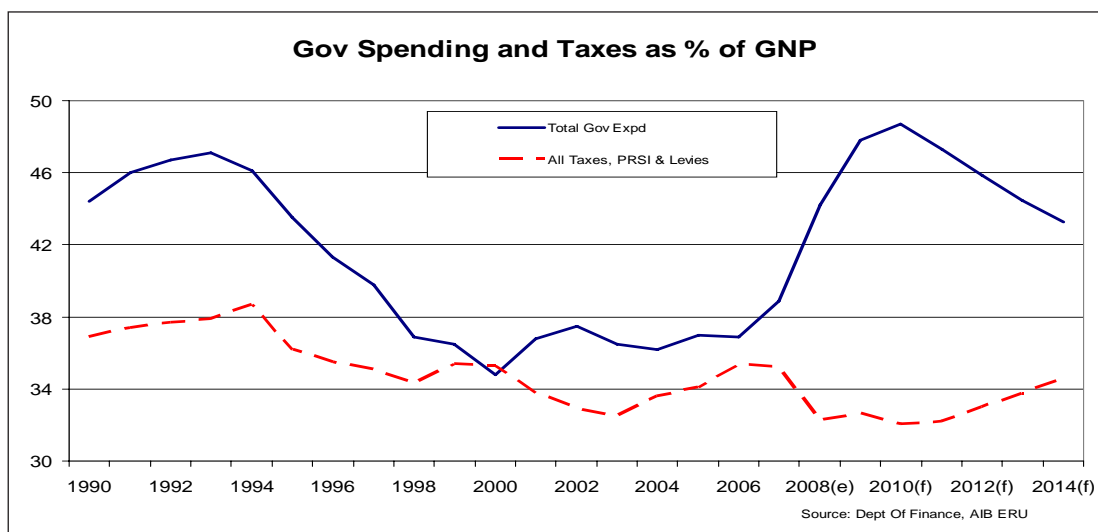
A key challenge in this regard will be to control the growth in public sector pay. The Exchequer pay and pensions bill has risen by 40% in the last four years and accounts for 37% of gross voted current spending. The new national pay deal, although allowing for an 11-month pay pause for public sector workers, provides for a 6.0-6.5% wage rise over its 21 month duration. This will be far in excess of inflation and is simply unaffordable.

The pay deal will have to be renegotiated as one of the steps that need to be taken to restore order to the public finances. A prolonged pay pause is required. Controlling the numbers employed in the public sector will also be important in containing growth in the pay bill. As well as an embargo on recruitment, the government needs to consider measures to promote voluntary redundancies, more career breaks and part-time working.

### **Need To Control Government Spending**

The accompanying chart clearly shows that the main reason for the deterioration in the public finances is the very strong growth in public spending in recent years rather than the marked decline in tax receipts. Total government spending has risen by €18 billion or over 35% in the past three years. More pertinently, the ratio of total government spending to GNP had remained very stable at 36-37% of GNP in the period 1998-2006. However, this is likely to have ballooned out to 48% of GNP this year.

On the other hand, total tax receipts, including PRSI and levies, are estimated to have fallen to 32% of GNP in 2008, down from 35% in 2007. This is a much smaller decline than the rise in government spending and the ratio should stabilise in 2009 following the tax hikes announced in the budget. It is clear from these figures, then, that the main focus in the coming years has to be on reducing government spending as a share of GNP. This will be very difficult to achieve while the economy is contracting, but it must be a key policy goal once the economy begins to recover. Tax receipts will also need to rise somewhat as a share of GNP.



A significant rise in the tax burden, though, is not the solution to the problem, especially in a recession and further large hikes in taxes should be avoided. However, with inflation falling to very low levels in 2009 and 2010, there should be scope for some hikes in indirect taxes in the next budget.



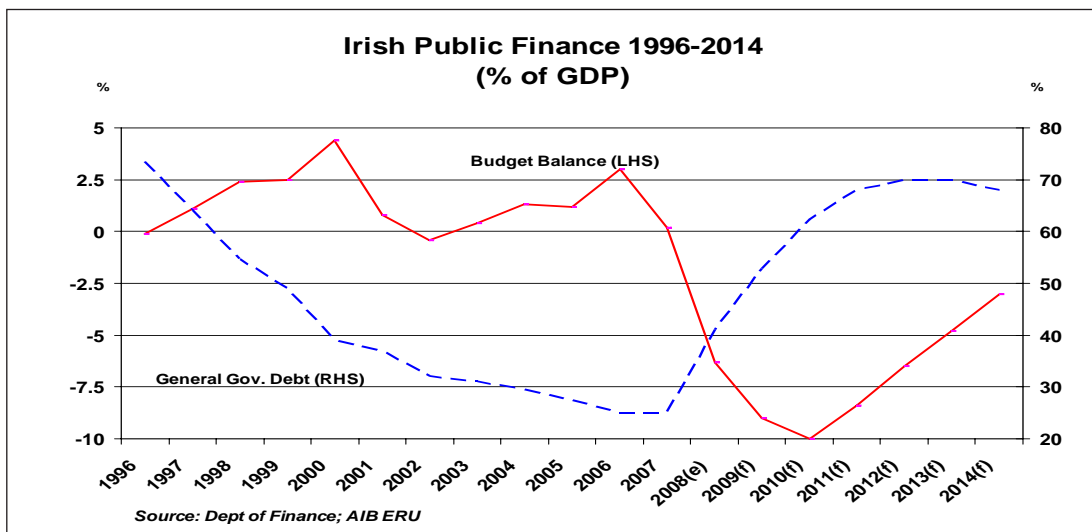
The government is going to have to endure high budget deficits until the economy picks up strength, which is unlikely to happen before 2011. As already indicated, the key to restoring order to the public finances will be to hold the growth in government spending well below the nominal growth rate of the economy in the next upswing, thereby reducing it as a share of GNP.

The Dept of Finance recently revised its macro-economic forecasts and published new five year projections on the public finances. These show the budget deficit falling sharply in the period 2011-2013 to 2.5% of GDP by 2013 on the back of a big fall in public spending as a share of GDP, in line with our view that this is the best route to put the public finances back on a sound footing.

Finally, it should also be pointed out that a large part of the fiscal deficit represents capital borrowing. The current budget deficit amounted to 1.6% of GDP in 2008, although this is set to rise to 5-6% of GDP in the 2009-2011 period. However, we expect the current budget deficit to be virtually eliminated again by 2014.

### Very Low Public Debt

Ireland is fortunate in that the National Debt is very low so the required fiscal adjustment can take place over a number of years. The latest official figures show that the General Government Debt/GDP ratio ended 2008 at 40.6%, up from 24.8% at end 2007. However, this does not allow for a large build up of cash balances by the government authorities last year to over €20 billion, or more than 10% of GDP. Taking this into consideration would bring the debt ratio down to around 30% of GDP.



Furthermore, deducting also the value of the National Pensions Reserves Fund and other funds managed by the NTMA from gross debt would bring the Debt/GDP ratio down to some 20% of GDP. The NTMA has reported that the actual National Debt stood at 32.5% of GNP at end 2008. However, if allowance is made for the National Pension Reserve Fund, the national debt/GNP ratio would stand at 22%.

Thus, Ireland has a very low net public debt, even after the difficult year for the public finances in 2008. It means that there is no need for fiscal policy to become overly contractionary and it gives the government the scope to bring the budget deficit down on a phased basis when the economy turns up again.