Irish Economic Commentary

At a Crossroads

- ***Short-term headwinds getting stronger -*** An unhelpful cocktail of factors, including an appreciating currency, persistent inflation pressures, an international credit crisis and a domestic unwinding of imbalances, are set to adversely impact Irish economic growth prospects in the short term. We are adjusting our economic growth forecasts to reflect these hurdles. We now expect GDP growth of 1.1% in 2008 (0.8% GNP), down from our previous forecast of 2.3%. For 2009, while we expect a rebound, growth is still likely to come in at a below trend rate of 2.0% (previously 2.5%), with the construction sector continuing to act as a drag.

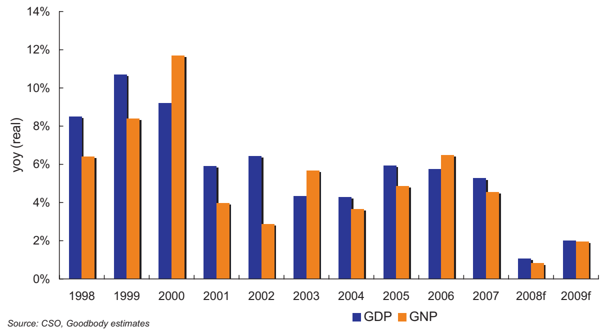
- ***A more subdued consumer spending environment -*** A more sudbued rate of consumer spending growth is the primary reason for our forecast revision in this *Commentary*. Although detailed information on consumer spending patterns at the beginning of the year is unavailable as yet, it is clear that the headwinds are increasing. In particular, labour market conditions have deteriorated, as evidenced by a sharp increase in the numbers on the Live Register in Q1. Unsurprisingly, this has been borne out in lower consumer confidence levels, but it has also manifested itself in the form of a 8% decline in car sales and a steady deceleration in spending growth on credit cards. We now expect consumer spending to grow by 1.6% in 2008 (3.0% previously) and 2% in 2009 (unchanged).

- ***Housing market continues to drag on growth... -*** House building activity continues to contract at a record pace. House registrations fell by 68% yoy in the first quarter, indicating little appetite to commence new projects until a pick-up in transactional activity. Recent tightening of lending standards by the financial institutions may delay a pick-up in housing demand which otherwise would have arisen due to falling house prices and improving affordability. Further, one-off housing, which had been holding up quite well, has started to decrease at a faster pace. We now expect 48,000 completions in 2008 and 35,000 in 2009 (previously 50,000 and 40,000, respectively).

- ***...and commercial building is likely to fall in 2009 -*** Commercial construction has enjoyed an impressive performance in recent years. However, this is a very cyclical industry, and with demand prospects weakening and credit becoming less freely available, this industry is now expected to contract in 2009.

- ***Strong Government hand required -*** Domestic and international headwinds present formidable challenges for the Irish economy in the short-term. Without access to monetary levers, the Government's response to the slowdown will be crucial. Although capital spending plans for the next number of years are well ahead of international peers, we believe that an acceleration of the roll-out of the National Development Plan, rather than a possible delay of some projects, is the best course of action. While this will come at the expense of larger than desired budget deficits, it is a short-term cost of both smoothing the cycle and increasing the productive capacity of the Irish economy in the medium-term. To do this, current spending must be kept in line with nominal economic growth (3-4% in 2009) and restraint must be achieved in upcoming wage negotiations.

Headwinds to depress growth in 2008

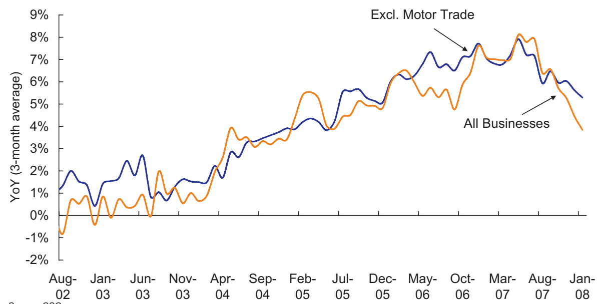


Source: CSO, Goodbody estimates

Irish Growth Aggregates

	2006	2007	2008f	2009f
Consumption	5.7%	5.4%	1.6%	2.0%
Government	5.3%	6.7%	4.5%	4.0%
Investment	3.1%	0.2%	-10.3%	-4.4%
Domestic Demand	**4.9%**	**4.1%**	**-1.3%**	**0.7%**
Exports	4.4%	8.2%	5.5%	4.0%
Imports	4.4%	6.4%	3.0%	2.5%
GDP	**5.7%**	**5.3%**	**1.1%**	**2.0%**
GNP	**6.5%**	**4.5%**	**0.8%**	**2.0%**

Retail sales growth on a moderating trend



Source: CSO

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KEY THEMES

Ireland has reached a crossroads, both politically and economically. When incoming Taoiseach Brian Cowen takes over the reins on 7th May 2008, he will be leading a country which is undoubtedly more prosperous than a decade ago. However, Ireland is also entering into a more challenging phase in its economic development, brought about by a combination of internal rebalancing and external uncertainty.

Growth of 1.1% expected in 2008

- We are pulling back our estimates for growth yet again in this *Commentary*. For 2008, we now expect GDP growth of 1.1% (0.8% GNP), down from our previous estimate of 2.3%. We expect an improvement to 2.0% growth in 2009, although this is also down from our previous estimate of 2.5%. Externally, the credit crisis is starting to have real effects on economic activity and this has compounded the slowing momentum as a result of contracting output in the construction sector. However, our latest downgrade to overall GDP growth in 2008 comes on the back of reduced consumer spending growth forecasts.

Labour market trends deteriorated in Q1...

- The latest evidence suggests that Irish consumer spending growth will slow markedly this year on the back of weaker employment prospects and falling confidence levels. Employment growth, one of the key drivers of household disposable income, is forecast to slow from 3.6% yoy in 2007 to only 0.5% in 2008, on the back of falling employment in the construction sector and slowing growth in the services economy. These softening labour market conditions have been picked up already in the Live Register data in the first quarter of 2008. In Q1, the number of people signing on for unemployment assistance rose by 16% qoq, its fastest rate of increase since 1975. Unemployment rate forecasts depend on the pattern of migratory flows. We estimate that the unemployment rate will increase to 6.6%, on the assumption that net migration halves in 2008, while net migration could fall towards zero in 2009. The latest information suggests that the inflow of migrants has already started to slow markedly, with the amount of PPS numbers issued in Q1 down 41% yoy.

...which impacts on our consumption growth forecasts

- Although data on consumer spending are patchy thus far, it is clear that the headwinds mentioned above, along with lower consumer confidence levels, are having an impact on consumer spending patterns. For example, retail sales growth slowed to 3.1% yoy in January, its slowest rate of increase since October 2004. Car sales have led this moderation, with registrations for new passenger vehicles down by 8% yoy in Q1. Spending on services is more difficult to get a handle on, but credit card data provide an important snapshot. In the first two months of 2008, growth in new spending on credit cards slowed to 5%, down from over 20% yoy less than twelve months previously. In real terms, this represents growth of just 2%. Given these headwinds, we see consumption growth moderating to 1.6% in 2008, representing the lowest rate of growth since 1991, when spending grew by only 1.1%. With the labour market remaining relatively loose next year and only subdued growth in disposable income expected, we see only a modest improvement to 2% in 2009.

Housing market adjustment continues apace...

- Builders and developers continue to stand on the sidelines, with the number of housing registrations falling by 68% yoy in the first quarter of 2008. In contrast to previous months, however, there has been a further contraction in the number of one-off houses commenced over the opening months of the year. In the three months to February, commencement of one-off housing units declined by -26%, relative to only -6% yoy in the three months to November. As a result, we are adjusting our housing completions forecasts further, and now expect 48,000 completions in 2008 and 35,000 in 2009 (relative to 50,000 and 40,000 previously).

...while inventory levels remain high

- The trends in the latest Daft.ie (Irish property website) report indicate the housing stock for sale is up 50% over the past twelve months. In relation to the second hand market only, there are currently c.49,000 homes for sale as of the end of April. We estimate that this is equivalent to 14 months of supply on current transaction trends. This compares to the US situation, where there is a current unsold stock of 10 months and a long-term months' supply of seven. The clearing of this stock will undoubtedly put pressure on house prices over the next eighteen months, which is reflected in our forecast that prices will decline by 7% this year.

Ireland not immune to credit crisis

- Tighter credit, as a result of the international credit crisis, has begun to manifest itself on the High Street in Ireland through reduced loan to value ratios and higher retail interest rates. Although, in theory, affordability has been improving over recent months, due to the combination of falling house prices and stable ECB interest rates, we must now include a practical caveat in coming to that conclusion. For example, 100% LTV financing, which accounted for 36% of total first-time buyer mortgages in 2006 is now largely unavailable. Therefore, the required access to increased equity for a house purchase may delay the likely upturn in demand due to falling house prices.

- Speculative development of commercial projects is now less likely to be commenced, which feeds into our view that commercial construction will decline in 2009. Overall, we see investment declining by -10% in 2008 and -4% in 2009.

Fortunes of external sector will be critical

- The performance of the external sector will be pivotal in the months ahead. Services have been the main source of export growth in recent times and this will need to continue for trade to make a meaningful contribution to growth. For 2007 as a whole, the volume of services exports posted growth of 15%, the fifth consecutive year of double digit growth. As a percentage of total exports, services have increased from 30% at the start of this decade to 48% at the end of last year. This performance occurred in spite of a strengthening currency, but the recent moves have been substantially more aggressive. We estimate export growth will slow to 5.5% this year and 4.0% in '09, after growth of 8.2% in 2007.

Inflation backdrop unhelpful at the current juncture

- Inflation has been surprisingly stubborn in the opening quarter of the year. The annual rate of inflation averaged 4.7% in Q1, and was advancing at an annual rate of 5% in March. With food prices leading the current spike, inflation in this area is not expected to ease in the short term. It is now likely that inflation will average 4% for the full year, although this should ease to 2.5% next year. Nevertheless, the elevated state of price pressures at present, creates a very difficult backdrop for the current pay negotiations, with restraint needed by all parties.

Part of a necessary rebalancing?

- We have argued previously that the anticipated slowdown in 2008 and 2009 is part of a necessary rebalancing away from the dependence on construction. However, this rebalancing has happened quicker than we would have expected initially and, allied to that, the recent credit crisis has increased the risks that the economic slowdown will be of a more protracted variety.

Government focus must be on capital spending...

- In the absence of monetary policy levers, Government policy must aim to cushion the blow from the expected slowdown in the Irish economy. Government tax revenues are already under pressure (down 6% in Q1) and this is likely to be the case for the next few quarters. As a result, difficult political choices will have to be made. While capital spending plans are the most politically easy to defer, for the sake of the medium-term development of the Irish economy, important infrastructure projects must not be scaled back or delayed. In fact, the increasing spare capacity in the construction sector opens the possibility that some projects in the National Development Plan could be front-loaded.

...while wage restraint must be delivered in upcoming negotiations

- To facilitate this, the Government must apply a firm hand in its policy actions over the next two years. Current spending growth must be kept to within nominal growth in the economy, meaning that spending on day-to-day activities must only grow by 3%-4% in 2009. To ensure this, the upcoming negotiations on a new national pay deal must not only encourage pay restraint, but also deliver it.

Capital spending increases can soften the blow, but also increase the economy's medium-term potential

- The benefits of such actions would be two-fold: (1) Increased capital spending would act to cushion the blow from lower output in both the residential and commercial construction sectors over the next two years, and thus smooth the economic cycle; a further €1bn of capital spending, above that earmarked in the Multi-Annual Capital Investment Framework, could add at least 0.5% to GDP growth in 2009, without breaching the Stability and Growth Pact budget deficit limit of 3% of GDP, and; (2) Medium-term benefits to competitiveness would be in place for the time the next cyclical upswing in the global economy occurs, which is likely to be towards the end of 2009 and into 2010.

- Clearly, the major drawback would be higher than desired budget deficits. We estimate that the budget deficit will amount to over 2% of GDP in 2008 and 2009, but overall Government debt levels remain low at close to 25% of GDP. If these deficits were used to finance investment in the medium-term prospects for economic growth, they should be recognised as necessary. Further, should the current credit crisis persist, the expected short slowdown could turn into something more prolonged.

IRELAND AT A GLANCE

	2005	2006	2007	2008F	2009F
Growth Components					
Consumption	7.3%	5.7%	5.4%	1.6%	2.0%
Government	4.0%	5.3%	6.7%	4.5%	4.0%
Investment	11.8%	3.1%	0.2%	-10.3%	-4.4%
Domestic Demand	8.1%	4.9%	4.1%	-1.3%	0.7%
Exports	5.2%	4.4%	8.2%	5.5%	4.0%
Imports	7.7%	4.4%	6.4%	3.0%	2.5%
GDP	5.9%	5.7%	5.3%	1.1%	2.0%
GNP	4.9%	6.5%	4.5%	0.8%	2.0%
Housing Statistics					
Completions	86,189	88,419	78,027	48,000	35,000
Average House Price (€k)	277,852	310,632	287,886	267,734	267,734
House Price Inflation (end-year)	9.3%	11.8%	-7.3%	-7.0%	0.0%
Mortgage Credit Growth (end-year)	27.1%	24.2%	13.2%	6.5%	4.4%
Prices					
Consumer Price Inflation	2.4%	3.9%	4.9%	4.0%	2.5%
Wage Inflation (GBS)	5.6%	4.8%	4.3%	4.3%	3.9%
Fiscal					
Exchequer Balance	-908	2,265	-1,623	-6,776	-7,132
Exchequer Balance / GNP	-0.7%	1.5%	-1.0%	-4.1%	-4.2%
General Government Balance	497	3,978	899	-4,057	-4,473
GGB / GDP	0.3%	2.3%	0.5%	-2.1%	-2.2%
Consumer Profile					
Real Household Disp. Income	7.0%	4.0%	2.3%	1.6%	1.3%
Employment Growth (end year)	4.4%	4.2%	3.2%	-1.0%	0.8%
Employment Growth (Full-year average)	4.9%	4.3%	3.6%	0.5%	0.2%
Unemployment Rate (end-year)	4.6%	4.3%	4.5%	6.6%	6.6%
Debt/Disp. Income	138.4%	144.9%	154.3%	158.1%	160.5%
Interest Rates (At year end)					
ECB	2.25%	3.50%	4.00%	3.50%	3.00%
BoE	4.50%	5.00%	5.50%	4.00%	3.75%
Fed	4.25%	5.25%	4.25%	1.50%	2.00%
Trade					
Current Account (€m)	-5,691	-7,271	-7,814	-4,868	-3,215
CA as a % of GNP	-4.2%	-4.9%	-4.9%	-3.0%	-1.9%
Exchange Rates (Average for the year)					
€/$	1.25	1.26	1.37	1.53	1.45
€/£	0.68	0.68	0.68	0.78	0.74

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REVIEW & FORECAST

At a turning point

Ireland has reached somewhat of a turning point, both politically and economically. When incoming Taoiseach Brian Cowen takes over the reins on 7th May 2008, he will be leading a country which is significantly wealthier than a decade ago. However, the country is also entering into a more challenging phase in its economic development, brought about by a combination of internal rebalancing and external uncertainty.

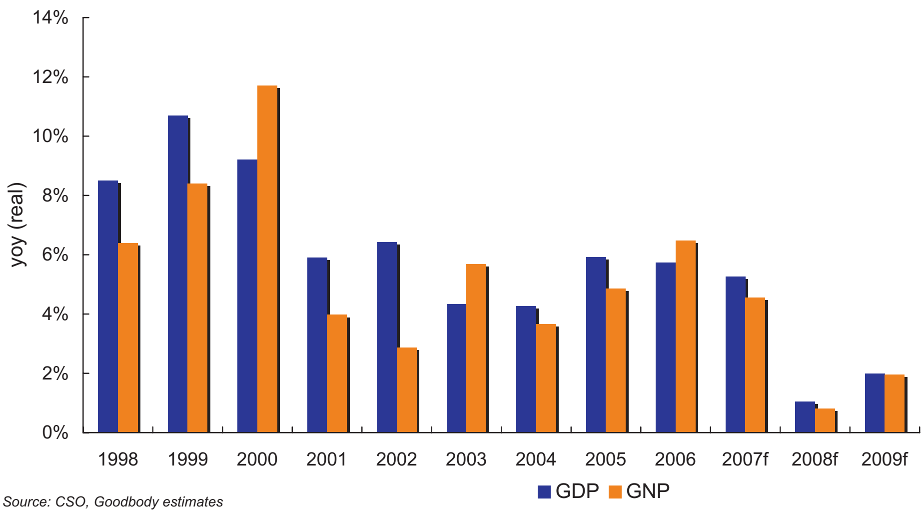
GDP growth of 1.1% expected in 2008...

Number of headwinds have come at once...

...with investment subtracting significantly from growth...

We are pulling back our estimates for growth yet again in this Commentary. For 2008, we now expect GDP growth of 1.1% (0.8% GNP), down from our previous estimate of 2.3%. We expect an improvement to 2.0% growth in 2009, although this is also down from our previous estimate of 2.5%. The downgrade to economic prospects comes as a result of a number of factors. Domestically, the contraction in the housing market continues to depress economic activity. Developers have continued to hold out on the commencement of new housing schemes in light of anaemic transaction activity and a significant amount of stock for sale on the market. This has forced us to pull back our estimate for house completions in 2008 and 2009 to 48,000 and 35,000, respectively (from 50,000 and 40,000 units previously). Furthermore, commercial construction is likely to fall from record levels in 2009 also, reflecting both its cyclical nature and the tightening of credit conditions. As a result, investment is expected to decline by 10.3% in 2008 and a further 4.4% in 2009. Exporters also face headwinds from the appreciating currency, although as we have seen in recent years, the link between currency movements and export growth has not been very strong.

Headwinds to depress growth in 2008



Source: CSO, Goodbody estimates

...as consumer spending growth is set to moderate...

...but consumer spending trends starting to soften

More importantly though, the latest evidence suggests that Irish consumer spending growth will slow markedly this year on the back of weaker employment prospects and falling confidence levels. Consumer spending has enjoyed an impressive period of growth over recent years on the back of sustained growth in household disposable incomes in particular. This performance, we believe, was completed without any significant wealth effect from the housing market, so we are sanguine on the prospects of falling house prices feeding into lower consumer spending. Nevertheless, employment prospects have deteriorated at the beginning of 2008, as evidenced by the fact that the numbers on the Live Register increased at their fastest quarterly pace since 1975 in Q1. Unsurprisingly therefore, Irish consumer confidence has fallen on the back of increased job insecurity.

...with growth of 1.6% expected in 2008

While data on the topic are patchy thus far, it is clear that the drivers of household income are waning, thus impacting on the consumer spending outlook in 2008. Retail sales grew by 3% yoy in January, down from a peak of 10% in May 2007, while car sales fell by 8% in the first quarter. Further, as an indication of the trends in the services sectors, credit card spending grew by only 5% in the first two months of the year, down from a peak of over 20% in April 2007. The key driver of household income is employment, and on this front, we expect the numbers employed to increase by only 0.5% in 2008, after 3.6% growth in 2007. The unemployment rate is expected to increase to 6.6% by the end of this year. As a result of these factors, we are pulling back our estimate of consumer spending growth in 2008 to 1.6% (previously 3%), while growth of 2% is expected in 2009.

Retail sales and credit card spending easing

Time for Government to step up to the plate?

One can argue that the expected slowdown is as a result of a necessary rebalancing of the economy away from its dependence on the construction sector. Indeed, we argued this point in our *Commentary* last summer (*Rebalancing Act*, 3rd August 2007). However, this rebalancing has happened quicker than we would have expected initially and, allied to that, the recent credit crisis has increased the risks that the economic slowdown will be of a more protracted variety.

A necessary rebalancing...

Current spending growth must be kept to 3-4% in 2009, while pay restraint must be delivered in upcoming pay talks

However, one can also argue that given the absence of monetary policy levers, which, in any case, may not work given the continuing stresses in the money markets, that fiscal policy should be used as a stabiliser in a cyclical slowdown. Government tax revenues will be under pressure over the next two years, and difficult political choices must be made. While capital spending plans are the most politically easy to defer, for the sake of the medium-term development of the Irish economy, important infrastructure projects must not be scaled back or delayed. In fact, the increasing spare capacity in the construction sector opens the possibility that some projects in the National Development Plan could be front-loaded. To facilitate this, the Government must apply a firm hand in its policy actions over the next two years. Current spending growth must be kept to within nominal growth in the economy, meaning that spending on day-to-day activities must only grow by 3%-4% in 2009. To ensure this, the upcoming negotiations on a new national pay deal must not only encourage pay restraint but also deliver it.

...but a strong Government hand is required...

Capital spending increases can soften the blow, but also increase the economy's medium-term potential

The benefits of such actions would be two-fold: (1) Increased capital spending would act to cushion the blow from lower output in both the residential and commercial construction sectors over the next two years, and thus smooth the economic cycle; we estimate that a further €1bn of capital spending, above that earmarked in the Multi-Annual Capital Investment Framework could add at least 0.5% to GDP growth in 2009, without breaching the Stability and Growth Pact budget deficit limit of 3% of GDP, and; (2) Medium-term benefits to competitiveness would be in place for the time the next cyclical upswing in the global economy occurs, which is likely to be towards the end of 2009 and into 2010.

...to ensure that short-term slowdown does not turn into something more prolonged

Clearly, the major drawback would be a higher than desired budget deficits. However, if these deficits were used to finance investment in the medium-term prospects for economic growth, they should be recognised as necessary. Further, should the current credit crisis persist, the expected short slowdown could turn into something more prolonged.

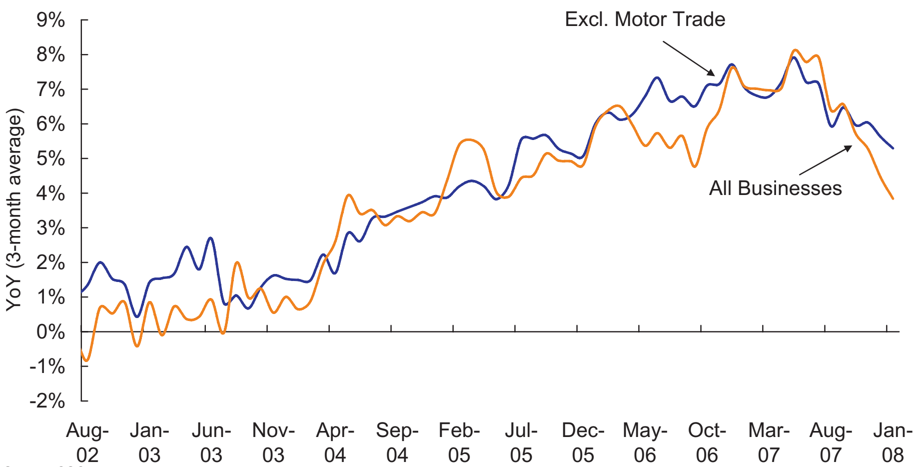
THE CONSUMER

Headwinds getting stronger for the Irish consumer

While 2007 was yet another impressive year for the Irish consumer, as evidenced by the most recent National Accounts, the trends as the year progressed are more instructive as to the likely outturn for 2008. While spending increased by 5.6% yoy in H1, and exceeded that pace in Q3 (6.3% yoy), the rate of growth slowed to only 4.4% in the final quarter. Though it is difficult to gauge specifically, that first half performance may have been flattered by the extra boost to incomes from the release of SSIA funds up to April 2008. In any case, since the turn of the year, momentum has eased further on the back of a loosening of labour market conditions and dented confidence levels. Hard data are only available for the first month of the year thus far, but they show that retail sales growth slowed to 3.1% yoy. The continued anaemic levels of consumer sentiment regarding job security over recent months do not suggest that there has been a sudden burst of spending since then, so the downward trend in annual spending growth is likely to continue over the coming months, on the back of strong base effects, at the very least.

Momentum in spending has eased since the start of the year

Retail sales growth on a moderating trend



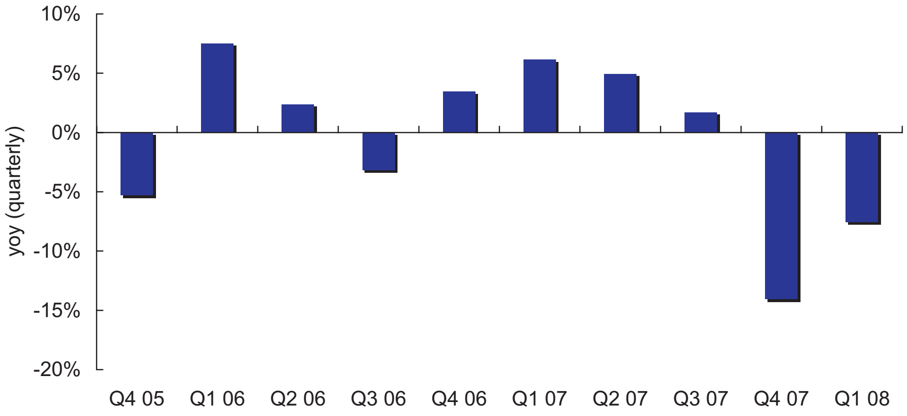
Source: CSO

Car sales leading the spending slowdown...

Indeed, more recent information in the form of car registrations for the entire first quarter point to a heightened consumer unwillingness to part with their cash. The trends in these data indicate that car sales will act as a drag on retail spending growth in Q1. In the first three months, new passenger vehicle registrations declined 8% yoy, but this trend deteriorated as the quarter progressed, with registrations in March falling by 23% yoy. While the introduction of a new Vehicle Registrations Tax (VRT) system is likely to be playing some role in this moderation, we suspect that the increased economic uncertainty is the main determinant. Car sales, both new and second-hand, are an important component of Irish retail sales, accounting for a third of the value of all goods spending. Furthermore, while car sales clearly have a large impact on overall retail spending aggregates, the trends in this area often provide a good barometer of consumer's sentiment regarding purchases of so called 'big-ticket' items (see our note *Vehicle registrations going into reverse*, released on 11th March 2008, for more details).

Weak new car sales to act as a drag on retail sales in the months ahead

Weak new car registrations point to downside risks for consumer spending



Source: SIMI

...but High Street spending also beginning to ease

While motor trades are set to act as the most significant drag on sales growth, momentum in spending has moderated across a number of areas. For instance, spending on the High Street (including items such as clothing and footwear), an area which has been extremely robust in the past number of years, has eased quite markedly in recent months. Although impressive rates of growth are still being achieved, they are well behind rates achieved in the recent past. For instance, spending on Textiles and Clothing was ahead 9% yoy in the three months to January, down from 14% in the three months to October. Footwear and leather sales volume growth has also moderated from 11% to 7% over the same period, highlighting that consumers have clearly reined in spending on discretionary items.

Consumers reining in spending on discretionary goods...

Spending on services is much more difficult to gauge, with official information not available on this topic until the release of the Q1 National Accounts data in June. Nevertheless, credit card data provides a snapshot of the trends in this area. Spending on credit cards amounted to 12% of total nominal consumer spending in 2007, although we must stress that the majority of the use of credit cards is for convenience purposes, given that payments received exceeded new spending on credit cards last year. As can be seen on the next page, new spending growth on credit cards has been slowing progressively over the past few months. In nominal terms, spending on credit cards grew by 6% yoy in the three months to February 2008, down from 18% yoy twelve months before. If we use the CPI for restaurants and hotels as a proxy for price changes in the services sector, this translates into a real increase of only 2% on credit card spending.

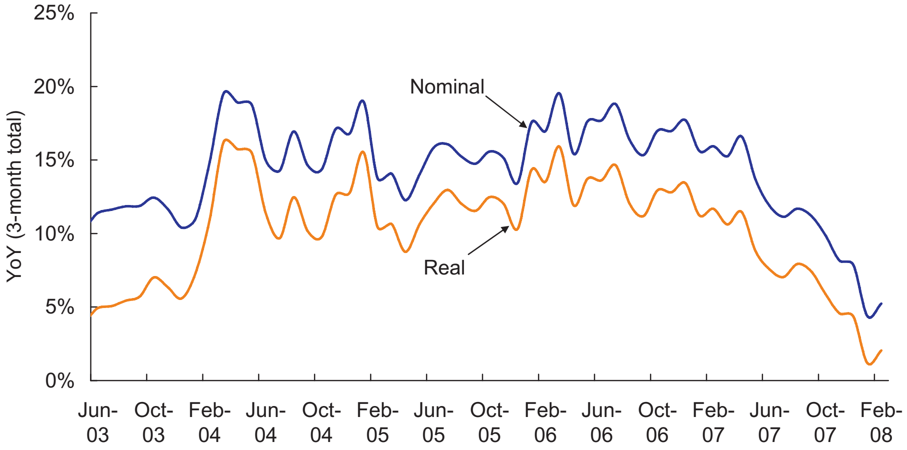
...while credit card data point to lower levels of spending on services also

House price correction matters little for consumption moderation

On top of slowing disposable income growth, it has been argued that a negative wealth effect from falling house prices will further contract consumer spending growth. We are more sanguine on these prospects. In recent years, real spending growth has not strayed far from real disposable income, meaning that savings ratios have remained at rather high levels throughout. This has not been the case in the UK and the US, where household savings ratios have fallen to historical lows over the period, as consumers dipped into the equity gains made as a result of the increase in house prices.

Stellar employment and earnings growth has been the driver of consumption

Slower spending on credit cards give clues on the service sectors



Source: Central Bank, CSO *Note: Real number calculated using the CPI index for the Restaurants and Hotels category*

Consumption growth forecast to slow to 1.6% in '08…

While confidence plays a role in short-term spending plans, the more important drivers are employment and earnings growth, both of which are set to moderate over the course of the year. Our forecasts suggest that employment growth will average only 0.5% in 2008, down from 3.6% yoy in 2007, while earnings will grow at a more moderate pace of 4% this year after growth of 5% in 2007. With the unemployment rate also ticking up (we expect an unemployment rate of 6.6% by year-end) this clearly creates a challenging backdrop for consumption growth. As a result, we are pulling back our estimate of consumption growth in 2008 from 3.0% to 1.6%. This would represent the lowest rate of consumer spending growth since 1991 when spending grew by only 1.1%.

Muted employment growth and increasing unemployment combine for a challenging backdrop

…while some of the effects will linger into 2009

With the labour market remaining relatively loose next year and only subdued growth in disposable income expected, the headwinds facing the consumer sector will remain into the first half of 2009, barring any tax stimulus package in the Budget in December. Furthermore, given that households are often slow to adjust their consumption patterns in the face of a changing financial situation, it remains our central case that moderate spending growth will continue in 2009. Currently, we have a 2.0% spending growth forecast pencilled in. The resilience of the Irish consumer is to be sorely tested over the next eighteen months, but we must not lose sight of the fact that Irish households are significantly more wealthy than was the case a decade ago and this should help to cushion the blow over the coming years.

Consumer resilence to be sorely tested

EMPLOYMENT

Labour market beginning to loosen

If one took the latest Quarterly National Household Survey - which relates to the final quarter of 2007 - as an indicator of the health of the Irish labour market, there would be no reason for concern. Total employment grew by 3.2% yoy in the final quarter, representing only a slight moderation on the third quarter. Further, the unemployment rate stood at 4.6%, very close to the level it has remained at for the past five years. However, although these headline numbers are impressive, the underlying details did provide clues as to the obvious easing of labour market conditions that we have seen since the turn of the year. Unsurprisingly, the contraction in the construction sector is at the core of the deteriorating employment prospects, with our projections implying a cumulative decline of 50,000 jobs in this sector. However, a more widespread weakening in both the domestic and international economies carrys risks that employers in a number of sectors will abandon hiring plans and, in some sectors, cut back on employment levels.

Easing external environment augmenting domestic labour market concerns

Live register numbers more timely indicator of latest trends

More timely indicators confirm our suspicion that this is already in train. On the construction front, according to the CSO's monthly indicator, employment in the sector (in firms with five or more employees) declined by -11% yoy in February. Only three months previously, the annual rate of decline stood at -5%, indicating that the downward trend has accelerated after the Christmas period. More generally, there was a substantial increase in those seeking unemployment benefit (Live Register) in the first quarter of 2008: In the first three months of the year, there was an increase of 28,300 in the numbers registering as unemployed, with March's monthly jump the largest annual increase since April 1983. Furthermore, the quarterly increase of 16% is the biggest since January 1975. According to these data, the unemployment rate now stands at 5.5%, a nine-year high, further underlining the quite rapid deterioration in labour market trends of late.

Live register data point to deterioration of labour market in Q1

Spike in live register numbers in Q1 2008

Source: Datastream

Job losses no longer confined to construction

If these job losses were confined to construction, one could be sanguine about the prospects for the wider labour market. Indeed, we argued this case for much of the past six months, as the vast majority of the increase on the Live Register was attributable to males. However, this is no longer the case. In the twelve months to December 2007, males on the Register increased by 15%, relative to a 1% increase in the number of females signing on. However, the March data reveal that the number of females on the

Job losses spreading into female employment more recently...

Register increased by 16% yoy, with males increasing by 34%. This suggests that the labour market weakness has begun to spread to other sectors.

Additional headwinds from the industrial sector….

The QNHS data also point to job losses in manufacturing, with industrial employment declining by 1.4% yoy (excl. construction). Industrial employment is quite sensitive to the global economic environment and with the US and the UK, two of Ireland's key exports markets, undergoing a period of subdued economic growth, further declines in employment in this sector are likely. For example, during the international slowdown which began in 2001, the industrial sector shed 4% of its workforce within a year. In the first quarter of 2008, redundancies increased by 21% yoy according to the Dept of Enterprise, Trade and Employment. Within this, manufacturing and construction have been leading the redundancies, unsurprisingly, and have accounted for 55% of those announced so far. While job losses in manufacturing & industry are not a new development in Ireland's recent past, the weak domestic environment, led by a contraction in construction in particular, coupled with subdued global demand, poses significant headwinds for the labour market for the remainder of the year.

...with further industrial job losses on the horizon, given the weaker global environment

…with no public sector boost likely this time round

In the last period of weakness in the Irish labour market, public sector expansion buoyed employment growth. For instance, private sector employment growth dipped into negative territory for three consecutive quarters from Q3 2002 to Q1 2003. However, average annual employment growth of 1.1% was still achieved over the period due to a surge in public sector recruitment, which managed to grow at an annual pace of 7% over that period. While we believe public sector employment will continue to increase in line with commitments set out in the National Development Plan in particular, growth is unlikely to match the pace seen at the time of the most recent economic slowdown.

Government unlikely to provide a fillip to the labour market this time round

Employment breakdown

NACE Code	'000	2002 Q4	2006 Q4	2007 Q4	Annual growth	5-year growth	% of Total	% of annual gain
A-B	Agr, Forestry & Fishing	122.6	114.7	118.7	**3.5%**	**-3.2%**	5.5%	6%
C-E	Other Production Industries	304.4	294.9	290.7	**-1.4%**	**-4.5%**	13.6%	-6%
F	Construction	190.1	284.6	279.0	**-2.0%**	**46.8%**	13.0%	-8%
G	Wholesale & Retail Trade	249.9	287.8	311.6	**8.3%**	**24.7%**	14.6%	36%
H	Hotels & Restaurants	112.9	124.0	132.3	**6.7%**	**17.2%**	6.2%	12%
I	Transport, Storage & Comm.	112.9	116.8	120.8	**3.4%**	**7.0%**	5.6%	6%
J-K	Fin. & other Bus. Services	224	276.2	297.1	**7.6%**	**32.6%**	13.9%	31%
L	Public Admin & Defence	87.4	102.5	105.0	**2.4%**	**20.1%**	4.9%	4%
M	Health	163.7	211.8	219.3	**3.5%**	**34.0%**	10.3%	11%
N	Education	112.1	122.5	129.2	**5.5%**	**15.3%**	6.0%	10%
	Public Sector	363	437	454	**3.8%**	**24.9%**	21.2%	25%
O	Other Services	98.7	122.6	122.1	***-0.4%***	***23.7%***	*5.7%*	*-1%*
	Total	1778.7	2072.1	2138.9	**3.2%**	**20.3%**	100.0%	100%

Source: CSO

Composition changing, with a large pickup in self employment

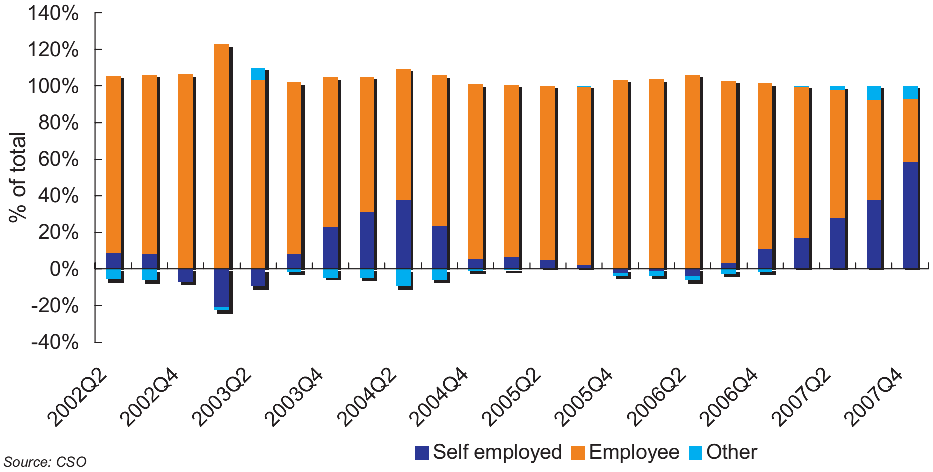
A notable feature of the Q4 2007 QNHS data was the significant increase in those being self-employed. In the final quarter of the year, 58% of employment growth was accounted for by the self employed category, a marked increase on the 38% contribution in Q3. This unprecedented contribution is due, in a large part, to construction sector employees taking up employment on a self employed basis, and, possibly, operating in the RMI sector.

Increasing self-employment accounted for 58% of employment growth in Q4 07...

There has also been a significant pickup in part-time employment, accounting for over half of job gains in the year to Q4. A year earlier, part-time employment accounted for less than 10% of job gains, meaning that recent employment growth has been of a lesser quality. Given that a similarly high dependence was seen in Q3 2007, this may be the start of a persistent trend. Such a contribution from part time employment has not been seen since Q3 2003, a time of distinct weakness in the labour market as mentioned above.

...with part-time employment also on the increase

Unprecedented contribution from self employment to overall employment growth



Source: CSO

Migrant proportion of workforce underestimated

How these changing dynamics impact on unemployment remains to be seen. Importantly, the recent QNHS release revealed that the proportion of foreign nationals in employment had been starkly underestimated up to now. After reconciling the Census data with the QNHS, it now appears that 15.7% of those in employment are of foreign origin, compared to the previous estimate of 11.6%. While all sectors saw some degree of underestimation in relation to foreign national participation, the main areas were those of the wholesale and retail and hotel and catering areas. Overall, this implies that there is a significantly larger mobile element of the working population that thought heretofore. While inward migratory flows will have a large bearing on the outlook for unemployment, the mobility of the present workforce is also an important consideration and is something that is very difficult to get a handle on.

Foreign nationals account for 16% of those in employment...

Future migratory flows will be critical for unemployment rate

On the former, it appears that a moderation in inward migratory flows is currently underway. Data on PPS numbers reveal a 41% decline in issuances in the first quarter of the year (see Appendix). This points to slower growth in the labour force in the months ahead. In recent years the pace of labour force growth has closely matched that of employment growth and a continuation of this would lead to only moderate increases in unemployment. Nevertheless, given the trends in the Live Register data, it is likely that the unemployment rate will breach the 6% rate in the short term. We see unemployment edging up to 6.6% by the end of 2008 on the basis of net migration flows halving relative to 2007. A flat unemployment rate forecast of 6.6% in 2009 assumes that net migration falls close to zero. Against this challenging backdrop of large pickup in unemployment, muted employment growth of just 0.5% (on average) is expected this year. However, it is very likely that the annual rate will be in negative territory by the end of the year. Conditions will remain similarly difficult into next year also, where we forecast a still subdued increase of just 0.2% employment growth for that year.

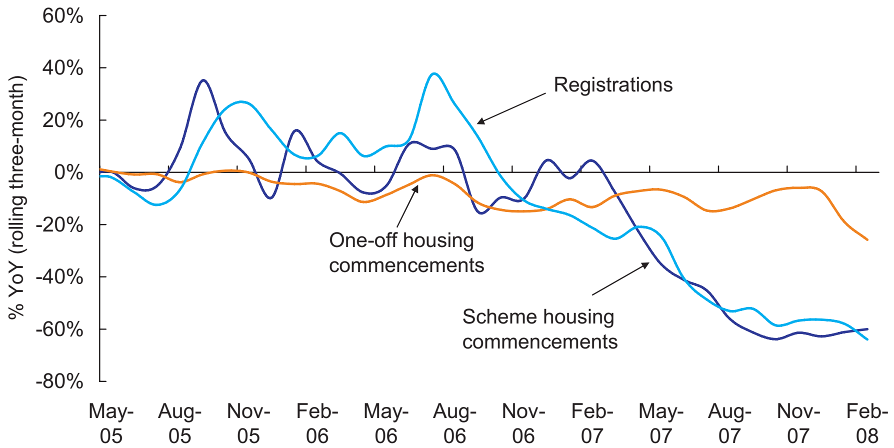
...but recent PPS data show inward migration slowing sharply

BUILDING, CONSTRUCTION & HOUSING

The adjustment in the Irish housing market, both in terms of prices and building activity, continues apace. As opposed to the sustained upward movement of prices and activity through the first seven years of the new millennium, the reversal has been somewhat more severe than even the most pessimistic of forecasters would have suggested. In this *Commentary*, we are adjusting our forecasts for housing completions further. We now anticipate housing completions will amount to 48,000 units in 2008, close to 40% down on 2007 levels, while we are reducing our estimate for 2009 to 35,000 units (previously 40,000 units). While this process was well in train before the credit crisis began last August, the tightening of credit standards by the financial institutions increases the risk that the slowdown will be repeated in the private non-residential arena, providing even more reason for the Government to continue to roll out the National Development Plan in full over the coming years.

Retreat in house prices and activity has been far more severe than expected

One-off housing commencements have fallen off recently, although not to the same extent as schemes



Source: DoELG, Goodbody estimates

Over-supply issues lingering

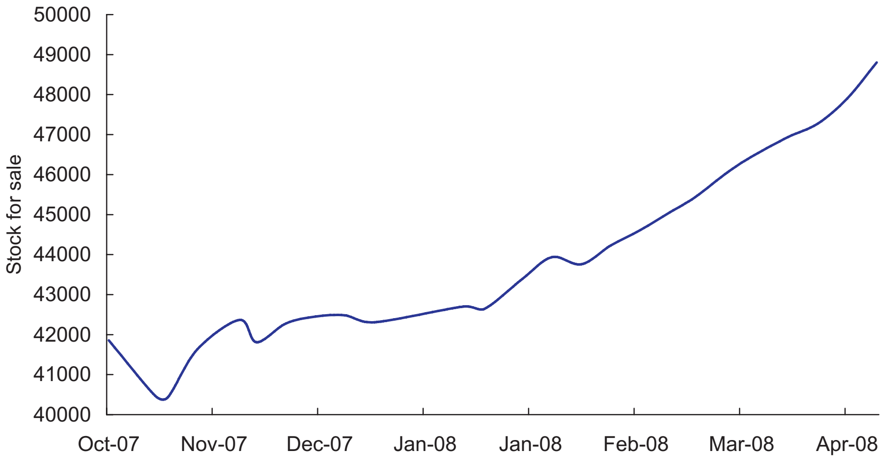
There are a number of issues that we can point to in relation to the current problems in the Irish housing market but, in our view, two lie at the very core. The first is supply, or namely, oversupply, of housing in some parts of the country in particular. Unfortunately, official data on this topic are unavailable, but the trends seen in the latest Daft.ie (Irish property website) report point to a substantial increase in the housing stock for sale over the past twelve months. According to the report, the stock of homes for sale on the website increased by 50% in the first quarter of the year. Through our own analysis of the data, the chart on the next page shows that the stock of second-hand homes for sale (as we are sceptical of the number of new homes for sale on the market) has continued to increase, even over the past number of weeks. There are currently c.49,000 second-hand homes for sale on the Daft.ie website as of the end of April. But what does this mean? According to data from the IBF, some 84,000 mortgages were paid out in 2007, while the Department of the Environment data reveal that mortgages for new and second-hand homes are split roughly 50%/50%. Our estimates suggest that given the continuing tightening of lending standards by the financial institutions, the volume of mortages paid out will fall by another 10% in 2008. Assuming that non-mortgage purchases of second-hand units amount to 10%, this means that current stock levels amount to c.14 months of supply. Unfortunately, we have no way of knowing how this compares historically in Ireland, but the US data point to a current unsold stock of 10 months and a long-term months' supply of seven. Clearly, there is a significant amount of stock that needs to be cleared and this process will undoubtedly put pressure on house prices over the next eighteen months, which is reflected in our forecast that prices will decline by 7% this year.

Stock for sale continues to rise - up 50% yoy in existing homes market...

...amounting to 14 months supply...

....and implying continued downward pressure on prices

Second-hand housing stock for sale continues to increase



Source: Daft.ie Note: We do not have an accurate estimate of the stock of new homes for sale

Tighter credit conditions has led to reduced LTV's and higher mortgage interest rates

Credit crisis hitting the High Street

The second core issue is the availability of credit. The credit expansion that has been witnessed in Ireland has played an integral role in Ireland's love affair with property over the past decade. The international credit crisis, therefore, has important implications for the economic performance of the country over the coming years. Tighter credit has begun to manifest itself on the High Street in Ireland through reduced loan to value ratios and higher retail interest rates. Although housing transactions already fell by 24% in 2007, this tightening of credit is likely to ensure a further contraction in 2008 and even into 2009. In terms of mortgage interest rates, some financial institutions have already announced increases to tracker, variable rate and fixed-rate products and more are likely to follow if inter-bank rates remain high. Indeed, the yield on the 3-month Euribor contract has risen strongly in recent weeks.

Non-res output to be affected also, but not until '09, given time lags involved

Although in theory affordability has been improving over recent months due to the combination of falling house prices and stable ECB interest rates, we must now include a practical caveat in that conclusion. Due to a wave of innovation over the past decade, mortgage products became available to an increased number of potential homeowners. This manifested itself in the form of increased loan-to-value ratios, lower retail interest rates and longer mortgage terms. The increased loan-to-value ratios were sufficient to counter the difficulty that potential homeowners would have in raising the initial deposit. Due to the recent tightening of lending standards, this process seems to be in reverse. For example, 100% LTV financing, which accounted for 36% of total first-time buyer mortgages in 2006 is now largely unavailable. Therefore, access to increased equity for a house purchase may delay the likely upturn in demand due to falling house prices.

However, the ongoing rollout of the NDP should take up some of the slack

Non-residential construction nearing its cyclical peak

With all of the recent focus on residential construction, the non-residential area, which has experienced an impressive upswing, has received less attention. Private non-residential construction is a notoriously cyclical industry. As a result, the sector enjoyed a healthy period of expansion over recent years as the economy churned out pretty impressive growth in employment and output, thus buoying demand for office and retail space, for example. In terms of demand, it is accepted that office take-up hit a record level in 2007. This was matched by the supply response, and strong activity trends are also expected to continue into 2008. However, with clearly more difficult times in prospect and access to funding, particularly for speculative development, not as freely available, output declines in commercial construction are likely, albeit with a certain time lag.

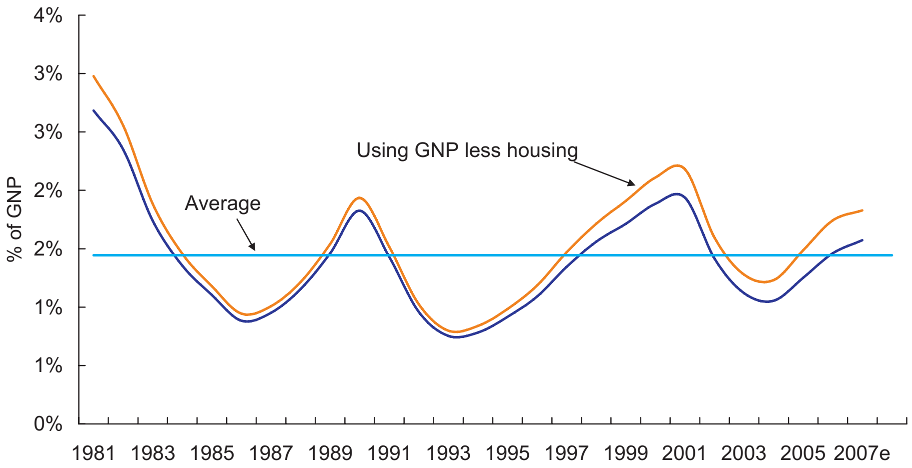
Downgrades in output forecasts led by weakening one-off housing

More reason for capital spending to take up the slack

For this reason, we expect private non-residential construction to decline in 2009, following another year of growth this year on the back of strong momentum. Lack of funding may mean that the fall in output, when it comes, could be particularly rapid, as projects which had previously received planning permission are scaled back or postponed entirely. Nevertheless, public spending dominates non-residential construction, accounting for an estimated two-thirds of output. Therefore, given the expected spare capacity in the sector over the next two years, it is imperative that the Government follows through with its commitments on the National Development Plan. Undoubtedly, pressure on the public finances will force difficult choices to be made on the spending side. In the past, capital spending was the first area to be cut, but the incoming Taoiseach, and current Minister for Finance, Brian Cowen, has stressed repeatedly that the full roll-out of the National Development Plan is the Government's responsibility this time around. Rhetoric must be matched with action over the coming years and there is even argument to believe that some projects should be front-loaded rather than deferred, to take advantage of the slack in the construction sector.

Capital spending needs to step up to the plate as commercial activity falls in 2009

Commercial construction as a % of GNP



Source: DoEHLG

One-off housing starting to weaken

Our forecast downgrades for the housing market output in this *Commentary* are driven primarily by two things. Firstly, as we have discussed in relation to the non-residential area, the access to, and the cost of, credit is likely to halt some projects over the next two years. Secondly, our views on house completions in 2009 assumed that the relative outperformance of one-off housing, as opposed to scheme housing, would continue. The more timely data on this front reveals that commencements of one-off housing has taken a further downleg over recent months. In the three months to February, commencements for one-off housing fell by 26% yoy, down from 6% yoy at the end of November. The appetite of the larger developers to commence new projects also remains weak, as evidenced by both the registrations' data and the information from the Department of the Environment. In the first quarter of the year, housing registrations fell by 68%. Until housing transactions start to improve, builders are likely to hold off on the commencement of new projects in significant numbers.

One-off housing activity has started to weaken recently

Prices declines will not be uniform

Given the stock issues in the market, it comes as no surprise that house prices continue to decline. In February, the latest data available, house prices fell by 9% yoy, with the monthly rate of decline remaining close to 1% consistently for a number of months. House price declines will not be uniform across the country or within sectors. For example, our analysis of the housing stock for sale shows that the most acute problems are located in the Midlands area, while the apartment sector in out of city-centre locations is likely to be most affected, given the prevalence of investors in that market. A lot of the froth has already been removed, but pressure is likely to remain until housing stock makes a meaningful move downwards.

Price inflation to remain in negative as stock is worked through

MONETARY ISSUES

Inflationary pressures proving stubborn

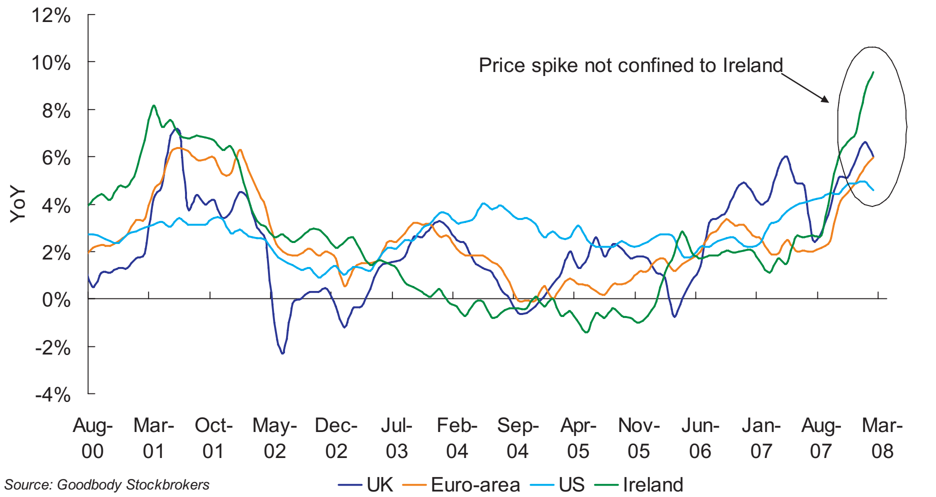
Inflation pressures have been surprisingly stubborn in the opening months of 2008. After averaging 4.9% last year, some moderation from this excessive high rate was anticipated. However, this has not occurred to the degree that might have been envisaged. The annual rate of inflation averaged 4.7% in Q1, and was advancing at an annual rate of 5% in March. External factors, or those outside the control of domestic policy, have been the main inflationary influence over the past two years. In 2007, mortgage interest payments were responsible; excluding this component, inflation would have averaged only 2.7%. While the 'culprit' may have changed in 2008, it remains the case that Irish inflation is largely influenced by external elements, with rising food prices the inflation foe in recent months.

Inflation averaged 4.7% in Q1, with ongoing pressure from food price inflation

Food price inflation now in unchartered territory...

Of course, commodity price increases have been a global phenomenon, as is evidenced by the chart below. In Ireland, the acceleration has been particularly noticeable. In December 2007, food inflation was running at 6.6%, but this accelerated to 9.6% yoy in March, three times the average pace seen over the past two years. The period surrounding the Food and Mouth crisis in 2001 saw food price inflation peak at 8.2% in March 2001, so this level has now been surpassed, setting a new record for food price rises. At that time the price increases remained confined to meat products. However, the current period is characterised by more widespread price increases. Wheat, bread and cereals prices increased by 15% yoy in March, while the price of dairy products such as milk, cheese and eggs increased by 23%. More recently, the price of meat products has started to advance and in March was increasing by 5% yoy, a six-year high pace of increase.

Spike in food price inflation an international phenomenon



Source: Goodbody Stockbrokers

Food inflation ahead by 9.6% yoy, led by cereal, dairy and meat products

….with increases in Ireland running ahead of international peers

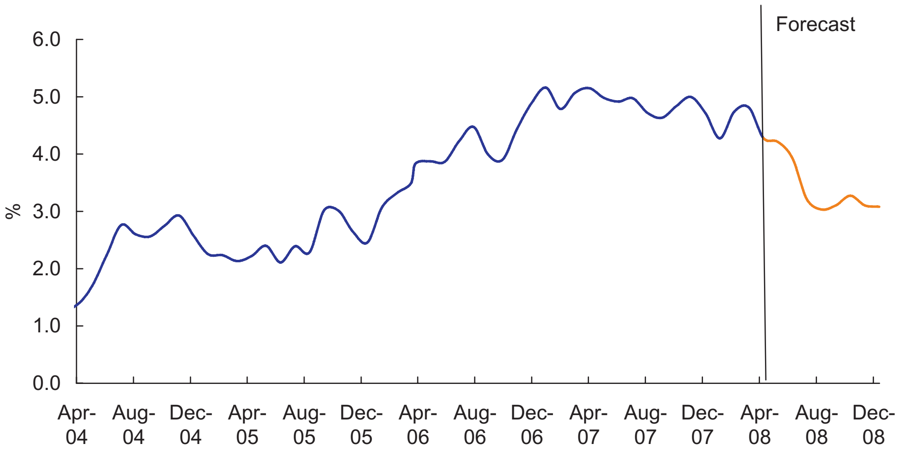
It is also worth noting that during the last period of global food price inflation in 2001, Irish food prices rose at a faster pace, and also persisted at a higher level for a more extended period, than those in the Eurozone, UK and the US. The pattern of recent price rises has mirrored this trend once again. While the latest bout of food inflation is indeed a global phenomenon, food price increases in Ireland to date have outstripped those seen in other nations, underlining, once again, Ireland's exposure to external factors. In March, food inflation in the Eurozone and the UK was increasing at an annual pace of 6%, well below that seen in Ireland.

Some positives in the pipeline

However, there are some factors which should have a positive effect on the inflation profile in the months ahead. Chief among these is the outlook for interest rates. We see ECB rates being 0.5% lower by year end but the timing of these expected rate cuts has become slightly more uncertain. We now think rate cuts by the ECB will be delayed until Q3, given that officials have alluded to continued elevated inflationary pressures in the months ahead as well as the ongoing threat of second round effects materialising. While mortgage interest costs in the CPI have moderated significantly, rate cuts will clearly have a very welcome effect on the inflation rate in the second half of the year. Furthermore, with rental growth also set to ease in coming quarters, the housing component of the CPI, where both these areas are captured, should moderate further.

Cut in interest rates will have a welcome effect on the CPI

CPI inflation - moderation likely in months ahead



Source: CSO, Goodbody estimates

Goods and services gap continues to narrow

On another positive note, it is encouraging to see the wide gap which had emerged between goods and services inflation beginning to dissipate. This is due to housing costs moderating as highlighted above, which has had a welcome effect on services inflation, while goods inflation has been pushed higher largely through food price rises. In March, services inflation was running at 5.7% yoy, while goods prices were increasing at a pace of 4.2% yoy. Twelve months previously, services and goods prices were increasing at an annual pace of 9.3% and 0.4%, respectively. Elevated services inflation has been a prominent feature of the CPI data for a prolonged period but now it is likely that we will see the gap contine to close, given the deflationary influences which are associated with a slowing economy.

Services inflation moderating while rising food prices pushing goods inflation higher

Moderation expected but not until H2

The pattern of inflation in the opening months of the year has materialised to be slightly higher than we would have anticipated. While this has been largely due to food prices, in the months ahead, higher energy prices are also set to play a role. Furthermore, the rate cuts by the ECB are now set to come later in the year, in contrast to our earlier call, delaying the expected moderation in inflation. These factors combined imply that inflation is now set to average 4% for the full year, although by year end the annual rate should be approaching 3%. Inflation is set to moderate further next year as economic growth remains below trend and for 2009 we forecast an average rate of 2.5% for the year.

CPI now set to average close to 4% for the full year

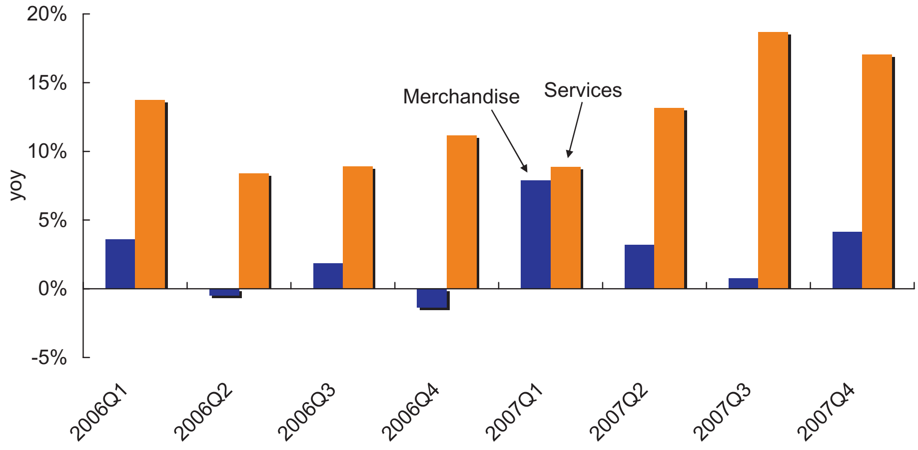
INTERNATIONAL FLOWS

External sector needs to step up to the plate

The external sector has been seen as the laggard in terms of the Irish economic performance in recent years, but an underwhelming net trade outturn in the 2003-2006 period in particular was more than compensated for by an extremely buoyant domestic economy. This situation is now set to reverse, with investment on a declining path and consumption growth also set to ease in the quarters ahead, implying a moderation in overall domestic economic activity. Against this backdrop, Ireland's external sector will need to step up to the plate and make a significant contribution to growth in the near term. However, this would not seem to be an unachievable objective. In the year gone by, net trade accounted for 2.3% of the 5.3% growth in GDP, a much improved performance on the 0.6% contribution from net trade in 2006, when GDP growth of 5.7% was achieved.

Net trade made a notable contribution to growth in '07 accounting for almost half of the increase in GDP

Services exports have remained stellar in recent quarters



Source: CSO, Goodbody estimates

Improvement in merchandise trade in '07

The analysis of Ireland's trade performance often focuses on a less than impressive performance from the merchandise sector. While it is true that goods exports have been muted in terms of the trade performance, it is also worth mentioning that the year gone by witnessed an improvement in merchandise trade. For 2007 as a whole, goods exports grew 4% in volume terms, well ahead of the 1% growth in exports seen the previous year. In the most recent quarter the volume of merchandise exports increased 4.1% yoy, up from just 0.8% growth in Q3. However, the fact that the value of goods exports fell 5% yoy in the three months to January is concerning, while the industrial production data (often a good lead indicator of export activity) also indicate weaker growth lies ahead.

Merchandise trade up 4% in real terms ...

Services continue to make impressive gains...

However, this pace of growth pales to that seen in the services sector. Annual growth in services exports in the final quarter was 17%, following growth of 19% yoy in Q3. For the year as a whole the volume of services exports posted growth of 15%, the fifth consecutive year of double digit growth. As a percentage of total exports, services have increased from 30% at the start of this decade to 48% at the end of last year. This 60% increase over the period in the relative proportion of trade that is services based is quite remarkable and further underlines Ireland's shift to a services-based economy. This can also be seen in the new projects coming on stream from the IDA (Industrial Development Agency). Almost 40% of the 114 new projects agreed in 2007 were releated to R&D activities, a key component of services exports.

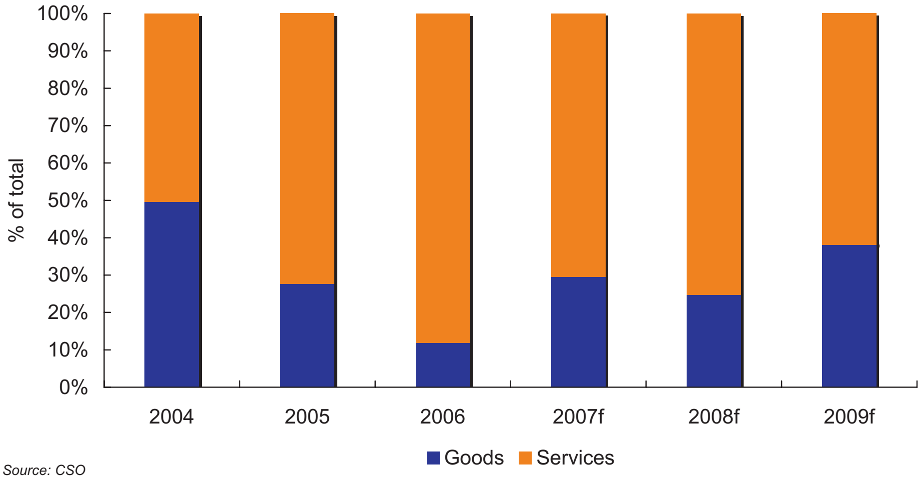
....but services remain the driver of export growth and now account for just less than half of all exports

…largely driving overall export growth

Given this buoyancy, it comes as no surprise that services have been the main driver of overall export growth in recent years. Services accounted for 70% of the growth in exports in 2007 after contributing an overwhelming 88% to overall export growth in 2006. While Ireland's attractiveness as a manufacturing location may have waned somewhat in light of competitiveness issues mentioned above, it is very encouraging to see that it has fared very successfully as a base for exporting services in light of these challenges. Over the past year, the euro has appreciated 16.5% against sterling and 16.7% versus the US dollar. In the first quarter of 2008, the euro's appreciation against these currencies has been in the order of 7.3% and 6.8%, respectively. Such a marked appreciation over a short period of time makes the performance of services exports all the more impressive and also highlights that the services sector is, to a certain degree, insulated from factors which the manufacturing sector is heavily exposed to.

An impressive contribution given the competitiveness and currency concerns

Contributions to export growth - goods v services



Source: CSO

Continued expansion in store for services sector

As such, while the ongoing upward pressure on the euro is unarguably a concern, the fact that Ireland's main source of export growth has made ongoing gains in such an environment is very promising and gives us comfort that further gains will be made in the services sector in the year ahead. Nevertheless, this is unlikely to be at the pace we have become accustomed to. Given the moderation in global growth prospects, especially near term prospects for the US and the UK, where Ireland has a large proportion of trade relative to other Eurozone countries, some easing in the rate of export growth as a whole, including that for services, is to be expected. We forecast services export growth of 10% in the current year, while we see goods exports increasing by 2%, leading to overall export growth of 5.6%. This compares to forecast import growth of 3.0% in 2008.

Continued growth in store for services sector, albeit at more moderate levels...

...but merchandise trade has become relatively muted

In relation to merchandise trade, the fortunes of this area are mainly concentrated in the chemicals sector, an area which accounts for half of total goods exports. The year gone by was a very buoyant year for this sector, with the increase in the value of chemical exports amounting to over one and a half times the increase in the value of goods exports overall. However, data on industrial production, a good lead indicator of trade activity, points to less robust growth in store. In the three months to February, the volume of industrial production increased by 2.5% compared to 10% growth in the three months to December. In relation to chemicals, the volume of production in this area slowed from 25% to 7% over the same period. This is a significant moderation and indicates that merchandise exports this year may struggle to match the performance seen last year.

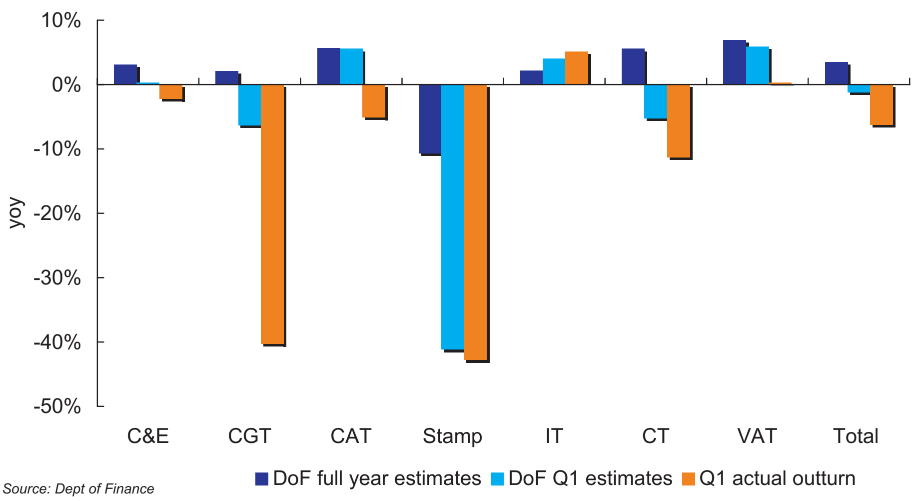
...while industrial production data point to subdued period ahead for merchandise

FISCAL ISSUES

Revenues fall well short of profile in Q1

While a number of datasets relating to the Irish economy are often released with quite a time lag, the same cannot be said of the Exchequer Returns data, which thus provide an important snapshot of economic activity. The newsflow from Q1 was disappointing. Overall tax revenue fell by 6% yoy in the first three months of 2008, translating into a shortfall of €600m relative to original Department of Finance expectations. This revenue deficit is attributable to weakness in two main categories, namely Capital Gains Tax and VAT. While Capital Gains Tax is quite a small category relative to the overall tax take (c.6.6% of revenues last year), the fact that revenues from this source are behind expectations by some €300m (-40% yoy), means the impact on the overall picture is quite profound. Furthermore, the fact that this category is closely related to developments in the equity and property markets and given the recent fortunes of both, this does not bode well for CGT revenues for the remainder of the year, given the continued weak performance of both markets. Indeed, the DoF has stated that it does not expect the shortfall, which has arisen in the first three months, to be recouped going forward.

Revenue shortfall across a number of categories in Q1



Source: Dept of Finance

VAT receipts pointing to consumer spending moderation

The second concerning element of the tax revenue data is the weak performance of VAT receipts. VAT and Income tax are the two main revenue gathers for the Government (combined accounting for 60% of total revenue) and, therefore, any adverse developments in either category warrants close attention. VAT receipts in Q1 were flat, relative to expectations for a 6% increase, and were €250m behind profile. The fact that new house completions are down by 30% yoy in Q1 goes some way towards explaining the shortfall. However, it is likely that moderating consumer spending is also a factor. Government forecasts have pencilled in a 7% increase in VAT receipts for the full year. However, the muted performance in Q1 makes this a very tall order in our opinion.

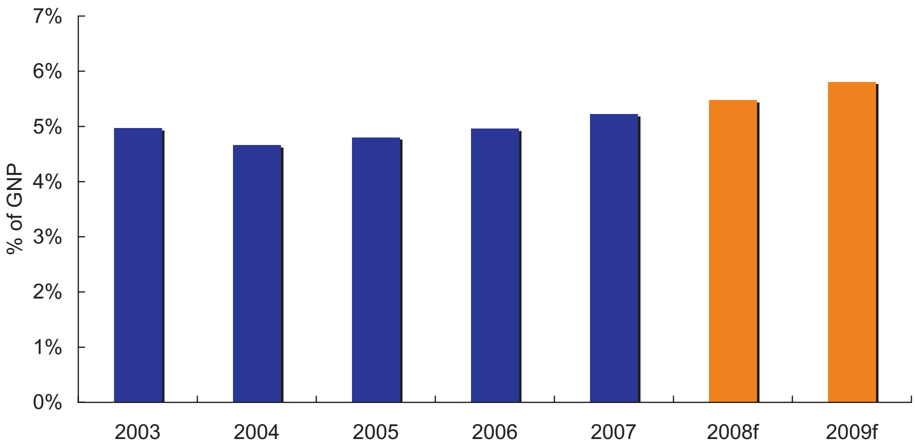
Possible headwinds for other tax categories also

In other areas, income tax has held up relatively well so far. However, when we adjust the data for the Exchequer contribution made towards maturing SSIA's (which was treated as a negative income tax), the 5% annual increase in Q1 moderates to 3.5%, indicating that the degree of momentum is not quite as strong as it initially appears. In Q2, as a result of exit taxes which boosted the income tax take, this adjustment will result in more favourable base effects and, as such, may very well point to resilience in the labour market. However, there are significant headwinds in store for this labour market as we highlight elsewhere.

Government revenue estimates unlikely to be met...

In total, the 3.5% revenue growth forecast pencilled in by the government for the full year looks decidedly optimistic at this point. Given the revenue deficit emerging thus far, as well as the challenging environment that is likely to prevail in the short to medium term, we see revenues coming in at less than last year's level. We now estimate a 1% fall in tax revenues for the full year, before revenues revert to positive growth once again next year. For 2009, we are forecasting a 5% increase in revenues, which still represents a modest outturn compared with previous years. Nevertheless, the weakening profile of revenue growth is set to create a very difficult backdrop for spending targets for both the remainder of this year and next. Current spending growth is set to moderate to c.5% next year (10% growth this year), while on the capital spending front the government has promised to continue the rollout of the NDP. As such, we expect voted capital spending to increase by 11% both this year and next, which would result in the capital spending increasing to 5.8% of GNP by the end of 2009. This adherence to spending targets on the capital side will be critical in Ireland continuing to bridge its infrastructural deficit as well as providing an outlet for the spare capacity, which has emerged in the construction sector.

Capital spending must continue to remain at high levels to cushion slowdown



Source: Dept of Finance, Goodbody estimates

....which will see debt levels tick up

Nonetheless, such an ambitious rate of capital spending growth will not be feasible without recourse to borrowing. We see the Exchequer Borrowing Requirement (EBR) increasing to €6.7bn this year (up from €1.6bn in 2007), while, next year, on our estimates the EBR will increase further to €7.8bn. This will have quite a marked impact on the General Government Balance in the short term. From a GGB surplus of 0.5% of GDP in 2007, we now expect that the GGB will be in deficit to the tune of -2.1% of GDP this year and -2.2% of GDP in 2009. However, it is worth noting that this would still be within the 3% limit allowed for in the Stability and Growth Pact. General Government Debt levels will also tick upwards. From a situation where General Government Debt amounted to just 24% of GDP last year, the extent of borrowing requirements in the short term will see Government debt levels move up to 28% of GDP by the end of 2009. Although a relatively sharp upward movement over a short period of time, Ireland's position as one of the least publicly indebted countries will barely alter. Average Eurozone debt levels amount to over 66% of GDP and so in this regard Ireland will still compare very favourably.

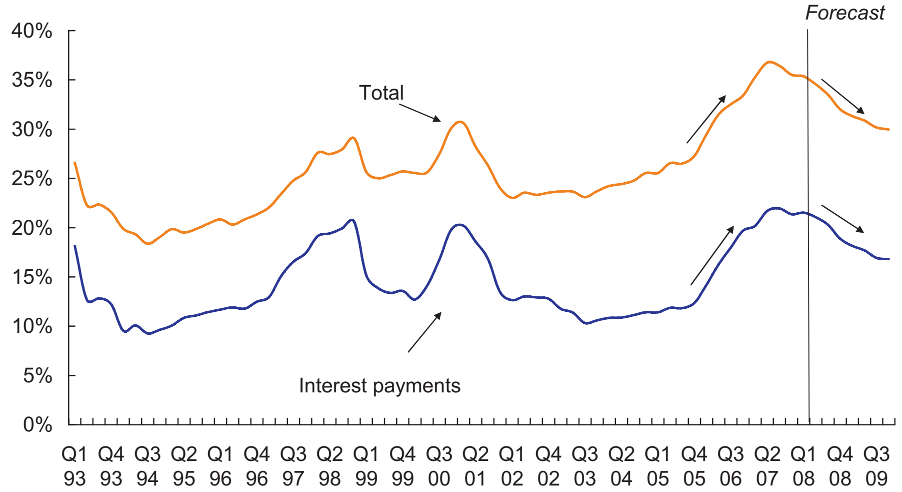
APPENDIX

Mortgage growth forecasts

	2005	2006	2007	2008f	2009f
FTB Volume	37,879	37,064	30,469	26,935	25,857
Growth		*-2.2%*	*-17.8%*	*-11.6%*	*-4.0%*
FTB Loan (€)	203,728	227,957	237,947	223,670	216,960
Growth		*11.9%*	*4.4%*	*-6.0%*	*-3.0%*
FTB Value (€m)	7,717	8,449	7,250	6,024	5,610
Growth		*9.5%*	*-14.2%*	*-16.9%*	*-6.9%*
Mover Volume	46,760	45,585	32,864	29,578	29,578
Growth		*-2.5%*	*-27.9%*	*-10.0%*	*0.0%*
Mover Loan (€)	221,557	249,380	264,332	245,829	240,912
Growth		*12.6%*	*6.0%*	*-7.0%*	*-2.0%*
Mover Value (€m)	10,360	11,368	8,687	7,271	7,126
Growth		*9.7%*	*-23.6%*	*-16.3%*	*-2.0%*
RIPS Volume	25,856	28,141	20,861	18,295	17,929
Growth		*8.8%*	*-25.9%*	*-12.3%*	*-2.0%*
RIPS Loan (€)	243,000	282,506	312,161	290,310	281,601
Growth		*16.3%*	*10.5%*	*-7.0%*	*-3.0%*
RIPS Value (€m)	6,283	7,950	6,512	5,311	5,049
Growth		*26.5%*	*-18.1%*	*-18.4%*	*-4.9%*
Re-mortgage Volume	25,944	26,565	25,937	26,715	26,982
Growth		*2.4%*	*-2.4%*	*3.0%*	*1.0%*
Re-mortgage Loan (€)	194,187	228,383	257,354	256,582	256,582
Growth		*17.6%*	*12.7%*	*-0.3%*	*0.0%*
Re-mortgage Value (€m)	5,038	6,067	6,675	6,855	6,923
Growth		*20.4%*	*10.0%*	*2.7%*	*1.0%*
Top-up Volume	64,821	66,598	47,967	43,170	43,170
Growth		*2.7%*	*-28.0%*	*-10.0%*	*0.0%*
Top-up Loan (€)	72,770	90,678	97,650	96,186	94,262
Growth		*24.6%*	*7.7%*	*-1.5%*	*-2.0%*
Top-up Value (€m)	4,717	6,039	4,684	4,152	4,069
Growth		*28.0%*	*-22.4%*	*-11.4%*	*0.0%*
Total Volume	201,260	203,953	158,098	144,693	143,517
Growth		*1.3%*	*-22.5%*	*-8.5%*	*-0.8%*
Average Loan size (€)	169,507	195,501	213,842	204,666	200,513
Growth		*15.3%*	*9.4%*	*-4.3%*	*-2.0%*
Total Gross lending (€m)	**34,115**	**39,873**	**33,808**	**29,614**	**28,777**
Growth		16.9%	-15.2%	-12.4%	-2.8%

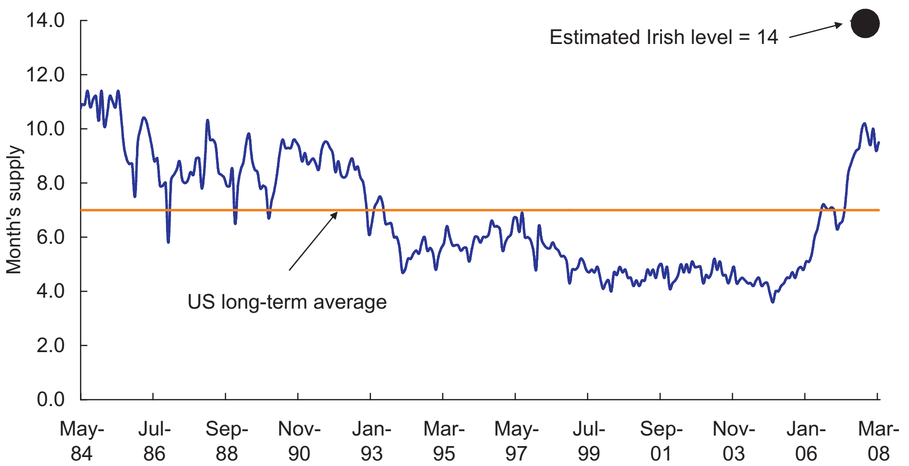
Source: IBF, Goodbody forecasts

Mortgage payments as a % of disposable income



Goodbody calculations based on a two-income family on the basis of a 90% LTV mortgage over 25 years

Month's supply of existing unsold homes in the US



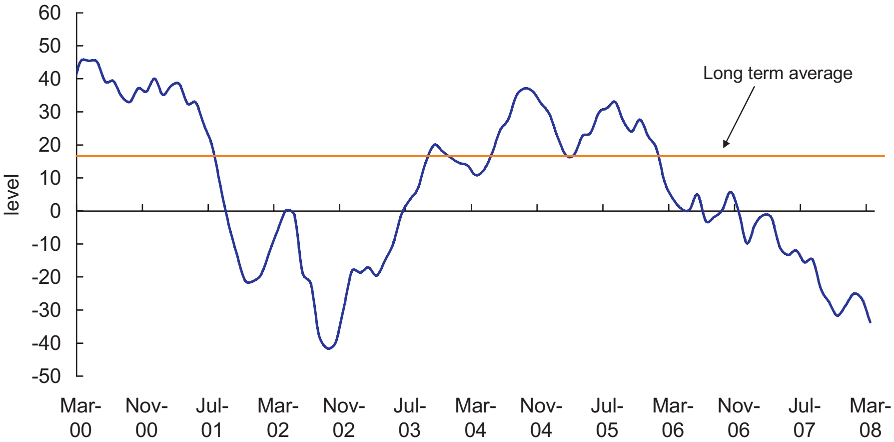
Source: Datastream

Real growth in industrial and commercial construction sectors

	2000	2001	2002	2003	2004	2005	2006	2007E
New								
Industry	6.7%	4.0%	-25.0%	-15.0%	0.0%	6.0%	5.0%	15.0%
Total Commercial	14.7%	3.6%	-22.6%	-17.7%	-3.9%	31.8%	23.2%	14.9%
- Office Development	16.1%	3.0%	-30.0%	-30.0%	-20.0%	40.0%	26.0%	25.0%
- Retail/Wholesale	11.6%	5.0%	-5.0%	4.0%	15.0%	25.0%	20.5%	5.0%
RMI								
Industry	1.7%	-20.4%	-4.3%	55.0%	0.7%	2.4%	11.2%	12.4%
Total Commercial	6.7%	3.8%	1.3%	21.3%	-2.8%	0.4%	23.6%	9.4%
- Office Development	8.0%	3.2%	-8.4%	3.1%	-19.0%	6.7%	26.4%	17.4%
- Retail/Wholesale	3.8%	5.2%	24.3%	53.2%	16.3%	-4.7%	20.9%	1.7%
Total								
Industry	6%	0%	-22%	-4%	0%	5%	6%	14%
Total Commercial	13%	4%	-19%	-10%	-4%	24%	23%	14%
- Office Development	15%	3%	-27%	-24%	-20%	32%	26%	23%
- Retail/Wholesale	10%	5%	-1%	13%	15%	17%	21%	4%

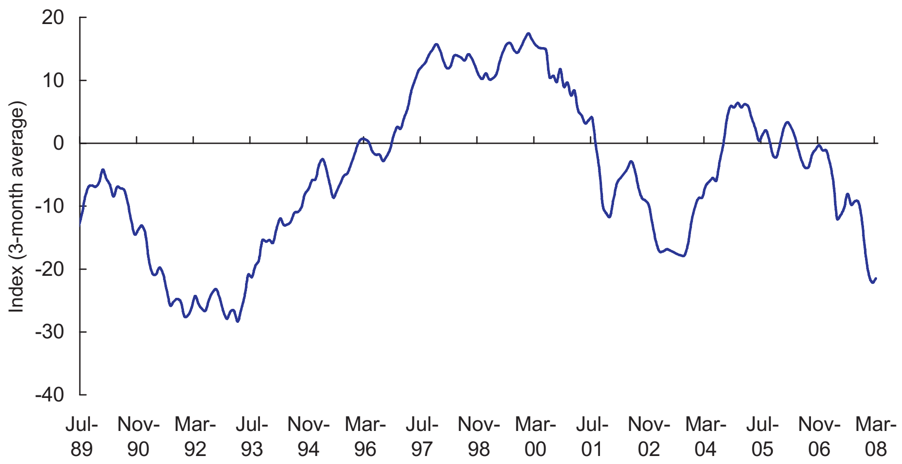
Source: DoEHLG

Construction confidence (3mma)



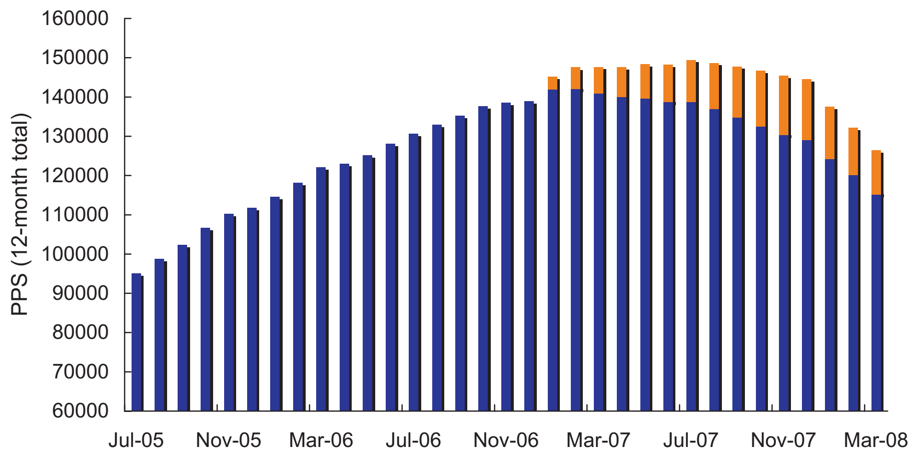
Source: Datastream

Irish consumer confidence



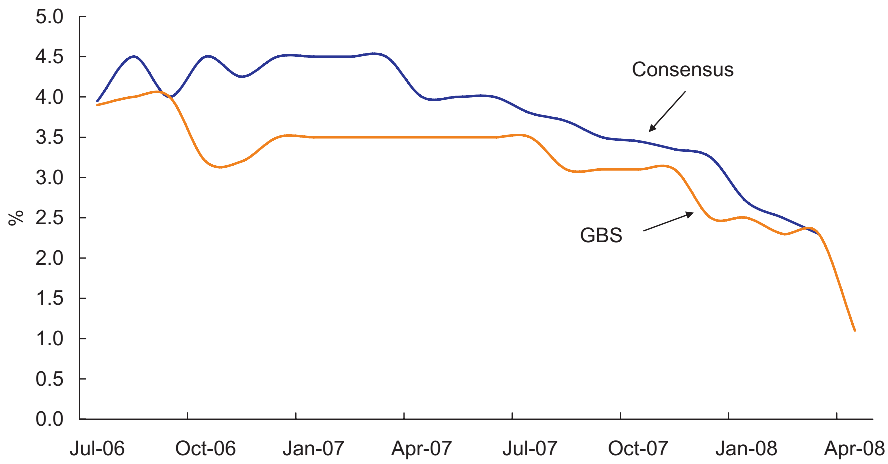
Source: Datastream

PPS number indicate immigration flows are past the peak



Source: Department of Social & Family Affairs

2008 GDP forecasts for Ireland



Source: Reuters, Goodbody estimates

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