

## The Sword of Damocles over Ireland

The Government last week unveiled that the overall fiscal consolidation is going to be in the range of €15-17bn as has been outlined over the last 2 weeks. Budget 2011 is going to consist of €6bn in measures. Details of exactly how these savings are to be achieved will be revealed in late November. The December 7<sup>th</sup> Budget will then bring forth the required legislative issues.

The Government has pencilled in the following real GDP, deficit and debt figures for the period 2011-2014:

**Table 1: DoF assumptions**

	2011	2012	2013	2014
Real GDP growth, %	1.75	3.25	3	2.75
Deficit to GDP, %	9.25	-6.75	-5.25	-3
Debt to GDP, %	105	106	105	101

The growth rates are at the upper range of forecasts and they have generally been perceived as being too optimistic by the market. We believe that the adjustment will, however, fall more heavily on expenditure than taxation and that a number of the measures will be “structural” in nature e.g. incentivising labour market participation (welfare cuts). This will make the growth forecasts more achievable. Nonetheless we have revised down our own GDP/GNP forecasts to 1.0/0.3% for 2011 and see them averaging 2.0/1.6% in the period 2012-2014 (see Appendix).

Ireland needs to re-enter the funding markets next year, realistically before the end of Q1 2011. Unless market sentiment towards Ireland changes dramatically on the back of a successful marketing effort by the Government, NTMA and EU then Ireland will have serious difficulty re-entering the funding markets and will either need to mobilise domestic options or call on the EFSF. For more on possible domestic options and the EFSF, [click here](#).

If Ireland is going to be able to issue in the funding markets then a number of things need to happen:

- 1) A credible, conservative and well marketed Budget will have to be delivered by the Minister for Finance (not sufficient as of yet).
- 2) Risk aversion towards the periphery more generally will need to subside (little evidence to date), and
- 3) Continued evidence that the economy is stabilising as seen in this month’s NCB PMIs, the Live Register data and the tax figures (see charts below).

A number of primary dealers in Irish bonds have released pieces over the last couple of days saying they believed it was likely that Ireland would need to tap the EFSF in the coming months. When your sales force doesn’t believe it can drum up sufficient demand for Irish bonds at feasible rates it gives an indication of sentiment out there. It is increasingly looking like the EFSF is the most likely scenario.

If there is not a dramatic change in sentiment we actually believe that it would be a positive for both the Irish economy and the bond market were Ireland to ask for the EFSF. Plans would be laid down in black and white and worries about interest costs would subside as they would be largely known. People and corporations like to make decisions in a stable world. Crucially it would enable the country to focus on correcting the deficit, regaining competitiveness and promoting its virtues – highly educated, English speaking, productive work force with world-class companies and a pro-business environment. Key of course in this view is that the 12.5% corporation tax rate would not be lost. The EFSF is there to help a country in “difficulty” not cause it further problems.

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Disclosures appear at the back of this document

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## Quarterly growth, NCB activity indexes and projections...

- **Broad picture:** Q2 2010 national accounts data saw GNP shrink by -0.3% after a decline of -1.2% q/q in Q1. Consumption decreased by -0.2% q/q and government consumption by -0.8% while there was a huge increase in investment of 11.5% q/q. Consumption is now 3.7 times greater than investment as opposed to a low of 1.8 times in the housing bubble driven period. Export growth slowed to 1.6% from 7.1% in Q1, while imports increased by 4.5% versus 3.7% in Q1. As such net exports were a drag on the GNP/GDP figures. GDP declined by -1.2% q/q after +2.2% q/q in Q1.
- The high frequency data in Q2 data had suggested that GNP had grown and the official reading of -0.3% could well be revised upwards to a positive number given the size of previous revisions. The high frequency data, however, are now signaling that GNP has slowed sharply from its Q2 level. Our proprietary economic activity index, based on hard data signaled that in the 3 months to August, the economy started to slow once again, a theme which continued into August and September as suggested by our more timely PMI based growth indicator (Chart A and B). There was some relief though as the PMIs did cross the 50 mark again in October (see next page).

Chart A: NCB Irish Economic Activity Index\*, saar%

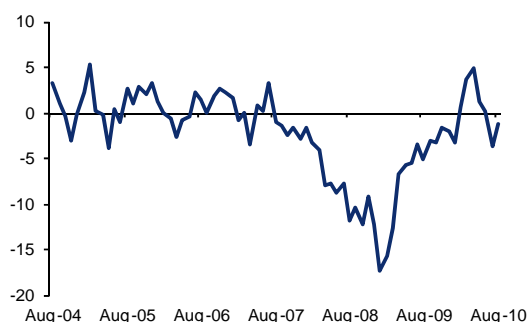


Chart B: NCB PMI growth indicator\*\*, >50=growth

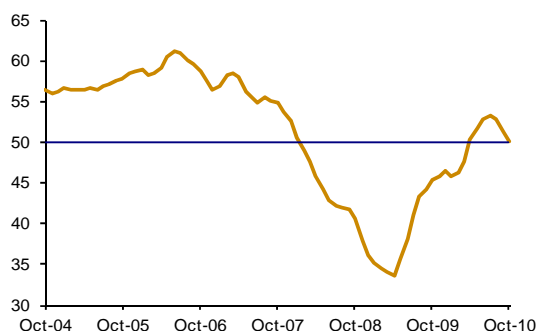


Chart C: Peak to current, nominal €bn

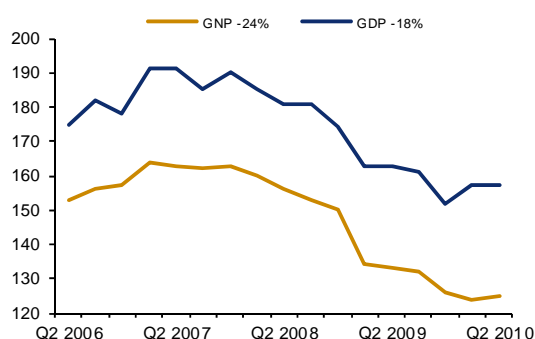
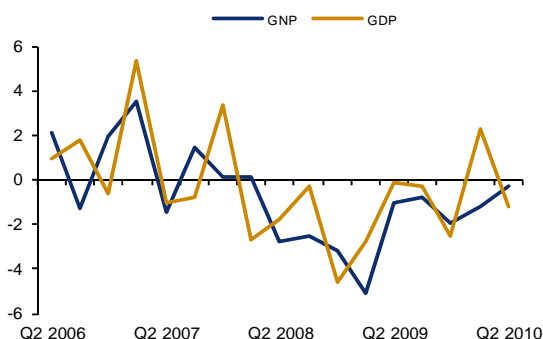


Chart D: Irish q/q% chg in GDP/GNP



Sources: Datastream, CSO, Central Bank of Ireland, NCB, authors' calculations

\* The NCB Economic Activity Index is designed to obtain a measure of the underlying trend in economic activity in Ireland. The index is created by manipulating the time series characteristics of the underlying data. The underlying data consists of monthly consumer, housing, industrial, external and financial data.

\*\* The NCB PMI growth indicator is calculated using the NCB manufacturing PMI, the NCB services PMI, the Ulster Bank construction PMI and lagged values of GDP.

## Activity indicators, growth...

- **Broad picture:** The NCB manufacturing PMI climbed back above the 50 mark in October after it fell below the 50 mark for the first time in eight months in September. The headline index rose to 50.9 from 48.4. New orders rose from, 48.8 to 50.9 driven by export orders rebounding from below the 50 mark.
- The NCB services PMI sector also rose above the 50 mark in October after it fell below the mark for the first time in six months in September. The headline index rose from 48.8 to 50.9 (Chart 3). New business continued to contract despite the index rising from 47.8 to 49.3, but export orders did manage to remain above the 50 mark.

Chart 1: NCB manufacturing PMI



Chart 2: NCB services PMI

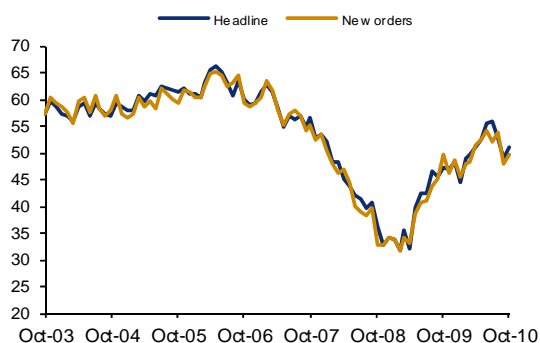


Chart 3: Ulster Bank construction PMI

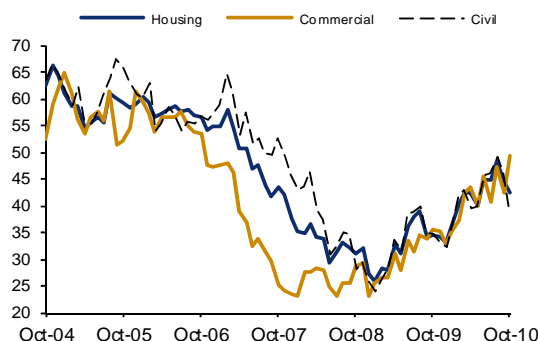


Chart 4: NCB growth indicator, >50 = growth

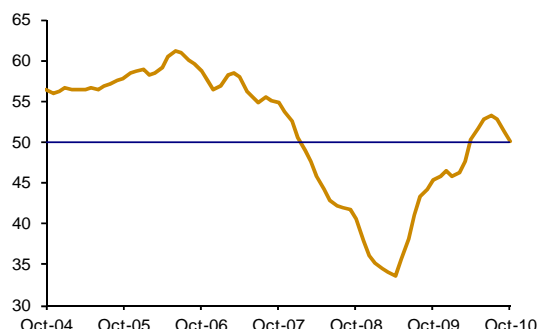


Chart 5: Value €bn and q/q % chg in volume of GNP and GDP

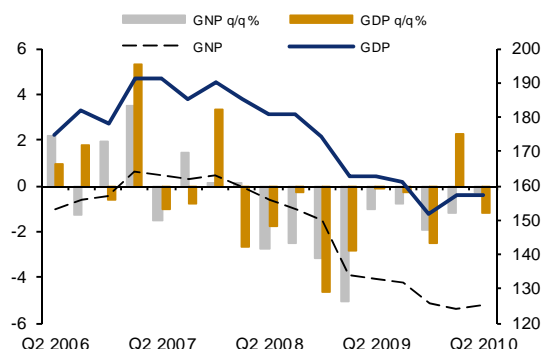
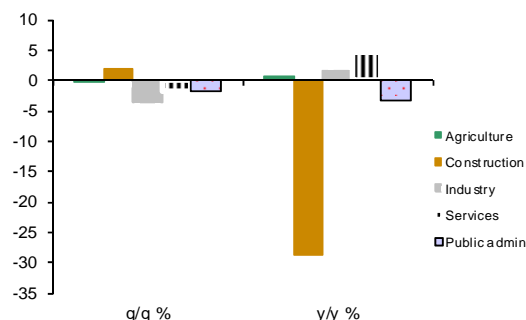


Chart 6: % chg sector in Q4 2009



## Consumer and labour market ...

- On a seasonally adjusted basis there was a monthly decrease of 6,600 in the Live Register (unemployment claims) in October 2010, following a fall of 5,400 in September. This is the largest monthly fall in the numbers on the Live Register in the current data series dating back to 1996.
- It does appear as if job shedding is easing in the economy with redundancies (separate statistics from Live Register) in September down 30% from September 2009 levels. In Q3 redundancies were down 24% from September 2009, but despite this the rate of inflows into the Live Register is still elevated highlighting that net job creation is still anaemic given the growth in the labour force.
- We have no timely data on employment creation and emigration. In other words it is impossible to decipher whether emigration rather than job creation is causing the large outflows from the live register. It is likely a combination of both. The standardised unemployment rate in October was 13.6%, down from 13.7% in September and the peak of 13.8%.

Chart 7: Live register data, sa

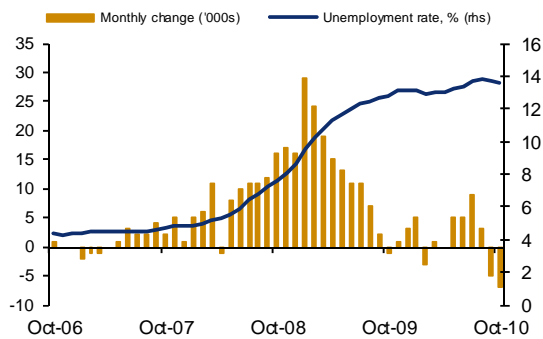


Table 1: Employment by broad sector, Q2 2010

Agriculture & others	183	1.4
Industry	240.1	-1.9
Construction	125.3	-2.5
Wholesale & retail	269.1	1.1
Transport & storage	89.7	-2.8
Hotels & restaurants	119.8	-1.9
Business, IT & science	339.5	-1.0
Public admin, education & health	492.5	0.5
Total	1859.1	-0.4

Chart 8: Irish inflation, y/y %

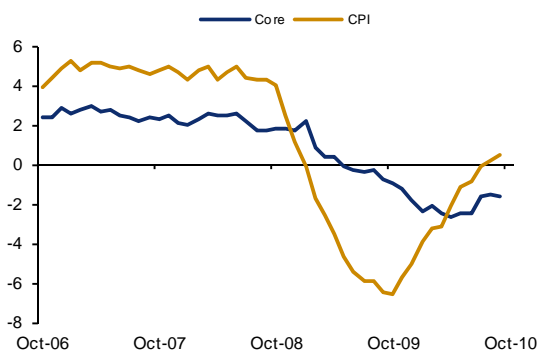


Chart 9: Consumer confidence, 3 month ma

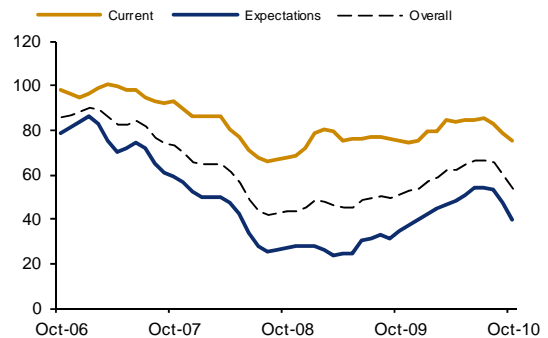


Chart 10: Retail sales ex motors, 3 month ma

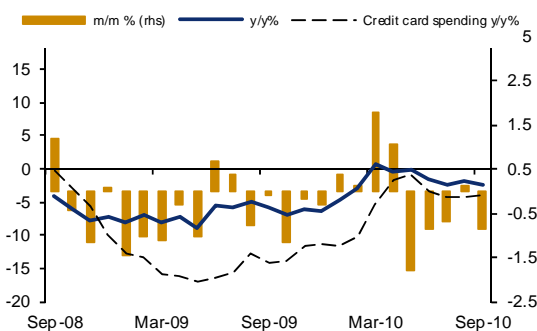
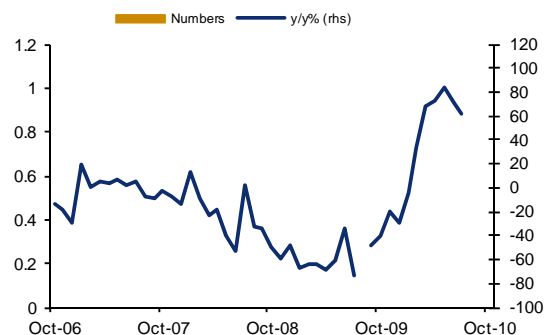


Chart 11: Cars licensed for first time



## Housing market ...

- The latest Daft.ie asking price index fell by 3.7% q/q in Q3 2010, after falling 4.8% in Q2 2010. This leaves the fall from the peak at 37%.
- Dublin city house prices continue to lead the fall, reflecting the larger increase in prices during the boom, but one imagines now also a greater amount of transactions. Dublin house prices fell by 4.4% q/q in Q3 2010, to leave the fall from the peak at 45%.
- The fall in Dublin house prices is more realistic of where we expect national prices to correct. As we outlined in the piece "[Is the decline in Irish house prices over?](#)" anecdotally, the general perception is that prices are in fact down somewhere in the region of 40—45%. This may not be too far off the bottom based on the various valuation measures outlined in that piece. In fact, under certain assumptions it is even rational to purchase at current prices given the costs of renting. The relative attractiveness of buying versus renting is also another swing factor in indicating that a bottom may not be too far off. The conclusion is that the final peak to trough price decline is likely to be in the region of 45-55% in nominal terms.

Chart 12: Tsb/ESRI house price index, 3ma chg

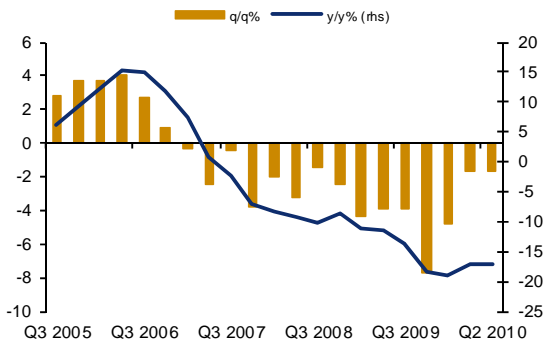


Chart 13: House prices, peak to trough

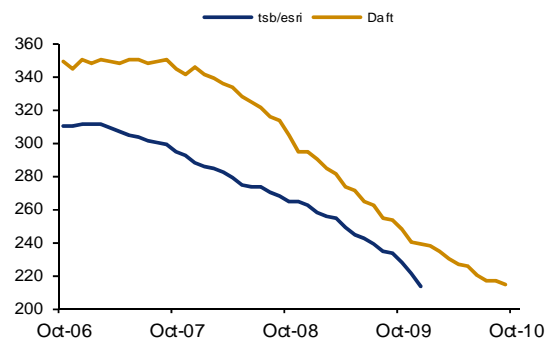


Chart 14: Rate of house building  
sa annualised, '000's

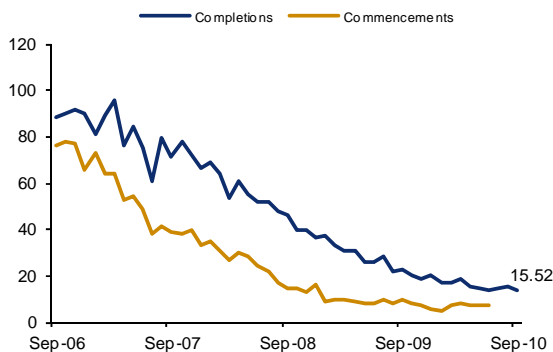


Chart 15: IBF mortgage drawdowns,  
sa annualised, '000's

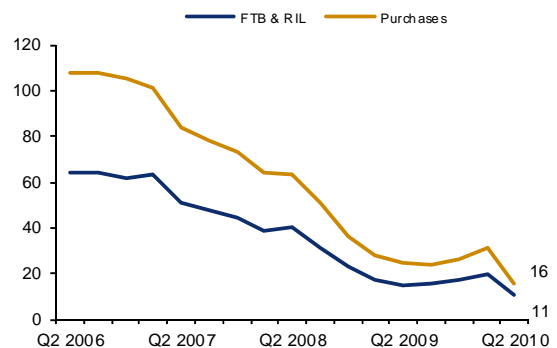


Chart 16: Daft stock of properties

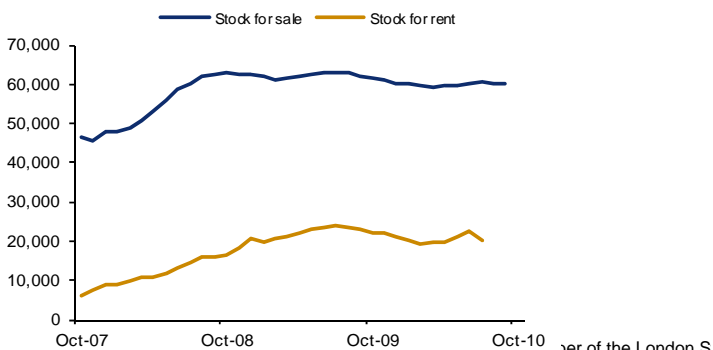
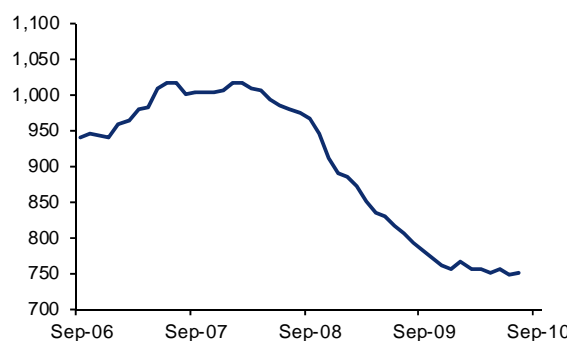


Chart 17: Peak to trough in rental prices



## Government finances...

- **Broad picture:** In October, voted current expenditure was largely in line with the Government's end of year targets while the much smaller category of voted capital expenditure was 22.5% ahead of target (by ahead we mean on target to contain spending). Tax receipts were 1.0% ahead of the Government's target (Table 2, 3). The Government forecast for 2010 is that the exchequer deficit will register €18.8bn. It now looks likely that the exchequer deficit will come in line with that monetary target, leaving an underlying deficit to GDP ratio of 11.9% (Chart 18).
- **The elephant in the room:** While the underlying deficit may come in largely in line with the monetary target, the general government deficit as a percentage is going to reach nearly 32%. The difference between this measure and the underlying deficit is the transfer of capital, via promissory notes, to Anglo Irish Bank primarily, but also Irish Nationwide and EBS. As such, the debt to GDP ratio will reach 100% by the end of 2010 (Chart 19).

Table 2: Tax take to Oct 2010, €mn

	€mn	% behind (-) target
Income Tax	8,622	-4.1%
VAT	8,446	0.5%
Corporation Tax	2,621	22.0%
Excise	3,687	1.9%
Stamps	795	-1.1%
Capital Gains Tax	133	8.3%
Capital Acquisitions Tax	189	-5.4%
Customs	190	14.2%
<b>Total</b>	<b>22,173</b>	<b>1.0%</b>

Table 3: Voted Expenditure to Oct 2010, €mn

	€mn	% ahead (+) target
<b>Voted Spending</b>	<b>37,187</b>	<b>2.7%</b>
Current	33,662	0.1%
Capital	3,525	22.5%

Chart 18: NCB forecasts

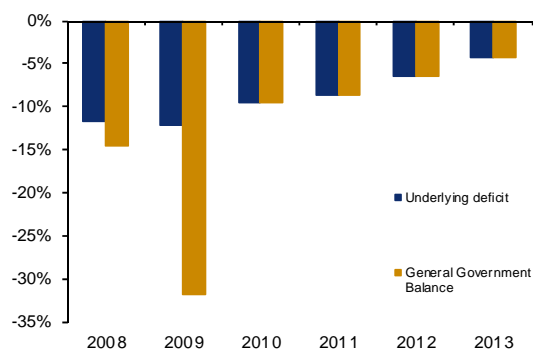


Chart 19: NCB debt to GDP forecasts

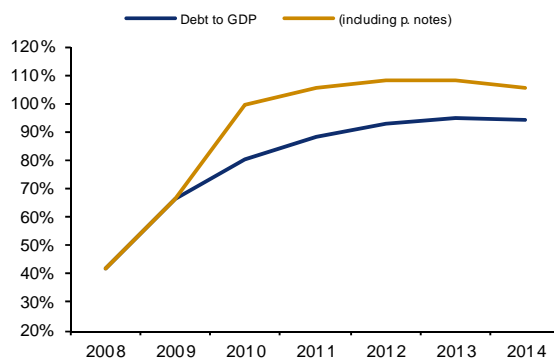


Chart 20: 5 year CDS various countries, bps

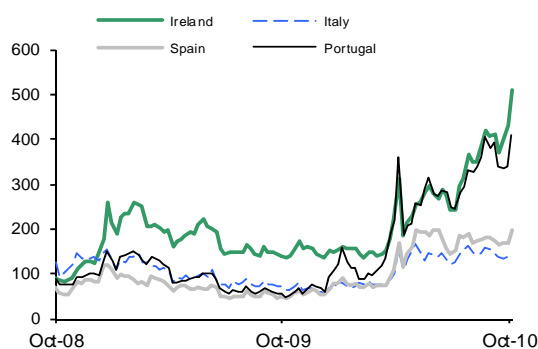
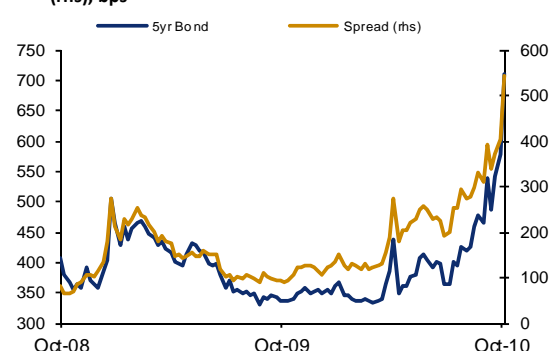


Chart 21: Irish government bonds & spread over German 5 year (rhs), bps



## Industrial production and external sector...

- Broad picture on industry:** The dichotomy between the modern sector and more employment intensive traditional sector has narrowed. On a quarterly basis, however, industrial output generally is beginning to slow (Chart 22). On a y/y basis the modern sector is still expanding on its stellar performance from last year, driven primarily by the chemical sector. As global deflation continues and confidence continues to filter back into the global economy, investment in machinery and equipment should begin to rebound.

Chart 22: Industrial production, 3ma m/m%

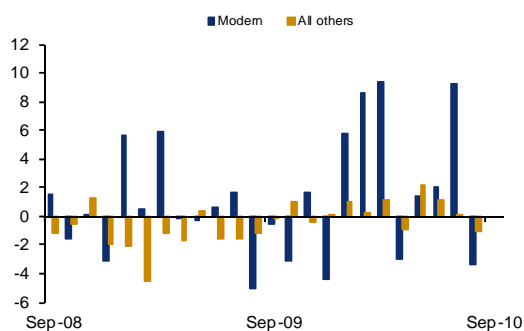


Chart 23: Industrial production, 3ma y/y %

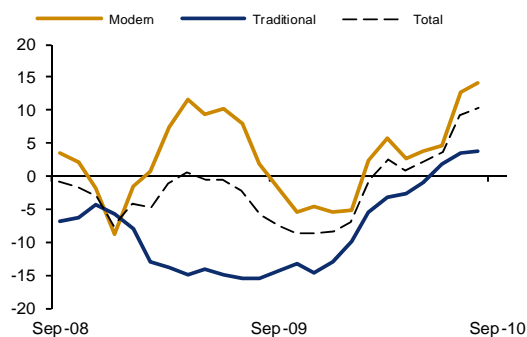


Chart 24: Industrial new orders, 3ma

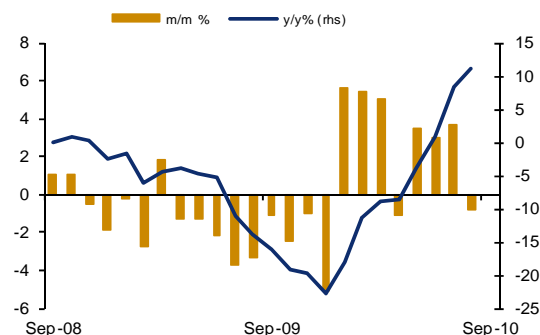


Chart 25: Merchandise exports, volume 3ma

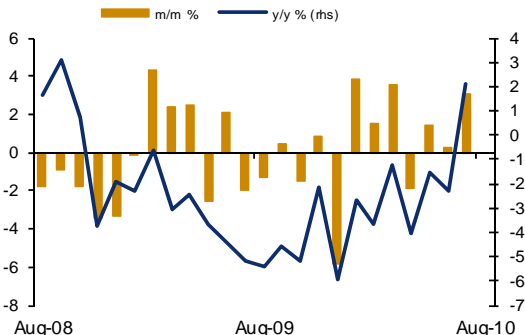


Chart 26: Value of exports by sector, 3ma y/y%

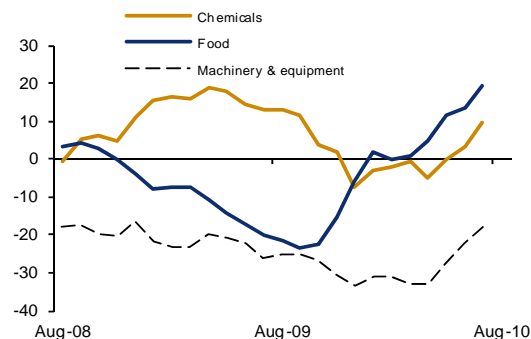
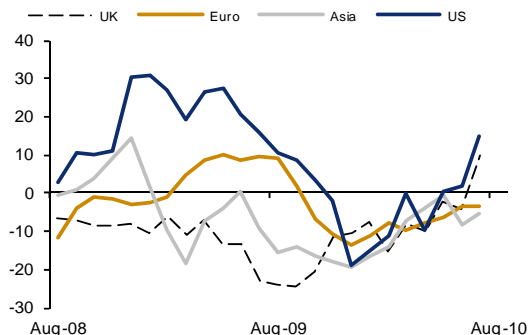


Chart 27: Value of exports to country, 3ma y/y%



## External sector continued ...

- Broad picture on external sector:** The current account deficit narrowed in Q2 2010 and now stands at 2.8% of GDP, having been in surplus in Q4 2009. Despite a current account deficit, the merchandise trade surplus actually widened. The services deficit remained in line with its recent levels, but the huge increase in income transfers from abroad, which accounted for the large difference between GDP and GNP q/q rates in Q1, was also the driver of the current account deficit.

Chart 28: Merchandise imports, volume 3ma

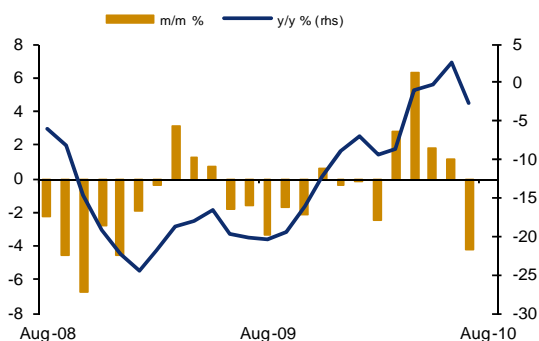


Chart 29: Value of imports by sector, 3ma y/y%

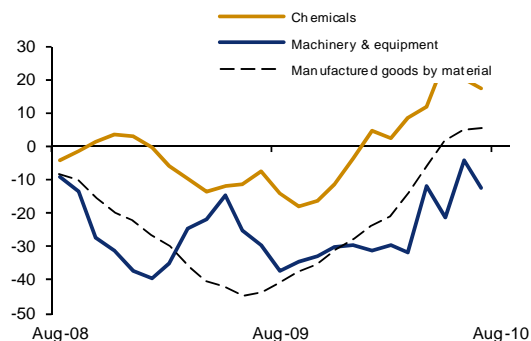


Chart 30: Effective exchange rate, relative to 41 trading partners

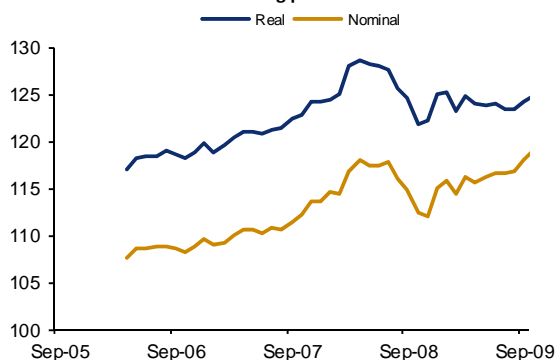


Chart 31: Services volumes, y/y%

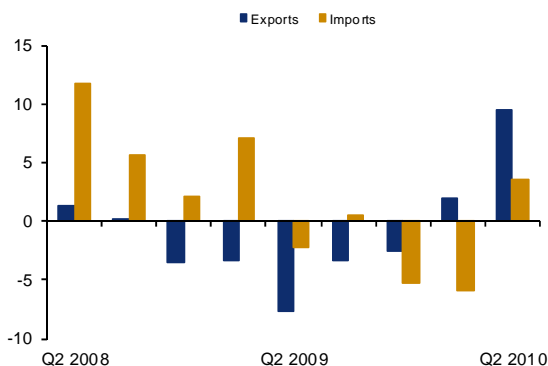
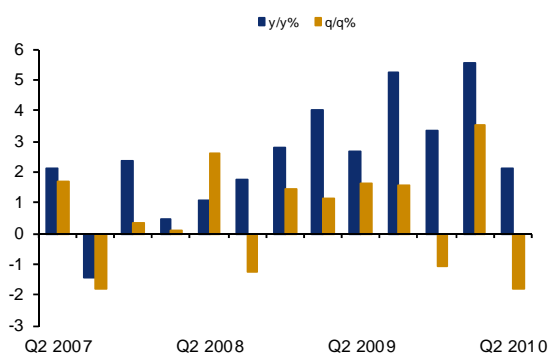


Table 4: Balance of payments

	2009	Q2 2010
Merchandise exports	81,037	21,756
Merchandise imports	57,227	11,959
<b>Merchandise balance</b>	<b>23,811</b>	<b>9,797</b>
Services exports	67,947	18,253
Services imports	75,617	20,656
<b>Services balance</b>	<b>-7,670</b>	<b>-2,403</b>
<b>Income balance</b>	<b>-25,155</b>	<b>-7,985</b>
<b>Current transfers</b>	<b>-1,154</b>	<b>-550</b>
<b>Current account balance</b>	<b>-10,169</b>	<b>-1,142</b>
<b>CA as a % of GDP</b>	<b>-6.6</b>	<b>-2.8</b>

Chart 32: Net exports contribution to GDP, %





## Private sector credit ...

- Note: interest rates for house purchase have appeared to bottomed and have started rising even before ECB hikes occur as the banks push through margin increases. Demand for mortgages still remains subdued according to the latest bank lending survey in July (Chart 35 & 36). Similarly, credit standards for mortgages remain tight adding further problems to the demand side of the housing market.
- Note, gap between deposits and loans will improve for domestic banks once they receive NAMA bonds: the gap between loans and deposits for retail banks in Ireland remains extremely large (Chart 37) but this situation has begun to ease after the transfers to NAMA (of course the gap between assets and deposits will only decrease by the amount of the haircut on the transfer).

Chart 33: Private sector credit, y/y% chg

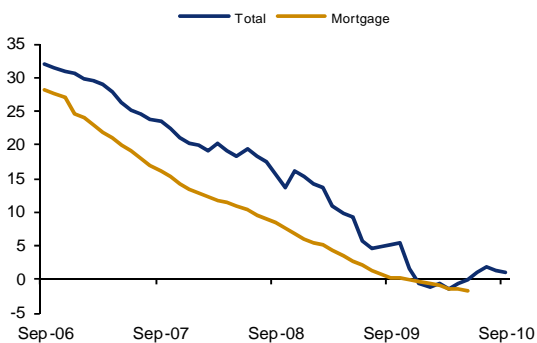


Chart 34: Sector breakdown of credit outstanding, Mar'10

	€mn	y/y% chg
Construction	12,659	-41
Wholesale/Retail Trade	11,891	-15
Hotels & Restaurants	10,578	-8
Real estate & business	86,971	-9
- Real estate activities	81,089	-9
Personal	164,398	-4
- residential Mortgages	146,473	-1
All others (excluding financials)	21,229	-19
Total (ex financials)	307,727	-11

Chart 35: Various interest rates, %

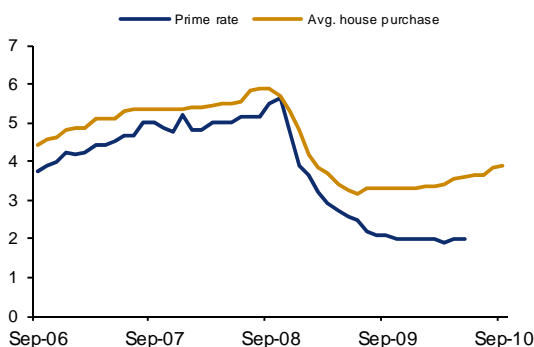


Chart 36: Bank lending survey, credit standards

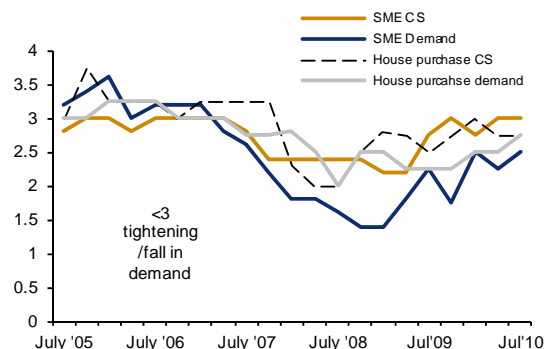


Chart 37: Domestic banks, Irish private sector

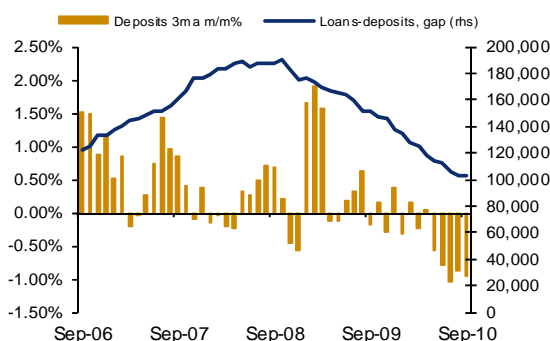
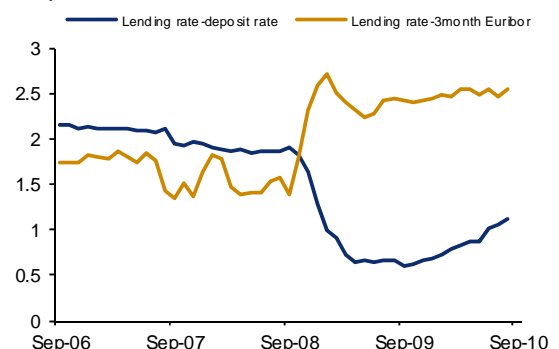


Chart 38: Spread between lending rates and deposit/interbank rates, %



Sources: Authors calculations, Central Bank of Ireland, CSO, Daft.ie, Datastream, Department of Finance, environ.ie, IBF

## Appendix 1: Economic forecasts

y/y% changes unless otherwise stated

	2007	2008	2009	2010	2011	2012	2013	2014
GNP	4.5	-3.5	-10.7	-3.0	0.3	1.6	1.7	1.6
GDP	5.6	-3.5	-7.6	-0.8	1.0	2.1	2.1	2.1
<b>Components of GDP</b>								
Consumption	6.4	-1.5	-7.0	-1.2	0.2	2.0	1.8	1.7
Government consumption	6.9	2.2	-4.4	-2.8	-3.8	-3.0	-2.5	-1.7
Investment	2.8	-14.3	-31.0	-23.6	-3.1	4.5	4.0	3.8
Gross Domestic expenditure		-4.3	-12.4	-5.7	-1.1	1.4	1.4	1.4
Exports	8.2	-0.8	-4.1	6.0	3.7	3.2	3.7	3.6
Imports	7.8	-2.9	-9.7	1.8	2.0	2.7	3.3	3.3
<b>Prices</b>								
CPI	4.9	4.1	-4.3	-1.7	1.5	2.2	1.7	2.3
HICP	2.9	3.1	-1.9	-1.4	0.9	1.8	1.7	2.0
<b>Labour market indicators</b>								
Employment	2.9	-4.0	-7.7	-4.0	0.2	1.5	2.1	2.3
Unemployment rate (year avg)	4.6	6.3	12.2	13.4	13.0	11.7	10.6	9.3

## Appendix 2: Public finance forecasts

	2008	2009	2010	2011	2012	2013	2014
GNP	-3.5	-10.7	-3.0	0.3	1.6	1.7	1.6
GDP	-3.5	-7.6	-0.8	1.0	2.1	2.1	2.1
Revenue receipts (€ millions)	43,022	35,344	34,699	36,964	39,795	42,563	44,935
Expenditure outlays (€ millions)	55,735	59,985	53,281	56,777	56,270	55,822	54,836
Exchequer balance (€ millions)	-12,714	-24,641	-18,582	-19,813	-16,475	-13,258	-9,901
Bond redemptions (€millions)			1,200	4,390	5,576	6,028	11,357
Gross funding need (€ millions)			20,027	24,203	22,051	19,286	21,258
General government deficit, (€ millions)	-13,198	-23,350	-49,455	-15,579	-14,595	-11,378	-7,871
General government deficit to GDP	-6.9%	-14.6%	-31.8%	-9.8%	-8.9%	-6.7%	-4.5%
General government deficit to GDP (excluding financial interventions)	-6.9%	-11.8%	-12.0%	-9.8%	-8.9%	-6.7%	-4.5%
Gross Government debt to GDP (GGD, %)	41.5%	66.1%	99.7%	106.3%	109.0%	109.2%	106.6%
GGD excluding promissory notes, %GDP	41.5%	66.1%	80.0%	88.9%	93.8%	96.0%	95.1%
NAMA bonds			38,500	38,500	38,500	31,500	28,875
NAMA bonds, % GDP			24.7%	24.2%	23.5%	18.6%	16.5%
State liabilities (GGD plus NAMA bonds)			124.5%	130.6%	132.5%	127.8%	123.0%
NPRF assets, % GDP			15.2%	15.2%	15.2%	15.2%	15.2%
Cash balances, % GDP			12.8%	12.8%	12.8%	12.8%	12.8%

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