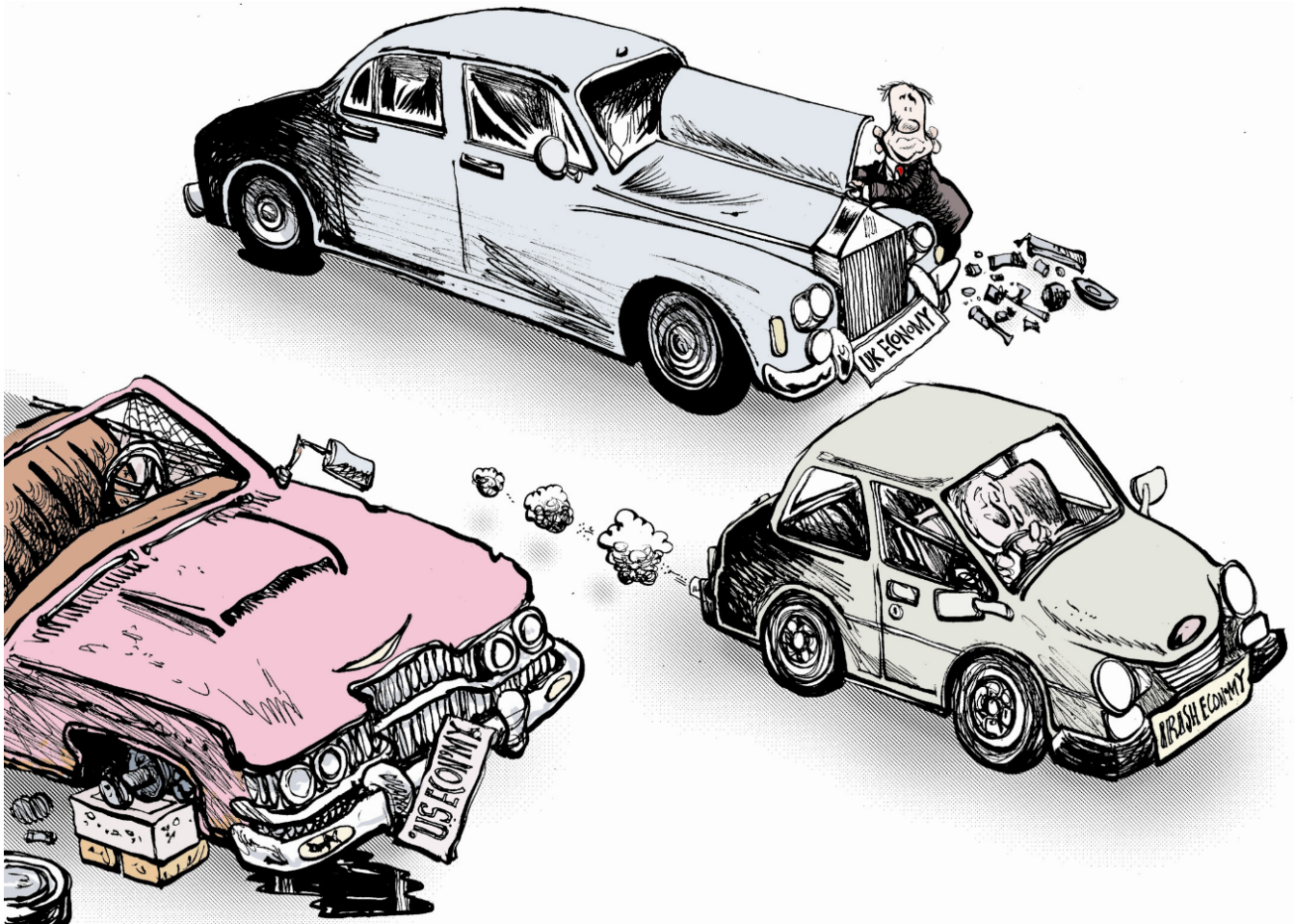


# The Irish Economy: Housing not the Engine of Growth



- The evidence is that the economy continues to perform
- The housing market is not the engine of growth in the economy
- Employment continues to grow, and consumption is strong
- Interest rates have peaked and taxes are not being increased
- Slowing growth in the US and the UK should not be a material drag

## Key Points

The economy is forecast to grow by 3.5% this year. The risks to this forecast, we believe, are to the upside. Current indicators of employment and consumption remain strong, despite weakness in the housing market since late 2006.

In 2009 we would expect GDP growth to move up to about 4.5%, closer to potential.

The housing market was not central to the boom in Ireland. House building currently accounts for about 10% of GDP. The average contribution to GDP growth from housing output since 1997 was just over 1 percentage point p.a., during a period in which GDP grew by almost 8% p.a. In 1996 and 1997 GDP grew by 8.3% and 11.5% respectively. The housing contribution was 1.5 percentage points in each of these years. In the years between 1998 and 2003, the housing contribution was between 0.5 and 1 percentage point p.a., while GDP averaged about 8% p.a. Housing became a more important contributor in the years 2002-2005, but its importance was small in 2006 and negative in 2007. These latter years, nevertheless, saw continuing strong growth in the overall economy.

For most of the period of the surge in growth in the economy, housing output, rather than leading the process, was lagging demand. House prices thus inflated rapidly. Now supply has caught up and a rebalancing of the forces in the market is underway. While supply now appears likely to be cut this year, the demographic forces, which underpinned demand growth since the mid 1990s, are set to remain very strong in the years ahead, though the period of demand acceleration is over. Thus the market should find an equilibrium rather than see a protracted fall in prices.

Currently, the economy continues to perform. While the slowdown in the housing market has been underway since the autumn of 2006, the impact on the wider economy has been minimal. GDP grew by about 5.6% in 2007, despite an estimated negative contribution of 1% from house building. Employment rose by 3.6% in 2007 and consumption by about 6%.

Household disposable income is not threatened by interest rate increases this year. Interest rates have peaked, and while the ECB are currently not for cutting, we think it possible later in the year that they will. The fiscal position in Ireland remains sound and taxes overall have not been altered in the Budget for 2008.

A slowdown in the US and UK should not be a material drag on the Irish economy. The international companies, which dominate exports, are also very large importers. Total employment in these companies is small in the overall economy. While appreciation of the Euro may impinge on some of the domestically owned exporting companies, again the impact on the aggregate economy is expected to be small.

## CONTENTS

### Page

<b>Current Indicators and Forecasts</b>	<b>4</b>
<b>Construction</b>	<b>8</b>
<b>Demographics</b>	<b>12</b>
<b>The Role of Credit</b>	<b>16</b>
<b>The Public Finances</b>	<b>18</b>
<b>The International Economic Outlook and Ireland</b>	<b>19</b>

Table 1- Current Indicators

	2007	2006
Real GDP	6.0% (Q1/Q3)	5.7%
Car Sales	4.3% (Jan-Dec)	4.2%
Retail Sales Volume	6.4% (Jan-Dec)	6.2%
Industrial Production	7.5% (Jan-Dec)	5.4%
Live Register ('000s)	162.3 (Jan-Dec)	157.4
Employment (%)	3.6% (Q1/Q4)	4.5%

## Current Indicators and Forecasts

### Current indicators of economic activity are generally indicating strength

Despite concerns about the possibility that the weakness in the housing market could lead to a generalised slowing of demand and a decline in employment, current indicators provide little evidence of such a development (Table 1). It is now about eighteen months since the housing market began to falter. It seems likely that much of the employment decline resulting from lower house building demand has already happened, since the industry is heavily structured on sub-contracting.

Employment grew strongly in 2007 despite an estimated 20,000 decline in employment in house building. Continued employment growth is the key support for demand. In 2007 car sales rose 4.3%. Retail sales grew by 6.4% y/y in volume and the year ended with December sales up 4.7%. This was spread broadly across most areas of consumption.

Indicators of demand so far in 2008 are mixed. January car registrations were over 12% above a year earlier. This strength may have been because some of the maturing SSIA funds in mid-2007 were used to order 2008 registered cars. According to data from the Society of the Irish Motor Industry, car sales in January and February together were 1.5% below a year ago. Vat receipts in the first two months of the year were over 2% down year-on-year. Income tax receipts rose in the same two month period by just over 3% on a year earlier.

### Growth to slow in 2008 because of housing and lack of SSIA effect

The Irish economy grew by an estimated 5.6% in 2007, fuelled by consumer spending, business investment, exports and government spending. Real GDP is expected to grow by 3.5% in 2008. The growth figure for 2008 reflects solid growth in consumption, exports and business investment. The drag on GDP will come from new residential investment and also from the absence of SSIA induced spending. In 2007 the drop in investment in dwellings reduced growth by about 1 percentage point, compared to what it would have otherwise been, as the number of house completions fell from 88,000 to 78,000.

Table 2 -GDP Expenditure Forecasts - 2008

	2007	Percentage change in			2008
	€mn	Value	Volume	Price	€mn
Personal Consumer Expenditure	90577	7.8	4.1	3.5	97601
Public Net Current Expenditure	28136	9.8	4.1	5.5	30901
Gross Domestic Fixed Capital Formation	48564	-3.6	-3.7	0.0	46798
Value of Physical Change in Stocks	230				300
Gross Domestic Expenditure	167507	4.8	1.9	2.9	175599
Exports of Goods and Services	149173	7.6	5.6	1.9	160501
Final Demand	316680	6.1	3.7	2.4	336101
Imports of Goods and Services	-130101	6.5	3.9	2.5	-138564
Statistical Discrepancy	1080				1080
Gross Domestic Product	187659	5.8	3.5	2.3	198617
Net Factor Income	-27291				-28542
Gross National Product	160368	6.1	3.3	2.7	170075

Personal consumption is expected to grow by 4.1% in 2008 in volume terms following an estimated growth rate of 6.1% in 2007. Strong employment growth, solid earnings and tax cuts allowed consumers to maintain robust consumption growth in 2007 despite higher petrol prices, food prices and increased debt servicing costs. The spending splurge, anticipated on the back of SSIA maturation, was more restrained than initial surveys suggested, with many households opting to rebuild their finances and/or invest in long-term savings prospects - life sector sales were up circa 30% y/y in 2007.

Household disposable income is expected to continue to grow solidly, supported by employment and earnings. For 2008 we expect employment growth of 2%, while nominal earnings are forecast to grow at 4.9% in 2008 (Table 3). Interest rates have peaked and seem likely to be cut later in the year.

Against a background of continued growth in employment, the fall-off in demand for property is likely to boost consumer spending in 2008 as consumers utilise some of the money they would have otherwise spent on moving house. While there may be a slowdown in spending on furniture and appliances for new homes, this is likely to be somewhat offset by existing home owners seeking to upgrade their houses. The significant impact on consumption could come from spending on discretionary items such as holidays, leisure and cars. While car sales according to the Society of the Irish Motor Industry fell by 1.5% in January and February, this is being attributed to the postponement of purchases because of changes in vehicle registration tax which are to take effect from July.

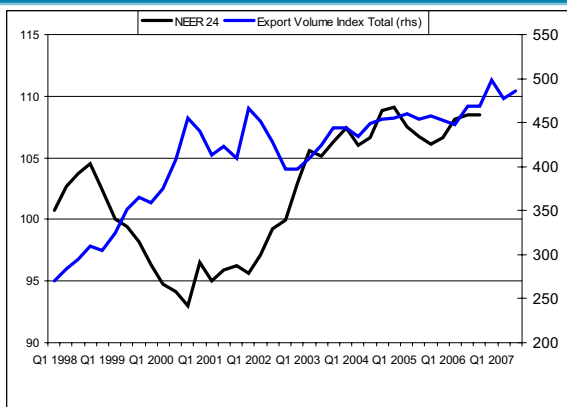
Inflation is forecast to ease from 4.9% in 2007 to 3.1% in 2008. Implicit in the inflation forecast is that the average price of a barrel of oil in 2008 will be \$100, but some of the impact of this on the Irish economy and inflation is expected to be mitigated by the appreciation of the euro. Food prices are assumed to rise by 7% and it is expected that there will be two 25bps interest rate cuts by the ECB - one in June and one in September. In aggregate, consumption expenditure has adjusted smoothly to higher food prices and higher petrol prices; this coupled with the prospect of rate cuts in 2008 should ensure another robust performance from consumers.

**Table 3 -Earnings - y/y% Change**

	Manufacturing	Financial	Public	Construction	Distrib. & Bus Servs	WTD AVG
2003	6	1.6	4.3	4.2	4.6	4.3
2004	4.4	5.6	8.5	4.8	5.1	5.8
2005	4.4	5.2	5.9	7.2	4.1	5.1
2006	3.2	6.9	4.5	1.7	5.8	4.5
2007e	5.1	6.8	5.2	5.7	5	5.4
2003-07	18.1	26.8	26.3	20.7	21.5	22.5
2008(f)	4.1	7.2	5	3	5.2	4.9

Government expenditure was extremely strong in 2007,

**Chart 1 -Nominal Effective Exchange Rate and Export Growth**



largely owing to an increase in voted current expenditure of 12.3% in value terms. For 2008 we project an increase in the volume of government consumption of goods and services of 4.1%, in comparison with 7% in 2007. The contraction in expenditure growth is due to a reduced rate of increase in projected voted current expenditure.

Investment in new residential house building is forecast to fall 30% in volume terms in 2008 after an estimated fall of 11% in 2007. The fall in new dwelling investments reflects the belief that there will be slightly less than 55,000 new home completions in 2008. In contrast we expect RMI (repair, maintenance and improvements) to enjoy another year of positive growth, and pick up some of the slack from residential construction. There is some evidence of this from the 2007 employment data which showed that a large part of the fall in the number of employees in construction was offset by a rise in the number of self-employed. We also expect commercial and civil construction to show positive growth. Overall total building and construction investment is forecast to fall by 9.3% in volume terms in 2008.

The pace of investment in machinery and equipment is expected to remain high, although growth will moderate from an estimated 20% in 2007. This portion of investment is forecast to increase by 15% in 2008.

Overall we expect Gross Domestic Fixed Capital Formation to decrease by 3.7% in volume terms in 2008 as compared with an increase of 2.9% in 2007.

The volume of exports of goods and services grew by an estimated 6.7% in 2007, up from 4.9% in 2006, reflecting a large pick-up in services exports of 9.9%, and a solid performance from merchandise exports which were up 4.7%. Services exports as a percentage of total exports have increased significantly over the last number of years and we see this trend continuing in 2008 with services exports forecast to grow by 8.3% in volume terms and to account for 44% of total exports.

Exports to the Eurozone, US and the UK account for approximately 40%, 18% and 16% of merchandise exports respectively. As Chart 1 illustrates, the nominal effective exchange rate has been rising since 2001 yet the volume of merchandise exports has continued to rise.

Merchandise exports are forecast to increase by 3.7% in



volume terms in 2008. It is worth noting that any slowdown in merchandise exports also results in a slowdown in merchandise imports as the largest exporters in the State are also the largest importers. This point is discussed more fully below. Total exports are forecast to rise 5.6% in volume terms in 2008, compared to 6.7% in 2007, reflecting a slowdown in the world economy.

Imports of goods and services showed strong growth in 2007, up 5.4% on a year earlier. Growth of services imports slowed from 6.4% in 2006 to an estimated 5.4% in 2007. The forecast for 2008 is for services imports to grow by 4.5% reflecting the slowdown in the growth of consumption. Merchandise imports are estimated to have grown robustly at 5.4% in 2007, up from just 2.2% growth in 2006. The increase in merchandise imports reflects the strong performance of exporting companies, which are large importers, and a significant increase in investment in machinery and equipment. For 2008 the forecast is for merchandise import growth to slow to 3.2% in line with slower export growth and a reduced rate of investment in equipment and machinery. In total, imports are forecast to rise by 3.9% in 2008.

The forecasts for import and export growth in 2007 and 2008, imply that the contribution of net trade to GDP growth will be positive.

## Construction

### House building: not the engine of growth in Ireland

Chart 2-House Price Inflation in Ireland

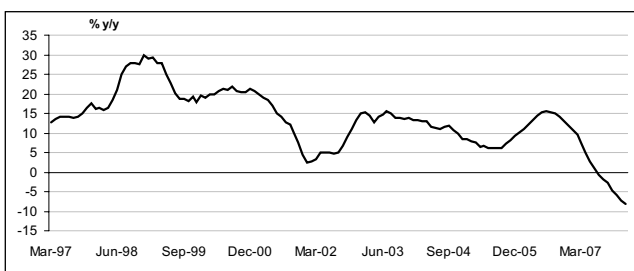
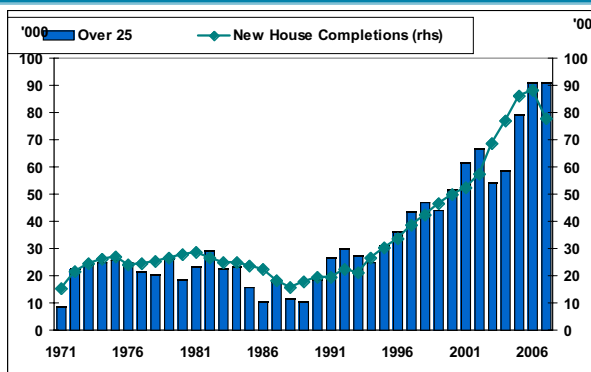


Chart 3-Growth in the Population aged over 25 and New House Completions



House building which currently accounts for about 10% of GDP, contributed about 1% p.a. to annual GDP growth of about 8% p.a. since 1997. Far from leading the boom in the economy, housing output lagged demand during the late 1990s, resulting in very sharp acceleration in house price inflation. As we can see from Chart 2, house price inflation was in the region of 20% per annum between 1998 and 2001. Were it the case that house building led the boom then housing supply would have been expected to be ahead of demand and house prices consequently soft. The main driver of the acceleration of growth in Ireland was the expansion of the population of working age and the resultant augmentation of the size of the domestic market. Demand for a wide range of goods and services grew on the back of this demographic change. Demand for accommodation was a clear beneficiary of this growth in the working age population. Chart 3 plots the broad relationship between the annual growth in the over-25 population, which is a proxy for the demand for accommodation, and housing completions. The growth in this age cohort picked up rapidly from the early 1990s and housing output was at first slow to respond and then much of the latter part of the 1990s and the early part of this decade was a story of builders struggling to match demand. It is implausible to suggest that because credit was available and interest rates falling, there was a largely speculation led boom in housing output over such a protracted period. Were that the case an oversupply situation would have emerged much earlier.

### Housing output has not been a large contributor to GDP growth since 2005

Employment in the private sector grew by over 450,000 between the first quarter of 1998 and the end of 2007. Private services accounted for 330,000 of this and construction 150,000 (agriculture and manufacturing declined). The growth in private services and construction has been driven by demographic change, in our view. There are now 2.1m people at work in Ireland compared to 1.5m in 1998. Of these almost 1m are employed in private services



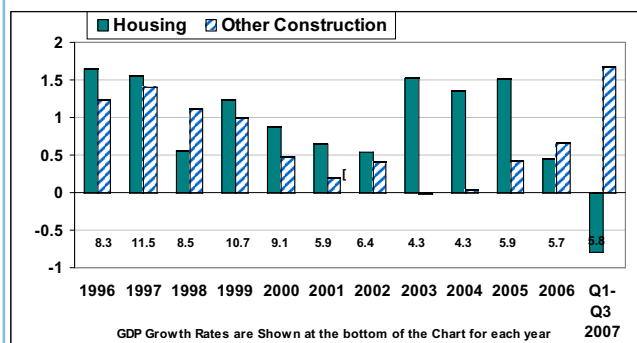
We can see from Chart 4 that the contribution of housing output to GDP in 1996 and 1997 was around 1.5 percentage points. GDP grew by 8.3% and 11.5% in each of those years respectively. In the subsequent five years the contribution to GDP growth from housing diminished to between 0.5 and 1 percentage point, in most instances, while GDP growth averaged 8% per annum. The years when the contribution of housing output to growth was large were 2003-05. In that period GDP growth averaged just over 4% p.a. while the contribution of housing was close to 1.5 percentage points on average. In 2006 the contribution of housing to growth diminished to less than 0.5 percentage point, while GDP rose by 5.7% and in 2007, housing output made a negative contribution of close to 1 percentage point but GDP is still estimated to have risen by about 5.6%. This shows clearly that housing has not been the key dynamic in the economy for the past two years.

### Overall employment has not fallen as house building declined

Just as house building activity did not dominate overall economic activity over the last decade, neither does a slowdown in the sector seem likely to do so. For 2007 as a whole, employment rose by 73,000, or 3.6% from 2006. The largest increase was in financial and business services, wholesale and retail trade, health and hotels and restaurants. Construction was a net positive on average over the year, though it did fall in the final quarter. Employment in private services rose by 41,000 from 2006 and the public sector added 19,000 jobs. Thus the overall picture for 2007 was not dissimilar to that seen in recent years in the Irish economy with growth in private services employment providing the main impetus to growth.

By Q4 2007 employment totalled more than 2.1m in Ireland. This was almost 68,000 above the same quarter in 2006, a growth rate of 3.3%. The growth rate in Q3 was 3.4%. The same sectors were responsible for most of the growth in Q4, as noted for the year as a whole. Employment in private services increased by 59,000 on a year earlier; an acceleration of the pace seen in earlier quarters of the year. Wholesale and retail was particularly strong and financial and business services kept up a strong pace.

**Chart 4-Contributions of Construction to GDP Growth**



The construction sector showed a fall of over 5000 in employment from a year earlier in Q4 2007. There was a fall of 15,000 in the number of employees in the sector, partly offset by an increase of 9,500 in the number of self-employed. Even if we were to regard all of the increase in self-employment as a de-facto rise in unemployment, the numbers are not large in the context of the total increase in employment in the economy. In any case it seems likely that the shortage of labour available for repair, maintenance and house improvement in recent years may mean there is strong pent-up demand for such labour now. Moreover, households which have decided not to move house in the current climate of uncertainty may be spending on upgrading their existing homes.

In regard to employment in house building, the Statistics Office have said provisionally that employment in house building in Q4 accounted for 63% of employment in building and construction compared to 68% in Q1. We estimate, having seasonally adjusted the data, that employment in house-building fell by about 20,000 between Q1 and Q4 2007. This would represent a fall of 10%. Nevertheless total employment in the economy grew by 54,000 over the same period.

### **The slowdown in housing activity was well underway in 2007**

House completions fell by more than 11% in 2007 and housing starts by much more, depending on which of the rather imprecise measures of starts we look at. It seems likely that much of the fall in house building employment, associated with the planned reduction in activity would have taken place last year as well, especially given the extent of subcontracting in the industry. There are not many large house building companies which might have hoarded labour in the hope of an upturn in the sector. Thus in terms of the knock-on effects on employment and demand from the fall in housing output, the largest impact may already be over.

## Non-Residential Construction has been an increasing contributor to growth since 2004

We can see from Chart 4 (page 9) that the contribution of non-residential construction to GDP growth has accelerated sharply since 2004, when it was negligible, to an estimated 1.7 percentage point positive influence in 2007. This growth was underpinned by the 250,000 increase in total employment in the economy since 2004 and will be further bolstered by the large increases in infrastructure expenditure announced in the National Development Plan 2007-13. An example of the scale of the investment involved may be seen in Chart 5 which shows that the Dublin Office Market has doubled to over 3m sq m since 1996. Chart 6 shows that investment in non-residential structures is set to continue to grow strongly. Planning applications for non-residential structures reached 2.7m sq m in the third quarter of 2007 compared to 1.8m sq m in the third quarter of 2006.

## Employment growth is the key determinant of (residential) and non-residential construction

Growth in non-residential construction depends in part on growth in employment. The numbers at work have grown at more than a 4% y/y pace since mid 2004. Income tax receipts, while erratic, as may be seen from Chart 7, averaged an annual growth rate of over 8% per annum during that period. Income tax growth was 6% y/y in the second half of 2007. While unemployment, as measured by the live register data, rose by 30,000 in the year to February 2008, it should be noted that this may well be as much affected by immigration flows as by any softening of employment. The Quarterly Household Survey is the definitive measure of unemployment and it showed an increase of 10,000 in the year to Q4 2007. The key to the strength of the Irish economy is not necessarily captured by the unemployment data but rather by the strength of the employment numbers.

Chart 5-Dublin Office Market 1996-2007

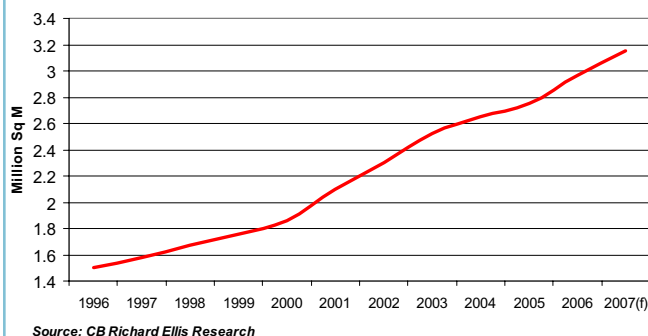


Chart 6 -Non-Residential Planning Permissions ('000 sq metres)

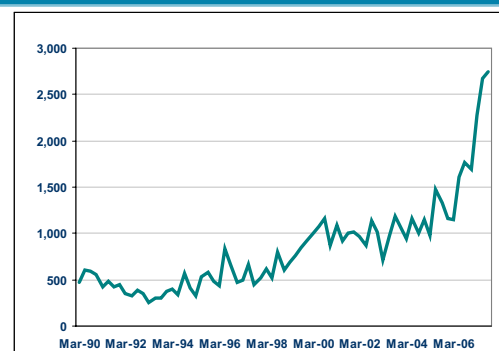
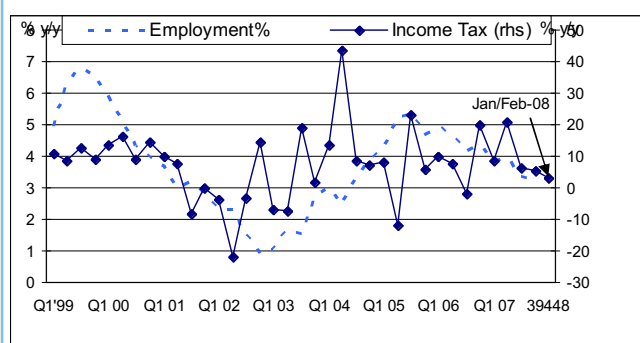


Chart 7-Employment Growth and Income Tax

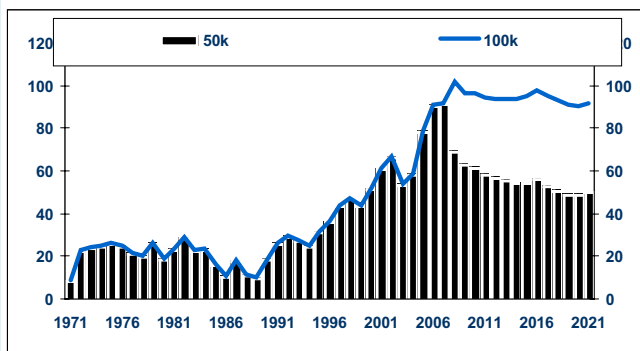


## Demographics

### The population in the peak earning years is set to grow rapidly from here

The age profile of the population is an important determinant of the growth in the domestic market. Of the 4.2m people enumerated in the 2006 census, 1m were aged between 21 and 35. The peak of lifetime earning and spending is in the years between 35 and 54. The eldest part of this 1m bulge in the population, caused by the 1970s-early 1980s baby boom, is just entering this peak earning age cohort. Households, whose head is aged between 35 and 54, account for 50% of total spending in the economy. This age cohort, we estimated in the 2020 Vision publication in 2006, could grow at 3% per annum until 2010. If immigration were to continue the pace of the last two years, (100,000 gross inflow), then the 35-54 population could rise by almost 4% per annum. In the years to 2010 this “structural” change in the composition of the population, by itself, was estimated in the 2020 document to boost consumption by 3% per annum in volume terms. On current rates of immigration this would be the low end of the range of estimates for the growth in consumption due to changes in the structure of the population. So consumer demand, and thus aggregate demand in the economy, is well underpinned by structural demographic factors.

Chart 8-Projected Annual Growth in the Over-25 Population - '000 p.a.



### Immigration and growth of the indigenous population will be supportive of housing demand

Just as consumption is underpinned by the demographic change, so obviously is the housing market. Chart 8 shows the projected growth in the over 25 population, a proxy for growth in the demand for accommodation, on different assumptions about the gross immigration flow.

We can see that at the pace seen in the last two years of 100,000 immigrants, the over 25 population would continue to rise at over 90,000 per annum in the next few years. Were immigration to slow to 50,000 immigrants the over-25 population would rise by about 60,000 p.a. The rate of new household formation associated with each of these migration assumptions would be 62,000 p.a., and 49,000 p.a. respectively. To estimate the required rate of house building implied by these rates of household formation we would have to make allowance for

replacement and second homes. These could run at a combined rate of 20,000 pa. Thus the underlying demand for accommodation, and new house building is very strong, on any plausible assumption about immigration.

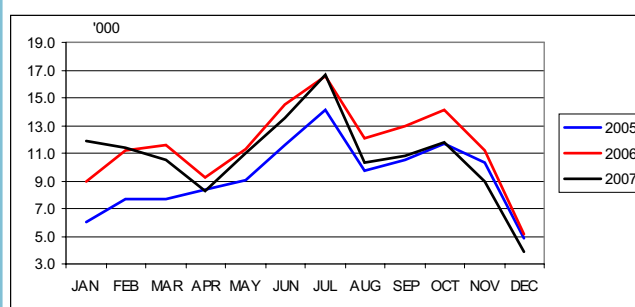
## Immigration is still high and likely to remain so

The immigrant flow, which is mainly from the ten Accession States in the EU, would appear to be still running at broadly the same pace as in 2006 according to data on Personal Public Service (PPS) applications, though the rate did ease in the second half of 2007 (Chart 9). The total number of such applications was 130,000 in 2007 compared to 139,000 in 2006 and 111,000 in 2005. There are more than 100m people in the twelve countries which have joined the EU since 2004, most with incomes well below the levels in Ireland. Given the availability of cheap travel, workers from these countries who have come to Ireland, should perhaps be regarded as a pool of labour available to the Irish economy, rather than as immigrants in the traditional historic connotation. Chart 10 shows the income disparity between Ireland and the Accession countries and provides a compelling reason for their residents, who have the initiative, to come here. Chart 11 shows that 66%, or 183,000 nationals of the ten Accession countries who applied for PPS numbers between 2002 and 2005 were in employment in Ireland in 2006. In the year to Q4 2007, of the 68,000 increase in total employment in Ireland 49,000 were nationals of the accession countries. The percentage of PPS applicants in the 2002-05 period from higher income countries such as the UK and the EU 15 still in employment in 2006 was 30% or below. This suggests that the flows from the low income countries are unlikely to dry up quickly and that most workers from these countries are staying for a protracted period.

## The immediate outlook for housing in 2008 is poor

The indicators available for housing starts in Ireland are the number of housing units insured against structural faults, housing commencements and planning permissions. The structural insurance data does not provide an accurate guide to starts because of the variability in the lag between taking out such insurance and actually beginning to build. The commencements data is only available for the past three years and also

Chart 9-Personal Public Service Number Applications from the Ten Accession Countries



(1) Jan 2008 Applications were 7,000 compared to 12,000 in Jan 2007

Chart 10-GDP per Capita - US \$ 2006

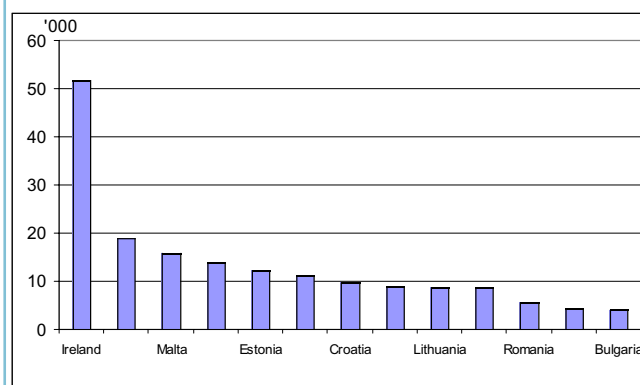
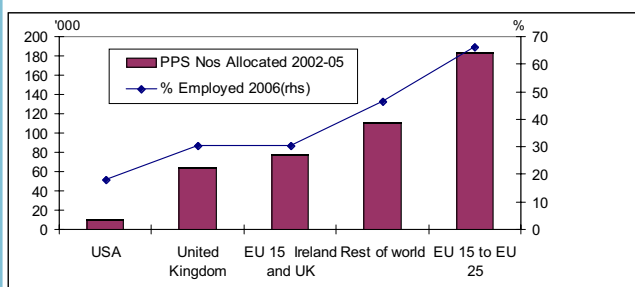


Chart 11-PPS Applicants 2002-05 Employed in 2006



varies considerably relative to house completions data. Statistical analysis of these indicators and house completions data gave very wide ranges for projected completions in 2008. In the case of the structural insurance data the range is 46,000 to 64,000 and in the case of the commencement data it is 42,000 to 60,000. Analysis of planning permission data, also an unreliable short term indicator, would suggest we could see 58,000 completions in 2008. In our forecasts we have opted for a figure of 55,000 for house completions this year, but there is a wide margin for error in this estimate.

### **But the overall economy should continue to prosper**

However, the emphasis being placed on how large the decline in housing output could be this year, and implicitly how sharp will be the slowdown in the overall economy, misses the point about what really drives growth in Ireland. In purely mechanistic terms, since housing output is about 10% of GDP, every 10% reduction in housing output would lead to a cut of 1% in GDP growth. However, the economy does not operate in such a purely mechanical mode. As long as employment is stable or growing, which it is, then the money not spent on moving house last year and this, because there is uncertainty about the extent of house price reductions, is unlikely to all be saved - particularly by non-first time buyers and those in the buy-to-let category. Spending on other consumption seems likely in these circumstances. So if a house moving decision is postponed or eliminated entirely, it may be decided to change the car or upgrade the existing house. While car sales have dipped so far this year, this could be because of the forthcoming change in vehicle registration tax. The repair, maintenance and improvement element in construction seems to be growing strongly. Thus a slowdown in housing output is not central to the performance of the Irish economy. Rather it is the overall growth in employment, mainly in the service sector which is crucial to economic performance. Underlying this are demographic influences which are expanding the size of the domestic economy.

### **Housing affordability is improving sharply**

While the underlying demand for accommodation is well underpinned by demographic factors, the housing market in Ireland has clearly slowed in the past year. This would



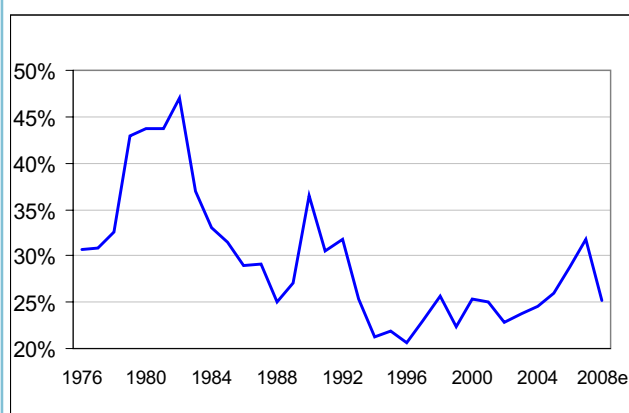
appear to be because an over-supply situation had developed coupled with a deterioration in affordability. By the end of 2006 house prices had been rising strongly for most of the previous ten years (Chart 2). ECB interest rates had been increased from 2% to 4% and, until recently, further hikes were expected. Affordability had thus deteriorated (Chart 12). The percentage of household disposable income required to make repayments over 25 years on a 90% loan on the average house price is estimated to have been almost 32% in 2007 compared to the less than 25% that had prevailed since the mid-1990s. Historically, periods of weakness in the housing market were associated with repayment burdens well in excess of 30%.

At this juncture it appears that Eurozone interest rates have peaked and are likely, in our view, to be reduced in later in the year. While activity in the housing market is generally sluggish, there are anecdotal reports that builders who have cut the price of new houses by 15%-20% are seeing strong demand. In our affordability estimates, if we assume a 15% fall in house prices in 2008 and interest rate cuts in the second half of the year totalling 50bps, we can see from Chart 12 that the mortgage repayment burden falls back sharply to almost 25% of disposable income in 2008. Each 10% cut in house prices reduces this percentage by 3 points and the assumed average decline of 25bps in interest rates over the year would cut the percentage by 0.8%. However, asking prices generally have come down only slowly. Data from MyHome.ie suggest that in Q4 2007 asking prices nationally were only 1.6% below the peak in 2006. At this pace it will take some time for the market to clear. However, the lead taken by some builders in cutting prices may accelerate the fall in asking prices of houses which have been for sale for a long time. This combined with growing expectations of interest rate cuts may begin to help activity pick up as the year progresses.

### **So it is not so much a “crash” as a price correction appropriate to a more balanced market**

The conditions for what could be described as a crash in the housing market would not appear to be in place. Interest rates have peaked at a relatively low level, fiscal policy is mildly expansionary and employment and earnings are still rising. Thus when the market clears any “overhang” normal functioning should resume, since

**Chart 12-Percentage of Household Disposable Income on Mortgage Repayments**



underlying demand for accommodation, driven by demographics remains strong. This could happen relatively quickly because builders would appear to be cutting back sharply on their plans for this year's output and first time buyers seem to be more active in the market, supported by favourable income tax treatment.

## The Role of Credit

### The pace of credit growth has eased since the dramatic rise in early 2006

Total private sector credit (PSC) outstanding reached €379bn in January 2008, up 16.8% (adjusted) on January 2007. PSC growth had accelerated from 2004 reaching 30% y/y in June 2006 as house prices and housing activity continued to accelerate and non-mortgage credit also boomed. Since then credit growth has decelerated (Chart 13). Mortgage credit growth peaked at 28% y/y in March 2006 but by January 2008 had slowed to 12.9% y/y.

### Mortgage credit accounts for a large part of personal debt in Ireland

A sectoral breakdown of PSC is available up to December 2007 (Table 4). This shows that borrowing by private households represented 53% of total non-financial credit outstanding. This is down from its share of 57% in 2004. Of this mortgage borrowing accounted for 45 percentage points in December 2007. Thus mortgage credit in Ireland accounted for 86% of personal credit outstanding in 2007 compared to a Euro area average of 71%. Real estate and renting accounted for 25% of Irish credit outstanding in 2007, up from 19% in 2004. The share of construction was up from 6% to 8% in the same period. Together real estate, renting and construction held a 33% share in total non-financial credit outstanding in December 2007. Growth in personal lending contributed 49% of the total increase in credit to the non-financial sector between December 2004 and December 2007, while real estate, renting and construction contributed almost 40%.

Chart 13-Growth of Private Sector Credit

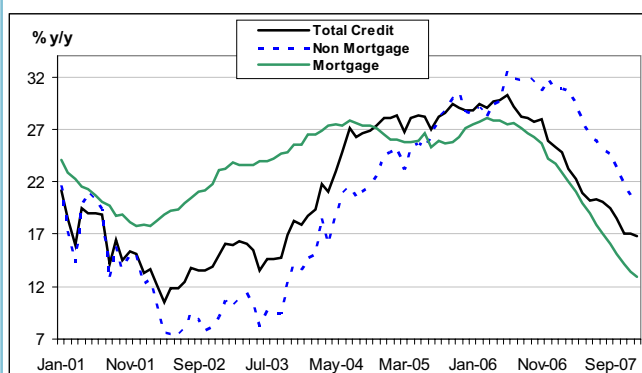


Table 4-Composition of Private Sector Credit

€m	% of Total Dec 2004	Dec-04	Dec-07	% of Total Dec 2007
Personal	57	94,879	182,319	53
Real estate, Renting	19	32,247	86,101	25
Construction	6	9,547	25,980	8
Manufacturing	3	5,509	8,082	2
Wholesale /Retail	5	7,724	13,483	4
Hotels & restaurants	4	7,002	11,745	3
Other	6	9,894	16,999	5
<b>Total non-Financial</b>	<b>100</b>	<b>166,802</b>	<b>344,709</b>	<b>100</b>

## While mortgage credit growth in 2008 may slow further it should pick up in 2009

Chart 14 shows the relationship between mortgage credit growth and the over 25 population. Clearly in the past year the growth in credit has slowed despite the continued fast increase in the size of the over 25 population. However, as Chart 15 shows the recent softening of house prices would appear to have been the dominant influence on credit growth. We have estimated the impact on mortgage credit growth of both the change in the over-25 population and the change in house prices. If immigration continues at 100,000 per annum for the next few years and house prices, having fallen 7% in 2007, fall 10% in 2008, mortgage credit growth would be estimated to be about 12% this year. Were house prices to fall 15%, mortgage credit growth would be forecast at 8% in 2008. The pace would be estimated then to rise to about 18% in 2009 and 2010 on the assumption that house prices remained unchanged and that immigration continued at 100,000 p.a. Were immigration to slow to 50,000, it would imply that, retaining the above assumptions about house prices, credit growth this year could slow to about 8% and then rise to 14% in the following two years.

## Consumption growth in Ireland has not been based on borrowing

The contention that Irish people are borrowing for consumption purposes does not seem to bear up to scrutiny. As outlined above mortgage borrowing accounts for 86% of personal credit growth. Chart 16 shows the ratio of household consumption to personal disposable income for Ireland the UK and the US. Apart from 2000 the Irish, on aggregate spent between 91% and 92% of their income. This is in contrast to the US and the UK where there has been a general updrift in the proportion of disposable income consumed. The percentage of disposable income consumed for both those countries stands at between 95% and 96%.

## Credit Card debt shows no signs of increasing

Total outstanding debt on personal credit cards stood at €2.8bn in January 2008, up 9% y/y. Most of the increase in credit card debt outstanding was due to the increasing number of credit cards. The number of personal cards

Chart 14-Growth of Private Sector Credit

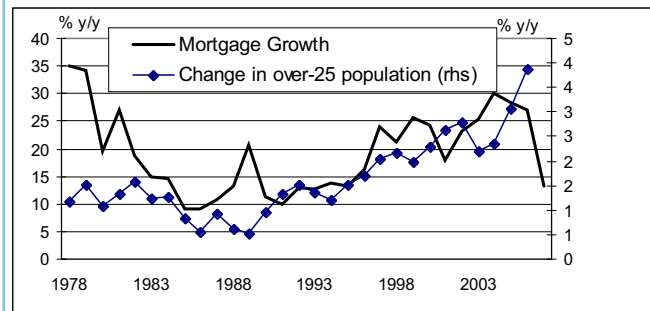


Chart 15-Mortgage Credit and House Prices

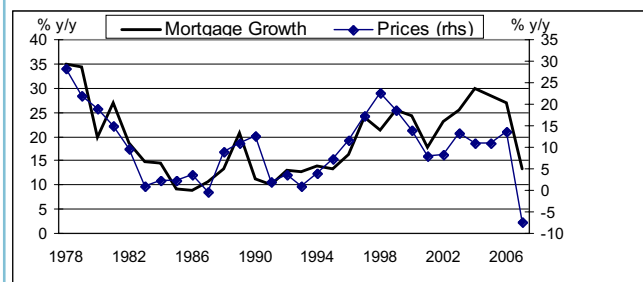


Chart 16-Consumption as % of Disposable Income

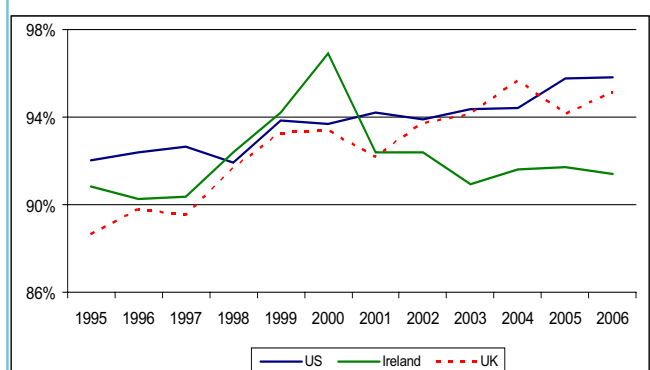
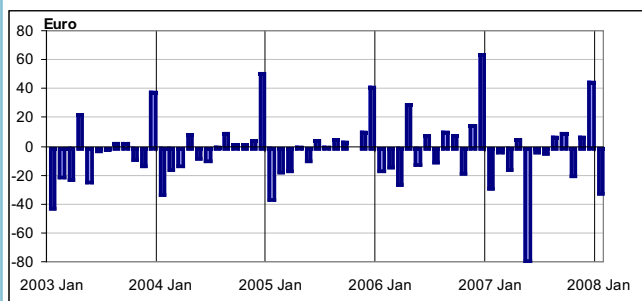


Chart 17-Spending less Payments per Card



issued rose 6%, or 120,000 between Jan 07 and Jan 08. Increased numbers of cards and increased usage would cause the average aggregate debt to grow. But as Chart 17 shows, spending less payments per month on personal credit cards is not trending up. The pattern suggests that consumers' peak of spending over repayment is in December at around €50 and then payments exceed spending for the following few months. The large excess of repayments in May 2007 was likely because of consumers using SSIA windfall to pay off credit card debt. January of 2008 saw the largest excess of payments over spending for January since 2005.

## The Public Finances

In 2007 there was an Exchequer deficit of €1.6 billion or 0.9% of GDP as compared with a budget target deficit of €546 million. The General Government balance showed a surplus of 0.5% of GDP in 2007. The worse than expected exchequer figures were due to a shortfall in tax revenues. Nonetheless the current budget balance still showed a surplus of approximately €7 billion or 3.7% of GDP.

Table 5 - Fiscal Projections

	2007	2008 Outrun	2009 Projection
<b>Current Budget</b>			
Net Current Expenditure	40890	44827	47333
Total Current Receipts	47887	49594	52498
Current Budget Balance	6997	4767	5165
Current Budget Balance % of GDP	3.7%	2.4%	2.5%
<b>Capital Budget</b>			
Net Capital Expenditure	10024	11089	11706
Capital Resources	1408	1456	1516
Capital Budget Balance	-8616	-9633	-10190
<b>Exchequer Balance</b>			
Exchequer Balance	-1619	-4866	-5825
Exchequer Balance % of GDP	-0.9%	-2.5%	-2.8%
<b>General Government Balance</b>			
General Government Balance	904	-1845	-2410
General Government Balance % of GDP	0.5%	-0.9%	-1.1%

The Exchequer deficit is due to rise to 2.5% and 2.8% of GDP in 2008 and 2009 respectively. The outlook is for a General Government budget deficit of 0.9% in 2008 and -1.1% in 2009. These projected balances include the cost of funding the National Development Plan 2007-2013. The current budget surplus is expected to come in at approximately 2.5% of GDP in 2008 and 2009.

The large current budget surpluses over the last number of years have enabled the government to finance capital expenditure without increasing debt. The government debt to GDP ratio has fallen from 32.2% of GDP in 2002 to 25.1% in 2007. The figure is expected to rise to 25.9% in 2008 and 27.6% in 2009. The expected debt to GDP figures will still be close to lowest in the EU.

## The International Economic Outlook and Ireland

### While the international environment has deteriorated the implications for Ireland may not be particularly adverse

Developments in the international economy have been dominated since last summer by the US housing market and the sub-prime crisis. While many commentators believe that a slowdown in the US economy and a depreciation of the US dollar will have adverse consequences for the Irish economy, we are not so convinced. The main impact on Ireland may stem from the tightening of credit conditions and increased funding costs brought about by uncertainties about the credit worthiness of counterparties in the banking system.

A recent IMF paper entitled "Spillovers to Ireland" encapsulated the view that Ireland is a small open economy and thus vulnerable to shocks from a slowdown in the international economy. The paper said that should US GDP fall by 1% then Irish GDP would fall by 1 ¾ percent and furthermore that Ireland's competitive position would have an adverse effect on growth in the future. These points are driven by the misconception that Ireland's economy is largely export driven and that Ireland's competitive position is deteriorating.

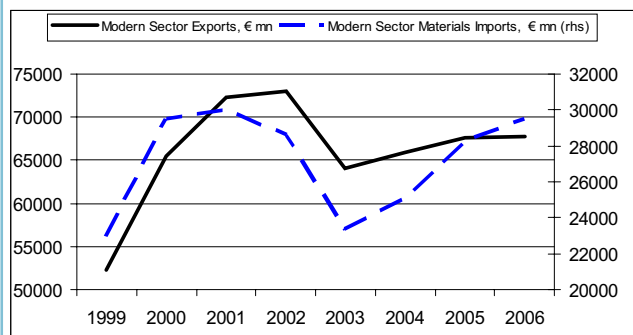
The paper stated that "shocks that cause one percentage point declines in annual US, Euro area, and UK GDP over a 4-quarter horizon cause annual Irish GDP to decline by about 1 ¾, 1 ½, ¼ percentage points, respectively" Given that the author foresees a decline in Irish GDP in the same time frame, the major mechanism through which Irish GDP would be affected as a result of a 1% decline in these other economies would be through exports.

However, it is not gross exports that are the key component in Ireland's growth rate but rather the net export contribution. While exports have risen rapidly over the last decade, so too have imports. Indeed the contribution of net exports to GDP growth has slowed markedly over the last 4 years as Table 6 illustrates.

**Table 6 - Contribution of Net Exports to GDP%**

Year	GDP %	Contribution of Net Exports to GDP%
1998	8.6	-0.3
1999	10.9	3.3
2000	9.4	1
2001	5.9	2
2002	6.4	2.4
2003	4.3	1.6
2004	4.3	0.3
2005	5.9	-1
2006	5.7	0.6

Chart 18 - "Modern" Sector Exports and Imports



### Foreign owned companies dominate Irish exports but they import a large proportion of their inputs.

Year-on-year percentage changes in exports and imports tend to move closely together. The “modern” (Pharma and Hi-Tech) sector of the economy is 80% foreign owned and accounts for 37% of industrial employment (as of Q2 2007 85,200 of the 239,000 employed in industry). The “modern” sector accounts for 70% of gross value added in industry and approximately 80% of all merchandise exports. It accounts for approximately 70% of all producer goods imports or 50% of total merchandise imports. Thus exports, which are dominated by this “modern” sector, tend to determine a large part of the fluctuation of imports. (Chart 18)

Thus to the extent that international demand slows down, diminishing demand for Irish exports, so too will it tend reduce imports. The impact on net exports and thus GDP growth may thus be minimal. Employment in the modern sector of the economy has fallen by 10,000 since 2000 to 85,200 in 2007, a period in which total employment in the economy rose by over 400,000.

Aside from labour cost issues, discussed below, the strength of the euro has also been cited as a major cause of concern for exporting firms and the Irish economy. Exporters from the traditional sectors will be more adversely affected by rising exchange rates as they import less of their materials and have smaller margins than firms in the modern sector. As the Central Bank has pointed out, an appreciation of the euro against the dollar has a negative impact on gross exports but this effect is less than for a proportionate appreciation against sterling. This reflects the different nature of the trade in US dollars, which is largely either trade between branches of multinational firms or trade in modern sector products, that are denominated in dollars.

The modern sector accounts for nearly 80% of exports and these firms import the majority of their materials. As a result they should be able to maintain margins, as the euro rises and thus remain competitive. Finally, it is worth reiterating that Ireland’s biggest trading partner is the Eurozone. In aggregate, the effect of a strong euro on the exports figure will be contained as a result of the composition of Ireland’s export sector. Perhaps the best



illustration of this is the fact that growth in exports has continued despite the rising nominal effective exchange rate (NEER) as shown in Chart 1.

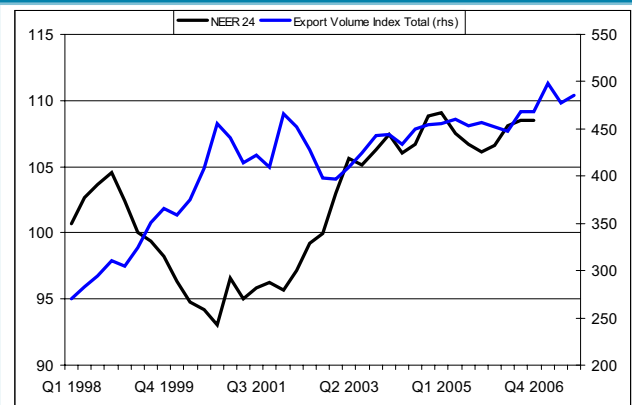
The IMF paper also stated that “The past deterioration in Irish competitiveness may have a stronger adverse impact on Irish GDP over time than has been observed so far.”

One of the most important elements regarding competitiveness is unit wage costs and how those unit costs compare with those elsewhere in the world. In this regard, the Irish Central Bank regularly publishes an index which relates unit wage cost developments in Irish manufacturing to the weighted average of those in trading partner countries. There has been little change in Ireland's comparative position since 2000 (Chart 19). But in that year, unit wage costs relative to trading partners were running around 57% below where they had been a decade earlier. Note that the Central Bank index includes an estimate for 2007 based on an assumed 3.5% rise in hourly earnings in Irish manufacturing.

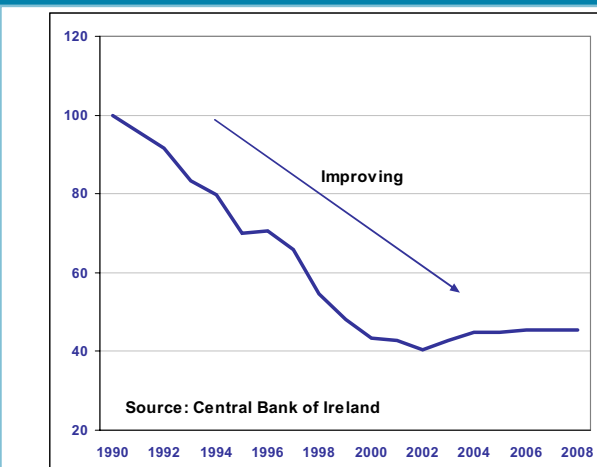
Even were wage costs to grow more sharply than the Central Bank assumes, the impact on the profitability of Irish manufacturing exporting would depend on how important wage costs are in the general scheme of things. Exports of chemicals (mainly pharmaceuticals) and machinery and equipment (primarily electronic equipment) constitute the majority of Irish exports and have provided most of the growth in exports in the past ten years. These sectors comprise what is officially designated the “modern” segment of Irish manufacturing industry. It is also, of course, the segment dominated by foreign multinational companies. Exports accounted for over 94% of these firms’ turnover. However labour costs are a small part of the equation for these companies, amounting to only 5% of turnover. In the remainder of the manufacturing sector, labour costs are substantially more important, at 21.5% of turnover, but export-orientation in these companies is small, generating less than 10% of turnover.

Unlike relative manufacturing unit wage costs, relative unit wage costs have been rising in the services sector since 2000. However, it is difficult to believe that Ireland can become “uncompetitive” when its labour market is open to almost all EU countries. The twelve new states in

**Chart 19 -Nominal Effective Exchange Rate and Export Growth**



**Chart 20 -Relative Unit Wage Costs**



the EU have much lower pay levels than Ireland and nationals of ten of them have free access to Ireland's labour market. This influences wage levels across almost all sectors of the Irish economy including those which might previously have been perceived as "sheltered" from international competition, take hairdressing as an example.

Unit wage costs do not take into account changes in non-labour business costs, including rents, energy, communications, insurance and waste. The National Competitiveness Council assessed the cost competitiveness of a number of Irish regions relative to international locations for a number of firms in key sectors. Of fourteen cities benchmarked, Dublin was ranked third most expensive for firms in the telecommunications software, fund administration and biotechnology sectors, fourth in the medical technologies, engineering, business hotels and biopharmaceuticals sectors, and fifth in the food processing sector. Cork, Galway and Limerick, had an overall cost advantage against most EU-15/US locations.<sup>1</sup> Enhanced competition in key areas such as energy, telecommunications and the professional services has the potential to lower the price of these non-labour costs. While the Government has been slow to adopt many of the changes suggested by bodies such as the National Competitiveness Council and the Competition Authority there has been notable progress in some areas, for example the telecommunication and banking sectors – and an increased focus by Government on the importance of competition.

In addition to price and cost developments, structural factors such as the business environment, the quality of the labour force and infrastructure are also important determinants of competitiveness. In this regard Ireland ranks well in comparison to other European countries, ranking second behind Finland in terms of overall business environment. The economy ranks particularly highly in terms of its tax system (first in the euro area), its legal and institutional framework (second) and the image of the country (second). Ireland's production infrastructure however only ranks seventh<sup>2</sup>. The National Development Plan (2007-2013) will make an important contribution in improving this element of the competitiveness package. Ireland is recognised as a

<sup>1</sup> Annual Competitiveness Report: Volume 1, Benchmarking Ireland's Performance available at <http://www.competitiveness.ie/>

<sup>2</sup> ECB Occasional Paper No.30 "Competitiveness of the Euro Area", p 53.

good place to do business with a tax regime, a regulatory environment and a workforce that is supportive of enterprise and investment. The continued investment in R&D and infrastructure and a proactive competition policy by the Government will ensure that Ireland remains competitive in the future.

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