26, January 2010

The Irish economy in 2010, growth and contraction

After a chaotic year in 2009, we expect the Irish economy to expand and contract in 2010. That is not a typo, we are forecasting that GDP will expand by +0.6% and that GNP will decline by -0.5%. The dichotomy between the two measures of activity is reflective of our expectation that exports will perform robustly in the face of global recovery while domestic demand will remain subdued. In 2011, we are looking for GNP to expand by 2.8% and GDP to expand by 3.3% (Appendix 1).

Price discounting by retailers has supported sales to-date. We expect price pressures to remain subdued in 2010, with the HICP declining by -1.2%. With prices declining, consumer confidence stabilizing and consumer attitudes shifting towards value we expect the volume of retail sales to grow in 2010. Retail sales represent approximately 45% of consumption with spending on transport, communications, professional services and housing making up most of the difference. Job losses and emigration, expected to total 30,000 in 2010, will weigh on overall consumption and as such we expect consumption to contract marginally in 2010. From 2011 onwards we expect consumption to grow at 2-3% per annum as employment and wages begin to grow and the savings rate begins to decline from its 2009 high of 11%.

Investment will once again be a major drag on the Irish economy in 2010, driven by another large decline in construction investment (-23%). We actually expect machinery and equipment investment to pick up in 2010 and average 5-6% growth over the period 2011-2014. The residential and commercial property market remains oversupplied and as such we expect construction investment to remain subdued over the next number of years. In percentage terms, we expect there to be little uplift in non-residential construction, in contrast to the residential new-build sector were there is likely to be quite a large increase in percentage terms as the number of completions works its way from 15,000 to 25,000 in 2014. Overall, it translates into modest increases in construction investment and total investment going from -15%y/y to +7%y/y in 2014.

As we stated back in April when there was a lot of worry about Irish government bonds, Ireland will not have a problem funding itself providing it sticks to its fiscal consolidation plan. Budget 2010 gave Ireland credibility but action is needed in each budget out to 2014. Government spending is expected to contract in each year between 2010 and 2014 as the government continues to shrink current expenditure in light of the budgetary deficits. The General Government Deficit ("GGD") is forecast at 11.0% of GDP in 2010, down from 11.4% in 2009. The GGD is forecast to decline to 4% of GDP by 2014 if a further €6.5bn is taking from current expenditure/taxation. This represents 4% of 2009 GDP or 7% of personal disposable income. The debt to GDP ratio is forecast to reach 78% by the end of 2010 or 112% if the NAMA bonds are included.

In sum, the domestic part of the economy is forecast to decline by 3.5% in 2010 after declining by 12% in 2009. In 2011, domestic expenditure is forecast to increase by 1.4%. Net exports are therefore set to be the main driver of growth in both 2010 and 2011 as the domestic Irish economy remains weak. Our view on the global economy is that it will perform better than expected in 2010 on the back of loose monetary policy and expansive fiscal policy. Post-2010 we are not expecting a double-dip in the advanced economies but for these economies to muddle through as life support in the form of accommodative monetary and fiscal policy is withdrawn.

It is necessary to continually questions one's views, especially as forecasting is even more than usual, extremely uncertain at this juncture. There are always numerous risks to an outlook; highlighted below are some of the major ones which we will be on the look out for in relation to the Irish economy.

Downside risks	Upside risks
• Global economy double-dips • Euro continually appreciates, particularly relative to sterling • Competitive/fiscal adjustment stalls • Savings rate stays stubbornly high as consumers remain in their shells • ECB hikes rates aggressively, increasing the repayment burden for an indebted economy • The remaining fiscal consolidation falls squarely on the shoulders of taxation. • The recovery is initially driven by exports but this does not translate into robust job creation	• Policy makers play a perfect game, demand from current account surplus countries comes on stream quicker than anticipated and the global economy enjoys an inflation free boom • Savings rate falls quicker than anticipated, leading to a virtuous cycle of consumption, job growth, consumption etc… • Investment by firms in equipment and machinery rebounds aggressively as confidence filters back • Credit conditions loosen, influx of new firms taking up commercial real estate, allowing non-residential construction to take off again.

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Quarterly growth, NCB activity indexes and projections…

- Broad picture: The NCB economic activity index continued to improve in Oct and signaled that underlying activity was still contracting at a -2% annualized rate (Chart A). The indicator is designed to look at the underlying trend in economic activity and therefore will not be as volatile as the GNP/GDP figures. Our more timely, PMI based, growth indicator also continued rising and actually breached the 50 mark in December signaling broad based stabilization in economic activity (Chart B). We are now looking for GNP to expand by the end of Q1 2010.

- We had been looking for GDP to expand in Q4 2009 but it actually came sooner and grew in Q3 2009 (Chart D). GDP increased by 0.3% q/q in Q3 on the back of a large contribution from net exports. GNP in contrast, declined by -1.4% q/q. There were also large downward revisions to the Q2 figures. GDP was revised from flat to -0.6% q/q and GNP was revised down by a full 1.2% from -0.5% to -1.7%. Growth has returned thanks to net exports, but shrinking imports outpacing shrinking exports is not a sustainable way for an economy to boost employment, which is ultimately needed for a sustainable recovery. The value of GNP has now declined by 20% from the peak; this is an enormous adjustment. Much of the personal debt is from the years 2005-2007, whereas the economy is now operating at a 2004 level.

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

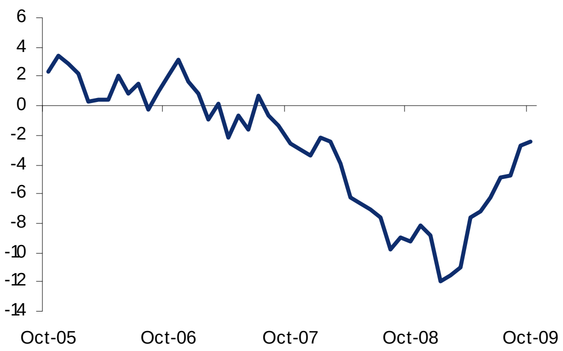


Chart B: NCB PMI growth indicator, >50=growth**

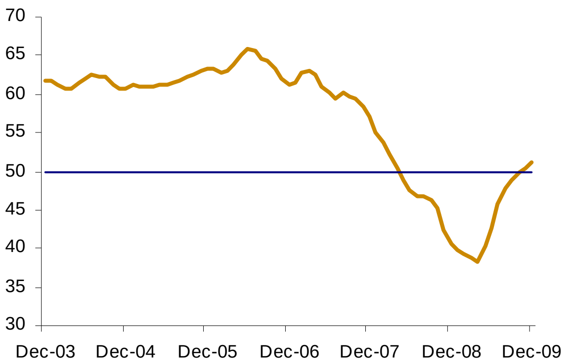
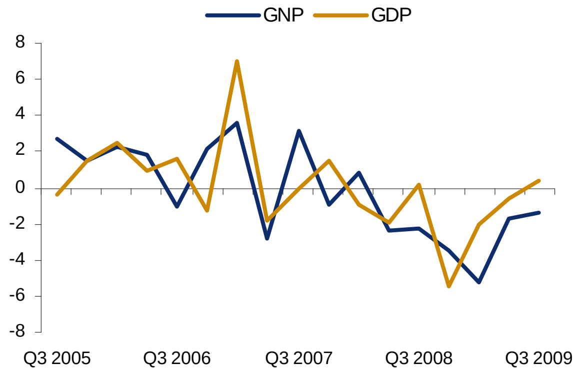


Chart C: Irish GDP, saar €bn

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 PMIs continue to signal contraction but are edging ever near to the 50 mark which signals stagnation. The services PMI regained ground in December after falling back and importantly new orders followed (Chart 2). The manufacturing PMI did not enjoy as much of an increase as the services PMI but nonetheless held its ground, the only disappointing thing being a downturn in the new orders index (Chart 1). New orders from abroad expanded once again in both the services and manufacturing PMIs, highlighting the pick up in global activity.

- The Ulster Bank construction PMI for December showed that job shedding continues in the sector. This is not surprising as commercial activity which began in the good times is still only being finished off. In general the construction sector remains extremely weak with the headline construction PMI falling back to 33.1 its lowest level since May 2009. There were sharp declines in residential, commercial and civil activity in December. Construction investment will continue to be a drag on economic growth in 2010 and will only make minor contributions post-2010 given the large amount of supply in both the commercial and residential markets. The job losses are therefore likely to continue in the construction sector and be a structural loss in employment.

Chart 1: NCB manufacturing PMI

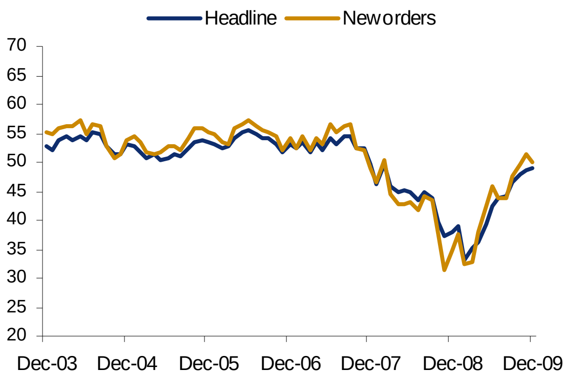


Chart 2: NCB services PMI

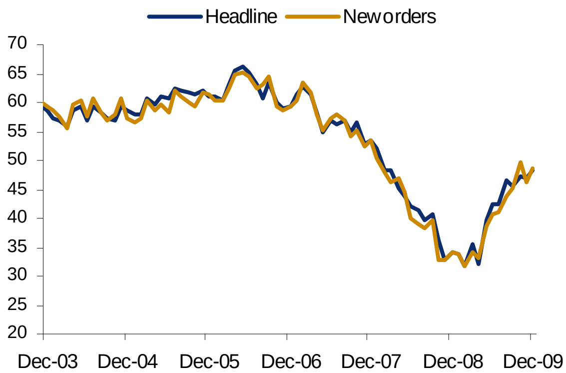


Chart 3: Ulster Bank construction PMI

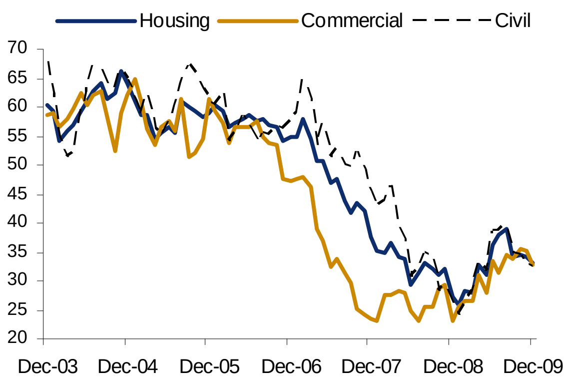


Chart 4: NCB growth indicator, >50 = growth

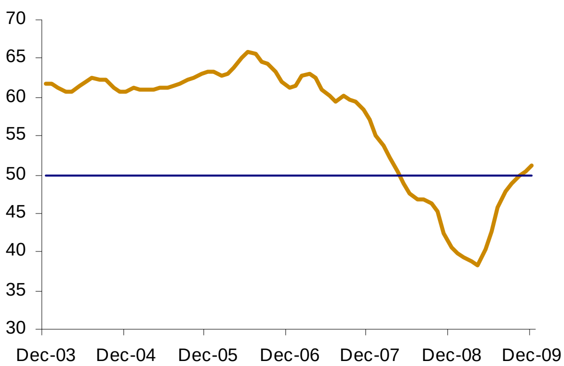


Chart 5: Value €bn and q/q% chg in volume of GNP and GDP

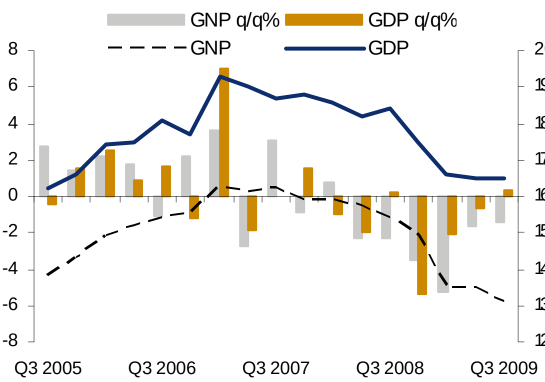
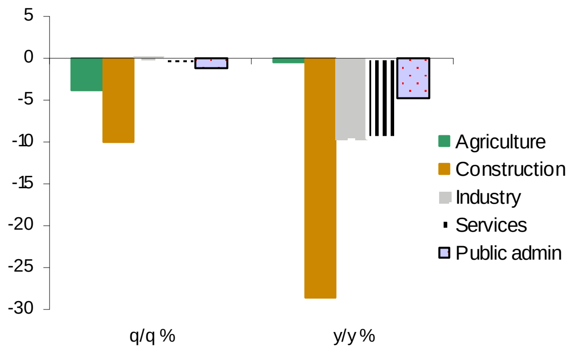


Chart 6: % chg sector in Q3 2009



Consumer and labour market …

- Broad picture: As is evident from the CPI, in the majority of sectors, firms have to continuously discount in order to keep people consuming. The volume of retail sales has risen by 15% from the January low but the value of sales has risen by only 9% over the same period. Price levels are likely to continue falling in 2010 and we are forecasting that the HICP will fall -1.2% in 2010 after falling 1.7% in 2009. Price declines have cushioned some of the blow to income levels and this combined with a shift in consumption behaviour towards discount stores will help the volume of consumption remain approximately flat in 2010 after a decline in the order of -7.5% in 2009.

- The Live Register unemployment rate having stabilized at approximately 12.4% for 4 months ticked up to 12.5% in December, the highest reading of the current cycle. . The emigration valve is likely to continue alleviating the rise in the unemployment rate but ultimately employment gains are unlikely to be vigorous enough to stop the unemployment rate continuing to rise towards 13.5% next year. On a seasonally adjusted basis employment has now fallen by 236,300 or 11% from the peak to stand at 1,903,800, with the pace of decline reaccelerating to -2.1% q/q in Q3.

Chart 7: Live register data, sa

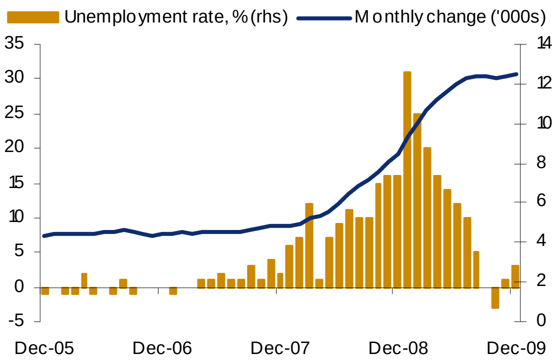


Table 1: Employment by broad sector

	000s	q/q % chg
Agriculture & others	199.2	-1.0
Industry	252.1	-4.7
Construction	151.5	-5.5
Wholesale & retail	271.8	-3.1
Transport & storage	96.1	0.3
Hotels & restaurants	123.3	-1.7
Business, IT & science	350.5	-0.1
Public admin, education & health	478	-0.4
Total	1922.4	-2.1

Chart 8: Irish inflation, y/y %

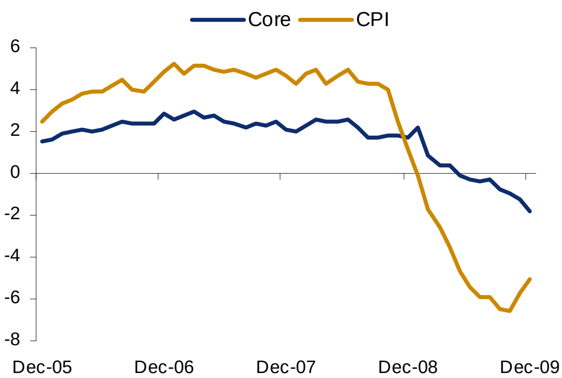


Chart 9: Consumer confidence, 3 month ma

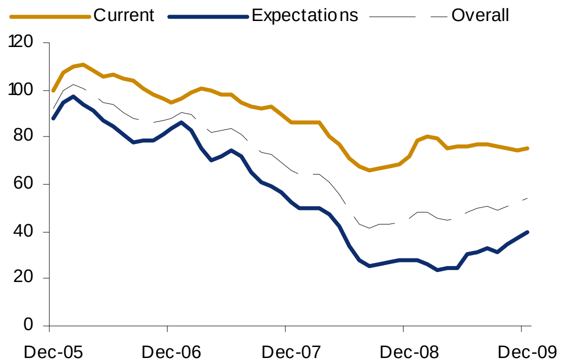


Chart 10: Retail sales ex motors, 3 month ma

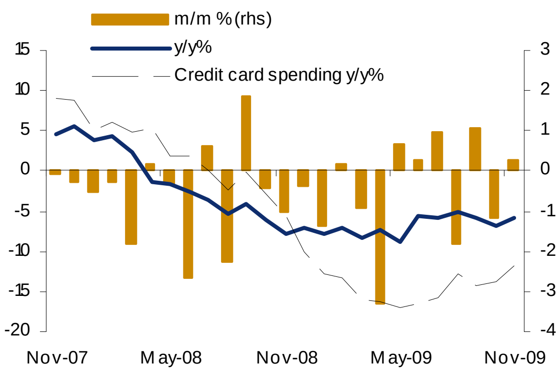
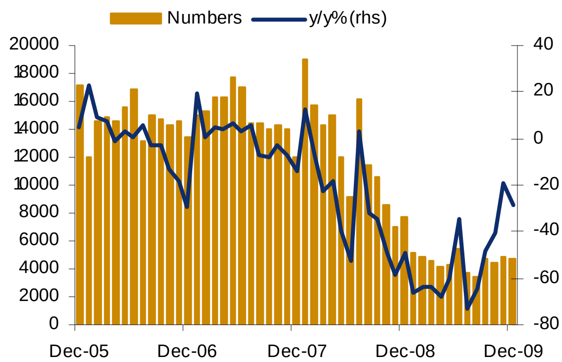


Chart 11: Cars licensed for first time



Housing market …

- The latest TSB/ESRI house price index revealed that sales prices at the end of 2009 were on average 32% below the peak. Dublin city continues to be the worst hit with asking prices now down 42.5% from the peak. Applying our usual rule of thumb that achieved prices are 5-10% below asking prices this implies that prices are now down approximately 40% nationally and 50% in Dublin. The more rapid pace of adjustment in the Dublin market is a result of prices rising more in the booom times but also due to a more active transactions market. In Dublin it takes 4 months for a sale to complete, compared to a national average of 9 months, though the time to complete a sale has begun to fall right across the country.

- The number of properties available for sale on Daft has stabilised at 60,000 as the curtailment in new builds puts less pressure on rising stocks and increased activity helps absorb some of that stock. With large amounts of stock available for sale particularly outside Dublin and the Mid East region relative to population and employment prospects, we expect prices in these areas to linger for sometime even when the bottom has been found. We would expect the Dublin market to bottom out first and with the stock of properties available for sale having declined from 7,000 to 6,000 and the time for sales to complete also declining this may not be too far off assuming no major shocks to the economy. It may be a bit of an oxymoron to talk about price declines in excess of 50% and also be talking about positives but the adjustment is required and the sooner the bottom is the found the more clarity it gives the Irish economy..

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

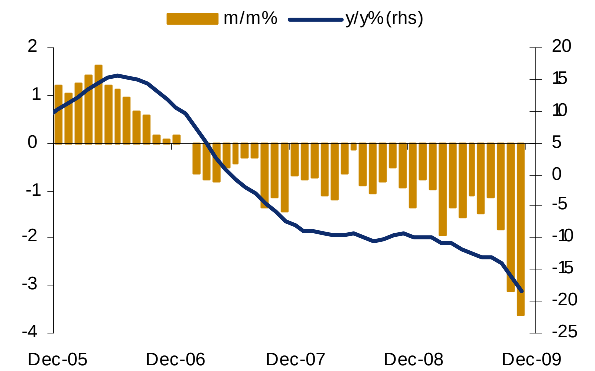


Chart 13: House prices, peak to trough

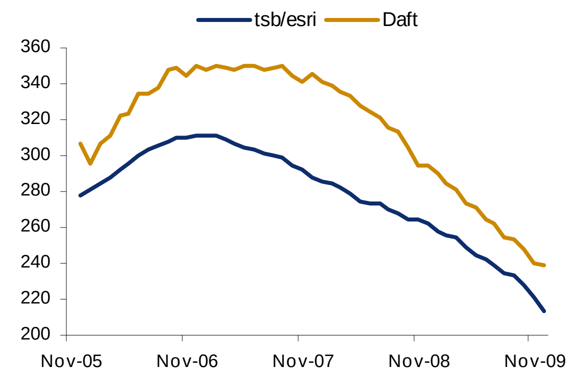


Chart 14: Rate of house building
sa annualised, 000's

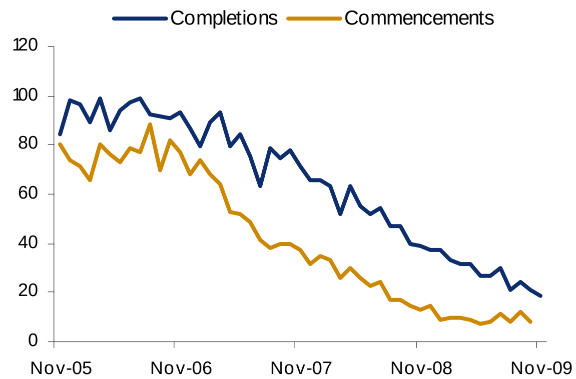


Chart 15: Mortgage drawdowns, monthly rate
sa annualised,'000's

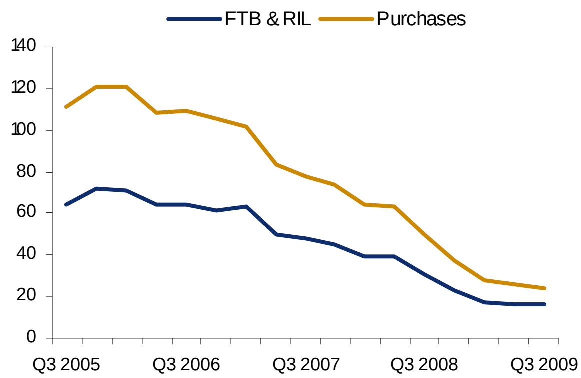


Chart 16: Daft stock of properties

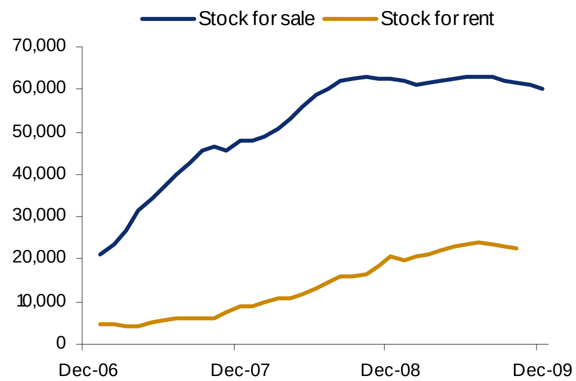
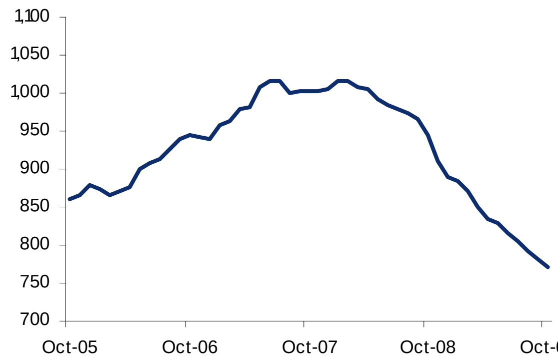


Chart 17: Peak to trough in rental prices



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Government finances…

- The December tax figures were greeted with a great cheer. True, tax receipts were €473mn ahead of the figure the Government had expected when they produced Budget 2010 at the beginning of December. However, the original profile from the April 2009 was for tax collection receipts to register €2,281mn in December pretty much in line with the €2,284mn that was collected. What this highlights is that it is extremely difficult to forecast even one month's tax receipts when you have 11 months of data. The reality is that the key tax variables, VAT and income tax, reflectthe overall economy, stabilization edging towards improvement.

- The upshot is that in 2009 the exchequer deficit totaled €24.6bn in 2009. The forecast for 2010 is that the exchequer deficit will register €18.8bn or a general government deficit of 11.6% of GDP. We like many others welcomed the recent budgetary measures but there is a danger that the Government sits on its laurels and basks in the praise from the international media. Budget 2010 was part 3 in a 7 part series; €2bn is set to come from current expenditure in each of Budget 2011 and 2012. That is exactly the same amount of money which was taken form Budget 2010 in these areas despite it being the "toughest Budget" that the Minister will have to deliver. Yes things are improving but some perspective is needed, there is a lot of reform to come.

Table 2: Tax take to December 2009, €mn

	€ mn	% behind (-) target
Income Tax	11,835	-5.1%
VAT	10,670	-6.6%
Corporation Tax	3,900	4.3%
Excise	4,703	1.4%
Stamps	930	-5.1%
Capital Gains Tax	542	-13.3%
Capital Acquisitions Tax	254	-14.0%
Customs	209	-9.2%
Total	33,043	-3.9%

Table 3: Voted Expenditure, €mn

	€ mn	% behind (-) target
Voted Spending	47,163	-0.5%
Current	40,256	-0.6%
Capital	6,907	0.3%

Chart 18: DoF exchequer balance deficit, €mn

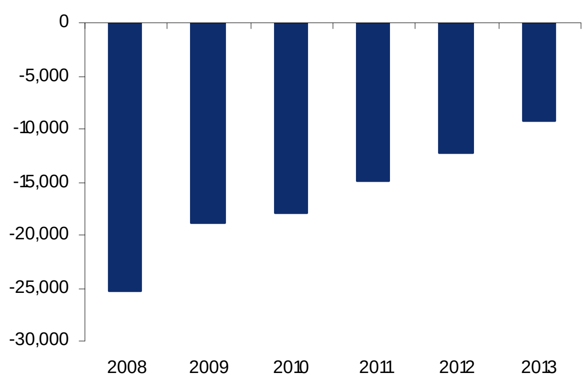


Chart 19: DoF debt to GDP forecasts

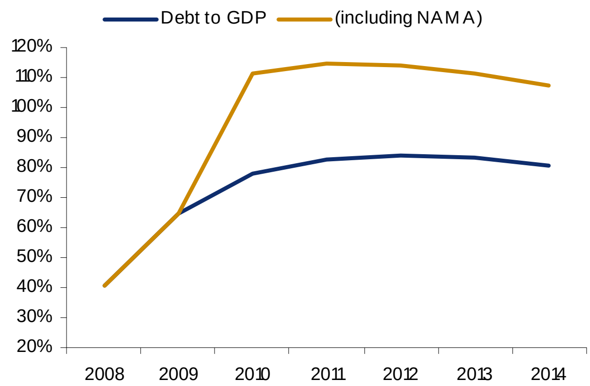


Chart 20: 5 year CDS various countries, bps

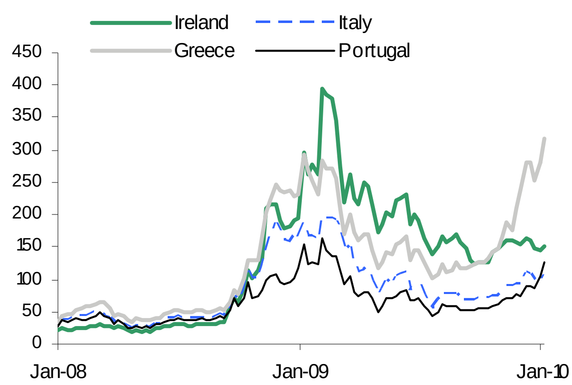
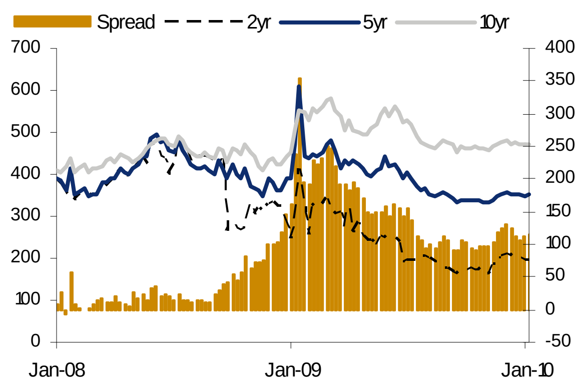


Chart 21: Irish government bonds & spread over German 5 year (rhs), bps



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Industrial production and external sector…

- Broad picture on industry: The pace of decline in industrial production and industrial continues to moderate. The overall figure however hides the stark dichotomy between the modern sector and all other sectors (Chart 23). The modern sector exports approximately 85% of its produce and it is this sector that is driving exports which increased marginally (0.2% q/q) in Q2 but still continue to fall on a y/y basis (Chart 25).

- Note, the chemical sector y/y increases are beginning to slow. Within the modern sector cyclical sectors such as office machines and electrical equipment have also followed the general pattern of large declines. This stands in sharp contrast to the chemicals sector which has enjoyed exceptional growth (Chart 26). Given the huge y/y gains from late 2008 to mid-2009 it will not come as a surprise to see the y/y rate leveling off.

- Note, on the currency front sterling appreciated against the euro or more appropriately the euro weakened on the back of worries about Greece's fiscal position. The exchange rate broke the key technical level of 88. Based on longer term fundamentals sterling should head back towards 80 over the next year. Ireland still remains expensive relative to its trading partners in terms of unit labour costs and sterling would still be significantly weaker than its average over the last 5 years but it would nonetheless be a boost at the margin for Irish exporters to the UK. (Chart 30 overleaf).

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

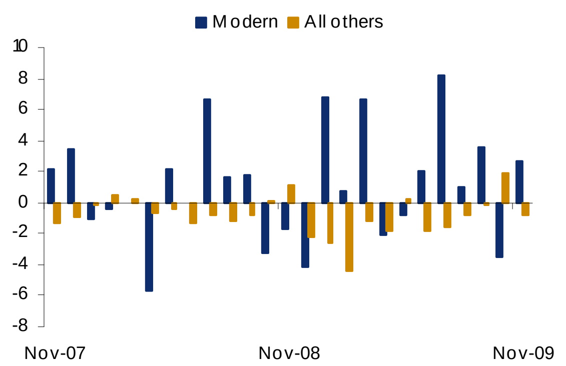


Chart 23: Industrial production, 3ma y/y %

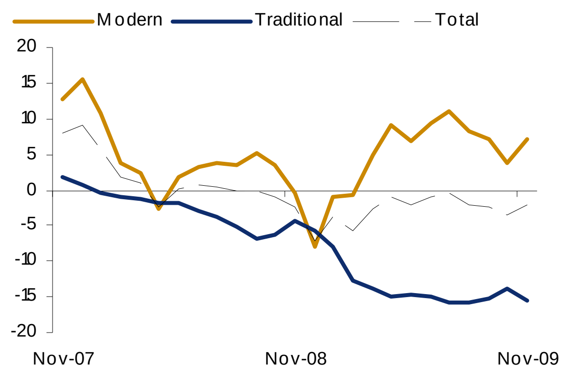


Chart 24: Industrial new orders, 3ma

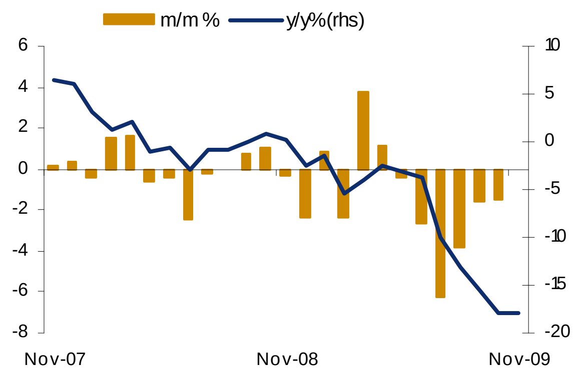


Chart 25: Merchandise exports, volume 3ma

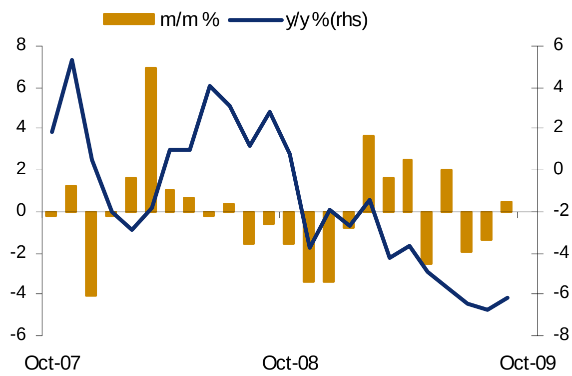


Chart 26: Value of exports by sector, 3ma y/y%

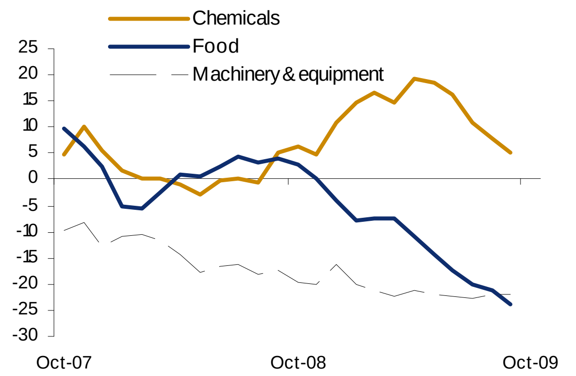
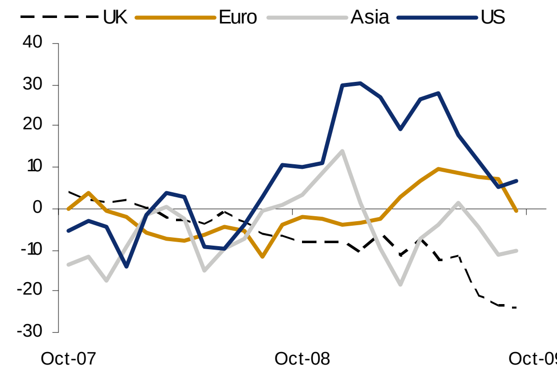


Chart 27: Value of exports to country, 3ma y/y%



External sector continued …

- Note: Merchandise imports remain weak as services imports remain robust (Chart 28, 31, Table 4). The former is driven by a weak domestic economy while the latter is driven by royalties/licenses and miscellaneous business services (advertising, R&D and inter-affiliate management charges) or more simply the "inputs" for multinational firms.

- Broad picture on external sector: The merchandise trade surplus narrowed in Q3 but still remained wide by recent standards as merchandise imports remained subdued. On the other hand the services deficit narrowed sharply as business services imports fell back sharply. Net transfers abroad widened once again causing the large decline in GNP relative to GDP in Q3. Nonetheless, the totality of it all is that the current account deficit narrowed sharply from 6.2% to 2.8% in Q3 2009 (Table 4).

Chart 28: Merchandise imports, volume 3ma

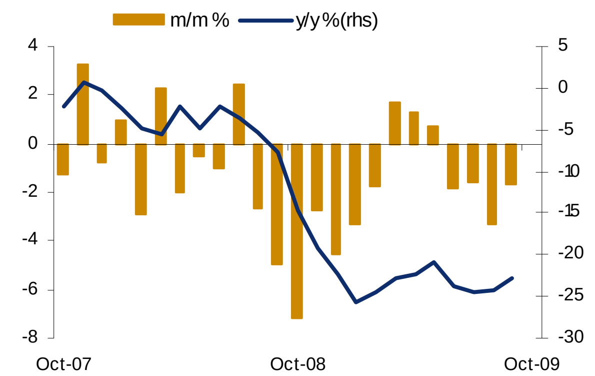


Chart 29: Value of imports by sector, 3ma y/y%

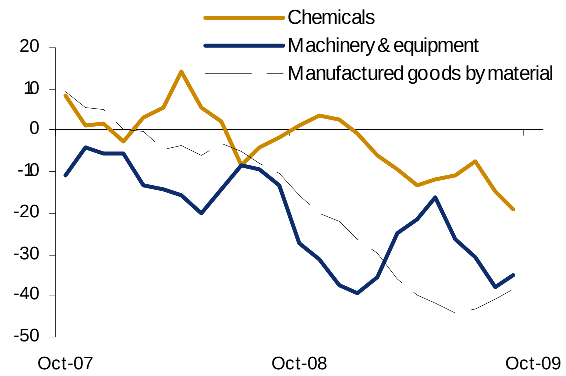


Chart 30: Effective exchange rate, relative to 41 trading partners

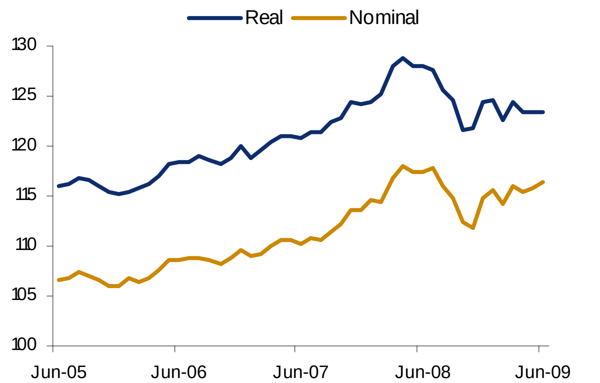


Chart 31: Services volumes, y/y%

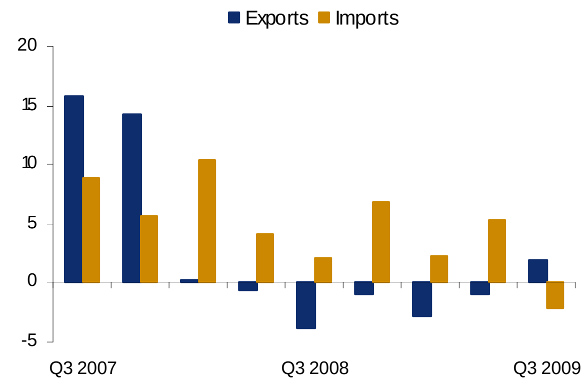
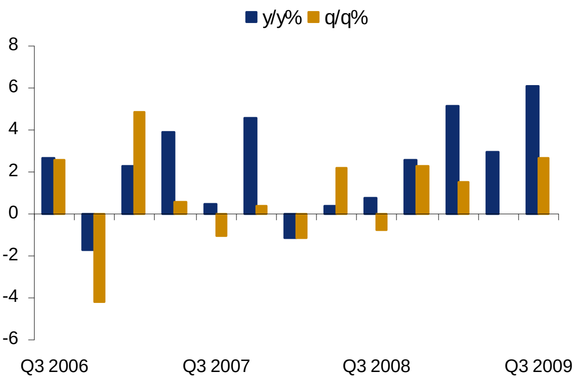


Table 4: Balance of payments

	2008	Q3 2009
Merchandise exports	81,495	18,526
Merchandise imports	57,675	10,373
Merchandise balance	23,819	8,153
Services exports	69,203	17,299
Services imports	74,574	17,569
Services balance	-5,370	-270
Income balance	-26,770	-8,426
Current transfers	-1,115	-359
Current account balance	-9,435	-902
CA as a % of GDP	**-6.1**	**-2.8**

Chart 32: Net exports contribution to GDP, %



Private sector credit …

- Broad picture: The pace of credit growth continued to slow as credit growth to a wide range of sectors contracted (Chart 33). Not surprisingly credit extended to the construction sector showed the sharpest contraction (Chart 34).

- Note: interest rates for house purchase have appeared to bottomed but demand for mortgages still remains subdued according to the latest bank lending survey (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 will ease once NAMA comes into operation (of course the gap between assets and deposits will only decrease by the amount of the haircut on the transfer, estimated to be between 28 and 23 percent for AIB and BOI respectively). With the banks likely to continue deleveraging, a weak economy and over indebtedness credit growth will continue to shrink for sometime.

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

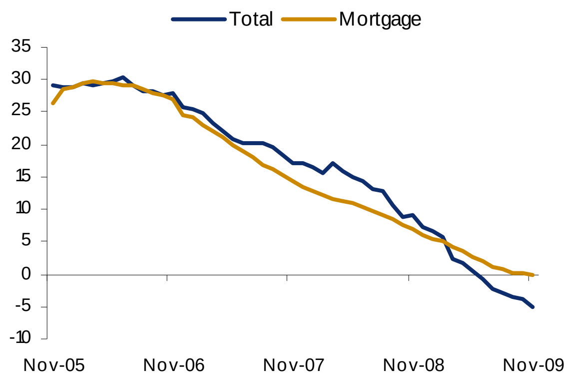


Chart 34: Sector breakdown of credit outstanding, Sep'09

	€mn	y/y% chg
Construction	16,603	-28
Wholesale/Retail Trade	12,965	-9
Hotels & Restaurants	11,214	-5
Real estate & business	95,146	-4
- Real estate activities	*88,050*	-4
Personal	169,047	-2
- residential Mortgages	*147,969*	0
All others (excluding financials)	24,272	-8
Total (ex financials)	329,247	-4

Chart 35: Various interest rates, %

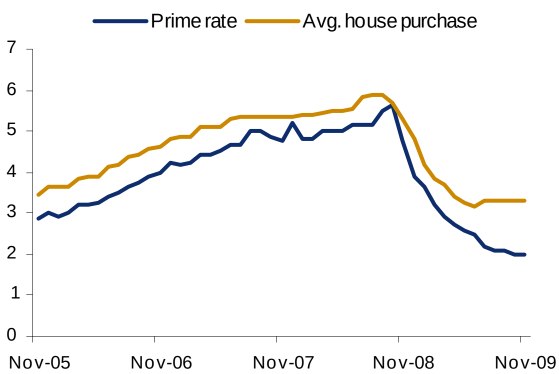


Chart 36: Bank lending survey, credit standards

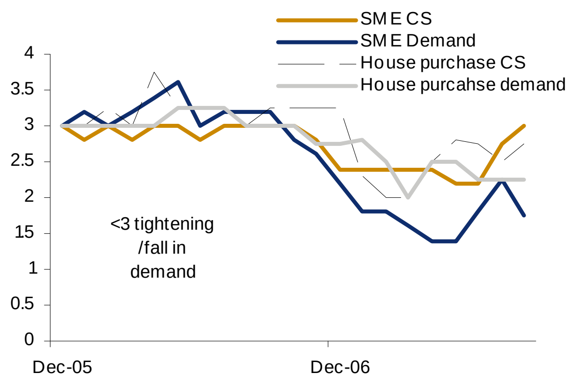


Chart 37: Retail clearing banks

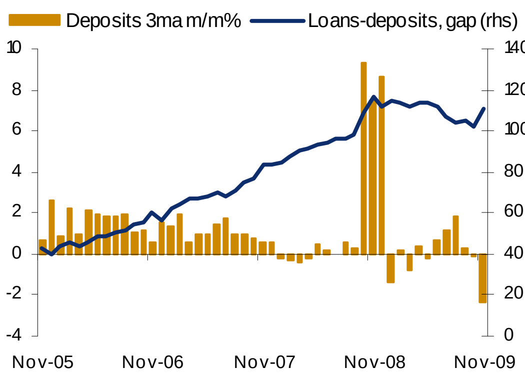
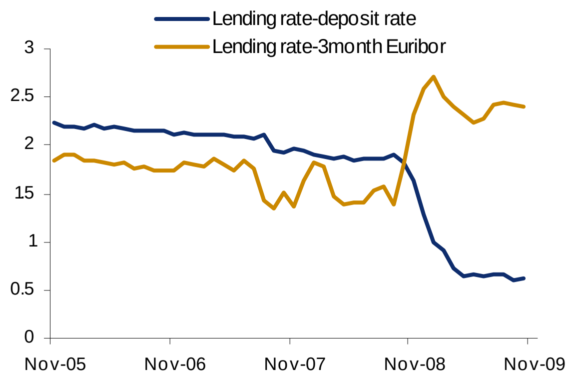


Chart 38: Spread between lending rates and deposit/interbank rates, %



Appendix 1: Annual data and forecasts

y/y% changes unless otherwise stated

	'2007	'2008	'2009	'2010	'2011	'2012	2013	2014
GNP	4.4	-2.8	-10.5	-0.5	2.8	2.6	2.7	2.8
GDP	6.0	-3.0	-7.3	0.6	3.3	2.8	2.9	3.0
Components of GDP								
Consumption	5.9	-1.0	-7.4	-0.2	2.1	2.7	2.4	2.2
Government consumption	6.9	2.6	-0.4	-2.8	-1.4	-1.0	-0.7	-0.3
Investment	2.3	-15.5	-32.0	-14.8	2.2	4.6	5.5	6.9
Gross Domestic expenditure			-12.1	-3.5	1.4	2.3	2.3	2.6
Exports	8.6	-1.1	-3.2	3.2	3.7	3.2	3.7	3.6
Imports	5.7	-2.1	-8.0	-0.5	1.7	2.7	3.3	3.3
Prices								
CPI	4.9	4.1	-4.3	-1.4	1.5	2.2	1.7	2.3
HICP	2.9	3.1	-1.9	-1.2	1.1	1.8	1.7	2.0
Labour market indicators								
Employment	2.9	-4.0	-7.7	-1.5	1.7	1.5	2.1	2.3
Unemployment rate (year avg)	4.6	6.3	12.2	13.2	12.1	10.9	9.9	8.5
Government finances								
Revenue receipts (€ millions)	49,294	43,022	35,344	35,340	36,355	38,878	41,104	43,728
Expenditure outlays (€ millions)	50,914	55,735	59,985	55,060	55,178	55,199	55,020	54,504
Exchequer balance (€ millions)	-1,619	-12,714	-24,641	-19,721	-18,823	-16,321	-13,916	-10,776
General government deficit to GDP	0.5%	-6.9%	-11.4%	-11.0%	-9.5%	-7.5%	-5.6%	-3.9%
Gross debt to GDP, not including NAMA	24.7%	41.5%	64.1%	77.5%	84.0%	87.1%	88.3%	86.9%
Financial indicators								
Current account deficit (% GDP)	-5.3	-5.2	-2.8	-0.8	0.2	0.4	0.4	0.5
EUR/GBP (year avg)	0.68	0.79	0.86	0.86	0.83	0.81	0.8	0.8
EUR/USD (year avg)	1.37	1.47	1.36	1.39	1.41	1.45	1.47	1.53

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