

## Irish Economy August 2009

Population (2008):	4.4 million
GNP per capita (2008):	EUR 34,960
Exchange Rate	EUR/STG: 0.86
(19 Aug 2009)	EUR/DLR: 1.41

### Signs of international pick-up offer important support to the Irish economic outlook, which has become less negative...

- Growth forecasts for Ireland's main trading partners (euro zone, US and UK) are now being revised higher as early signs of gradual recovery have emerged in recent months.
- The improvement in the international environment, together with the surprising resilience of Irish exports to date, is one important reason why we have become somewhat less pessimistic on the Irish growth outlook.
- Thus, following a succession of downward revisions in previous forecasts, our assessment of growth prospects this time around includes a modest upward revision in GNP to -3.2% for 2010 (previously -3.5%), while our 2009 growth forecast is broadly unchanged, at -8.9%.
- While the economy will contract on average in 2010, the trajectory should become progressively less negative over the course of the year, with a return to positive y/y growth rates likely as we move into 2011.

### Exports hold the key to recovery prospects as domestic headwinds remain substantial...

- The global outlook is far from robust, but continued gradual improvement is critical from an Irish perspective as domestic demand remains under significant pressure.
- We are somewhat less downbeat on consumption reflecting a less negative trajectory in retail sales growth in recent months and some signs that the sharp deterioration in the labour market may be abating. Large-scale declines in consumer prices offer important support - we look for an average decline in the CPI of 4.3% this year.
- Nonetheless, our forecast calls for consumption declines of 7.5% and 3.0% this year and next, and thus still paints a very soft picture in the context of weakness in disposable incomes and higher savings rates. Unemployment is likely to continue to rise considerably, albeit peaking late next year at a slightly lower level (15.4%) than previously forecast.
- We are raising our 2009 housing completions forecast to 22,500 units from 18,500 in our March update on the basis of available data so far this year. However, we have revised down our outlook for home-building next year by more to leave it at 10,000 (from 15,000) in the face of the considerable supply overhang. This would be the lowest annual total since records began in 1970 and implies another year of material drag on overall growth from the housing sector in 2010.
- Notwithstanding the major improvement in affordability due to lower prices and interest rates, excess supply and subdued demand will put further downward pressure on house prices and we anticipate a total cumulative decline in prices from their early '07 peak of around 45% (we estimate the actual correction to date at around 35%).

### Budget deficit target likely to be missed this year; medium-term fiscal challenge is enormous...

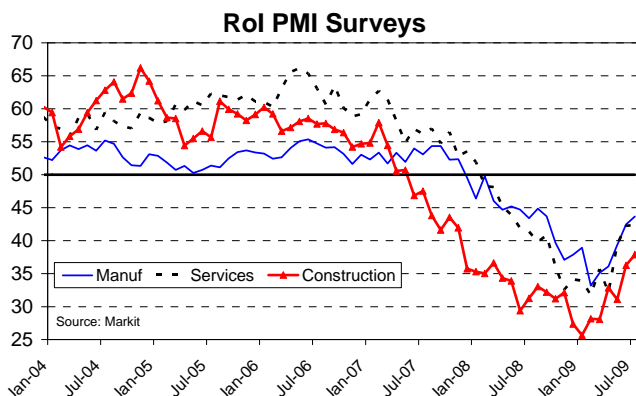
- Exchequer returns figures to July point to the possibility of a €1bn shortfall in tax revenues for the full year, marking the third consecutive year in which tax receipts undershoot official projections. While spending is also running behind schedule, the net underlying position points to the strong likelihood of the 10.75% general government deficit target being missed in 2009, albeit probably not by a significant amount.
- But the much more significant issue is the enormous size of the fiscal tightening which is needed over and above the sizeable correction which has already been implemented. The scale of the required adjustment is over €16bn in the coming four years: that is, €11bn over and above the McCarthy group recommendations which we think should be implemented to the fullest extent possible. The December Budget is therefore shaping up to be unavoidably tough.

## Overview

The latest (Q1) data show real GDP in Ireland has now fallen by almost 10% from peak representing considerable underperformance in an international context over the same period (cf. UK -4.9%, US -3.7%, EZ -4.9%). GNP (a better measure of national income in Ireland) has fallen by even more and is down 13%.

The weakness is being driven by extremely weak domestic demand. The sum of government, consumer and investment spending plunged by almost 15% in the year to Q1 – a record pace of decline. A key factor in explaining absolute and relative RoI weakness is the extent of the ongoing house-building correction which is subtracting an estimated 3.5 percentage points from growth in 2009. Consumer spending has also taken a big hit and is down 9.1% y/y in Q1. Household incomes have felt the weight of a sharp weakening in labour market conditions (the unemployment rate has doubled over the past year to hit 12.2% in July) and a significant increase in the tax burden, the latter due to ongoing sizeable fiscal consolidation efforts. Financial market and economic turmoil combined with extremely elevated levels of uncertainty have sparked a surge in savings rates and have hurt confidence which remains at very low levels historically, albeit that recent readings are showing some marginal improvement.

While the economy clearly remains very weak, we take some modest encouragement from incoming indicators which are pointing to some easing back in the rate of contraction. The monthly Purchasing Managers Indexes on activity in Services, Construction and Manufacturing, while still at low levels, have all moved off their cycle lows (hit in Jan-Feb) and have established mini up-trends, thus mirroring developments in the equivalent surveys internationally. Monthly flows onto the Live Register have fallen back noticeably since the beginning of the year (10,500 in June vs. 31,400 in January). Irish exports have also held up better than expected. They did fall by 3%/y/y in Q1, but this compares favourably with much sharper falls elsewhere incl. in the US, UK (both -12%) and Germany (-18%). This outperformance reflects resilience in some MNC-dominated and less cyclically-sensitive sectors such as pharmaceuticals and chemicals. Also, Ireland's export sector has less exposure to areas of particular weakness internationally e.g. cars and capital goods.

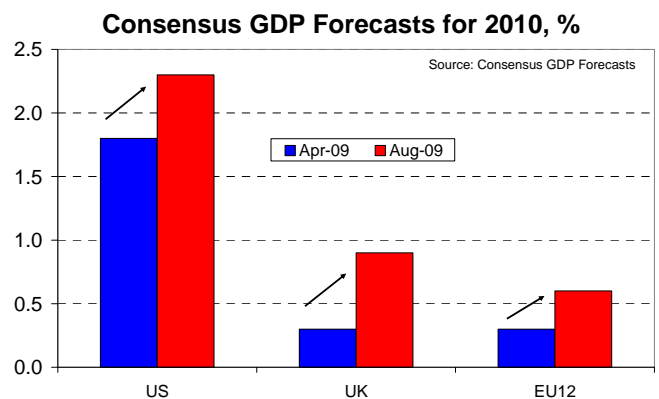


Perhaps the most important development from an Irish perspective in recent months has been the improvement in the global economic environment. Signs of gradual recovery are emerging in Ireland's main trading partners following the success of the international authorities in stabilising the financial system and reflecting the huge amount of stimulus which has been supplied. While the recovery scenario is not without risks, the indications of improvement on this front are

very welcome indeed and serve to boost the Irish export outlook.

Overall, somewhat improved economic and financial conditions globally and the less negative tone to some domestic indicators have arrested the downward slide in our Irish growth forecasts. Our GNP forecast for this year is broadly unchanged at -8.9% (we had become more negative in the months following our March update) and we have revised up our forecast for next year to -3.2%, from -3.5% previously.

While the economy will contract on average in 2010, the trajectory should become progressively less negative over the course of the year, with a return to positive y/y growth rates likely as we move into 2011. The headwinds facing the domestic economy from the ongoing investment, property and consumption corrections are strong. Plus, a huge, multi-year tightening of fiscal policy is necessary given the dire state of the public finances, while the restoration of health to the banking sector is another extremely important challenge. In this context, the Irish recovery scenario is dependent on a continued gradual improvement in the external environment.



## External Environment

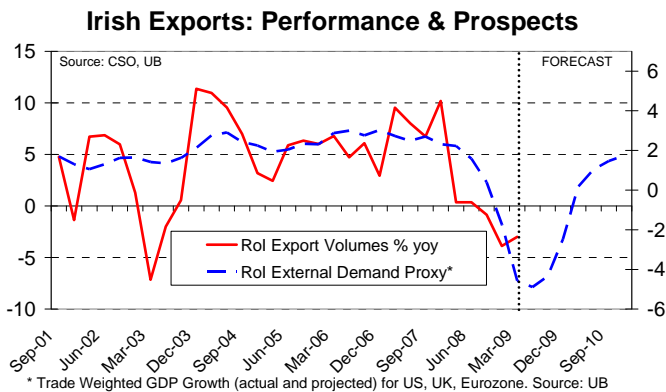
The latest national accounts data reveal that total Irish exports fell by 3% in the year to the first quarter. As recently as the end of 2007 they had been growing by 10%, a turnaround that serves to highlight how the global recession has impacted on this important sector of the economy. And yet, that Irish exports were down 'only' 3% in Q1 represented a better-than-expected outcome. To put this performance in context, exports out of Germany – the world's biggest exporter - plunged by 18% over the same period while the US and UK export sectors each recorded declines of some 12% as international trading volumes generally plummeted in the aftermath of the collapse in confidence post the Lehman bankruptcy.

Ireland's relative outperformance reflects the make-up of the export sector which has a larger exposure to the somewhat less cyclical chemicals and pharma sectors; the value of chemical exports was actually up 14% y/y in Q1. Also, there is less exposure here to some areas which have been particularly hard-hit globally. Included in this category are capital goods and cars, two sectors which have felt the brunt of the international downturn but to which the Irish export base has comparatively low exposure.

Not only have exports held up better than expected to date, but it is also the case that the outlook for Ireland's main trading partners has improved. Global economic pessimism was extremely intense at the time of our March forecast. However,

financial conditions have since improved notably, reflecting the success of the authorities in averting a full-on meltdown of the financial system. The result has been a pick-up in business confidence which is now turning into a more stable global economic environment with signs of recovery emerging across the US, UK and euro zone. Together, these economies account for about 75% of Irish export demand and it is significant that growth expectations are now improving in each case; consensus GDP forecasts for 2010 have been marked higher for all three regions over the past few months. Notably, the US economy is expected to grow by 2.3% next year, up from 1.7% in March.

It is not that growth prospects in these economies are robust. But they are improving nonetheless, and we expect a continued gradual pick-up to be reflected in a better trajectory for Irish exports (see graph below), notwithstanding ongoing challenges on the competitiveness and exchange rate fronts. For example, even if sterling continues its gradual recovery in the months ahead, the Eur/Stg rate is still likely to average about 10% higher than the 80p average seen in 2008 which adds to the imperative of reducing the domestic cost and price base.



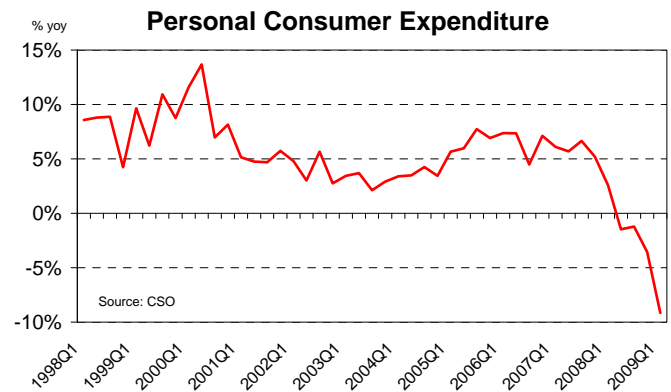
Indeed, merchandise (goods) trade data available for April and May show an acceleration in export growth in Q2 relative to the March quarter. Even allowing for the possibility of further weakness in the quarters ahead, we have revised up our export forecasts for this year and next and now look for -3% and +0.4% respectively (from -4% and -2% previously). On our forecasts, export growth in y/y terms gets back into positive territory over the second half of next year and we expect that better momentum to carry over into a stronger performance in 2011.

On the import side, the outlook remains very weak. Such a prognosis is in line with the ongoing severe contraction in domestic demand which resulted in a near 12% drop in import volumes in Q1. However, we have become slightly less pessimistic on this front (e.g. our consumption forecast is now a tad less negative – see below) so we have pulled back on the extent of the expected decline in imports. This is now put at -8.3% and -2.8% for 2009 and 2010.

Overall, the net effect of the updates to our export and import forecasts is that the boost to growth from net external demand is now somewhat higher compared with our previous forecast. Given the major headwinds which continue to confront the prospects for domestic consumption and investment, the boost to growth coming from this source is very welcome indeed, even if it partly reflects the statistical effect of imports falling at a faster rate than exports. We estimate the contribution of net trade to economic growth at 4% and 2.9% points this year and next respectively.

## Consumer spending

At almost 60% of total Gross National Product (GNP), consumer spending is a hugely important determinant of Irish economic growth. It is made up of two components, spending on goods and spending on services, each of which account for roughly half of the total. In the first quarter of the year spending on goods fell by 15.2%, while services spending fared better, albeit still falling by 3.4%. The result was an unprecedented 9.1% decline in total consumer spending, which contributed roughly 5 percentage points to the 12% fall in GNP over the same period.

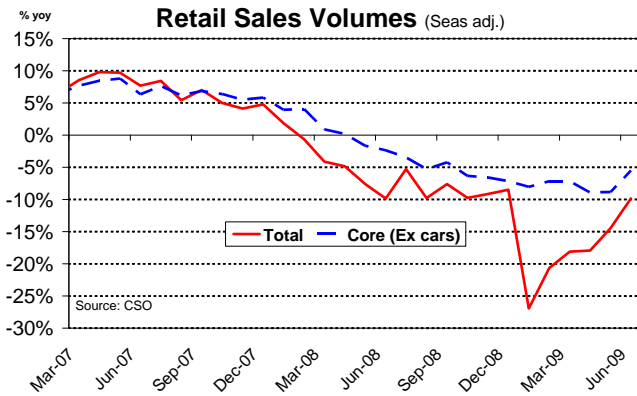


The sharp falloff in consumer spending has multiple drivers, most of which are set to remain prevalent in coming quarters. The near-doubling of the unemployment rate over the past year, hitting 12.2% in July, has seriously reduced aggregate household incomes. The tax hikes introduced in the October and April Budgets have also been a pronounced negative for disposable incomes and spending, as has the general downward pressure on wage levels across the economy. Furthermore, uncertainty surrounding job prospects and the economic and fiscal outlook has resulted in more cautious spending attitudes, resulting in a sharp rise in household savings rates.

The marked decline in consumer spending has also been evident in the falloff in the main spending related taxes, VAT and excise duties. Combined receipts in these tax categories fell by a large 20% in the first quarter of the year when compared with the same period in 2008. In the second quarter of the year, the rate of decline accelerated to 23%. The latest data for July show a lower 22% decrease, albeit that this was solely attributable to a better performance of excise receipts.

While consumer spending growth will remain under considerable pressure for some time for the reasons outlined above, some key measures and indeed drivers of consumer spending have shown signs of improvement in recent months.

Total retail sales were considerably less negative in the second quarter of the year, falling by an average of 13.9% y/y, compared with 21.6% in the first quarter of the year. This improvement mainly reflected a modest pick-up in car sales following the massive 55% decline in the first quarter of the year. However, the latest figures hint at a more broad-based recovery in spending in June, with five of the nine major retail categories posting monthly increases. Core retail sales (excluding cars) rose by 2% m/m in June, which brought the annual rate to minus 5.5%, the best performance since September 2008. We expect this less negative trend will continue in coming quarters which should generate a similar pattern for overall consumer spending over the same period.



The pace of decline in some key drivers of consumer spending has also shown signs of easing in recent months. The latest Live Register figures for July showed an additional 10,500 individuals claiming unemployment benefit in the month, down from 31,400 additions in January. This would indicate that the deterioration in the Irish labour market, while still pronounced, will not be as great as had been previously anticipated, and we now expect a slower rate of contraction in employment this year and next (see Labour Market section below).

One major support to consumer spending is the substantial fall in prices, which according to the latest Consumer Price Index (CPI) figures for July were down 5.9% when compared with last year. More broad-based price falls in the Irish economy have emerged in recent months, outside of the fall in mortgage interest rates, thus boosting the purchasing power of any given level of income. Consumer confidence remains depressed and close to record lows. However, in recent months confidence has levelled off, and on the less volatile 3 month moving average basis has nudged up slightly. While confidence is set to remain subdued for the foreseeable future, we expect a further gradual improvement going forward, as the realisation that the worst of the crisis is over feeds through to sentiment.

At the time of our March forecasting exercise, we projected a fall in consumer spending of 6.5%. In the interim we felt that the likely outcome would be closer to minus 8.5%, in part relating the negative impact of the budgetary tax hikes on disposable incomes. However, given that the signs from both indicators and drivers of consumer spending have been generally less negative of late, this forecast looks a bit on the pessimistic side and we now expect a fall in consumer spending of 7.5% this year.

Our less negative assessment of employment prospects in 2010 means that we have revised our consumer spending forecast for next year upwards. We now expect spending will fall by 3%, relative to a forecast fall of 5% in March, which explains part of the upward revision to our overall growth forecast for next year. An improving labour market situation, in addition to a gradual return to more normal confidence levels, should see consumer spending returning to modest positive territory in 2011.

## Investment

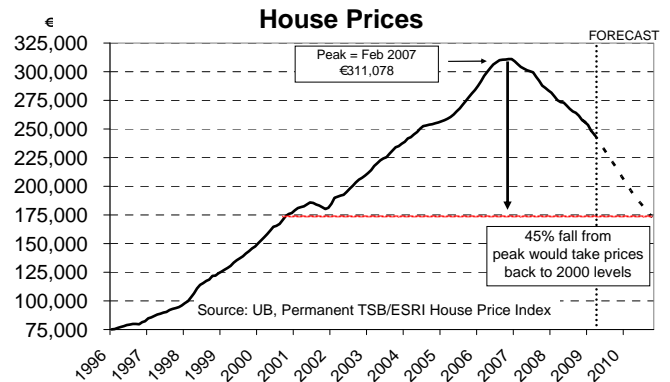
2008 saw a major 16% contraction in investment, as the housing correction gathered speed, non-residential building activity stagnated and purchases of machinery and equipment also turned negative. The slowdown accelerated in first quarter of 2009, with a decline of 34.1% in total investment, driven by a 35% fall in building and construction activity and a 33% drop in machinery and equipment. The primary driver of this more

negative trend was the housing component of building and construction, which fell by a significant 47%, and alone subtracted some 4 percentage points from total GNP in the first quarter.

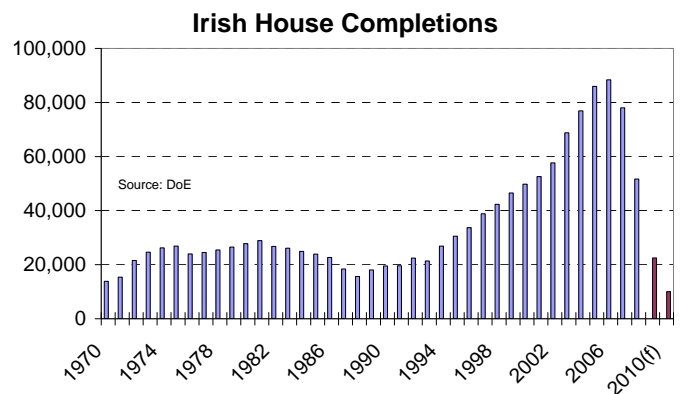
Given the weakness in the domestic economy, the extent of the supply overhang of both residential and non-residential properties, further falls in prices/values and the tighter credit environment, we see total investment falling by 29.4% this year and by a further 19.9% next year, with residential construction continuing to represent the main drag.

## Housing

Annual house price inflation peaked at 15.5% in mid-2006 but fell off rapidly thereafter as rising interest rates curbed affordability. By June 2009 we had experienced 28 successive monthly price falls and a 22% fall from peak in average house prices, according to the Permanent TSB/ESRI house price index. Given the lags in reporting – the statistics are based on bank drawdowns – and the virtual absence of transactions, the true decline is much greater. We believe that the actual fall in prices is of the order of 35% and predict a further fall of 10%, resulting in a total drop from peak of 45%. This, in turn, implies sharp reported falls of 13% in the Permanent TSB/ESRI index this year and a further drop of 20% next year, as the index comes into line with reality.



The industry response to falling prices and rising unsold stocks has been to curtail supply sharply. Registrations for insurance against structural defects are used as a proxy for starts and, nine months later, for completions. Using the registrations data alone, completions are estimated at 18,500 units in 2009. However, actual completions in the year to June have outperformed what the registrations data implied, by an average of almost 650 units per month.



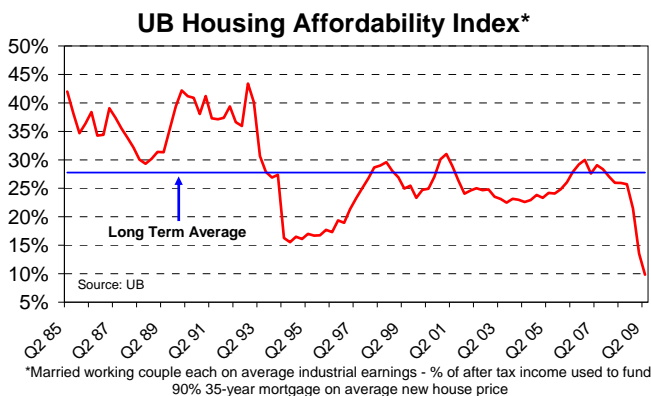
On the basis of the stronger incoming completions data, we are revising our 2009 completions forecast up to 22,500, from 18,500 at the time of our March forecast update. Some of this

outperformance is likely attributable to timing factors, in that the lack of demand for homes, in addition to the considerable supply overhang, may mean that some houses built in 2008 are not connected to the ESB grid until this year, thus boosting the completions figures this year.

Despite the upward revision to our 2009 completions forecast, housing output in 2009 is still estimated to fall by over 55% on the 2008 level of 51,724. However, the negative drag from housing on growth is slightly lower, at 3.5 percentage points, and explains part of the upward revision to our 2009 growth forecast.

We estimate that the cumulative level of completions for the three years 2008 to 2010 will be 84,500. While this is down enormously on the 252,000 units completed in the three years to 2006, it remains the case that market conditions are characterised by a significant amount of excess supply. Last autumn, Homebond and the Construction Industry Federation estimated the supply overhang at 35,000. However, the situation has almost certainly worsened since then, with recent estimates of the excess supply of new housing units in the order of 50-60,000. The latest data from the DAFT website indicates that the stock of unsold second hand houses and apartments is of the order of 57,000.

Affordability is no longer a constraint on house purchase and for a first-time buyer couple who can avail of mortgage interest relief is at the highest in the history of the series (see graph). This reflects a combination of factors, including significantly lower house prices, the very substantial mortgage interest-rate reductions and increases in mortgage interest relief. Much improved levels of affordability offer significant support to market conditions. However, the confidence factor remains a major obstacle, as prospective buyers are reluctant to transact given the widespread anticipation of lower house prices, heightened concerns about job security and uncertainty about the future economic and taxation environments.



The extent of and the uncertainty surrounding the supply overhang are both considerable and will take some time to be resolved. Against the backdrop of reduced lending appetite for building and development activity, this leaves us favouring a scenario in which there is a further significant scaling back of housing output next year. We expect another sizable fall in completions to 10,000 in 2010, which would be the lowest level of home-building since at least 1970. Housing is therefore forecast to subtract from growth again next year, taking away approximately 2 percentage points.

New house starts will not recover until buyers re-emerge and the overhang of unsold stock begins to be eroded. While this dynamic may take hold at some point in 2010, both prices and building activity have further to fall in the meantime. Beyond 2010, it is reasonable to expect some recovery in housing output as an annual total of 10,000 is well below estimates of

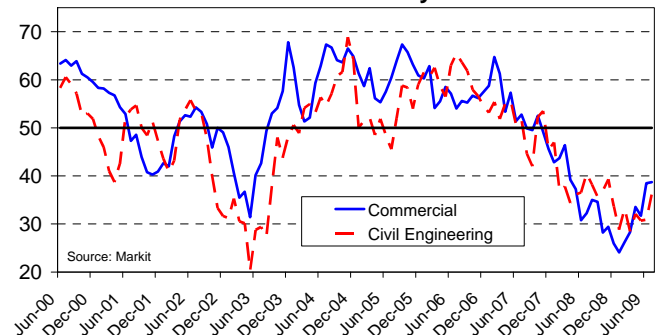
medium- to long-term housing demand. This is put at 40,000 or more by the ESRI out past 2012, for example. So beyond the current and ongoing severe adjustment, it is likely that from 2011 on there will be some positive impetus to growth from housing, albeit that there is no prospect of a return to the excessive levels of 80,000 units seen at the height of the boom.

### Other Building & Construction

The Ulster Bank Construction PMI indicated that both commercial and civil engineering activity weakened throughout the course of 2008 and fell significantly in the first quarter of 2009. CSO quarterly national accounts (QNA) data for the first quarter of the year confirmed this weakness, with a contraction of 28% year-on-year in Other Building and Construction.

While still at low levels, both commercial and civil engineering activity according to the PMI have moved off their cycle lows (hit in Jan-Feb of this year) and have established mini-up-trends in recent months, thus mirroring developments in the equivalent surveys internationally. While activity in these sectors will remain subdued into next year, the PMI data is consistent with a more moderate pace of contraction in the second quarter of this year, and thereafter, following a particularly weak first quarter.

### UB Construction PMI for Commercial and Civil Activity



As is the case with housing, the slowdown in the commercial property sector has resulted in a virtual absence of transactions so it is difficult to get realistic property values. Estimates are therefore subject to more uncertainty than usual. IPD data in the year to the second quarter of 2009 suggest that capital values have fallen by 49% from peak (Q3 '07), though the reality is that the actual decline to date may be somewhat greater at perhaps around 55%. The bulk of the price adjustment has likely already occurred, though further market weakness is likely with tentative estimates of a cumulative peak to trough decline of around 60-65%.

Following an increase of 8.6% in non-residential construction activity in 2008, we expect a 20.5% decline in 2009 as the economic slowdown, falling capital values and supply overhang of properties available for rent, have a further negative impact on new investment projects. The continuation of these factors, coupled with limited availability of credit, means that activity in the commercial property sector will remain subdued into 2010, and we forecast a further 20% decline in the sector next year.

Investment in machinery and equipment fell off sharply in 2008, dropping by more than 15% on 2007 levels, driven by the massive 40% decline in the final quarter of the year. This poor performance continued into the first quarter of 2009, albeit that the annual rate of decline decelerated slightly from the preceding quarter, to minus 33%. A significant proportion of investment in machinery & equipment is related to the construction sector, which partially explains the sharp fall in the first quarter of the year, in spite of the 12% rise in the volatile aircraft component. For 2009 as a whole, we expect a fall of

20.2% in total machinery and equipment. The further contraction in economic growth next year, in addition to ongoing weakness in the construction sector, leads us to anticipate a further albeit more modest fall in of 7.8% in 2010. These forecasts are subject to considerable uncertainty given that the quarterly outcomes can be heavily skewed by the timing and extent of aircraft purchases.

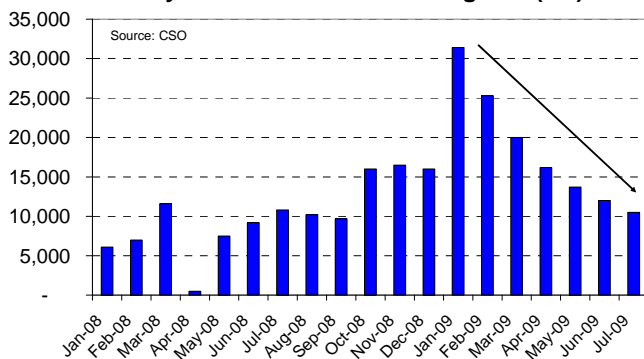
## Labour Market

The more broad-based weakness in the Irish labour market, outside of construction, has become increasingly evident since the latter half of 2008. This was confirmed in the latest Quarterly National Household Survey (QNHS) data for the first quarter of 2009, which showed significant employment losses in the services and agricultural sectors, albeit that job losses in construction continued to dominate. On a seasonally-adjusted basis, total employment fell by 72,000, or 3.5%, when compared with the final quarter of 2008, a notable acceleration on the 1.7% decline in the previous quarter.

Following a surprisingly slow initial adjustment given the deteriorating economic climate, the labour force fell by almost 30,000 in the first quarter of 2009, on a quarter-on-quarter basis. However, as the fall in employment was considerably greater than the drop in the labour force, the unemployment rate rose to 10.2%, from 8.1% the previous quarter, and 4.9% in the first quarter of 2008.

The Live Register measures unemployment claimants rather than unemployment per se, but its timeliness means that it acts as a useful indicator of the latest labour market trends. The Live Register estimate of the unemployment rate in the second quarter of the year was 11.6%, and showed a rise to 12.2% in July. Unemployment, according to this measure, is therefore back at levels last seen in early-1995, although these figures are subject to revisions when the official QNHS data for the second quarter are released in September.

Monthly Additions to the Live Register (SA)



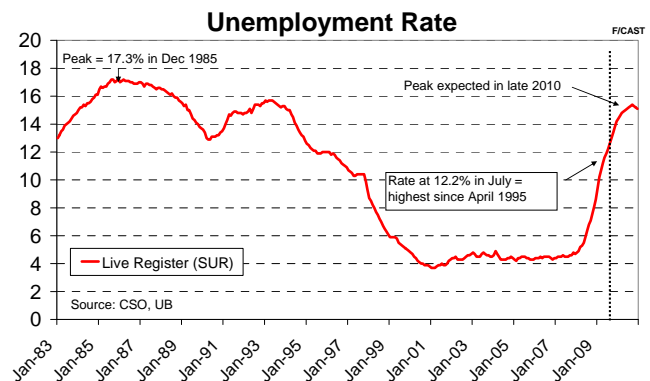
On a claimant count basis, the latest Live Register figures for July showed the number claiming unemployment benefit rose by 10,500 in July, the lowest monthly increase since September 2008. This represents a substantial improvement on the average monthly rise of almost 26,000 in the first quarter of 2009 and of almost 14,000 in the second quarter. It is unlikely that the monthly additions to the Live Register will continue to trend down at the rate observed in the second quarter of the year. In particular, there are risks of a further marked shakeout in construction-related employment in August and September following the builders' summer holidays. However, over time some gradual improvement is the most likely scenario.

For 2009 as a whole, we forecast that employment will fall by an estimated 8.3%, with job losses in the construction and related

sectors accounting for the bulk of the job losses. This represents an upward revision from our forecast fall of 9.5% in our March economic update, in part explained by our slightly less negative outlook for the Irish economy this year. In addition, signs from incoming data such as the monthly Live Register figures and the employment indexes of each of the Manufacturing, Services and Construction PMIs suggest that the deterioration in the Irish labour market, while still pronounced, will not be as great as we had previously anticipated.

In terms of the labour force, we anticipate that it will continue to decline in coming quarters, albeit not by as much as we had pencilled in in March. We now forecast a contraction of 67,000 in total in 2009. However, as with any labour market forecast, there are huge uncertainties surrounding the extent of the labour force fall this year. While we have scaled back our estimate somewhat, we remain more pessimistic relative to other commentators, as we implicitly expect a more marked decrease in participation rates and/or stronger migratory outflows.

Although employment is to fall by less than we previously thought, the smaller forecast decline in the labour force means that we are set to experience a further sharp rise in the unemployment rate over the remaining months of 2009. We continue to forecast the unemployment rate will hit 14% by the end of the year, and average 12% for 2009 as a whole.



The labour market outlook for 2010 remains poor. Employment is forecast to fall by a further 4.8% on average next year. While the employment situation in each of the main sectors will remain under pressure, signs of improvement should become evident by the end of the year. Indeed, this forecast compares favourably with our estimated fall of 7.5% at the time of our March forecast update – a consequence of our less negative assessment of the economic prospects for next year and the fact that there are already signs of some easing in the pace of deterioration of the labour market.

We anticipate a further 35,000 fall in the labour force next year, as the US and UK economies show further signs of improvement and employment opportunities abroad begin to show improvement. Based on these labour force and employment assumptions, the unemployment rate is estimated to peak at 15.4% in the latter part of next year, and to average 15% for the year as a whole. This represents an upward revision from our March forecast update, when we estimated employment would peak at the higher level of 16% and average 15.5% for the year as a whole.

## Inflation

The turnaround in Irish inflation has been truly striking. For the most part the CPI measure was in excess of 4% for the two years up to July 2008, averaging 4.7% over that period. The combination of a relentless move higher in global commodity prices, a steady increase in ECB official interest rates and a very buoyant economy all combined to generate consistently firm upward pressure on the overall price level. But over the past year, the factors that had been responsible for the majority of the upward pressure on Irish inflation have gone sharply into reverse, taking the CPI measure down like a stone from 4.4% in July of '08 to -5.9% in July of this year – a remarkable and unparalleled 10.3% swing in measured inflation within 12 months.

The most important driver of this dramatic turnaround has been mortgage interest costs. Although this component only accounts for some 6.5% of the overall CPI, its decline has been extremely rapid, reflecting the unprecedented rate-cutting cycle of the ECB. Interest rates were slashed from 4.25% as recently as early October last year to a new all-time low for the ECB of 1% in May. With about 300bps of this cumulative reduction feeding through to lower standard variable rates (the measure used by the CSO to capture this effect in the CPI), mortgage costs have collapsed. The annual rate of change in this category has plunged from +13% to -48% between July '08 and July of this year. Of the 5.9% decline in the total CPI over the past year, a full 4.1 percentage points was accounted for by the mortgage interest rate component, highlighting the overwhelming influence of this variable in the huge swing in the overall CPI over the past 12 months.

Energy prices have also imparted strong downward impetus on the price level, with the annual rate of change here also turning around sharply in the face of substantial declines seen in wholesale energy costs on the world markets from their peak in Summer '09. Crude oil prices hit a record high of nearly \$150 per barrel in July of last year but by the end of the year had sunk to around \$40pb, a collapse which contributed to a large move in the energy component of the CPI. This has gone from 13.8% to -13.4% over the past 12 months. Over this period, energy has gone from boosting CPI inflation by nearly 1% point to pulling it lower by just over the same amount. Thus, energy and mortgage interest together accounted for about 5.3% points of the 5.9% decline in the CPI in the year to July 09.

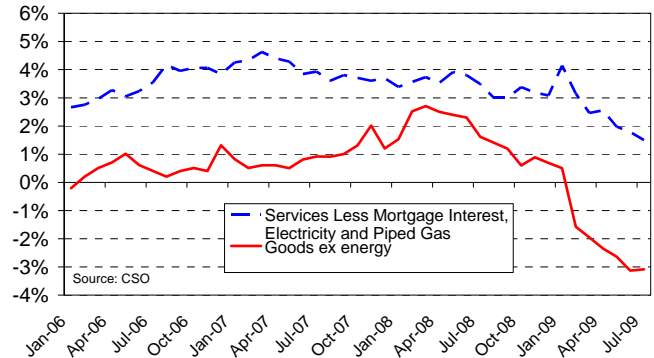
But what is also clear from recent Irish consumer price trends, is that downward pressure on prices has emerged across a wide range of different areas, not just those driven mainly by external factors such as interest rates and energy costs. For example, the latest (July) CPI release shows that 7 of the 12 principal price categories are now showing y/y declines; a year ago that number was just 2. As the graph below clearly shows, even stripping out the effects of energy and mortgage interest costs, underlying, or core, prices are now coming under significant downward pressure in both the goods and services sectors.

This is a reflection of the pronounced weakness in the overall economy, weakness which has dented household incomes and spending and hence has reduced firms' pricing power and sparked increased competitive pressures. The considerable weakness of sterling relative to the euro has also been a factor here, reflected in significantly lower inflation readings in import-heavy categories such as food and clothing & footwear. Food price inflation has gone from 7.1% to -4.2% over the past year while clothing prices continue to fall very sharply, down 11.2% in the past 12 months.

As we look forward, we expect core inflation pressures to weaken somewhat further, reflective of a still-weak domestic

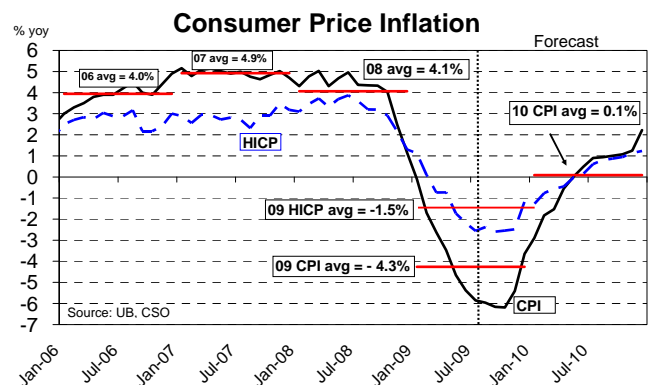
economic backdrop. However, we are probably within a few months of the peak of deflation price pressures at the headline CPI level. We think total CPI inflation will hit -6% by August, but that it is likely to become progressively less negative thereafter as the base effects associated with the ECB's rate-cutting campaign (which began in October '08) turn less supportive. Mortgage costs will remain in negative territory in y/y terms until around May 2010, but the extent of the declines will be easing back considerably as that point approaches, in the process dampening significantly the downward pressure on headline inflation. Also, our base case envisages the ECB beginning to hike rates over the latter part of 2010, a scenario which will bring some outright upside pressures to the CPI towards the end of the forecast horizon.

### CPI: Core Goods and Services



In addition, crude oil prices have risen sharply since our March forecast. Prevailing futures pricing now points to an average price per barrel of (Brent) crude of around \$60 this year and \$75 in 2010, up from \$47 and \$53pb respectively in early March. This higher profile for energy costs will add to the upward trajectory of the CPI beyond the next few readings. In fact, petrol prices have already begun to move higher and are up some 24% in the past six months to around the 117p per litre (as per the AA survey).

Overall, from an average level of 4.1% last year, CPI inflation is likely to average -4.3% this year. Late this year and into 2010 will see a marked decline in the rate of decline as the mortgage and energy effects wash out and if anything begin to go the other way. While y/y changes in the headline CPI will likely turn positive from around the middle of next year, soft underlying price pressures should keep the average annual change in the CPI close to zero – our forecast is +0.1%. On a European harmonised (HICP) basis (which excludes mortgage interest), the average decline we expect for this year is -1.5%, giving way to something of the order of 0.2% for 2010 on average.



Finally, it is worth putting recent trends in Irish inflation in their international context. Irish inflation (on European Harmonised basis) is now well into negative territory at -2.6%, thus well

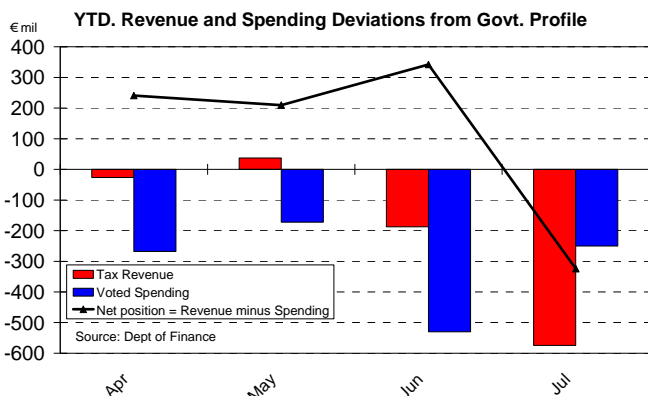
below UK (+1.8%) and euro zone (-0.7%) levels, implying that Ireland is now making important progress in improving its competitiveness.

## Public Finances

We are now some four months on from the April supplementary budget which was the latest in a series of initiatives implemented by the Government to address the escalating problem of the chasm between revenue and spending. The package announced then was designed to achieve an improvement in the budgetary position of the order of €3.3bn for this year (equivalent to €5bn in a full year). Of course, this followed earlier measures including spending cutbacks last summer, the October budget and the public sector pension levy. Taking all such measures into account, it is clear that there has been a serious attempt on the part of the authorities to tackle the grave deficit problem.

And yet, even having taken these steps, the post-budget projection still envisaged a shortfall of revenue relative to spending of some €20billion, equivalent to some 12% of GDP this year in total exchequer terms, or 10.75% on a General Government balance (GGB) basis. The latter is the measure used by the European Commission in assessing our compliance (or not) with the requirements of the Stability and Growth Pact which sets a limit for budget deficits within the euro zone of 3% of GDP. Clearly, the 10.75% forecast for this year represents a significant overshoot of the normally allowable level of borrowing.

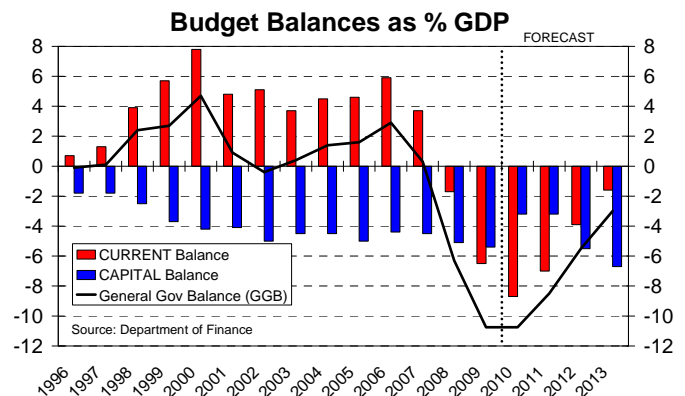
But aside from the issue of any breach of European rules, it is worth highlighting that a persistently large budget deficit is simply not economically sustainable as it would imply a rapid accumulation of debt which, in turn, would necessitate an ever-increasing burden of taxation over time in order to service the higher borrowing levels. So there is absolutely no alternative to a large-scale fiscal correction in order to restore order to the public finances. In fairness, this correction is now underway, with the total adjustment for the current year estimated at around 5% of GDP (relative to a policy-unchanged scenario), an enormous shift in the fiscal stance by any standard. In other words, had the measures announced to date not been implemented, the projected -10.75% GGB figure would have been closer to -16%.



Yet enormous challenges remain in relation to getting the public finances back onto a sustainable path. In the short term, exchequer returns figures to July point to the possibility of a €1bn shortfall in tax revenues for the full year. While spending is also running behind schedule, the net underlying position (total voted spending relative to tax receipts) points to slippage relative to plan of perhaps €600m for the full year. As an important aside, while we welcome indications of spending

restraint, we have some concerns that it seems to be the capital side which is being targeted in this regard, with the capital spend some €275mn (or 7.9%) behind profile just four months into the plan – a profile that itself envisaged an 18% pull-back in capital spending over the whole year. The near-term outlook for the public finances points to the strong likelihood of the 10.75% target being missed in 2009, and we forecast an 11.1% General Government Deficit this year.

There is little that can be done about that at this stage of the year, as another unscheduled Budget is neither realistic nor practical. But what is absolutely critical is that the Government sticks to its medium-term fiscal consolidation strategy. The outline of the plan was laid out in the April Budget and provides for measures totalling €9.4billion to be delivered in the next two years alone and a further €7billion in the period 2012-2013. Thus, in order to achieve the planned reduction in borrowing by 2013, the total savings (including all types of spending cuts as well as taxation hikes) that need to be found amount to over €16 billion.



This places the recommendations of the recent McCarthy report in context. The reality is that even if the total €5.3bn package of savings were to be fully implemented, the Government will need to implement additional tax and spending measures, over and above those in the report of An Bord Snip Nua, to the tune of over €11 billion in the coming four years.

This scenario does not even allow for the apparently lower-than-expected tax yield from measures already implemented (as per the latest Exchequer figures noted above). Nor does it make provision for NAMA. Although not likely to be counted within the General Government accounting framework (as such outlays are likely to be treated as financial investments, hence bringing some return over time), NAMA could add considerably to the burden on the overall Exchequer position in the medium to long term. NAMA is a significant initiative and will certainly help clean up help much-impaired balance sheets of Irish banks – a necessary condition for maintaining the flow of credit. However, there are few details on the key issue of asset pricing at this stage. The size of the haircut applied will determine the extent of the recapitalisation needs of the sector. Further state investment appears inevitable though the valuation applied to the assets will determine the profile of risk-sharing between the taxpayer and shareholders, and hence the ultimate burden to the Exchequer.

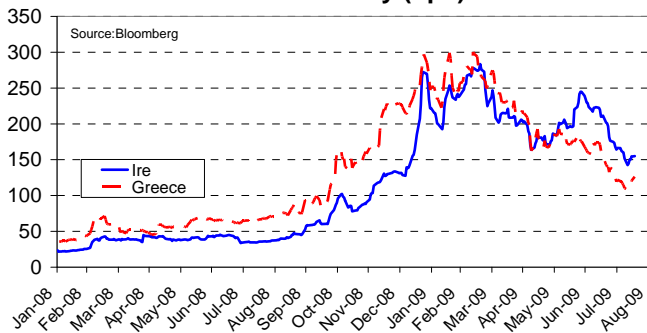
Note that even with all of this planned corrective action, the country would still be running a deficit of some €6bn, or 3% of GDP, in 2013 on the measure used for European comparison purposes. But a deficit of that magnitude is certainly much less problematic than the double-digit deficits facing the economy this year and next. Plus, it would bring us back to the limit of 3% required by compliance with the EU Stability and Growth Pact to which we are committed by virtue of our membership of the euro zone. Moreover, having published a medium-term plan



to get back on track, it is critical to demonstrate consistent progress in implementing the stated plan so as to ensure the sovereign debt markets remain receptive to the large amount of Irish government bonds which will need to be issued in the future.

The premium attached to Irish bonds relative to Germany has narrowed in quite considerably in recent months, currently standing at just over 1.5% from a high earlier in the year of over 2.8%. While this move is certainly helpful, the declines in the Irish spread need to be seen in the context of a generalised improvement in the international debt markets in recent months; Greek spreads have narrowed by even more than their Irish equivalents, for example. Furthermore, it remains the case that Irish spreads are the highest in the euro zone, highlighting ongoing caution among investors about the medium-term outlook for the state's financial position.

### 10-Year Govt Bond Spreads, Rel to Germany (bps)



Given the scale of the fiscal problem, our conclusion is that the Government should proceed with as close to full implementation of the McCarthy Group recommendations as is possible. Furthermore, we agree with the Group's suggestion that public sector pay and pension arrangements be reviewed in the context of the seriousness of the current situation, with such a review to incorporate a new Benchmarking exercise. The greater the amount of savings that can be found on the current spending side, the less will be the need for further increases in taxation. While some further tax increases are inevitable, we broadly welcome official indications suggesting that future hikes will focus on the taxation of property, carbon use and child benefit rather than on incomes. The forthcoming Commission on Taxation report will presumably be important in informing policy choices on these, and other, fronts.

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# Summary Table

	2006	2007	2008	2009F	2010F
<b>GROWTH</b>					
Consumer Spending (%YOY)	6.6	5.9	-1.0	-7.5	-3.0
Investment (%YOY)	4.0	2.3	-15.5	-29.4	-19.9
- Housing	2.6	-6.4	-26.3	-40.1	-30.2
- Other Building & Construction	8.6	19.7	8.6	-20.5	-20.0
- Machinery & Equipment	-1.4	13.9	-15.4	-20.2	-7.8
Government Spending (%YOY)	5.8	6.9	2.6	-0.3	-2.0
Exports (%YOY)	5.1	8.6	-1.0	-3.0	0.4
Imports (%YOY)	6.5	5.6	-2.1	-8.3	-2.9
<b>Real GDP (% YOY)</b>	5.4	6.0	-3.0	-8.0	-2.8
<b>Real GNP (% YOY)</b>	6.3	4.4	-2.8	-8.9	-3.2
<b>PRICES</b>					
CPI (% YOY) Average	4.0	4.9	4.1	-4.3	0.1
HICP (% YOY) Average	2.7	2.8	3.1	-1.5	0.2
<b>HOUSING MARKET</b>					
Completions	88,187	78,027	51,724	22,500	10,000
PTSB/ESRI House Price Index (% end-year)	13.4	1.1	-9.4	-13.0	-20.0
<b>LABOUR MARKET</b>					
Employment (% YOY) Average	4.4	3.6	-0.6	-8.3	-4.8
Unemployment Rate annual avg.%	4.4	4.5	6.3	12.0	15.0
<b>PUBLIC FINANCE</b>					
General Government Balance (% GDP)	2.9	0.2	-6.3	-11.1	-11.1
<b>EXCHANGE AND INTEREST RATES</b>					
ECB Refi Rate (End of Period)	3.5	4.0	2.5	1.0	1.5
EUR/\$ (End of Period)	1.32	1.46	1.40	1.33	1.30
EUR/£ (End of Period)	0.67	0.74	0.96	0.80	0.78