Produced by the Economic Research Unit
April 2011

Bank of Ireland
Global Markets

TheOutlook

A quarterly analysis of trends in the Irish economy

GDP expectations for 2011 revised down

- Surprising weak end to 2010
- GNP to outpace GDP this year

The past month has thrown up two surprising and unwelcome data releases in Ireland. The first was that the unemployment rate over the past six months has been much higher than previously published, on the basis that the labour force stopped falling in the final quarter of 2010. This in turn implies that the scale of net emigration of late is much lower than previously thought, contrary to popular belief. We doubt whether this marks a clear break in the previous trend but the near-term impact is that the unemployment rate in 2011 is now expected to average 14.4% from 13.6% last year, albeit having probably peaked in recent months.

The fourth quarter national accounts were also something of a shock, with nominal GDP deemed to have fallen by a massive 6.6% in just three months. The decline in real GDP was also a substantial 1.6%, driven by falling exports, contrary to the trend over the rest of the year. As a result, the economy entered 2011 in a weaker state than most expected and as a consequence we are revising down our GDP growth forecast for the year to a modest 0.5%, in line with the latest consensus, with external trade again providing the main positive contribution, offsetting lower consumer spending and another decline in capital spending. This dichotomy between the export and domestic sectors has been a feature of the economy for some time now and looks set to continue on the assumption that global growth continues to expand at the brisk pace projected by the IMF. The recent increase in oil prices presents a clear downside risk to world economic activity, however, and alongside rising ECB rates will also result in higher Irish inflation than previously expected; we expect CPI inflation to average 3%, although the HICP measure, the standard across the EU, may rise by only 2% and as such below the expected euro average of 2.4%.

The fourth quarter national accounts also revealed that the income of residents in Ireland, captured in GNP, actually ended the year on a strong note, despite the fall in GDP, due to weak multinational profit outflows and strong growth in Irish income earned abroad. As a result we expect GNP growth to outpace that of GDP in 2011, with the former rising by 1.2%.The aggregate imbalances evident in the economy in recent years are also no longer in evidence, and as a result we expect Ireland to run its first Balance of Payments surplus in over a decade.

Dr. Dan McLaughlin

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Irish GDP

0.5% growth now expected this year

The economy contracted 1% last year…

The Irish CSO surprised the consensus (and ourselves) by announcing a 1.6% fall in seasonally adjusted real GDP for the fourth quarter of 2010, which alongside a downward revision to the previously published Q1 figures resulted in a 1% fall in GDP for 2010 as a whole. Consequently, the Irish economy is now seen to have contracted for a third consecutive year, with a total fall of 14.5% from the cycle peak in the final quarter of 2007. Moreover, the fall in nominal GDP in Q4 was put at an extraordinary 6.6% which meant that GDP in 2010 was much lower than the government had anticipated, at €153.9bn against a projection in excess of €157bn.

Irish net exports has proved the only positive in the GDP data over the past few years, and that was the case again in 2010, with the volume of exports rising by 9.4% against a 6.4% increase in imports, thereby contributing 3.3 percentage points to GDP (exports now account for 96% of GDP). That pattern was expected to materialise in the fourth quarter data, but in the event exports were deemed to have fallen by 1.4% against a flat reading for imports, thereby producing a significant negative contribution to growth. We do not expect this to be repeated in 2011, and forecast export growth of a similar, albeit slightly slower, magnitude than last year, but with import growth picking up to 7.5%, partly due to base effects. Irish firms selling into foreign markets have obviously benefited from the strength of global demand as well as a substantial improvement in Irish competitiveness (as measured by relative unit labour costs) and we expect this to continue given a fair wind in terms of world trade.

…and domestic demand may remain weak…

The recent rise in oil prices provides a significant downside risk to global activity and hence to Irish growth, and higher energy prices and rising interest rates will push up Irish inflation. Consequently, we now expect real consumer spending in Ireland to fall by 2% this year, given a projected fall in real disposable income and the assumption of an unchanged savings ratio. The data on the latter is not timely and prone to revision but it seems clear that the savings rate has risen sharply in recent years and may have been above 13% in 2010, driven by the rise in unemployment and deleveraging by Irish households. The implication is that a significant fall in savings is unlikely in the absence of a marked improvement in the labour market and we do not envisage the latter in 2011.

The largest single factor behind the sustained fall in Irish GDP has been a plunge in capital spending; the 28% decline in 2010 followed a 31% collapse a year earlier and a 17% fall in 2008. As a result capital spending now accounts for just 12% of real GDP and therefore less than half its share at the peak of the boom, with housebuilding alone declining from 11% to just 2%. The latter had shown signs of bottoming in the latter half of 2010, based on completions data, but has weakened further given the available figures for the year to date, although the pace of decline has slowed sharply. Consequently, we envisage a 14% fall in construction spending in 2011, from -33% in 2010. Business spending on machinery and equipment shows few signs of bottoming either, but again we expect a more modest fall this year, some 10%, with the result that total capital spending is projected to fall by 12%, before returning to modestly positive growth in 2012.

…but inventories may rise…

Inventories have also fallen substantially in recent years and hopes of a turn in that cycle, which had risen after a modest stock build in Q3, were dashed with another large decline in the fourth quarter. We still expect this cycle to turn in 2011, however, and have projected a modest stock build for the first time in three years.

…we are revising down our GDP forecast…

The net result of the above forecasts is that GDP is projected to grow by a very modest 0.5%, which is over 1% below our previous forecast, reflecting higher inflation and the impact of a much weaker carryover from 2010. In contrast, GNP, (which adjusts for net flows of profits and interest, and so is a better measure of the income of Irish residents) is expected to grow by 1.2%, in part because of a positive carryover effect; GNP rose by 2% in the final quarter of last year, leaving annual GNP growth at 2.8% in Q4. The odd combination of falling output (GDP) and rising resident incomes reflected a weak quarter for multinational profits and strong growth in Irish income earned on assets held abroad. These flows can be and often are very volatile on a quarterly basis, but we feel that the carryover effect is substantial, and will result in a stronger GNP growth figure for 2011 relative to GDP.

…and project a BoP surplus…

The final months of 2010 also saw the largest Irish quarterly Balance of Payments surplus ever recorded, the €1.4bn reading partially offsetting deficits in the earlier part of the year and thus reducing the annual BoP deficit to €1.1bn or 0.7% of GDP. We expect the economy to record a €1bn BoP surplus in 2011, equal to 0.6% of forecast GDP. The implication is that the various economic sectors of the economy are now in broad balance; the public sector is obviously running a large deficit, but this is now being offset by the surpluses being run by the household and corporate sectors. A few years ago the BoP deficit was over 5% of GDP, implying a saving shortfall in Ireland and hence the need for finance from abroad, but this no longer the case, albeit following a massive contraction in GDP.

Irish real GDP (% change)

	2009	2010	2011 (f)
Personal Consumption	-7.0	-1.2	-2.0
Government Consumption	-4.4	-2.2	-2.0
Capital Formation	-31.0	-27.8	-12.3
- Building & Construction	-34.9	-33.1	-13.5
- Machinery & Equipment	-19.3	-15.3	-10.0
Stocks (% of GDP)	-1.3	-0.5	0.3
Exports	-4.1	9.4	8.8
Imports	-9.7	6.6	7.5
GDP	-7.6	-1.0	0.5
GNP	-10.7	-2.1	1.2

Inflation

Upside surprises year to date

Higher energy and mortgage costs driving CPI…

Irish inflation has surprised to the upside of late and the consensus forecast for 2011 has moved higher, although we suspect it is still too low, given the outlook for mortgage interest. This component has a weight of 6.7% in the Irish CPI and has risen by some 29% over the past year, so adding 1.9 percentage points to the overall index. The ECB repo has not changed over that period, of course, so the increase reflects an attempt by lenders to pass on higher funding costs to new borrowers and to existing mortgage holders not on a tracker mortgage (which has a fixed spread over the repo rate). The ECB has now embarked on a tightening cycle, so the mortgage component is likely to rise again in May, as the April increase is passed on, and again later in the year.

The recent rise in oil prices has also pushed up energy prices, by an annual 15% in March, and represents a substantial upside risk. Global food prices have also risen and this is now being reflected in the Irish CPI, with the food component rising by 1.2% in the first three months of the year.

…which may now rise by 3% this year.

Domestic demand in the Irish economy remains weak and so there are still some deflationary forces at work, providing some offset to the upward price pressures; drink and tobacco prices in March were still marginally down on an annual basis, clothing and footwear was down 2.6%, household equipment 2.3% and recreation and culture 1.3%. Despite this, we now expect CPI inflation to average 3% this year, from -1.0% in 2010, and to reach 4% in the latter months of the year.

The HICP measure of inflation, the EU standard, excludes mortgage interest and so is less volatile that the CPI. It too has accelerated in recent months, to 1.2% in March from -0.2% at end 2010 and we expect an annual average of 2% for 2011, from -1.6% last year. This is still likely to be below the euro average of around 2.4%, so implying a further narrowing of Irish prices relative to the euro norm.

CPI Inflation (annual change, %)

	2010	2011
Q1	-3.4	2.3
Q2	-1.4	3.4
Q3	0.2	3.5
Q4	0.9	4.1
Annual	-1.0	3.0
HICP	-1.6	2.0

The Labour Market

Unemployment rate revised up

The labour force decline stalled in Q4…

The Irish labour market has been characterised by falling employment and a contracting labour force for the past three years but that pattern was partially arrested in the final quarter of 2010, as revealed in the Quarterly National Household Survey.

The data showed that the labour force was broadly unchanged in the quarter when seasonally adjusted, in turn implying that the pace of net emigration had slowed appreciably, which is at variance with the widely held popular view that there is a substantial outflow of Irish nationals. Employment continued to fall, however, by 16,000 or 0.9%, with the result that the total unemployed jumped to 315,000 from 290,000 in the previous quarter, pushing the unemployment rate up to 14.7% from 13.7%. This was substantially higher than the previously published monthly estimates, (averaging 13.6% in Q4), with significant knock-on effects on the subsequent monthly data and on forecasts for this year as a whole.

…but employment is still falling.

Employment fell by an average 4.2% in 2010, following an 8.2% plunge in 2009 and although the pace of decline has slowed, there is no clear indication that employment has stabilised as yet. The pace of redundancies did slow sharply in the latter half of 2010 but has picked up marginally again this year, and the monthly decline in the Live Register has also decelerated. Consequently, we expect a further fall in employment in 2011, albeit at a slower pace of 1.5%, equivalent to an average job loss figure of 28,000.

The surprise stabilisation in the labour force in Q4 is unlikely to be repeated in the succeeding quarters in our view, given the outlook for labour demand, and we therefore expect a further decline in the labour force in 2011, but at a much slower pace (15,000 from 48,000 in 2010). As a result, the unemployment rate is set to average 14.4% which implies a steady but modest fall from the current 14.7% over the coming months. The trend in the labour force is very uncertain it has to be said, so a faster decline is possible if the level of immigration picks up again.

Labour Market (annual averages '000)

	2009	2010	2011(f)
Employment	1929	1848	1820
Labour Force	2187	2139	2125
Unemployed	259	292	305
(% of labour force)	*11.8*	*13.6*	*14.4*

Exchequer Finances

Budget broadly on target

Tax receipts 1.8% behind profile…

The 2011 Budget, delivered in early December last year, was predicated on real GDP growth of 1.7% and projected an Exchequer Borrowing Requirement (EBR) of €17.7bn, comprising a current budget shortfall of €11.5bn and a capital deficit of €6.1bn.

In the Budget the Minister for Finance had cut spending by €3.9bn (split evenly between current and capital) and raised some €2bn in revenue, via higher taxes (€1.4bn) and additional measures including some asset disposals. When adjusted for the actual end-2010 outturn, the Budget target was based on a tax revenue growth of 9.9% (including a transfer of a health levy into the income tax component) and a 2.9% rise in current expenditure or 3% excluding debt interest.

The evidence year to date is that the Budget is broadly on target, although there are a number of issues which may cause concern in the coming months. Tax receipts showed annual growth of 3.7% over the first quarter of 2011 but emerged behind profile, albeit marginally so, at €138m or 1.8%. Excise duties are running ahead of projections (€60m) as is corporation tax (€78m) but the two most significant tax headings are behind; income tax receipts are €125m (4.2%) adrift of profile, while VAT is €179m (5.4%) behind. These figures suggest that consumer spending remains weak and that employment and income are soft. We expect economic activity to pick up through the year but the risk must be that tax receipts come in under target, given that GDP growth now looks set to come in below that forecast at budget time.

…but spending also below target.

Spending is also running behind profile, however, by €256m or 2.3%, albeit still growing strongly on an annual basis; current spending rose by 6.3%. The net result was a current budget deficit of €4.2bn in Q1, compared with €3.7bn in the corresponding period of 2010. The capital deficit was considerably higher, however, largely reflecting the inclusion of a €3bn charge, the annual cost of funding the Promissory Notes issued to Anglo Irish Bank and INBS. Consequently, the overall deficit in Q1 was substantially higher than last year, at €7.1bn against €3.9bn.

Exchequer Finances (€bn)

	2010	2011	2011
		(Budget)	(Forecast)
Current Spending	47.0	48.4	48.4
- Voted	40.5	41.7	41.7
- Non-voted	6.5	6.7	6.7
Revenue	34.4	36.9	36.4
- Tax	31.8	34.9	34.4
- Other	2.7	2.0	2.0
Current Budget Balance	-12.6	-11.5	-12.0
Capital Balance	-6.2	-6.1	-6.1
Exchequer Balance	-18.7	-17.7	-18.1
General Government Balance	-50.1	-15.2	-15.7
(% of GDP)	*(32.50%)*	*(9.40%)*	*(10.10%)*

Exchequer Funding

Market responds positively to stress tests

The authorities overfunded in Q1…

The EU measures the fiscal stance via the General Government Balance, but the EBR, which is cash based, is the amount the State has to actually fund. That total for 2011, (€17.7bn) implied a gross funding requirement of €22.3bn, given €4.6bn in redemptions, due in November, which under normal circumstances would have been funded in the market, but is now likely to met from the EU/IMF facilities available to Ireland.

The Irish Government drew down €17.8bn from these official sources in the first quarter of 2011 and raised another €1bn, largely through the National Savings Schemes (marketed to retail investors). The EBR in Q1 was €7.1bn so the NTMA (which manages the sovereign debt) substantially overfunded, and repaid some €4.8bn in commercial paper. This still resulted in a €6.7bn addition to cash balances which stood at €15.7bn at end-2010 and hence rose to €22.4bn at end-March.

…the risk premium on Irish debt remains high but has fallen.

The price of existing Irish debt implies that the market is not convinced that Ireland will be successful in bringing the deficit down to the target level by 2014; 2-year yields spiked to around 10% in late March and the 10-year yield exceeded that level, with the spread to bunds widening to 680 basis points. The cost to the State of support for the banking system and the contingent liabilities inherent in the bank guarantees are significant factors, of course, and to that end it was noteworthy that the Irish debt markets rallied following the recent stress tests results.

As a result of the tests the Irish Central Bank deemed that four banks required an additional €24bn in capital (including €21bn equity) in order to meet a minimum core Tier 1 capital ratio of 10.5% and a stress ratio of 6%. The banks will be given some time to raise the capital from non-State sources and any residual will be met from €10bn from the National Pensions Reserve Fund, with another €7bn coming from cash balances. Ireland’s debt ratio will rise as a result of any additional cash injections into the banking system, but at this stage it is not clear how much that will be; the Department of Finance now believe the debt ratio will peak at 111% of GDP in 2013, against a Budget-time projection of 103%.

The price of Irish debt was also boosted by an announcement from Standard & Poor’s, which changed the outlook for Ireland to stable following a downgrade to BBB+, which was itself better than many expected. Consequently, Irish sovereign bonds have rallied, and outperformed in the euro area; the 10-year spread to bunds has fallen by around 100bps from the highs, albeit still at around 575bps.

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Market data supplied by Thomson Reuters

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