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Bank of Ireland
Global Markets

TheOutlook

A quarterly analysis of trends in the Irish economy

GDP seen flat in 2008 after extraordinary slowdown

- Fall in housing completions in line with expectations
- Exports the key in growth outlook
- Irish consumer spending abroad is now material

It now transpires, following data revisions, that the Irish economy's performance over the past five years was even stronger than originally thought; growth averaged 5.5% a year, and is now put at 6% in 2007. This makes the pace of the current slowdown all the more remarkable, with negative GDP growth recorded in the first quarter of 2008, although GNP did stay positive, if marginally so.

A fall in house completions was a prime factor but not unexpected, and it was the performance of some of the other components of growth that surprised. In that sense everything that could go wrong for the Irish economy has gone wrong – the credit crunch is now almost a year old, oil prices rose from $100 to $145 in the three months to July, the Irish equity market has fallen 30% year to date, the ECB has raised rates despite slowing activity in Europe, and sterling and the dollar have remained weak. Business and consumer confidence has crumbled in the face of this barrage, resulting in a sharp fall in non-residential capital spending by the private sector and a marked slowdown in consumer spending. Indeed, the impact of the latter is even more pronounced for Irish retailers, as the foreign spend of Irish residents is now material and impacting the macro data, having risen by 30% in the first quarter, against a 2% rise in spending by tourists coming to Ireland.

Exports dominate Irish GDP, (a 1% rise would offset a 9% fall in house completions) and the sudden slowing in service exports is the other unexpected development in the first quarter, given the consistent double digit growth seen in recent years. Moreover, the path of external trade will determine whether GDP growth for the year will be positive or negative – we now forecast a flat reading. Irish incomes may grow, however, albeit marginally, as GNP growth is forecast to be positive, reflecting a projected fall in multinational profits. Employment growth looks set to decelerate against this backdrop, from the 54,000 recorded in the first quarter to an average of 25,000 for the year as a whole, leaving the average unemployment rate at 5.8% and above 6% by the year-end.

The risks to any forecast are unusually high in the current environment, but house completions will become less significant (down to 7.5% of GDP in the first quarter and likely to be below 6% by Q4) and the other international headwinds battering the Irish economy will presumably die down eventually. Consequently, GDP growth may pick up next year, albeit to only 1.5% in the absence of a substantial fall in oil prices and interest rates, with a similar figure for GNP. Inflation too is forecast to decline, after remaining stubbornly high at an average of 4.5% in 2008. The exchequer finances have not remained immune from the economy's travails, and the Government will have to trim the growth in current spending to about 4% in 2009 if it is to maintain capital spending at this year's level and keep the fiscal deficit below 3% of GDP.

Dr. Dan McLaughlin

Irish GDP

Growth slows rapidly

2007 growth revised higher…

The CSO recently published its first estimate for economic growth in the first quarter of 2008, incorporating substantial revisions to the recent past. These involved upward revisions to output, with GDP in 2007 now put at €190.6bn, over €4bn above the original estimate, with GNP some €3bn higher. The average annual growth rate of GDP in the five years to 2007 is now put at 5.5%, and as such just marginally ahead of GNP at 5.3%, with the long standing growth differential between the two measures narrowing through a combination of slower growth in multinational profits and a pick up in the income earned on Irish investments abroad.

The revisions also carried implications for 2008 as they included changes to last year's output figures and the quarterly profile. GDP growth in 2007 is now put at 6%, from the original 5.3%, with upward revisions to consumption and investment, offsetting a downward revision to exports. GNP growth was also revised, but this time lower, reflecting higher factor outflows, to 4.1% from 4.5%.

…so pace of slowdown was remarkable.

The new data shows that the economy slowed rapidly in 2007 following a very strong first quarter, with GDP growing by just 0.7% on a seasonally adjusted basis in the second half of the year, although the carry over from H1 was sufficient to leave the annual growth in Q4 at 5.5%. This quarterly pattern implied that annual GDP growth would slow sharply in the first quarter of 2008 on base effects alone, but in the event GDP actually declined marginally from the previous quarter in seasonally adjusted terms, to leave output 1.5% down on an annual basis, although GNP growth remained positive, at 0.8%.

This annual decline in Q1 GDP was a surprise to the consensus view, and our own. Residential construction was a factor, with house-building down 30%, but this was in line with most estimates, albeit knocking 3 percentage points off annual growth. Home improvements rose as expected, by just shy of 10%, but other building and construction fell, (despite solid growth in public sector capital spending), by 3.8% or by over 15% when land transfers are included. This left total building and construction 21% down on the year. Spending on machinery and equipment also fell, by 12%, to compound the problem, no doubt reflecting a combination of the credit crunch and the deteriorating global economic environment. The net result was a fall in total capital spending of 18.6% and we now expect that the annual average for 2008 will be only marginally better, with some positive base effects in terms of spending on machinery and equipment alongside declines in residential construction at a similar pace to the first quarter.

Consumers spending more abroad…

Consumer spending also slowed appreciably in the first quarter, to 3.5% from 5.4% in the previous quarter, and is now likely to be weaker than we envisaged earlier in the year. One factor at work is inflation, which thanks in the main to food and energy, has remained stubbornly high, thus eroding real incomes. Spending in cash terms also slowed, however, as household income growth has slowed relative to 2007; employment grew by 3.6% last year and wage growth exceeded 5%, giving an 8.8% rise in total wage income, but that figure may be only around 6% in 2008, given that employment growth may average only 1%. The savings ratio may also rise, given the uncertain economic backdrop, and so we expect real spending growth of 2.5% for the year as a whole, from 6.3% last year and two consecutive years of 7% growth before that. It is also noticeable that consumer spending grew much faster than retail sales due in part to a substantial increase in spending abroad by Irish residents; foreign spending rose by 30% in the first quarter versus a 2% rise in spending by tourists coming to Ireland.

…exports surprised to downside…

Government spending grew by 4.5% in the first quarter, which appears a reasonable assumption for the year as a whole, but the surprise element in Q1 was exports, and the path of external trade over the remainder of 2008 will determine on which side of zero GDP growth finally emerges, given its importance in the national accounts. Total exports amounted to €151m in 2007, against a GDP total in excess of €190bn, with service exports amounting to €66bn, having risen at a consistent double digit pace in recent years. That pace faltered in Q1, however, as service exports growth slowed to just 4.2%, which alongside negative growth in manufactured exports reduced the annual growth in the volume of total exports to just 0.5%, from 8.2% in the previous quarter. Imports slowed too, to 0.7%, but it was this unexpectedly weak export performance which not only surprised but resulted in a negative GDP reading.

zero GDP growth now expected in 2008…

The base effects for the rest of the year are more positive for merchandise exports than for imports, and volumes may be revised higher given other data on falling export prices. The first quarter figure also showed a sharp fall in insurance earnings, which are volatile through the year and may recover somewhat. Consequently we expect exports to grow by 3.5% in 2008 as a whole, with import growth of under 1%.

The export volume data for merchandise exports is also somewhat at odds with manufacturing output, which rose by an annual 2.7% in the first quarter, although the national accounts data does show a stock build. We also expect a positive contribution from stocks for the year as a whole. The net result is that GDP growth is now forecast to be flat on the year, with a positive contribution from net trade offsetting the impact of falling domestic demand, led by the plunge in capital spending. GNP growth may stay positive however, as the slowdown in export growth curbs multinational profits, with the result that net outflows are forecast to decline relative to 2007, thus boosting GNP growth to 0.6%.

…but uncertainties abound.

These forecasts are obviously clouded with uncertainty - oil prices, ECB policy, the persistence of the credit crunch, the shape of a US recovery, if any near term, and the outlook for the US dollar are just some of the factors which will impact on Irish consumers and business in the coming months, and make any projections for 2009 subject to more caveats than usual. Our own view is that Irish house completions will not fall forever, and at some stage will cease to become a significant negative for growth. One should also remember that house-building has already fallen to 7.5% of GDP and will be below 6% by the fourth quarter, so any change in that sector becomes less significant for overall growth. At the moment we are penciling in 1.5% GDP growth for 2009, on the basis that house-building stabilises and consumers receive a boost from falling inflation. A fall in oil prices and lower interest rates would lead to stronger growth than forecast, but neither are guaranteed.

Irish Economy Forecasts

GDP (% Change)	2006	2007	2008(f)	2009(f)
Personal Consumption	7.1	6.3	2.5	2.5
Government Consumption	4.8	6.0	4.5	1.0
Capital Formation	4.0	1.2	-16.6	-2.0
Stocks (1% of GDP)	0.8	-0.1	0.6	0.2
Exports	5.7	6.8	3.5	3.5
Imports	6.3	4.1	0.5	3.0
GDP	5.7	6.0	0.0	1.5
GNP	6.3	4.1	0.6	1.5

Inflation

Inflation high for longer than expected

Inflation has been in a 4.5% to 5% range.

Irish inflation, as measured by the CPI, has been in a broad 4.5-5% range for over eighteen months now, briefly breaking to the upside at 5.1% in the spring of 2007 and below the lower bound, to 4.3%, on two occasions this year. The consensus view, which we shared, was that inflation would fall steadily in 2008, but this has proven to be wrong, thanks in the main to international trends in food and energy, although the persistence of the credit crunch also has a role to play.

Food and non-alcoholic beverages account for 11.7% of the CPI basket and had generally lagged other price increases in recent years, but this changed last autumn, with annual inflation in that category accelerating from 2.7% in September to 9.3% in March 2008. This may have been the peak of the cycle as recent months have seen a deceleration, and a sharper fall is likely from September in the absence of another surge in global food prices.

Food and oil have kept inflation high...

Another key factor in Irish inflation of late, and indeed, across the global economy, has been the extraordinary performance of oil prices, doubling in dollar terms in 2007, and then reaccelerating again from April after a modest retreat to leave prices in early July still 100% above the level twelve months earlier. Consequently, the annual rate of energy inflation in Ireland has remained in a broad 7.5%-10% range since last winter, when many expected a deceleration. This may indeed materialise but energy has kept prices under upward pressure in recent months.

Food and energy inflation has also helped to push up inflation across the euro area, and Irish inflation as measured by the HICP index has been broadly in line with that trend, climbing to 3.7% in May from 2.8% a year earlier. The HICP index does not include mortgage costs, and these have proven to be another significant factor in the Irish CPI, as they account for 6.7% of the total index. Mortgage costs had risen sharply in 2006 and 2007 but the annual increase has decelerated in recent months, reflecting base effects. The decline has not been as substantial as we had envisaged however, due to the upward drift in effective mortgage rates in response to the rise in wholesale rates.

…some relief seen in 2009.

The recent rate rise by the ECB will also feed through in the next month so we may well see Irish inflation remaining above 4.5% till the last few months of the year, leaving the annual average also at 4.5%, which is marginally lower than 2007 (4.9%) but a third consecutive year of inflation at 4% or above. On the positive side a stabilisation in oil prices would help to push inflation lower in 2009, and we expect an average of around 3% in terms of CPI inflation.

Inflation (CPI, % Change)

	2008	2009
Quarter 1	4.7	3.6
Quarter 2	4.6	2.9
Quarter 3	4.7	2.5
Quarter 4	4.3	2.7
Year	4.5	2.9

Bank Lending

Credit growth still slowing

The pace of credit growth peaked in Ireland in the first half of 2006, at 28.1% in the case of residential mortgages and 30.3% for total lending to the private sector, and although both have slowed significantly since then, the respective trends have differed.

Mortgage lending growth now at 11%...

Gross mortgage lending turned negative in the first quarter of 2007, and fell by 20% in the year to Q1 2008, which means that the mortgage stock is still growing but at a much slower rate than in the recent past. As a result the annual increase in mortgage debt had slowed to 13.4% by end 2007 and the latest reading, for May 2008, was 11.1%. Lending is slowing at a decelerating pace, however, with the three-month annualised change in May at 9.7% from a low of 7.5% in March, perhaps indicating that gross lending is no longer falling at a 20% annual rate. Indeed, a number of lenders have pointed to a pick up in applications in the second quarter, although it remains to be seen what impact the ECB rate rise in July has on mortgage demand. Despite the slowdown, Irish mortgage lending is still growing at twice the pace of the euro zone average.

…but non-mortgage lending has proved more resilient…

Non-mortgage lending has proven more resilient, ending 2007 with annual growth of 20.6%, and slowing modestly to 18.2% in the latest reading to May. Despite some ill-informed speculation to the contrary, personal unsecured lending in Ireland is extremely low (accounting for 6% of total lending at March 2008) and the resilience of non-mortgage lending is accounted for by the corporate sector, although one might expect the latter to slow given the current phase of the economic cycle, particularly in construction and real estate activities.

…personal unsecured debt is low, notably in credit cards.

Personal unsecured debt stood at €24.5bn at end-March, equivalent to 17% of the total secured on residential property, with the outstanding balances on credit cards at only €2.8bn. Consumer behaviour in relation to card debt has changed, with May 2007 seeing a marked increase in the repayments made during the month, no doubt reflecting the fact that many households saw the maturing of their SSIA accounts. Certainly the following months saw a substantial deceleration in the growth of card debt, from 17.1% in April 2007 to 7.2% twelve months later. May did see a rebound to 11.9%, but the actual monthly payment was on a par with the record high the previous month, so the upturn merely reflected the base effect from the previous year.

Further evidence then that the Irish consumer has become more circumspect about the near-term outlook and there is little in the lending data overall to signal any upturn in economic activity.

Exchequer Finances

Tax shortfall projected at €3bn in 2008

The Budget was predicated on 3% GDP growth…

The 2008 Budget was predicated on real GDP growth of 3% and nominal growth of 5.5%. The Department of Finance also expected a slowdown in the housing market, and projected a 10% fall in stamp duty which alongside modest growth in capital taxes and income tax trimmed the forecast rise in tax receipts to 3.5% on the 2007 outturn. It quickly became apparent, however, that capital taxes were falling sharply and that VAT would be substantially adrift of the 7.3% rise penciled in at Budget time. By March the tax shortfall was €600m and over the second quarter the slippage in VAT and capital taxes grew, with stamp duty also deteriorating relative to forecast.

The net result was a €1.45bn shortfall relative to expectations at end-June, with tax receipts 8.1% below the first half of 2007. VAT had become the largest culprit, running some €600m behind target, reflecting the decline in house completions and a broader weakening in consumer spending, including car sales. The impact of the housing downturn was also evident in capital taxes (€400m adrift of forecast) and stamp duty (over €200m slippage) although income tax was broadly on target as was corporation tax.

…and receipts now expected to be €3bn adrift.

The Department of Finance then took the unusual step of revising its economic outlook at the mid-year point (it now expects GDP growth to be 0.5% and the unemployment rate to average 5.8% from 5.6%) and projected a full-year tax shortfall of €3bn. This actually implies a significant improvement in the annual pace of decline as it leaves receipts less than 3% below the 2007 outturn, but seems a reasonable estimate at this stage of the year, given that the June data did point to some levelling off in the pace of declines. The unexpected rise in unemployment is expected to add some €500m to spending but this is to be met by finding 'savings' in other areas of expenditure, to leave overall spending on target. The implication then is that the General Government deficit will emerge at €4.9bn instead of the €1.9bn originally projected, the former exceeding 2.5% of GDP.

Current spending growth likely to be trimmed to under 5% in 2009.

The Government has therefore decided to increase borrowing in 2008 to finance the tax shortfall, rather than cut projected spending in capital or current terms. This seems reasonable particularly as the current budget is still forecast to be in surplus to the tune of €1.7bn. The 2009 Budget promises to be difficult, however, even if growth is projected to pick up marginally, as any forecast upturn in tax receipts will probably be modest at best. Current spending growth would have to be cut back to less than 5% to keep the current budget in surplus in such circumstances, and assuming that capital spending is maintained at 2008 levels in real terms.

Exchequer Finances
(Euro bn)

	2007	2008 (budget)	2008 (f)
Current Spending	40.9	44.8	44.8
- Voted	37.0	40.4	40.4
- Non-Voted	3.0	4.4	4.4
Revenue	47.9	49.6	46.6
- Total	47.2	48.9	45.9
- Other	0.7	0.7	0.7
Current Budget Balance	7.0	4.8	1.8
Capital Balance	-8.6	-9.6	-9.6
Exchequer Balance	-1.6	-4.9	-7.9
General Government Balance	0.9	-1.8	-4.8
(% of GDP)	0.4	-0.9	-2.7

The Irish Labour Market

Unemployment rises sharply

The numbers on the Live Register have risen sharply…

The most timely data on conditions in the Irish labour market is the monthly claimant count, known as the Live Register, although it includes part-time, seasonal and casual workers so is not a measure of unemployment. The latter is determined by the Quarterly Household Survey, which also provides data on the labour force and a detailed breakdown of employment by sector. Nonetheless, the trend in the Live Register is used as an input in calculating the monthly unemployment rate and is often a lead indicator of changes in the labour market.

On that basis conditions in the market, which had softened through 2007, albeit from a position of full employment, have deteriorated significantly in the year to date. The Live Register total began to drift higher in the autumn of 2007, ending the year at 172k, to give an annual rise of 15k. Since then the pace of signing on has increased, with the June 2008 total at 217k, leaving the annual increase at 54k. Some 31k of the total were claiming benefit, meaning that they had recently left employment, with the balance of 23k claiming allowances which is paid to those who may never have had paid employment. The unemployment rate was 5.7% on the latest reading, having risen from 4.6% last December.

…implying a further deceleration in employment growth.

The implication is that the next Quarterly Household survey will show a further deceleration in employment growth, although any slowdown is coming off a high base, which means that the annual change in employment is still likely to be positive. This was evident in the first quarter data, showing annual employment growth of 54k, or 2.6%, although this was down on the previous quarter figure of 67k and compared with 76k twelve months earlier. The survey did show annual job losses in construction and manufacturing, but these were more than offset by strong job gains in services, notably financial and wholesale. Total employment stood at 2.14m against a labour force of 2.24m, leaving 102k unemployed. Labour force growth has also slowed, reflecting a more modest rise in the participation rate and a softening in the pace of immigration, even though the latter accounted for 75% of the labour force growth in Q1.

We expect employment growth to slow through 2008, ending the year flat to give an annual average growth of 25k or some 1%. The labour force is also slowing but at a more modest pace, which will leave unemployment at 135k at year-end, or over 6%, with the average for the year at 5.8%. 2009 may see some modest pick up in employment through the year but this will not be strong enough to prevent the unemployment rate average some 6.5%

Labour Market (annual average ‘000)

	2007	2008 (e)	2009 (f)
Employment	2117	2141	2147
Labour Force	2218	2272	2298
Unemployment	101	131	151
Rate (%)	*4.5*	*5.8*	*6.5*

Contacts

Bank of Ireland Global Markets
www.boi.ie/globalmarkets

Chief Executive: Austin Jennings
Head of Global Customer Business: Deirdre Flannery

Colvill House, Talbot Street, Dublin 1, Ireland
Fax: +353 1 799 3035 Tel: +353 1 799 3000
e-mail: info@boigm.com

Economic Research Unit (ERU)

Chief Economist, Bank of Ireland: Dr. Dan McLaughlin
Senior Economist: Michael Crowley
Economist: Patrick Mullane

Tel: +353 1 609 3341
e-mail: eru@boigm.com
Listen to Daily Commentary on Freephone: 1800 60 70 60

Corporate & Institutional Sales — Freephone 1800 30 30 03

Deputy Head of Customer Group John Moclair	
Corporate: Paul Shanley	+353 1 790 000
Institutions: Gavin Rylands	1800 60 70 40
Property & Specialised Finance: Ed Preston	+353 1 609 3277
Corporate Relationship Manager: Eamon McManamy	+353 1 609 3215
Head of Business Development: Fintan Reilly	+353 1 609 3465

Retail Sales — Freephone 1800 790 153

Head of Retail Sales & Customer Group Operations: Aine McCleary	
Business Development & Sales Management: Adrienne McNally	
Business Banking Sales: Leslie Cosgrave	1800 790 153
Branch Sales / Dealer Assistants: Liam Connolly	+353 1 609 4330

Global Markets United Kingdom (UK)

Managing Director: Peter Goshawk
Chief Dealer: Liam Whelan
Head of Business Development: Duncan Wilson
Head of London Treasury Sales: Sandra Perry

Eastcheap Court, 11 Philpot Lane, London EC3M 8BA
Tel: +44 (0) 20 7560 8600
GB Treasury Sales Team Freephone: 0800 039 0038
NI Treasury Sales Team: 0800 776 616

Global Markets United States (US)

Head of US: Darsh Mariyappa
Head of US Business Development: Joe Connolly
Head of US Sales: Garreth Boyle

300 First Stamford Place, Stamford, CT 06902, US
Tel: +1 203 391 5555
Fax: +1 203 391 5901

Global Products Team

Global Head of Structured Business: Brian Vaughan	Tel: +353 1 790 0040
Head of Structured Products Distribution: Barry McLaughlin	Tel: +353 1 790 0400

Marketing

Head of Marketing: Damien Daly — Tel: +353 1 609 3302

Market data supplied by Reuters