

The Irish Economy

Recession Ends As Exports Surge

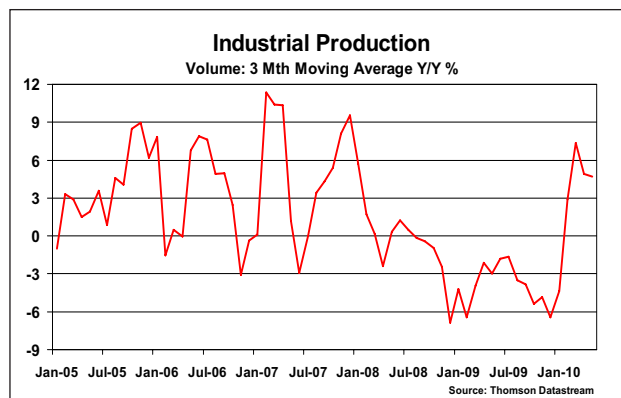
Q1 2010 Irish National Accounts data released at end June, show that the economy has emerged from a two year long recession, with GDP rising by 2.7% in the quarter as exports surged ahead. However, it is going to be an uneven recovery in 2010 in both pace and breath.

Industrial production and external trade figures can be quite volatile and GDP could well have declined in Q2, though it should pick up again in H2 2010. The economy still faces considerable headwinds, with declining construction activity and government spending continuing to weigh on growth. We expect that GDP, after showing 0% growth in 2010, will expand by 2.5% next year as the negative factors weighing on growth start to abate, and exports and consumer spending strengthen. GDP growth of 4-5% is expected thereafter.

GDP Rises by 2.7% in Q1 2010

- The world economy started to recover around the middle of 2009. The expectation was that it would be the middle of this year, though, before the Irish economy started to grow again. However, **there has been a lot of evidence of a pick up in Irish activity since the start of the year, which was confirmed by recent CSO data showing that GDP rose by 2.7% seasonally adjusted in Q1 2010.**

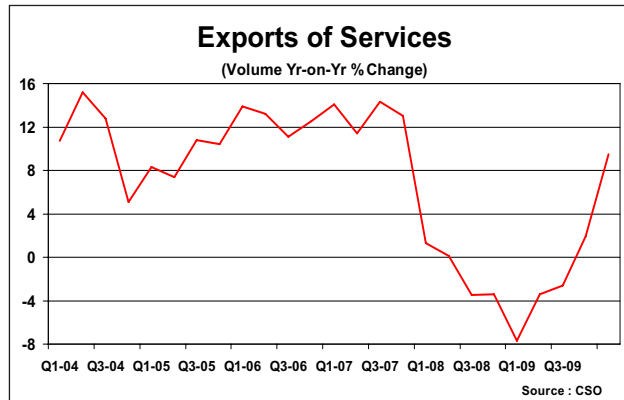
- There has been a **strong rebound in activity in the industrial sector of the economy** in particular, which accounts for close to one-quarter of GDP. **Industrial output was up by 6% year-on-year in the first five months of 2010**, leaving it some 9% higher than in the second half of last year. Although the surge in output has been primarily driven by the multi-national firms in sectors such as pharmaceuticals, there also has been a welcome rise in output in indigenous sectors too.



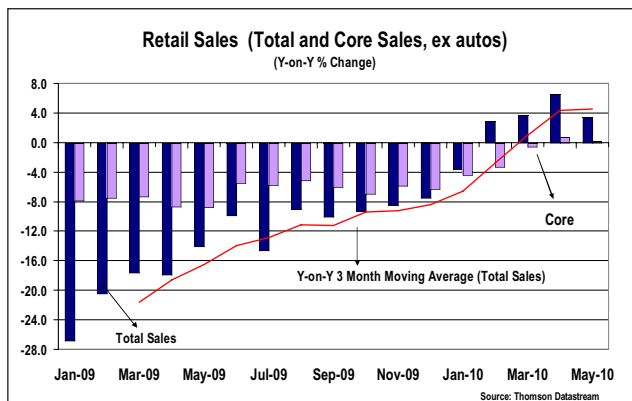
- The surge in industrial output has seen a return to growth for goods exports, which rose by 2.4% year-on-year in volume terms in Q1 2010, having declined by over 5% in 2009. Nearly half of Irish exports now consist of services. These declined for much of 2008-09, before rising by 1.9% year-on-year in Q4 2009 and then surging by 9.5% year-on-year in Q1 2010.
- Overall, then, **total exports grew strongly in the opening quarter of the year.** They increased by almost 7% in seasonally adjusted, volume terms over Q4 2009, to leave them up by 5.5% year-on-year. Imports rose by just 2% seasonally adjusted in Q1 and were still

down by 2% on year earlier levels. Thus, net trade made a major contribution to GDP growth in Q1.

- Overall, it seems that the pick-up in the world economy and global trade, the weakening of the euro against sterling and the dollar and the major gains in competitiveness being made by Ireland have all combined to kick-start a strong recovery in Irish exports. This is very good news as **exports are a very large part of the Irish economy**, equating to 87% of GDP (107% of GNP) in 2009.

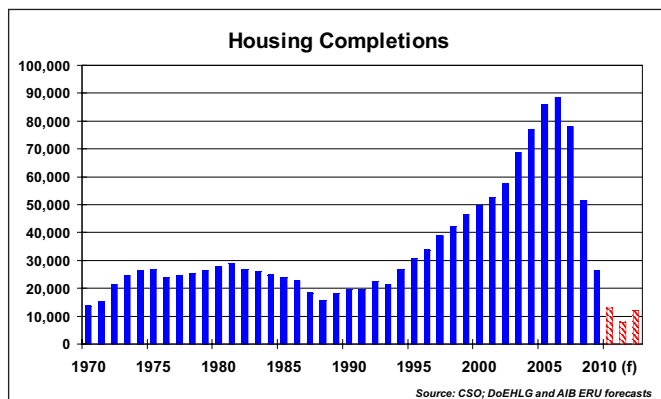


- On the domestic front, there are signs of improvement in the economy too. **New car sales were up by 44% year-on-year in the first half of 2010.** This is not a surprise given that an attractive car scrappage scheme was introduced at the start of the year. However, encouragingly, non-auto retail sales are also recovering.



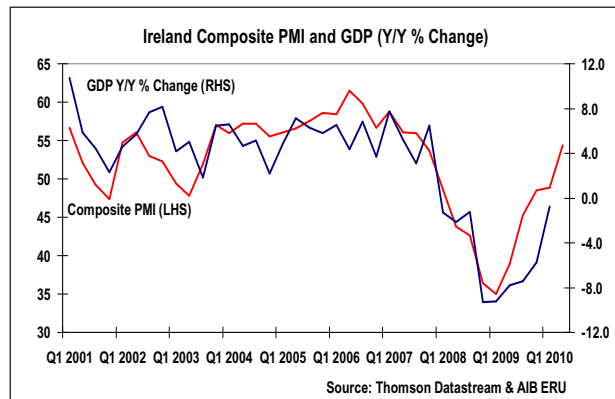
- The latest data show that despite another harsh budget last December, **retail sales excluding the motor trade rose in each of the first three months of 2010** to record their first quarterly increase in over two years, rising by more than 1% in volume terms. They sustained these gains in April/May, with their year-on-year rate turning positive.
- It should be noted, though, that **important parts of the Irish economy continued to contract in Q1.** Indeed, overall total consumer spending remained sluggish, declining by 0.2% in Q1 on Q4 2009 levels, indicating that spending on personal services has yet to recover. High unemployment, downward pressure on wages and incomes, as well as tight credit conditions are all constraints on consumer spending. However, the most pronounced areas of weakness in the economy are fixed investment and government spending.

- Housing completions fell a further 50% year-on-year in the opening quarter of 2010** and the broader construction sector remained very weak, including public capital spending. Investment in machinery and equipment fell by 16.5% year-on-year. In total, **fixed investment contracted by 30% year-on-year in the quarter. Meanwhile, government spending fell by 6.4% year-on-year in the first quarter.**

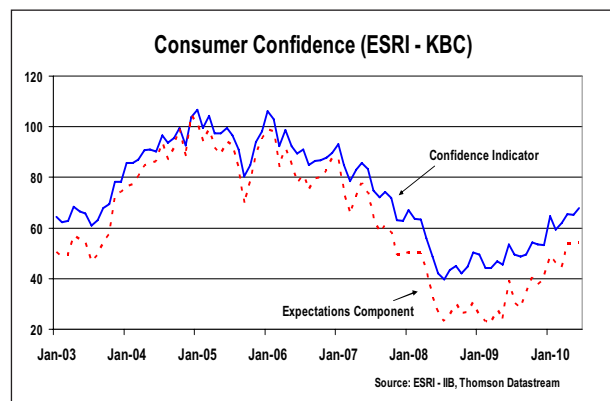


GDP Growth Forecast at 0% for 2010 and 2.5% in 2011

■ **Leading indicators of activity in manufacturing and services suggest that the rebound in activity will continue.** The PMIs for both sectors have been above the key 50 level since the spring. Meanwhile, the OECD's leading indicator for Ireland, which has also been on an uptrend over the past year, has moved above the key 100 level in recent months.



■ **Consumer confidence has picked up to its best level in two years,** although it is still some way below its pre-recession levels. Personal savings have risen strongly in the past couple of years and it may well be that these will be run down somewhat in 2010, supporting household spending. Marked falls in consumer prices are also boosting real spending power.



■ **Nonetheless, GDP growth could have easily slipped back into negative territory in Q2.** We have

only limited data for Q2 at this stage. However, industrial output in April/May was down by over 5% on Q1 levels. The merchandise trade surplus in April was also well down on Q1 levels because of a rise in imports. Housing completions maintained their marked decline in Q2, while public capital spending was particularly weak. Government spending also continued to decline in Q2.

■ **Notwithstanding this, GDP growth should pick up again in H2 2010** given the continuing improvement in external demand and ongoing gains being made in Irish competitiveness, as well as signs of a stabilisation in consumer spending and expectations of an unwinding of some of the fall in government spending in H1 as it was partly due to timing factors. We expect GDP growth to turn positive on a year-on-year basis in H2 2010.

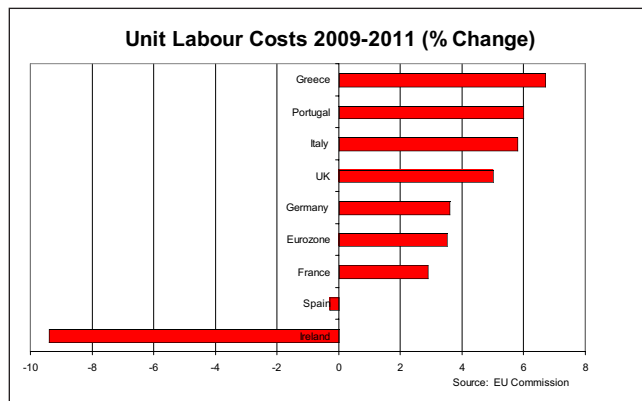
■ However, with some sectors of the economy still very weak, and given the **large negative carryover effects from last year**, when GDP contracted by 7.6%, it will be a challenge for the economy to record a positive growth figure for 2010 as a whole, despite the very strong start to the year. **Our forecast is for no change in GDP in 2010. A positive figure is certainly possible**, especially if exports sustain their strength and consumer spending picks up - the latest ESRI forecast is for growth of 0.25% in 2010, while the Dept of Finance is now forecasting a 1% rise in GDP this year.

■ **The main negative factors holding back growth this year should abate appreciably in 2011.** The housing sector, in particular, will have reached very low levels of activity by end 2010. Even though housing is set to decline somewhat further next year, it will no longer be a very severe drag on GDP growth. Fiscal policy in Ireland is also expected to turn somewhat less contractionary in 2011. Meanwhile, the recovery in developed economies is expected to have gained strength by next year. Hence, organisations such as the European Commission, OECD and the Economic and Social Research Institute (ESRI) are forecasting that **growth in Irish GDP will pick up to around 2.5-3% in 2011.**

- **Although the Irish economy has emerged from recession, it still faces considerable downside risks and challenges.** Given that the recovery is very much export led, the **main risk is now external in the shape of a renewed weakening of the global economy.** Although the IMF is optimistic about global growth prospects next year, there are some fears of a double-dip recession in developed economies, especially if the fiscal tightening now underway in many countries proves overly aggressive.
- It is also worth noting that the economy is likely to contract on a GNP basis this year and our forecast is for GNP to expand by just 1.5% in 2011 compared to 2.5% for GDP. This is because much of the growth is export led and thus results in a marked rise in profit outflows from multi-nationals, depressing GNP.

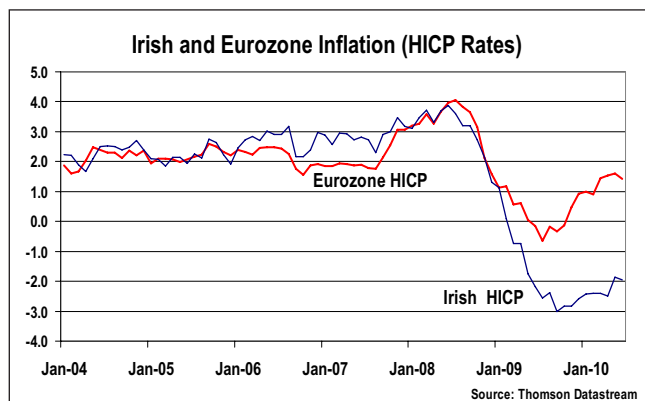
Major Gains in Competitiveness Aid Declining BoP Deficit Trend

- The deep recession provided Ireland with the opportunity to regain lost competitiveness and correct external imbalances. **Pay cuts have become the norm** in both the public and private sectors. As a result of the sharply declining cost base, **the EU Commission estimates that unit wage costs will fall by 9.5% in Ireland in the period 2009-2011**, while at the same time they will rise by 3.5% in the eurozone and 5% in the UK. **Ireland has effectively undergone a sizeable devaluation of its real exchange rate.**



- **The improved competitiveness has been a key factor in the recovery of the Irish economy** this year in that it has allowed it to take advantage of the global upturn via higher exports. It has also allowed a rebalancing of the economy away from its over reliance on the construction sector towards export orientated activity. **The balance of payments deficit fell steeply last year as domestic demand contracted sharply**, declining to 3.7% of GDP from 6.6% in 2008. **The deficit fell further in Q1 as exports surged, declining to under 2.5% of GDP.** Most forecasters see the BoP deficit being eliminated in 2010/11, although we are not fully convinced given the recent high net income outflows.

- Meantime, retail prices continue to fall in Ireland. The consumer price index fell by 4.5% in 2009, while the HICP index fell by 1.7%. **At mid-2010, the Irish CPI rate stood at -0.9% with the HICP rate at -2.0%.** This compares to HICP rates of +1.4% in the eurozone and +3.2% in the UK.



- Thus, Ireland is continuing to deflate its cost base and make competitiveness gains. Furthermore, house prices are estimated to have fallen by close to 50% from their peak at this stage, while rents are down by 25%.

IRISH BENCHMARK MACRO ECONOMIC FORECASTS: JULY 2010

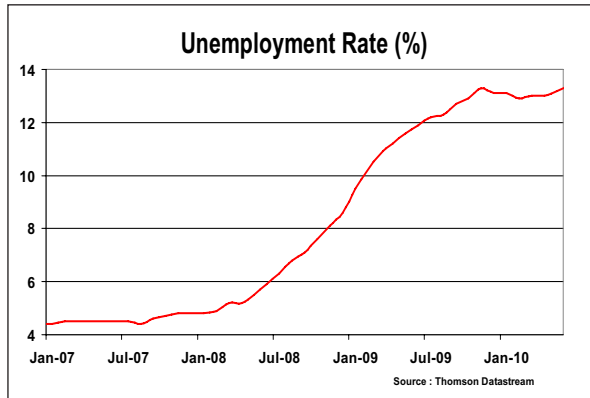
<i>Annual average % change unless otherwise stated</i>	2008	2009	2010 (f)	2011 (f)	2012 (f)
Real GDP	-3.5	-7.6	0.0	2.5	4.0
Real GNP	-3.5	-10.7	-2.5	1.5	3.5
Domestic Expenditure	-4.3	-12.4	-5.7	-0.3	3.0
Personal Spending	-1.5	-7.0	0.0	1.5	2.5
Government Spending	2.2	-4.4	-4.5	-2.0	0.0
Fixed Investment	-16.8	-31.0	-25.0	-5.5	9.5
Contribution of Stocks to GDP Growth	-0.8	-1.4	1.2	0.4	0.1
Total Exports	-0.8	-4.1	4.2	4.5	5.0
Total Imports	-2.9	-9.2	0.0	2.5	4.2
Level of GDP (€bn, current prices)	180.0	159.6	155.0	160.5	169.0
Level of GNP (€bn, current prices)	154.7	131.2	123.5	126.5	133.5
Industrial Production (Vol)					
Total	-1.8	-3.9	5.5	6.0	6.5
Modern	0.0	3.4	9.0	9.0	9.5
Other	-4.1	-14.4	0.5	2.0	2.5
Housing					
Average House Price Inflation (end year)	-9.1	-18.5	-12.0	0.0	3.0
House Completions (CSO Basis '000)	51.7	26.4	13.0	8.0	12.0
Labour Market					
Labour Force Growth	0.8	-2.4	-1.9	0.5	1.1
Employment Growth	-1.1	-8.2	-3.5	0.2	1.7
Unemployment Rate (%)	6.3	11.8	13.3	13.5	13.0
Net Immigration (Year to April '000)	39.0	-7.8	-50.0	-50.0	-25.0
Costs and Prices					
CPI	4.1	-4.5	-1.1	1.5	2.5
Irish HICP	3.1	-1.7	-1.5	0.8	1.5
Mfg Output Prices (Home Sales)	5.3	-0.5	-1.0	0.5	1.5
Earnings Growth (Whole Economy)	2.6	-0.7	-3.0	1.0	2.5
Unit Wage Costs (Whole Economy)	5.2	-1.4	-6.4	-1.3	0.2
External Account					
Total Trade Balance* (% of GNP)	+10.4	+18.3	+22.0	+23.2	+22.1
Current Account Balance (% of GNP)	-6.6	-3.7	-3.6	-3.5	-3.7
(* Goods and Services)					
Public Finances					
General Gov. Balance (€ m)	-13,200	-23,350	-18,500	-17,000	-13,000
General Gov. Balance (% GDP)	-7.3	-14.6	-11.9	-10.6	-7.7
General Gov Net Debt* /GDP ratio (%)	31.0	51.0	63.0	68.0	71.0
(* = gross GGD less cash balances. No provision made for promissory notes)					
Private Sector Finances					
Personal Disposable Income	6.5	-5.4	-4.2	1.8	3.7
Personal Savings Ratio (%)	6.3	11.9	10.3	9.7	8.6

Forecasts prepared by AIB's ERU, historical data sourced from CSO, Dept of Finance, DoE & permanent tsb

Labour Market Remains Very Weak

- **Unemployment rose sharply in 2008 and the first half of 2009 but the pace of increase has moderated considerably since then.** The Live Register, a good monthly

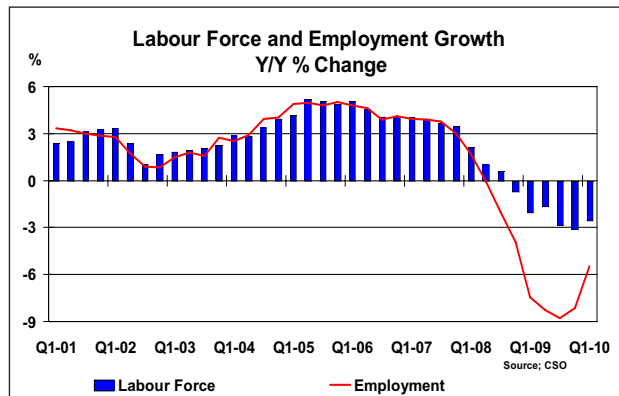
measure of the trend in unemployment, rose from 160,000 in July 2007 to 426,000 by August 2009. However, it was then confined to a very narrow range of 425,000-433,000 up to April 2010. The unemployment rate in Q1 2010 stood at 12.9%, up only slightly from 12.7% in Q3 2010, having surged over the previous 18 months from a level of under 5%.



- **Redundancies peaked around mid-2009** and were down by 20% in the first half of this year. Nonetheless, the economy is continuing to shed jobs, especially in the construction sector where output is still in sharp decline. Thus, monthly redundancies, while falling, remain at a high level.

- The latest Quarterly National Household Survey (QNHS) data, which are for Q1 2010, do show a **slowdown in the rate of contraction in employment**, which fell by 5.5% year-on-year compared to falls of 8.8% and 8.1% year-on-year in Q3 and Q4 2009, respectively. We expect that employment will fall by 3.5% on average in 2010 following a decline of 8.2% in 2009.

- The economy has shed some 270,000 jobs since employment levels peaked in the fourth quarter of 2007 and the number employed has fallen by some 12.5%. The contraction in employment has been led by the construction sector where employment levels have more than halved, falling from a peak of 275,000 in Q2 2007 to 130,000 by Q1 2010. **The construction sector directly accounts for more than half of all jobs lost.**

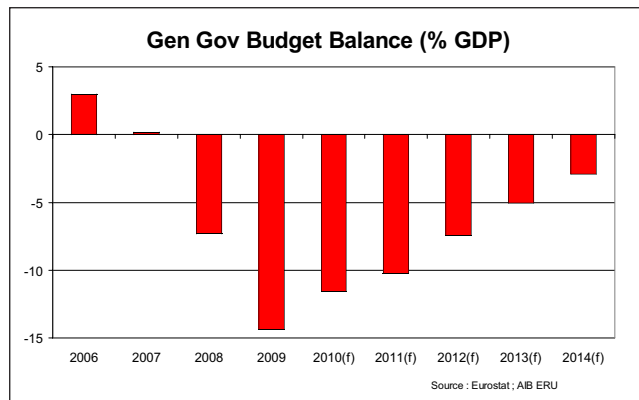


- The fall in employment is occurring hand in hand with a contraction in the labour force which is helping to limit the rise in unemployment. **The fall in the labour force is primarily due to an outflow of non-Irish nationals who have lost their jobs:** the labour force contracted by 56,000 or 2.5% in the year to Q1 2010, with 54,000 of this decline due to a fall in non-Irish national numbers. This is because job losses have been largely concentrated in sectors which employ a lot of non-Irish nationals, in particular construction. Employment of non-Irish nationals fell by 17.3% in the year to Q1 2010 compared to a fall of 3.5% for Irish nationals.

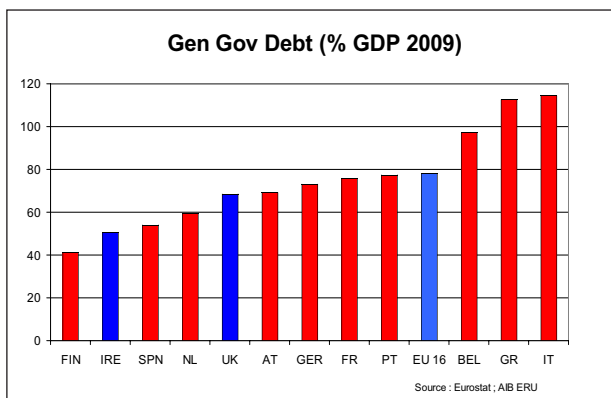
- More recent **Live Register data point to a renewed rise in unemployment in May/June.** This may reflect students who have completed courses now signing on for benefits as well as temporary lay-offs in the education sector over the summer - the Live Register levelled off after August of last year. The unemployment rate had picked up to 13.4% by June. We expect that it will now average around this level in 2010 and average 13.5% in 2011.

Underlying Budget Deficit Stabilised

- Good progress has been made in tackling Ireland's fiscal deficit. **Strong corrective fiscal measures have helped stabilise the underlying budget deficit.** Fiscal tightening amounted to around 5% of GDP last year and some 2.5% of GDP in 2010. This included some very severe measures, in particular an effective cut of 15% in public sector pay and 4% reduction in most social welfare payments. There have also been significant increases in taxes on income.



- **The mid-year Exchequer Returns showed that the government is on course to meet its main fiscal target of stabilising the underlying general government budget deficit at around 11.5-12.0% of GDP this year.** Further, though less severe, corrective fiscal measures amounting to about 1.8% of GDP or €3 billion are planned for the 2011 budget. A total of €4.5 billion (less than 1% of GDP per annum) in further budgetary savings are required over 2012-14 to bring the budget deficit back down below 3% of GDP by 2014.
- **Ireland was fortunate that its public debt had fallen to a very low level by the start of the recession** – less than 25% of GDP - which was one of lowest debt ratios in the EU. The General Government Debt/GDP ratio had risen to 64% by end 2009. However, this does not allow for a large build up of cash balances by the government authorities to some €22 billion, or around 13% of GDP. Taking this into consideration would bring the debt ratio down to around 51% of GDP.



- Furthermore, deducting the value of the National Pension Reserve Fund (NPRF) and other funds managed by the NTMA from gross debt would bring the ratio down to 38% of GDP. The gross General Government debt ratio stood at 79% of GDP for the eurozone and 68% for the UK at end 2009.
- The expectation was that Ireland's gross debt/GDP ratio would rise to around 77% by end 2010. Allowing for continuing high cash balances would leave the ratio at about 63% of GDP at end 2010. It would fall to around 50% of GDP if the NPRF assets are taken into consideration.
- **These 2010 government debt and budget deficit estimates, though, do not make any allowance for post-2009 capital injections by the State into fully nationalised financial institutions** - mainly Anglo-Irish Bank. This is being done via promissory notes over a ten to fifteen year period and could amount to up to €20 billion. The EU has yet to rule on how these notes will be treated in calculating government debt and deficit figures. There are indications that **the bulk of the promissory notes may have to be included in this year's figures even though the funds are not being borrowed in 2010.**



- **If this proves to be the case, it would greatly inflate this year's deficit and debt figures.** The ESRI believes that €13 billion will have to be added to this year's deficit and debt figures for promissory notes, pushing the budget deficit up to some 20% of GDP. It would push Ireland's gross debt figure up to about 86% by end year.
- Official forecasts had predicted that Ireland's General Government debt would top out at 84% of GDP in gross terms in 2012. The inclusion of the €20 billion in promissory notes in the debt figures would mean that the gross debt ratio would top out at over 95% of GDP by 2012-13.
- We would highlight again that **the actual level of government borrowing and the national debt are not being increased in 2010 by these promissory notes.** The authorities 2010 funding programmes are unaffected. Instead, the payments to the financial institutions of the promissory notes will be spread out over the next ten to fifteen years so it will increase Exchequer borrowing by a €1-2 billion per annum over this period. There may well be a formal ruling on the matter by September.

Favourable Medium-Term Growth Prospects

- The ESRI has just published an update of its **Recovery Scenarios for Ireland** which looks at the prospects for the economy over the coming decade, in particular the next five years. As a result of the uncertainty about the future, the ESRI looks at a **High Growth** scenario and a **Low Growth** scenario. The former assumes that the economy will respond as in the past to renewed growth in the world economy and gains in competitiveness. The latter is based, for a variety of reasons, on a much lower responsiveness of Irish output with respect to rising world output than in the past.
- **Under the High Growth scenario, the economy recovers significant momentum by 2011 and averages a robust 4.6% GDP growth rate in the period 2011-2015.** The recovery is export lead, with the rise in world demand having a substantial beneficial impact on Ireland, reflecting the exceptional openness of the economy and improvements in competitiveness. This translates into a pick up in domestic demand, with consumer spending also benefiting from a gradual decline in the personal savings ratio from its current elevated levels, while improving company profitability helps a recovery in private non-residential investment.
- **Under the less optimistic Low Growth scenario, there would still be a significant recovery by the economy over the period 2011-2015, with GDP growth averaging 3.2%.** As a result of a lower response to rising world output, growth in exports and thus output and employment are lower than under the *High Growth* scenario, as is domestic demand also. The ESRI notes that, while **the current evidence suggests that the High Growth scenario may be the more likely of the two**, there are a wide variety of factors which could result in the actual outcome being closer to the *Low Growth* scenario, including a lower growth path for the world economy than currently envisaged.
- The **High Growth Scenario would see the Irish economy restored to full employment by 2015, with the general government budget deficit falling to 2% of GDP by then**, assuming that the government implements its fiscal consolidation plans for the period 2011-14 in full. **Under the Low Growth scenario, the unemployment rate would stand at 7% by 2015, while the budget deficit would still be around 4% of GDP.** Thus, under this scenario, it would require even more painful corrective fiscal action than currently planned by the authorities to get the budget deficit down below 3% of GDP. This is not surprising as the Dept of Finance's fiscal consolidation plans to achieve a 3% budget deficit are based on GDP growth averaging 4% per annum in the 2011-2014 period.