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Bank of Ireland
Global Markets

TheOutlook

A quarterly analysis of trends in the Irish economy

Consumer spending improving as recovery broadens

- Exports still driving the economy
- EBR may undershoot target

The Irish economy, as measured by GDP, recorded positive growth in the first quarter, as we expected, and the consensus view now projects modest growth for the year as a whole and, as such, has moved nearer our own 1% forecast, which remains unchanged.

The upturn has been led by the external sector and exports will continue to be the main driver of activity, boosted by global demand, with sales to the UK also supported by the past year's rally in sterling against the euro. A range of monthly indicators are now pointing to a broadening of the Irish recovery, including retail sales, which look set to record very strong growth in the second quarter. As a consequence, we expect overall consumer spending to increase in Q2 and to rise further as the year unfolds, although the carry-over effects of last year's 7% fall will leave average growth for the year flat in 2010.

The recent data also points to a possible cycle floor for house completions, although this still implies large annual falls in building and construction, with business spending on machinery and equipment also set to decline further. Indeed, total investment spending in 2010 will amount to only 12.5% of real GDP on our forecast, less than half its share at the peak of the boom in 2006. The depth of the Irish recession can therefore be seen as primarily due to a collapse in capital spending, with the fall in consumer outlays the other main factor.

Exports now account for over 90% of GDP, and the accompanying growth of multinational profits will dampen GNP, which we still expect to contract by 1.5% this year. Uncertainties abound, both domestic and international, but at this stage we still expect GDP to grow by 3% next year, which is in line with the consensus view.

The pace of job losses has slowed and the unemployment rate may be at or near the peak, with many unemployed non-Irish nationals leaving the country, as employment is unlikely to rise until 2011. Gross pay in Ireland did not fall as much as some expected and Ireland's experience of price deflation may be coming to a close - we still expect a return to positive annual inflation by year-end.

Finally, the underlying fiscal deficit (i.e. excluding capital injections to Anglo and INBS) may emerge below the Budget projection: tax receipts are broadly on target, capital spending is likely to undershoot, debt service payments may be lower than projected and the Central Bank surplus is running well above expectations. Moreover, fees for the 2010 ELG guarantee on bank deposits is not included in the Budget arithmetic and may well amount to around €1bn by year-end, which is similar to the fees for the 2008 guarantee, which is incorporated.

Dr. Dan McLaughlin

Irish GDP

The recession ended last year

Strong GDP growth in Q1…

The recently published Quarterly Accounts for Q1 incorporated revisions to previously published data, although the broad trend remains unaltered. The economy, as measured by real seasonally adjusted GDP, still peaked in the final quarter of 2007, and then recorded eight consecutive quarters of negative growth, although the scale of that contraction is now put at -14.3%, from -12.2%. The CSO revised exports lower, with the result that annual growth in 2008 is now -3.5% (from -3.0%) with last year's contraction put at -7.6% (previously -7.1%). The change to the export data also impacted estimates of multinational profit flows, and the fall in GNP in 2009 was revised to -10.7% (from -11.3%), although the 2008 figure was revised lower, to -3.5% from -2.8%.

The Q1 data revealed a significant rise in GDP in the quarter, thereby formally signalling the end of the Irish recession; GDP rose by 2.7%, which allied to a substantial base effect (output had fallen 2.5% in Q1 2009) reduced the annual decline in GDP to just 0.7% from 5.8% in the previous quarter.

The pace of recovery prompted most analysts to revise up their forecasts for the full year and the consensus now expects marginally positive growth, and as such more in line with our own 1% forecast, which we are maintaining.

…with exports leading the recovery.

Although Irish exports fell last year, the decline was much smaller than the euro norm or, indeed, world trade, and it seemed reasonable to assume that exports would rise in 2010 given the global upturn. In the event, the rise in the first quarter, at 6.9% on a seasonally adjusted basis, was stronger than we initially expected, although industrial production jumped by over 15% in Q1, implying a decent gain. Consequently, we are revising up our full year export forecast, and now project a 7% volume increase (the annual rise in Q1 was 5.5%). Imports also rose in the quarter, by 2%, and we now expect a positive import figure for 2010 as a whole and have pencilled in a 1.5% increase. This still implies a sizeable net stimulus from the external sector, as in 2009. Furthermore, the deficit on Ireland's balance of payments, which can be seen as a measure of imbalances in the economy, is forecast to fall to around 1% of GDP from 3% last year and 5.7% in 2008.

The pick up in imports implies that domestic demand is also showing some signs of life and that is certainly the case on the consumer side. Personal Consumption did fall again in the first quarter but only marginally so (-0.2%) and the available data signals the strong likelihood of a rise in consumer spending in Q2. Retail sales have risen strongly of late (boosted by a car scrappage scheme) and a significant increase in the second quarter looks assured, while core sales (i.e. ex autos) also looks to have risen, albeit at a more modest pace.

Consumer spending also looks set to pick up...

The trend in consumption also highlights the importance of automatic fiscal stabilisers, as the impact of falling wages (down 0.6% in 2010) and employment on aggregate household income has been partially offset by a rise in aggregate transfers from the Exchequer and a fall in the total tax take. Monetary policy has also played a part, with mortgage holders benefiting from the plunge in ECB rates from late 2008, although some borrowers have recently seen a rise in borrowing costs that are not linked to the ECB repo rate. Real incomes have also been boosted by the fall in consumer prices. Households also appear to have adjusted their savings habits and, although the absence of timely official data makes any definitive conclusions on savings tentative, it does appear that the savings ratio has risen sharply since 2007 and may now be just under 11%. Consumer confidence has risen of late, but we are reluctant to postulate a sharp decline in savings until employment starts to grow, and as a result we retain our flat reading for consumer spending for 2010 as a whole, following a 7% decline last year, which does imply some increase through the year.

The encouraging signs on the consumer front must be set against a relentless stream of bad news in capital spending, which fell by 13.8% in the first quarter and by an annual 30%. The precipitous collapse in residential construction has been well documented (house building fell by an annual 53% in Q1 and now accounts for only 2.1% of GDP),

…although capital spending is still very weak.

but the plunge in spending on machinery and equipment is almost as startling, having fallen by 45% over the past two years. Consequently, total capital spending now accounts for only 13% of real GDP and looks set to decline further through the year - we expect building and construction to fall by 33% in 2010, with a 7% fall in spending on machinery and equipment.

The monthly data on house completions does indicate that a bottom in residential construction may be at hand, but this still implies large year-over-year falls in the second half of 2010 and early 2011.

GNP still expected to decline this year…

In summary then, we have an economy which may grow by 1% this year in GDP terms, with a further fall in domestic demand more than offset by another strong performance from the export sector. The profile may also be uneven through the year and we would not rule out marginal falls in quarterly GDP, particularly in Q2. The absence to date of a pick up in domestic activity has meant that the recovery has not been widely felt throughout the economy, but a rise in consumer spending will provide some more tangible signs that the recession is over, although we still expect GNP to fall this year, given the strength of exports and, therefore, the impact on multinational profits, which will outpace the return on Irish assets held abroad.

…3% growth still likely next year.

GNP is forecast to return to growth next year, however, as the upturn in the economy is expected to become a little more balanced - exports may still lead the way but consumer spending is forecast to pick up momentum given some modest gains in employment, with capital spending on machinery and equipment also expected to return to positive territory. We retain our 3% GDP forecast for next year, which is in line with the consensus, although enough uncertainties abound, both domestically and internationally, to render any forecast more tentative than usual.

Irish Economy Forecasts (% change)

	2009 (actual)	2010 (estimate)	2011 (forecast)
Personal Consumption	-7.0	0.0	2.0
Government Consumption	-4.4	-4.0	-2.0
Capital Formation	-31.0	-25.3	-5.8
- Building and Construction	-35.0	-33.0	-15.0
- Machinery and Equipment	-19.3	-7.0	10.0
Stocks (% of GDP)	-1.3	-0.6	0.0
Exports	-4.1	7.0	6.0
Imports	-9.7	1.5	4.5
GDP	-7.6	1.0	3.0
GNP	-10.7	-1.5	2.5

Inflation

Deflation trend may be over

The CPI index has risen of late…

Ireland's experience of price deflation, which has lasted much longer than the euro norm, may have come to an end, judging from the recent trend in the CPI. The index started to fall on a monthly basis in late 2008 and by January this year had recorded a cumulative decline of 7.3% from the peak. Prices then rose for four consecutive months, however, albeit broken by a marginal (0.1%) decline in June, bringing the total increase over the five-month period to 1.1%. The scale of the price falls last year means that the annual inflation rate in June was still in negative territory, at -0.9%, but we still expect the annual rate to have turned positive by year-end.

The precipitous fall in mortgage interest payments from late-2008 till mid-2009 was the prime factor behind the decline in the CPI, as it carries a 6.7% weight in the index. Base effects alone would have prompted a change in the trend this year but in the event recent months have seen an upturn in effective mortgage rates, so in June mortgage interest payments had actually risen by an annual 16.5%. Similarly, energy prices are also rising on an annual basis, so adding further upside momentum. The trend in food prices (11.7% of the index) has also turned, following a prolonged decline through 2009, with marginal increases in recent months contributing to a marked deceleration in the annual pace of price decline.

…and annual inflation may have turned positive by year-end.

The lagged effect of sterling's depreciation against the euro from 2007 to 2009 may also have put downward pressure on Irish prices, as did the slump in retail sales and a fall in nominal pay, but sterling has rallied significantly over the past year and high street spending appears to be picking up, so these deflationary forces may be far less significant in the coming year. Moreover average pay rates in the economy have not fallen as much as some expected. Consequently, we expect the annual CPI inflation rate to average 1.8% next year and to accelerate in the second half in response to higher rates from the ECB.

The HICP index, the EU standard, does not include mortgage interest and, consequently, price deflation on that measure has not been as pronounced, with a 4.4% fall from the peak to January 2010. Again, this appears to have been the floor, with a 0.5% rise since then, albeit still leaving the annual inflation rate at -2.0%. Aside from interest rates, the same factors impacting the CPI may also push the annual inflation rate in this measure into positive territory towards year-end, although the pick-up in 2011 is likely to be more modest, with an annual average of 1.0%.

CPI Inflation (% change)

	2009 (actual)	2010 (forecast)
Q1	-1.5	-3.4
Q2	-4.5	-1.4
Q3	-6.1	-0.2
Q4	-5.8	1.0
Year	-4.5	-1.0
HICP	-1.7	-1.4

The Irish Labour Market

Pace of job loss slows

Employment still falling but at a slower pace…

The most comprehensive data source on developments in the Irish labour market is the Quarterly National Household Survey, although figures are only available for the first quarter. These showed that the economy is still shedding jobs, but at a much slower pace than the previous year: employment fell by a seasonally adjusted 17,000 in Q1, or 0.9%, against a 1.2% decline in the previous quarter and a 3.6% plunge in Q1 2009. The annual pace of job loss also slowed appreciably to 5.5% from 8.1% in the previous quarter.

Employment in the construction sector fell further and now stands at 131,000, 7% of the employed population, against a cycle high of 285,000 (13.7% of total employment), with more job losses likely to emerge. Employment is also still falling in manufacturing and agriculture, although some private sector service industries are hiring labour and the pick up in high street spending augurs well for the wholesale and retail sectors. Pay rates have also declined in many areas, making labour more attractive to employers, but we doubt if employment will begin to rise on a consistent basis till 2011. Consequently, we still expect an average 4% fall in employment this year.

The labour supply has also fallen sharply over the past eighteen months, although again the pace of decline slowed in Q1. The Irish participation rate has fallen substantially (to 60.7% from a cycle high of 64.8%) particularly in the 15-24 age group, and the available data points to a substantial pick up in immigration. Employment for non-Irish nationals fell by an annual 50,000 in Q1, but unemployment actually declined by 4,000, with 54,000 leaving the workplace and, in most cases, the country.

…and unemployment expected to average 13.3%.

Again, we are inclined to maintain our existing labour force forecast, incorporating an average 50,000 fall this year, followed by a further modest decline in 2011, which leaves the average unemployment rate for 2010 at 13.3%, declining to 12.8% next year. This implies a further marginal rise in the coming months, given the first quarter average of 13% and 13.2% in Q2, although the monthly estimates, based on the trend in the claimant count, are subject to substantial revision: the previously published unemployment rates for late 2009 were subsequently revised up, while the initial estimate for the first quarter of 2010 was revised down.

Labour Market (annual average ‘000)

	2009	2010 (forecast)	2011 (forecast)
Employment	1929	1851	1852
Labour Force	2187	2136	2125
Unemployed	259	286	263
(%)	*11.8*	*13.3*	*12.8*

Exchequer Finances

Core deficit may undershoot target

The Government expects the 2010 Budget to be on target…

The 2010 Budget was predicated on a 1.3% contraction in real GDP, which now looks pessimistic in the light of recent developments. Indeed the Department of Finance has revised its growth forecast and now expects the economy to expand by 1%. Despite this change, the authorities still expect a Budget outturn in line with the original projection and reiterated this view following publication of spending and tax data for the first half of the year.

On the revenue side, tax receipts emerged €227m or 1.5% behind profile, in large part due to a €300m slippage in income tax. Revenue on that heading is now 8.6% down on the previous year, no doubt reflecting a continued fall in employment and a decline in earnings. Stamp duty (€44m) and excise duty (€23m) were also marginally adrift of expectations, although this was offset by above-profile returns from VAT (€50m), capital taxes (€34m) and corporation tax (€34m).

On the spending side, current expenditure was broadly in line with the projected profile but a substantial undershoot on the capital side has been apparent in recent months, although the official explanation points to timing issues, as opposed to a more fundamental undershoot.

The above fiscal trends left the current budget deficit at €8bn for the first six months of the year, against €7.2bn in the same period of 2009, although the overall deficit was much lower than the previous year, at €8.9bn against €14.7bn, reflecting lower capital outlays in 2010 and the impact of a capital injection to Anglo Irish Bank last year. The 2010 annual payment to the National Pensions Reserve Fund was also brought forward to 2009.

…but an undershoot looks possible.

Our own view is that the Exchequer Borrowing Requirement (EBR) may well emerge below the target. Tax revenue is likely to be around forecast but non-tax revenue could be well above expectations thanks to a much larger surplus from the Central Bank. Day-to-day spending may come in around target but debt service payments may well be lower than originally projected, with capital spending also finishing the year below the Budget forecast. As a consequence we expect an EBR outturn of around €18bn and this excludes the sizeable sums accruing in bank fees for the 2010 deposit guarantees (the ELG scheme) which are not included in the Budget arithmetic. Direct capital injections into the banking system (€13bn ytd) are also not included and these may be added to the General Government deficit, although not to the EBR.

Exchequer Finances (€bn)

	2009 Actual	2010 Budget	2010 Forecast
Current Expenditure	45.2	47.1	46.9
- Voted	40.2	40.2	40.3
- Non-voted	5.0	6.9	6.6
Revenue	33.9	33.4	33.8
- Tax	33.0	31.0	31.1
- Other	0.9	2.4	2.7
Current Budget Balance	-11.4	-13.7	-13.1
Capital Balance	-13.3	-5.1	-4.9
Exchequer Balance	-24.6	-18.8	-18.0
General Government Balance	-23.4	-18.7	-18.0
(% of GDP)	*14.3%*	*11.6%*	*11.2%*

Funding the Exchequer Deficit

Funding reaches 90% of annual target

Over €18bn debt funding year to date…

In January, the NTMA, the agency responsible for managing Ireland's sovereign debt, announced a funding target for the year of €20bn, based on the official Budget deficit projection of €18.8bn and modest debt redemption. By end-June the agency had funded over 80% of this target and another auction in July brought the total to 90%, implying that some over-funding is in prospect in the absence of a substantial deterioration in investor sentiment.

The NTMA has raised €11.5bn via seven monthly auctions year-to-date, and an additional €5bn through a bond syndication in January. In addition some €1.6bn was raised through the National Savings schemes (marketed to the retail sector) giving a total in excess of €18bn in debt funding.

The net sum (i.e. after bond redemptions) raised in the first half of the year was €14.2bn, compared with an exchequer deficit of €8.9bn implying a comfortable over-fund. However, the NTMA chose to run down its commercial paper borrowings by over €8bn which resulted in a net reduction in cash balances over the period of €1.3bn. Nevertheless, this still left outstanding cash balances at €20.5bn at end-June, as the NTMA likes to have a large supply of liquidity at hand to cover periods of market turbulence.

…at a slightly lower yield than last year.

The weighted average yield on new Irish bond issuance year to date is 4.57% which is marginally lower than 2009 as a whole despite a slightly longer maturity profile, so from an Irish taxpayers perspective the cost of borrowing has declined in 2010. Yet the average spread over Germany is virtually identical over the time periods (at 187bp in 10-year bonds), so the improvement has been solely due to a fall in bond yields internationally.

The 10-year Irish spread over Germany, a proxy for the perceived risk of holding Irish debt, moved sharply higher in recent months, from a low of 128bps to a high in excess of 300bps, albeit largely due to concerns about peripheral euro government bonds in general rather than any specific Irish issue. Indeed, the spread has begun to narrow again to around 275bps and we would expect some further tightening in the coming months in the absence of a general shock to the euro system, reflecting Ireland's return to economic growth and the prospect of some undershooting of the Budget target. The main specific shorter-term Irish risk relates to the two fully state–owned banks and their capital requirements; €13bn has been provided so far in 2010 by way of a promissory note. This is payable over a 10-15 year period and as such will not be funded near term, although it has been added to the Government's projected end-year debt figure. Eurostat may also decide to add it to this year's General Government deficit, although that remains unclear.

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