Quarterly ECONOMIC OUTLOOK

IBEC

April 2011

Jobs budget must provide confidence boost

Irish consumers have experienced a challenging start to 2011. January saw the full impact of the difficult December Budget filter down to workers' pay packets. Although the tax hikes had been well flagged in the course of the budgetary analysis, their implementation still surprised many employees and were a blow to consumer spending. Commodity price inflation has also started to feed through to retail prices, particularly in the case of fuel, and inflation will weigh heavily on real disposable incomes this year. Finally, the recent ECB rate increase decision will come as a blow to many householders, with the prospect of further increases in the pipeline. In the context of these headwinds, it is essential that the May jobs budget delivers a much-needed shot in the arm to the confidence of consumers and businesses.

Priorities for jobs budget

The Programme for Government contains a series of commitments in relation to the jobs agenda which are to be delivered within Government's first 100 days. These include positive measures such as the reduction in the lower rate of employers' PRSI; fast-tracking of labour intensive capital projects; and a reduction in the lower rate of VAT. However, it has also committed to reversing the reduction in the national minimum wage. IBEC believes that such a measure would undermine some of the proposed positive initiatives and flies in the face of the labour cost competitiveness challenge still facing the country. We have continued to make this case to both the new Government and the EC/IMF/ECB. Indeed, it was one of the main topics of discussion when IBEC met with the delegation heads recently. Nevertheless, the jobs budget represents an important opportunity to demonstrate that Ireland is open for business and Government could usefully reflect on the largely pro-enterprise content of the recent UK Budget, delivered in similarly difficult fiscal circumstances.

Banking recapitalisation

The latest round of bank stress tests, published on 31 March, was relatively positively received by international observers. It is clear that the most recent exercise has much stronger credibility than previous iterations. For the first time during the banking crisis, the Central Bank has been able to complete the level of granular analysis required in the bank loan books. Previous loss estimates had largely relied on analysis of the largest loans and sampling but the current stress test process has been much more comprehensive. The analysis has also involved significant external expertise and the ECB played a central oversight role. The loan losses assumed are fairly brutal and are probably more akin to US experiences rather than patterns typical in a European context. Business will have concerns about the reduced level of banking competition in the Irish market, but crucially the banking sector remains largely intact and non-Irish owned banks continue to play a significant role in servicing the economy's credit requirements. IBEC believes that while the sovereign debt position has been pushed to its limit, the economy is capable of servicing it if sufficiently strong growth rates are delivered.

Impact of commodity spikes

Global and domestic inflation rates have increased sharply since the start of the year as previous commodity price pressures have been intensified by the crisis in Libya. Irish consumers have already experienced the impact of higher retail prices for fuel and food and the pass-through is likely to continue for at least a further six months, even if global prices stabilise. Higher-than-desired inflation has also led the ECB to increase rates for the first time since July 2008. This will add further to the Irish consumer price index (CPI) in 2011 and the CPI increase is likely to average about 2.7% this year, although core price inflation remains fairly muted.

2011 growth forecasts

The outlook for GDP growth in 2011 has weakened somewhat since our last forecasts, largely on the back of a deteriorating consumer situation. Our GDP growth forecast is 1.3%, while GNP will remain largely flat. Inflation and interest rate increases will erode real disposable incomes and we now expect consumer spending to fall by 1.5% this year. Exports are again expected to perform strongly and we are forecasting growth of 6%. All other sectors of the economy will continue to shrink, although the pace of decline in the investment sector is set to be much less than that experienced in both 2009 and 2010. We forecast a drop in investment of 6%, comprised of a 14% decline in building and construction activity and a recovery of 10% in investment in machinery and equipment. The labour market remains fragile and while firm hiring intentions in exporting companies have improved, total employment is forecast to fall by about 1% during the year.

Economic growth

Following two years of extreme turbulence the economy stabilised somewhat in 2010. GDP for the full year fell by 1%, while GNP was down 2.1%. The two-speed nature of the Irish economy emerged very strongly last year. As a result of recovery in our main export markets and a significant improvement in competitiveness, the export sector performed exceptionally well, growing by 9.4%. Exports of goods rose by 7.7% and services exports were up 11.5%. Exports of modern goods led the way with the pharmaceutical sector again the star performer but the recovery was fairly broad based and most of the traditional sectors of the economy also posted a solid return. Exports of food and drink and plastic and metal goods gained momentum as the year progressed. In the services sector, ICT and financial services both recorded strong growth.

The domestic economy remained fragile last year with both investment and consumer spending substantially weighing on economic growth. Consumer spending made a reasonably promising start to the year, largely as a result of a budget without significant tax increases, but it waned as the year progressed and reacted badly to the worsening fiscal position in the latter months of the year. The government sector was a further drag on growth in 2010 and overall the exceptionally strong export performance was just not enough to fully offset the continued weakness in domestic demand.

The outlook for 2011 has worsened somewhat since our Q1 publication and we have reduced our forecast for GDP from 1.7% to 1.3%, while GNP will remain almost flat this year. The main development in the economy since our last set of forecasts is further headwinds for consumers. The inflationary outlook has deteriorated considerably in recent months and this will directly squeeze real disposable income. The related factor of higher interest rates will also come as a blow to households still adjusting to the income effects of a tax-heavy budget. The labour market is also weaker than previously estimated as the Q4 Quarterly National Household Survey data put the unemployment rate at 14.7% - a sharp increase on the previous quarter.

GNP and its components

Annual % change

	2010	2011	2012
Consumer spending	-1.2	-1.5	0.2
Government spending	-2.2	-4.5	-3.0
Investment	-27.8	-5.6	4.1
Exports	9.4	6.0	4.5
Imports	6.6	3.1	2.9
GDP	-1.0	1.3	2.5
GNP	-2.1	0.2	1.9

Table 1

Retail activity in the first quarter of the year has looked fragile and our current forecast is that consumer spending will drop by 1.5% this year, marginally worse than the rate of decline in 2010.

Exports will remain the brightest component of the economy this year and are expected to grow by about 6%. The investment sector is close to bottoming out, but will have a further marginally negative impact on growth in 2011. A continued strong export performance should see more robust GDP growth in 2012, but the outlook will remain dependent on the absence of further additional austerity measures. While the savings rate remains high, many householders are in a very difficult fiscal position and further austerity will weigh heavily on consumers' ability to spend.

Business outlook

IBEC's latest Quarterly Sentiment Survey found that while confidence in the overall business environment remains weak, managers' perceptions about the outlook for their own business improved substantially in Q1 to +19 from +7 in Q4 2010. The forward-looking index has now been positive and improving for three consecutive quarters, reflecting the extent to which the real economy has the capacity to drive growth, despite the ongoing fiscal and banking sector problems.

The survey does, however, highlight the divergence between the domestic and exporting sectors. The outlook for export sales reached a series-high of +53 in Q1, with only 9% of respondents expecting exports to fall and 17% anticipating a substantial improvement. The index on domestic sales recovered in Q1 after having dipped sharply in Q4 (the survey was conducted just prior to the EU/IMF loan deal). The +1 reading is the first time the index has been in positive territory since Q1 2010, but given the headwinds the domestic economy faces, it remains to be seen whether the improvement will prove sustainable. Encouragingly, companies' expectations about employee numbers is also showing an improving trend; the index in Q1 was close to balance at -3.

IBEC business confidence indicator

Figure 1

Consumer spending

First estimates indicate that consumer spending fell by 1.2% in 2010, a stabilisation relative to 2009, when expenditure fell by 7.0%. In nominal terms, however, the decline was a more steep 3.4%, reflecting the extent to which deflation had an impact on businesses' bottom lines last year.

The annual pace of decline in volume terms accelerated during the course of the year from 1.0% in Q1 to 1.4% in Q4. In the final quarter, expenditure on goods fell by 1.8% while spending on services fell by 1.2%. The value of consumer spending, however, stabilised somewhat, from an annual fall of 4.8% in Q1 to a decline of 2.5% in Q4.

Consumer sentiment fell sharply during the latter half of 2010 and despite some recovery in the early months of this year remains extremely weak. Forward-looking perceptions, however, improved somewhat in February, perhaps as a result of the run-up to the election. The new Government has a window of opportunity to convince the electorate that it is able to take decisive action on the economy, which may help shore up confidence in the near term.

Nonetheless, consumers remain very cautious and face a number of headwinds this year. Budget 2011 will have reduced disposable incomes across the board by close to 3%. Rising inflation in the form of higher energy prices will eat further into spending power, while ECB interest rate hikes will be felt by those on variable rate or tracker mortgages, comprising approximately 86% of all mortgage holders.

The savings rate is currently very high at about 12%. This has, in part, been enabled by lower mortgage repayments following the sharp reduction in the ECB's interest rate from 4.25% in the aftermath of the Lehman Brothers collapse in September 2008. We therefore believe that households will have some capacity to compensate for the rate hikes by running down the savings rate, ameliorating some of the impact on domestic demand. The outlook for the labour market, though still bleak, is less adverse than last year, and will therefore not be as big a negative for consumer spending.

KBC-ESRI consumer sentiment index

Figure 2

Taken altogether we have revised down our consumer spending forecast for the year, pencilling in a drop of 1.5%. Given that deflation in the domestic economy is now coming to an end, we would expect the value of spending to fall by a similar amount, in contrast to recent years that have seen much sharper drops in turnover than in the volume of sales.

Investment

The collapse in investment continued apace during 2010. The decline in construction output of 33% was almost identical to that experienced in the previous year and the overall decline in total investment moderated only marginally from 31% to 28%. The construction sector has still not bottomed out, but the 70% decline in the value of output since 2007 means that the sector is clearly approaching stabilisation. Significantly, any further falls in activity will have a much smaller impact on economic growth given the much-reduced relative size of the sector in the economy.

Housing activity continued to decline during 2010 and the number of completions fell from 26,000 to 15,000. Essentially, new housing activity is now reduced to one-off builds and some completion of existing housing schemes in cases where NAMA has decided to fund such projects. Housing completions are likely to remain in the 10,000 to 15,000 range for at least a further three years or so. A significant housing oversupply remains on the market and there is no evidence that this has been reduced in any meaningful way during the past year or so. Housing transaction levels remain exceptionally low and with the expectation of further price drops, the standoff between purchasers and vendors may continue for a little longer. More normal credit conditions and an expanding labour market are the other prerequisites for a return to any sort of normality in housing transaction levels.

Home refurbishment works are now as important in value terms as the new build sector. After holding up well in the initial stages of the economic crisis, activity in the sector weakened again during 2010. The surge in the number of households in negative equity and credit restrictions have clearly reduced the availability of financing for home improvements. It is likely, however, that there is considerable pent-up demand in the sector as many families have been unable to move home due to either the fragility of the housing market or the "locked-in" effects of tracker mortgages. A more ambitious home retrofitting funding programme by Government may also result in some increased activity in the sector in the short term.

Activity in the broader civil engineering sector is set to remain fairly weak over the coming years. Last year saw the completion of a series of major infrastructure projects - both publicly and privately funded - and the immediate pipeline for major projects is exceptionally bare. The previous Government's review of the public capital

Bank stress tests and restructuring

The latest round of stress tests on the Irish banks has revealed a capital shortfall of €24 billion. This consists of €18.7 billion capital requirement under the PCAR exercise (taking account of loan loss provisions by consulting firm BlackRock), €2.3 billion cash capital for additional conservatism and a further €3 billion contingent capital as buffer against loan losses beyond 2013.

The Central Bank also released details on deleveraging of the banking sector and the capital requirement contains a loss provision for deleveraging. Deleveraging by end 2013 will amount to €72.6 billion and as a result the loan-to-deposit ratio for the Irish banking sector will fall from 180% to 122%. To limit the impact on the domestic economy, the bulk of this will be achieved through targeting non-core loans, located mainly in the UK.

Jointly with the stress tests, the Minister for Finance also announced the Government's plans for restructuring of the banks. Government proposes to form two universal full-service banks as core pillars to the Irish banking system. These pillars will be made up of Bank of Ireland and the merged entity of AIB and EBS; Irish Life and Permanent will undergo significant restructuring.

Anglo Irish and Irish Nationwide Building Society will be merged into a Government-owned banking group.
This new entity will work out their combined loans over a period of years, and will eventually be wound down.

Underlying assumptions

In the normal course of events, the Central Bank would use loan loss estimates submitted by the banks themselves. The banks have consistently underestimated the losses during the crisis. Given this, the Central Bank engaged external consultants BlackRock to conduct a detailed assessment of future lifetime loan losses for the current exercise, reaching a significantly more pessimistic result than the banks' own provisions.

The BlackRock assessment produced gross lifetime loan losses of €40 billion over a horizon out to 2040, which the Central Bank converted to three-year loan losses of €27.7 billion for the purposes of the capital review. It is not standard regulatory practice to calculate current capital requirements based on potential loan losses over a very long time horizon, but to provide full transparency, the Central Bank has published these results.

The stringency of BlackRock's assumptions is worth emphasising - reportedly the US state Nevada, particularly severely affected by the subprime crisis, was used as a benchmark. Thus the loan loss provisions are built on assumptions about repossessions levels that simply are not part of European culture, providing additional comfort about the conservatism of the loan loss projection.

Impact on sovereign debt position

Irish taxpayers will bear about €19 billion of the current recapitalisation costs as subordinated debt holders will experience burden sharing of about €5 billion. The bulk of the Government funding will come from a combination of National Pensions Reserve Fund assets and existing cash balances. The additional borrowing requirement is therefore limited to about €2 billion but may fall further depending on revenues realised from asset sales. As a result of this, the overall impact on Ireland's sovereign debt position is limited.

We therefore retain our view that the sovereign debt position remains sustainable, though at the limit of what the economy can bear. At the current level, the economy can meet its debt servicing requirements. The primary challenge for the new Government is to ensure that the economy starts to generate the required growth rates. The business community is well placed to do this but Government must prioritise policy measures which are supportive of enterprise and of getting people back into employment. Banks will also continue to face liquidity pressures and it is essential that the ECB fully delivers on its responsibilities as the lender of last resort.

Impact on the business sector

In order for the business sector to continue to drive growth and recovery in the Irish economy, it needs a fully functioning utility banking sector and a stable Government fiscal position. The latest chapter of Ireland's banking crisis provides the most substantive restructuring of the sector to date. A two-pillar banking system almost entirely owned by the State raises some concerns about effective competition in the sector. The ongoing presence of non-Irish-owned banks certainly helps, but restoring the domestic banks to private ownership and to a state where they are capable of meeting the financial needs of a recovering economy must be an absolute priority for the Government.

Despite the measures taken to date, the banking sector will face further significant challenges, mainly in relation to the required pace of deleveraging and liquidity provision.
It is essential that the ECB remains fully committed in its role as lender of last resort to the Irish economy. IBEC will continue to make the case, both domestically and internationally, that excessive deleveraging of the banking system, which runs the risk of the fire-sale of assets, would be detrimental to prospects for economic recovery.
While deleveraging will mainly focus on UK-based non-core loans, limiting the impact on the Irish business sector, it is essential that the impact of asset disposals on Irish business is carefully monitored.

Investment				
Annual % change				
	2009	2010	2011	2012
Building & construction	-34.9	-33.1	-14.0	0.0
Plant & machinery	-19.3	-15.3	10.0	10.0
Total	-31.0	-27.8	-5.6	4.0

Table 2

investment programme in July 2010 has been overtaken by the events of the loan arrangements with the troika and the four-year plan. The existing allocation for public capital investment envisages a 60% reduction in spend from that achieved in 2007. It is essential that this is not cut any further and that a meaningful public capital investment programme proceeds.

While the current funding market for private investment in infrastructure is difficult, Government should display a greater level of ambition in relation to public-private partnerships (PPPs) in particular. There is also the potential to achieve greater "bang for buck" in the public capital budget by spreading the funding across a larger number of projects which could be co-funded by the private sector. Support from the European Investment Bank and the possible roll-out of euro project bonds also offer the potential to improve activity levels in the sector. Total building and construction investment is expected to fall by 14% this year, largely as a result of a much-reduced public capital investment programme.

Firm-level investment in machinery and equipment and in some building work is expected to improve in 2011. Following over two years during which firms postponed a series of capital works, there is likely to be a bounce-back this year. Exporting businesses have now used up existing spare capacity and many firms are planning either expansionary investment or replacement over the coming quarters. We currently expect firm investment in equipment and machinery to increase by about 10% this year. Total investment in the economy, however, will drop by about 6% in 2011, before a marginal recovery in 2012.

Labour market

While the outturn for 2010 was somewhat weaker than we had hoped, the year nonetheless brought a degree of stabilisation to the Irish labour market. Employment fell by 80,700 (or 4.2%), but this represented a slowdown on 2009, when 171,00 (or 8.1%) jobs were lost. Over the course of 2010, the fall in employment slowed from 108,000 in Q1 to 64,500 in Q4. Unemployment ended the year at 14.7%, up a full percentage point on Q3 and higher than had been estimated by the Live Register.

Employment fell in most sectors last year, with construction (-36,100), industry (-14,500), retail (-6,500) and the financial sector (-6,100) the worst affected. Only two sectors, health and education, added jobs during 2010.

Data for the final quarter of the year show that construction lost 26,800 jobs relative to Q4 2009, and employment in the sector is now 60% below the Q4 2007 peak. Other sectors to record high numbers of job losses were financial services (-8,800) and industry (-8,400). It is noteworthy, however, that on a seasonally adjusted basis industry added a small number of jobs relative to Q3. The manufacturing PMI has indicated expanding employment for four consecutive quarters and the March reading was the strongest since June 2000. Given the strong upturn in activity, we therefore expect the sector to add close to 2,500 jobs this year.

Manufacturing and services firms in internationally traded sectors will add jobs this year, but this will be outweighed by job losses in domestic sectors of the economy. Construction will continue to lose jobs. Public sector employment will fall over the coming years; the programme for Government has a target to reduce public sector numbers by 18,000-21,000 by the end of 2014.

Restructuring of the domestic banking sector will inevitably result in job losses in the next few years, and while the international financial services sector will add some jobs, financial sector employment in aggregate will fall. Overall, we expect employment in the economy to fall by 1% in 2011, before returning to modest growth of 0.5% in 2012.

While we are now beginning to see some stabilisation in the pace of job losses, weak job creation has meant that long-term unemployment has increased sharply over the course of the recession. It now accounts for over 50% of total unemployment, the highest proportion since early 1998. Unless urgent action is taken, Ireland risks a period of persistent structural employment.

We look forward with keen interest to the Government's jobs budget in May. While Government can do very little to

Labour market				
000s annual average				
	2009	2010	2011	2012
Agriculture	96	85	88	89
Industry	411	360	351	351
Services	1,422	1,403	1,391	1,399
Total	1,929	1,848	1,830	1,839
Unemployed	259	292	278	267
% Unemployed	11.8	13.6	13.2	12.7
Labour force	2,187	2,140	2,107	2,106

Table 3

directly create jobs, particularly given the current fiscal constraints, it can create an environment where business can prosper and create jobs.

In addition to ambitious retraining and reskilling measures, we would also look for Government to address the incentive to work in the context of an ambitious reform of the social welfare system. Moreover, skills gaps in specialised areas such as ICT now hamper job creation and must be addressed. Finally, given its internationally high marginal tax rate of 52%, Ireland is now much less attractive for mobile global talent, a situation further exacerbated by recent changes to taxation of employee financial incentives.

Prices and wages

Global and domestic inflation has picked up considerably since the start of 2011 and now presents a major downside risk to the economic outlook. Global commodity prices for both energy and agricultural products are close to, or have exceeded, the highs of 2008. The lagged nature of pricing pass-through means that even if commodity prices were to ease back in the next few months, the inflationary impacts would persist at the retail level for at least a further six months.

At a domestic level, the consumer price index (CPI) has increased rapidly since last autumn. While commodity price inflation was a central driver in this, the most significant contribution has come from mortgage interest costs. A number of financial institutions have implemented interest rate increases for variable rate mortgages over the past six months or so and mortgage interest rate inflation reached 28.6% in March. The headline CPI reached 3.0% in March - but when mortgage interest in excluded the CPI was just 1.6%.

Despite the commodity-related price increases, the harmonised index of consumer prices (HICP) remained relatively low at 1.2% in March. From a competitiveness point of view, this measure of inflation is more important. In February, the latest month for which international price comparisons are available, the harmonised index in Ireland was the lowest of the eurozone countries and was well below the eurozone average of 2.4%. This indicates that despite the return to positive inflation in Ireland, lower price growth than in our main trading partners will continue to enable further competitiveness gains.

The imported nature of current inflation is particularly damaging to disposable income. Higher oil prices are a blow to Ireland's improving current account position and ultimately result in a greater share of household income leaving the economy. Consumers have been particularly badly hit rising motor fuel prices - petrol inflation is now running at 16.8%, while diesel prices are up 22.4% in the year.

Higher mortgage interest costs also eat into discretionary disposable income. Although the CPI mortgage interest component is based on a stylised model rather than actual mortgage payments made by householders and this may sometimes overstate cost increases, it is clear that consumers have already felt the impact of higher interest rates with further increases to come. Every 25 basis points increase in the ECB base rate will add about 0.3% to the CPI in a full year and will extract about €250 million from discretionary disposable income.

It is highly likely that the ECB will have implemented a further 25 basis points increase by July and the current market expectation is that the base rate will reach 2% by early 2012. There are considerable downside risks to the euro-zone economic outlook, however, and the ECB will closely monitor data over the summer months before deciding on further changes in the autumn. Significantly, despite the surge in the headline inflation rate in Europe, there are still no signs of second-round effects and the core inflation rate remains fairly subdued.

In summary, inflation in the Irish economy is set to be much higher this year than anticipated even a few months ago. The CPI is set to average about 2.7% for the year, while the HICP will average about 1.4%. This higher-than-expected inflation is one of the main reasons for the significant downward revision we have made to our forecast for consumer spending this year. However, inflationary pressures are likely to ease in the second half of the year as commodities are expected to come back from recent highs. There is substantial spare capacity in the economy and second-round inflationary effects are therefore likely to be limited. We are currently forecasting a moderation in the CPI to about 1.6% for 2012.

The majority of firms (60%) plan to implement a further year of pay freezes in 2011. Some firms in exceptionally difficult trading conditions are planning further pay reductions, while a proportion of those companies which

Inflation forecasts

2011	Annual rate	Annual average
March	2.3%	2.7%
June	3.1%	
September	2.8%	
December	2.6%	
2012		
March	1.8%	1.6%
June	1.3%	
September	1.6%	
December	1.7%	

Table 4

are benefiting from the strong export recovery will deliver pay increases. On average, there will be no change in nominal pay rates this year. Since the start of the recession, average pay rates in the private sector have dropped by about 5%, but through exceptional productivity growth, Irish firms have achieved a substantial reduction in unit labour costs and are now in a much stronger competitive position.

Exports and exchange rates

Irish exports performed exceptionally well in 2010 and were valued at 103% of GDP - a record high. Export growth for the year stood at 9.4% and was marked by strong growth of 12% in the second half of the year. Ireland's biggest trading partner for goods exports remains the United States, which accounts for 23.2% of all goods exports. The United Kingdom has overtaken Belgium as Ireland's second biggest trading partner for goods exports. It should be noted, however, that Belgium's high export value largely relates to its position as Europe's principal transhipment point. All sectors except for machinery and transport equipment, which continues to suffer from the collapse of the construction sector, recorded growth over the course of the year. Service sector exports enjoyed strong growth in 2010 and increased by 11.5%.

Exports declined by 1% in January. Interestingly, most sectors experienced growth in January however; this was offset by 11.6% decline in chemical exports to EU countries outside of the United Kingdom. Chemical exports are very volatile and any discerning trend will not be known until first quarter estimates. On a more positive note exports of goods to the United Kingdom increased sharply by 23.6% in January.

A weaker currency throughout the course of 2010 improved Ireland's cost competitiveness and has played a role in fuelling Ireland's export led recovery. However, a change in policy by the ECB has left some exporting firms vulnerable to consequent exchange rate risks.

The financial markets have priced in two additional interest rate rises for 2011. These increases may lead to a further strengthening of the euro. By mid-February, sterling strengthened to £0.84. However, in the last month this has weakened to £0.88. This increase was largely driven by comments from ECB president Jean Claude Trichet that "strong vigilance" was needed on inflation. In addition, the Bank of England has kept interest rates at their current level. Expectations of higher ECB rates seem to have been enough for traders to buy euro despite wider economic and banking instability. In contrast to the ECB, the US Federal Reserve affirmed plans last month to buy $600 billion worth of treasuries through June and to keep rates "exceptionally low" for an "extended period." This clear divergence in monetary policy between the two institutions has lead to the euro strengthening against the dollar to a 13-month high of $1.44.

Exchange rates - monthly averages

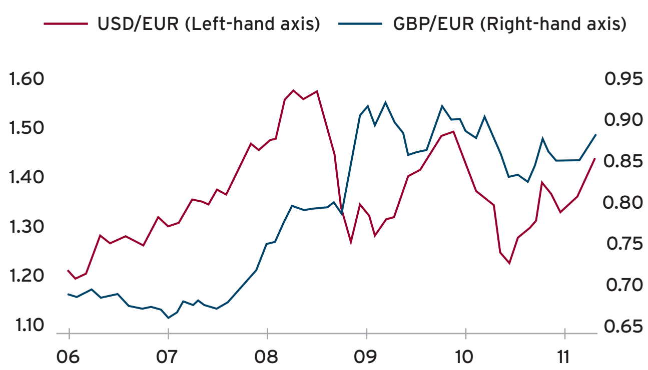

Figure 3

Public finances

The results of the first quarter Exchequer returns were mixed. Total tax revenues at the end of March were up 3.7% over the same period last year. However, the tax revenues were €136 million or 1.8% behind the target set by the Department of Finance. The biggest revenue generators, income tax and VAT were 4.2% and 5.4% behind target.

March is an important month for VAT receipts, which are due in January and every second month from there on. The VAT returns for the quarter were disappointing, with returns down 3.4% on the same quarter last year. This is testament to the fact that the domestic economy and consumer spending continues to be weak. The disappointing income tax and VAT receipts were offset by gains in corporation tax, excise duty and capital acquisitions tax. On the expenditure side, net voted expenditure was 1.7% higher than in the corresponding period of 2010. However, this increase related to a reclassification regarding the universal social charge. Eliminating the impact of this reclassification, net voted expenditure was 2.3% lower than expected for Q1. All departments were under profile, the only notable exception was capital expenditure in the Department of Education and Skills, which was 18% above target.

For Q1 the Exchequer deficit was €7.1 billion compared to a €3.9 billion in March 2010. The Department of Finance says that this is largely accounted for by a payment of €3.1 billion to Anglo Irish Bank and Irish Nationwide. The cost of servicing the Exchequer debt in the first quarter was €848 million, up €86 million year-on-year. The returns also confirm that the government has come €0.7 billion under the €7.8 billion deficit target set by the EU-IMF programme.

International economies

After a growth rate of 4.8% in 2010, the global economy is expected to moderate slightly in 2011. The macroeconomic effects of the devastating earthquake in Japan remain unclear although it is widely expected that the country will fall into recession for 2011. There will be a continued divergence between growth in advanced economies and emerging economies as advanced economies continue to grapple with the economic and banking collapse. The outlook for emerging economies remains bright led in particular by India and China. Inflation and asset price bubbles remain a concern in China fuelled by capital inflows and low interest rates. Nonetheless, Ireland's export sector should continue to benefit from growth in the world economy.

United Kingdom

The UK economy contracted by 0.6% in the last quarter of 2010. The underlying economic picture is weak, a fact that prevented the Bank of England raising interest rates this month. The recent budget revised downwards projections on economic growth from 2.1% to 1.7%. This is attributed to weak final quarter growth in 2010, the rise in world commodity prices and higher-than-expected inflation. The budget also outlined a 5% cut in corporation tax over the next four years. Corporation tax will be reduced by 2% in 2011, and will decrease by 1% per annum for the next three years until it reaches 23%. The Treasury is to publish a paper considering, amongst other issues, the case for Northern Ireland having lower corporation tax than the rest of the UK.

Euro area

Doubts about the extent of the problems in the financial sector and the ability of European institutions to solve sovereign debt crises continue to be of concern in the euro area. Such concerns will continue unabated until the ECB addresses debt and liquidity concerns facing peripheral member states. The euro area seasonally adjusted unemployment rate was 9.9% in February 2011. Spain has the highest unemployment rate in Europe at 20.4% while the lowest unemployment rate at 4.3% was recorded in the Netherlands. In 2010, the German economy expanded by 3.5%, the highest growth rate since reunification and outpaced all euro area economies except for Slovakia and Malta.

Portugal has experienced both political and economic instability after the government's austerity plan was defeated. Portugal's problems have heightened due to debt repayments of €9.5 billion between April and June. In normal times, countries simply roll over the debt through funds acquired from secondary markets but 10-year lending rates for Portugal currently stand at an unsustainable rate of 8.5%, 1.8% higher than when it last borrowed on 12 January. Since Portugal is unable to access funds from the market at a sustainable level, it has requested financial assistance. Negotiations over the terms of the package are likely to take place over the coming weeks.

United States

In the United States, real GDP increased 2.9% in 2010, the biggest gain since 2005, compared to a decrease of 2.6% in 2009. The increase in real GDP in 2010 primarily reflected positive contributions from exports, personal consumption, and fiscal stimulus. Consumer spending, which accounts for more than 70% of GDP, grew 4.4%. The extended fiscal stimulus plan in addition to further tax cuts will ensure that growth will not slow substantially in 2011.

The US unemployment rate fell to a two-year low in March of 8.8%. It was the fourth monthly fall in a row. Indeed the unemployment rate has fallen by a percentage point during the last four months. Although the trend is positive, further gains need to be made in order to move to the pre-recession rate of around 5%. The positive jobs growth marks the first consistent move away from the 10% level of unemployment experienced in 2009.

Real GDP growth - selected countries

Annual % change	2010	2011	2012
Euro area	1.7	1.0	0.5
UK	1.3	1.5	1.5
Germany	3.6	3.0	1.5
France	1.7	1.8	0.7
US	2.9	3.0	2.0

Table 5

Inflation - selected countries

Annual % change	2010	2011	2012
Euro area	1.6	1.7	0.5
UK	3.3	3.2	1.0
Germany	1.1	1.2	0.8
France	1.7	1.5	0.7
US	1.5	1.3	0.3

Table 6

Unemployment rate - selected countries

Annual % change	2010	2011	2012
Euro area	10.0	10.5	11.0
UK	7.9	8.6	9.4
Germany	6.8	6.7	6.5
France	10.0	10.7	11.3
US	9.7	9.2	8.7

Table 7

Source: *Capital Economics, April 2011*

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