Quarterly
ECONOMIC OUTLOOK

IBEC

January 2012

Balancing austerity with growth measures

The fifth quarterly review of Ireland's international loan agreement with the troika confirmed that the programme is on track but many challenges remain. To date, the fiscal and reform targets have been met and Ireland's progress has been good in comparison to that of the other EU programme countries. The escalation of the eurozone crisis has meant that the external economic environment has taken a sharp turn for the worse, however, and economic growth forecasts have been revised downwards. Due to no fault of its own, therefore, it will be more difficult for the Irish Government to continue to meet the loan programme's budget deficit targets. Ireland has proven its capacity to deliver on necessary austerity but with the more difficult economic conditions it is essential that the loan programme provides the flexibility for much needed growth measures.

Government's second jobs initiative is a welcome development and demonstrates a policy commitment to addressing the unemployment crisis. In order to make meaningful inroads into joblessness, however, the economy desperately needs a stimulus of significant scale. IBEC has already identified to Government a number of innovative measures targeted at supporting domestic demand which would not require exchequer funding. The rationale for investing in strategic infrastructure, through either pension funds, proceeds from the sale of state assets or in partnership with the private sector, also remains exceptionally strong. There is no escaping the need to close the gap between the exchequer income and expenditure but this must be done in tandem with measures which will help get significant numbers of people back to work.

Eurozone crisis hindering recovery

Ireland's economy experienced solid recovery in the first half of 2011. Exports continued the impressive growth of 2010 and firms started to invest in machinery and equipment again as they became more confident about the economic outlook. The sharp rise in economic uncertainty in the eurozone in the autumn, however, led to a slowdown in export growth, the postponement of some investment decisions and weaker consumer spending. The third quarter outturn for the Irish economy was therefore disappointing as GDP contracted sharply again. Exports continued to grow but at a much slower pace than in recent times and not sufficiently strongly to offset the continued weakness in domestic demand. The final quarter of the year was most likely another difficult one for the economy as the ongoing eurozone worries weighed strongly on all sectors. Overall, GDP volume grew by a little over 1% last year but the money value of GDP disappointed due to a combination of a strong euro and continued deflation in many sectors of the domestic economy. As we have previously noted, the movement in nominal GDP is of greater importance for Ireland at present as it determines the ability to meet the bailout programme budget deficit targets.

2012 looks challenging but with upside possibilities

The sharp slowdown in the eurozone economy means that our forecast for Irish GDP has been revised downwards to about 1%. A number of the eurozone economies and the UK are currently in or close to recession. Demand for Irish exports will therefore be weaker than expected this year but exports will continue to grow and Irish firms will further increase their market share. A major silver lining of the eurozone crisis will be a much more benign exchange rate environment for exporters. The euro has remained almost irrationally strong over the past couple of years and the average exchange rate against the dollar last year of $1.39 made for tough trading conditions. While currency forecasts are notoriously difficult, the euro will most likely be significantly weaker against both the dollar and sterling this year. This will be a major boost both to the competitive position of Irish exporters and to the nominal value of exports and GDP.

The first half of 2012 will be tough for the Irish economy. Public sector employment reductions and large scale redundancies in the banking sector will further weaken labour market conditions. Eurozone worries will continue to weigh on the consumption and investment decisions of firms and householders. The possibility of upside surprises also remains, however. Household net incomes were not reduced in Budget 2012 and the stimulus provided by ECB rate cuts will boost discretionary income. If market and public confidence in the eurozone situation was to strengthen, then consumer spending and exports could recover as the year progresses. In the meantime, conditions will remain tough for Ireland's economy but stronger export values should be enough to ensure that we continue to meet the loan agreement targets. To tackle the unemployment crisis, however, domestic demand urgently needs a shot in the arm.

Economic growth

Last year saw Ireland's GDP increase for the first time since 2007 as the continued recovery in exports outweighed the decline in domestic demand. Ireland's net export position as a percentage of GDP is exceptionally large in international terms and this means that, unlike most other countries, a strong export performance can result in economic growth even if the domestic economy remains in recession. Export growth in the first half of last year averaged 5.5% and resulted in a healthy improvement in GDP. The Q3 National Accounts were much softer than expected, however, and all sectors of the economy, including exports, showed signs of renewed weakness.

The volume of consumer spending was down almost 4% on Q3 of 2010, investment activity slumped by 22% and export growth eased back from 6.1% in Q1 to just 2.4%. The escalation of the eurozone crisis was most likely a significant factor in the weaker activity recorded in all sectors of the economy. The disappointing Q3 outturn therefore clearly poses downside risks for the economic outlook and most forecasters have pared back their 2012 expectations in recent months. However, as we have often noted previously, Ireland's quarterly economic data are particularly volatile and analysts should not read too much into a single quarterly observation. Indeed, much of the collapse in investment activity in Q3 was due to the 80% drop in spending on aeroplanes, although the knock-on impact on GDP would have been limited due to a corresponding reduction in imports. The third quarter consumer spending numbers were also most likely affected by the ending of the car scrappage scheme in June.

Despite these factors it is clear, however, that the economy was much weaker in the second half of 2011 than in the first. The escalation of the eurozone crisis from late summer effected both the demand for Irish exports and the confidence of domestic consumers. While many of Ireland's strongest export sectors are fairly immune to dips in the business cycle, sub-supply businesses to Europe's large industrial manufacturers reported a sharp fall in orders from August. With the UK and the eurozone either in or close to recession at present it is inevitable that export growth in 2012 will be slower than that in 2011. Unlike the 2008-09 period, however, the current phase of the economic crisis is more confined to Europe and the US and other markets are performing better. Not all export markets will therefore be weak in 2012 and global trade is still likely to experience some growth, albeit fairly anaemic.

The ongoing eurozone crisis continues to dominate the economic outlook and the first half of 2012 is likely to be particularly uncertain. A weaker euro will be a significant silver lining in this crisis and will help boost Ireland's nominal GDP. We expect real GDP growth this year of a little under 1% but nominal growth could be as high as 3% which would be sufficient to meet the terms of the troika agreement.

GNP and its components

Annual % change

	2010	2011	2012	2013
Consumer spending	-0.8	-2.5	-2.0	0.5
Government spending	-3.8	-3.5	-4.0	-3.0
Investment	-24.9	-12.3	-3.7	9.9
Exports	6.3	4.5	3.0	4.0
Imports	2.7	0.4	0.4	3.0
GDP	-0.4	1.4	0.9	2.6
GNP	0.3	-0.5	-0.3	2.1

Table 1

Business outlook

IBEC's business sentiment survey for Q4 2011 shows a decided deterioration in business confidence, but specifically a widening divergence between exporting and non-exporting companies. Managers' confidence in the three-month outlook for the overall business environment fell to -29 from -11 in the previous quarter and -32 in Q4 2010. The three-month outlook for own-business confidence turned negative for the first time since the second quarter of 2010, falling to -3 from +19 in the previous quarter and +7 in the same quarter a year ago.

Despite the deterioration in overall sentiment, managers in exporting companies remained confident in the outlook for their businesses with an index reading of +19. Confidence in export sales remained strong at +29, showing only mild decline from previous quarters, and the outlook for export order books also remained firmly in positive territory. Food and drink, medical devices, pharmaceutical and ICT companies were among the most optimistic. The outlook for companies reliant on the domestic market is, however, much more muted. Expectations about domestic sales fell sharply to -17 from +2 in the previous quarter; this was the

IBEC business confidence indicator

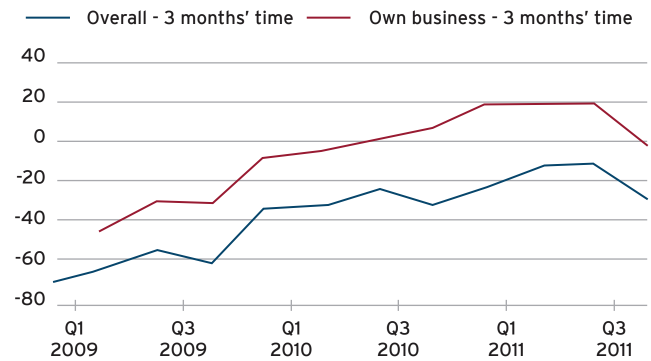

Figure 1

weakest reading since Q3 2009. Retailers were particularly pessimistic, but sentiment also declined in wholesale and distribution companies and other domestic services.

Consumer spending

The third quarter of 2011 proved particularly challenging for the domestic market and the volume of consumer spending fell by 1.3% in the quarter. Consequently, the annual pace of decline accelerated to 3.9% from 2.4% in Q2. Unlike 2009 and 2010, the value of consumer spending is tracking better than the volume, recording an annual fall of 3%.

Retail sales for the last months of the year have been slightly more positive (see figure 2 below), so the outturn for the final quarter may be somewhat less adverse. Overall, consumer spending will nonetheless have fallen by about 2.5%, making 2011 the fourth consecutive year of falling expenditure.

The main driver of consumer spending in 2012 will be the very weak sentiment, arising largely from the uncertainty caused by the prolonged eurozone crisis and the risks it poses for the global economy and by proxy Irish recovery. In contrast, some aspects of consumer fundamentals are better than this time last year.

Budget 2012 saw no income tax hikes, so pay packets, unlike in January 2011, were untouched. The pay cutting cycle seems now to be largely over (see section on prices and wages), so incomes are beginning to stabilise. The biggest positive for the consumer, however, comes from the ECB interest rate cuts. Factoring in the two 0.25% hikes in April and July, we had estimated that mortgaged households' discretionary income would fall by 1.6% in 2012; now, given that the rate increases have been reversed, discretionary income is set to rise by 6.5%.

All told, if the cloud of uncertainty hanging over the eurozone were to lift in the coming months, the latter half of 2012 could well surprise us on the upside. This is,

Consumer spending and retail sales

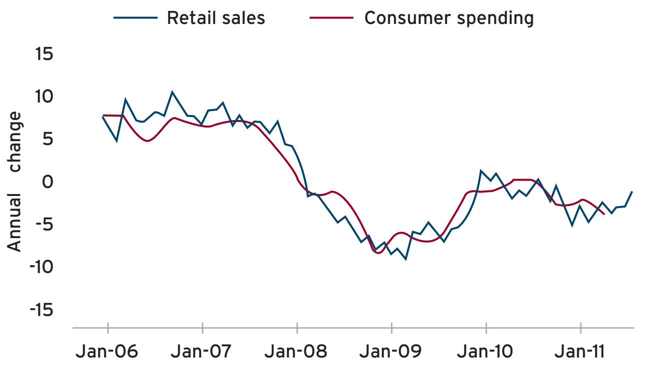

Figure 2

however, far from a certainty and we have accordingly downgraded our consumer spending forecast for 2012 to a fall of -2%. However, 2013 should present a somewhat more benign picture. Based on the more favourable fundamentals, but predicated on an easing in eurozone uncertainty, we have pencilled in a modest increase in consumer spending of 1%.

Investment

There was a sharp decline in investment activity in Q3 of last year. Following some stabilisation in the first half of 2011, the pace of deterioration was somewhat surprising. While the Irish quarterly national accounts data are much more volatile than the international norm, and a single quarter's observations should not be over-analysed, it appears that the escalation of the eurozone crisis in the second half of last year resulted in renewed weakness in investment activity.

Construction activity in the first half of 2011 deteriorated at the slowest pace in three years, while firm investment in machinery and equipment increased for the first time since the onset of recession. This suggested that the substantial drag on economic growth from the sector was beginning to wane. The third quarter figures were exceptionally weak, however, and have forced us to revise downwards both our 2011 and 2012 forecasts for investment activity. The pace of annual decline in construction picked up again while the very sharp fall in aeroplane purchases was a major drag on the overall investment sector. Investment in new dwellings recorded an annual fall of 27% compared to 20% in Q2, while home refurbishment works dropped by 20% as against a 7% decline in both Q1 and Q2. The drop in investment in 'other construction', mainly civil engineering works, averaged 24% in the first three quarters of the year.

Aeroplane purchases currently account for close to 15% of total investment in the Irish economy, largely due to the very significant presence of aeroplane leasing firms. Spending on planes is particularly lumpy and there is extreme volatility in the quarterly numbers. Investment in Q3 was down over 90% compared with Q2 and the annual increase of 11% in Q1 gave way to a drop of over 80% in Q3. This volatility often has a significant impact on the overall investment trends in the economy but the fact that the planes are all imported means that there is generally no impact on GDP numbers.

Firm-level investment in machinery and equipment also declined again in the third quarter following a positive start to the year. Annual growth of 4% was recorded in the first half of 2011 as businesses responded to growing export orders and limited spare capacity by undertaking new equipment and machinery investments. The eurozone economy slowdown in Q3, however, directly affected the order books of many exporters and an increase in overall economic uncertainty resulted in postponement of some investments.

Eurozone crisis – state of play

The EU summit on 9 December was the latest attempt to address the ongoing sovereign debt crisis in the eurozone. The biggest upset was the UK's refusal to participate in a treaty change, forcing instead the other member states to push ahead with an intergovernmental fiscal compact. The agreement will be binding on the 17 euro area members, but other member states are able to opt in; at the time of writing it appears that all member states except the UK will sign up to the intergovernmental treaty.

Fiscal compact: The cornerstone of the fiscal compact is a balanced budget rule, which limits the structural deficit to 0.5% of GDP. An automatic correction mechanism will be triggered in the event of deviation. At the December summit, it was intended that the balanced budget rule would be enshrined in national legislative systems at "constitutional or equivalent level"; however, a draft document from January has toned down the text to "binding and permanent provisions, preferably constitutional". This development likely arose from concerns over a potential referendum in Ireland and the impact of a possible "No" vote. Given that any treaty is likely to be subject of a Supreme Court challenge, the referendum question will remain unclear for some months to come.

In addition, the existing 3% deficit rule of the Stability and Growth Pact was strengthened, so that sanctions and corrective steps recommended by the European Commission are adopted unless opposed by a qualified majority of euro area members. The agreement also reiterated the so-called 1/20 debt reduction rule, which means that member states with debt in excess of 60% of GDP must reduce debt levels by 1/20th per year on average over three years or risk being placed in excessive deficit procedure.

Timeline: European Council President Herman Van Rompuy intends that the member states will agree on the new fiscal compact treaty by the end of January 2012 and sign it by early March. The compact would then enter into force in January 2013, provided that at least 12 eurozone member states have ratified the intergovernmental treaty.

European Stability Mechanism: The council's other key decision was to accelerate the creation of the European Stability Mechanism (ESM), which will replace the current European Financial Stability Facility (EFSF). The aim is to have the ESM operational by July 2012, rather than waiting until the middle of next year. The EFSF will, however, continue funding the ongoing Irish, Portuguese and Greek loan programmes. The provision for private-sector involvement remains in the event that a country avails of financial assistance from the ESM, but is to be decided on a case-by-case basis and, in addition, the agreement emphasises that the Greek debt writedown remains "unique and exceptional". All eurozone government bonds issued from mid-2012 will include collective action clauses, which will allow for orderly debt restructuring if a country is deemed to be insolvent.

Ratings downgrades: In mid-January, the French, Austrian and other downgrades by Standard and Poor's led the agency to also cut the rating for the EFSF. Klaus Regling, head of EFSF, stated that the lending capacity of the stability facility will remain unchanged at €440 billion, despite the downgrade. The facility retains ample funds for Ireland, Portugal and Greece. However, if the EFSF's cost of borrowing increases as a result of the downgrade, this would have a direct impact on the interest rate that Ireland pays on the bailout loans. The ESM, on the other hand, will have its own capital base and will be less affected by the member states' credit ratings.

Financial transaction tax: The European Commission presented a proposal for a financial transaction tax (FTT) in September 2011 and is hoping to have the tax in place by January 2014. The proposal would result in a 0.1% tax on the exchange of shares and bonds and 0.01% on derivative contracts, where at least one party to the transaction is located in the EU. The European Commission says the tax would raise about €57 billion annually; however, the adverse economic impact of the tax may well be more severe and revenue lower than the Commission estimates. Although the tax is aimed at transactions between financial institutions only, business organisations across Europe are concerned that the cost will ultimately be passed onto customers, increasing the cost of capital, and that the definition of financial institutions could be so broad that it will have a direct impact on non-financial sector businesses.

The introduction of the tax at EU level requires the agreement of all 27 member states. This seems highly unlikely, given that the UK and Sweden are opposed to the tax and would give support only if it were introduced at a global level; financial services account for about 10% of the UK's GDP. Although the majority of the EU's financial transactions happen in the UK, France and Germany remain committed to the tax, in part driven by a desire to show to the electorate that the financial sector is making a contribution towards the costs of the financial crisis. Both countries have indicated that they will push for the tax to be implemented in the eurozone, should agreement among all 27 member states prove impossible. This has the potential to place Ireland at a disadvantage relative to the UK and the Irish Government's preference is for the introduction of the tax globally or at EU level, rather than just in the euro area.

Investment

Annual % change	2010	2011	2012	2013
Building & construction	-30.3	-20.1	-10.5	5.2
Plant & machinery	-14.5	0.0	5.0	15.0
Total	-24.9	-12.3	-3.7	9.9

Table 2

We retain the view that a large cohort of manufacturing businesses have limited spare capacity due to strong recovery in export levels over the past three years, which, coupled with a number of years of under-investment, will result in higher spend on machinery and equipment once the eurozone uncertainty eases.

Following a number of years of very sharp declines in construction activity, investment in the sector is close to bottoming out. New house construction of about 11,000 in 2011 is unlikely to change much in 2012. Home refurbishment works will remain sensitive to wider consumer confidence sentiment but could benefit substantially from a carefully tailored Government stimulus package. The reductions in the public capital investment programme will, however, result in a further fall in construction activity this year.

While Government has regularly stated its ambitions in relation to delivering a stimulus package for the domestic economy through a public capital programme it is unlikely that any such measures could be delivered in 2012. The potential use of any funds raised through the sale of state assets remains unclear. If agreement is achieved with the troika to allocate a proportion of the proceeds to a public capital investment programme, there is likely to be a significant time lag before any construction activity would commence. We estimate that overall investment activity in the economy fell by about 12% in 2011 and will fall by about 4% this year.

Labour market

Following the relatively benign employment figures from Q2, the renewed acceleration in the pace of job losses in the third quarter was a disappointment. The annual decline at 2.5% was not much different from the 2.0% recorded in Q2, but on a seasonally adjusted basis the quarter-on-quarter fall was 1.1% - significantly higher than in Q2 and the fastest since Q3 2009.

Financial services saw the largest quarterly decline in employment of 4,500, followed by professional and scientific services with a 3,500 drop. Public service staff reductions were reflected in 1,900 and 1,100 drops in health and education, respectively. Although at a slower pace, industry continued to lose jobs. Firms continue to seek improved productivity, and prevailing economic uncertainty is likely to dampen new hiring.

A surprise on the upside was the 1,200 jobs gained in construction in the quarter, leading the annual pace of decline to ease to its slowest since Q4 2007. We doubt, however, that the sector will continue to add jobs and have pencilled in some further modest losses in 2012 before employment reaches a plateau in 2013. The hospitality sector added a further 1,400 jobs in Q3, but this was less than the 4,700 gain in Q2. Wholesale and retail employment also grew for the second consecutive quarter, but given the weak outlook for consumer spending, we expect some further job losses in 2012.

Employment will have fallen by about 2% in 2011, bringing the total number of people employed to just over 1.8 million, down from over 2.1 million at the peak. Given that we have pared down our macroeconomic forecasts, we have also downgraded our view on the labour market. Reductions in public sector numbers and upcoming redundancies in the financial and insurance sector will lead to some bleak numbers for the first half of the year, but the situation should stabilise in the second half. We now expect employment to fall by about 0.4% this year and have pencilled in a very tentative recovery of just 0.5% in 2013.

The unemployment rate in Q3 increased to 14.4%, up from 14.2% in Q2 and 13.5% a year previously. Overall, unemployment is set to have averaged about 14.3% in 2011. The decline to 13.8% in 2012 and 13.1% in 2013 is driven by a decrease of the labour force, rather than employment gains. The decline in the size of the labour force from 2.4 million at the peak to the current 2.1 million is driven by outward migration, as unemployed people seek work elsewhere, and by falling labour market participation.

Labour market participation rates have fallen steadily throughout the recession, from 64% at the peak in 2007 to 60% at present. The trend has been most accentuated among males in the 15-24 age cohort, but, as a slight silver

Employment

000s annual average	2010	2011	2012	2013
Agriculture	85	84	84	84
Industry	360	339	338	340
Services	1,403	1,385	1,378	1,386
Total	1,848	1,807	1,800	1,809
Unemployed	292	305	293	277
Unemployment (%)	13.6	14.4	14.0	13.3
Labour force	2,140	2,112	2,093	2,086

Table 3

lining, many of these have returned to education. This will ease transition to new industries and improve the productive capacity of the economy over time, but also emphasises the importance of effective labour market supports. It is essential that the new Solas (to replace FÁS) embraces a demand-led approach to work and education placements and works closely with industry to identify areas with future employment potential.

Prices and wages

Following two years of falling prices, inflation returned to the Irish economy in 2011. The Consumer Price Index (CPI) increased by 2.6% last year, largely as a result of higher energy prices and mortgage interest costs. Energy prices have continued to rise into 2012 but ECB rate reductions will mean that mortgage interest costs will fall this year. Budget 2012 will lead to a number of consumer price hikes, however, and the CPI is likely to increase by about the same rate as in 2011. Overall, though, the average price level in the Irish economy remains below where it was prior to the economic crisis and this has significantly helped Ireland regain much of its lost competitiveness.

The annual inflation observations, as measured by the CPI, returned to positive territory in late 2010 and the inflation rate remained consistently about 2.5% during 2011. Energy costs jumped 11% last year while mortgage interest costs were 20% higher. High global energy prices meant that Irish fuel prices increased sharply during 2011. Diesel prices in December recorded an annual increase of 11% while petrol prices were up 6%.

Government policy left a significant footprint on price developments in 2011. Changes to the structure of medical fees saw hospital charges increase 10%, while the price of private health insurance jumped by 23%. Education costs and public transport fares also increased. Although global inflation is slowing rapidly at present, Budget 2012 will result in a further series of price rises in the Irish economy. Education, health and fuel costs will all increase, while the increase in the VAT rate will affect a broad range of items. We forecast that the CPI increase in 2012 will be 2.5%, just marginally below the 2011 average.

The Q4 2011 IBEC Quarterly Business Sentiment Survey, conducted in November, found that the vast majority of employers plan to freeze basic pay rates for the fourth successive year in 2012. Some 69% of firms surveyed stated that their basic pay rates would remain unchanged this year. This is reflective of the difficult trading conditions which many Irish businesses continue to face and the need for further reversal of Ireland's labour cost disadvantage.

Just under one quarter (23%) of firms plan to award some basic pay increase this year and the median increase was reported at 2%. Just 15% of firms increased basic pay rates during 2011. The percentage of firms planning to reduce pay rates in 2012 is reported at 5%, down slightly from 7% in 2011. While it is clear that the vast majority of firms have completed their pay restructuring, a further deterioration in financial circumstances for a small percentage of firms will necessitate some additional pay cuts.

Given that the unemployment rate remains over 14%, there is clearly considerable spare capacity in the Irish labour market and for the vast majority of skill sets and professions there is little or no wage pressure. In a number of specialist skill and technical categories, however, labour shortages remain and some firms are responding to this by offering higher wages. Some sectors have also continued to perform well during the downturn and following a number of years of pay freezes have decided to award staff modest pay increases. Overall, however, Irish wage trends remain much more subdued than in the majority of our trading partners and a further period of pay restraint will continue to boost the competitive position of firms.

The average change to basic rates in 2011 was a drop of 0.2%, while an increase of 0.4% is forecast for 2012. This compares very favourably to international pay developments. The EU Commission estimates that average employee compensation in the eurozone increased by 2.1% in 2011 and has forecast a jump of 2.3% in 2012. Despite the weak labour market situation in the UK, high inflation has resulted in some wage demands and the latest data show that average weekly earnings are up about 2% on an annual basis.

After a sustained period of higher than target inflation in both the eurozone and the UK, inflationary pressures are now easing and coupled with a sharp slowdown in growth, this is likely to result in more moderate pay increases in our main trading partners over the coming years.

Inflation forecasts

2011	Year-on-year quarterly average	Annual average
March	2.3%	2.6%
June	2.9%	
September	2.5%	
December	2.7%	
2012		
March	2.6%	2.5%
June	2.6%	
September	2.4%	
December	2.2%	

Table 4

Exports and exchange rates

Exports continue to grow, although the pace slowed in the second half of the year as global activity waned. Data from the national accounts show that exports grew 4.4% in the first nine months of the year compared to the same period last year. This was balanced between goods, up 4.2%, and services, up 4.7%.

More detailed monthly data for January-October show that goods export growth remains broad based. The value of food exports continue to benefit from high commodity prices on world markets with over 16% growth. Chemical exports grew by over 8% with growth primarily concentrated in organic chemicals and pharmaceuticals. Machinery and transport equipment returned to modest growth in 2011 although a slowdown in the later part of the year restricted expansion to just 0.3%.

Quarterly balance of payments data show that computer services is the largest and fastest growing service export component with growth of nearly €3 billion or 15% for the first three quarters, underlining the current strength of the ICT sector. Transport and tourism and travel are up 13% and 12% respectively; this is consistent with the 7% growth in overseas visitors. The positive trend is, however, dependent on the performance in the global economy as indicated by the 3% annual decline in visitor numbers in the period September-November.

The value of imports is up 7% with over 60% related to producer capital and materials used in production. The UK is our largest import market with nearly a third of all imports sourced from the region. It is also our fastest growing source of imports with value increasing 16% in the first ten months.

Currency markets continue to be extremely turbulent with large fluctuations occurring throughout 2011. The euro began 2011 at $1.33, strengthened by 12% to a peak of $1.49 in May but finished off the year 13% weaker at $1.29. Euro strength in the first half of 2011 was largely related to ECB insistence on raising interest rates, and the reversal of this policy due to the ongoing eurozone crisis has coincided with the declining value of the euro, particularly in the last quarter.

Eurozone inflation eased to 2.8% in December and with last year's oil and commodity price rises set to fade in 2012, the ECB has room to allow for further policy interventions. Although currency markets remain volatile, it is unlikely that the euro will appreciate against the dollar in 2012 with further weakening a far more likely scenario. Sterling was less volatile against the euro but strengthened from £0.86 at the start of the year to £0.90 in July before declining in the final quarter to finish off at £0.83. The recent strength of sterling has continued into the early part of 2012 and is welcome for many indigenous companies for which the UK is the predominant export market.

Public Finances

The Exchequer returns for Q4 were somewhat disappointing with tax revenue over €1 billion behind target leading to the tax take for the year as a whole falling 2.5% or €873 million behind target. The major revenue generators income tax, VAT and corporation tax all came in behind target. VAT ended the year €489m or 4.8% under target, although €120 million can be accounted for by a cut in the lower rate of VAT. Corporation tax was €500 million behind target, although €261 million from 2011 was not included in the December figures owing to timing issues. Stamp duty was €436 million above target, explained by the €457 million collected from the private sector pension levy. Although revenue was behind target it was up by almost €2.3 billion compared to 2010.

Although revenue came in slightly behind target, a reduction in government spending ensured that the troika's budgetary targets were met. Net government expenditure came in €440 million or 1% under target and made up for the shortfall in tax receipts. Government expenditure is down 5% or almost €3 billion compared to last year. The biggest spending cuts occurred in health (€887 million), transport (€636 million), environment and local government (€379 million) and community, equality and gaelteacht affairs (€271.8 million).

The returns shows an exchequer deficit of €24.9 billion, €6.2 billion higher than 2010. However, excluding the bank recapitalisation payments the underlying deficit fell by €2.75 billion. The returns correspond to a deficit of around 10% of GDP and despite missing the Budget 2011 target of 9.6%, it is under the deficit limit of 10.6% set by the troika. Given that the 2012 deficit target of 8.6% is identical between Budget 2012 and the troika, this reduces the scope development for the indigenous companies for whom the UK is the predominant export market.for error and requires all current revenue and spending targets to be met during 2012.

Exchange rates - monthly averages

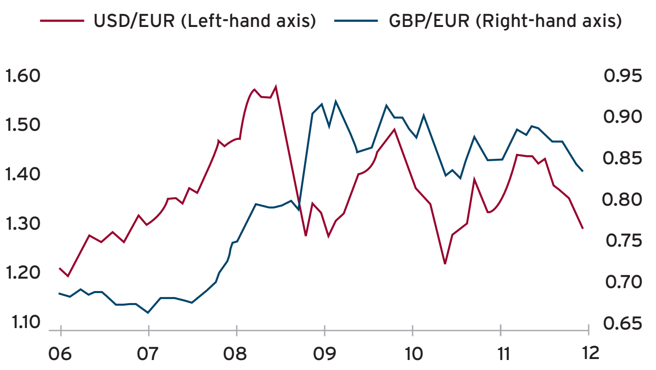

Figure 3

International economies

The eurozone debt crisis in conjunction with volatile commodity prices and disruptions to supply chains caused by the earthquake in Japan resulted in weaker than anticipated growth in the global economy last year, leading the OECD to reduce its 2011 global forecast from 4.2% to 3.8%. Despite pressure in advanced economies, the global economy was buoyed by a strong performance from emerging nations. Chinese growth remained strong but was tempered by interest rate increases to control inflation, while Latin American countries benefited from rising commodity prices. China's growth should slow in 2012 due to moderating trade conditions and a slowdown in its hyperactive property market. World growth is expected to moderate to 3.4% in 2012 before recovering to 4.3% in 2013.

United States

Despite the global slowdown, the US economy gained momentum in the latter part of 2011 and grew by around 1.8% last year. After strong employment growth in December the unemployment rate has fallen to 8.5%, this combined with rising consumer sentiment should provide a boost to consumption. Households made little progress in reducing household debt in 2011 although debt is 10% below the peak levels of 2008. US manufacturing grew for the tenth successive quarter in Q4 and was broad based across a number of sectors. This, coinciding with positive data in January, suggests that industry will be an important source of growth in 2012. With forecasts of 2% and 2.5% growth in 2012 and 2013, the outlook for the US is brighter than the eurozone or the UK. Growth, however, will continue to be curtailed by the ongoing crisis in Europe.

UK

The UK economy continues to disappoint with GDP growing less than 1% in 2011. For 2012, risks remain to the downside, with fiscal consolidation set to continue as the deficit of 9% is twice the EU average. Manufacturing continues to perform well, but with new orders primarily coming from export markets future growth is tied to the performance of the external economy. The unemployment rate rose to 8.3% in Q3, the highest level in 16 years, and highlights the fragile state of the labour market. Inflation declined to 4.8% and is expected to fall further as commodity prices and the temporary effects from VAT hikes dissipate. This provides relief to consumers while allowing monetary policy to remain supportive. Like the eurozone, growth will be marginal in 2012 with the threat of recession a concern.

Eurozone

After solid growth in the early part of the year the second half of 2011 turned out to be more difficult. The average unemployment rate in the bloc rose to a record 10.3%, accentuating the divergence among member states. Unemployment in Germany hit its lowest level since reunification but continued to climb in many other economies. Eurozone GDP grew by around 1.5% in 2011, but little or no growth is expected in 2012, with a return to recession becoming a distinct possibility. However, the outturn will be largely determined by the extent to which the bloc takes decisive action to end the debt crisis.
The next three months will provide a significant test for market sentiment with Italy and Spain due to roll over €56 billion and €12 billion worth of debt. Recent bond auctions for these countries attracted a strong response at significantly lower interest rates than those seen at the end of last yea despite recent ratings downgrades.

Real GDP growth - selected countries

Annual % change	2011	2012	2013
Euro area	1.6	0.2	1.4
UK	0.9	0.5	1.8
Germany	3.0	0.6	1.9
France	1.6	0.3	1.4
US	1.7	2.0	2.5

Table 5

Inflation - selected countries

Annual % change	2011	2012	2013
Euro area	2.6	1.6	1.2
UK	4.5	2.7	1.3
Germany	2.4	1.6	1.5
France	2.1	1.4	1.1
US	3.2	2.4	1.4

Table 6

Consumer spending - selected countries

Annual % change	2011	2012	2013
Euro area	0.4	0.1	0.9
UK	-0.9	0.5	2.0
Germany	1.0	0.7	1.1
France	0.6	0.7	1.6
US	2.3	2.2	2.6

Table 7

Source: *OECD Economic Outlook, November 2011*

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