Quarterly
ECONOMIC OUTLOOK

IBEC

July 2011

Consumers can influence scale of Budget adjustment

Amidst the further escalation of the eurozone crisis it has gone largely unnoticed that recent data on the Irish economy were better than expected. The CSO has confirmed that the size of the economy last year was larger than previously estimated and the population is about 100,000 greater than forecast. This bodes well for the short-term challenges which the economy faces and also for the country's medium-term growth potential. The ebb and flow of the eurozone crisis will continue to have a significant bearing on our economic fortunes but remains largely outside of our control. The level of consumer spending also has a role in determining how much the government needs to cut or tax in December's Budget and this is something which remains within the control of households themselves. Our collective energies must therefore focus on influencing that component of the economic jigsaw which we can still determine.

Economic outturn 2010

Ireland's economy in 2010 performed better than previously estimated. Recent figures confirmed that GDP fell by just 0.4%, compared to a provisional estimate of a 1.0% drop. The final data also show that the nominal size of the economy last year at €156 bn was €2 bn larger than thought. This is crucially important in terms of reaching the deficit target agreed with the EU-IMF. In normal times, economists focus on real changes in GDP as the most relevant measure of growth in an economy. At present, however, a more accurate metric of economic progress is the change in GDP in value terms, as ultimately this will determine our ability to meet the loan agreement budget deficit targets. It is therefore positive that 2010 saw both the volume and value of activity in the economy stabilise. Ireland's export sector rebounded exceptionally strongly last year on the back of improved competitiveness and a recovery in the global economy. Consumer spending remained subdued, however, as the headwinds of lower incomes, job losses and tax increases all impacted on disposable income. As significant, however, was the exceptionally high savings ratio as consumers opted to pay down debt and increase their precautionary savings.

Economic outlook

The business recovery has gained momentum in the early part of 2011 as Irish firms build on the 'right-sizing' undertaken since 2008. Exports have remained buoyant but there is now growing evidence of some positive spillovers for other sectors of the economy. Firms' investment in machinery and equipment is growing again as Irish businesses demonstrate their confidence in the outlook for the economy. The percentage of firms planning to hire new staff has also increased significantly as businesses are both tooling up and staffing up to meet the continued growth in export demand. The consumer remains reluctant to spend or invest, however, and the economic recovery remains unbalanced. In order to make meaningful inroads into the employment problem, domestic demand must start growing again.

Despite the weak consumer position, the growth outlook for both this year and next remains positive. The money size of the economy will grow by 3% this year and by about 4.5% next year. We are slightly more optimistic on the growth outlook than in our previous forecast and the nominal size of the Irish economy will actually be €4 bn higher by end 2012 than we previously expected. This augurs well for Ireland's ability to reach its agreed deficit reduction targets.

Delivering domestic recovery

The key to a sustained economic recovery and employment growth is an improvement in domestic demand. Firms will play their part through increased investment and Government can help by maintaining the capital investment needed to meet the requirements of our growing population. It is also essential that consumers return to more normal spending and savings patterns. A more sustainable savings ratio of 7% or so would unlock much needed demand in the economy. This additional spending by consumers would filter through the economy in the form of more jobs and greater tax revenue for the State and would ultimately obviate the need for any additional austerity measures.

If the consumers who can afford to do so choose to spend rather than save, the benefit to the economy and ultimately themselves would be substantial. For every three additional euro spent, there would be a reduction of one euro in the future tax bill. Government must support consumer spending by communicating effectively on the economy and giving clarity on future taxes and charges in a manner which consumers can relate to.

Despite the grave economic uncertainty, Irish consumers can still significantly determine their own destiny. Irish firms remain ambitious for this economy and Government and households must be likewise. Now is not the time for austerity bravado to sate perceived market demands. Growth is the key to debt sustainability and Irish households must play their part in delivering this.

Economic growth

There were a number of pleasant surprises in the recent CSO national accounts data releases. The economy in 2010 performed better than previously estimated, with GDP sliding by 0.4% and GNP growing by 0.3%, compared to provisional estimates of drops of 1.0% and 2.1% respectively. The GNP revision of almost 2.5 percentage points is unusually large but there appears to be particular volatility in the GNP numbers at present. The economy last year was also much larger in money terms than previously estimated - nominal GDP was some €2 bn or 1.3% higher than the provisional estimate. GDP in nominal terms is particularly important in the context of Ireland's deficit targets set out in the loan agreements with the EU-IMF. Overall, therefore, the Irish economy in 2010 through the rear view mirror looks much better than it did at the time.

There has also been a positive, if somewhat mixed, economic performance in Q1 of this year. Seasonally adjusted GDP grew by 1.3% in the quarter and was also marginally higher on the corresponding quarter of last year. GDP in nominal terms grew by 5.1% in the quarter and, while acknowledging the usual health warnings in relation to the volatility of quarterly data in the Irish economy, this bodes well for the nominal GDP growth outlook for this year.

Looking at the components of growth in Q1, it is clear that the divergence between the performance of the domestic economy and that of the export sector continues to grow. Consumer spending was down 1.9% in the quarter, the biggest drop since Q1 2009. On an annual basis it was 2.7% down on Q1 of last year. At the other end of the spectrum, the net export performance was exceptionally strong. Net exports jumped 21% in the first quarter and were over double that recorded in Q1 2008. There was a good balance between goods and services export growth with the former up 6.2% and the latter 8.0% higher than in Q1 2010. Crucially, there is now evidence that the stellar export recovery is leading to spillovers for other parts of the economy. Exporting firms appear to have utilised whatever spare capacity was available and are now increasing their investment in equipment and machinery.

GNP and its components

Annual % change

	2010	2011	2012
Consumer spending	-0.8	-1.9	0.2
Government spending	-3.8	-3.8	-4.0
Investment	-24.9	-4.5	7.0
Exports	6.3	6.2	5.5
Imports	2.7	3.9	4.1
GDP	-0.4	1.5	2.8
GNP	0.3	0.6	2.1

Table 1

Despite a disappointing first quarter outcome for GNP, which dropped by 4.3%, we remain positive on the overall economic outlook for 2011. A combination of very strong net export growth, a recovery in investment in machinery and equipment and a slowing pace of decline in construction activity will result in GDP growth this year for the first time in four years. GDP is set to increase by 1.5% in real terms and 3% in nominal terms. Consumer spending will remain the most worrying weak spot in the Irish economy and will fall by close to 2% this year.

Business outlook

The Q2 2011 IBEC Business Sentiment Survey showed that managers' perceptions of the overall trading environment continued to improve. The current conditions index at -17 was still negative, but up from -23 in Q1 and -40 in Q2 2010. The forward-looking index rose to -13 from -17 in Q1 and -32 in Q2 2010. It is clear that the outlook, though still challenging, is improving gradually.

Managers' confidence in their own businesses remained broadly unchanged from the previous quarter. Own business confidence has now been positive for four consecutive quarters, highlighting the divergence between individual company performance on the one hand and the problems of the sovereign on the other.

The index for export sales declined somewhat from the very high Q1 reading, but the index at +41 continues to point to solid export growth in 2011. The indicator for domestic sales dipped back into the negative at -4, reflecting the two-speed nature of the economic recovery and the challenging outlook for the domestic market. Finally, companies employment expectations remained stable at -3. While the index continues to point to some job losses, it is encouraging that over 20% of companies plan to hire new staff in the coming three months. This is nearly double the percentage in Q2 2010.

IBEC business confidence indicator

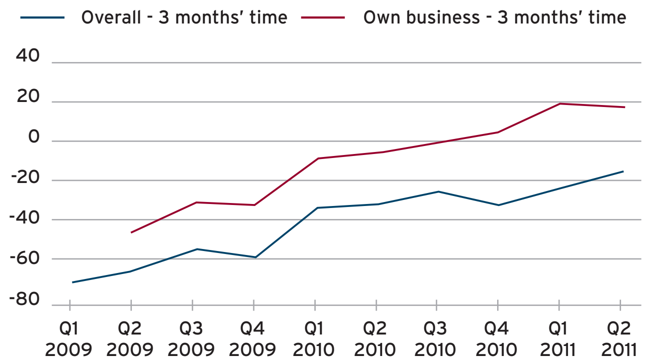

Figure 1

Consumer spending

The national accounts release for 2010 shows that the outturn for the year was somewhat more positive than had been suggested by the initial figures. The volume of personal consumption fell by 0.8%, rather than the 1.2% initially estimated. The fall in value terms was revised to 3.1% from 3.4%. The upshot is that the value of consumer spending at €82.6 bn was €1.2 bn greater than we had initially thought.

The data for Q1, however, paint a fairly bleak picture of the consumer market and the volume of personal consumption fell by 2.9% in the year. The decline was broadly balanced between goods and services, with car sales the only component showing growth. In nominal terms consumption fell by 2.6%. The only slight silver lining in the data is that the period of deflation seen during 2009 and 2010 now appears to be at an end, with the value of sales now tracking volumes fairly closely.

The outlook for the second quarter remains fairly poor. The annual decline in retail sales (excluding car sales), which track consumer spending fairly closely, accelerated to over 5% in April and May. The renewed increase in the pace of decline has affected sales across the board, with only motor trades and electrical goods increasing sales on an annual basis.

As a result of the weak incoming data, we have pared back our consumer spending forecast for 2011 somewhat and now expect a fall of just under 2%. Several factors are eating into consumers' disposable incomes this year, including a temporary uptick in inflation, ECB interest rate hikes and continuing job losses.

However, the outlook for 2012 is more benign for all these: we expect the labour market to stabilise, inflation to slow and the ECB to pause in its interest rate cycle after the next upward hike or two. Crucially, the current uncertainty about the composition of the fiscal adjustment will have been resolved and consumers will have clarity on how the austerity programme will affect household incomes. We therefore expect consumer spending to stabilise next year and have pencilled in a very marginal increase of 0.2% for 2012.

Consumer spending and retail sales

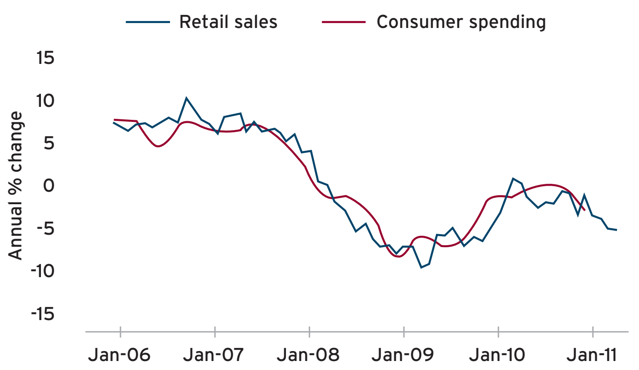

Figure 2

Investment

Ireland's recession is entirely due to the unprecedented collapse in domestic demand between 2007 and 2010. A surge in net exports has helped to offset some of the decline in the domestic economy but given the fact that domestic demand accounts for over three-quarters of GDP, the impact of its decline on overall economic activity has been dramatic. The sharp fall in investment activity since 2007 has accounted for about two-thirds of the overall drop in domestic demand, with the drop in consumer spending making up just one-third. The reduction in government spending has accounted for less than 5% of the fall in domestic demand.

In 2010 the value of total investment had fallen to just €18 bn from a peak of €48 bn in 2007 - a drop of 63%. The volume reduction has been somewhat less at 52%. Investment as a share of GDP has dropped from 22% to 12% over this period, with construction falling from 15% to 7%.

From an economic forecasting perspective there are two important considerations arising from this sharp decline. Firstly, investment as a percentage of GDP is now well below its long-term average and is therefore likely to increase again once current stock overhangs are cleared. Secondly, while it appears that construction sector output is set to fall further during 2011, the drag on growth will be much less than in previous years due to a combination of a slower pace of decline and the fact that construction's share of GDP is now so much smaller.

The first quarter data on economic output brought confirmation that Irish business has begun to increase its investment in equipment and machinery again. This is a very positive sign that the strong export performance is spilling over into other sectors of the economy. While there may be a fairly high import content in some equipment in particular, this increase in investment by exporting firms will have a series of positive spin-offs for a range of businesses in the domestic economy.

The 6.3% jump in exports in 2010 meant that firms recovered all of the losses recorded during the global downturn of 2008 and 2009 and it is no surprise that capacity constraints are now leading to a pick-up in investment trends. Machinery and equipment investment increased by 6% in the first quarter of the year and when the volatile aeroplanes component is stripped out, investment by firms was also higher than in Q1 2010. Total investment in equipment and machinery had fallen by 40% over the course of the recession. It is therefore expected that following a number of years of limited

Medium-term consumer spending outlook

Personal consumption in Ireland, measured in constant prices, had by 2010 fallen by close to 9%. The further decline forecast this year will bring the cumulative fall to about 10%. Because of the steep price deflation experienced during 2009 and 2010, the value of sales - effectively, business turnover - has fallen by almost 14%. No sector has been immune, though those closely linked with the housing market have felt the pain most acutely.

In contrast, consumers' incomes have not fallen by nearly as much. In 2009, the latest data available at the time of writing, disposable income fell by just over 2%, while consumption in value terms fell by over 10%. The gap between the two is formed by savings together with debt repayment and, unsurprisingly, the savings rate shot up to about 12% and has remained high. Though incomes fell by a further 2-3% in 2010 owing to job losses and budget tax hikes, the underlying pattern will have remained very much the same.

However, as we detail elsewhere in the publication, we believe that the consumer market is now close to bottoming out. The 2012 outlook for some of the key drivers of consumption expenditure, such as unemployment and inflation, is more benign than it had been for 2011. We have, therefore, pencilled in a very modest increase of 0.2% - a welcome stabilisation following four years of a contracting market.

With a market close to the bottom, now is a good time to consider the outlook for the domestic market.
The economy will expand this year thanks to strong exports, but personal consumption must play its part if Ireland is to achieve balanced growth.

There are a number of reasons why the outlook for consumer spending over the medium term is relatively benign. While there is certainly no return to annual growth rates of 6% or over, we believe there is no reason why consumer spending would not return to fairly solid growth of around 2-3% per annum in volume and around 5% in value.

Overall economic performance and the labour market are fundamental building blocks of consumption and work through both the impact on incomes and on consumer confidence. The benefits of export growth will trickle down to the domestic economy in terms of investment and employment. This process is already beginning to happen, which in turn will boost consumer demand. While most private sector companies will opt for a wage freeze, some companies in sectors performing exceptionally well will grant modest pay increases this year or the next. This stabilisation in incomes will also help the consumer market.

Apart from the more positive short-term outlook for the economy, we also believe that some of the structural issues are less severe than initially thought. While the outstanding stock of debt remains fairly high, Irish households have been able to reduce the burden at a rapid pace. Data from the Central Bank show that household liabilities (including sole traders) had by Q4 2010 fallen by almost €18 bn or 8.5% from the Q4 2008 peak.

On the other side of the balance sheet, financial assets have recovered from the 2009 dip. Thanks to a combination of fairly rapid deleveraging and asset price growth, roughly balanced in their contributions, households' net financial position has improved significantly. Net financial wealth in 2010 grew by 26% relative to 2009 and by Q4 2010 was up an impressive 70% on the Q1 2009 trough. Finally, if house price decreases continue at the current pace, values will by 2012 be close to a historical average in relation to household incomes.

Reduced debt levels and stabilisation in asset values will help consumers feel more comfortable with their net debt positions, enabling them to bring down the savings rate to a more normal 7-8% range from the current very high 12%.

Demographics are also an important part of the story. The Irish domestic market during the boom years grew not only because individual consumers spent more, but also because the size of the market increased thanks to population growth.

The recent preliminary Census results show that the worst fears about emigration have not been realised. Rather than shrinking, the Irish population continued to grow throughout the recession and was, in fact, 100,000 greater in April this year than had been estimated in 2010.

European comparisons also present Ireland in a favourable light. Ireland does not face a rapidly ageing population and, in addition, has the highest birth rate in the EU at over 17 births per 1,000 population. According to recent forecasts by Eurostat, Ireland is expected to see the strongest population growth in the EU up to 2060, with the population increasing to over 6.5 million, or by almost 50%. The EU average is just 3%.

The medium-term fundamentals of the Irish economy remain solid and the potential growth rate is about double that of the euro area. Short-term difficulties remain, however, and Government must become more effective in how it communicates these challenges to consumers.

To date, it has not given householders certainty on the shape of the forthcoming budgetary adjustment and in response consumers have retrenched further. Government must now move to explain to households in an easily understood way how the budgets over the next years will affect disposable incomes.

Investment

Annual % change	2009	2010	2011	2012
Building & construction	-31.1	-30.3	-16.7	0.0
Plant & machinery	-19.7	-14.5	15.0	15.0
Total	--27.6	-24.9	-4.5	7.0

Table 2

replacement and a recovery in industrial output, investment in machinery and equipment could pick up quite sharply over the coming quarters. Access to credit will obviously remain a constraint on the investment plans for some indigenous companies and the majority of the increase is likely to occur in the multinational sector. We are currently forecasting a 15% increase in machinery and equipment investment in 2011 and a further 15% recovery next year.

While the pace of decline in construction sector output slowed somewhat over recent quarters, the sector is set to contract further in 2011. The annual fall in housing output slowed from 49% in Q1 2010 to 27% in Q1 2011, while over the same period the decline in non-housing construction output eased from 29% to 21%.

The public capital investment programme had been a key factor in maintaining civil engineering activity in recent years but with the completion of a series of major projects in 2010, the pace of decline over the coming quarters is likely to remain fairly strong. The Government is also in the process of undertaking a review of the five-year capital envelope and it remains to be seen how much public funding will be allocated to infrastructure investment over the coming years. In the short term, total construction investment is set to fall by a further 15% this year before stabilising in 2012.

Labour market

Labour market data from the CSO show that employment continued to fall in the first quarter of 2011, but at a slower pace than previously. On an annual basis, employment shrunk by 2.9% or 53,400. While this is still substantial, it is the slowest pace since Q3 2008 and about half of that recorded in Q1 2010. On a seasonally adjusted basis employment fell by 0.5% or 9,300 relative to Q4 2010.

Construction again accounted for the greatest number of job losses in the year, with a decline of 21,800.
The employment situation in hospitality deteriorated sharply, with 20,800 jobs lost relative to Q1 2010. Employment in the sector had held broadly stable during 2009 and 2010 despite a large fall in activity, so it was not unexpected that the decline in activity would eventually feed through to staff numbers. Industry lost 11,600 jobs in the year and it appears that the upturn in activity will take a few quarters to translate to employment gains in the sector. Public sector employment (excluding temporary census staff) fell by 3,100. Education was the only sector to add jobs with an increase of 3,700 over the year.

Looking at the seasonally adjusted data, the biggest job losses in the quarter were in hospitality and retail, reflecting the ongoing weakness in the domestic economy. Though the VAT decrease that came into effect at the start of July may provide some help for the struggling hospitality sector, we still expect employment to fall this year before a modest recovery in 2012. Similarly, we expect retail employment to contract this year, but given that employment in the sector has already fallen by 16%, we don't expect the decline to be quite as marked.

It now looks like the worst of the construction sector jobs losses are behind us. The sector lost 1,200 jobs in the quarter, the smallest quarterly decline since construction employment began to shrink in Q3 2007. Given the likely further reduction in public capital spending, we expect construction employment to continue to fall in 2011 and 2012, but at a slower pace than before.

Professional and financial services activities both added jobs in the quarter, reflecting the robustness of traded services. However, given the forthcoming job losses in the domestic banks, we expect financial services to lose jobs on a net basis this year, despite the strong performance of the IFSC and related activities.

Overall, we expect employment to fall by about 1% this year, before stabilising in 2012. In the aftermath of a recession, jobs recovery typically lags the upturn in GDP by six months to a year. This effect is likely to be particularly accentuated in Ireland, given the export-led nature of the economic upturn. Though export growth will have spillovers for the domestic economy, it takes some time for the benefits to trickle down. Ultimately, we need a return to more balanced growth and a recovery in the more jobs-intensive domestic activities before we can begin to make serious inroads into reducing unemployment.

Labour market

000s annual average	2009	2010	2011	2012
Agriculture	96	85	89	90
Industry	411	360	345	345
Services	1,422	1,403	1,393	1,401
Total	1,929	1,848	1,827	1,836
Unemployed	259	292	285	274
% Unemployed	11.8	13.6	13.5	13.0
Labour force	2,187	2,140	2,112	2,110

Table 3

Prices and wages

The first half of 2011 saw a marked increase in inflationary pressures both in Ireland and internationally. Higher commodity prices, in both food and energy, were the main reason behind the global consumer price rises, while in Ireland the increase in the Consumer Price Index (CPI) was mainly due to higher imported fuel prices and mortgage interest costs.

Global commodity prices have moved downwards a little since the start of the year but the time lag involved in pass-through to consumer prices could yet see some related consumer prices increasing further in the second half of this year. Food commodity prices are currently about 10% off peak while oil, priced in euro, is also 10% below its April high but remains some 30% higher than July 2010 prices. Inflationary pressures in developed economies have therefore eased somewhat in more recent months and this trend is likely to continue into 2012.

The monthly inflation observations, as measured by the CPI, increased sharply from 1.7% in January to 3.2% in April but May saw the inflation rate slip back to 2.7%. The three-month increase in the CPI in the February to April period was the largest recorded since April 2008. Higher mortgage interest rates accounted for 40% of this increase, while the spike in fuel prices made up a further 25%. Over the past 12 months these two factors contributed to 80% of the total increase in the CPI. It is therefore evident that underlying price pressures in the Irish economy remain fairly muted. Given the ongoing weakness of domestic demand, consumers will remain sensitive to any price adjustments and this is likely to be reflected in the pricing policy of businesses.

Despite the recent uptick in the CPI, the Harmonised Index of Consumer Prices (HICP) has not increased as rapidly. This measure, which strips out the volatile mortgage interest component, is a more relevant yardstick of movement in our international competitive position.

The HICP fell by 1.7% in 2009 and 1.6% in 2010 and the annual change increased from 0.2% in January to 1.2% in May. In April, the latest month for which internationally comparable data are available, the HICP increase in Ireland of 1.5% was the lowest in the EU-27 and was substantially below the EU average of 3.2%. The fact that inflation in the UK in April was 4.5% gives a clear indication of how Ireland is rapidly closing the price differential over our main trading partners which had emerged prior to the economic crisis.

The inflationary outlook for the coming quarters remains fairly benign. The CPI has most likely passed its peak in the current cycle and monthly inflation rates are likely to range from 2% to 2.5% over the second half of the year. Some further pass-through is likely on the commodity side - particularly in relation to food prices, which have remained remarkably subdued in recent months.
The ECB July rate increase will also be passed on to mortgage holders over the coming months. Overall, however, prices will remain relatively flat and the CPI increase is likely to average 2.5% in 2011 and about 1.7% in 2012. The HICP increase is expected to average 1.5% both this year and next.

In addition to improvements in Ireland's relative price position, competitiveness gains are also being made on the pay front. On both a unit labour cost and nominal wage comparison basis, Ireland's labour cost disadvantage has narrowed considerably over the past three years. Encouragingly, the most recent IBEC pay survey shows that this progress will continue in 2012. Almost three-quarters of firms will apply pay freezes in 2011, while just short of 70% plan to freeze basic wage rates next year. On average, basic pay rates will fall by 0.12% in 2011 and will be essentially flat in 2012. About 30% of firms are currently planning to deliver pay increases in 2012 but these firms will predominantly be in the high-tech export sector. A small proportion of firms have stated that they will need to deliver further pay reductions in either 2011 or 2012 in order to ensure their viability and preserve as much employment as possible.

Irish firms have made great strides in restoring their competitive position over the past few years and this has translated into growing exports and higher market share. On a nominal wage cost basis Ireland has already reversed about one third of the cost disadvantage against our EU-15 trading partners and strong productivity growth has meant that the unit labour cost improvement has been even greater.

Inflation forecasts

2011	Year-on-year	Annual average
March	2.3%	2.5%
June	3.0%	
September	2.3%	
December	2.2%	
2012		
March	1.6%	1.7%
June	1.2%	
September	2.1%	
December	2.1%	

Table 4

Exports and exchange rates

Irish exports continue to perform strongly with the national accounts for the first quarter showing 6.2% growth on Q1 2010. More detailed monthly data show that exports grew by 6% to the euro area due in particular to 23% and 10% gains in France and Germany respectively. Exports to the US and Great Britain also grew in the first quarter with the US having the highest growth rate of 11.2%. The headline export performers were food, up 20%, and chemical exports, up 13.5%. Encouragingly, the decline in exports of machinery and transport equipment appears to have bottomed out in March after it posted its first year on year gain since December 2006. Total services exports increased by 8% in the first quarter with the balance of payments showing that this rise was due to an increase in computer and business services.

Imports were up 12.6% or €1.38 bn on the first quarter of 2010. However, almost two-thirds of this increase is derived from imports of producer capital goods and materials for production. While the national accounts deduct imports in deriving GDP these imports are subsequently used in the production of goods, including exports. The overall effect will be increased exports and GDP over the coming months as these specific imports are put into production and added value is obtained.

The euro has become volatile recently and in the long run it is expected to weaken as the crisis in the euro area continues. The ECB raised interest rates again to 1.5% in July and a further rise is expected before the end of the year. The euro fell to a record low against the Swiss franc in July and a four-month low against the dollar as the borrowing costs for the eurozone's more indebted member states, including Italy and Spain, rose to new highs. Furthermore, once inflation stabilises and the ECB rate hike cycle ends, monetary policy will not be supportive of the euro, which will subsequently lose value against sterling and in particular the dollar.

Exchange rates - monthly averages

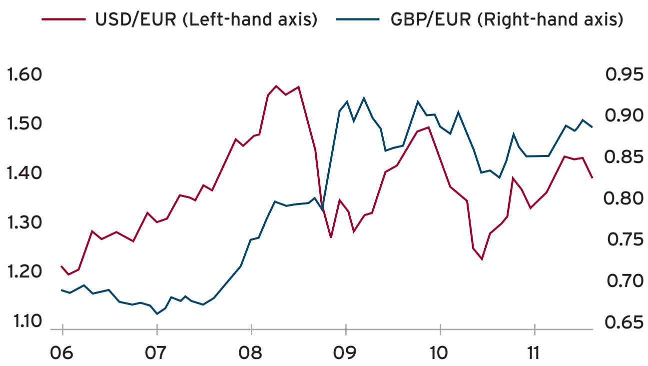

Figure 3

Although the US Federal Reserve ended its $600 bn bond buying programme it continues with its policy of maintaining interest rates at 0-0.25%, a policy it will continue with for "an extended period". Given the Fed's mandate it is unlikely to tighten policy substantially over the coming months. Sterling has proved to be particularly weak and holds little attraction to investors due to underlying weaknesses in the UK economy. Sterling is likely to remain weak with the Bank of England keen to promote growth through low interest rates in spite of high inflation.

Public finances

Exchequer returns for the first six months of the year confirm that Ireland is on track to meet its commitments under the EU-IMF agreement, with both revenue and expenditure broadly on target. The headline Exchequer deficit for the year to June was higher than last year, but this was owing to the bank promissory notes paid out in March. The underlying deficit came in at €7.8 bn, an improvement of €1.1 bn or 12.5% on the same period last year.

The promissory notes were counted on the general government balance last year when the obligation occurred, giving rise to the massive 32% deficit recorded in 2010. This is the measure that the EU considers in its excessive deficit procedure. However, because the Exchequer accounts operate on a cash basis, the promissory notes will be recorded on the books each March when each tranche is paid out. This will cause a divergence between the general government and Exchequer balances in coming years, but, crucially, the promissory notes have already been accounted for on the gross government debt and will not add further to Ireland's debt burden.

Tax receipts indicate that the domestic economy was fairly weak in the first half of the year. VAT came in €134 mn or 2.6% under profile, but most of the shortfall occurred in February. After weak income tax returns in Q1, Q2 returns rebounded strongly and returns were up €11 mn on profile for the first six months. Corporation tax receipts were 7.6% behind profile with a particularly weak Q2. The Department of Finance suggest that the weak returns may be explained by greater company investment and consequent tax offsets. Government expenditure was €21.9 bn or €343 mn under profile with the main under-spends occurring in Agriculture Fisheries & Food and Social Protection.

International economies

After strong growth in 2010 the underlying trends remain consistent with a global economy that is in expansion mode, albeit at a slower pace and with higher inflation than last year. Despite a number of headwinds, the global economy will benefit from historically low interest rates combined with the International Energy Agency's recent decision to draw down its oil reserves in response to the loss of production in Libya which caused global energy prices to rise in early 2011. Modest growth in the west is complemented by a strong performance in the emerging economies, particularly China. High inflation continues to be of concern for China and the central bank has been raising interest rates since October. The impact on the economy, however, will be limited, and is unlikely to push China into a hard landing.

Euro area

The euro area posted strong growth of 2.5% in Q1, but remains over-reliant on an expanding German economy which continues to post record levels of growth. Inflation for the region was 2.7% in May and given the ECB's policy of maintaining price stability below but close to 2%, it is likely that the bank will continue to set aside concerns about growth in the periphery.

Greece's need for a second financial package came to a head when the IMF indicated that it would withhold its €3.3 bn contribution unless the EU closes Greece's funding gap for 2012. The passing of a €28 bn austerity package by the Greek parliament ensured the next tranche of loans will be paid. However, the terms of a second package up to 2014 have yet to be finalised with contributions from bondholders causing discord. Contagion to other member states continues to cause concern with bond yields for Spain and Italy rising to their highest levels since the introduction of the euro. This systemic contagion accelerates the need for decisive intervention by the EU.

United Kingdom

The UK recovery remains modest and below expectations with 1.6% year on year growth for Q1. The weakness of the recovery raise questions about whether the economy can withstand government cuts coming into force this year. There are concerns that the Government's aims to rein in the budget deficit through intensive austerity will weigh on growth prospects for the foreseeable future. Growth will remain subdued in the coming quarters as cuts in combination with high inflation further squeeze households' real incomes. Annual inflation reached 4.5% in April, the highest since October 2008, and unemployment currently stands at 7.8%. On the upside, total manufacturing output increased by 2.8% in May having rebounded from the impact of the additional public holiday in April and the supply effects of the earthquake in Japan.

United States

The US economy expanded at a moderate pace with growth varying across different sectors of the economy. Real GDP increased by 1.9% in Q1 of 2011 and reflects positive contributions from exports and consumer spending, although growth was below expectations of around 2.2%. This reflected a 5.1% increase in imports and in particular a decrease of 8.1% in government spending. In April, monthly consumer spending fell for the first time since January 2010 as consumers came to grips with rising food and energy prices. Overall, however, growth is expected to pick up in the second half of the year as the effects of the Japanese earthquake on manufacturing dissipates and energy prices moderate on the back of increased supply.

Real GDP growth - selected countries

Annual % change	2010	2011	2012
Euro area	1.7	2.0	2.0
UK	1.3	1.4	1.8
Germany	3.5	3.4	2.5
France	1.4	2.2	2.1
US	2.9	2.6	3.1

Table 5

Inflation - selected countries

Annual % change	2010	2011	2012
Euro area	1.6	2.6	1.6
UK	3.3	4.2	2.1
Germany	1.2	2.6	1.7
France	1.7	2.4	1.6
US	1.6	2.6	1.5

Table 6

Compensation per employee - selected countries

Annual % change	2010	2011	2012
Euro area	1.8	2.3	2.4
UK	2.8	2.8	2.8
Germany	2.8	3.4	3.2
France	2.3	3.3	3.5
US	3.1	3.0	3.5

Table 7

Source: *OECD Economic Outlook, May 2011*

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