QUARTERLY REVIEW

ECONOMIC TRENDS

JUNE 2008

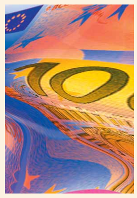
Attention must now focus on economy

Although there are yet no National Accounts data available for the first quarter of the year, there is compulsive evidence that 2008 will be the most difficult year for the Irish economy in decades. The slowdown is sharp and real, requiring the Government to focus its attention on the many problems besetting the economy. The referendum result rejecting the EU Reform Treaty has only added further difficulties for both the economy and the Government.

The house-building collapse combined with an oversupply of commercial property will result in a decline in construction investment of 22%, which is likely to be followed by a further decline of close to 10% in 2009. The retail sector has been in freefall since the end of December as figure 5 on page 4 graphically demonstrates. This may overstate the slowdown in personal consumption because there could be some retail trade lost to Northern Ireland and elsewhere because of the strength of the euro. Most of the weakness, however, stems from a sharp fall in consumer confidence; the IIB/ESRI Consumer Sentiment Index hit its lowest point since the Index began in 1996. Even though the change in the car tax regime due to come into force in July might have postponed some car purchases, the slowdown in the rest of retail sales is broad and deep with the biggest falls experienced by retail activity closely associated with housing. The slowdown will result in employment scarcely growing at all this year. On top of this, high energy, raw material and food prices have pushed up global inflation, a phenomenon from which Ireland is not immune.

This slowdown is having a big toll on exchequer revenues. In the first five months of the year, tax receipts were €1.2 billion behind target. This shortfall will be around €3 billion or more by the end of the year. The tax base going into 2009 will also be that much lower and revenues in 2009 will fall short of what was budgeted for the year because growth will be lower than forecast.

Faced with these challenges, the government has three tasks of immediate importance. The first is to limit the fallout from the rejection of the Lisbon Treaty and reach a workable accommodation with Europe. The second is to set about a thorough reappraisal of government expenditure. We said after Budget 2008 that more would have to be done to rein in current expenditure growth to sustainable levels. The worsening economic climate has made this an even more urgent exercise. The Government has already indicated that there will have to be expenditure cuts. We agree. They must be achieved to the largest possible extent by a thorough purging of any wasteful current expenditure. Efficiencies through increased productivity will help reduce expenditure. An automatic reaction to cut back the National Development Programme would be inappropriate. The focus must remain on enhancing productivity through continuing to build essential physical infrastructure and to enhance education, training and R&D. The third is to ensure that economic realism informs wage negotiations. Global events have hit real living standards and cannot be clawed back by non-productivity related pay increases. We must not revisit the 1970s when to our great cost we met global inflationary pressures by a simple upward adjustment in wages.



Output

The Irish economy performed strongly in 2007, recording a GDP growth of 5.3%. This was slightly lower than the growth in 2005 of 5.9% and in 2006 of 5.7%. Consumer spending grew by 5.4%, which again was a little slower than the growth in the preceding two years. The manufacturing sector recorded its strongest growth since 2002 increasing by 7.5% compared with 5.2% in 2006. Growth was quite widespread across sectors with the modern sector growing by 8.7% and the traditional sectors by 3.7%. Exports of goods and services recorded their most rapid growth since 2001, registering an increase of 8.2%. This was in part the result of the fast pace of the growth in exports of services, which accounted for 43% of total exports of goods and services. Investment, however, stagnated as housing output fell by almost 12%.

Seasonally adjusted data revealed a weakening picture throughout 2007 with second quarter growth falling q-on-q by 1.4%, almost recovering in the third quarter, then falling back by a further 0.8% in the last

IN THIS ISSUE:

- GDP growth to slow to 0.4%;
- Employment stagnates;
- Building and Construction investment to fall by 22%;
- Retail sales collapse in first 4 months;
- Inflation remains high;
- Interest rate rise on the cards.

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GNP and its components

Annual % change

	2007	2008	2009
Consumer spending	5.4	1.3	1.8
Government spending	6.7	4.5	3.0
Investment	0.2	-15.3	-4.8
Exports	8.2	5.5	4.8
Imports	6.4	2.0	3.0
GDP	5.3	0.4	2.2
GNP	4.5	0.2	2.0

Table 1

quarter. Many indicators now point to a much weaker performance in the first half of 2008. Retail sales up to April have plummeted; construction employment is down an annual 12% in the first four months; industrial production growth has slowed to 2.2% in the same period; visible exports were down in value by 5.5% in the first quarter, implying weak volume growth of perhaps 2%; tax receipts up to May are €1.2 billion down on expectations. We now expect GDP growth of only 0.4% in 2008. The housing correction will result in a 40% fall in housing output, causing total investment to drop by 15%; consumer spending will grow by a little over 1%, as employment stagnates, real income growth slows and more restrictive credit conditions begin to bite.

Manufacturing growth

Annual % change - 3mma

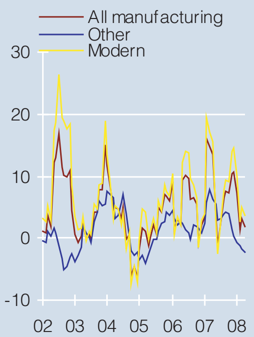


Figure 1

Economic growth

Annual % change - 3mma

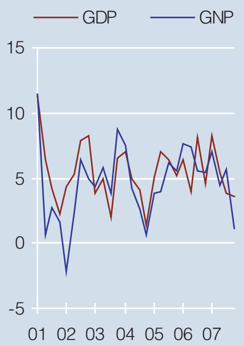


Figure 2

The housing correction will persist into 2009 and, combined with excess supply of commercial buildings, will result in a third successive fall in construction investment. A second year of weak employment growth will result in lack-lustre consumer spending. As the exchequer will lack the resources for the Government to take stimulatory action, GDP growth of just over 2% is forecast for 2009.

However, these two years of very slow growth should be viewed in a longer context. The rebalancing of the economy has coincided with a global slowdown and damaging credit crunch. The ESRI envisages a rebound possibly in 2010 and annual growth of over 3.5% in the medium term.

Employment

The labour market will weaken substantially in 2008 and is unlikely to show significant recovery in 2009. As a result, we expect unemployment to increase from 4.5% in 2007 to 5.7% in 2008 and 6.5% in 2009. Employment growth will slow to just 0.4% in 2008 down from a growth of 3.6% in 2007 and accelerate only modestly to 0.9% in 2009. The increase in unemployment will be contained by a sharp reduction in the growth of the labour force to 1.7%, having averaged an annual increase of 4.4% in the preceding three years. We anticipate that the increase in net inward migration will slow markedly in 2008 in response to reduced employment opportunities. Latest employment data record that non-Irish workers accounted for 90% of the annual increase in employment in the first quarter of 2008. We think there will be a general slowdown in employment across all sectors of the economy with service sector growth slowing from 4.4% to 2.9% as the private sector responds to slower domestic demand and the public sector feels the consequences of significantly reduced exchequer resources. The biggest impact, however, will be the fall in construction jobs and a resumption of the decline in manufacturing employment. (See box on page 4 for longer-term view of the labour market.)

The Quarterly National Household Survey records a significant deceleration in employment growth from an annual rate of 3.2% in the fourth quarter of 2007 to 2.6% in the first quarter of 2008. Employment growth has been slowing since 2005 when it reached 4.9%. On a seasonally adjusted basis, the increase in employment decelerated quarter-on-quarter from 0.8% in the last quarter of 2007 to 0.3% in the first quarter. This is the weakest rate of quarterly growth since the last quarter of 2002. We expect the second quarter figures to disimprove significantly as first quarter data in fact relate to the December – February period and so probably do not capture the full extent of the weakness. Construction sector employment has been declining on a seasonally adjusted basis since the second quarter of 2007; employment losses are likely to be much greater in the March-May period because we know that many builders significantly reduced activity after December and we expect house completions to fall from 78,000 in 2007 to 45,000 in 2008 and to 35,000 in 2009. The CSO's Index of Employment in Construction records employment in May down by an annual 13.8%. In the four years to 2007, the construction sector supplied 88,000, some 28.5%, of the 310,000 jobs generated in Ireland.

Despite the quarterly decline in construction employment since the second quarter of 2007, average annual employment grew by over 10,000 in the year. The large drop in house completions, the Ulster Bank's Purchasing

Labour force forecast

'000 Annual average

	2006	2007	2008	2009
Agriculture	116	116	118	118
Industry	564	578	544	532
Services	1363	1423	1464	1494
Total at Work	2044	2117	2126	2144
Unemployed	95	101	129	149
% Unemployed	4.4	4.5	5.7	6.5
Labour Force	2139	2217	2255	2293

Table 2

Managers Index and the FÁS/ESRI Employment and Vacancies Report for April all point to a sharp drop in construction employment in 2008 of over 30,000. In 2007, employment in the non-construction industrial sector had broken its five-year continuous decline, growing by 0.9%. However, in the fourth quarter of 2007, employment fell by an annual 1.4% and by 2.5% in the first quarter of 2008. Given the weak global economic climate and lost competitiveness aggravated by the strength of the euro, we think industrial employment will fall by at least 1% in 2008 and slip further in 2009. In the five months to May 2008, 53.3% of all redundancies were in the construction and manufacturing sectors, even though those sectors account for only 27% of total employment.

Unemployment

% of labour force

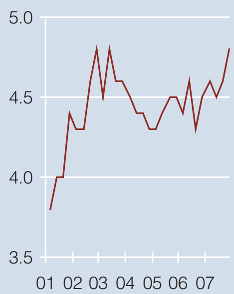


Figure 3

Inflation

Headline inflation as measured by the consumer price index (CPI) rose by 0.8% in the month of May, after an April pause. As a result, the annual rate of inflation rose from 4.3% in April to 4.7% in May. It had hit 5% in March. Inflation in the first five months of the year averaged 4.6% and compares with the average of 4.9% for the year 2007. Mortgage interest continues to be a significant component of the CPI; excluding mortgage interest, the rate of inflation averaged 3.5% in the first five months of the year.

Major contributors to inflation in the year to May were petrol, diesel and home heating oil, which increased by 8.2%, 23.2% and 47.4% respectively. Total energy prices increased by 9.2%. The monthly increase in food prices was a more moderate 0.4%, but was 8.2% ahead of May 2007. Even though there was no increase in the official ECB interest rate from 4%, average mortgage interest rate repayments rose by 2% in the month and 16.9% in the year because of tighter credit conditions resulting from the credit crunch. The increase in inflation was a disappointing reversal of the lower rate recorded in March but it reflects a global phenomenon from which Ireland has no immunity. All countries are now suffering the adverse consequences of energy prices and in some, the issue has become the focus for demonstrations and blockades. The EU Harmonised Index of Consumer prices records Irish inflation in May rising from 3.3% to 3.7%; similarly, the euro area inflation rate has risen from 3.3% to 3.7%. The strong growth of emerging economies will continue to result in high oil price pressures in the short term, which will only be solved by increasing production. Food prices will also remain an upward pressure. The European Central Bank has advanced the possibility of an interest rate hike in July; Fed chairman Bernanke has also warned of growing inflationary pressures and the Bank of England governor Mervyn King talked of a period of rising inflation and falling economic growth.

The downward trajectory we had envisaged for inflation in the second half of the year now seems unlikely. The headline rate will no longer benefit from lower interest rates we had expected in the final quarter of the year; rather, there could be an interest rate rise that would push up inflation in the short term. Upward pressure on energy prices could persist and households can expect sizeable increases in electricity and gas prices in the final quarter of the year. Some limited price moderation could be expected from sterling priced goods as forward contracts unwind. On balance, we think prices are now unlikely to fall in the second half of the year. We have revised our forecasts upwards and now expect inflation in 2008 to average 4.6% and 3.2% in 2009.

Consumer price index

Annual % change

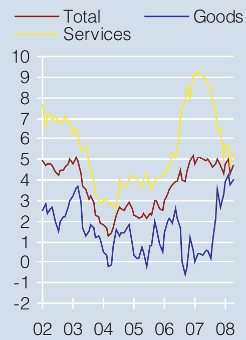


Figure 4

Inflation

2008	Quarter	Year	Annual
March	1.6	5.0	4.6
June	1.0	4.6	
September	0.9	4.5	
December	1.3	4.9	
2009	**Quarter**	**Year**	**Annual**
March	0.6	3.8	3.2
June	0.6	3.4	
September	0.0	2.5	
December	0.6	1.8	

Table 3

Ireland's New Labour Market *by Reetta Suonperä, economic policy executive*

The Irish labour market has undergone a remarkable transformation as the number of people in employment has nearly doubled over the past 20 years. In 1988, unemployment stood at 16.3%, the participation rate [1] was 52.3% and just over 1.1 million people were in employment. In contrast, the Q1 2008 Quarterly National Household Survey from the CSO shows unemployment at 4.8%, the participation rate at 63.5% and 2.1 million people in employment.

Unemployment fell dramatically due to strong economic growth, while female participation in the labour market has nearly doubled. In recent years, the biggest change has been the emergence of migration as a positive force for the labour market. Only in 1994 more people left the country than entered. As employment opportunities became available in a growing economy, returning Irish migrants added to the Irish skill pool with experience they had acquired during their years abroad. Since the turn of the millennium, the picture has been somewhat different. Migration picked up in pace since the accession in May 2004 of the ten new member states. In 2004, the CSO recorded net migration of 32,000 individuals to the state. In 2005, this figure was 55,100, peaking at 71,800 in 2006, with an estimate of 67,300 for 2007.

Labour force composition

	Irish nationals	Non-Irish nationals
Agriculture	93.1%	6.8%
Industry	81.1%	18.9%
Construction	82.3%	17.7%
Wholesale & Retail	80.6%	19.4%
Hotels & Restaurants	62.1%	37.9%
Transport, Storage & Communication	87.1%	12.9%
Financial & Other Business Services	82.8%	17.2%
Public admin & Defence	98.3%	1.7%
Education	92.8%	7.2%
Health	85.0%	15.0%
Other Services	84.9%	15.1%
Total	83.5%	16.5%

Table 9

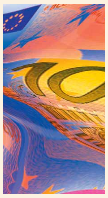
As can been seen in Table 9, 16.5% of workers in Ireland are non-Irish nationals. In many sectors nearly 20% are non-Irish, while in the hospitality industry the proportion is close to 40%. Studies from the ESRI indicate that lack of English language skills in particular forms a barrier, hindering recent arrivals to Ireland from utilising their full potential and finding jobs that would meet their educational qualifications. It is a problem not just for the individuals themselves, but also for Irish society and economy as a whole, where a segment is underutilised in terms of their skills and capabilities.

Migration is the key variable of Ireland's population growth. In the CSO's recent projections it accounts for 90% of the total difference between the lowest and the highest estimate. Three migration scenarios are considered. In the high migration setting net immigration continues at more than 60,000 per annum until 2011, with a gradual moderation to 30,000 per annum by 2021 and subsequent years. Assuming more moderate inflows, net immigration would be 50,000 per annum until 2011, levelling off to 10,000 per annum by 2021. Finally, the CSO considers a scenario with zero net migration, but a net emigration scenario is not considered.

In contrast, the ESRI in its 2008-2015 Medium Term Review sees migration slowing down to 10,000 per annum by 2010, before rising again to 15,000 per annum in the period after 2015. If growth falls below the benchmark scenario, net emigration becomes a possibility. The CSO's more optimistic projections were likely driven by the above-expected levels of migration in recent years: in its 2004 projections the CSO considered 30,000 per annum in the high migration scenario to 2006, in contrast to the actual 71,800 achieved. This highlights the difficulty of accurately predicting migration flows: many variables, including economic conditions in Ireland and elsewhere, as well as official policy, need to be taken into account.

The most crucial point, however, is that excluding the return of mass emigration, Ireland's population will continue to grow. If fertility remains stable at current levels, Ireland's population will exceed 5 million by 2036, even in the absence of positive migration flows. If immigration remains strong, however, 5 million will be reached by 2016, and by 2041 the population could exceed 7 million. The National Spatial Strategy is the Government's main official tool of steering where populations cluster on the island. Initially published in 2002, it is now integrated to the National Development Plan 2007-2013. It envisions an Ireland with eight national gateways of 'critical mass necessary to sustain strong levels of job growth in the region'. Four of these exist already in terms of scale and critical mass: Cork, Limerick, Galway and Waterford; while four are cities, or clusters of cities, with potential to grow into regional centres of importance.

[1] The number of persons in the labour force expressed as a percentage of the total population aged 15 or over



Consumer Spending

Retail sales in the first four months of the year are in freefall. Data on retail sales up to April record an exceptionally rapid pace of decline in volumes over a period of only eight months. The accompanying chart (figure 6) illustrates the extent of the deceleration. Total sales decelerated rapidly from September 2007 when annual growth was recorded at 6.3%; by December, that growth rate had almost halved to 3.5%. The rate of change turned negative in February 2008 and by April, the annual rate of fall was a rapid 3.1%. Excluding the more volatile motor trade sales, the fall in other sales was slightly less steep; by the end of 2007, annual growth had slipped to 3.9% and only turned negative in April recording a fall of 2.9%.

Motor trade sales in the first four months of the year recorded a fall of 4.1% on the same period of 2007 and the month of April was only slightly less negative. Sales have been affected by motor

Retail sales

Annual % change
Jan – Apr 08

Motor Trades	-4.1
Non-Specialised Stores	+3.5
Department Stores	+2.6
Food/Beverages/Tobacco	-1.4
Pharmacies	+3.2
Textiles and Clothing	-0.1
Footwear and Leather	-3.3
Furniture and Lighting	-4.4
Electrical Goods	-5.7
Hardware	-1.7
Books/News/Stationery	-2.3
Other Retail	+1.5
Bars	-3.9
Excl. Motor Trades	+0.9
All Businesses	-0.8

Table 4

taxes, which change in July 2008 to favour lower carbon emission vehicles; the credit crunch may also be taking its toll. Supermarket sales were holding up quite well, growing by 3.5% in the first four months of the year, but in April they too crashed, falling back year-on-year by 0.4%. Retail sectors related to housing and household formation have been the biggest casualties so far this year. Furniture and lighting sales fell by an annual 4.4% in the first four months of the year, electrical goods fell by 5.7% and hardware paints and glass fell by 1.7%.

Although there are no National Accounts figures for the first quarter on total personal consumer spending, it seems more than likely that it too has fallen sharply and the evidence suggests a further slip in the second quarter. The IIB/ESRI Consumer Sentiment Index for Ma hit its lowest level since the index began in 1996; VAT returns for the first five months of 2008 are down on profile, confirming continuing weakness.

Many factors are conspiring to weaken consumer spending: the labour market has weakened, high inflation persists, house prices are falling and the effects of tighter credit conditions are being felt. Sterling weakness may have resulted in some retail trade being lost to Northern Ireland; the fall in consumer spending therefore may not be as great as indicated by retail sales.

We now think consumer spending will slow to a growth of only 1.5% in 2008, recovering a little to 2% in 2009. This is in sharp contrast to the 5.9% average growth of the preceding three years.

Consumer sentiment indicator

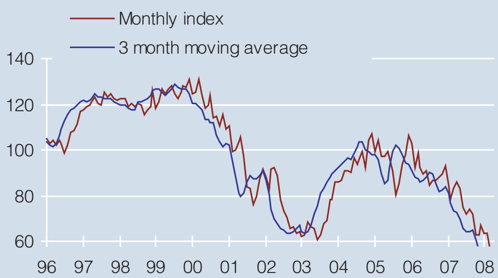


Figure 5

Retail sales

Annual % change - 3mma

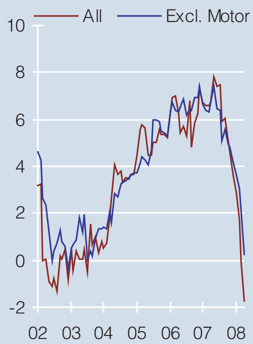
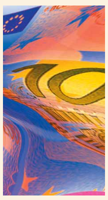


Figure 6

Government Spending

Budget 2008 planned for an increase in net current spending of 9.5% and capital spending of 10.7%. Tax revenue was budgeted to rise by 3.4% as a fall in stamp duty revenue of 10.6% was forecast and a much slower growth of 2.1% was expected from capital gains tax. The exchequer borrowing requirement was expected to rise from €1.6 billion to €4.9 billion and the General Government Balance was budgeted to deteriorate from a surplus of €900 million to a deficit of €1.8 billion.

Expenditure data in the first five months of the year suggests that overall spending is running close to expectations with capital spending 3.2% ahead of target and current spending 1% behind target. In the first five months of 2008, total tax revenue is 8% down on the same period of 2008 and 6.4% down on what the Department of Finance projected; total tax revenue is some €1.2 billion behind projections. VAT revenue accounts for 51% of the shortfall, capital gains tax for 31% and stamp duty for 11%. This reflects the very sharp slowdown in the building and construction sector and the depressed state of the housing and commercial property markets. It also reflects plummeting retail spending. All the indications are that these trends will not be reversed in 2008 and the revenue shortfall will continue to rise as the year passes. We believe that exchequer revenue will undershoot target by at least of €2.8 billion, pushing the General Government Balance from 0.9% of GDP to 2.5%. The depressed revenue base for 2009 will make revenue yields in that year lower than had been forecast, thus maintaining intense pressure on government resources in 2009. If government spending projections for 2009 remain intact, the deficit on the General Government Balance could rise to over €6 billion and would come very close to the borrowing limit allowed under the rules of the Stability and Growth Pact. It behoves the government to rein back its current spending over the remainder of 2008 and prepare for Budget 2009 with current expenditure targets appropriate to the reduced resources. Every effort should be made to maintain capital expenditure under the National Development Plan.



Investment

Investment will be a significant drag on economic growth in 2008 and will continue to contract in 2009. It has been evident for some time that activity in the housing sector has been falling. The impact of the decline will be most severely felt from a national accounts perspective in 2008. Housing completions fell by about 12% in 2007 but other elements of the investment sector were just about buoyant enough to ensure that total investment in the economy recorded a marginal increase. The fall in house completions is to set to be much starker in 2008 and total investment will decline substantially this year.

Following a number of years during which the investment sector of the economy was one of the primary drivers of economic growth, total investment increased by just 0.2% in 2007. Activity in the housing sector had begun to slow down from end 2006 and after reaching a record output level of 88,000 units in that year, house completions fell to 78,000 in 2007. Home improvement activity grew by about 10% last year but given that the value of output from the sector is only about 15% of new housing development, this only partly compensated for the new housing slowdown. Both commercial building activity and the public sector capital programme remained buoyant in 2007 and total investment in this sector was up 17%. A spike in aeroplane purchases was a significant factor in the 13% increase in machinery and equipment investment in 2007.

House starts are currently running at about minus 60% on a six month trailing basis and it now appears likely that housing completions in 2008 will be back by a further 40%. Scheme developments remain exceptionally weak and while both one-off housing and public housing (both of which are not covered by the housing starts data) are maintaining reasonable momentum, there is no evidence yet of housing activity having bottomed out. The commercial property sector is set to become much weaker as we move through 2008. Activity levels held up well during 2007 but asset values and rents are now clearly under pressure and activity levels are set to decline sharply over the next year or so. The public capital programme should remain strong during 2008 – the Exchequer Returns data for the first five months of the year show that spending is well ahead of last year's level. This will be significant in the context of a slowing commercial building sector and the total construction sector, excluding housing, should expand by about 5% in 2008.

Investment

Annual % change

	2007	2008	2009
Building & Construction	-3.3	-21.9	-9.0
Plant & Machinery	12.6	5.0	5.0
Total	0.2	-15.3	-4.8

Table 5

The Ulster Bank Construction PMI continues to reach new record lows and provides a bleak short-term outlook for the sector. In May the activity index fell to 33.9 (a reading below 50 signifies the sector is contracting). Housing activity declined to 28.1, commercial activity was at 37.3 and civil engineering activity at 36.1. The latter reading appears to contradict the view emerging from the Exchequer Returns data that the public capital investment programme continues apace, for the present at least. Overall, the building and construction sector is set to contract significantly in 2008 and a relatively small increase in machinery and equipment will do little to prevent the total investment sector from acting as a significant drag on economic growth in 2008. Total investment is forecast to decline by about 15% this year.

A range of factors continues to suggest further contraction in housing activity in 2009. The housing scheme starts pipeline remains exceptionally weak, while the imminent threat of an interest rate rise, the continued impact of the credit crunch and weaker economic circumstances generally all point to further decline in house completions next year. IBEC is forecasting a further 25% reduction in total house completions in 2009 – the number of units completed is unlikely to exceed 35,000. It is looking increasingly likely that 2009 will also be a challenging year for the commercial property sector. Activity in the sector is likely to contract, while the public capital programme is expected to expand but at a slower pace than in recent years. With investment in machinery and equipment forecast to grow by about 5%, total investment in the economy is expected to decline by 5% in 2009.

Trade

There are limited indications of trade performance in the first quarter of 2008. The latest national accounts data relate to the fourth quarter of 2007 and record that the volume of exports of goods and services continued to grow strongly in the last quarter of 2007, recording a volume growth of 9.3%, the most rapid pace in fifteen quarters. On a seasonally adjusted basis, the growth rate decelerated from 2.5% to 1.6%; average growth for the year was 8.2%, the most rapid growth since 2001. The visible trade figures were much less solid with an average annual growth for the year of 5.5% with the growth rate declining from a first quarter 10.1% annual increase to only a 0.8% increase in the final quarter. Service sector exports were much stronger. According to Balance of Payments data, the value of service exports grew by a substantial 17.7% in 2007, with final quarter exports up 21%. Exports of services are now having a huge impact on overall export performance, with service exports accounting for 43% of total exports of goods and services.

First quarter data suggest visible exports are weak. There was an annual decrease in the value of exports of 5.5%; although there are no price indicators for the first quarter, it is quite likely that export prices fell by at least 6% because of currency movements. The volume growth could therefore be 1% or 2%, which would be close to the first quarter performance of the manufacturing sector. This suggests that export performance of goods will tend to be quite a bit weaker than in 2007, but service exports are likely to be more robust.

However, we must await the first quarter balance of payments data for service exports. If the strong performance evident in the last quarter of 2007 carried over into the first quarter of 2008, total exports of goods and services could be considerably stronger. We expect exports of goods and services to increase by 5.5% in 2008 and by 5% in 2009.

Imports of goods and services grew by 6.4% in 2007, up from 4.4% in 2006. The volume of physical imports rose by only 0.6% and in value by 2.8%; the value of imports of services (which is 53% of total goods and services) increased by 10%, boosting the total. In the first three months of the year, the value of visible imports was 6.6% below the first quarter of 2007. Although we expect stronger service imports, it is likely that total imports of goods and services will be weak in 2008 and 2009. Large imports of planes in 2007 will not be repeated in 2008 and seems unlikely in 2009; low consumer spending growth will also contain import demand. We expect the volume of imports of goods and services to grow at half the rate of 2007 both this year and next at about 3%. The current account balance of payments deficit was €9.3 billion in 2007 (59% of GNP). The deficit has risen substantially since 2003 when it was in balance. We expect that with slower import growth the deficit will reduce in 2008 and 2009.

Financial

The trend in the increase of private sector credit continued to moderate in April after a tick-up in March. This confirms the continuing slowdown in credit growth that has persisted since it hit a peak in June 2006. Annual adjusted credit growth was 30.3% then; in April 2008 the growth rate had almost halved to 15.9%. Non-mortgage credit has slowed from an annual rate of 32.6% in June 2006 to 19.3% in April 2008 and adjusted mortgage lending has decelerated from 27.8% in June 2006 to 11.4% in April 2008. Annual credit card growth, which peaked in March 2007 at 19.6%, decelerated sharply in May to 11.5%, coincident with the final maturity of SSIAs, and maintained that level of growth to the end of the year. Growth decelerated further in 2008, averaging 8.2% in the first four months of the year, hitting a low of 7.2% in the month of April.

The ECB kept euro area interest rates on hold at 4% at the 5 June meeting. President Jean Claude Trichet surprised the markets by suggesting that interest rates may rise in July; the hawkish tone of comment indicates that the focus will continue to be directed at ensuring that the current high rate of inflation does not become entrenched in longer-term high inflation expectations. Inflation in the euro area accelerated from 3.3% to 3.7% in May, and first quarter GDP growth was a strong annual 2.2%; M3 money supply growth remained at an uncomfortably rapid 10% rate. That said, the downward trend in unemployment has stalled at 7.1% and expectations are that as the economy slows perhaps even more rapidly because of the rate hike, the ECB will cut rates sometime in the first half of 2009.

Relative interest rate movements will also have an impact on exchange rate movements. Market forecasts are mixed but tend towards some strengthening of the dollar from the current $1.56 towards $1.50

Exchange rates

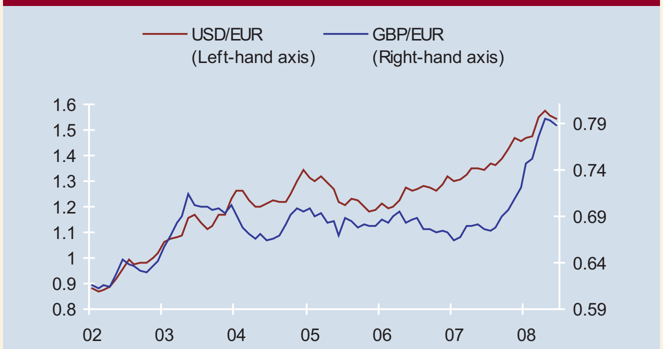


Figure 7

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by year-end. Fed Chairman Bernanke's remarks suggesting the dollar is too weak will tend to reinforce the dollar's value. Sterling is expected to remain relatively weak with main forecasts suggesting that the trading range of the euro will tend to be in the £0.78 to £0.82.

International

Global Economy

Global growth is cooling rapidly and the global economic situation continues to be beset by uncertainty. The economic slowdown has been greatest in advanced economies while emerging markets have been more resilient. The European Commission projects global growth of 3.8% for 2008, a downward revision to previous forecasts. The balance of risks to the short-term global outlook remains tilted to the downside while the risks related to inflationary pressures have risen, presenting central banks with a policy dilemma. The IMF argues for the worldwide tightening of monetary policy.

US

Economic growth in the first quarter stood at 0.9% q-o-q and 1.7% y-o-y in line with Fed Chairman Bernanke's comments in April that real GDP would not grow 'much, if at all' in the first half of 2008. The IMF and the Commission forecast growth of 0.5% and 0.9% respectively for 2008. The Fed's most recent projection of 0.3% growth this year is significantly more bearish. In April, the FOMC cut interest rates to 2%. Policy focus has shifted of late from the promotion of 'sustainable economic growth and stability' to the Fed's current mission to prevent soaring costs from embedding themselves into inflation expectations. This suggests priority will be given to combating inflationary pressures and that the interest rate cutting cycle has ended. Core CPI inflation was 2.3% y-o-y in May with headline inflation running at 4.2% y-o-y. In spite of dollar weakness, the trade deficit rose to $60.9 billion. Efforts to strengthen the currency are on the agenda as Bernanke stated recently that the weak dollar has contributed to rising inflation.

Euro area

First quarter GDP growth in the euro area was 0.8% q-o-q and 2.2% y-o-y. Both the Commission and the OECD forecast growth of 1.7% in 2008. The ECB last month revised its 2008 inflation forecast to 3.4% from 2.9%. Annual inflation stood at 3.7% in May, a 16-year high and significantly higher than the ECB's target of 'below but close to 2%'. The ECB held interest rates at 4% on 5 June. President Trichet believes inflation levels will remain 'high for a protracted period'. The ECB is in a 'state of heightened alertness' regarding inflation and a one-off quarter point interest rate hike looks likely in July. Unemployment for the euro area stood at 7.1% in April indicative of the resilience of the economy to the global slowdown.

UK

UK GDP grew by 0.4% q-o-q in the first quarter of 2008 and by 2.5% y-o-y confirming that the economy is slowing. The National Institute of Economic and Social Research reported that the economy 'scarcely' grew in the three months to May with growth amounting to 0.2%. The Commission recently cut its growth forecast for the UK for 2008 to 1.75. Inflation in April was 3%, up 0.5% m-o-m. The above consensus rise was due to rising utility, food and alcohol prices. The Bank of England expects inflation to peak at 4% later this year, mirroring consumer expectations. This would be almost double the target rate. The Bank of England left interest rates unchanged at 5% on 5 June. With inflation forecast to be almost double the target rate in 2008, hawkish policymakers will favour raising interest rates.

By Eoin Cuddihy, economic policy executive

Real GDP growth – selected countries

Annual % change	2007	2008	2009
Euro area	2.6	1.7	1.5
UK	3.0	1.7	1.6
Germany	2.5	1.8	1.5
France	1.9	1.6	1.4
US	2.2	0.9	0.7

Table 6

Inflation – selected countries

Annual % change	2007	2008	2009
Euro area	2.1	3.2	2.2
UK	2.3	2.8	2.2
Germany	2.3	2.9	1.8
France	1.6	3.0	2.0
US	2.8	3.6	1.6

Table 7

Unemployment rate – selected countries

Annual % change	2007	2008	2009
Euro area	7.4	7.2	7.3
UK	5.2	5.4	5.7
Germany	8.4	7.3	7.1
France	8.3	8.0	8.1
US	4.6	5.4	6.2

Table 8

Source: European Commission Forecast, Spring 2008.