QUARTERLY REVIEW
ECONOMIC TRENDS

IBEC

JUNE 2010

Re-establishing the credibility of the euro

By and large the global economic recovery is under way albeit weak and much assisted by monetary and fiscal stimuli. In the real economy of the production of goods and services we believe that Ireland began to emerge from recession in the early part of 2010, though the level of output will remain below peak levels for at least the next three years. What hangs over us and indeed much of Europe are the consequences of a massive build-up of public and in some countries, including Ireland, private debt.

Despite the fact that Ireland has the highest public deficit in the euro area, commentators and the markets, for the most part, have differentiated Ireland from other high deficit peripheral countries, largely because of the credibility of our response to the crisis and the significantly less challenging structural reforms that need to be undertaken here than in other economies. The substantial, timely and determined efforts by Government as well as the flexible response from businesses in addressing their lack of competitiveness through wage reductions, wage freezes and workplace adjustments have gained international credibility. Increasingly, other high deficit economies are following Ireland's lead and are taking substantial corrective action as indeed they must.

But the credibility of the euro area and the currency itself has been badly damaged and has not been helped by the initial lacklustre response to the Greek crisis by the leaders and finance ministers of some fellow euro member states. The threat of contagion was underestimated. It is a great concern to European business and indeed global business that economic governance in the euro area has been found wanting.

A currency union without political union or federalism requires a credible system of economic governance. We detail in a box on page 4 the European Commission's Communication on how this might be achieved, by a method of deeper and broader surveillance than the Stability and Growth Pact provides that would include warnings on both fiscal and competitiveness imbalances. In broad measure IBEC supports this initiative, as do most other business organisations in Europe. Whether these measures will be sufficient to allay the markets will to a large degree depend on the commitment of member states.

Why is this needed? This is what the Commission says. "There was not enough commitment to fiscal consolidation, in particular during good economic times. In some Member States revenues were temporarily boosted by tax-rich activity, driven by unsustainable booms in housing, construction and financial services... It would appear particularly important to detect asset price booms and excessive credit growth at an early stage to avert costly corrections of fiscal and external balances at a later stage."

This fits the Irish case perfectly. Had such a system been in place at the outset of the single currency, arguably we might have avoided the economic imbalances that made the global economic crisis so much worse for Ireland. Caution rather than exuberance would have ruled the day and business would have had a more stable operating climate.

Some will argue that it saps national sovereignty. So it does a little, but that is the price and indeed the comfort of sound governance in a single currency. The Commission proposes the establishment of a European Semester for economic policy coordination so that Member States would benefit from early coordination at European level as they prepare their national stability and convergence programmes including their national budgets and national reform programmes. Ireland effectively would have to subject its economic plans, including the Budget, to the scrutiny of our euro area partners and other member states would have to do the same. This would help identify emerging imbalances in good time.

We all must accept that, through our policy choices including tax, regulatory enforcement or even the partnership process, good economic governance suffered since joining the single currency. This is in marked contrast to the years leading up to the euro when Ireland pursued appropriate policies to ensure the economy was judged fit to be a member. Since 2000, the economy suffered a sustained loss of competitiveness and a construction bubble that crowded out the traded sectors. This happened in other peripheral countries too.

The crisis affords us the opportunity to make some fundamental improvements to economic governance at European and at member state level. It seeks to inject prudence and a significant element of external surveillance into the national debate on policy.

For Ireland the Commission's *Europe 2020* strategy offers a useful independent input into economic management. The reports the Irish Government would have to provide to the Commission envisage an input from the social partners and would address progress in achieving labour market reforms, increasing R&D, spreading innovation, ensuring the delivery of appropriate education and training, facilitating more public procurement and enhancing the infrastructure including broadband, transport and energy. This should lead to better economic management with a focus on avoiding imbalances not only in Ireland but across the euro area and as such is a worthwhile development, which should be supported.

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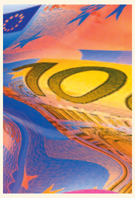


Output

Current analysis of both the global and domestic real economies throws up far more positives than negatives. In the US, economic recovery is spreading from manufacturing to the consumer sector and the better than anticipated labour market performance suggests that a self sustaining recovery is gaining momentum. Although recovery in the euro zone is fairly muted, all of Europe's main economies are out of recession. It is now most likely that Ireland exited recession in the early part of this year and a range of activity indicators point towards continued economic expansion. Activity levels in the real economies are therefore not a major concern at present. The difficulty is that the fallout from the euro zone sovereign debt crisis has led to renewed stress in financial markets. If this continues for a number of months, economic activity levels would inevitably be damaged and fledgling recoveries could be severely set back.

The global economic recovery has gained momentum through the second quarter of 2010. Forecasts for global GDP growth have been revised upwards with the IMF now expecting growth of over 4% in both 2010 and 2011. Recovery has been particularly strong in the US with the 2010 growth forecasts now ranging from over 3% to close to 4%. Retail spending has bounced back fairly strongly in recent months and the latest non-farm payrolls have been stronger than expected.

Improving international demand and the significant weakening of the euro over recent months have therefore provided a much more positive environment for Ireland's export sector. Net exports will make a positive contribution to growth during 2010 but critically the outlook for consumer demand has also improved since the start of the year and is now helping to lift the economy out of recession.

The National Accounts for 2009 show that the volume of economic activity dropped the most on record last year. GDP fell by 7.1% while GNP was down 11.3%. The collapse in economic activity was the worst recorded by any developed economy in the current global crisis. Investment exerted the largest drag on growth, falling by 30% in the year. Personal consumption fell by 7.2% last year but encouragingly the pace of decline moderated significantly as the year progressed. The bulk of the collapse in consumer spending occurred in the first quarter of the year when a seasonally adjusted quarterly fall of 7.3% was recorded. By the final quarter of the year this had moderated to a decline of 0.5% and the annual fall had gone from 9.5% in the first quarter to 5.2% in the last quarter. Unlike the investment sector of the economy, therefore, fortunes in the consumer sector were clearly deteriorating at a much slower pace as the year progressed. In GDP terms the seasonally adjusted decline in the final quarter of the year was larger than expected but this provides a fairly weak base for the first quarter of 2010 and strengthens the likelihood that GDP will have grown in the early part of this year.

GNP AND ITS COMPONENTS

Annual % change

	2008	2009	2010	2011
Consumer spending	-1.0	-7.2	-1.0	1.6
Government spending	2.6	-1.2	-3.0	-2.0
Investment	-15.5	-29.7	-19.2	-1.5
Exports	-1.0	-2.3	2.3	4.5
Imports	-2.1	-9.3	-0.7	2.9
GDP	-3.0	-7.1	-0.1	2.3
GNP	-2.8	-11.3	-1.5	1.6

Table 1

QUARTERLY GDP AND GNP

Seasonally adjusted

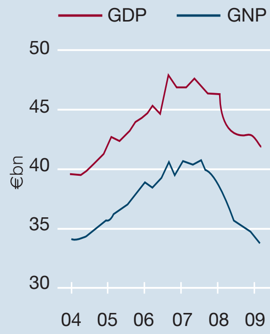


Figure 1

The improvement in consumer spending outlook recorded towards the end of last year has clearly continued into 2010. The retail sales figures show that the total volume of sales in the first quarter of the year recorded annual growth of 1.1%. A large factor in this has been the recovery in new car sales. Excluding cars, retail sales volumes in the first quarter were down 2.9% on an annual basis, but encouragingly on a seasonally adjusted basis recorded month-on-month increases in each of the first three months of the year.

Unlike most other developed economies, manufacturing output in Ireland held up reasonably well during 2009. Output finished the year down 3.5% but this headline figure masks the divergence between the performance of the traditional sector and that of the modern sector. Traditional industries, which suffered much more as a result of the collapse in domestic demand and were also severely impacted by the weakness of sterling, saw output fall 14.4%. The modern sector, however, performed much more strongly and grew by 3.4%. Within this, both the medical devices and the pharmachem sector fared particularly well with output growth of about 10% and 20% respectively. The Dell factor contributed to a drop in computer and electrical equipment output of just over 30%.

Manufacturing output in the first quarter of this year grew by 6.9% on the same period last year. Output from the modern sector was up 11%, while that in the traditional sector fell by 3.4%. On a seasonally adjusted monthly basis, however, the traditional sector has shown some signs of recovery in recent months and output in the first quarter of 2010 was up 2.3% on that achieved in the final quarter of last year. The weaker euro, coupled with Ireland's non-currency related competitiveness gains, is likely to help recovery in both traditional and modern manufacturing over the coming months. Indeed the manufacturing Purchasing Managers Index (PMI) at 54.1 in May was well back into positive territory and had expanded for the fourth month in a row.

While overall economic activity looks to have turned a corner in early 2010, the recovery is likely to be fairly muted for the remainder of the year. Consumer spending will strengthen a little on the back of a relaxation of the very high savings rate which emerged during 2009, but consumers will still face considerable headwinds over the coming months in the form of no wage growth, no net job creation and higher taxes in Budget 2011. The investment sector has yet to bottom out and will be a drag on growth until 2011. Exports will probably perform a little stronger than previously expected and will benefit from the weaker euro. GDP in 2010 is therefore likely to be largely unchanged from that in 2009 and we are forecasting an annual fall of just 0.1% with GNP set to fall by a more sizeable 1.5%.

The outlook for 2011 continues to be shrouded by uncertainty. On the one hand, developments in the real economy are largely positive and a combination of improving demand in our trading partners and a more favourable currency scenario should be good news for the Irish economy. The cloud of the sovereign debt crisis continues to hang over the global economy, however. Indeed anecdotal evidence is already emerging of major investment projects being mothballed as a direct consequence of the sovereign debt crisis. The earlier than expected, and largely more aggressive, fiscal austerity measures introduced by a number of European governments will inevitably damage the global economic recovery. In the absence of meaningful employment growth, consumer spending is likely to remain fairly subdued in 2011, while it will be at least 2012 before investment makes a contribution to economic growth. At present we are forecasting that Ireland's GDP will expand by 2.3% in 2011 but for the moment considerable downside risks remain to this estimate.

Employment

Ireland has suffered a dramatic fall in employment of 12% from the peak and unemployment correspondingly has increased from 4.4% to 13.1% in Q4 2009. The severity of the labour market reaction has been exacerbated by the nature of the crisis; the IMF in its April outlook finds that recessions coupled with financial crises and house prices busts are associated with larger-than-expected increases in unemployment. In addition, the recovery phase is likely to be more muted.

We estimate that a further 70,000 jobs will be lost in 2010, before employment stabilises in 2011. A total of 260,000 jobs will have been lost from the peak, when employment stood at 2.1 million. Because jobs growth tends to lag output growth, significant net employment creation will not resume until 2012 and it is unlikely that employment will return to pre-crisis levels until 2015 at the earliest. Unemployment will peak at 13.5% this year, before falling slightly to 12.8% in 2011; this is a result of falling participation as job seekers become discouraged or migrate, rather than net job creation.

The construction sector will continue to see significant job losses of the order of 23,000 in 2010, with further losses likely in 2011; employment in the sector will have more than halved from the 2007 peak. Though some bounce-back may materialise from 2012 onwards, many of these jobs will have been permanently lost. Industry and wholesale/retail will also continue to see significant job losses this year, before stabilisation in 2011. In the financial services sector, growth in international finance may, we believe, offset the expected job losses in the domestic banking sector. In the sectors mostly financed from public spending (public administration, education and health) we expect employment to fall by 15,000 this year, as the impacts of fiscal consolidation feed through to staffing levels. Overall, we expect employment levels in the public sector to fall to 2006-2007 levels.

Employment

000's annual average

	2008	2009	2010	2011
Agriculture	115	96	91	91
Industry	520	411	380	373
Services	1,465	1,422	1,390	1,398
Total	2,100	1,929	1,861	1,862
Unemployed	141	259	292	273
% Unemployed	6.3	11.8	13.5	12.8
Labour force	2,241	2,187	2,152	2,135

Table 2

As a result of the severity of the recession, long-term unemployment has climbed dramatically. In Q4 2009, 89,000 had been unemployed for more than a year, the highest level since 1997. The long-term unemployment rate stood at 4.1%, significantly higher than the pre-crisis average of 1.3%. Another source of concern is the falling labour market participation rates, particularly for males. In Q4 2009, the participation rate for males stood at 69.5%, down from 74.3% prior to the crisis. The last time the participation rate was below 70% was 1998. This falloff is a reflection of the sectors that have been hit the hardest by the recession, construction and manufacturing. In Q4 2009 there were in total 98,000 fewer people in the labour market than at the peak.

Unless addressed, these problems may cause further damage to Ireland's potential growth rate and dampen economic recovery. A suite of interventions, including retraining and reskilling and activation measures, are required to prevent further damage to Ireland's labour market. The undoubted competitiveness gains of the last year resulting from pay freezes/wage reductions and workplace change, will, if maintained, enhance job opportunities, especially in the traded sector.

Live register

Seasonally adjusted

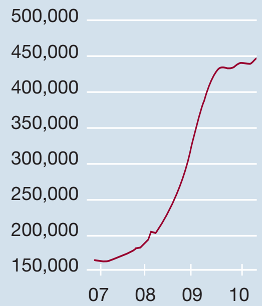


Figure 2

Restoration of confidence in the euro requires improved euro area governance

The problem

One of the second round effects of the global financial crisis of the last two years is the laying bare of the inadequacies of the economic governance system for the sixteen member states, operating in the single currency area of the euro. The crisis has clearly shown the limitations of the current Stability and Growth Pact (SGP) in either enforcing discipline or of highlighting the risk of instability in a timely way that could have prevented it. Although member states have to submit annual stability updates (in Ireland they are published alongside the annual Budget on Budget day), they have little role in non-budgetary economic management.

The destabilising sovereign debt crisis arising in Greece has spread fear of contagion across the euro area. Such is the seriousness of the crisis that respected international commentators as well as the markets and even the German Chancellor have alluded to the possible very adverse impact for the future of the euro. Businesses across Europe are seriously concerned that the heightened uncertainty and financial stress is harming business planning while rising public debt is crowding out companies' access to finance and raising the prospect of significantly higher taxes in the future.

The European stabilisation mechanism agreed by euro area Member States following discussions over the weekend of 7-10 May is only a temporary fix for three years to buy time to address the real issues. It consists of overall EU financial support of €500 billion in the form of a €60 billion loan facility and €440 billion loan guarantees; the IMF has pledged a further €250 billion bringing the total available support for stressed Member States to €750 billion. Any support measures would be given only under strict conditionality.

The way forward

The markets know that the stabilisation mechanism is not a long-term solution. Therefore, there is an urgent need to agree a way of ensuring that immediate, appropriate and credible actions are taken at a national level in all EU member states to restore long-term sustainability to the public finances. In addition and of equal importance there is a need for all member states to implement far reaching structural reforms (well functioning labour markets, increased competition, conducive business environment, facilitation of innovation and increased R&D), which will boost the euro area's growth potential and hence facilitate the process of fiscal consolidation. With regard to better and more credible economic governance in the euro area, deeper and broader surveillance including earlier warnings on both fiscal and competitiveness imbalances must now be an essential part of an effective crisis prevention system.

IBEC supports this general move towards more stringent surveillance to ensure that not only our own domestic policies are sustainable but equally importantly that those of other member states are too. As we have seen with Greece, one weak link puts in jeopardy the whole euro area. It is difficult to envisage how this current crisis can be resolved or another one prevented, if significant additional measures to oversee both fiscal and competitive imbalances are not introduced.

IBEC has been of the view for some time that the Lisbon reform agenda had little teeth and that member states that failed to implement their agreed reform programmes were subjected to no sanction and little or no peer review pressure. Over many years, this has led to increasingly divergent progress in carrying out structural reform across the member states. Within a single currency, a lack of coordination of structural reforms inevitably leads to increasingly divergent levels of competitiveness, which causes mounting stresses as those member states that fall behind operate under an ever more inappropriate monetary regime.

Europe 2020: a European strategy for smart, sustainable and inclusive growth

The European Commission outlined its proposals for reinforcing economic policy coordination in its Communication of 12 May 2010 and called for a robust framework for crisis management for euro area member states.

In this Communication, the Commission seeks to bring the successor to the Lisbon Reform Agenda, Europe 2020, into a more prominent position with a view to achieving a more integrated surveillance of economic policies. In order to prevent the occurrence of the severe imbalances in the euro area that we have witnessed in recent years, there is a need to deepen the analysis and expand economic surveillance beyond the budgetary dimension to address other macroeconomic imbalances, including competitiveness developments, with a view to facilitating a policy driven adjustment at national level. In drawing up its annual reporting on policy progress to the Commission, each government would be expected to engage with its European parliamentarians and the social partners to ensure that the Council recommendations are fully debated at member state level.

The SGP was deficient because although it had a rules-based approach regarding allowable levels of deficits and debt, it concentrated mainly on the deficit for which there was corrective action (the excessive deficit procedure). It did not focus on the sustainability of debt levels. More importantly, it had no role to play in preventing the build-up of macroeconomic imbalances of the kind that gave rise to the collapse of tax revenues in Ireland when the bubble burst.

In its May Communication, the Commission seeks to go further than Europe 2020, by proposing to upgrade the existing but ineffective peer review of macroeconomic imbalances into a structured surveillance framework for the euro area. It recommends keeping a scoreboard on external and internal developments that would indicate the need for corrective action in specific member states. It also suggests that warnings and recommendations from the European Systemic Risk Board (yet to come into operation), to prevent excessive credit growth or exuberant asset price developments, would also be considered a matter of common concern resulting in peer pressure for remedial action.

By pulling all these differing aspects of surveillance together under what it terms a European Semester, the Commission proposes there should be a simultaneous assessment of both fiscal and structural policies in each EU member state with country specific recommendations. IBEC is supportive of such an approach as a reform agenda with some teeth is a mechanism to ensure that member state economies develop towards more economic convergence and reverse falling competitiveness, which underlies the build up of imbalances that give rise to current account deficits. The European Commission sees these three areas of surveillance – budgetary, macroeconomic and financial – coming together to redress the missing preventive dimension of current budgetary and economic surveillance. It believes that this process would allow the formulation of genuine guidance early enough in the year to allow governments to reflect these conclusions in the preparation of their own budgets and reform programmes.

IBEC believes that this would bring a valuable independent input to economic policy formulation.

Prices and wages

Despite some month-on-month increases in the consumer price index (CPI) since the start of this year, there remains little or no core price pressure in the Irish economy. The recent increases in the CPI have been largely due to the effects of mortgage interest rate increases and higher energy prices. In annual terms, the CPI remains in negative territory and is unlikely to turn positive until late Autumn.

Significant price falls were recorded across most sectors of the economy in 2009. The CPI fell by 4.5%, with food down 3.5%; clothing and footwear 11.7%; housing 22%; house furnishings 3.1%; and transport 4%. Increases were recorded in alcoholic beverages and tobacco (mainly due to increased Government taxes); and health and education. Goods prices fell by 4.3% during the year while services fell by 4.6%. Price discounting was commonplace right across the retail sector during 2009 as retailers sought to contain volume losses.

The pace of deflation peaked in October 2009 when the CPI was down 6.6% on an annual basis. Price declines have moderated since then with the CPI in April 2.0% below the year earlier level. Month-on-month price falls are still evident in the retail sector (food; clothing and footwear; and household furnishings) but price increases have occurred in housing and energy products. Despite the absence of interest rate increases from the ECB, the mortgage interest component of the CPI has increased by over 10% since July 2009 as a result of higher variable rate charges from the main lending institutions. However, the current euro zone fiscal crisis is likely to result in the further postponement of ECB rate hikes which should continue to keep mortgage interest costs relatively low.

The sharp depreciation of the euro over recent months will ultimately result in some price pressures on imports but the global inflationary outlook remains fairly benign and the domestic situation is therefore likely to remain likewise. We are set to experience considerable spare capacity in the Irish economy for a number of years and this will place continued downward pressure on prices, particularly in the services sector of the economy. On average, the CPI is forecast to fall by a further 1% or so in 2010 and will increase by 1.8% in 2011. The price level in the economy will remain well below that recorded at the outset of the crisis for some time yet and it is likely to be end 2013 or early 2014 before the CPI returns to the August 2008 level. This means that despite the forecast re-emergence of annual inflation in the CPI later this year, there will be no cost of living justification for wage increases for some time yet.

Average wages fell by about 3% in the private sector during 2009. IBEC's Quarterly Business Sentiment Survey shows that one in four firms implemented pay rate reductions during 2009, with the majority of firms maintaining pay freezes. Where pay rate reductions were recorded, the average cut was 12%. The survey suggests that the frequency of pay cuts has reduced in 2010 with only about one in ten firms likely to cut pay rates this year. The vast majority of firms plan to maintain pay freezes again this year. On average, private sector pay rates are set to fall by a further 1% in 2010.

Inflation forecasts

2010	Quarterly	Annual	Annual Average
March	0.1%	-3.3%	-1.0%
June	0.5%	-1.4%	
September	0.6%	0.0%	
December	0.1%	0.8%	
2011			
March	0.5%	1.5%	1.8%
June	0.8%	1.9%	
September	0.5%	1.9%	
December	0.4%	2.1%	

Table 3

Consumer spending

We have revised upwards our outlook for consumer spending since our last forecasts in March. While at that time, we had expected that the absence of tax increases in Budget 2010 would ultimately boost consumer confidence, the recovery has been somewhat stronger than we expected. The ESRI/KBC consumer confidence indicator has remained about 10 points above where it was prior to Budget 2010 and at 65.3 in May is well above where it was for most of 2009. Interestingly despite the strong media focus on the euro zone fiscal crisis over the past month or so, the consumer sentiment index in May was largely unchanged from that in April.

While there is no official estimate available yet for consumer spending in the first quarter of the this year, the retail sales data point towards a steady if unspectacular improvement since last December's Budget. Total volume of retail sales was 1.1% higher in the first quarter of this year compared to the same period last year. A recovery in car sales has been a significant factor in this recovery. Indeed the Society of the Irish Motor Industry (SIMI) sales data to the end of May show that new car sales were up 41% on the same period last year and exceeded the full-year sales recorded in 2009. This points to a continued recovery in the retail sales index through the second quarter of the year at least.

Consumer confidence

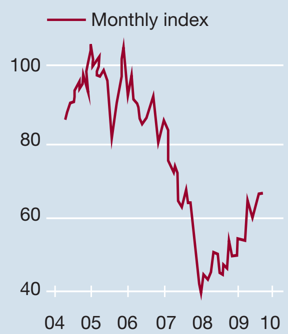


Figure 3

Excluding cars, retail sales in the first quarter remained 2.9% lower than in quarter 1 of 2009 but significantly sales grew on a month-on-month basis in each of the first three months of the year. The rate of annual decline also moderated from -4.5% in January to just -1.2% in March. This suggests that annual growth in core retail sales volumes should emerge in the second quarter of the year.

Investment

Investment continues to have a significant drag on Irish economic growth. Although the rate of decline in both building and construction and investment in plant and machinery has slowed considerably, the turning point for investment is set to lag that of the remainder of the economy by up to 12 months. Uncertainty in relation to future Government investment in the public capital infrastructure programme poses a further risk to the construction sector. With the completion of a range of transport and other public capital building projects during this year, the industry is concerned that activity in 2011 will fall further than previously expected. Meanwhile a combination of credit access difficulties; the need for business to further deleverage; and renewed volatility in international credit markets is weighing on the investment plans of firms.

The Ulster Bank Construction PMI has risen somewhat since the start of 2010 but has now remained in negative territory for a period of almost three years. Activity levels in the sector therefore continue to contract but not as rapidly as during 2009. Building and construction activity in 2009 fell by just over one-third and output from the sector last year was just 40% of that recorded in 2007. House building remains the largest casualty. The number of units completed in 2009 fell by 50% to 26,000. Housing starts during the year, however, ground to almost a stand-still at not much over 10,000, indicating that most activity last year was largely a legacy effect. The current run of starts indicates that completions are unlikely to exceed 13,000 or so during 2010 and 2011 is unlikely to see anything higher. Output from the residential housing sector is therefore likely to bottom out at a value of less than €3 billion or only 15% of that recorded in 2007. In recent months further research has confirmed that the housing overhang is much larger than previously estimated. At anticipated demand levels it will take about five years for the excess housing stock to be run down. This points towards a further sustained period of depressed output levels from the housing sector.

The home improvements sector is now about the same size in value terms as the new build sector. Following strong growth in the sector of 15% in 2008, the deepening of the recession in 2009 resulted in weaker activity in this sector also. Output was down 9% for the year with accelerating weakness towards the end of the year not boding well for activity in the sector during 2010. Tighter access to credit and falling house prices will also further limit the degree to which home owners can avail of equity release for home improvement works.

Output in the non-housing components of the construction sector fell by 25% in 2009. This was largely due to the collapse in the office and commercial building sector. Like the housing sector, significant over-supply problems are expected to suppress activity in this sector for a number of years. The other large component of the non-housing construction sector is the Government's capital investment programme. Public capital investment has been reduced

Investment

Annual % change

	2008	2009	2010	2011
Building & construction	-15.5	-33.8	-26.3	-7.3
Plant & machinery	-15.4	-15.7	0.0	10.0
Total	-15.5	-29.7	-19.2	-1.5

Table 4

from €8.5 billion in 2008 to €6.5 billion in 2010. Government has already announced a further €1 billion reduction in Budget 2011. A reduction in tender prices of about 30% for new work, however, has meant that Government investment is now achieving much better value for money. A key concern for the industry at present is the fact that the project pipeline looks very weak. With so many major capital investment projects coming to completion during 2010, it is timely that Government is in the process of reviewing its original National Development Plan (NDP) for the period 2007-13. The radically changed fiscal position and the demand related impacts of the recession mean that a re-prioritisation of projects under the NDP is essential. Government should prioritise those projects which support employment through both direct construction and also by reducing the cost of doing business in Ireland. Addressing remaining transport infrastructure gaps, investment in utilities and supporting the smart economy must remain key objectives for public investment. Even if Government commits to maintaining Exchequer capital investment at €5.5 billion over the coming years, this represents about a 40% reduction from the peak investment level and would result is some further contraction in the construction sector.

Total investment in machinery and equipment dropped by 16% in 2009. Capital investment by firms fell by a much more severe 40%, however, as an increase in spending on planes masked the scale of the decline in investment by the non-airline sector. Access to credit difficulties are likely to continue to restrict capital investment by firms during 2010, while continued uncertainty in relation to the global economy will mean that many investment plans remain under review. On balance we expected little change in investment in plant and machinery during 2010 before a modest recovery in 2011.

In summary, overall investment in the economy is set to contract by close to 20% this year. The pace of contraction has slowed from that in 2009 but it is likely to be early 2011 before the investment sector of the economy reaches a turning point. Output from the sector will be fairly static in 2011 and the building overhang will result in a fairly muted recovery over the coming four or five years.

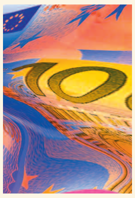
Exchequer finances

The Exchequer tax receipts for the period to end May were largely in line with Government expectations. May was an important month for the Exchequer returns as it is a VAT payment period. The VAT numbers, which largely reflect activity in the first four months of the year, were ahead of profile and are a further indication of some recovery in consumer spending. At end-March VAT receipts were down 13% on the 2009 performance but by end-May that decline had moderated to 8.2%.

The most worrying feature of the tax receipts is the growing shortfall in income tax revenue. Income tax revenue to end May was almost 5% below forecast, constituting an undershoot of some €220 million. Following from the disappointing Live Register numbers for May this is further evidence that the labour market remains fairly weak. Capital gains tax and capital acquisitions tax receipts were both ahead of forecast while the pace of decline in stamp duty revenue has moderated since the start of the year.

A worrying feature of Government expenditure in the year to date is the growing shortfall in capital investment. To end-May voted capital expenditure was some €400 million or 20% below forecast. Capital investment by its nature can be lumpy but it is important that Government continues to invest in much needed capital infrastructure. Any further cutbacks in the capital programme would be very damaging to the economy's growth potential.

On balance, Government will be fairly happy with the outturn for the public finances in the early part of the year. Tax revenue is largely in line with expectations and expenditure controls are helping to reduce the underlying deficit also.



Exchange rates

Exchange rates have fluctuated significantly during the financial crisis, reflecting turbulence in the markets. The euro had been exceptionally strong against both the dollar and sterling, but has weakened in the wake of the Greek sovereign debt crisis. The euro has fallen by 15% against the dollar from the beginning of the year; the exchange rate at the time of writing stands at $1.22. Relative to sterling, the euro has weakened by 6.5% to £0.83 during 2010. This fall in the sterling exchange rate is a welcome boost to Irish exporters, particularly indigenous companies for which the UK is the main destination.

EXCHANGE RATES

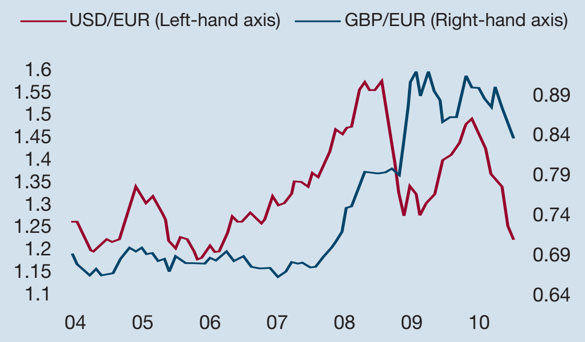


Figure 4

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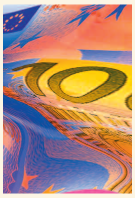

International

All the main forecasting agencies revised growth projections upwards in their spring forecasts. Trade has rebounded strongly and there are signs that policy-driven growth is becoming self-sustained expansion. However, growth is picking up at varying speeds. The performance in emerging and developing economies has been more robust, while advanced economies look decidedly more fragile. The OECD in its May Economic Outlook points out that though the pick-up in growth has surprised on the upside, the downside risks have also increased. The emerging Asian economies will need to rebalance growth in order to prevent domestic overheating. Meanwhile, the recent volatility in euro area sovereign debt markets poses a serious downside risk to growth in the region. It is clear that the financial sector has yet to return to stability, some three years after the crisis in the subprime markets began.

Euro area

Germany faces a challenge to rebalance the economy; demand from its traditional trading partners is set to remain weak. Though capital goods exports to emerging economies with high investment needs may pick up some of the slack, domestic demand will nonetheless need to take a more prominent role as a driver of German growth. France coped better with the global crisis than most other euro area partners. However, a relatively good performance in the downturn does not rule out a sluggish recovery. In particular, the closed nature of the French economy implies it will receive little boost from a rebound in global demand. Moreover, the need for structural reform, which hampered growth prior to the crisis, will come to the fore again. The Spanish economy is set to emerge from recession in 2010 after a severe contraction. The economy must rebalance away from construction to more broad-based domestic demand and higher export growth. The need to restore public finance to balance remains a formidable challenge and, at the same time, questions remain about Spanish banks' exposure to the domestic property bubble. Overall, the eurozone must reform institutions, embed fiscal discipline and begin the process of fiscal consolidation. Simultaneously, countries must implement bold structural reforms to boost growth. Given the near-total failure to meet the 2010 objectives of the Lisbon Agenda, the outlook for the EU's new 2020 targets is hardly encouraging.

US

Thanks to strongly supportive fiscal and monetary policy interventions, the US exited recession in mid-2009. However, as the stimulus to the economy fades, recovery is set to remain subdued. Historically, growth has rebounded strongly after a recession and in this context GDP growth of around 3% per annum is likely to disappoint. The weakness in the recovery reflects the severe nature of the recession and the combined impact of the house price bust and financial distress. There are some signs, however, that the recovery is becoming self-sustaining. The latest employment report showed that non-farm payrolls increased by over 200,000 in March and April, at which level unemployment will gradually begin to fall. If jobs growth is sustained, it will in turn boost household incomes and consumer spending.

UK

Although the UK is out of recession, the recovery remains muted. Private consumption, the biggest component of GDP, is unlikely to post strong growth; the outlook for jobs creation remains poor and the prospect of higher interest rates is likely to encourage households to maintain high savings rates. Though news from manufacturing has been positive, the sector accounts for only 13% of GDP and will therefore only provide limited boost to overall growth. Exporters have to date opted to use sterling weakness to boost margins, rather than increase sales volumes. The challenge of fiscal consolidation is daunting against this backdrop of economic fragility.

Real GDP growth – selected countries

Annual % change	2009	2010	2011
Euro area	-4.1	1.2	1.8
UK	-4.9	1.3	2.5
Germany	-4.9	1.9	2.1
France	-2.5	1.7	2.1
US	-2.4	3.2	3.2

Table 5

Inflation – selected countries

Annual % change	2008	2009	2010
Euro area	0.3	1.4	1.0
UK	2.2	3.0	1.5
Germany	0.2	1.3	1.0
France	0.1	1.7	1.1
US	-0.3	1.9	1.1

Table 6

Budget deficit – selected countries

As % of GDP	2008	2009	2010
Euro area	-6.3	-6.6	-5.7
UK	-11.3	-11.5	-10.3
Germany	-3.3	-5.4	-4.5
France	-7.6	-7.8	-6.9
US	-11.0	-10.7	-8.9

Table 7

Source: OECD forecasts, May 2010.