QUARTERLY REVIEW
ECONOMIC TRENDS

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A crisis requiring clarity of purpose

Two major problems face the Irish economy. The first is the global credit crisis with all its repercussions on stock markets around the world and the damaging impact on the financial sector's ability to function as a provider of credit to business and consumers. The second is the hard landing for the Irish economy and the sharp fall in Exchequer revenues, which will result in Ireland incurring deficits in the General Government Balance in both 2008 and 2009 well in excess of the 3% of GDP limit set by the Growth and Stability Pact.

The solution to the first problem requires the success of the US Administration's $700 billion bailout plan aimed at quelling the fears in financial markets, which have driven the financial system worldwide to the verge of collapse. It also requires central banks of the world, including the European Central Bank, to continue to supply adequate liquidity to the system. Domestically, the Government has shown itself willing to ensure the operability of the financial system by its own interventions and may yet have to do more. Inevitable ensuing tighter regulation of the financial sector, from whichever source it springs, should be implemented rigorously with an enlightened self-interest with regard to Ireland's global competitiveness. In the light of the worldwide crash in stock market values, the Government should – even temporarily – relax the pension fund standard to prevent driving even more companies to abandon their defined benefit schemes because of the onerous cost implications.

The second problem requires a very determined effort by government to rectify the unsustainable gap between revenue and expenditure that has emerged over the course of 2008 and that will continue in 2009 and probably 2010. A most disconcerting feature of the recession is the rapidity and magnitude of the deterioration in government finances. Forecasts of tax revenue yields were well wide off the mark in 2008 and the shortfall has grown as the year progressed. A mid-year assessment put the shortfall for the year at €3 billion, but it quickly became apparent that it would be much greater; it now seems that this shortfall will be closer to €7 billion. Without correction, the General Government Balance will be in deficit to the tune of €9 billion in 2008 and €14 billion in 2009 equating to about 5% and 8% of GDP, the magnitude of deficits only reached by Greece and Portugal in the 2004-2006 period. A further worrying feature is that the current budget balance, which had recorded significant surpluses for over a decade, will, if left unchecked, record a deficit of over 3% of GDP in 2009. This would inevitably squeeze capital spending. The Government is well aware that the current tax base is unsustainable and there will be no recovery from the lost revenue, which accrued from the house and property boom.

Budget 2009 must begin the process of urgent public service reform. It must identify and eliminate wastage and prioritise the level of current public service provision. It needs to find at least €2.5 billion additional cuts to those already planned for 2009. One element should include the public sector wage bill reducing by 5%. Tax increases should be avoided and essential capital expenditure must proceed to ensure future competitiveness.

Output

The Irish economy is experiencing a truly shocking deceleration in activity, the likes of which have not been seen for decades. Admittedly coming after a long period of exceptionally rapid growth, Ireland's relative income levels remain high and the economy is not burdened by a high debt to GDP ratio. Nevertheless, the dramatic reversal in economic fortunes will have a severely disruptive effect, not least on government revenues, which will in 2008 fall short of budget by about €7 billion or some 14%. Employment will fall and the decline in consumer confidence will continue in 2009.

The economy has come to the end of an extraordinary period of fourteen years of "super growth" which the Central Statistics Office records at 7.4% per annum. Growth over the last five years was unhealthily dependent on housing construction, which was at an unsustainably high level; the traded sector, the key to sustainable high-income levels, made a much weaker contribution to growth than in the past. Although the threat of a hard landing was

IN THIS ISSUE:

- GDP to fall in 2008 by 1.9% and by 1.5% in 2009;
- Employment to fall by 1.5% in 2009;
- Unemployment over 9% in 2010;
- Consumer spending stagnates;
- Inflation to drop below 2% in second half of 2009;
- Interest rates cuts to start by end of 2008.

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GNP and its components

Annual % change	2007	2008	2009	2010
Consumer spending	6.3	0.0	0.5	1.5
Government spending	6.0	3.8	-2.0	0.0
Investment	1.2	-22.3	-17.9	1.7
Exports	6.8	2.3	1.8	3.0
Imports	4.1	-1.8	-1.0	2.3
GDP	6.0	-1.9	-1.5	2.1
GNP	4.1	-1.6	-1.4	2.0

Table 1

in sight, we failed to avert it. The global slowdown and the horrendous financial crisis have added an unquantifiable downside to an already troubled economy. We expect that GDP will fall by almost 2% in 2008, after a 6% increase in 2007 – an unprecedented deterioration of eight percentage points. Frankly, the uncertainty surrounding the global financial crisis and the impact this will have on the real economy of both the world and Ireland makes it impossible to forecast the economic outturn for 2009 with any certainty. Tentatively we think that GDP growth will fall by a further 1.5%.

The Quarterly National Accounts record that GDP in the first half of the year fell by an annual 1% and GNP by 0.6%. By the GDP measure,

Manufacturing growth

Annual % change - 3mma

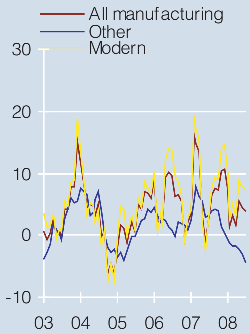


Figure 1

Ireland technically entered recession by recording two successive quarterly declines. On an annual basis, GDP fell by 1.3% in the first quarter and by 0.8% in the second quarter. On a seasonally adjusted basis, there was a quarterly decline of 0.3% in the first quarter followed by a 0.5% decline in the second quarter. Available data relating to retail sales, unemployment, manufacturing output, trade and exchequer returns, suggest that GDP will fall further in the third quarter; the consensus view is by about 2%. With the exception of government spending, all sectors of demand in the first half of 2008 were very weak.

By far the greatest drag on growth is the massive 18.9% fall in investment reflecting in particular the house-building crash, and a fall in machinery and equipment of some 30%. Even after allowing for a large fall in aircraft purchases, investment in other machinery and equipment fell by some 17.5% in the first half of the year indicating a weak investment climate in other business sectors. Overall, we believe investment will fall by a massive 22% in 2008 and by 18% in 2009. A more detailed analysis of investment is on page 6.

Consumer spending has collapsed from a strong 6% growth in 2007; we anticipate that there will be no growth in 2008 and only a 0.5% growth in 2009. Retail sales figures record a sharp decline from a year ago and consumer confidence remains weak. Higher unemployment rising above 8%, the fall in asset prices and the impact of restricted credit is likely to result in a rise in the savings ratio in 2009.

The manufacturing sector in 2007 recorded its strongest performance since 2002 growing by 7.5% comprising an increase in the modern sector of 8.7% and the traditional sector of 3.7%. In 2008 output is considerably weaker with growth in the first half of the year of only 3.5%, with the modern sector recording 6.1% growth and the traditional sector falling by 6.2%. Data for July suggest a weaker second half performance with manufacturing declining by an annual 4.3%, the modern sector falling by 3.5% and the traditional sector by 6.2%. Data from the Purchasing Managers Index for October suggest that manufacturing output will continue to weaken in the coming months. Growth in manufacturing for the year as a whole is likely to be about 1%. Global conditions in 2009 suggest that there will be continued pressure on manufacturers, with a further decline in traditional sector output. The modern sector, including software, should still record a growth in low single digits.

The continuing uncertainty surrounding global financial markets and its impact on the global economy makes it more hazardous to forecast the shape of the Irish economy in 2010. At this remove, credit conditions may still be difficult and the Government will still have to pursue a policy of strong fiscal correction. Hopefully, the global economy and, in particular, Ireland's most important trading partners, will be recording stronger growth than in 2009. We do not anticipate a strong bounce, and are pencilling in a growth of just over 2% for GDP. Unfortunately, this is unlikely to stimulate employment growth, and we expect unemployment to go above 9% in 2010.

Economic growth

Annual % change - 3mma

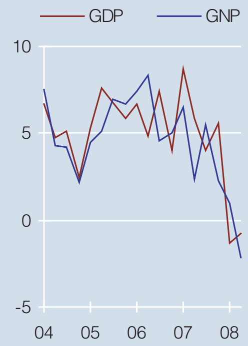


Figure 2

Government Spending

The deterioration in Exchequer finances has been so extreme over 2008 that it will require fundamental reform to correct. High levels of government expenditure relied on recent past burgeoning tax revenues accruing from the housing and property boom, which could never be sustained

Labour force forecast

'000 Annual average

	2006	2007	2008	2009	2010
Agriculture	116	116	123	129	133
Industry	564	578	539	496	474
Services	1363	1423	1453	1458	1470
Total at Work	2044	2117	2115	2083	2078
Unemployed	95	101	132	186	215
% Unemployed	4.4	4.5	5.9	8.2	9.4
Labour Force	2139	2217	2247	2270	2293

Table 2

over the medium term. The upshot of the hard landing, which the Irish economy is now experiencing, is an unprecedented collapse in Exchequer revenue across almost all tax heads, but particularly those related to the property market. Capital gains tax, stamp duties and VAT have all seriously underperformed and the Department of Finance greatly overestimated Exchequer revenues. Budget 2008 anticipated total tax revenues of €49 billion in 2008 and €52 billion in 2009. Early in 2008 it became apparent that revenues of this magnitude were seriously over-optimistic. In July the Department estimated that there would be a shortfall of €3 billion, in early September this was revised to €5 billion; the outcome is likely to be nearer to €7 billion. The lower revenue base in 2008 will have a consequent impact on

Unemployment

% of labour force

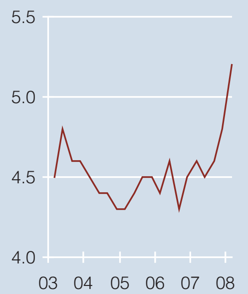


Figure 3

depressing revenue in 2009; these lost revenues relating to the housing boom will never return. The General Government Balance in 2008 will exceed the 3% of GDP limit set by the Growth and Stability Pact by a wide margin. Our estimates suggest the deficit on current trends could rise close to 8% in 2009.

Consumer price index

Annual % change

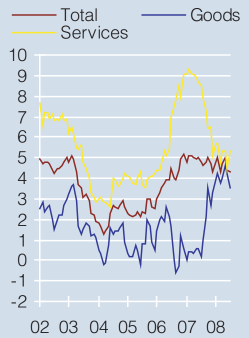


Figure 4

Financial stability is crucial for investment. In Budget 2009, the Government must produce a budget, which will demonstrate to the EU Commission that the General Government Balance can return below the 3% deficit limit within three years. As far as possible increased taxation must be avoided to plug the gap that emerged in 2008; experience has taught us that a high tax economy will result in a stultified economy. The rationale for maintaining an ambitious programme of capital investment remains strong, to build the adequate infrastructure to ensure future productivity growth and competitiveness. It is clear that some moderation of planned expenditure under the NDP is required; it is essential, however, that capital projects which will provide the greatest return on investment should continue without delay.

The bulk of the adjustment must focus on current expenditure. The current budget, which had been in surplus for over a decade, has fallen into deficit in 2008. The spending adjustments required are of the order of magnitude that they cannot be accomplished in a year. Nominal current expenditure in 2009 should be reduced by a further 6% from those already announced by the Minister for Finance in July. This will require a reduction in the public sector wage bill of 5%. IBEC has made this recommendation in its Pre-Budget Submission to the Minister for Finance. The further deterioration in the public finances since the submission was made only emphasises the urgency of the task.

Labour Market

The latest Quarterly National Household Survey from the CSO showed a significant slowing of the Irish labour market. Employment grew at an annual rate of just 0.3% in the second quarter of 2008, compared to 4% in the same quarter of last year. The impact of the construction sector correction is evident: employment in construction declined by 9.5% or 26,800. Manufacturing employment fell by 8,800 and emphasises the very difficult environment in which Irish exporters now operate. As a consequence of employment losses in these two sectors, male employment fell by 14,600 or 1.2% over the year. In contrast, female employment increased by 21,500 or 2.4%.

Inflation

2008	Quarter	Annual	Year
March	1.6	5.0	4.5
June	1.4	5.0	
September	0.5	4.4	
December	0.5	4.1	
2009	**Quarter**	**Annual**	**Year**
March	0.6	3.0	2.5
June	0.6	2.2	
September	0.2	1.9	
December	0.5	1.9	
2010	**Quarter**	**Annual**	**Year**
March	0.4	1.7	2.0
June	0.9	2.0	
September	0.3	2.1	
December	0.6	2.2	

Table 3

Explaining the global financial crisis *by Reetta Suonperä, economic policy executive*

The storm, originating in the US subprime mortgage market, had been brewing for quite some time. A long period of easy credit, low interest rates, macro-economic stability and economic growth led to a boom in consumer borrowing. One outcome in particular was a long period of rising house prices, now recognised as a bubble. This has happened not only in the US, but also across most of the western world. A mentality developed where people started believing that asset prices would only ever go up, never fall.

As markets were booming, lending in the US became decoupled from the act of holding the debt. Since the institution offering the mortgage was not exposed to any of the risk, lending standards became looser and looser. At the height of the boom it was possible to obtain a mortgage without proof of income or job. In a rising market, deposits were strictly optional and mortgages were offered at initial low teaser rates. The expectation was that the borrowers would be able to easily refinance the mortgage once the original interest rate expired. Lending was also extended aggressively from traditional prime lending to the so-called subprime sector, to people with poor credit histories. The banks that initially gave the mortgages sold them on to investment banks, which then repackaged the loans as sophisticated financial instruments known as asset-backed securities. The reasoning was that while an individual might default on a mortgage, not all loans would go bad and risk was thus reduced. Or so the thinking went.

In 2006 as the US housing market started to fall, refinancing of mortgages became increasingly difficult. Many people were faced with repayments they were not able to afford and defaults on mortgages increased sharply. As default rates soared, the payments from the synthetic credit instruments started to dwindle and the value of the asset-backed securities collapsed. The securities sold worldwide as low-risk investments now turned out to carry significantly more risk than advertised.

Over the past year, losses from the financial crisis have amounted to some $500 billion worldwide, with about half of these in the US. The write-downs have occurred mainly in mortgage-backed assets. However, financial institutions will face higher rates of loan defaults in the months to come – there is an inherent lag between the fall in asset values and a pick up in default rates. The IMF estimates that losses from the financial crisis will total $1.3 trillion worldwide. Dominic Strauss-Kahn, managing director of the IMF, has outlined three steps for addressing the immediate short-term fallout of the financial crisis. Central banks must provide liquidity to banks and financial institutions to prevent bank runs, and assure depositors that their savings are safe. Treasuries must remove the reason for bank runs to occur in the first place by buying up distressed assets. Finally, capital injections are required to recapitalise the financial system.

In first stage of the crisis, liquidity was the main problem. Banks were wary of lending to each other in the normal manner, not knowing each other's exposures to the risky and illiquid mortgage-based assets at the heart of the financial turmoil. Figure 5 shows a dramatic jump in the difference between the Libor and overnight index swap rates. The wider the difference, the less willing banks are to lend. As losses have accumulated, however, capital destruction has become the key issue. Until bank capital reserves have been restored, their ability to lend will remain compromised. This will have severe negative consequences for real economic activity, as banks will not be able to extend loans even to viable enterprises or creditworthy consumers.

Ultimately, the taxpayer will have to step in. The Swedish solution to their banking crisis of the early 1990s provides guidance. The first step was to introduce a blanket guarantee to protect all depositors and other creditors, with shareholders of the banks as the only exceptions. Then the authorities moved to separate the good from the bad. Banks were forced to write down their losses at an early stage. Sweden avoided a Japanese-style 'lost decade' where banks deferred reporting losses for as long as possible and where the banking system was virtually paralysed. Those banks that were deemed not viable were wound down in an orderly manner. Banks that would ultimately return to profitability received capital injections, in exchange for equity. Ultimately, the cost to the Swedish tax payer was limited.

At the time of writing, the entire global financial system is fraught with uncertainly. The House of Representatives in the US will vote on the $700 billion rescue package, which, if passed, will help stabilise the system. In Ireland, the Government has implemented a deposit guarantee scheme for Irish banks. In the months to come, Ireland and the world must draw lessons from successful past interventions. The banking sector cannot be allowed collapse; the repercussions for the economy, businesses and consumers alike, would be too severe to even contemplate. Once the crisis has passed, however, regulatory failure must be addressed. In a globalised financial system, transparency and regulatory oversight must be on a global scale.

Libor – OIS spread

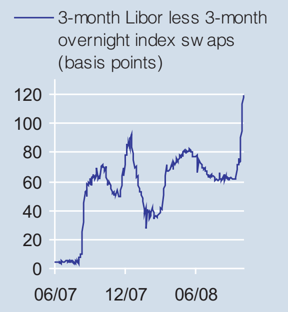


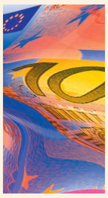
Figure 5

Overall, non-agricultural private sector employment declined by 15,200, with declines in construction and manufacturing partially offset by a gain of 23,400 in private sector services, mainly in wholesale and retail trade and financial services. The growth in services employment, however, has slowed significantly over the past 12 months. The financial sector is under pressure from the credit crunch, while the outlook for retail sector employment is weak given the sharp falls in retail sales that we have seen this year. All employment growth in financial services took place in the latter half of 2007, with small quarterly declines in 2008. Retail and wholesale trades also showed a marked slowdown in the pace of job growth in the first half of this year. We believe that employment is likely to record a marginal decline in 2008, falling by 1.5% in 2009, and more or less marking time in 2010. There is little to suggest any sector of the economy where strong growth might occur. The rebalancing in the construction sector is likely to see employment levels over the next two years drop back to 2003 levels. This essentially means a fall of around 90,000 in the sector, the bulk of which will take place in 2008 and 2009. We expect the retail and hotel sectors, which had experienced annual growth of 18,000 per annum in the previous three years, to record no growth in the next two. The finance and business services sector in the five years to 2008 recorded an increase in employment of over 70,000. Given the intense pressure that the financial sector is under, it is unlikely to be a source of employment growth over the next two years. The public sector, including health and education, will also be severely constrained by the necessity of government to take firm control of government spending.

A crucial but unknown element is how much will labour force growth slow as a result of weaker job opportunities. A number of factors will be influential. These include how much will inward migration slow down; how big an exodus will there be of non-Irish nationals who have lost their jobs; how many Irish members of the labour force will emigrate and how big will be the increase in discouraged workers. We have made the assumption that the labour force growth will slow to 1% in both 2009 and 2010 (the average in the first seven years of the decade was 3.3%). On this assumption, unemployment would rise to over 8% in 2009 and over 9% in 2010.

Consumer sentiment indicator

Figure 6



Consumer Spending

Consumer confidence as measured by the IIB/ESRI Consumer Sentiment Index peaked in the first quarter of 2006 and has declined at an increasing pace since. The trend line of the Confidence Index in September was 42.7 compared with 73.6 in September 2007 and 87.4 in September 2006. Data from the Quarterly National Accounts pick up a marked deceleration in consumer spending from the third quarter of 2007. Growth slowed from an annual 7% in the third quarter to 5.4% in the final quarter. In 2008 first quarter growth slowed further to 3.6% and second quarter figures recorded an annual decline of 1.4%. The collapse in retail sales has been startling. As the graph shows there has been an extraordinarily sharp decline in retail sales, from an annual growth of 7.1% in July 2007 to an annualised decline of 4.5% in the three months ending July 2008.

Retail sales

Annual % change - 3mma

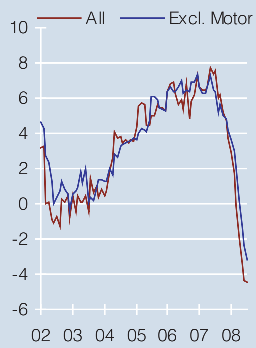
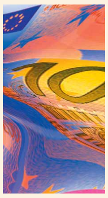


Figure 7

With unemployment rising to 6.3% in September and likely to keep rising throughout 2009 into 2010, consumer confidence will remain weak. The increasingly deteriorating financial crisis will further dent confidence and will make credit conditions more difficult. The August Monthly Statistics from the Central Bank provided further evidence of slower consumer spending, from weaker credit card payments.

Lower employment levels and the uncertain climate will tend to keep consumers away from big ticket items. The collapse in the housing market has been a significant factor in the decline of retail spending on furniture and lighting and electrical goods. High inflation in 2008 chipped away at consumers' real incomes.

In the first six months of 2008 consumer spending grew in real terms by an annual 1.1%. The worsening trend in retail sales as the year proceeds suggests further weakness in the second half. That said, there is some leakage of retail spending into the US and Northern Ireland as consumers take advantage of the favourable exchange rate. Nevertheless, we think consumer spending will mark time in 2008. Conditions in 2009 will be only a little more favourable, as we expect inflation to decelerate to 2.5% and the ECB will likely reduce interest rates. But the increased uncertainty, further employment losses, restricted credit conditions and probably a tough budget to take on board, all point to consumers keeping a tight control on their spending. We, therefore, expect little uplift in 2009, with spending rising by only 0.5%.



Investment

The pace of decline in total investment in the Irish economy in the second quarter of this year was almost identical to that in the first quarter. Total investment was down 18.8% in the quarter; the first half year was down marginally more. Following an increase of just 1.2% in investment in 2007 the sector will have a substantial drag on economic growth in both 2008 and 2009.

The housing sector continues to contract rapidly with new house starts currently down about 70% on year earlier levels. The climate for housing investment remains exceptionally weak and the stock of unsold units overhanging the market continues to increase. House registrations in the months of July and August were the lowest for these months for any year since 1987. The industry will continue to bring to completion the housing units already commenced but the pipeline for house completions in 2009 and 2010 continues to weaken sharply. Total new house starts in 2008 are likely to be 70% down on the 2007 level and 83% lower than the number of houses started in 2006.

House completions in the first half of 2008 were 30% down on the corresponding period in 2007 and output is likely to slow further in the second half of the year. Total new house completions for the year are set to be in the 45,000-50,000 range and will be down circa 40% on the 2007 output level. Home improvements activity has been reasonably buoyant in the first half of this year and investment in the second quarter of the year grew by 18% annually compared to an increase of 10% in the first quarter. Given the extremely low levels of transactions and mobility currently evident in the housing market, some households are choosing to invest in extensions or attic conversions. The credit crisis is likely to result in lower levels of investment in home improvements in the second half of the year. The pace of deterioration in the housing sector will accelerate in 2009. The housing starts data indicate that completions in 2009 will fall by a further 50% to about 25,000 units. This would be the lowest level of house completions in any year since 1993. In relative terms the home improvements and extensions sector will become much more important. An increase of about 10% in activity levels in 2009 would result in the total value of the sector reaching about 60% of the new housing sector. In 2006, home improvements only corresponded to 16% of the value of the new housing sector.

After contracting somewhat in the first quarter of the year, the 'other building and construction' sector expanded by 4% in the second quarter. The public capital investment programme has continued strongly during 2008 and has helped bolster the construction sector. In rural areas, EU grant aided farm improvement schemes have also supported significant activity but this work has a completion deadline of December 2008 and will therefore contribute to a general slowing in construction activity in 2009. The commercial and office property sector has weakened considerably in recent months. A number of major projects will continue to be completed in 2008 but very few new developments are being commenced and office/commercial investment will slow substantially in 2009 and 2010. Total investment in the 'other building and construction' sector is set to increase by just 2% in 2008, following an almost 20% increase in 2007.

Given the growing difficulties in the public finances, there are increasing risks that some parts of the planned public capital investment programme will not proceed in 2009. The Government is currently in the process of re-prioritising the National Development Plan (NDP) and the plan's investment is now likely to be spread over a longer timeframe. Taking into account the impact of the credit crisis, a weakening commercial property market, and some adjustments to the public capital programme, it is forecast that investment in other building and construction will fall by about 10% in 2009 and a further 5% in 2010.

Investment in machinery and equipment fell by 30% in the second quarter of the year, largely due to a near 70% drop in investment in planes. Although this investment tends to be very lumpy in the national accounts it is likely that the considerable difficulties in the airline sector will see further falls in plane investment in the second half of 2008 and into 2009. Investment in machinery and equipment is forecast to decline by 30% in 2008 and is set to fall by a further 5% in 2009.

Total investment in the Irish economy will decline by 22% in 2008 and fall by a further 18% in 2009. By 2009, new housing as a percentage of total investment will have fallen to just 20%, down from 40% in 2006.

Investment

Annual % change	2007	2008	2009	2010
Building & construction	-1.9	-20.1	-21.2	-0.9
Plant & machinery	13.5	-30.0	-5.0	10.0
Total	1.2	-22.3	-17.9	1.7

Table 4

Inflation

Much of the global slowdown in the last year has resulted from the sharp rise in inflation of oil, food and other commodity prices. The strength of the euro on foreign exchange markets has helped mitigate the impact in the euro area but it did not prevent the harmonised consumer price index rising to 4% in June and July, double the rate at which the European Central Bank directs monetary policy. However, the fall in oil prices and commodity prices have eased euro area inflation, which fell back to 3.8% in August and flash estimates released at the end of September recorded a further fall in September to 3.6%. Irish inflation on an EU harmonised basis has fallen more rapidly; it hit 3.9% in June and fell to 3.2% in August. The consensus is that it will fall to 3.1% in September and fall to 2.5% in 2009 and to 2.3% in 2010.

On a Consumer Price Index (CPI) basis, which includes mortgage interest rates and some insurance products, inflation in Ireland hit 5% in June. Since then it has decelerated to 4.3% in August and is likely to fall close to 4% by December. There are a number of factors which suggest that inflation could decelerate rapidly in 2009. Global demand will be weaker than in 2008, reducing demand for oil and other commodities. We have already seen a reduction in global food prices, and other commodities have peaked and are now falling. Food prices, which have been a significant factor in pushing up inflation in Ireland, appear to have peaked and have started to fall back. According to the CPI, food prices have fallen month-on-month for three consecutive months, June to August; on an annual basis, food inflation peaked at 9.3% in March 2008, falling back to 6.4% in August. Energy inflation, however, remains high recording a 13.8% increase in August. The index will remain high in September, pushed up by an increase in gas prices.

The European Central Bank may well start to reduce interest rates by the end of 2008 if a lower inflationary outlook is more evident. This would exert a downward pressure on inflation, which we think could drop below 2% in the second half of 2009. We think inflation will average 2.5% in 2009 and 2% in 2010.

The employers and trade unions will decide late in November, after consultation with their members, whether to ratify the proposed wage agreement. The terms in the private sector are for a 21-month agreement of 6.1% to follow on from the end of the last agreement which for many companies was 31st March 2008. There would be a three-month pay pause followed by a 3.5% increase for six months and a 2.5% increase for 12 months. Average pay would rise by 4.3% in 2008 and in 2009.

Trade

The Quarterly National Accounts record that exports of goods and services grew in volume by an annual 1.5% in the first half of 2008, growing by 0.6% in the first quarter and falling by 1.1% in the second quarter. The volume of imports of goods and services fell by 0.5%. Balance of Payments figures record that in value terms goods exports fell by 4.2% while service exports increased by 4.7%. This performance of exports in the first half year is markedly weaker than in 2007; the value of goods exports increased by 1.2% and service exports by 15%. The current account balance of payments deficit emerging in 2008 is 7.4% of GNP. This represents a doubling of the deficit since 2005.

Financial

According to the Central Bank August Monthly Statistics, mortgage lending growth in Ireland slowed to just 9%, the slowest pace since 1987. The monthly increase of €508 million was just over half of that recorded in July. Though mortgage lending is usually slower in August, the increase this year was exceptionally low at just a quarter of that recorded in August 2006. The pace of mortgage lending growth has been slowing for two years now, from peaks of 27% growth in 2006. The Central Bank in its briefing noted that the slowdown in mortgage borrowing comes despite 18 months of falling house prices. In addition, that banks participating in the July euro area Bank Lending Survey reported tighter credit standards on loans to households, and attributed this to a rise in their costs of funds and an increased perception of risk – in particular, general expectations regarding economic activity. Consumers are beginning to feel the pinch from rising unemployment and a weaker economy, and consequently new spending and repayments on credit cards were noticeably lower in August than in July, though the annual rate of increase remained unchanged at 10.2%.

The European Central Bank left interest rates unchanged at 4.25%, but President Jean-Claude Trichet said that a cut in interest rates had been discussed in the light of falling inflation and a less bullish outlook on euro area growth prospects. A cycle of interest rate cuts could begin before the end of the year. The news resulted in the euro exchange rate falling to $1.38 and £0.782.

Exchange rates

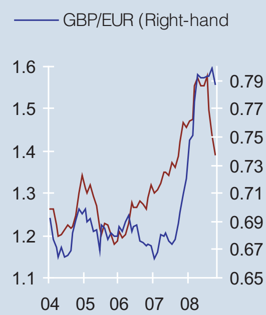


Figure 8

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International

The slowdown in the global economy is now entering its second year. Global growth is expected to decelerate significantly in the second half of 2008 before recovering gradually in 2009. The IMF has cut projections for growth in 2008 to 3.9%; to date it remains confident that the current financial storm can be weathered without a damaging global recession. The short term will continue to be beset with uncertainty as central banks worldwide provide liquidity to reassure fragile financial markets.

United States

The Fed's Beige Book released in September showed the US economy is sputtering amid weak housing, difficult credit conditions and a retrenchment in consumer spending whilst inflationary pressures persist. GDP in the Q2 rose 2.8% q-o-q buoyed by the fiscal stimulus package introduced in early 2008. Fed Chairman Bernanke acknowledged that growth in the second half will be "appreciably below its potential rate" and the "intensification of financial stress" could prove a significant further drag on growth. The IMF forecasts growth of 1.3% in 2008. Headline inflation fell to 5.4% in August down slightly from the 17 year high recorded in July. Core inflation remained unchanged at 2.5% above the Fed's 1-2% "comfort zone". The fall in oil prices and the dollar's recent rally are "encouraging" according to Bernanke and these factors coupled with weak growth "should lead inflation to moderate this year and next". Despite the fragility of the economy, the Fed held interest rates steady at 2% on September 16th. Unemployment rose to 6.1% in August, a five year high. There is an urgent need for the $700 billion bailout or Troubled Assets Relief Program (TARP) proposed by congressional leaders to rid vulnerable financial institutions of "toxic assets" to succeed in restoring confidence to the financial markets.

Euro area

GDP rose 1.4% y-o-y in Q2 but contracted by 0.2% q-o-q. This quarterly contraction was the first recorded since the inception of the euro in 1999. The IMF and the OECD forecast growth of 1.4% and 1.3% respectively for 2008. The Commission recently claimed the euro area will escape a recession in 2008, albeit barely. Euro area unemployment climbed to 7.5% in August. Initial estimates show inflation was down 0.2% m-o-m in September and y-o-y it fell to 3.6%. This rate is still almost twice the ECB's explicit inflation target, which is "close to but below 2%". The ECB has forecasted that inflation will ease to between 3.4 and 3.6% for 2008 with Jean Claude Trichet promising the delivery of price stability by 2010. The ECB kept interest rates at 4.25% on 4 September, but Trichet introduced the possibility of interest rate reductions in the near future.

United Kingdom

Growth in Q2 stagnated q-o-q but was up 1.5% y-o-y, the weakest increase since 1992. The OECD recently slashed its forecast for growth this year to 1.2% and now predicts that the economy will contract in Q3 and Q4. The BoE recently stated that GDP growth would be "broadly flat over the next year or so". The Bank kept interest rates steady at 5% on the 4th of September last. Headline CPI inflation rose to 4.7% y-o-y in August. The Bank's short-term forecast indicates that inflation will peak slightly above 5% towards the end of the year. In the medium-term, the inflation outlook looks set to ease significantly so an aggressive interest rate cutting strategy looks likely once inflationary pressures subside. Sterling will remain weak over the coming months as the UK economic outlook deteriorates.

by Eoin Cuddihy, economic policy executive

Real GDP growth – selected countries

Annual % change	2007	2008	2009
Euro area	2.6	1.3	0.9
UK	3.1	1.2	0.6
Germany	2.5	1.9	0.8
France	2.1	1.1	1.0
US	2.2	1.8	1.4

Table 5

Inflation – selected countries

Annual % change	2007	2008	2009
Euro area	2.1	3.5	2.4
UK	2.3	3.8	2.9
Germany	2.3	2.9	2.1
France	1.6	3.1	2.1
US	2.9	4.5	2.9

Table 6

Unemployment rate – selected countries

Annual % change	2007	2008	2009
Euro area	7.4	7.3	7.6
UK	5.2	5.4	5.7
Germany	8.4	7.8	7.9
France	8.3	7.4	7.7
US	4.6	5.5	6.2

Table 7

Source: Consensus Forecasts, September 2008.