QUARTERLY REVIEW

ECONOMIC TRENDS

IBEC

OCTOBER 2010

Budget must balance growth and fiscal correction

Budget 2011 is likely to be one of the most scrutinised and debated economic events in the State's history. Recent months have seen a growing realisation that the scale of the cumulative fiscal correction needed over the coming four years will be far greater than the €7.5 bn previously indicated by Government. The higher than expected cost to the Exchequer of repairing the financial system has also put Ireland back into the international spotlight. The decisions to be taken over the coming weeks are therefore central to the country's economic future and it is essential that this debate remains rational and anchored in the wider context of the current fundamentals of our economy. It is thus crucial to have clarity on the central issues of the current state of the real economy, the sustainability of the debt burden and the likely range of economic growth rates out to 2014.

The second quarter figures for economic growth disappointed somewhat but the negative response they received was excessive. Quarterly growth figures for a small open economy such as ours are notoriously volatile and it can be misleading to read too much into a single quarter's performance. When the first half of the year is taken as a whole, the economy performed largely as was expected. Indeed, IBEC's own forecast for GDP growth for 2010 remains almost one percentage point above the Government expectation of December last year. Two further difficulties have emerged in recent months, however. Firstly, the final national accounts data for 2009 show that the nominal size of the economy was much lower than the Department of Finance had originally estimated. Secondly, the global economic recovery has lost steam in recent months and Government's growth forecasts for the 2011 to 2014 period now appear too optimistic.

September's announcement from Government on the final cost of the banking restoration programme led many commentators to question the sustainability of Ireland's sovereign debt position. Much of this comment again lacked clarity on the crucial facts. The full accounting of the banking costs means that the debt-to-GDP ratio will reach 100% this year and will peak at about 115% in 2014. While this represents a rapid escalation from the pre-crisis debt ratio it is not exceptional in international terms – it is just above the debt level of the euro zone and the US, about the same as that in Belgium and below that in Italy. The crucial issue in assessing debt sustainability is the debt servicing cost. At its worst, some 16% of Government revenue will go towards paying interest on the national debt but this is well below the cost incurred in the 1980s when debt servicing costs peaked at 26% of revenue. Our escalated debt level will have a limiting impact on growth but it is a burden which the economy can bear.

The deficit reduction target for 2014 is a much greater challenge than debt sustainability. The main problem in the public finances is the underlying gap which has emerged between current expenditure and tax revenues, not costs associated with the banking sector. In our Pre-Budget Submission, IBEC accepts the four-year timetable for the deficit reduction set out by the EU Commission as a given and Budget 2011 must put the public finances on the path towards that target. It is also important, however, that the upcoming Budget does not deliver an excessive frontloading of the fiscal adjustment to such a degree that it strangles the fledgling economic recovery. GDP growth is of equal importance in meeting the 2014 target as is the nominal scale of the deficit reductions. The most effective way to tackle the deficit is therefore through growth in enterprise, growth in employment and ultimately growth in the economy. The vast majority of the adjustment must be on the current expenditure side but some steps must also be taken towards replenishing the tax base. A greater share of those at work must pay some income tax but we must keep our rates down in order to remain competitive.

The 2014 deficit target is challenging but achievable. Over the course of recent Budgets the cumulative fiscal adjustment has been €14.5 bn and it now appears that the remaining fiscal adjustment target out to 2014 will be close to this amount. We are therefore at the halfway point in the adjustment process but crucially the worst of the economic contraction is behind us. This year has seen the economy stabilise and growth will re-emerge in 2011. It is difficult for any agency to be precise on what the growth outlook is for 2012 and beyond but it may well surprise on the upside. Ireland has regained considerable competitiveness over the past two years or so and is now a much stronger location for traded enterprise and a more attractive destination for foreign direct investment. It is this sector of the economy which will lead recovery and ultimately create the activity and employment which is central to the deficit reduction strategy.

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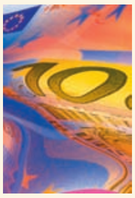


Output

The global economy has actually performed somewhat better than expected during 2010. Recovery in the first half of the year, in particular, was more robust in most developed economies than had been anticipated by the main forecasting agencies. The 2010 forecasts for a number of major economies have therefore been revised significantly upwards in recent months. For example, in its spring forecasts the EU Commission expected the German economy to grow by 1.2% but by September this was revised up to 3.4%. Despite the better than expected outturn for 2010, however, it is also now clear that the risks to the medium-term outlook have intensified in recent months. The main developed economies are unlikely to fall back into recession but it now looks likely that economic growth in 2011, at least, will be lower than expected and will be weaker than the 2010 performance.

In the first half of this year currency movements were working strongly in Ireland's favour and provided a significant boost to exports. In recent months, however, a global currency war has developed and the euro has been the big loser in this.
The current fairly elevated euro exchange rate against the main global currencies seems at odds with economic fundamentals but it is difficult to see when a position closer to equilibrium will be reached. The upshot for Irish exporters is that the currency outlook for 2011 is more challenging than we would have hoped. This is likely to subdue somewhat the strong export recovery which we have experienced in early 2010.

The Irish economy will perform better than expected in 2010. This time last year, Government expected GDP to contract by a further 1.3% in 2010 but it now appears GDP will essentially be flat this year. The second quarter national accounts data have presented a further challenge for Ireland's deficit reduction target, however. In last December's Budget the Department of Finance had forecast that GDP in nominal terms this year would reach almost €161 bn off a base of €165 bn in 2009. The CSO, however, has made some statistical corrections to the historic national accounts data with significant implications for nominal GDP in both 2008 and 2009. The 2009 starting point for nominal GDP is now €160 bn rather than the €165 bn previously estimated and the 2010 outturn is expected to be about €3 bn

GNP and its components

Annual % change

	2009	2010	2011	2012
Consumer spending	-7.0	-1.3	0.7	1.5
Government spending	-4.4	-3.0	-3.5	-2.0
Investment	-31.0	-21.2	-2.3	4.0
Exports	-4.1	5.3	4.2	3.9
Imports	-9.7	1.7	1.9	2.2
GDP	-7.6	-0.3	2.2	3.1
GNP	-10.7	-2.3	1.2	3.4

Table 1

GDP and GNP growth

Seasonally adjusted

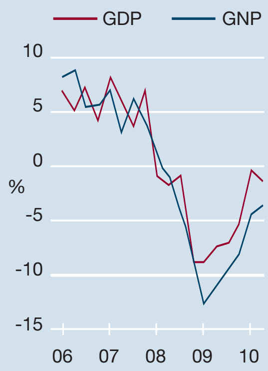


Figure 1

below the Department's original forecast. In summary, therefore, the growth story in the Irish economy this year is likely to be more positive than expected but the downward revision to the nominal GDP figure makes the 2014 deficit reduction target even more difficult to achieve.

The second quarter national accounts data were clearly a disappointment, if as much for the negative international and domestic reaction they received as for the detail on a weaker than hoped for performance in the economy. The economic performance in the first quarter of the year was well ahead of expectations and heralded a technical end to Ireland's recession. In particular, the net export performance was exceptionally strong – on a seasonally adjusted basis exports grew by 7.1%, with services export growth in the double digits. The contribution from exports waned significantly in the second quarter, however. The seasonally adjusted improvement was just 1.6% but import growth at 4.5% outpaced this. Encouragingly, the rate of decline in consumer spending slowed further from 0.5% in Q1 to just 0.2% in Q2.

Manufacturing recovery gained momentum through 2010, with annual growth of 3.4% in the first quarter and 3.7% in the second. The modern manufacturing sector has again been leading the way and recorded a 7.6% output growth in the January to August period. The traditional manufacturing sector arrested the substantial declines recorded since 2008 and output was unchanged from the corresponding period in 2009. Pharmaceutical output has been the dominant driver in the recovery in industrial production with output up 18% in the first eight months of the year.

Our forecast for GDP in 2010 is little changed from our June estimate. A buoyant performance in the first quarter of the year was tempered by a disappointing second quarter but on balance the recovery to date has taken hold largely as expected.
The domestic economy continues to contract while the export sector has staged a strong recovery. The outlook for 2011 and beyond, however, has grown more uncertain over recent months. More aggressive fiscal austerity measures are clearly going to have damaging consequences for the domestic economy. Irrespective of the specifics of the fiscal adjustment package, it is going to dampen the pace of recovery for the coming years. Measures taken to close the budget deficit will ultimately put the economy on a sounder footing and will boost growth rates in the future but for the first two to three years after their introduction they will dampen economic activity.

We have therefore revised downwards our GDP forecasts for both 2011 and 2012. Following three years of falling consumer spending, the recovery in 2011 will be weaker than expected as householders adjust to changes in disposable income. Government spending cutbacks are also likely to be higher than previously forecast, while the export environment for Irish businesses will also be somewhat less benign. Crucially, however, the economy has returned to a growth trajectory and, depending on international developments, the pace of recovery may well surprise on the upside.

Employment

The Quarterly National Household Survey from the CSO reveals that though employment continues to fall, the pace is slowing. In Q2, the annual decline slowed to 4.1% from 5.3% in Q1 2010 and 8.2% in Q2 2009. Seasonally adjusted data also confirm that the pace of job losses is slowing; the quarterly fall in Q2 was 7,600, compared with 14,600 in Q1 and 35,900 in Q2 2009. Nonetheless, 80,000 jobs were lost in the year to June 2010 and 290,000 from the peak in Q3 2007. Employment in the economy stood at 1.86 million, down from 2.15 at the peak.

Employment fell on an annual basis in 10 of the 14 sectors recorded in the QNHS. The biggest loss of 30,100 was recorded in construction and employment in the sector has now more than halved from the peak. Though the pace is slowing, job losses in the sector have yet to come to a halt. Industry lost 18,200 jobs in the year to Q2 2010, while wholesale and retail lost 8,600. The financial sector lost 5,500 jobs, reversing some of the (surprising) employment gains posted during 2008 and 2009. Information and communication added a very small number of jobs, at a much slower pace than in previous quarters.

Employment in education and public administration remained stable, but health added 7,100 jobs. Though the bulk of this was technically in the private sector, it is likely that the public purse ultimately foots the bill through contracted agency staff. We had previously pencilled falls in public sector employment this year, but most recent data indicate that this is not materialising. Despite hiring caps employment in health, education and public administration (sectors mostly financed from public spending) increased by over 2,000 in the first half of the year.

Employment

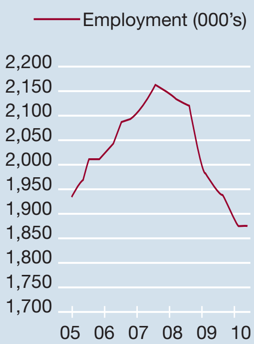


Figure 2

Employment

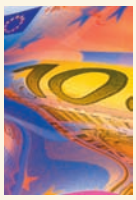
000's annual average

	2009	2010	2011	2012
Agriculture	96	85	84	83
Industry	411	369	364	368
Services	1,422	1,403	1,406	1,431
Total	1,929	1,858	1,854	1,882
Unemployed	259	286	277	260
% Unemployed	11.8	13.3	13.0	12.1
Labour force	2,187	2,144	2,131	2,141

Table 2

The number of claimants on the Live Register ticked up during the summer months, but latest figures show the number signing on declining again. Newly available data on occupational groups confirms that the impact of job losses has been concentrated in the lower skilled occupations.
A quarter of claimants reported 'craft and related' as their last occupation, 16% 'plant and machine operatives', 11% 'personal and protective services' and 10% 'sales occupations'.
In contrast, only 4% reported 'managerial and administrative' as their last occupation, while 6% were from 'professional occupations'. The task that the Government faces in reskilling and retraining is daunting, but necessary if Ireland is to avoid a prolonged period of structural unemployment. Ireland appears to be experiencing a classical labour market mismatch situation, with significant skills shortages in some areas, such as IT and specialist sales occupations, coupled with oversupply in other occupations.

Given that the recovery to date has been concentrated in the exporting sectors, with the more labour intensive domestic sector lagging behind, job creation in the economy is set to remain muted. Employment in 2011 is likely to be flat relative to 2010, with growth of 1.5% projected for 2012.
The unemployment rate has to a certain extent been contained by falling participation rates and net emigration – problematic in themselves of course – and stood at 13.2% in Q2. However, given muted job creation, unemployment will fall back only slowly and is projected to average 13% in 2011 and 12.1% in 2012.



Prices and wages

Following 19 months of deflation, the Consumer Price Index (CPI) returned to positive territory in August. There is little in the way of any meaningful price pressure in the Irish economy, however, and it is likely that inflation will remain fairly subdued for some time yet. Prices fell by 4.5% in 2009 as fairly aggressive discounting occurred right across the Irish economy. Falling retail prices and the substantial reduction in mortgage interest costs were the

Banking rescue and Ireland's fiscal sustainability

The announcement in late September of the Government's revised estimate of the scale of banking supports, while a regrettable additional burden on the state, does not in a material way alter the underlying debt dynamics.

In a worst-case scenario, the total cost of the banking interventions (excluding NAMA, which is expected to break even) will be €50 bn. This includes somewhat higher recapitalisation of AIB and Irish Nationwide and a worst-case payment of €34.2 bn in promissory notes to Anglo Irish Bank. Stringent stress testing of the banks' loan books was part of the process, and capital at AIB and Bank of Ireland will be well above regulatory requirements in order to give the banks sufficient cushion for writedowns of non-NAMA loans.

Because of Eurostat accounting rules, Ireland will recognise the banking bailout upfront in its 2010 deficit and government debt. This pushes the deficit up to about 32% of GDP and the debt-to-GDP ratio close to 100%. However, once the promissory notes have been acknowledged in 2010, the deficit will normalise again in 2011.

The crucial point is that the additional, higher banking costs will not alter the underlying debt dynamics in a material way. The growth rate of the economy in coming years and the price that Ireland pays on its debt, rather than the stock of debt, are the key determinants of Ireland's fiscal sustainability. A credible four-year fiscal plan to bring the deficit down to 3% of GDP by 2014 is vital in both aspects, in providing certainty and confidence to both the domestic economy and international investors.

The debt-to-GDP ratio will peak at about 115% in 2014 or so. This is high, but bearable and not exceptionally out of line internationally. The IMF in its October World Economic Outlook projects that the US gross debt will reach 110% of GDP by 2015; Italy's debt will come close to 120% of GDP; Greece's debt-to-GDP ratio is projected to reach 130%; Belgium has lived with a high debt burden for several decades; and Japan's net liabilities are approaching 150%, with gross debt at about 250% of GDP.

Debt servicing burden

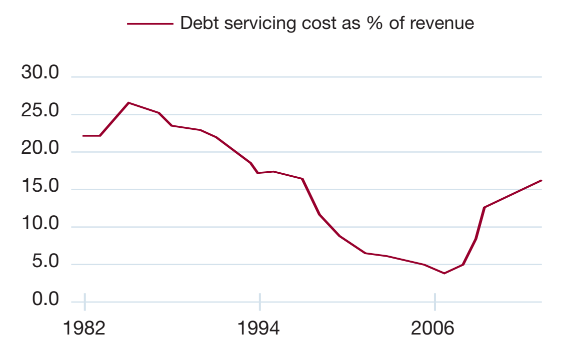


Figure 3

The Government's ability to service its debts is what ultimately determines fiscal sustainability. In this context, it is reassuring to remember that Ireland has been through worse. The cost of servicing Ireland's national debt as a share of Government revenue, shown in the adjacent chart, is projected to rise to 16% in 2014. This is substantially less than the interest burden of 25% that Ireland bore in the 1980s and is only back to mid-1990s levels.

As we point out in the section on Exchequer finances, both tax revenue and expenditure have come in on target during 2010 and the Government has proven that it is capable of credible adjustment. Given that growth is likely to be somewhat lower than the Government previously forecasted and the additional burden from the banking rescue, the adjustment to 2014 will need to be significantly higher than the €7.5 bn previously planned.

While tough, the challenge is still manageable. Crucially, the Government from July 2008 to date – a period of just over two years - delivered €14.5 bn adjustments. Even in a worse case scenario where lower growth would push the outstanding adjustment towards €15 bn, we are halfway there and have four years in which to complete the task. Additional spending cuts and tax increases will lower growth, but fiscal multipliers (the positive effect of fiscal stimulus and negative effect of a contraction) are smaller in a small, open economy, so the impact on growth will be limited.

The full reckoning of the banking crisis has now taken place. While it adds to the scale of the challenge, the banking rescue is a once-off event. The fact remains that the underlying deficit is in excess of 10% of GDP. Ireland's core problem is a structural shortfall in its tax revenues coupled with an expenditure base predicated on the unsustainable revenues collected during the boom. This will take a number of years to address, but realistic assumptions about future growth rates show that the task, while formidable, can be done. With cash reserves of about €20 bn the National Treasury Management Agency (NTMA) can afford to stay out of the bond market until 2011. This gives Ireland enough breathing space to demonstrate that we are equal to the challenge facing us.

largest contributors to deflation last year. The scale of retail price reductions have been much less in 2010 and mortgage interest is again an upward pressure on the CPI as many of the financial institutions have increased their variable rates. The Harmonised Index of Consumer Prices (HICP), which excludes mortgage interest, shows that core prices continue to fall on an annual basis – the HICP remained at -1.0% in September.

Goods prices in the CPI were 1.6% lower in September 2010 on the corresponding month last year, while services were 2.1% higher. Food prices were down 2.0% in the year and have continued to decline marginally in recent months despite some spikes in a range of global commodity prices. These higher commodity prices are expected to feed into at least some food item prices as we move in 2011. Clothing and footwear prices are down over 7% in the year and are almost 30% below where they were in December 2006. Energy prices have increased by 8% over the past year, largely due to somewhat higher world oil prices. Petrol pump prices in Ireland seem to have largely stabilised in recent months, and the stronger euro is again likely to subdue import prices for energy. Despite the fact that the ECB has not increased its base rate, the Irish financial institutions have increased their variable mortgage rates on a number of occasions over the past year. Mortgage costs in the CPI are now 25% higher than this time last year.

International inflationary pressures, with the exception of some commodity items, remain fairly muted and the stronger euro is also expected to keep downward pressure on Ireland's import prices. The Irish economy is also going to continue to have extensive spare capacity for a number of years, so many of the normal drivers of inflation will be absent for some time yet. Mortgage interest costs will eventually add considerably to the CPI once the ECB decides to end its period of 'emergency rates'. This is unlikely to happen in 2011, however, and we therefore remain fairly sanguine on the inflation outlook for at least the next 18 months or so. The CPI is set to fall on average by 0.9% in 2010. The monthly observations in 2011 are unlikely to exceed 1.5% at any stage and the annual average increase next year is expected to be just over 1%. The cumulative fall in the CPI since the start of the recession has been 7.3% and although prices have started to increase marginally again it will be a number of years before the price level in the Irish economy returns to where it was in summer 2008.

Inflation

2010	Quarterly	Annual	Annual Average
March	0.1%	-3.3%	-0.9%
June	0.5%	-1.3%	
September	0.5%	0.2%	
December	0.1%	0.9%	
2011			
March	0.2%	1.3%	1.1%
June	0.4%	1.2%	
September	0.4%	1.0%	
December	0.0%	1.0%	

Table 3

Average wages have continued to fall in 2010. IBEC's Quarterly Business Sentiment Survey shows that basic pay rates dropped by 2.4% in 2009 and are set to fall by a further 1% in 2010. About one in four firms cut basic pay rates last year and some 15% did so in 2010, with the majority of firms (70%) freezing basic pay rates. The outlook for 2011 is little changed from the 2010 outcome, with about two-thirds of firms set to freeze pay rates, while 6% plan to cut rates. Following a 13.1% reduction in firms' pay bills over the course of 2009 and 2010, businesses expected their pay bill to fall by a further 0.5% in 2011.

Consumer spending

Consumer sentiment has experienced a significant setback since the beginning of autumn. It became clear in August that the cost of the banking resolutions was going to be higher than previously indicated. Around this time Ireland's bond spreads started to widen considerably as the international markets intensified its scrutiny of both the banking costs and the medium-term outlook for the Irish economy. The subsequent acknowledgement by Government that the fiscal adjustments planned for Budget 2011, and for following three years, would need to be substantially greater than previously envisaged has scared Irish consumers. The widespread media coverage of the renewed difficulties with the public finances has clearly damaged both consumer sentiment and actual spending patterns in recent months.

Consumer spending in the first quarter of the year gained some momentum as households loosened the purse strings somewhat, following a budget which delivered no tax increases. Core retail sales (excluding motor trades) grew by 1.2% in volume terms and the recovery was fairly broad based across the retail sub-sectors. This recovery began to run out steam in the second quarter, however, and both April and June saw the volume of core sales declining again. The figures available for July and August show that the annual comparison has turned negative again following two months of positive figures in the spring. Although the aggressive discounting seen in the retail sector in 2009 has not been as prevalent this

KBC/ESRI Consumer Sentiment Index

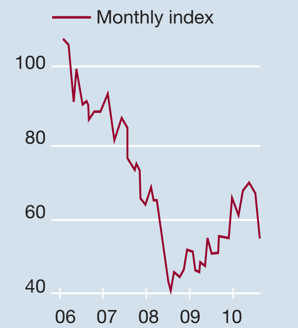


Figure 4

year, the fall in sales value continues to be about two percentage points greater than the volume fall. Recent feedback from the sector suggests that retailing will face a very challenging final quarter and the total volume of sales this year is likely to be marginally below the 2009 level.

The ESRI/KBC consumer confidence indicator fell from 66 in August to 61 in September and slumped further to 52 in October. It is now back to the level of September 2009 and the fall over the past two months has been the sharpest since the crisis began in 2008.

The consumer spending estimates from the National Accounts were somewhat more negative that the trend shown by the retail sales index. On a seasonally adjusted basis, consumer spending recorded a quarterly decline of 0.5% in the first quarter of the year and dropped by a further 0.2% in quarter 2.

Investment

Over the course of the recession, the collapse in investment has been the largest drag on economic growth. Total investment fell by 16% in 2008, 31% in 2009 and is set to drop by a further 21% in 2010. Following three years of such substantial decline, the sector is now close to bottoming out, however, and this will be a big boon to the prospects for economic growth over the coming years. The value of investment this year is set to be less than half of what it was in 2007. The building and construction component will have fallen by nearly two-thirds from peak to trough, while investment in new housing next year will be some 80% lower than the 2007 output level.

New housing output reached 10,000 units in the first nine months of the this year – a drop of 48% on the same period in 2009. At the current run-rate full-year house completions for 2010 are likely to be just short of 14,000. The monthly registrations data indicate a further drop in completions next year of about 20%, resulting in housing output in 2011 of about 11,000 units. Following a period of resilience in the home improvements sector earlier in the recession, recent quarters have seen some renewed decline in this area. Home improvements investment was down 20% in the first half of 2010, compared to the corresponding period last year. Nevertheless, the sector has become increasingly important to the construction industry as it is now of the same scale as the new housing sector and accounts for close to one-quarter of the total construction industry. Lack of mobility in the housing sector appears to have led to increased activity in some parts of the home improvements sector over the past couple of years but the recent rapid fall in consumer sentiment and renewed concerns about the fiscal outlook are likely to mean a fairly flat outturn in 2011.

The drop in activity in the non-residential construction sector has been much less than that in housing. The sector continued to grow in 2008 when residential output was already falling sharply. Over the course of 2009 and 2010, however, it will have fallen by about 43%. Commercial development has been the biggest casualty and the decline in the sector has been on a par with that in the housing sector during both 2009 and 2010. The Exchequer funded capital investment programme is the other major component of this part of the construction industry and its output has held up reasonably well to date. A number of major investment projects have been completed in 2010, however, and even allowing for Government's recent commitment to an ambitious capital investment programme for the coming years, activity may slow somewhat in 2011 as new projects move through the pipeline. Tender prices are in the range of 20% to 30% lower than in 2008 enabling the public capital investment programme to deliver greater 'bang for its buck'. Therefore, even allowing for the budget reductions that have already been implemented, the current investment commitments would deliver a volume of activity not too much below what has been achieved in recent years, once a normal flow of projects resumes. It is probably unrealistic to assume, however, that the construction industry can continue to deliver projects at these much reduced tender prices indefinitely and any further reductions in the capital investment budget for the coming years are likely to result in a major scaling back of project delivery and both overall activity and employment in the construction sector.

Investment in machinery and equipment grew marginally in the second quarter of 2010 but following a weak first quarter, it was down 9% in the first half of the year. The bounce back in the second quarter was largely due to higher expenditure on planes, an investment pattern which tends to be very lumpy. From a firm investment perspective, the outlook remains fairly uncertain. Both access to and cost of credit issues continue to be an obstacle to firm investment plans. There is also considerable uncertainty surrounding the sustainability of the global economic recovery and export firms are likely to remain cautious on new investment plans until it is clear that the outlook for international demand is more stable. There is obviously a limit, however, to the timeframe for which firms can postpone replacement and modernisation of equipment and machinery and following three years of falling investment we anticipate some recovery in firms' investment plans in 2011.

Following a continued rapid decline of the investment sector of the economy in 2010, we expect to see a turning point in 2011. Average annual investment will still fall by a couple of percent next year but the latter part of the year should see the recovery take hold, leading to growth of about 4% in 2012. Total building and construction investment will drop by a

Investment

Annual % change

	2009	2010	2011	2012
Building & construction	-34.9	-28.0	-9.1	0.0
Plant & machinery	-19.3	-5.0	10.0	10.0
Total	-31.0	-21.2	-2.3	4.0

Table 4

further 9% in 2011 before stabilising in 2012, while investment in machinery and equipment is forecast to grow by 10% in both 2011 and 2012

Exchequer finances

The costs associated with the banking sector rescue, while a regrettable extra burden, have to some extent detracted attention from the more positive news to be gleaned from Exchequer statements. Numbers for the first three quarters of the year show that the Government's plan is working: both revenue and expenditure have come in according to the department's estimates and the deficit in money terms, excluding the banking rescue, is in line with projections.

The Exchequer had, by the end of September, collected €22 bn in tax revenue – only a 0.2% shortfall on the target. Looking beyond the headline numbers, we see that customs is up 15.1% on profile, corporation tax is up 12% and capital gains is up 10.4%. VAT and excise are broadly in line with expectations, a positive given the concerns around the domestic sector of the economy. Income tax is down 4.4% on profile, reflecting a somewhat weaker than anticipated labour market.

Given that economic activity has continued to decline this year, most tax headings are down on the revenue collected in 2009. Overall, revenues are down 6.5%, with income tax down 6.5% and VAT down 5.7%. The trend, however, has improved from the end of Q2, when total revenue was down 8.7%, income tax was down 8.6% and VAT was down 8%.

Expenditure is also broadly on target, with total voted expenditure down 2.5% on profile. Of this, current expenditure is running 0.4% above projections. Capital expenditure, however, is 24% below target, translating to a shortfall of €942 mn. Capital expenditure is lumpy by its nature, but spending in this area has been running below target throughout the year. IBEC has raised concerns over this shortfall, stating emphatically that Government must continue to invest in productive infrastructure, thereby enhancing Ireland's growth potential and providing some stimulus for the domestic sector

Exchange rates

The IMF sounded a warning in early October about the damaging effects of a global currency war. The prospect of a second round of quantitative easing by the Fed, in an effort to keep deflation at bay and stimulate the economy, has led to a weakening of the dollar exchange rate relative to other currencies.

Previously, the matter was limited to posturing between China (reluctant to let its currency appreciate) and the US (keen to stimulate the economy and receive a boost from net exports), but has now escalated beyond these two. Emerging economies are resorting to capital controls in a bid to prevent their currencies from rising. Brazil has doubled the tax on foreign investment in its bonds and Thailand has introduced a similar tax where investors were previously exempted.

The euro has risen by 16% from its June trough of $1.19 and at the time of writing was trading at $1.40, only barely below the most recent peak of $1.41. The ECB appears unwilling to follow the Fed and the Bank of England to further monetary easing; indeed, the most hawkish ECB members want to withdraw existing supports and begin raising interest rates. This is likely to put upward pressure on the euro exchange rate, making life more difficult for exporters in the region. This is turn will dampen eurozone growth. Indeed, EU Commissioner for Monetary and Economic Affairs, Olli Rehn, has said that "if the euro continues to bear a disproportionate burden in the adjustment of global exchange rates, the recovery of the euro-area economy might be weakened".

The euro exchange rate relative to sterling, of course of particular significance for Irish indigenous exporters, appeared to be on a helpful trajectory in the second quarter of the year, declining from £0.91 in March to £0.81 in June. Some of that gain has now been reversed and sterling at the time of writing was trading at £0.88. Moreover, sterling looks likely to remain at fairly weak levels, given the prospects of further monetary easing by the Bank of England and budgetary austerity imposed by the government. This will have an adverse impact on Ireland's growth prospects, as we discuss in the first section of the newsletter.

The divergences in exchange rate forecasts are unusually large at this time, reflecting uncertainty in the global environment. While some commentators had anticipated that, taking account of economic fundamentals, the euro would reach parity with the dollar in the next year or two, this now looks far from assured. Ultimately, the factors that would drive the euro exchange rate down are far from desirable: sluggish growth and renewed concerns about peripheral countries' fiscal positions.

Exchange rates

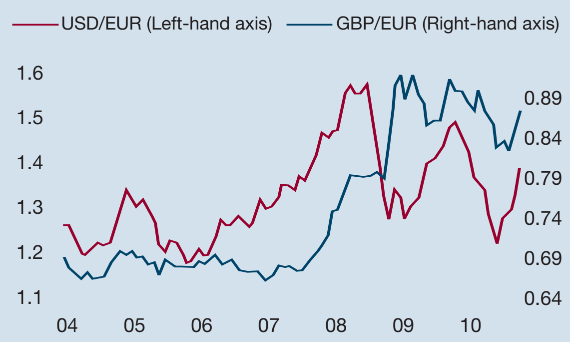


Figure 5

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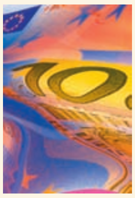

International

The strength of the global recovery has surprised on the upside during 2010. However, progress will continue at differing paces across regions, the IMF stated in its October World Economic Outlook. Emerging Asia is outperforming advanced countries, where the recovery has been subdued in historical terms. The IMF projects world GDP growth of 4.8% in 2010, slowing to 4.2% in 2011. Risks to the forecasts remain on the downside and challenges of stimulus withdrawal without damaging the fledgling recovery in the short term and global rebalancing in the medium term are daunting.

US

The US economy is recovering, but growth slowed in Q2 2010 and is set to decelerate even further in coming quarters. Consumer spending, the biggest component of US GDP, has remained weak, owing to deterioration in household net worth; higher savings needed to rebuild balance sheets; tighter credit; and higher unemployment. In contrast, private investment has rebounded strongly and firms have also been able to increase productivity. Though a double-dip recession is not the central forecast, the pace of growth will be slower than in previous recoveries. IMF projects that GDP growth will slow from 2.6% in 2010 to 2.3% in 2011. With considerable spare capacity in the economy and growth below potential, unemployment is set to remain high. Risks are to the downside; the real estate market remains fragile and consumer price deflation cannot entirely be ruled out, though the Fed is prepared to use quantitative easing to reflate the economy. The most significant medium-term challenge is to stabilise the public debt, a task that goes beyond the administration's existing fiscal plans.

Euro area

The recovery in Europe has been highly uneven. Sharp divergences are emerging between Germany, benefitting from rising exports, and peripheral countries. Germany in the second quarter posted the highest growth rate since reunification. Growth, largely driven by a resurgence in world trade, is likely to slow in the second half of 2010 and into 2011, as growth in trading partners becomes more muted. In France, withdrawal of fiscal stimulus coupled with continued high unemployment is weakening consumer spending. The electorate is resisting an increase in the pension age; this is just one indicator that the government will find it difficult to meet its fiscal targets. Italy is benefitting from a revival in its industrial sector, but consumer spending remains weak. Fiscal tightening will weaken private demand further and a rising euro will put exports under pressure; all of this translates to a subdued recovery, with some risk of a double-dip. Spain, Greece and Portugal all face significant challenges in restoring balance to public finances and fiscal tightening will drag on growth in these countries.

UK

The UK economy grew strongly in Q2, but growth is weakening sharply. Recent manufacturing, construction and services sector surveys all point to a slowing pace of expansion. If more negative news about the economy materialises, the Bank of England is likely to embark on another round of quantitative easing. Domestic demand is set to remain weak, given the drag from fiscal contraction. Employment expanded fairly rapidly during the summer, but this is likely to slow together with GDP growth; a weaker labour market will squeeze consumer spending further. Companies' expectations about exports are also weakening and given strong import growth, net exports have not added to GDP. The kind of import substitution that might have been expected to arise given the weaker currency has failed to materialise and the UK may have a capacity constraint in the ability to produce the kinds of goods consumers and firms source from abroad.

Real GDP growth – selected countries

Annual % change	2010	2011	2015
Euro area	1.7	1.5	1.7
UK	1.7	2.0	2.6
Germany	3.3	2.0	1.3
France	1.6	1.6	2.1
US	2.6	2.3	2.6

Table 5

Source: IMF forecasts, October 2010.

Happy Retirement David Croughan

Following 34 years of service, David Croughan retired from the role of IBEC's Chief Economist during October. David had edited this publication for much of that time and was a prominent figure in national economic debate. He also played a key role in leading the euro changeover initiative and is highly regarded for his work at a European level. We are sure you will join with us in wishing David every happiness on his retirement.