Quarterly
ECONOMIC OUTLOOK
IBEC
October 2011

Growth outlook justifies sticking to fiscal plan

Ireland benefited from a number of very positive economic developments over the summer months and our international reputation has consequently strengthened considerably. Unfortunately, it is now the economies of our main trading partners which are of greater concern as the risks surrounding the economic outlook have heightened in recent months. It is likely that demand from the eurozone will be weaker than hoped for but the latest evidence suggests that Ireland's export performance can remain robust through a combination of stronger market share and success in new markets.

The economy performed better than most expected in the first half of this year, largely on the back of another very strong period of export growth. The international markets have been pleasantly surprised that Ireland has succeeded in delivering economic growth despite the scale of the necessary austerity. The reduced interest rate charges on our international loans have also been a major fillip and have helped change the market perception of Ireland's debt sustainability. This combination of the more positive growth story and lower interest rates has meant that Ireland is no longer perceived as a state facing insolvency. Government must now build on this momentum by delivering a growth strategy for the economy which will drive domestic recovery to match that in the export sector. It is only through a balanced economic recovery that we can begin to make serious inroads into the unemployment crisis.

€3.6 bn will do

The first necessary step in supporting stabilisation and ultimately recovery in the domestic economy is the correct calibration of the fiscal adjustment. There has been much discussion recently on the merits of Government going beyond an adjustment of €3.6 bn in Budget 2012. The austerity hawks argue that doing more will win us favour in international markets and provide a cushion against the risk of missing the deficit target due to slower economic growth. IBEC agrees that it is essential that Government reaches the 8.6% budget deficit target for 2012 but the latest evidence suggests that we remain on track to do so and that a larger Budget package risks further damaging the fragile domestic economy. This in turn will result in even weaker consumer spending, lower GDP growth and a more challenging task in correcting the public finances. The economy has managed to grow this year despite substantial austerity but there is now a real risk that increasing the Budget 2012 adjustment beyond the planned amount could in fact be counter-productive. By 'sticking to the plan' on the scale of adjustment and doing it in such a way that is less damaging to growth i.e. no income or business tax increases, Government could provide a much needed boost to consumer and business spending plans for next year. A higher than planned adjustment will undermine the credibility of the Government's new four-year plan before the ink has even dried and immediately negate any of the potential certainty benefits which it hopes to generate.

Economic outlook

Economic growth will lose some momentum in the latter part of this year as consumer spending and exports soften in the wake of more uncertain international economic prospects. Crucially, the greatly improved competitive position of Irish exporters will mean that export growth will be maintained and the economy will still grow in the second half of this year, albeit at a slower pace than in the first half. We expect GDP growth to average 1.4% for 2011. Looking to next year, Ireland remains on target to outperform the growth prospects of many of our trading partners. Exporters will continue to grow market share and win new business, meaning that exports will again make a strong contribution to economic growth. Crucially, the drag from the investment sector of the economy on growth is coming to an end and 2012 will see the first positive growth contribution from investment since 2007. Lack of spare capacity means that firms will invest more in machinery and equipment, while the construction sector will reach a floor next year. GDP is forecast to grow by over 2% next year.

As we detail in subsequent sections, there is considerable pent-up demand in Irish households. It is true that a significant cohort will be stifled by their debt burden for some years yet, but there are other large cohorts, particularly some older age groups and younger people without mortgage debt, who are over-saving and have the capacity to revert to more normal spending and saving patterns. A normalisation of consumer behaviour holds the key to recovery in the domestic economy. There are a range of policy levers which Government can use to ensure that this happens sooner rather than later and Budget 2012 presents the opportunity to deliver some of these innovative measures.

Economic growth

Economic growth in the first half of 2011 was well above consensus and official expectations but was largely in line with IBEC's previous forecasts. Seasonally adjusted GDP grew by 1.9% in Q1 and 1.6% in Q2. The export performance was exceptionally strong in the first quarter - recording a quarterly growth of 3% - and although the rate of growth slowed somewhat in the second quarter, export volumes still expanded by 1%. In annual terms, goods exports grew by 5.4% in the first half of the year while the volume of services exports was up 5.6%. The sectoral spread of the continued export recovery was also more even than in 2010, as many of the non-modern sectors recorded solid growth. The food and drink sector had an exceptionally strong performance and this more broad-based improvement in the export performance augurs well for a continued contribution from exports to GDP growth over the coming quarters.

Consumer spending remains the major weak spot in the economy and on an annual basis it fell by over 2.5% in the first half of the year. It performed somewhat better than expected in the second quarter but this was most likely due to a spike in car purchases prior to the ending of the car scrappage scheme. Other more timely indicators such as the consumer sentiment index and the latest retail sales data suggest that consumer spending has remained weak and is likely to decline by about 2% this year.

Overall, our growth forecasts for 2011 remain largely unchanged from the last time out. The strong momentum in the first half of the year provides a sizeable carry-over effect and despite some slowing of exports as a result of the renewed uncertainty in the international economy, GDP growth is forecast to average 1.4% for the year.
A disappointing feature of the recent economic performance has been the more negative than expected GDP deflator. This negative price effect in economic output has meant the nominal or 'money size' of GDP has been worse than expected. The lower-than-forecast nominal level of GDP directly impacts on the deficit reduction target and has been a concern for Government. Factors such as higher energy import costs and a stronger than expected euro against the dollar contributed to the negative deflator but it is somewhat surprising that the weaker nominal GDP has not impinged on tax revenue forecasts. A silver lining in the recent escalation of the eurozone crisis is that a weaker euro exchange rate will help boost Ireland's export values as a large share of exports by the multinational sector are priced in dollars.

The ongoing slowdown in the eurozone clearly presents a risk to Ireland's growth outlook but we believe a number of factors point towards further GDP recovery in 2012. Firstly, while international demand has clearly slowed in recent months Irish exporters appear to be weathering the storm so far, largely due to an improvement in market share. Secondly, exports are dominated by sectors such as healthcare and food which tend to prove relatively resilient in a downturn. Finally, while activity in the eurozone has slowed sharply, the US economy is likely to hold up better than expected by many and this will help support the strong FDI performance of recent years.

GNP and its components

Annual % change

	2010	2011	2012
Consumer spending	-0.8	-2.0	-0.5
Government spending	-3.8	-3.5	-4.0
Investment	-24.9	-7.5	6.8
Exports	6.3	5.0	4.5
Imports	2.7	2.1	2.8
GDP	-0.4	1.4	2.4
GNP	0.3	0.4	1.6

Table 1

Business outlook

The Q3 IBEC Business Sentiment Survey showed that Irish companies have remained optimistic about the outlook for trading conditions, despite the crisis of confidence that has hit the eurozone. Managers' perceptions about the current overall business environment in Ireland improved to -13 from -17 in Q2, while the three-month forward-looking index increased to -11 from -13 in Q2. (A positive balance indicates that more firms have a positive rather than negative outlook.) Interestingly, sectors with high concentrations of multinational firms view the overall business environment more positively than those where indigenous firms dominate. Managers' confidence in their own business also improved in Q3; the current conditions index rose to +17 from +14 in Q2 and the forward-looking indicator to +19 from +17.

The outlook for customer base in the coming three months improved sharply to +26 from +19 in Q2 and +8 in Q4 2010. This indicates that Irish exporters are winning customers

IBEC business confidence indicator

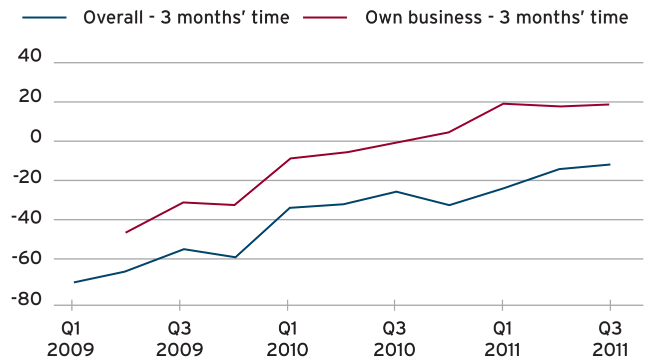

Figure 1

and market share, thanks to significant improvements in competitiveness. Export sales expectations remain very strong at +31. Although this is down from an exceptionally high peak in Q1 this year, the index, now at the same level as in 2010, continues to point to robust export growth. The index for employment expectations is at balance, for the first time since the series began in 2009. Almost 25% of companies plan to hire more staff in the next three months and are quite upbeat about employment expectations, though sectors with a weaker activity outlook plan on further reductions in staff numbers.

Consumer spending

Following relative stabilisation in 2010, consumer spending has resumed a downward trajectory during 2011. National accounts show that the volume of consumer spending fell by 2.7% in the first half of the year. However, in contrast with 2009 and 2010, the value of sales is holding up slightly better than volume, falling by 1.9%. This renewed weakness is likely caused by the combination of tax hikes at the start of the year and renewed decline in consumer confidence as a result of the EU/IMF loan deal.

The seasonally adjusted data appear, at first glance, to paint a slightly more positive picture. The volume of sales fell by 1.9% quarter-on-quarter in Q1, but grew by 0.3% in Q2. Likewise, value fell by 1.2% in Q1 but recovered by 0.7% in Q2. However, the more positive outturn for Q2 was almost entirely due to an upsurge in car sales, ahead of the scrappage scheme expiry. It is therefore likely that the Q2 gains will be reversed in the Q3 figures.

The ESRI/KBC Consumer Sentiment Index weakened in September for the fourth consecutive month. The current conditions index has remained relatively stable, but the index of consumer expectations, which measures consumers' perceptions of future financial, economic and employment outlooks, has deteriorated sharply.
The ongoing eurozone turmoil and possible concerns over Budget 2012 seem to be reflected in Irish sentiment.

Consumer spending and retail sales

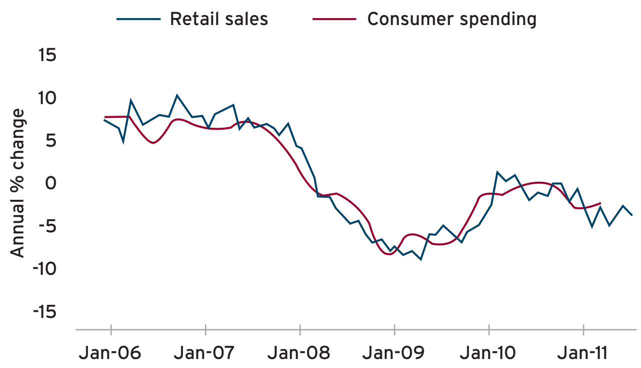

Figure 2

We have held our consumer spending forecast for 2011 virtually unchanged at -2%. However, our view for 2012 is now more negative at -0.5%. The halting (and possible reversal) of ECB interest rates increases is positive for disposable incomes. Fragile sentiment, rising energy prices, a weak labour market outlook and the impact of austerity budgets means that the outlook for the consumer market remains bleak.

Despite the hits to disposable incomes, the savings ratio remains high and we believe there are some consumer segments that may be 'over saving'. On the next page we detail some suggestions that Government should act on to bring forward consumption decisions.

Investment

Falling investment has been a major drag on economic output over the course of the recession. In fact, if the collapse in investment had not occurred Ireland would most likely not have experienced falling GDP at all. Prior to the recession, investment accounted for an exceptionally large share of GDP (22%), while the drop in activity (-53%) over the past three years has been unprecedented for a developed economy. Following a fall of 29% in 2009 and 25% in 2010, the pace of decline has moderated somewhat in 2011 but total investment will continue to have a negative impact on growth this year.

Investment in Q1 2011 was down 9% annually compared to a fall of 29% in Q1 2010. While the rate of decline picked up a little again in the second quarter, during the first half of 2011 output dropped by 12%. Housing and commercial property investment continues to see a sharp reduction while investment in equipment and machinery has shown a significant improvement. New housing activity was down 24% in the first half of the year and investment in commercial property dropped by a similar percentage. It is clear that the construction sector remains very fragile and the recent PMI for the sector points to some further contraction over the coming months.

New house completions for 2011 are forecast at about 10,000 units with a similar level of activity planned for 2012. There are few, if any, scheme projects currently active and the vast bulk of new housing activity is confined to the one-off sector. The sharp fall in mortgage lending (it is down by circa 90% from the peak) means that the transaction volume remains exceptionally low and without an increase in transactions unsold stock will not be moved. The housing overhang is therefore likely to remain for a number of years but demand for new housing is likely to re-emerge in major urban centres such as Dublin much quicker than in other regions. It is likely that considerable pent-up demand has developed in some urban areas in particular and once purchaser confidence and more normal mortgage lending conditions return, the level of housing transactions could quite rapidly reach 40,000 units or so. Over the medium-

Measures to stimulate the domestic economy

The strong export performance will result in GDP growth this year for the first time since 2007, and is resulting in some job creation. To achieve balanced economic growth and make serious inroads into reducing unemployment, it is, however, essential that the improvement in export activity is matched by a recovery in domestic demand.

At present, individuals are postponing consumption and investment decisions that, once unlocked, will provide a substantial stimulus for the domestic economy. The wealth stock in Ireland remains high, particularly in older age cohorts. The savings ratio has increased substantially since the onset of the recession to 13% at the start of 2011. While some of the increased saving is directed towards debt repayment, many householders have also increased their precautionary savings. The younger age groups are in many cases likely to be saving to buy a house.

An improvement in sentiment is a prerequisite for consumer spending returning to a more normal state, but there are, nonetheless, a number of fiscally neutral policies Government can pursue in order to stimulate domestic demand. IBEC has identified five specific policy areas which Government should address to bring forward consumption and investment decisions; tap into the wealth stock; and normalise the savings ratio:

Economic communication and budget policy: uncertainty about the economic outlook greatly reduces consumer confidence and spending and is exacerbated by inaccurate and misleading claims made about the Irish economy. Government needs to have a clearer strategy and operational process for targeting communication on the economy directly at the concerns of consumers. In particular it needs to be more effective in countering the often very damaging inaccuracies of some domestic and international economic commentators. As a matter of urgency it needs to address issues such as Ireland's debt sustainability. A more effective economic communication strategy should involve greater input by independent third parties such as the new Fiscal Council or the EU/IMF.

Effective communication around the new four-year plan for the public finances will also have a significant impact on consumer confidence. It is crucial that this plan clearly sets out the detailed household budget impacts of all planned fiscal policy measures. The scale and the detail of the budget measures will have a significant impact on consumer spending over the coming years. It is essential that all measures are stress tested against their impact on both employment and domestic demand.

Pensions: despite the turbulent market conditions of recent years, Irish pension funds are currently worth about €70 bn, largely invested outside of the state. Many of the individuals who put substantial contributions into AVCs or personal pensions during the boom years are now in more difficult financial circumstances and may wish to draw down a portion of their pension pots to either pay down debt or fund their living expenses. Government should therefore allow a period of three years during which up to 25% of the value of AVCs and personal pensions could be drawn down without penalty and at the standard rate of tax. Short-term changes to pension rules should also be made to allow drawdowns for major life events such as home purchase or coping with unemployment.

Social welfare retail and services payment card: Government should introduce a payment card for some social welfare payments, piloting the approach on child benefit payments, which currently costs the Exchequer €2.2 bn. It is likely that a sizeable percentage of the €2.2 bn is not spent on goods and services in the state, being either saved by middle and upper income families or repatriated by EU nationals working in Ireland.

Government should reform the scheme by offering a voucher payment (using a retail and services payment card). In order to encourage take-up of the payment card the value of cash benefits should be reduced by 25%. This would result in a substantial net saving for the Exchequer, as not all recipients would take up the payment card option. There will also be an upside for consumers; some retail sectors will be able to offer additional incentives to customers using the payment card.

Property transactions: the property market has effectively frozen over the past few years. In a normal market about 40,000 mortgages would be issued per year - four times the current rate, but half of the peak level. Each property transaction results in spending of about €20,000 on professional services, furnishings and home improvements. A normalisation of transactions in the market would therefore generate about €600 mn per year directly for the domestic economy, bringing substantial economic and employment benefits.

Government should introduce a suite of policy measures which would create a two-year window of opportunity for home purchases. Purchases during this time should gain exemptions from any new property tax and Government should pre-announce an increase in stamp duty. Government should also immediately roll out a national house price database to improve market transparency and reduce buyer uncertainty and ensure adequate supply of mortgage credit by the state-controlled financial institutions.

Home improvements: the home improvements sector is currently valued at about €2.2 bn - about the same as the new home building sector. A 30% increase in activity would generate thousands of jobs and would directly yield some €100 mn to the Exchequer - with further substantial indirect or multiplier benefits. To incentivise older age cohorts with high savings levels and younger age groups who are unable to move house due to negative equity to invest in formal-economy home improvement works, Government should introduce a home improvement tax credit for work carried out by tax compliant contractors.

Investment

Annual % change	2009	2010	2011	2012
Building & construction	-31.1	-30.3	-17.3	0.0
Plant & machinery	-19.7	-14.5	8.0	15.0
Total	-27.6	-24.9	-7.5	6.8

Table 2

term, the demographic position would indicate that house completions of close to this order would also be required.

A significant overhang also remains in the commercial property sector and activity levels continue to weaken. The sector is also likely to see a variable recovery with demand for retail property likely to be subdued for a considerable period, while activity in the prime office space market may return relatively quickly. The past year has also seen a sharp decline in the public capital investment programme due to the completion of a series of major infrastructure projects during 2010. The outlook for Exchequer funding for capital investment is uncertain and unless Government can secure financing through its NewEra initiative few projects of scale will commence over the next couple of years.

IBEC has flagged for some time that the strong recovery in exports was likely to result in a pick-up in investment by firms in machinery and equipment. This transpired in the first half of 2011 as Irish businesses responded to improved trading conditions and limited spare capacity. Firm investment in equipment and machinery was up 7% in Q1 and 4% in the first half of the year. Despite renewed concerns about the global economic recovery and the tight availability of credit, the outlook for business investment remains positive as Irish exports will record another year of strong growth in 2011. We expect investment in machinery and equipment to grow by 8% this year and by 15% in 2012.

The sharp fall in investment activity is now slowing and the sector is unlikely to have a downward impact on overall GDP from 2012 onwards. We expect construction activity to flatten off during 2012, while greater investment by firms in plant and machinery is likely to result in some growth in investment activity in the coming years. Following a further decline in investment of about 8% in 2011, we are forecasting growth of 7% for next year.

Labour market

The pace of job losses is slowing, according to Q2 labour market data from the Central Statistics Office. On a seasonally adjusted basis, employment fell by 3,200 compared with Q1. This is less than half the number of jobs lost in the first quarter and the smallest drop since Q1 2008. Q2 was also the third consecutive quarter that employment was falling at a slower pace, indicating that the labour market is beginning to stabilise.

On an annual basis, employment fell by 37,800 or 2% in Q2. This is a slowdown on Q1, when 53,400 jobs were lost, translating to a decline of 2.9%. Overall, we expect the fall in employment to average about 1.5% in 2011, returning to marginal growth of 0.9% in 2012.

A great deal of variation underlies the aggregate numbers. Of the 14 sectors classified in the Quarterly National Household Survey, 8 added employment in Q2 relative to Q1. This is the largest number of individual sectors adding jobs since Q1 2008. Crucially, job gains are primarily concentrated in the private sector. Health was the only area related to the public purse adding jobs in Q2.

Hotels and restaurants added 4,600 jobs in Q2. Although employment continues to fall on an annual basis, the quarterly upturn indicates that job numbers in the sector may well be very responsive to the improvement in visitor numbers. Other areas to post employment gains in Q2 were information and communication, administrative and support services, financial services (likely in international firms), transportation and storage and, somewhat surprisingly, retail and wholesale trade.

Given the weak retail sales data, and the more positive outlook of wholesalers evident in the IBEC Business Sentiment Survey, it is likely that the job gains were in the latter rather than former. Agriculture has also been adding jobs over the past few quarters, showing growth on an annual basis. The outlook is relatively benign given wider developments in the sector, such as the forthcoming removal of milk quotas.

Job losses continue, nonetheless, in the sectors most affected by the recession. Construction employment has yet to stabilise and in Q2 lost 19,600 jobs relative to Q2 2010. Though the pace of decline is slowing, this is still significant and accounts for over a third of the total number of jobs lost

Employment

000s annual average	2009	2010	2011	2012
Agriculture	96	85	88	90
Industry	411	360	335	335
Services	1,422	1,403	1,397	1,411
Total	1,929	1,848	1,820	1,836
Unemployed	259	292	296	278
% Unemployed	11.8	13.6	14.0	13.2
Labour force	2,187	2,140	2,116	2,114

Table 3

in the year to Q2. Unfortunately, the recovery in output has yet to translate to employment gains in industry, which continued to lose jobs both on a quarterly and annual basis.

The seasonally adjusted unemployment rate in Q2 was 14.2%, up from 13.8% in Q1. The most recent monthly data indicate a stabilisation; in September the Live Register measure of unemployment was 14.3%. The long-term unemployment rate remains high at 7.7% in Q2, up from less than 1.5% before the crisis. In total 300,000 were unemployed in Q2, of which 164,000 had been unemployed for more than a year.

Prices and wages

Global commodity prices and higher mortgage interest rates resulted in an increase in the Consumer Price Index (CPI) during the first half of 2011. Inflation, as measured by the CPI, averaged 2.3% in the first quarter and 3.0% in Q2. The monthly observations on the CPI have since moderated somewhat and are likely to fall further during the remaining months of the year and into 2012.

Inflation has spiked sharply across developed economies over the past 18 months or so. Inflation in the eurozone is currently running at 3.0% and is expected to average about 2.5% this year. The weakness of sterling has resulted in higher import costs in the UK with its inflation rate expected to average over 4% for 2011. Higher prices for food and energy have been the main cause of inflationary pressures, while relatively high inflation over recent years in the large exporting emerging economies has also meant that goods imports by developed countries no longer have such downward pressure on prices. Global inflation, however, is expected to slow sharply during 2012, largely due to slower economic growth and stabilisation in commodity prices.

In Ireland, almost all of the inflation experienced during the past year has been due to either imported commodities or higher mortgage interest payments. Fuel prices have jumped by 15% in the past year while the mortgage interest component of the CPI has increased by 17%. The CPI excluding energy and mortgage interest has increased by just 0.6% in the past year. The weakness of domestic demand has meant that there has been little or no inflation in domestic goods and services. Indeed the internationally comparable measure of inflation - the Harmonised Index of Consumer Prices (HICP) - shows that inflation in Ireland, at just 1.3%, is the lowest in the EU and about half the eurozone average.

Despite relatively high inflation internationally, the outlook for price developments in the Irish economy remains fairly benign. High commodity prices are currently in the process of moderating and core inflation in developed economies has remained well behaved. Domestically, it is likely that mortgage interest costs should subtract rather than add to the CPI during 2012. The market consensus is that the ECB will deliver two interest rate reductions over the next six months or so and this will have an immediate and direct impact on the cost of tracker mortgages. The lower ECB rates and pressure from the Financial Regulator will mean that variable rates are also less likely to rise in 2012.

We expect the CPI to continue to moderate over the coming months and for the increase to average about 2.5% for 2011 with the HICP increase averaging 1.2%. Our 2012 forecast for the CPI inflation rate is 1.5% and about 1% for the harmonised rate.

Average wages in the private sector have fallen by close to 5% over the duration of the recession. In those companies where pay cuts were implemented, they primarily occurred in 2009 and 2010. Most businesses froze pay during 2011 but some pay reductions were again implemented and the average change to wages was a drop of 0.2%. A small number of companies delivered pay increases in 2011, predominantly in the high tech export sector.

IBEC's Quarterly Business Sentiment Report of over 400 companies provides a comprehensive assessment of companies' pay plans for 2012. The Q3 survey conducted in September was done at a time when most companies had completed their first solid assessment of pay patterns for next year. It shows that continued economic uncertainty and the need for Irish business to regain further competitiveness, means that the vast majority (64%) of employers plan to freeze pay rates again in 2012. Less than one in three businesses envisage pay increases and the average increase in these firms will be 2%. Reflecting the severe trading conditions still faced by many businesses, 5% of firms reported the need to seek pay reductions in 2012. The average expected change to wages for 2012 is forecast at a marginal increase of just 0.3%.

Over the past three years Ireland has regained about half of the labour cost disadvantage which it had against its EU-15 competitors. Continued lower inflation and firm expectations for wage developments for 2012 augur well for further

Inflation forecasts

2011	Quarter	Year-on-year	Annual average
March	1.7%	2.3%	2.5%
June	0.7%	3.0%	
September	0.1%	2.4%	
December	0.0%	2.4%	
2012			
March	0.5%	1.7%	1.5%
June	0.6%	1.0%	
September	0.5%	1.7%	
December	0.0%	1.6%	

Table 4

competitiveness improvements over the coming years. This significant improvement in our competitive position is remarkable within a common currency and has paved the way for continued recovery in Ireland's export performance.

Public finances

September Exchequer returns continue the trend of the year so far, with tax revenues slightly ahead of target and expenditure falling slightly faster than planned. The underlying Exchequer deficit, excluding bank recapitalisation costs, fell by €2.5 bn - or almost 20% - relative to the first nine months of 2010. Crucially, Ireland continues to meets its commitments under the EU/IMF loan agreement. A positive outturn for 2011 will also mean that the base on which the 2012 target is set will be more favourable.

The positive tax receipts were largely thanks to capital gains coming in substantially above profile. Corporation tax came is slightly below profile; however, Q4 is the significant period in terms of corporation tax receipts with nearly half of all expected corporation returns due over the period. Income tax is broadly in line with estimates, reflecting the stabilisation in the labour market.

VAT was 3.6% under target for the year to September. While this points to ongoing weakness in the domestic economy, the shortfall is also in part explained by the reduction in the lower rate of VAT for goods and services related to the tourism and hospitality sector that came into effect in July. The measure, not included in the profile against which receipts for the current year are measured, is expected to cost €120 mn this year, but will be offset by revenues from the pension levy.

Overall expenditure was 2.2% less than budgeted. Current expenditure came in 1.5% under the target, which is very positive. We are, however, concerned over the emerging shortfall in capital spending, which was 11.3% less than planned. The capital budget has already taken significant hits and we worry that excessive cutbacks will damage Ireland's competitiveness and productivity in future years.

Exports and exchange rates

Irish exports continued to grow strongly in the first half of 2011, up 5.5% on the first six months of 2010. This was balanced between goods, up 5.4% and services, up 5.6%. Growth slowed slightly from an annual 6.1% in Q1 to 4.9% in Q2, but nonetheless the pace remained very robust. The second half of 2011 will be more challenging for exporting firms, given the slowdown in global demand. However, due to recent competitiveness gains any slowdown will be tempered by the ability of Irish firms to win new customers and capture market share. Data from the IBEC Business Sentiment Survey show that exporting companies remain confident in their outlook for export sales. Overall, we expect exports to grow by 5% this year, with strong performance continuing into 2012 with growth of 4.5%.

More detailed monthly data show that the export recovery has been broad based and all major commodity groups posted gains on the first half of 2010. The food sector in particular has performed exceptionally strongly; the value of total food exports was up 17%, with dairy up 42.3% and meat up 12.2%. Within the modern sector, chemicals exports were up 10.9%, with the important pharmaceutical sector up 14.4%. Exports to all major trading partners increased over the period with the only major decline occurring for Spain, to where exports are down 15.5%. The balance of payments data show that the increase in services exports was mainly concentrated in business services and particularly computer services, which are up 15%.

The value of imports was up 9% in the first half of the year, with over half of this arising from an increase in producer capital goods and materials used in production; the recovery in imports therefore reflects greater firm investment and expanding output. In spite of increased imports, the value of Ireland's trade surplus was €21.3 bn in the first six months of the year, up 9% on 2010. This is the third highest trade surplus in the EU behind the Netherlands and Germany.

The euro weakened to a ten-year low against the Japanese yen in October and against the dollar in August and September. The exchange rate relative to the dollar hit a nine-month low of $1.32 in early October, but is, at the time of writing, trading at about $1.37 - around the level seen in Q1 2011. Although we believe that the euro is overvalued relative to its equilibrium price, the ebb and flow of the eurozone crisis makes any short-term currency predictions particularly precarious. Despite concerns about the eurozone, sterling has remained relatively stable against the euro as the UK struggles to come to grips with a sluggish economy. The Bank of England extended its quantitative easing programme by £75 bn to £275 bn in a bid to boost lagging growth, which could lead to a further weakening of sterling.

Exchange rates - monthly averages

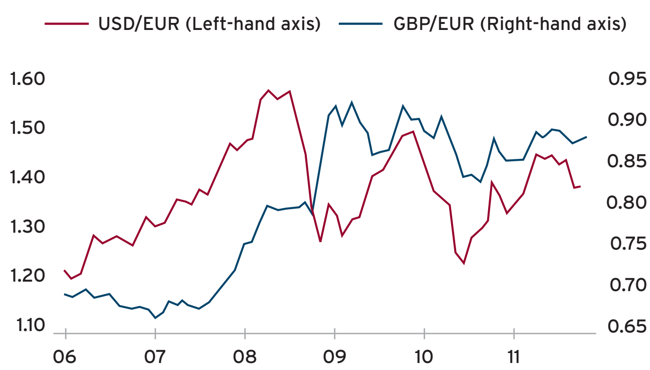

Figure 3

International economies

Uncertainty over the outlook for the global economy has increased; the third quarter of the year proved very turbulent as activity slowed and risks to growth heightened. Advanced economies continue to suffer from a lack of confidence and the threat of contagion in the eurozone has created volatility in global markets as investors worry about sovereign debt levels. Growth in emerging economies continues to be strong and will remain the main driver of global growth. The slowdown in demand has affected export-oriented countries such as Taiwan and Malaysia, but strong domestic demand ensures that growth in emerging economies remain on target. Concerns of overheating have eased slightly as tightening measures by monetary authorities have gradually moderated growth in Asia and Latin America.

United States

The first half of 2011 proved disappointing for the US economy, with annualised growth averaging only 0.9%, the slowest in more than two years. The outturn for Q1 was particularly weak at just 0.4% annualised, but this was in part due to temporary factors such as adverse weather, the rise in commodity prices and a disruption to manufacturing due the effects of the earthquake in Japan. Growth picked up in Q2 to 1.3% on the back of increased investment and exports. Household spending remained weak and continues to be the biggest domestic factor curtailing growth. High unemployment at over 9%, slow wage growth, falling house prices and high levels of household debt all weigh on consumer incomes and spending. Overall, the US economy will continue to grow during the latter half of 2011 and in 2012, but at a modest pace and below the potential capacity of the economy. Nevertheless, it looks in better shape to weather the current phase of the crisis than the eurozone.

United Kingdom

The UK recovery has proved more anaemic than initially predicted and quarterly growth came in at just 0.1% in Q2. The main drivers of the weak performance were consumer spending, which contracted by 0.8%, the biggest drop in more than two years, and a 1.2% decline in industry. Inflation increased to 5.2% in September, driven by food and energy prices, but should be close to peak. The unemployment rate reached a 15-year high of 8.1% in July and the outlook for the jobs market remains very weak. The UK manufacturing PMI came in above expectations in September and industrial production rose 0.2% in August, suggesting that the sector could make some contribution to growth in the coming quarters but it is likely to be fairly limited.

Eurozone

The sovereign debt crisis intensified with the admission from the Greek government that the deficit would reach 8.5% of GDP in 2011, well in excess of the 7.6% target agreed with the EU and IMF in July. The likely outturn for 2012 was also revised upward as the economy continues to contract sharply. Despite failing to reach agreed targets the next €8 bn tranche will be paid out, but subject to further austerity measures, including cuts to the public sector numbers and the introduction of a property tax.

The first half of the year was mixed for the wider eurozone economy. In Q1, output expanded by a robust 0.8% quarter-on-quarter, but growth slowed to just 0.2% in Q2, owing to a decline in consumer spending. Following a couple of months of slightly softer data, there was an improvement in eurozone industrial production in August, which grew by 5.3% year-on-year. German growth remained solid, and both Ireland and Estonia posted double-digit growth. Nonetheless, the sovereign debt crisis continues to cause uncertainty for the economic outlook and most of the leading indicators are now pointing to a sharp slowdown in European economic activity.

Real GDP growth - selected countries

Annual % change	2010	2011	2012
Eurozone	1.8	1.6	1.1
UK	1.4	1.1	1.6
Germany	3.6	2.7	1.3
France	1.4	1.7	1.4
US	3.0	1.5	1.8

Table 5

Inflation - selected countries

Annual % change	2010	2011	2012
Eurozone	1.6	2.5	1.5
UK	3.3	4.5	2.4
Germany	1.2	2.2	1.3
France	1.7	2.1	1.4
US	1.6	3.0	1.2

Table 6

Unemployment rate - selected countries

Annual % change	2010	2011	2012
Eurozone	10.1	9.9	9.9
UK	7.9	7.8	7.8
Germany	7.1	6.0	6.2
France	9.8	9.5	9.2
US	9.6	9.1	9.0

Table 7

Source: *IMF World Economic Outlook, September 2011*

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