QUARTERLY REVIEW
ECONOMIC TRENDS

IBEC

OCTOBER 2009

Correcting public finances needs firm resolve

It seems that the massive resources that went into the global fiscal stimulus and the monetary easing aimed at repairing the damaged financial sector have not been used in vain; following a dire first quarter the world economy is pulling out of the worst recession since the second world war and the major forecasting agencies have upgraded their forecasts for 2010. This is great news for an open economy such as Ireland. In Ireland, our worst fears may turn out to have been just a little overcooked; the fall in output in 2010 may not be as great as we first thought, down only 1.6%, and unemployment we think will remain below 14%; hopefully consumer spending has bottomed out after its worst collapse in history. The electorate gave a resounding YES vote to the Lisbon Treaty, which was a first major step in repairing our battered international reputation and ensured that the interest rates paid on our debt did not suffer a further premium charge.

But all is not right in Ireland – far from it – and painful corrective action must be taken which will be felt by everyone. The public finance deficit is unsustainably high, our excessively high cost structures have eroded competitiveness making our goods and services, once the most competitive in Europe, difficult to sell on international markets. The economy must undergo a restructuring of activity away from the predominance of catering to domestic demand to once again providing goods and services for the vast global markets. Only by undertaking the necessary structural reforms to achieve this will we prevent the surge in short-term unemployment transmuting into a problem of high long-term unemployment.

We believe that the current relatively short window of deflation must be seen as an opportunity to make progress on the major policy challenges of addressing our competitiveness difficulties and correcting the public finances.

Correcting the public finances is a top priority. Following a series of expenditure and taxation adjustments stemming from the middle of 2008 and culminating in the supplementary Budget in April 2009, the Government sought to contain the rising deficit on the general government balance. It targeted a deficit equivalent to 10.75% of GDP in 2009 reducing, with the approval of the ECB, to 3% of GDP by 2013. Despite large increases in taxation through the income levy, the September Exchequer returns have shown just how difficult raising revenue is in a depressed economy at a time of deflation. The Government accepts, only six months after the supplementary Budget, that tax revenue will undershoot by €2 billion and the deficit will rise to 12% of GDP. It is clear that another approach is needed, one that focuses more on current expenditure reductions than on the vain hopes of tax increases. It is imperative that Budget 2010 uses the opportunity of falling prices to reduce current expenditure. Nominal cuts in expenditure, including public sector pay and social welfare, in the upcoming Budget could be achieved without cutting real incomes and living standards. This opportunity must be seized.

Restoring competitiveness is crucial. Both the private and public sectors are in the same boat; the private sector must contain costs to survive and grow businesses and employment; the public sector must contain costs within the limits of tax revenue to avoid crippling taxation or unsustainably high debt levels. Extensive survey work of our members revealed that on average the total pay bill in private sector companies has decreased by 11% in 2009. Those companies facing the most difficulties, have cut the most. Of the 56% of companies that had reduced their pay bill, the average reduction was 21%. Private companies have achieved these pay reductions in a variety of ways – not all of them easily measured. Aside from wage rate reductions, some employees have accepted pay reductions by forfeiting shift premia; others have worked unpaid overtime; others have agreed to taking one or two days a month of unpaid leave. This has not only reduced pay levels but has also increased productivity. A large number of companies indicated that further pay reductions are needed in 2010. While not all private sector employees have experienced pay cuts, those working in businesses most affected by the recession have accepted substantial pay rate reductions of the order of 12% to protect their jobs.

Appropriate adjustments are needed in the public sector. The pension levy has is a contribution but the impact has been dissipated by the payment of increments. The ESRI study, *The Public-Private Sector Pay Gap in Ireland*, has found that the overall public sector pay premium was 26% in 2006.

Ireland has no option but to cut our cost and earnings levels closer to those of our trading partners. To think otherwise is to live in a parallel universe. As a society we need to agree a way to restore the competitiveness that earned us the high living standards and most importantly the full employment which until recently we enjoyed. Over twenty years ago social partnership successfully served this process; it could do again but that needs all the partners to face up to the realities.

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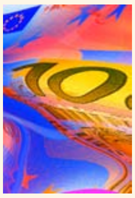


Output

There is little doubt now that the global economy is showing solid signs of recovery in the second and third quarters of the year, following a very weak first quarter. This is not surprising given the vast amounts of fiscal and monetary policy stimulus pumped into countries the world over. The data we have on the Irish economy suggest that the last quarter of 2008 and the first quarter of 2009 were the periods of most rapid contraction and the second quarter recorded a deceleration in the pace of decline. Using the less reliable seasonally adjusted figures, the positive signs were starker. Following two quarterly declines amounting to 7.9%, second quarter GDP stabilised; GNP fell by a quarterly 0.5% following two quarters of decline amounting to 9.1%. This is encouraging, given the near absence of stimuli in the Irish economy up to the middle of the year. Following a 3% decline in GDP in 2008, we estimate that GDP will fall by 7.5% in 2009 and by a further 1.6% in 2010. This is a somewhat less negative forecast from our previous Quarterly when we estimated the fall in GDP would be 8.4% in 2009 and 2.9% in 2010. Nevertheless, Ireland has suffered the worst decline of all developed economies and is likely to respond late to the general upturn in the global economy.

The Quarterly National Accounts relating to the second quarter contained some mixed news. The bad news was that the first quarter figures were revised further downwards to record an annual fall of 9.3% from a previous estimated fall of 8.5%; the fall in GNP was revised down to 13.1% from 12%. The good news was that there was a noticeable deceleration in the second quarter with the Central Statistics Office estimating the annual fall in GDP was 7.5% and for GNP 11.6%.

On the demand side, the huge drag on the economy, of course, has been the collapse of the building and construction sector. Data relating to the first two quarters of the year indicate housing continued to decline at annual rates of over 50% with only investment in house improvements showing some reasonably solid growth. Other building and construction, including commercial

GNP and its components

Annual % change

	2008	2009	2010	2011	2012	2013
Consumer spending	-1.0	-7.7	-3.0	1.5	2.0	2.5
Government spending	2.6	-1.0	-2.0	-2.0	-1.5	-1.0
Investment	-15.5	-29.4	-13.7	1.5	3.4	8.3
Exports	-1.0	-3.0	0.5	3.0	4.0	4.0
Imports	-2.1	-8.0	-3.0	2.3	3.2	3.4
GDP	-3.0	-7.5	-1.6	1.7	2.6	3.6
GNP	-2.8	-10.6	-2.1	1.5	2.4	3.5

Table 1

Economic growth

Seasonally adjusted

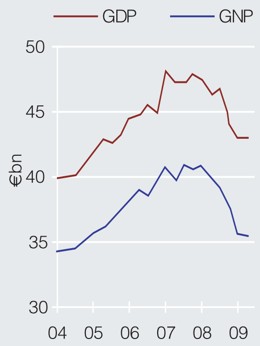


Figure 1

buildings showed some deceleration in the rate of annual decline from 28% in the first quarter to under 20% in the second. A concern is that investment in plant and machinery, excluding aircraft, remained very weak with an annual decline of 48% in the first quarter and 38% in the second. Our view is that building and construction output will fall by close to 20% in 2010 after a decline of 34% in 2009. No significant growth is expected until 2013.

Following the collapse of private consumption in quarter one, there were positive developments emerging for the second quarter. Consumer spending recorded an annual fall of 9.6% in the first quarter of this year. Second quarter figures recorded a deceleration in the decline to 6.8%. Evidence from retail sales in the June-July period suggest a further slight easing in the rate of decline and the KBC-ESRI Consumer Sentiment Survey has recorded slightly more positive expectations in recent months than at the start of the year. However, we do not see any return to consumer spending growth in 2010, which seems to partly account for some of the more bullish forecasts for 2010 and 2011. We believe there are still factors that will be a drag on buoyancy, including the tax overhang from increased taxes in 2009, the further fall in employment and the very modest uptick in consumer sentiment expectations. Much, of course, will depend on whether the huge appetite for precautionary savings that has emerged over the last year will diminish markedly over the next year. Even so, the precarious nature of the public finances brought yet again into focus by the poor September Exchequer returns implies a drag on consumer spending through more taxes or through Government current expenditure cuts, including social welfare.

According to the Quarterly National Accounts, total industry output declined by an annual 10.8% in the first quarter of the year, slowing from a 15.1% decline in the final quarter of 2008; the decline accelerated a little to 11.3% in the second quarter of the year. Stripping out the large falls in building and construction, the rest of industry, including utilities, had remained in positive territory up to the last quarter of 2008 when output collapsed by 13.5%. The quarterly seasonally adjusted fall was a horrendous 12.2%. There was an immediate rebound in the first quarter of 2009 with a seasonally adjusted quarter-on-quarter increase of 9.5%. In the second quarter there was a fall-back of 1.0% leaving output 4.8% below the second quarter of 2008.

Looking more closely at the manufacturing sector, total manufacturing has performed well by international comparisons. Total manufacturing declined by just 1.1% in the first half of the year compared with the first half of 2008, with a strong seasonally adjusted quarterly increase of 4.7% in the first quarter giving way to a 2.6% fall in the second. In the July-August period output fell by 3.7%. The performance of individual sectors of manufacturing, however, is diverse with only the chemicals and pharmaceutical and medical devices sectors recording very strong growth, while the normally resilient ICT sector and most of the traditional industries experiencing sharp declines. In the first eight months of 2009 the ICT sector fell by an annual 26% and in July-August the pace of decline accelerated to 36%, suggesting the sector is not on a recovery path. The traditional sectors fell by an annual 14.5% in the first six months of the year and recorded a further decline of 15% in July-August. A further difficulty for manufacturing has been the downward pressure on selling prices. The CSO data for example record that while the volume of manufacturing output decreased by an annual 13.8% in the month of August, the fall in the value of turnover was 23.5%, implying sharp price reductions in response to mounting competitive pressures resulting in a harsh squeeze on margins.

The relative resilience of total manufacturing has also contributed to a reasonable export performance. Exports of goods and services stagnated in value terms year-on-year in the first half of 2009, falling by just under 3% in volume terms. Disaggregated data show that goods exports fell by 3.4% while service exports fell by 1.2%. It is imperative that the Irish economy undergoes significant structural rebalancing, reorienting productive effort into the traded goods and services sectors away from the excessive reliance on construction and domestic demand. However, to return to the export-led growth of the previous decade will require that Ireland regains the lost competitiveness resulting from the construction bubble in recent years.

Serious uncertainties still prevail with regard to the restoration of normal credit conditions; also, the continuing precarious nature of the public finances injects considerable doubt as to the magnitude of tax increases or expenditure cuts in 2010. The manufacturing PMI has shown some less negative tendencies as has the services sector PMI. However, the surveys remain negative making us question the likelihood of a return to growth in early 2010. For these reasons, and the expected continued weakness in consumer spending, we think that GDP will fall back by a further 1.6% in 2010 only returning to growth of around 1.7% in 2011. Provided the global economy continues to gain pace through 2011 – which is not certain – GDP growth could accelerate over the course of the two subsequent years, perhaps hitting 3.5% to 4% in 2013.

Employment

The labour force is undergoing significant structural change as the collapse of the construction sector will have resulted in a direct loss of employment in that sector of some 130,000 jobs from the peak of employment in 2007 to the trough in 2010. The loss of jobs has rippled through many sectors of the economy, though up till now the public sector has more or less been immune from the shake-out. After four years of strong employment growth averaging 4% per annum, the bubble burst and the small fall in employment of 1.1% experienced in 2008 became a flood in 2009 when we estimate employment will fall by 7.9%, with a further fall of 3.5% in 2010. By 2010 we estimate that employment will have fallen from 2.12 million in 2007 to 1.87 million – a loss of 256,000 jobs.

We expect that industrial employment will fall by some 45,000 by 2010 from its peak of 297,000 in 2007. The retail wholesale sector is set to shed 40,000 jobs from its peak employment 304,000 in 2008; the accommodation sector is likely to lose 17,000 jobs from its 2007 peak of 133,000 jobs. Employment in the professional sectors began to fall in the third quarter of 2008 from its peak of 117,000 and by the second quarter of 2009 had lost 14,000. Those working in administration have also faced job shedding, with the loss of 16,000 jobs in the second quarter of 2009 compared with the fourth quarter of 2007.

Public administration had up to the second quarter of 2009 suffered no job losses, education had suffered a loss of 3,500 and the health sector 1,500. Out of 389,000 employed in health education and public administration only 5,000 jobs have been shed; it is likely that the bulk of adjustment in these sectors will occur in 2010. Transport, information and financial and insurance activities have escaped job losses, with the last two making small employment gains.

We doubt that employment will have regained its peak level of 2.12 million by 2015. Many construction sector jobs will be permanently lost and industrial sector employment is unlikely to go back up to its 2007 peak of 297,000. Some recovery of

Employment

Labour force

	2008	2009	2010	2011	2012	2013
Agriculture	115	100	99	99	98	98
Industry	520	417	386	388	392	400
Services	1,465	1,418	1,382	1,387	1,411	1,452
Total	2,100	1,935	1,867	1,874	1,902	1,950
Unemployed	141	266	299	270	253	216
% Unemployed	6.3	12.1	13.8	12.6	11.7	10.0
Labour force	2,241	2,201	2,165	2,144	2,155	2,165

Table 2

jobs will take place in tourism and wholesale/retail, but we expect the strongest growth to come from information, financial and professional service sectors. Following the restructuring, the industrial share of jobs we expect will fall from 26% to around 20% of total employment and the service sector share will increase from under 70% to 75%. This has significant training implications to ensure that the increase in short-term unemployment does note transmute into a high level of long-term unemployment.

The seasonally adjusted trend in employment, along with the output data, suggests that the first quarter of 2009 was the worst period for job losses. Seasonally adjusted data record accelerating quarterly declines in employment throughout 2008, reaching the most rapid rate of 3.4% in the first quarter of 2009. Second quarter data show a deceleration in the decline to 1.8%. Although Live Register figures are not a measure of unemployment, they do give a more timely indication of unemployment trends. The most recent data for September indicated unemployment remained stable at the August level of 12.6%. Other indicators that the labour market will not deteriorate as much as we expected at the writing of the last Quarterly are given by the decrease in the numbers joining the Live Register. In January 2009, the monthly increase was 31,400; by September this increase has slowed to just 600. A Temporary Employment Subsidy scheme belatedly introduced in September should help to reinforce the slowdown onto the Live Register. Redundancies, however, remain high, though in the third quarter they averaged a monthly 6,087 compared with a second quarter monthly average of 7,320.

The rate of unemployment is being contained by the fact that the labour force is also falling. Emigration has returned with a consequent impact on the labour force. In the second quarter the labour force was 36,500 lower than the second quarter of 2008 in the main due to non-Irish nationals leaving the workforce. Of the 59,600 annual fall in non-Irish nationals in employment, 24,500 became unemployed and 35,200 left. Of the 114,700 annual fall in Irish nationals in employment, 113,400 became unemployed and only 1,300 left the labour force.

Consumer spending

Consumer spending started to show signs of weakness in the first quarter of 2008 when annual growth suddenly slowed to 2.6% after three strong years of growth averaging 6.4% per annum. In the second quarter of 2008 annual growth turned negative falling by 1.5%, and the negative growth gained pace throughout the year up to the first quarter of 2009 when consumer spending recorded an annual decline of 9.6%. The second quarter decline slowed to 6.8% and on a seasonally adjusted basis there was a quarter-on-quarter increase of 0.5% following a quarterly fall of 5.2% in the first quarter. This pattern of decline has also been reflected in retail sales, which, excluding motor sales, also recorded rapidly falling annual sales from the first quarter of 2008. In the first quarter sales fell by an annual 7.4% and showed no sign of bottoming out in the second quarter as they fell by 7.6%.

The only positive signs can be gleaned from the months of June and July when the volume of sales fell on an annual basis by 5.5% and 6.2% respectively. However, this needs to be treated with caution as volumes are being maintained by massive discounting. In the same months the value of sales fell by 10.8% and 11.8% respectively, implying price reductions of the order of 5.5%. This is greatly adding to the problems of retailers who are not only faced with declining volumes of trade but even greater declining turnover. As overheads are fixed, retailers are experiencing a savage squeeze on margins. Car sales have been particularly badly hit by the recession; in the year to July car sales were down an annual 47.4%. The hoped for reduction in the negative trend that appeared in May and June evaporated in July.

Apart from car sales, other sectors most badly affected tend to be those associated with big ticket items related to the home; furniture and lighting sales are down in volume by 31% in the first seven months of the year compared with the same period of 2008, hardware sales are down 18% and electrical goods sales are down 11.2%.

The squeeze on consumer spending stems from a combination of many factors: a fall in employment of 7.9%, wage reductions or freezes, significant tax increases and weak consumer confidence that has significantly raised precautionary savings. Unlike some commentators who see a reasonably strong uplift in consumer spending over the next twelve months, we remain less sanguine. We believe that employment will continue to fall in 2010 and stagnate in 2011; though the unemployment rate is unlikely to rise above 14% - a quite better scenario than only three months ago – we think it will remain high enough to deter the return of exuberant shoppers. In any case, the lower unemployment rate reflects a return to emigration, which in itself will take away from consumer spending. The KBC/ESRI consumer sentiment survey of consumer expectations remains lacklustre and only a little off the trough reached in the middle of 2008. Our view is that consumer spending could fall by another 3% in 2010, before showing modest growth from 2011 onwards.

Prices

Average prices in Ireland continue to fall at an almost unprecedented rate. Annual deflation at 6.5%, as recorded in September, is currently higher than at any time since 1922. Price falls are now widespread across almost all sectors of the economy. In September, prices fell on an annual basis in eight of the twelve product groups included in the Consumer Price Index (CPI). On the more timely monthly basis prices increased in only one of the groups, clothing and footwear – and this was a post sales season impact. On a seasonally adjusted basis, therefore, prices are currently falling in all sectors.

The main factors behind the price falls have changed considerably during the year. In the early part of 2009, mortgage interest was by far the largest contributor to the fall in the CPI, accounting for 90% of the fall in the CPI in the first half of the year. In the most recent three-month period, however, groceries have been the main influence on price declines with the sector accounting for half of the fall in the CPI. Restaurants and hotels and clothing and footwear are the two other sectors which have contributed most to the falling CPI in recent months. The CPI is set to fall on average by 4.5% in 2009 and is likely to fall by at least a further 0.4% in 2010. The mortgage interest impact on deflation will reduce rapidly over the coming months and its base effect will finish next June. ECB rates are unlikely to increase until the end of next year at the earliest. Substantial spare capacity will dampen prices right across the economy over the coming years but exchange rates and global commodity prices will also remain key determinants of consumer prices. The recent significant falls in grocery prices have been largely a result of industry restructuring; greater competition in the retail sector; exchange rates; and lower commodity prices. It is unlikely that all of these factors will remain beyond next year but price reductions in the sector are likely to continue for a number of months yet.

The current period of deflation has a wide range of implications for the economy. For consumers, the cost of living has obviously fallen significantly and this is helping to soften the impact of wage reductions and tax increases. For business, deflation is resulting in lower selling prices and turnover falling faster than sales volumes. A period of sustained deflation would be very damaging for business as it would result in consumers postponing investment and consumption decisions on the basis that they expect prices to fall further in the future. It is unlikely that Ireland will experience such a malign deflationary spiral – monetary union and the globalised nature of our economy mean that external factors will most likely remain the dominant influence on prices. The current relatively short window of deflation must therefore be seen as an opportunity to make progress on the major policy challenges of addressing our competitiveness difficulties and correcting the public finances. In relation to the public finances, in is imperative that Budget 2010 uses the opportunity of falling prices to reduce current expenditure. Nominal cuts in expenditure in the upcoming Budget could be achieved without cutting real incomes and living standards. Another important implication of deflation is the impact on Government's tax revenue. The most direct consequence of falling prices is reduced VAT receipts but all tax revenues would be impacted over time if deflation persisted.

INFLATION FORECASTS

2009	Quarter	Year	Annual
March	-1.8	-1.5	-4.5
June	-1.8	-4.5	
September	-0.4	-6.1	
December	0.0	-5.8	
2010			
March	0.4	-2.8	-0.4
June	0.5	-0.7	
September	0.5	0.5	
December	0.3	1.5	

Table 3

Earning trends

Only limited CSO data are available on earnings trends for 2009. The first quarter data for 2009 show that average earnings in industry were still increasing – a finding which appears to fly in the face of the widespread perception of what is actually happening in the economy. It is possible that the CSO data were collected before most employers implemented pay cuts, as April remains the most common month for salary reviews and pay adjustments. The CSO also acknowledged that because so many businesses have ceased operation over the past year this would also have an impact on the average earnings reported, as firms paying wages at the higher end of the distribution are more likely to survive the recession that those at the lower end of the distribution.

IBEC has conducted a Quarterly Business Sentiment survey of its members during 2009 with typical responses of about 500 firms employing 90,000 workers. The recent Quarter 3 survey shows that employers have taken a series of measures to reduce their payroll costs during 2009. On average, across all firms, employer pay bills are down 11% since the start of the year. In the 56% of firms which had actually reduced their pay bill, however, the average cut was 21%. Average employee pay rates across the entire sample fell by 2% but in those firms in most difficulty i.e. the 20% of firms which cut basic pay rates, the average pay cut was 12%. Firms also recorded substantial payroll savings through cuts in bonuses; overtime; shift premia and unpaid leave. Many firms also reported significant productivity gains through changes to work practices.

Investment

The investment sector of the economy is set to remain in decline until at least 2011. By 2010 the value of investment activity in the Irish economy will be exactly half of that recorded at the peak of the cycle in 2007. This represents a substantial loss of activity and employment, much of which is structural and will therefore not return when the business cycle picks up again over the coming years. The construction workforce re-skilling challenge and the permanent loss of taxation revenue are just two of the many challenges facing policy makers in the wake of the property crash.

Final figures for 2008 show that total investment fell by 16% last year. New house building was down 34%, while investment in machinery and equipment dropped by 15%. Investment in commercial building and in public capital projects held up well through most of 2008 and finished the year 9% above the 2007 level. The home improvements sector also fared strongly last year as many households sought to extend and renovate rather than attempt to purchase or sell residential property in a very unstable market. This year has seen a further deceleration in new housing activity, with an almost complete collapse in new house starts. Given the severe liquidity and solvency issues facing the house building sector only a small portion of the new houses already commenced will actually be completed this year. Total new house completions this year are therefore forecast at about 25,000 – a fall of over 50% from the 2008 level. The home improvements sector has continued to grow in 2009, albeit at a slower pace than last year. Nevertheless the investment in home improvements in 2010 will be two thirds greater than that in new housing. The emergence of significant negative equity problems and continued low levels of transactions in the second hand housing market will mean that over the coming years large numbers of households will opt for extensions and renovations rather than moving home.

The collapse in commercial building activity lagged that in the housing sector by about a year or so and it was the second half of 2008 before conditions really deteriorated. Following the banking crisis of autumn 2008, lack of access to credit led to the abandonment of many commercial and office building projects. Worsening economic conditions over the past year have resulted in a substantial oversupply of office and commercial property in all areas of the country. The public capital programme continued at a firm pace in 2008 but the budget for 2009 has been reduced by 18% and despite some unit cost savings, this has resulted in a significant fall-off in activity levels. Government investment in public infrastructure in 2010 will probably hold up reasonably well as the National Roads Authority pushes to complete the major inter-urban motorways before the end of next year. As little or no new road projects are currently scheduled for post 2010, it remains unclear what level of public capital investment Government will proceed with once the current roads programme is complete. Output from the commercial and public capital construction sectors is expected to fall by 25% in 2009 and decline further in 2010.

Investment

Annual % change

	2008	2009	2010	2011	2012	2013
Building & construction	-15.5	-33.6	-18.9	-0.1	0.2	7.4
Plant & machinery	-15.4	-15.0	0.0	5.0	10.0	10.0
Total	-15.5	-29.4	-13.7	1.5	3.4	8.3

Table 4

Investment in machinery and equipment held up reasonably well during the first half of 2008 but fell sharply towards the end of the year. Investment for the full year was down 15% but fell by 41% in the final quarter of the year. A combination of credit access difficulties and the more difficult trading environment impacted significantly on firm investment decisions in the first half of 2009. Investment in machinery and equipment (excluding planes) was down 48% in the first quarter of the year and by 38% in the second quarter. Investment in planes remained quite strong during the worst of the global crisis – most likely reflecting previous purchase commitments – and the total investment in equipment and machinery was down 31% on year earlier levels in the first quarter of this year but increased by 11% in the second quarter. We expect a slight improvement in firm level investment in the second half of 2009 and total investment for equipment and machinery for the year is expected to be about 15% down on the 2008 level.

Following a decline in total investment in the Irish economy of 16% in 2008, 2009 is set to experience a much sharper drop of 29%. The drag on economic growth from the sector will therefore be much greater than in 2008. Looking to 2010 it is clear that the new housing sector will remain largely stagnant with only a limited number of completions from one-off housing and the social housing sector – there will be little or no developer housing scheme activity in 2010. We therefore expect house completions to reach only about 10,000 units next year. The remainder of the building and construction sector will also continue to contract, given the substantial overhang of commercial property on the market and the constraints on the public finances to fund the public capital programme. Capital investment by firms is forecast to pick up somewhat during 2010 but the annual total will most likely be unchanged from that in 2009. Overall, the investment sector of the economy is forecast to contract by a further 14% in 2010 and this means that the remaining sectors of the economy would need to grow quite strongly in order to avoid a third successive year of falling GDP. The investment sector of the economy is forecast to return to modest growth in 2011 but even with improving economic conditions over the coming years the size of the sector in 2013 will still remain over 40% below that in 2007.

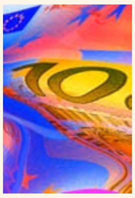
Exchequer finances

The April supplementary budget, with its spending adjustments and tax impositions, aimed to contain the general government balance to a deficit of €18.4 billion or 10.7% of GDP. It planned to achieve this by raising tax revenues of €34.4 billion. The Exchequer Returns up to the end of September have been so weak that the Minister for Finance has revised the expected tax receipts for 2009 down by some €2 billion; the Minister now expects receipts to be only €32.4 billion and the deficit on the general government balance to rise to 12% of GDP. Up to the end of September the two big revenue raisers, income tax and VAT, are down 9.4% and 21.3% respectively on the same period of 2008 and this despite significant income tax hikes through the income levies. Revenue receipts in the next month are unlikely to provide any boosts to the Exchequer position as weak consumer spending – exacerbated by leakage across the border to Northern Ireland – will continue to generate a low yield of VAT, and income tax from self-assessed tax payers in October and November is expected to be well down on 2008.

The loss of €2 billion in tax receipts in 2009 lowers the base on which 2010 tax revenues are derived, adding to 2010 funding problems. This makes it all the more urgent that Government reduces expenditure levels as it is clear that increasing taxation in a depressed economy is unlikely to result in a high yield in revenue. There are two helpful factors for the Minister for Finance. Firstly, the Government's predictions of a fall in GDP of 2.9% in 2010 now seem unduly pessimistic and, secondly, unemployment was forecast to increase to 15.5% of the labour force now also looks more likely to be 13.5%. These less gloomy numbers, if they prove correct, will help both the spending and revenue sides of the Exchequer's accounts.

We gave general support to the Government's plans to make substantive adjustments to expenditure and revenue in 2010 and 2011 and to take what further measures were needed to bring the general government deficit down to 3% of GDP by 2013, a plan which met with EU approval. The plan aimed to make adjustments of €4 billion in each of 2010 and 2011, equivalent to full year adjustments of €4.75 billion and €4.6 billion. Where we took issue with Government was the unduly heavy bias towards making the adjustment from taxation increases rather than expenditure reductions. International evidence and our own experience of the 1980s suggest that sharp focus on expenditure reductions, while slowing the economy in the shortterm would bring greater and more rapid gains in the medium term. The evolution of tax revenue in 2009 only adds weight to the urgency with which cuts need to be effected. Our recommendation to Government for the 2010 Budget is that the target to reduce the deficit on the general government balance to 3% of GDP by 2013 should be met and that the vast bulk of this reduction should be achieved through spending cuts, including pay and social welfare. The September Consumer Price Index fall of 6.5% confirms that there is a short window of deflation in which such reductions could be achieved while protecting real living standards.

Trade and balance of payments



The volume of exports of goods and services fell by an annual 3% in the first quarter of 2009 and by 2.5% in the second quarter. Visible goods fell by 3.7% y-on-y in the second quarter, a slight acceleration on the decline in the first quarter. Services exports fell on an annual basis by 2.8% and 0.9%, respectively, in the first and second quarters. Total export performance has been fairly solid when compared with the large double digit declines experienced in other countries and in value terms visible exports were up 1.6% y-on-y in the first half of the year. However the headline figure conceals the very narrow base for this strong performance: in the first half of the year exports of pharmaceuticals increased by an annual 22% and professional and scientific equipment by 11%. Almost all other sectors recorded significant falls with exports of meat down 7.5% and of dairy products 17.3%; exports of beverages were down 14% and computer exports 27%.

Service exports, which now account for 45% of all exports fell by an annual 1.8% in the first half of 2009; service exports performed worse than visible exports in 2008, having grown far more rapidly in the three years to 2007, averaging 12.6%. This current weakness is associated with problems in the financial and insurance sectors resulting from the global disruption of the financial sector. Our view is that the volume of exports of goods and services will decline by the order of 3% over the rest of 2009, growing only marginally in 2010, though a strong upturn in markets of importance for Irish exporters could make this forecast conservative. The depressed state of the domestic market has resulted in imports of goods and services falling by an annual 8.8% in the first half of the year; there is little reason to anticipate a pick-up in the second half and therefore we expect total services to decline by 8% in 2009 and 3% in 2010. This weakness means that there will be a strong positive contribution from net exports in both 2009 and 2010.

The Central Bank forecasts a substantial improvement in the deficit on the current account of the balance of payments. Having recorded a deficit of 6.1% of GNP in 2008, the Bank forecasts the deficit will reduce to 3.5% of GNP in 2009 and to 1.8% in 2010.

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World economic context

The global economy has pulled out of recession in the second half of 2009, thanks to aggressive monetary and fiscal policy intervention. However, the IMF forecast in October that the world economy will contract by 1.1% in 2009 as a whole, before returning to growth of 3.1% in 2010. Recovery remains fragile and the timing of the exit strategies (withdrawal of stimulus) will be crucial. Act too early and risk a so-called double dip recession. Leave stimulus in place for too long and cause an upsurge in global inflation. The rebalancing of the global economy also remains a substantial challenge. The export-led countries with significant current account surpluses, such as China and Germany, will need to reorient their economies more towards domestic demand. On the other hand, countries such as the US and the UK that have relied too heavily on domestic demand must do exactly the reverse.

The financial crisis may have resulted in permanent damage to world potential output; the IMF forecasts that global output will grow by around 4% during 2010-2014, "appreciably less than the 5% growth seen in the years just before the crisis". Rising unemployment in the wake of the financial crisis presents a challenge in most advanced economies. If the economic recovery fails to gain momentum, unemployment may approach 10%.

US

Output in the US fell substantially in the first half of 2009, but thanks to policy intervention the economy has returned to growth in the second half of the year. GDP, however, will fall by 2.7% on average in 2009. The recovery will be sluggish and GDP will grow by 1.5% in 2010. Unemployment will continue to climb to 10% at the end of 2010. The medium-term outlook for the US economy has been damaged by the financial crisis and the IMF projects that growth is likely to remain below 2% for some time. Domestic demand is likely to remain muted as households to rebalance their damaged investment portfolios and the savings rate climbs further. Weak global activity will constrain export growth.

Euro area

Latest data from Europe indicate that the recession there has ended, but GDP will still fall by an average 4% in 2009. Germany has suffered from the fall in exports resulting from the collapse in world trade. However, recovery in global demand will be good news. Private and public consumption have been supportive of economic activity and though the projected fall in GDP of 5.3% for 2009 is steep, it is much milder than the fall in Germany's exports. Unemployment has risen by only 0.75%, thanks to increased subsidies for part-time work. On the downside, the labour hoarding means that employment growth is likely to remain sluggish in the recovery phase. The global crisis has been less pronounced in France, because of its larger government sector and lesser degree of trade openness. The other major economies, Italy and Spain, are lagging the upturn, which could cause problems for the interest rate setting by the ECB.

UK

In the UK, output is forecast to fall by 4.4% in 2009, before a return to modest growth of 0.9% in 2010. Both financial and housing markets are showing sign of stabilising, and the weak sterling will give a boost to net exports. However, the rebalancing of the economy is far from complete. Though substantial fiscal stimulus has helped cushion the fall in the economy, the deficit at 12% of GDP and a debt to GDP ration heading towards 80% are truly unsustainable. Credit conditions remain tight and the household savings ratio at 5% is still far from its long-run average of 8%.

Real GDP growth – selected countries

Annual % change	2008	2009	2010
Euro area	0.7	-4.2	0.3
UK	0.7	-4.4	0.9
Germany	1.2	-5.3	0.3
France	0.3	-2.4	0.9
US	0.4	-2.7	1.5

Table 5

Inflation – selected countries

Annual % change	2008	2009	2010
Euro area	3.3	0.3	0.8
UK	3.6	1.9	1.5
Germany	2.8	0.1	0.2
France	3.2	0.3	1.1
US	3.8	0.4	1.7

Table 6

Unemployment rate – selected countries

Annual % change	2008	2009	2010
Euro area	7.6	9.9	11.7
UK	5.5	7.6	9.3
Germany	7.4	8.0	10.7
France	7.9	9.5	10.3
US	5.8	9.3	10.1

Table 7