

## IRISH QUARTERLY ECONOMIC OUTLOOK: SEPTEMBER 2008

To put it bluntly this has been an “annus horribilis” for the Irish economy, with things appearing to go from bad to worse by the day. House prices continue to fall sharply, unemployment is rising strongly, government tax receipts are running significantly below target, and all three Purchasing Managers’ indices (manufacturing, services and construction are deep into negative territory). Although consumer confidence picked-up in August from its historical low hit in July, it still remains very depressed. ***The general public has become increasingly concerned about the underlying state of the Irish economy and employment prospects going forward, and this is being reflected in weaker personal spending and declining tax receipts.***

The latest Reuters poll of Irish economists, for August, is looking for an average contraction in real GDP of 0.9% this year, compared with growth of 6.0% in 2007. ***We think GDP could fall by as much as 2.5% in 2008.*** Either way, though, we are set for the first annual fall in GDP since 1983. It is very difficult at this stage to make a forecast for 2009, with so much uncertainty still out there, and a lot will depend on what sort of fiscal package the Government presents in the forthcoming Budget. However, ***we are tentatively projecting real GDP growth of 0.5% next year, though that is based on the assumption that key external factors (lower oil prices, stronger dollar and lower interest rates go our way). But, the recovery in growth is likely to be centred on the second half of 2009, and we will still be in negative growth territory in the first half of the year.***

The labour market has weakened dramatically this year, with the jobless rate now back over 6.0% for the first time in almost ten years. Most of the job losses in recent months have been focused on the construction side, but other sectors too are now feeling the pinch. ***Apart from further losses in the building industry, the transport, manufacturing, retail and financial services sectors are all likely to be particularly vulnerable over the next twelve months or so. Indeed, we believe we could see the jobless rate running close to 8.0% in 2009.***

House prices are likely to continue to drift lower into 2009 unless the Government takes some remedial action in the October Budget and/or the ECB takes an easier stance on interest rates. Overall, we think that it will be 2010 before house prices are back on a rising trend. ***We are looking for an average annual fall in house prices of 9.8% in 2008 and 7.5% in 2009.***

The one positive development over the next few months is likely to be a sharp fall in consumer prices as global oil/commodity prices continue to ease. ***At this point in time, it looks like the average inflation rate in 2008 will be around 4.6% as against 4.9% in 2007, but the average rate next year should be closer to 3.0%, and every chance that the headline inflation rate will be low as 2.0% come the latter part of 2009.***

However, the key issue at this stage is the likely response of the Government to the current economic crisis. The early indications are that what we will get next month is a ‘balancing of the book’ exercise, but what we believe the economy needs is a significant fiscal stimulus. The Department of Finance appears to be far too obsessed with meeting the requirements of the Stability and Growth Pact (SGP) which pertain to Eurozone members, namely that the General Government Deficit in a given year should be no more than 3.0% of GDP and total government debt outstanding should be no greater than 60% of GDP. But, ***the bottom line is that the Irish economy is in such poor shape at the moment, that only a significant breach of Stability Pact rules through a substantial fiscal package will in our view put the economy back on the road to recovery.***

2/3 Exchange Place, IFSC  
Dublin 1, Ireland  
DX no: 64  
Tel: +353 (0)1 611 9200  
Fax: +353 (0)1 829 1877

86 South Mall  
Cork, Ireland  
DX no: 2008  
Tel: +353 (0)21 490 6500  
Fax: +353 (0)21 427 6036

100 O'Connell Street  
Limerick, Ireland  
DX no: 3046  
Tel: +353 (0)61 414 065  
Fax: +353 (0)61 419 750

info@bloxham.ie  
www.bloxham.ie

## Irish Overview:

### **....risks of global recession increasing ....**

The world economy has shown increasing signs of fragility in recent weeks with the risk of the first recession since 2000/01 rising. In a clear signal of falling global trade, the *Baltic Dry Index*, a measure of demand for shipping services, has tumbled almost 40% since May. Although the US economy has performed quite well in the first half of the year all things considered, with revised second-quarter GDP figures showing annualised growth of 3.3%, the main stimulus in the first half of the year, mainly the tax rebate cheques for consumers and strong exports will be nowhere near as positive in the second half of 2008. Although the world's largest economy may avoid recession, it will skirt very close to one in our view. Recent figures for the Eurozone, Japan and Canada show that the G7 bloc as a whole is going through a serious downward adjustment. Both Euroland and Japan contracted in the second quarter, the UK was static, and while Canada recovered from negative growth in the opening quarter, the increase in GDP was fairly modest. **The bottom line is that four out of the world's five biggest economies, with the notable exception of China, are at risk of recession.** Furthermore, a recession in these major economies would result in a sharp fall in growth in the BRIC (Brazil, Russia, India and China) bloc. It should also be pointed out that we do not need to have a negative growth rate in the world to have a recession. In fact, **the IMF says that average world growth below 3.0% would constitute a recession as emerging market economies usually grow much faster (6%) than advanced economies where growth averages about 2%.** China, for example, with a growth rate of 10% to 11% cannot provide enough jobs for the millions entering its workforce every year. So a deceleration of growth to 5% to 6% would cause severe pain.

### **....little to smile about on the Irish economic front at this juncture....**

To put it bluntly this has been an "annus horribilis" for the Irish economy, with things appearing to go from bad to worse by the day. House prices continue to fall sharply, unemployment is rising strongly, government tax receipts are running significantly below target, and all three Purchasing Managers' indices (manufacturing, services and construction are deep into negative territory). Although consumer confidence picked-up in August from its historical low hit in July, it still remains very depressed. The general public has become increasingly concerned about the underlying state of the Irish economy and employment prospects going forward, and this is being reflected in personal spending. Indeed, the year-on-year fall of 5.2% in the volume of retail sales in June was the biggest annual decline since January 1987. Of course the deep turmoil in the building industry compounded by the credit crunch continues to weigh negatively on economic performance and sentiment. The latest data from the construction side continue to paint a very gloomy picture going forward. The seasonally-adjusted *Construction Purchasing Managers' Index* picked up to 33.0 in August from 31.3 in July and June's low of 29.4, but still extremely weak. Furthermore, the PMI sub-index for construction employment continues to set fresh lows confirming that the large increase in the August Live Register was probably mainly building related. But, at least, the other sub-indices painted a somewhat more encouraging picture. The housing PMI has oscillated around 25 for much of this year indicating that activity continues to decline though the rate of decline has stopped accelerating. The civil and commercial indices also show tentative signs of levelling off. Still, it is far too early to be jumping for joy, given that all three construction components remain well below the 'neutral' 50 mark. At this stage we can write off 2008, and only hope that next year brings some cheer, but that is by no means guaranteed. Indeed, a lot will depend on external factors going our way. However, that is not to say that the Irish government should be relaxing on its laurels. The opposite is in fact the case. **We continue to believe that the October Budget needs to deliver significant fiscal stimulus for PAYE workers in order to get the economy going again. The Budget strategy should also be geared to giving help to the building and export sectors as well as attempting to unblock the logjam in the banking sector.**

## Irish Economy:

### ....latest National Accounts data point to Ireland on brink of recession....

Ireland's economy slowed in the first quarter of 2008 as a shrinking building sector and declining investment took their toll and raised fears of a recession after more than a decade of economic boom. Ireland's GDP shrank at an annual rate of 1.5% in the first quarter, the first year-on-year decline since the CSO began publishing quarterly data in 1997, down from a growth rate of 5.5% in the fourth quarter of 2007 and below the 1.0% growth rate that had been expected by economists. Meanwhile, GNP grew 0.8% and revisions to data for the fourth quarter of 2007 ensured the economy sidestepped a second consecutive quarterly contraction but things are likely to get tougher. We may have avoided technical recession in the January-March period, but the first-quarter figures on the whole point to trends that will continue throughout the year.

**Housing is set for much bigger falls in the second half of 2008 as the collapse in housing starts feeds through to completions.** Turmoil in global markets has compounded the impact of an end to Ireland's decade-long property boom, sounding the death knell for the rapid rates of growth of the "Celtic Tiger" economic miracle that began in the 1990s. For 2007, the CSO said it had revised earlier growth data, putting the annual rise in GDP at 6.0% versus a preliminary estimate of 5.3%. However, final numbers for GNP put economic growth last year at 4.1% as against 4.5% previously.

### ....Irish economists continue to downgrade growth forecasts....

The latest monthly *Reuters* poll of Irish analysts, for August, showed that economists now expect a deeper contraction in Ireland's economy this year than they did in July as poor consumer sentiment, job worries and a continued housing slowdown batter growth prospects. **GDP is now projected to drop by 0.9% in 2008, according to the median in the poll of 12 economists, down from a 0.6% contraction in the July poll and 1.1% growth seen in June's survey.** Economists have also lowered their forecasts for 2009 GDP growth to 0.7%, from 1.1% seen in the last survey. Negative GDP growth this year, would be the first official downturn since the economy contracted back in 1983. Given weak consumer sentiment, retail sales are now expected to fall by 2.0% in 2008, versus a July forecast of flat sales and 5.9% growth in 2007. With the continued deterioration in labour market conditions, it is unlikely that consumers will return to the stores in any great numbers over the remainder of 2008. Unfortunately, the labour market is set to deteriorate further over the coming months with manufacturing, retail, construction and financial services all likely to shed further jobs, while the public sector will offer little solace. Economists also remain downbeat on the housing market with house prices expected to fall 10% this year, from a 9.9% drop seen in July. As regards 2009, house prices are now projected to decline by 5.0%. The weakness in the housing sector is likely to continue for some time and commercial building will also remain in the doldrums. The one positive bit of news at this juncture is that the continued slide in world oil prices should eventually help to ease inflationary pressures in the economy. At this stage it does look like commodity prices are set to fall further in the coming months due to slower global demand, and it is hard to see domestic businesses being able to raise prices in a recessionary environment. As a result, the headline inflation rate could well be running below 3.0% next year, which is one reason the Government should not be committing itself to over-the-top wage demands in any new national wage deal. **The fall in commodity prices, if it continues, also increases the chances that Irish economic performance will be better than is being forecast at this juncture, but economic growth is still likely to be low by historical standards.**

**Table 1: Contributions to Irish Economic GDP Expenditure Growth: Percentage Points**

%	2007	2008 (f)	2009 (f)	2010 (f)
Consumer Spending	2.8	0	0.3	2.0
Government Spending	0.8	0.7	0.4	0.5
Fixed Investment	0.3	-4.0	-0.8	0.4
(Housing)	(-1.1)	(-2.3)	(-1.5)	(0.4)
(Other Construction)	(0.7)	(-1.5)	(-0.3)	(0.2)
(Machinery & Equipment)	(0.7)	(-0.2)	(1.0)	(-0.2)
Stocks	-0.3	0.5	-0.5	-0.2
Exports	5.1	1.0	3.2	4.4
Imports	-2.7	-0.7	-2.1	-3.1
Net Exports	2.4	0.3	1.1	1.3
<b>GDP</b>	<b>6.0</b>	<b>-2.5</b>	<b>0.5</b>	<b>4.0</b>

#### ....consumer spending slowing sharply....

The provisional volume of retail sales (i.e. excluding price effects) fell by 5.2% in June compared with the same month in 2007. Month-on-month, there was a monthly decline of 0.7%, the fifth consecutive monthly decrease in spending. Meanwhile, excluding motor trades, sales were down 1.9% in the month and 1.8% in the year. In the first six months of 2008, total retail sales were down 2.4% year-on-year in volume terms, with sales excluding motor trades 0.1% lower over the same period. The provisional volume of retail sales (i.e. excluding price effects) fell by 5.2% in June compared with the same month in 2007. Month-on-month, there was a monthly decline of 0.7%, the fifth consecutive monthly decrease in spending. Meanwhile, excluding motor trades, sales were down 1.9% in the month and 1.8% in the year. In the first six months of 2008, total retail sales were down 2.4% year-on-year in volume terms, while sales excluding motor trades were 0.1% lower over the same period. A number of factors are contributing to the weak trend in consumer spending this year. Disposable income growth has been eroded by high consumer price inflation and the emergence of weakness in the labour market, mainly emanating from declining construction employment, but also reflecting a more generalised weakness in labour demand. In addition, surveys indicate a sharp decline in consumer confidence regarding both current conditions and future economic prospects, the fall out from the weak housing market, financial market turbulence and a general increase in economic uncertainty. **Following an average volume increase of 6.3% in personal expenditure on goods and services in 2007, we think we will do well to have a flat reading this year, though it would be no great surprise if real consumer spending was actually lower in 2008 than last year.** Furthermore, consumers are likely to remain cautious next year against a background of continued labour market weakness and with little prospect at this stage of significant increases in disposable income. However, **on the assumption that inflationary pressures around the world start to ease as the global economy slows, and the ECB cuts interest rates, we are currently forecasting a 0.5% increase in personal consumption for 2009. But, the risks to spending are to the downside.**

**Table 2: Irish Economic Growth % (Bloxham Forecasts)**

%	2007	2008 (f)	2009 (f)	2010 (f)
<b>GDP</b>	<b>6.0</b>	<b>-2.5</b>	<b>0.5</b>	<b>4.0</b>
Consumer Spending	6.3	0	0.5	4.0
Fixed Investment	1.2	-15.0	-2.5	2.0
Government Spending	6.0	4.5	2.5	3.0
Exports	6.8	1.0	4.0	5.5
Imports	4.1	1.0	3.0	4.5
Consumer Prices	4.9	4.6	2.8	2.5
HICP	2.8	3.5	2.9	2.5

#### Government Spending:

##### ....government expenditure growth to moderate this year and next....

According to the most recent *National Accounts* data, the volume of government spending increased by 6.0% in 2007. On the basis of published Exchequer data and taking account of planned adjustments announced by the Government, **the volume of government consumption is projected to increase by about 4.5% in 2008 and by 2.0% in 2009, representing a significant moderation compared to the pattern of recent years.**

#### Investment:

##### ....all 'doom and gloom' on the construction front....

The main negative effect on domestic demand this year is coming from a contraction in investment expenditure, accounted for, in the most part, by an adjustment in residential construction investment but also due to emerging weakness in other sectors as the economy slows. **Following a substantial supply response in recent years, where the housing stock expanded by an average of approximately 80,000 units over the last five years, significantly above estimates of medium-term demand, supply is set to slow substantially this year, the effect of which will dampen GDP and GNP growth forecasts.** But, on a more positive note, the adjustment in the housing sector means that building and construction, as a proportion of economic activity, is set to return to more sustainable levels.

The latest available Quarterly National Accounts indicate that overall investment fell by 18.6% in the first quarter of 2008, compared with the same period the previous year. Housing investment was down by approximately 25%, year-on-year, with a 30% drop in new dwellings offset slightly by growth in repairs and maintenance. Tentative estimates also suggest that other areas of building and construction, mainly office, industrial and retail investment, also contracted in the opening months of the year, as did investment in machinery and equipment. In terms of the outlook for 2008, housing output is set to fall back dramatically this year, as developers react cautiously to the weaker pricing environment, lower levels of demand and an overhang in supply. Following 78,000 new house completions last year, we think the final figure for 2008 will be around 45,000, a decline of over 42% from 2007. **Given the lag between registrations and completions, continued weakness in house registrations, the most reliable indicator of future housing activity, suggests that completions are set to fall further in 2009. In the absence of stimulus from the Government to help the market, we are now forecasting a total of 24,000 for next year.** Tighter credit conditions and higher interest rates are now estimated to be impacting more seriously on developments in both the residential and non-residential building sectors than had previously been assumed. Although commercial and retail investment activity remained buoyant throughout 2007, forward looking indicators would suggest some emerging weakness as economic growth slows. Weak consumer spending and employment growth, coupled with a decline in consumer sentiment, suggest a limited capacity for further expansion in the retail sector. Deteriorating competitiveness suggests that there may also be limited scope for the kind of industrial infrastructural investment growth of recent years. Infrastructural investment expenditure, however, supported by investment under the National Development Plan, should ensure some growth in non-residential construction growth this year and may limit any decline in 2009.

#### Stocks:

**.... positive contribution from stocks on the cards in 2008....**

The *National Accounts* data revealed a significant build-up in stocks of €567m in the first quarter of this year following a similar increase in the fourth quarter of last year. For 2008 as a whole, **stock building is expected to contribute positively to growth. However, this trend is likely to be reversed somewhat in 2009** since some of the stock built up this year is probably involuntary, reflecting a greater than anticipated slowdown in effective demand.

#### External Trade:

**....export outlook set to deteriorate ....**

Following the buoyancy of last year's export performance, the indications in the first half of 2008 are a weakening trend. Merchandise exports were up 4.8% in volume terms in 2007, but growth has slowed to just half this in 2008 to date. Slowing merchandise export growth has been compounded by a surprisingly muted performance on the services side. Meanwhile, following import growth of 3.7% for last year as a whole, so far in 2008 import volumes have fallen almost 5.5%, reflecting weaker consumer demand. It maybe too early to say that the trend in exports will be down from here following last year's solid performance. However, the lagged impact of price competitiveness pressures, in particular, significant adverse exchange rate movements, have begun to take effect. Furthermore, the *Quarterly National Accounts* indicate that a build-up of inventories occurred in the first quarter. This suggests that the weakened merchandise export performance may continue over the rest of the year, as this build-up is unwound. That said, euro/dollar exchange rate developments should start to turn positive for exporters in the coming months. **After a reasonable start to 2008, it now looks like the malaise affecting the other sectors of the Irish economy is starting to hit merchandise exports. This doesn't augur well for national output in the second half of 2008 as both personal spending and fixed investment (mainly building and construction) are likely to remain very weak.**

**Table 3: Balance of Payments on Current Account (€m)**

	2007	2008 (f)	2009 (f)	2010 (f)
Trade	22,459	19,978	21,046	24,000
Services	-2,869	-2,000	-1,400	-1,000
Income	-28,608	-29,500	-30,700	-32,000
Current Transfers	-1,283	-1,200	-1,400	-1,700
<b>Current Account</b>	<b>-10,302</b>	<b>-12,722</b>	<b>-12,454</b>	<b>-10,700</b>
(as % of GNP)	(-6.4)	(-8.2)	(-7.9)	(-6.4)

## Balance of Payments:

### *....services exports starting to suffer too....*

While services sector exports have been the mainstay of overall export growth in recent times, a significant moderation in annual growth was evident in the opening quarter of 2008, with an increase of 0.8% in volume terms. The performance of services exports at a sectoral level varied considerably. Growth in computer services, the single largest services export sector, remained strong, with an annual increase of 11.5% in value terms in the first quarter. But, a pronounced moderation was evident in the trade-related sub-sector of business services. It would appear that a significant factor behind the deceleration in services export growth has been the fallout from the turbulence in financial markets. The financial services sector made a positive yet modest contribution to services export growth on a year-on-year basis in the opening quarter while insurance services declined by almost 16% over the same period. As imports of insurance services weakened by a comparable amount, the net impact on the services trade balanced was reduced considerably. Net factor income outflows are estimated to have declined in the first quarter of 2008 relative to the same period last year due to an increase in factor inflows and, to a somewhat lesser extent, a decline in income outflows. Income outflows were weak, year-on-year, in the opening quarter of 2008 due to a base effect, with particularly strong outflows recorded in the same period last year. The contribution of this component seems set to remain negative, reflecting the fact that Ireland is expected to become a net contributor to the EU Budget in the near future. **Combining the prospective trends of all the components of the current account, the deficit seems set to widen further in 2008 to 8.2% of GNP from 6.4% of GNP in 2007. However, a slight improvement to 7.9% of GNP is projected for 2009.**

## Employment:

### *....labour market trend deteriorating rapidly ....*

At a time when the Irish economy is in desperate need of some good news, the latest *Quarterly National Household Survey*, provided just the opposite. According to the latest survey, employment rose by a modest 6,900 or 0.3% in the year to the second quarter, bringing total employment to 2,101,600. This compares with the impressive annual rise of 53,800 or 2.6% in the year to 2,135,000 in the first quarter of the year. Although the growth in employment was again above the EU average, it is a major cause for concern that over the quarter, employment was down 1.2% compared with the opening quarter. Furthermore, the numbers in the labour force growth slowing to 1% from a rate of 4.2% over the same period last year. It is also worth noting that while the data were theoretically for the second quarter, they only cover the period March-May, with the actual survey itself taken in mid-April. **The economic climate has worsened substantially since then and the Live Register figures have been soaring in recent months, pointing to a deteriorating jobs market.** When seasonally-adjusted factors were taken into account, there was a quarterly decrease of 15,400 in the number of persons employed. That compares with a quarterly increase of 22,100 in the second quarter of 2007 and an average quarterly rise of 17,000 for 2007 as a whole. The nature of employment has also changed with the numbers in full-time employment falling 4,300 in the year, while this was offset by part-time employment increasing by 11,000 over the year. Employment in the construction sector fell sharply by an alarming 26,800 or 9.5% in the year to the second quarter of 2008, compared with an annual growth rate of 6.3% in the same period in 2007. All of the decrease in construction was attributable to males. The fall in employment in construction was partially offset by increases elsewhere in the Wholesale and retail trade (+16,200), Health (+10,700) and Financial and other business (+10,400). The Central Statistics Office estimates that the breakdown of construction workers between residential (new housing, repairs and maintenance) and non-residential in the second quarter was 59.2% and 40.8% respectively, compared with 69% and 31% respectively when the question was first asked in the survey almost two years ago. Meanwhile, there was a total of 115,500 in the second quarter of 2008 representing an increase of 15,200 in the year. When seasonal factors were taken into consideration there was a quarterly increase of 7,700 in the numbers unemployed with the seasonally-adjusted jobless rate rising to 5.1% from 4.8% previously. The latest available figures for the EU 27, which are for the first quarter of 2008, showed that between the opening quarters of 2007 and 2008, Ireland's employment level grew by 2.6% and its labour force by 2.9%. The comparable figures for the EU-27 were 2.3% and 1.5% respectively. **Given the further deterioration in the construction industry in recent months it is likely that the Q3 and Q4 employment surveys will be a lot weaker than Q2's. All in all, we expect overall employment figures to go negative in the rest of the year and are forecasting jobs growth to be flat at best for 2008 as a whole, but**

**Table 4: Employment & Unemployment (Annual Average)**

(000s)	2007	2008 (f)	2009 (f)	2010 (f)
Industry	578	556	526	530
Services	1,423	1,445	1,463	1,500
Agriculture	116	116	116	115
<b>Total</b>	<b>2,117</b>	<b>2,117</b>	<b>2,105</b>	<b>2,145</b>
Unemployment (LFS basis)	101	143	180	170
Labour Force	2,217	2,260	2,285	2,315
SUR %	4.5	6.3	7.9	7.3

**....Live Register paints more negative labour market picture ....**

The headline Live Register rose 9,200 in unadjusted terms month-on-month in August to 247,400. The rise in those signing on last month compared with an increase of 17,400 in July and a monthly decrease of 400 in August 2007. Furthermore, when seasonal factors were taken into account, the total number on the Live Register increased sharply, posting a monthly rise of 9,100 to 235,100, its highest level since March 1998. Worryingly, there has been an increase of 28,300 seasonally-adjusted in the last three months alone. Apart from the sharp fall in construction employment, other sectors like manufacturing, transport, retail, and financial services are starting to feel the pinch too. Redundancies notified to the Department of Trade, Enterprise and Employment are up 36% on an annual basis in the year-to-date and the likelihood is that things will get worse before they get better on the jobs front. Year-on-year there were 73,200 more people signing on the Live Register in August 2008 than in August 2007. Furthermore, a massive hole has been blown in the public finances by the weakening labour market through both lower tax receipts and increased social welfare payments. It is estimated that it costs the Exchequer €11m for every 1,000 people on the Live Register. Following the sharp rise in the seasonally-adjusted figures in August, the revised unemployment rate (based on the latest Quarterly National Household Survey) rose to 6.1% from 5.8% in July. Indeed, one has to go back to December 1998 to find the last time we had a jobless rate of 6.1%. According to the latest Reuters poll (August) of Irish economists, the unemployment rate is expected to rise to 6.4% by year-end, up from 4.6% in December 2007. **A further worsening of the jobs market is projected for 2009, with the median forecast of economists putting the unemployment rate at 7.1% at the end of next year. However, we think this figure looks overly-optimistic, and we feel the jobless rate could be running close to 8.0% next year, before recovering somewhat in 2009.**

**Inflation:****....price pressures likely to ease in the coming months ....**

At last a bit of good news on the Irish economic front, with the headline inflation rate falling back sharply in July, but we were here before earlier in the year and it didn't last, and despite the recent sharp fall in oil prices we still think that inflation is more likely to be running closer to 5.0% than 4.0% over the next couple of months. That said, the fall in the headline annual inflation rate to 4.4% from 5.0% in June is a welcome development. The decrease in the HICP inflation rate to 3.6% from 3.9% previously is also positive. In the first seven months of the year the headline inflation rate averaged 4.6% down from 5.0% in the same period last year, but still too high for comfort. However, the HICP rate averaged 3.5% in January-July 2008 as against 2.8% in the same period last year. It is quite clear at this stage that the trend in world oil and food prices will be critical to the inflation outlook over the remainder of the year, and the recent sharp fall in commodity prices augurs well at this stage. But, it would be foolish to assume that just because prices have fallen sharply in recent weeks that we have definitely seen the peak in oil/food prices in this current cycle. Quite simply, we just don't know, but recent developments are at least encouraging. With Irish electricity prices rising by 17.5% in August on top of higher mortgage interest repayments and increases in back-to-school costs, it looks to us like inflation will pick back up again in the short-term, but unless oil prices rebound sharply it is unlikely that the headline inflation rate will break above 5.0% over the remainder of 2008. Indeed, we think that the global credit crunch, falling property prices and high oil prices will ultimately prove to be deflationary for the world/Irish economy, pointing to a sharp drop in inflationary pressures next year. As such, it would in our view be foolish for the Irish government to be factoring in a continuation of current high inflation over the next 12-18 months when it comes to the national wage talks. **At this stage, it looks like the average inflation rate in 2008 will be around 4.6% as against 4.9% in 2007, but the average rate next year should be closer to 3.0%, and every chance that the headline inflation rate will be low as 2.0% come the latter part of 2009.**

## House Prices:

### *....house prices to fall further this year....*

House prices took a turn for the worse in 2007 and for the year as a whole were down almost 7.5% on 2006. However, there is a general feeling out there that house prices have fallen more than the official statistics suggest. According to the latest *permanentsb/ESRI* index, house prices fell for the 17th month in a row in July. House prices were down 9.4% in the year, but this was an improvement on June when the annual decrease was 9.7%. In the first seven months of 2008, prices were down 5.2%. The average price of a house fell 0.2% in July, compared with a drop of 0.6% in the previous month and a 1.2% fall in May. The rate of decline in house prices appears to be moderating, which is encouraging, but there is still some way to go in our view before we reach the bottom. **Prices are likely to continue to drift lower into 2009 unless the Government takes some remedial action in the next Budget and/or the ECB takes an easier stance on interest rates. Overall, we think that it will be 2010 before house prices are back on a rising trend. We are looking for an average fall in house prices of 9.8% in 2008 and 7.5% in 2009.**

## Competitiveness:

### *....loss of competitiveness still an issue....*

Ireland's underlying competitiveness position continues to be negatively affected by exchange-rate developments. In its most recent quarterly economic bulletin, the Irish central bank said that one way of measuring the extent of the deterioration in price competitiveness is through examining trends in Ireland's Harmonised Competitiveness Indicator (HCI). The HCI can be interpreted as an effective exchange rate index for the Irish economy, which reflects trade-weighted movements in the euro exchange rate against our main trading partners. The HCI has increased steadily in recent years and by over 11% since the early part of 2006, and the most recent merchandise export figures would tend to suggest that exporting firms are facing significant competitive pressures. In the second quarter of 2008, the HCI was up by 7.6%, year-on-year. Meanwhile, there were relatively strong increases in pay in the economy in 2007, although it appears that wage increases moderated as the year progressed. It is likely that wage increases will be more moderate in 2008. This is based firstly on the fact that wage increases slowed in the latter half of 2007 and entered 2008 with less momentum than in previous years. Secondly, and more importantly, the prospects for employment and economic growth are considerably less favourable than in previous years with unemployment projected to increase significantly. Consequently, average nominal compensation per employee is projected to increase by just under 4.0% in 2008, down from almost 6.0% in 2007. The outlook for 2009 remains uncertain at this stage. The current pay element of the *Social Partnership, Towards 2016*, expires later this year and new pay negotiations are currently in progress, which would likely take effect from 2009 onwards. **Employment growth is projected to be negative in 2009, with the jobless rate increasing further. As a result, any wage increases next year are likely to be fairly modest.**

## Public Finances:

### *....public finances deteriorating at a rapid rate....*

The Exchequer figures for the first eight months of 2008 showed an overall budget deficit of €8,425m compared with an overall deficit of €2,879m in the same period last year. In the December Budget, the Government set an overall Exchequer deficit target for this year of €4,866m (-2.3% of GDP), and a General Government balance of -0.9% of GDP. However, in light of the severe economic downturn, it is now very likely Ireland's General Government balance will this year breach the 3.0% of GDP allowed for under the Maastricht Treaty. The seriousness of the situation has led to the unprecedented step of the Budget being brought forward. Instead of being presented in early December, the 2009 Budget will be unveiled on Tuesday, October 14. In January-August 2008, tax revenue amounted to €24,773m or 9.4% below January-August 2007. In the January-July period tax receipts were 9.3% lower year-on-year. Last December's Budget allowed for an overall official increase in tax revenue this year of around 3.5%. Furthermore, the figure of €24,773m up to the end of August was €2,762m below the Department of Finance's monthly profile projection of €27,535m. At the end of the July, tax receipts were €2,226m below target, so the overall underlying picture continues to worsen.

Within the tax profile all headings were running below target, with the biggest discrepancies in VAT (-€1,177m), Stamp Duties (-€480m) and Capital Gains Tax (-€436m). It is clear that consumer spending remains very depressed, a fact underlined by the latest new car sales data from the SIMI. After picking up in July following the changes in VRT rates at the start of that month, sales collapsed again in August, down 41.6% in the year, to leave sales in the first eight months of 2008 down 16.7% on the same period last year. Meanwhile, the poor performance in CGT reflects the adverse conditions in equity and property markets. The next key payment date for CGT is at the end of October, but no major improvement is expected. The size and speed at which the public finances have moved from a position of surplus (in 2006, the General Government was in surplus to the tune of 3.0% of GDP) to one of deficit is a source of serious concern. Given the likely deficit outlook for 2008, it means that there will have been a swing of 6 percentage points of GDP, or €10.5bn, from surplus to deficit in the public finances in the space of two years. However, it is important to put this in context. Firstly, the set of negative circumstances facing the Exchequer have been exceptional, originating from both domestic and external sources, and secondly, Ireland continues to have a very low debt to GDP ratio, a high level of public capital investment and a National Pension Reserve Fund, all of which bode well for sustainable growth in the long-term. **At this stage we now think the Exchequer will be in deficit to the tune of €8.5bn (though that's probably immaterial) in 2008, leaving the Minister for Finance, Brian Lenihan, with a major headache as he prepares to present his first Budget next month. Given our low debt/GDP ratio, we would strongly encourage the Minister to breach the Maastricht Treaty temporarily, and deliver a fiscal stimulus package (tax cuts) to boost the downtrodden consumer and flagging economy.**

**Table 5: Irish Exchequer Returns (€m)**

	2005 Out-turn	2006 Out-turn	2007 Out-turn	2008 (f) Out-turn
Central Fund	3,895	4,161	3,931	4,000
Supply Services	29,601	32,915	36,959	40,000
<b>Total Current Spending</b>	<b>33,496</b>	<b>37,076</b>	<b>40,890</b>	<b>43,000</b>
Tax Revenue	39,254	45,539	47,249	42,350
Non-Tax Revenue	595	606	638	650
<b>Total Revenue</b>	<b>39,849</b>	<b>46,145</b>	<b>47,887</b>	<b>43,000</b>
<b>Current Budget Surplus</b>	<b>6,353</b>	<b>9,069</b>	<b>6,997</b>	<b>0</b>
<b>Capital Deficit</b>	<b>6,852</b>	<b>6,804</b>	<b>8,616</b>	<b>8,500</b>
<b>Exchequer Balance</b>	<b>-499</b>	<b>2,265</b>	<b>-1,619</b>	<b>-8,500</b>
<b>(% of GDP)</b>	<b>(-0.3)</b>	<b>(1.4)</b>	<b>(-0.9)</b>	<b>(-4.6)</b>
<b>General Government Balance</b>				
<b>(% of GDP)</b>	<b>(1.1)</b>	<b>(2.5)</b>	<b>(0.5)</b>	<b>(-3.2)</b>

**....innovative measures needed in October Budget....**

The Government has finally woken up to the extent of the downturn in the Irish economy and the sharp deterioration in the public finances, with the date for Budget 2009 brought forward from early December to Tuesday, October 14. However, the question remains what sort of policy response should the Government be considering to halt the slide, and kick-start the economy? The early indications are that what we will get next month is a 'balancing of the book' exercise, but what we believe the economy needs is a significant fiscal stimulus. The Department of Finance appears to be far too obsessed with meeting the requirements of the Stability and Growth Pact (SGP) which pertain to Eurozone members, namely that the General Government Deficit in a given year should be no more than 3.0% of GDP and total government debt outstanding should be no greater than 60% of GDP. However, the bottom line is that the economy is in such 'dire straits' at the moment, that only a significant breach of Stability Pact rules through a substantial fiscal package will put the economy back on the road to recovery. The Government can rightly say that many of the factors that have led to the sharp downturn in the economy were outside of its control, but it would be wrong to base its fiscal strategy on the assumption that these factors will turn our way in the coming months. That indeed may be the case, and in fairness, there are signs recently that oil prices, the dollar and ECB interest-rate policy are moving in our favour. But, there is no guarantee that this situation will last indefinitely, and policy-makers need to have a Plan B (domestic fiscal strategy) in place if Plan A (improved external/global conditions) don't come to fruition. In reality though, government policy should be a combination of Plan A and Plan B, not an either or. **The Government should not be afraid to temporarily breach the SGP rules.**

Real Irish GDP growth was 6.0% last year and according to the latest Reuters monthly economists' poll, GDP is set to contract by 0.9% in 2008. We ourselves think GDP could fall by as much as 2.5% on average this year. **Either way, though, a slowdown in economic activity of at least 7 percentage points in the space of 12 months is clearly a large macro-economic shock of the scale recognised by the terms of the SGP as an acceptable reason to break the 3% deficit ceiling.** With public investment running at over 4% of GDP in 2007, Ireland's General Government Deficit can be interpreted as being primarily directed at investment spending, rather than consumption. At the end of the day, a high level of public investment is required to redress quite obvious deficiencies in the public capital stock, which has suffered from chronic under-investment during the long phase of fiscal austerity in the 1980s and 1990s. Again, the SGP explicitly recognises a high rate of public investment as an exculpatory factor in assessing breaches of the deficit limit. Most important of all, though, Ireland after 20 years of sustained improvement in its fiscal position, has a very low overall General Government Debt level as a % of GDP. According to the NTMA, Ireland's debt ratio was 24.8% of GDP in 2007, the second lowest in the Eurozone after Luxembourg. Furthermore, deducting the value of the National Pensions Reserve Fund and other funds managed by the NTMA, the debt ratio was just under 12% of GDP. **Although we recognise that the Government needs to tread carefully, and it is not quite clear at what stage in the economic cycle Ireland is currently at, doing nothing poses a greater risk than trying to do something positive in our view.** Below we list 10 policy issues that the Minister should consider in the forthcoming Budget, in an attempt to stimulate the economy.

1. **Boost consumer confidence through increasing disposable income** (e.g. cut income taxes).
2. **Restore confidence in the housing market** (e.g. cut stamp duty further).
3. **Remove the logjam in the banking system** (ensure borrowers who want a loan can get a loan, particularly for house purchase).
4. **Privatise remaining State-owned companies.**
5. **Reform public service** (a freeze on public sector wage bill a must).
6. **Offer tax relief for hard-pressed exporters.**
7. **Ensure the National Development Plan is delivered on.**
8. **Reduce VAT on energy bills** (would offset pain for consumers of recent sharp rise in electricity and gas bills).
9. **Make sure that price reductions are passed on to consumers** (this particularly relates to imported UK goods and sterling weakness versus the euro).
10. **Maintain low corporate tax regime and Ireland's high standard of education** (essential for trying to attract foreign direct investment to Ireland).

**The bottom line is that Ireland is facing into very difficult times over the next twelve months or so, but if the right fiscal response is put in place now, the length of the downturn can be shortened significantly. It is our view that the most appropriate response is a temporary breach of the Stability and Growth Pact rules by pushing the General Government Deficit as a % of GDP well over the 3.0% limit through a substantial fiscal stimulus. We also question whether in the current uncertain climate where many private-sector workers have lost their jobs, and many more are likely to do so before the crisis is over, that those in the 'sheltered sector' (i.e. civil servants) should be allowed make the policy decisions that will impact greatly on the 'non-sheltered' part of the economy.**

**Table 6: Adjusted Credit & Mortgage Annual Lending Growth %**

	Credit	Mortgages
Jul 2007	20.3	17.9
Aug 2007	20.1	17.0
Sep 2007	19.5	16.1
Oct 2007	18.5	15.1
Nov 2007	17.1	14.2
Dec 2007	17.0	13.4
Jan 2008	16.6	12.9
Feb 2008	15.6	12.3
Mar 2008	17.1	11.6
Apr 2008	15.9	11.4
May 2008	15.1	10.9
Jun 2008	14.3	10.2
Jul 2008	13.3	9.6

## Private-Sector Credit:

### ....credit demand continues to slow....

Although private-sector credit increased by €3.3bn during July 2008, which was above the average monthly increase for the year to date, its annual rate of increase weakened further, falling by one percentage point to 13.3%. This was the lowest annual growth rate since July 2002. Growth in non-mortgage credit also slowed in July, falling from 20.2% in June, to 18.8%. Outstanding indebtedness on credit cards fell in July. While new spending amounted to €1.2bn in the month, the level of payments received, at €1.3bn, exceeded this. The result was that the level of outstanding indebtedness on credit cards dropped back below €3bn in July, and its year-on-year increase declined to 10.2% from 11.4% in June. The annual growth rate of residential mortgages, inclusive of securitised residential mortgages, dropped to 9.6% in July. The last time the annual rate of increase in residential mortgages was in single figures was at end-1987. Residential mortgages increased by €964m in July, just above the average monthly change for the year to date of €923m. This is in marked contrast to the monthly increase of €2.4bn in July 2006 and underlines the extent to which activity in the housing market has contracted. Total outstanding residential mortgages stood at €146.3bn in July. The latest sectoral breakdown of private-sector credit is up to June 2008. Just three out of fifteen sectors experienced annual increases in credit of 20% or more in the second quarter of this year. The annual increase in lending for real estate activities reached its lowest rate since 1997 in the second quarter of 2008, at 20.7%. The annual growth rate in lending to construction declined to 4.6%, from 35.6% in the second quarter of 2007. Property-related lending, which accounted for nearly four-fifths of the total change in private-sector credit during the second quarter of 2007, accounted for half of the increase in the second quarter of this year. Meanwhile, it is not only Ireland that is suffering on the credit front but Eurozone as a whole. While companies' appetite for credit remained solid in July, mortgage lending growth fell to the lowest level in the Eurozone's history as homebuyers continue to run for cover in slumping markets in Spain, France and Ireland. Furthermore, the figures showed that currency in circulation and overnight deposits (M1) growth slowed to an all-time low of 0.5%, pointing to deep recession in the 15-country bloc in the coming months. **The bottom line is that the downward trend in Irish credit growth is likely to continue for the foreseeable future. Indeed, it won't be too long in our view before the annual rate of increase in overall credit demand will be running in single digits as well and below the Eurozone average (currently 11.1%). With the outlook for the Irish economy looking quite bleak over the next six to twelve months, credit growth is likely to weaken further going forward, and the unadjusted residential mortgage lending growth figure could turn negative before the year is out.**

## Interest Rates & Exchange Rates:

Table 7: Official Interest Rates 2008/2009

	Current	End Sept (f)	End Dec (f)	End Mar (f)	End June (f)
US	2.00	2.00	2.00	2.25	2.75
Eurozone	4.25	4.25	4.25	4.00	3.75
Japan	0.50	0.50	0.50	0.75	0.75
UK	5.00	5.00	4.75	4.50	4.25
Canada	3.00	3.00	3.00	3.00	3.00
Sweden	4.75	4.75	4.75	4.75	4.50
Norway	5.75	5.75	5.75	5.75	5.75
Switzerland	2.75	2.75	2.75	2.50	2.50
Australia	7.00	7.00	6.75	6.75	6.50
New Zealand	7.75	7.75	7.25	7.00	6.75
China	7.47	7.47	7.47	7.47	7.47

### ....as economy falters, Eurozone tries benign neglect ....

Despite rising risks of recession, the European Central Bank refuses to cut interest rates as long as inflation risks becoming invasive, and European governments say they have no money to help the economy through hard times. Europe's non-intervention looks all the more striking given that the Eurozone economy shrank in the second quarter, while growth in the United States, where the trouble started, picked up. **It is obvious that the ECB wants the Eurozone economy to sweat out its problems.**

One can only describe as “masterful inactivity” the ECB’s refusal to lower interest rates, let alone slash them like the Federal Reserve has done to support activity. As far as the ECB is concerned, it has a mandate focused on price stability, and nothing should be done that could worsen or prolong the run-up in inflation which has plagued the region for the best part of a year. The Eurozone economy, as ECB President Jean-Claude Trichet assessed at the central bank’s September monetary policy press conference, hit “a trough” in the second quarter and should start to recover once the third quarter draws to a close at the end of this month. However, we don’t share that analysis, and believe the 15-country bloc is heading for recession. Even if the European Central Bank were to cut interest rates now, it would probably be too late. What seems crazy to us is that in the US since last year people were saying non-stop that the credit crunch is the worst financial crisis since 1929. The word recession was deployed much faster. And since people then got scared they responded. We wouldn’t argue that the ECB should have cut rates with abandon as with the Fed, but the wisdom of all that hawkish rhetoric and the rate hike in July seems really questionable now. The general feeling out there is that Europe’s governments lack the budgetary resources for a stimulus plan of the kind Washington unveiled in January at a cost of some \$150bn, though France has called for discussions on a joint EU response to the problem. But, with no signs of a fiscal stimulus package and **with the ECB continuing to tow a tough line, there is every chance that the Eurozone will end up being the biggest loser of all.**

**Table 8: Bloxham Main Irish Economic Forecasts**

	Real GNP Growth (%)	Real GDP Growth (%)	Avg. Inflation Rate (%)	BOP		Budget Balance		Unemployment		Debt/GDP
				C/A €m	% GNP	€m	% GDP	Level '000	Rate (%)	Ratio (%)
<b>2006</b>	6.3	5.7	4.0	-6,304	-4.1	2,265	1.3	93	4.4	25.1
<b>2007</b>	4.1	6.0	4.9	-10,302	-6.4	-1,619	-0.8	101	4.5	24.8
<b>2008 (f)</b>	-2.5	-2.5	4.6	-12,722	-8.2	-8,500	-4.6	143	6.3	27.5
<b>2009 (f)</b>	0.5	0.5	2.8	-12,454	-7.9	-10,450	-5.5	180	7.9	32.0
<b>2010 (f)</b>	3.5	4.0	2.5	-10,700	-6.4	-9,100	-4.5	170	7.3	35.0

2/3 Exchange Place, IFSC  
Dublin 1, Ireland  
DX no: 64  
Tel: +353 (0)1 611 9200  
Fax: +353 (0)1 829 1877

86 South Mall  
Cork, Ireland  
DX no: 2008  
Tel: +353 (0)21 490 6500  
Fax: +353 (0)21 427 6036

100 O’Connell Street  
Limerick, Ireland  
DX no: 3046  
Tel: +353 (0)61 414 065  
Fax: +353 (0)61 419 750

info@bloxham.ie

The publication is solely for information purposes and cannot be construed as a representation by Bloxham. The views in this report are expressions of opinion and are given in good faith, but are not guaranteed. These are subject to change without notice.

Written by Alan McQuaid.  
Direct Tel:+353 (0)1 611 9226  
E-Mail:mcquaida@bloxham.ie

Published by Bloxham © 2008.

Bloxham is a Member of the Irish Stock Exchange and the London Stock Exchange. Regulated by The Financial Regulator under the Stock Exchange Act, 1995.

11/9/08