

# Economy Watch

Snapshot of Irish Economic Forecasts

Vol. 1 Spring 2008



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## 2008 SET TO BE A YEAR OF CHALLENGES FOR THE IRISH ECONOMY...

Forecasts for Irish economic growth in 2008 have been revised downwards across the board as the slowdown in the domestic housing market coincides with a turbulent external environment.

The more pessimistic commentators – Ulster Bank and Davy (+2.0%) – are now forecasting output growth in 2008 to be at its lowest level since pre-Celtic Tiger years.

On the other hand some commentators remain relatively optimistic, with Bank of Ireland, for example, predicting GNP growth at 4% in 2008.

While there is a consensus that growth will slow, historically when a recession arrives it has usually been forecast as a slowdown. There tends to be an

optimistic bias in downturns (not always offset by a pessimistic bias in upturns).

The *DKM Snapshot* of consumption and export forecasts – the expected sources of growth in 2008 – may turn out to be on the optimistic side. This is especially the case given consumer sentiment and the economic projections for the US and the rest of the world. In our next update we will be watching carefully the trend in the forecasts for these key drivers.

- ▶ GNP growth slipping back to just 2.6% in 2008, 3.5% in 2009
- ▶ Unemployment rate pushing up towards 5.5%
- ▶ Personal consumption growth to slow sharply this year
- ▶ Investment growth negative in 2008 as housing output falls
- ▶ Wage and price inflation to ease back
- ▶ Exports holding up well, despite weaker external conditions

### In this issue:

- ▶ Housing market weakness
- ▶ Consumer spending
- ▶ Prospects for Irish manufacturing
- ▶ Exports and exchange rates
- ▶ The benefits of slowing down
- ▶ Focus on the external environment

### At a Glance

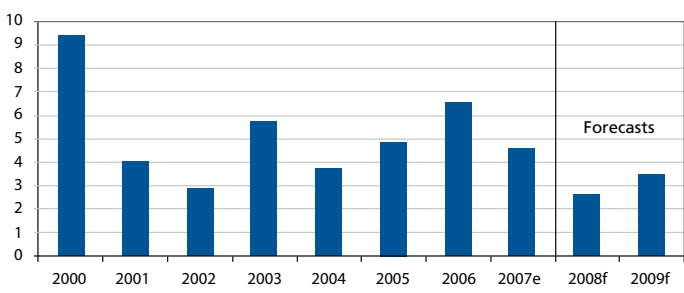
Summary of Forecasts*	2007	2008	2009
	%	%	%
GNP	4.8	2.6	3.5
GDP	5.1	2.9	3.6
Unemployment Rate	4.6	5.5	5.7
Employment Growth	3.1	0.9	1.6
Wage Inflation	4.9	4.3	4.2
CPI Inflation	4.9	3.3	2.5
HICP Inflation	2.8	2.5	2.1
Private Consumption	5.7	3.8	3.2
Public Expenditure	4.8	4.0	3.0
Investment	1.8	-4.6	2.4
Exports	6.4	5.4	4.7
Imports	5.1	3.9	4.1
Budget Balance	0.8	-0.7	-1.1

\*Figures represent forecast averages, see note on back page

## Snapshot of Irish Economic Forecasts - Annual % Growth

	GNP		GDP		Unemployment Rate*		Employment Growth		Wage Inflation		CPI Inflation		HICP Inflation	
	2008	2009	2008	2009	2008	2009	2008	2009	2008	2009	2008	2009	2008	2009
AIB	2.2	3.5	2.5	3.7	5.2	5.6	1.2	1.5	4.5	4.5	3.5	2.3	3.0	2.3
BOI	4.0		4.0		4.9		2.0		4.7		2.7		2.5	
Central Bank	2.6		3.0		5.6		0.8		4.1		3.5		2.6	
Davy	2.0	3.8	2.6	3.6	5.5	5.0	1.1	2.6	4.5	4.5	3.3	2.5	2.5	2.0
Dept. Finance	2.8	3.3	3.0	3.5	5.6	5.6	1.1	1.3					2.4	2.0
ESRI	2.3		2.3		5.8		0.4		4.0		3.3		2.8	
EU			3.5	3.8	5.3	5.5	1.3	1.5	4.0	4.0			2.2	2.0
Goodbody	2.3	2.5	2.3	2.5	6.0	6.3	0.3	0.8	4.9	3.7	3.2	2.5		
IMF	3.2	3.9	3.0	3.8	5.5		1.1		3.1				2.1	
NCB	3.3		3.5											
NIB			3.9		5.4								2.0	
OECD	3.0		2.9	4.2	5.6								2.5	
Ulster Bank	2.0	4.0	2.1	4.0	5.5	6.0	0.9	1.6			3.1	2.5	2.9	2.3
<b>Average</b>	<b>2.6</b>	<b>3.5</b>	<b>2.9</b>	<b>3.6</b>	<b>5.5</b>	<b>5.7</b>	<b>0.9</b>	<b>1.6</b>	<b>4.3</b>	<b>4.2</b>	<b>3.3</b>	<b>2.5</b>	<b>2.5</b>	<b>2.1</b>

### Irish GNP % Growth



### The housing market continues to weaken...

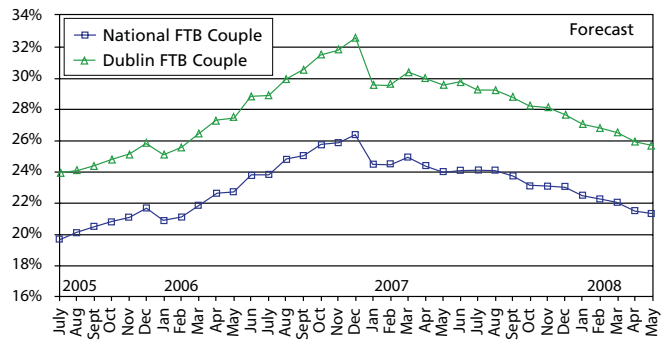
Most indicators now show a declining housing market. Average house prices fell by 7.5% nationally in 2007, with anecdotal evidence suggesting price reductions in the region of 20% required to shift new units in some areas. Employment in construction has already begun to decline, with the QNHS figure down 1.4% in Q3'07 on the previous quarter. Firms with 5 or more employees had shed over 5% of their workforce in the year to November '07. The value of mortgage lending fell by almost a third in the year to Q3'07.

Completions in 2008 are set to fall by between 30 and 40%. Based on a review of eleven forecasts, the average prediction for 2008 is 51,000 units. This would represent a fall of 42% on the 2006 peak, or 35% on the 2007 outturn. The impact on GNP growth could be significant, with a 35% fall in new housebuilding reducing GNP by around 3.5%.

Non-residential construction to compensate (somewhat) for the downturn in housebuilding. While private sector non-residential investment may yet respond to the economic slowdown, public sector capital expenditure is expected to increase by 20% in nominal terms this year compared with 2007, based on the continued roll-out of the National Development Plan.

On the up-side, affordability for first-time buyers has improved significantly. Falling house prices, increases in mortgage interest relief and stable mortgage rates have led to a welcome recovery in affordability back to early 2006 levels (see graph). This will be an important ingredient in stimulating a housing recovery over the medium term.

### % of net income required to fund mortgage repayments in the first year



### Consumer spending to slow sharply this year

Consumer spending was worth an estimated €87.2 billion to the Irish economy in 2007, equivalent to about 55% of GNP.

The DKM Snapshot of economic forecasts suggests consumption growth will slow sharply this year to +3.8%, following growth of 5.7% in 2007. Falling house prices, a slight increase in unemployment and weaker consumer sentiment will all weigh heavily on consumer spending in 2008. Despite a slight upturn in January, the IIB/ESRI Consumer Sentiment Index remains at its lowest level since August 2003.

At this point in time, average wages are expected to grow by 4.3% in 2008. With CPI inflation forecast at 3.3%, this implies real

Private Consumption		Public Expenditure		Investment		Exports		Imports		Budget Balance**		
2008	2009	2008	2009	2008	2009	2008	2009	2008	2009	2008	2009	
3.5	4.0	3.5	3.0	-10.0	-0.5	5.3	5.0	2.7	4.0	-0.9	-1.1	AIB
4.5		3.5		-2.0		5.0		4.0		-0.8		BOI
3.5		3.6		-3.6		5.8		4.2		-0.9		Central Bank
3.0	3.0	4.5	3.0	-7.9	3.8	5.7	5.0	3.1	4.7	-0.9	-1.0	Davy
3.8	3.9	3.6	2.9	-1.6	2.3	5.6	5.2	4.5	4.3	-0.9	-1.1	Dept. Finance
3.8		3.5		-3.7		5.0		4.4		-0.9		ESRI
3.4	3.7	3.5	3.0	-0.5	2.6	5.8	6.2	4.7	5.9	-0.2	-0.6	EU
3.0	2.0	4.5	4.0	-6.8	-1.3	5.0	4.0	3.1	2.8	-1.2	-1.7	Goodbody
3.7	1.8	3.5	0.5	-2.2	0.3	3.9	4.0	2.0	2.8	0.2	0.2	IMF
4.1		4.1		-3.7		5.6		3.9				NCB
5.0		4.0		-3.0		6.4		5.0				NIB
4.7		5.2		-1.9		5.4		5.2		1.0		OECD
3.0	3.3	4.5	3.5	-8.5	8.7	5.0	4.0	3.3	4.5	-1.4	-1.6	Ulster Bank
3.8	3.2	4.0	3.0	-4.6	2.4	5.4	4.7	3.9	4.1	-0.7	-1.1	Average

\* year average;  
\*\*as a % of GNP

wage growth of +1.0% this year. However, the prospects for wage growth are somewhat dependent on the next Social Partnership Agreement, as the current agreement expires in April 2008.

## Irish manufacturing appears to be holding up well ...although the outlook for '08 is uncertain

Provisional figures for December show Industrial output growth in 2007 at 7.4%. The 'modern sector' (which accounts for 36% of industrial employment and 71% of industrial output) performed particularly strongly in 2007 (+9.1%), while production in the 'traditional' sector increased by 2.5% last year.

Data on Irish industrial orders – an indicator of future activity – for November show annual growth of 10.6%, suggesting that activity in the sector could remain strong into 2008.

However, the latest *NCB Purchasing Managers Index* for January showed a deterioration in manufacturing business conditions for the second month in a row, with the index reaching its lowest level since July '03. The employment component of the index was particularly weak in January, hitting its lowest level since the survey began (in May 1998).

## Exports and exchange rates

A weaker economic outlook in our main trading partners (see overleaf) and the continued strength of the euro against both the dollar and the pound is likely to result in slower export growth this year. The *DKM Snapshot* shows export growth of 5.4% this year. Although lower than in 2007, this would nevertheless represent a remarkably robust performance in the Irish export sector, given the expected global slowdown this year.

The euro is now at an all time high against both the dollar and the pound, having gained more than 10% in value over the past year (see chart overleaf). Recent interest rate cuts in both the

US and UK point to the possibility of further falls in both currencies over 2008.

## Employment Outlook

Live Register returns indicate that the unemployment rate may have ticked up to around 4.9% in January. The *DKM Snapshot* shows unemployment moving further above trend this year, to 5.5%, the highest rate in almost a decade. Although this represents a slight increase in unemployment, Irish rates remain considerably below the Eurozone average (7.2% in December '07, Eurostat).

A recent TNS-mrbi survey (conducted in November) shows that business confidence among SME's in this country remains robust as we enter 2008. 58% of firms surveyed expect sales to increase in 2008, with only 10% predicting a decline. Furthermore, the survey suggests a positive outlook for employment, with just 6% of firms predicting a decline in their staff numbers for 2008.

## The benefits of slowing down...

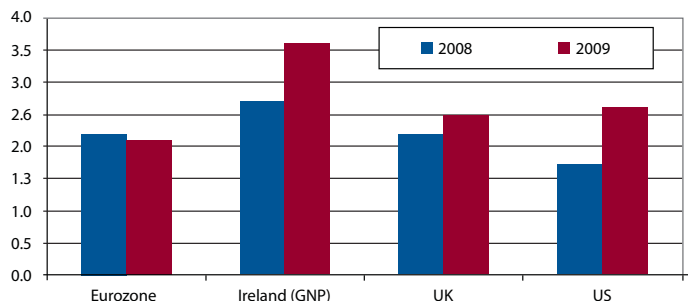
A slowdown in economic activity over the coming year could result in some easing of competitiveness pressures within the Irish economy. Most forecasters are predicting a marked slowdown in the rate of price and wage inflation for 2008. The *DKM Snapshot* shows CPI inflation falling to 3.3% in 2008, from around 5% in 2007. In fact the latest CSO data for January showed CPI inflation at 4.3%, down from 4.7% in December. HICP inflation is expected to be around 2.5% this year – this remains slightly higher than the forecast for the Eurozone of 2.1%.

The expected slowdown in construction activity in 2008, particularly in new residential building, should also help to rebalance the economy away from an over-reliance on the domestic construction sector. A movement towards lower levels of housing output over the next couple of years could represent a healthy adjustment towards more sustainable growth in the Irish economy.

# FOCUS ON THE EXTERNAL ENVIRONMENT

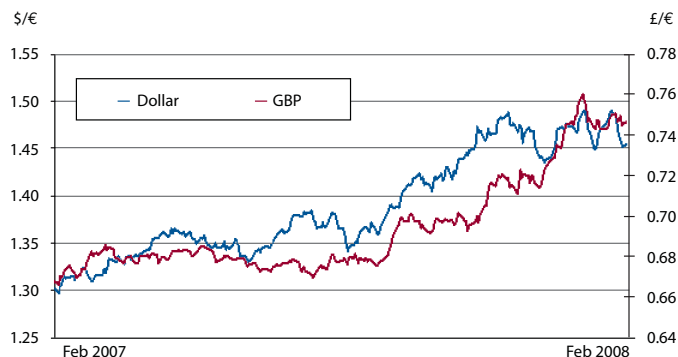
The risk of recession now looms over the US economy, while in both the UK and the Eurozone recent strong growth looks likely to weaken in 2008.

GDP % Growth Forecasts



Source: Eurostat, except Ireland (DKM Snapshot)

Euro vs Dollar and Sterling



Source: European Central Bank

## UK

The latest figures from the UK suggest that economic activity is set to weaken sharply over the course of the year.

- ▶ The UK housing boom appears to be at an end – house prices fell for the third month in a row in January, while new mortgage lending fell to a record low in December.
- ▶ Higher utility bills, tighter credit conditions, and a falling stock market likely to further weaken consumer spending.
- ▶ Manufacturing output fell again in December, while the manufacturing PMI survey for January was at its lowest level in two and a half years.
- ▶ Financial Services more vulnerable in the wake of recent turmoil in global markets.
- ▶ The Bank of England cut interest rates by 0.25 percentage points in February.
- ▶ However, continued price pressures mean that the Bank will be reluctant to cut rates too rapidly in the short term.

## US

Economic activity in the US has stalled as the sub-prime mortgage crisis continues to bite.

- ▶ GDP growth slowed dramatically in Q4 2007, to an annual rate of just +0.6%. The IMF has cut its 2008 growth forecast for the US to +1.5%.
- ▶ House prices are falling at their fastest rate since the 1930's, while a stock market slump combined with rising inflation have further dented consumers' confidence and spending power.
- ▶ Unemployment jumped to 5% in December.
- ▶ The Federal Reserve Board slashed 1.25 percentage points off interest rates in little over a week at the end of January. Meanwhile, the US government has introduced a \$150 billion fiscal stimulus package. Doubts remain, however, about whether these steps can avert a sharp downturn in 2008.

## Eurozone

There are mixed messages coming from the Eurozone economy.

- ▶ The Eurozone performed strongly through most of 2007; GDP grew 2.7% in the year to Q3 2007, driven by strong investment and exports.
- ▶ Unemployment remains stable at 7.2%, and German unemployment is now at its lowest since 1992 (8.1%).
- ▶ However, a number of downside risks are emerging for 2008:
  - Consumer spending is flat.
  - Manufacturing appears to be slowing.
  - Business confidence is weakening, with the Eurozone Purchasing Managers Index and the German Ifo Business Climate Index both in decline.
- ▶ While the ECB left interest rates unchanged (at 4%) at their latest meeting, there are growing expectations of rate cuts during 2008.
- ▶ The IMF now expects Eurozone growth for 2008 to slow to 1.6%.

NOTE: The average figures presented in this report (referred to in the text as the *DKM Snapshot*) represent a weighted average of the latest forecasts for the Irish economy from 13 independent sources, compiled by DKM. Older forecasts are given a smaller weighting in calculating this average. Figures quoted represent the latest available figures from each source at the time of going to press.

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