"Rules are for the obedience of fools and the guidance of wise men”

Douglas Bader

Quietly, without fanfare, the ECB has manoeuvred a dramatic decline in the international value of the Euro. This has been achieved without many loud accusations of beggar my neighbour policies and competitive devaluations. Nor has it stoked inflation in the Euro area although that may have been one of the objectives. The fall in energy prices has so far masked the inflationary impact of the decline in the Euro.

Lower oil prices and a competitive currency should allow the Euro area to grow its share of the world economy even if domestic demand is restrained. The noises coming from the EC and the ECB suggest that they believe a significant recovery is underfoot.

Why then are the forecasts for the Irish economy in 2016 lower than the expected outturn for 2015? A close analysis of the forecasts suggests that it is the Department of Finance and “official” forecasts, influenced by the Department, that are less optimistic. This may be a deliberate effort to downplay expectations in 2015 with an election looming next year. Do not be surprised if the official forecasts move upwards as Budget 2016 approaches thus permitting a degree of fiscal easing.

Indeed the Government have already been making noises with regard to the fiscal stringency still demanded of Ireland (but not France or Italy) by the EU. One suspects that, while the Greek government have learned a lesson in promising to spend money they don’t have, the EU have learned that keeping an undue rein on fiscal flexibility leads to the election of Governments with a mandate to behave irresponsibly.

The requirement that the Debt to GDP ratio should not be in excess of 60 per cent and the Government borrowing requirement be not more than 3 per cent of GDP is recited as if they represented an extra two commandments Moses brought down in stone. In an environment when some sovereign debt is trading at negative interest rates and Ireland can borrow at very low interest rates these rules make no sense. At 5 per cent interest rates (compatible with 2% inflation and 3% GDP growth per annum) a 60 per cent Debt to GDP ratio would result in an interest bill of 3 per cent of GDP. As long as GDP was growing at 5 per cent per annum nominal, the Debt to GDP ratio would be stable.

At current long term interest rates a Debt to GDP ratio of 150 per cent would result in a interest bill of 3 per cent of GDP. If Ireland can borrow additional funds at long term interest rates of 2 per cent and refinance existing debt at similar rates this should allow more flexibility in the fiscal stance. Expect this argument to be advanced with greater strength as the election looms. In the meantime the economic forecasts remain on the cautious side.

Forecasts At a Glance

<table>
<thead>
<tr>
<th></th>
<th>2014</th>
<th>2015e</th>
<th>2016f</th>
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<tbody>
<tr>
<td><strong>GNP</strong></td>
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<tr>
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<tr>
<td><strong>Domestic Demand (ex. Stocks)</strong></td>
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<td><strong>Private Consumption</strong></td>
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<tr>
<td><strong>Investment</strong></td>
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<td>11.2</td>
<td>8.7</td>
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<tr>
<td><strong>Exports</strong></td>
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<td>5.3</td>
<td>4.3</td>
</tr>
<tr>
<td><strong>Imports</strong></td>
<td>13.2</td>
<td>5.1</td>
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</tr>
<tr>
<td><strong>Unemployment Rate</strong></td>
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<td>8.8</td>
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<tr>
<td><strong>Employment Growth</strong></td>
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<tr>
<td><strong>Wage Growth</strong></td>
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<tr>
<td><strong>CPI Inflation</strong></td>
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<td>0.1</td>
<td>1.2</td>
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<tr>
<td><strong>General Gov. Balance</strong></td>
<td>-3.7</td>
<td>-2.7</td>
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</tbody>
</table>
Investment and exports the keys to growth…

Domestic demand buoyed by improved confidence which will encourage a more balanced economic expansion

The Irish economy has finally entered a phase of robust growth having expanded by the fastest rate in Europe in 2014. Growth of 4.8% in the year returned GDP to 2008 levels as – quite significantly – all sectors of the economy made a positive contribution. Agriculture (+10%) and distribution, transport & communications (+8%) were the foremost sectors of expansion. On the expenditure side, investment (+11.3%) and net exports (+10.4%) were the headline performers. Growth in private consumption was modest (+1.1%), although it was the first annual increase since 2010.

Domestic demand improved by 2.9% in the year to make a pronounced impact on economic growth, and consensus forecasts expect that it will continue to expand in 2015 and 2016. It is anticipated that growth in investment will be greatest as the construction market regains ground, while foreign direct investment – spurred by the weakened Euro – should continue apace, thus boosting building and plant investments. Private consumption – supported by income tax reductions and further improvements in the labour market – is expected to assume an important position in the recovery with volume forecasts of 2% and 1.9% in 2015 and 2016 respectively. However, an elevated debt burden per capita may act as a drag in this area.

As the final part of domestic demand, government spending is expected to increase over the coming two years, and especially in the lead up to the general election of 2016. Expenditure is forecast to increase by between 0.5% and 1.1% up to 2016 as the government gradually reduces the general deficit within (potentially softening) IMF and EU budgetary guidelines.

… as the economy continues to outperform its European neighbours.

Private debt and mortgage arrears may act as a drag on recovery

Consensus forecasts show that the Irish economy is expected to continue to experience robust GDP growth of 3.9% in 2015, with some moderation to 3.2% in 2016. An expected loosening of fiscal policy will provide added impetus. These fiscal stimuli will be facilitated by strengthening Exchequer returns in recent months, but the deficit will not fall as swiftly as a consequence. At the end of March, tax revenue collected was up by 13.4% year-on-year and stood 5.5% above profile. This unexpected bounce in tax intake will provide further leeway for the government to implement more expansive fiscal policies, thus stimulating the domestic economy.

Despite this optimism, an underlying economic issue remains in the form of the large debt overhang which private citizens need to service. A total of 145,949 mortgages were in arrears at the end of 2014, one quarter of which were buy-to-let mortgages. A worrying figure is that almost three quarters of the overall total were over 90 days in arrears. Moreover there are signs of increasing numbers of borrowers in difficulty facing a loss of ownership, which could increase the number of repossessions this year. The majority are likely to relate to principal dwellings, which, if they materialise, could put further pressure on demand in the private rented sector. As those in arrears strive to manage their financial situation and the over 41% of households with non-mortgage debt (Central Bank Bulletin, Q1 2014) do likewise, household debt will continue to restrain consumer spending in the medium term.

The general government deficit was approximately 3.7% of GDP in 2014 which was well inside the EU/IMF target level of 5.1%. The target for 2015 is 2.9% and consensus forecasts expect that this will be achieved despite the government implementing a less austere Budget 2015 against the advice of the IMF and EU, as firm signs of a recovery took hold. International confidence in the repair of the national finances is evident as yields on Irish 10-year bonds declined to below 1% for the first time ever in February. This was supplemented by another first in the financing of the State: the sale of Irish Treasury Bills at negative yields by the National Treasury Management Agency in March. Such low or negative interest rates are highly advantageous for the government when seeking finance or rolling over portions of a national debt which amounted to 110.5% of GDP (Department of Finance Monthly Bulletin, April 2015) at the end of 2014.
**Consumer Sentiment on an upward trend...**

The 3-month moving average of the KBC ESRI Consumer Confidence Index reached a 9 year high in March.

Consumer sentiment continues to show signs of improvement with the overall ESRI/KBC Consumer Sentiment index up in March to 97.8 from 96.1 in February. Indeed the March reading was the highest since April 2006 while the 3-month moving average also reached its highest point in nine years. Irish consumers have generally become more positive about their current and future household finances but displayed more uncertainty with regards to employment opportunities for the coming year. A further improvement in the Index of Consumer Expectations implies that their strengthening confidence in a broader economic recovery this year should prompt greater household spending. However the high debt levels referred to earlier suggests that spending in 2015 is likely to be lower than it would otherwise be.

**as motor trades drive improved retail sales...**

Consumer sentiment reflected in purchases of durables.

After a relatively stable period in the autumn and early winter of 2014, the Retail Sales Volume Index recorded a strong increase in February 2015 (+8.3% yoy). Gains were particularly pronounced for motor trades (+21.1%) and the sale of furniture & lighting (+20.7%). According to SILM, new car registrations increased by 14,816 (+29.7%) in the first three months of 2015 compared to the same period last year. Even when motor trades are stripped out of the Volume index, yoy growth in retail sales for February 2015 remained impressive at 4.9%. Notable negative contributions came from the volume of retail sales of books, newspapers and stationery (-3.6%) and the bar trade (-2.3%).

**but price deflation remains a concern.**

Consumer Price Index (CPI) dips below zero in three consecutive months.

It is to be hoped that augmented consumer confidence will be reflected in increased prices in the medium-term so as to avoid the deflationary-spiral currently threatening much of the Eurozone. The plummeting price of oil has been a key contributor to this situation, while the Irish CPI fell below 0% for a third consecutive month in February. Year-on-year price declines in February in the segments of transport (-7%), clothing & footwear (-3%), food & non-alcoholic beverages (-2.9%), and furnishings & household equipment/maintenance (-2.7%) were significant factors, partially offset by price inflation in education (+4.9%) and miscellaneous goods & services (+2.3%).

**Business confidence builds across sectors...**

Purchasing Managers’ Indices continue to portray growth.

Investec’s Services PMI for March remained in expansion mode (above 50) having reached a near 8-year high of 62.5 in January. Strengthening domestic demand is seen as a key factor in the index reaching 60.9 in March while the new orders index remains comfortably above average. The Manufacturing PMI slipped from a 15-year high of 57.5 in February to 56.8 in March as the weak Euro boosted exports but also pushed up input costs.

... as Live Register numbers continue to decrease.

Unemployment rate expected to fall below 10% this year.

2014 was a year of consistent improvements in the labour market as 29,100 individuals joined the workforce between Q4 2013 and Q4 2014. Construction experienced the greatest proportional increase in employment of 12.6% but the sector remains firmly in recovery mode from a very low base. Education had the second largest expansion as numbers employed rose by almost 5,000. Employment figures for caring, leisure & service occupations experienced a significant increase (+7.8%) and will have benefitted from the recent strength of an Irish tourism sector which will gain further from the currently weak Euro. Such improvements in the labour market drove numbers on the Live Register down by almost 40,000 in the year. The unemployment rate consequently fell from 12.1% in January 2014 to 10.4% at the end of the year, and down to a 6-year low of 10% in March 2015. Consensus forecasts expect that the average annualised rate will fall to below 10% in 2015 and below 9% in 2016.
Global growth projections for 2015 have been downgraded to 3.5% as the benefits of falling oil prices are expected to be outweighed by lower medium-term growth prospects in most major economies. Growth has been markedly uneven across the largest economies, with the United States outperforming expectations but most other economies falling short of expected growth rates. In Asia, it is anticipated that a moderate slowdown in China will compound the severe economic issues of Japan, while Russia will suffer from lower oil prices and a much-weakened Rouble. The Eurozone remains weak with a lingering concern over deflation, so global growth for 2015 will be driven by select emerging economies and a strengthening US revival.

**Euro Area**

Quantitative Easing drives the Euro to 12-year lows as green shoots finally emerge

The IMF forecasts that Eurozone GDP will rise by 1.2% in 2015 (reduced from the 1.4% projected in October 2014) as weak investment rates and a middling outlook hamper a broader recovery. Quantitative Easing (QE) — announced by the ECB in January but brought into effect in March — is a significant intervention by the ECB to stimulate a recovery. It is beginning to bear fruit in the form of stronger inflation projections and higher asset prices, while the significant depreciation in the value of the Euro will provide some boost for the export sector. The risk of deflation has loomed over the region for some time so the combination of increasingly expensive imports, a stimulated export sector and more abundant flows of money should alleviate the gravest concerns. Domestic demand will be supported by the fall in the price of oil as consumers’ disposable incomes can be directed to other sectors of the economy, while more neutral fiscal policies will also contribute positively.

The situation in Greece has calmed following the election of the Syriza party and its subsequent climb down on hard line pre-election promises, but concerns remain over the government’s commitments to enforce tax, revenue and structural reforms as part of an extended loan programme with the troika. In the largest economies of France and Germany, growth forecasts have been marginally reduced for 2015 to 0.9% and 1.3% respectively. The French situation is particularly troublesome as the country was recently granted a further 2-year extension to lower its government deficit below 3% of GDP, in return for commitments to reform. Italy is expected to experience only a minor economic expansion in the year, but Spain is expected to have growth of 2% -- albeit from a low base following five years of recession.

**United States**

Economy rebounds to beat expectations as unemployment continues to fall; interest rates to be gradually hiked

The US economy recorded strong growth of 2.4% in 2014 and the IMF anticipates that this will be backed up by a further expansion of 3.6% in 2015 (increased from the 3.1% projected in October 2014). The unemployment rate has benefitted considerably and now stands at 5.5%, far below the 2009 peak of 10%. Domestic demand has been a key driver of growth as falling unemployment coupled with low oil prices, increasing wages and an expansive monetary policy have boosted consumer spending. Inflation has been steadied by the mix of a strong dollar and low oil prices. The conclusion of the Fed’s QE programme has boosted the dollar, particularly against the Euro which is weakening from the ECB’s own QE stimulus package. The US has been a vital player in the worldwide oil supply market, boosting its production to reduce both the price of oil per barrel (down over 50% from its 2014 peak) and the traditional dominance of OPEC countries in the market.

At its March meeting, the Federal Open Market Committee (FOMC) made a minor alteration to its monetary policy statement which now indicates that the Federal Reserve is confident in the economy’s revival and will most likely hike interest rates within its next two meetings (in April and June).

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<tr>
<th>Major economies’ GDP growth forecasts</th>
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<td></td>
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<td>2014 (%)</td>
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<td>UK</td>
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<td>China</td>
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<td>India</td>
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**United Kingdom**

Budget 2015 adheres to fiscal prudence as exports suffer from a strong Pound

Budget 2015 contained few surprises as the Chancellor of the Exchequer stuck to his promise to continue on the path of fiscal prudence despite the looming general election on May 7th. Headline budgetary giveaways — accommodated via adjustments in other areas — consisted of a tax cut for the currently challenged oil sector, an increase of the income tax threshold and a reduction or freezing of duties. The Budget comes against the backdrop of an economy which expanded by 2.6% in 2014, and is forecasted by the IMF to grow by a further 2.7% in 2015. The UK’s unemployment rate has continued to decline and stands at 5.7%, 1.5 percentage points below the same period in 2014. This, along with low interest rates, has helped domestic demand to recover, despite wages remaining depressed relative to the rest of Europe.

The continued strength of the Pound Sterling against the Euro has hurt trade as 2014 saw a 2.2% year-on-year decline in EU export levels. The Pound’s appreciation was particularly pronounced at the tail end of 2014, and this is reflected in January 2015’s exports to the EU falling 11.5% below the same month last year. Trade with all major European economies declined and exports to Ireland fell by 15.7% yoy. The hope is that as the Eurozone economy recovers, so too should the UK’s current account deficit, which ended the year 2014 at 5% of GDP.