

# Economy Watch

Snapshot of Irish Economic Forecasts

**FINAL PRINT ISSUE**  
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## EXCESS HOUSING INVENTORY CANNOT BE ELIMINATED WITH RESTRICTIVE CREDIT

The combined housing collapse and global credit crisis has left Ireland in one of the worst situations among developed economies. We cannot rely on an improved global economic outlook to pull us out.

Excess housing inventories represent the 2nd stage of a recessionary decline in final demand. Until inventories are reduced, new construction will not take place. In retail, excess inventories lead to sales and price reductions to clear stock. This has been happening gradually in the housing market.

One factor slowing the move to equilibrium is the fear of pricing below the "real" price and forgoing profits. Another is that dramatic price cuts may not work unless combined with measures to free up credit for buyers.

If one looked at the Irish banking system as one single bank (given the coverage of State Guarantees that is not entirely unrealistic) it is clear that banks can only *reduce* their exposure to developers by *increasing* their exposure to homebuyers. Unless some outside party enters the Irish mortgage market on a grand scale, the domestic credit crisis will require actions to reduce excess housing inventory.

It is difficult to see individual house-buyers as a worse credit risk than developers gloomily surveying millions of square feet of unsold apartments and houses. Unfortunately, the main emphasis in banks is to reduce the balance sheet which means rationing mortgages to homebuyers while trying to get developers to reduce their credit lines. It is a circle which cannot be squared and is likely to prolong and intensify the current economic recession.

- ▶ 5 percentage points cut from *DKM Snapshot* 2009 GNP forecast
- ▶ Irish economy to contract 1.8% in 2008 and 2.1% in 2009
- ▶ Investment to plummet 19% in 2008 and 19% again in 2009
- ▶ Unemployment could exceed 8% by end 2009
- ▶ Budget deficit well outside EU limit throughout 2008/09
- ▶ Export growth to slow to 2.1% in 2009 in a weak external environment

### In this issue:

- ▶ Global crisis hits Irish markets
- ▶ Credit markets drive housing affordability
- ▶ Construction: the most serious contraction in 25 years
- ▶ Consumer and business confidence sinks
- ▶ Focus on the external environment

### At a Glance

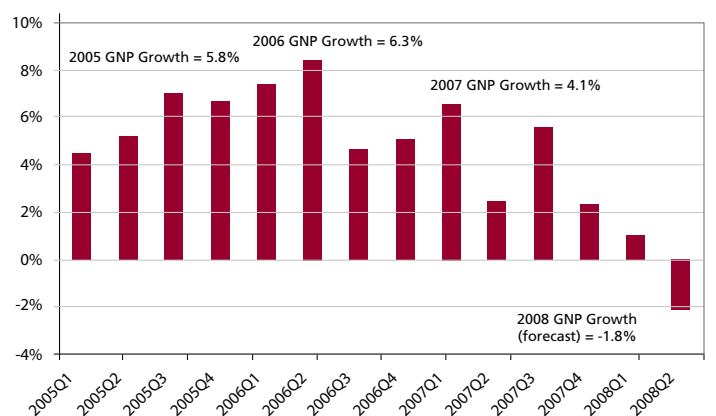
Summary of Forecasts*	2007	2008	2009
	%	%	%
GNP	4.1	-1.8	-2.1
GDP	6.0	-1.7	-1.7
Unemployment Rate	4.5	6.2	7.8
Employment Growth	3.6	-0.2	-1.5
Wage Inflation	4.8	4.0	2.7
CPI Inflation	4.9	4.3	1.8
HICP Inflation	2.4	3.2	2.0
Private Consumption	6.3	-0.3	-0.8
Public Expenditure	6.0	4.1	0.7
Investment	1.2	-18.6	-18.7
Exports	6.8	2.2	2.1
Imports	4.1	-1.0	-1.3
General Gov. Balance	0.3	-5.1	-7.0

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

### Snapshot of Irish Economic Forecasts

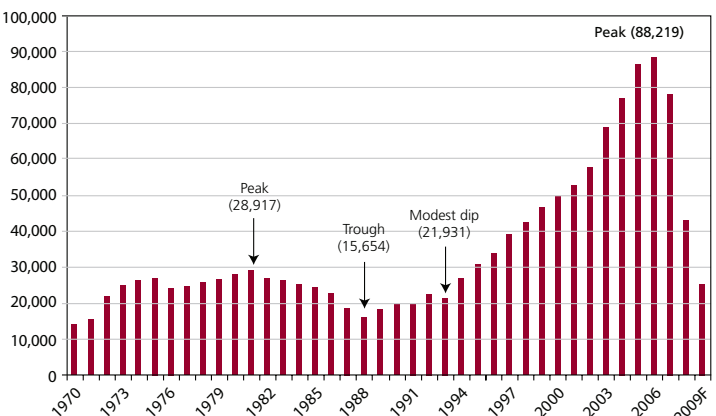
	GNP		GDP		Unemployment Rate*		Employment Growth		Wage Inflation		CPI Inflation		HICP Inflation	
	2008	2009	2008	2009	2008	2009	2008	2009	2008	2009	2008	2009	2008	2009
AIB		-3.5		-2.5		7.5		-2.5				1.1		2.4
BOI	-1.5	-1.0	-1.6	-1.0	5.8	7.5	0.0	-1.5	4.0	3.0	4.4	2.2	3.3	2.2
Blokhams	-2.5	-2.5	-2.0	-2.2	6.3	7.9	0.0	-1.7	4.5	2.5	4.5	2.7	3.3	2.8
Central Bank	-1.4	-1.3	-0.8	-0.9	5.9	7.5	-0.3	-0.9	3.9	3.2	4.4	1.9	3.3	1.6
Davy	-2.0	-3.4	-1.7	-2.8	6.6	8.5	-0.2	-3.9	4.0	3.5	4.3	0.6	3.3	1.1
Dept. Finance	-1.6	-1.0	-1.3	-0.8	5.8	7.3	0.0	-0.9			4.4	2.5	3.4	2.2
ESRI	-1.3	-0.7	-1.3	-0.7	6.1	8.0	-0.7	-2.2	3.5	2.5	4.5	2.0	3.3	2.4
Goodbody	-2.4	-4.5	-2.5	-4.0	6.5	8.3	-1.9	-1.7	4.4	2.2	4.4	2.0		
IBEC	-1.6	-1.4	-1.9	-1.5	5.9	8.2	-0.1	-1.5			4.5	2.5		
IMF			-1.8	-0.6	5.7	7.0	2.1	2.1					3.2	2.1
NIB	-1.5	-1.0	-1.5	-0.5	7.0	8.0	-0.5	-2.0	4.5	2.0	3.6	1.5	2.5	1.5
Ulster Bank	-2.0	-3.0	-2.0	-3.0	6.5	7.5	0.0	-1.5	4.0	3.0	4.1	0.8	3.2	1.6
NCB	-1.0	0.4	-1.6	0.0	5.8	6.7	0.6	0.2	4.1	3.6	4.8	2.7		
EU			2.3	3.2	5.6	5.8	0.7	1.6	4.9	3.5			3.3	2.4
OECD			1.5	3.3	5.7	6.5	1.3	0.8	3.7	3.6			3.4	2.1
<b>Average</b>	<b>-1.8</b>	<b>-2.1</b>	<b>-1.7</b>	<b>-1.7</b>	<b>6.2</b>	<b>7.8</b>	<b>-0.2</b>	<b>-1.5</b>	<b>4.0</b>	<b>2.7</b>	<b>4.3</b>	<b>1.8</b>	<b>3.2</b>	<b>2.0</b>

### Quarterly real GNP growth (yoy)



Source: CSO

### Housing Supply Cycle



Source: DEHLG, DKM

## Global crisis hits Irish markets

“Uncertainty” prevails in 2009 forecasts. Financial market turbulence has significantly amplified the effects of an already weak housing sector and private consumption levels. Even though the government has stepped in to guarantee bank deposits, instability remains a feature of Irish markets and consumer and business confidence is low. Forecasters warn that further downward revisions are possible.

## Credit markets drive housing affordability

Although affordability (i.e. the percentage of net income required to fund a mortgage) has improved, the ability to raise the required deposit has seriously deteriorated. Credit markets are currently driving housing market transactions – in a stable environment, interest rates and incomes would be more important.

## Construction...the most serious contraction in 25 years

Housing supply will weaken again in 2009. The 6 available forecasts project an average 25,000 houses to be built next year, 72% below the peak of 88,219 in 2006.

DEHLG forecasts overall construction output to decline by more than 20% this year and over 15% in 2009. The sharp contraction in housebuilding is compounded by difficulties securing debt-finance for private non-residential construction and the €1.6 billion '09 Budget cut to capital spending.

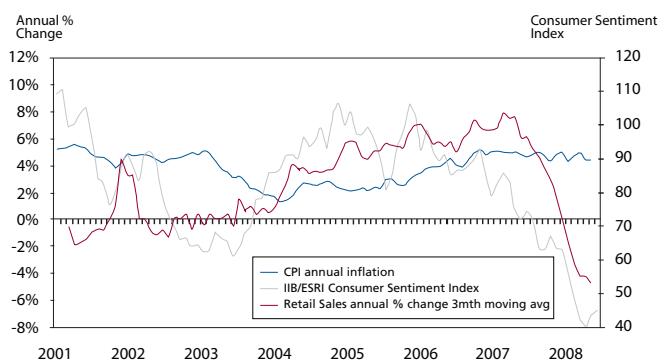
## DKM Snapshot: investment to contract 19% in '08 and 19% again in '09

CSO data for Q2 '08 showed investment has declined 18.8% since Q2 '07, marking one full year of contraction. Investment in new houses was down 30%, and machinery and equipment down 19% (excl. aeroplanes), reflecting low business confidence.

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

Private Consumption		Public Expenditure		Investment		Exports		Imports		General Gov Balance**		Forecast Date	
2008	2009	2008	2009	2008	2009	2008	2009	2008	2009	2008	2009		
	-1.7		0.5	-	-22.5		2.5		-1.5			AIB	10/08
0.0	0.0	4.0	1.0	-17.4	-12.0	2.0	1.5	-1.0	-0.5	-5.5	-6.6	BOI	10/08
-1.0	-1.5	4.5	0.8	-15.0	-17.5	1.0	2.2	1.0	-1.5	-5.5	7.5	Bloxhams	10/08
0.4	0.4	5.0	2.2	-17.3	-16.8	2.5	2.2	-0.7	-0.6	-2.8		Central Bank	10/08
-0.5	-2.8	4.0	2.8	-19.3	-25.8	1.8	1.5	-1.7	-3.4	-5.6	-9.1	Davy	10/08
0.7	0.5	3.9	0.7	-19.2	-17.2	2.5	2.5	-0.8	-1.0	-5.5	-6.5	Dept. Finance	10/08
-0.5	0.5	4.0	-1.0	-19.8	-19.1	2.9	2.9	-1.7	-1.2	-5.5	-5.4	ESRI	10/08
-0.5	-3.0	4.2	1.0	-18.0	-19.3	1.5	1.3	-0.9	-1.2	-6.2	-8.7	Goodbody	10/08
0.0	0.5	3.8	-2.0	-22.3	-17.9	2.3	1.8	-1.8	-1.0	-5.0	-8.0	IBEC	10/08
										-4.0	-4.7	IMF	10/08
-0.5	0.0	4.0	1.0	-18.0	-18.0	3.0	3.0	-1.0	-1.3	5.5	-6.5	NIB	10/08
-1.0	-2.0	4.0	1.0	-20.0	-20.0	2.0	1.5	-1.0	-1.5	-5.5	-7.0	Ulster Bank	10/08
1.4	1.1	3.9	2.4	-17.9	-12.3	2.0	2.9	0.1	1.0	2.8	3.9	NCB	08/08
2.9	3.2	3.5	1.6	-7.4	2.5	5.4	4.9	3.3	4.5	-1.4	-1.7	EU	04/08
3.0	2.6	4.3	3.6	-9.2	1.5	5.0	3.8	3.4	2.9	-1.3	-2.6	OECD	06/08
-0.3	-0.8	4.1	0.7	-18.6	-18.7	2.2	2.1	-1.0	-1.3	-5.1	-7.0	Average	

## Retail Sales, Consumer Sentiment and Inflation



Source: CSO, IIB/ESRI

## Consumers continue to brace for recession

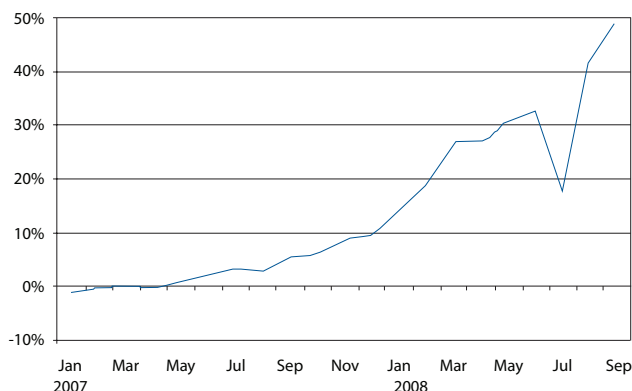
Retail sales volumes fell 6% in August compared with August '07, representing the largest annual decrease since February 1984 (CSO). Low sales reflect weak consumer sentiment, stemming from recent high inflation, financial market instability and the wealth effects of asset price and house price losses.

The housebuilding contraction is also impacting on retail sales. The greatest fall in August sales volumes was in Furniture & Lighting (down est. 20% on Aug '07). Despite relief from lower inflation and interest rates, the *DKM Snapshot* projects a further 0.8% contraction in private consumption in '09, as rising unemployment hits spending power and consumer confidence remains shaken.

## DKM Snapshot: Heading for 8% unemployment

Live Register figures for September indicate unemployment may

## Live Register Annual % Change



Source: CSO

have risen to 6.3%. Total numbers reached 244,500 (seas. adjusted), up 9,400 from August and 79,565 (49.5%) from September '07.

## Deflationary '09 Budget won't tackle deficit

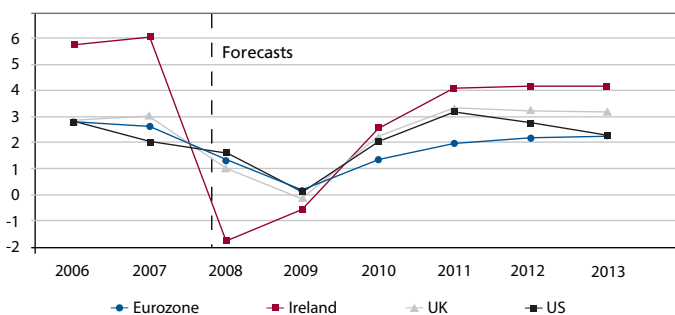
The *DKM Snapshot* deficit of 5% of GDP in '08 and 7% of GDP in '09 is more pessimistic than the Department of Finance. A greater contraction in GDP than the DOF has forecasted will result in lower tax receipts, greater social welfare payments and a greater deficit. Deflationary measures – including an income tax levy for high income earners, increases to CGT and DIRT, and an 8.4% cut to capital spending – are now being employed to contain the deficit. Current spending will grow at 6.5% in '09, offsetting the deflationary impacts. While this has slowed from the 10% growth seen in '08, continued high growth will quickly become unsustainable, as options to cut capital spending and raise revenue are exhausted. (DOF forecasts)

# FOCUS ON THE EXTERNAL ENVIRONMENT

The world economy is reeling from the fallout of a prolonged credit binge. Housing markets continue to weaken, although the full effects of chaos in financial markets have yet to filter down to the “real economy”. Despite inflation easing off, the path back to sustainable growth looks rocky – at least for 2009.

Recent economic news has been overwhelmed by the turmoil in global financial markets, beginning with the collapse of Lehman Brothers on September 14. Despite governments stepping up to recapitalise banks and guarantee deposits, markets remain highly unstable. This has amplified the effects of the global downturn.

## % Real GDP Growth - IMF Projections



Source: IMF

## Weak prospects for global growth

The IMF's World Economic Outlook (Oct '08) projects that global growth will slow to 3% in 2009, its slowest rate since 2002 (down from 5% in 2007 and 3.9% in 2008). The slowdown will be most pronounced in the advanced economies, where growth is expected to fall from 1.5% in 2008 to 0.5% in 2009, 2% in 2010, with recovery to 2.9% in 2011. It is encouraging that the IMF projects a return to trend within 2 years, although this is heavily caveated on governments successfully restoring stability to global financial markets.

The IMF projection of Ireland's contraction is noticeably greater than that for the US, UK and broader Eurozone – highlighting our reliance on the construction sector for much of our growth in recent years.

Increased credit tightening internationally is making it more difficult for banks to finance worthwhile investments. It is as if there is no fuel going into the engines of economic growth.

Credit tightening will continue to affect the “real economy” by

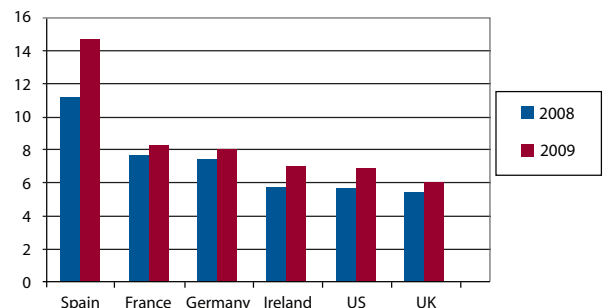
reducing investment and private consumption levels, which knock on to industrial production and the construction industry. Then rising unemployment feeds back into lowering consumption and investment and so on. Government budgets will also be strained by falling revenues and greater social welfare payments, on top of the costs of bailing out banking systems.

Exports are also expected to suffer in a weak external environment. The IMF projects world trade volume growth will slow to 4.1% in 2009 (down from 9.3% in 2006 and 7.2% in 2007).

Industrial production fell 0.9% in Europe in the year to July and 0.1% across the entire OECD, having grown at 4% and 3% respectively over 2006 and '07 (OECD).

Unemployment rates are expected to rise in 2009 to rates not seen in most countries for a decade – Spain will suffer most through unemployment in its construction industry.

## IMF Unemployment Projections



Source: IMF

## Inflation: some relief for advanced economies

With the global slowdown hitting demand, the price of oil has slumped, quelling the threat of growing inflation in advanced economies. Interest rates will be cut to help stimulate the economy. This should help to prevent further mortgage defaults, without risking high inflation. However, confidence will take time to restore. The focus remains on governments' abilities to shore up stability in financial markets.

NOTE: The average figures presented in this report (referred to in the text as the *DKM Snapshot*) represent an average of the latest forecasts for the Irish economy from 15 independent sources, compiled by DKM. Due to recent significant economic events, forecasts more than one month old have not been used to calculate the average. Figures quoted represent the latest available figures from each source at the time of going to press.

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