

Economy Watch

Snapshot of Irish Economic Forecasts

Vol 4. March 2009



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THE SLUMP IS GETTING SLUMPIER

In a reverse of the optimism in the heady days of almost double digit growth, forecasters are now outdoing each other in pessimism. To paraphrase a former leader, "The slump is getting slumpier".

It is clear that, in line with most developed economies, the economic brakes were slammed on in Ireland in the last quarter of 2008 and demand destruction continued in 2009. In Ireland, as in the UK and Spain, the collapse in private demand was against a background of weakening construction demand as the property boom subsided from early 2007. The Irish experience is not unique but the fiscal implications are unique.

Forecasts for the Irish economy are made on an annual basis. So even if the economy picked up towards the end of 2009 (and that is not suggested by the narrative of most forecasters) there will still be a measured decline in 2010. This is a law of arithmetic rather than economics.

In the current fiscal environment it is difficult to envisage domestic demand providing a stimulus. Public spending is being cut and will be cut further. The Government is in serious denial if it believes that the rise in the deficit caused by the functioning of automatic stabilizers such as unemployment benefits and declining activity-related taxes represent a stimulus.

The microeconomic role of Bord Snip Nua may be an essential antidote to the public spending binge of the last decade, but the macroeconomic effect of cuts will be real and immediate. One man's waste may be another's job.

[Continued on page 4.](#)

- ▶ GNP to contract by 6% in 2009 – a 4 point cut since our last issue.
- ▶ Unemployment rate approaching 11% and rising
- ▶ Government deficit to exceed 10% of GDP in 2009
- ▶ Domestic demand weak throughout 2009

At a Glance

Summary of forecasts*	2008a	2009f	2010f
	%	%	%
GNP	-3.1	-6.0	-2.6
GDP	-2.3	-5.4	-2.1
Private Consumption	-0.8	-4.4	-3.1
Investment	-19.9	-23.6	-10.9
Public Expenditure	2.1	0.3	0.4
Exports	-0.4	-2.8	0.1
Imports	-4.4	-6.3	-2.1
Unemployment Rate	6.1	10.9	12.6
Employment Growth	-4.1	-6.4	-4.8
Wage Growth	3.3	-0.4	-0.7
CPI Inflation	4.1	-2.6	0.2
HICP Inflation	3.1	-0.2	0.7
General Gov. Balance	-6.3	-10.6	-10.7

*2009 and 2010 are forecast averages, see note on back page

In this issue:

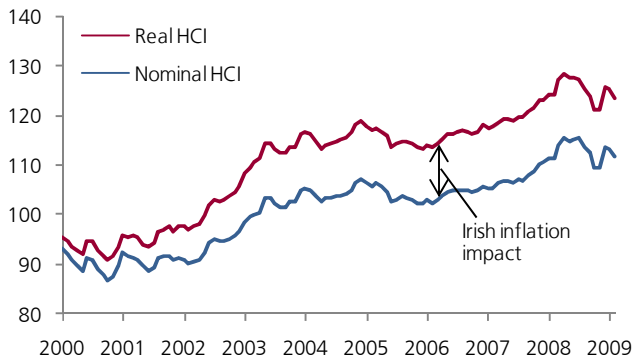
- ▶ Opinion: Restoring public finances and clearing the housing market are immediate priorities for recovery
- ▶ Improving Ireland's competitiveness as domestic economic indicators spiral downward
- ▶ Priorities for the April Budget
- ▶ Focus on the External Environment

Snapshot of Irish Economic Forecasts

Annual % change

	GNP		GDP		Private Spending		Investment		Public Spending		Exports		Imports		Forecast Date
	2009	2010	2009	2010	2009	2010	2009	2010	2009	2010	2009	2010	2009	2010	
AIB	-3.5	-0.5	-4.0	0.0	-2.5	-1.0	-23.5	-9.0	0.5	0.5	0.0	2.0	-3.5	-0.2	01/09
BOI	-4.0		-1.5		-2.0		-17.5		0.7		-0.5		-4.0		01/09
Bloxhams	-5.0	-2.5	-4.0	-1.0	-2.5	-0.5	-18.5	-5.5	0.8	1.0	0.2	2.0	-4.0	-2.0	01/09
Central Bank	-4.7		-4.0		-2.5		-25.2		0.5		-0.7		-4.6		01/09
Davy	-7.0	-4.1	-6.7	-3.6	-5.0	-5.0	-25.2	-19.0	0.0	-3.5	-5.1	-1.2	-8.0	-4.3	02/09
Dept Finance	-4.5	-1.1	-4.0	-0.9	-2.7	-0.9	-22.7	-11.5	0.7	0.6	-0.5	0.7	-4.5	-1.7	01/09
ESRI	-4.6		-3.9		-3.6		-19.3		-1.0		-0.4		-3.5		12/08
EU			-5.0	0.0	-3.3	0.4	-26.3	-4.1	0.5	0.8	-2.6	1.4	-6.1	1.3	01/09
Goodbody	-6.3	-2.8	-6.0	-2.5	-7.0	-5.0	-22.6	-13.5	0.4	0.2	-2.5	0.0	-6.9	-3.3	02/09
IBEC	-1.4		-4.0	-1.5	-3.1	-2.6	-22.2	-5.6	-1.0	-1.0	1.0	2.0	-2.0	1.3	12/08
IMF			-0.6	2.5											11/08
NCB	-4.9	-1.4	-4.4	-1.2	-3.9	-1.9	-21.3	-10.5	0.7	0.6	-0.9	2.3	-3.6	1.0	02/09
NIB	-6.0		-6.0		-4.5		-25.0		-1.0		-6.0		-10.0		03/09
OECD			-1.7	2.6	0.4	1.6	-23.8	-2.6	2.3	1.5	1.4	2.7	-1.2	0.5	11/08
PwC			-4.1		-3.1		-19.0		2.2		-1.3		-3.6		01/09
Ulster Bank	-7.9	-3.4	-8.0	-3.5	-6.5	-5.0	-27.7	-8.7	0.0	-2.0	-4.0	-2.5	-7.5	-4.0	03/09
Average	-6.0	-2.6	-5.4	-2.1	-4.4	-3.1	-23.6	-10.9	0.3	-0.7	-2.8	0.1	-6.3	-2.1	

Harmonised Competitiveness Indicators



Source: Central Bank

From boom to bust

Ireland has experienced a dramatic reversal from 4.1% GNP growth in 2007 to a 3.1% contraction in 2008. *The DKM Snapshot forecasts GNP contracting a further 6% in 2009, with more recent forecasts as low as -8%. Based on a limited number of forecasts for 2010, another 2.6% contraction is expected.*

Although the international financial crisis exacerbated the domestic downturn, cracks were developing over the last decade. *The National Competitiveness Council has shown that Irish competitiveness declined by 32% between January 2000 and September 2008* (see chart above). One third of the loss was due to higher costs (difference in real and nominal HCI), and the remainder the stronger euro (real HCI).

The Central Bank confirmed in January that competitiveness declined further during 2008. However, a weak labour market and deflation in 2009 may partially counteract the exchange rate impact, to the extent that these affect Ireland more than our trading partners.

As of January 2009, average national house prices had fallen by 17.1% (or 20.1% in real terms) since the peak in early 2007 (ptsb/ESRI House Price Index). Despite record low interest rates, construction activity will not pick up until credit markets begin to function properly again and confidence is restored.

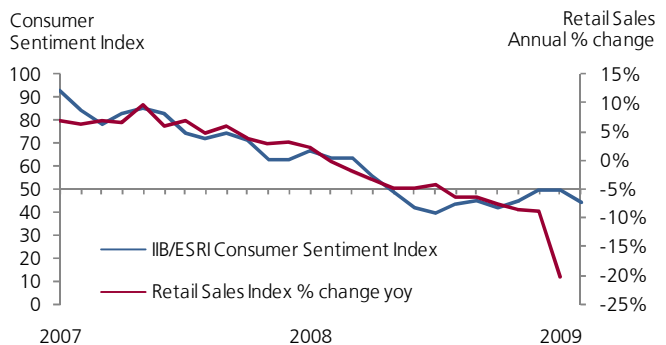
Poor sentiment restrains domestic demand...

So far, 2009 has seen a continuation of the sharp downward trend in consumer sentiment and retail sales (see chart below).

The IIB/ESRI Consumer Sentiment Index fell 5 points in February (left axis). Retail sales in January were down 20.4% from their January 2008 level, falling by a significant 9.4% since December 2008 (right axis). The main driver was car sales, which fell 42.2%. Sales of furniture & lighting, electrical goods and household goods also fell substantially in the year to January.

The DKM Snapshot projects private consumption will decline 4.4% in 2009 and 3.1% in 2010. Investment will fall 23.6% in 2009 and 10.9% in 2010, following a 19.9% contraction in 2008.

Retail Sales and Consumer Sentiment



Source: CSO, IIB/ESRI.

... amid falling export orders

Falling export orders in February led to a record low NCB Purchasing Managers Index – marking the 15th successive month of contraction.

The DKM Snapshot projects exports will decline 2.8% in 2009, returning to a negligible 0.1% growth in 2010. Given weak domestic demand, this would indicate limited prospects for recovery in 2010.

Snapshot of Irish Economic Forecasts

Annual % change

* year average; ** as a % of GDP

	Unemployment Rate*		Employment Growth		Wage Inflation		CPI Inflation		HICP Inflation		General Government Balance**		Forecast Date
	2009	2010	2009	2010	2009	2010	2009	2010	2009	2010	2009	2010	
AIB	9.0	10.0	-3.5	-2.2	1.0	1.0	-2.5	1.0	0.0	1.2	-9.0	-10.0	01/09
BOI	9.8		-4.0				-2.0		0.4		-6.5	-10.6	01/09
Bloxhams	9.5	11.0	-5.0	-2.5	-2.0	0.0	-0.8	1.5	0.5	1.5	-9.5	-8.0	01/09
Central Bank	9.4		-4.6		0.4		-1.9		0.2		-9.5		01/09
Davy	12.1	14.1	-7.5	-7.5	1.0	-2.0	-3.9	-2.0	-1.4	-1.5	-13.3	-11.6	02/09
Dept Finance	9.2	10.5	-4.0	-1.9			-1.0	1.5	0.5	1.5	-9.5	-9.0	01/09
ESRI	9.4		-5.5		0.0		-2.0		0.5		-10.2		12/08
EU	9.7	10.7	-4.0	-1.5	0.9	1.6			0.7	1.8	-11.0	-13.0	01/09
Goodbody	12.6	14.9	-6.9	-4.4	-0.1	-2.4	-3.0	-0.4			-12.3	-13.2	02/09
IBEC	10.7	11.1	-7.3	-2.5			-1.5	1.6			-10.8	-9.8	12/08
IMF	7.0		2.1						2.4	2.0	-4.7		11/08
NCB	9.4	10.2	-4.8	-3.9	-0.4	0.0	-0.7	1.8	0.5	1.6	-9.7	-9.3	02/09
NIB	12.0		-8.0		-2.0		-2.9		-1.0		-11.0		03/09
OECD	7.7	7.8	-2.3	0.5	2.1	1.6			0.9	0.9	-7.1	-7.0	11/08
PwC									0.7				01/09
Ulster Bank	12.0	15.5	-9.5	-7.5			-4.0	0.0	-1.1	0.4	-11.0	-10.5	03/09
Average	10.9	12.6	-6.4	-4.8	-0.4	-0.7	-2.6	0.2	-0.2	0.7	-10.6	-10.7	

Unemployment approaching 11%...

In February, 354,437 people were on the Live Register, up 87% on February 2008. Over 6,000 people joined the Register each week, up more than 300% on February last year.

The *DKM Snapshot* projects the average annual unemployment rate will approach 11% in 2009, rising to 12.6% in 2010.

...in the early stages of price deflation

The *DKM Snapshot* projects 2.6% CPI deflation in 2009, rebounding slowly to 0.2% CPI inflation in 2010. Deflation dampens economic activity, as consumers will not buy if they believe prices will fall further.

The CPI rate stood at -1.7% in February, so forecasters believe prices will deflate further. The most pronounced price drops in February were in mortgage interest, rent, clothing & footwear and transport.

The Irish rate of HICP was just 0.1% in February. HICP does not include mortgage interest. Prices are falling faster in Ireland than the rest of the Eurozone, where average HICP inflation was 1.2% in February. If this overall price trend is reflected in business costs, it may begin to reverse the impact of high inflation in Ireland in recent years, which damaged our competitiveness within the Eurozone.

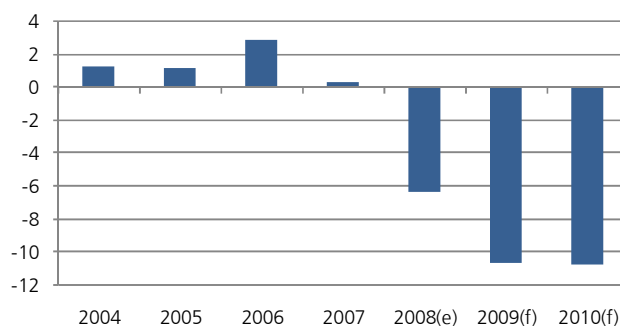
Government finances have collapsed

In January, the European Commission forecast that Ireland's government debt would spiral to 68% of GDP by 2010, up from 41% of GDP in 2008, and 25% of GDP over 2006-7.

The *DKM Snapshot* projects a general government deficit in excess of 10% of GDP in 2009 and 2010, with some forecasters suggesting a deficit in excess of 13% of GDP.

Tax receipts in the first two months of 2009 were €1.8bn below the same period last year. This, combined with greater social welfare outlays, created a €2.1bn shortfall. The ballooning deficit has forced an emergency Budget on 7th April.

General Government Balance (% of GDP)



Source: Eurostat, Department of Finance (2008 estimate), *DKM Snapshot* (forecasts)

Priorities for the April Budget

There is a growing consensus on, and acceptance of, the necessity for far-reaching contraction on both sides of the Budget. It is to be hoped that the Government will live up to expectations and seize this opportunity to produce a coherent, well thought out plan for the medium-term that will be viewed as fair by the population and sufficient by the international community. In doing so, it will not only restore much needed international confidence in the Irish economy, but also take a step towards leaving a positive economic legacy.

There are two immediate priorities for the April Budget:

- Broaden the tax base and streamline tax exemptions**
 Tax receipts had become increasingly dependent on transaction taxes such as stamp duties and capital gains tax, which rely on a strong economy. We cannot wait for recommendations from the Commission on Taxation's report later this year.
- Protect jobs**
 The Public Capital Programme should immediately facilitate labour-intensive projects that are ready to proceed to construction.

THE SLUMP IS GETTING SLUMPIER

Continued from page 1.

Tax burden likely to rise sharply

The ratio of tax to GNP may have fallen as revenues from stamp duties, capital taxes, VRT and VAT collapse. However, any appearance of a lower tax burden is illusory.

For much of the past decade a significant proportion of the domestic tax base has been borrowed: loans for land purchases and “second-hand” houses funded stamp duty revenue; car loans provided finance for VRT and VAT on cars; while household mortgages financed VAT on new housing and large household items. The public sector may have been running a surplus but it could only do so because the private sector was running a deficit, financed by borrowing.

Increases in taxation, likely to focus on income levies and PRSI contributions, are inevitable in the April Budget. This will add to the downward pressure on domestic spending caused by tight lending conditions.

Weak aggregate demand reduces bank lending opportunities

Much hot air and newsprint has been wasted on discussions of the need to provide resources for the banking system to lend again. Far less discussion has been on who the borrowers might be. Many potential homebuyers are squeezed out by the tighter lending standards imposed by banks at the behest of the Financial Regulator. Construction projects are not fundable, given the weakness in demand for housing due to tougher mortgage policies, the unsold stock of housing and the virtual collapse in demand for commercial and retail space.

Corporate borrowers fall into two categories at present: those who desperately need funding to stay afloat and those, mainly multinational, with access to credit lines from outside the Irish banking system. The former are likely to be the victims of the tighter lending criteria adopted by the banks and sanctioned by the Regulator and main shareholder – the Government. The latter will benefit from any monetary easing in the Eurozone.

The banks may need recapitalization in order to transition from a dependence on a sovereign guarantee to reliance on their own balance sheets. They do not need recapitalization to fund viable lending in the current economic climate. Only a significant improvement in demand will generate a flow of viable lending opportunities for the banks.

An Irish “bad bank” is not the solution

Unless the Exchequer takes over the liability of difficult loans from the banks – and it is difficult to see why it should – the contingent liability will remain with the bank and will affect its future lending policies. Indeed the bank will have continuing responsibility for the fate of the loans but no power to influence matters. Given that TDs have already intervened to influence banking decisions, on the basis of the public support to the banking system, the prospects of a “bad bank” becoming a politician’s piggy bank are only too real.

Examples from Scandinavia are wholly inappropriate. First,

domestic financial measures were preceded by a large devaluation – which paradoxically had the effect of increasing the toxicity of the loans as many Swedish and Finnish borrowers had drawn loans in foreign currencies. Second, the Swedish and Finnish Central Banks were the only source of liquidity for kroner and markka loans and acquiring impaired loans from the domestic banking system was the best way of injecting domestic currency liquidity, especially as many of the impaired loans were in foreign currencies.

The acquisition of impaired assets by a state-run “bad bank” will not stimulate increased domestic lending by the banking system. It will simply accelerate the repayment of euro funding obtained from overseas banks via the interbank market. In effect, an Irish “bad bank” will create liquidity for non-Irish euro lenders to the Irish banking system.

Property markets must be cleared

At present the overhang of unsold newly constructed residential dwellings is being financed by the banking system. A relatively small number of developers have relatively large debts which can only be paid off if the properties are sold. The Irish banking system, as a whole, would be better off if the properties were sold at a market clearing price and funded by 90 to 95% mortgages. The credit profile of 1,000 borrowers owing 90% of €250 million is far more attractive than the credit profile of a single developer owing €250 million. The Financial Regulator may be improving the individual credit risk of each piece of new lending by the banks but at the expense of the credit risk of the banking system as a whole.

In the short run, we need creative measures to shore up demand and structural measures to improve public finances

For example, VAT refunds of up to 50% of VAT paid on big ticket items (such as new housing and large consumer expenditures) might be offered for a limited fixed period. The refund infrastructure is already in place for non-EU tourists. Similarly a refund of 50% of stamp duty might be made for a limited period. Both these measures will only transfer spending from the next period but may be enough to limit revenue loss until signs of economic recovery become evident. A VAT refund system is far more attractive, and less biased towards imports, than a car scrappage scheme that is likely only to improve distributors’ margins which are under pressure from weaker demand and lower priced imports.

On the expenditure side, it will be the easy option to slash the Public Capital Programme (PCP). However, the PCP ought to be restructured to facilitate labour-intensive projects which have planning, are already tendered, and are ready to proceed to construction. New buses and trains will only generate employment in Sweden, France and Germany, not Ireland.

Until there is a clearer vision of global growth, particularly in the US, UK and Europe, forecasts for Ireland will be pessimistic. A coherent and sustainable policy response, which is awaited on 7th April, will help support confidence that, when recovery comes, Ireland will be able to participate.

FOCUS ON THE EXTERNAL ENVIRONMENT

Global output and trade continued to plummet in the first two months of 2009, as tight credit conditions muted demand and business and consumer sentiment remained low. It seems that a feedback loop has developed – the financial crisis caused demand to weaken and now deteriorating conditions in the ‘real economy’ are compounding the woes of financial institutions.

Indicators released over the past three months signal a deeper than anticipated downturn in the global economy

A recent statement by the Bank of England acknowledged the extent of this by pointing out that 54 out of 57 nations recorded negative growth in industrial output for the final quarter of 2008. The global nature of the slowdown is also evident by growth of spending which is at the lowest level for over 40 years in the UK, US, Japan and the Eurozone.

The severity of the downturn has affected most aspects of economic activity with world trade down by as much as 5% in the final quarter of 2008 – primarily caused by a fall off in demand but exacerbated by an increased difficulty in obtaining credit. This is compounded by the likelihood of a more severe contraction for the first part of 2009 as the functioning of the financial markets remains impaired.

Coinciding with the above sequence of events, global inflationary pressures have diminished rapidly. Sluggish demand, weaker labour market conditions and the rapid reduction in the price of oil have ensured that global inflation is now on a downward trajectory.

The seriousness of the overall situation is illustrated by the response of the global monetary authorities

The orchestrators of monetary policy have responded vigorously in their respective attempts to free up liquidity and stimulate growth in spending. The Federal Reserve has aggressively loosened conventional monetary policy whereas Europe has slashed its key interest rate to an historic low of 1.5% but has resisted US pressure for a larger stimulus package.

The ECB does not believe that Europe needs more stimulus spending as this could potentially undermine the Euro whilst also increasing the public deficit. The ECB, however, did emphasise its potential to lower its interest rate further to free up credit. Nonetheless, this move has left the US and Europe in disagreement in advance of the upcoming G20 Ministerial meeting in London on 2nd April.

The huge concerted effort to stem the crisis has involved China and the US devoting approximately 5% of their GDP levels to

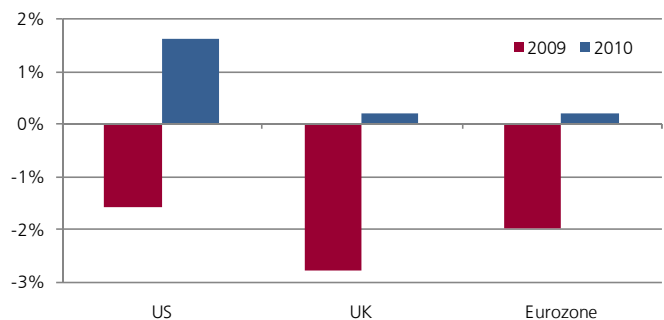
their own separate fiscal stimulus packages. Europe has provided slightly less in comparison with between 3-4% of GDP allocated to their economic recovery plan. As an open economy Ireland will derive benefits from all such measures through increased demand for exports.

Ireland is set to receive €100 million of the €5 billion EU stimulus package which will be directed towards infrastructure projects in the form of energy, telecoms and farming projects – very small in the Irish context of an overall Exchequer capital programme of around €8 billion.

The fate of the global economy lies in the ability of various governments to succeed in their respective reforms

The restoration of consumer confidence and employment stability within the economies should be given the utmost attention by international policymakers if the economic stagnation is to be reversed.

IMF GDP Growth Forecasts, Jan 2009



Source: IMF, Jan 2009

In January, the IMF revised down its forecast for 2009 world GDP growth to ½%, 1¾ points below its November 2008 forecast. The IMF predicted gradual recovery during 2010, although noting that, “the outlook is highly uncertain, and the timing and pace of recovery depend critically on strong policy actions”.

It is the resolve and skill of economic policymakers that will determine the length and depth of the current recession as well as the dimensions of the ensuing recovery.

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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