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If it were done when 'tis done, then 'twere well it were done quickly

The original Mac the Knife (in Act 1 Scene 7 of *Macbeth*) pondered the benefits of immediate action provided such action achieved the desired outcome. A similar problem confronts the Minister for Finance. Would a serious frontloading of the pain of fiscal adjustment mean that the job was "done". Or would it all come asunder as the economy buckled under the strain.

The problem facing those who urge a more moderate approach is that such advice is manna from heaven to politicians who like nothing better than to put off till tomorrow any unpleasant measures which do not have to happen today. A policy that might make sense in an ideal world can look suspiciously like prevarication and a lack of political fortitude especially to those who have to be convinced to lend money to the Irish Government.

The best way to convince observers that you are heading to Galway from Dublin is to proceed directly on the N6 for a reasonable time and distance. A scenic excursion to the byways of Kildare and Meath might appear suspiciously like you have changed your plans or lost your way. Similarly the best way to convince observers of the intention to reach a 3 per cent borrowing target is to make meaningful headway towards that target as soon as possible.

The current forecasts for 2011 shown in this edition of Economy Watch suggest a back-ending of the adjustment with the projected decline in the borrowing requirement less than that required to reach the target of 3% of GDP by 2014. A pro rata adjustment over the four years would require the borrowing requirement to fall to around 9.75% of GDP. All the indications from Merrion Street and Brussels suggest that the 2011 adjustment will be front-loaded. If this were actually to be the case then a deficit of around 9% of GDP would be indicated.

If the deficit was to be reduced on this scale in 2011, the current projections for domestic demand look more than a little optimistic. With construction activity almost non-existent relative to the boom years there is little left to reduce in fixed investment spending. It is hard to see private consumption recover in 2011 in the face of the likely increase in taxes and reduced public spending. While the global economic outlook looks more promising than it did several months ago, it is also hard to see the United Kingdom, our closest trade partner with the largest impact on domestic activity, offering much in the way of growth. So we might expect to see some downward revisions in the 2011 growth forecasts by the time of the next Economy Watch.

A front loading of the fiscal adjustment combined with a clear path to the full adjustment might lead to a stabilisation of domestic demand and the prospect of modest growth in future years as confidence grows. It could also lead to significantly lower interest rates both for the Exchequer and for banks seeking funding. What we cannot afford is a severe correction which does not spell out in detail what will take place in 2012 to 2014. The certainty of the axe with the uncertainty as to where it will fall is a recipe for a dampening of the "animal spirits" of entrepreneurs so admired by Keynes as the engine of growth. Without a clear path to recovery we will be faced with stagnation.

Of course fiscal rectitude alone will not ensure recovery. There is much to be done in restoring the banking system which is now stuffed with paper issued by NAMA and faces the risk that the ECB will rein in its use as a source of funding. We need also to break the log-jam created by shifting almost the entire residential and commercial construction sector of the economy into public hands. These more "micro" issues will require radical policy adjustments even after the dust has settled on the issue of the timing and scale of fiscal adjustment.

In this issue:

- ▶ Tentative signs of stabilisation in the Irish economy but significant policy challenges remain.
- ▶ Strong export growth to underpin recovery; domestic demand likely to remain weak and unemployment high over forecast horizon.
- ▶ A clear strategy for fiscal adjustment over the medium term is necessary to ease ongoing market concerns.

Forecasts At a Glance

	2009a	2010f	2011f
	%	%	%
GNP	-10.7	-1.8	1.7
GDP	-7.6	0.1	2.4
Private Consumption	-7.0	-1.1	0.9
Public Expenditure	-4.4	-2.7	-2.6
Investment	-31.0	-21.0	-1.7
Exports	-4.1	5.8	4.9
Imports	-9.7	2.3	3.1
Unemployment Rate	11.8	13.4	13.2
Employment Growth	-8.2	-3.6	-0.1
Wage Growth	-2.0	-3.3	0.0
CPI Inflation	-4.5	-0.9	1.6
HICP Inflation	-1.7	-1.4	0.7
General Gov. Balance (% of GDP)	-14.6	-31.8	-10.7

Snapshot of Irish Economic Forecasts

Annual % change

	GNP		GDP		Private Consumption		Public Expenditure		Investment		Exports		Imports		Forecast Date
	2010	2011	2010	2011	2010	2011	2010	2011	2010	2011	2010	2011	2010	2011	
AIB	-2.5	1.5	0.0	2.5	-1.5	1.0	-3.5	-2.0	-22.0	-5.5	7.2	5.3	3.7	3.0	Oct-10
BOI	-1.5	2.0	0.5	2.5	-1.0	1.0	-2.0	-3.0	-21.0	-2.5	8.0	6.5	5.0	5.0	Oct-10
Blokhams	-1.5	1.8	1.0	2.5	-1.0	1.0	-2.0	-3.0	-18.0	-4.0	4.0	4.5	-0.7	2.8	Sep-10
Central Bank	-1.7	1.7	0.2	2.4	-1.1	0.4	-2.0	-3.0	-20.9	-3.3	5.4	5.1	2.6	3.4	Oct-10
Davy	-1.5	1.2	0.3	1.9	-1.0	-0.8	-2.1	-4.7	-19.9	-2.9	5.2	4.9	2.6	2.3	Oct-10
Dept Finance	-1.7	3.0	-1.3	3.3	-3.0	2.6	-3.0	-0.5	-19.2	4.5	0.4	3.4	-2.8	2.6	Dec-09
ESRI	-1.4	1.9	-0.1	2.3	-0.5	1.0	-3.0	-3.0	-25.6	-3.4	7.5	5.5	3.6	3.8	Oct-10
EU			-0.9	3.0	-2.4	1.4	-2.7	2.0	-17.6	4.2	2.0	4.3	-1.3	3.5	May-10
Goodbody	-2.0	2.0	0.1	2.2	-0.9	1.0	-3.6	-3.0	-23.6	-2.5	5.6	5.0	2.7	2.5	Oct-10
IBEC	-1.5	1.6	-0.1	2.3	-1.0	1.6	-3.0	-2.0	-19.2	-1.5	2.3	4.5	-0.7	2.9	Jun-10
IMF			-0.3	2.3											Oct-10
NCB	-3.0	1.4	-0.8	1.9	-1.2	1.1	-2.8	-3.0	-23.6	2.3	6.0	3.7	1.8	2.5	Oct-10
NIB			0.8	3.5	0.2	3.0	-3.0	-2.0	-20.0	0.0	4.5	5.0	0.0	3.0	Jul-10
OECD			-0.7	3.0	-2.7	0.6	-2.5	-0.6	-19.2	-1.0	3.7	5.2	-0.4	3.1	May-10
Ulster Bank	-1.1	1.8	0.5	2.4	-1.0	1.1	-3.0	-2.1	-18.8	1.8	8.4	4.2	4.7	2.2	Oct-10
Average	-1.8	1.7	0.1	2.4	-1.1	0.9	-2.7	-2.6	-21.0	-1.7	5.8	4.9	2.3	3.1	

Modest signs of recovery but challenges remain

While the forecasts for the Irish economy still suggest a modest contraction in 2010 followed by a return to growth in 2011, a number of factors have contributed to an increasingly uncertain outlook for the economy, and this is reflected in the downward revisions to the forecasts since our last *Economy Watch*.

GNP is expected to contract by 1.8% in 2010, before a return to growth of 1.7% in 2011. Recent figures from the *Quarterly National Accounts* confirm that the economy is still contracting (on a GNP basis), albeit at a much slower pace than in 2009. The forecast contraction of just 1.8% for 2010 overall implies a pick-up in economic activity in the second half of the year.

The national accounts data also reveal the two-speed nature of the recovery thus far. The traded sector has grown very strongly in the first half of the year, with exports increasing by almost 7% relative to the first six months of 2009. By contrast, domestic demand remains subdued. Private investment fell by 26% in the first half of the year, while consumption declined by 1.4%. While these figures mark a significant improvement relative to the magnitude of contraction experienced in 2009, it is very clear that a sustained recovery in the Irish economy is still some distance away.

For 2011, the forecasts indicate that the economy will grow by 1.7%. While a return to growth is undoubtedly a welcome development, it must be noted that this is a very modest pace of growth and, as the forecasts for the labour market suggest, will not result in any significant job creation next year.

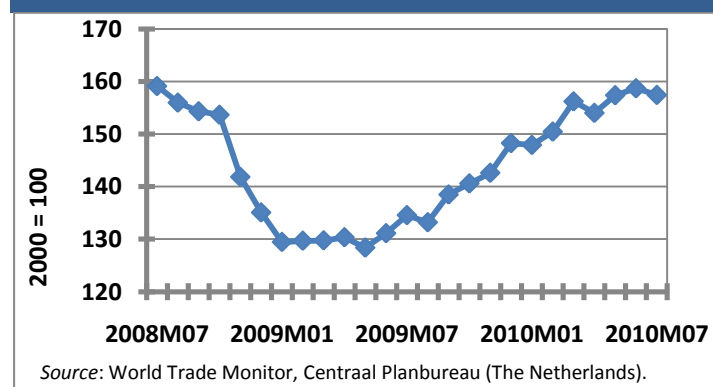
The overall outlook for the Irish economy has become increasingly uncertain over the last few months and a number of policy challenges remain. The recent turmoil in the sovereign debt market, exacerbated by the revised estimates of the banking sector bailout cost, has increased the pressure on the Government as it prepares Budget 2011 and a revised four-year programme of fiscal adjustment. The overall adjustment now required is significantly larger than previously envisaged, and this will have obvious implications for household disposable incomes. While the external side of the economy is now out-performing previous expectations, a resumption of strong growth in domestic demand will be necessary to achieve a more robust recovery in the economy.

Exports to lead the way out of recession

In light of the strength of the export performance so far this year, the forecasts for export growth in 2010 and 2011 have been revised upwards, to 5.8% and 4.9% respectively. The recovery in exports was initially concentrated in the chemical and pharmaceutical sectors, however recent data suggest a more broad-based recovery, including indigenous sectors such as food and beverages.

World trade volumes have rebounded sharply over the last 18 months following their collapse at the end of 2008, and Ireland has benefitted from the strength of external demand.

World Trade Volumes



Price deflation in the domestic economy in 2009 and 2010 has contributed to a significant improvement in Irish cost competitiveness, and current inflation forecasts for Ireland and its trading partners suggest that further improvements may be achieved in 2011.

Following the crisis in Greece earlier this year, the euro fell to a four year low against the dollar and an eighteen month low against the pound. The single currency has since strengthened but remains well below the levels reached against both the dollar and the pound in the 2007-2008 period. If this position is maintained into 2011, it should provide a further boost to Irish exports outside the Euro Area.

According to the Central Bank's Real Harmonised Competitiveness Indicators, Irish competitiveness has improved by 9.4% in the last two years, reflecting both exchange rate movements and our lower inflation rate relative to our main trading partners.

Snapshot of Irish Economic Forecasts

Annual % change * year average; **GGB is the average of forecasts issued in October (taking account of the revised estimates of banking sector losses)

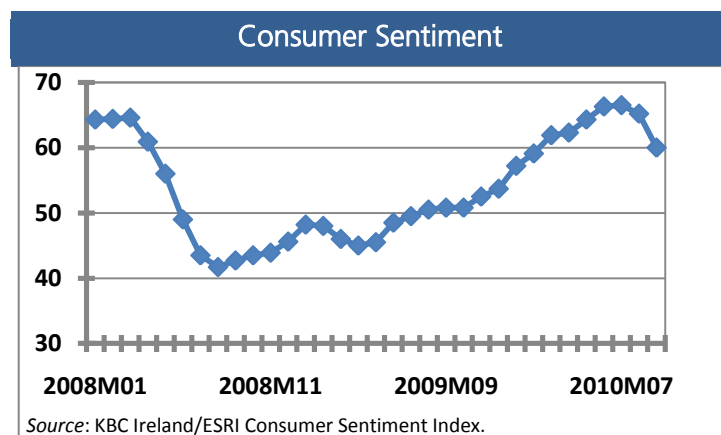
	Unemployment Rate*		Employment Growth		Wage Inflation		CPI Inflation		HICP Inflation		General Govt. Balance**		Forecast Date
	2010	2011	2010	2011	2010	2011	2010	2011	2010	2011	2010	2011	
AIB	13.4	13.5	-3.5	0.2	-4.0	0.0	-0.6	2.0	-1.3	1.0	-32.0	-10.5	Oct-10
BOI	13.4	13.1	-3.5	0.2			-0.7	2.1	-1.3	1.2	-31.6		Oct-10
Blokhams	13.5	13.8	-4.0	-0.6	-3.0	1.0	-0.8	1.4			(-11.5)	-9.8	Sep-10
Central Bank	13.5	13.3	-4.0	-0.4	-3.0	0.8	-0.9	1.4	-1.4	1.1			Oct-10
Davy	13.4	13.3	-4.1	-0.6	-2.8	0.2	-1.0	0.8	-1.4	0.2	-31.6	-10.6	Oct-10
Dept Finance	13.2	12.6	-3.4	1.0			-0.8	1.8	-1.2	1.0	(-11.5)	-10.0	Dec-09
ESRI	13.3	13.5	-3.5	-0.6	-3.0	-1.0	-0.8	1.8	-1.5	0.5	-31.0	-10.3	Oct-10
EU	13.8	13.4	-3.5	0.4	-5.0	-1.7			-1.3	0.8	(-11.7)	-12.1	May-10
Goodbody	13.4	13.6	-3.6	-0.4			-1.0	1.4	-1.6	-0.6	-32.0	-9.7	Oct-10
IBEC	13.5	12.8	-3.5	0.1			-1.0	1.8					Jun-10
IMF	13.5	13.0							-1.6	-0.5			Oct-10
NCB	13.4	12.3	-3.0	1.0			-1.7	1.5	-1.4	0.9	-32.3	-12.5	Oct-10
NIB	13.2	12.0							-1.4	1.0			Jul-10
OECD	13.7	13.0							-1.4	0.8	(-11.7)	-10.8	May-10
Ulster Bank	13.4	13.3	-3.6	-0.2			-0.9	2.2	-1.6	0.9	(-12.0)	-10.0	Oct-10
Average	13.4	13.2	-3.6	-0.1	-3.3	0.0	-0.9	1.6	-1.4	0.7	-31.8	-10.7	

Consumption still falling amid dip in sentiment

Private consumption fell by a massive 7% in 2009. The pace of decline has slowed in the first half of 2010 – consumption was down by 1.4% compared to the first six months of 2009. Consumer confidence is weakening once again, and any significant rebound in consumption in 2011 appears unlikely.

In the first eight months of the year the Retail Sales Index for all retail businesses grew by 1.6% year-on-year. This is largely due to car sales, which increased by 19% over the same period. Stripping out car sales the index declined, although at a much slower pace of 1.6%.

The KBC Ireland/ESRI Consumer Sentiment Index rose steadily from mid-2009 as consumers became more positive about the economic outlook. However, sentiment has dipped in the last two months and it is likely that this is related to the uncertainty surrounding the banking sector problems and the public finances. Confidence levels are likely to be severely tested in the coming months in the run-up to Budget 2011. Against this backdrop, forecasts for consumption have been revised downward. With household incomes likely to take a significant hit in 2011, consumption is expected to increase by just 0.9% in volume terms.



Labour market difficulties to persist into 2012

Unemployment rose rapidly over the last two years and the latest official estimate of the unemployment rate was 13.2% in Q2 (seasonally adjusted). The rate is expected to average 13.4% in 2010, before falling slightly to 13.2% in 2011.

The expected export-led recovery implies no real pick-up in the labour market until 2012 at the earliest. Exports are much less labour-intensive and a stronger rebound in domestic demand will be necessary to generate any significant job creation.

Banking and fiscal crises still a source of concern

The General Government Deficit is expected to rise to a dramatic 31.8% of GDP this year, including once-off payments to the banks. The deficit is expected to fall to 10.7% in 2011.

The Government has indicated that it is injecting €30.7 billion into Anglo Irish Bank and Irish Nationwide in 2010, bringing the deficit to almost 32% of GDP. This is undoubtedly a dramatic figure and the losses in the banking sector have been truly shocking. Nonetheless, the markets were clearly looking for some clarity in relation to the scale of these losses and the recent announcement by the Minister for Finance has at least removed some element of uncertainty.

Looking at the actual Exchequer performance thus far this year, the collapse in tax revenues appears to have ended, with the exception of income tax receipts. The underlying deficit, which excludes the once-off payments to the banking system, has stabilised and is expected to be approximately 11.7% of GDP this year, falling from 12.1% of GDP in 2009.

GGB (% of GDP)	2009	2010	2011
General Government Balance	-14.6	-31.8	-10.7
Excluding bank payments	-12.1	-11.7	-10.7

In light of the recently revised estimates of the cost to the State of supporting the banking system, the task of reducing the deficit to 3% of GDP by 2014 has become significantly more challenging. The Government has indicated that the savings required over the next four years will amount to €15 billion. It is therefore likely that the savings in Budget 2011 will be well in excess of the €3 billion previously envisaged. The revised four-year austerity programme due to be announced in the coming weeks will provide more details on the magnitude of fiscal adjustment that will be necessary in each year. Implementing a sizable austerity package will undoubtedly slow the pace of recovery in the economy. However, our recent experience in the bond markets has highlighted the need for a clear and credible medium-term strategy.

FOCUS ON THE EXTERNAL ENVIRONMENT

The world economy expanded at an annual rate of 5.3% during the first half of 2010, according to the latest *World Economic Outlook* published by the IMF. This aggregate figure masks the underlying multi-speed nature of the recovery thus far, in which the performance of the emerging and developing economies has surpassed that of the advanced economies. World output is expected to increase by 4.8% in 2010 and by 4.2% in 2011. However, forecasts for the advanced economies suggest a more modest recovery – output is expected to grow by 2.7% in 2010 and by 2.2% in 2011. These figures are more relevant from an Irish perspective as our most important trading partners are the UK, the US and the Euro Area. By contrast, the emerging economies are expected to register output growth of 7.1% in 2010 and 6.4% in 2011.

UK

The UK economy strengthened in the second quarter of 2010, with GDP growth of 1.2% (quarter-on-quarter, seasonally adjusted). This was the fastest pace of quarterly growth in nine years, and was largely fuelled by strong growth in construction and business services.

It is expected that the recent depreciation of Sterling will provide a boost to UK exports. This, in turn, is projected to be the main engine of growth in the UK economy over the forecast horizon. Domestic activity is likely to remain subdued throughout 2010 and 2011 as a result of the unprecedented magnitude of fiscal consolidation and the weakness in the supply of credit to the private sector. This projected weakness in domestic demand is bad news from an Irish perspective and will have negative implications for Irish exporters. Overall, the UK economy is expected to register GDP growth of 1.7% in 2010 and 2.0% in 2011.

Major economies GDP growth forecasts

	2009a	2010f	2011f
	%	%	%
UK	-4.9	1.7	2.0
US	-2.6	2.6	2.3
Eurozone	-4.1	1.7	1.5
Germany	-4.7	3.3	2.0
Japan	-5.2	2.8	1.5
China	9.1	8.5	9.0
India	5.7	9.7	8.4

Source: IMF *World Economic Outlook*, October 2010

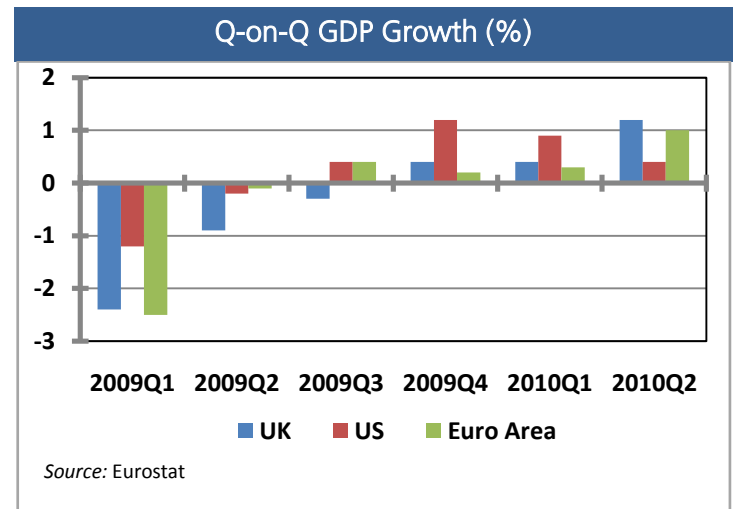
US

Recent data indicate that economic activity in the US slowed sharply in the second quarter of the year. The economy grew by just 0.4% (quarter-on-quarter, seasonally adjusted) as the contribution of inventories subsided and the impact of the substantial macroeconomic stimulus wore off.

Looking ahead, the outlook for the US economy has become gradually more uncertain over the last few months as recent data releases have fallen short of previous expectations. The housing market continues to struggle where sales have recently fallen to historically low levels. The labour market also remains sluggish and the pace of job creation has consistently underperformed, relative to expectations.

NOTE: The average figures presented in this report represent a weighted average of the latest forecasts for the Irish economy from 15 independent sources, compiled by DKM. Older forecasts are given a lower weighting in calculating this average. Figures quoted represent the latest available from each source at the time of going to press.

These concerns are evident in weak consumer sentiment and are manifested in an unusually high savings rate of approximately 6%. A robust growth performance will require an upturn in personal consumption – the largest component of US GDP.



Euro Area

The pace of the Euro Area recovery strengthened in the second quarter of the year, when GDP grew by 1% compared to the previous quarter. However, this was primarily driven by strong growth in Germany and there is little evidence yet to suggest that a broad based recovery has taken hold.

The withdrawal of the exceptional fiscal policy measures, the growing concerns over public debt sustainability and a fragile financial sector are contributing to a relatively poor economic performance in many Euro Area countries and an uncertain outlook for 2011. The IMF is currently forecasting growth of 1.7% in 2010 and 1.5% in 2011.

The turmoil in the sovereign debt markets throughout 2010 has caused severe disruption to the normal functioning of financial markets. Many European banks remain heavily dependent on ECB financing facilities and have significant exposure to Government debt, which increases the risk of future shocks to the European financial system. With bond yields remaining elevated in a number of Euro Area economies, Governments are now facing the daunting task of implementing sizable fiscal consolidation packages in the face of weakening growth prospects.

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New services

DKM Economic Consultants are delighted to announce the appointment of Gráinne Pyne as Senior Economic Consultant with the firm. As an addition to the team, Gráinne strengthens DKM's capabilities across a range of areas, particularly in relation to competition, litigation and regulatory issues. Gráinne has extensive experience of sector analysis, strategic planning, policy evaluation and impact assessment, competition policy and state aid.



Recent and forthcoming publications

- Review of the Construction Industry 2009 and Outlook 2010-2012
(Available to download at www.dkm.ie)
- MyHome.ie Property Barometer Q3 2010
(Available to download at www.dkm.ie)
- EBS/DKM Affordability Index (November 2010)
- Euroconstruct Individual Country Report on Ireland (for the 70th Euroconstruct Conference, Budapest, December 2010)