DKM ECONOMIC CONSULTANTS

Economy Watch

Snapshot of Irish Economic Forecasts

Issue 8, June 2011

PROCRAST-A-NATION ONCE AGAIN

There is an unusually high variation in forecasts for the out-turn for 2011 given that we are nearly six months through the year. The main variations arise from differing views as to the negative impact of consumption and investment. There is far less variability in the forecasts for exports which are the main positive influence on GDP in 2011.

For 2012 export growth is assumed to slow but the reduction in growth is expected to be offset by stability in consumer demand and investment. The expected reduction in the public borrowing requirement in 2012 is modest and certainly won't impress capital markets. If the consensus output forecasts are achieved and the borrowing requirement remains above 8.5% of GDP, the toe the NTMA dips into the global capital market will be highly tentative indeed. In these circumstances the Varadkar scenario is more plausible than the optimism of the Minister for Finance.

The slow stately pace of the deficit reduction strategy contains the seeds of its own destruction. First, it will achieve little in terms of allowing the State to borrow at reasonable margins over Bund rates, a necessary condition if we are to avoid a second bailout. Second, the willingness of the electorate to acquiese in an unbounded exercise in slow deflation will be severely tested. Introductory rates for water and property tax to be followed in the certain future by much higher rates will have the same deflationary impact as the immediate implementation of the higher rates but leave public borrowing too high in 2012.

The recapitalisation of the banking system is also taking place at far too slow a pace and without a clearly defined end. The ECB and the IMF want the Irish banks to shrink their balance sheets. The Government is, in part, justifying the recapitalisation of the banks on the grounds that this will permit new lending. Loan expansion and balance sheet contraction are mutually exclusive objectives. The truth is that unless the Irish banks are acquired by creditworthy international banks, their domestic deposit base will not sustain current lending levels let alone provide for expansionary finance.

The State should be looking for a credible buyer of either or both pillar banks and should, if necessary, be prepared to pay the buyer for removing the contingent burden of the State guarantee. The ECB might be asked to contribute also as their exposure to the Irish banks would be measurably improved.

Limping along hoping that international capital markets will find an 8.5% borrowing requirement in 2012 acceptable and that depositors will once again have faith in a guarantee from an increasingly indebted Government is a recipe for disaster. Procrastination did not work in the 1980s and it is unlikely to work this time around.

In this issue:

- Following three consecutive years of contracting, the economy looks set to return to GDP growth in 2011/2012.
- The Balance of Payments surplus set to expand further as robust growth in exports is expected to continue.
- Domestic demand unlikely to pick up until next year, led by investment and private consumption.
- Competitiveness further enhanced, but unemployment remains a pressing concern.

Forecasts At a Glance

	2010a %	2011f %	2012f %
GNP	-2.1	-0.1	1.7
GDP	-1.0	0.7	2.2
Private Consumption	-1.2	-1.6	0.5
Public Expenditure	-2.2	-3.4	-2.5
Investment	-27.8	-10.2	1.6
Exports	9.4	6.6	5.5
Imports	6.6	4.2	4.1
Unemployment Rate	13.6	14.3	13.7
Employment Growth	-4.2	-1.5	0.5
Wage Growth	-1.7	-1.1	0.0
CPI Inflation	-1.0	2.4	2.1
HICP Inflation	-1.6	1.2	1.1
General Gov. Balance	-11.8	-10.2	-8.5

Snapshot of Irish Economic Forecasts

Annual real % change

	GNP		GDP		Private Consumption		Public Expenditure		Investment		Exports		Imports		Forecast Date
	2011	2012	2011	2012	2011	2012	2011	2012	2011	2012	2011	2012	2011	2012	
AIB	-1.5	1.0	0.5	2.0	-1.0	0.0	-3.0	-2.0	-14.0	0.0	7.0	5.5	5.0	4.0	May-11
BOI	1.2	3.0	0.5	3.5	-2.0	1.0	-2.0	-1.0	-12.0	2.0	8.8	7.0	7.5	5.0	May-11
Bloxhams	0.2	1.8	1.0	2.0	-1.0	1.0	-4.0	-3.0	-7.0	2.0	6.8	5.5	3.0	3.5	May-11
Central Bank	0.0	1.6	0.9	2.2	-2.2	0.0	-4.7	-3.0	-11.5	2.0	6.1	5.9	3.5	4.6	Apr-11
Davy	0.6	1.7	1.6	2.4	-1.4	0.4	-5.2	-3.2	-6.4	1.0	6.8	5.0	3.6	3.5	Mar-11
Dept Finance	0.3	2.0	0.8	2.5	-1.8	0.0	-3.0	-2.3	-11.5	1.0	6.8	5.7	4.7	4.1	Apr-11
ESRI	0.5	2.0	2.0	3.0	0.0	2.0	-2.0	-4.0	-10.3	-2.0	7.5	7.5	6.0	6.3	May-11
EU			0.6	1.9	-1.9	-1.0	-4.4	-0.4	-13.5	2.0	6.0	5.2	3.2	4.0	May-11
Goodbody	-0.4	1.1	0.4	1.5	-1.7	-0.4	-3.5	-3.0	-9.0	1.8	6.9	4.5	4.8	3.0	May-11
IBEC	0.2	1.9	1.3	2.5	-1.5	0.2	-4.5	-3.0	-5.6	4.1	6.0	4.5	3.1	2.9	Apr-11
IMF			0.5	1.9											Apr-11
NCB	-1.4	1.4	-0.4	1.9	-2.0	1.6	-3.5	-3.0	-6.2	4.5	6.0	3.2	3.7	2.7	May-11
NIB			0.8	1.9	-2.0	0.5	-4.0	-2.0	-8.0	0.0	7.0	5.5	4.3	4.5	May-11
OECD			0.0	2.3	-2.1	0.3	-1.9	-2.0	-11.0	0.8	5.3	6.6	4.0	5.3	May-11
Ulster Bank	-0.1	1.3	0.6	2.2	-1.5	0.7	-2.7	-2.8	-15.6	2.4	5.5	5.3	2.2	4.3	May-11
Average	**-0.1**	**1.7**	**0.7**	**2.2**	**-1.6**	**0.5**	**-3.4**	**-2.5**	**-10.2**	**1.6**	**6.6**	**5.5**	**4.2**	**4.1**	

Economic growth to stabilise in 2011...

Ireland's economy is expected to expand by 0.7% (GDP) this year, following three consecutive years in decline.

The most recent Quarterly National Accounts confirm that the Irish economy continued to contract in 2010, with annual declines recorded in both GDP (-1.0%) and GNP (-2.1%). The outturn for 2010 implies that total output has fallen by 11.8% since 2007.

Despite potentially turning the corner in 2011, the economy continues to be affected by weak domestic demand. Each component is expected to decline further in 2011, led by falling investment (-10.2%), which is heavily influenced by the crisis in the building and construction sector.

Private expenditure is suffering from weaker after-tax incomes, while the threat of unemployment is spurring precautionary savings. OECD figures show that household savings rate reached 19.3% of disposable income in 2010 compared to just 0.04% in 2007.

The outlook for public spending is particularly grim and this will remain extremely tight over the coming years as the Government struggles to bring the current account deficit to below the EU target of 3% by 2015.

The expected gradual expansion of national output this year would only slightly offset previous declines, while GNP looks set to remain marginally negative at -0.1%. Stronger growth is envisaged for this measure in 2012 however, supported by an expected upturn in domestic demand.

...assisted by a robust exports performance

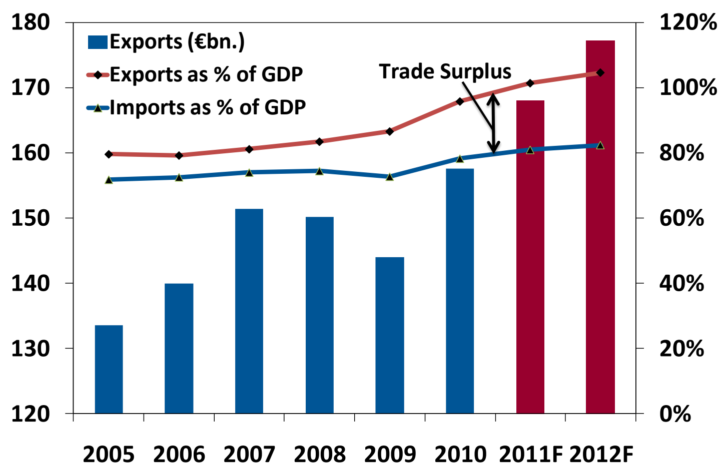
Vigorous growth in exports over the coming years is driving the positive outlook, with export volumes expected to grow by 6.6% in 2011 followed by growth of 5.5% in 2012.

There was a positive Balance of Trade in 2010 to the value of approximately €28,814mn. Despite a projected surge in imports this year, the trade surplus looks set to expand by an additional 17.3% in 2011 and a further 11% in 2012.

The strong growth in exports is exemplified by recent dealings with some of our main trading partners, Great Britain and USA. Latest figures available indicate that exports to the USA increased by 20% (€598m) in the first two months of 2011 compared with the first two months in 2010. Similarly, exports to Great Britain have grown by 18% (€314m) over the same timeframe.

The surge in exports can be explained by the large presence of foreign-owned companies benefitting from improved competitiveness and the upturn in global demand, while indigenous firms, comprising just over 10% of total exports, have successfully turned to markets abroad.

Performance of Irish Exports



Source: CSO, Forecasts for 2011/2012 based on DKM Snapshot

Consumer spending remains suppressed by poor overall confidence

Upward adjustments in consumer sentiment during the first half of 2010 dissipated during the second half.

The total volume of retail sales declined by 3.9% in April 2011 compared with April of the previous year. This decline worsens to 5% when core retail sales are considered i.e. motor trades are excluded. Fuel and furniture displayed quite significant annual declines of 11.9% and 16.2% respectively.

Despite this, consumer sentiment increased by 34% during the first 5 months of 2011, according to the latest KBC/ESRI Index. While the latest gains have come on the back of extremely low levels, a continuation of this trend would see an elevation of confidence levels to coincide with the projected upturn of private consumption in 2012.

Snapshot of Irish Economic Forecasts

Annual % change * year average; ** underlying GGB (excluding State support to the banking sector) as a % of GDP

	Unemployment Rate*		Employment Growth		Wage Inflation		CPI Inflation		HICP Inflation		General Govt. Balance**		Forecast Date
	2011	2012	2011	2012	2011	2012	2011	2012	2011	2012	2011	2012	
AIB	14.2	14.1	-2.0	0.0	0.0	1.0	3.0	2.5	1.5	1.2	-10.00	-8.60	May-11
BOI	14.4	13.8	-1.5	0.5	-1.0	0.0	3.0	3.0	2.0	2.0			May-11
Bloxhams	14.0	13.5	-1.0	1.6	-2.0	0.5	3.0	3.5	1.5	2.0	-10.20	-8.80	May-11
Central Bank	14.3	14.1	-1.4	0.1			2.2	1.3	0.8	0.5			Apr-11
Davy	14.5	14.2	-1.8	0.4	-1.8	0.4	1.0	0.8	0.5	0.7	-9.60	-7.80	Mar-11
Dept Finance	14.4	13.7	-1.6	0.5			2.5		1.0		-10.00		Apr-11
ESRI	14.3	14.0	-1.5	0.3	0.8	0.8	2.5	1.5	1.5	1.0	-10.00	-8.50	May-11
EU	14.6	14.0	-1.5	0.4	-2.5	-0.9			1.0	0.7	-9.50	-8.50	May-11
Goodbody	14.0	13.2	-2.0	0.6	-1.8	-1.4	1.5	2.0			-11.70	-8.70	May-11
IBEC	13.2	12.7	-1.5	0.0			2.7	1.6					Apr-11
IMF	14.5	13.3							0.5	0.5			Apr-11
NCB	14.3	13.3	-0.2	1.5			2.3	2.2	1.6	1.8	-10.50	-8.70	May-11
NIB	14.2	14.0							0.7	0.7			May-11
OECD	14.7	14.6							1.7	0.5	-10.10	-8.20	May-11
Ulster Bank	14.4	13.7	-2.1	0.5							-10.20	-8.60	May-11
Average	**14.3**	**13.7**	**-1.5**	**0.5**	**-1.1**	**0.0**	**2.4**	**2.1**	**1.2**	**1.1**	**-10.21**	**-8.53**	

Cost competitiveness enhanced...

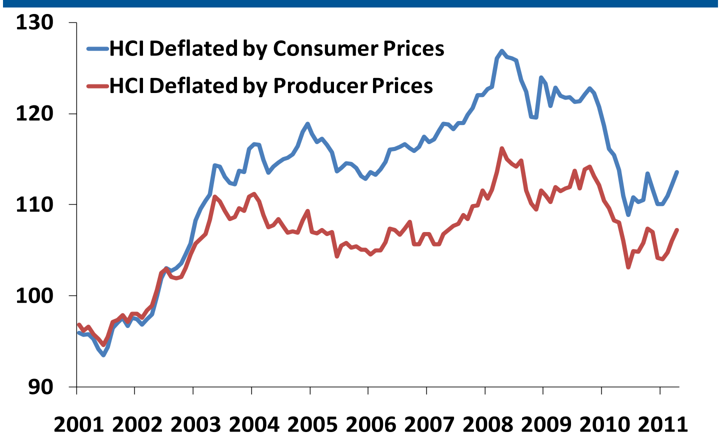
Few positives generally accompany such a pronounced fall-off in national output but Ireland stands to benefit from a significant improvement in overall cost competitiveness in the three years to April 2011.

The Harmonised Competitiveness Indicator (HCI), as deflated by producer prices, implies that Ireland is approximately 7.7% more competitive than in April 2008. This is of significant benefit to firms competing in external markets – a key feature of Ireland's anticipated recovery.

Similarly, when deflated by consumer prices, the HCI also points to a marked improvement of approximately 10.5% in Ireland's competitiveness over the past three years.

Subdued inflation has been a natural response to the dramatic fall off in domestic demand but improved competitiveness can also be attributed to record low interest rates, which had been held at 1% for a prolonged 24 month period (May 2009-April 2011).

Harmonised Competitiveness Indicators*



* A decrease in the series marks an improvement in competitiveness
Source: Central Bank

Notwithstanding this beneficial adjustment, Ireland remains a relatively expensive place to do business with competitiveness only back to 2005 levels. Moreover, the considerable improvement in competitiveness is unlikely to be repeated as interest rates are signalled to increase again in July and domestic demand is projected to return to growth in 2012.

The Unemployment Rate has yet to peak...

Rapidly increasing unemployment has been a key feature of the current downturn and employment generation is widely expected to lag imminent economic growth.

Unemployment averaged 13.6% during 2010 but had crept up to 14.7% by the end of the year. Males have been disproportionately affected by the downturn with 17.9% unemployed in Q4 2010, reflecting the collapse in the male dominated construction sector.

Live Register figures for May 2011 confirmed that the standardised unemployment rate has worsened and now stands at 14.8%. This compares to the OECD unemployment rate of 8.2% in March 2011, and 9.9% in the Euro Area.

The DKM Snapshot projects a deterioration of the unemployment rate to 14.3% for 2011, before reducing marginally to 13.7% in 2012. This is despite estimates of approximately 52,000 people emigrating during 2011.

...despite the recent Jobs Initiative

With the coalition Government firmly in place, they have come under increasing pressure to deliver on promised employment stimulus measures.

In May 2011 an Exchequer neutral Jobs Initiative was announced, to be primarily funded by a 0.6% levy on private pension funds and expected to generate €470mn per year over 4 years. Measures to boost employment included:

- reducing the lower rate of VAT on a range of tourism related goods and services from 13.5% to 9%;
- halving employers PRSI for those earning less than €356 per week, affecting approximately 600,000 workers;
- €90mn set aside for improving roads and schools.

Uncertainty surrounding the bailout

The IMF and European Commission have recently come out with separate announcements proclaiming that the Irish bailout is 'on track', although challenges remain. The requirement for Ireland to return to the bond market next year is an obvious challenge as the cost of borrowing remains extremely high. This has resulted in one Minister suggesting that we may need an extension of the existing programme or indeed another programme.

FOCUS ON THE EXTERNAL ENVIRONMENT

Global economic growth decelerated to approximately 3.75% during the second half of 2010 compared with 5.25% in the first half of the year. As the world economy continues to move forward it is characterised by an unbalanced recovery with output in advanced economies below potential. The overall outlook is positive with the IMF expecting world output to grow at 4.4% in 2011 and 4.5% in 2012. With investment levels strengthening and the gradual recovery of employment spurring consumption, the advanced economies are projected to expand by 2.4% in 2011 and 2.6% 2012. This compares with higher growth of 6.5% per year expected in developing economies, which will need to guard against overheating and credit booms.

UK

UK GDP staged a feeble recovery in the first quarter of 2011 with growth of 0.5% barely offsetting the surprise contraction at the end of 2010. A quarterly increase of 0.9% in services and 1.1% in manufacturing was positive but the underlying growth in the economy may not be strong enough to withstand the biggest fiscal squeeze since WWII.

Growth prospects in 2011 are constrained to 1.5% due to the front-loaded contractionary fiscal policy that will dampen domestic demand and exogenous price shocks that have weighed on consumer confidence. The labour market will remain sluggish in 2011 with an expected elevated unemployment rate of 7.8%. Looking further ahead, the overall economic forecast for 2012 is more upbeat with growth of 2.3% envisaged while prospects for job creation also look set to improve. The outlook will however remain vulnerable to Eurozone difficulties and the potential for these to escalate.

Major economies GDP growth forecasts

	2010a %	2011f %	2012f %
UK	1.3	1.5	2.3
US	2.8	2.8	2.9
Eurozone	1.7	1.6	1.8
Germany	3.5	2.5	2.1
Japan	3.9	1.4	2.1
China	10.3	9.6	9.5
India	10.4	8.2	7.8

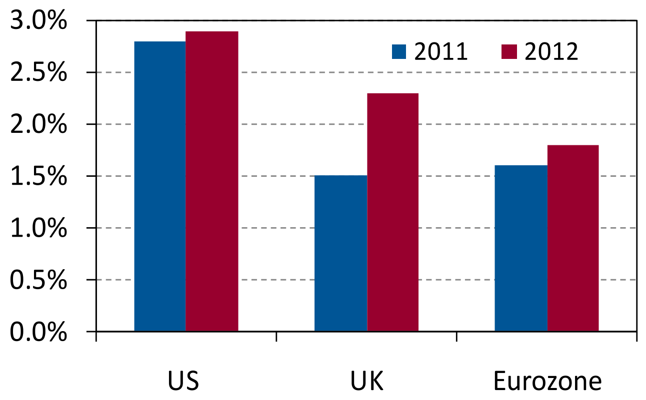
Source: IMF

US

The US Economy grew by 2.8% during 2010 and despite year-on-year growth in GDP of just 1.8% in Q1 2011, activity is expected to remain firm in 2011. Notwithstanding this, output remains significantly below potential and while the pace of job creation has picked up considerably, it is clear that long term unemployment and broader measures of underemployment remain well above historic highs. Having shed more than 8.5m jobs in 2008 and 2009, the labour market has added less than 1.7m jobs since the trough. Unemployment is expected to remain high at 8.5% in 2011, declining only moderately to 7.8% in 2012.

The current account deficit in the US has receded, primarily via weak domestic demand. Overall credit growth remains low but financial conditions have generally improved and this has helped rebuild consumer sentiment somewhat. The depressed housing market and aforementioned labour woes will however act as a drag on the US economy with growth of 2.8% expected in 2011 followed by 2.9% in 2012.

IMF GDP Growth Forecasts, April 2011



Euro Area

The recovery in the Eurozone is proceeding at a modest pace despite the financial turbulence that has gripped the region.

Continued strains on the vulnerable European sovereigns pose a significant threat to growth with the gradual expansion of the Eurozone set to remain uneven. Liquidity support from the European Central Bank to affected countries has ensured that the damage to economic activity has been limited to these economies while self-sustained growth has emerged in the rest of Europe.

The outlook for 2011 is very much influenced by the Eurozone's larger economies respective deficit reducing measures and the more fragile peripheral economies which will be burdened by front-loaded fiscal consolidation. Output will remain below potential and unemployment will be high. Modest growth of 1.6% in the Eurozone is therefore projected by the IMF for 2011 with the economies of Greece and Portugal expected to contract further.

(Forecasts quoted here draw largely on the IMF World Economic Outlook – Spring 2011).

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.

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