

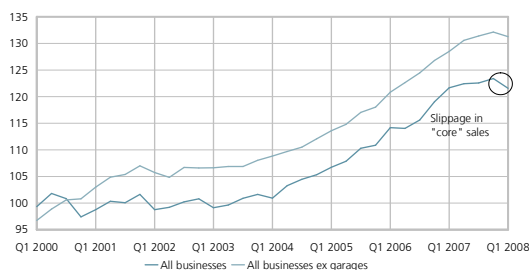


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Retail sales (2000=100, sa, 3mma)



Source: CSO

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Davy on the Irish economy

Cutting 2009 growth forecast to 2% due to tighter credit availability and absence of interest rate relief

Trimming our 2008 GNP volume growth estimate to 1%

- We have cut our 2008 growth forecast due to deteriorating conditions for consumers. Our forecast for consumer spending was 2.5% in volume, but we now expect only 1% due to a weakening labour market, tighter credit and a negative wealth effect.
- As a result, we have trimmed our GNP volume growth estimate for 2008 to 1% from 1.7%.
- Goods exports were robust in Q1, and we are sticking to our forecast in the absence of any data on services year-to-date.

Reducing our 2009 GNP forecast to 2% from 3.4%

- We are forecasting 2% real GNP for 2009 compared with 3.4% previously.
- We do not expect the housing market to bottom in 2008. We now forecast 25,000 house completions in 2009 versus our previous figure of 40,000. That subtracts over 1% directly and indirectly from GNP.
- We have pencilled in a 10% decline in private non-residential building for 2009.
- The unemployment rate is set to reach 7% by year-end 2009 – the rise limited by lower net migration.
- Based on its Budget 2008 estimates, the government may breach the 3% deficit limit in 2009.

The economy may not bounce back to trend until 2010

- In our research note "Beyond the housing shock" (February 26th 2008), we argued that potential growth in Ireland is a healthy 3.5-4%. However, we do not see the economy growing in line with trend until 2010.

Please refer to important disclosures at the end of this report.

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Table 1: Summary of economic forecasts

	2006	2007	2008F	2009F	
Expenditure components of GNP (% change in volume)					
Consumer spending	5.7	5.4	1.0	2.0	
Government spending	5.3	6.7	4.5	3.0	
Investment	3.1	0.2	-13.4	-9.2	
- Residential investment	3.5	-8.8	-33.9	-31.4	
- Non-residential building investment	9.5	6.4	5.0	0.0	
- Machinery and equipment	-5.1	12.6	5.0	5.0	
Exports	4.4	8.2	6.0	6.0	
Imports	4.4	6.4	1.7	2.8	
GDP	5.7	5.3	1.7	2.6	
GNP	6.5	4.5	1.0	2.0	
Balance of payments					
Current account (€m)	-7276	-9391	-3038	2362	
% of GNP	-4.9	-5.9	-1.8	1.4	
Inflation (% change yoy, annual average)					
Consumer Price Index (CPI)	4.0	4.9	4.1	1.8	
Harmonised Index of Consumer Prices (HICP)	2.7	2.9	3.3	1.7	
Wage inflation	5.0	4.5	4.0	3.75	
Labour market (% change yoy)					
Employment	4.5	3.6	0.8	0.0	
Unemployment rate (end-year, sa)	4.2	4.6	6.1	7.0	
Public finances (€m)					
Exchequer Balance (€m)	2265	-1623	-8295	-10328	
% of GNP	1.5	-0.5	-5.0	-5.9	
General Government Balance (€m)	4390	900	-5275	-6913	
% of GDP	2.5	0.5	-2.7	-3.3	
Government debt					
% of GDP	25.1	25.1	27.5	29.0	
Interest and exchange rate forecasts				Current	End-2008
Official interest rates (end-year)					
Eurozone			4.0%	4.0%	
US			2.0%	2.0%	
UK			5.0%	4.5%	
Exchange rates					
\$/€			1.57	1.55	
£/€			0.80	0.85	

Source: Davy

Economy to slow to pace not seen since the 1980s

The Irish economy, already reeling from the housing recession, has taken three further blows in 2008. First, the credit crunch is now having an impact on the real economy. Development finance is scarce, reducing new building investment, and mortgage lending has tightened, limiting new housing sales. Second, the European Central Bank (ECB) is not helping by keeping its base interest rate unchanged. The prospect of relief on that front is slim in the short term. Third, the other downside of not having control of monetary policy is crystallising: the euro has appreciated fast, particularly against sterling. The UK matters a lot to our indigenous exporters and to the domestic tourism industry.

As a result, we have cut our forecasts significantly for 2008 and 2009. Here are the main changes and the reasoning behind them:

- **GNP volume forecast of 1% in 2008 and 2% in 2009**

GNP

For 2008, we have cut our volume forecast to 1% from 1.7%. The main reason for the change is that we see lower consumer spending growth than previously.

For 2009, we now expect a 2% increase in real GNP, down from 3.4%. The salient factor is that we now envisage a more prolonged housing downturn. The number of completed housing units will be sharply lower than we had previously projected. That subtracts more than 1% directly and indirectly from the level of GNP.

- **GDP will grow faster than GNP as foreign-owned firms grow their output faster than the domestic economy**

GDP

GDP will grow faster than GNP in both 2008 and 2009. It will be a case of *déjà vu*. In 2001 and 2002, GDP outperformed because foreign-owned firms expanded their output much more quickly than Irish-owned factors of production.

Another way of looking at it is that foreign-owned multinationals will book more value-added in Ireland to avail of the tax benefits as their top-line growth slows globally.

We expect 1.7% real GDP growth in 2008 (was 2.3%) and 2.6% in 2009 (was 3.8%).

- **Consumer spending growth of only 1% in 2008 before a pick-up to 2% in 2009**

Consumer spending

Consumer spending may expand only 1% this year in volume (we previously forecast 2.5%). The main factor is slowing real income growth, reflecting lower employment gains, softer wage growth, rising food and energy costs, the absence of interest rate relief and tighter credit.

We actually project that real disposable income will rise 1.8%, but we have factored in higher precautionary saving due to the loss of household

wealth over the last year. The savings ratio may reach 7.6% compared with 6.9% in 2007.

For 2009, we see an improvement in the pace of household spending: growth in volume may nudge up to 2%, primarily due to lower inflation.

Housing

The housing market remains critical to prospects in Ireland on an 18-month view (for a detailed discussion see our research note "Irish banks and property", published May 28th). At least we are confident that we are nearer the end than the beginning. Residential investment as a percentage of the economy will be down to early 1990s levels by year-end 2008, and house prices have corrected some distance.

But we do not see a bottom in 2008. It is vital that new housing sales overtake house completions. That inflection point will probably be reached some time in H1 2009.

Therefore, we have cut our house completions forecast for 2009 to 25,000 from 40,000. We still predict 45,000 finished units in 2008. That is close to "being in the bag" given the lead time between starts and completions.

House prices may fall 10.7% on average (12 months over 12 months) in 2008 followed by a further decline of 7.2% in 2009.

Other investment

As a result of the credit crunch, new commercial building activity is coming under a little pressure. We forecast that private non-residential building will remain flat year-on-year (yoy) in 2008 before a 10% drop in 2009.

We still expect that the government will meet its capital spending commitments in both years. It is absolutely critical that it keeps its nerve.

Machinery and equipment investment has moderated, in line with lower business confidence.

External trade

Goods exports held up pretty well in Q1 when the dollar impact on the cash value is taken into account. But service exports, which have exploded in recent years, are crucial to the outlook.

In the absence of data year-to-date, we stick with our 6% volume forecast for total exports for 2008 and 2009. However, we acknowledge that there may be some downside risks due mainly to unfavourable exchange rate trends.

- House completions forecast is cut to 25,000 for 2009 from our previous 40,000

- Government to meet its capital spending commitments

- Exports to grow 6% in volume in 2008 and 2009, but import growth to slow markedly

Indigenous industry will struggle, while multinational industry outperforms. Irish-owned industry is more geared to the UK market than its multinational counterparts. The euro has appreciated 15% against sterling over the past nine months, and UK demand is also slowing as the economy decelerates.

Imports have already slowed markedly due to softening consumer demand and fewer orders of new vehicles from consumer and businesses. Imports may inch up 1.7% in volume in 2008 and by a slightly faster 2.8% in 2009.

- **Government to miss its tax revenue target by €3bn in 2008; deficit of 2.7%**

Government

We think that tax revenue will miss the government's target by €3bn in 2008. The miss will be mainly property-related. Having enjoyed positive surprises from the property market in 2004-2006, the pendulum has swung the other way.

The general government deficit may jump to 2.7% in 2008, well above the official forecast of -0.9%.

In 2009, the Stability and Growth Pact deficit limit of 3% will probably be breached unless the government takes some action. We assume that it will leave its capital spending plans untouched and that current spending will bear the brunt of belt-tightening.

Labour market

Employment growth is set to slow sharply this year, primarily due to job losses in housing. Job growth may slip to 0.8% on average compared with 3.6% last year. But immigration is slowing, in line with deteriorating conditions. That causes the labour force to expand at a slower rate, preventing a spike in the unemployment rate. We forecast an unemployment rate of 6.1% by year-end.

Employment may remain unchanged on average in 2009 compared with 2008. Again construction will be the culprit: employment may drop just over 10% in that sector. That implies employment growth of 1.4% in the rest of the economy. We see the unemployment rate at 7% by year-end 2009.

- **Inflation to drop below 2% in 2009 due to below-trend growth and no repeat of this year's commodity price spike**

Inflation

Inflation will decelerate into next year, mainly following on from below-trend growth in the domestic economy. We do not expect the spike in commodity prices to be repeated next year.

CPI inflation may average 4.1% in 2008, before a sharp deceleration to 1.8% in 2009. Our equivalent forecasts for HICP – the EU standardised measure – are 3.3% and 1.7%.

- ECB on hold in 2008 but will cut by half a percentage point to 3.5% in 2009

Interest and exchange rates

The ECB will probably leave its refi rate on hold at 4% in 2008. But we see a cut to 3.5% in 2009, possibly beginning in the first quarter, as the euro area economy grows slightly below-trend. The caveat is money markets: if these do not free up, the ECB may still be forced to cut this year.

We expect that the Bank of England will eventually cut its repo rate to 4%, or even lower, some time in 2009. The economy will weaken significantly in the second half of 2008 as the housing market downturn and tighter credit bite. But the Bank of England may only lower rates twice more by 25 basis points this calendar year, leaving the repo rate at 4.5% by December.

Our view on the ECB and Bank of England suggests that sterling may weaken further in 2008. We would not rule out a test of 0.90 over the next 12 months. Meanwhile, the US Fed may have finished cutting its funds rate for this cycle. The dollar may trade in a 1.5-1.6 range against the euro, ahead of further recovery in 2009.

Trends for 2008 have been terrible

Irish macro trends have been overwhelmingly weak so far in 2008. Unemployment claimants have spiked; business and consumer confidence has dipped; housing starts continue to decline; retail sales have dropped; and tax revenue lags expectations.

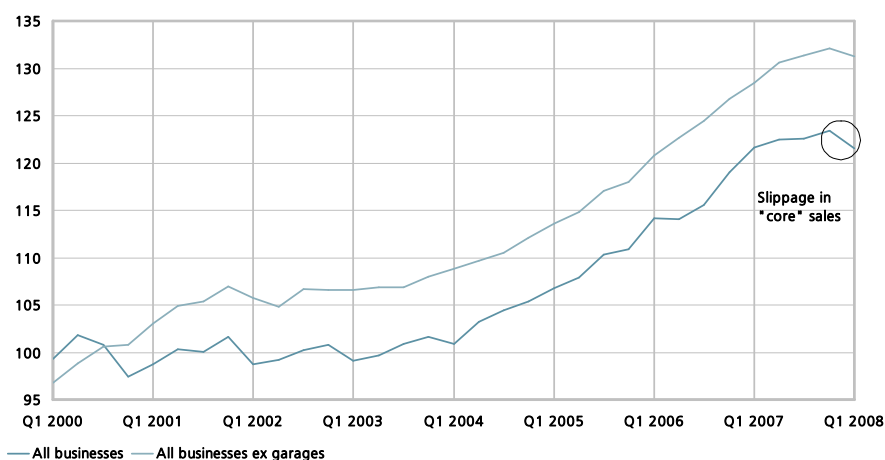
Consumer spending growth slows due to lower employment growth, weak new home sales, car tax changes and tighter credit

Retail sales are being hit by a number of negative factors: weaker earnings growth on the back of the housing recession, the knock-on impact of reduced new home sales on related durable goods spending, higher inflation and tighter credit. In addition, declining household wealth, due mainly to falling house prices, may have led to a rise in precautionary saving. Note too that consumer spending faces tough annual comparisons: the SSIA savings scheme ended last year, boosting consumer spending by around 1%. Here is a summary of the key data year-to-date:

- Precautionary saving may have increased

- Retail sales fell for the first time in four years on an annual basis in February. In March, sales dropped 2.1% year-on-year (yoy) in volume.
- Car sales have had a significant impact on the aggregate growth rate. New car sales have plummeted as a result of government changes to road tax and to vehicle registration tax along with high petrol prices. In March and April, new car sales shrunk 22% yoy.
- However, even excluding garages, sales decreased in the first quarter compared with October-December 2007 (see Figure 1).

Figure 1: Retail sales (volume, 2000 = 100, sa, 3mma)



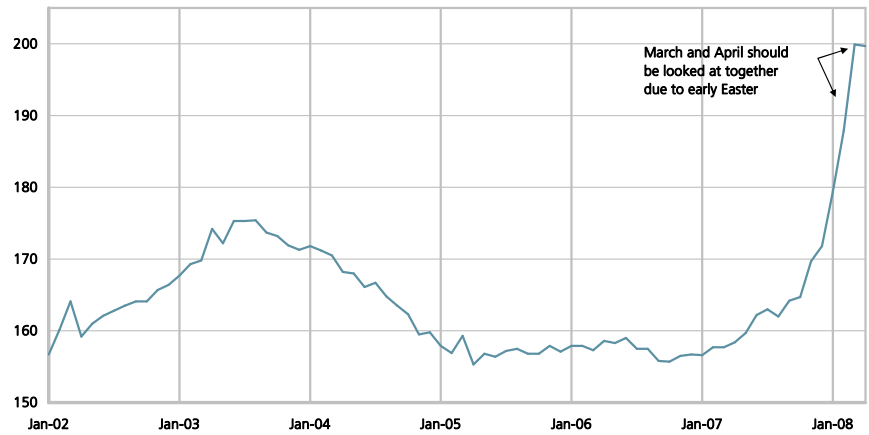
Source: CSO

- Unemployment claimants have spiked. The Live Register jumped 6.4% in March – the most since 1975 – but flattened in April (see

Figure 2). The timing of Easter had an effect, but claimants are still up over 25% yoy, the biggest increase for 25 years.

- Note that the number of female claimants has risen in recent months, suggesting that the labour market outside housing has softened (females account for only 5% of construction workers).

Figure 2: Live Register (000s, sa)

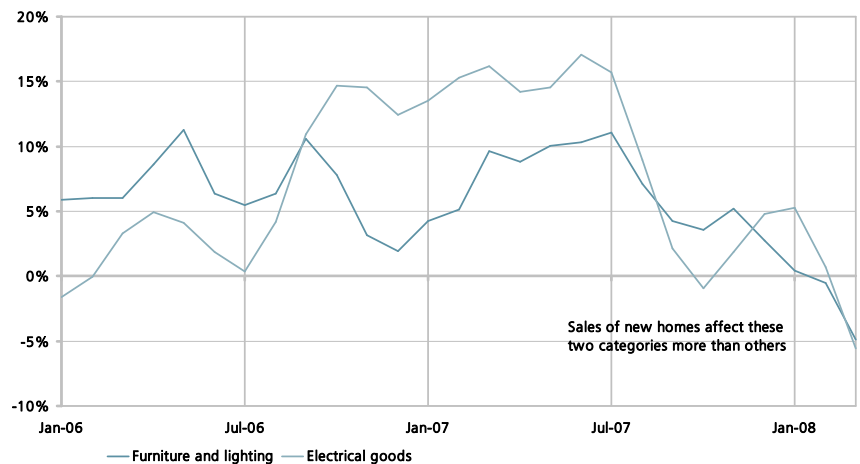


Source: CSO

- New housing-related sales are suffering

- Furniture sales and electrical goods are suffering, in particular due to the sharp decline in new housing sales (see Figure 3).

Figure 3: Retail sales (vol., furniture/lighting and electrical goods, % chg. yoy)

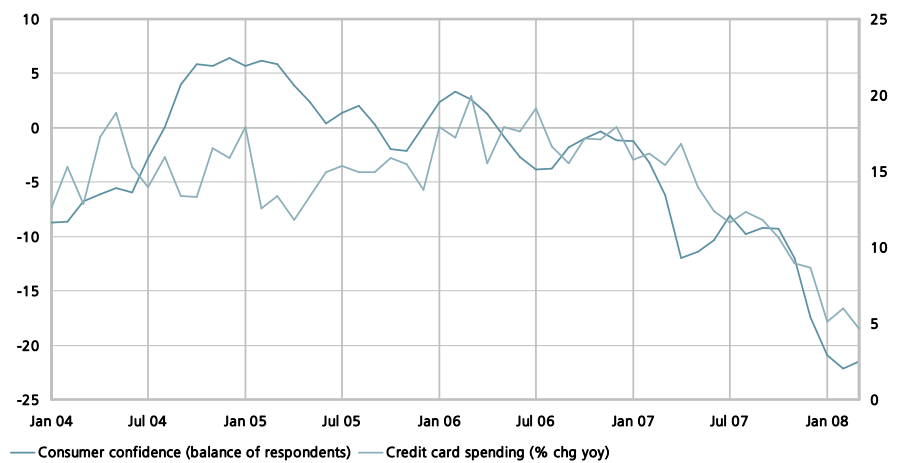


Source: CSO

- Retail confidence is close to an all-time low (although the index only stretches back to 2000).
- Consumers are cautious, based on the decline in credit card spending and the confidence index (see Figure 4).
- No data on wages are yet available, but food and energy price hikes have harmed real incomes.
- Goods imports were exceptionally weak in Q1, falling 6% yoy.

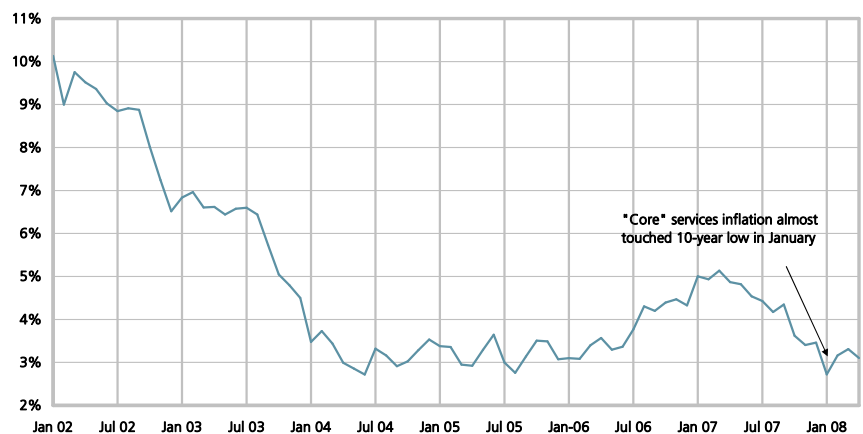
- Anecdotal evidence suggests that retail conditions did not pick up in April or May.
- Slowing underlying services inflation hints that spending on services may not have slid by as much as retail sales in volume terms: note that total consumer spending is evenly split between the two (see Figure 5). The trend in "core" services inflation reflects the fact that the economy is growing below potential.
- But real incomes are being hurt by higher food and energy prices. The CPI inflation rate has remained well above 4%. HICP inflation, which includes mortgages, rose to 3.7% in March – the highest rate since September 2003 – before moderating to 3.3% in April.

Figure 4: Consumer confidence (lhs) and credit card spending (rhs)



Source: European Commission; Central Bank of Ireland

Figure 5: Services CPI (ex-mortgages, % change yoy)



Source: CSO; Davy

Housing still mired in recession, and commercial new building is beginning to weaken

For a detailed top-down discussion of residential and commercial property in Ireland, please see our research note - [Irish banks and property - Trouble brewing, but the market is pricing in an unlikely outcome](#) released today.

- Two factors will delay the recovery in the housing market: tighter mortgage availability and no relief cuts in interest rates

The construction sector, specifically housing, led the downturn in the Irish economy. Housing remains mired in a deep recession, although the pace of decline in activity (in terms of volumes) has moderated. We do not think that housing will bottom until 2009. Two factors will delay a recovery. First, credit is less available. All banks have tightened up on mortgage lending criteria. Second, the ECB does not look like cutting interest rates in 2008. Meanwhile, banks are passing on higher money market rates to existing and potential homebuyers.

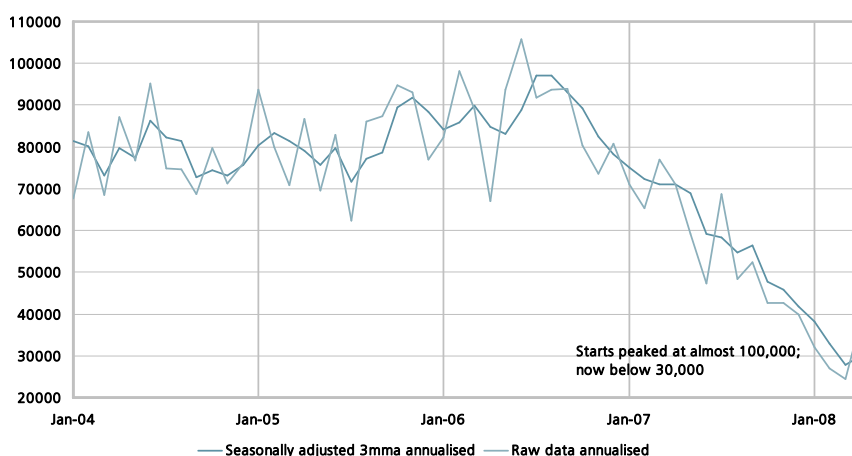
The global deleveraging process has also affected private non-residential building. Commercial building activity has decelerated as development finance in particular has become scarce and financial institutions are more risk averse.

- Capital spending is in line with the Budget despite what surveys suggest

As for infrastructure, spending is in line with the Budget (the government has provided data up to end-April). So the implied contraction in civil engineering in the construction PMI is somewhat puzzling.

- Housing starts are running at an annualised rate of 30,000 (3mma). That compares with 71,000 a year ago (see Figure 6).

Figure 6: Housing starts (seasonally adjusted, 3mma, annualised)



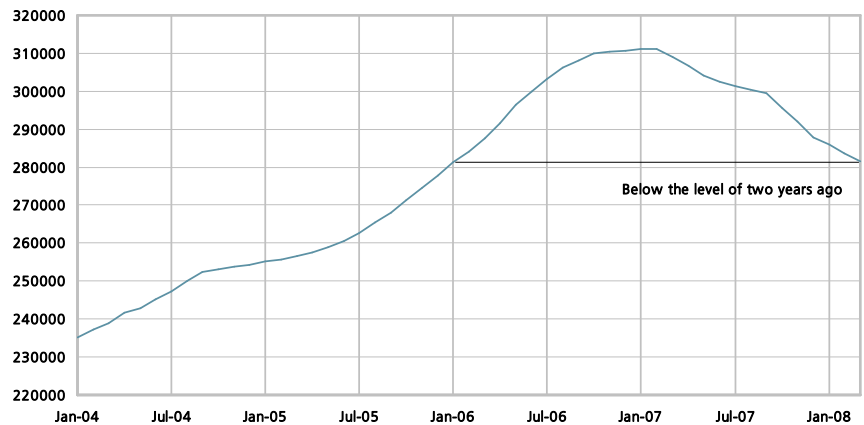
Source: Davy; Homebond; Premier Guarantee

- House prices are down 10% from peak officially (see Figure 7). However, the most recent data are for March, and the inherent lag is two months (they are compiled at mortgage drawdown stage). This means that we have an official picture up until the end of January.

Much deeper price cuts for new homes – 15-25% yoy – have since materialised.

- The true house price decline is masked by the lag in data: 15-25% new home price cuts have been prevalent

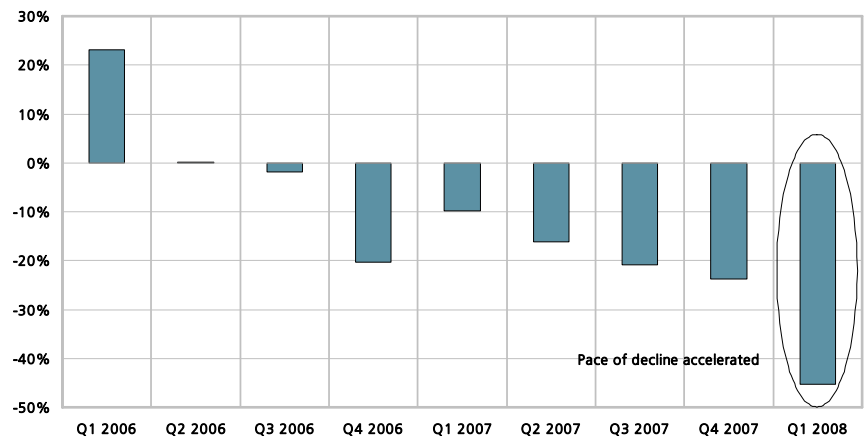
Figure 7: House prices



Source: Permanent TSB/ ESRI

- First-time buyers mortgage approvals slipped 45% yoy in Q1. Again, note that the data probably only reflect transactions from part of Q4 2007 until early February due to reporting delays (see Figure 8).

Figure 8: Mortgage approvals (first-time buyers, % change yoy)

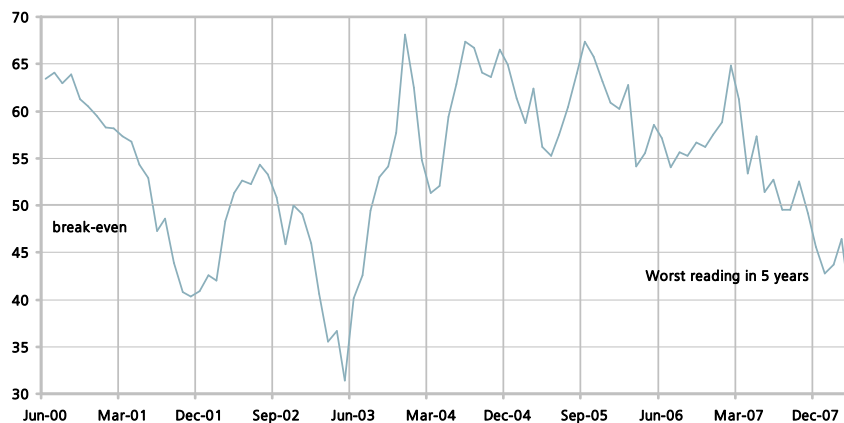


Source: Irish Bankers' Federation

- Investor mortgage volumes were down 27% yoy, similar to the 2007 trend.
- Mortgage credit value growth was 11.6% yoy in March compared with 22.0% in the same month a year previously.
- Commercial new building has slipped due to the credit crunch.
- Commercial new building is contracting month-on-month, according to the Ulster Bank PMI index. The reading of 39.2 in April, below the breakeven figure of 50, was the lowest since 2003 (see Figure 9).

- Infrastructure spending is still on track, according to the official government exchequer returns.
- Construction confidence is at an all-time low of -69 (the series dates back to 1983).

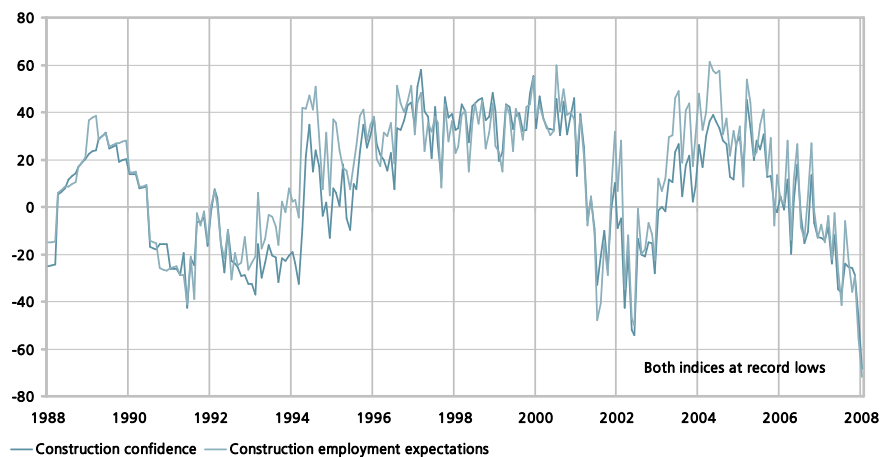
Figure 9: Commercial building PMI



Source: Ulster Bank

- Construction employment expectations are also at a record low (see Figure 10).

Figure 10: Construction surveys (balance of respondents)



Source: European Commission

There is at least 12 months of new stock on the market

The most important issue for the housing market is that the glut of unsold stock begins to clear. There are a few key points to make:

- The supply of new stock is going to be much reduced in 2009 due to the savage cuts in housing starts.
- Sales are running at an annualised pace of about 5,000 in Dublin.
- If that is the pace countrywide, it suggests that new home sales will be in the region of 20,000 this year.

- For the market to clear, the equation is simple: new home sales must overtake new house completions

- From what we understand, there are about 40,000 new units completed and unsold on the market.
- That implies almost two years of supply based on the current sales pace.
- To cause the stock of unsold homes to fall, house completions need to dip below the pace of new home sales.
- Housing starts are currently running at less than 25,000 annualised.
- Sales need to pick up to an annualised rate of at least 25,000 if housing starts are to continue at the current pace.

Government finances are coming under pressure as tax revenue slows

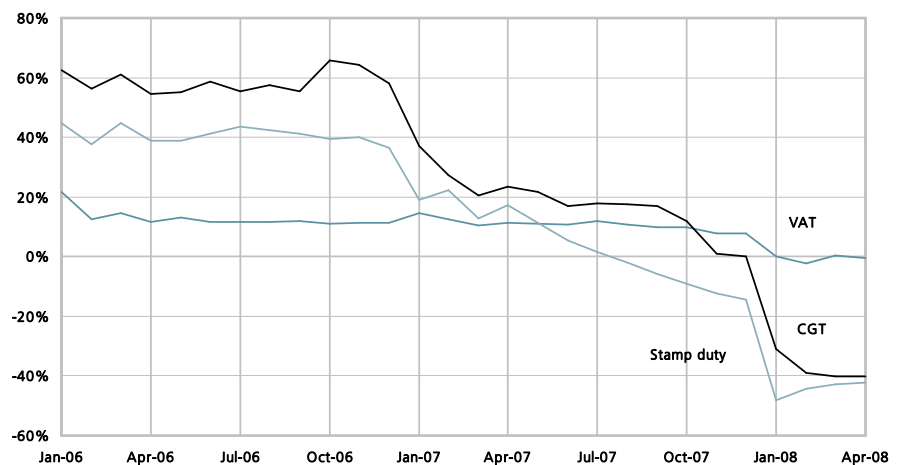
Tax revenue is running behind forecast this year. The main culprits are once again housing-related. Stamp duty, VAT and Capital Gains Tax (CGT) are all lagging the official projection after four months. Income tax has held up well so far, but excise duties are suffering due to the government's ill-timed car tax changes. Corporation tax is back-end loaded; trends under that heading are not a great guide early in the year.

Stamp duty receipts dropped sharply from May 2007 onwards. In recent months, stamp revenue has declined between 35% and 48% each month yoy. In January-April, it fell 42% compared with the same period in 2007 and is 7.2% behind expectations.

- Housing-related receipts are under pressure: CGT and VAT are now following stamp duty lower

VAT receipts are hurting because there is 13.5% baked into the final selling price of a new home. Given that new home prices are down and sales are soft, VAT is lagging the government's estimate by €277m (or 5.4%) at this stage.

Figure 11: Housing-related tax revenue (% change yoy, cumulative during year)



Source: Department of Finance; Davy

CGT is finally coming under significant pressure due to the housing slowdown, the weakness of the development land market throughout

2007 and the near-40% fall in the value of the Irish stock market in the last year. It is now €344m, or 36.4%, behind target.

Expenditure is pretty much in line with target, but it is really too early to comment on trends. Capital spending is actually ahead of target despite the weak readings from the civil engineering survey. Keep in mind that the Budget is very much skewed towards year-end. In fact, 63% will be allocated to the second half of the year.

Exports are not as bad as value figures suggest, but services data are eagerly awaited

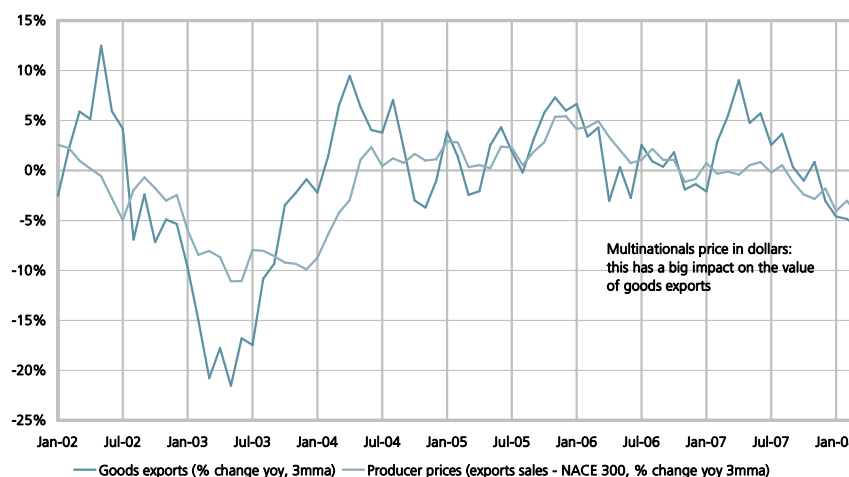
Goods exports faltered in March after a healthy rebound in January and February. The value of goods exports fell 5.2% month-on-month and by 15.5% yoy. That left exports down almost 6% in value in Q1.

But the data are not as bad as they seem. First, March may well have been affected by the early Easter, which has played havoc with Irish data released for that month so far. Second, these figures are reported in value terms. Volumes held up much better: the bulk of Irish goods exports are priced in dollars as they originate from multinationals. We know that export prices were down significantly in Q1. Third, industrial production data showed output up 2% in Q1, albeit that the multinational sector outperformed indigenous industry where production dropped yoy.

- The dollar pricing impact distorts the reported value data, making the figures look worse than they are

- Multinational industry is doing much better than indigenous firms so far in 2008

Figure 12: Goods exports and export prices at the factory-gate (% chg yoy)



Source: Davy; CSO

Overall, we reckon that goods exports were about flat in volume terms in Q1 compared with the same quarter of 2007. Unfortunately, we still have no data on services, which account for more than 40% of total exports. Services will be the key swing factor for overall export performance in 2008.

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