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Davy Research

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Research Report: Irish economy

Davy on the Irish Economy

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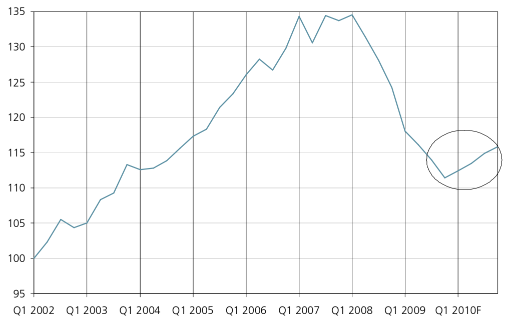
Economy finally out of recession; sequential real growth of at least 1% probable for next few quarters

Real GNP (quarterly, Q1 2000 = 100, sa)



Source: CSO; Davy forecasts

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Broad range of indicators point to growth in Q1

- The Irish economy probably returned to growth quarter-on-quarter in Q1 (GNP volume).
- Latest data from retail sales, PMI indicators, industrial production, goods exports and car sales point to an end to the recession that commenced in late 2007.
- Recovery is export-led, as is desirable. The trend in service exports at the end of last year and new export orders in Q1 suggest that increased global demand is having a positive effect. Consumer spending has been stable for almost a year and is now set for growth as precautionary saving eases. But investment will lag.

Economy to grow at c.1% quarter-on-quarter pace

- Focus on the quarterly data to spot the turning point in the Irish economy; annual averages provide few insights. We forecast c.1% quarter-on-quarter growth in the volume of GNP throughout 2010. Note, though, that nominal GNP will struggle to expand thanks to ongoing and necessary price deflation.
- We expect the unemployment rate to peak in Q3 at 13.6%, about six months after the bottom in real activity. But unemployment will remain stubbornly high for a time. Export-led growth is not labour-intensive enough to reduce unemployment quickly.

Ireland has made significant competitiveness gains

- Ireland continues to make inroads into the wage and price premium it built up versus its trading partners during the investment bubble of 2002-2007.
- Like the on-track fiscal consolidation, regaining price competitiveness is a multi-year adjustment.

Forecast table

Table 1: Summary of economic forecasts

	2008	2009	2010F	2011F
Expenditure components of GNP (% change in volume)				
Consumer spending	-1.0	-7.2	1.0	4.0
Government spending	2.6	-1.2	-5.0	-2.0
Investment	-15.5	-29.7	-12.8	-0.6
- Residential investment	-26.3	-41.1	-31.8	-0.2
- Non-residential building investment	-1.7	-28.9	-10.0	-12.0
- Machinery and equipment	-15.4	-17.5	2.0	10.0
Exports	-1.0	-2.3	2.5	6.0
Imports	-2.1	-9.3	1.4	5.0
GDP	-3.0	-7.1	1.0	4.2
GNP	-2.8	-11.3	-0.6	2.9
Balance of payments				
Current account (€m)	-9,436	-4,814	-4,327	-4,101
% of GNP	-6.1	-3.7	-3.4	-3.2
Inflation (% yoy, annual average)				
Consumer Price Index (CPI)	4.1	-4.5	-1.9	0.4
Harmonised Index of Consumer Prices (HICP)	3.1	-1.7	-2.1	-1.2
Wage inflation	3.1	-3.0	-2.0	1.0
Labour market (% change yoy)				
Employment	-1.1	-8.1	-3.7	0.9
Unemployment rate (end-year, sa)	8.2	13.1	13.6	12.9
Public finances (€m)				
Exchequer Balance	-12,715	-24,788	-17,779	-18,015
General Government Balance	-13,198	-23,350	-28,719	-27,030
GGB % of GDP	-7.3	-14.3	-17.7	-16.0
Underlying GGB % of GDP		-11.8	-10.9	-10.1
Base interest rates (%)		*Current*	*End-2009*	*End-2010*
Eurozone refi rate		1.0	1.0	1.25
US Fed funds target rate		0.25	0.25	1.0
UK repo rate		0.5	0.5	1.0
Exchange rates				
$/€		1.33	1.50	1.45
£/€		0.87	0.90	0.85

Source: Davy forecasts

Irish economy has pulled out of two-and-a-half-year recession

The Irish economy has pulled out of recession. We expect growth of 1% quarter-on-quarter in Q1 to be confirmed by the National Accounts at the end of June. That expansion is likely to continue in the second quarter, marking the end of the recession.

- **No current euro area members have ever experienced a recession as severe as that encountered in Ireland**

The economy entered recession at the end of 2007. The peak-to-trough decline in GNP was more than 17% in volume and eclipses the 13% peak-to-trough decline experienced in Finland in 1990-1993. No current euro area members have ever experienced a recession as severe as that encountered in Ireland.

It must be remembered, however, that there were winners and losers in this recession. Top of the losing list was anything related directly or indirectly to construction. Indigenous manufacturing industry was not far behind: it experienced a torrid time from mid-2007 on. Leading the winners were internationally traded services and high-tech manufacturing. Public servants did not fare too badly either given the lack of job losses.

- **We forecast that the economy will grow about 1% quarter-on-quarter (4% annualised) from Q1 2010 through the first part of 2011**

Looking ahead, the economy is set for a period of solid volume growth. But nominal (or cash) growth will be more limited as many sectors experience ongoing price deflation. We forecast that the economy will grow about 1% quarter-on-quarter (or 4% annualised rate) from Q1 2010 through the first part of 2011.

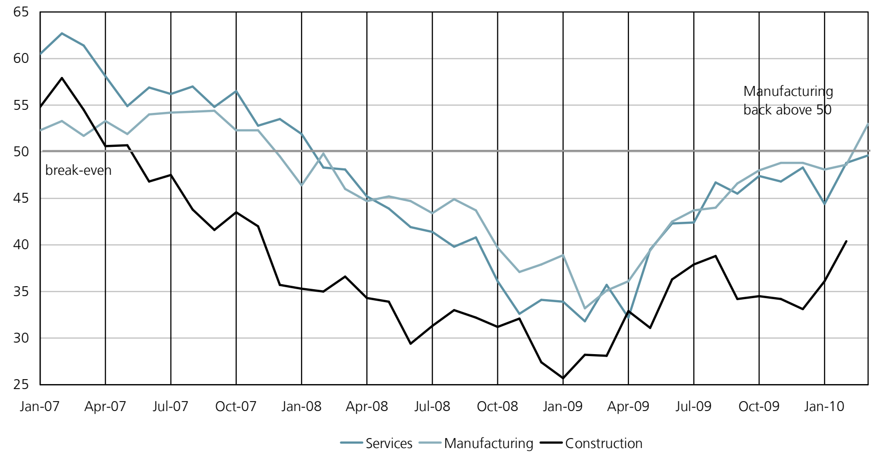
Recent data show the economy (except for construction) returning to growth

- **Survey indicators and hard data highlight renewed growth across many sectors of the economy**

Recent high frequency data point to an economy that turned the corner in Q1 (as we had suggested might happen 11 months ago: see *Davy on the Irish Economy*: "Ireland is probably past the worst of the recession; economy may bottom in Q1-Q2 2010", issued May 14th 2009). Survey indicators and hard data highlight renewed growth across many sectors, something that had not been experienced for at least two years. Here is the key evidence from those indicators:

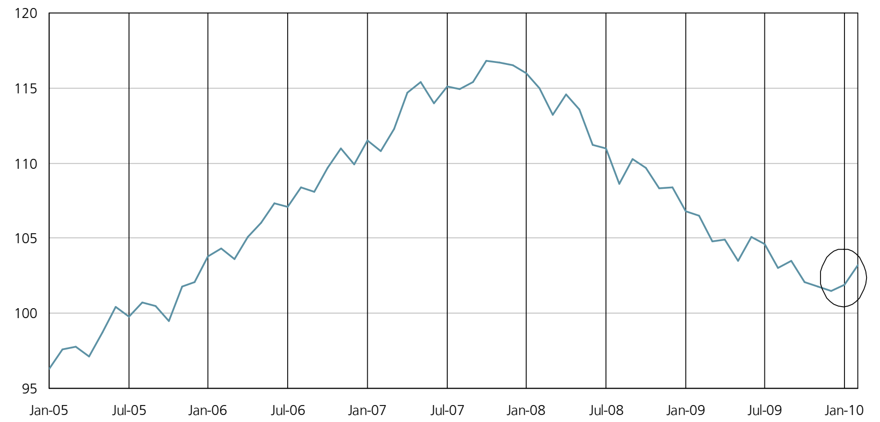
- 'Core' retail sales increased for two straight months in January and February for the first time since October 2007.
- Industrial production jumped 17% in January-February compared with the Q4 average. Goods exports for the first two months of the year grew sequentially as a result.
- The PMI manufacturing index has vaulted the 50 level, which divides recession from contraction.
- The PMI services index is almost back to 50, at 49.6. New export orders signal growth in internationally-traded services.
- Consumer confidence has reached its highest point since January 2008. In fact, all of the survey indicators (including the PMIs) are at their highest point since Ireland entered recession.
- Moreover, imports into Ireland look to have increased in Q1. That had not happened since Q1 2007 and suggests that consumer spending on durable goods is finally recovering.

Figure 1: PMI surveys (50 is the line between recession and growth)



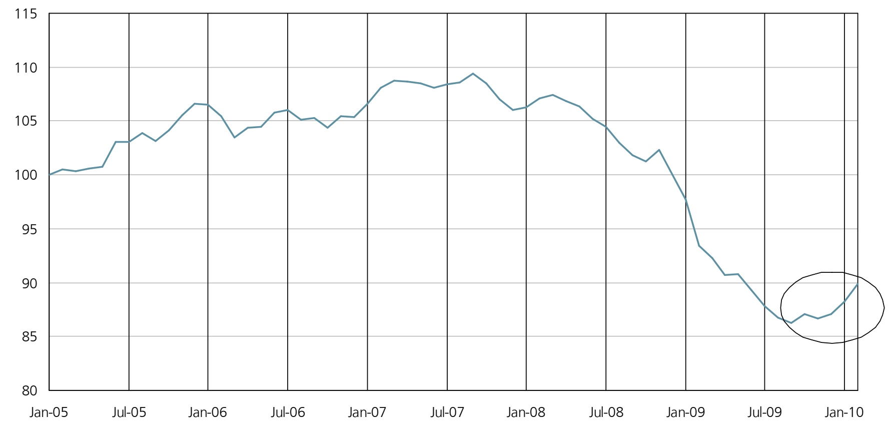
Source: Markit; Ulster Bank

Figure 2: Retail sales (ex-garages, volume, seasonally adjusted)



Source: CSO

Figure 3: Industrial production (volume in 'traditional' sector, Jan 2005=100, sa)



Source: CSO

Economy to expand at near-1% quarter-on-quarter pace in 2010

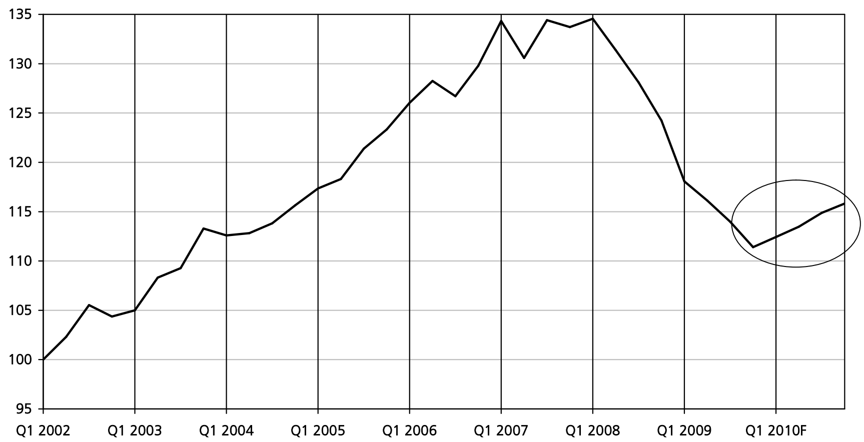
Commentators in Ireland seem to have an obsession (almost uniquely in the developed world) with annual changes. But 12 months is an age in macroeconomic terms, particularly at turning points. It is difficult and unsatisfactory to attempt to spot whether activity has reached an inflection point by focusing on the change compared with this time last year. For example, in any given year, activity could plummet for the first six months and then move sideways for the next six. The annual change would show up as a big negative, yet the period in which the economy had troughed would be long in the past.

- An undue focus on annual average changes rather than quarterly ones will conceal the current turn in the economy

Undue focus on the annual average will conceal the turn in the economy at present. For example, we estimate that the economy grew by 1% in the first quarter compared with the final three months of last year. Yet the year-on-year change (from which it is impossible to spot the inflection point) will show a *decline* of at least 5%.

In Q1, consumer spending was at worst flat quarter-on-quarter. Investment declined but at a slower pace (2.5% or c.10% annualised) than during 2009. Government current spending fell on the back of fiscal consolidation. Exports have recovered due to the global uplift, and imports probably rose sequentially at their fastest pace since Q3 2007.

Figure 4: Real GNP (quarterly, Q1 2000 = 100, seasonally adjusted)



Source: CSO; Davy forecasts

Looking ahead, we forecast that the economy will expand at a pace of roughly 1% sequentially (or 4% annualised) for the remainder of 2010 (see Figure 4). It is worth bearing in mind that those forecasts are real (or volume) changes. Nominal GNP and GDP will expand at a much slower pace because prices are still falling.

Full year average annual growth of 3% in GNP likely for 2011

- We think the economy will grow 3% in real GNP terms in full year 2011 versus full year 2010

Annual average forecasts are less interesting than quarterly forecasts for 2010 as they hide the economy's turning point. But we cannot be precise with quarterly forecasts for 2011. In aggregate, we think the economy will grow 3% in real GNP terms in full year 2011 versus full year 2010. GDP may grow at a faster pace of 4-4.5%. That compares with an average annual decline of 0.6% in GNP this year but growth of 1% in GDP.

Consumer spending has actually been stable for almost a year

It has almost gone unnoticed that consumer spending has been stable since Q1 2009. The bulk of the damage was done in the year to Q1 2009, when spending fell by a massive 9.3%. In the following three quarters to Q4 2009, spending was only 0.4% lower.

- **Total real purchasing power across the economy did not drop during the recession**

Another fact that has received little attention is that economy-wide real income did not decline during the recession. Real income per household fell slightly on average because the number of households continued to increase. But total real purchasing power across the economy did not drop. Of course, there was wide dispersion: households in which a bread-winner lost a job were hit hard, but households not impacted by unemployment and that saw wages stay unchanged gained in real income terms because prices dropped.

- **Inflation-adjusted incomes actually inched up 0.1% last year and may rise 0.4% in 2010**

Falling real incomes did not cause the decline in consumer spending (see Table 2). Wage and self-employed income did drop dramatically, particularly in early 2009. But the impact of the automatic stabilisers – social welfare payments (they jumped €5bn last year) – cushioned the blow. That is the fiscal stimulus never highlighted. Taxes paid nudged down in line with declining wages. Moreover, prices fell by 3.4%. So nominal (cash) disposable income slipped 3.3% last year and may fall by 1.6% in 2010. But taking the fall in prices into account, inflation-adjusted incomes actually inched up 0.1% last year and may rise 0.4% in 2010.

Table 2: Household disposable income (€m)

	2005	*2006*	*2007*	*2008*	*2009*	*2010F*	*2011F*
Employee wages	65568	71956	77163	78698	70121	66157	67437
% change		9.7	7.2	2.0	-10.9	-5.7	1.9
Self-employed income*	12773	13578	13678	12519	10896	10732	11228
% change		6.3	0.7	-8.5	-13.0	-1.5	4.6
Total normal wage and trading income	78340	85534	90840	91217	81017	76889	78666
% change		9.2	6.2	0.4	-11.2	-5.1	2.3
(Net) Interest, dividends, rents	6406	6184	7054	6877	6534	6370	6530
% change		-3.5	14.1	-2.5	-5.0	-2.5	2.5
Social transfers	17179	19096	21674	24925	29910	32901	34546
% change		11.2	13.5	15.0	20.0	10.0	5.0
Taxes on income and wealth	19564	21407	23558	23460	21205	21430	22555
% change		9.4	10.1	-0.4	-9.6	1.1	5.2
Statistical discrepancy	247	-1446	-1876	-365	-328	-328	-328
Household cash disposable income	82608	87961	94133	99195	95928	94402	96858
% change		6.5	7.0	5.4	-3.3	-1.6	2.6
PCE deflator (%)		2.4	3.4	3.1	-3.4	-2.0	-0.5
Household real disposable income		4.0	3.5	2.2	0.1	0.4	3.1

*including agricultural household income
Source: CSO; Davy forecasts

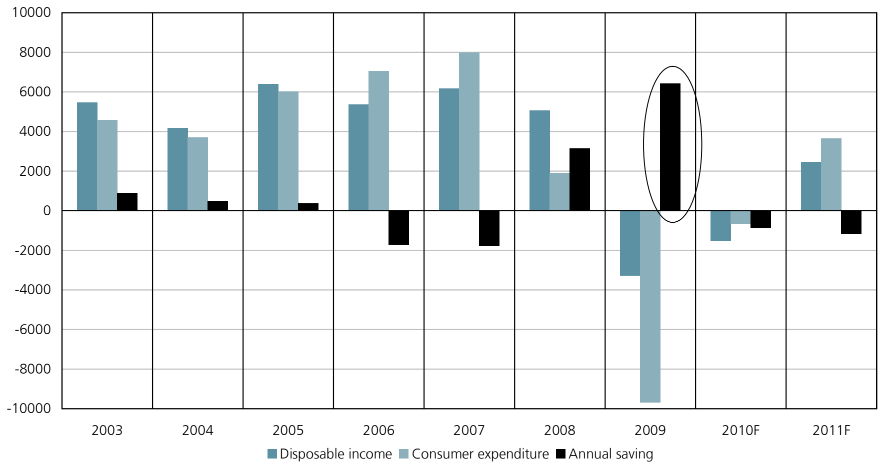
Savings ratio spike caused by three main negative factors: two are now reversing

If the change in disposable incomes did not warrant such a collapse in spending in the year to Q1 2009, then what did the damage (see Figure 5)? Precautionary savings spiked from 2007 on. In 2007, households were saving €2 out of every €100 in after-tax income; by last year, they were saving €12 out of every €100. We think there were three broad reasons for the 10 percentage point spike in the savings ratio from 2% to 12%:

- Rising unemployment, expected tax increases and pressure on household wealth caused the savings ratio to spike

- First, unemployment was rising rapidly throughout 2008 and early 2009. The unemployment rate soared from 4.9% in February 2008 to 11.2% by April 2009. Household expectations were adaptive rather than rational. They extrapolated this trend into the future and, fearful for their jobs, cut back on discretionary spending.
- Second, the perception was that the government had lost control of the public finances in H2 2008-Q1 2009. After the initial income levies were introduced in October 2008 (and topped up in April 2009), households expected taxes to increase indefinitely.
- Third, household net worth was savaged in 2008 and 2009. Too much wealth was concentrated in property, exacerbating the negative effect on savings relative to other countries. Consumers compensated by saving out of income instead.

Figure 5: Household nominal income, spending and saving (change yoy, €m)



Source: Davy; CSO

Precautionary saving has peaked: unemployment rate starting to flatten, and no further significant tax rises likely

Two of the three negative impulses on consumer spending are dissipating. The unemployment rate is set to peak at 13.6% in Q3 2010 (employment growth will resume from Q4 2010 onwards), and taxes are unlikely to increase substantially. A property tax and water charge may be introduced, but we do not expect further hikes in the rate of income tax. The base may be broadened (as 50% of workers currently pay no income tax at all), but the salient point is that households finally have some clarity. On the downside, household wealth will remain under pressure for a while: we do not expect house prices to bottom this year.

- The improvement in the labour market and the public finances may lower the savings ratio from a peak of 12.3% in 2009 to 10.5% in 2011 on average

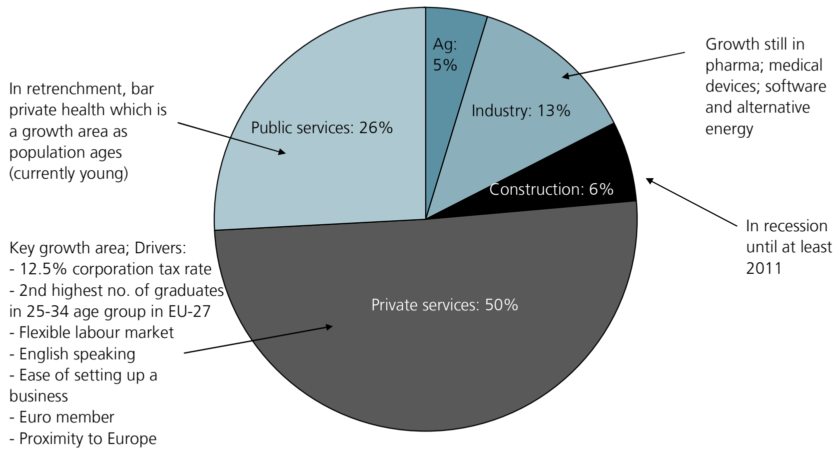
The improvement in the labour market and the public finances may lower the savings ratio from a peak of 12.3% in 2009 to 10.5% in 2011 on average.

Labour market has been stabilising in the last six months; peak in unemployment likely in Q3

- **Irish employment is set to grow again quarter-on-quarter by Q4 2010, marking the first quarter of expansion in three years**

Irish employment is set to grow again quarter-on-quarter by Q4 2010. That would mark the first quarter of expansion in exactly three years. The turn will be led by private services, which has a share of 50% of employment (see Figure 6). More specifically, internationally-traded business services, communications, Information Services (IS) and tourism will lead the recovery. Other sectors that may experience job growth include private health, high-tech manufacturing, mining and utilities. Construction employment will lag and may not even see the bottom in 2011. Indigenous manufacturing and agriculture may begin to stabilise late this year, but growth is unlikely before 2011.

Figure 6: Split of employment in the economy



Source: Davy; CSO

Labour force decline continues this year as a result of emigration and reduced participation

- **We expect the unemployment rate to peak in Q3**

We expect the unemployment rate to peak in Q3. It has been stuck at 13.4% for the three months of January, February and March. We expect a slight further increase to 13.6% by Q3. That may prove the peak, about six months after the turn in the economy.

- **The drop in labour supply has limited the rise in the unemployment rate**

The drop in labour supply has limited the rise in the unemployment rate. This happens naturally during recessions as workers become discouraged. If the participation rate had stayed at its peak cycle level, the unemployment rate would be three points higher at 16.4%. The working-age population has also been under pressure due to rising emigration. This is unfortunate but is a safety-valve and the corollary of the 2003-2007 period. It highlights the openness and flexibility of the Irish labour market. We think that net outward migration was about 25,000 in the year to April 2010 (the population year runs April to April), but that may prove to be the worst year of the cycle. The new outflow may slow to 20,000 in the year to April 2011.

- **We expect employment to decline 3.7% on average this year but to expand by 0.9% in 2011**

Overall, we expect employment to decline 3.7% on average this year (full year 2010 versus full year 2009) but to expand by 0.9% in 2011. The labour force may shrink by 1.9% on average this year (versus -2.4% in 2009), but we think that it will grow again in 2011 by 0.6% (see Table 3).

Table 3: Labour force forecasts (% change yoy, unless stated)

	2008	*2009*	*2010F*	*2011F*
Employment	2099.5	1928.6	1856.7	1873.9
% change		-8.1	-3.7	0.9
Labour force	2240.8	2187.2	2145.6	2157.4
% change		-2.4	-1.9	0.6
Unemployment rate*		13.0	13.6	12.9

*year-end (Q4)
Source: Davy; CSO

Irish exports beginning to grow again: future is about services

- Exports of services are surging again, while the goods trade continues to struggle

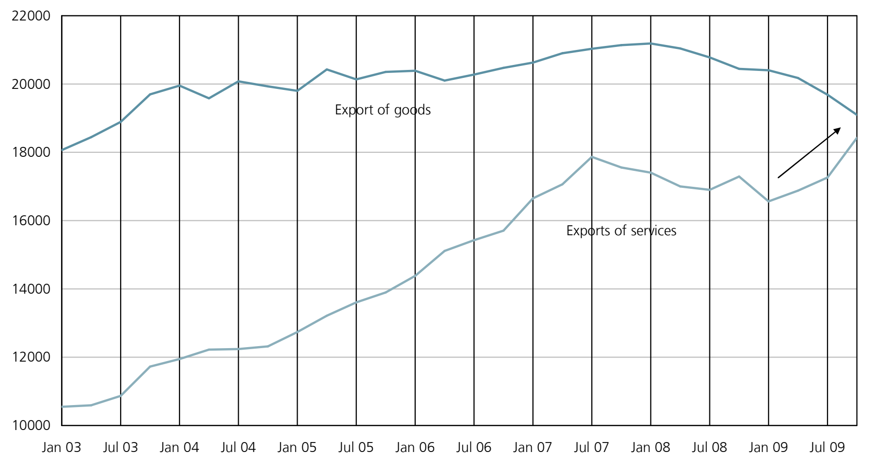
Irish exports grew marginally in Q4 2009. By volume, exports increased 0.1% but were still down 4.9% from the peak in Q4 2007. Yet that aggregate number conceals plenty: exports of services are surging again, while the goods trade continues to struggle.

- We are confident that the secular growth story for Irish services exports remains intact

Figure 7 captures the remarkable trend in Irish exports since 2003. The construction bubble somewhat concealed the fact that Irish services exports enjoyed stellar growth between 2003 and 2007. We are confident that the secular growth story for Irish services exports remains intact. Ireland's advantages for service companies are manifold:

– 12.5% corporation tax rate;
– second-highest number of graduates in the 25-34 age cohort in the EU-27;
– cost of setting up a business: Ireland ranks second in the OECD.
– flexible labour market: Ireland ranks fourth in the OECD.
– only English-speaking country in the euro area.

Figure 7: Export split (€m, quarterly volume, seasonally adjusted)



Source: CSO; Davy

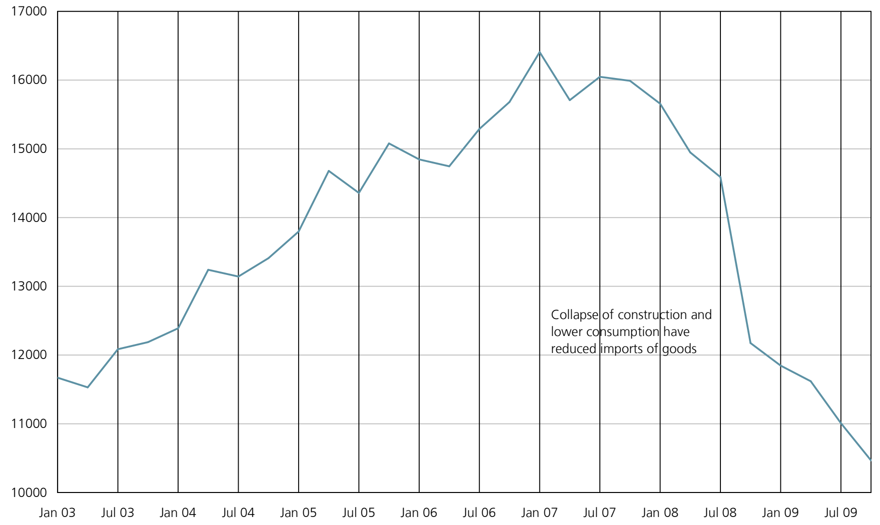
- We expect services to become the dominant component of Ireland's export sector

The final quarter of last year was a watershed: Irish services exports (not seasonally adjusted) passed out goods exports in nominal terms for the first time in any quarter ever (Figure 7 shows the trend in real terms seasonally adjusted and so does not show this crossover). Although goods exports will begin to perk up in line with global recovery and the reduction in Ireland's cost base relative to its trading partners, we expect services to become the dominant component of Ireland's export sector.

- We forecast that the volume of aggregate exports will grow by 2.5% on average in 2010. In 2011, exports may expand by 6% in volume.

We forecast that the volume of aggregate exports will grow by 2.5% on average in 2010. In 2011, exports may expand by 6% in volume. That growth rate would still be about half of a percentage point short of the 2003-2007 average. We believe that there is potential for upside as competitiveness gains and strengthening overseas markets bear fruit.

Figure 8: Imports of goods (€m, quarterly volume, seasonally adjusted)



Source: CSO; Davy

Collapse in goods imports has documented demise of construction

No metric has documented the sharp fall in Irish economic activity during the recession better than goods imports. Figure 8 shows the trend since Q1 2003: goods imports are now below the level of seven years ago. The savage cutback in investment was the main trigger for the 36% collapse in the period Q1 2007-Q4 2009. The slippage was even more marked when consumer spending dropped sharply in the 12 months to Q1 2009.

- The savage cutback in investment was the main trigger for the 36% collapse in goods imports in the period Q1 2007-Q4 2009

But there have been recent signs of stability, providing yet more evidence of the economy's bottom. Data for January and February suggest that goods exports nudged higher in Q1 for the first time in three years. This coincided with stability in consumer spending. However, goods imports will not recover meaningfully until investment in machinery and equipment begins to stir. Look out for indications of a pick-up in business spending in H2.

- Look out for indications of a pick-up in business spending in H2

In contrast, services imports (like their export counterpart) have held up. This reflects stronger global demand as activity between subsidiaries of multinational companies with operations here and overseas begins to lift. Total imports may grow slightly faster than final demand this year. We forecast that imports of goods and services will rise 1.4% in volume in 2010. Next year will see stronger activity on the back of healthier spending on physical goods by both consumers and businesses. We predict 5% aggregate import volume growth in 2011.

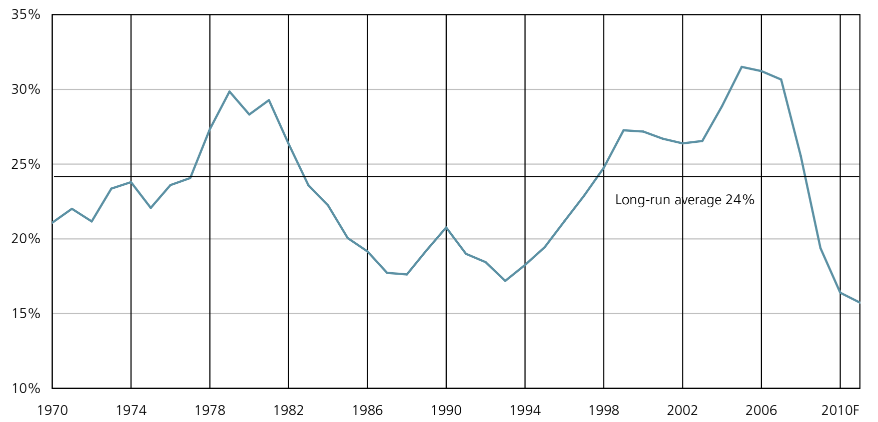
- We predict 5% aggregate import volume growth in 2011

Investment recession not over: construction will not trough until 2011

- The investment to GNP ratio will reach a record low in 2010

Ireland's boom and bust in 2002-2009 was all about investment. The excesses of 2002-2007 are being purged, but fresh investment is remarkably low. The investment to GNP ratio will reach a record low in 2010 and is likely to stay at a level well below average for a couple of more years as the glut of excess building is cleared. But a recovery in investment will unleash a powerful force at some point in the future, perhaps in 2013.

Figure 9: Gross fixed investment to GNP ratio (%)



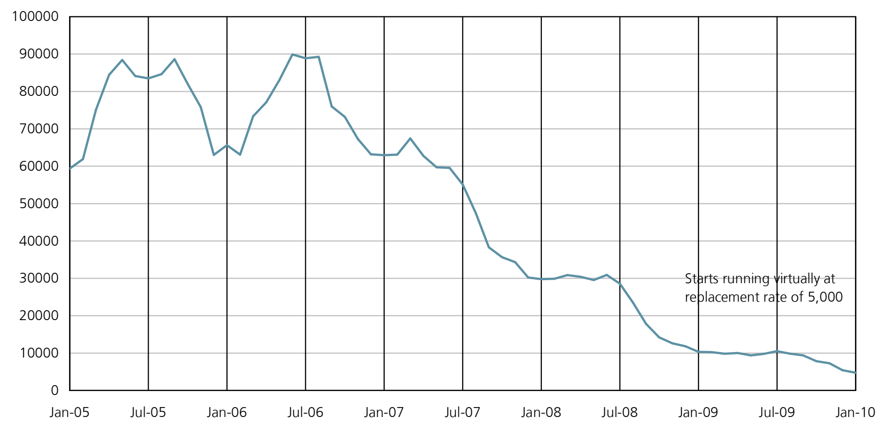
Source: CSO; Davy

- We know that construction will remain in recession in 2010 and for most of 2011

Ireland's long-run investment to GNP ratio is 24%. But the investment booms of 1978-1982 and 2002-2007 may inflate the long-run trend. Yet investment to GNP can stay low (below 20%) for many years, as evidenced in the decade from 1985 onwards. We know that construction will remain in recession in 2010 and for most of 2011. Machinery and equipment investment may rise from low levels, but it will not be enough to see the ratio lift from the 15-16% mark.

Forward-looking indicators suggest that housing and private building are set to remain sluggish. Private housing starts are running at an annualised rate of only 5,000. The private commercial arena is still beset by significant oversupply: as a result, new activity is in decline. Unlike the manufacturing and services PMI indicators, the construction PMI is still recording month-on-month declines (the latest reading was 42.3) – albeit nowhere near as severe as a year ago (low of 25.6 in January 2009).

Figure 10: Private housing starts (monthly annualised rate)



Source: Department of the Environment, Heritage and Local Government

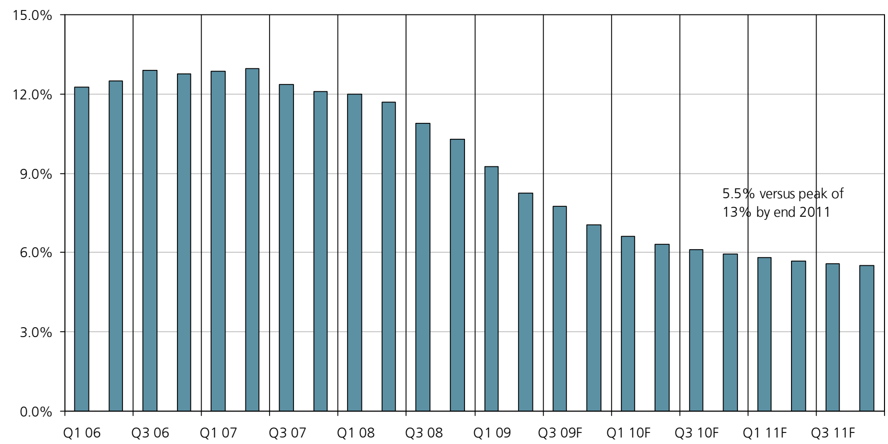
Construction sector cannot afford further cut in capital programme; employment share headed for less than 6% already

- **The construction industry is more reliant than ever before on government help, but the state has steadily cut its capital programme over the last two years**

The construction industry is more reliant than ever before on government help. But the state has steadily cut its capital programme over the last two years, and further inroads cannot be sustained.

As it is, the voted (i.e. state-directed expenditure) capital Budget is €6.4bn for this year. But most contractors would insist that is a number for completed activity: few new projects are being tendered. For example, the main inter-urban motorway network is slated for completion by the end of 2010. Note, too, that building work accounts for only about 70% of voted capital spending.

Figure 11: Construction as % of total employment



Source: CSO; Davy

The state's influence on the construction industry does not end with the €6.4bn package. Semi-state companies are still investing substantively in the power-generation, transmission and telecommunications network. This non-voted capital spending (i.e. not part of the official state Budget) is worth almost €2bn to the industry this year.

- The government has already outlined a further €1bn cut in the direct capital programme as part of the €3bn fiscal consolidation planned for 2011

The problem is that the government has already outlined a further €1bn cut in the direct capital programme as part of the €3bn fiscal consolidation planned for 2011. Less than 18 months ago (in the October 2008 Budget), the government budgeted for €8.2bn in voted capital spending for 2011 – some €2.7bn more than the current total. The industry's size is headed for €11bn next year from a peak above €38bn, so €2.7bn would make quite a difference. We have consistently argued that the government should use the dramatic fall in tender prices (-29%) to increase the number of projects to keep the level of nominal spending as high as possible. The search for cost savings should be focused even more aggressively on day-to-day government expenditure.

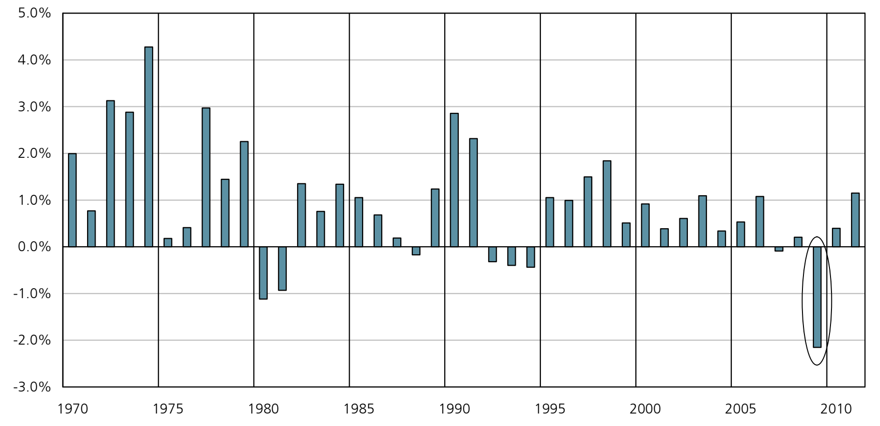
- Cost savings should be focused even more aggressively on day-to-day government expenditure

Stock-building will boost bottom-line GNP in 2010 and 2011 having exerted 2%+ drag in 2009

- Total stocks at hand fell by €2.8bn in 2009, the biggest drop ever

The liquidation of physical stocks across the economy significantly cut bottom-line GNP in 2009. Total stocks at hand fell by €2.8bn, the biggest drop ever. In fact, stocks had dropped in only seven previous years stretching back to 1970 (see Figure 12). The negative drag on the economy was worth 2.2% of GNP.

Figure 12: Change in physical stocks (% of GNP)



Source: CSO; Davy

Going all the way back to 1970, stock-building added 1% on average to GNP per annum. But the 1970s was a funny period, pockmarked by stockpiling of oil. Taking the period 1980-2008, the average annual change in stocks was +0.7% of GNP.

- We forecast that stocks will increase by €500m, or 0.4% of GNP, this year, which would be some way short of the typical rebound in stocks after recession

We expect businesses to gradually replenish stocks, which must now be at depleted levels. Of course, there was much liquidation of materials – especially in construction – that will not be restocked. We forecast that stocks will increase by €500m, or 0.4% of GNP, this year – some way short of the typical rebound in stocks after recession. For example, physical stock-building was worth 1.2% of GNP in 1989, rising to almost 3% in 1990. In 1995 and 1996, stock replenishment amounted to at least 1% of GNP in each year. Next year, we expect stock-building to accelerate to about €1.5bn, or 1.1% of GNP. There could well be some upside to our forecasts if business confidence is restored even more quickly in the next 18 months.

Prices set to fall again in 2011, but at slower pace

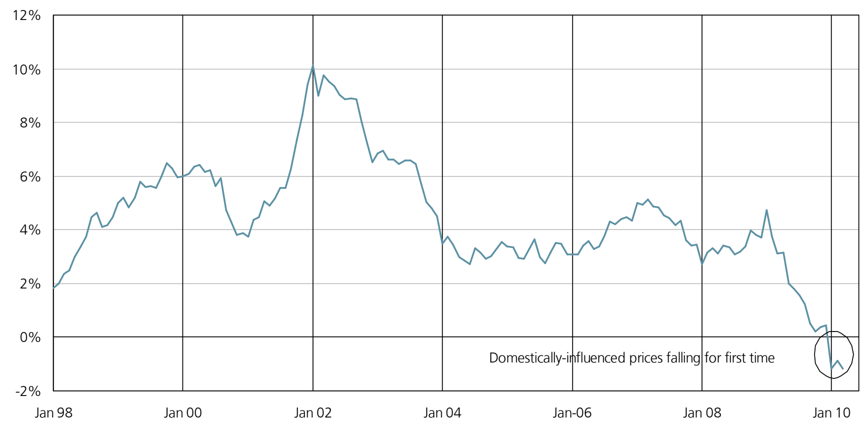
Ireland has experienced deflation since mid-2008. The HICP – the comparable price measure across the EU-27 – is down 4.3% since then. It is a necessary adjustment as Ireland has begun to narrow its price premium versus the euro area.

- **We expect prices to keep falling in the short term, albeit at a slower pace than in H2 2008 and 2009**

We expect prices to keep falling in the short term, albeit at a slower pace than in H2 2008 and 2009. For one thing, goods prices may not deflate at the same pace. It took some time for the strength of the euro against sterling in 2008 to feed through to sticker prices at the shops. That eventually happened throughout 2009, but the trend has more or less run its course and the euro has recently weakened. In addition, fuel prices have risen. Luckily, increased competition in Ireland's energy market may keep a lid on electricity and gas prices. Retail discounting more generally may be losing momentum as consumer demand recovers.

It is elsewhere that price deflation is no harm. Underlying services inflation was too high for years, as sheltered sectors of the economy raised prices with impunity. This part of the economy has felt the harsh wind of recession over the last 18 months and prices are finally falling. In fact, 'core' services deflation started for the first time in January 2010 and has continued (see Figure 13). Price pressure is likely to remain subdued for quite a while, helping Ireland to rebuild competitiveness.

Figure 13: CPI services (ex-mortgages, % change yoy)



Source: CSO; Davy

By December 2009, we forecast that the HICP will be 0.8% lower than its March 2010 level. The CPI, however, will be all but unchanged because mortgage rates will be rising. For full year 2010 (see Table 4), we project annual deflation of 2.1% for HICP and 1.9% for CPI. In 2011, HICP may fall 1.2%. But the CPI is likely to increase slightly by 0.4%, thanks to hikes in the base refi rate by the ECB and widening of mortgage margins by banks.

Table 4: Price level forecasts (% change year-on-year)

	2009	*2010*	*2011*
HICP	-1.7	-2.1	-1.2
CPI	-4.5	-1.9	0.4
PCE deflator	-3.4	-2.0	-0.5

Source: Davy; CSO

Recovery will not be uniform across the economy

We reckon that the economy in aggregate has emerged from recession. But that does not mean that every sector has stopped shrinking. Construction will lag, as we have already noted. But the volume of activity in public services is also unlikely to increase significantly in the near future, given the fiscal situation. Agriculture and tourism are only beginning their tentative recovery. Crucially, private services – the powerhouse of the economy with c.50% of value added – was already stabilising at the end of 2009 and began to grow again in Q1.

Table 5: Sectoral performance (% change quarter-on-quarter, unless stated)

	Agriculture	*Construction*	*Industry*	*Civil Service & Defence*	*Distr., Transport, Commun.*	*Other services (private and public)*
Q4 2009	3.5	-9.7	-4.3	1.0	-0.7	-0.2
Start of recession*	-5.4	-50.5	-8.4	-5.2	-13.8	-3.7

*% volume decline from start of recession in that particular sector
Source: CSO

The National Accounts provide a broad split of GDP by output into different sectors (see Table 5). They do not follow the employment split exactly (see Figure 6), but the difference is not enormous. Other services roughly equates to private services, although it includes health and education in this case and leaves out distribution, transport and communication which is calculated separately.

- **The service sector weathered the recession best and is also one of the first parts of the economy to stabilise**

It is obvious from Table 5 that the service sector weathered the recession best and is also one of the first parts of the economy to stabilise. The peak-to-trough decline (Q4 was probably the bottom) was only 3.7% for services versus 51% for construction output, a sector that will not reach a floor until well into 2011 at the earliest. Moreover, services fell only 0.2% quarter-on-quarter (qoq) in Q4 compared with declines of 9.7% in construction and 4.3% for industry. The pace of decline of activity in distribution, transport and communications also slowed to 0.7% qoq. Agriculture actually grew as commodity prices (especially milk) rebounded. Tourism is picking up too, as is manufacturing indigenous industry (as per the industrial production numbers). Overall, we estimate that roughly 75% of the economy returned to growth in Q1.

- **We estimate that c.75% of the economy returned to growth in Q1**

Households have reduced unsecured debt by 22%, but mortgage debt remains high

In the next 18 months, we expect the savings ratio to decline somewhat. But it will probably remain above the long-run average for one key reason: the stock of household debt among young age groups is a constraint.

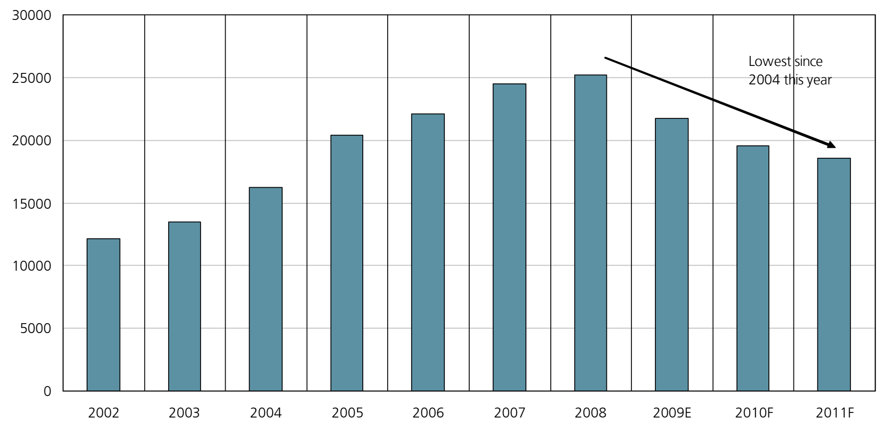
Debt service is more important than the level of debt per se, and the servicing cost for Irish households has declined sharply mainly due to the repayment of chunks of unsecured debt. Yet the level of debt surely matters, particularly when twinned with negative equity.

The level of debt hurts both productivity and consumption as follows:

– productivity by reducing labour mobility; and
– consumer spending via negative wealth effects (i.e. through the savings channel).

So when the savings ratio drops, it will probably nudge down to 10% rather than 7-8%. Unfortunately, that will reduce potential growth if not offset by higher public investment. Regrettably, we cannot carry out the detailed analysis that we would like to. No data are available on who has all the debt, i.e. the cross-section by age group. It is evident that the salient 25-34 spending age group took on much of the mortgage debt in 2004-2006, but we do not know how much exactly. There is no way of calculating how many individuals or households are blighted with negative equity for example. These data are available with the mortgage banks – the figures should be passed on to the Central Statistics Office.

Figure 14: Unsecured personal debt (annual average, €m)



Source: Central Bank of Ireland

- **A corollary to the rise in the savings ratio is the decline in unsecured debt**

A corollary to the rise in the savings ratio is the decline in unsecured debt. It dropped to €20.1bn by Q4 2009, down from €25.7bn at the peak in Q1 2008. By the end of 2001, it will be below €18bn. This year, the level of unsecured debt on average will be lower than in 2005. It made sense for consumers to pay off unsecured debt last year, given that the interest rates charged are at least double mortgage rates. Equally, it must be noted that some of this debt was written off by banks.

Mortgage debt remains stubbornly high; new lending still shrinking

On the other hand, gross mortgage debt has not shrunk all that much. The level of mortgage debt is down only 0.6% from peak despite the lack of new lending. Only 0.8% (or €1.2bn) of the gross mortgage book has been written off. Our banks team reckons that the total cumulative charge for the cycle may be around 2%. There are a number of reasons why the level of mortgage debt has not reduced by much:

- The mortgage term has been extended (life of a mortgage) to help those in difficulty; repayment rescheduling has been rife.
- Bullet repayments, e.g. from bonuses, are scarce.

- Repossessions were already difficult to force in Ireland thanks to family law legislation and archaic bankruptcy laws; it is even tougher now with the moratorium on legal proceedings imposed on banks and, in any case, banks do not want to sell into a weak market.
- Banks have not systematically closed on distressed buy-to-let (BTL) borrowers.

New lending is sluggish (see our banks team's research note "Gross Mortgage Lending: Mortgage lending falls 58.5% year-on-year; outlook to remain weak", issued February 15th). Only first-time buyers (FTBs) are providing any small signs of life, albeit that volumes in that segment still dropped 11% year-on-year in Q4 (the latest data available). The Q1 numbers may be close to flat for FTBs compared with 2009.

BTL is the fly-in-the-ointment. More than 25% of the gross mortgage book in Ireland is accounted for by investment property. BTL has been a distant second on banks' list of priorities after sorting out development lending. Distressed selling has barely occurred thus far, in part because of the oversupply of new developments already. As NAMA gets up and running, that dynamic may change. We expect increased write-offs in BTL, which may reduce gross mortgage outstanding somewhat more quickly than heretofore. Nonetheless, the workout of bad mortgages will take many years.

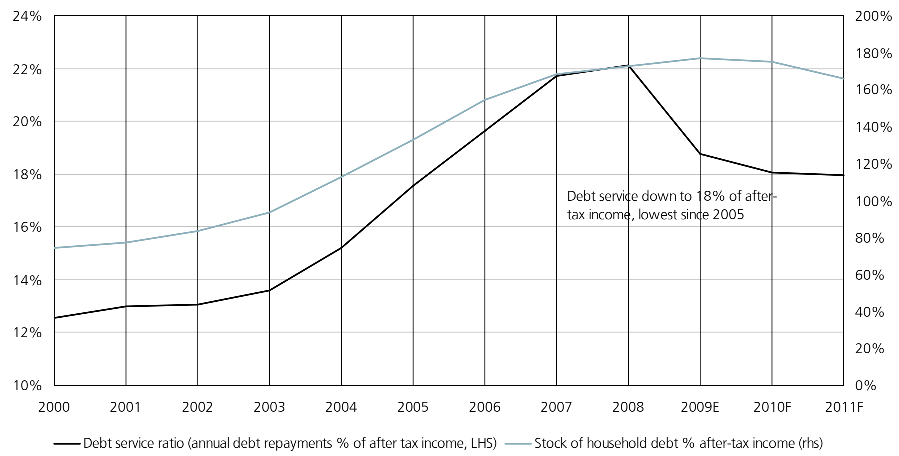
- **In the short-term, mortgage debt service will be primarily impacted by rising interest rates rather than changes in its outstanding level**
- **We expect average mortgage rates across the economy to rise towards 5% by the end of 2011 from only 3.4% today**

Therefore, in the short-term mortgage debt service will be primarily impacted by rising interest rates rather than changes in its outstanding level. This year, the European Central Bank (ECB) is unlikely to move until Q4 at the earliest; even then, it will hike by 25 basis points at most. However, banks are pushing up margins. All in all, we expect average mortgage rates across the economy to rise towards 5% by the end of 2011 from only 3.4% today.

Taking the trends in secured and unsecured household debt into account, the debt service ratio will slip towards 18% of after-tax income this year, the lowest since 2005. It will be more or less unchanged next year as debt reduction and rising disposable income offset the jump in interest rates.

The level of debt meanwhile will remain quite high at 166% of after-tax income by 2011. The good news is that unsecured debt will amount to only 12% of total personal debt. That compares with 25% in 1999.

Figure 15: Household debt ratios



Source: Davy

Underlying deficit to drop towards 11% in 2010

We won't dwell on the fiscal picture here. Please see our recent note ("Ireland's underlying deficit to fall in 2010; headline number will look ugly thanks to banking write-offs", issued April 23rd). Importantly, the underlying general government deficit (i.e. excluding capital injections into nationalised banks) will drop towards 11% of GDP this year from 11.8% last year thanks to last December's gross €4bn fiscal consolidation and stabilising tax revenue.

- **We believe it is time for the government to frame next December's Budget**

In our view, it is time for the government to frame next December's Budget. We hope that the 'Croke Park Agreement' holds. That agreement will see reductions in the cost of the state through outsourcing, voluntary redundancy, natural attrition, changes in work practices and general restructuring of public services in return for guarantees that public pay won't be cut again at least until 2014. It will go some way to finding the €2bn extra necessary for the 2011 consolidation package. The timing is favourable in the context of the recent upheaval in Greece.

As it stands, we have one element of the Budget package: the €1bn cut in capital spending from €6.5bn to €5.5bn. At least €1bn may come from further current spending reductions viz. the Croke Park Agreement. The other €1bn will come from the following menu: a property tax, water charges or broadening of the tax base (50% of workers pay no income tax whatsoever).

Ireland regaining price competitiveness, but it is a multi-year process

- **Ireland has started to slowly regain price competitiveness over the last 18 months**

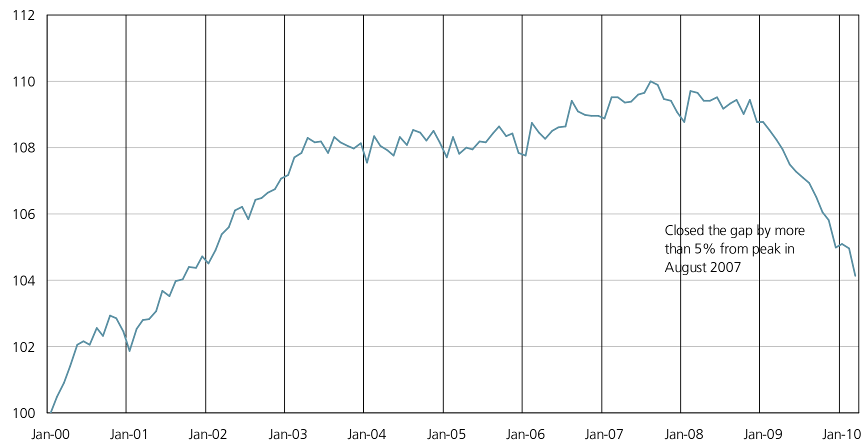
Ireland has started to slowly regain price competitiveness over the last 18 months. Compared with the euro area, Ireland has closed its nominal wage gap by more than 5% and it price level premium by almost 6%. A number of other domestic developments have helped:

- Commercial property prices are down 56% from peak.
- House prices are down 35%, which reduces upward pressure on wages and hence decreases potential labour costs for business.
- Commercial rents are down 22% from the zenith in Q3 2008.
- Housing rents have already dropped 25% and look to have settled.
- Electricity prices have declined by 11% and gas prices by 21%.

- **The gap between the respective HICP level in Ireland and the euro area had narrowed by 5.3% up to March 2010**

Almost 50% of Ireland's exports are destined for the euro area. Unfortunately, Ireland's price level was 21% above the euro area average by 2007. Since August 2007, though, Ireland has made inroads to that unfavourable premium. The gap between the respective HICP level in Ireland and the euro area had narrowed by 5.3% up to March 2010 (see Figure 16).

Figure 16: Ireland HICP price level versus euro area (re-based to January 2000=100)*



*This does not mean that the price levels were equal in January 2000: respective indices simply re-based.
Source: Davy; Datastream

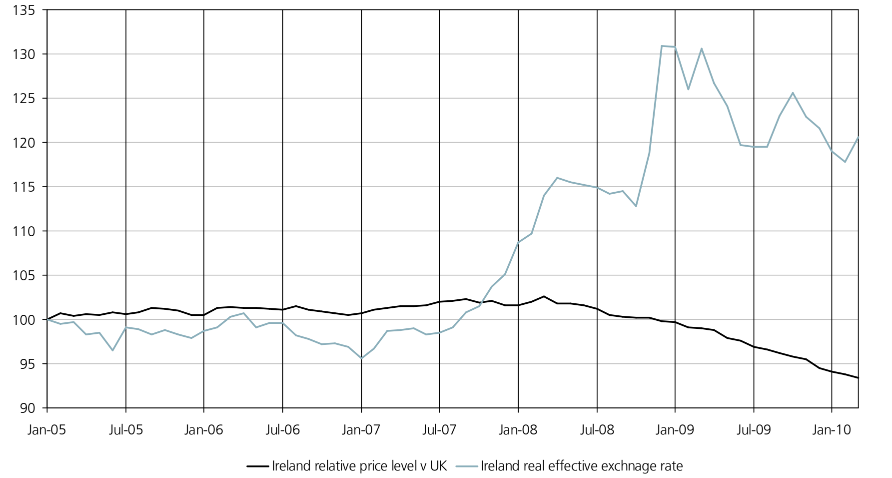
Further euro weakness versus sterling would help; dollar not a big boost

Ireland's dependence on the UK is sometimes exaggerated: exports to the UK (including Northern Ireland) are now less than 20% of the total. But it is true that the employment share of those Irish exporters is greater than their output share: they reside mainly in labour-intensive industries such as agribusiness, food processing and basic manufacturing.

- **If sterling begins to strengthen after the UK election when a proper fiscal consolidation package is introduced, it would provide quite a boon to Irish exporters**

Fortunately, Ireland is also gaining price competitiveness against the UK. It has closed the relative price level premium by a massive 9%. But the exchange rate did more damage than underlying prices in H2 2007 and 2008. The real exchange rate differential is still some 20% worse than in 2005-2007 (see Figure 17). If sterling begins to strengthen after the UK election when a proper fiscal consolidation package is introduced, it would provide quite a boon to Irish exporters.

Figure 17: Ireland price level and real exchange rate versus UK



Source: Davy; Datastream

The euro has weakened considerably against the dollar since the Greek crisis began. Even through 20% of Irish exports go to the US, the dollar is not as important as sterling from the point of view of trading edge. Most Irish exports to the US (and a significant chink of exports to the euro area) are intra-subsidiary of multinational companies and are priced in dollars. The dollar move does little harm, but it won't make a large difference to bottom-line GNP or employment.

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Neutral	28	34	10	26
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