



Rossa White

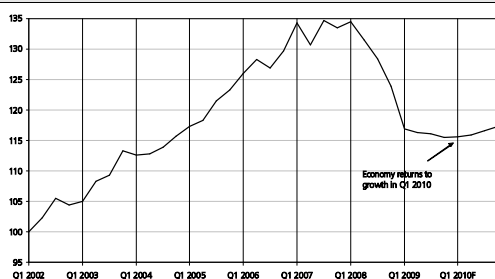
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Davy on the Irish Economy

Economy to grow by 4% in 2011

GNP volume (Q1 2002 = 100, sa)



We expect the Irish economy to return to growth in 2010

- The Irish economy is set to return to growth in Q1 2010. We expect average annual growth of 0.5% in real GNP in 2010, but that conceals gradual acceleration in economic activity intra-year. It implies a peak-to-trough decline in GNP of 14% from Q3 2007-Q4 2009.

- We look for a broad range of indicators to indicate growth by early 2010, including survey data, retail sales, tax receipts and industrial production.

- Consumer spending may increase 1.5% as real incomes stabilise and precautionary saving eases.

- Export growth is likely to quicken as Ireland benefits from global economic recovery.

- The peak in unemployment will lag the trough in the economy by six to nine months. We expect the unemployment rate to peak below 14% in Q3 2010.

Economy to grow at above-trend rate of 4% in 2011

- We expect the volume of GNP to grow at an above-trend rate of 4% in 2011.

- We assume that agriculture, industry and private services will expand. Construction output will shrink until 2011, while the amount of public services may decline slightly.

- The economy will recover from a lower base due to firmer global demand (export growth is forecast to reach 6%), slowly loosening credit conditions, gradually falling household saving (from a 30-year high) and rising business investment.

Recovery will not feel that strong on the ground

- It may not 'feel' like conditions are improving that quickly: domestic demand will lag growth in bottom-line GNP. In addition, unemployment will take time to fall: we expect the rate to eventually dip below 12% by end-2011.

- Equally, not every sector will be recovering: indigenous industry and construction will lag.

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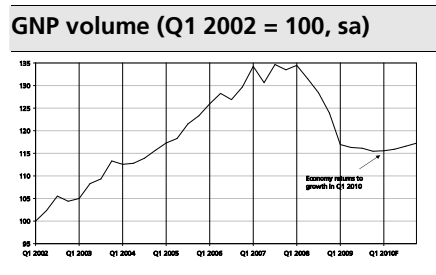
Table 1: Summary of economic forecasts

	2008	2009F	2010F	2011F
Expenditure components of GNP (% change in volume)				
Consumer spending	-1.0	-7.0	1.5	3.8
Government spending	2.6	-1.0	-3.0	-1.5
Investment	-15.5	-27.0	-11.5	2.8
- Residential investment	-26.3	-38.6	-28.4	11.1
- Non-residential building investment	-1.7	-24.5	-11.2	-10.4
- Machinery and equipment	-15.4	-12.5	6.0	10.0
Exports	-1.0	-2.0	3.5	6.0
Imports	-2.1	-7.5	1.4	4.9
GDP	-3.0	-6.3	1.2	4.1
GNP	-2.8	-9.6	0.5	3.9
Balance of payments				
Current account (€m)	-9435	-5189	-3107	-1833
% of GNP	-6.1	-3.8	-2.3	-1.3
Inflation (% yoy, annual average)				
Consumer Price Index (CPI)	4.1	-4.3	-0.5	2.0
Harmonised Index of Consumer Prices (HICP)	3.1	-1.6	-1.1	1.0
Wage inflation	3.1	-3.0	-2.0	1.0
Labour market (% change yoy)				
Employment	-1.1	-7.8	-2.5	2.5
Unemployment rate (end-year, sa)	8.2	13.0	13.5	11.9
Public finances (€m)				
Exchequer Balance	-12715	-25098	-19904	-17761
General Government Balance	-11796	-19162	-18809	-14958
GGB % of GDP	-6.5	-11.4	-10.9	-8.7
Base interest rates (%)				
		<i>Current</i>	<i>End-2009</i>	<i>End-2010</i>
Eurozone refi rate		1.0	1.0	1.5
US Fed funds target rate		0.25	0.25	1.5
UK repo rate		0.5	0.5	2.0
Exchange rates				
\$/€		1.46	1.50	1.40
£/€		0.92	0.90	0.80

Source: Davy forecasts

Main forecast changes

- First forecast for 2011.
- GNP change for 2009 revised down from -8.6% to -9.6% (annual average).
- GNP change for 2010 revised up from a decline of 3.1% to growth of 0.5% (second upward revision).
- Unemployment rate for year-end 2010 revised down from 14.3% to 13.5%.



Source: CSO; Davy forecasts

Summary of forecasts

- The Irish economy should return to quarter-on-quarter GNP growth by Q1 2010. The seasonally adjusted quarterly numbers are pivotal at this turning point in the cycle (see "Be careful of the arithmetic at the cyclical turn" on page 16).
- We expect agriculture, industry and private services to expand. Construction will shrink until 2011, while public services may decline slightly.
- We will look for a broad range of indicators to indicate growth by early 2010 (note that GNP numbers are revealed with a three-month lag): PMI surveys to signal expansion, retail sales to rise, tax revenue to pick up month-on-month seasonally adjusted (where possible to measure it) and industrial production to record higher sequential output.
- On an annual average basis (i.e. full year 2010 versus full year 2009), GNP may grow 0.5% in 2010. But there will be growth intra-year from the first quarter on.
- Consumer spending is set to increase by 1.5% on average in 2010. We expect exports to rise by at least 3%, but investment will fall for a third straight year.
- The unemployment rate will peak in H2 2010 at below 14%.
- We expect the economy to grow by 4% in GNP volume in 2011.
- Exports may return to at least the rate of growth recorded in 2002-2008 in 2011. Our baseline forecast sees exports expanding by 6% in volume.
- Consumer spending may grow by 3.8% as incomes recover and precautionary saving unwinds somewhat.
- It may not feel like the economy is recovering as strongly as the bottom-line numbers. Domestic demand will lag growth in overall GNP in a reverse of the 2002-2007 period.
- Growth may not exceed trend (which we reckon is 2.5-3%) sufficiently to bring the unemployment rate down quickly.
- We reckon that the unemployment rate will dip below 12% by end-2011.
- We expect the GGB deficit to reach 11.4% of GDP this year; at this stage we will not second-guess the official forecast too much for 2010. We see the GGB deficit falling slightly to 10.9% of GDP.

Economy to grow by 4% in 2011

We expect the Irish economy to return to above trend growth in 2011. Our forecast is for volume growth in GNP – the best measure of Irish economic activity – of 4%. Next year, we project that GNP will grow 0.5% in volume on an annual average basis. But that annual average will hide faster annualised intra-year expansion.

Table 2: Irish macro forecasts (% change in volume, annual average)

	2009	2010	2011
GNP	-9.6	0.5	4.1
GDP	-6.3	1.2	3.9

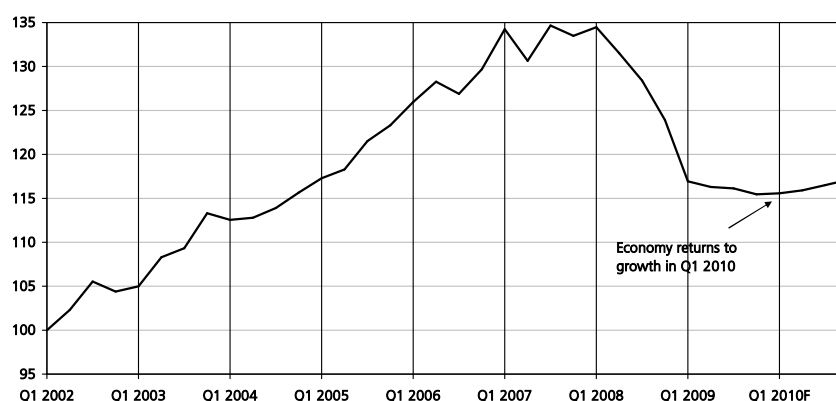
Source: Davy forecasts

Economy to bottom at end-2009 and grow again in early 2010

As for the immediate outlook, we believe that the economy will bottom at the end of this year and grow again in early 2010. We have become more confident due to a broad range of indicators. Back in May, we suggested that the economy would begin to expand sometime in Q1-Q2 2010 (see [Davy on the Irish Economy - Ireland is probably past the worst of the recession; economy may bottom in Q1-Q2 2010](#), published May 14th 2009). At the time it was an out-of-consensus call, and we were the first to revise up our estimates for 2010. Since then, the high frequency data – especially the PMI surveys – have improved steadily. But retail sales also look close to an inflection point and price discounting has moderated. Furthermore, tax revenue has begun to flatline (following severe decline) and unemployment claimants are growing at a much slower pace than early in 2009 (see Page 19 for more detail on recent indicators).

- Economy to grow again in Q1 2010

Figure 1: Ireland GNP (volume, re-based to Q1 2002 = 100, seasonally adjusted)



Source: CSO; Davy forecasts

- Consumer saving to peak as percentage of income this year

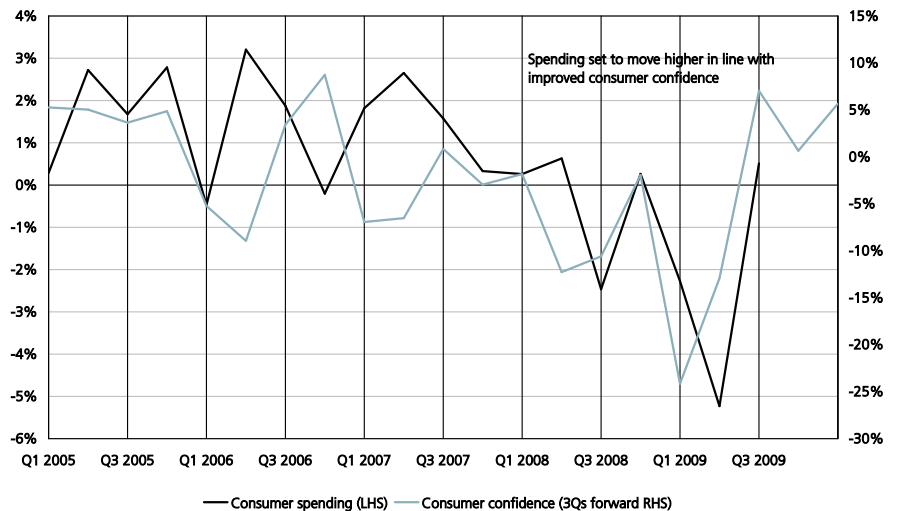
One of our key assumptions is that precautionary saving has reached its peak. Consumers have moved from saving 2.3% of their after-tax income in 2007 to 11.5% in 2009, a rise of more than nine percentage points. We do not expect them to save a greater proportion of income: from here on, consumer confidence in the medium-term outlook for incomes will rebuild gradually. Any reduction in saving has the potential to provide a significant stimulus. Meanwhile, Irish exports will rise more quickly as the global economic recovery gains strength.

Consumer spending probably bottomed in volume in Q2

- Consumer spending may grow from low base, slowly at first

The bulk of the consumer recession took place in Ireland in the year up to the end of the first quarter of 2009. Spending dropped 9.4% in volume in that period. Consumer spending finally stabilised in Q2, growing by 0.5% in volume. But price discounting still continues, albeit at a slower pace: the value of consumer spending rose only 0.1%. It seems that the spike in precautionary saving is levelling off. The volume of spending may have bottomed, whereas the value of spending may yet drop slightly. We expect spending to grow steadily again from here, rising at a faster pace from Q2 2010 onwards next year. At the end of the consumer recession in Q2 2009, spending was some 9% lower in volume than at its peak.

Figure 2: Consumer spending and consumer confidence (% chg qoq)



Source: CSO; ESRI/KBC; Davy estimates

Real disposable income has not declined sharply: spike in precautionary saving has led to collapse in spending

Disposable income has been hit by a sharp decline in payroll employment, softer wages, lower rent and dividend income and severe recession in self-employed occupations. In addition, income tax hikes have exacerbated the situation.

- Real incomes actually haven't collapsed; rapid saving adjustment has done most damage to spending

Compensating for the reduction in personal income, the (rather generous) automatic stabilisers have been in full operation. In fact, social transfers from government to those claiming benefits from the state will

- **Falling interest rates and lower consumer prices have helped offset some of the decline in wage income**

be some €5bn higher in 2009 than in 2008, equivalent to 5% of disposable income.

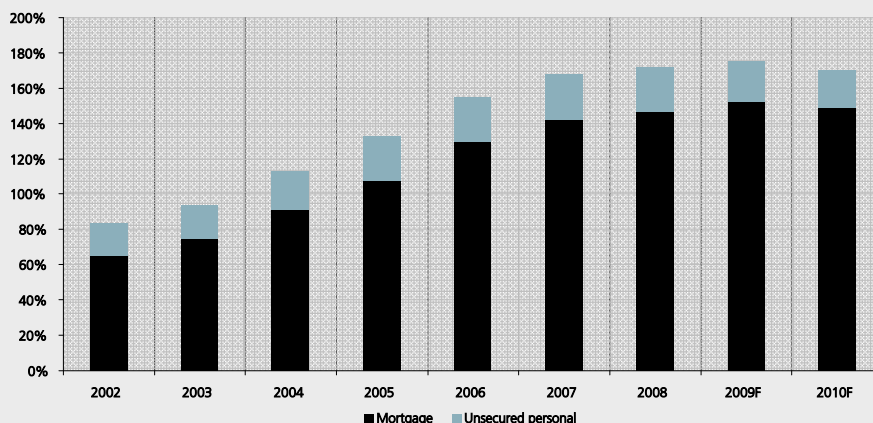
There have been other offsets too. Falling interest rates (and increased repayment of expensive unsecured debt) have reduced debt servicing costs by almost €4bn (or 4% of disposable income) compared with 2008. Meanwhile, the HICP (which excludes mortgage interest repayments) will drop 1.6% on average this year.

Remarkably, therefore, real incomes will drop less than 1% year-on-year on average in 2009. Yet consumer spending may slide 8% on average (most of this damage occurred in Q1). So it was increased precautionary savings rather than a major turnaround in after-tax real income that caused spending to collapse. As a result, the savings ratio has shot up by fully nine percentage points in two years.

Debt service burden eased in 2009, may fall marginally in 2010

Irish household debt exploded in the period 2002-2008. The rise was fuelled by easy credit availability, inappropriately low interest rates and the impact of those variables on asset prices, which in turn fed back into more credit being made available. Household debt rose from €55bn to €171bn in six years, albeit that the vast bulk of the increase was mortgage rather than unsecured debt (+€103bn versus +€13bn). Disposable incomes did not keep pace. So the household debt to (annual) disposable income ratio jumped from 83% to 172% (see Figure 3).

Figure 3: Household debt % of annual after-tax income

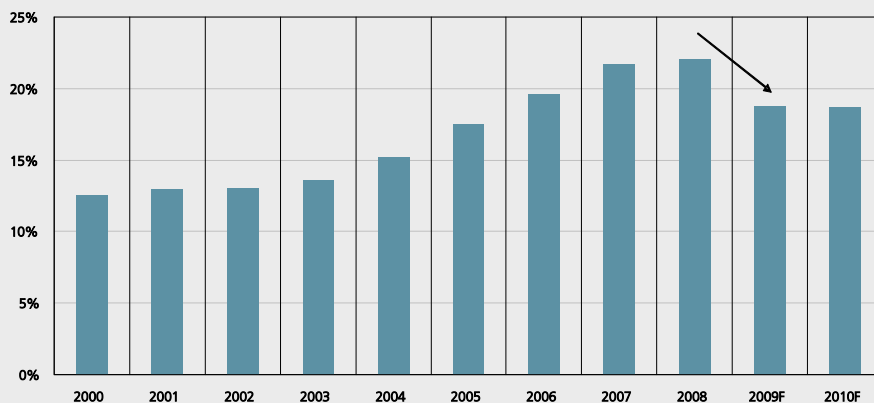


Source: Davy estimates; Central Bank of Ireland; CSO

- **Ratio of household debt to disposable income set to fall to 170%**

Households are now in debt payoff or debt write-off phase. Total household debt will drop both this year and next. However, incomes are down too, so the debt to disposable income ratio will fall only marginally to 170% on average next year from a peak of 175%.

Figure 4: Household annual debt service % of annual after-tax income



Source: Davy estimates; Central Bank of Ireland; CSO

- Household debt service fell by almost €4bn this year

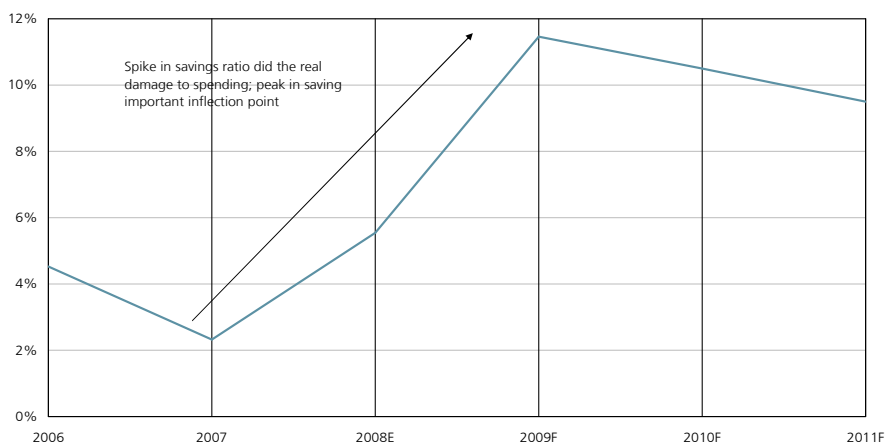
Yet it is debt service that matters most. Crucially, annual debt repayments as a percentage of after-tax income fell sharply in 2009 due to falling interest rates. The ratio dropped from 22.1% in 2008 to 18.7% this year. That was the lowest ratio since 2005 and boosted consumer cash flow by €3.8bn year-on-year.

Even though interest rates are set to rise slightly next year (as banks push up margins and the European Central Bank starts hiking in H2 2010), we estimate that debt service costs will remain unchanged at 18.7% of disposable income. Debt write-offs help here, although consumers have been paying off expensive unsecured debt rather than cheaper mortgage debt this year. We expect that trend to continue next year. A rising interest burden in 2011 will become more manageable as disposable incomes begin to grow at a faster pace. We expect disposable incomes to increase by 2.7% on average in 2011.

Peak in saving key inflection point for consumer spending

There are numerous reasons for the incredible spike in saving. We estimate that personal saving has jumped by €6.5bn year-on-year (or 6.7% of disposable income) this year. The obvious reasons, grounded in theory, include major fears about job security as the recession intensified. Personal wealth took a battering, particularly because of Irish households' overweighting in property assets. Finally, it became clear that the first part of the government's fiscal consolidation involved significant income tax hikes. Households feared more to come, hence reducing their estimates of permanent income.

Figure 5: Household savings ratio (annual saving as % of after-tax income)



Source: CSO; Davy estimates

But it is not clear that all of the saving was rational. Hysteria about Ireland's solvency in the domestic and international media in the period from January through March clearly played a part: consumer spending consequently plunged 6.2% quarter-on-quarter in Q1. In addition, taxpayers' lack of faith in the government's efforts to get a handle on the fiscal and banking crisis kept confidence low in the first half of the year.

- Sight of peak in unemployment is critical for spending to recover, but lagged realisation that the state has a handle on the banking sector and public finances may help too

If consumer confidence improves, precautionary saving will peak and then gradually subside. Two factors are required:

- First, households need to see signs that the unemployment rate is peaking. The rate of increase has already slowed to 0.2 percentage points monthly from 0.5 points+ earlier this year. We expect employment growth (see Table 3) to resume in the third quarter of 2010: consumers will start to anticipate this after the turn of the year.
- Second, the triple policy boost of NAMA, the Lisbon Treaty and the Budget is crucial. Even if not universally popular, confidence will slowly recover from near-record lows if there is a realisation that the banking system is headed for recovery; that we have cemented our place in the EU with the economic safeguard that provides; and that taxes will not rise much further.

- Theoretically, Ireland's savings ratio should not reach the European average

We do not believe that 12% is a reasonable level for the Irish savings ratio, not far below the EU-27 average of 13.8%, given that the spending culture is somewhere between European (high savings) and Anglo-Saxon (low saving) norms. Moreover, Ireland's younger population suggests that savings should be relatively lower than in continental Europe according to life-cycle theory. Each 1 percentage point drop in savings boosts real consumer spending by 1.2% and GNP by 0.4% in 2011. Our baseline case is for the personal savings ratio to drop to 9.5% in 2011 from 10.5% next year.

- Sectors exposed to international recovery will stabilise first

Unemployment rate set to peak below 14%

We documented the recent trend in the labour market when the Q2 Quarterly National Household Survey and population estimates were released last week (see "[Unemployment likely to peak below 14%; net outward migration for first time since 1996](#)", published September 22nd 2009).

The table below provides our forecasts for employment across sectors out to the end of 2011. We have included the end-year figures rather than each individual quarter. The picture is clear: internationally-traded sectors (e.g. accommodation/food service activities (tourism), information and communication, professional/scientific/technical and other (mainly business) services) recover first, in line with the global rebound and Ireland's improved competitiveness. Construction is the last part of the economy to bottom, while we assume that public employment remains relatively flat.

The table hides our assumption that indigenous manufacturing industry takes until 2011 to stabilise, finally benefitting from a gradual reduction in the domestic cost base and improved global conditions. For it to happen sooner, more needs to be done to cut wage costs for that challenged, labour-intensive part of the economy.

Table 3: Employment forecast by sector (000s, seasonally adjusted, year-end)

	Q4 2008	Q4 2009	Q4 2010	Q4 2011
Agriculture, forestry and fishing	115.7	99.8	99.8	102.6
Industry	277.4	253.4	243.4	243.4
Construction	213.4	137.6	119.2	121.2
-Construction: Residential	114.6	60.1	51.1	53.1
-Construction: Non-residential	98.8	77.4	68.2	68.2
Wholesale and retail trade	290.8	275.0	280.5	303.6
Transportation and storage	91.1	92.3	93.2	97.0
Accommodation and food service activities	118.5	118.5	125.7	133.4
Information and communication	68.8	72.2	73.4	74.9
Financial, insurance and real estate activities	107.8	106.2	105.1	105.1
Professional, scientific and technical activities	110.6	100.4	109.8	115.3
Administrative and support service activities	67.9	65.4	67.9	73.5
Other NACE activities	104.0	98.6	99.6	105.7
Public administration and defence	105.9	108.2	108.2	108.2
Education	149.9	148.0	148.0	151.0
Human health and social work activities	228.4	221.8	219.6	224.0

Source: Davy forecasts; CSO

Rising emigration to limit rise in unemployment rate

Net outward migration resumed in Ireland in the year to April for the first time since 1996. This was led by nationals of the EU-12 accession countries: they accounted for more than two-thirds of the swing in migration from a net inflow the previous year to a net outflow.

It is easy to see why. For those who have remained, the unemployment rate among nationals of the EU-12 has jumped from 6% a year ago to 19%. That rate is set to fall as more of these workers leave for economies where employment growth is likely to resume sooner. Crucially, Poland

- The unemployment rate among nationals of EU-12 accession countries is up from 6% to 19%

has weathered the downturn well and the UK, which is an obvious alternative destination, has already definitely emerged from recession.

Rising emigration is the first stage in limiting the increase in unemployment. The second stage is when employment growth resumes: we see employment expanding again in Q3 2010 – roughly six months after the trough in the economy.

- Consensus unemployment forecasts are way too high

Consensus unemployment forecasts are way too high (e.g. 15.5% for end-2010 as per the last Reuters survey of Irish forecasters). In fact, lower unemployment means that the government's social welfare estimates are too high for 2009 by about €400m. We expect the unemployment rate to peak at 13.6% in the third quarter of 2010. By the end of 2011, our baseline forecast is for the unemployment rate to dip below 12%.

Table 4: Labour market forecasts (annual average unless stated)

	2008	2009	2010	2011
Employment	2099.5	1935.0	1887.0	1933.7
% change year-on-year		-7.8	-2.5	2.5
Labour force	2240.7	2229.7	2220.7	2212.2
% change year-on-year		-0.5	-0.4	-0.4
Unemployment rate*		13.0	13.5	11.9

* year-end
Source: Davy forecasts; CSO

Irish exports have outperformed during global recession because of defensive mix

- Ireland's exports grew while euro area, UK and US exports declined in Q2

Irish exports have performed well during this recession. They actually returned to growth quarter-on-quarter in Q2, rising by 0.2% in volume. That means Ireland eclipsed the performance in other developed economies (see Figure 6) in both Q1 and Q2 of 2009. For example, the rest of the euro area saw exports drop again in Q2, as did Britain and America. Japan was one of the few economies to record faster export growth than was experienced in Ireland.

Figure 6: Comparative export performance, Q2 (% change qoq, sa)



Source: Datastream; Davy

That result is mainly due to the high share of pharmaceutical and chemicals products in Irish exports. These products tend to be quite resilient during recessions because people still have to spend on healthcare.

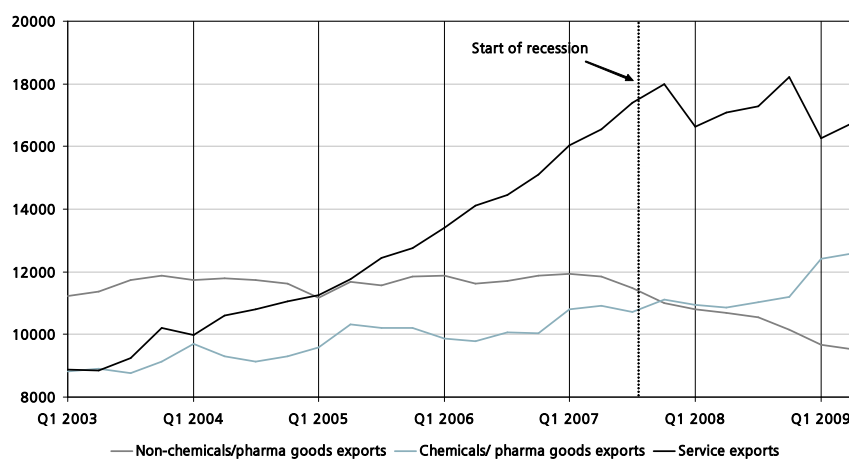
Chemicals/pharma have grown during recession; services have remained resilient, but the rest of goods exports have been hit hard

- Divergence between new era service exports, recession-resilient chemicals/pharma and the rest of Irish exports

But the headline export figures for Ireland conceal a lot. There are three key parts of the total: chemical/pharmaceutical goods exports; all other goods exports; and services exports. Their performance has diverged since 2002, telling us plenty about what was going on beneath the surface of the Irish economy. Chemicals exports continued to grow, while the remainder of goods exports went sideways between 2002 and 2007 (see Figure 7). Meanwhile, services exports doubled in the period Q1 2003-Q3 2007 (the quarter when the Irish recession began).

Chemicals/pharma exports are influenced by secular trends such as an aging demographic in the US and Europe. Most of these companies are based here for tax and regulatory reasons and price in dollars, so exchange rate movements and labour costs are less relevant. Conversely, the rest of goods exports (of which indigenous companies form a large part) have been hurt by Ireland's rising labour costs and price level. So they lagged well behind the growth in heavy goods trade worldwide during the global growth phase 2002-2007. Services, though, are more influenced by other secular trends such as the growth in cross-border business services due to technological advances. Ireland is ideally placed in this area as a result of its ready supply of graduate-level labour.

Figure 7: Breakdown of Irish exports (quarterly, value €m, seasonally adjusted)



Source: CSO; Davy estimates

- Heavy goods exports, of which indigenous companies account for a large part, have suffered: down 20% in the recession

Since the recession began, Irish goods exports excluding chemicals/pharma have moved more or less in line with the decline in global heavy goods exports. They have slipped more than €2bn, or 20%, in two years. Recent favourable developments such as the decline in Irish wages and prices versus the rest of the euro area are most relevant for the companies that produce these exports as opposed to the multinational sector. The recent bottom in the global economy and nascent recovery should also lead to growth again in this area. But non-chemicals and pharma goods exports may lag the growth in euro area goods exports until Ireland's

cost base has converged further. Any strengthening of sterling against the euro would help.

Figure 7 also shows that service exports have been quite resilient since the recession began in Q3 2007 (note that the collapse in domestic demand, not exports, pushed Ireland into recession). We expect services exports to recover in the next year as global recovery gains momentum, albeit that growth may not be quite as stellar as in the period 2002-2007. The expansion will initially be led by software/IT, business services, transport and tourism.

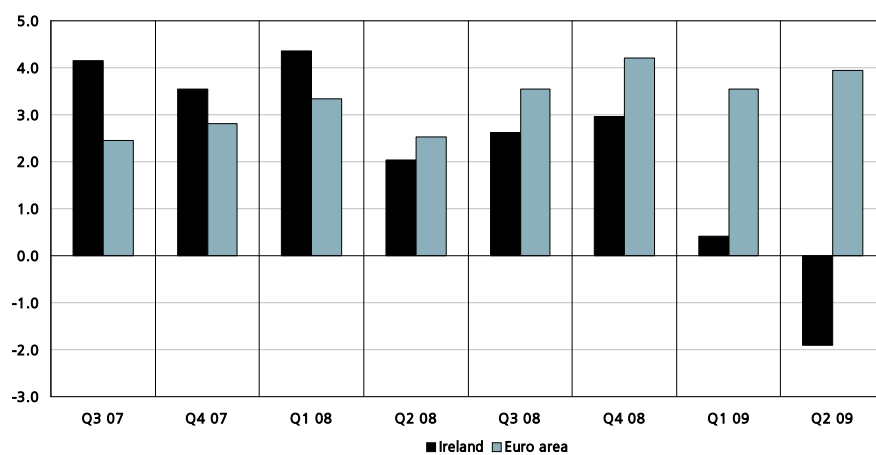
Exports likely to grow in line with euro area in 2010, possibly a touch faster in 2011

We expect exports to grow by about 3.5% in volume in 2010. That would be in line with or a little higher than the consensus forecast for euro area export growth (3%). We add a slight premium because we think the consensus view on global trade remains somewhat too cautious. We think that euro area forecast will be revised up between now and year-end.

Note that Irish exports grew at a slightly slower pace than the euro area in 2002-2008. Ireland saw annual average growth of 5.1% versus 5.8% for the euro area. Our forecast assumes that Ireland can match the euro area rate of growth as a result of the improvement in competitiveness so far (with more to come over the next 18 months).

- Exports may grow in line with euro area export trend initially, then possibly a touch faster in 2011 due to competitiveness gains

Figure 8: Hourly earnings (% change year-on-year)



Source: Eurostat; CSO; Davy estimates

- Wide range in bull and bear case for exports

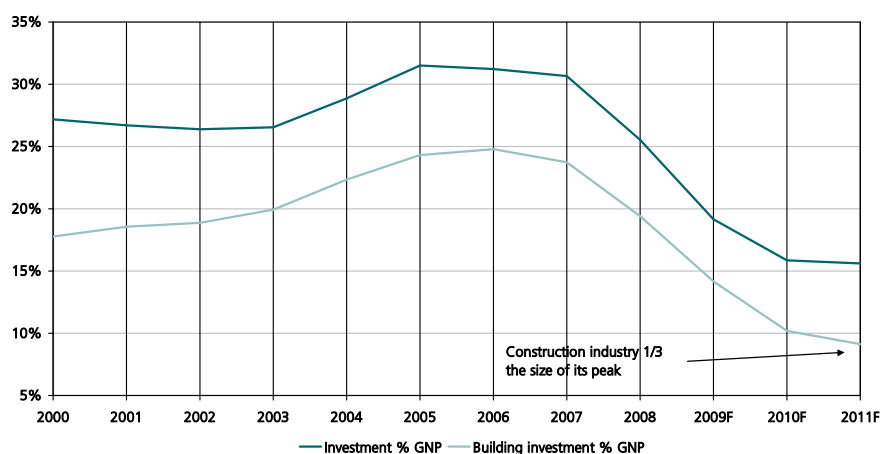
For 2011, our baseline forecast sees export volume growth of 6%. We expect that euro area exports will be growing close to their previous trend by then. Ireland's exports may outperform the euro area by a small margin due to its expanding service export base, while indigenous goods exports may begin to grow again as a result of competitiveness gains.

- Building investment to drop from 25% of GNP at peak to just 9%

Investment will continue to decline until 2011

Payback for the investment bubble of 2002-2007 will continue until 2011. We do not expect investment to grow again until then. By that stage, investment will drop to just over 15% of GNP, half of the ratio seen at the peak (see Figure 9). Building investment will dip to 9% of GNP compared with a high of almost 25%. This means that construction, an industry worth over €38bn in 2007, will see its revenue dwindle to €12-13bn.

Figure 9: Investment spending % GNP



Source: CSO

Private housing starts running at annualised rate of 10,000

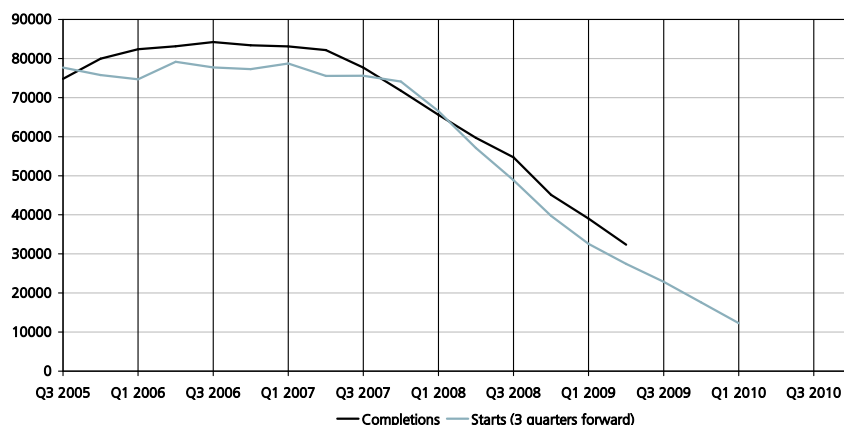
Private housing starts seem to have bottomed in recent months. They have settled at an annualised rate of about 10,000. The best guide to housing starts is the commencement notice series from the Department of the Environment, Heritage and Local Government. Local authorities collect data on all scheme and one-off private housing units commenced but, bizarrely, do not have to publish data on their own (social) housing starts.

To provide an idea of the collapse in housing activity by private builders/developers, it is worth looking at the totals for scheme housing starts (i.e. where more than one unit is built together). At the peak, they were running at an annualised rate of 60,000-70,000; now the run-rate is just 3,000.

- House completions to settle at 12,000-13,000 in 2010 and 2011

The chart below is a concise guide as to what to expect from private house completions in the next year. The lag between starts and completions is typically 9-12 months. So private house completions are headed for about 10,000. Figure 10 does not capture social/local authority building, where the rate of completion is set to halve from its recent rate of 6,000-7,000 units in the next two years. Our forecasts assume that some private housing units will not be completed (or will be demolished). Therefore, total house completions (private and government) may slip from 25,000 this year to about 12,000 in 2010 before rising slightly to 13,000 in 2011.

Figure 10: Private housing starts and completions (12-month running totals)



Source: Davy estimates; DoEHLG

Non-residential building set to decline until 2011; government must not cut capital spending any further

Non-residential building will decline until 2011. The correction in private building of offices, retail, industrial units, hospitals and hotels has some way to run yet due to major oversupply. But the government has also cut back significantly on the state's capital programme. It has been slashed by one-quarter already from €43bn to €31bn over the years 2009-2013.

- Infrastructure deficit still exists: we cannot afford any more cutbacks

We cannot afford any further cutbacks in this December's Budget for 2010: construction employment is already diving, and we have to look to gain competitiveness through improved infrastructure. Note that Ireland's 'quality of infrastructure' is still rated only 25th of 28th in the OCED in an annual survey of business executives despite the massive progress made over the last decade.

Fortunately, semi-state companies are still investing so the government voted spending underestimates the total public capital programme. We expect public capital spending to decline 10.7% this year, 11% in 2010 and 12.4% in 2011 in value terms.

The value of private building is being hit much harder than the public capital programme. In fact we think that private non-residential building investment (excluding site transfer costs, i.e. stamp duty) will decline in value from over €5bn in 2008 to less than €1.1bn in 2011, a fall of nearly 80% from peak. Most of the correction is from volume, but tender prices will also slide at a rate of more than 10% in the next two years.

- Total building will keep declining in 2009-2011; only housing will return to modest volume growth in 2011, helped by renovations

We forecast that the total volume of building will fall on average in 2009, 2010 and 2011 (see Table 5). The biggest drops arise in 2009 and 2010, when construction volume may slip 31.6% and 19% respectively. By 2011, housing will return to growth, albeit from a very low base. Note that major renovation/repairs (RMI) will account for 68% of housing investment in 2011 compared with 14% at the peak for new

house building in 2006. But non-residential building will continue to shrink into 2011, although the pace of decline will moderate.

	2009	2010	2011
Residential	-38.6	-28.4	11.1
-New private housing	-53.3	-57.1	25.0
-RMI	4.0	5.0	5.0
Non-residential	-24.5	-11.2	-10.4
Total building	-31.6	-19.0	-1.7

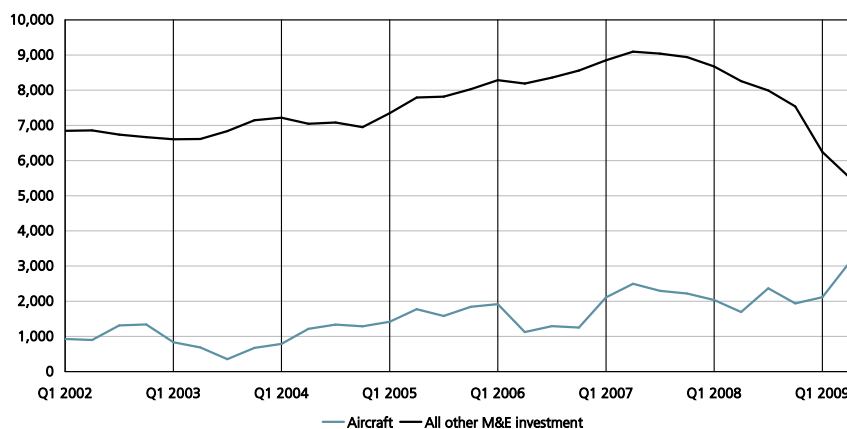
Source: Davy

Machinery and equipment investment may recover gradually as credit squeeze eases and economy recovers

Business investment in machinery and equipment has taken a severe knock during the Irish recession (see Figure 11). This reflected deteriorating prospects for the real economy, but also the banking crisis. Lack of funding availability hurt investment in this area. The decline is also tied to the collapse in investment in construction machinery compared with 2005-2006: large quantities of equipment are lying idle in this sector.

- Overall supply of equipment is a drag, especially in construction

Figure 11: Machinery and equipment investment (€bn, 4-quarter moving total)



Source: CSO

Fleet investment by airlines, especially Ryanair, has boosted the total in the last number of quarters. We expect this investment to be ongoing.

- Business investment to recover on prospects for economy; easing in credit supply

Business investment will gradually recover from the low base in 2010 and 2011 as credit conditions ease and the outlook for the global economy improves. Machinery and equipment investment may lift 6% in volume next year and 10% in 2011 following a 13% decline this year.

Be careful of the arithmetic at the cyclical turn

- Intra-year recovery can be hidden by focus on annual averages at cyclical turn

It is dangerous to focus too closely on annual averages (or year-on-year comparisons) at any time because it is too easy to miss turning points. However, the use of annual average comparisons is totally misleading at two crucial points in the cycle: at the entrance to or exit from recession.

Let us look at what the arithmetic implies for what is really going on in the Irish economy in 2009. The quarterly seasonally adjusted GNP series should be the default for analysing the up-to-date trend in economic economy at any time, especially now that the series is almost 13 years old. Take Q1 2009 in that series as the starting point. The seasonally adjusted level of economic activity (in GNP terms) in that quarter was €35.4bn. If the economy stayed at that level for the rest of the year (in other words, if €35.4bn of national income was also generated in quarters two, three and four), it would equate to no growth or no decline – to an economy that was essentially flat, the recession having ended at Q1.

Even if that had happened, the annual average decline in 2009 over 2008 (i.e. four quarters on average for 2009 versus full year 2008) would still have been almost 10%, suggesting that the economy was still deep in recession! That is because there was a huge negative carryover from 2008 into 2009 because the economy collapsed intra-year last year, falling 13% between Q1 2008 and Q1 2009 – the period when the bulk of the Irish recession really took place. In other words, the level of the economy was a lot lower by Q1 2009 than it was a year before.

In reality, the recession did continue into Q2 2009, albeit at a much reduced pace. In Q2 compared with Q1, the volume of GNP fell 0.5% quarter-on-quarter seasonally adjusted or about 2% at an annualised rate. That compares with the 10-20% annualised declines witnessed in Q1 2008-Q1 2009 when the ferocity of recession was at its greatest.

- Pace of recession has slowed rapidly from Q1 2009 onwards

It does not change the arithmetic too much however (see Table 6). We think the annual average decline in GNP in Ireland for 2009 compared with 2008 will be 9.6%. But that very much hides the intra-year story that the recession was slowing from Q1 2009 on. If our quarter-on-quarter forecasts turn out to be correct, the economy will be only 1.3% smaller in GNP terms in the coming quarter – Q4 2009 – than it was at Q1 2009. In contrast, the annual average for 2009 gives the impression that the economy was still mired in deep recession.

Table 6: Most of the recession took place in the year to Q1 2009

GNP (€bn s.a)			
Q1 2008	40.7		
Q2 2008	39.8		
Q3 2008	38.8	Average 2009 v 2008	-10%
Q4 2008	37.5		
Q1 2009	35.4	Q1 2008-Q1 2009	-13.0%
Q2 2009	35.2		
Q3 2009F	35.1		
Q4 2009F	34.9	Q1 2009-Q4 2009	-1.4%

Source: Davy

Government finances in better shape than a year ago, but hard decisions still due

The Irish fiscal consolidation has been significant in the last year. It has totalled as much as 5% of GDP. It is fair to say that we have a pretty good handle on the budgetary situation now: the issue is not whether the overall deficit will spiral out-of-control; rather, it is how to bring the structural deficit down.

- **Must shift fiscal consolidation mix away from tax to spending**

We have written extensively on the government finance situation (and bond market) throughout the year. Our latest thoughts were summarised in our *Weekly Market Comment* of September 14th ("[Government expenditure still has to be tackled](#)"). In this article, we suggested that expenditure needs to be tackled in the December Budget, albeit that the size of the consolidation earmarked (€4bn for 2010) should not be altered. It is a case of shifting the mix of the adjustment away from tax towards current (rather than capital) public spending to boost competitiveness.

As regards the National Accounts definition of government spending, we expect some volume decline in the next three years. Net expenditure of central and local government on current goods and services may slip 3% in 2010 and 1.5% in 2011 in real terms. This measure equates roughly to the amount of day-to-day public services delivered. Note that other forms of government spending impact elsewhere in the National Accounts (e.g. pay and social transfers on consumer spending and capital spending in the investment line).

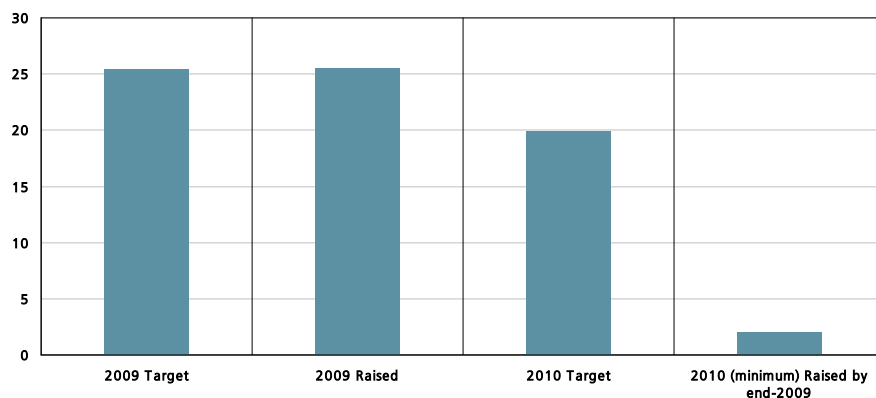
General Government Deficit will be smaller in 2010 than in 2009

Looking at the overall bottom line, we think that the General Government Deficit is set to come in at about 11.4% of GDP. Tax may undershoot the government's April forecast by €500m-€1bn. But the government's forecast for the average level of unemployment claimants in 2009 is too high by about 35,000. That will cut the social welfare bill by €400m compared with its April estimate.

- **General Government Deficit may fall to 10% or lower in 2010**

For 2010, we are not going to second-guess the government at this point. Assuming that the government does stick with the same bottom-line fiscal consolidation as outlined in April, the targeted GGB deficit is 10.75% of GDP. Remember that forecast was based on more bearish macro assumptions than our own. If the economy progresses along the lines suggested in this document, some of the cyclical part of the deficit will be corrected next year. We could see the bottom-line deficit falling to 10% of GDP or lower in 2010.

Figure 12: Irish state funding situation (€bn)



Source: NTMA; Department of Finance; Davy

- Irish funding for 2009 now complete; chance to pre-fund for 2010 and at cheaper rate than earlier this year

Note, too, that funding has gone well this year (see "[Irish state's funding outlook clearer than it was six months ago](#)", published July 8th 2009). The 2009 target of €25.4bn has already been met by the National Treasury Management Agency. It is certain that some pre-funding will be done for next year because two more auctions are due. Benign bond market conditions mean that it would be worth seriously looking at raising more of the funds required to meet next year's budget deficit before year-end (see Figure 12).

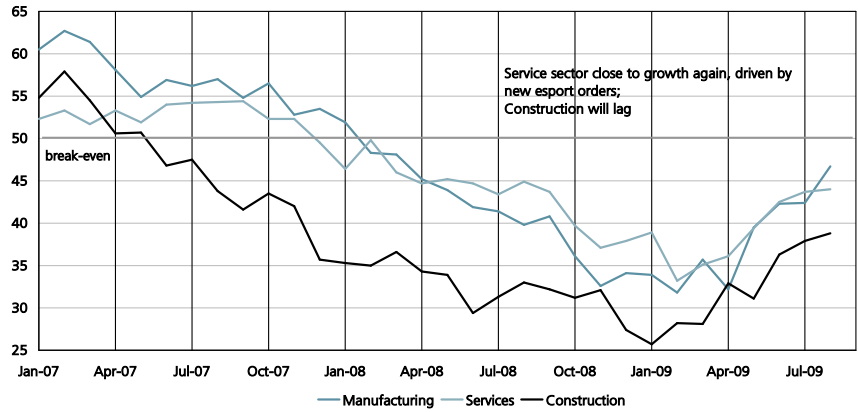
Assuming safe passage for the Lisbon Treaty and the NAMA legislation, we see Irish bond spreads converging further with Germany. From a peak of 285 basis points, ten-year spreads now sit 144bp over the bund benchmark. That means Ireland could not only pre-fund for next year, but at a much cheaper rate than early in 2009.

Recent data have improved albeit that the economy is still in recession

We noted in May that the high frequency indicators were showing signs of improvement. That was a nascent trend at the time, but it has extended in the last four months. The economy is still in recession and will be for another three to four months, but the pace of decline has slowed.

- Survey indicators inching back towards growth line

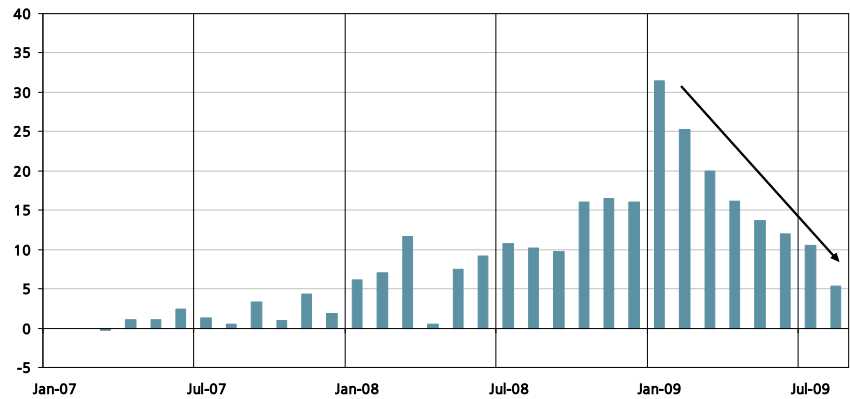
Figure 13: PMI indicators (50 is the line separating growth from recession)



Source: Markit; Ulster Bank

- Unemployment claimants rising at slower pace month-on-month

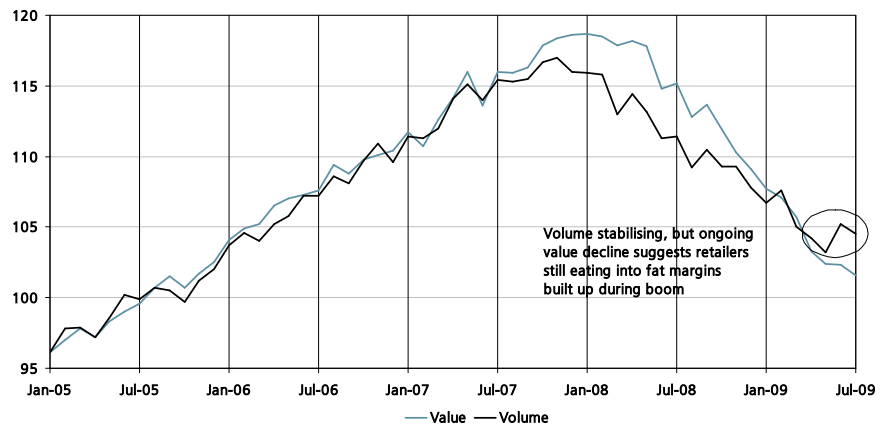
Figure 14: Live Register (monthly change, 000s, seasonally adjusted)



Source: CSO

- Retail sales beginning to stabilise at lower level

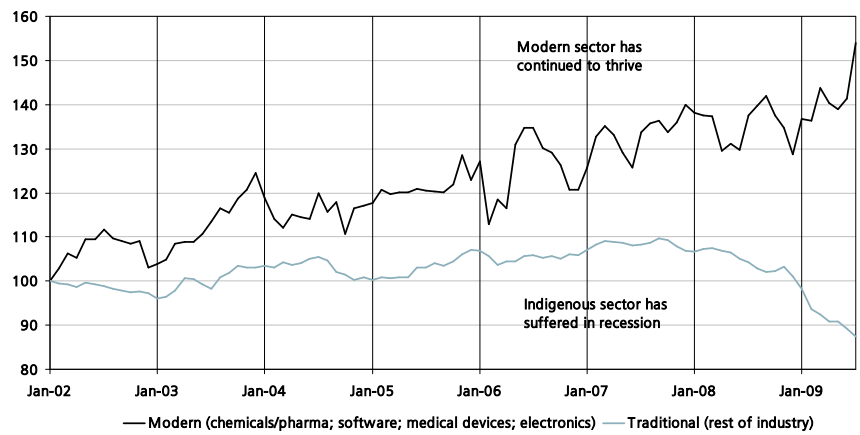
Figure 15: Retail sales index (seasonally adjusted)



Source: CSO

- Tale of two industries

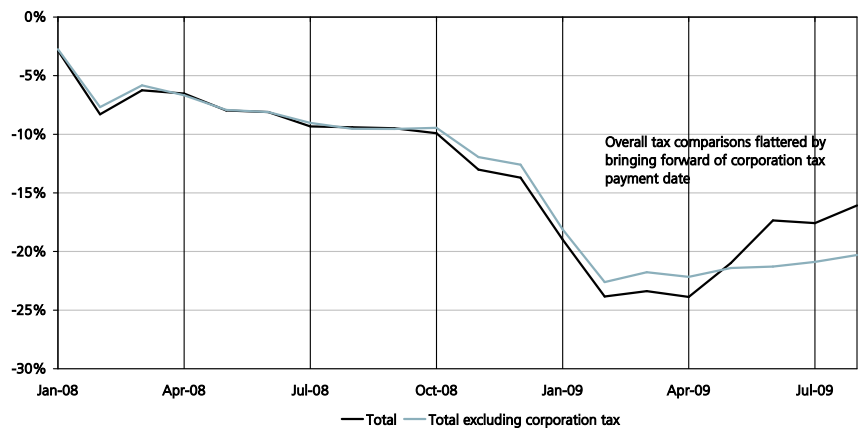
Figure 16: Industrial production index (re-based to Jan 2002 = 100, sa)



Source: CSO; Davy estimates

- Tax revenue stabilising, albeit from low base (especially in H2)

Figure 17: Tax revenue (% change year-on-year)



Source: Department of Finance; Davy estimates

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