Irish Economic Outlook
August 2010

A host of indicators point to an economy that turned a corner in the first half of this year…

- A surge in the output and exports of the Irish multi-national sector was a major driver of the return to positive quarterly GDP growth in the first quarter of this year. But encouragingly recent quarters have witnessed emerging evidence of modest improvement beyond the activities of multi-national firms. The output of 'traditional' segments of the manufacturing base, including the food and beverage sector for example, is now also in recovery mode. In addition, overall consumer spending is almost certainly going to record a positive second quarter, reflecting not just a pick-up in car sales but also the fact that ex-motors sales volumes have managed to grow by 1.1% in each of the first two quarters of this year. This marks some underlying improvement that is consistent with a gradual ongoing improvement in consumer confidence.

- These improvements lead us to revise up our economic forecasts for this year, which now envisage average annual GDP growth of +1%, up from -0.5% previously. GNP is somewhat weaker, partly reflecting the strength of MNC profit outflows, though we have made upward revisions here too, with growth on this metric now expected at -0.4% from -1.2% previously.

…but a continuation of the export-led Irish recovery is critically dependent on the international outlook, where downside risks have risen lately

- The export-led recovery now underway in Ireland reflects the pick-up in the global economy which has been in recovery mode for over a year now. However, it would be wrong to assume that the domestic recovery will be plain sailing from here. Corrections in property markets and the public finances are ongoing while there have been signs of a stalling in the positive trends in core retail sales in the most recent couple of months.

- Of more concern are the indications of a slowing global economy, notably in the US where a series of recent economic numbers have disappointed to the downside. Our base case is that the global recovery will remain broadly on track, albeit at a gradual pace. On this basis we forecast a continuation of the export-led recovery which should promote improved domestic confidence and ultimately provide the platform for a recovery in domestic demand, beginning next year. An improvement in Irish competitiveness is also supportive of the Irish export dynamic, as reflected in declines in domestic costs and prices, in both absolute and relative terms, as well as recent declines in the euro's value against the dollar and sterling. Overall, we are projecting average GDP growth in 2011 of around 3%. Nonetheless, the downside risks facing the international outlook have risen lately, and these will require very careful watching as without the critical support from external demand, it is very difficult to see the Irish recovery staying on track.

Unemployment rate now close to peak, but no quick fix in sight for the jobs crisis

- On the jobs front, the labour market is set weaken further in the short term: employment probably has further to fall, though at a reduced pace compared with heretofore, while the unemployment rate is set to peak between 13.5 and 14% later this year, from 12.9% in Q1.

- The international experience of the lags between the return to positive economic growth and employment gains over the past year points to the possibility of some slight net job creation here by the end of this year. However, the nature of the early stages of the Irish recovery, driven as it is by exports, argues against much of an early uplift in employment. Export growth is not labour-intensive, a point highlighted by the fact that there was very little direct net job creation in exporting firms over the pre-crisis years of 2002-2007 – a period of relatively buoyant demand in Ireland's key trading partners. Nevertheless, any increase in employment would be extremely welcome following a downturn which has seen the economy shed over 270,000 jobs, and a more stable employment situation may see the unemployment rate edge lower next year, aided by further falls in the labour force.

The Irish government is a "credible deficit reducer" but Anglo recap costs weigh very heavily on investor sentiment as this year's headline deficit number could get extremely ugly

- Turning to the public finances, the fiscal correction has entered its third year and the considerable progress to date means that in our view the Irish government has established itself as a "credible deficit reducer". This year's underlying fiscal targets are broadly on track reflecting assertive control of government spending and an improving trajectory for growth in tax receipts. However, the scale of the deficit means that several more years of fiscal

Ulster Bank Limited accepts no liability for the outcome of any actions taken arising from the use of this report

tightening are in prospect and it remains a key policy priority that budgetary targets continue to be met in order to avoid a Greek-style outcome for the Irish public finances.

- While the underlying fiscal situation looks to be unfolding in line with expectations, the same cannot be said of estimates of the budgetary cost of recapitalising the banking sector which have continued to ratchet higher. This is particularly so in the case of Anglo-Irish Bank which on some recent official estimates could end up costing the State some €25bn, and possibly more on the more pessimistic estimates of some private sector analysts. The extremely large costs involved, as well as ongoing uncertainty about what the true final cost will ultimately amount to, are weighing heavily on investor sentiment in Irish government bond markets where spreads relative to Germany have widened out to new crisis highs in recent days.

- Depending on how events unfold in the months ahead, as well as the statistical treatment of further injections into Anglo, such outlays could result in a spectacularly ugly headline budget deficit number for this year, maybe of the order of mid-20s% of GDP and perhaps even higher in a truly extreme scenario. Without seeking to play down how ugly a prognosis that represents, it is critical to recognise that the banking sector injections are non-recurring. Thus, while there clearly will be a considerable additional debt burden arising from the state outlays in Anglo, for example, the path back to the target for the underlying deficit of 3% by 2014 is unaffected. Indeed, the underlying deficit most likely peaked last year at 12.1% and on our forecast will fall to 11.4% this year and towards 10% in 2012. Nevertheless, it is extremely important for the Irish authorities to provide clarity as soon as possible around the future plans for Anglo, and the ultimate total cost thereof to the exchequer.

Forecast Overview

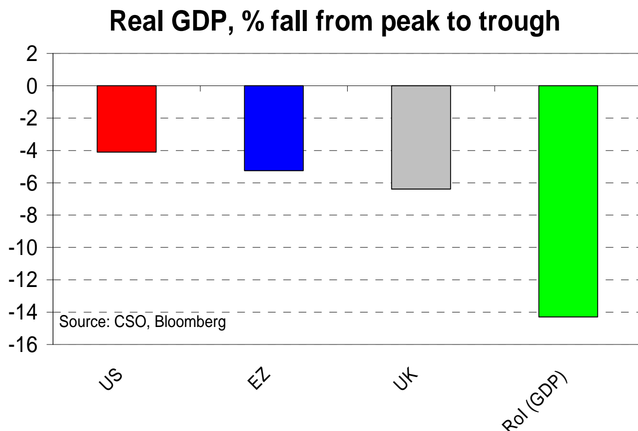
	2007	2008	2009	2010E	2011F
GROWTH					
Consumer Spending (%YOY)	**6.4**	**-1.5**	**-7.0**	**-0.1**	**1.7**
Investment (%YOY)	**2.8**	**-14.3**	**-31.0**	**-19.3**	**1.8**
- Housing	*-6.1*	*-21.4*	*-41.0*	*-37.0*	*-5.0*
- Other Building & Construction	*20.0*	*5.9*	*-24.3*	*-15.4*	*-3.0*
- Machinery & Equipment	*15.7*	*-15.3*	*-19.3*	*-2.9*	*10.0*
Government Spending (%YOY)	**6.9**	**2.2**	**-4.4**	**-4.2**	**-1.7**
Exports (%YOY)	**8.2**	**-0.8**	**-4.1**	**7.4**	**4.5**
Imports (%YOY)	**7.8**	**-2.9**	**-9.7**	**2.3**	**2.9**
Real GDP (% YOY)	**5.6**	**-3.5**	**-7.6**	**1.0**	**3.1**
Real GNP (% YOY)	**4.5**	**-3.5**	**-10.7**	**-0.5**	**2.7**
Housing Completions	**78,027**	**51,724**	**26,820**	**12,000**	**10,000**
PRICES					
CPI (% YOY) Average	**4.9**	**4.1**	**-4.5**	**-0.7**	**2.2**
HICP (% YOY) Average	**2.8**	**3.1**	**-1.7**	**-1.4**	**0.9**
LABOUR MARKET					
Employment (% YOY) Average	**3.7**	**-1.1**	**-8.1**	**-3.9**	**0.0**
Unemployment Rate annual avg.%	**4.6**	**6.4**	**11.8**	**13.3**	**13.0**
PUBLIC FINANCE					
General Government Balance (% GDP)*	**0.1**	**-7.3**	**-12.1**	**-11.4**	**-10.0**
EXCHANGE AND INTEREST RATES					
ECB Refi Rate (End of Period)	**4.0**	**2.5**	**1.0**	**1.0**	**1.75**
EUR/$ (End of Period)	**1.46**	**1.40**	**1.43**	**1.12**	**1.17**
EUR/£ (End of Period)	**0.74**	**0.96**	**0.89**	**0.78**	**0.79**
* as measured on underlying basis (i.e. excluding the costs of injections into banking sector					

RBS

Ulster Bank Limited accepts no liability for the outcome of any actions taken arising from the use of this report

Overview

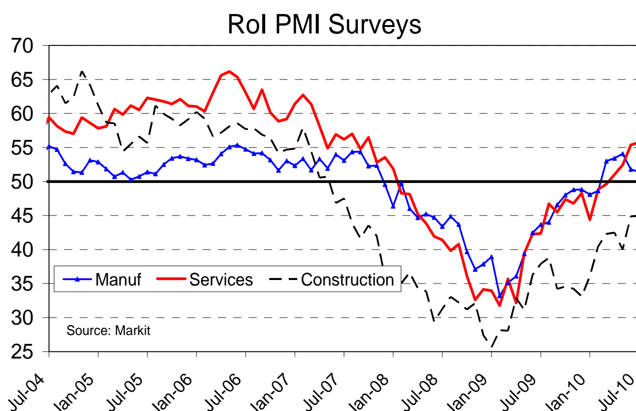
Irish economic activity peaked at the end of 2007 and in the following two years real GDP contracted for eight consecutive quarters and by a total of 14.3% - making the Irish contraction amongst the deepest experienced anywhere in the world over the course of the so-called Great Recession. Real GNP – perhaps a better gauge in terms of the hit to domestic incomes - fell by even more in recording a drop of 16% over the same period.



However, a host of economic indicators suggest that the first half of this year marked a turning point for the Irish economy. Most significantly, the most recent national accounts showed a quarterly increase of 2.7% in real GDP in the first three months of the year, indicating that output returned to growth somewhat earlier than expected.

External demand is always a key driving force in the early stages of a cyclical pick-up in a small, open economy such as Ireland and sure enough, the dominant factor in the positive Q1 GDP outcome was a pick-up in export growth which kicked in with greater vigour than anticipated.

The 6.9% surge in exports in Q1 was the strongest quarterly performance in three years, and followed the pick-up in the global economy which has been in recovery mode for over a year now. A recovery in the internationally traded segments of the Irish economy had been flagged by the timely PMI surveys. Both manufacturing and services surveys had begun to record rising export orders from around the third quarter of last year, with overall activity returning to expansion territory by March and April of this year respectively.



The national accounts data indicate that the performance of multi-national corporations (MNCs) played a very important part in the first quarter GDP strength, as the alternative GNP measure which strips out the repatriated profits of such entities, actually fell again in the March quarter, albeit by a comparatively modest 0.5%. That MNC strength played a key role in the turnaround in Irish output is not surprising given their size and near-exclusive focus on export markets.

But an encouraging aspect of the economy's performance in recent quarters has been the emerging evidence of modest improvement in areas of the economy beyond the multinational sector. Industrial production numbers show that the output of 'traditional' segments of the manufacturing base, including the food and beverage sector for example, are now also in recovery mode. Production in such firms is also benefiting from the improved external environment and has risen for three consecutive quarters up to June. While the gains to date have been modest in comparison to the losses suffered over the downturn, at least a pattern of growth has been restored.

Turning to the demand side of the economy, overall consumer spending is almost certainly going to record a positive Q2, though that won't be confirmed until the release of second quarter national accounts next month. In the meantime, we know that there has been a pick-up in car sales reflecting both some boost from the scrappage scheme as well as some underlying pick-up from the depressed levels of last year while the more timely retail sales numbers show that ex-motors sales volumes have managed to grow by 1.1% in each of the first two quarters of this year. This marks some underlying improvement that is consistent with a gradual ongoing improvement in consumer confidence.

These improvements lead us to revise up our economic forecasts for this year, which now envisage average annual GDP growth of 1%, up from -0.5% previously. GNP is somewhat weaker, partly reflecting the strength of MNC profit outflows, though we have made upward revisions here too, with growth on this metric now expected at -0.4% from -1.2% previously. We note that the clear turnaround in the trajectory for GDP growth is closely following the signal from the trends in the much more timely composite PMI index (available to July), which also suggests that a pattern of improvement has been maintained since Q1, which is the latest available official GDP estimate.

However, it would be wrong to assume that the recovery will be plain sailing from here. There have been some signs of a stalling in the more positive trends in some domestic indicators lately. Notably, the monthly profile of core retail sales softened in May/June following a run of four consecutive monthly gains earlier in the year. There has also been some modest softening in new export orders in the past couple of months according to the manufacturing and services PMIs, though orders are still rising in both cases. These developments point to some moderation in the pace of improvement as the economy entered the third quarter.

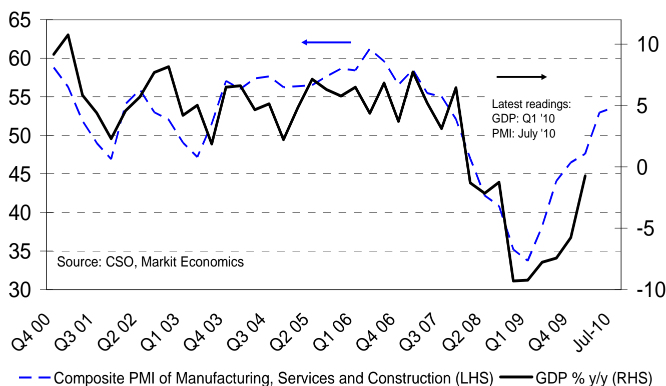
The economy also continues to face a number of structural headwinds. While the property correction is well-advanced it has not yet fully run its course. We continue to anticipate total cumulative declines in house prices nationally of 45-50% vs. an estimated decline of around 40-45% to date. Similarly, the construction sector is still very much in contraction mode, albeit amidst some signs that the rate of contraction may be easing back somewhat. Housing remains a particularly weak spot here and we estimate completions at 12,000 for this year, down over 50% from around 27,000 last year.

Turning to the public finances, the correction in the public finances has entered its third year and the considerable progress to date means that in our view the Irish government

has established itself as a "credible deficit reducer". Targets for the underlying budget situation are broadly on track which should result in a reduction of the underlying deficit from a peak of 12.1% last year to 11.4% this year and to around 10% in 2011. However, the scale of the deficit means that several more years of fiscal tightening are in prospect. Thus, fiscal policy will continue to weigh on domestic demand for some time to come, though it is a key policy priority that budgetary targets continue to be met in order to avoid a Greek-style outcome for the Irish public finances.

Other key domestic policy priorities of course include further progress on NAMA implementation and banking sector recapitalisation, so that over time the expected recovery in domestic demand is not jeopardised. It is also vey important to get clarity as soon as possible around the future plans for Anglo, and the ultimate total cost thereof to the exchequer. The shockingly large costs involved could result in an extremely ugly headline budget deficit this year of the order of mid-20s% of GDP and perhaps even higher in an extreme scenario, and the considerable uncertainty about what the true final cost will ultimately amount to is weighing heavily on investor sentiment in Irish government bond markets where spreads relative to Germany have widened out to new crisis highs of close to 3.5% in recent days.

On the growth front, the indications of a slowing global economy lately are a troubling development, notably in the US where a series of recent data points have disappointed to the downside. At this stage it is difficult to know whether what is unfolding here is some softening in momentum following an early-cycle snap-back in growth or whether the global recovery is headed for a premature end. For now, our base case leans towards the former interpretation, in support of which we note the strength of US corporate profitability, the ongoing process of financial sector healing, the apparent resilience to date of the euro area and UK economies, and the large amounts of stimulus (especially of the monetary variety) still in the system. Thus, our central scenario envisages a continuation of the global recovery, albeit at only a moderate pace.



Looking forward from here, it is hard to overstate the importance of a favourable external environment to Irish growth prospects. Our base case anticipates that Ireland's key trading partners will continue to recover gradually. This is an environment that should foster further expansion of Irish exports, the performance of which is also underpinned by improvement in Irish competitiveness, as reflected in declines in domestic costs and prices, in both absolute and relative terms, as well as recent declines in the euro's value against the dollar and sterling. A continuation of the export-led recovery should promote improved domestic confidence and ultimately provide the platform for a recovery in domestic demand, beginning next year. On this basis, we are projecting average GDP growth in 2011 of around 3%.

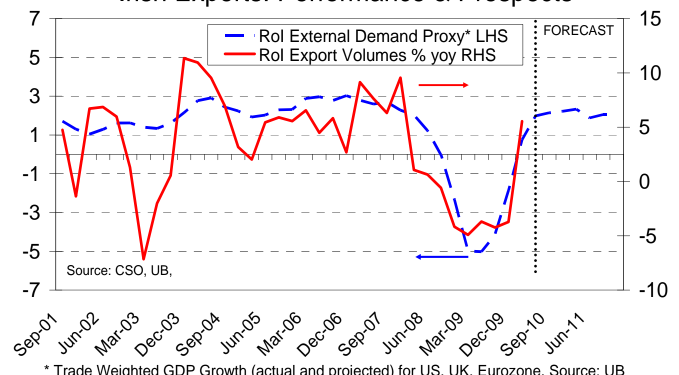
On the jobs front, the international experience of the lags between the return to positive economic growth and employment gains points to the possibility of some slight net job creation by the end of this year. However, the nature of the early stages of the Irish recovery, driven as it is by exports, argues against much of an early uplift in employment. Export growth is not labour-intensive, a point highlighted by the fact that there was very little direct net job creation in exporting firms over the pre-crisis years of 2002-2007 – a period of relatively strong demand in Ireland's key trading partners.

Overall, the Irish economy is still very weak: the level of GDP is still 12% lower than pre-recession levels; the improvements in some areas are tentative at this stage; while there are other sectors, notably construction, for which recovery remains elusive. Nevertheless, it is important to acknowledge the body of evidence, which includes GDP, exports, the PMIs, industrial production, car sales and ex-car retail sales that is telling us the economy has bottomed out and has turned the corner. Our conclusion is that the Irish economy has made some important early progress in a number of key areas over the first half of the year in establishing a more favourable growth dynamic. Nonetheless, the downside risks facing the international outlook have risen lately, and these will require very careful watching as without the critical support from external demand, it is very difficult to see the Irish recovery staying on track.

External Environment

Economic recovery in Ireland's key trading partners (KTP) – the euro zone, UK and US – has been underway for pretty much a full year now. Economic growth turned positive in the euro area and the US in the third quarter of last year, with the UK following suit three months later. Activity has continued to expand since then across these economies reflecting the turnaround in the global cycle.

While the improvement in international demand to date is modest in comparison with the major declines seen over the course of the Great Recession, the pick-up has been very welcome from an Irish perspective and is providing a discernible lift to Irish exports. Indeed, the positive impulses from the global recovery first began to show through in the new export orders indexes of the monthly PMI surveys of both manufacturing and services which pushed above the expansion threshold of 50 around the third quarter of last year. And sure enough, a much-improved export performance showed through very clearly in the Q1 national accounts data published in late June.



* Trade Weighted GDP Growth (actual and projected) for US, UK, Eurozone. Source: UB

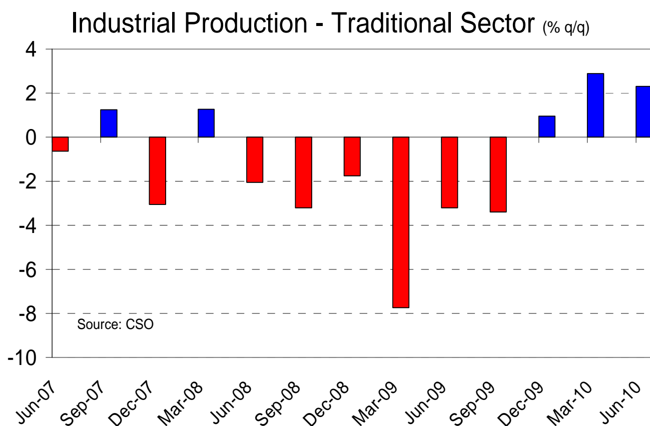
These showed that total exports surged in the first quarter of this year, with a 6.9% quarterly jump reflecting the strongest performance in 3 years. Indeed, with global imports up 5.7% in the same period, this pattern has resulted in a further increase

Ulster Bank Limited accepts no liability for the outcome of any actions taken arising from the use of this report

RBS

in Ireland's share of world trade following a year of outperformance in 2009. Ireland's exports fell by 'only' 4.3% last year vs. the near 13% collapse of trade volumes seen globally. As discussed previously, this resilience partly reflected the compositional structure of the Irish export sector with the multi-national driven chemicals (including pharma) sector (which accounts for over one half of good exports) putting in a very robust performance of +6.8% y/y last year.

Available data to April this year point to some reversal of the strength of the pharma as well as the machinery and transport equipment sectors (another area heavily influenced by multi-national activity) which are down 5% and 31% respectively to leave overall goods exports running some 6% lower than in the first four months of last year. However, there is some encouragement to be taken from the fact that there does appear to be some broadening out in the sources of the export recovery, with eight of the nine non-chemicals sectors showing gains in export values year to date, albeit modest ones in most cases – including a 5% rise in food, beverages and tobacco exports.



Indeed, further evidence of a broadening out in the recovery comes from the monthly industrial production release which usefully splits out its data into 'modern' (a proxy for multi-national activity) and 'traditional' (a proxy for other mainly indigenous industries). The latest figures are for June and show a third consecutive quarterly gain for the output of the 'traditional' sectors of the industrial economy. The 6.5% recovery to Q2 of this year from the cycle low of Q3 last year needs to be seen in the context of the 4.1% and 14.4% declines recorded in annual average terms in 2008 and 2009 respectively. But at least the rot has been stopped and recovery is underway.

One of the pitfalls in tracking the performance of the Irish export sector is the lack of timely official data, particularly on the increasingly important services element. Indeed, services have become an increasingly important source of growth in Irish exports in recent years, now accounting for 47% of the total, up from 41% as recently as 2005. Relative strength of services was again evident in the latest numbers which come from the aforementioned Q1 national accounts data. And while indications from the Irish Exporters Association indicate that service exports remained solid in Q2, the only official data on exports for the June quarter relate to the merchandise (i.e. goods) side which at the moment cover the period to May. Encouragingly, these provide evidence that the export recovery continued in the last quarter, with the average level of export values in April and May running 6.8% higher than the Q1 average.

Not as encouraging are the signals coming through lately from the more timely PMI surveys. The indexes covering new export orders in both manufacturing and services have slipped back in the last couple of readings, no doubt reflecting some indications of a softening of the global growth dynamic lately. We are incorporating some export weakness into our quarterly export profile for the third quarter, partly reflecting payback for what looks to have been a particularly buoyant first half and partly reflecting some signs of slower international activity. However, our base case anticipates a continued, if moderate, recovery in our KTP as a gradual post-crisis healing of the global economic and financial systems results in ongoing recovery (see our latest Focus on Markets for more details). And on this basis, we project a 7.4% increase in export volumes this year on average, helped of course by the exceptionally strong start to the year, and a further 4.5% increase next year. Reinforcing the expected support from foreign demand is the ongoing improvement in Irish competitiveness. This is being reflected in declines in domestic costs and prices, in both absolute and relative terms, as well as recent declines in the euro's value against the dollar and sterling with the single currency some 13% and 8% lower respectively at present compared to the end of last year.

Given the high import content of Irish exports, the early-year pick up in the latter corresponded to an increase in imports too, albeit that they rose by a more modest 2% q/q in Q1.

Given the reliance of the Irish economy's overall recovery on a continued boost from external demand, the indication of a softening in global activity coming through recently is not a good sign. In this context, we are mindful of some increase in the downside risks facing the Irish export outlook, risks to which we will be paying very close attention in the months ahead. In particular, a key issue for the Irish and global outlooks alike is whether what is unfolding at present is just a softening in global growth, from in some cases strong levels, or whether a period of pronounced weakness is headed our way. We will be tracking global growth indicators closely in the months ahead to follow how this critical theme plays out.

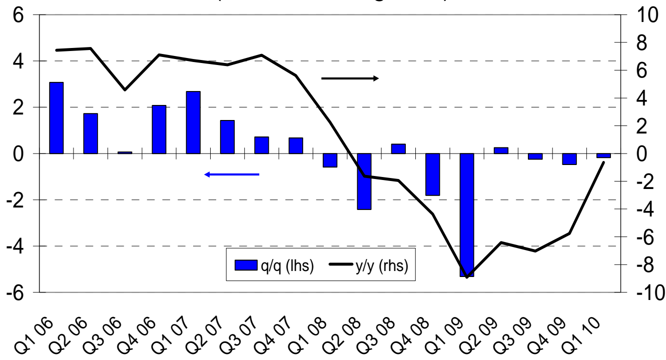
Consumer spending

Total consumer spending fell by an unprecedented 7% in annual average terms in 2009, as disposable incomes felt the weight of a sharp fall in employment and a large increase in the tax burden, and uncertainty surrounding job prospects and the economic and fiscal outlook contributed to a sharp rise in household savings rates. While the headwinds facing consumers remain numerous, including ongoing falls in employment and downward pressure on incomes across the economy, the situation has been looking decidedly more stable so far in 2010.

The first quarter Quarterly National Accounts (QNA) numbers showed that overall consumer spending remained in negative territory in year-on-year terms. However, the 0.8% drop was the smallest annual decline in two years. While base effects are playing some role, this moderation is also partly attributable to the recovery in car sales, which have been helped by the stimulus provided by the Government's scrappage scheme, as well as some underlying recovery from extremely depressed levels.

We also pay particular attention to the quarter-on-quarter rates of change, given their importance in showing turning points. On this basis, consumer spending fell by a modest 0.2% relative to Q4 of 2009, which represents a moderation on the 0.5% quarterly rate of decline in the preceding quarter and a significant improvement on the huge 5.3% drop in the first quarter of 2009.

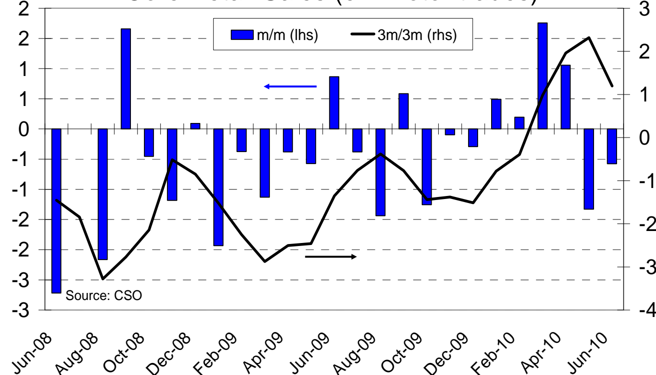
Ulster Bank Limited accepts no liability for the outcome of any actions taken arising from the use of this report



Consumer spending can be broken down by goods and services, each of which make up roughly half of the total. Spending on goods fell at a quarterly pace of 2.2% in Q1. While this represented the weakest quarter since the 8.0% decline in Q1, a large part of the weakness was again attributable to a falloff in car sales. Indeed, we would not have been surprised to have seen a larger fall in goods spending in the first quarter, given that retail sales volumes were down a significantly larger 6.2%. Services spending fared much better in Q1, with higher consumption of energy over the cold snap at the beginning of the year likely to have contributed to the near 2% quarterly rise.

While there is a notable absence of timely data on services spending, the monthly retail sales data serve as a useful proxy for spending on goods. Total retail sales came in some 7.4% ahead of the Q1 average in Q2, as the large cars-related 6.1% drop in the first quarter was more than fully reversed. When coupled with the continued improvement in consumer confidence and ongoing price declines, this provides a solid basis for expecting a positive second quarter for total consumer spending.

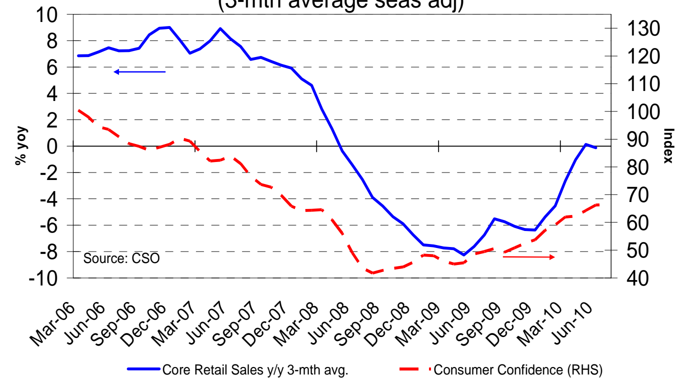
Large-scale volatility in the motors component continues to be the driver of the huge quarterly swings in the total retail sales data. For this reason, we look at so-called core retail sales (ex. motor trades) to get a better picture of the underlying trend in consumer spending. On this basis, sales volumes showed their second consecutive quarterly rise of 1.1%, having fallen for 8 quarters in a row prior to that.



While the quarterly retail sales data provide evidence of ongoing improvement in spending trends, this was driven by impressive growth in volumes around the turn of Q1, while both total and core sales showed monthly declines in May and June. We will need to see a resumption of monthly increases in retail sales going forward if our base case for a continued improvement in the q/q trajectory in consumer spending in the second half of the year is to remain on track.

Of course there are risks in both directions around any forecast. The downside risks stem from further employment losses which will lessen the consumer's ability to spend and factors such as the possibility of further tax increases in future budgets which will work to constrain the willingness to spend. However, increasing signs of an improvement in consumer confidence, a further improvement in the economic situation and a possible slight improvement in the employment situation

by the end of the year should be supportive of a further improvement in the trajectory.



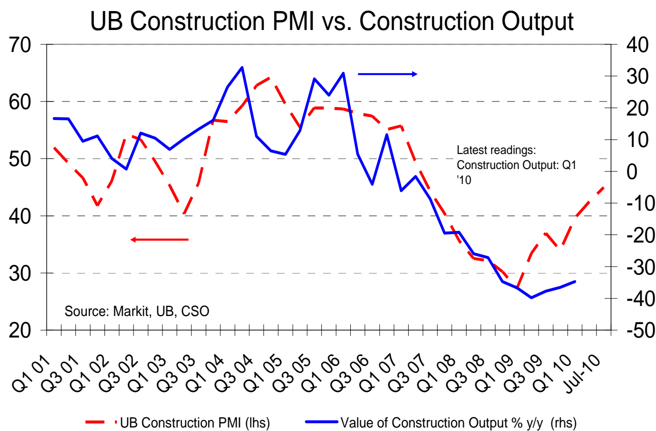
So where does this leave us? While we now feel that our previous forecast decline of 1% now looks too negative, we are refraining from factoring in any recovery in consumer spending in average annual terms this year given that we expect consumers will remain cautious and savings will remain elevated at just below 11% (up from 3.6% in 2007). On this basis, we are forecasting a modest 0.1% fall in consumer spending in 2010,

Despite the a slight 1% acceleration in pay growth we expect next year (from a fall of around 2.5-3% this year), the lack of any notable improvement in the labour market situation and the prospect of higher interest rates will limit the extent of the recovery in consumer spending. While we think that household savings rates are in the process of stabilising at high levels (at around the 11% mark), it will likely be some time before outright declines in savings unleash much spending power from households. Uncertainty surrounding future budgetary changes is another reason why we have refrained from a factoring in a stronger rebound in consumer spending next year. At this stage we are forecasting average annual growth of the order of 1.7%.

Investment

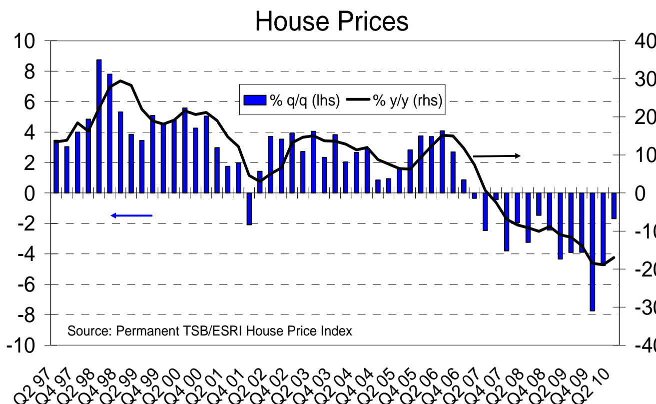
According to the National Accounts data, total investment contracted by an unprecedented 31% y/y in 2009. While the non-housing and machinery and equipment components experienced sharp declines, housing remained the primary drag on total investment activity, falling by some 41% y/y. Indeed, it also continued to represent a significant negative for overall economic activity, subtracting around 3.5 percentage points from GDP in the year. The situation remained weak in the early months of 2010, with the quarterly rate of decline in total investment accelerating to 13.8% in Q1, the fastest rate of decrease since Q4 2008. A deterioration was evident in each of the main components in investment in the first quarter, albeit that the weakness remained most pronounced in housing, and in particular residential construction which was down 53.4% y/y.

The outlook for investment in 2010 as a whole remains poor. The significant supply overhang of both residential and non-residential properties, further falls in prices/values, a tighter credit environment and ongoing weakness in the domestic economy all are expected to contribute to a further sharp contraction in the sector. We see total investment falling by 19.5% this year. While residential construction is expected to continue to drive the slump in total investment, incoming data has caused us to make a slight upward revision to our house completions forecast, to 12,000 from 10,000 previously. Looking ahead to next year, an improvement in economic conditions should see a return to modest positive growth in total investment volumes of the order of 1.8%. However, we expect residential construction will subtract from growth for the fifth consecutive year in 2011, as market conditions continue to be characterised by a significant amount of excess supply.



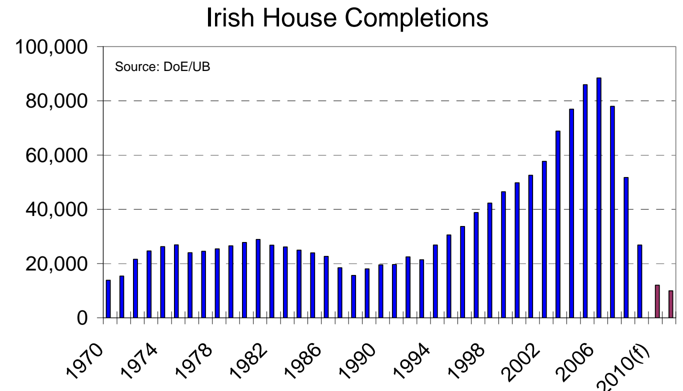
Housing

By Q2 2010 2009 we had experienced 14 successive quarterly falls in average house prices and a 35% fall from the peak in the final quarter of 2006, according to the Permanent TSB/ESRI house price index. Given the lags in reporting – the statistics are based on bank drawdowns – and the small number of transactions, in reality the decline is much greater. Our guesstimate is that the true fall in prices on average nationally to date is of the order of 40-45%, and we continue to expect a cumulative drop of 45-50% by the end of the year taking prices back to 2000 levels.



Our house price forecast also implies sharp reported falls in the Permanent TSB/ESRI index this year, as the index comes into line with reality. Around the turn of the year we started to see greater signs of a catch-up, with national average prices falling at a quarterly rate of 7.7% in Q4 2009 and by 4.8% in Q1 2010. While this pace of decline moderated to 1.7% in the second quarter, we would expect to see a resumption of steeper price declines in coming quarters.

The sharp fall in house prices and pronounced rise in unsold stocks has resulted in a substantial drop in new house building. Irish house completions data are based on connections to the ESB electricity grid. On this basis, 26,820 units were recorded as completed in 2009, a reduction of almost 50% on the 2008 level. The registrations data had implied a smaller 18,500 units would be completed last year, with some of this outperformance likely attributable to timing factors, in that the lack of demand for homes, in addition to the considerable supply overhang, may have meant that some houses built in 2008 are not connected to the ESB grid until 2009, thus boosting the completions figures last year.



The outperformance of completions relative to our expectations in 2009 increased the likelihood that there would be some payback this year. However, incoming data suggests that this payback will be slightly less than we had previously anticipated. Actual completions totalled 8,383 in the year to July. As we still have 5 months to go, this leaves us expecting completions of the order of 12,000 this year. While this represents a modest upward revision to the 10,000 level previously forecast it is important not to loose sight of the big picture – 12,000 completions would still represent the lowest level of home-building since at least 1970 and would see housing subtracting 2 percentage points from growth this year. Indeed, the Ulster Bank construction PMI is continuing to paint a bleak picture of the Irish housing sector. While activity levels across the commercial and civil engineering sub-sectors are also continuing to slide, the contraction in housing remains the most severe, albeit that at least the index is some way off the record lows seen around the turn of 2009.

As we have pointed out for some time now, housing affordability is much improved reflecting a combination of factors, including significantly lower house prices, the very substantial mortgage interest–rate reductions and increases in mortgage interest relief. However, the demand for new housing is likely to remain muted for some time to come. Prospective buyers remain reluctant to purchase given the widespread anticipation of lower house prices, in addition to concerns about job security, albeit that there is some anecdotal evidence of buying interest in some segments of the market. Irish Banking Federation data for the first half of 2010 did show a considerable easing in the annual rate of decline in the number of mortgage drawdowns for first-time-buyer house purchases - the recorded 4.3% y/y drop compares with a 47% decrease in the corresponding period in 2009.

New housing starts will not recover until buyers show a greater willingness to transact and the overhang of unsold stock begins to be eroded. In terms of the latter, the extent of and uncertainty surrounding the level of excess supply is an additional complication. In reality, the size of the overhang is likely to be in excess of 130,000. Indicators of future housing activity ranging from planning permissions to commencement notices to registrations continue to point to a further falloff in

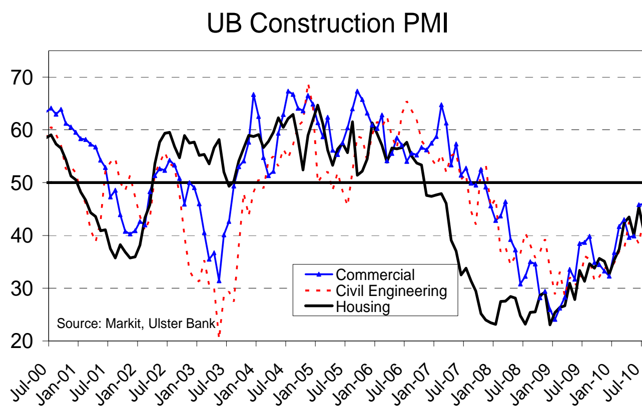
RBS
Ulster Bank Limited accepts no liability for the outcome of any actions taken arising from the use of this report

activity in the sector. Based on these data and also allowing from some payback from the higher forecast for this year, we are now forecasting 10,000 house completions next year. While we do anticipate a better performance in the repairs and maintenance area will provide some offset, this is not expected to be enough to prevent another annual decline in overall housing next year. We are factoring in a 5% decrease, which would see housing representing a drag on growth for the fifth year in a row, albeit that the magnitude of this subtraction considerably less than in previous years.

We see the situation stabilising beyond 2011 taking us to a scenario where housing is no longer subtracting from growth. However, any increases in new housing activity out to the middle of this decade are expected to be modest.

Other Building & Construction

Activity in non-residential construction also remains depressed, as is evidenced in the timely monthly Construction PMI data for commercial and civil engineering activity available up to July. Commercial investment projects are continuing to feel the weight of the economic slowdown, falling capital values and a considerable supply overhang of properties available for rent. The need for a huge fiscal retrenchment has put the breaks on new public investment projects.



National Accounts data for the first quarter of the year showed the annual pace of decline in non-residential construction accelerated to -29.5%, from -27.4% in Q4 2009. While activity in these sectors will likely remain subdued in the quarters ahead, a more moderate pace of contraction is expected going forward. This is backed up by the PMI data, which has shown an easing in the rate of decline in both commercial and civil engineering in recent months from the period of intense weakness in early-2009.

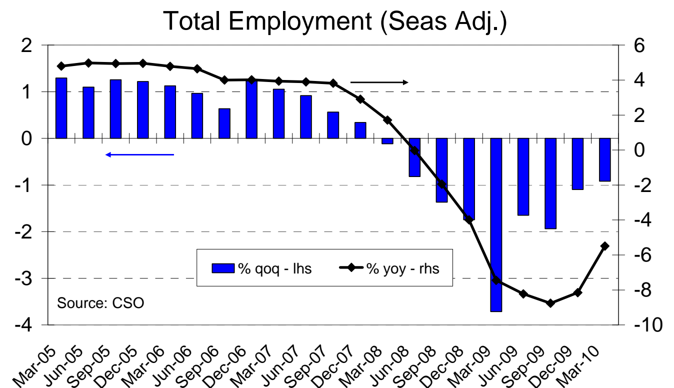
This said, a continuation of the factors outlined above means that activity in the non-residential investment sector is set to fall further this year. Following a 24.3% contraction in 2009, we expect an 15.4% decline in 2010. While the improvement in economic conditions that we are factoring in for next year should provide some boost to the non-residential construction in 2011 in H2, this is no longer expected to be enough to see a return to positive average annual growth. Whereas before we had forecast a modest average annual increase of 4%, we now expect a further 3% decline in non residential building activity next year given the expected cuts in capital spending in Budget 2011.

Machinery & Equipment

In 2009 investment volumes in machinery and equipment fell by an average of 19.3% compared with the same period in 2008, with a significant proportion of this weakness related to the construction sector slump. Looking at the quarterly pattern, the annual decline accelerated from 9.6% in Q4 2009 to 16.6% in the first quarter of 2010, with the volatility here driven by timing factors associated with aircraft purchases. While we are forecasting a resumption of modest economic growth this year, continued strains in the construction and manufacturing sectors leads us to anticipate a further fall in of 3.0% in 2010. With domestic and international conditions expected to show greater signs of improvement in 2011, a 10% increase in machinery and equipment is forecast.

Labour Market

There have been numerous indicators in the past few months pointing to an economy that is in recovery mode. These include the official Q1 GDP data, the monthly PMIs of manufacturing and services, retail sales, industrial production and exports. The labour market remains weak for sure, evidenced by the fact that employment is continuing to fall. However, this is to be expected given the lags between changes in economic activity and employment. What is noteworthy is that the pace of job-shedding is continuing to ease back considerably, thereby providing some validation of the more encouraging signals which have been coming through from other indicators on the economy lately.



The most comprehensive information on the state of the labour market comes from the Quarterly National Household Survey (QNHS), the latest of which is for Q1 of this year. The level of employment in the first quarter stood at a seasonally-adjusted 1.87 million, the lowest level in some six years, following a decline of 55,000, or 5.5%, in the year. However, looking a year-on-year changes will always obscure the more important point which is what has been happening in the most recent quarter. Comparing Q1 of this year with Q4 of last, the economy lost 17,300 jobs which is certainly not good news. However, this represents the smallest quarterly fall in employment in two years and is way less severe than the staggering weakness from the same period last year when employment fell by over 76,000.

At a sectoral level, it is unsurprising that the sectors which experienced the largest increases in employment during the boom years, namely construction and wholesale and retail, have seen the largest falls over the course of the downturn. Outside of agriculture (where survey problems are making it difficult to get an accurate read at present) the largest fall in Q1 was a 4,100 decline in construction employment. However, this was the smallest quarterly decline since the final quarter of 2007. When taken together with the broadly stable level of employment in wholesale and retail in Q1 this would indicate that the intensity of layoffs in the hardest hit sectors of the economy is easing off.

A few sectors even managed some small gains in employment in Q1 including accommodation and food service activities, information and communication, professional, scientific and technical activities as well as education and health. So there is

also some early evidence of stability in the demand side of the labour market, even if it will likely take more time for definitive signs of broad-based improvement to come through.

Somewhat surprisingly, the numbers unemployed fell back by 7,300 between the Q4 of last year and Q1 of this year, the first quarterly decline in unemployment since the modest 1,000 fall in Q3 2007. We also saw a moderation in the unemployment rate from (an upwardly revised) 13.3% in Q4 2009, to 12.9%. While this is certainly an encouraging development, it likely exaggerates the extent of the improvement, with the easing back in the unemployment rate importantly linked to the 13,700 decline in the labour force in the quarter, rather than any improvement in the employment situation.

There continues to be two main factors explaining this shrinking labour force. Firstly, there is an ongoing decline in participation rates. The overall participation rate fell to 61.2% in Q1 from 62.5% a year ago, with this factor alone accounting for almost 70% of the fall in the workforce over the period. Secondly, outward migration is also continuing to play a role in the adjustment underway in the Irish labour market with the CSO estimating indicatively that almost 60,000 Non-Irish nationals aged 15 and over left the country in the year to Q1.

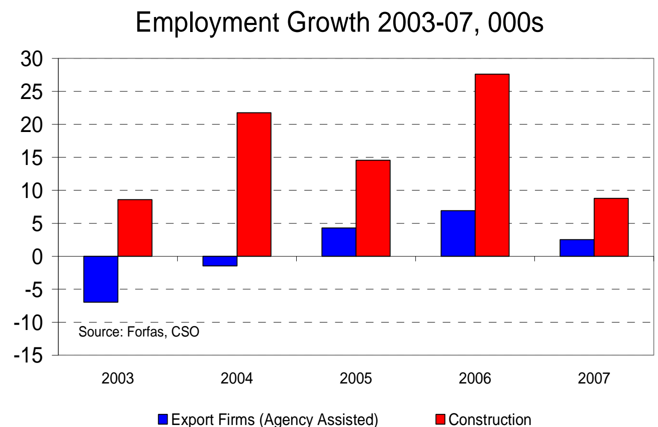
The QNHS measure of the unemployment rate is the official one. However, the more timely Live Register estimate of the unemployment rate is generally a reasonably good guide. This measure is based on unemployment benefit claimants. While the 13,700 rise in claimants in the first six months of this year represents a dramatic turnaround from the 110,500 increase in the same period last year, a notable moderation in the numbers signing on over the Feb-Apr period has given way to renewed weakness in recent months. While seasonal adjustment factors around summer time may have played some role in the large increases in recent months, the trajectory here has been moving in the wrong direction lately.

This renewed weakness as per the Live Register data in recent months has also been evident in the employment index of the manufacturing PMI. Having risen above the 50 mark in May, a contraction in manufacturing employment was again signalled in June and July. The employment measure of the services PMI has offered a little more encouragement, with the index continuing to rise steadily in recent months, and at 49.5 in July looks set to hit/breach the 50 mark in August.

While the latest QNHS showed a moderation in the unemployment rate in Q1, the Live Register data and employment index of the manufacturing PMI points to clear upward pressure on the rate in recent months. We forecast a peak unemployment rate of 13.6% by the end of the year on the QNHS numbers, to leave the annual average rate at 13.3% from 11.6% last year. It should be noted that it is assumed ongoing declines in the labour force, as opposed to any notable improvement in labour demand, driving our expected stabilisation of the unemployment rate in the final quarter of this year.

While a continued improvement in the economic environment will translate into an improvement in the labour market situation over time, the nature of the recovery we expect rules out any significant employment gains in the early stages of the recovery. As discussed in the external trade section, despite the renewed risks to the global outlook in recent months, we continue to expect that exports will be the main driver of the recovery. However, an export-led recovery will have some important implications for the near-term outlook for employment growth.

The boom period between 2002 and 2007 was characterised by impressive growth in the domestically focused construction sector. However, growth in exports on the back of the buoyancy in the global economy was also a feature of the economic environment during that period, though the impact on employment was very different. The Annual Employment Survey from Forfas is very useful in this context as it provides indicative information on employment levels within Irish exporting firms, both indigenous and foreign-owned. However, it should be noted that while the coverage of foreign-owned companies is comprehensive given that they typically fall into the agency supported category (which is the basis for the survey), there may be some underreporting of employment in Irish-owned firms as coverage here is not as widespread. The comparison between employment trends in exporting firms and the construction sector is instructive. While the CSO estimates the construction sector added over 80,000 to employment over the period 2002-2007, the significantly less labour intensive export sector directly added just 5,300 net jobs according to Forfas survey estimates.



Therefore, an export-led recovery means that any notable recovery in employment growth is likely to be some way off. The pattern in our main trading partners has generally been that there is a 9 month lag between the trough of the economic cycle in GDP terms and the return of positive employment growth. We have allowed for a longer 12 month time lag in the case of Ireland, with some very modest gains in employment expected in the final quarter of this year. This leaves another sharp annual contraction in employment this year, of the order of 4%.

Looking ahead to next year, while we have factored in a continuation of small quarterly increases in employment, it will likely be the second half of the year before the annual rate of change shows even modest increases. As a result we are factoring in no change in average annual employment growth next year. In terms of the implications for the unemployment rate, we expect only modest downward pressure to leave the annual average rate at an elevated 13.0% on average in 2011. This compares with 12.4% at the time of our January update.

Inflation

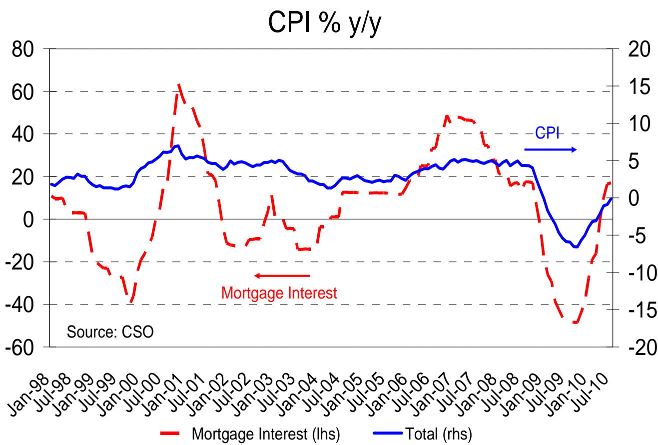
Following a year in which the Consumer Price Index (CPI) recorded its largest annual drop since the 1930s, incoming news on price developments is pointing to an easing in deflation pressures.

The CPI fell by 4.5% in annual average terms in 2009, though the extreme point of the cycle was the -6.6% y/y decline seen in October last year. Since then there has been a steady acceleration in the annual rate of change which, though still negative, stands at just -0.1% on the latest (July) data.

As is often the case with directional shifts in the CPI, the mortgage interest (MI) component has been a major swing factor. Even though it accounts for only 6.7% of the total index,

the annual changes have been so large as to have a large impact on the recent movements in the CPI.

Following the 3.25% of reductions in ECB official interest rates between October '08 and May '09, the MI component showed its largest annual declines in October of last year, at -49%. But with the ECB no longer cutting rates, an easing of the pace of decline was always inevitable. Moreover, pressures on bank funding costs have seen outright increases in standard variable mortgage rates (SVR) - the interest rate measure used by the CSO in calculating MI – which have risen by around 0.7% over the past year. The result is that the MI component is rising at an annual pace of 17% as per the July numbers, in the process providing considerable upward impetus to the CPI.



The European harmonised measure of prices (HICP) excludes MI and the swings on this metric have been less pronounced as a result. The HICP did decline in 2009, with a 1.7% average annual fall highlighting the downward flexibility of prices as the recession gripped. Not only have prices fallen in absolute terms, but they have also done so relative to our key trading partners. The UK's HICP last year was up 2.2% while that in the euro zone was up 0.3%, relative movements which have generated a welcome and much-needed improvement in Ireland's competitiveness.

But similar to the CPI, the point of peak deflation pressures on the HICP measure was reached last Autumn, with the low point of the cycle corresponding to the -3% reading last September. There has been a steady easing off of the annual rate of deflation since then, albeit not nearly on the scale of the acceleration on the CPI: on the latest (July) numbers, the y/y rate of HICP inflation stood at -1.2%.

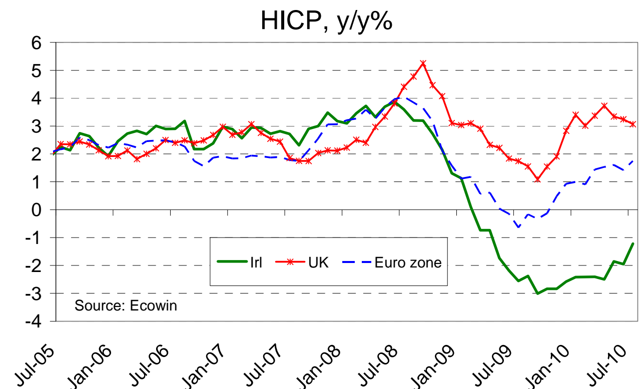
Several factors are contributing to the observed easing of downward price pressures outside of MI in recent quarters.

First, crude oil prices rose by almost 50% between the first half of 2009 and the first six months of this year, a development which has seen the energy component of the CPI move from a low of –13.4% in July of last year to +9.8% y/y in July.

Second, the euro has reversed some of its prior strength on the currency markets this year, notably vs. sterling against which the single currency has fallen by some 12% from the high of 94p seen last October. Thus, from a situation where currency movements were imparting downward pressure on prices, they are now the source of some upward pressure. This looks to be coming through in food prices, for example, as approximately one fifth of consumer foodstuffs are imported from the UK. These have risen by a total of 0.6% since the low-point in April, thereby producing a notable easing in the rate of deflation which has halved from -8.1%y/y in January to -4% in July.

Aside from these largely external factors, underlying price pressures have remained very subdued. Core services CPI inflation for example is a measure which strips out MI as well as electricity and gas and this has remained in negative territory this year, from levels in the 3.5-4% range in 2008. This is an indication of the degree to which demand-side pressures have remained very muted indeed reflecting the softness in domestic economic conditions in general and the ongoing downward pressure on wage rates in particular. But it is worth pointing out that while this measure has not shown the same pronounced tendency towards higher inflation rates as the components discussed above, it is no longer trending downwards. Broadly, this is probably a reflection of the fact that the overall economy has left the period of extreme weakness of 2009 behind it, with some early, if still tentative, signs that consumer demand is stabilising.

Looking ahead, the trajectory for the CPI will continue to be importantly shaped by MI-related developments. Already-announced SVR increases by several mortgage lenders will result in further monthly increases in the MI component in August/September, moves which we expect will herald the end of a 19-month period of deflation on the CPI measure. We anticipate a move back into positive y/y rates of overall CPI inflation from next month. For 2011, we are pencilling in the beginning of some normalisation of the ECB interest rate stance from around the middle of the year which will add further to the upward pressure on the CPI next year. In average annual terms, we are projecting CPI inflation rates of -0.7% and 2.2% for 2010 and 2011 respectively.



The anticipated pick-up in the HICP measure is not as pronounced as MI is not a relevant factor. But the broad pattern here too is one of higher inflation rates, albeit at a much more gradual pace. Global food prices have come under firm upward pressure lately (partly reflecting adverse weather conditions in some important growing areas), with the Economist's global food commodity index up over 16% since mid-June for example, in the process reaching its highest level since September 2008. This is likely to add to recent upward pressure on Irish food prices in the months ahead. We also retain a bias for further weakness for the euro on the currency markets (see our latest Focus on Markets for why we target 78p by year end vs. sterling) which if proved right may amplify movements in food (and other) prices in the period ahead. Current pricing in wholesale energy markets also imply some upward pressure from this source, with crude oil futures priced for a 10% price increase between now and the end of next year. Finally, if the broader economy remains on the recovery path as envisaged by our base case, then the extent of downward pressure on underlying prices will likely ease back too.

Ulster Bank Limited accepts no liability for the outcome of any actions taken arising from the use of this report

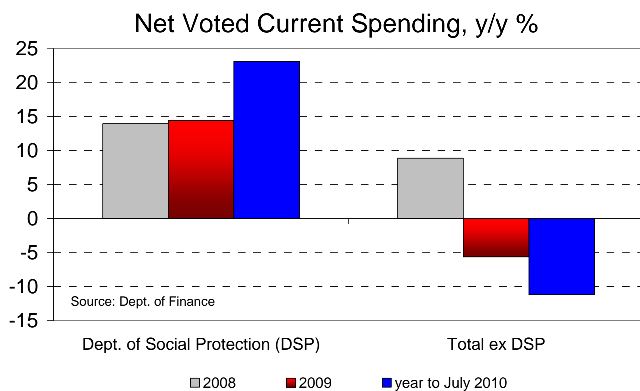
Overall, we expect the HICP to stop falling in annual terms by around the end of this year, which would result in an annual average rate of -1.4% for the year as a whole. Further modest upward pressure beyond then yields an average level of HICP inflation for 2011 of 0.9% on our forecast. While a return to positive inflation rates next year marks the end of a two-year period of absolute declines in the Irish HICP level, the modest rise we anticipate is subdued and consistent with further improvements in competitiveness given expected HICP rates for next year of 2.5% and 1.6% for the UK and euro zone respectively.

Public Finances

The Irish fiscal correction has now entered its third year. While it seems like a distant memory at this stage, the first steps taken to address the deterioration in the public finances took place in the Summer of 2008. Since then, a whole host of measures and initiatives have been introduced to address a

major deficit problem. In terms of the impact on the budgetary situation for 2009 alone these measures summed to 4% of GDP, while last December's budget unveiled the planned €4bn package, equivalent to about 2.5% of GDP.

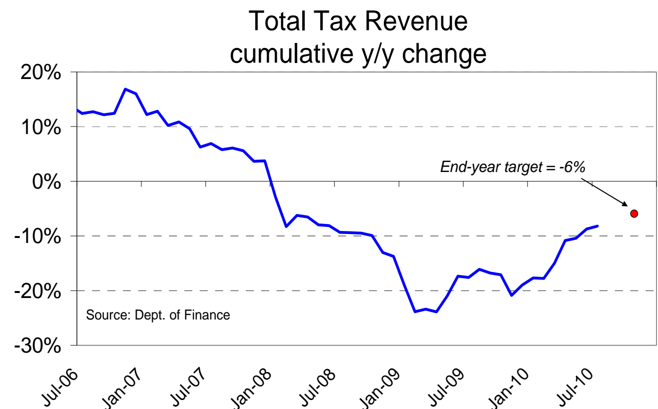
Despite the significant steps taken to date, thus far it has mainly been a situation of running very fast to stand still. The underlying (i.e. excluding banking sector supports – more on this below) general government deficit hit a cycle high of 12.1% in 2009, up from 7.3% in 2008 (and a surplus of 0.1% in 2007) as the incremental policy changes (as substantial as they have been) have struggled to keep pace with major deterioration in the balance between spending and revenues. In other words, the underlying deficit estimate for last year would have been considerably worse (perhaps around 16% of GDP) absent the significant policy changes which have been implemented.



But incoming numbers are pointing to a situation that is finally moving in the right direction. Considerable discretionary spending restraint is showing through clearly in Exchequer returns data for the year to July. These show total spending by Government departments is running 7% lower in cash terms vs. 2009 levels and also some 2.6% below plan. This decline is led by a major cutback in the capital budget where spending is 36% lower than last year and actually about 22% below the Department of Finance's profile for this stage of the year. Day to day spending is right on plan running 2.9% below 2009 levels. This may seem somewhat disappointing given the extensive steps to rein in current expenditure (including cuts in social welfare and public pay rates). However, it masks a much stronger pullback in 'core' spending. Thus, if we strip out a 23% increase in spending at the Department of Social Protection (which is a function of higher job market-related social welfare payments), the remainder of current expenditure is down over 11% on year-ago levels.

On the revenue side, tax receipts are running 1.4% behind expectations. Income taxes are the main source of the downside surprise here as a 5.8% shortfall relative to plan in this category has offset some slight upside surprises in VAT, Corporation Tax and Capital Gains.

But looking at the broader picture on tax receipts, there is encouragement to be taken from the improving trajectory of recent trends. Overall tax revenues were down 19% in 2009, but since then there has been a steady easing in the rate of decline which stood at -8% in the year to July.



The December Budget had a full-year target for the tax take of €31bn, implying a 6% fall for the year as a whole. Even allowing for continued improvement in the economy in the second half of the year, that forecast is now under some pressure given the modest slippage in the first seven months of the year. However, we think that the major pull-back in capital spending relative to early-year plans could be an indication of a strategy whereby any shortfall in tax receipts is compensated for by savings on the spending side. Such an approach is not without merit given the sensitivity of international debt markets to negative public finance newsflow, whereby any 'missed' targets could contribute to a worsening of investor sentiment and put upward pressure on funding rates. Overall, on this basis, our sense if that the underlying budgetary arithmetic for this year is broadly on track.

In terms of trends in Ireland's borrowing costs, the tail end of 2009 and the early months of this year saw steady reductions in the 10-year spread relative to Germany, in recognition of the steadfast efforts of the authorities here to tackle a highly problematic situation. The December Budget won many plaudits in the international arena (including from ECB President Trichet), as investors gave a thumbs up to the strategy of achieving virtually the entire €4bn budgetary package through reductions in spending, rather than through taxation hikes. By mid March, the 10-year spread had fallen to a 15-month low of under 1.30%, down from a high of almost 3% in March '09. Moreover, the reductions in the Irish spread over that period stood in contrast to the spread-widening that was being experienced by other high-deficit countries at that time – a indication of improved attitudes towards the Irish sovereign name in both relative and absolute terms.

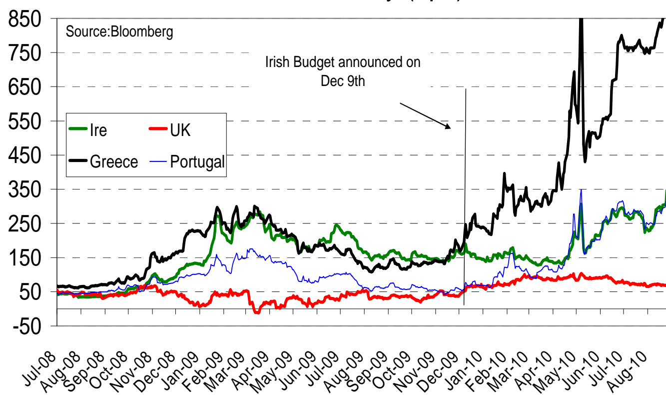
However, a combination of international and domestic developments have since put considerable upward pressure on Irish spreads once again. The eruption of the Greek crisis in late April / early May brought renewed negative focus on the economic, budgetary and financial sector vulnerabilities of periphery countries in the euro zone. The outcome was an across the board shunning of periphery debt. This resulted in major upward pressure on spreads here, albeit not to the same extraordinary degree as in Greek markets, as investors parked

Ulster Bank Limited accepts no liability for the outcome of any actions taken arising from the use of this report

RBS

their willingness to differentiate between countries with varying track records and degrees of commitment to fiscal rectitude.

But the widening of Irish spreads since mid March has not just been about the Greek crisis and its aftermath. The mounting size of and uncertainty surrounding government support measures for the banking sector has also weighed heavily on investor sentiment towards Irish debt. The upward revision of the ultimate cost to the Exchequer of state support for Anglo has been a particularly thorny issue and not just in domestic political terms. Following the latest information on asset quality, recent official guidance from the Governor of the Central Bank Patrick Honohan is indicating that the total cost of Anglo could be of the order of €25bn, of which €4bn was provided for last year, though some private sector analysts are more pessimistic and think it could be more. Either way, the situation remains unhelpfully uncertain as the reality is that even at this stage we are dealing with estimates rather than definitive pronouncements (the same point, though on a relatively minor scale, also applies to the prevailing official estimate of about €4bn for INBS).



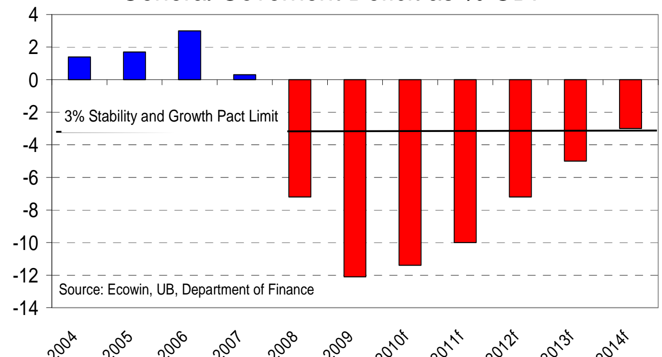
There is also uncertainty about both the timing as well treatment of such transfers from a general government deficit accounting perspective. Last year's €4bn injection into Anglo has already been reclassified by Eurostat as spending rather than investment on the grounds that it is not likely to generate a return. This resulted in a restatement of the deficit figures which in headline terms for last year now stand at 14.6% vs. what we referred to above as the 'underlying' deficit of 12.1%. Similarly, the €8.3bn committed to Anglo earlier this year has received similar treatment as per Q1 deficit estimates from Eurostat. Depending on timing, and the extent to which remaining commitments are treated in the same fashion (there may be an element of the Anglo outlay which may get recorded as equity in some new much downsized 'good bank' post the eventual restructuring), one could see an extreme, though unlikely, scenario whereby banking sector support measures add around €25bn, a monstrous 15.6% of GDP, to this year's general government deficit, and perhaps even more if the more pessimistic Anglo scenarios play out.

The extremely large costs involved, as well as ongoing uncertainty about what the true final cost will ultimately amount to, are weighing heavily on investor sentiment in Irish government bond markets where spreads relative to Germany have widened out to new crisis highs in recent days of close to of 3.5%. Given the negative implications of the considerable uncertainty in this key area, it is extremely important for the Irish authorities to provide clarity as soon as possible around the future plans for Anglo, and the ultimate total cost thereof to the exchequer.

In light of the important progress on stabilising the underling (non-banking) problem in the public finances, we are anticipating a reduction in the underlying general government deficit this year, which we expect to come in at 11.4% of GDP, down from 12.1% last year on a like-for-like basis. But, the headline number will likely be much worse than that and depending on the various wildcards above, it could in extreme circumstances get to as high as mid-20s% of GDP and maybe even higher in a truly extreme scenario – a truly horrendous prognosis by any standards.

Without seeking to play down how ugly a scenario that represents, it is critical to recognise that the identified banking sector commitments are non-recurring. Thus, while such outlays represent a one-off, if enormous, hit to the exchequer, the burden of the underlying problem of the gap between ordinary spending and revenues (€19bn in 2009) is one that would remain with the economy indefinitely if not acted upon. This is why tackling the underlying deficit is so critical and why is it vital that the government continues to hit its fiscal objectives, an imperative made all the more pressing by the ramped up estimates of the costs on the banking measures.

The Government has set out a medium-term strategy to get the underlying deficit down to 3% by 2014, and has thus far made very significant progress towards that goal. By formulating a specified, medium-term path for the budgetary targets, and by executing on the strategy on a sustained basis over the past two years, the Irish government is, in our view, "a credible deficit reducer". In other words, its actions to date demonstrate that its budgetary plan is not simply an aspiration, but that it is backed up by a demonstrable determination to take the difficult decisions to get the public finances back on to a sustainable path.



* deficit estimates presented here are on an underlying basis i.e. they do not include the costs of state transfers to the banking sector. When such transfers are included this takes the 2009 deficit to 14.6% of GDP - see text for discussion of the 2010 estimate.

While such credibility is hard-won, it could easily be lost if performance were to slip behind plan. Thus, it goes without saying that the €3bn package pencilled in for the coming December Budget must be delivered. As already announced, €1bn of that will come from lower capital spending which leaves some uncertainty around where the remaining €2bn of savings will be found. In keeping with the praise for his efforts last year, the recommended course of action for the Minister would be to achieve as much as possible on the current spending side, so as to avoid having to add further to the overall burden of taxation facing the economy as it tries to stay on the recovery path.

We would make two further suggestions regarding the Budget. First, that it be used as an opportunity to provide more detail (e.g. specifying the current/capital spending / taxation split) regarding the intended adjustments in future years. The provision of additional detail would make the plan more concrete and would thus reinforce its credibility in the eyes of international investors, while such clarity would also help reduce

RBS
Ulster Bank Limited accepts no liability for the outcome of any actions taken arising from the use of this report

uncertainty about future budgetary changes among domestic firms and consumers. Second, budgetary strategy should incorporate a commitment to respond quickly and flexibly in the event that a deterioration in fiscal trends jeopardises the achievement of stated targets. With the international recovery looking less assured lately, the downside risks to the Irish growth outlook have risen somewhat. The December Budget was based on average GDP growth of over 4% per annum per annum over the period 2011-14. While such a forecast is certainly not implausible, it is perhaps more optimistic than cautious. A prudent risk management approach would recognise the corresponding risks facing the public finances and include an element of contingency planning in the event that the downside risks materialise.

Regarding the national debt, clearly a large underlying deficit problem combined with a costly series of banking sector interventions is a very poor mix for debt dynamics. And Irish debt trends have indeed begun to deteriorate rapidly. However, they are doing so from extremely low pre-crisis levels with gross debt levels (the measure typically used in Europe for comparison purposes) standing at a lowly 25% of GDP in 2007 – less than half the average level across the euro zone of 66% for the same year. The December Budget projected a peak debt level on this measure of about 84% of GDP in 2012, but this is not a complete picture of the overall position. Adding to the debt relative to this figure will be the estimated total costs of the bank recapitalisation process which weren't included in the Budget day calculations. Plus, even though a Eurostat ruling permits NAMA to be treated on an off balance sheet basis, provision does needs to be made for it in making a meaningful assessment of the country's overall level of indebtedness. Some assumptions can help shed light on the sums involved: for the purpose of illustration, arguably aggressively negative assumptions about NAMA / Banking recap costs could include that the total additional recap costs for 2010 amount to €37bn (23% of 2010 GDP) as assumed by S&P in a recent analysis, and that NAMA only recovers about half of the transfer value of its eventual total asset portfolio, implying a cost of the order of €20bn, or 12.5% of GDP.

But there are important offsets on the asset side of the equation which also need to be factored in. These include the large cash balances held by the exchequer at present. These stood at €20.5bn at the end of June (almost 13% of 2010 GDP) reflecting the prudent funding activities of the NTMA which mean the country's borrowing requirements out until the end of the second quarter of next year are fully funded. The considerable asset holdings of the National Pension Reserve Fund which are estimated at €24bn (15% of GDP) at the middle of this year also need to be taken into account. The result of these calculations yields an estimated peak net debt level of below 100%. While this is certainly far from a position of comfort, it is very far indeed from the debt levels facing Greece in the coming years which, even if all of the exceptionally challenging fiscal targets are hit, are headed towards 150% of GDP. It is also worth pointing out that prospective sovereign debt levels in Ireland are also set to be close to if not lower than other higher income EU member states including both Italy and Belgium who are both likely to have peak debt levels at or in excess of 100% of GDP. Those particular countries enjoy 10-year borrowing costs between 1.7 and 2.6% lower than Ireland at present, highlighting the scope for Irish bond spreads to eventually narrow in from extremely elevated levels at present, once some of the fog lifts on the various uncertainties discussed above.

Simon Barry,
Chief Economist, Republic of Ireland
E- mail: Simon.Barry@ulsterbankcm.com
Tel: + 353 1 643 1553
Mobile: +353 86 3410142

Lynsey Clemenger
Economist
E-mail: Lynsey.Clemenger@ulsterbankcm.com
Tel: + 353 1 643 1565

Ulster Bank Limited accepts no liability for the outcome of any actions taken arising from the use of this report

DISCLAIMER

This document is issued for information purposes only for clients of Ulster Bank Group who are eligible counterparties or professional customers, and does not constitute an offer or invitation to purchase or sell any instrument or to provide any service in any jurisdiction where the required authorisation is not held. Ulster Bank and/or its associates and/or its employees may have a position or engage in transactions in any of the instruments mentioned.

The information including any opinions expressed and the pricing given, is indicative, and constitute our judgement at time of publication and are subject to change without notice. The information contained herein should not be construed as advice, and is not intended to be construed as such. This publication provides only a brief review of the complex issues discussed and readers should not rely on information contained here without seeking specific advice on matters that concern them. Ulster Bank make no representations or warranties with respect to the information and disclaim all liability for use the recipient or their advisors make of the information. Over the-counter (OTC) derivates can involve a number of significant and complex risks which are dependent on the terms of the particular transaction and your circumstances. In the event the market has moved against the transaction you have undertaken, you may incur substantial costs if you wish to close out your position.

Ulster Bank Limited Registered Number R733 Northern Ireland. Registered Office 11-16 Donegall Square East, Belfast, BT1 5UB. Authorised and regulated by the Financial Services Authority. Member of The Royal Bank of Scotland Group.

Ulster Bank Ireland Limited . A private company limited by shares , trading as Ulster Bank , Ulster Bank Group and Bank Uladh. Registered in Republic of Ireland. Registered No. 25766. Registered Office: Ulster Bank Group Centre, George's Quay, Dublin 2. Member of the Royal Bank of Scotland Group. Ulster Bank Ireland Limited is regulated by the Financial Regulator.

Calls may be recorded.