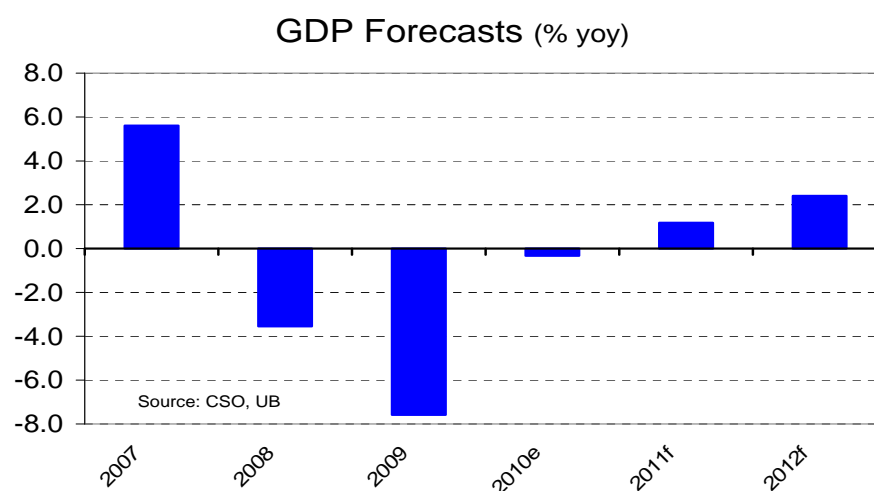


Irish Economic Outlook February 2011

Irish Economic Growth – Down, But Not Out

Recovery process underway, driven by strongest export performance in 10 years

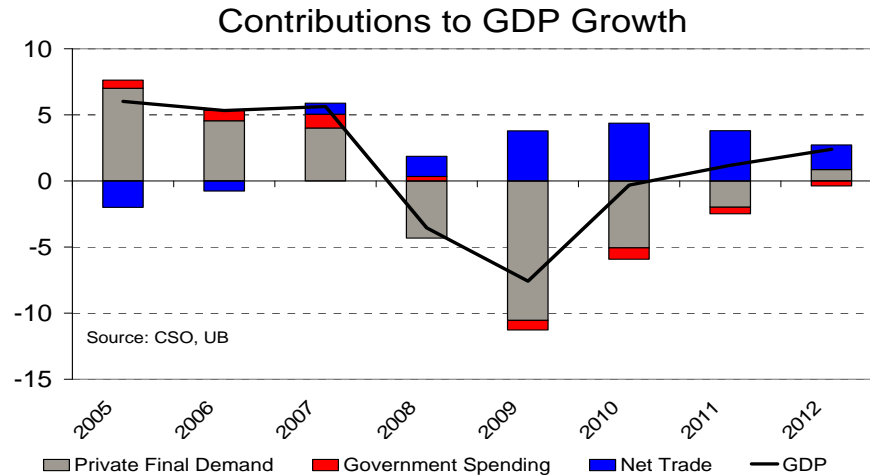
- For a small, extremely open economy like Ireland where exports amount to 90% of GDP, the early phases of cyclical recovery generally tend to stem from an uplift in global economic conditions. That dynamic is clearly playing out in the case of Ireland which is visibly benefiting from an international recovery which is almost two years old.
- Export growth has been an extremely important bright spot in the Irish economic landscape and is estimated to have reached 10% in 2010 – the fastest growth since 2000. Several aspects of this performance offer important encouragement: export gains have been larger than most forecasters had been expecting, are outperforming most other advanced economies, are becoming more broadly-based and are beginning to generate some positive job creation.
- The positive contribution to overall economic growth from the traded sector is coming through in the trends in aggregate measures of the economy's output with both GDP and GNP recording quarterly gains in two of the past three quarters. For 2010 as a whole, it looks like the economy may have contracted very marginally in GDP terms (-0.3%) following the 7.6% collapse in 2009, with the sharp change in trajectory indicating that relative stability returned to the economy last year following the plunge at the height of the recession. GNP continues to under-perform - in part reflecting profit outflows from a buoyant multi-national sector - and is estimated to have fallen by 2.1% last year, albeit a much slower pace of decline vs. the 10.7% nose-dive seen in 2009.



Intensification of the fiscal correction will hamper, but not kill off, recovery momentum

- One key international development from an Irish perspective is the reacceleration in global activity which has emerged in recent months, notably in the US where growth expectations have been revised higher lately helped by recently announced fiscal and monetary stimulus measures. This offers critical support for the Irish economy as we look forward, even if the pace of export growth is set to moderate somewhat this year, as the post-crisis snap back in global trade volumes fades.
- As encouraging as the health of the export sector is, overall prospects for the economy are importantly affected by the ongoing fiscal retrenchment. The required adjustments both for 2011 and for the multi-year period to 2015 have doubled relative to expectations six months ago. This additional fiscal tightening has a major bearing on the outlook for domestic demand, which is set to fall for a fourth consecutive year in 2011 reflecting further weakness in consumer, business & construction and government spending.

- But despite the ongoing declines in these areas, the strength of net trade is such that overall economic growth will record a return to positive territory this year. We expect GDP growth of 1.2% and weaker GNP growth of 0.1%, albeit that these projections are some way weaker than the 2.5-3% estimates that seemed plausible six months ago prior to the resizing of the fiscal correction. Moreover, the absence of a recovery in domestic demand in 2011, despite the expected rise in GDP, means the early stages of this recovery will lack a feel-good factor for most households and domestic-facing businesses.
- While some areas of domestic demand may begin to stabilise later this year, it will be 2012 before business and consumer spending can return to positive, though very modest, rates of expansion on a full-year basis. This expected broadening of the economy's improvement should result in a further moderate pick-up in growth momentum in 2012 when we expect GDP growth of 2.4% (1.6% for GNP).



But sluggish growth prospects mean progress in restoring lost output and employment will be painfully slow

- The expected improvement in the economy's growth dynamic is extremely welcome. However, the recovery scenario that appears likely at this stage needs to be seen in the light of the extremely heavy losses in output and employment experienced over what was an extremely severe recession. In total, real GDP, for example, slumped by over 14% from its peak in Q4 '07 to its low point in Q4 '09. On a base-case scenario of a return to average growth rates of around 2.5% in the coming years, it will take the economy some eight years to merely recover the output lost over the downturn. Interestingly, the US economy – itself experiencing a sub-par recovery - has just reached that particular milestone. It took the US three years (from Q4 '07 to Q4 '10) to see GDP return to its pre-crisis level, highlighting the relative weakness of the Irish recovery dynamic.
- One implication of a sluggish recovery is that it will be difficult to make significant inroads into the unemployment problem. This is especially the case in the early stages of the recovery which are being driven by export growth which is not labour intensive.
- But there are some tentatively encouraging signs on the labour market beginning to emerge. The unemployment rate looks like it peaked below 14% last summer, with the latest Live Register estimate recording some slight declines in recent months to take it to 13.4% in January. There is little doubt that the stabilisation in the jobless rate is linked to ongoing declines in the labour force reflecting both outward migratory flows and greater participation in education. However, we are also beginning to see some early signs of slight improvement on the demand side of the jobs market. Net employment in the multi-national sector rose in 2010, indicating that the export resurgence is starting to generate real-economy impacts, while there has also been a modest uptick in new job vacancies relative to year-ago levels, pointing to the possibility of some slight improvement in employment prospects later in the year.
- But our forecasts envisage that employment will fall again on average in 2011, with a 1.2% drop at least representing an easing in the pace of decline relative to 2010 when it fell by an estimated 4%. The beginnings of a recovery in domestic demand in 2012 should help foster some modest employment gains next year of 0.5%, though this outlook is likely to result in rather modest downward pressure on the unemployment rate which we expect to average 13.2% and 12.6% in 2011 and 2012 respectively, from 13.3% in 2010.

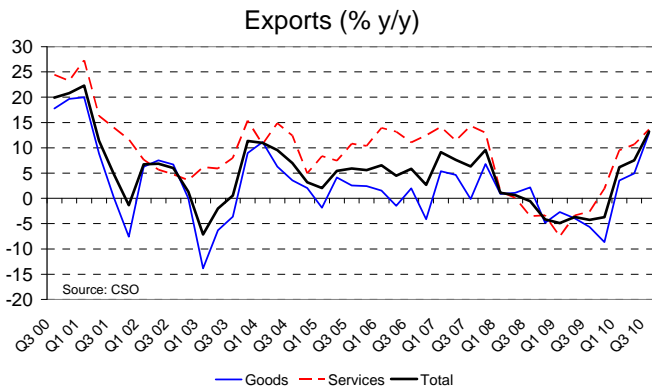
Forecast Overview

	2008	2009	2010E	2011F	2012F
GROWTH					
Consumer Spending (%YOY)	-1.5	-7.0	-1.2	-1.4	1.2
Investment (%YOY)	-14.3	-31.0	-26.7	-10.2	2.4
- Housing	-21.4	-41.0	-36.8	-17.9	2.6
- Other Building & Construction	5.9	-24.3	-29.1	-18.0	-3.0
- Machinery & Equipment	-15.3	-19.3	-12.2	3.0	6.0
Government Spending (%YOY)	2.2	-4.4	-5.1	-3.1	-2.5
Exports (%YOY)	-0.8	-4.1	10.3	6.7	5.2
Imports (%YOY)	-2.9	-9.7	6.3	3.4	4.3
Real GDP (% YOY)	-3.5	-7.6	-0.3	1.2	2.4
Real GNP (% YOY)	-3.5	-10.7	-2.1	0.1	1.6
Housing Completions	51,724	26,420	14,602	10,000	10,000
PRICES					
CPI (% YOY) Average	4.1	-4.5	-1.0	1.9	2.4
HICP (% YOY) Average	3.1	-1.7	-1.6	0.8	1.1
LABOUR MARKET					
Employment (% YOY) Average	-1.1	-8.1	-4.0	-1.2	0.6
Unemployment Rate annual avg.%	6.3	11.8	13.3	13.2	12.6
PUBLIC FINANCE					
General Government Balance (% GDP)*	-7.3	-11.9	-11.6	-9.8	-7.8
EXCHANGE AND INTEREST RATES					
ECB Refi Rate (End of Period)	2.5	1.0	1.0	1.25	2.5
EUR/\$ (End of Period)	1.40	1.43	1.34	1.35	1.30
EUR/£ (End of Period)	0.96	0.89	0.86	0.82	0.79
* as measured on underlying basis (i.e. excluding the costs of injections into banking sector)					

External Environment

Without question the most positive aspect of the Irish economy's performance over the past year has been the strength of the export sector. The most comprehensive account of the sector's performance comes via the quarterly national accounts (QNA) which include estimates of trade in both the goods and services sectors. Monthly external trade numbers are available on a monthly basis, and though they are more timely, they suffer from the drawback that they capture developments in merchandise (goods) trade only i.e. trade in services, which now accounts for some 48% of total export volumes, are not covered. Thus, the latest official estimates of total export performance relate to the third quarter of last year.

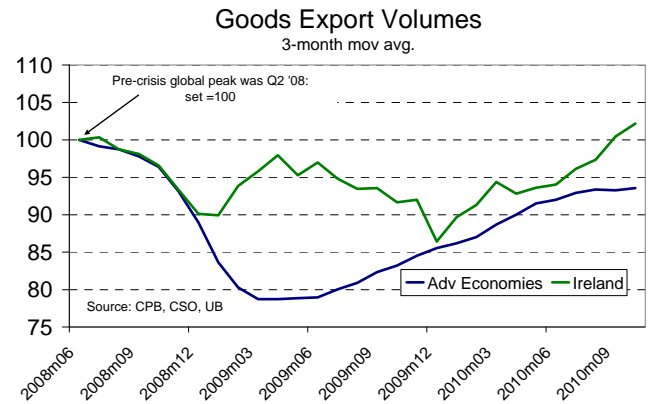
These show total exports growing at an annual pace of 13%. This marks a very impressive acceleration from the 4.2% y/y drop recorded in the third quarter of 2009 reflecting solid gains in each of the three quarters of last year (the average quarterly rise was in excess of 4%).



Being a small, open and flexible economy, Ireland has been well-placed to benefit from the snap back in global trade following the end of the Great Recession in 2009. Thus, the recovery in Ireland's key trading partners, the euro zone, UK and US (which together are the destination for some three quarters of Ireland's exports) has underpinned the turnaround in Irish export performance. While the recovery in the advanced economies has been subdued relative to typical business cycle experience, these economies did nonetheless see a return to positive economic growth last year in annual average terms. US real GDP expanded by 2.9% in 2010 following a 2.6% contraction in 2009, while the UK and euro zone are estimated to have grown by 1.4% and 1.7% last year respectively following output drops of 5.0% and 4.0% in 2009.

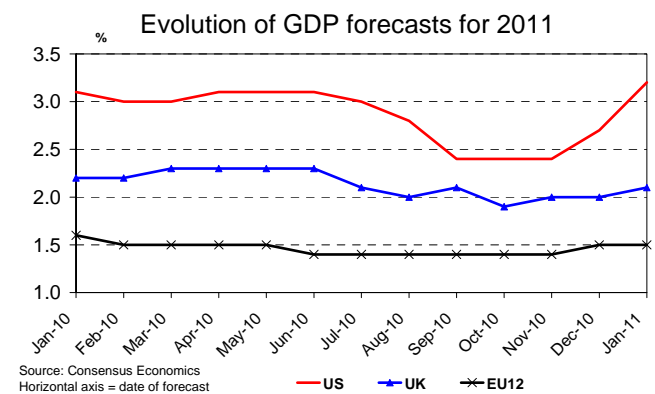
In addition to the extent of the pick-up in Irish export growth, two other dimensions of export performance are worth noting. First, Ireland's export sector is out-performing that in many other advanced economies. For example, annual export growth in Ireland at 13.2% in the year to Q3 compares favourably with the UK (7.5%), euro area (11.3%) and the US (12.7%). Moreover, an examination of the trends in goods exports in Ireland relative to the advanced economies over the course of the downturn reinforces the point. As the graph below indicates, not only did Ireland experience a shallower decline in goods exports (helped by the presence of less cyclical sectors such as pharma and chemicals) during the global recession, its recovery has been notably stronger. In particular, Irish goods export volumes are 2% above their pre-recession peak seen in Q2 2008 while those of the advanced economies in aggregate are still over 6% lower. Thus, while the turnaround in the global trade cycle has been the primary

catalyst for the recent strength of Ireland's export performance, the fact that Irish exports are performing more strongly than other developed economies provides support for the view that export growth is also benefiting from ongoing improvements in Irish competitiveness reflecting the downward adjustment in the domestic price and cost base in the past couple of years.



Second, it is encouraging that the export recovery is looking increasingly broad-based. The Q3 QNA figures show strong volume growth in the goods and services sectors, both of which are rising at a rapid clip of over 12% y/y. Within the goods sector, the latest monthly figures on trade values show that nine of the ten categories of exports on which performance is measured are now showing exports up in the year to October relative to the same period in 2009. Indeed, it is noteworthy that growth in the value of food exports is now outpacing that in chemicals, indicating that the export recovery is now about much more than buoyancy in the multi-national sector.

Overall, it looks as if exports recorded their strongest year since 2000 last year. We estimate growth of over 10% in volume terms in 2010. The adverse weather at the end of the year represents a downside risk to final quarter performance, but we note that October goods export volumes are well up on the average level in Q3, implying healthy momentum early in the quarter.



Looking to 2011, export growth will slow somewhat as the strong early-cycle recovery in global trade recedes somewhat. However, we take a good deal of encouragement from the fact that the global economy reaccelerated late last year, after going through a mid-cycle slowdown last summer. In particular, a strengthening of US activity in recent months, combined with the latest injections of monetary and fiscal stimulus from the US authorities, have resulted in improved prospects for the US economy in 2011. Consensus GDP growth estimates for the coming year in the US now stand at 3.2%, up from 2.4% as recently as November. The recovery in the UK and euro area is

not as well-established but growth is expected to proceed in these economies too, albeit at more moderate rates of around 1.5-2%. The global recovery continues to face some downside risk, not least linked to the evolution of the sovereign debt crisis in the euro area, while higher oil and commodity prices are also an unwelcome headwind, albeit that they partly reflect rising global demand, especially in emerging markets.

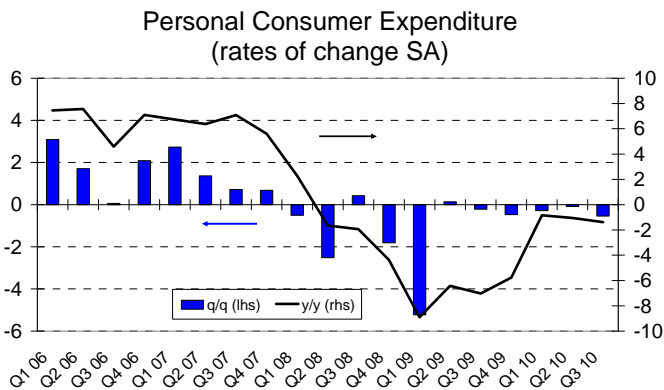
However, the central scenario remains one of continuing gradual recovery in Ireland's key trading partners. On this basis we expect Irish exports to continue to perform relatively well over the forecast horizon, underpinned by gains in competitiveness. Our forecast calls for 6.7% growth in exports in 2011, and 5.2% in 2012.

Import performance is a function of export growth (reflecting the use of imports as inputs into the process of export generation) and that of domestic demand. Thus, the pick-up in exports has resulted in a corresponding acceleration in import dynamics. However, domestic demand is still very weak, and is still falling reflecting declines in consumer, business and government spending. Thus, while import growth is expected to return to positive territory in 2010 (+6.3%, from -9.7% in 2009), the extent of the pick-up lags some way behind that of exports. This delivers a strongly positive contribution to overall GDP growth from external trade in 2010, a pattern which we expect to continue in 2011 based on expected import growth of 3.4%. Net trade boosts GDP growth by nearly 4 percentage points in 2011 on our forecast, thus providing a major support to macroeconomic performance this year. A slight recovery in domestic demand in 2012, combined with modestly slower export growth, generates a smaller, but still positive, contribution from net trade in 2012.

Consumer spending

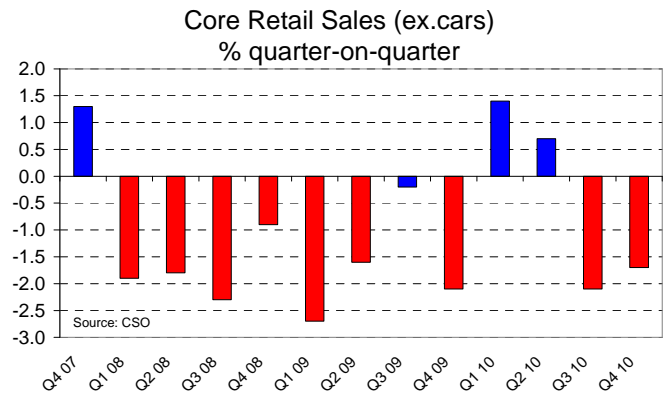
Consumer spending is an extremely important area of the Irish economy. Not only does it make up almost half of total GDP, but it also has an important indirect bearing on other key areas including investment, the labour market and prices.

Having shown some signs of stabilising in the second quarter of last year, consumer spending experienced some renewed weakness in Q3. The Quarterly National Accounts (QNA) showed a quarterly decline of 0.5%, which translated into an annual drop of 1.3%. So while the rate of contraction has eased considerably relative to the declines of 5.2% q/q and 9.1% y/y at the height of the recession in Q1 2009, it is clear that household spending decisions have continued to be constrained by falling disposable incomes and a weak labour market more generally, not to mention the heightened uncertainty and anxiety in the run up to Budget 2011.



Consumer spending can be broken down by goods and services, which make up approximately 45% and 55% of the total, respectively. Both fell in Q3, with services spending down 0.5% from Q2 and goods spending down a slightly larger 0.8%. We know from the retail sales data that goods spending was flattered by the ongoing recovery in car sales in the third quarter, which have continued to be boosted by the Government's scrappage scheme, as well as some underlying recovery from extremely depressed levels. Meanwhile, spending on core goods as proxied by retail sales outside of motors weakened again in Q3, falling by 2.1%, having increased in the previous two quarters.

The retail sales data are useful not only because they show a breakdown across different categories of goods spending, but also because of their relative timeliness – we now have data up to December of last year. Following some signs of stabilisation in October and November, the extreme adverse weather contributed to a weak month for retail sales in December. Total sales volumes fell by some 1.1% from November, the largest monthly drop in 2010 save the motors-related 17% slump in January. On the core retail sales measure, sales volumes fell by a significant 2.5%, the sharpest monthly drop since May 2003. Indeed, with the cold-snap clearly playing a role and consumer confidence taking a hit on account of Budget 2011 and the EU/IMF deal, it wouldn't have been surprising to have seen an even larger fall.

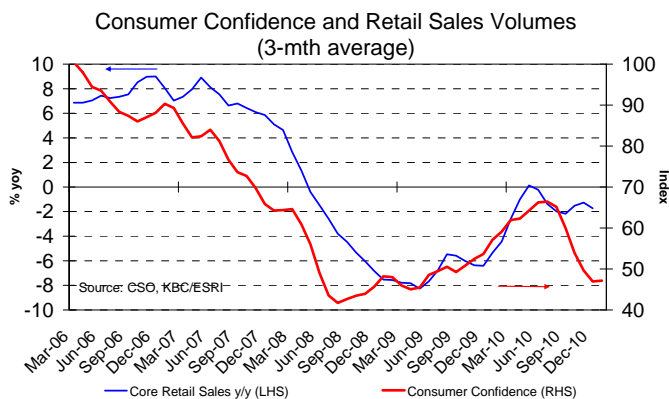


The release of the December retail sales figures provides a steer on spending patterns over the full final quarter of last year. Total sales volumes fell by 0.5% in Q4 relative to Q3, pointing to renewed weakness in the final months of 2010. That worsening momentum was even more evident in core sales which fell by 1.7% q/q in Q4, with eight of twelve non-motors sub-sectors recording falling sales relative to year-earlier levels. While we have no such up to date data on services spending, the breadth of the ongoing declines across many retail categories paints a picture of continued underlying weakness in consumer spending at the end of 2010. This leads us to anticipate another sizable quarterly decline in total consumer spending in Q4, taking the average annual decline to somewhere in the region of 1.2% last year.

In terms of the outlook, early indications do point to a buoyant start to 2011 for car sales, which on some industry estimates are running almost 30% higher than in January 2010. Indeed, the extension of the car scrappage scheme to June of this year is no doubt playing a role here. However, consumer confidence is still very weak. The KBC/ESRI Consumer Confidence measure has been on a downtrend since the middle of last year, with the ongoing weakness of the economy and worse than expected position of the domestic banking system contributing. On the December figures, the headline index hit its lowest level since early 2009 at 44.4, as EU/IMF intervention

became a reality and the Budget 2011 impact on taxes and benefits became evident. And while the latest January figures show some modest improvement in confidence, sentiment in the months ahead is likely to be subdued with the employment situation remaining weak and incomes continuing to fall.

It is against this backdrop that households are likely to continue to engage in high levels of precautionary saving and to pay off debt for most of 2011, so there seems little reason to expect any near-term uplift in underlying spending. However, later in the year we see the employment situation improving slightly and a related improvement in incomes. In terms of the latter, following an estimated decline of over 2% in 2010, we expect a more modest decline this year. Such dynamics should support some modest reduction in precautionary saving, following the jump in the savings rate from zero to in excess of 12% over the 2007-09 period, albeit that it is likely to remain at very elevated levels.



In terms of what this means for consumer spending, a less weak trajectory in employment, wages and confidence more generally as 2011 progresses should translate into a modest improvement in spending by the end of the year. However, given the ongoing weakness we envisage for most of 2011, we anticipate another year of average annual decline in consumer spending this year, of the order of 1.4%. Looking ahead to 2012, further modest employment and income gains are expected, and some further moderation in savings should unleash a greater degree of spending power to households. On this basis, we expect growth of around 1.2%. While still undoubtedly subdued, this would represent the first year of growth in consumer spending since 2007. There are downside risks associated with these forecasts, with the lack of any major improvement in the labour market situation and the prospect of higher interest rates potentially limiting the extent of the recovery in consumer spending.

Investment

According to the latest National Accounts data, the quarterly rate of decline in investment activity accelerated to 18.1% in Q3, the steepest rate of decrease for the current cycle. While undoubtedly weak, this was partly a payback following the upside surprise in Q2, when a rise of 10.5% q/q was observed. The swings here are largely the result of the notoriously volatile machinery and equipment component, which in turn is heavily skewed by aircraft investment. While a seasonally adjusted quarterly breakdown of the investment categories is not available, the fact that annual rate of change in machinery and equipment moved from +3.3% in Q2 to -27.2% in Q3 is indicative of a large drag from this category.

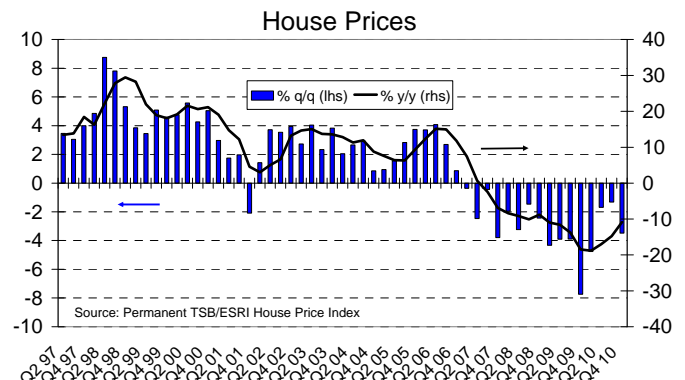
Given the degree of renewed weakness in Q3, it is no surprise that investment remained the main drag on domestic demand,

down over €1 billion or 31% on a year earlier. While housing remained the particular weak-spot, down 34% on last year, this represents a moderation on the 38% annual decline in Q2 and compares with a peak rate of decline of 46% in the second quarter of 2009. And while the rate of decrease in non-residential construction accelerated slightly to fall by a large 31%, trends here have been broadly stable over the course of 2010.

Despite some signs of stabilisation last year, the outlook for investment in 2011 is for continued weakness. Ongoing weakness in the domestic economy, the property supply overhang, further falls in income, subdued confidence and tighter credit will work to keep housing and commercial activity subdued. Meanwhile, civil engineering activity will feel the weight of the cuts to capital spending contained in the National Recovery Plan and Budget 2011. Overall, we are forecasting an annual decline of 10.2% in total investment in 2011. This represents an improvement on the 26.7% rate of decline we expect took place in 2010, helped in part by a less steep fall in housing completions and a modest increase in machinery and equipment. While the declines in housing and commercial activity will likely have bottomed out by next year and a more favourable economic backdrop should contribute to further modest increases in machinery and equipment, the ongoing reductions in government capital spending will limit the gains in total investment activity. On this basis, we are forecasting only modest annual growth of 2.4%.

Housing

By Q4 2010 we had experienced 16 successive quarterly falls in average house prices and a 38% 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 thus far is some way greater. Our guesstimate is that the true fall in prices on average nationally to date is of the order of 45%, and we continue to expect a cumulative drop of 45-50% by the end of the year taking prices back to 2000 levels.

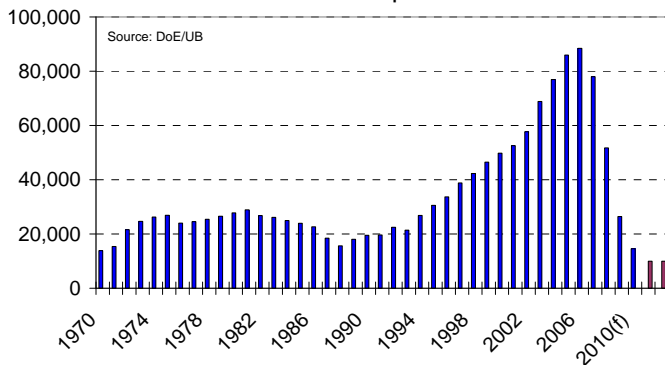


Our house price forecast implies sharp reported falls in the Permanent TSB/ESRI index this year, as the index comes closer into line with reality. Around the turn of the last year we started to see greater signs of a catch-up, with national average prices falling at a quarterly rate of 7.7% in Q4 2009 and by 4.8% in Q1 2010. While the pace of decline moderated notably in the second and third quarters last year, Q4 saw the resumption of steeper price declines of the order of 3.5%.

It is well known at this stage that 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, 14,602 units were recorded as completed in 2010, a reduction of 45% on the 2009 level of 26,420. However,

question marks remain over the reliability of the ESB data in giving a true estimate of actual new homebuilding activity in recent years - it is highly unlikely that almost 15,000 new units were actually completed last year. Timing factors are likely to be playing a role, in that the lack of demand for homes, in addition to the considerable supply overhang, has meant that some houses built in previous years were not connected to the ESB grid until 2010, thus boosting the completions figures (the same likely held true in 2009 also).

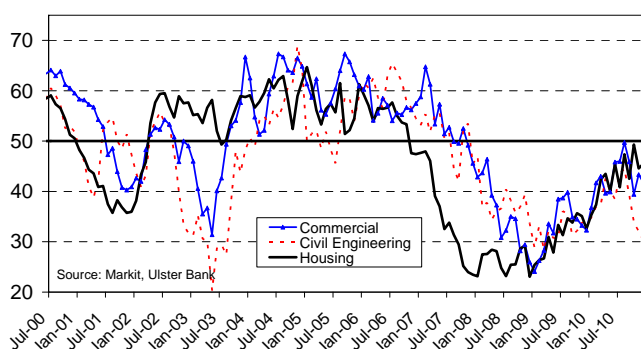
Irish House Completions



As we have pointed out for some time now, housing affordability is much improved reflecting a combination of factors, including significantly lower house prices and the very substantial mortgage interest-rate reductions. However, the demand for new housing is likely to remain muted given the anticipation of lower house prices, further falls in employment and income (not to mention uncertainty about the prospects for both) and tighter credit. An additional factor is that standard variable mortgage interest rates have begun to rise and the ECB may begin raising official interest rates later this year, which will impact on affordability and represent an additional fear-factor for potential homebuyers. On the supply side, new housing starts will not recover until buyers show a greater willingness to transact (there is some anecdotal evidence of this) and the overhang of unsold stock begins to be eroded.

Taking these factors into consideration, in addition to what forward looking indicators of housing activity are suggesting, we anticipate a further fall in completions to 10,000 in 2011. We see the situation stabilising in 2012, albeit with housing activity remaining at extremely low levels historically.

UB Construction PMI



Other Building & Construction

Activity in non-residential construction also remains depressed, with the National Accounts data for the third quarter of the year showing an annual rate of decline of 31%. The timely monthly Construction PMI data for commercial and civil engineering activity, available up to December, serve as a useful indicator of future trends in these sectors. 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. However, the PMI and indeed the IPD data suggest that the pace of decline in commercial activity and values are moderating.

Meanwhile, the need for a huge fiscal retrenchment has resulted in a notable scale back in public investment projects. The PMI data indicates that civil engineering is now the main weak spot in construction sector activity. Indeed, we expect that civil engineering will represent a considerable drag on total investment activity this year and next.

Following an estimated 29% contraction in other building and construction 2010, a further fall of 18% is forecast this year. While stabilisation and perhaps even modest increases in commercial activity in 2012 will contribute to some improvement in the trajectory, government capital spending cuts mean we are expecting another year of decline in other building and construction in 2012 of the order of 3%.

Machinery & Equipment

In the third quarter of last year the rate of decline in machinery and equipment was significant at 27% and represented a major drag on total investment activity. While there is no doubt that underlying activity in this area of investment is continuing to feel the weight of the construction sector slump, the headline numbers are subject to considerable volatility as they are often heavily skewed by timing factors associated with aircraft purchases. This is evidenced by the fact that total machinery and equipment had been up by 3.3% y/y in Q2 as aircraft purchases rose by 16%, while the latter fell back by 62% in Q3 and drove the sharp decline in machinery and equipment and indeed overall investment.

Our forecast of a resumption of modest domestic economic growth this year should see some small gains in machinery and equipment, of somewhere in the region of 3%. With domestic and international conditions expected to show greater signs of improvement in 2012, a slightly higher 6% increase in machinery and equipment is forecast for next year.

Labour Market

The Irish labour market remains fragile, as evidenced by the fact that employment is continuing to fall. The latest official figures are those contained in the third quarter Quarterly National Household Survey release. This data showed renewed downward pressure on employment levels, with the seasonally adjusted numbers experiencing a 23,500 drop in Q3 relative to Q2. This represented an accelerated rate of job-shedding from the 8,700 drop recorded for Q2 and in fact was the weakest quarter for jobs growth since the same quarter in 2009.

Further adding to the poor tone of the numbers was that the weakness was broad-based, with ten out of fourteen categories recording falling employment levels on the quarter. Significant weakness was evident in construction, which saw a further decline of 11,600. This takes the cumulative job losses in that sector to 157,600, as the level of employment has now plunged to 113,800 from 271,400 at its peak just over three years ago. In percentage terms, this represents a decline of 52% as employment in the economy's weakest sector has collapsed to levels last seen some thirteen years ago. There were also declines of about 3,500 in each of the Financial, Insurance & Real Estate and Professional, Scientific & Technical activities categories.

On a slightly more positive note, there was a second consecutive quarterly increase in Agriculture, Forestry and Fishing, consistent with other signs of improvement in the Agri

sector generally, while there were also some very small increases in the Transport and IT sectors. The figures point to a 6,800 increase in jobs in education in Q3, though the CSO cautioned that this estimate may not be fully reliable for statistical reasons.

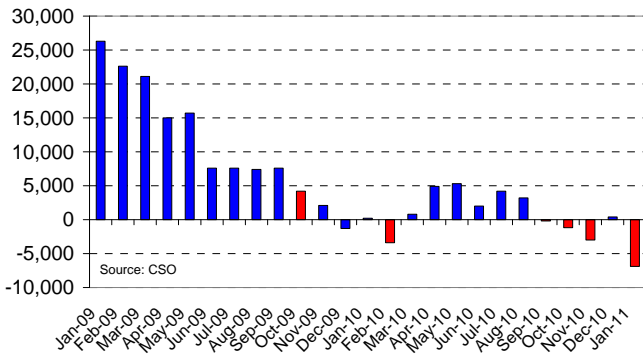
In terms of the unemployment situation, the Q3 QNHS data confirmed the weakness signalled by the more timely monthly Live Register (LR) figures. The numbers unemployed rose by 3,800 between Q2 and Q3. While this represented a moderation on the 7,200 rise in Q2, it translated into an increase in the unemployment rate from 13.2% to 13.6% - a new high for the cycle. Indeed, it is important to point out that were it not for the significant 16,600 fall in the labour force in Q3, the upward pressure on the jobless rate would have been greater (given that the employment situation continued to deteriorate).

There continues to be two main factors explaining the shrinking labour force. Firstly, there is an ongoing decline in participation rates, which is partly related to higher levels of participation in education. The overall participation rate fell to 60.6% in Q1 from 61.9% a year earlier, 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, with the CSO estimating indicatively that 40,900 Non-Irish nationals aged 15 and over left the country in the year to Q3.

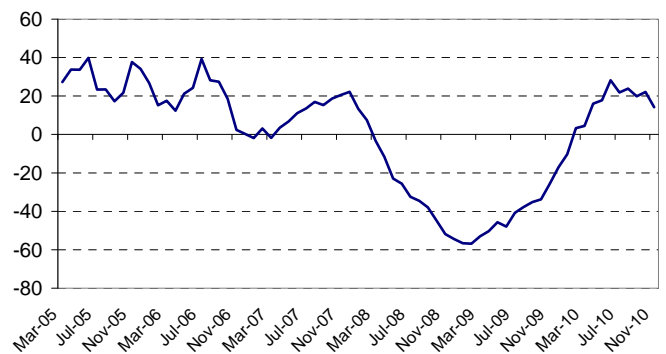
last year. So we would expect to see some stabilisation in the Q4 QNHS figures. Nevertheless, for 2010 as a whole the unemployment rate likely averaged around 13.3%, marking the weakest year for the Irish labour market since 1994.

In terms of the outlook for the year ahead, early indicators do suggest that the trajectory is continuing to move in the right direction. Indeed, the LR figures do suggest that the jobless rate may now have passed its peak point of this cycle, with the rate falling back to 13.4% in January having held steady at between 13.5-13.6% for all of the second half of last year. There is little doubt that the stabilisation in the jobless rate is linked to ongoing declines in the labour force reflecting both outward migratory flows and greater participation in education. However, we are also beginning to see some early signs of slight improvement on the demand side of the jobs market. Net full-time employment in the multi-national sector rose by 1,350, or by 1.1%, in 2010, indicating that the export resurgence is starting to generate real-economy impacts, while there has also been a modest uptick in new job vacancies relative to year-ago levels, pointing to the possibility of some slight improvement in employment prospects later in the year. Furthermore, a range of other labour market indicators including redundancies (which were 26% lower than year-ago levels in January) and the employment index of the manufacturing PMI (which is in modest expansionary territory) are also suggesting the jobs market may finally be stabilising.

Monthly Additions to the Live Register



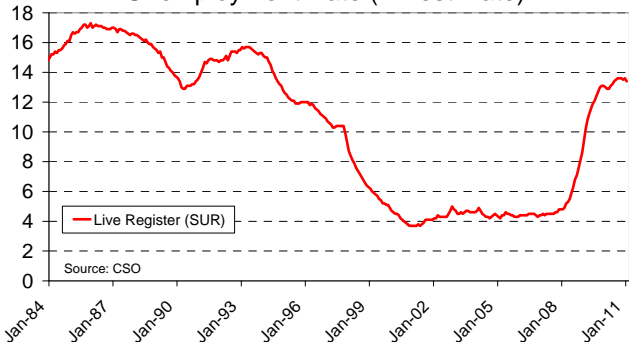
Job Market Vacancies (FAS), y/y % 3ma



While the QNHS measure of the unemployment rate is the official one, the LR data serve as a more timely guide on the labour market. The December data pointed to a soft end to a very weak year for the Irish labour market, with the number of claimants rising by 400 on a seasonally adjusted basis compared with November. The slight deterioration here marked a departure from the improvements which had been recorded in prior months, as the number of claimants had fallen in each month over the September to November period. Encouragingly, on the latest January data the general pattern of improvement evident towards the latter part of last year resumed, with claimants falling by a significant 6,900.

That's not to say that we anticipate any major recovery in employment growth in coming quarters. As we have highlighted previously the export-led nature of the recovery we expect is not likely to lead to the creation of a significant number of new jobs, given the non-labour intensive nature of the sector. In terms of other sectors, employment in the construction sector will likely continue to decline in coming quarters, in part related to the further fall in housing completions we envisage. Furthermore, the change in structure in the banking system will likely to lead to losses in the Financial, Insurance & Real Estate category and a continuation of subdued consumer spending will hinder any improvement in employment in Wholesale and Retail. In terms of the public sector, we know from the National Recovery Plan that an employment ceilings reduction of the order of 6,900 in 2011 and 2,200 in 2012 will lead to redundancies here.

Unemployment Rate (LR estimate)



Overall, while the economy is expected to grow by 1.2% in GDP terms this year, we are factoring in another decline in employment of 1.2% in 2011. This forecast assumes some small quarterly gains in employment later in the year, which we expect will continue over the course of 2012. However, the subdued nature of the pick-up in employment we expect is evident in our modest 0.6% average growth forecast for 2012.

The LR release also contains an estimate of the unemployment rate, which showed a steady rate of 13.6% in the final quarter of

In terms of the implications for the unemployment rate, in keeping with recent trends we expect some further modest downward pressure over the course of the year taking the rate to 13.0% in the final quarter. Such a trajectory would leave the

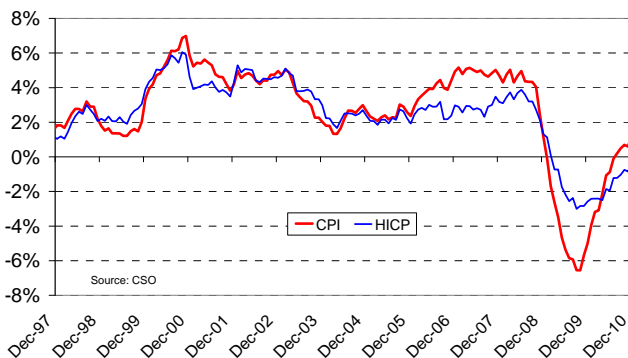
average rate at a still elevated 13.2% on average in 2011. It is important to point out that the slight nudge down the unemployment rate we expect this year is the result of ongoing declines in the labour force as emigration continues, as opposed to any notable pick-up in labour demand. For 2012, we are forecasting the unemployment rate will edge down by a slightly greater degree, to 12.6% on average. While labour force dynamics will continue to play some role, as the economic recovery strengthens this should allow for greater signs of improvement in labour demand.

Inflation

2010 saw the second consecutive year of deflation in the Irish economy, as the Consumer Price Index fell by 1% on average last year, following on from the 4.5% drop recorded in 2009.

That the rate of price decline in the average annual measure eased so considerably is a clear indication of the reduction in the degree of downward pressure on the CPI which took hold over the course of last year. In fact, the low point of the inflation cycle was in October 2009 when prices were falling at a y/y pace of 6.6%. Since then there has been a notable change in CPI inflation dynamics which has resulted in fourteen consecutive months of acceleration, leaving the annual rate at a two-year high of 1.3% in December of last year – a dramatic turnaround from the -5% level recorded a year earlier.

CPI and HICP Annual Rates



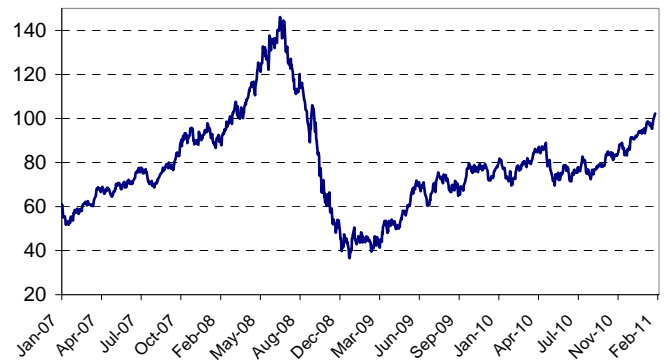
Higher mortgage costs have played a major role here. A 24.4% recorded rise in mortgage interest payments over the past year has boosted the CPI by 1.2 percentage points, thus accounting for nearly all of the rise in the aggregate price level over the past twelve months. Mortgage costs are estimated in the CPI via a calculation involving the standard variable rates (SVR) offered by lenders, and these have risen by some 0.7% on average over the past year as mortgage providers have sought to align lending rates with higher bank funding costs.

However, the acceleration in inflation over the past year goes beyond the trend in non-mortgage prices. The CPI ex-mortgage interest has steadily moved off its cycle low of -2.4% in October 2009 to stand at +0.2% in December – its first positive reading since early 2009. Similarly, the European Harmonised measure, HICP, which differs from the CPI in a number of respects the most important of which is its exclusion of mortgage interest, has also seen a marked change in trajectory. It stood at -0.2% in December, up from the cycle low of -3% seen in September 2009.

Developments in a number of areas have been noteworthy in this respect. Upward pressure on energy and other commodity prices at the global level is manifesting itself for example. Brent crude oil prices have jumped to over \$100pb at present from \$72 per barrel in late August. The Economist's global food

commodity price index was 37% higher than year ago levels in late January following a 45% surge since the middle of last year which has taken it to new record highs. The strengthening economic expansion in emerging markets where generalised inflation pressures are now building is a source of upward pressure in both cases, while additional idiosyncratic factors are also at play (political unrest in the Middle East in the case of oil, and weather-related supply disruptions in the case of some foodstuffs including wheat).

Brent Oil Price, \$ pb



Reflecting the above developments, the annual rates of change in the Food & Beverage and Energy price components of the Irish CPI were at -8.1% and +2.4% respectively in December 2009, but had shifted to +0.1% and +13.7% respectively by December 2010. There has also been a shift in trajectory in clothing and footwear prices which, though still falling, are doing so at a much reduced pace of 4.1% compared with the double digit declines recorded earlier in the year. Some decline in the euro's value against sterling is probably a contributory factor here, as the single currency softened in Q2 of last year in the aftermath of the Greek public finance crisis.

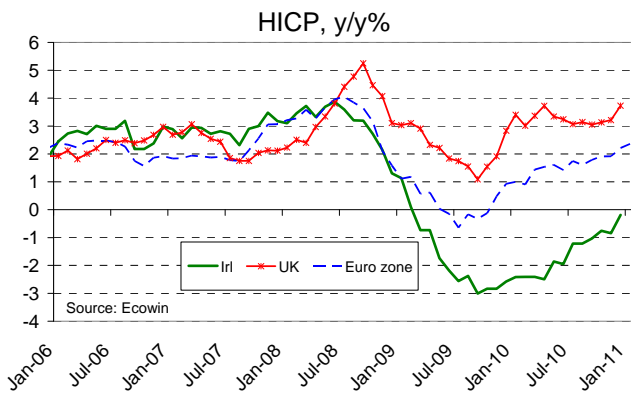
Despite these, largely external, sources of upward pressure on Irish inflation it is both interesting and significant that the annual rate of change in core services prices is not showing any upward drift. This is a category that strips out energy supply and mortgage payments and thus captures price developments in the largely non-traded sectors of the economy and should therefore act as a guide as to underlying price pressures. Inflation here remains very subdued at -0.3% with little sign of upward momentum – a reflection of a very weak labour market and low levels of consumer demand.

Looking ahead, the mortgage interest rate component is likely to remain a source of upward pressure on the CPI. The ECB looks likely to begin a process of normalising its interest rate stance later this year (we pencil in the first hike in December, though there is a risk of an earlier move). Moreover, independent of ECB rate changes, SVRs are likely to rise further in the period ahead reflecting the ongoing strains in bank funding markets. There will also be some upward pressure stemming from indirect tax changes in the recent Budget as well as from recently announced large increases in medical insurance. The latest large increases in energy and agricultural commodity prices, if sustained, are likely to be felt in incoming price readings also. But against this, the backdrop for consumer demand remains weak and should ensure that domestically-generated inflation will remain very muted. Overall, we expect CPI inflation to average 1.9% this year, and 2.4% in 2012. For the HICP, we are pencilling in 0.8% in 2011 and 1.1% in 2012, with the more subdued outlook relative to the CPI reflecting the exclusion of mortgage interest costs.

While these projections anticipate an end to the fall in the Irish price level and a return to positive HICP inflation rates, it is worth highlighting that this is still an outlook consistent with

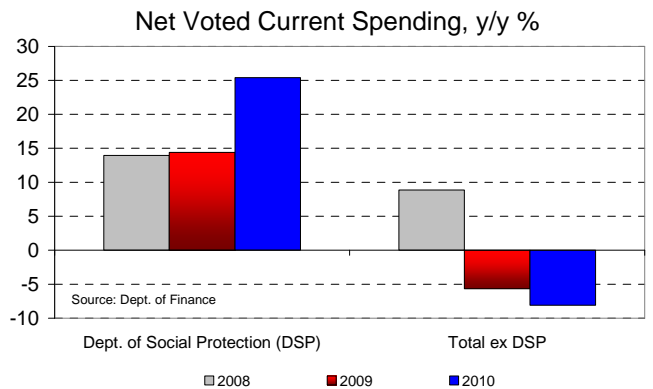
declining *relative* prices in Ireland. HICP inflation in the UK is expected to be at 3.6% and 1.9% this year and next respectively while the equivalent estimates for the euro area are 1.9% and 1.9%, implying that Ireland is likely to make further progress in restoring its competitiveness in the coming two years.

There are risks in both directions to the Irish inflation outlook. Current futures pricing points to a levelling off in wholesale energy prices around current levels. However, momentum in these and other commodity markets looks strong which could result in additional upside in the coming months against the backdrop of strong demand from buoyant emerging market economies. Any major declines in the euro's value on the currency markets would also exert some additional upward pressure on prices of imported consumer goods. Meanwhile in the other direction, weakness in domestic labour markets and household income and spending could intensify further which could add to downward price pressure on the underlying price level.



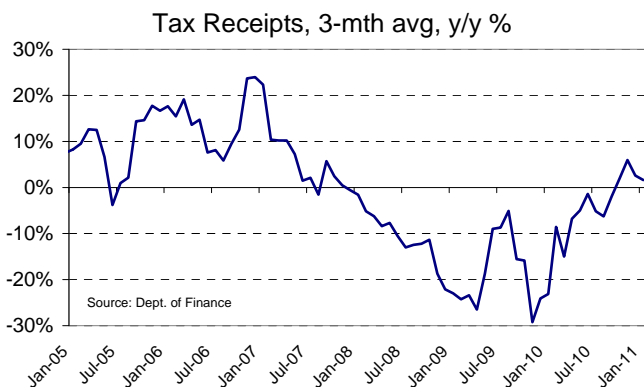
at the height of the recession. Receipts in the final quarter of last year were up 2.6% relative to the same quarter in 2009. Corporation taxes have been an area of particular buoyancy reflecting the strength of the multi-national dominated export sector, while excise duties were also ahead of plan. Income tax receipts, however, remain a source of relative weakness, consistent with poor labour market dynamics.

On the expenditure side, total spending last year by government departments was down 1.5% on 2009 levels in cash terms following a marginal overshoot of just 0.3% relative to the expected outturn. The decline was led by ongoing large adjustments on capital spending which was down 14% from 2009 while day-to-day spending rose very slightly (by 0.6%). The aggregate numbers on current spending mask some important divergences. In particular, spending by the Department of Social Protection (DSP) on welfare payments etc is a major source of upward pressure, and rose by over 25% last year. In contrast, spending outside of the DSP declined by over 8% last year. This builds on the 5.7% fall in 2009 and provides important evidence of broad-based restraint in non-welfare departmental spending.



Public Finances

2010 Exchequer returns data provide important confirmation that the underlying fiscal position has stabilised. For the year as a whole, the State ran an exchequer deficit of €18.75 billion, in line with the forecast produced at the time of the December 2009 Budget. The achievement of this headline deficit target reflects important progress on both the spending and revenue sides of the government accounts.



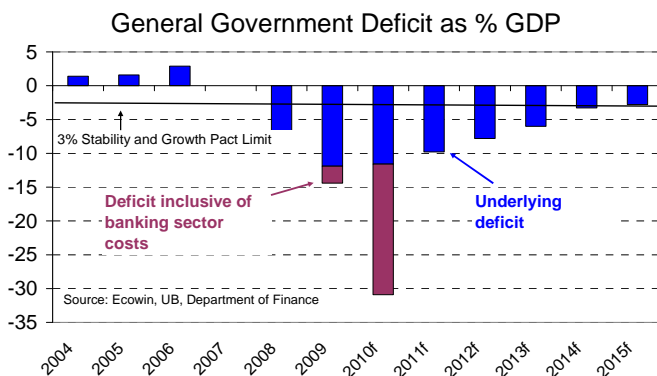
Tax receipts were better than expected in the final five months of the year, with the performance for the year as a whole delivering an upside surprise of over €700 million, or 2.3% relative to the annual target. Not only were tax revenues better than expected, but the outright trends are now showing clear signs of improvement. The total tax take is now rising in year-on-year terms, reversing the pattern of significant declines seen

Separate to the trends in standard receipts and outlays, the public finance position last year was seriously affected by costs associated with supporting the banking system. Such costs impacted the General Government (GG) Balance measure of the budget deficit – the standard measure used for EU purposes - to the tune of some €31 billion. This reflects the up-front capital support provided in the form of Promissory Notes to several institutions, albeit that the related financing will be spread over a period of 10 to 15 years and there was no additional cash borrowing associated with this support in 2010. The accounting treatment of this support, however, had the effect of causing a surge in Ireland's estimated GG deficit which is estimated at 31.5% for last year, up from 14.4% in 2009. However, these figures mask an important stabilisation in the underlying GG deficit which is estimated at 11.6% in 2010, down a touch on the 11.9% recorded in 2009.

Looking forward, the National Recovery Plan sets out the Irish fiscal strategy for the coming years, and the targets therein make up a key element of the Memorandum of Understanding (MoU) between the Irish authorities and the EU/IMF as part of the support package put in place late last year. The Plan builds on the significant corrective action already taken – action which has seen measures totalling approximately €15bn implemented in the two and a half year period from mid-2008. The Plan proposes a further €15 billion adjustment in 2011-14 designed to return the deficit to below 3% by 2014. Two noteworthy features of the Plan are the degree of front-loading (€6 billion of adjustments, 40% of the total, are to be implemented this year in a demonstration of the government's commitment to making significant early progress) and the tax and spending mix, with

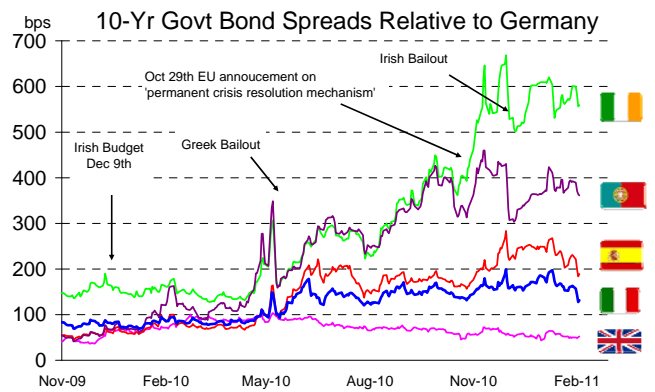
expenditure measures accounting for two-thirds of the total adjustment.

The €6 billion of measures in Budget 2011 will contribute to a further improvement in the underlying budget deficit situation this year. However, we note that our forecasts for some of the key macro aggregates including GDP, consumer spending and employment are lower than those on which the Budget arithmetic was based. For example, we expect consumer spending to fall by 1.4% this year vs. the Budget projection of flat and we anticipate a 1.2% decline in employment vs. a fall of 0.2% as per the Budget. This implies that the size of the tax base may be somewhat smaller than anticipated, which may result in lower-than-expected inflows of tax receipts. January exchequer returns showed tax receipts were up 1.9% on year-ago levels, though it will take a few more months of data to reveal the extent, if any, of the shortfall which may be emerging. Our expectation is that the GG deficit is likely to fall to 9.8% this year, which although not as low as the official projection of 9.4% would still represent an important milestone in that it would herald a return to single-digit territory.



The extant plan is for a further €3.6bn package of adjustments for 2012. However, it is virtually certain that there will be a change in government in the coming weeks which introduces some uncertainty about fiscal strategy beyond this year. It will be important for the new government to quickly provide clarity on two important areas: first, that it is committed to a deficit reduction strategy that gets / keeps the deficit on a sharply improving trajectory with a view to getting it down to 3% by 2015 (the Commission have already granted Ireland an extension from the original 2014 deadline, reflecting some downside risks in the growth outlook); and second, that it sets out the detail of the composition of measures that will make up such a strategy to eliminate as quickly as possible uncertainty households and businesses have about future policy changes that may impact on them. Work by the IMF and OECD tends to emphasise a preference for weighting large budgetary adjustments towards spending reductions rather than tax increases, so that excessive tax hikes don't jeopardise economic recovery. At this stage, we are pencilling in another fall in the deficit for next year, to 7.8% of GDP.

Despite the encouraging signs of a stabilisation in the underlying public finances, strains in the market for Irish sovereign debt remain very high. Spreads relative to Germany on Irish 10-year bonds soared late last year, rising from 3.6% in mid-October to record EMU highs of around 6.7% in November and have averaged 5.7% in the past two months. These developments have reflected concerns about growth prospects and an intensification of market anxiety about the health of the banking system, and the potential implications of further losses for the indebtedness of the state. The need to address such concerns is a very prominent priority in the EU/IMF programme which sets out the need for a "fundamental downsizing, restructuring and reorganisation of the banking sector".



Of the €85bn total external assistance package (which includes a domestic resources element of €17.5bn), €35bn is directed towards the banking sector of which €10bn is to be used for immediate recapitalisation. This includes a direct capital injection to help raise bank core tier 1 capital ratios to in excess of 12%, with a new higher minimum level of 10.5% to now also apply. The remaining €25bn of banking sector support is provided on a contingency basis, available for drawdown if needed. Critical in determining the need if any to drawdown on that contingency fund will be the forthcoming round of stress tests to be undertaken next month by the Central Bank, in conjunction with the EU authorities and the IMF. If these show capital levels falling below the new standards, then further capital injections will occur. Official forecasts anticipate a peak level of gross government debt of around 103% in 2013, up from an estimated 95% in 2009 and 66% in 2009, but the debt profile could end up resulting in a peak in excess of 120% (as per recent conservative projections from the IMF) depending on the need for additional support for the banks.

A greater degree of rigour and transparency has been promised for this assessment, and a robust process, along with publication of detailed results, should provide badly-needed clarity on the size of any potential future liability for the sovereign.

Also of interest in the weeks and months ahead will be any concrete progress in refining the policy response of the EU authorities to the sovereign debt crisis across the euro area more broadly. There have been some encouraging signs lately that policy-makers may be becoming somewhat more flexible in their thinking and application in this area. Initiatives such as expanding the European Financial Stability Facility (EFSF) and making it more adaptable (to possibly include the purchase of government debt) would be steps in the right direction and may contribute to some easing of tensions in periphery debt markets generally, while any move in the direction of lowering the interest rate attached to such support would also help improve perceptions of debt sustainability for highly indebted countries such as Ireland.

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