DKM
ECONOMIC
CONSULTANTS

Economy Watch

Snapshot of Irish Economic Forecasts

Vol. 2 Summer 2008

Brendan Dowling
Chairman DKM

"THERE AIN'T NO CURE... YET"

In our last *Economy Watch* we suggested that the 2008 growth forecasts were likely to be revised downwards. And so it has proved with an average reduction of a full percentage point.

By the time of our next issue, the focus will be on 2009, where we suspect there will again be downward revisions. The deflationary impact of $140 oil has not yet been factored into the forecasts. There has been a massive shift in the terms of trade in favour of producers of oil and other commodities. Paradoxically, if the ECB and the Fed are successful in curbing inflation, it will not be possible to pass price increases back to the oil-exporters through traded non-oil goods. The adjustment will instead take place through increased volumes, which will be slower and bumpier.

On the domestic front, the collapse of house construction is likely to be compounded by a reduction in private commercial investment due to softening demand, higher interest rates and far tighter credit conditions. There are worrying signs that, in spite of a low public debt to GNP ratio, the Government is looking to cut back on capital spending. Such a pro-cyclical policy would make Irish economic growth reliant on a sharp upturn in the external environment. In present circumstances this looks like a pipe-dream.

Creative measures to improve domestic demand may be required if the economy is to avoid an even slower pace of economic growth in 2009 than is currently envisaged.

- 1 percentage point shaved off 2008 GNP growth forecast
- Consumer spending growth to halve this year
- Investment decline accelerates
- High global commodity prices fuelling inflation
- Unemployment to rise to 5.8% in 2008
- Sharp increase forecast in 2008 budget deficit

In this issue:

At a Glance

Summary of Forecasts*	2007	2008	2009
	%	%	%
GNP	4.5	1.6	2.8
GDP	5.3	1.8	3.0
Unemployment Rate	4.5	5.8	6.2
Employment Growth	3.6	0.8	0.9
Wage Inflation	4.9	4.3	3.8
CPI Inflation	4.9	3.7	2.3
HICP Inflation	2.8	3.1	2.2
Private Consumption	5.4	2.7	2.8
Public Expenditure	6.7	4.1	3.0
Investment	0.2	-9.7	-0.9
Exports	8.2	5.5	4.9
Imports	6.4	3.1	3.7
Budget Balance	0.5	-1.8	-2.1

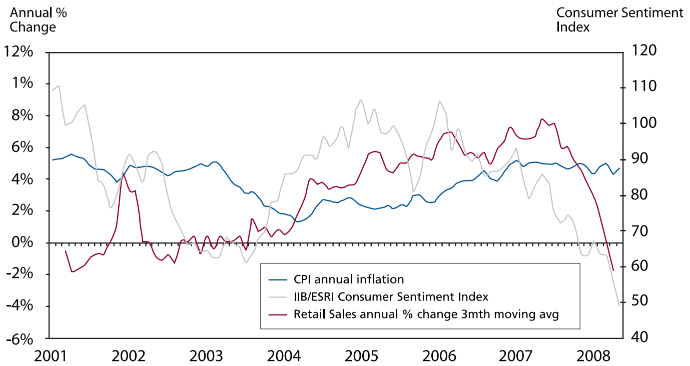
*Figures represent forecast averages, see note on back page

DOMESTIC PERFORMANCE

Snapshot of Irish Economic Forecasts

	GNP		GDP		Unemployment Rate*		Employment Growth		Wage Inflation		CPI Inflation		HICP Inflation	
	2008	2009	2008	2009	2008	2009	2008	2009	2008	2009	2008	2009	2008	2009
AIB	2.0	3.1	2.2	3.2	5.7	6.3	1.0	1.0	4.5	4.0	3.9	2.5	3.2	2.4
BOI	3.0	4.0	3.0	4.0	5.5	5.5	1.9		4.7		3.6		3.0	
Central Bank	1.9	3.2	2.4	3.6	5.9	6.0	0.5	1.6	4.2	4.0	3.2	1.6	2.9	2.2
Davy	1.0	2.0	1.7	2.6	6.1	7.0	0.8	0.0	4.0	3.8	4.1	1.8	3.3	1.7
Dept. Finance	2.8	3.3	3.0	3.5	5.6	5.6	1.1	1.3					2.4	2.0
ESRI	1.6	3.0	1.8	3.1	6.0	6.2	0.0	1.1	4.0	3.5	3.4	2.2	2.9	2.5
EU			2.3	3.2	5.6	5.8	0.7	1.6	4.9	3.5			3.3	2.4
Goodbody	0.8	2.0	1.1	2.0	6.6	6.6	0.5	0.2	4.3	3.9	4.0	2.5		
IBEC	0.5	2.1	0.6	2.4	5.7	6.5	0.4	0.8			4.0	2.7	3.4	2.5
IMF			1.8	3.0	5.3	5.0					3.2	2.1		
NIB	2.9	4.0	2.9	4.0	6.0	6.5	1.0	2.0	4.5	4.0	3.2	2.3	2.5	2.0
OECD			1.5	3.3	5.7	6.5	1.3	0.8	3.7	3.6			3.4	2.1
Ulster Bank	0.5	2.0	0.5	2.2	5.7	6.5	0.5	-0.4			4.4	2.8	3.5	2.5
Average	**1.6**	**2.8**	**1.8**	**3.0**	**5.8**	**6.2**	**0.8**	**0.9**	**4.3**	**3.8**	**3.7**	**2.3**	**3.1**	**2.2**

Retail Sales, Consumer Sentiment and Inflation



Source: CSO, IIB/ESRI

Short-term forecasts less optimistic

The *DKM Snapshot* has trimmed a full percentage point off Irish GNP growth forecasts for 2008 since our Spring release. At 1.6%, this weighted average is buoyed up by three projections of around 3% growth. The biggest changes are to the investment and private consumption figures, reflecting the wider impact of the slowdown in residential construction.

...reflected in weak consumer sentiment

Consumer spending growth is now expected to halve this year to 2.7%. High inflation, rising unemployment and tighter lending conditions have combined to dampen spending.

CPI inflation increased to 4.7% in May, driven by higher food (+8%) and fuel (+9.2%) prices, and mortgage repayments (+16.9%). Given that we are now halfway through the year, the *DKM Snapshot* of 3.7% inflation may be too optimistic. Our *Focus on the External Environment* looks at the underlying global factors driving Irish inflation.

Negative global economic headlines and declining house prices are leaving consumers feeling distinctly gloomy. The *IIB/ESRI Consumer Sentiment Index* hit new lows in May, while retail sales fell 3.2% yoy in April.

Government finances feel the strain

Exchequer Revenues for the first 5 months of the year are already 6.4% (€1.2 billion) behind target, 8% lower than in the same period last year. The shortfall was mainly attributable to poor VAT returns, a direct result of the consumer slowdown, while Capital Gains Tax and Stamp Duties combined were 43% lower than last year. Surprisingly, the only revenue heading to hold up this year so far is income tax receipts.

The *DKM Snapshot* shows a government deficit of 1.8% of GDP this year. However, the downside risks have led the IMF to forecast a 3.2% budget deficit, with IBEC and Davy also predicting Ireland may nudge the 3% EU limit.

...as housebuilding tumbles

Construction prospects in 2008 continue to be dominated by new residential construction. The level of unsold stock remains high while we are experiencing downward spirals in house prices (10.5% off their Jan'07 peak in May'08), housing supply (down 27.5% in first four months), mortgage lending (transactions down 23% in value terms in year to March'08) and consumer sentiment.

Housing registrations, a leading indicator of housing starts, show a downward trend since Sept'06, with annual registrations (incl. one-offs) down 60% by end May.

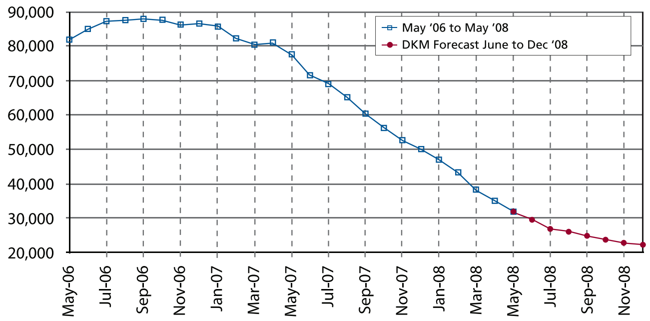
As a result the rate of house-building is expected to tumble from 21 units per 1,000 of the population in 2006 to just 10 units in 2008, although we will still be ahead of the average of 5 units across Western Europe. Allowing for time lags and an estimate for public

Private Consumption		Public Expenditure		Investment		Exports		Imports		General Gov Balance**		
2008	2009	2008	2009	2008	2009	2008	2009	2008	2009	2008	2009	
3.5	3.5	4.0	2.2	-10.5	-3.5	5.3	5.0	2.7	3.5	-1.5	-2.0	AIB
4.0	4.5	5.0	3.0	-3.9	3.0	5.0	5.0	3.8	5.0	-1.4		BOI
3.4	3.0	3.6	2.8	-7.5	1.2	5.6	5.9	3.9	4.6	-0.9	-1.1	Central Bank
1.0	2.0	4.5	3.0	-13.4	-9.2	6.0	6.0	1.7	2.8	-2.7	-3.3	Davy
3.8	3.9	3.6	2.9	-1.6	2.3	5.6	5.2	4.5	4.3	-0.9	-1.1	Dept. Finance
3.0	3.3	4.0	3.5	-7.4	0.0	5.4	5.7	4.0	5.3	-1.2	-2.0	ESRI
2.9	3.2	3.5	1.6	-7.4	2.5	5.4	4.9	3.3	4.5	-1.4	-1.7	EU
1.6	2.0	4.5	4.0	-10.3	-4.4	5.5	4.0	3.0	2.5	-2.1	-2.2	Goodbody
1.8	2.0	4.5	3.0	-15.3	-4.8	5.5	4.8	2.0	3.0	-2.5	-2.7	IBEC
										-3.2	-2.9	IMF
3.7	4.0	4.0	3.3	-5.7	2.0	6.4	5.0	3.9	3.7			NIB
3.0	2.6	4.3	3.6	-9.2	1.5	5.0	3.8	3.4	2.9	-1.3	-2.6	OECD
2.0	1.5	4.0	2.8	-15.7	2.1	5.5	4.5	2.5	4.5	-2.0	-2.3	Ulster Bank
2.7	2.8	4.1	3.0	-9.7	-0.9	5.5	4.9	3.1	3.7	-1.8	-2.1	Average

* year average;
**as a % of GDP

sector completions, the total number of units built this year is forecast at 43,000, falling further to 28,000 in 2009. This implies that new residential investment will drop to an estimated 5% of GNP this year from a peak of 13.5% in 2006, with obvious implications for GNP growth. These numbers make the fixed investment forecasts in the *DKM Snapshot* appear optimistic.

Housing Registrations*
(twelve month running total)



* Adjusted to include one-off housing; excludes public sector units.

Construction – public sector the future driver?

Notwithstanding recent record levels of non-residential building supply, the economic slowdown is likely to weaken demand for private non-residential building activity. It is thus possible that the public sector could be the key driver of construction over the medium term. With a public capital programme in the order of €13.7 billion this year, this level of investment could make a substantial contribution to sustaining activity in the construction sector. Recent noises from government regarding possible retrenchment of the NDP are worrying in this regard. However, we would acknowledge the requirement that all public investment projects be critically assessed for value for money.

Other indicators mixed

Live Register figures for May showed the number of people claiming at its highest level in almost a decade. Females accounted for 45% of new claimants in May, indicating that job losses have spread beyond the construction sector. The *DKM Snapshot* suggests the unemployment rate will reach 5.8% this year (up from 4.5% in 2007).

The *NCB Purchasing Managers Services* index showed a contraction of the services sector for the third month in a row in April, as the knock-on effects of the housing downturn begin to show up in banking and other related services.

The 'modern' (high-tech and chemical) manufacturing sector continued to perform well into 2008, with annual output up 4.5% in Q1, while 'traditional' manufacturing output fell by 1.9%. Irish industrial orders were up 5.2% yoy in March.

The *DKM Snapshot* shows export growth continuing strong at 5.5% in 2008, despite the deteriorating international environment and stronger Euro.

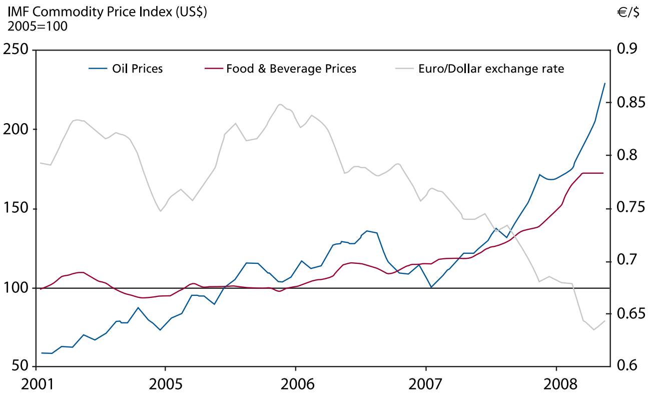
Medium-term recovery predicted

While the short-term forecasts have deteriorated significantly since the last *Economy Watch*,the medium-term outlook remains more positive. The recent ESRI Medium Term Review projects potential per annum growth of 3.75% out to 2015, based on expected productivity and labour force growth – concurring with the Davy's Research Report of February 2008.

FOCUS ON THE EXTERNAL ENVIRONMENT

Commodity price shocks are a risk to short-term stability and, while underlying growth prospects may be strong, the end is not yet in sight. Managing inflation during a global downturn is an important challenge for central bankers

Commodity Prices and Exchange Rates



Source: IMF, European Central Bank

Oil price shock continues

Oil prices continue to hit record highs – as of 17 June '08, prices were almost 160% higher than the low of January '07 (117% higher in Euro terms).

Right now, demand and supply in oil markets are very tight, such that any minor shock – e.g. from geopolitical instability – leads to a jump in prices. The IEA predicts that supply will just meet demand this year at 86.8mb/d.

Many analysts reject market speculation as a root cause of the current spike. They say that 'spot' oil prices should be unaffected by market speculation, which only involves oil futures. Furthermore, if speculation were inflating prices, we would expect hoarding, but commercial stocks in the OECD fell in Q1 and are predicted to remain below their 5-year average for the remainder of 2008.

Constraints in expanding production are a more likely cause. State control of the world's largest oil reserves leaves commercial operators with the more expensive and marginal fields. Meanwhile, the credit crunch may have impacted on the financing of new exploration.

A number of transient factors have also added to the upward pressure on oil prices: the weak dollar, spiralling input costs and financial uncertainty.

Whether or not the price of oil hits further headline-grabbing highs is less relevant than the long-run price equilibrium. A couple of demand-side factors should eventually limit the rise: alternative energy sources becoming more competitive; and behavioural changes in response to price signals. Already, demand for oil in the OECD has fallen for 11 straight quarters.

Some analysts believe oil prices have already overshot. Oil price forecasts suggest an average of around $120/bbl for this year and next. The ESRI has based its latest Medium Term Review (MTR) on the IEA's forecast of $74/bbl in 2012, $91/bbl by 2020 and $110/bbl in 2025.

High oil prices act as a tax on oil importing countries. In the US, it is estimated that the recent increases have all but wiped out the consumer gains from the government's $150 billion fiscal stimulus. The high cost of oil will act as a further drag on Irish growth also. The ESRI MTR predicts oil will remain our dominant energy source to 2025 – with little deviation from the current 66% of final energy use.

Other commodities

The IMF's "all commodities" price index rose on average 23% per annum from 2003-07, driven by strong global economic growth, particularly in emerging economies, and demand for resources.

IMF Head, Dominique Strauss-Kahn, attributes almost 45% of total worldwide inflation to food prices. This would represent a far greater contribution than oil. However, oil prices also drive up food prices, through higher input costs and demand for bioethanol, a substitute fuel (31% of US corn crops will be devoted to ethanol production in 2008/09).

Balancing act: Interest rates

Commentators also blame loose monetary policy for indirectly driving commodity inflation. Negative real interest rates in the US over 2003-05 paved the way for the deterioration in lending standards that led to the sub-prime crisis and the global credit crunch.

Now, central bankers walk the tightrope, aiming to avoid recession without fuelling inflation. Consumers feel the pinch on two fronts – inflation and falling asset values. The ECB has indicated we may see interest rate hikes soon.

NOTE: The average figures presented in this report (referred to in the text as the *DKM Snapshot*) represent a weighted average of the latest forecasts for the Irish economy from 13 independent sources, compiled by DKM. Older forecasts are given a smaller weighting in calculating this average. Figures quoted represent the latest available figures from each source at the time of going to press.

Telephone: 353 1 6670372; Fax: 353 1 6144499; E-mail: info@dkm.ie; Website: www.dkm.ie