The Domestic Economy

Forecast Highlights

- The level of activity in the Irish economy, as measured by GDP, contracted by an estimated 7 per cent last year. National Income, as measured by GNP recorded a much larger decline of about 11.3 per cent. The divergence between GDP and GNP last year reflected the impact of significant net factor income outflows which are included in GNP but not in GDP.

- Following a sharp contraction in the level of output at the end of 2008 and in early 2009, the pace of decline has moderated significantly since. This gradual stabilisation is likely to continue into the first half of this year, followed by the emergence of modest export-led growth thereafter. Domestic demand will continue to contract in 2010, albeit at a slower pace than last year. For 2010 as a whole, the economy is again likely to record negative growth of about 1 per cent in GDP terms with GNP declining by about 2 per cent.

- Looking ahead to 2011, with domestic demand likely to have levelled off and no longer imparting a negative contribution to overall growth, a sustained recovery in exports should provide the basis for a rebound to growth of about 2½ to 3 per cent. This level of growth should support some modest increase in employment next year. This outlook is contingent on the durability of the international recovery since domestic sources of growth are unlikely to emerge in the near term.

- The weakness in aggregate demand last year was reflected in extremely challenging labour market conditions. Employment losses were widespread averaging about 8 per cent. The impact of rising emigration and falling labour market participation on labour supply slowed the rise in unemployment, which averaged just below 12 per cent last year. This trend is expected to continue in 2010, limiting the increase in the unemployment rate to an average of about 13½ per cent despite a decline in employment of about 3¾ per cent.

- A significant rebalancing in the composition of final demand from domestic to external sources is reflected in a decline in the Balance of Payments deficit from 6.1 per cent of GNP in 2008 to a projected deficit of about 2½ per cent of GNP this year. Further improvement towards balance in 2011 will be mainly due to an improvement in exports rather than contracting domestic demand, which should begin to stabilise at that stage.

- The consumer price level declined significantly last year and inflation is projected to remain negative in 2010. Harmonised Index of Consumer Prices (HICP) inflation is forecast to average about –1.1 per cent in 2010 while the Consumer Price Index (CPI) is forecast to decline by 1.3 per cent.

- Despite a rebound in external inflation, overall inflationary pressures are likely to remain subdued into next year, as labour market weakness persists and disposable incomes contract sharply. Inflation is forecast to average about 1 per cent next year, remaining below the euro area average and indicating a further improvement in price competitiveness with respect to our trading partners in the euro area.

Overview

The level of activity in the Irish economy, as measured by GDP, contracted by an estimated 7 per cent last year. National Income, as measured by GNP recorded a much larger decline of about 11.3 per cent. A severe contraction in domestic demand, with both consumption and investment expenditure declining sharply and government consumption also contracting, accounted for much of the decline in overall activity. Exports volumes also declined somewhat but, nevertheless, performed quite well, given the exceptionally weak external environment. The relative resilience of overall exports was accounted for by a strong performance of foreign owned sectors such as pharmaceuticals, which in turn contributed to a sharp increase in profit repatriation. This factor, together with relatively weak income inflows and an increase in interest payments, resulted in a sharp rise in net factor income outflows. These outflows led to a significant divergence between GNP and GDP last year.

Following an exceptionally weak first quarter, the rate of decline in activity moderated during the remainder of last year. In the third quarter, according to Quarterly National Accounts data, GDP increased marginally by 0.3 per cent reflecting a sharp decline in imports which offset a contraction in all components of final demand. The gradual stabilisation in the level of output is likely to continue into the first half of this year followed by the emergence of modest export-led growth thereafter.

If, as expected, the recovery in external demand gathers momentum during the course of 2010, Irish exports should also revive, returning to positive growth of about 1½ per cent for the year as a whole. However, domestic demand looks set to decline again this year. Consumption is projected to decline in real terms reflecting continued erosion of disposable incomes arising from further declines in employment and earnings and a rise in the personal tax burden, reflecting a carryover from measures introduced in 2009. Investment will also make a negative contribution to growth this year, albeit a less significant one than in 2009, reflecting both a moderation in its rate of decline and its much lower share in overall GDP.

For 2010 as a whole, the economy is again likely to record negative growth of about 1 per cent in GDP terms with GNP declining by about 2 per cent. Looking ahead to 2011, with domestic demand likely to have levelled off and no longer imparting a negative contribution to overall growth, a sustained recovery in exports should provide the basis for a rebound to modest growth of about 2½ to 3 per cent.

External demand conditions facing the Irish economy were on balance quite negative last year, reflecting a severe contraction in world demand against a background of severe disruption to international financial markets. The downturn internationally was highly synchronised with a low point, manifest in a sharp contraction in world trade volumes, reached in the first quarter of last year. This was followed by a gradual recovery during the remainder of the year, supported in most industrialised economies by exceptional monetary and fiscal policy accommodation. A key policy decision will be the timing of the gradual removal of these supports. Delayed action risks the emergence of inflation and the embedding of structural fiscal imbalances which would undermine the long-term sustainability of public finances. A premature reversal of the current accommodative stance, however, risks undermining the still fragile recovery in private demand. Notwithstanding uncertainties regarding the resilience of the recovery, the consensus outlook from international agencies such as the OECD, IMF and EU Commission is for a modest rebound in world demand which gains some momentum over the next two years. Following a decline of 3.8 per cent in 2009, real GDP in Ireland's main trading partners, weighted by their shares in Irish exports is projected to increase by 1.4 per cent this year, accelerating to 2.1 per cent in 2011.

Irish exports proved quite resilient last year with volumes declining at a relatively modest rate of about 2.5 per cent, compared to a decline in world trade volumes of about 12.5 per cent (OECD estimate). This represents a much stronger performance than that of most of Ireland's trading partners where export volume declines matched the double digit decline in world demand. However, total export volumes were flattered by a strong performance by the modern sector and, in particular, pharmaceuticals, while indigenous sectors such as food and drink performed exceptionally poorly. These sectors, which are relatively labour intensive, have a large exposure to the UK market where adverse exchange rate trends have exacerbated the impact of the loss of cost competitiveness in recent years. In terms of overall exports, there is a reasonable prospect of a return to positive growth this year against a background of a modest recovery in external demand. However, notwithstanding recent significant improvements, particularly in the area of wage costs, there is some way to go in fully reversing past competitiveness losses which continue to hamper recovery. This factor, together with sector specific factors in the IT sector will weigh on overall export volume growth for much of this year. For the year as a whole, exports are projected to increase in volume terms by about 1½ per cent reflecting a gradual upward trend during the year. This upward trend should continue into next year provided the ongoing improvement in relative cost competitiveness is sustained and the recovery in external demand does not falter.

Although exports declined last year, net exports (exports minus imports) made a significant positive contribution to overall GDP growth. This reflected a very significant decline in import volumes due, in the main, to the weakness of domestic demand. The impact of weak import demand was particularly evident in the latest Quarterly National Accounts data for Q3 2009, when a sharp decline in imports resulted in a small positive increase of 0.3 per cent in GDP despite a decline in all components of final demand. A further decline in import demand is likely this year, again reflecting the impact of contracting domestic demand.

Domestic demand, which contracted by about 13 per cent, was the main driver of the overall decline in output and employment last year. Investment expenditure was the weakest component, declining by over 30 per cent and, within this, housing completions were down by around 50 per cent. Non-housing investment also contracted sharply in the face of a severe downturn in demand. The outlook for investment this year remains difficult. Leading indicators point to a further significant decline in housing output and over-supply in commercial building points to a similar outlook in that sector. Prospects for machinery and equipment investment also remain poor. Overall, investment expenditure is projected to decline by about 18½ per cent this year. Consumer expenditure declined sharply last year, by about 7½ per cent. Declining employment and wages, coupled with increases in taxes, depressed disposable incomes, while heightened uncertainty regarding current and future prospects contributed to an increase in precautionary saving. In the year ahead, disposable incomes will remain under severe pressure and although a gradual improvement in confidence could arrest the increase in the savings rate, a further decline in the volume of consumption of about 3 per cent seems likely.

The contraction of domestic demand has driven a significant rebalancing in the composition of final demand from domestic to external sources which is manifest in a significant increase in the merchandise trade balance. Taking account of some offsetting deterioration in the invisibles balance, a decline in the deficit on the Current Account of the Balance of Payments, from 6.1 per cent of GNP in 2008 to about 2½ per cent of GNP seems likely this year. Further improvement towards balance in 2011 will be mainly due to export growth rather than contracting domestic demand which should begin to stabilise at that stage.

The weakness in aggregate demand and, in particular, the severe contraction in domestic expenditure last year was reflected in extremely challenging labour market conditions. Employment losses were wide-spread averaging about 8 per cent and were particularly severe in the construction sector, in domestically orientated services and in labour intensive manufacturing firms. Unemployment

Table 1: Expenditure on Gross National Product 2008, 2009^f and 2010^f

	2008	% change in		2009^f	% change in		2010^f
	€ million	Volume	Price	€ million	Volume	Price	€ million
Personal consumption	93,863	–7.5	–2.7	84,431	–3.0	–1.1	81,031
Public consumption	28,901	–1.0	–2.5	27,884	–3.0	–3.9	25,993
Gross domestic fixed capital formation	39,474	–30.5	–7.2	25,465	–18.4	–5.1	19,731
of which:							
• Building and construction	29,997	–33.8	–10.7	17,732	–22.9	–7.6	12,624
• Machinery and equipment	9,477	–20.0	2.0	7,733	–8.0	–0.1	7,107
Value of physical changes in stocks	317			–1,400			200
Statistical discrepancy	365			365			365
Gross domestic expenditure	**162,920**	**–13.0**	**–3.6**	**136,745**	**–4.7**	**–2.3**	**127,320**
Exports of goods & services	151,896	–2.5	0.5	148,848	1.4	–0.6	150,047
Final demand	**314,816**	**–7.9**	**–1.5**	**285,593**	**–1.5**	**–1.4**	**277,367**
Imports of goods & services	–133,002	–9.1	0.2	–121,057	–2.2	–0.1	–118,350
Gross domestic product	**181,814**	**–7.0**	**–2.6**	**164,536**	**–1.0**	**–2.4**	**159,017**
Net factor income from rest of the world	–27,218			–32,039			–32,814
Gross national product	**154,596**	**–11.3**	**–3.4**	**132,497**	**–2.0**	**–2.8**	**126,203**

increased sharply to an average of almost 12 per cent. The impact of rising emigration and falling labour market participation on labour supply slowed the rise in unemployment, particularly in the second half of last year. This trend is expected to continue this year, limiting the increase in the unemployment rate, which is expected to average about 13½ per cent, despite a decline in employment of about 3¾ per cent.

The rate of Irish Harmonised Index of Consumer Prices (HICP) inflation averaged –1.7 per cent in 2009 while the Consumer Price Index (CPI) declined by 4.5 per cent, with base effects from mortgage interest repayments accounting for the large differential. Base effects, also arising from volatility in international commodity prices, will continue to strongly influence headline inflation rates over the short-term. Despite signs that external prices are beginning to rebound, inflationary pressures overall are likely to remain subdued during 2010 as challenging labour market conditions persist and disposable income growth remains constrained. Accordingly, the HICP and CPI are projected to record more modest declines of about 1.1 per cent and 1.3 per cent, respectively, this year. Inflation is likely to turn positive in 2011, averaging about 1 per cent on CPI basis with HICP inflation somewhat less than this. The risks for the inflation outlook appear to be broadly balanced and relate in the main to the projected muted recovery of the domestic economy and the evolution of international commodity prices.

The Irish annual average HICP inflation rate is likely to be significantly lower than the corresponding inflation rate for the euro area again this year, indicating a further boost to price competitiveness. There are also tentative signs of an improvement across a range of cost competitiveness indicators following a number of years in which the Irish economy experienced a substantial deterioration in competitiveness relative to our main trading partners. In particular, the significant downward adjustments in wages per employee should provide a timely boost for export competitiveness, made all the more necessary by the significant appreciation of the euro exchange rate against sterling during the past two years. Similarly, property prices, rents and energy costs have fallen significantly during the past year. The outlook for competitiveness developments in 2010 is also favourable, although much will depend on the projected rebound in productivity growth and labour market developments and exchange rate developments. Lowering the costs of doing business in Ireland represents a necessary adjustment and would leave the economy better placed to benefit from a global economic upturn. The prospects for further recovery in wage and cost competitiveness in 2010 are relatively good.

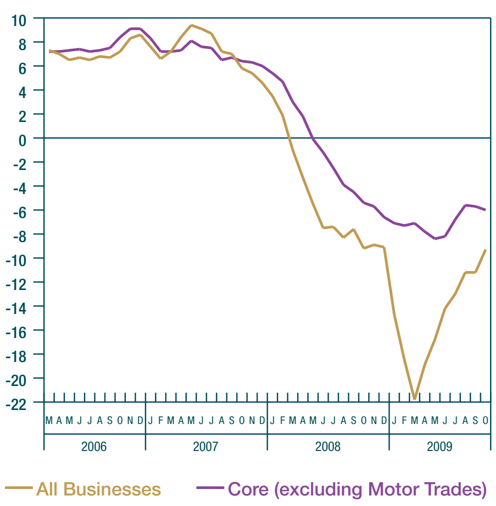
Demand

Consumer Spending

The volume of consumer spending declined significantly during the course of last year reversing the cumulative increase of the previous three years — the volume of consumer expenditure is currently back at its level in 2005. National Accounts data show an annual decline of 7.3 per cent in the third quarter of the year following declines of 6.9 per cent and 9.5 per cent respectively in the previous two quarters. For the year as a whole, the volume of consumption is estimated to have declined by about 7.5 per cent in 2009.

Although available indicators point to some moderation in its rate of decline following an exceptionally weak first quarter, consumer demand remained quite subdued throughout the year. Retail sales, which declined precipitously in the first quarter of this year on foot of exceptionally weak sales of cars and other consumer durables, recovered during the remainder of the year but remained sharply down on a year-on-year basis. New car registrations (SIMI data), down by 65 per cent in the first quarter, remained exceptionally weak for the remainder of the year and declined by 62.1 per cent for the year as a whole. The weakness of retail sales both in real and nominal terms was reflected in a sharp drop in indirect tax receipts with VAT and excise duty receipts down by 20.6 and 13.6 per cent respectively in 2009.

Chart 1: Index of Volume of Retail Sales



Source: CSO

The decline in consumer expenditure last year reflected the impact of contracting disposable incomes and exceptionally weak consumer confidence which prompted an increase in precautionary savings. Although there are signs of improving consumer sentiment in recent months which should provide some support for demand, the further erosion of disposable incomes arising from declining employment incomes and an increased tax burden, arising from a carryover from 2009, will give little scope for increased consumer demand in 2010. Although there is a reasonable prospect of a return to positive growth in consumer spending at some stage during the second half of the year, a decline of about 3 per cent is in prospect for the year as a whole.

Investment

Quarterly National Accounts for the third quarter of 2009 show that the largest negative impulse to domestic demand continues to come from large decreases in investment, which declined at a record pace in year-on-year terms at 35 per cent. The bulk of the contraction is coming from the building and construction component and the prospects for the remainder of last year and into this year are for continued declines in activity, the levels of which are likely to remain low for some time to come. For 2009 as a whole, house completions slowed to about 26,420 new units[1] from approximately 52,000 units the previous year, a decline of about 50 per cent. The Bank's statistical model, based on forward looking indicators (registrations), suggests that house completions are likely to fall to, at most, 10,000 units this year — comprising mostly one-off units as new housing schemes and apartment developments come to a halt. Coupled with some limited growth in repairs

[1] This figure is based on connections to the electricity grid. The actual underlying completions figure for 2009 is likely to be lower than this as some houses that were built in previous years were only connected to the grid as potential buyers were identified.

and maintenance, investment in residential housing is forecast to decline by approximately 36 per cent this year, following a projected decline of 40 per cent last year. House-building activity is likely to remain at this low level next year as overcapacity, financial constraints and a lack of demand are still the prevalent forces in the market.

Following declines of 29 per cent in the first three quarters of 2009 year-on-year, weakness in non-residential construction is also set to continue into 2010 as commercial, retail and industrial market fundamentals remain weak and government investment records significant declines as outlined under the Public Capital Programme[2] in Budget 2010. Demand for property in most sectors remains weak, with oversupply, falling rents and capital values (see the section on commercial property prices) and uncertainty over how NAMA will affect the market. A recent market report (from CB Richard Ellis (CBRE)) indicates that the total value of commercial investment deals signed in the first three-quarters of 2009 reached just €71 million, compared with €465 million in the first three-quarters of 2008. Non-residential investment is forecast to fall by 27 and 13 per cent in 2009 and 2010, respectively.

Taken together, the forecasts for residential and non-residential investment imply that investment in building and construction is forecast to decrease by almost 34 per cent in 2009, followed by a further reduction of 23 per cent in 2010.

In conjunction with the downsizing of the construction sector and a weak manufacturing sector outlook and broad-based weakness in the economy more generally, investment in machinery and equipment is forecast to decrease by 20 per cent this year and 8 per cent in 2010. These forecasts are, however, tentative in nature given the uncertainty surrounding the timing and magnitude of aircraft purchases. Given the assumptions for construction and machinery and equipment investment, overall investment is estimated to have contracted by 30.5 per cent in 2009 and is forecast to decline by 18.4 per cent in 2010.

[2] Falling tender prices means that the volume decline in government investment will be less than that indicated in value terms.

Stock Changes

Stocks made a negative contribution to the change in GDP last year of about 1 percentage point. Some recovery in inventory levels is assumed this year in line with improving prospects for output growth.

Government Consumption

The volume of Government consumption declined by 0.7 per cent on average in the first three quarters of last year and is estimated to have declined by about 1 per cent for the year as a whole. On the basis of expenditure plans as set out in the 2010, the volume of Government consumption is projected to decline in real terms by about 3 per cent this year.

External Demand and the Balance of Payments

Merchandise Trade

The performance of merchandise exports weakened further during the third quarter of 2009, yielding an average decline of 4.4 per cent during the first three quarters of the year in volume terms. It is, however, important to view such an outturn against the backdrop of sharply contracting world trade volumes and a generally more challenging operating environment for Irish exporters. The weakening of merchandise exports during the third quarter also partly reflected the volatile nature of output from the broad chemicals sector, with some fall off in organic chemicals occurring during this period. Nevertheless, the exceptional buoyancy of the pharmaceuticals sector continued in the third quarter, with an increase of around 25 per cent in value terms. Given recent price developments, this suggests a somewhat less pronounced increase in volume terms. As regards the outturn for the final quarter of 2009, the new export orders index of the NCB Purchasing Managers' Index for Manufacturing is consistent with a modestly stronger outturn for merchandise exports, with the index standing above the contraction/expansion threshold of 50 during both November and December. Nevertheless, merchandise exports

Table 2: Merchandise Trade (Adjusted) 2008, 2009f and 2010f

	2008	% change in		2009f	% change in		2010f
	€ million	Volume	Price	€ million	Volume	Price	€ million
Merchandise exports	82,693	–3.9	1.3	80,530	0.7	–1.3	80,054
Merchandise imports	–58,428	–22.7	1.1	–45,670	–9.7	–0.5	–41,028
Merchandise trade balance (adjusted)	24,265			34,860			39,026
(% of GNP)	15.7			26.3			30.9

are estimated to have fallen further during the final quarter of the year resulting in an annual average decline of 3.9 per cent in volume terms. Such an outlook represents a downward revision relative to the previous Quarterly Bulletin, reflecting recent, more negative developments. The 2010 outlook for merchandise exports depends heavily upon the strength of the recovery in external demand as well as the external market share that Irish exporters are able to capture. While external demand is projected to expand this year, modest rates of increase are anticipated by historical standards. As a result, the recovery in merchandise exports seems likely to be muted, with an increase of 0.7 per cent in volume terms.

The background of sharply contracting domestic demand has significantly impacted upon merchandise import flows, with double-digit declines recorded during the first three quarters of 2009. The pace of decline in merchandise imports accelerated in the third quarter, with a year-on-year fall of 24.4 per cent in volume terms. As regards the outturn for 2009 as a whole, an average annual decline in volume terms of 22.7 per cent is envisaged. Given the projected contraction in domestic demand during 2010, demand for merchandise imports seem set to fall further. Accordingly, a marked decline in the volume of merchandise imports is projected, with a fall of 9.7 per cent in average annual terms. Given the dramatic falloff in merchandise import volumes during 2009, an improvement in the merchandise trade surplus during 2009 is estimated to have occurred. Similarly, a rise in the merchandise trade surplus is anticipated in 2010.

Services, Factor Incomes and International Transfers

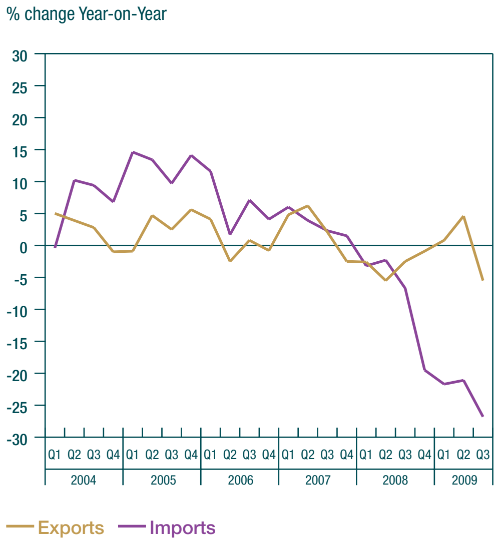
Following a sharp falloff during the first half of 2009, services exports rose during the third quarter, with a year-on-year increase of 2.0 per cent in volume terms. This represents the first such increase since the beginning of 2008, which tentatively suggests that services exports have begun to recover. At a sectoral level, a significant divergence in performance was evident. Much of the strengthening during the third quarter of 2009 reflected the buoyant performance of business services and, to a somewhat lesser extent, computer services, which, when combined account for almost 65 per cent of services exports. In contrast, the insurance and financial services sectors continued to place downward pressure on services export activity during this period. The NCB Purchasing Managers' Index for Services suggests that services exports recovered further during the final quarter of 2009, pointing to increasing rates of expansion in services sector activity. The PMI new export orders index reached 54.7 in December, up from 52.7 in the previous month, a level which represents the highest reading since October 2007. On this basis and amid the stabilisation in world trade flows, it is estimated that services exports grew further during the final quarter of 2009. Consistent with the prospects for some recovery in external demand during 2010, modest growth in services exports is projected, as the recovery in a number of sectors, in particular, computer and business services, gathers momentum.

Services imports declined by 2.2 per cent in volume terms, year-on-year, in the third quarter of 2009. The bulk of this decline related to tourism and travel services and business services, with an annual decline in value terms

Table 3: Current Account of Balance of Payments 2008, 2009f and 2010f

€ million	2008	2009f	2010f
Current account			
• Merchandise trade balance (Adjusted)	23,820	33,867	38,034
• Services	–5,371	–7,069	–7,329
• Net factor income from rest of the world	–26,771	–31,592	–32,367
• Current international transfers	–1,115	–1,120	–1,320
Balance on current account	**–9,437**	**–5,914**	**–2,982**
(% of GNP)	–6.1	–4.5	–2.4

Chart 2: Value of External Trade



Source: CSO

of 18.8 per cent and 1.7 per cent, respectively, in the third quarter. Services imports are projected to have increased during the final quarter of 2009. As regards the outlook for 2010, a further increase in services imports is envisaged. Given that the performance of services imports is estimated to have outpaced that of the export side, the services trade deficit seems likely to have widened during 2009. Some further widening in the services trade deficit is projected in 2010.

Net factor income outflows increased, year-on-year, in the third quarter of 2009, rising by 11.9 per cent. This increase reflected a sizable falloff in income inflows and, to a somewhat lesser extent, weaker income outflows. Net factor income outflows are estimated to have risen during 2009 as a whole and this is expected to be followed by a further, albeit modest, increase this year. The international transfers component of the current account was negative in the year to the third quarter of 2009. The negative contribution to the current account arising from this component is projected to continue throughout the remainder of 2009 and 2010. Combining the prospective trends across the various current account components, a deficit of around 4.5 per cent of GNP is estimated for 2009. Some further improvement is anticipated this year, with a current account deficit of 2.4 per cent of GNP.

Supply

Industry and Services Output

Provisional data from the CSO suggest manufacturing output contracted in annual terms by 1.8 per cent in the year to November 2009. The divergence in performance between the modern and traditional sectors widened throughout 2009, with the modern sector growing by 6.2 and the latter contracting by 14.9 per cent over the same period. Output in the modern sector in 2009 was supported almost entirely by the buoyancy of the pharmaceutical subsector which is estimated to have expanded by a considerable 21.6 per cent in annual terms in the eleven months to November, relative to growth of 1.2 per cent a year previously. Pharmaceuticals now account for almost 58 per cent of gross output in the modern sector overall. In contrast, chemicals continued to weaken, falling by 10.7 per cent over the period, exhibiting a marked acceleration in contraction since their fall of 1.3 over the same period in 2008. The contraction

Table 4: Industry and Manufacturing Output, Annual Percentage Change

	Industrial Output			
	Modern	Other	Manufacturing	Total Industry
1999	21.3	9.2	15.0	14.8
2000	19.1	9.7	14.6	14.3
2001	16.3	5.5	11.4	11.0
2002	13.0	2.6	8.5	8.2
2003	7.0	4.0	5.6	5.7
2004	0.3	2.5	1.1	1.2
2005	5.2	2.3	4.1	4.0
2006	3.8	1.6	3.1	2.9
2007	6.6	3.0	5.3	5.0
2008	0.4	–4.1	–1.9	–1.8
2009[e]	7.2	–14.3	–1.4	–1.6
2010[f]	3.9	–1.6	0.6	0.4
2011[f]	3.5	–0.9	1.3	1.2
Average 1999-2011	8.3	1.5	5.2	5.0

Note: As output data produced by the CSO now conforms with NACE Rev2 categorisation practices, and has been re-based to 2005, these figures no longer correspond directly with the industrial sector figures referenced in previous Quarterly Bulletins published before QB4 2009.

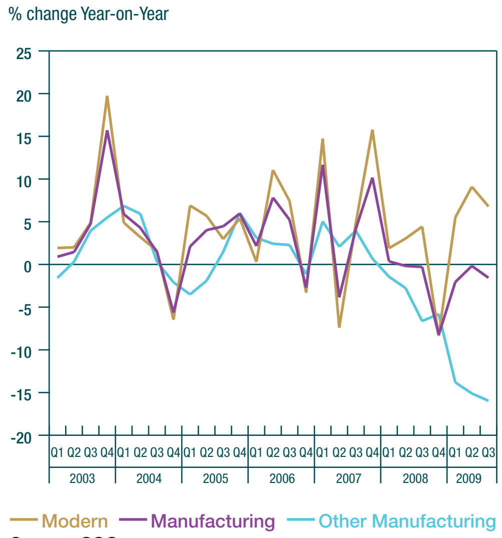
in manufacturing output less chemicals and pharmaceuticals gathered pace as the year progressed, culminating in a fall of 16.3 per cent in annual terms over the year to November 2009, highlighting the extent to which output trends in manufacturing industry are dominated by the performance of pharmaceuticals.

As indicated by the NCB Purchasing Managers Index (PMI), a composite indicator tracking the activity in manufacturing industry, production has now contracted in each month since December 2007. While the headline index stood at 48.8 in December (a value below 50 indicates a contraction in activity), levels now appear to have recovered to values registered in the first quarter of 2008. Despite ongoing contraction in prices, employment and output prices, the fortunes of new orders and exports have improved with each of the three latter components breaching the 50 index mark for the first time since February 2008.

Given the pick-up in global demand anticipated this year and the consequent positive outlook for exports, output in manufacturing is expected to grow by 0.6 per cent in 2010. Continued weakness in the traditional sector is anticipated to act as a drag on the expectedly buoyant modern sector.

The latest Quarterly National Accounts show that output in the services sector also contracted in 2009, with annual output in the third quarter in the Other Services and Public Administration sectors down 3.4 per cent and 4.9 per cent, respectively. The pace of deterioration in the third quarter accelerated from that of the second quarter. Sharp output declines were also posted in the Distribution,

Chart 3: Volume of Industrial Production



Source: CSO

Table 5: Summary of Agricultural Output and Income 2008, 2009f and 2010f

	2008	% change in			2009e b	% change in			2010f
	€ million	Value	Volume	Price	€ million	Value	Volume	Price	€ million
Goods output at producer prices[a]	5,827	–18.9	–3.0	6.3	4,727	4.1	1.6	2.6	4,919
Intermediate consumption	4,494	–9.0	–3.5	2.6	4,091	1.1	2.5	0.4	4,135
Net subsidies plus services output less expenses	1,904	–1.5			1,876	–3.5			1,810
Operating surplus	2,324	–30.3			1,620	6.6			1,727

[a]Including the value of stock changes.
[b]CSO estimates.

Transport and Communications sub-sector, which contracted throughout the year with output falling by 9.0 per cent in annual terms in the third quarter of 2009. The NCB Purchasing Managers Index for Services (excluding retail and wholesale), having posted sharp declines from October 2008 through to July 2009, appears to have stabilised, nudging back towards the 50 mark in the last quarter of 2009, driven by strong gains in the confidence and exports component.

Agricultural Output

Full year preliminary CSO price estimates suggest that output prices in 2009 were down 15.7 per cent on their 2008 levels, with input prices down 8.6 per cent in annual terms. This implies an estimated worsening in terms of trade of 7.7 per cent in 2009 driven principally by output price changes.

The most recent Quarterly National Accounts for the third quarter of 2009 reveal that output in the Agriculture, Forestry and Fishing sector (capturing a broader set of activities than those implicit in Table 5) fell by 0.4 per cent relative to the same period last year, in contrast to the annual growth rate of 4.4 per cent registered in the second quarter of 2009. Notably, these declines were recorded before the occurrence of the November flooding or severe frost over the new-year and reflected already low yields resulting from the particularly wet summer.

The outlook for the sector in 2010 will thus be dominated by the adverse impact of the flooding which swept the country in late 2009 and the subsequent bout of severe frost. Advance estimates from the CSO suggest that before any provision for flood implications is made, operating surplus was down 30.3 per cent in annual terms in 2009, due to a combination of adverse terms of trade movements and continued euro appreciation, which placed the export segment of the sector under considerable strain in the latter part of 2009 in particular.

The Labour Market

A further marked deterioration in labour demand was evident in the third quarter of 2009, with the fall in employment outpacing that of the previous quarter. When seasonal factors are taken into account, total employment fell by 2.1 per cent in the third quarter. This compares with a decline of 1.7 per cent in the second quarter. The weakness of labour demand was broadly based, with employment falling, year-on-year, in nine of the fourteen economic sectors. There was, however, considerable variation across sectors in terms of the magnitude of the fall; much of the weakness was concentrated in the construction, industry and wholesale and retail sectors. It is important to note that the decline in overall employment would have been larger had the fall in full-time employment not been partially offset by an increase in the number of part-time workers. On the basis of the outturn for the third quarter, further weakening in labour demand seems likely to have occurred during the final quarter of 2009. It is, nevertheless, anticipated that the pace of

Table 6: Employment and Unemployment 2008, 2009^f and 2010^f

(annual average '000)	2008	2009^f	2010^f
Agriculture	115	98	95
Industry (including construction)	520	414	383
Services	1,465	1,420	1,382
Total employment	2,100	1,933	1,860
Unemployment	141	261	290
Labour force	2,241	2,194	2,150
Unemployment rate (%)	6.3	11.9	13.5

Note: Figures may not sum due to rounding.

contraction in employment slowed, producing an annual average decline of 8.0 per cent.

The labour force also weakened appreciably during the third quarter of 2009, contracting by 2.8 per cent, year-on-year. This fall off may primarily be attributed to a decline in participation, as illustrated by the 1.7 percentage point drop in the labour force participation rate. A fall in participation amongst younger persons (aged 15-24) and males underpinned the sharpness of the decline in participation. This reflects the fact that they have been most exposed to job losses in the construction sector. Furthermore, a period of rising unemployment is generally associated with a declining participation rate, as people become discouraged about the prospects of finding work and the numbers undertaking further education rises in response to weak labour demand. In addition to changes in participation, the labour force is also affected by demographic factors, namely, changes in migration and the age structure of the population, which are estimated to have contributed 10,600 persons to the overall decline in the labour force. Based on tentative estimates provided by the CSO, the number of non-Irish nationals in the labour force fell by around 40,500 persons over the same period. This implies that the changing age structure of the population boosted the labour force by around 30,000 persons, year-on-year, in the third quarter. Some further fall off in labour supply is estimated for the final quarter of 2009, with the overall decline for the year averaging around 2.1 per cent.

The decline in the labour force during the year to the third quarter served to partially offset the impact of contracting labour demand on the unemployment rate. As a result, the pace of increase in unemployment slowed in the third quarter, with the unemployment rate in seasonally adjusted terms rising to 12.4 per cent from 11.6 per cent in the second quarter. This represents the smallest such increase since the second quarter of 2008. In addition to changes in the level of unemployment, developments in relation to the duration of unemployment are also of considerable importance. The bulk of the increase in unemployment during the year to the third quarter reflected a rise in short-term unemployment. The long-term unemployment rate has, nevertheless, risen markedly as the downturn has persisted, reaching an 11-year high of 3.2 per cent. While the QNHS points to continued labour market weakness during the third quarter of 2009, more recent data from the Live Register suggests that labour market conditions stabilised somewhat during the fourth quarter, with an average monthly increase of 400 persons. This compares with an average monthly increase of 5,300 during the previous quarter. As regards the unemployment outturn for 2009 as a whole, the unemployment rate is estimated to have averaged around 11.9 per cent.

As regards the outlook for 2010, the weakness is expected to remain as labour market developments typically lag movements in economic activity. Employment is expected to fall by around 3.8 per cent this year, with the construction, manufacturing and domestically orientated services sectors recording the largest rates of decline. The continued weakness of labour demand is expected to weigh upon labour force developments this year. It is envisaged that outward migration flows will continue while further declines in labour force participation are anticipated. Reflecting such a combination of developments, the labour force is expected to fall by around 2 per cent in average annual terms. When combined with the estimate for employment, the unemployment rate is projected to average 13.5 per cent in 2010.

Pay

Based on data from the CSO's Earnings, Hours and Employment Costs Survey (EHECS), wage pressures fell further during the year to the second quarter of 2009, with average weekly earnings on a whole economy basis declining by 1.1 per cent. This compares with a rise of 0.3 per cent, year-on-year, in the first quarter. The weakness of average weekly earnings during this period was broadly based at a sectoral level (See Box A below for further analysis). A decomposition of average weekly earnings reveals that the fall observed in the second quarter was strongly influenced by reductions in hours worked — average weekly paid hours dropped by 2.7 per cent annually in the second quarter. By comparison, average hourly earnings increased, rising by 1.8 per cent over the same period. Nevertheless, hourly earnings decelerated somewhat relative to the 3.6 per cent increase of the previous quarter. A breakdown of average hourly earnings into regular and irregular components suggests that the bulk of the observed deceleration has been driven by cuts in irregular earnings such as bonus payments. This is evidenced by the sharp contrast between the 26 per cent fall in irregular earnings and the 3.4 per cent rise in hourly earnings excluding irregular payments. Such an outturn is not surprising given that irregular earnings represent the most flexible component of pay.

There are two important factors to be taken into account when analysing the EHECS results for the second quarter of 2009. The first of these relates to compositional effects, which arise as layoffs tend to disproportionately affect less skilled and lower paid workers while those with higher skills tend to be retained. Such changes in the composition of employment place upward pressure on average earnings. The second factor relates to the public service pension levy. Average weekly earnings published in the EHECS are gross amounts before deductions for PRSI, tax and other levies. Accordingly, developments in public sector wages do not include the impact of the public service pension levy, which amounts to around 7 per cent on average. Tentative estimates suggest that, when both compositional effects and the pension levy are taken into consideration, the whole economy annual rate of decline in average weekly earnings exceeded 4 per cent in the second quarter of 2009.

As regards the outturn for 2009 as a whole, it seems likely that the downward momentum of the first two quarters continued into the second half of the year given the backdrop of falling prices and labour market slack. Accordingly, average compensation per employee is estimated to have declined by 2.9 per cent during 2009. A further fall is anticipated during 2010, with cyclical factors continuing to weigh upon wage developments. It is important to note that the projections are not adjusted for compositional effects yet they incorporate both the pension levy and the public service pay cut announced in Budget 2010. The public sector pay cut places considerable downward pressure on the 2010 estimate of nominal compensation per non-agriculture employee, with a projected decline in the region of 2.8 per cent in 2010. The 2010 projection for compensation per employee has been revised sharply downwards, relative to that of the previous Quarterly Bulletin. This downward

BOX A: Sectoral Pay Developments

The first results from the CSO's expanded quarterly earnings survey, the Earnings, Hours and Employment Costs Survey (EHECS), were recently published. This survey includes a 2-digit NACE breakdown and covers all sectors of the economy with the exception of agriculture, forestry and fishing. One of the key advantages of this survey is the enhanced comparability across sectors that it provides. The EHECS also includes more detail than was previously available on the various components of earnings, such as hourly earnings and weekly hours worked. This box provides a brief overview of the latest sectoral developments in pay, based on the results of the EHECS for the second quarter of 2009, focusing in particular upon the change in average weekly earnings and its composition.

Table: Annual Change in Earnings Q2 2009

Sector	Average Weekly Earnings	Average Hourly Earnings	Average Weekly Paid Hours
	%	%	%
Industry	0.6	4.4	–3.6
Construction	–1.3	4.0	–5.1
Wholesale & Retail Trade	–1.7	1.3	–2.9
Transportation & Storage	–3.5	–2.3	–1.2
Accommodation & Food Services	–1.5	0.6	–2.1
Information & Communication	0.1	1.1	–0.9
Financial, Insurance & Real Estate	–13.3	–11.6	–1.9
Professional, Scientific & Technical	–1.8	–1.6	–0.2
Administrative & Support Services	–0.6	1.1	–1.7
Arts, Entertainment, Recreation & Others	–1.2	1.2	–2.4

Analysis of the sectoral profile of annual developments in average weekly earnings in the second quarter reveals that the downward adjustment was broadly based, with declines across a range of sectors. A rise in average weekly earnings was, however, recorded during this period in five of the thirteen economic sectors; three of which relate to the public sector. As a result, the 1.1 per cent whole economy decline in average weekly earnings during the year to the second quarter was solely explained by developments in the private sector — average weekly earnings in the public sector rose by 1.3 per cent in the second quarter of 2009, while a decline of 3.1 per cent was recorded in the private sector. However, as highlighted in the main text, EHECS data on public sector pay does not include the public service pension levy. It is necessary to take the pension levy into account in a comparison of wage developments at a sectoral level as public sector pay was effectively cut via the introduction of the pension levy. Accordingly, developments in the public sector are not included in this analysis, with the focus on developments in the private sector.

Considerable variation existed at a sectoral level in terms of the magnitude of the change in average weekly earnings in the second quarter of 2009, with the annual change ranging from a decline of 13.3 per cent to an increase of 0.6 per cent. The largest downward adjustment in average weekly earnings of 13.3 per cent took place in the financial services sector. Another sector witnessing a strong decline in average weekly earnings was the transportation & storage sector, with a fall of 3.5 per cent. An annual increase of 0.6 per cent in industrial average weekly earnings was, however, recorded in the second quarter of 2009.

As regards the composition of the adjustment in weekly earnings in terms of changes in hours, hourly earnings, or a combination of both, some variation exists. Only three of the ten economic sectors, namely, the transportation & storage sector, the financial, insurance & real estate sector and the professional, scientific & technical sector, recorded a fall in both hours and hourly earnings, year-on-year, in the second quarter of 2009. Reductions in average weekly hours worked were, however, observed in all sectors. This suggests that there has been a heavy reliance amongst firms upon adjusting hours worked as a means of reducing the wage bill amid tough operating conditions. Cuts in hours worked were particularly sharp in the construction and industry sectors, with reductions of 5.1 per cent and 3.6 per cent, respectively. This development is also consistent with firms reducing labour utilisation in line with cyclical downturn.

The broad-based decline in average weekly hours was, however, not accompanied by a proportional reduction in hourly earnings, with a whole economy increase in hourly earnings of 1.8 per cent. A breakdown of average hourly earnings by sector reveals that the sharpest increases were recorded in industry and construction, with increases of 4.4 per cent and 4.0 per cent, respectively. This suggests that the largest falls in average hourly earnings during the year to the second quarter were not observed in the sectors experiencing the sharpest contractions in employment. However, a key consideration in relation to the buoyant increases in average hourly earnings within industry and construction relates to changes in the composition of employment. A dramatic change in employment composition occurred in industry during the year to the second quarter of 2009, with almost 85 per cent of the 23,000 job losses in this sector relating to production, transport, craft and other manual workers. The sharp fall in this category of workers was accompanied by a modest decline in the number of employees at management level. Such a dramatic change in the composition of employment places upward pressure on average earnings in industry and, as a result, the 0.6 per cent increase in average weekly earnings does not provide a true reflection of underlying changes in pay. A similar, albeit less pronounced, compositional effect was evident in the construction sector over the same period.

The largest reduction in average hourly earnings took place in the financial services sector, with a decline of 11.6 per cent, year-on-year, in the second quarter of 2009. Such an outturn is noteworthy given that average hourly earnings rose in almost all other sectors. The sharpness of the decline can, however, be almost entirely attributed to a cut of around two-thirds in irregular payments. The role of irregular earnings in driving movements in average hourly earnings is comparatively higher in the financial services sector as bonus payments tend to feature more prominently in pay in this sector. While the decline in irregular earnings was clearly most pronounced in financial services, year-on-year declines in irregular earnings were recorded in almost all sectors. This development reflects the fact that irregular earnings represent the most flexible component of pay. It is also necessary to briefly consider developments in hourly earnings excluding the irregular component as the importance of irregular earnings as a share of hourly earnings can vary significantly across sectors. Three of the ten economic sectors recorded a year-on-year reduction in hourly earnings excluding irregular earnings, with reductions of less than one per cent in two of these sectors. This suggests that the downward adjustment in hourly earnings has predominantly occurred in irregular earnings, the most flexible component of pay.

Table 7: Inflation Measures — Annual Averages, Per Cent

Measure	HICP	HICP excluding Energy	Services[a]	Goods[a]	CPI
2007	2.8	2.7	4.4	1.5	4.9
2008	3.1	2.6	3.4	2.9	4.1
2009	–1.7	–1.0	1.2	–4.1	–4.5
2010[f]	–1.1	–1.7	0.4	–2.3	–1.3

[a]Goods and services inflation refer to the HICP goods and services components.

revision is almost solely driven by the inclusion of the public sector pay cut. Combining the outlook for wages with that of employment suggests falls in the non-agricultural pay bill of 10.5 per cent and 6.5 per cent are likely in 2009 and 2010, respectively.

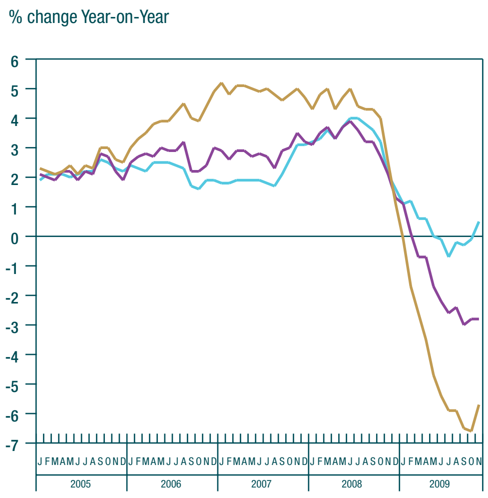
Inflation

Consumer Prices

Annual inflation, which is in the midst of a period of unusually high volatility, likely reached a trough in the final quarter of last year. According to the latest CSO outturns, the annual rate of HICP inflation, which excludes mortgage interest repayments, was –2.6 per cent in December while the annual rate of CPI inflation was –5.0 per cent. Movements in oil prices and mortgage interest rates have been important contributory factors to the short-run volatility in inflation; energy prices and mortgage interest repayments contributed 0.2 percentage points and –3.0 percentage points, respectively, to the annual CPI inflation rate of December. Core inflation measures, such as the HICP excluding volatile components such as energy prices and unprocessed foods, were also in the main negative during the same month suggesting more generalised price declines. Meanwhile, services inflation remained slightly positive after a prolonged moderation.

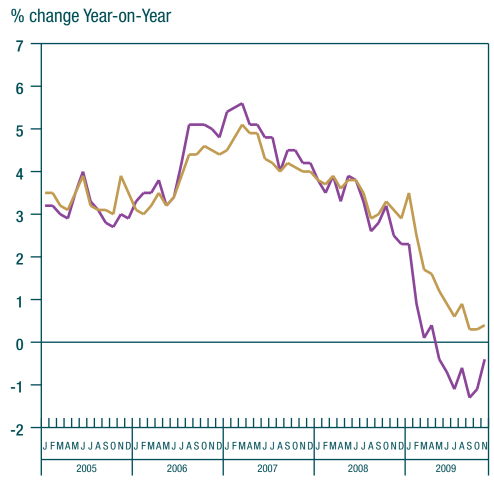
Oil prices have been characterised by strong volatility in recent years, with the euro price of oil 32.8 per cent lower in 2009 than the previous year. The effects of lower oil prices were most immediately felt in liquid fuel prices, with petrol and diesel prices down last year by 7.8 per cent and 18.3 per cent, respectively. Meanwhile, airlines passed on lower oil prices and offered numerous promotional fares to maintain volumes, with the result that airfares were down 9.1 per cent annually in 2009. There

Chart 4: Consumer Prices



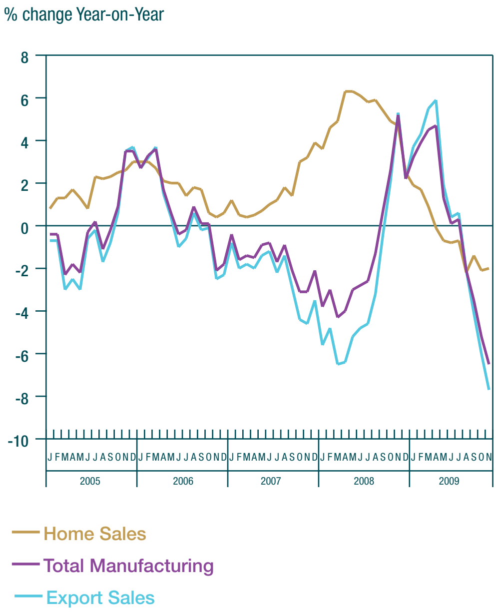
Ireland: Consumer Price Index
Ireland: Harmonised Index of Consumer Prices (HICP)
Euro-16: Monetary Union Index of Consumer Prices (MUICP)
Source: CSO

Chart 5: Services Sector Inflation



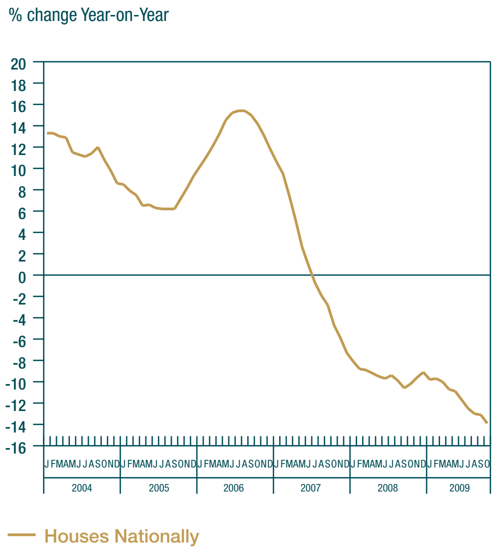
HICP Core Services
HICP Services (Overall)
Note: Core Market Services equals HICP services excluding telecommunications, alcohol-related and administered services.
Source: CSO

Chart 6: Manufacturing Producer Price Inflation



Source: CSO

Chart 7: Permanent tsb / ESRI House Price Index



Source: Ptsb/ESRI

has been some upward movement in airfares towards the end of the year but this is largely due to seasonal effects and an increase in baggage charges. The impact of oil prices on gas and electricity prices normally acts with a longer lag, and the annual average increases of 2.8 per cent and 1.3 per cent in 2009 reflected the 24 per cent euro oil price increase of the previous year. The full impact of the lower oil prices of 2009 on gas prices may not materialise until this year, with a fall of 15.7 per cent in average prices projected. Average annual electricity prices also look set to fall back during this year, to close to 2007 levels, providing a further timely boost to competitiveness.

During 2009, a squeeze on disposable incomes, a large jump in the savings rate and a substantial decline in employment, led to a sharp contraction in nominal spending. Retailers, aided by lower prices for UK imports due to the sharp depreciation of sterling, responded by lowering prices to stimulate demand. Retailers sought to lower prices from producers and wholesalers, resulting in further subsiding of supply chain inflationary pressures. The intensified competitive pressures were quite apparent in the food retail sector even when allowance is made for international food commodity price trends. As consumers became more price conscious and inclined to alter their shopping habits, the more established retailers introduced more aggressive price reductions in order to stem market share losses to discount retailers. As a result, food and non-alcohol beverage prices across the sector fell by a large cumulative 8.1 per cent in the year to December.

The estimated direct effect of the taxation measures contained in Budget 2010 on the annual HICP inflation rate for 2010 is for a decrease of between 0.2 and 0.3 percentage points. As households re-evaluate their financial positions following the Budget, the easing of uncertainty may provide some support to consumer confidence and to consumption during 2010, but it is still anticipated that the broader indirect impact of the Budget may contribute an additional –0.2 percentage points to the annual HICP inflation rate. Overall, labour market weakness, together with an anticipated further easing of supply chain inflationary pressures and continued disposable income constraints, are likely to apply ongoing downward pressure on prices. However, such downward pressure may be somewhat offset by positive contributions to the headline price level emanating from both administered services and energy prices.

Box B: Base effects on annual HICP and CPI inflation rates

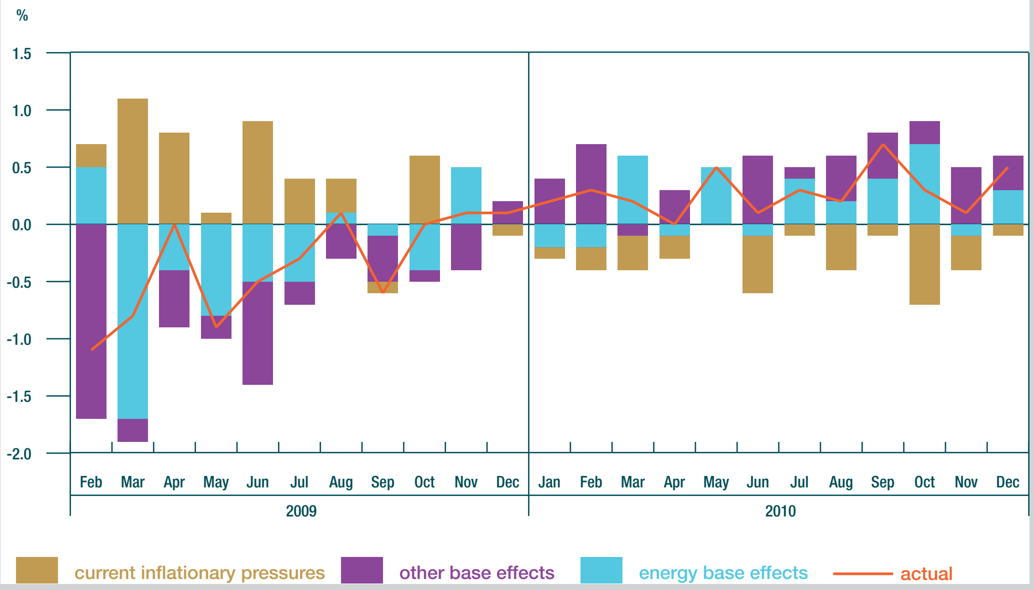
Annual inflation rates tend to have more prominence in discussion of inflation developments than monthly inflation rates. It is important to keep in mind that changes in the annual inflation rates can be heavily influenced by base effects, particularly during the current period of relatively high volatility. Indeed, in recent years and over the projection horizon, base effects have dominated and will continue to dominate movements in both the annual HICP and CPI inflation rates. This Box will illustrate how base effects are defined, why it is important that allowance is made for base effects when interpreting changes in annual inflation rates from one month to the next, and how base effects contributed to annual inflation rates during 2009 and are likely to continue to affect annual inflation rates in 2010.

The *base month* of an annual rate of inflation for a given month is the same month one year earlier. A *base effect* is defined as the contribution to the change in the annual inflation rate in the given month that stems from that part of the month-on-month change in the base month that cannot be accounted for by typical changes including seasonal fluctuations. In other words, the base effect may be any out of the ordinary change in month-on-month inflation that relates specifically to the base month. In order to identify inflation developments that are more 'current' in nature, it is important to first disentangle any base effects. It is worth noting that, when central bank credibility is such that second-round effects are limited, the base effects will to a large degree only have a short-term impact on inflation and will not help to explain the underlying trend in inflation.

During the current period of relatively high volatility in inflation, the change in annual inflation rates from one month to the next tends to be heavily influenced by base effects. For example, although there was no change in the CPI on a monthly basis in November 2009, there was a sharp rise in the annual CPI inflation rate to -5.7 per cent, from a rate of -6.6 per cent the previous month. The large shift upwards in the annual outturn for November 2009 reflects the impact of a strong base effect (relating to the pass-through of a 50 basis points ECB base rate cut in November 2008) rather than any dramatic developments in inflationary pressures during the month.

The unusually high volatility in the annual Irish HICP inflation rate in recent years can be explained to a large extent by the strong volatility in international commodity prices. Energy base effects and, to smaller degree, food base effects were quite prominent during 2009 and are likely to continue to be during the course of 2010 (see Chart A). Both energy base effects and other base effects were pushing the annual inflation rate downwards during much of 2009 and offset the positive contribution from more current inflationary pressures. The latter contribution subsided as 2009 progressed reflecting the continued contraction in economic activity. In contrast to last year, the contribution of base effects is set to work in the opposite direction during 2010, offsetting the negative contribution from more current inflationary pressures. The net effect will see the annual HICP inflation rate gradually rise during this year.

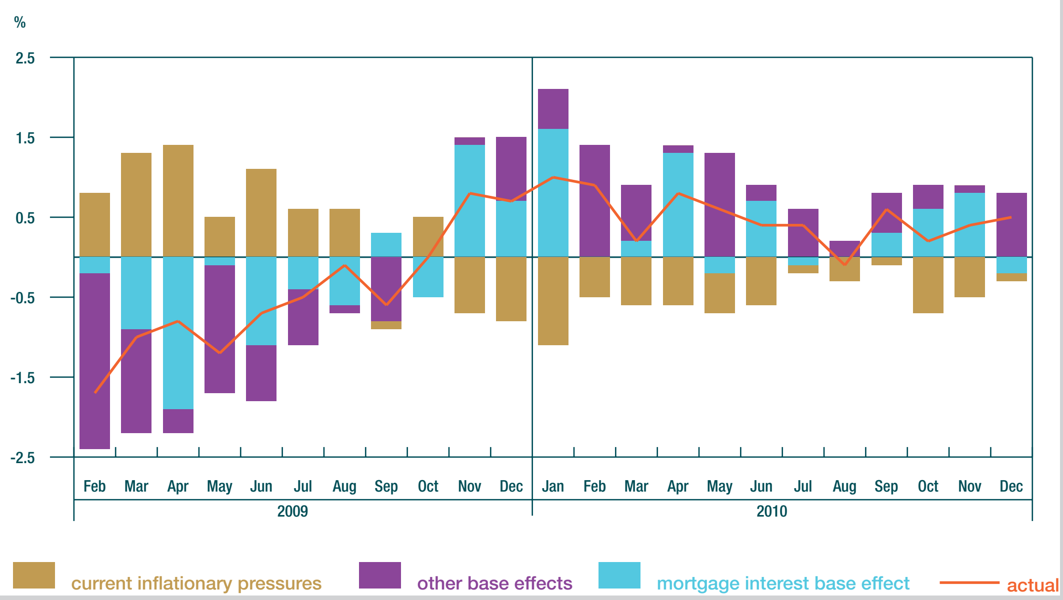
Chart A: Contribution of Base Effects to the Monthly Changes in Annual HICP Inflation



Note: For a given month, the base effects are calculated as the deviation of the monthly change twelve months previously from the 5-year average monthly change for that month.

Along with base effects arising from volatility in energy prices, the impact of changes to mortgage interest repayments on the annual CPI inflation rate was important last year (see Chart B). The mortgage interest base effect was pushing the annual CPI inflation rate downwards during the first three quarters of 2009, offsetting the positive contribution from inflationary pressures pertaining during that period. As noted above, the contribution from inflationary pressures subsided as 2009

Chart B: Contribution of Base Effects to the Monthly Changes in Annual CPI Inflation



Note: Other base effects include significant energy base effects.

progressed reflecting the continued contraction in economic activity. In contrast to last year and with a similar profile to the energy base effects impact, the contribution of base effects from mortgage interest repayments is set to work in the opposite direction during 2010, offsetting the negative contribution from inflationary pressures. The net effect will see the annual CPI inflation rate also gradually rise during this year.

In conclusion, due to the impact of base effects arising from volatility in energy and mortgages interest rates last year, movements in both the annual HICP and CPI inflation rates will mask the underlying pattern of inflation during 2010. Indeed, of the projected increase in the annual HICP inflation rate between December 2009 and December 2010 of 3.3 percentage points, 6.2 percentage points will reflect the cumulative upward impact of base effects while actual inflationary pressures will account for –2.9 percentage points. Similarly, of the projected increase in CPI to the end of 2010 of 6.0 percentage points, 11.6 percentage points will reflect the cumulative upward impact of base effects while actual inflationary pressures will account for –5.6 percentage points.

There are signs that some downward external price pressures are beginning to reverse. According to future markets, oil prices in dollars are projected to be about 30 per cent higher on average in 2010. The fall in piped gas prices of 8 per cent in February may alleviate some upward pressure on energy prices but carbon levies will have a partial offsetting impact. The average HICP price level is now projected to fall by 1.1 per cent this year, with this fall reflecting to some extent a negative carryover from 2009. Upward base effects are set to dominate movements in both annual HICP and CPI inflation rates and the impact of such base effects on headline inflation rates is considered in Box B above. The outlook for CPI inflation this year will depend to a degree on the path of interest rates. In its forecasts, the Bank makes the technical assumption that interest rates move in line with market expectations. Taking into account market expectations of increases in ECB base rates towards the latter part of this year, the projection for the average rate of annual CPI inflation is –1.3 per cent for 2010.

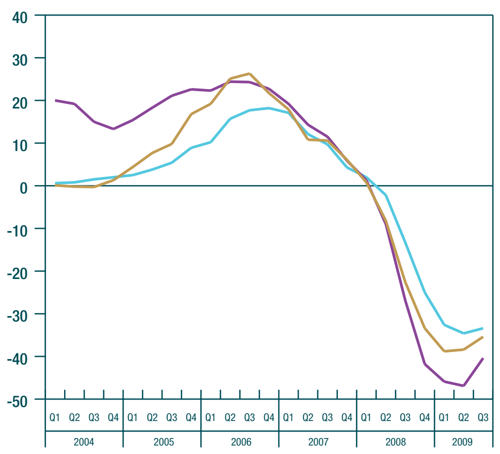
Property Prices

The ESRI/PTSB house price index indicates a cumulative fall in house prices of 26.6 per cent between the peak of early 2007 and October last year. Although quality adjusted and based on actual transactions, these data come with some important caveats, in particular, the unusually low number of transactions of late and the fact that the index lags the market by some months. That said, monthly declines in house prices of between 1 and 2 per cent were recorded during much of 2009 as weak sentiment outweighed a considerable easing in affordability pressures. Private rents fell by over 24.4 per cent between the peak of April 2008 and the end of last year. The large decline in rents reflects sharp falls in disposable income and employment, higher stocks of properties available to rent and the re-emergence of net outward migration. The rate of decline in rents has slowed recently, which may be attributed partly to a fall of about 10 per cent in the supply of rental properties in the three months to October 1st, according to Daft.ie data. However, with a significant oversupply of rental accommodation, estimated at over 20,000 units, still remaining and the prospect of continued outward migration, the decline in rents will likely continue into this year.

Overall commercial property prices have fallen by a cumulative 52.1 per cent in nominal terms between their peak of late 2007 and the third quarter of last year, based on data from the Society of Chartered Surveyors/ Investment Property Databank. The recent declines in property values across all sectors remained quite steep, with quarter-on-quarter falls of between 8 per cent and 9 per cent recorded for each sector during the third quarter of last year. According to the Jones Lang LaSalle Irish Rental Index, rents in the retail sector fell by a cumulative 17.5 per cent between their peak of

Chart 8: SCS / IPD Irish Commercial Property Index

% change in capital values, Year-on-Year

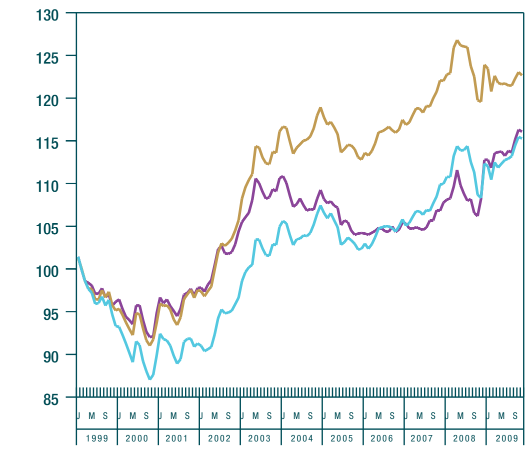


— Office — Retail — Industrial

Source: SCS/IPD

Chart 9: Harmonised Competitiveness Indicators

Base: Quarter 1, 1999 = 100



— Nominal HCI
— Producer Price Deflated HCI
— Consumer Price Deflated HCI

Sources: Central Bank of Ireland and ECB

the first quarter of 2008 and the third quarter of 2009. Rents in the office and industrial sectors began to decline during the second half of 2008 as important trading partners moved into recession but the subsequent declines were steeper; the cumulative declines from peaks were 18.4 per cent and 14.3 per cent, respectively, providing a significant boost to international cost competitiveness. The ban on upward only rent reviews comes into effect from the end of February, but it is not retrospective and it may have only a modest effect in the short-term.

Competitiveness

There are increasing signs that the overall competitiveness position of the economy is improving following a number of years in which Ireland lost competitiveness relative to our main trading partners. In particular, the significant downwards adjustments in prices and wages are providing a timely boost for exporters, made all the more necessary by the continued appreciation of the euro exchange rate in 2009. The outlook for this year is for further price and wage reductions, which should help to improve international price and cost competitiveness.

Exchange Rate Developments

The euro appreciated significantly against sterling over the course of 2009 by 11.9 per cent on average and ended the year trading at the £0.90 mark. This followed a strong appreciation in the euro sterling exchange rate in 2008, which has meant that over the past two years, the euro has gained in value by approximately 30 per cent against sterling. This has serious implications for the indigenous manufacturing sector whose principal export market is the UK, with the latter market accounting for approximately half of all indigenous manufacturing exports[3]. In contrast, the euro declined on average by 5.2 per cent in value against the dollar over the course of 2009, although this masks the fact that the euro appreciated significantly in the fourth quarter of the year by 12.2 per cent annually. The movements in the euro exchange rate against Ireland's major trading partners can be summarised by the nominal Harmonised Competitiveness Indicator (HCI), which can be interpreted as an effective exchange rate. The nominal HCI appreciated in year-on-year terms by 0.9 per cent in the first eleven months of 2009. In contrast, the consumer price deflated HCI declined by 1.4 per cent over the same period, as a result of lower inflation in Ireland relative to our trading partners, pointing to a modest improvement in Irish price competitiveness.

[3] According to the CSO Census of Industrial Production for 2007, 47 per cent of Irish owned manufacturing firms' exports went to the UK.

Chart 10: Hourly Earnings in Manufacturing (in Local Currency)

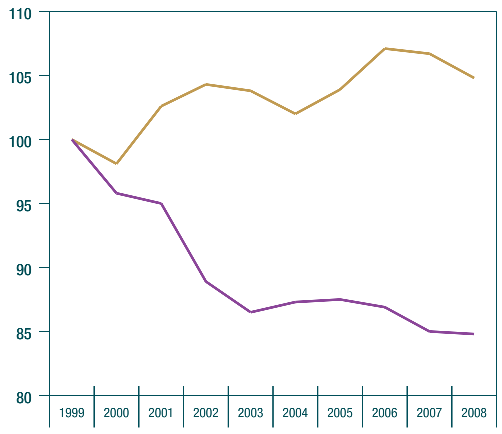
% change Year-on-Year

Ireland
Major Trading Partners
Relative Hourly Earnings

Source: Central Bank of Ireland calculations

Chart 11: Unit Wage Costs in Manufacturing

Base: 1999 =100



Wage share weighted
Output share weighted

Source: Central Bank of Ireland calculations

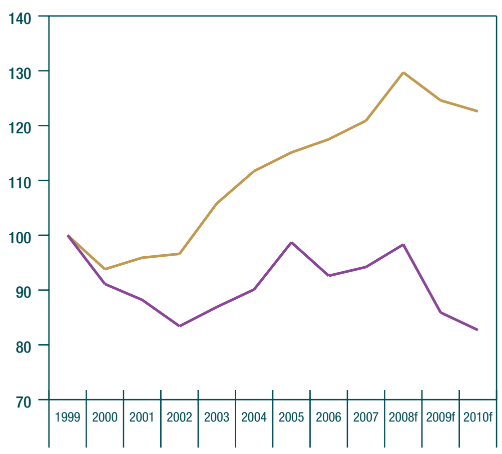
Productivity and Cost Competitiveness

Labour retention in the face of output declines had resulted in falling measured productivity in 2008; in contrast, the sharp declines in employment in 2009 resulted in a modest increase in productivity last year, measured on a GDP basis[4]. In light of recent trends and the macroeconomic and labour market outlook for 2010, positive productivity growth of 2.9 per cent is projected for this year.

Recent and prospective productivity developments coupled with the outlook for wages should lead to a further improvement in Irish unit labour cost competitiveness. Unit labour costs are expected to decline by 5.5 per cent this year, following an estimated decline of 3.8 per cent in 2009. These declines follow robust increases in unit labour costs in the 5-year period to 2008, when unit labour costs increased by 4 per cent per annum on average. The outlook for unit labour costs compares favourably with developments in Ireland's main trading partners. In the euro area, for example, nominal unit labour costs increased by an estimated 3.3 per cent last year, with a decline of 0.4 per cent projected for 2010, according to the latest European Commission estimates. These projections would point to an improvement in Ireland's labour cost competitiveness position relative to our major trading partners and would also leave the economy better placed to benefit from a global economic upturn.

Chart 12: Irish Unit Wage Costs Relative to Main Trading Partners (in Common Currency)

Base: 1999 =100



Whole Economy   Manufacturing Sector

Source: Central Bank of Ireland, ECB and AMECO

[4] On a GNP basis, productivity remained negative in 2009, reflecting the very sharp contraction in real GNP.

Public Finances

The 2009 Outturn

The magnitude of the deterioration in the public finances last year was captured by the sharp increase in the Exchequer deficit to €24.6 billion, up from €12.7 billion in 2008 (Table 8). The end-year Exchequer outturn however, was about €600 million better than was predicted in the December Budget reflecting an improvement in tax receipts in the final month of the year.

On the revenue side, tax receipts fell sharply in 2009 to €33 billion, a fall of 19 per cent in annual terms. Most of the major tax heads underperformed, with the two largest taxes, VAT and income tax down by 20.6 per cent and 10.2 per cent, year on year, respectively. Capital taxes remained extremely weak last year reflecting the continuing contraction in the housing sector. On the upside, corporation and excise taxes came in ahead of target in 2009, although still registering sharp year-on-year declines. The end-year tax take was approximately €500 million better than expected in last December's Budget. Despite this, taxes by year end had reverted back to 2003 levels.

On the expenditure side, total net voted spending amounted to roughly €47 billion last year, a decline of 4.4 per cent (€2 billion) relative to 2008[5]. Within this, net voted current spending amounted to €40.3 billion, which was down 1.2 per cent in year-on-year terms. On the capital side, net voted expenditure amounted to €6.9 billion in 2009, a fall of 19.3 per cent year-on-year. In contrast, non-voted capital expenditure increased sharply by €5.3 billion, to reach €7.8 billion in 2009, due to payments to Anglo Irish Bank and the front loading of the annual contribution to the National Pensions Reserve Fund. Central Fund expenditure also increased sharply due to much higher debt servicing costs, which increased by over €1 billion in 2009 (Chart 13). In contrast to the trend in tax receipts, total expenditure by year end, was approximately 70 per cent above 2003 levels.

[5] Expenditure totals relate to figures published in the end 2009 Exchequer Statement.

When the end-year Exchequer data are factored in, the broader General Government deficit[6] for 2009 is likely to come in below the 11.7 per cent of GDP Budget target, perhaps by about ¼ per cent of GDP. In terms of borrowing, the overall debt to GDP ratio is estimated to have increased to 64.5 per cent of GDP last year, up from just 25 per cent at end-2007. That said, when account is taken of cash balances held by the Exchequer and the value of the National Pensions Reserve Fund, the net debt position is lower at an estimated 39.5 per cent of GDP at end 2009.

Exchequer Financing

The Exchequer deficit of €24.6 billion last year was financed by very high levels of Government borrowing. This borrowing was mainly financed through the issuance of Government bonds by the National Treasury Management Agency (NTMA) and overall the NTMA raised roughly €35 billion in long-term funding in 2009.

Budget 2010

The 2010 Budget was presented to the Dáil on December 9th against a very challenging economic background, with an estimated pre-Budget General Government Deficit of 11¾ per cent of GDP for 2009 and 13½ per cent in 2010, despite the introduction of significant consolidation measures, amounting to approximately 5 per cent of GDP, since mid-2008. As mentioned above, tax revenues in 2009 reverted back to around 2003 levels and were down €14 billion, or by 30 per cent since 2007.

Having predominantly focused earlier in the adjustment process on taxation and levy increases, the 2010 Budget consisted of a €4 billion expenditure based consolidation package (just over €3 billion net)[7], with only minimal changes on the taxation side, with the aim of stabilising the General Government

[6] The Exchequer Balance measures the performance of Central Government on a "cash basis". The General Government Balance (GGB) measures all arms of Government on an "accruals basis". The GGB is the standard measure used by the EU in assessing and comparing fiscal performance.

[7] Budget 2010 is estimated to have a dampening effect on economic activity, with negative revenue buoyancy of about €900 million, although this is offset to a degree by projected lower interest costs of €200 million.

Table 8: Outturn for 2009 and Budgetary Plans for 2010

	2008 €m	2009 €m	% Change	2010 €m	% Change
Current Expenditure					
— Central Fund Services[a]	3,936	4,992	26.8	6,932	38.9
— Net Voted Expenditure[b]	40,757	40,256	–1.2	40,191	–0.2
Total	**44,693**	**45,248**	**1.2**	**47,123**	**4.1**
Current Revenue					
— Tax revenue	40,777	33,043	–19.0	31,050	–6.0
— Non-tax revenue[c]	847	836	–1.3	2,355	181.7
Total	**41,624**	**33,879**	**–18.6**	**33,405**	**–1.4**
Current Budget Balance	**–3,069**	**–11,369**		**–13,718**	
Capital Budget Balance	**–9,645**	**–13,272**		**–5,062**	
Exchequer Balance	**–12,714**	**–26,641**		**–18,780**	
General Government Balance (% of GDP)[d]	**–7.2**	**–11.7**		**–11.6**	
Source and Application of Funds					
Total (Borrowing)/Repayments	–30,311	–24,474			
Total Increase in Exchequer Deposits	17,597	–167			
Exchequer Balance	**–12,714**	**–24,641**			

[a]Debt servicing, judicial salaries and pensions and EU Budget contribution.
[b]Government current expenditure on areas such as Social Welfare, Health, etc.
[c]Central Bank surplus income, National Lottery surplus, interest and dividends. The increase in 2010 is primarily driven by receipts from the Credit Institutions Scheme 2008.
[d]Budget 2010 estimate.

Deficit in 2010 at 11.6 per cent of GDP (Table 8). In Exchequer terms, this translates into a deficit of €18.8 billion.

The main adjustments on the expenditure side in Budget 2010 were as follows:

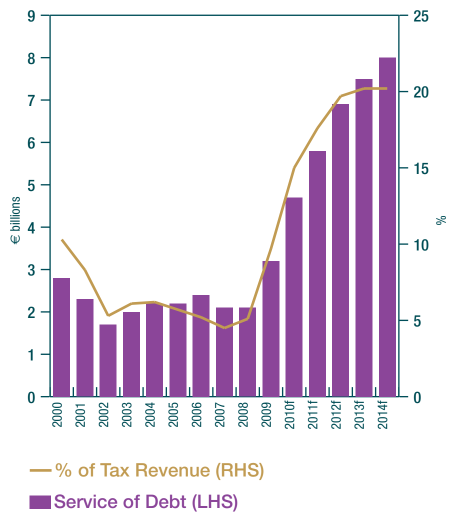
- Public Sector Pay: €1.0 billion in payroll savings through tiered pay cuts;
- Social Welfare: €0.8 billion in savings;
- Other current expenditure savings of €1.3 billion;
- Capital savings amounting to €1.0 billion.

Despite these consolidation efforts, significant pressures remain on the current expenditure side due to the operation of automatic stabilisers coupled with a much higher national debt interest burden, as evidenced by a further sharp increase in central fund expenditure in 2010 (Table 8). In terms of the latter, higher national debt interest repayments will become an increasing drag on resources in the coming years, rising from €2.5 billion in 2009, or approximately 8 per cent of tax revenue to a projected 20 per cent of tax revenue by 2014, according to Budget 2010 (Chart 13). These pressures on the current expenditure side emphasise the necessity to keeping to a viable medium-term convergence path.

The decision to tackle the deficit through reducing expenditure was taken in the context of falling prices and already high rates of effective taxation. In terms of the former, the fall in prices mean that Government can pay less for the same level of services and maintain the real value of transfers at a lower nominal cost. In addition, the decision to reduce expenditure accords with the lessons from Ireland’s experiences in the 1980s, and also from international evidence, that carefully targeted and prioritised expenditure-based consolidation measures are generally more effective than an over-reliance on tax based solutions. In this context, Budget 2010 is a significant step in restoring stability to the public finances.

The mechanical effect of the reduced net spending in the Budget on aggregate demand

Chart 13: Interest Expenditure



Source: Budget 2010 and Central Bank Estimates

is likely to exert a negative impact on growth in 2010, although this could be offset by an improvement in consumer confidence and a more positive international market outlook on the Irish economy[8]. The taxation measures in Budget 2010 are likely to exert further downward pressure on consumer prices this year with a direct effect of about 0.3 percentage points.

Ireland — Stability Programme Update

An 'Updated Stability Programme' (SP) for Ireland was also included in Budget 2010. This showed revised macroeconomic and fiscal projections covering the period to 2014. The macroeconomic outlook in the SP, projects a further contraction in GDP by 1.3 per cent this year, before a return to positive growth of 3.3 per cent in 2011. Over the period 2011-2014, average annual GDP growth of 4 per cent is forecast. The labour market outlook is projected to improve, albeit more gradually, with the unemployment rate remaining in double digits until 2014. Consumer price inflation is projected to average 1.6 per cent per annum over the 2011-2014 period.

Fiscal Stance of Budgetary Policy

In order to assess the underlying impact of the Budget on the economy, it is necessary to examine the change in the structural primary budget balance, which is, the fiscal position adjusted for the economic cycle, interest payments and excluding temporary factors. The Department of Finance estimate that whilst the actual budget deficit will be 11.6 per cent of GDP in 2010, the structural primary deficit will be 6.5 per cent in 2010, as compared with a deficit of 7.2 per cent in 2009. This projected improvement in the structural deficit indicates a tightening in budgetary policy in 2010 with the aim of stabilising the General Government Deficit this year. Furthermore, the structural deficit is projected to improve further by an annual average of 1.7 per cent between 2011 and 2014. This suggests that total structural corrections will amount cumulatively to 7.6 per cent of GDP over the period of 2010 to 2014, in order to bring the General Government Deficit below the 3 per cent of GDP Stability and Growth Pact deficit limit by 2014, the deadline set by the European Commission.

[8] In the context described here, the increase in the savings ratio in Ireland in recent years may partly have been driven by concerns about government borrowing and the potential future tax liability. Therefore, concerted action to improve the government finances may limit the increase in savings by giving confidence that the fiscal outlook is improving.