



Budgeting for Fiscal Stability

Pensions
Protection
Investments

Economic Outlook

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30th November 2011

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MOST INDICATORS OF ECONOMIC ACTIVITY IN MOST COUNTRIES HAVE DIPPED IN A VERY WORRYING MANNER.

KEY POINTS THIS QUARTER

- The international economic backdrop has deteriorated significantly since the beginning of the summer. Most indicators of economic activity in most countries have dipped in a very worrying manner. Policy makers need to recognise that the lack of growth and not inflation has to be the key priority. The Bank of England and the Federal Reserve will persist with historically low interest rates. The ECB will cut rates further, with a base rate of at least 0.75 per cent a clear possibility.
- Europe is on the verge of major change, much akin to what happened in 1989. The Euro could now easily fall apart, or if it is to be saved, it will require fundamental changes to the way in which Europe is governed politically and economically. Policy makers will have to realize that the economic and political cost of the Euro falling apart would far outweigh the costs of keeping it together. The choice is in Europe's hands.
- From an Irish perspective, we need to create a contingency plan in the event of the system falling apart - this could involve a re-establishment of the sterling link or seeking to anchor to either the informal hard or soft Euro bloc that would ensue if the system were to collapse. Ireland will not influence the solution to this European crisis, so in the meantime we should keep the head down and proceed with haste to get our public finances out of their totally unsustainable position. We need to make sure we are in as strong a place as possible in the event of the unthinkable happening. Government cannot be deterred by vested interest groups who are more concerned with their own interest rather than the national interest.
- Economic conditions remain very difficult and challenging in the Irish economy. The dual nature of the economy is however more apparent than ever. Domestic demand, as in consumer spending and business investment spending, remains very weak, while the export side of the economy is performing relatively strongly.
- All indicators of housing activity including mortgage lending, new home commencements, registrations, planning permissions and prices are still weakening. House completions in 2011 could be around 11,000 and national average prices look set to decline by around 13 per cent. Looking ahead to 2012, prospects for recovery in the market are not promising. Lack of credit and pressure on disposable incomes will be the two dominant negative factors. National average house prices could fall by another 8 per cent in 2012 and new home completions are likely to be around 10,000. The balance of risk for next year is still very much on the downside as it is very difficult to identify any factors that could possibly give a boost to the market.
- Preparing a macro-economist forecast for the Irish economy for 2012 is a pretty meaningless and dangerous exercise; such is the element of uncertainty now prevailing. Based on the assumption, which is a very brave assumption at this juncture, that the Euro crisis will eventually be resolved in a manner which will keep the system intact, with Ireland remaining a part of it, the growth outlook for 2012 is for modest growth at best. In the event of the Euro breaking up, the Irish economy and its financial system would be likely to descend into chaos.

ECONOMIC OUTLOOK

- Based on a survival of the Euro, GDP looks set to expand by around 0.5 per cent in 2011 and 1.4 per cent in 2012. GNP looks set to contract by around 0.3 per cent in 2011 and expand by 0.3 per cent in 2012.
- Consumer spending will remain under pressure in 2012 as the fiscal correction continues to bite. Export growth and import growth will be slower than in 2011, so net trade will be the only meaningful contributor to economic growth in 2012.
- There is not a lot that the Irish Government will be able to do to resolve the crisis in the Euro Zone – that will be resolved or not as the case might be in the corridors of power in Berlin, Brussels, Frankfurt and Paris. The key task of the Irish Government will be to proceed with the issues that are within its own control. The key economic policy imperatives for Government in order to re-create a sustainable economic model include the creation of a sustainable public finance situation; the re-establishment of a functioning banking system; re-establishing the competitiveness of the economy; restoring confidence; supporting the protection and creation of jobs; and the restoration of Ireland's international reputation.
- While the export recovery is good news, the growth is being driven by higher productivity rather than employment creation. A recovery in domestic demand is essential for employment creation and stronger public finances. Until adequate credit flow returns to the business sector, investment will remain weak. Government included in its Programme for Government a commitment to set up a Strategic Investment Bank, but unfortunately that commitment appears to have receded. A new bank capitalised by funding from the National Pension Reserve Fund (NPRF) and external investment, targeting the credit-starved SME sector is an important component of Ireland's recovery path.
- Given the totally unsustainable nature of the Irish public finances, it is difficult to argue with the broad thrust of medium-term fiscal policy as outlined by the Minister for Finance. However, one aspect of the fiscal debate that has been misdirected since 2008 is the consistent focus on the quantity of tax increases and expenditure cutbacks, rather than on their quality. While fiscal adjustment is always going to be painful by definition, there are good and not so good ways of actually doing it. If targeted properly, the fiscal adjustment can be less damaging and negative from an economic and social perspective.
- Virtually every citizen of the country will be worse off after Budget 2012 and indeed at the end of the medium-term fiscal correction. The outlook for the Irish economy is clearly very challenging and is likely to remain so for the best part of the next decade. As part of this, the Irish will have to face the unfortunate reality that the standard of living will be lower over the next decade than it was over the past decade. If it is any consolation, most countries face a similar prospect, including the U.S.
- The Minister for Finance must remain steadfast in his commitment to get borrowing back under control and stabilise the dangerously high debt level. Vested interest groups should not be allowed stand in the way of what needs to be done. Choices will of course have to be made. While recognising that whatever measures might be taken will damage employment, the imperative is to introduce measures that would be least damaging to employment. So for example, a 2 per cent increase in the VAT rate would not be as damaging to employment as an increase in income tax. Tough choices will have to be made.

THE ECONOMIC AND POLITICAL COST OF THE EURO FALLING APART WOULD FAR OUTWEIGH THE COSTS OF KEEPING IT TOGETHER.

INTERNATIONAL BACKGROUND AND OUTLOOK

The developed world is currently characterised by low growth, high unemployment, and Government borrowing and debt levels that are too high for comfort. These economies are currently under significant pressure from a combination of the ongoing fallout from the greatest global financial crisis since the 1930s and Government debt levels that are quite simply unsustainably high and which will have to be brought down with negative implications for medium to long-term growth.

Fiscal consolidation will have to be a key feature of the developed world economies over the next decade in order to attempt to alleviate the serious imbalances in the global economy.

Table 1 provides a sample of projected gross and net Government debt levels and budget deficits in 2011 and the latest unemployment rate in a range of developed economies.

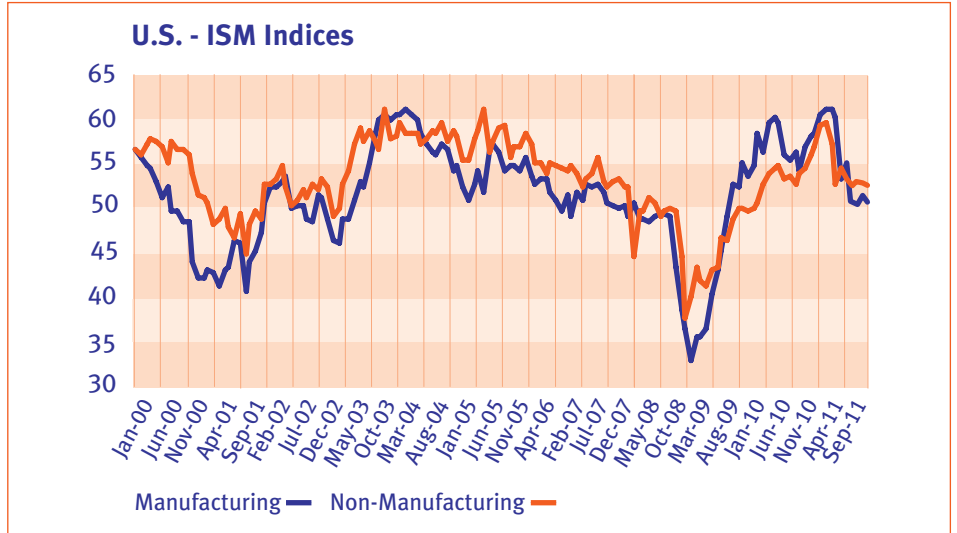
Table 1

ECONOMY	GROSS DEBT % GDP	NET DEBT % GDP	NET BORROWING % GDP	UNEMPLOYMENT RATE
U.S.	100.0%	72.6%	-9.6%	9.0%
Euro Area	88.6%	68.6%	-4.1%	10.2%
Germany	82.6%	57.2%	-1.7%	7.0%
France	86.8%	81.0%	-5.9%	9.9%
Italy	121.1%	100.4%	-4.0%	8.3%
Japan	233.1%	130.6%	-10.3%	4.1%
U.K.	80.8%	72.9%	-8.5%	8.3%
Canada	84.1%	34.9%	-4.3%	7.3%

Source: OECD, Sept 2011 & National Statistical Agencies

Against this background, the international economic performance has deteriorated significantly since the beginning of the summer. In the U.S., GDP expanded at a seasonally adjusted annualised rate of 0.4 per cent in the first quarter, 1.3 per cent in the second and 2 per cent in the third. Growth is clearly well below potential and the unemployment rate remains stubbornly high at 9 per cent of the labour force.

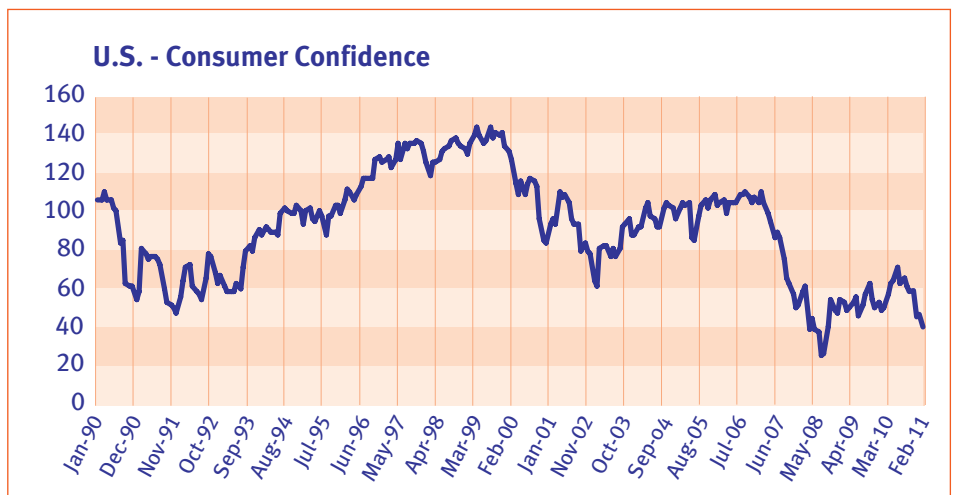
Chart 1



Source: Bloomberg

The ISM indices of manufacturing and service sector activity are still both reading above the crucial 50 level but both are hovering dangerously close (Chart 1). Consumer confidence levels also remain very weak as consumers remain under pressure due to high unemployment and a very uncertain fiscal outlook (Chart 2).

Chart 2

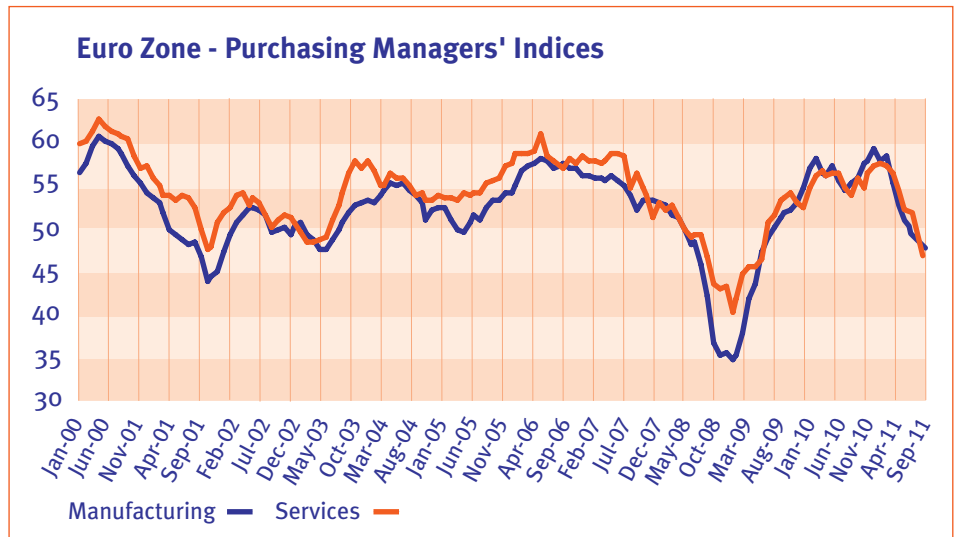


Source: Bloomberg

IN THE EURO ZONE, WHERE THE SOVEREIGN DEBT CRISIS IS GATHERING MOMENTUM, GROWTH HAS ALSO SLOWED QUITE DRAMATICALLY.

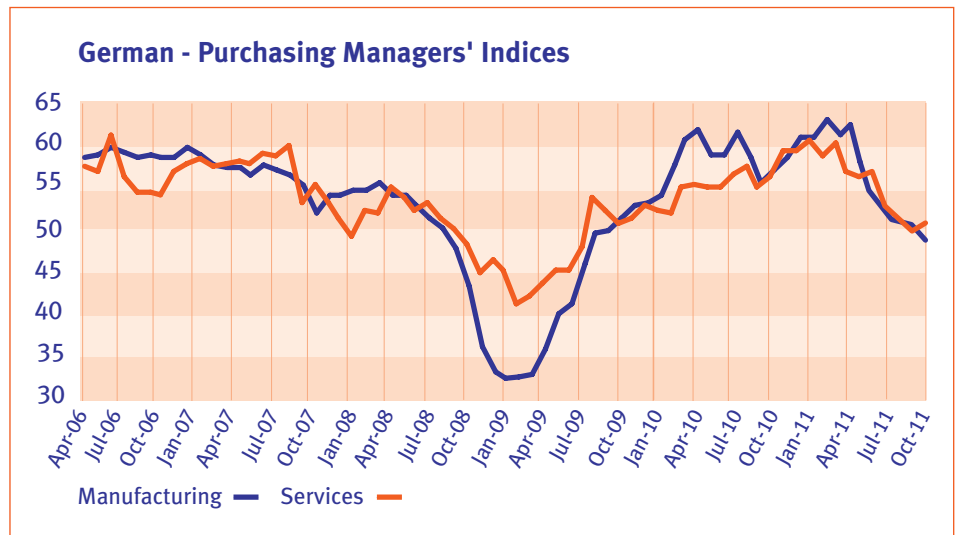
In the Euro Zone, where the sovereign debt crisis is gathering momentum, growth has also slowed quite dramatically. In the third quarter, GDP in the Zone expanded by just 0.2 per cent. The annual growth rate slowed from 1.6 per cent in the second quarter to 1.4 per cent. In the North, France and Germany experienced reasonable growth, but in the South, Spain stagnated and Portugal contracted by 0.4 per cent. The purchasing managers' indices of manufacturing and service sector activity have both fallen below the crucial 50 level in recent months (Chart 3). Even in the previously very robust German economy, the indices are hovering around the 50 level (Chart 4) and business confidence has weakened sharply.

Chart 3



Source: Bloomberg

Chart 4

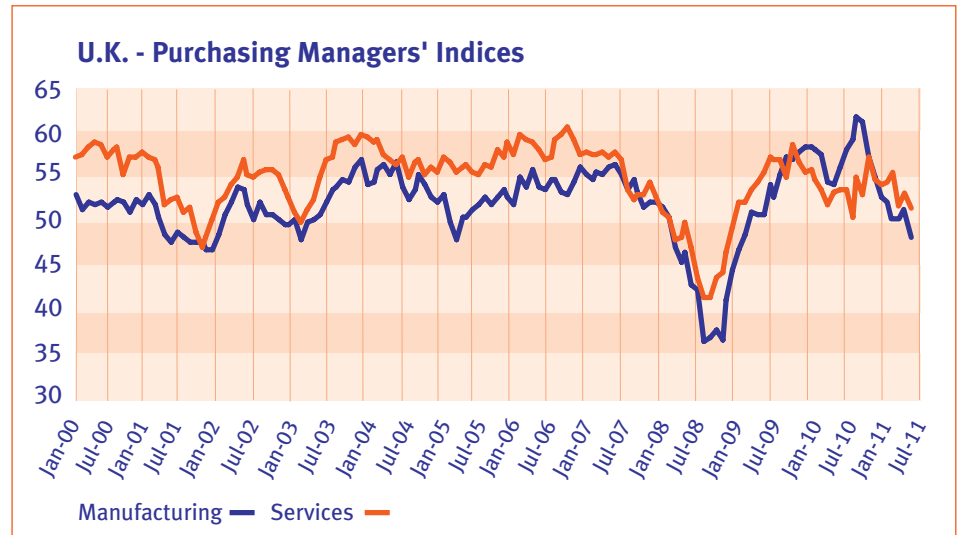


Source: Bloomberg

EUROPE IS ON THE VERGE OF MAJOR CHANGE, MUCH AKIN TO WHAT HAPPENED IN 1989.

In the UK, growth has also slowed markedly but not as significantly as might have been expected given the nature of the fiscal squeeze in that economy. GDP expanded by 0.4 per cent in the first quarter, 0.1 per cent in the second and 0.5 per cent (preliminary) in the third. The growth in the third quarter was driven primarily by the services sector, although consumer spending is holding up quite strongly given the magnitude of the fiscal tightening. The purchasing managers' indices of the manufacturing and service sectors have both fallen below the 50 level, suggesting a significant weakening in both sectors over the coming months.


Chart 5



Source: Bloomberg

All in all, the global economic backdrop has deteriorated markedly over the past six months and the outlook for the coming year is not promising. Fiscal austerity will be a key theme. The lack of growth and high unemployment will have to be the focus for global policy makers and inflationary fears cannot influence policy. The Bank of England and the Federal Reserve will persist with historically low interest rates. The ECB will cut rates further, with a base rate of at least 0.75 per cent a clear possibility.

Nobody can now claim to know with any certainty how the Euro Zone crisis will unfold over the coming weeks. However, it is very clear that the survival of the project in its current form is now high risk and very finely balanced. From an economic perspective, the decisions needed to save it are reasonably straight forward. In the short-term, this will necessitate the creation of an EFSF of at least €3 trillion and massive bond purchasing by the ECB based on quantitative easing of money supply, Greek default of at least 50% and re-capitalisation of the affected banks. This will have to be followed up in the longer-term with the creation of a Euro-bond guaranteed by Europe and greater fiscal discipline imposed from the centre. In other words, the creation of fiscal federalism. This should have happened back in 1999, but the whole Euro project was a victory for politics over economics. The economic realities have now come back to bite and it will be interesting to see how the political system responds.



It is far from clear how political agreement will ever be reached either from the Germans who will effectively be bankrolling the solution or those countries that will be forced to cede so much political and fiscal sovereignty. The constitution of the ECB will have to be changed to allow it do what is necessary and treaty changes will be required. This will prove very difficult, not least in Ireland where a referendum would have to be held. However, the political systems will have to recognise that the cost of saving the system is likely to be far less than the political and economic chaos that would follow if the system were allowed fall apart. If the Germans agree to sign the proverbial cheque, the Euro can survive. If the Germans refuse, it will fall apart. It is quite simple.

The costs of the Euro falling apart would be enormous. Politically, the whole process of European Union could be set back 50 years and could seriously fracture the political entity. That would leave China and the U.S. as the global economic and political superpowers. Economically, a breakup would create chaos – the banking systems and economies of the weaker countries would be thrown into chaos and the core countries would experience a rapid and damaging appreciation of their currencies.

Europe is on the verge of major change, much akin to what happened in 1989. The Euro could now easily fall apart or if it is to be saved, it will require fundamental changes to the way in which Europe is governed politically and economically.

From an Irish perspective, we need to create a contingency plan in the event of the system falling apart. This could involve a re-establishment of the Sterling link or seeking to anchor to either the informal hard or soft Euro bloc that would ensue if the system were to collapse. Ireland will not influence the solution to this European crisis, so in the meantime we should keep the head down and proceed with haste to get our public finances out of their totally unsustainable position. We need to make sure we are in as strong a place as possible in the event of the unthinkable happening. Government cannot be deterred by vested interest groups who are more concerned with their own interest rather than the national interest.

AFTER THREE VERY DIFFICULT YEARS FOR THE IRISH ECONOMY, 2011 HAS SEEN SOME STABILISATION OF ECONOMIC ACTIVITY.

CURRENT STATUS OF THE IRISH ECONOMY

ECONOMIC GROWTH

After three very difficult years for the Irish economy, 2011 has seen some stabilisation of economic activity. In the second quarter real GDP was 1.6 per cent higher than the previous quarter and real GNP was 1.1 per cent higher. In the first half of 2011, gross domestic product (GDP) was 1.3 per cent higher than the first half of 2010 and gross national product (GNP) was 1 per cent higher. In the first half of the year, consumer spending was 2.7 per cent lower than the first half of 2010; net expenditure by Government was 3.6 per cent lower; investment was 11.8 per cent lower; exports were 5.5 per cent higher and imports were 2.1 per cent higher.

One of the key challenges for policy makers is that the recovery in the economy is being primarily driven by the external sector, with much of the export growth being driven by productivity improvements rather than employment creation. A meaningful recovery in domestic demand will be a pre-requisite for a more broadly-based recovery and a sustainable improvement in employment and the public finances. Domestic demand remains very weak as consumers still lack the confidence to spend with disposable incomes still falling while business investment spending continues to be hampered by a lack of credit.

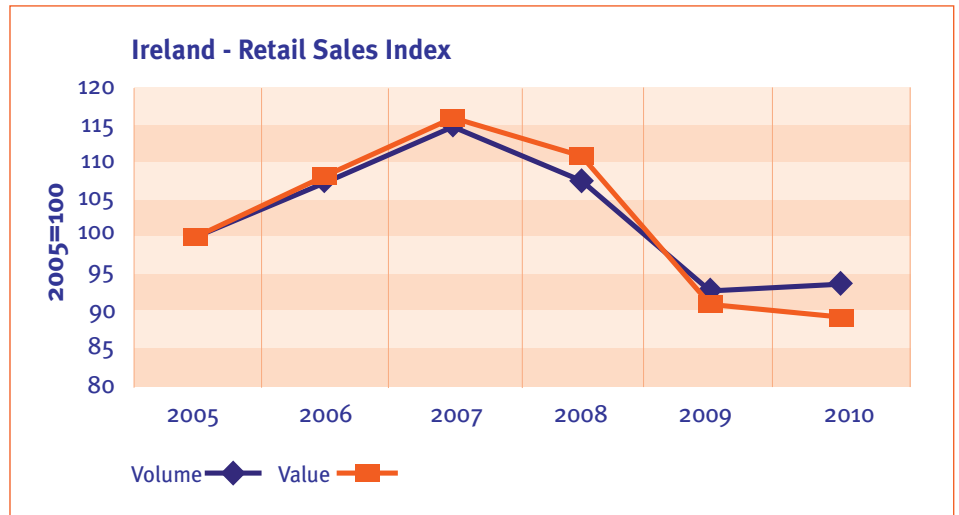
CONSUMER SPENDING

In the period from 2000 to 2007, consumer spending became a key driver of economic activity, much of it fuelled by cheap and readily available credit. This changed dramatically after 2008. In 2008, total consumer spending on goods and services declined by 1.1 per cent in real terms; it declined by 6.9 per cent in 2009 and by 0.8 per cent in 2010. The weakness has carried over to 2011. In the first half of the year, total consumer spending was 2.7 per cent lower than the first half of 2010. The explanatory factors are quite obvious and easy to understand. They include downward pressure on wages, a sharp decline in employment, higher personal taxes, cuts in Government expenditure, massive destruction of personal wealth, personal debt difficulties and significant downward pressure on disposable incomes.

Retail sales data capture expenditure on goods only and account for approximately 44 per cent of total consumer expenditure on goods & services. Having grown strongly for a decade, retail sales fell very heavily from 2008 onwards. In volume terms, retail sales fell by 6.1 per cent in 2008 and by 14 per cent in 2009; sales expanded by 1 per cent in 2010. In value terms, retail sales fell by 4.5 per cent in 2008, 18 per cent in 2009 and 2 per cent in 2010. The marked divergence in growth in volume and value terms from 2009 onwards is indicative of the fact that retailers are being forced to cut prices to shift stock. In short, it has been a very difficult trading environment for the retail sector.

CONSUMER CONFIDENCE REMAINS FRAGILE, ALTHOUGH THERE WAS AN UNEXPECTED AND NOT EASILY JUSTIFIABLE IMPROVEMENT IN OCTOBER

Chart 6

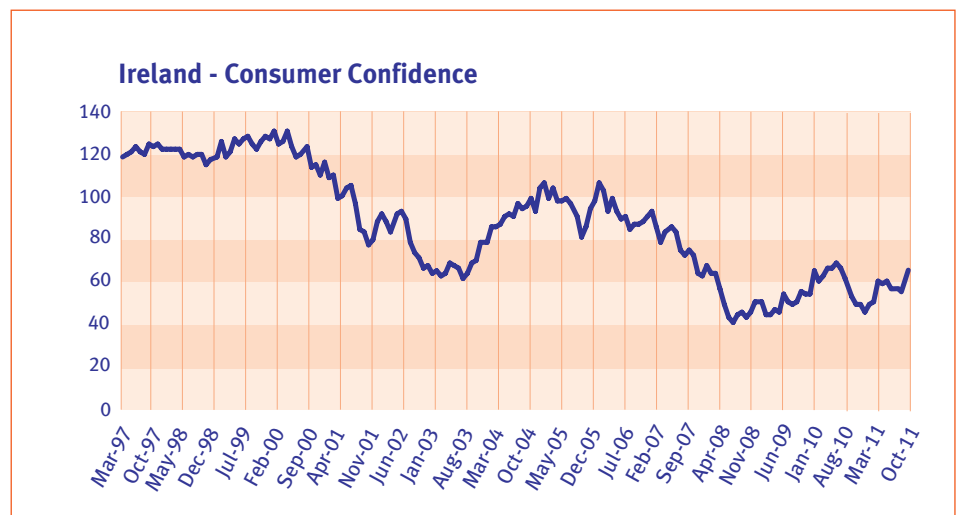


Source: CSO

The weakness in retail spending has continued in 2011. In the first nine months of the year, the volume of retail sales was 1.3 per cent lower than the same period in 2010, while the value of sales was down by 1.1 per cent. When the motor trade is excluded, the underlying picture was even weaker – the volume of sales declined by 3.3 per cent, and the value of sales declined by 2.4 per cent.

Consumer confidence remains fragile, although there was an unexpected and not easily justifiable improvement in October. Consumers remain very concerned about future employment prospects, downward pressure on earnings, mortgage and other personal debt difficulties and the ongoing fiscal adjustment. Personal savings levels are high but consumers lack the confidence to spend and are engaging in pre-cautionary saving. Fragile consumer confidence is being further exacerbated by the ongoing and escalating Euro Zone crisis.

Chart 7



Source: ESRI/KBC Bank, November 2011

EXTERNAL TRADE

The trade data show that in the first nine months of the year, the value of merchandise exports, which excludes services such as tourism and financial services that we export, was 4.1 per cent higher than the first nine months of 2010. The value of exports in September was 2.7 per cent higher than September last year. In the first nine months imports were 6.1 per cent higher than the same period last year. A total merchandise trade surplus of €33.3 billion was recorded in the first three quarters, which was almost 2 per cent ahead of the same period in 2010. In the first eight months, exports of food and live animals showed growth of 15 per cent, while exports of chemicals & pharmaceuticals expanded by 8.5 per cent.

In the context of the very stark slowdown in global economic activity, this export performance is very impressive, although the pace of growth is clearly losing some momentum. The performance of the Agri-food sector is particularly encouraging and the farming interest groups are certainly well within their rights in calling on the Government to do nothing in the budget that might undermine the competitiveness of that increasingly important and high value added sector of the economy.

The strong export performance reflects stronger external demand and improved cost competitiveness. This model needs to be promoted by policy makers. The key risk for the export sector is the ongoing weakness of the global economy.

EXTERNAL COMPETITIVENESS

At a macro-economic level, the Harmonised Competitiveness Indicator (HCI) is a key measure of a country's cost competitiveness measured against its major trading partners.

There are three ways of measuring the HCI:

1. The nominal HCI, which includes inflation,
2. The real HCI, which is deflated by consumer prices and
3. The real HCI deflated by producer prices.

Between 2000 and 2008, Ireland lost considerable international cost competitiveness on all three metrics. Between the end of 2000 and April 2008:

- The nominal HCI appreciated by 31.4 per cent,
- The real HCI deflated by consumer prices appreciated by 39.4 per cent and
- The real HCI deflated by producer prices appreciated by 26.3 per cent.

This reflected adverse exchange rate movements as well as sharp increases in the general cost of doing business and in consumer prices. This loss of competitiveness was instrumental in the slowdown in both service and merchandise exports and the pressure on the capacity to attract foreign direct investment. Following the onset of recession in 2008, Ireland's external cost competitiveness improved as most prices and costs responded to the changed economic circumstances.

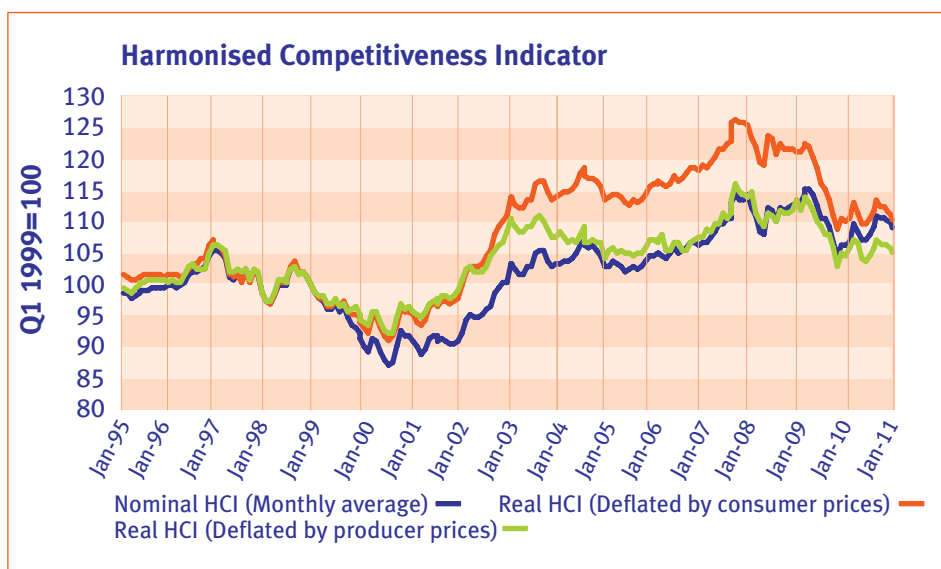
EXPORT PERFORMANCE IS VERY IMPRESSIVE, ALTHOUGH THE PACE OF GROWTH IS CLEARLY LOSING SOME MOMENTUM.

Between April 2008 and September 2011:

- The nominal HCI has fallen by 4.8 per cent,
- The real HCI deflated by consumer prices has fallen by 13.2 per cent and
- The real HCI deflated by producer prices has fallen by 9.3 per cent.

This reflects favourable exchange rate movements, a downward adjustment to consumer prices and a decline in many of the costs of doing business.

Chart 8



Source: Central Bank of Ireland

THE LABOUR MARKET

Not surprisingly, against this very challenging economic background the labour market has deteriorated in a very damaging fashion - unemployment has increased sharply and significant job losses have occurred across the private sector and more recently in the public sector.

Table 2 provides a sector-by-sector breakdown of recent employment trends across the economy. The most up to date data refer to the second quarter of 2011. Between the highest point of the labour market in the third quarter of 2007 to the second quarter of 2011, total employment in the economy declined by 328,500.

Table 2

EMPLOYMENT TRENDS			
SECTOR	CHANGE FROM PEAK*	CHANGE OVER 12 MONTHS	NUMBERS EMPLOYED Q2 2011
Agriculture, F&F	-30,400	+900	85,800
Industry	-71,900	-6,400	233,700
Construction	-162,900	-19,600	105,700
Wholesale & Retail Trade	-48,600	-3,500	265,600
Transportation & Storage	-2,600	+5,000	94,700
Accommodation & Food Services	-30,600	-12,600	107,200
Information & Communications	-	+800	74,900
Financial, Insurance & Real Estate	-5,700	+700	103,900
Professional, Scientific & Technical	-14,800	+900	101,800
Administrative & Support Services	-16,600	+4,800	66,100
Public Admin. & Defence	-7,500	-7,600	100,200
Education	-7,400	-3,300	146,500
Human Health & Social Work	-	+3,000	237,900
Other	-13,500	-900	97,200
Total	-328,500	-37,800	1,821,300

Source: CSO, Quarterly National Household Survey, September 2011.

*The peak of employment in various sectors may have occurred in different quarters from the peak in overall employment. Hence the figures in the column do not add up to total decline in employment. Total employment peaked in Q3 2007.

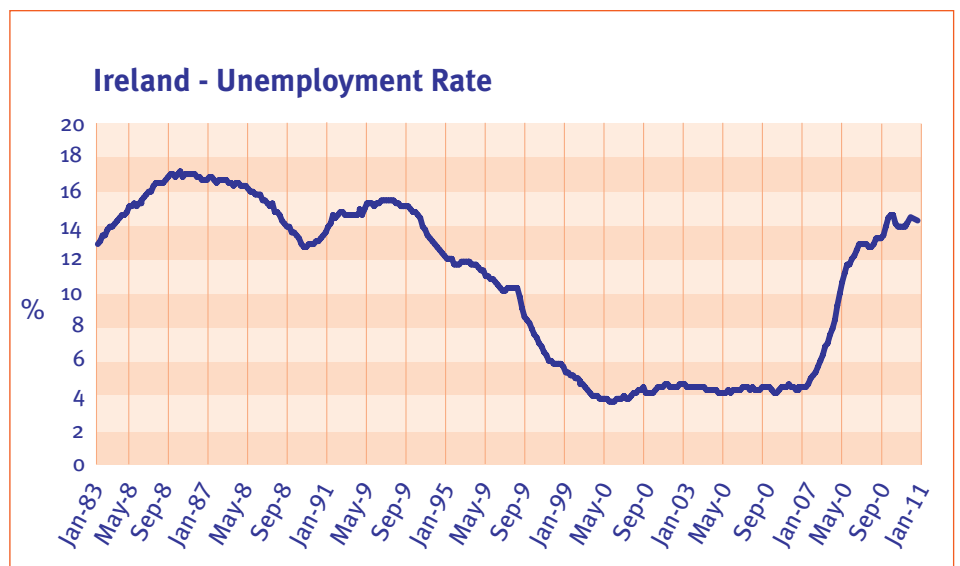
THE LABOUR MARKET BACKGROUND REMAINS VERY WEAK.

The second column in Table 2 shows the decline from the sectoral peak to the second quarter of 2011 by sector. The construction sector has clearly experienced the most dramatic decline in employment. However, significant job losses have also occurred in areas such as manufacturing industry, the wholesale & retail trade and accommodation and food services. More recently, job losses are starting to occur in the public sector as the consolidation of the public finances has resulted in a ban on recruitment across the public sector.

It is also becoming apparent that the very negative momentum that has characterised the labour market for the past three years is decelerating, as evidenced by the decline of 2 per cent or 37,800 in the 12-month period to the end of the second quarter. In the year to the second quarter of 2010, the annual rate of decline was 4.1 per cent. These increasing signs of stabilisation in the labour market are consistent with growing evidence that the overall economy is now stabilising after a precipitous decline in activity from 2008 onwards.

The live register is not designed to measure unemployment in the economy. It includes part-time workers (those who work up to three days per week), seasonal and casual workers entitled to Jobseekers' Benefit or Allowance. However, the live register is still a good gauge of labour market conditions. In October 2011, the live register totalled 430,432 which was actually 879 lower than a year earlier. In October 2011, the unemployment rate stood at 14.4 per cent of the labour force, compared to 4.3 per cent at the end of 2006.

Chart 9



Source: CSO

The number of people classified as long-term unemployed accounted for 53.9 per cent of total unemployment in the second quarter of 2011 and the long-term unemployment rate stood at 7.7 per cent of the labour force, up from just 2.6 per cent two years earlier.

EXPANSION HAS CARRIED OVER TO 2011, ALBEIT AT A SIGNIFICANTLY SLOWER PACE.

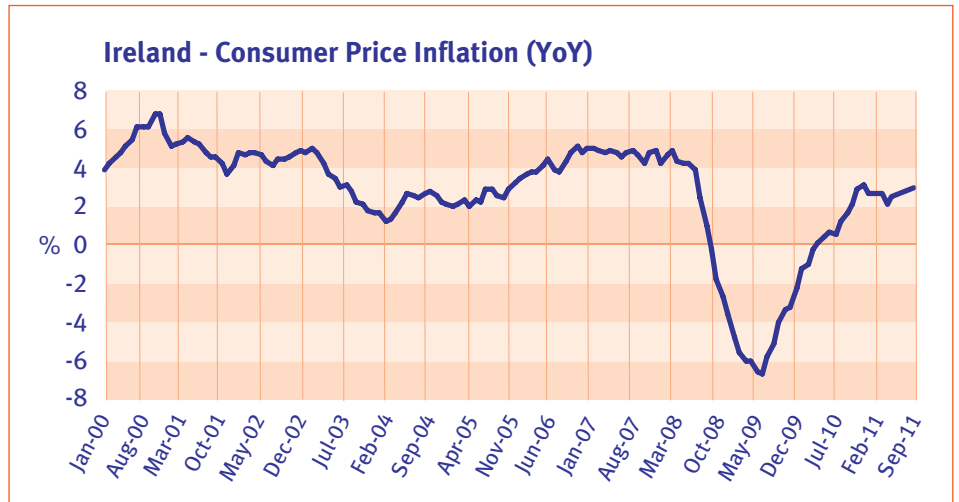
MANUFACTURING OUTPUT

Ireland's manufacturing sector performed very strongly in 2010. Output expanded by 8.3 per cent, with the 'modern sector' expanding by 10.7 per cent and the 'traditional sector' by 1.9 per cent. Expansion has carried over to 2011, albeit at a significantly slower pace. In the first nine months of the year, overall manufacturing output was 1.9 per cent higher than the equivalent period in 2010. Output from the 'modern sector' expanded by 1.5 per cent while output from the 'traditional sector' expanded by 1.2 per cent.

CONSUMER PRICE INFLATION

Consumer price inflation in Ireland averaged 4 per cent between 2000 and 2008, which was double the 2 per cent inflation target that is pursued by the European Central Bank. The high level of inflation primarily reflected very strong demand in the economy, the sharp increase in the general cost of doing business across the economy, strong growth in house prices and weak consumer resistance to higher prices against a background of buoyant economic and income growth in a very strong labour market.

Chart 10



Source: CSO, Consumer Price Index, November 2011

Average consumer prices in Ireland fell by 4.5 per cent in 2009 and by 1 per cent in 2010. However, the annual rate of decline bottomed out in July 2010. Between August 2010 and October 2011, the annual rate of inflation has increased from 0.2 per cent to 2.8 per cent. The consumer price index peaked in September 2008 and reached its nadir in January 2010. Between September 2008 and January 2010, average consumer prices fell by 7.7 per cent. Between January 2010 and October 2011, prices have increased by 4.7 per cent.

Table 3

CONSUMER PRICE INFLATION		
COMMODITY GROUP	ANNUAL PRICE CHANGE (OCT '11)	CHANGE JAN '00- OCT '11
Food & Non-Alcoholic Bevs.	+1.4%	+17.8%
-Food	+1.1%	+17.6%
-Non-Alcoholic Beverages	+3.8%	+18.6%
Alcoholic Beverages & Tobacco	-0.5%	+45.5%
Clothing & Footwear	-0.3%	-35.2%
Housing, Water, Electricity, Gas	+10.2%	+92.2%
Furnishings, Household Equip	-2.2%	-9.3%
Health	+2.3%	+83.3%
Transport	+3.6%	+30.8%
Communications	+1.0%	+0.5%
Recreation & Culture	-0.8%	+21.3%
-Newspapers, Books & Stationery	-0.6%	+40.5%
Education	6.5%	+106.2%
Restaurants & Hotels	-0.9%	+43.7%
All Items	2.8%	+36.7%

Source: Consumer Price Index Detailed Sub-Indices Release, CSO November 2011.

Table 3 shows the trend in prices for a number of commodity groups in the year to October 2011 and in the period from January 2000 to October 2011.

During the periods of very high inflation in the Irish economy over the past decade, those sectors exposed to high levels of competition, both from domestic and external sources have experienced significantly lower rates of price increase.

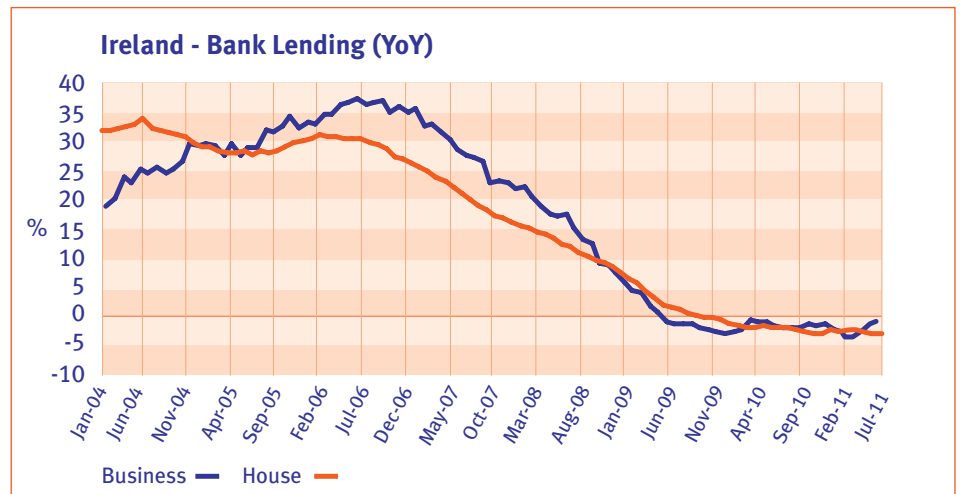
For example, in the twelve months to October 2011, the retail price for Food & Non-Alcoholic Beverages increased by 1.4, compared to an average consumer price increase of 2.8 per cent. Food prices increased by 1.1 per cent and non-alcoholic beverage prices increased by 3.8 per cent. In the period between January 2000 and October 2011, the retail price of Food increased by 17.6 per cent and the retail price of Non-Alcoholic Beverages increased by 18.6 per cent. Over the same period, overall average consumer prices increased by 36.7 per cent, with the cost of Education increasing by 106.2 per cent and the cost of Health by 83.3 per cent.

THE OVERALL ECONOMY IS STILL BEING STARVED OF CREDIT.

CREDIT GROWTH

Credit conditions remain very tight in the economy. In the year to September, lending for mortgage purposes declined by 2.5 per cent and lending to business declined by 1.4 per cent. The overall economy is still being starved of credit.

Chart 11



Source: Central Bank of Ireland

THE HOUSING MARKET

All indicators of housing activity remain very weak and are still showing no signs of recovery, or indeed stabilisation.

- House completions in 2010 totalled 14,602, down from 26,420 in 2009. In the first nine months of 2011, completions totalled 7,917, which is 26.4 per cent lower than the first nine months of 2010.
- New home registrations totalled 1,680 in 2010, down from 3,743 in 2009. In the first nine months of 2011, registrations totalled just 625, which represents a decline of 57.7 per cent on the first nine months of 2011.
- New home commencements totalled 6,371 in 2010, down from 8,604 in 2009. In the first nine months of 2011, there were 3,662 commencements, a decline of 32.4 per cent on the first nine months of 2010.
- CSO data on planning permissions show that in the first half of 2011, planning permissions were granted for 6,977 dwelling units, which represents a decline of 35.9 per cent on the first half of 2010.
- House prices continue to decline and the pace of decline is accelerating. National average house prices fell by 2.2 per cent during October and were 15.1 per cent lower than a year earlier. National average prices have declined by 45.4 per cent from peak. The fall has been more severe in the apartment market. The other indices published by the CSO give some insight into the variation by sub-market. The CSO index indicates that the various segments of the market attained their peak at different stages during 2007.

THERE
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MARKET UNTIL
BANKS START TO
LEND AGAIN.

Table 4

CSO HOUSE PRICE INDEX-CHANGE FROM PEAK TO OCTOBER 2011	
CATEGORY	CHANGE FROM PEAK
National - All	-45.4 %
National - Houses	-43.7 %
National - Apartments	-57.9 %
National Ex - Dublin All	-41.5 %
National Ex - Dublin Houses	-40.8 %
Dublin - All	-53.1 %
Dublin - Houses	-50.9 %
Dublin - Apartments	-60.1 %

Source: CSO, Residential Property Price Index, October 2011

THE MORTGAGE MARKET

Total mortgage lending in the third quarter reached €623 million, which is almost 50 per cent of the level achieved in the third quarter of last year. In the first nine months of the year a total of €1.82 billion was lent for mortgages purposes, compared to €3.76 billion in the same period last year. It now appears that total mortgage lending for the full year will be around €2.3 billion. This compares to total lending of €39.9 billion at the peak of the madness in 2006.

These numbers are staggeringly weak and suggest that the market is effectively dead. The banks could well argue that this is due to the lack of demand for mortgages from a suffering and pretty downbeat populace, but some demand does exist but the banks are quite simply not in the business of lending. There will be no stabilisation and certainly no recovery in the housing market until banks start to lend again.

Table 5

VALUE OF MORTGAGE MARKET DRAW DOWNS							
MARKET SEGMENT	2005	2006	2007	2008	2009	2010	Q1-Q3'11
	€m	€m	€m	€m	€m	€m	€m
First Time Buyer	7,717	8,448	7,250	4,833	2,671	2,037	799
Mover Purchaser	10,359	11,368	8,687	5,572	2,355	1,539	668
Residential Investment Letting	6,283	7,950	6,512	4,096	798	216	56
Re-Mortgage	5,038	6,067	6,675	5,295	1,129	461	142
Top-Up	4,717	6,039	4,684	3,253	1,123	493	159
Total Drawdowns	34,114	39,872	33,808	23,049	8,076	4,746	1,824

Source: IBF Mortgage Market Profile, November 2011.

OVERALL ASSESSMENT OF HOUSING MARKET

It is clear from all available evidence that the housing and mortgage market still remains very weak and is still not showing any signs of stabilising. In relation to housing demand, a significant scarcity of adequate credit availability, more expensive credit where available and low levels of buyer confidence due to a variety of economic and financial factors are hampering demand. On the supply side, there is still serious excess supply in components of the marketplace, although there is marked evidence of scarcity in established areas in Dublin in particular. The lack of mortgage credit is the biggest issue but with the cost of mortgage credit already rising and set to rise further over the coming year, the housing and mortgage markets look set to remain very weak for some time to come. Sales activity is somewhat better but is being driven by significant price cuts from already very low price levels.

New home completions this year are likely to be around 11,000. While there is excess supply in the market, official data suggest that it is not as great as previously believed and there is a likelihood that some shortages could start to emerge in some areas over the next couple of years. However, against a background of credit scarcity for both developers and potential house buyers and shattered levels of confidence, supply will not be forthcoming for at least the next couple of years.

The fundamentals of the housing and mortgage market are still weak and are unlikely to get significantly better any time soon. The impact of NAMA on the market in terms of fire-sale prices, general sales activities and the completion of unfinished estates will have a fundamental bearing on the market into the medium-term.

Against this general background, national average prices could fall by around 13 per cent in 2011 and a further decline of at least 8 per cent could be seen in 2012. New home completions are likely to be around 10,000. The balance of risk for next year is still very much on the downside as it is very difficult to identify any factors that could possibly give a boost to the market.

THE KEY TASK OF THE IRISH GOVERNMENT WILL BE TO KEEP THE HEAD DOWN AND PROCEED WITH THE ISSUES THAT ARE WITHIN ITS OWN CONTROL.

THE ECONOMIC AND POLICY OUTLOOK

Preparing a macro-economist forecast for the Irish economy for 2012 is a pretty meaningless exercise; such is the element of uncertainty now prevailing. Based on the assumption, which is a very brave assumption at this juncture, that the Euro crisis will eventually be resolved in a manner which will keep the system intact, with Ireland remaining a part of it, the following prognosis is suggested. It is obviously subject to much more than the usual health warning.

It is clear from almost all economic indicators that the Irish economy remains in a very difficult place and that it will be very challenging to get balanced and sustainable economic growth back on track. There is not a lot that the Irish Government will be able to do to resolve the crisis in the Euro Zone – that will be resolved or not as the case might be in the corridors of power in Berlin, Brussels, Frankfurt and Paris. The key task of the Irish Government will be to keep the head down and proceed with the issues that are within its own control.

The key economic policy imperatives for Government are now well documented and generally accepted:

- Creating a sustainable public finance situation,
- Re-establishment of a functioning banking system,
- Re-establishing the competitiveness of the economy,
- Restoring confidence,
- Supporting the protection and creation of jobs, and
- Restoration of Ireland's international reputation.

Gradual progress is being achieved on all of those fronts and Ireland is now being viewed somewhat more favourably by international observers. There is a view that the fiscal correction under way since 2008 is working and that the Irish are accepting the necessary fiscal adjustment. There is also confidence in the ability of the Irish authorities to continue to proceed with the planned fiscal adjustment. The bottom line is that relative to Greece, Ireland looks in a strong position.

While the export recovery is good news, the growth is being driven by higher productivity rather than employment creation. A recovery in domestic demand is essential for employment creation and stronger public finances. Consumer spending is being restrained by ongoing pressure on disposable incomes and a strong sense of foreboding about the future. Business investment spending on the other hand is being primarily restrained by lack of credit. Until adequate credit flow returns to the business sector, investment will remain weak. Government included in its Programme for Government a commitment to set up a Strategic Investment Bank but unfortunately that commitment appears to have receded. A new bank capitalised by funding from the National Pension Reserve Fund (NPRF) and targeting the credit-starved SME sector is an important component in Ireland's recovery path.

IRELAND IS NOW BEING VIEWED SOMEWHAT MORE FAVOURABLY BY INTERNATIONAL OBSERVERS.

Specifically, looking out to 2012:

- Consumer spending power and confidence will remain under pressure from ongoing weakness in the labour market, downward pressure on earnings, the increased personal tax burden, cutbacks in Government expenditure and nervousness about the possible implication of a breakup of the Euro. Consumer spending looks set to decline by around 2.5 per cent in 2011 and by 1.25 per cent in 2012. The fiscal squeeze will be the key factor.
- Gross domestic fixed capital formation (investment) looks set to decline by around 8 per cent in 2011. Investment in building and construction looks set to decline by up to 30 per cent; other building and construction looks set to decline by 20 per cent; and investment in machinery and equipment should expand modestly. The decline in investment will be more modest in 2012.
- Exports will continue to provide the strongest stimulus to growth, but the deteriorating global economy is a source of serious concern and does represent a significant risk to export growth.
- Labour market conditions remain very difficult in 2011. It is likely that average employment across the economy could decline by around 35,000 in 2011 and by around 8,000 on average in 2012. The unemployment rate is likely to average 14.3 per cent in 2011 and 14.1 per cent in 2012.
- Inflation will continue to be pushed up by higher prices for food, insurance, fuel and energy, health, education and mortgage interest costs. The budget is likely to add to measured inflation through various indirect tax changes. Average prices still look set to rise by around 2.7 per cent in 2011 and 2.5 per cent in 2012.
- GDP looks set to expand by around 0.5 per cent in 2011 and 1.4 per cent in 2012. GNP looks set to contract by around 0.3 per cent in 2011 and expand by 0.3 per cent in 2012.

Table 6

IRISH ECONOMIC FORECAST			
AVERAGE	2010	2011f	2012f
GDP	-0.4%	+0.5%	+1.4%
GNP	+0.3%	-0.3%	+0.3%
Consumption	-0.8%	-2.5%	-1.25%
Gross Domestic Fixed Capital Formation	-24.9%	-8.0%	-3.5%
Government	-3.8%	-3.8%	-3.8%
Exports Goods & Services	+6.3%	5.5%	+5.0%
Imports Goods & Services	+2.7%	2.5%	+2.8%
Consumer Price Inflation	-1.0%	+2.7%	2.5%
Unemployment (average)	13.6%	14.3%	14.1%
House Completions	14,602	11,000	10,000

f=forecast

BUDGET 2012 AND BEYOND

THE PUBLIC FINANCES

The public finances remain in a very difficult place. In 2010, the country ran an Exchequer deficit of €18.7 billion. In the first ten months of 2011, an Exchequer deficit of €22.2 billion was recorded, up from €14.4 billion in the same period last year. Just over €10.6 billion of this deficit is due to Promissory Note payments to Anglo Irish Bank and Irish Nationwide Building Society and EBS and the once-off payments for the recapitalisation of the banking system in July. The underlying deficit is about €3 billion better than the equivalent period in 2010. Despite this, the underlying deficit is still unsustainably high and needs to be reined in as quickly as possible.

Table 7 provides a breakdown of tax revenues in the first ten months of the year, both in terms of percentage change on the first ten months of 2010 and against expectations. Overall tax revenues are €184 million behind of expectations. Tax revenues are stabilising after a precipitous decline in recent years. Expenditure also remains under control. When adjusted for the Universal Social Charge (USC), total net voted expenditure is estimated to have declined by 4.1 per cent to end-October. Despite the difficult economic climate, expenditure is being kept under control. This is very important.

Table 7

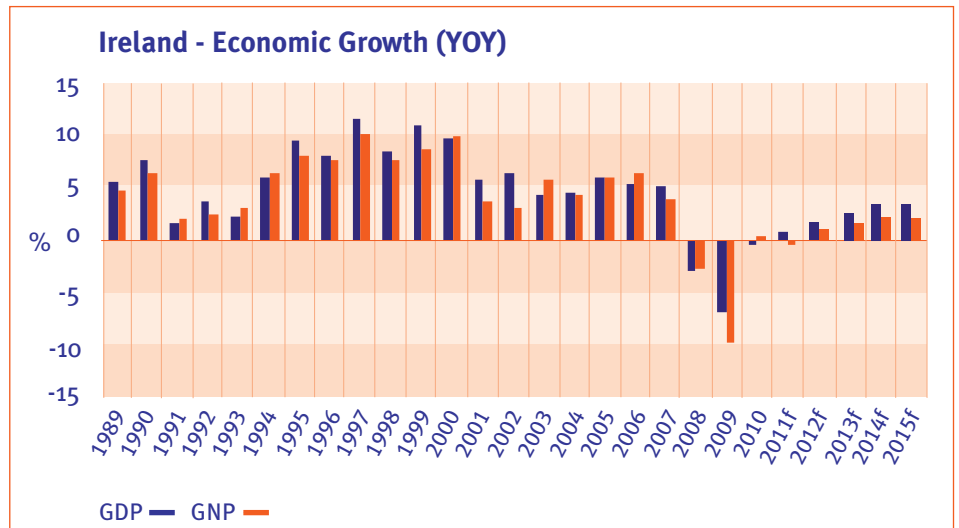
EXCHEQUER RETURNS (JAN-OCT 2011)		
TAX HEADING	ANNUAL GROWTH	AGAINST TARGET
		€m
Customs	+4.6%	+3
Excise Duty	+1.2%	+17
Capital Gains Tax	-14.1%	-11
Capital Acquisitions Tax	+16.7%	-12
Stamps	+52.1%	+415
Income Tax	+21.8%*	-125
Corporation Tax	-5.5%	-109
Value Added Tax	-3.0%	-383
Total Tax	+8.0%	-184

Source: Department of Finance *Includes Universal Social Charge

MICHAEL NOONAN MUST COME UP WITH AT LEAST €3.8 BILLION ON DECEMBER 6TH. ANYTHING LESS WOULD BE ECONOMIC FOLLY.

The Minister for Finance has laid out the broad fiscal parameters for the period 2012 to 2015. Based on what may turn out to be optimistic economic projections, the Government aims to deliver a package of €12.4 billion in fiscal austerity over the period. It is intended that expenditure reductions will account for 62.5 per cent of this massive fiscal adjustment with tax and revenue raising measures accounting for the rest. In 2012, the correction will be in the region of €3.8 billion with €1.6 billion coming in tax and revenue raising measures.

Chart 12



Source: CSO & Department of Finance Projections (November 2011).

Given the magnitude of the fiscal correction already engineered between 2008 and 2011 (circa €20 billion), the process will become much more difficult from here on. Any measures that will be introduced will prove very unpopular and will elicit very vocal responses. For example, the speculated increase of 2 per cent in the top VAT rate, the speculated cut of €10 in child benefit, the speculated increase in third-level fees and the speculated €8 cut in unemployment benefits have all elicited very negative responses. The reality is that whatever measures are introduced will prove extremely unpopular but the political system will have to do the right thing.

The Minister for Finance must remain steadfast in his commitment to get borrowing back under control and stabilise the dangerously high debt level. Vested interest groups should not be allowed stand in the way of what needs to be done. Michael Noonan must come up with at least €3.8 billion on December 6th 2011. Anything less would be economic folly.

Choices, will of course, have to be made. While recognising that whatever measures might be taken will damage employment, the imperative is to introduce measures that would be least damaging to employment. So for example, a 2 per cent increase in the VAT rate would not be as damaging to employment as an increase in income tax.

VERY SKILFUL AND INNOVATIVE THINKING WILL BE REQUIRED TO PULL THE ECONOMY OUT OF ITS CURRENT MORASS.

Those who argue that Irish Government expenditure and taxation are lower as a percentage of GDP than the EU average should look at how spending and taxation are distributed across the population. For example a small percentage of the workforce pays the bulk of taxation in Ireland, just as social expenditure needs to be adjusted not on a per capita basis, but rather on the basis of the per capita payments to those who are the beneficiaries of social expenditure.

The bottom line is that virtually every citizen of the country will be worse off after Budget 2012 and indeed at the end of the medium-term fiscal correction. The outlook for the Irish economy is clearly very challenging and is likely to remain so for the best part of the next decade. As part of this, the Irish will have to face the unfortunate reality that the standard of living will be lower over the next decade than it was over the past decade. If it is any consolation, most countries face a similar prospect, including the U.S. Very skilful and innovative thinking will be required to pull the economy out of its current morass and lift the long term growth potential of the economy. The quality of the labour force and the ability to attract and retain highly skilled workers will be a key determinant of Ireland's success or failure. Against this background, tax and expenditure measures should be mindful of the disincentive effects of high personal tax rates. This is a particular issue for the multi-national sector in Ireland. Increasing the personal tax burden any further will make it more difficult for such companies to attract the quality of workforce they need to justify investment in Ireland.

Given the totally unsustainable nature of the Irish public finances, it is difficult to argue with the broad thrust of medium-term fiscal policy as outlined by the Minister for Finance. However, one aspect of the fiscal debate that has been ongoing since 2008 is the consistent focus on the quantity of tax increases and expenditure cutbacks, rather than on their quality. While fiscal adjustment is always going to be painful by definition, there are good and not so good ways of actually doing it. If targeted properly, the fiscal adjustment can be less damaging and negative from an economic and social perspective.

THIS PUBLICATION IS BASED ON DATA AVAILABLE UP TO NOVEMBER 22nd 2011.
THE INFORMATION CONTAINED HEREIN IS BELIEVED TO BE RELIABLE BUT IS
SUBJECT TO CHANGE WITHOUT NOTICE.

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