



Economy To Recover After Setback

Ireland's economic performance remained impressive in 2007, with real GDP estimated to have grown by 5.5% and employment rising by 3.4%. However, much slower rates of growth in output and employment are in prospect in 2008 reflecting, in particular, a sharp contraction in housing activity and a weaker global economy. The fundamentals of the economy remain sound, though, so growth should pick up in 2009/2010 as the downturn in housing bottoms out and global growth improves.

The economy is entering a period of much weaker growth, but from a strong base. The public finances are in very good order, the economy is close to full employment with a very flexible labour market and all sectors of the economy have enjoyed strong growth in recent times. It has been particularly encouraging to see a marked pick up in manufacturing output and a rebound in goods exports over the past year. Even more encouraging is the continuing buoyancy of the services sector, including the continued strong rise of service exports, which are likely to comprise 45% of total exports this year. The volume of service exports has grown by more than 10% in each of the last five years.

The Irish economy, though, is set to experience a marked deceleration in the pace of economic activity in 2008. Real GDP is forecast to grow by 2.5%. This represents a sharp slowdown from the estimated GDP growth rate of 5.5% last year, and 5.7% and 5.9% recorded in 2006 and 2005, respectively.

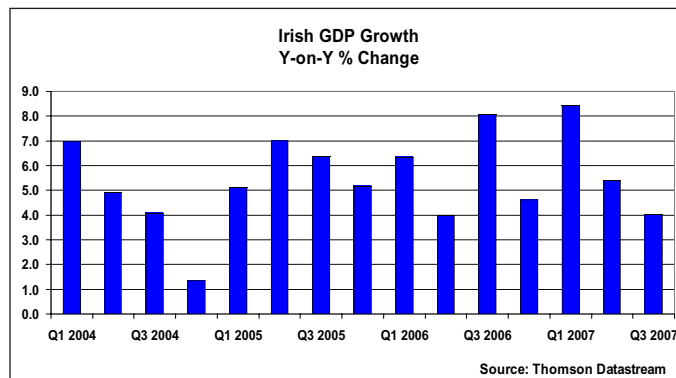
The main factor behind the slowdown in GDP growth in 2008 is a slump in new housing output, with housing completions forecast to fall to around 50,000 this year from 78,000 in 2007. Taken together with a fall in housing transfer costs, such a decline will knock close to 4% off GDP in 2008. The external environment is also much more challenging, with a slowdown in key export markets and the currency appreciating strongly, so export growth will slow.

Although there has been much talk that the economy had become overly dependent on housing in recent years, the reality is different. Excluding housing, GDP growth exceeded 5% in each of the last three years, averaging 6.3%. Even with new housing declining by 12% last year, the economy still grew by an estimated 5.5%. Given this performance, we see no reason not to expect a resumption of strong growth once the sharp downward adjustment in housing activity is complete and the global economy returns to a firmer footing.

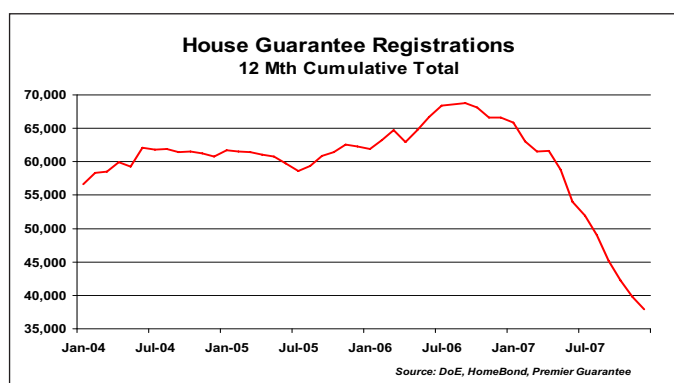
Thus, GDP growth should pick up again in 2009 and 2010 as the downturn in new housing activity starts to level off and no longer acts as a major drag on GDP growth and the global economy recovers. We see GDP rising by 3.7% in 2009 and 4.4% in 2010. Even if our forecasts prove overly optimistic, the downturn in activity is unlikely to derail the economy completely. The economy will still hold onto virtually all the substantial gains in output, employment and living standards achieved since 1993. Furthermore, the medium term growth prospects for the economy remain very favourable, judging by demographic trends.

HOUSING DOWNTURN TO SEE GDP GROWTH SLOW SHARPLY IN 2008

- The economy continued to perform exceptionally well in the first three quarters of 2007, according to the latest data. GDP growth averaged 6% over the period, with GNP up by 5.9%, reflecting strong growth in both domestic spending and exports. Employment increased by 3.3% in the year to Q3 2007, with the job gains spread right across the economy, while the unemployment rate remained low, averaging 4.4%.



- Although housing activity slowed sharply in the second half of last year, we still estimate GDP growth at 5.5% in 2007 as a whole, down only slightly from 5.7% in 2006. This represents a strong underlying performance by the economy in 2007. A build up of inventories added 0.8% to growth in 2006 but an inventory rundown subtracted around 0.8% from GDP growth last year. Apart from housing, all other sectors of the economy registered stronger growth last year, with net exports contributing some 2% to GDP growth.
- However, this period of strong growth in output and employment is coming to an end. Growth is expected to be much weaker in 2008. Many of the factors which have been boosting activity are now waning. In particular, housing activity has already turned down. Housing registrations have been in sharp decline for over a year now, while housing completions have been on a downtrend since the summer.

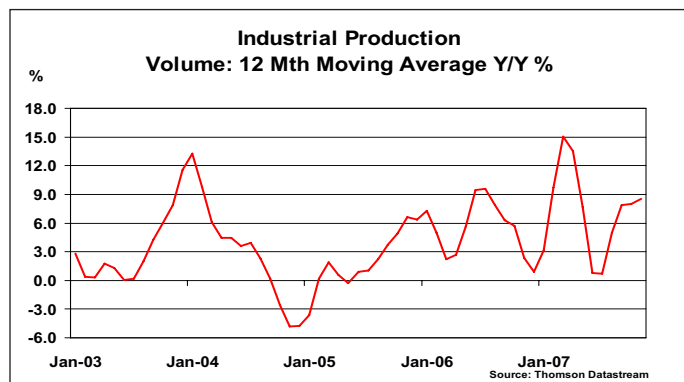


- The scale of the decline in housing activity and the fact that it accounts for a relatively large part of the economy implies that the downturn in the sector will have major consequences. Housing completions declined by 12% during the second half of 2007, and we expect that completions will fall by some 36% in 2008, given the marked decline in housing registrations over the past year.
- Investment in new dwellings accounted for over 9% of GDP in 2007, so a 36% decline in the sector would directly knock well over 3% off real GDP in 2008. An additional negative effect is that there are associated transfer costs (almost 2% of GDP) that move in a positively correlated way with housing activity. In total, then, a 36% fall in new housing output would take close to 4% off real GDP in 2008.
- Of course, the decline in housing output will have knock on consequences for other areas of the economy, such as consumer spending. Indeed, consumer spending is expected to slow anyway this year due to subdued growth in employment, a waning SSIA impact and higher interest rates. The 2008 budget was also less generous than the previous two budgets in terms of the boost it provided to disposable income from increases in social welfare payments and reductions in income tax.

BUT SOLID GROWTH IN NON-HOUSING ACTIVITY

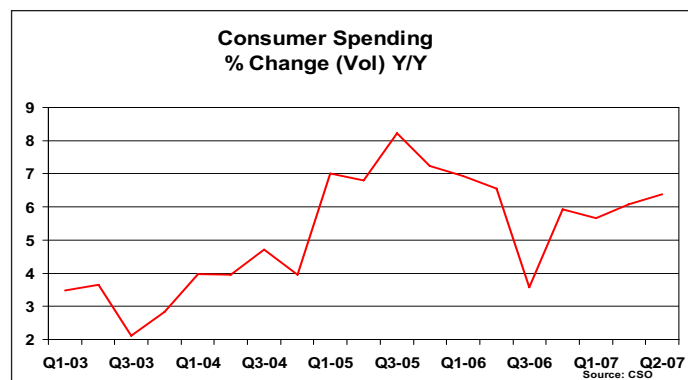
- Nonetheless, the prospects for much of the economy are still quite favourable. Private non-residential construction activity is expected to continue expanding, while a further large increase in public capital spending was contained in the 2008 Budget, which provided for a rise of 21% in such expenditure.
- Furthermore, although this year's budget is less stimulatory than in 2006 and 2007, it is still expansionary. As well as the large increase in capital spending, it provides for a rise of 8.2% in gross current spending. It should also be noted that while growth in consumer spending will decelerate, it is still expected to increase by around 3.5% in 2008, underpinned by solid growth in personal disposable income, which is forecast to rise by close to 6% this year.

- It has been encouraging to see the marked pick up in manufacturing output and a rebound in goods exports over the past year. Even more encouraging is the continuing buoyancy of the services sector, including the continued strong rise of service exports. These are likely to comprise 45% of all exports in 2008, up from 25% at the start of the decade.



- The external environment, though, is turning less favourable, with fears of a recession in the US, growth in Europe set to slow considerably and the euro appreciating markedly during the past year, most notably against two of Ireland's main trading partners, the UK and US. Thus, exports in 2008 are unlikely to repeat their strong performance of 2007, when they rose by an estimated 7.5% in volume terms. The recent sharp fall in the manufacturing PMI is consistent with a slowdown in export growth.
- The volume of service exports, though, has grown by more than 10% in each of the last five years, a trend that shows little sign of abating. Nonetheless, Ireland's main trading partners are set to experience much weaker growth this year and this has to weigh on Irish exports. Thus, we look for export growth of around 5.3% this year, down from some 7.5% in 2007, with the strong underlying uptrend in service exports preventing an even greater deceleration in export growth in 2008.

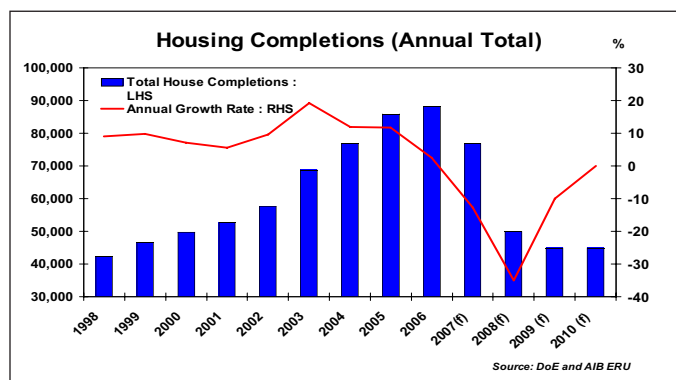
- Overall, then, GDP growth is forecast to slow markedly to around 2.5% in 2008, on the back of weaker growth in both exports and the three main components of domestic demand - household spending, current government expenditure and fixed investment, particularly housing. Indeed, we look for domestic spending to decline by 0.3% this year after a rise of 4.7% in 2007. Not surprisingly, then, we expect much weaker growth in imports also this year, especially as they were boosted in 2007 by a substantial jump in imports of transport equipment that may not recur in 2008.



MEDIUM TERM GROWTH PROSPECTS REMAIN FAVOURABLE

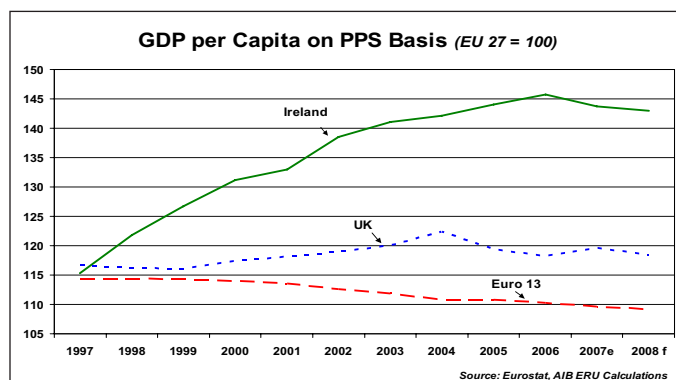
- A 2.5% GDP growth rate in 2008 would be the lowest recorded since the early 1990s. However, it would still rank as quite an achievement by the economy given the circumstances, with the fall-off in housing taking close to 4% off GDP, as well as the much weaker external environment. Net trade, though, as in 2007 is expected to make a significant contribution to GDP growth again this year, boosting it by around 2.5%. Hence, without net trade, GDP growth would be flat.

- The economy is expected to pick up some momentum in 2009 as the rate of decline in the housing sector slows considerably. Hence, it will not be as big a drag on overall GDP growth. We expect a fall of 10% in housing completions next year, compared to 36% this year. Thus, growth in domestic spending should rebound to some 2.7%, with GDP growth recovering to around 3.7%. We see new housebuilding activity levelling off at this lower level in 2010, with GDP growth rising to close on 4.5%.



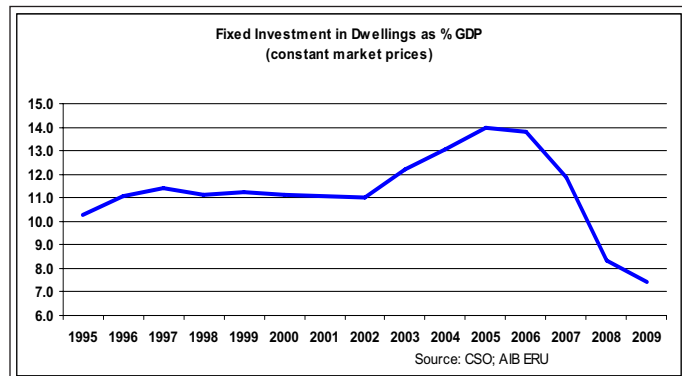
- Overall, then, what we are forecasting is a marked slowdown in economic growth from its robust pace in 2005-2007 but not a complete slump in activity. However, the risks to our growth forecasts are on the downside, reflecting two factors in particular. First, the decline in housebuilding activity may prove even steeper than predicted, especially in regard to 2009. Second, there is also a risk of a sharper downturn in global activity in 2008/09 than currently envisaged, making it difficult for net trade to make the expected significant contribution to Irish GDP growth in the period ahead.

- Even if our forecasts prove overly optimistic, the downturn in activity is unlikely to derail the economy completely. The economy will still hold onto virtually all the gains in output, employment and living standards achieved since 1993. These are very impressive gains, with real GDP increasing by 167% and employment rising by over 75% in this period. As the chart shows, there has been very strong growth in GDP per capita in Ireland relative to the UK and eurozone over the past decade.

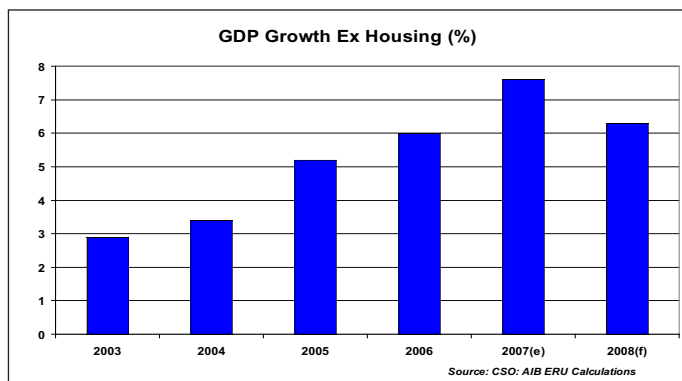


- Indeed, the economy has also shown remarkable resilience and robustness in the face of economic shocks in recent times. In particular, it overcame the ICT bust in 2001-2002, despite a large exposure to the sector and a considerable loss of output and employment in manufacturing industry. Hence, though there were commentators who believed that the rapid growth of the Celtic Tiger era was something of a mirage that would not prove sustained, it is now clear that a remarkable and permanent rise in living standards has taken place, and the economy has indeed moved onto a new plain.

■ It should be noted that the economy is entering this period of weaker growth in very strong shape. The public finances are in very good order, the economy is close to full employment with a very flexible labour market, while all sectors of the economy have enjoyed strong growth in recent times. As a result, the economy has become much less dependent on housing activity in the past couple of years. The share of GDP accounted for by total investment in housing has declined from 14% in 2005 to 12% in 2007 and is likely to fall to 8.3% in 2008, its lowest level in more than a decade.



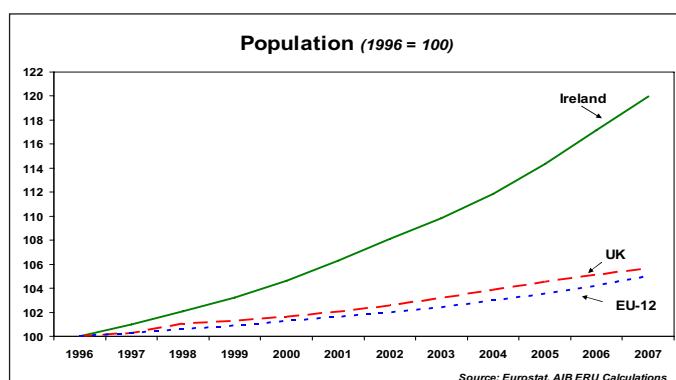
■ Indeed, although there has been much talk that the economy had become overly dependent on housing activity in recent years, the reality is quite different. Excluding housing, GDP growth exceeded 5% in each of the last three years, averaging 6.3%, a rate that it is expected to achieve this year also. Even with new housing output rising by just 3.3% in 2006 and declining by 12% last year, the economy still grew by 5.7% and 5.5%, respectively, in both years. Given this performance, we see no reason not to expect a resumption of strong growth once the marked downward adjustment in housing activity is complete and the global economy regains momentum.



Given this performance, we see no reason not to expect a resumption of strong growth once the marked downward adjustment in housing activity is complete and the global economy regains momentum.

- There are concerns, though, that a deterioration in competitiveness will constrain the ability of the economy to move back onto a robust growth path. The marked widening of the current account deficit in recent years, relatively high level of prices and wages in Ireland, and appreciation of the exchange rate are often cited as evidence of a marked deterioration in the competitiveness of the Irish economy.
- There is no doubt that Irish competitiveness has deteriorated since earlier in the decade as evidenced by the trends in various competitiveness indicators published by the Central Bank of Ireland. Nonetheless, there is little evidence that the loss of competitiveness is impacting greatly on the growth rate of the economy. Even excluding housing, the economy has grown strongly in recent years. There has been a revival in manufacturing activity in the past couple of years and a pick up in merchandise exports. It is true that there has been a marked fall in the merchandise trade surplus since 2004. However, this largely reflects factors such as a surge in the bill for fuel imports and rising imports of machinery and equipment for investment purposes.
- Furthermore, service exports continue to power ahead with a marked contraction in the trade deficit on services in recent years. The economy is becoming more services orientated, notably on the external trade side, which may be limiting the effects of a loss in competitiveness. Nonetheless, containing costs will be important going forward as there may well be a lag between the erosion of competitiveness and its impact on the economy's growth rate.

- The medium term growth prospects for the economy are largely determined by population and labour force trends, productivity growth, and investment - especially on infrastructure. The government plans to increase public capital investment spending considerably further in the next five years under the National Development Plan, boosting the productive capacity of the economy. Meantime, population growth in Ireland has been very strong over the past decade, with the population increasing by over 20% compared to around 5% in the UK and the eurozone. It is noteworthy that population growth has averaged a very strong 2.4% in the past three years. Even excluding net immigration, the natural increase in the population is running at close to 1%, which augurs well for the long-term growth potential of the economy.



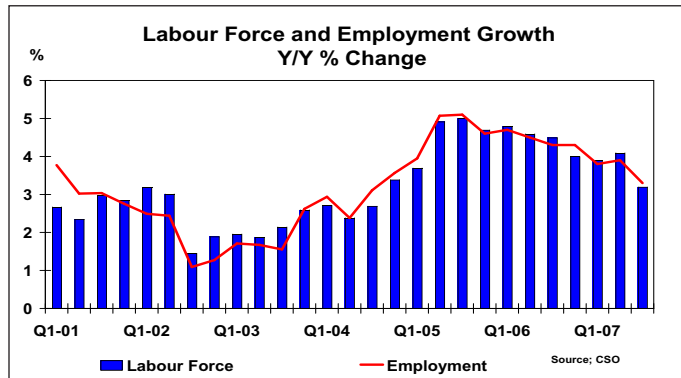
IRISH ECONOMIC GROWTH FORECASTS 2006 - 2010					
(% Volume)	2006	2007(e)	2008(f)	2009(f)	2010(f)
Consumer Expd	5.7	5.9	3.5	4.0	4.2
Government Expd	5.3	6.7	3.5	3.0	3.0
Fixed Investment	3.1	1.5	-10.0	-0.5	3.0
Domestic Spending	4.9	4.7	-0.3	2.7	3.7
Exports	4.4	7.4	5.3	5.0	5.5
Imports	4.4	5.7	2.7	4.0	4.8
GDP	5.7	5.5	2.5	3.7	4.4
GNP	6.5	5.2	2.2	3.5	4.3

Source: CSO; AIB ERU Forecasts

- The Economic and Social Research Research Institute estimated in its last Medium Term Review, published two years ago, that the Irish economy has the potential to grow by 4.5% a year out to 2010, falling to 3.5% a year to 2015 and 2.5% a year out to 2020. It estimates that productivity growth should be fairly stable over the whole period at around 1.8% per annum. However, it expects a marked slowdown in labour force growth to 1.1% in 2010-2015 and 0.7% in 2015-2020.
- However, given the recent strong trends in population growth, and inward migration in particular, these labour force projections for the 2010-2020 period appear to be too pessimistic. In our view, there is no reason why the economy cannot continue to attract large inflows of both labour and investment, even if net inward migration is unlikely to be sustained at the recent very high levels. Thus, the prospects for growth in the economy remain favourable over the medium term and we expect Ireland to be able to sustain GDP growth of around 4.0-4.5% per annum in the coming decade.

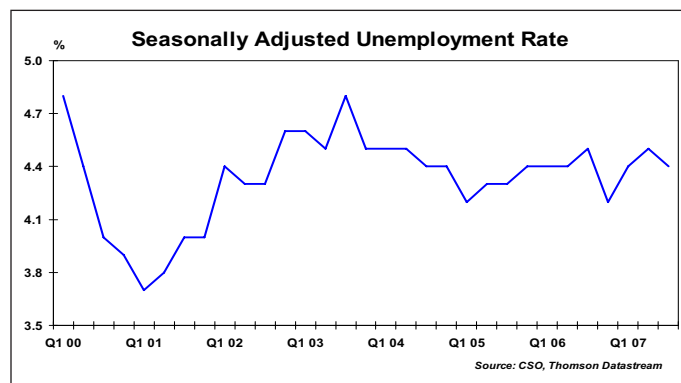
LABOUR MARKET TO SOFTEN CONSIDERABLY

■ The Irish labour market has been characterised by very strong growth in the labour force and employment in recent years and a stable, low unemployment rate. Both the labour force and employment expanded by some 4.5% in 2005 and 2006, with their growth rates decelerating to around 3.5% last year. Meanwhile, the unemployment rate has been very stable since 2002 at around 4.5%. The key to this strong growth in the labour force and employment has been the large influx of foreign workers into the Irish economy.

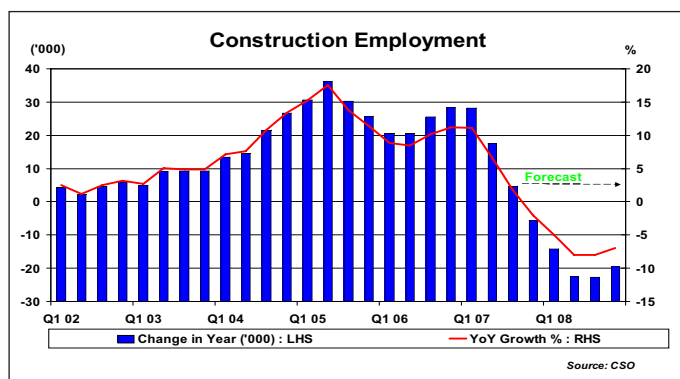


■ The latest data, which are for Q3 2007, show that net inward migration accounted for 70% or 48,000 of the 69,000 increase in the labour force over the previous twelve months. Furthermore, the number of non-Irish nationals in employment rose by 48,400, while the number of Irish nationals in employment rose by 19,200 in the year to Q3 2007. Thus, inward migration was the prime source of employment growth last year and these data also highlight the flexibility of the Irish labour market.

■ However, the marked deceleration in the pace of economic activity in 2008 will have predictable consequences for the labour market. Indeed, this has already become evident in recent Live Register data. The Live Register had been edging upwards in 2007, before it climbed sharply in the latest three months. It rose from 165,000 in October to 179,400 in January. Notably, nearly all of a 23,000 increase in the Live Register in the twelve months to January was accounted for by males. This is consistent with a marked decline in employment in the male-dominated construction sector in the closing stages of 2007, a trend that is becoming evident in the CSO's index of construction employment.



■ Employment in construction could contract by over 20,000 during 2008. Not surprisingly, then, we expect that the growth in total employment in the economy will decelerate to 1.2% this year from 3.4% in 2007. However, labour force growth is also projected to slow, given recent signs that inward migration has peaked and with a deceleration evident in the uptrend in

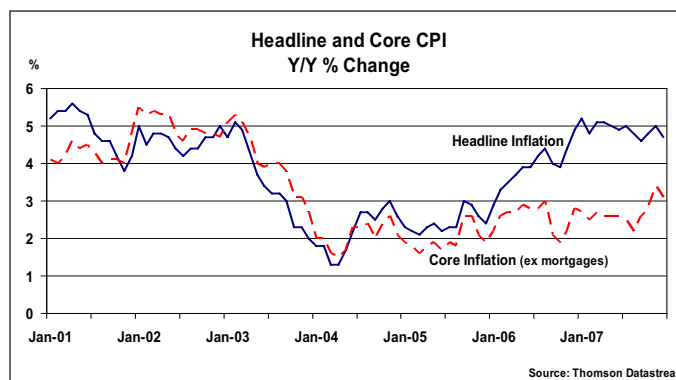


the participation rate. Indeed, some non-Irish nationals from Eastern Europe who are made redundant in the construction sector may eventually return to their home countries, whose economies have picked up considerably in recent times, or move to another country to gain employment.

- The marked rise in the Live Register in recent months indicates that unemployment has started to move upwards. However, we believe the uptrend will be tempered by a sharp slowdown in labour force growth. Indeed, labour force growth has been on a decelerating trend over the past two years. Thus, an average jobless rate of 5.2% is forecast for this year, up from 4.5% in 2007. Employment and labour force growth should pick up over the course of 2009/2010 but the the unemployment rate could still continue to move upwards to average 5.8% in 2010.

INFLATIONARY PRESSURES TO EASE

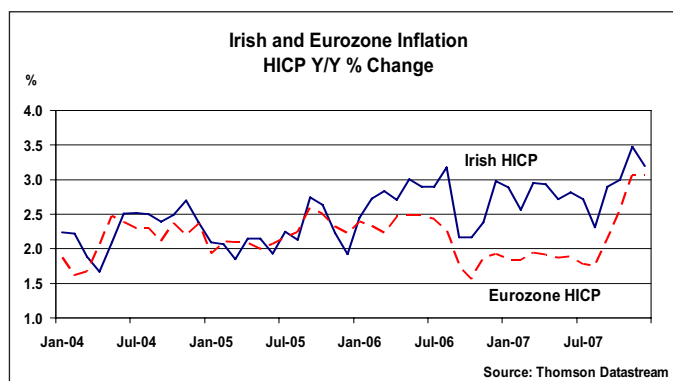
- Inflation has picked up a lot in the last two years, especially the headline CPI rate. It averaged 4.9% last year after 4.0% in 2006, well up on its 2005 level of 2.5%. Much of the rise, though, is due to increased mortgage costs. Excluding mortgages, CPI inflation averaged 2.6% in 2006 and 2.7% last year.



- The rise in the EC measure of Irish inflation, the HICP rate, which excludes mortgage interest, has also been much less pronounced. It averaged 2.8% last year and 2.7% in 2006, up 2.2% in 2005. A hike in Excise Duty on cigarettes, though, added about 0.4% to inflation last year, while higher food and energy prices have also boosted the HICP rate. Indeed, the gap between HICP inflation in Ireland and the eurozone has narrowed over the course of the past year, falling to just 0.1% at end 2007 as the hike in Irish Excise Duty dropped out of the annual inflation rate in December.

- The headline CPI rate would appear to have peaked at this stage and can be expected to fall steadily to around 3% by the summer as the impact of ECB rate hikes on mortgages drops out of the annual comparison. The appreciation of the euro and signs that oil prices might have passed their peak, with the global economy now slowing, augur well for inflation prospects in 2008 and 2009. The HICP rate, though, is expected to remain at around the 3% level until the autumn, given the high level of energy and food prices, but it should fall to around 2.5% by end year.

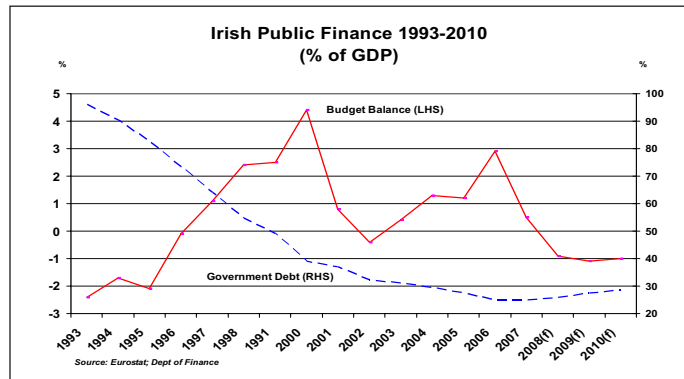
- The headline CPI rate is likely to average 3.5% this year, while the HICP rate is forecast to average below 3%. We expect headline CPI inflation and the HICP rate to fall back to around 2.3% in 2009. The decline in headline CPI inflation would prove even more pronounced if the ECB actually begins to cut interest rates in the coming year.





STRONG PUBLIC FINANCES

■ The Irish public finances remain in a very strong state, despite lower than expected tax receipts last year. Ireland still recorded another General Government budget surplus in 2007, equivalent to 0.5% of GDP. This was the tenth budget surplus recorded in the past eleven years. Meantime, the General Government debt/GDP ratio was unchanged at 25% in 2007. The slowdown in the pace of economic growth means that the public finances will move into deficit in the period ahead. The Dept of Finance is forecasting a General Government deficit of 0.9% of GDP for 2008 and expects the deficit to remain at around 1% of GDP in 2009 and 2010 also. The General Government debt/GDP ratio is expected to have edged slightly higher to 28.7% by 2010, still a very low level.



■ It should be noted that Ireland will continue to run a substantial current budget surplus, which is expected to be of the order of 2.5% of GDP in 2008. Ireland runs a large capital budget deficit to finance an ambitious public capital spending programme aimed at redressing the country's large infrastructure deficit. Indeed, the forecast General Government budget deficit of €1.85 billion for 2008 is modest enough in the context of the €8.6 billion Exchequer provision for voted capital spending this year. It should also be noted that the Government sets aside 1% of GNP each year for the pre-funding of future public pension liabilities. This National Pension Reserve Fund stood at €21.3 billion at end 2007 (13% of GNP).

■ The move to a budget deficit in 2008 should not be viewed as a cause for concern, given that Ireland's public finances are in a very strong state, with a much more favourably budgetary position than most of the EU. Even if the budget deficit exceeds target, it should still be comfortably within the 3% of GDP limit set down by the EU.

Key Irish Economic Forecasts 2007-2010 (%)

	2007	2008	2009	2010
Real GDP	5.5	2.5	3.7	4.4
Real GNP	5.2	2.2	3.5	4.3
Employment	3.4	1.2	1.5	2.3
Unemployment Rate	4.5	5.2	5.6	5.8
Consumer Prices	4.9	3.5	2.3	2.5
Budget Bal. (% of GDP)	0.5	-0.9	-1.1	-1.0

Source: Dept of Finance; AIB Economic Research Unit

■ Fiscal policy should be counter-cyclical and thus stimulatory, if at all possible, in an economic slowdown. It is particularly important that there is continued strong growth in public capital spending in Ireland to help alleviate the large infrastructural deficit. Such spending boosts the long term growth potential of the economy. Thus, we would not favour any scaling back of capital spending plans to keep the General Government budget in surplus and are not at all bothered by the emergence of a modest budget deficit. The Irish public finances are in a strong enough position to allow for the full implementation of the National Development Plan. Thus, we expect fiscal policy to remain supportive of the economy in the period ahead.