The Domestic Economy — Real and Financial Developments[1]

Overview

The Irish economy is in the second year of recession with the level of output, as measured by Gross Domestic Product (GDP), forecast to contract by 8.3 per cent this year, following a decline of 3 per cent in 2008. In GNP terms, the economy contracted by 2.8 per cent last year and is forecast to decline by 9.4 per cent this year. The downward trend in activity is expected to continue into the first half of next year, followed by a stabilisation and gradual recovery in the second half of the year. For next year as a whole, a decline in activity of about 2.7 per cent in GDP and 3.5 per cent in GNP terms is projected. This outlook is contingent on a gradual recovery in world demand next year. By contrast, the contraction in domestic demand is likely to continue. With forward-looking indicators pointing to a further contraction in housing output and declining disposable incomes likely to depress consumer demand, there is little prospect of any recovery in domestic demand before 2011. At that stage, however, the rebalancing of activity in the economy is likely to have run its course and the prospect of some recovery in domestic demand together with a further rebound in external demand should support a return to modest growth overall. The sharp decline in output over the past two years has had severe consequences for the labour market. Following a significant deterioration over the last year, a continued decline in employment and a corresponding increase in unemployment are in prospect for the remainder of this year and in 2010. Unemployment is likely to average 12 ¾ per cent of the labour force this year, rising to an average of 15 per cent in 2010. Reflecting the weakness of demand, there has been a significant moderation in domestic inflationary pressures which, combined with declining inflation internationally, is manifest in a decline in measured inflation both this year and next. (A more detailed analysis of inflation and competitiveness follows in the next chapter).

The external environment faced by the Irish economy has been deteriorating since the beginning of last year, with a gradual moderation in growth in advanced economies, turning to recession in the second half of the year. The downturn deepened significantly in the fourth quarter and in the first quarter of 2009 against a background of severe financial market disruption. Notwithstanding the improvement in some forward-looking indicators in recent months, projections by international agencies such as the OECD, IMF and EU Commission point to GDP declines in most advanced economies followed by, at best, a muted recovery in 2010. Following modest growth of 0.7 per cent in 2008, the real level of GDP in Ireland's main trading partners, weighted by their shares in Irish exports, is likely to decline by 4.2 per cent in 2009. A muted recovery to positive growth of just 0.2 per cent is projected for 2010.

Taking account of the very difficult external environment, the performance of Irish exports has been impressive in the first half of the year. Exports of goods and services declined by 0.7 per cent on a seasonally adjusted basis in the first quarter and were down by only 3.0 per cent on an annual basis. This modest decline contrasts with much more severe declines in exports of other euro area countries. The strength of Irish exports overall reflects a particularly strong performance by the broad chemicals sector. However, more traditional, labour intensive firms, with a higher

[1] The projections in this Bulletin were compiled in early July 2009 and do not take account of data published subsequently. They are based on the technical assumption that exchange rates will remain unchanged from their average values at that time. Interest rates are assumed to move in line with market expectations. Oil prices are assumed to evolve in line with the futures market. The projections were compiled independently by the Bank and not as part of a Eurosystem exercise.

dependence on the UK market have fared less well. For the year as a whole, the performance of exports may deteriorate somewhat compared with the first quarter, due in part to firm-specific factors in the IT sector. Taking account of carryover effects, this is also likely to restrain the growth in exports in 2010. Depressed domestic demand conditions have contributed to a significant decline in import demand, which is expected to persist into 2010. Taken together with the relatively robust performance of exports, this should be reflected in a substantial narrowing of the balance of payments deficit this year, with the expectation of a surplus in 2010.

The rapid correction in the balance of payments from a significant deficit of 5.2 per cent last year to a probable surplus in 2010 is testament to the dramatic adjustment in the structure of the Irish economy over the period, which has been driven by a severe contraction in domestic demand. All components of domestic demand are currently in decline. Fixed investment is likely to fall by about one-third this year and at about half this rate of decline in 2010. House completions are likely to decline by over 60 per cent to an average of about 20,000 units this year and, taking account of trends in starts in the first half of the year, could fall as low as 12,000 next year. On this basis, the share of housing investment in GDP would decline to below 4 per cent next year compared with a peak of 12.8 per cent in 2006. Non-housing fixed investment, including machinery and equipment and commercial construction, is also declining sharply and is unlikely to return to positive growth before 2011.

The decline in consumer demand this year is most dramatically illustrated in the collapse in new car sales, which are down by almost two-thirds in the first half of the year compared with the same period last year. Other components of retail sales have also declined sharply, particularly those sectors dependent on housing demand. Consumption of services, normally more resilient than retail sales in a downturn, has also declined. Overall, domestic demand is likely to decline by almost 14 per cent this year and more than accounts for the aggregate fall in GDP. A positive contribution of about 4 percentage points from net exports (exports minus imports) is also mainly driven by domestic demand since it arises primarily from the dramatic decline in import demand.

While the rate of decline in output should slow appreciably next year, the relative contributions to the change in GDP are likely to mirror trends in 2009. Domestic demand will again decline significantly, driven by weak consumption and a further decline in fixed investment, particularly in the housing sector. Export volumes are likely to decline somewhat, reflecting muted external demand conditions but, with import demand declining at a faster rate, net exports will again provide some positive offset to the decline in domestic demand.

The continued contraction in aggregate demand is reflected in quite adverse labour market trends. Employment is falling slightly ahead of the decline in output and is now expected to fall by 8.8 per cent this year, and by a further 4.5 per cent in 2010. The impact of this on the unemployment rate is likely to be mitigated by a decline in the labour force of about 2 per cent in both years due to a combination of falling participation rates and net outward migration. The unemployment rate is projected to average 12.8 per cent in 2009, rising to an average of 15 per cent in 2010.

Inflationary pressures have eased significantly in the domestic economy, not least in the labour market, with increasing evidence of nominal wage reductions and other cost saving measures. These reductions, although perhaps contributing to the depressed state of domestic demand in the short term, represent a necessary adjustment to Irish cost competitiveness, which should support a sustainable export led recovery in aggregate demand when external conditions improve.

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

	2008	% change in		2009f	% change in		2010f
	€ million	Volume	Price	€ million	Volume	Price	€ million
Personal consumption	93,863	–8.0	–2.7	84,054	–4.5	–0.8	79,642
Public consumption	28,901	–0.5	–3.2	27,849	–1.5	–1.3	27,073
Gross domestic fixed capital formation	39,474	–34.5	–8.8	23,589	–16.2	–5.2	18,733
of which:							
• Building and construction	29,997	–37.4	–12.8	16,368	–18.9	–7.7	12,241
• Machinery and equipment	9,477	–25.0	1.6	7,221	–10.0	–0.1	6,492
Value of physical changes in stocks	317			–900			0
Statistical discrepancy	367			367			
Gross domestic expenditure	**162,922**	**–13.8**	**–3.9**	**134,959**	**–5.2**	**–1.6**	**125,915**
Exports of goods & services	151,896	–4.5	1.2	146,794	–1.3	–0.3	144,472
Final demand	**314,818**	**–9.3**	**–1.3**	**281,753**	**–3.2**	**–0.9**	**270,387**
Imports of goods & services	–133,002	–10.7	0.8	–119,740	–3.8	0.5	–115,824
Gross domestic product	**181,816**	**–8.3**	**–2.8**	**162,013**	**–2.7**	**–1.9**	**154,563**
Net factor income from rest of the world	–27,218			–26,970			–27,200
Gross national product	**154,598**	**–9.4**	**–3.5**	**135,043**	**–3.5**	**–2.3**	**127,363**

Domestic Demand

Personal Consumer Spending

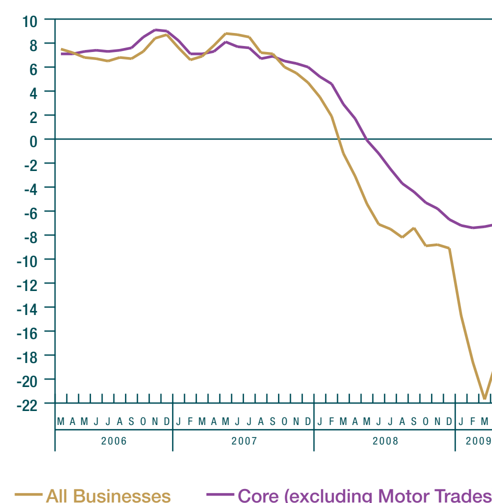
The negative trend in consumer demand during the course of last year worsened significantly in the early months of 2009. National Accounts data for the first quarter of this year show a quarterly decline of 6.2 per cent, in seasonally adjusted terms, bringing consumer expenditure back to its lowest level since the fourth quarter of 2005.

The weakness in consumer demand was reflected across a range of indicators including car sales, retail sales and indirect tax receipts. Retail sales in the first quarter declined by 21.4 per cent, year-on-year. While much of this decline was accounted for by car sales which were down by almost two-thirds, other sectors, particularly those linked to the housing market, were also very weak. The weakness in car sales and retail sales was reflected in a significant shortfall in indirect tax receipts — excise duties and VAT recorded annual declines of 23.3 per cent and 21.3 per cent, respectively, in the year to end-June 2009. While more recent observations show some improvement in a number of these indicators, in most cases this reflects a slowdown in the rate of decline rather than a return to positive growth.

The acute weakness of consumer demand this year reflects both severe pressure on current incomes and elevated concerns about the prospects for incomes and employment. Personal disposable income came under acute downward pressure in the early months of this year due to a combination of rapidly declining employment, wage and salary reductions and increases in taxes and levies. The extreme weakness in labour market conditions is reflected in very negative sentiment on the part

Chart 1: Index of Volume of Retail Sales

Year-on-Year % - 3 Month Moving Average (SA)



of consumers regarding current conditions. Although there has been some improvement in sentiment regarding future prospects, albeit from historically low levels, which may provide some support for consumer demand, it is unlikely to outweigh the effect of the decline in disposable incomes. Accordingly, the downward trend in consumer expenditure is likely to persist through the remainder of 2009. For the year as a whole, consumer expenditure is projected to decline by 8 per cent.

Taking into account the outlook for income and employment next year, a further decline in the volume of consumption of about 4.5 per cent seems likely in 2010. While the prospect of a modest recovery in the economic outlook may contribute to improved consumer sentiment, the effect of further erosion in disposable incomes is likely to be the dominant influence on consumer demand next year.

Government Consumption

The volume of government consumption increased by 2.6 per cent last year, according to Annual National Accounts data. Taking account of expenditure plans as set out in the April 2009 Supplementary Budget, government consumption is projected to decline in real terms by about 0.5 per cent this year and by 1.5 per cent in 2010.

Investment

The scaling down of the Irish construction sector continued apace in the first quarter of 2009 according to the latest quarterly National Accounts. Overall investment in the economy declined by 34.1 per cent year-on-year in the first quarter, with a 34.6 per cent decline in building and construction accompanied by a 33 per cent decline in investment in machinery and equipment. Within the building component, investment in the residential housing stock declined by 47.4 per cent in the first quarter compared to the same quarter a year earlier, while other construction-related components, mainly commercial and infrastructural investment, declined by 28 per cent in the year to the first quarter.

This scale of decline in new investment spending is likely to continue for much of the remainder of this year as residential and commercial property markets undergo a fundamental reassessment of asset values, with any major resumption in investment unlikely until the glut in supply has been cleared and prices stabilise.

In the residential housing sector, following 51,724 new house completions in 2008, output is set to fall back substantially again this year reflecting weak demand, expectations of further house price decreases and an overhang of unsold housing units. Figures from the Department of the Environment, Heritage and Local Government (DoEHLG), based on new house connections to the electricity grid, suggest that there were 12,162 completions in the first five months of the year. Forward-looking indicators and the Bank's statistical models of the house-building sector suggest that underlying house completions look set to fall to somewhere in the region of 20,000 units this year, a drop of more than 60 per cent on last year's outturn. The DoEHLG headline house completion figure may exceed this, since it is based on connections to the electricity grid and, given the excess of unsold units and limited demand, some dwellings are likely to have been built in 2008 but not connected to the grid until 2009, raising the completion figures in 2009.

For next year, while subject to considerable uncertainty, it is likely that housing supply will moderate even further as the factors currently impacting the market — declining prices, the supply overhang and tight credit and financing conditions — continue to weigh on developers. New house registrations amounted to just 1,736 in the opening five months of 2009 and are running at a rolling 12 month total of 6,733 units. While new house registrations do not cover all scheme housing, local authority housing and one-off houses, the extreme weakness would suggest that underlying completions are likely to be in the region of 12,000 units next year, assuming one-off housing holds up reasonably well — of which there is some anecdotal evidence. Commencement notices registered just 3,970 units in the opening five months of 2009 and are running at a cumulative 12 month total of

13,916. It should be noted that there are downside risks to both this year's and next year's completions forecasts as some units which have been registered, and on which work may have started, are unlikely to see completion as some developers face severe financial difficulties.

With regard to non-residential building and construction, activity in the commercial sector, mirroring the residential sector, has also slowed significantly as financial constraints, falling capital values and rental flows and oversupply have led to the delay or postponement of projects. A recent market report (from CB Richard Ellis (CBRE)) indicates that the total value of commercial investment deals signed in the first half of 2009 reached just €41.6 million, compared with €392 million in the first half of 2008. According to latest Society of Chartered Surveyors/Investment Property Database quarterly Irish index (SCS/IPD), in the first quarter of 2009, capital values across all commercial sectors declined quarter-on-quarter by 10.9 per cent (a moderation on the previous rate of decline but probably brought about by a lack of transactional activity) and by 42.4 per cent in the year to the first quarter. Given the strong supply response of recent years, weak demand, weaker rental flows (down 3.2 per cent in the first quarter compared to the previous quarter), significant liquidity constraints and uncertainty about the economic climate, capital values are likely to continue their downward adjustment. Reflecting this weakness, the volume of production in non-residential building declined by 21.2 per cent in the first quarter year on year according to the CSO's Production in Building and Construction Index.

Sentiment in the construction sector remains at an all time low according to the Ulster Bank Construction PMI. With residential activity at a virtual standstill and commercial activity following suit, support from infrastructural investment looks to be easing somewhat as pressures on the public finances increase. There is already anecdotal evidence that the pipeline of new civil-engineering projects has dried up, with capital expenditure provisions being used to close out existing projects.

Overall, in light of residential and non-residential developments, building and construction investment is forecast to contract by 37.4 per cent this year and by a further 18.9 per cent in 2010. There are, moreover, downside risks to these forecasts in the current economic environment.

The machinery and equipment component of investment, a significant proportion of which is related to the construction sector, is also forecast to decline substantially this year, following a contraction last year. The decline in overall economic activity, a shrinking construction and manufacturing sector and declining merchandise exports suggest that investment in machinery and equipment could decline by as much as 25 and 10 per cent this year and next, respectively. These forecasts are, however, tentative in nature given uncertainty surrounding the timing and magnitude of aircraft purchases. Given the assumptions for construction and machinery and equipment investment, overall investment is forecast to contract by 34.5 per cent and 16.2 per cent in 2009 and 2010, respectively.

Stock Changes

According to annual National Accounts data, the accumulation of stocks amounted to €317 million during 2008 and made a contribution of 0.2 percentage points to the change in real GDP last year. The positive accumulation of stocks last year overall reflected a significant build up in the first three quarters of the year which was followed by a significant decline in the fourth quarter of the year. The unwinding of inventory levels continued in the first quarter of this year, albeit at a slower pace than in the previous quarter. Stock levels are expected to decline further during the remainder of 2009. Some recovery in inventory levels is assumed next year in line with improving prospects for output growth.

Merchandise Trade and the Balance of Payments

Merchandise Trade

Merchandise exports declined by 3.1 per cent in volume terms, year-on-year, in the first quarter of 2009. Such an outturn is surprisingly

resilient in view of the severe, and highly synchronised, contraction in the volume of world trade flows that occurred during the first quarter of 2009. The strength of this performance may be largely attributed to sector-specific factors and, specifically, the fact that the less cyclical chemicals sector accounts for around half of merchandise exports. According to CSO External Trade Statistics, the broad chemicals sector was the dominant source of merchandise export activity during the first quarter of 2009, with an increase of 12.8 per cent in value terms. Given recent price developments, this suggests a single digit increase in volume terms. The robust performance of the chemicals sector, however, contrasts sharply with that of other sectors and, in particular, the more traditional exporting sectors such as food and beverages. It is anticipated that the downward momentum of such sectors will weigh heavily on Ireland's merchandise export performance over the remainder of this year. In addition, the broad chemicals sector represents an extremely volatile component of merchandise exports and, as a result, the sustainability of its buoyant first quarter performance is somewhat uncertain. Taking account of these caveats and incorporating the impact of the closure of Dell's manufacturing operations, the performance of merchandise exports is projected to deteriorate further during the course of 2009, with an overall decline of 4.8 per cent in volume terms. However, the outlook has been revised upwards relative to the previous Bulletin on the basis of the favourable first quarter outturn. Looking ahead to 2010, merchandise exports are expected to weaken further, albeit at a reduced pace to that of 2009. A decline in merchandise exports of around 2.8 per cent is currently projected.

The backdrop of contracting domestic demand continued to place significant downward pressure on merchandise import flows in the first quarter of 2009, with an annual decline of 24.9 per cent. The outlook for merchandise imports in 2009 of a decline of 21.6 per cent in volume terms represents a downward revision relative to the previous Bulletin and is in line with revisions to domestic demand. The persistence of weak domestic demand conditions during 2010 is likely to result in a further contraction in the volume of merchandise imports, with a projected decline of 9.2 per cent. As the downward trend in merchandise imports seems set to significantly outpace that of exports this year, the merchandise trade surplus is expected to rise sharply. Further improvement in the merchandise trade balance is anticipated in 2010.

Services, Factor Incomes and International Transfers

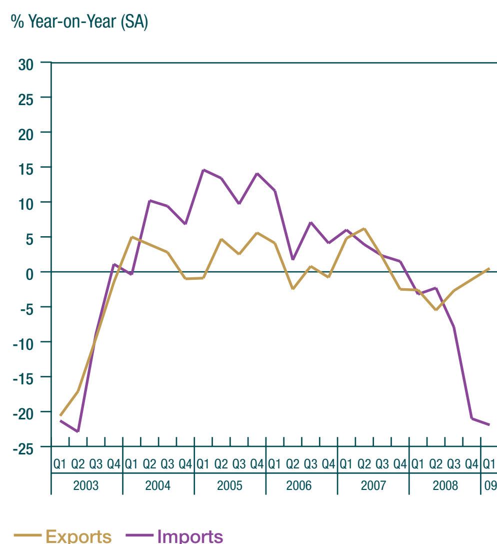
As with merchandise exports, the performance of services exports in the first quarter of 2009 proved to be somewhat stronger than anticipated given the backdrop of contracting world trade volumes. Nevertheless, the 2.8 per cent, year-on-year, decline in services export volumes during the first quarter of 2009 contrasts sharply with the double-digit buoyancy of recent years. The performance of services exports at a sectoral level varied considerably. Services exports were somewhat boosted during the first quarter of 2009 by the 6.8 per cent increase in the business services component, which accounts for around 31 per cent of services exports. By contrast, the insurance and financial services sectors placed considerable downward pressure on services export activity during this period, as illustrated by CSO data on the breakdown of IFSC and non-IFSC activity in the internationally traded services sector. IFSC related exports declined by 7.8 per cent annually in the first quarter of 2009 compared with an increase of 0.4 per cent for non-IFSC services exports over the same period. As regards the outlook for 2009, some further falloff in services export activity is envisaged during the remainder of the year, with most sectors expected to record declines. Services exports are expected to recover, albeit modestly, in 2010. Consistent with the resilience of the first quarter outturn, the short-term outlook for services exports has, however, been revised upwards. Services import growth was broadly flat, year-on-year, in the first quarter of 2009, with an increase of 0.2 per cent in volume terms. Given the weakened outlook for the foreign-owned exporting sectors, services imports are expected to decline during 2009 as a whole. Nevertheless, the decline in services imports seems set to be less than that of services 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	–4.8	2.0	80,259	–2.8	–1.3	76,994
Merchandise imports	–58,428	–21.6	1.6	–46,535	–9.2	0.0	–42,196
Merchandise trade balance (adjusted)	24,265			33,724			34,798
(% of GNP)	(15.7)			(25.0)			(27.3)

Net factor income outflows were noticeably strong in the first quarter of 2009, rising by 16.5 per cent annually, with the result that the decline in GNP substantially outpaced that of GDP. This reflected a sizable pick-up in profit outflows and, to a somewhat lesser extent, a falloff in income inflows. Net income outflows are, however, expected to weaken somewhat for 2009 as a whole. This is consistent with the projection of a falloff in the performance of the foreign-owned exporting sectors during the remainder of the year. The international transfers component of the current account was negative in the year to the first quarter of 2009. The negative contribution to the current account arising from this component is projected to continue throughout 2009 and 2010. Combining the prospective trends across the various current account components, a deficit of around –0.7 per cent of GNP is expected in 2009. Some further improvement is anticipated in 2010, with a current account surplus of 0.4 per cent of GNP.

Chart 2: Value of External Trade



Capital and Financial Account Q1 2009

The Capital Account, which primarily covers capital transfers, recorded a €5 million deficit in the first quarter of 2009, representing a decrease compared with a surplus of €29 million in the same quarter in 2008. Net outflows of €3.8 billion were recorded on the Financial Account in the first quarter of 2009, reflecting withdrawals by foreign residents in Irish residents' liabilities. Net errors and omissions, the item inserted to account for statistical discrepancies in the Balance of Payments' Accounts, was a credit of €6.4 billion in the first quarter of 2009. This is the largest quarterly net errors and omissions recorded in the Balance of Payments' Accounts since 1998.

Net direct investment amounted to outflows of €15 million from the Irish economy in first quarter of 2009, a significant decrease from net outflows of €2.1 billion in the same quarter last year. An increase in inward direct investment of €794 million arose from reinvested earnings of €6.2 billion exceeding equity withdrawals of €2.1 billion and intercompany loans, advanced by Irish-based foreign-owned companies to their affiliates abroad, of €3.3 billion.

Irish direct investment abroad amounted to €809 million, down from €1.4 billion in the same quarter last year.

Cross-border transactions in securities resulted in portfolio investment net inflows of €12.7 billion. Irish residents redeemed €40.4 billion of their investments in foreign securities, mainly comprising of withdrawals worth €31.5 billion in debt instruments, more specifically bonds and notes. Similarly, non-resident investors

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

€ million	2008	2009f	2010f
Current account			
• Merchandise trade balance (adjusted)	23,820	32,732	33,805
• Services	–5,371	–6,670	–6,150
• Net factor income from rest of the world	–26,771	–25,950	–26,180
• Current international transfers	–1,115	–1,035	–935
Balance on current account	**–9,437**	**–923**	**540**
(% of GNP)	–6.1	–0.7	0.4
Capital and financial account	**2007r Full year**	**2008r Full year**	**2009 Quarter 1**
Balance on capital account	**39**	**68**	**–5**
Financial account			
• Direct investment	2,602	–22,892	–15
• Portfolio investment	–7,283	–39,352	12,678
• Other investment	16,744	78,378	–16,531
• Reserve assets[a]	–12	–78	41
Balance on financial account	**12,051**	**16,057**	**–3,827**
Net errors and omissions	–1,966	–6,690	6,362

[a] Change in reserves on a transactions basis, i.e. excluding valuation adjustments. A minus figure equals a net increase in reserves.
Note: The CSO have not yet incorporated measurement of FISIM into Balance of Payments data. As a result, the data in this table will differ from the National Accounts data in Table 1.

withdrew investments of €27.8 billion from Irish-issued securities, reflected in withdrawals of €14.2 billion in equity securities and €13.5 billion in debt securities.

The other investment component, comprising transactions in external assets and liabilities not recorded under direct investment or portfolio investment, accounted for net outflows of €16.5 billion. Irish residents increased their investment in foreign assets by €1.5 billion in the first quarter of 2009, a significant reduction in investment in foreign assets compared with investment of €68.3 billion in the same quarter last year. Foreign residents withdrew nearly €15 billion worth of investments from Irish residents. Official external reserves decreased by €41 million in the first quarter of 2009 to €731 million at end-March. This included a quarterly valuation adjustment, a write-up of €8.6 million.

Output Trends and the Labour Market

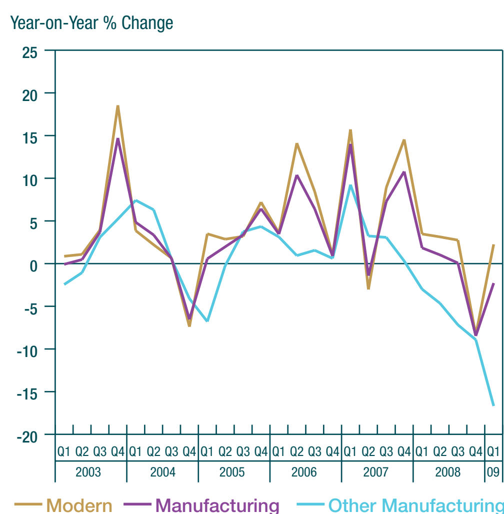
Industry and Services Output

The manufacturing sector is experiencing continued pressure, with total manufacturing output estimated to have fallen by 1.4 per cent in the first four months of 2009 relative to the same period last year[2]. This contrasts with 0.3 per cent growth over the same period in 2008. The deterioration in the sector was driven by a sharp contraction in output in the traditional sector (excluding mining, quarrying and electricity industries) which fell by 17 per cent year on year in the four month period to April. On the other hand, the modern sector has proved quite resilient in recent months, with output expanding by 3.8 per cent year-on-year in the four month period to April. However, the expansion in modern sector output in recent months has been driven almost entirely by the volatile chemicals sub-sectors, while the technology and other modern sub-sectors performed relatively poorly over the period.

Within the modern sector, output in the chemicals sub-sector, (which accounts for about 50 per cent of gross output of the modern sector), expanded by 21.6 per cent in annual terms in the four month period to April. The strong increase in chemicals output, was driven by a sizeable expansion in output (22.3 per cent) of the basic chemicals sub-sector, as well as a 13.5 per cent rise in pharmaceuticals output. In contrast to the chemicals sub-sectors,

[2] Based on NACE Rev1.1 classification data available up to April 2009. Figures for May 2009 onwards will be published in accordance with NACE Rev 2 and will feature in the next Bulletin.

Chart 3: Volume of Industrial Production



output in the electrical and communications sub-sectors contracted on average over the period. In particular, output in the largest modern sub-sector outside of chemicals, the 'Radio, TV and Communications Equipment and Apparatus' sub-sector, contracted by 30.9 per cent over the four month period to April, in annual terms.

Given the fact that the performance of the chemicals sub-sector tends to be quite volatile, it is useful to examine the volume of output in the manufacturing sector, excluding chemicals. In contrast to the 1.4 per cent contraction in total manufacturing sector output previously alluded to, when the chemicals sub-sector is excluded, output in the remaining manufacturing sectors fell by a much stronger rate of 14.8 per cent over the four month period to April, in annual terms. This highlights the fact that several manufacturing sub-sectors (both traditional and modern) are experiencing difficulties in the current recession. In particular, in the traditional sector, output has been down strongly each month in the year to April (starting at –12.3 per cent in January and the rate of decrease worsening thereafter). The largest traditional sub-sector — the food and beverages sub-sector — contracted by 3.9 per cent in the three-month period to March, similar to its performance over the same period of 2008.

The NCB Purchasing Managers Index (PMI) provides a more recent qualitative view of developments in the manufacturing sector. The latest release points to sustained declines in the manufacturing sector in the first half of 2009, with output decreasing in June for the sixteenth consecutive month. However, there were some tentative signs of easing in the rate of contraction of measures such as output, employment and new orders in June. The seasonally adjusted PMI, which is designed to track the overall health of the manufacturing sector, rose slightly to 42.5 in June, from 39.4 in May. Despite the increase in the index, a value below 50 nonetheless indicates continued contraction in the sector. However, June's contraction was the slowest since September 2008. Further sharp falls in employment were registered in June, continuing the decline which has been evident over the last nineteen months.

In light of the ongoing economic difficulties both in Ireland and in Ireland's main trading partners, 2009 is expected to be a difficult year for manufacturing industries. In particular, output in manufacturing is anticipated to decline by 3.4 per cent in 2009, with the modern sector expected to contract by 2.4 per cent in the year. The traditional sector is expected to contract at a more rapid pace, with output forecast to fall by 7.8 per cent in 2009.

In line with developments in the industrial sector, the services sectors of the economy are experiencing a contraction in output at present. In particular, the latest Quarterly National Accounts show that output in the Distribution, Transport and Communications sub-sector was down 10.9 per cent in annual terms in the first quarter of the year, with output of Other Services and that of Public Administration down 3.5 per cent and 0.7 per cent, respectively.

The June NCB Purchasing Managers Index for Services signalled a continued reduction in activity in the Irish services sector, albeit at a slowing pace. The headline Business Activity Index rose from 39.5 in May to 42.3 in June (where an index value below 50 indicates contraction in the sector), indicating that while continuing to contract sharply, the rate of decline has slowed somewhat. Input prices eclined at the fastest pace registered in the nine-year history of the Index to 34.3, reflecting

Table 4: Industry and Manufacturing Output, Annual Percentage Change

	Industrial Output			
	Modern	Other	Manufacturing	Total Industry
1998	30.1	10.2	21.3	19.8
1999	21.4	5.6	15.0	14.8
2000	20.3	8.0	15.8	15.4
2001	15.1	1.2	10.3	10.0
2002	11.9	–2.1	7.5	7.2
2003	6.0	1.3	4.6	4.7
2004	–0.7	2.3	0.1	0.3
2005	4.2	0.2	3.1	3.0
2006	6.8	1.5	5.3	5.1
2007	8.8	3.9	7.5	7.3
2008	0.4	–5.8	–1.2	–1.2
2009[f]	–2.4	–7.8	–3.4	–3.2
2010[f]	–2.6	–3.3	–2.7	–2.7
Average 1998-2010	9.2	1.0	6.4	6.2

Note: The data shown in this Table, and all data in this section, are based on NACE REV1.1 classification data available up to April 2009. In order to conform with the European Commission's reclassification requirements, figures released for May 2009 onwards (May figures first published July 9th 2009) will relate to NACE Rev 2 industry classification, with figures rebased to 2005=100 and backcast to 1980. As a result, the new CSO series, and subsequent Bulletin forecasts, will contain an expanded set of subsections to those formerly available under NACE Rev1.1.

an ongoing six-month fall in input costs. Confidence registered modest gains, rising to 54.8 in June, up from 50.8 in May, indicating a slight source of optimism beginning to percolate through the sector. The new orders index fell considerably, despite the pace of reduction slowing since May.

Agricultural Output

According to the CSO's 'Output, Input and Income in Agriculture' release, which shows the final estimates for 2008, the value of agricultural goods output rose by 2.6 per cent in 2008, with the cattle and pig sectors the main source of these increases. However, output in volume terms fell by 1.5 per cent, suggesting that value increases were driven solely by price increases over the year. Expenditure on intermediate consumption was up 12.3 per cent in 2008 in value terms, largely driven by high feed, fertiliser and energy costs. However, the volume of intermediate consumption was down by 0.5 per cent in annual terms in 2008. Agricultural operating surplus fell by 12.4 per cent in 2008 in value terms, following a rise of 11.8 per cent in 2007, highlighting the high level of volatility experienced by farm incomes in the recent past. This trend was evident throughout EU-27 countries, with average declines in operating surpluses of the EU-27 amounting to 6 per cent.

Although the value of output in the sector rose in 2008, input prices rose faster than output prices, due in part to a fall in net subsidies. This culminated in a worsening in the terms of trade index by approximately 8 per cent in 2008.

The Quarterly National Accounts for the first quarter of 2009 indicate that output in the broader Agriculture, Forestry and Fishing sector (not directly comparable to output developments cited in Table 5) declined by 1.5 per cent on a year earlier. However, this represents a tentative improvement on the fourth quarter of 2008 annual decline of 16.1 per cent.

According to the Department of Agriculture, Fisheries and Food's recently published 'Annual Review and Outlook for Agriculture, Fisheries and Food', the medium term global outlook is for gradual recovery of the sector supported by a number of structural drivers such as growth in global food demand, development of the biofuel sector, and a long term reduction in food-crop productivity growth. EU cereal prices are forecast to recover over the medium-term, to levels higher than previously experienced.

The outlook for the Irish agricultural sector for the remainder of 2009 is mixed. Prospects for the sector over the coming year are likely to be punctuated by the fall-out from harvest difficulties experienced earlier in the year, while in the shorter term challenges are mounting in the dairy sector in particular.

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

	2008	% change in			2009f	% change in			2010f
	€ million	Value	Volume	Price	€ million	Value	Volume	Price	€ million
Goods output at producer prices[a]	5,853	–5.1	–1.2	–3.9	5,554	–3.0	–0.2	–2.9	5,385
Intermediate consumption	4,577	–4.2	1.1	–5.2	4,385	–2.6	0.2	–2.8	4,272
Net subsidies plus services output less expenses	1,885	–1.5			1,864				1,808
Operating surplus	2,263	–6.8			2,116	–6.5			1,947

[a]Including the value of stock changes.

Overall, agricultural prices are expected to continue their downward trajectory throughout 2009, both on the output and input side. The current forecast is for a fall in output prices of 3.9 per cent in 2009 and a further fall of 2.9 per cent in 2010. Operating surplus is anticipated to decline by 6.8 per cent in 2009, driven by increased VAT payments, reduced government grant payments and reduced REPS payments.

The Labour Market

According to the most recent Quarterly National Household Survey (QNHS), the scale of the deterioration in labour market conditions accelerated during the first quarter of 2009. The downward momentum of labour demand intensified during this period, as evidenced by the sharp contrast between the 3.5 per cent seasonally adjusted employment decline of the first quarter, and the 1.7 per cent fall of the previous quarter. The weakness of employment was broadly based at a sectoral level — nine out of the fourteen economic sectors recorded an annual decline in employment during the first quarter of 2009. Considerable variation existed, however, as regards the magnitude of declines at a sectoral level. The decline in employment was heavily concentrated in the construction sector, which accounted for approximately 46 per cent of overall job losses. The wholesale and retail trade sector, a prominent source of labour demand over recent years, accounted for a further 19 per cent of the overall decline. The sharp year-on-year decline in full-time employment in the first quarter of 2009 was partly offset by a modest increase in the number of part-time workers. The majority of these part-time gains were classified in the ‘under-employed’ category, suggesting that individuals were not choosing to work part-time. This is consistent with firms reducing labour utilisation in line with the deterioration in macroeconomic conditions.

The labour force also weakened appreciably in the first quarter of 2009, with an annual decline of 2 per cent. The falloff in labour supply during the first quarter is solely attributable to a decline in participation, as evidenced by the 1.5 percentage point fall in the participation rate. The role played by demographic factors, i.e. inward migration and changes in the population age structure, weakened dramatically — falling from an increase of almost 53,000 in the first quarter of 2008 to just over 1,000 in the first quarter of 2009. The sharp deceleration in the demographic contribution over recent quarters may primarily be attributed to the slowing of inward migration flows. Data on the issuance of Personal Public Service (PPS) numbers provides some insight into the falloff of inward migration, with the allocation to Accession States down 66 per cent, year-on-year, in June. As the decline in employment considerably outpaced that of the labour force unemployment rose sharply, as illustrated by the increase in the unemployment rate to 10.2 in the first quarter of 2009 from 4.9 per cent in the same period last year.

The Live Register provides some insight into labour market developments subsequent to the first quarter of 2009. The number of persons on the Live Register, adjusted for seasonal factors, increased by 11,400 in June, the smallest monthly increase since September 2008. The pace of increase in claimants clearly decelerated during the second quarter of 2009 — the average monthly increase during the second quarter of 13,600 persons was around half that of the first quarter. It is, however,

important to note that the number of persons joining the Live Register is not expected to continue to decelerate at the pace witnessed in the second quarter.

As regards the outlook for 2009 as a whole, employment is projected to fall by 8.8 per cent in average annual terms, with total employment returning to early 2005 levels. At a sectoral level, the construction sector is expected to continue to dominate in terms of job losses. Correspondingly, the negative spillover effects to the services sub-sectors arising from the construction sector are expected to become greater this year. The outlook for 2009 represents a sizable downward revision relative to the projection published in the previous Quarterly Bulletin as the fall in employment during the first quarter of 2009 exceeded expectations. The sharp deterioration in labour demand is expected to weigh upon labour force developments during 2009. In terms of participation effects, it is envisaged that individuals will become discouraged from searching for employment or opt to stay on longer in education and, as a result, participation rates are expected to decline further. Contracting labour demand is also expected to have a dampening effect on migratory flows as potential migrants may be discouraged from moving to Ireland while previous migrants may return home or move elsewhere. Accordingly, it is envisaged that a modest net outflow of migrants will be observed during 2009. The migratory response is, however, subject to considerable uncertainty as there is no precedent for this in an Irish context. Reflecting such a combination of developments, the labour force is projected to decline in annual average terms by around 2 per cent. While such a decline will somewhat dilute the impact of the sharp contraction in employment, the unemployment rate is nevertheless expected to rise markedly this year, averaging almost 13 per cent.

Further deterioration in labour market conditions is envisaged during 2010. The pronounced downward momentum of labour demand is expected to continue next year, with a projected decline of 4.5 per cent. This reflects broad based weakness at a sectoral level. The labour force is expected to continue on its downward trend during 2010, with a further decline of around 2 per cent. Such an outlook is based on the assumption of net outflows of migrants combined with a negative contribution from participation effects. It is, however, important to note that the short-term outlook for the labour force is surrounded by a high level of uncertainty. Taking account of the outlook for employment and the labour force, the unemployment rate is expected to average around 15 per cent in 2010.

The Public Finances

Mid-year Exchequer Returns

The latest Exchequer returns data for the first half of 2009 confirm the very challenging fiscal environment and the marked deterioration in the health of the public finances. In the year to end-June, there was an Exchequer deficit of €14.7 billion, compared with a deficit of €5.6 billion over the same period in 2008. Much of the deterioration, approximately €6 billion, was accounted for by payments to the NPRF for bank re-capitalisation purposes (€3 billion) and a payment of €3 billion to Anglo Irish Bank.

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

(annual average '000)	2008	2009^f	2010^f
Agriculture	115	112	111
Industry (including construction)	520	435	400
Services	1,465	1,370	1,320
Total employment	2,100	1,916	1,830
Unemployment	141	281	323
Labour force	2,241	2,196	2,152
Unemployment rate (%)	6.3	12.8	15.0

Note: Figures may not sum due to rounding.

The deterioration in the public finances has been mainly driven by the sharp macroeconomic slowdown, coupled with the unwinding of structural imbalances within the economy. In all, total tax revenue in the first six months of the year amounted to €15.8 billion, which was marginally worse than Department of Finance expectations, but was down 17.3 per cent in annual terms. The underlying picture was weaker however, due to a change in the payment schedule for corporation taxes, which resulted in significant inflows in the latter in June. When allowance is made for this, the annual decline in tax receipts was closer to 20 per cent in the first half of 2009.

All of the other major tax heads were significantly down year-on-year, reflecting very weak domestic demand and a depressed international economic environment. In particular, in the year to June, the two most important tax categories, VAT and income tax were down by 21.3 and 8.3 per cent, respectively. Furthermore, the pace of decline for both taxes accelerated in the April-June quarter, relative to the first quarter of 2009, which is a source of concern for the second half of the year, although additional receipts from the income levy should act as a counterbalancing force. The other main tax categories, predominantly transactions taxes, also declined sharply in the first six months of 2009 mainly as a result of anaemic consumer spending and a collapse in housing related activity.

On the expenditure side, total (voted) current spending in the first six months of the year amounted to €20 billion, which was up 2.6 per cent in annual terms. Much of the increase in spending has been driven by the effect of automatic stabilisers, in particular through the medium of higher unemployment related expenditures reflecting a sharp increase in numbers on the Live Register. On the capital side, voted expenditure decreased significantly, by 9.4 per cent in the first six months of the year. As a result, overall voted spending was up marginally in annual terms and was slightly below its expected profile.

The other main expenditure categories (non-voted current and capital), however, increased very sharply in the first half of the year due predominately to increased payments to the NPRF as part of the bank recapitalisation programme and a payment to Anglo Irish Bank

Table 7: Mid-year 2009 Exchequer Returns

	2008 Outturn €m	2009 End-June Outturn		
		€m	% Annual Change	% Budget Estimate
Current Expenditure				
— Central Fund Services[a]	3,936	3,493	18.5	59.7
— Net Voted Expenditure[b]	40,757	20,031	2.6	49.4
Total	**44,693**	**23,524**	**4.7**	**50.7**
Current Revenue				
— Tax revenue	40,777	15,809	–17.3	46.0
— Non-tax revenue[c]	847	501	25.8	58.8
Total	**41,624**	**16,310**	**–16.5**	**46.3**
Current Budget Balance	**–3,069**	**–7,213**		
Capital Budget Balance	**–9,645**	**–7,496**		
Exchequer Balance	**–12,714**	**–14,709**		
Source and Application of Funds				
Total Repayments	–30,311	–21,635		
Total Increase in Exchequer Deposits	17,597	6,926		
Exchequer Balance	**–12,714**	**–14,709**		

[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, etc.

Table 8: Fiscal Outlook, % of GDP

	2008[e]	2009[f]	2010[f]
General Government Deficit			
Department of Finance		$10\frac{3}{4}$	$10\frac{3}{4}$
IMF		11.8	12.7
OECD[a]		11.5	13.6
European Commission[b]		12.0	15.6
Current Estimated Outturn	7.3		
General Government Debt			
Department of Finance		59.0	73.0
IMF		59.9	75.0
OECD		n.a.	n.a.
European Commission		61.2	79.7
Current Estimated Outturn	44.2		

a The balance does not include additional fiscal measures outlined by the authorities for 2010.
b The balance for future years is based on a no policy change scenario. Public Finances in EMU 2009

Exchequer Financing

The Exchequer deficit of €14.7 billion in the first six months of the year was associated with a further sharp increase in Government borrowing, which amounted to €21.6 billion over the period. Most of the borrowing was accounted for by the issuance of government bonds (€15.4 billion) and commercial paper (€5.8 billion).

Outlook for 2009

The speed and severity of the deterioration in the public finances is a source of serious concern. Ireland has an excessive General Government Deficit with a European Council recommendation to correct the situation by 2013 at the latest. There have been a series of government consolidation measures over the past year, aimed at limiting the decline in the headline deficit, including those measures in the supplementary budget last April. These measures are part of a 5-year plan aiming to restore balance to the fiscal position by 2013.

The fiscal outlook for 2009 is particularly stretched with Ireland likely to have the highest General Government Deficit in the EU for the second year in succession given the latest European Commission projections. At present, the main deficit projections range from $10\frac{3}{4}$ to 12 per cent. (Table 8), with the gross debt ratio expected to rise towards 60 per cent of GDP.

For 2010 and in the years to 2013, considerable additional consolidation measures will be needed along the lines of the proposed measures in the supplementary budget, which amounted to approximately 2½ per cent of GDP on average each year if fiscal balance is to be restored within this timeframe.

Monetary and Financial Market Developments

Introduction

Conditions in international financial markets have generally improved through mid-year from their very fraught state in the wake of the bankruptcy of Lehman Brothers last autumn. Concerns regarding liquidity and counterparty risk have abated somewhat, as reflected in secured and unsecured money market and credit default swap spreads. However, the restoration of these calmer conditions has required unprecedented actions on the part of central banks in providing large quantities of liquidity to banking systems and through major support operations by governments to banks. These measures have been complemented by macroeconomic measures aimed at supporting aggregate demand through a major easing of monetary policies and expansionary fiscal policies. Nonetheless overall financial conditions remain tight and fragile. Although corporate bond markets in some countries are beginning to function more normally, markets in most other financial instruments remain substantially impaired. In addition, bank lending flows remain limited in most countries despite central bank actions of both a

conventional and unconventional kind to promote greater credit flows to businesses and households.

This international context and the major downturn in the real economy provided the backdrop for developments in Ireland's financial sector in the second quarter. In order to address the problems in the banking sector, the Government announced the establishment of the National Asset Management Agency (NAMA) in the Supplementary Budget in early April. It is proposed that NAMA will initially purchase property development loans from certain institutions at a discounted value in exchange for Government securities. The objective of this initiative is to cleanse the banks' balance sheets of bad loans and to leave them in a position to fund more effectively and provide credit to the economy.

The yields on Irish Government bonds narrowed somewhat against those of Germany during the second quarter, amid a more general increase in risk appetite in the market. However, the implications of the Government support schemes to the domestic financial sector, the deterioration in the public finances and the prospects for the economy in general meant that Irish yield spreads vis-à-vis Germany did not tighten as much as those of other euro area sovereign bonds. Irish yields remain the highest in the euro area.

Government support schemes across the globe, and the general easing of conditions in money markets in the second quarter have contributed to some improvement in access to wholesale funding for banking systems including Ireland's, albeit from a very challenging position in late 2008 and early 2009. The ECB reduced its main refinancing rate to an historic low of one per cent and provided additional liquidity through the use of longer-term refinancing operations out to twelve months maturity. The reductions in official and interbank interest rates seen since the beginning of the year have in general been passed on to retail rates for loans (see Box 1) and to a lesser degree deposits. Despite this, survey evidence suggests that both credit supply and credit demand remain muted given the prevailing economic conditions. Outstanding private-sector credit has fallen consistently in the most recent months, with mortgages, consumer credit, and lending to most business sectors contracting on a quarterly basis. Meanwhile Ireland's contribution to the euro-area money supply (M3) continued to decline during the second quarter of 2009.

Interest Rates

During the second quarter the ECB reduced its main refinancing operations (MRO) rate by 50 basis points to 1 per cent, as inflationary pressures continued to ease given the continued economic weakness in the euro area. The corridor between the ECB's main refinancing rate and the deposit facility rate narrowed to 75 basis points by the end of the period. In addition, the ECB continued to provide Eurosystem counterparties with abundant liquidity, through its full allotment policy for its main refinancing and enhanced longer-term refinancing operations (LTRO), such as the introduction of the twelve-month LTRO. This led to a large liquidity surplus in the Eurosystem, and high recourse to the overnight deposit facility towards the end of June.

Table 9: Monetary Policy Operations: Ireland, 3 March to 30 June 2009

	No. of bidders	No. of bids	Amount bid	Amount allotted	Marginal rate	Weighted average
			€ million	€ million	%	%
Recent MRO	11	11	17,115	17,115	1.00	1.00
Quarterly rolling average MRO	17	17	46,119	46,119	1.24	1.24
Recent LTRO	22	22	47,644	47,644	1.00	1.00
Quarterly rolling average LTRO	7	7	11,277	11,277	1.18	1.18

Chart 4: EURIBOR Q2 2009

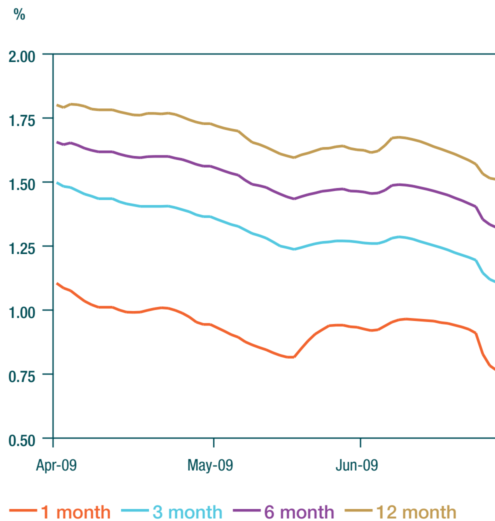
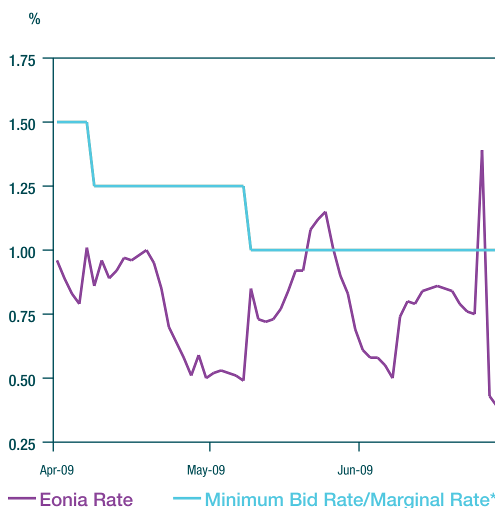


Chart 5: Euro Area Overnight Rate, Minimum Bid Rate and Marginal Rate



*As of October 2008, refinancing operations with the Eurosystem are conducted on a fixed rate tender, as opposed to a variable rate tender basis. Hence there is no difference between the marginal rate and the minimum bid rate.

ECB actions contributed to a continuing gradual normalisation of conditions in euro-area money markets since the intensification of financial market tensions in September 2008. Unsecured euro-area money market rates continued to fall between April and June, consistent with this normalisation. Spreads between unsecured and secured rates, as represented by Euribor-OIS spreads[3], declined further and have now returned to levels last seen before the bankruptcy of US investment bank Lehman Brothers.

Domestic Lending and Deposit Rates[4]

Interest rates in Ireland continued to fall for businesses and households between end-January and May 2009, reflecting further cuts in the ECB main refinancing rate. Interest rates for new short-term or variable-rate loans to non-financial corporations (NFCs) fell by more than the cumulative one percentage point reduction in the ECB rate during the period, and margins over interbank rates also declined. Overall, NFC loan rates have fallen further than the ECB rate since the beginning of the rate-cutting cycle in October (see Box 1). However, there has been a notable difference in the interest rate pass-through for small and large loans to businesses since late-2008, as the gap between interest rates for loans under and over €1 million widened considerably, both in Ireland and in the euro area as a whole. Although data on interest rates for small or large businesses are not collected, the size of loan is often used as a proxy for the size of the customer. One potential explanation for this phenomenon is that historically larger margins on loans to smaller firms tend to be observed in a downturn, as they are perceived to be riskier by banks and have less recourse to other funding sources such as debt markets.

The level of pass-through for new mortgages and loans for consumption purposes with rates fixed up to one year has also been significant. The average rate for existing mortgage holders in Ireland is among the lowest in the euro area, having fallen by 85 basis points between January and May 2009. This is due to the high proportion of mortgages for which banks are contractually obliged to pass on ECB rate cuts to customers in full.

[3] An overnight index swap (OIS) is an interest rate swap whereby the overnight rate is swapped for a fixed interest rate over a fixed period of time.

[4] Further detail on lending and deposit rates are published in Tables B2.1 and B2.2 of the Statistical Appendix.

Table 10: Deposit Rates to Households and Non-Financial Corporations[a]

%	2008	2009				
	Dec.	Jan.	Feb.	Mar.	Apr.	May
DEPOSITS						
Households						
— Overnight[b]	1.04	0.89	0.79	0.64	0.66	0.61
— With agreed maturity	1.26	2.62	2.01	1.84	1.74	1.64
— Redeemable at notice[b]	2.97	2.63	2.80	2.50	2.45	2.29
Non-financial corporations						
— Overnight[b]	0.68	0.71	0.53	0.40	0.40	0.37
— With agreed maturity	0.72	2.48	1.86	1.61	1.45	1.48

[a] Rates are for new business.
[b] For these categories, new business is defined as outstanding amounts.

The cuts in the ECB rate since January have been passed on to customers with agreed maturity and notice deposits. However, banks have been constrained in reducing overnight rates further in response to ECB rate cuts due to their already low level.

Chart 6: New NFC Loans with Floating Rate and up to One-Year Initial Rate Fixation

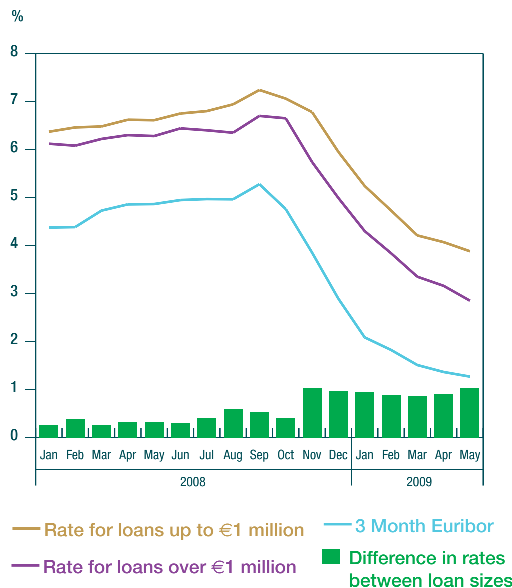
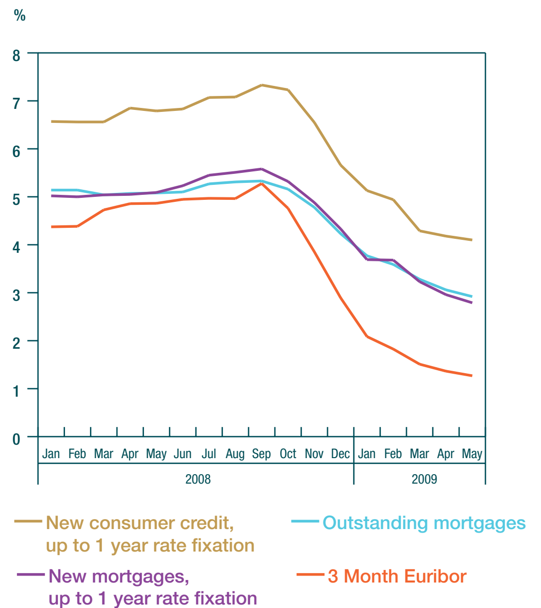


Chart 7: Lending Rates to Households



Box 1: Interest Rate Pass-through from Recent ECB Policy Measures

In the aftermath of the collapse of Lehman Brothers and the escalation of the financial market turmoil, central banks throughout the world embarked on a rapid reduction in policy rates, bringing them down to historical lows. In line with this, wholesale money market rates have declined substantially from the highs witnessed last October.[5]

The purpose of this Box is to examine the extent to which such rate reductions were reflected in retail lending rates up until the end of May. While banks obtain funding from a number of diverse sources, ECB and wholesale rates naturally have an important impact on the interest rates they charge their customers. In terms of retail rates, this Box focuses on new loans to non-financial corporations (NFCs) and households by banks resident in Ireland. Loans are categorised according to the agreed period of fixation of the interest rate, and are classified here as either up to, or over, one-year fixation. Hence, all variable rate loans irrespective of maturity are included in the up to one-year interest rate fixation category as well as loans with rates fixed for up to and including one year. All other loans are included in the category greater than one-year fixation. Some comparison will also be made with the respective interest rates at a euro area level[6]. It is important to remember that the rates discussed in this paper are nominal, rather than real, and so are not adjusted for inflation. Given that inflation has fallen substantially over our reference period, declines in nominal interest rates have not translated into similar falls in their real counterparts.

Lending Rates to NFCs

In Ireland, interest rates on loans to NFCs with a rate fixation of up to one year declined by more than the fall in the ECB's main refinancing rate, in the period from September 2008 to May 2009 and also relatively more than in the euro area as a whole over the same period. Loans in this category account for over 80 per cent of total new lending to NFCs and a large proportion of this is short maturity. As variable-rate NFC lending is generally linked to interbank rates, the pass-through is generally quite swift. However, the level of Irish rates still remains higher than the euro-area average. This disparity could be explained by differences in firm size between Ireland and the euro area for this type of lending[7]. The interest rate on loans fixed for more than one year has also declined by more than the euro-area rate[8].

[5] The latest retail interest rate data available are up to the end of May 2009; therefore for comparability with the retail rates only the decline in the 3-month Euribor rate from the end of September 2008 until the end of May 2009, which was just over 400 basis points, is considered.

[6] A few caveats should be kept in mind when comparing Irish and euro-area rates, such as product differentiation, varying degrees of risk, different banking market structures and regulatory frameworks across countries.

[7] Smaller countries such as Ireland tend to have a higher proportion of loans to smaller companies. Smaller companies usually pay higher interest on loans as they are perceived to have a greater credit risk than larger companies (McElligott, QB 1 2007).

[8] This analysis ignores the size of the loans agreed, and hence the difference between the pass-through to large and small loans over the period. There is evidence that larger loans have seen greater pass-through than smaller loans (see Chart 6).

Figure A: Loans to NFCs: Changes in Interest Rates from end-September 2008 to end-May 2009

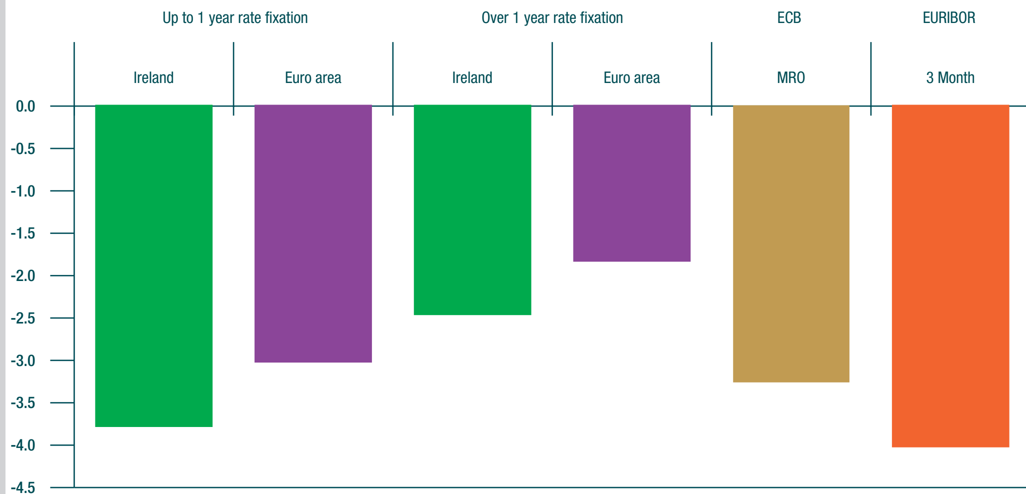


Figure B: Loans to Households: Changes in Interest Rates from end-September 2008 to end-May 2009

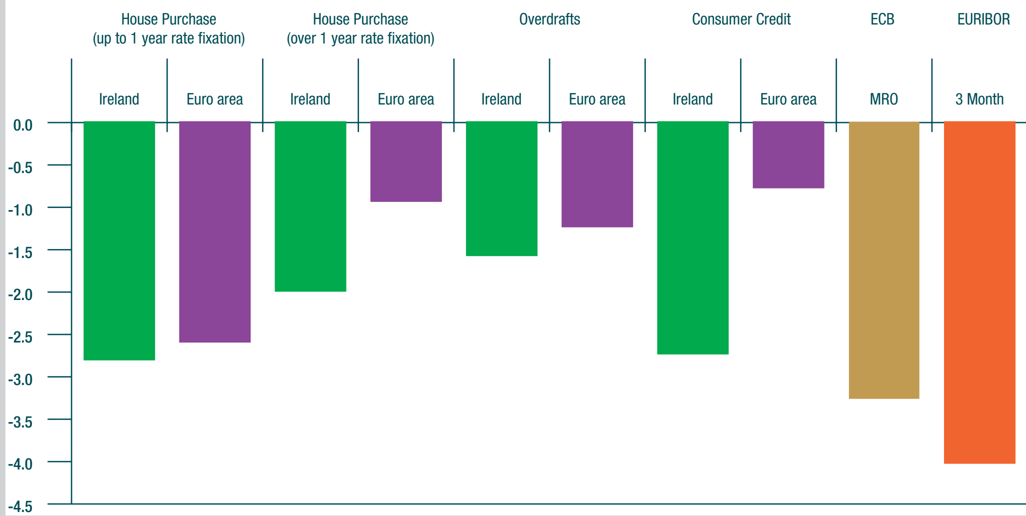


Table 1: New Business Lending Rates to NFCs

		September 2008	May 2009	Change
	3-month Euribor	5.28	1.27	–4.01
	MRO	4.25	1.00	–3.25
Ireland	Up to 1 year fixation	6.78	3.01	–3.77
	Over 1 year fixation	6.39	3.94	–2.45
Euro Area	Up to 1 year fixation	5.77	2.76	–3.01
	Over 1 year fixation	5.81	3.99	–1.82

Table 2: New Business Lending Rates to Households

		September 2008	May 2009	Change
	3-month Euribor	5.28	1.27	–4.01
	MRO	4.25	1.00	–3.25
Ireland	Loans for House Purchase			
	— *Up to 1 year fixation*	5.58	2.79	–2.79
	— *Over 1 year fixation*	5.72	3.74	–1.98
	Overdrafts	13.98	12.42	–1.56
	Consumer credit	7.77	5.06	–2.72
Euro Area	Loans for House Purchase			
	— *Up to 1 year fixation*	5.80	3.22	–2.58
	— *Over 1 year fixation*	5.36	4.44	–0.92
	Overdrafts	10.80	9.58	–1.22
	Consumer credit	8.15	7.39	–0.76

Lending Rates to Households

The majority of loans for house purchases have a variable interest rate and so are categorised as up to one-year fixation. As can be seen, interest rates have declined most for this category, implying that new Irish mortgage customers have, in general, benefited more than the average euro area resident from the recent ECB rate cuts as a higher proportion of Irish mortgages are in this category than elsewhere. In Ireland, around 80 per cent of new loans for house purchases are categorised as having up to one-year interest rate fixation. This is significantly higher than the same euro-area figure of around 40 per cent. Consumer credit interest rates also decreased more in Ireland than in the euro area.

Conclusion

In summary, at the time of writing, Irish banks have, in general, passed on more of the ECB policy rate reductions to lending rates to both households and businesses, relative to their euro-area counterparts. However, these rate reductions must be considered in light of other important external factors. Firstly, these interest rates occur in an environment of tighter non-price terms on new loans and give no information about agents' ability to access credit. Secondly, interest rates are declining contemporaneously with inflation rates, so that the declines seen in nominal rates have not translated into similar falls in the real rates.

Private-Sector Credit[9]

The annual rate of increase of private-sector credit (PSC) has fallen to less than one per cent as the underlying trend of decline in recent months continues. The supply of, and the demand for, credit has been weak given both the difficult economic conditions and the balance sheet constraints of lenders. Outstanding PSC fell by €9.3 billion in the three months to May, with approximately two-thirds of this decline being recorded during March. Lending to NFCs fell by €4.3 billion, inclusive of write-downs, over the period while lending to 'other financial institutions' (OFIs) declined by €1.5 billion. However, movements in this latter category were dominated by a fall in non-euro lending to non-bank IFSC companies and have little impact on the domestic economy.

Meanwhile, credit advanced to households (inclusive of securitised mortgages) continued to fall as it has done since Autumn 2008, declining by €2.1 billion in the three months to May. This was mainly driven by a fall of €1.1 billion in consumer credit reflecting repayments of loans and very weak consumer spending. Residential mortgage lending declined by an underlying €112 million over the period, with repayments outstripping new mortgage lending in both April and May.

The latest available data on the breakdown of residential mortgages by mortgage type shows that buy-to-let and holiday home mortgage debt outstanding declined by €179 million in the first quarter of 2009, whereas mortgages for principal dwellings increased by €607 million. Data from the Irish Banking Federation (IBF)[10] indicate that the value of new mortgages issued in the first quarter of 2009 was a little over half the amount issued in the last quarter of 2008, further emphasising the low levels of activity in the housing market.

[9] All growth rates quoted in the private-sector credit (PSC) section are the adjusted growth rates. PSC and non-mortgage credit growth rates are adjusted for lending to non-Monetary Financial Institutions (MFI) IFSC entities and for valuation effects caused by exchange-rate movements. Residential mortgage growth rates are adjusted for securitisations and reclassifications.

[10] IBF/PwC data series on New Lending (excluding 'switcher' mortgages), May 2009.

Chart 8: Annual Rates of Credit Growth

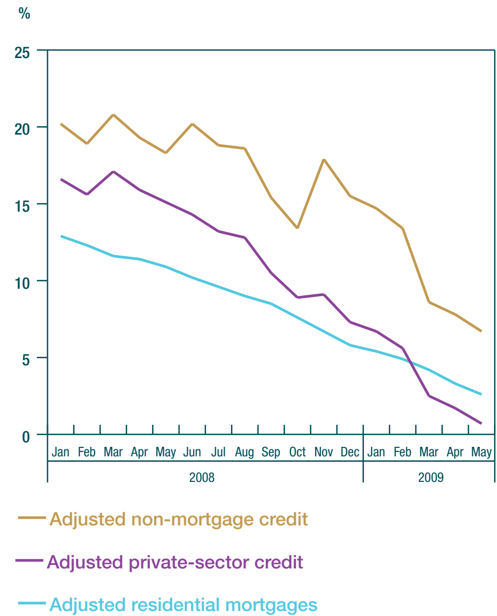
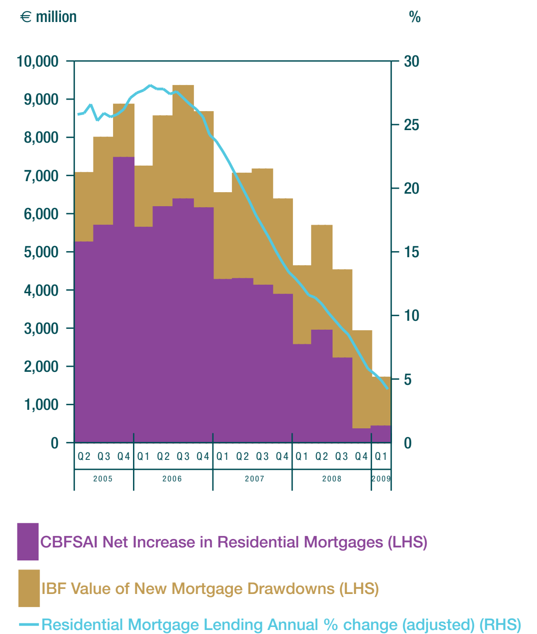


Chart 9: Quarterly Increase in Residential Mortgages — New Lending and Outstanding Amounts



Sectoral Breakdown of PSC[11]

Revised data for the sectoral breakdown of PSC indicate that credit to almost all sectors declined over the first quarter of 2009. Lending to the real estate and construction sectors in aggregate continued to contract over the first quarter of 2009, with the year-on-year increase

[11] Further details on the sectoral breakdown can be found in the 'Credit, Money and Banking Statistics' section of the CBFSAI website (www.centralbank.ie) as well as in *Table C8: All Credit Institutions: Sectoral Distribution of Advances* and *Table C9: All Credit Institutions: Sectoral Distribution of Advances and Deposits* in the Statistical Appendix of this publication.

in lending to these sectors falling to one per cent in Q1 2009. Lending to some of the more significant non-property related sectors, such as manufacturing, wholesale/retail trade and hotels and restaurants, appears to have peaked between Q2 2008 and Q3 2008.

Table 11: Sectoral Breakdown of Private-Sector Credit[a]

	Total stock at end-Mar. 2009		Change in credit			
			Q-on-Q		Y-on-Y	
	€ million	% share	€ million	% change[a]	€ million	% change[a]
Primary Industries[b]	6,418	1.5	76	1.2	346	5.7
Manufacturing	8,571	2.0	–349	–3.9	119	1.4
Electricity, gas and water supply	1,251	0.3	–135	–9.7	146	13.2
Construction	21,285	5.0	–879	–4.0	–3,807	–15.2
Wholesale/retail trade and repairs	14,053	3.3	–38	–0.3	482	3.6
Hotels and restaurants	11,437	2.7	–25	–0.2	–668	–5.5
Transport, storage and communications	3,347	0.8	–227	–6.4	30	0.9
Financial intermediation	86,164	20.2	2,402	2.9	20,093	30.4
Real estate	88,830	20.8	–918	–1.0	4,900	5.8
Business services	7,157	1.7	–193	–2.6	–46	–0.6
Services to households	6,507	1.5	64	1.0	416	6.8
Personal	171,287	40.2	–983	–0.6	3,146	1.9
of which:						
– Residential mortgages	148,332	34.8	426	0.3	5,930	4.2
– Other housing finance	899	0.2	–128	–12.5	–260	–22.4
– Other	22,056	5.2	–1,281	–5.5	–2,523	–10.3
Total	**426,307**	**100.0**	**–1,205**	**–0.3**	**25,157**	**6.3**

[a] The growth rates are inclusive of securitised residential mortgages, but are not adjusted for accrued interest, lending to the IFSC or exchange-rate valuation effects. Adjusted growth rates for overall private-sector credit, mortgage credit and non-mortgage credit are available from the CBFSAI Monthly Statistics.

[b] Primary industries refer to agriculture and forestry, fishing, and mining and quarrying.

Source: CBFSAI. Data are based on NACE Rev. 1 industrial codes. For earlier data see Table C8 of the CBFSAI Quarterly Bulletins.

Reflecting current financing conditions, holdings of securities, primarily by the financial sector, continues to be the most prominent component of credit growth. This sector showed an increase of 30.4 per cent in Q1 2009, largely arising from internal securitisations by credit institutions. Internal securitisations arise where credit institutions repurchase the asset backed securities they issue through Special Purpose Vehicles (SPVs) for use as collateral in ECB refinancing operations.

The Bank Lending Survey Results

The July 2009 Bank Lending Survey (BLS) relating to Irish banks examines changes in credit market conditions regarding enterprises and households during the second quarter of 2009, expected changes in credit conditions during the third quarter of 2009 and the banks' perception of their access to wholesale funding markets.

Credit Standards

During the second quarter of 2009 credit standards tightened on loans to enterprises and households[12]. While Table 10 indicates a fall in deposit rates, banks have identified the cost of funds along with balance sheet constraints and greater risk perception as contributing to the tightening of credit standards on loans to enterprises and households. The tightening of credit standards was the same for both loans to large enterprises and small and medium sized enterprises (SMEs) as banks reported an increase in loan margins, more restrictive collateral requirements, and reduced loan covenants in their dealings with businesses.

During the third quarter of 2009, credit standards on loans to enterprises are expected to tighten again whereas credit standards on loans to households for house purchase are expected to remain unchanged.

[12] Participating banks were asked to indicate how credit standards on loans to enterprises and households changed in the second quarter of 2009 with a response of three indicating unchanged credit standards, a response greater than three representing a loosening of credit standards; and a response less than three corresponding to a tightening of credit standards.

Table 12: Change in Credit Standards

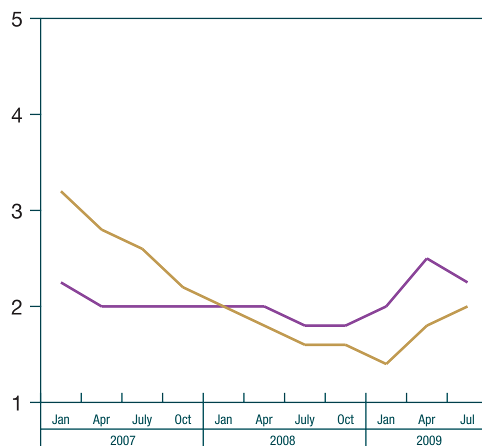
		Q1 2009	Q2 2009
Enterprises:	Overall	2.20	2.40
	Small/medium enterprises	2.20	2.75
	Large enterprises	2.00	2.75
	Short-term loans	2.20	2.40
	Long-term loans	2.20	2.40
Households:	House purchase	2.75	2.50
	Consumer credit and other lending	2.75	2.75

Key: 1 = tightened considerably; 2 = tightened somewhat; 3 = basically unchanged; 4 = eased somewhat; 5 = eased considerably.

Loan Demand

Loan demand by enterprises decreased during the second quarter of 2009[13], the tenth successive quarterly decline. The decline in loan demand was greater for loans to large enterprises compared with SMEs and was driven by lower levels of fixed investment and reduced Mergers and Acquisitions activity. The demand for household loans also decreased during the second quarter of 2009 reportedly driven by less favourable housing market prospects, declining consumer confidence, and reduced spending on durable consumer goods.

Chart 10: Changes in Loan Demand — Enterprises and Households



Loan demand by enterprises is expected to decrease during the third quarter of 2009, albeit at a slower rate than the decline reported for the second quarter of 2009, while loan demand by households is expected to remain unchanged.

Wholesale Funding

Participating institutions report that although recent Government announcements regarding recapitalisation support and State guarantees continue to assist banks, access to wholesale funding remained challenging across the maturity spectrum during the second quarter of 2009. Meanwhile the transition to Basel II is reported to have had a stronger impact on credit standards for loans to enterprises, particularly loans to SMEs compared with loans to households.

Money Supply

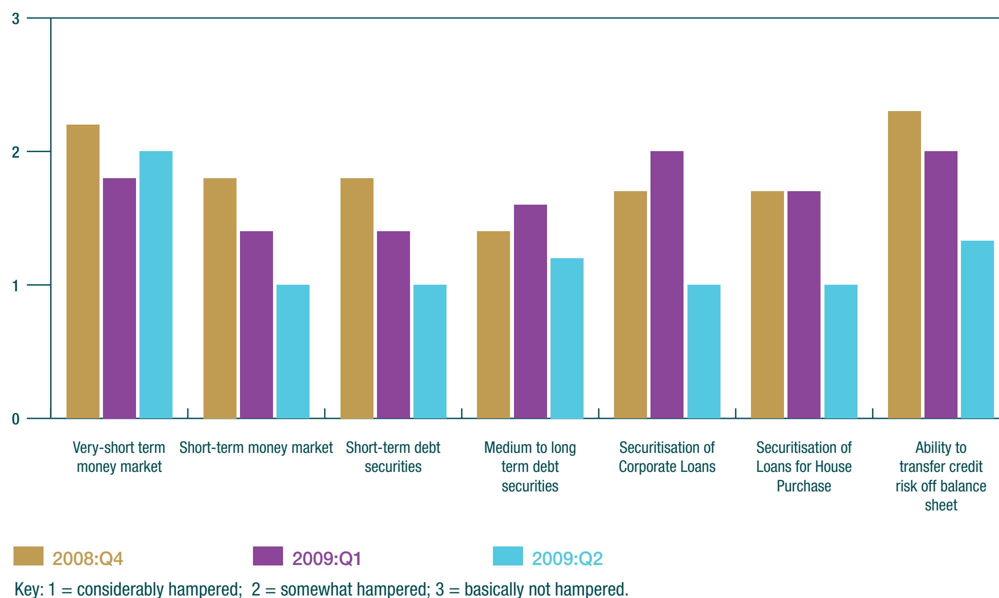
The annual growth rate of Ireland's contribution to the euro-area money supply (M3)[14] remained negative in May at minus 5.5 per cent, continuing a trend evident since April 2008. Most recently this has been driven by increased holdings of debt securities with up to two years maturity by Irish resident monetary financial institutions (MFIs) which consist of credit institutions and money market funds (MMFs) and deposit outflows.

The decline in M3–M2 evident in 2008 has continued in 2009, although the underlying cause has changed. Debt securities with up to two years maturity in M3 are measured on a net basis, i.e. issues by Irish resident MFIs less holdings of securities issued by Irish and other

[13] Similar to the questions that examine changes in credit standards, banks were asked to indicate on a five point scale how loan demand to enterprises and households changed during the second quarter of 2009 with a response of three corresponding to unchanged loan demand, a response greater than three representing increased loan demand, and a response less than three indicating a decrease in loan demand.

[14] Money supply data published by the CBFSAI measure the Irish contribution to the euro-area money supply, and include balances of both residents of Ireland and other Monetary Union Member States.

Chart 11: Access to Wholesale Funding Markets



Key: 1 = considerably hampered; 2 = somewhat hampered; 3 = basically not hampered.

euro-area MFIs. In 2008 debt securities issued by Irish resident MFIs fell by approximately 33 per cent while holdings of securities issued byeuro-area MFIs remained relatively unchanged. However since the beginning of 2009 issuance of debt securities by Irish resident MFIs has increased by approximately €3.9 billion to the end of May. This has been more than offset by a significant increase in the holdings of Irish and other euro-area MFI securities of approximately €16 billion over the period. This development is likely to have been influenced by the support provided by various euro-area government guarantees to MFI debt securities.

Deposits with an agreed maturity of up to two years have declined in 2009 alongside a continuing fall in overnight deposits. One significant factor contributing to the decline in deposits was the classification of Irish credit unions as ‘credit institutions’ from 1 January 2009, which removed their deposits with other MFIs from the money supply measure. However the annual rate of decline in overnight deposits has slowed in 2009, as the spread between overnight and short-term deposit rates has narrowed. Combined with the increase in the public’s currency holdings, which is consistent with general economic uncertainty among households and NFCs, this has led to the pace of contraction in M1 on an annual basis to slow to minus 6.8 per cent in May.

Government Bonds

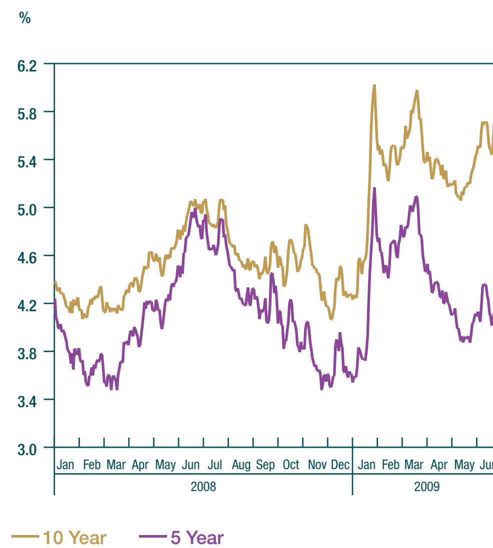
By the end of June the National Treasury Management Agency (NTMA) had raised over €20 billion of the €25 billion funding requirement for 2009 through both regular and syndicated auctions amid good demand. The Irish Government yield curve steepened during the second quarter of 2009 as the yield on the ten-year bond rose and that of the five-year bond fell, tracking the move of other euro-area sovereigns. The Irish bond spread vis-à-vis Germany tightened over the quarter; however Irish yield spreads remain the highest in the euro area. In terms of the ten-year yield, the differential tightened from 247 basis points to 234 basis points, while in terms of the five-year yield, the spread tightened from 230 basis points to 152 basis points. This tightening was part of a general trend in peripheral European bond markets as risk aversion faded amid signs that the speed of the economic contraction was slowing for a number of major economies. However, Irish bond yield spreads did not tighten vis-à-vis Germany as much as other peripheral markets, reflecting continuing concerns about the Irish fiscal situation and credit ratings downgrades.

Table 13: Irish Government Bond Yields and Differentials

End-month %		5-year bond yield	Differentials against: Germany	UK	US	10-year bond yield	Differentials against: Germany	UK	US
2008:	March	**3.92**	0.31	–0.10	1.46	**4.30**	0.41	–0.06	0.88
	June	**4.89**	0.27	–0.34	1.56	**4.96**	0.35	–0.15	1.00
	September	**4.13**	0.36	–0.07	1.15	**4.59**	0.58	0.14	0.76
	December	**3.59**	1.27	1.16	2.04	**4.27**	1.32	1.25	2.15
2009:	January	**4.75**	2.26	1.89	2.87	**5.52**	2.22	1.82	2.68
	February	**4.81**	2.58	2.19	2.83	**5.51**	2.40	1.89	2.50
	March	**4.53**	2.30	2.17	2.87	**5.46**	2.47	2.29	2.80
	April	**4.12**	1.77	1.75	3.11	**5.20**	2.02	1.70	2.08
	May	**4.09**	1.46	1.53	1.75	**5.46**	1.87	1.71	2.00
	June	**4.01**	1.52	1.13	1.46	**5.73**	2.34	2.04	2.20

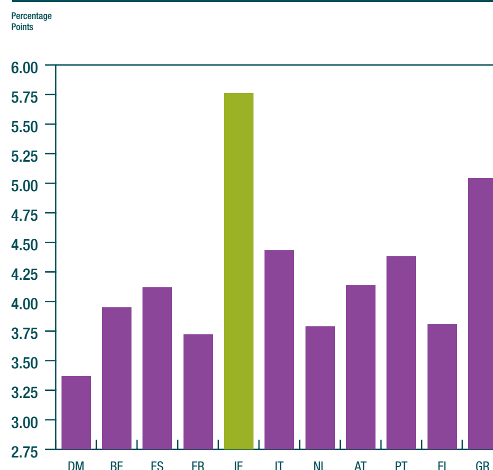
Note: (–) denotes Irish yields are lower than foreign yields.

Chart 12: Irish Government Bond Yields



10 Year 5 Year

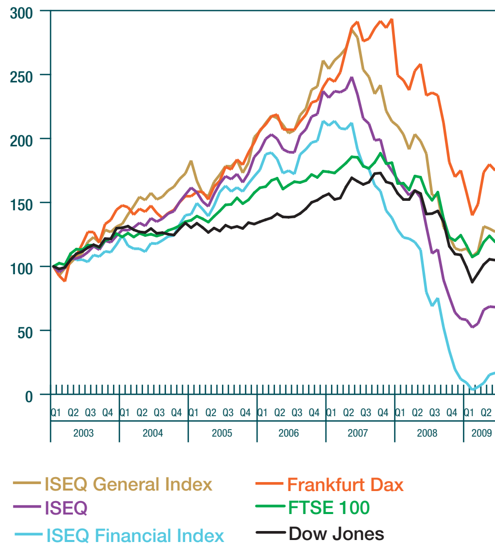
Chart 13: Ten-Year Bond Yields End-June 2009



Irish Equity Market

The value of Irish shares as measured by the ISEQ overall index, increased over the second quarter of 2009 by just over 23 per cent. This is the best single quarterly return, although it follows a long period of very poor performance. Gains on the overall index were due to increases in both the ISEQ Financial and General Indices of 192.5 per cent and 13.8 per cent respectively. Despite bank downgrades and large reported losses, improving investor sentiment and hopes that the worst of the financial turmoil may be passing, managed to support markets. Following quarter highs in mid June due to more positive international economic data releases, the ISEQ began to retreat on concerns regarding the timing and certainty of the economic recovery and finished the quarter rather flat. It is important to note that the remarkable returns over the period, particularly for financials, are from a very low level, with the Overall Index reporting its lowest value in around 14 years and the Financial Index reporting its lowest ever value, during Q1 2009. Although Irish shares in general outperformed global peers, the trend over the period was largely mirrored by international indices. Other major global indices also had exceptionally strong second quarter returns following a disappointing first quarter, with financials in general outperforming other sectors.

Chart 14: Irish and International Share Price Indices



Domestic Prices, Costs and Competitiveness

Introduction

Inflationary pressures moderated substantially over the course of the past year as consumer demand weakened sharply, commodity prices fell back from their peaks of last summer, and the impact of the euro appreciation vis-a-vis sterling gradually filtered through to consumer prices. As a result, the Irish Harmonised Index of Consumer Prices (HICP) is forecast to fall by about 1.3 per cent in 2009, significantly lower than the increase projected for the euro area HICP of between 0.1 per cent and 0.5 per cent. The Irish Consumer Price Index (CPI), which includes changes in average mortgage interest repayments, is forecast to fall by 4.1 per cent on average this year. Modest falls in both the CPI and HICP price levels of about 0.3 per cent are forecast for 2010, although there is some upside risk from a recovery in international energy prices. This contrasts with forecast inflation of between 0.6 per cent and 1.4 per cent for the euro area next year.

Housing affordability pressures have eased markedly over the past year as prices have declined more than 21 per cent from their peak of early 2007 and average mortgage interest rates have fallen significantly since last summer. However, demand for housing continues to be weak as consumer sentiment remains negative due to high levels of job insecurity and concerns over income prospects. Private rents have also fallen sharply in response to a large increase in the supply of rental properties and a softening in demand for accommodation from migrants. Further significant falls in capital values across all commercial property sectors were recorded during the first quarter of this year, against a background of cautious investor sentiment and a significant overhang of supply. Despite the first signs of commercial rents declining, the sharp declines in capital values over the past three quarters across all sectors have resulted in a recovery in yields, albeit from historically low levels.

Labour cost increases have been relatively high for a number of years up to recently leading to a deterioration in our international labour cost competitiveness position. Indeed, unit labour cost levels for the whole economy were estimated to be higher than the average for the euro area during 2008. A prolonged period of wage and price moderation relative to the main trading partners will be necessary in order to re-establish our international competitiveness. Furthermore, recent exchange rate volatility, particularly in the sterling/euro exchange rate, has emphasised the need for flexibility in the labour market and in the economy more generally. Anecdotal and survey evidence point to signs of flexibility in the labour market although it will be some time before this can be confirmed with hard data. Economy-wide productivity gains have been relatively modest and cost increases until recently have been relatively high across a wide range of non-labour production inputs. This calls for renewed efforts to enhance the economy's productivity potential and highlights the need for more competition in the non-traded sectors of the economy in order to reverse competitiveness losses.

Consumer Prices

Inflationary pressures continue to ease quite significantly. The annual HICP inflation rate was -2.2 per cent in June, with energy price base effects applying some downward pressure on the price level. Core inflation indicators, which exclude more volatile components such as energy prices, are also in the main negative as price declines become more generalised. Measures for core inflation and recent developments in Irish core inflation are examined in more detail in the Box in this chapter. Meanwhile, the annual CPI inflation rate, which includes mortgage interest repayments, was -5.4 per cent in June. The main drivers of the annual fall in the CPI price level in June were the mortgage interest repayments and energy prices components with contributions of about -3.9 and -1 percentage points, respectively.

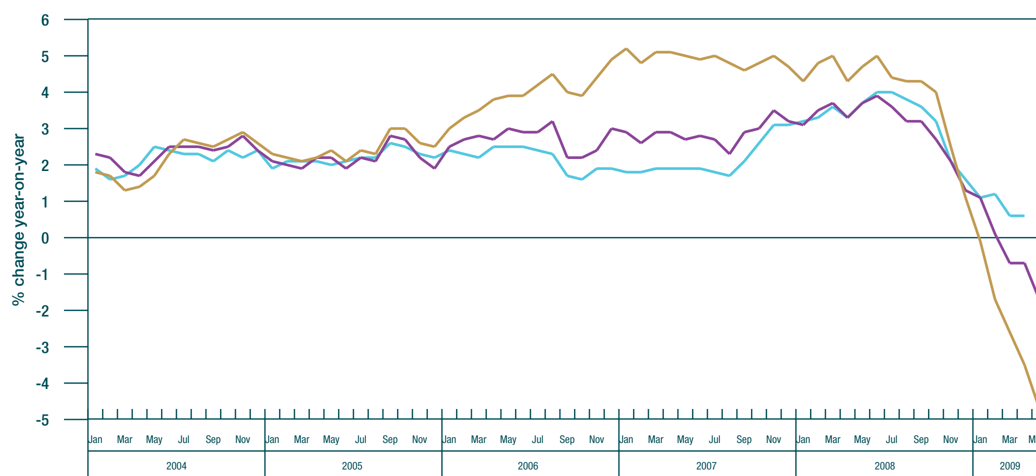
Table 1: Inflation Measures — Annual Averages, Per Cent

Measure	HICP	HICP excluding Energy	Services[a]	Goods[a]	CPI
2005	2.2	1.3	3.3	1.2	2.4
2006	2.7	2.2	3.8	1.7	3.9
2007	2.8	2.7	4.4	1.5	4.9
2008	3.1	2.6	3.4	2.9	4.1
2009[f]	–1.3	–0.8	0.9	–3.2	–4.1
2010[f]	–0.3	–0.9	0.0	–0.5	–0.4

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

Energy prices were down 11.3 per cent in June, compared with the same month last year, and the year-on-year declines are likely to become larger in the coming months as the particularly high oil prices of last summer impart a stronger downward base effect. Gas and electricity prices, which normally show a lagged response to international energy prices, fell significantly in May this year as price reductions announced by the Commission for Energy Regulation (CER) earlier this year fed into the CPI for the first time. Gas prices fell 12 per cent and, in the case of electricity prices, Bord Gais prices were also taken into account giving rise to a recorded overall fall of slightly more than the 10 per cent announced by the CER. However, crude oil prices have increased significantly in recent months and this has already filtered through to liquid fuel prices. Meanwhile, other industrial goods prices have fallen sharply since last year, with particularly large annual falls recorded in clothing and footwear. Overall, goods prices fell by about 5 per cent, year-on-year, in June, with energy prices contributing as much as 2 percentage points to this fall.

Chart 1: Consumer Prices



Ireland: Consumer Price Index

Ireland: EU Harmonised Index of Consumer Prices (HICP)

Euro 15: Monetary Union Index of Consumer Prices (MUICP)

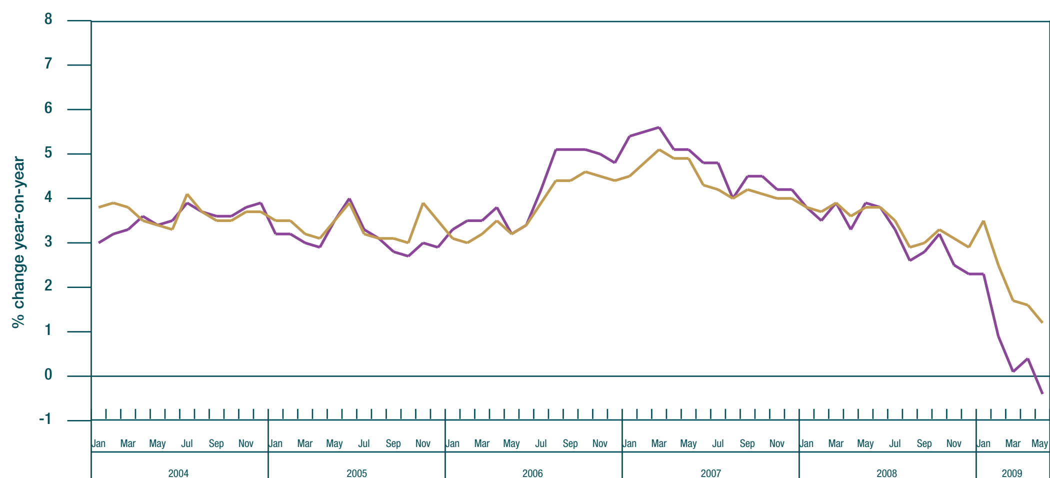
Turning to food prices, the HICP measures for both processed and unprocessed food have declined significantly in recent months — the food and non-alcoholic beverages sub-index declined by 2.3 per cent in the second quarter. Intensified competition between the multiples and the discount retailers in a market of more price-conscious consumers, along with the effect of weaker sterling, have been important contributory factors to these falls. However, further significant food price declines may be contained somewhat as sterling has recovered some ground lately and food prices internationally have shown signs of recovering. Furthermore, the supplementary Budget imposed increases in excise duties for

diesel and tobacco products. These excise duty measures are estimated to add about 0.2 percentage points to HICP inflation for 2009, although, given the substantial impact on disposable incomes of the various income tax/levy increases, the net effect of the supplementary Budget on inflation is likely to be negative.

There was some easing of inflationary pressures in other components reflecting the sharp contraction in personal consumption expenditure and the worsening outlook for economic activity and employment. The moderation in core market services inflation, which began in early 2007, has culminated in a fall in annual terms for the first time in May. Private rents in the second quarter of this year, along with travel and accommodation costs, were markedly lower compared with a year earlier, but home and car insurance premiums have recorded strong increases over the same period. However, in the remaining services categories, the trend in prices is still generally upwards, with the largest increases in administered prices. Overall annual services inflation was still positive at 1 per cent in June.

Inflationary pressures are likely to continue to moderate through the year mainly due to weak demand conditions. The average rate of Irish HICP inflation is forecast to fall to about -1.3 per cent in 2009, significantly lower than the increase projected for the euro area HICP of between 0.1 per cent and 0.5 per cent. These projections are based on oil prices averaging about 60 dollars per barrel this year and there may be some upside risk to these projections. The Irish Consumer Price Index (CPI) is forecast to fall by 4.1 per cent on average this year, with the annual inflation rate reaching a trough of about -5.8 per cent during the third quarter of the year. The difference between the CPI and the HICP forecasts for 2009 mainly reflects the large decreases in mortgage interest rates since last autumn. The average price level is projected to fall also next year; the CPI and the HICP annual inflation rates are likely to converge to about -0.3 per cent, again significantly lower than the corresponding projections for the euro area of between 0.6 per cent and 1.4 per cent. As a result, there is likely to be a significant improvement in price competitiveness with respect to our trading partners in the euro area over the course of this year and next. Nevertheless, the price level in Ireland remains well in excess of the euro area average.

Chart 2: Services Sector Inflation



HICP Services (Overall)

HICP Market Core Services

Note: Core Market Services equals HICP services excluding telecommunications, alcohol and administered services.

Box: Measures of Irish Core Inflation

This Box examines recent developments in Irish core inflation. The concept of core inflation is discussed and the relative merits of core inflation measures are briefly considered. Recent developments in a range of statistical measures of Irish core inflation are analysed in order to explain the factors driving the Irish HICP.

Core or underlying inflation can be useful in identifying medium-term price trends as well as the drivers behind headline inflation. Measures of core inflation, in effect, try to look through short-run volatility to see where inflation is headed in the medium term or where inflation might have been after abstracting from the temporary factors. Base effects can have an undue influence on annual comparisons and core inflation measures may also help to limit the impact of such base effects. While the concept of core inflation has intuitive appeal, there is no consensus on the optimal approach to measuring it as no approach consistently delivers reliable indications of underlying trends over time. Moreover, most measures do not have a theoretical basis. Finally, it could be argued that headline inflation has a greater bearing on price and wage formation. In view of these limitations, core inflation measures are generally only used to complement the analysis of price developments. For example, the headline Harmonised Index of Consumer Prices (HICP) for the euro area remains the key measure in the ECB's quantitative definition and analysis of price stability.

Common measures of core inflation

In order to uncover persistent trends or trends common to most components, a measure of core inflation should help to remove component-specific or strong relative price effects. Frequently used measures of core inflation simply exclude certain categories of items in the HICP where the items that are excluded have tended to be historically quite volatile. Examples of such measures include the HICP excluding energy, on the basis that energy prices tend to be quite volatile. The HICP excluding energy and unprocessed food is another frequently used measure, on the basis that unprocessed food items may exhibit strong seasonality. A further measure used is the HICP excluding energy and both unprocessed and processed food, which recognises that alcoholic beverages and tobacco can be heavily influenced by one-off changes to excise duties.

While such measures are well understood and can be easily calculated, they can be misleading as they may inadvertently remove trends that are more persistent in nature. For instance, structural changes in the supply of, and demand for, food commodities could potentially have significant longer-term implications for food prices. Also, given that strong energy price movements tend to impact on spending on other goods and services, excluding the energy price component may not reliably indicate where inflation might have been without the energy price volatility. Finally, the components typically excluded may not be the most volatile components at every point in time.

Alternative measures of core inflation include symmetric trimmed means, which exclude the largest and smallest items from the sample of price changes at any given point of time. These purely statistical measures again, however, may also exclude some outlying prices whose movements reflect longer-term trends. For example, price movements in electronic equipment are often strongly negative reflecting the rapid rate of technological progress and it could be argued on economic grounds that such items should be included in a measure of core inflation.

The band-pass filter and the HP filter have also been used to identify underlying trends in inflation. These filters attribute a certain proportion of each shock hitting a series to a

change in the trend of the series while the remainder is regarded as noise. Again, these measures are mechanistic in nature and have no structural interpretation. They also suffer from end-of-sample problems. Finally, other more model-based measures, such as the structural VAR, are not treated here but have been the subject of previous research at the Bank[1].

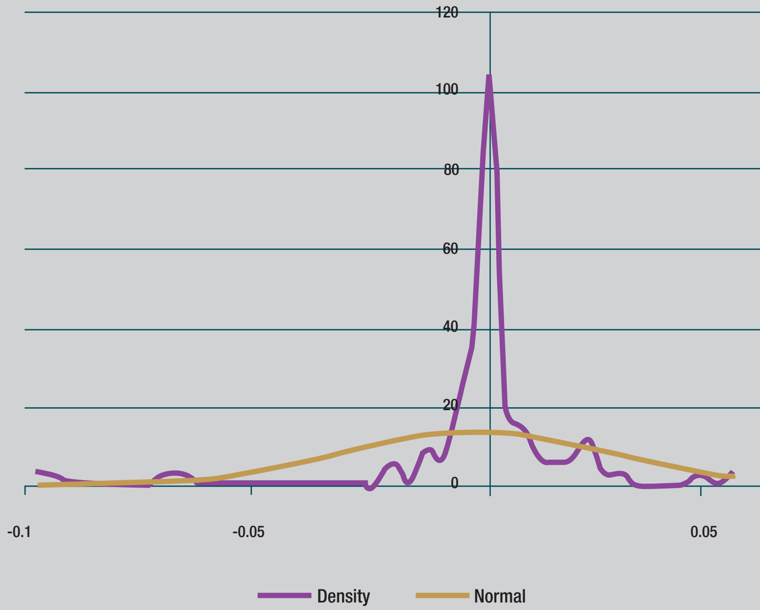
Recent developments in Irish core inflation

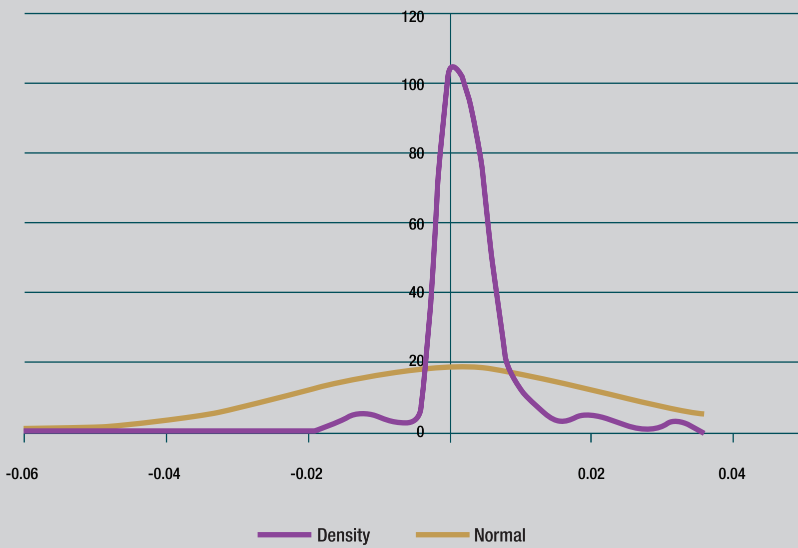
The Irish HICP, which is an expenditure weighted mean of over 600 items, has been especially volatile in recent years (see Chart A). For the most part, the HICP, excluding energy, and the HICP, excluding energy and unprocessed food have tracked each other quite closely suggesting that the volatility in the energy component was much stronger than in the unprocessed food component. During the first three quarters of 2007, the headline HICP moved in the middle of the range of core inflation measures. Subsequently, the headline HICP gradually moved higher than the core inflation measures, largely as a result of energy prices picking up during the final quarter of 2007. With oil prices falling off their peaks of last summer and energy prices moderating from the fourth quarter of last year, the Irish core inflation measures fell to a lesser extent and are now significantly above the headline HICP inflation rate. Core inflation measures are likely to remain above headline inflation until the end of this year, as energy base effects, in particular, continue to exert downward pressures on headline inflation. Base effects will more likely then operate in the opposite direction into 2010.

[1] Bermingham, C. "How core inflation for forecasting headline inflation", Central Bank and Financial Services Authority of Ireland, Research Technical Paper 11/RT/06.

Chart A: Headline HICP and Core Inflation

Chart B: Irish and Euro area distributions of price changes, May 2009





Developments in core inflation in the euro area were examined in a recent ECB Monthly Bulletin[2] and the results suggested that there was not much evidence of emerging generalised price declines in the euro area. However, in the case of Ireland, there is stronger evidence that price declines are more widespread in Ireland than in the euro area overall and are not confined to the well-identified groups such as energy prices and IT prices. This is evident in see Chart B below which compares the distribution of individual prices changes in Ireland with the euro area. While the cross-sectional distribution in May 2009 illustrates that there were large annual falls in energy prices, there were also significant declines in private rents, clothing, new and second-hand cars and accommodation services. Many of these items have large weights in the HICP basket for Ireland. The broad nature of the price declines is representative of the general weakness in the economy at present, with price falls in many sectors. Continued falls in the prices of technology items, which is part of a long-term trend, mirrored the situation at the euro area level but these items were less important in Ireland than the euro area.

[2] See Box 4 in ECB Monthly Bulletin June 2009.

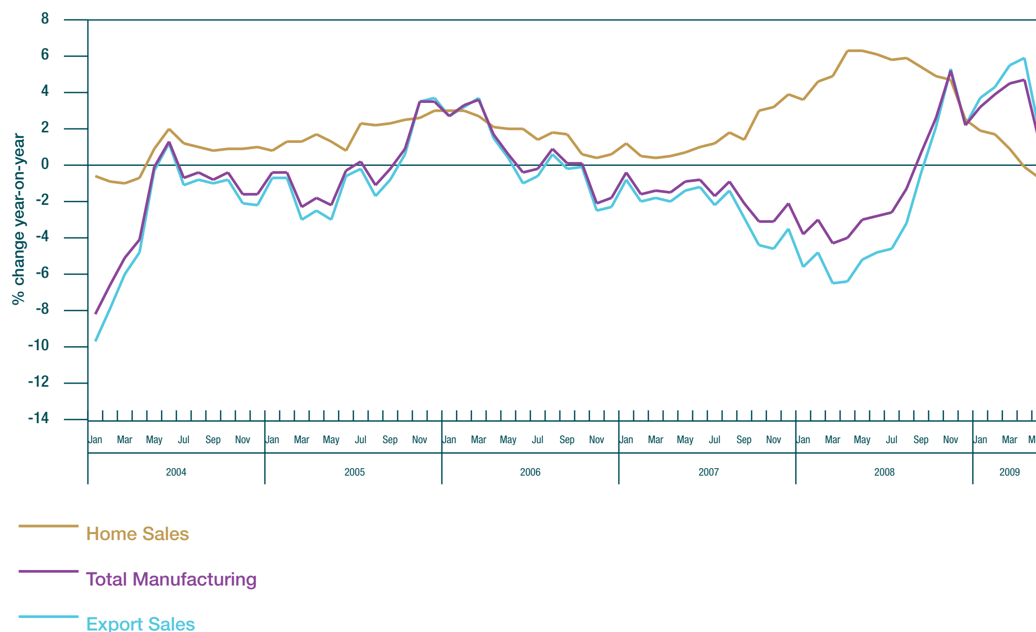
The broad nature of price declines in Ireland is clear from the number of price falls in the HICP. Of a total of 93 broader categories, 52 posted a negative price change in May this year relative to May last year for Ireland, relative to just 15 price declines for the euro area. The number of positive price changes in the 0-4% bracket was 76 in the euro area and just 33 for Ireland. The broad nature of Irish price declines is also evident from more detailed data. Based on price data available for over 600 items that constitute the HICP, almost 400 showed a price decline over the year. As a result, one can tentatively conclude that there appears that there is less downward rigidity in Irish consumer prices relative to euro area prices.

Industrial Producer Goods Prices

Following a strong pick-up in annual producer price inflation for exports in earlier months, manufacturing export prices have softened in recent months, as strong fluctuations in the euro/dollar exchange rate impacted on the export sales price index. Although only about 18 per cent of goods exports are destined for the US, exports of multinationals based in Ireland to destinations across the globe also generally tend to be priced in dollars. Abstracting from currency fluctuations, the longer-term trend in goods export prices is downwards as exports from the heavily weighted high-tech sectors, such as ICT and pharmaceuticals, are often characterised by falling prices reflecting the rapid rate of technological advances and associated product cycle effects.

The sharp fall in domestic consumption and the relatively weak sterling/euro rate, compared with a year earlier, has intensified competitive pressures on retailers. Responding to the more challenging conditions, retailers have pushed for lower prices from producers and wholesalers, leading to some subsiding of inflation along the supply chain. Manufacturing product prices for home sales were down 0.7 per cent in May 2009, year-on-year, compared with an annual increase of 6.3 per cent in May last year. The outlook is for a further moderation in aggregate home sales price inflation as the disposable incomes of domestic consumers continue to be squeezed.

Chart 3: Manufacturing Producer Price Inflation



Property Prices

Residential property prices fell by a cumulative 21.1 per cent in nominal terms between their peak of February 2007 and May this year, according to the ptsb/ESRI house price index. These data are based on mortgage drawdowns and the true extent of the fall is likely to be larger when allowance is made for the lag between the sale price agreement and the mortgage drawdown. Also, transaction activity has been particularly subdued recently, with some vendors possibly unprepared to adjust downwards sufficiently to reflect the changed market conditions; for this reason, recorded price declines tend to underestimate actual price declines when prices are adjusting downwards rapidly. Although affordability pressures have eased considerably, weak sentiment has been the prevailing influence on demand, with potential buyers continuing to postpone decisions on making large purchases. With additional tax changes weighing on future disposable incomes and further losses in employment in prospect, house prices may fall further. This is all the more likely in the context of the significant overhang of supply.

Private rents in May this year were 3.4 per cent lower than in February; this compares with a quarterly fall of 6.8 per cent in February 2009 and 7.2 per cent in November 2008. Private rents peaked in February 2008 and have now fallen by 19.7 per cent since then, as builders and developers released unsold stocks for rent and recent strong inward migration flows went into reverse. In addition, some property owners may be entering the rental market in order to make up for declining income from other sources. According to the latest Daft.ie Rental Report, the supply of rental properties in April this year was more than twice the level of a year earlier despite a sharp increase in average monthly lettings over the same period. With a large oversupply of rental accommodation remaining, a continuation of the decline in rents probably has some way to go. Until such time as there is some stabilisation in the rental market, the fall in house prices is likely to persist.

Chart 4: permanent tsb / ESRI House Price Index

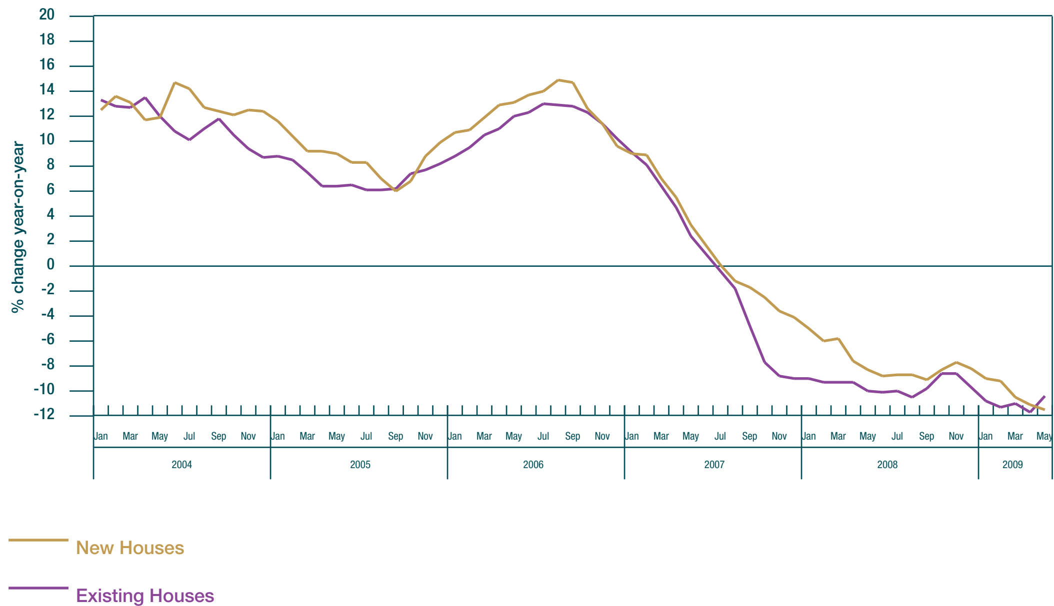
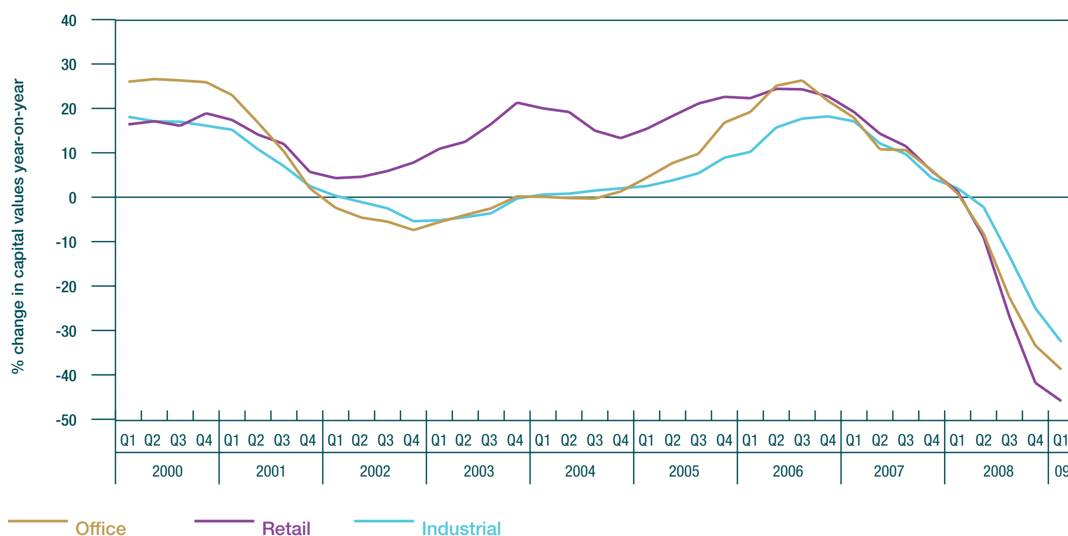


Chart 5: Department of the Environment Housing Statistics

Commercial property values continued to fall sharply in the first quarter of this year, as the deteriorating outlook for the economy impacted on investor sentiment. According to data from the Society of Chartered Surveyors/ Investment Property Databank (SCS/IPD), commercial property values declined, quarter-on-quarter, by 10.9 per cent during the first quarter, compared with falls of 15.0 per cent and 16.5 per cent during the third and fourth quarters of last year. The fall in the first quarter of this year was again broad-based with capital values in the retail, office and industrial sectors all recording declines in the region of 10 to 11 per cent, compared with the previous quarter. The Jones Lang LaSalle (JLL) Irish Property Indices largely corroborate these findings. As noted in previous Bulletins, these data are based on quite light transaction activity and on valuations

which may not always adequately reflect the fall in prices when these are falling rapidly. According to the JLL Property Index, rents fell across all sectors for the first time in the first quarter of this year. Rents in the retail sector fell by a modest 1.9 per cent, quarter-on-quarter, in the first quarter of this year while rents in the office and industrial sectors fell by 3.2 per cent and 3.7 per cent, respectively, during the same period. With domestic consumption contracting sharply this year, there is likely to be a further softening of rents in the retail sector although the impact of upward-only rent reviews for existing contracts will likely continue to contain the falls. The recent strong declines in values across all types of commercial property have resulted in a recovery in yields despite the fall in rents.

Chart 6: SCS / IPD Irish Property Index



Competitiveness

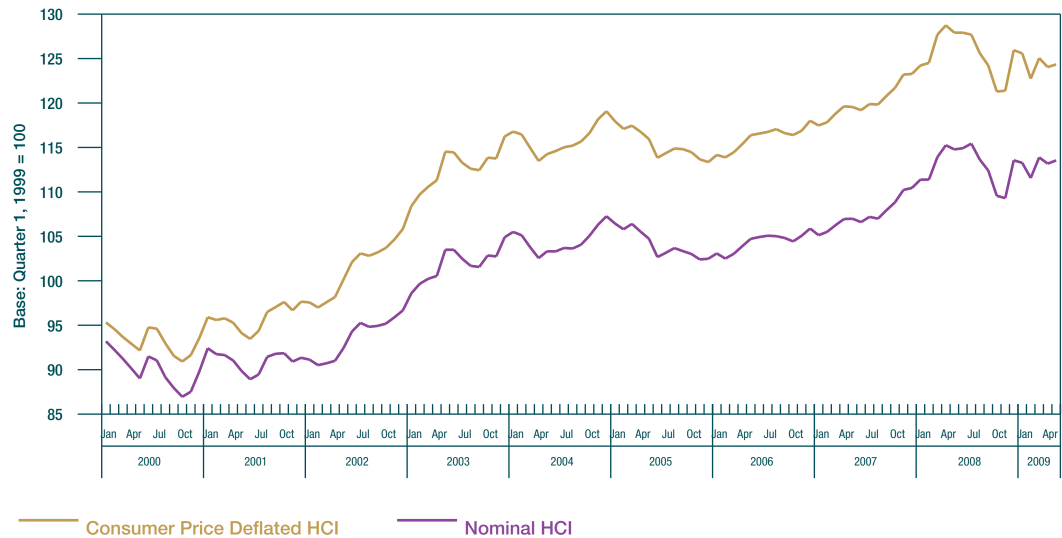
The Irish economy has been hit by a series of negative shocks over the past two years. With a relatively high cost base and a difficult structural rebalancing already in train, the economy was not well placed to cope with these simultaneous shocks. On the external side, the appreciation in the value of the euro, particularly against sterling, intensified pressures on the exporting sector. In order for the economy to take advantage of an eventual recovery in demand in our trading partners, it is imperative that recent competitiveness losses are reversed. This will necessitate a rebound in productivity growth and significant wage and cost moderation.

Exchange Rate Developments

The euro strengthened by 4.6 per cent against the dollar in the three month period to June this year, compared with the previous quarter, while recording a quarterly decline of 3.2 per cent against sterling over the same period. As a result, since end-December 2008, the euro has fallen in value by about $10\frac{1}{2}$ per cent against sterling, although in year-on-year terms, the euro was still 11.3 per cent stronger against sterling in the second quarter of 2009.

Developments in the euro exchange rate against the currencies of Ireland's major trading partners, is reflected in the nominal Harmonised Competitiveness Indicator (HCI), which can be interpreted as an effective exchange rate. Following a robust appreciation in the HCI in 2008 by just over 5 per cent, the HCI declined by an average of 0.3 per cent in annual terms in the first six months of 2009. This mainly reflected movements in the euro/dollar and euro/sterling exchange rates. In real terms, however, the decline in the HCI was larger, with the consumer price-deflated HCI down 2.1 per cent over the same period reflecting lower inflation in Ireland relative to our main trading partners as well as exchange rate movements. Such developments have contributed to some recovery in the competitiveness position of domestic exporters, following a number of years of significant deterioration in price competitiveness.

Chart 7: Harmonised Competitiveness Indicators



Pay

Pay increases in the economy moderated slightly in 2008 as compensation per non-agricultural employee increased by 4.0 per cent, down from 4.5 per cent in 2007. However, the outturn for last year was stronger than anticipated given that output had already begun to contract. As regards developments at a sectoral level, relatively robust wage increases were recorded across a range of sectors annually in the fourth quarter of 2008. Wage growth in the industrial sector was notably strong, with a year-on-year increase in average weekly industrial earnings of 4.2 per cent.

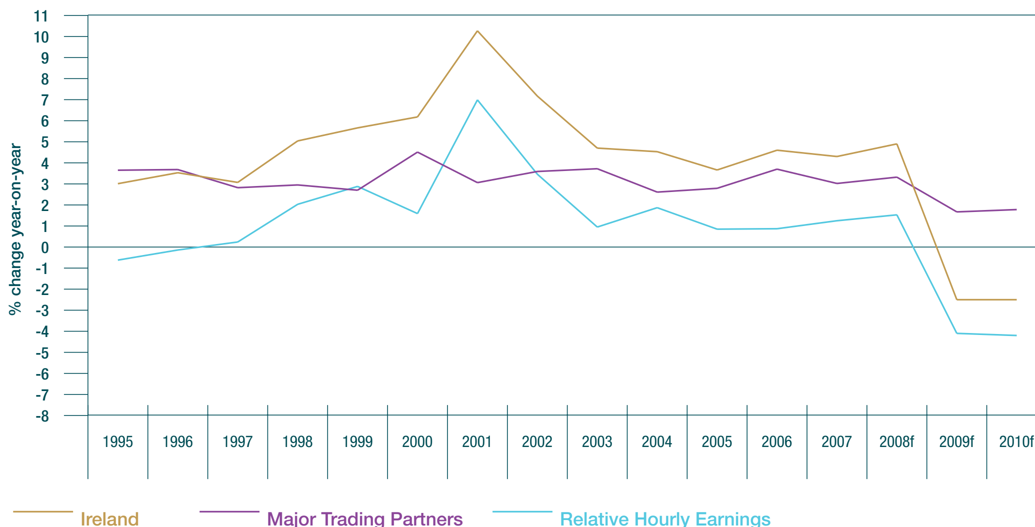
Reflecting the sharp contraction in construction-related activity, an annual fall of 2.4 per cent in the average weekly earnings of construction employees was recorded in the final quarter of 2008. Wage increases across other sectors were, however, surprisingly robust over the same period. One possible explanation for such a strong outturn relates to compositional effects. Such effects arise from the fact that layoffs are often initially concentrated amongst lower skilled workers, which tends to inflate average wages per employee. The timing of the pay element of the second phase of *Towards 2016* may also have played a role in the upward wage pressure observed in the fourth quarter. It is, however, important to note that sectoral earnings survey data are subject to large revisions and are quite volatile. In view of this, the outturn for the fourth quarter should be interpreted with some caution.

The robustness of the fourth quarter increases will have implications for the wage outlook for this year in most sectors, due to significant positive carryover effects. Nevertheless, cyclical factors are expected to dominate during 2009, with considerable downward pressure likely in line with the backdrop of declining prices and spare capacity in the labour market. It is anticipated that wages will remain under pressure during 2010 in view of the projected further deterioration in the economic and labour market conditions. Wage data for 2009 are at present limited to anecdotal and survey evidence. Such evidence suggests that nominal wage reductions have been taking place across some of the private sector since the beginning of the year. Public sector pay was also effectively cut via the introduction of the public service pension levy, with the deduction amounting to 7.5 per cent on average.

Accordingly, the wage outlook is set to weaken, with average nominal compensation per employee forecast to decline by 3.9 per cent in 2009, followed by a further fall of 3.1 per cent in 2010. When combined with the projected fall in the number of non-agricultural employees, it

suggests that the non-agricultural pay bill will fall by 12.4 per cent and 7.5 per cent in 2009 and 2010, respectively. It is important to note that the outlook for pay developments is subject to considerable uncertainty due to the difficulty in ascertaining the speed with which wages will adjust to the sharp deterioration in growth and labour market conditions.

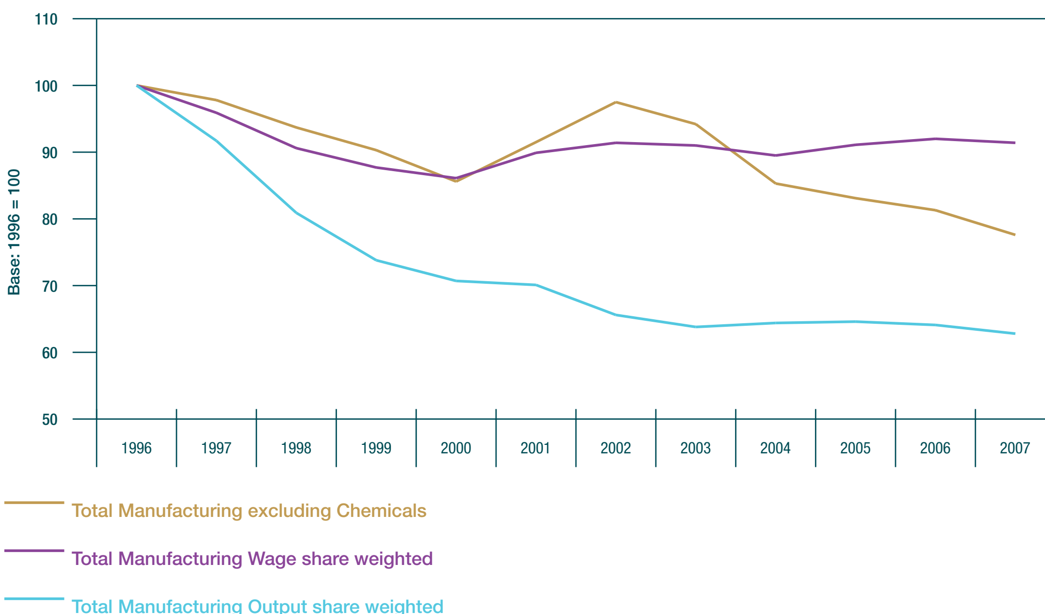
Chart 8: Hourly Earnings in Manufacturing (in Local Currency)



Productivity and Cost Competitiveness

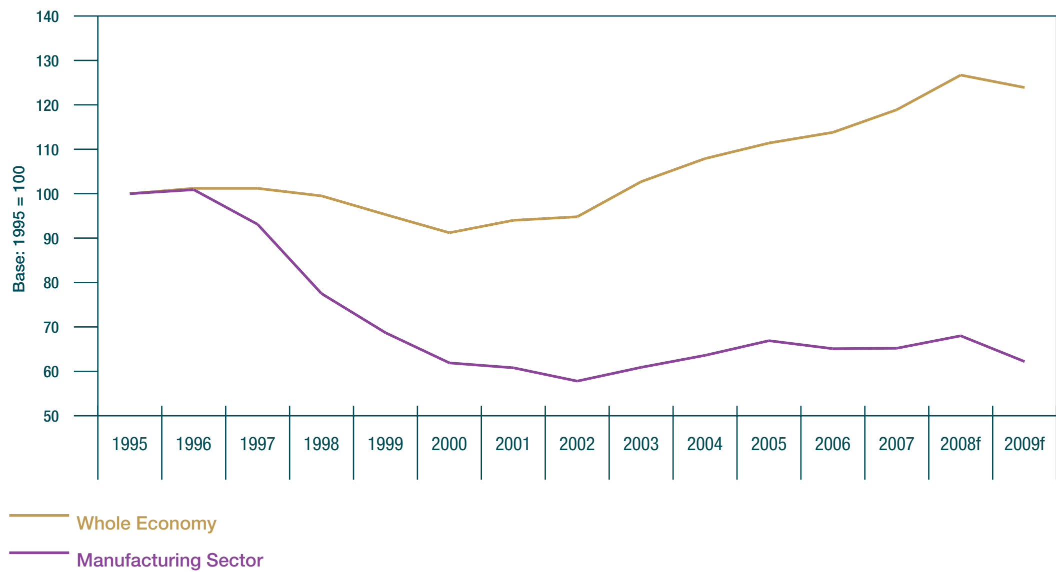
The recently published preliminary National Accounts for 2008 indicate that productivity, as measures by (real) GNP per person employed, declined by 1.7 per cent in 2008, which was the first annual fall in productivity since 1998. This reflected weak economic growth coupled with what would now appear to be a large element of labour hoarding, particularly in the first half of last year. In 2009, productivity growth is expected to remain negative, albeit with a smaller decline in the region of 0.7 per cent envisaged. In 2010, a return to positive productivity growth of 1.1 per cent is projected. This outlook reflects a rapid labour market adjustment to the economic downturn and a continuing structural shift in the economy away from the labour intensive construction sector, where productivity increases tend to be relatively low.

Chart 9: Unit Wage Costs in Manufacturing



Economy-wide unit labour costs, which take account of both productivity and wage developments, are key indicators of international competiveness. In recent years, unit labour costs in Ireland increased much more rapidly than in our trading partners, reflecting weak gains in productivity coupled with relatively robust increases in wages. According to the National Accounts data for 2008, unit labour costs are estimated to have increased by 5.7 per cent last year, well above equivalent rates of increase in our major trading partners. In the US and UK, unit labour costs in 2008 increased by an estimated 1.7 and 2.4 per cent, respectively.

Chart 10: Irish Unit Wage Costs Relative to Main Trading Partners (in Common Currency)



For 2009 and 2010, the upward trend in unit labour costs in Ireland is expected to be reversed. This is largely driven by the outlook for wages and the assumed further reduction in activity levels in the construction sector. Overall, unit labour costs are expected to decline by 3.2 and 4.2 per cent, respectively, in both 2009 and 2010. This compares favourably, with projected increases for unit labour costs in our major trading partners (Table 3). These developments should help to improve the price competitiveness of Irish exports, although, as stated in previous Bulletins, it is likely that a prolonged period of wage moderation and a stronger productivity performance will be required to regain past competitiveness losses arising from the domestic demand driven boom of recent years.

Table 3: Unit Labour Costs, % annual change

	2007	2008	2009f	2010f
Ireland	3.8	5.7	–3.2	–4.2
Euro Area	1.8	3.4	3.7	0.1
UK	1.4	2.4	2.4	0.4
USA	2.8	1.7	2.9	–1.5

Source: Ameco Database and Central Bank calculations. GNP used for Irish figures.

While unit labour cost indices give a good indication of labour cost competitiveness, other measures confirm a broader deterioration in Irish competitiveness in an international context. According to the IMD World Competitiveness Yearbook 2009, which ranks countries according to their competitiveness levels using a range of indicators, Ireland's competitiveness position deteriorated significantly over the past year from the 12th most competitive economy (out of 57) in 2008 to 19th in 2009[3]. This reflected a combination of factors, not least the deterioration in the fiscal position and the sharp economic slowdown. Furthermore, countries were also assessed in terms of how equipped they were to fare through the crisis and how they were placed to improve their competitiveness. On this ''stress test'' measure, Ireland ranked as the 25th best placed country. The magnitudes of the housing and financial crises were cited as important factors in weakening the Irish position.

An improvement in competitiveness will necessitate a recovery in productivity levels and more moderate increases in economy-wide wage and non-wage costs in the years ahead if the Irish economy is to return to export-led growth. In terms of the former, wage increases should relate to productivity improvements.

[3] According to the IMD World Competitiveness Ranking, out of 57 economies, the top 5 in order of ranking were the US, Hong Kong, Singapore, Switzerland and Denmark.

Developments in the International and Euro Area Economy

Overview

The global economic outlook has shown some tentative signs of improvement in recent weeks but remains weak, although gradual recovery should take hold over the coming quarters. Uncertainty surrounding the outlook remains high, however. Robust policy measures have prevented the crisis from reaching its full negative potential and the severe pace of economic contraction around the turn of the year is unlikely to be repeated. Nevertheless, downside risks remain and negative feedback between the financial sector and the real economy may have further to run. Economic recovery is likely to be gradual and unfold at different stages across regions, depending on the extent of strains in various financial systems and the amount of policy stimulus in the pipeline.

The rapid intensification of the financial crisis late last year, following the collapse of Lehman Brothers' in mid-September, saw economic activity contract sharply in the final quarter of last year and the first quarter of this year. The impact on credit markets and economic confidence was severe, and households and firms reacted by reining back spending and sharply curtailing production, leading to a global contraction in output. As it became apparent in the wake of the decisive action taken by the authorities throughout the world that the worst fears of a systemic financial sector collapse were unlikely to come to pass, these tensions have unwound to some extent. This has driven improvements in financial market and economic indicators though these are still generally at levels not yet consistent with economic expansion. Much of the impact of policy stimulus has still to be felt and it is notable that, of the major economies, some of the most significant signs of recovery are evident in China, where the transmission of stimulus measures has been relatively strong to date.

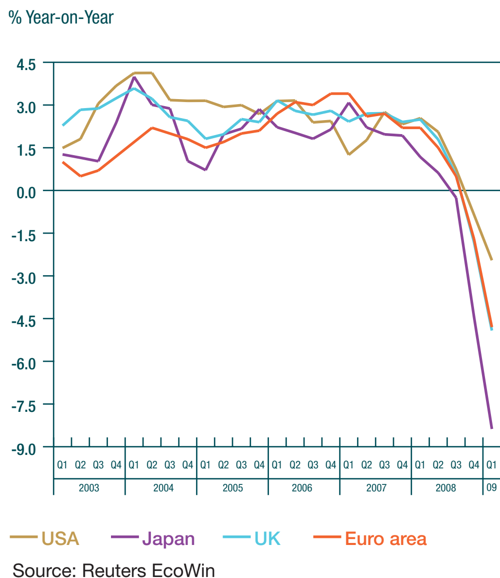
Policy actions have been key to reducing the worst stresses of the crisis but stimulus effects are generally subject to significant lags. Specific measures to shore up banking systems have successfully supported many banks that would otherwise have been vulnerable to stress. Interest rates have been substantially reduced and many central banks have introduced measures designed to ensure that market rates remain low over longer horizons as well as initiatives to improve the functioning of specific markets. Similarly, many governments have approved substantial fiscal stimulus packages but many of the specific measures require significant implementation time, particularly those related to infrastructure projects.

Table 1: Changes in Key Economic Variables in Selected Economies

	Real GDP Growth %			Inflation %		
	2008	**2009[f]**	**2010[f]**	**2008**	**2009[f]**	**2010[f]**
US	1.1	–2.8	0.9	3.8	–0.6	1.0
Japan	–0.7	–6.8	0.7	1.4	–1.4	–1.4
Euro area	0.5	–4.8	0.0	3.3	0.5	0.7

[f] Forecast
Source: OECD Economic Outlook, June 2009

Chart 1: GDP Growth



Source: Reuters EcoWin

Looking ahead, global economic activity is likely to remain weak for most of this year, with a gradual, and possibly uneven, economic recovery only taking hold in various regions either late this year or sometime next year. The positive impact of policy stimulus will be counterbalanced to a large extent by the continuing negative feedback between the financial sector and the real economy. Bank balance sheets remain under significant strain and the impact of economic recession has yet to be fully felt, with both corporate and household loan defaults likely to increase. Furthermore, sharp increases in unemployment are likely to dampen consumer spending significantly. The interaction of such large counterbalancing factors, alongside their uneven distribution across economies, could see significant volatility in the pattern of economic recovery.

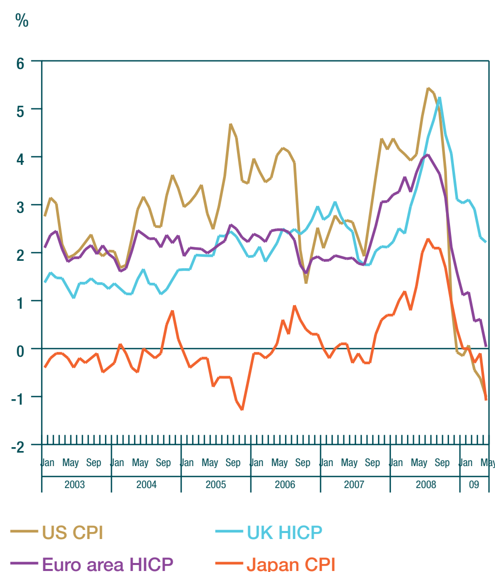
Global inflation rates may be close to troughs due to the pattern of commodity prices but underlying pressures are very weak. Base effects from commodity prices have driven headline inflation to very low and even negative rates but these will soon unwind. In addition, commodity prices, most notably oil prices, have risen in recent months, tempering the impact of base effects and further underpinning a recovery in inflation rates later this year. Underlying inflation rates are generally moderating, however, owing mainly to the impact of the weak economy on wage bargaining and firm pricing power. Looking ahead, commodity prices are likely to remain volatile but considerable slack is expected to persist in the global economy into the medium-term, dampening underlying inflationary pressures.

Section 1: Euro Area

Economic Growth

Against the backdrop of the sharpest deterioration in global activity in many decades, the euro area economy has weakened significantly in recent quarters. Real GDP recorded quarterly contractions of 1.8 per cent in the final quarter of 2008 and 2.5 per cent in the first quarter of this year, as the financial market turmoil intensified and spread to the real economy. Such a downturn is unprecedented in recent history. Table 2 outlines the contributions made to GDP by the various expenditure components over this period. The synchronised nature of the global downturn has led to a sharp contraction in world trade and this weighed heavily on euro area exports, while imports to the region fell significantly reflecting weak domestic demand and an unfavourable export outlook. The weakness in domestic demand was the result of a decline in both household and business

Chart 2: Inflation in the Major Economies



Source: Reuters EcoWin

Table 2: Contributions of expenditure components to quarter-on-quarter variation in real GDP

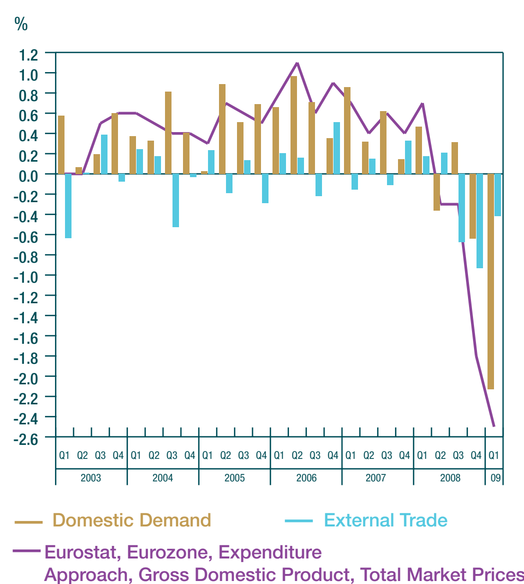
	2008			2009
	Q2	**Q3**	**Q4**	**Q1**
Personal Consumption	–0.2	0.0	–0.2	–0.3
Government Consumption	0.2	0.1	0.1	0.0
Investment	–0.3	–0.2	–0.9	–0.9
Inventories	–0.2	0.4	0.3	–1.0
Exports	–0.1	–0.2	–3.0	–3.2
Imports	0.3	–0.4	2.1	2.9
GDP	**–0.3**	**–0.3**	**–1.8**	**–2.5**

Source: Eurostat.

expenditure. Increasing unemployment and more general concerns about the economic outlook weighed on private consumption, while a sharp fall in order books, declining capacity utilisation and housing market corrections in a number of economies resulted in a sharper fall in fixed investment expenditure. On a more positive note, euro area businesses began the process of running down high inventory levels. While this weighed on first quarter GDP it suggests that firms will be in a better position to increase output in the coming quarters.

Turning to more recent developments, the latest economic data suggest that the rate of decline in GDP may have reached its trough in the first quarter of the year. Survey indicators of

Chart 3: Contributions to Real GDP Growth, 2003-2008



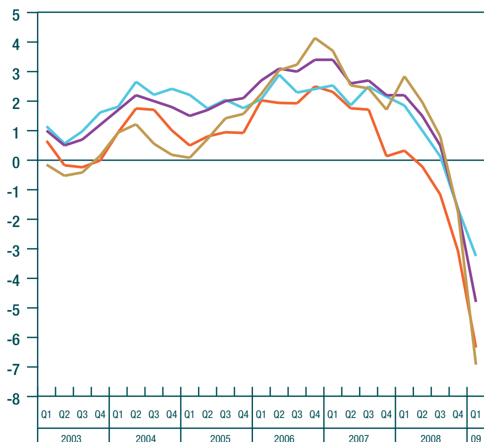
Source: Reuters EcoWin

confidence and activity have increased from the record lows reached in February and March following the strong policy response across the region, while there has also been an improvement in hard data on production, exports and orders. Nevertheless, these indicators remain consistent with a further contraction in economic activity in the coming quarters — albeit at a weaker pace — and a return to positive growth may be delayed until the middle of next year. This reflects both external and domestic factors. While global activity and trade are expected to return to positive growth in coming quarters, the pace of recovery is forecast to be modest relative to its historical trend. This is not too surprising given the extent and synchronised nature of the downturn, characterised as it has been by asset price declines, financial sector strains and factors weighing on demand in some trading partners. This explains the continued low level of confidence amongst exporters in the region. It will also take time for a sustainable recovery in domestic demand to take hold. The labour market is expected to continue to deteriorate — the OECD has forecast an average unemployment rate of 12 per cent in 2010, compared to a rate of 9.5 per cent in May — which will weigh on consumer spending. Combined with the weak external outlook and the very low level of capacity utilisation, meanwhile, this points to a slow recovery in fixed investment spending.

Reflecting these developments, the latest projections by the Eurosystem staff anticipate

Chart 4: Euro Area GDP Growth

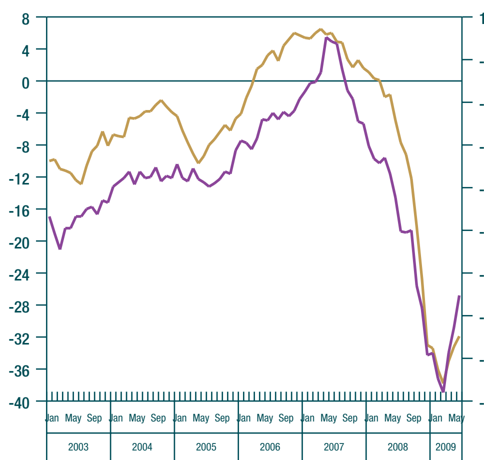
% Year-on-Year



Germany — Eurostat, Euro Zone, Total at market prices, Chain-linked, Chg Y/Y — France, Total, EUR, 2000 prices — Italy

Source: Reuters EcoWin

Chart 5: Euro Area Confidence Indicators



Industrial Confidence

Consumer Confidence (Right Axis)

Source: Reuters EcoWin

that euro area real GDP will contract by between 5.1 and 4.1 per cent this year, with growth of between -1.0 and 0.4 per cent projected for 2010. These figures are broadly in line with those produced by other international organisations. The risks to this economic outlook, meanwhile, are currently broadly balanced. There may be stronger than expected positive effects from the extensive macroeconomic stimulus underway but, on the other hand, downside risks remain, such as the potential for financial sector strains to have a stronger than expected impact on the real economy over the forecast horizon.

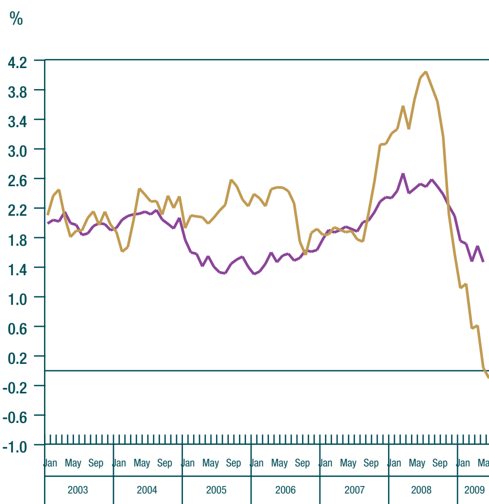
Inflation

The annual headline rate of HICP inflation dipped into negative territory for the first time in June to a rate of -0.1 per cent, having declined consistently from a peak of 4.0 per cent last July. This mainly reflects the impact of commodity prices, which, notwithstanding some recovery this year, are still much lower than a year ago, due to sharp declines in the second half of last year. Sharp movements in the headline measure have masked a significant decline in underlying inflation since the start of the year, indicating that economic weakness is having a dampening impact, amid signs of frailty in wages and firms' pricing power. When energy and food prices are excluded, the inflation rate declined to 1.4 per cent in June from 1.9 per cent in December.

Producer price inflation has declined more sharply, to -5.8 per cent in May from 9.2 per cent last July, reflecting the stronger relative impact of commodity prices. Final goods prices 'at the factory gate' have been more resilient, although prices have been declining for capital goods since March and consumer goods since April. Producer prices for food have stabilised, however, since April following a trend of

Chart 6: Euro Area Inflation Indicators

%



Headline inflation — Core inflation

Source: Reuters EcoWin

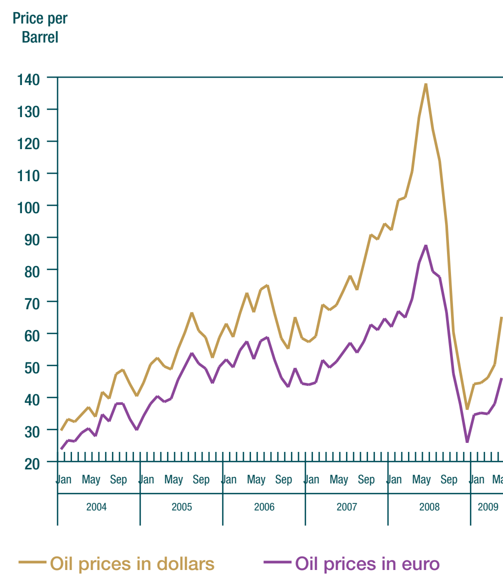
gradual decline in previous months; this could indicate that a similar trend of gradual decline in HICP food prices may be coming to an end. Import prices and survey indicators of producer prices both suggest ongoing downward pressures.

Wage growth has begun to decline, but there is uncertainty as to whether the extent of adjustment will match the fall in inflation. The latest hard data suggest only a moderate decline in annual rates in the first quarter compared with the final quarter of last year. Nevertheless, the indications are that there will be substantial negative drift from negotiated wage rates this year, particularly among contract workers, while hours worked are being reduced. Furthermore, unemployment has risen strongly this year and survey measures of wages and employment intentions remain very weak. Yet, adjusted for the decline in consumer inflation, it is unclear whether or not wage rates are moderating in real terms.

Oil prices declined steadily from their peak of €90 ($143) in early July of last year to hit their lowest point at the end of December. Since then prices have increased steadily, levelled off in the summer, and stood at €44 ($61) in the second week of July, as measured by London Brent crude. Exchange rate movements have tempered the impact in euro terms. Although the demand for oil has been lower in all countries this year compared with 2008, there have been some upward revisions for forecast global demand in the second half of 2009, as the rate of contraction in world output begins to slow. Oil supplies have decreased from both non-OPEC and OPEC regions, although not by as much as originally expected. Oil prices are now around 50 per cent lower than a year ago, in euro terms.

Food commodity prices have also declined markedly from their peak in the summer of last year, and appeared to have stabilised in early 2009, before embarking on a steady upward trend. However, food prices still remain below their year earlier levels, declining by an annual rate of 18.2 per cent in May. Metal prices and other industrial input prices have also begun to rise slightly in recent months, after levelling off at the beginning of the year, following the

Chart 7: Oil Prices — Brent Crude



Source: Reuters EcoWin

sharp declines of the final quarter of 2008. The fiscal stimulus package currently underway in China helped support metal prices, as government spending on infrastructure increased significantly.

Headline inflation may only be in negative territory for a very short period, as base effects in commodity prices will reverse from August. Based on the latest commodity price futures, this would see inflation increase quite rapidly to above 1 per cent by the end of the year and broadly stabilise thereafter, with weak economic growth expected to have a significant dampening impact. The latest projections by the Eurosystem staff are for inflation to average between 0.1 and 0.5 per cent this year and 0.6 to 1.4 per cent next year. Risks to the inflation outlook are primarily centred on the extent to which economic activity and commodity prices deviate from current expectations. These risks are linked, of course, in that stronger or weaker activity may also impact on commodity prices.

Emerging EU Member States

Economic growth in the eight Emerging EU Member States fell very sharply at the end of 2008, and GDP continued to contract in most countries in the first quarter of 2009. The

Box: IMF's General SDR Allocation

At the G-20 Summit on April 2, world leaders pledged to support growth to emerging market and developing countries by boosting the IMF's lending resources to USD 750 billion. The leaders committed to increase the resources available to the IMF in three ways: by raising USD 250 billion through bilateral loan contributions from, and sales of, IMF financial instruments to financially strong countries, agreeing sales of IMF gold to provide USD 6 billion additional financing for poor countries and supporting a USD 250 billion general allocation of the IMF's Special Drawing Rights (SDRs). This Box concentrates on the SDR allocation as it is expected to be implemented first.

What is an SDR?

The SDR is an international reserve asset, created by the IMF in 1969 to supplement the existing official reserves of member countries. Its value is based on a basket of international currencies which includes the US dollar, the euro, the yen and the pound sterling[1]. The composition of the basket is reviewed every five years to ensure that it reflects the relative importance of currencies in the world's trading and financial systems. SDRs are allocated to member countries in proportion to their IMF subscriptions, or quotas[2]. The SDR also serves as the unit of account of the IMF and some other international organisations.

The Rationale for SDR Allocations

An SDR allocation is a costless way of adding to members' international reserves, and it has the effect of directly increasing members' own international reserves. An SDR allocation provides each member with an asset on which interest is neither earned nor paid. For member countries that choose to hold their allocation, the net carrying cost is zero. If, for example, a member's SDR holdings rise above its allocation, as a result of purchases from another member, it earns the SDR interest rate on the excess; conversely, if it holds fewer SDRs than allocated, it pays the SDR interest rate on the shortfall[3]. An SDR allocation, therefore, permits members to reduce their reliance on more expensive domestic or external debt for building reserves. The case for an SDR allocation is usually made when the need for additional long-term global reserves is deemed to exist.

The SDR is not a claim on the IMF but a potential claim on the freely usable currencies of other IMF members which includes U.S. dollars, euro, Japanese yen and sterling, but other member currencies can also be used. IMF members can voluntarily exchange SDRs for currencies among themselves. If, however, the voluntary agreements to exchange SDRs for such currencies are not sufficient, the IMF can designate certain countries to exchange SDRs.

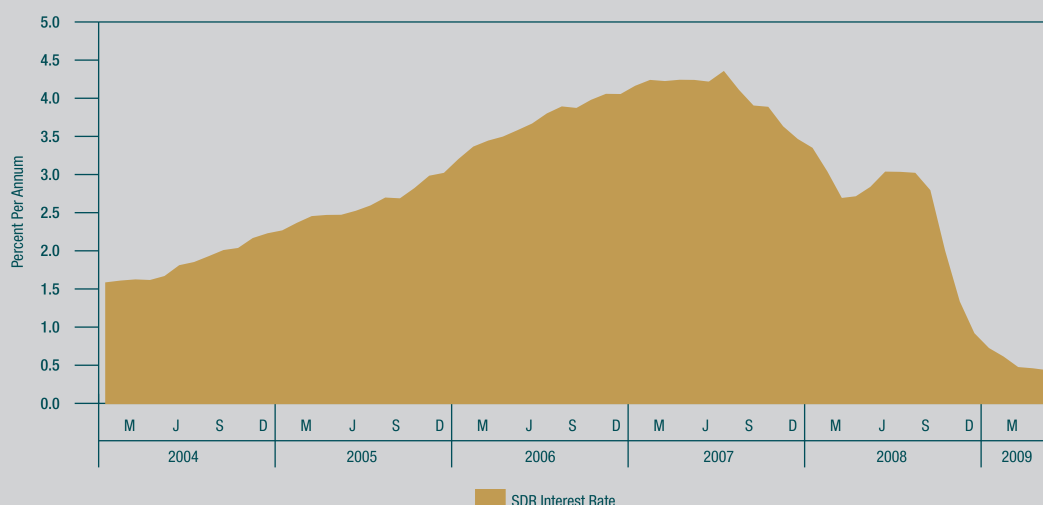
SDR allocations help to increase the international reserves of all IMF countries. For low-income countries, in particular, they provide a liquidity buffer in case of shocks. This is important given the increase in global financial volatility due to the current economic and financial crisis. SDRs can be used for a number of purposes: financing balance of payments needs, acquiring assets as part of a reserve management strategy, or paying part of quota increases.

[1] The value of the current SDR is derived from the US dollar, euro, Japanese yen, and sterling, accounting for 44%, 34%, 11% and 11%, respectively, for the period from 2006 to 2010.

[2] Quota subscriptions generate most of the IMF's financial resources. Each member country of the IMF is assigned a quota, based broadly on its relative size in the world economy. A member's quota determines its maximum financial commitment to the IMF and its voting power, and has a bearing on its access to IMF financing.

[3] The SDR interest rate is calculated on the financial instrument of each component currency in the SDR basket, expressed as an equivalent annual bond yield: three-month Eurepo rate; three-month Japanese Treasury Discount bills (effective February 5, 2009, replacing the thirteen-week Japanese Government financing bills); three-month UK Treasury bills; and three-month US Treasury bills.

SDR Interest Rates



Source: Ecowin

Of the USD 250 billion proposed by the G-20 leaders, emerging markets and developing countries would as a group be allocated almost USD 100 billion (40 percent), of which low-income countries would account for about USD 19 billion (close to 8 percent). The remaining USD 150 billion (60 percent) of SDRs will be held by advanced countries.

SDR Allocation mechanisms

There are, in general, two kinds of SDR allocations:

1. General allocations of SDRs need to be based on a long-term global need to increase the stock of global reserve assets. Decisions to allocate SDRs have been made only twice previously in 1970-72 and 1979-81[4]. Due to the global economic and financial crisis, world leaders have proposed that global reserves should increase by USD 250 billion in 2009. Recent analysis undertaken by IMF staff supports this proposal.

2. A proposal for a special one-time allocation of SDRs was approved by the IMF's Board of Governors in September 1997[5]. This allocation was proposed for equity reasons, in order to provide SDR allocations for all IMF members. Members that joined the IMF since 1981 — more than one fifth of the current IMF membership — had never received an SDR allocation. Under this proposal, the total allocation of SDRs would double to SDR 42.8 billion. While more than three quarters of the IMF's voting power[6] accepted the proposed amendment, the US (with 16.75 percent of the total vote) needed approval from the US Congress. The G-20 endorsed urgent ratification of this special allocation, and in June 2009, US Congress approved both the special allocation and the proposed general SDR allocation.

The result of the implementation of the combined general (USD 250 billion, SDR 158 billion[7]) and special one-off allocation of SDRs (SDR 21.4 billion) would be more than an eight fold increase in global SDR assets. While SDR allocations can be cancelled, this has not happened in the past. The proposed SDR allocations could be implemented by end-August 2009.

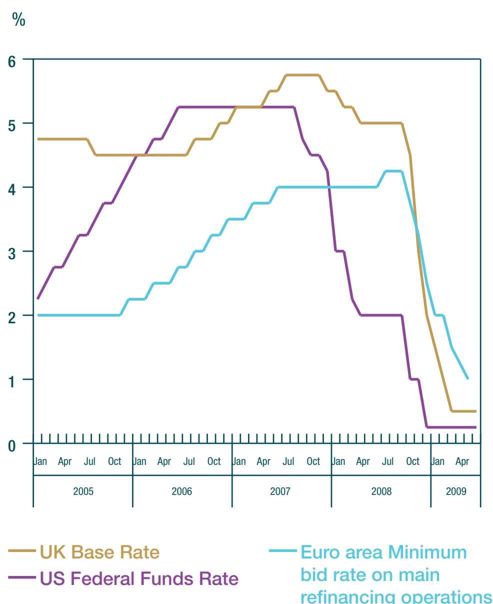
[4] The first allocation was for a total amount of SDR 9.3 billion, distributed over three years in 1970-72. The second allocation was distributed over three years in 1979-81 and this brought the cumulative total of SDR allocations to SDR 21.4 billion.

[5] Through a proposed Fourth Amendment of the IMF's Articles of Agreement.

[6] 77.68 percent of IMF voting power.

[7] Rate of USD to SDR is 0.632 on 7 July 2009.

Chart 8: Key Policy Interest Rates



Source: Reuters EcoWin

worldwide collapse in trade was the main driving force behind the economic slowdown, as well as tighter financing conditions, negative wealth effects from falling asset prices, and negative confidence effects. Output is forecast to remain weak over the remainder of this year, and a return to growth is not expected until the middle of next year. Although current account positions in the Central and Eastern European countries are likely to remain in deficit in most countries in 2009, they have been declining strongly and will come in well below the double-digit rates seen in some countries in recent years. After experiencing external funding difficulties, three EU Member States have sought international financial assistance, namely Hungary, Latvia and Romania. In addition, Poland has been granted access to the IMF's precautionary Flexible Credit Line.

Inflation continues to moderate in most Emerging EU countries as commodity prices fall and the world economy slows. However, inflation projections diverge considerably reflecting differences in the economic outlook.

Section 2: External Environment

United States

US economic activity declined significantly in the fourth quarter of 2008 and the first three months of 2009 as the financial market turmoil intensified and the housing market continued its sharp correction. Following a quarterly annualised decline of 6.3 per cent in the final months of 2008 real GDP contracted by 5.5 per cent in the first quarter of this year. This represented the sharpest decline in output over a six-month period in over 50 years. As Table 3 outlines there were some more favourable developments in the first quarter despite the very sharp fall in the headline GDP figure. Aside from a moderation in the overall pace of contraction — which appears to have reached its trough in the final months of 2008 — consumer spending turned positive once again as heavy discounting boosted auto sales, while US firms reduced stock levels aggressively, a development that should lead to a quicker recovery in production in the coming quarters.

More recent economic data has, on balance, been broadly favourable. Survey indicators of activity and confidence have picked up, with the improvement in new orders components particularly notable. There have also been more positive signs from the housing market; it appears that new home sales and housing starts may have begun to stabilise and the housing inventory, while still high, has started to moderate. Reflecting these developments, financial markets now expect that the economy

Table 3: Real GDP and expenditure components: annualised growth rates

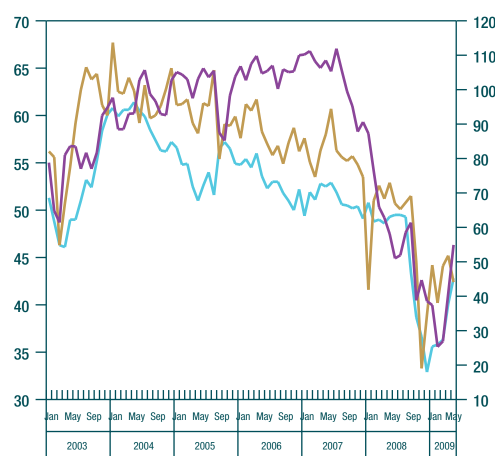
	2008			2009
	Q2	**Q3**	**Q4**	**Q1**
Personal Consumption	0.9	–2.8	–3.0	1.0
Government Consumption	0.8	1.1	0.3	–0.6
Fixed Investment	–0.3	–0.8	–3.4	–6.0
Inventories	–1.5	0.8	–0.1	–2.2
Exports	1.5	0.4	–3.4	–4.2
Imports	1.4	0.7	3.3	6.6
GDP	**2.8**	**–0.5**	**–6.3**	**–5.5**

Source: Bureau of Economic Analysis

will return to positive growth in the second half of this year. Looking further ahead, however, there are still considerable uncertainties over the pace of recovery. Recent forecasts produced by the World Bank, IMF and OECD highlight this uncertainty; while these organisations expect an increase in real GDP in 2010, the size of the increase forecast varies from just under 1.0 to 2.0 per cent. The outlook for personal consumption is particularly uncertain given the deteriorating labour market; the unemployment rate has almost doubled in the past 18 months and the OECD expects the rate to average over 10 per cent next year for the first time in over 50 years. Against this backdrop the personal savings rate continued to strengthen in the first half of this year, increasing to a 15-year high of 6.9 per cent in May.

The Federal Reserve's Federal Open Market Committee (FOMC) kept interest rates unchanged at their meetings in April and June, maintaining a target range of zero to 0.25 per cent. The Committee added that 'economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period' and continued to stress that 'the Federal Reserve will employ all available tools to promote economic recovery and to preserve price stability'. The annual change in the US Consumer Price Index turned negative in March and its 1.3 per cent contraction in May was its largest since 1950. The Federal Reserve's preferred gauge of inflation, the core PCE deflator, has, by comparison, been broadly stable at just below 2 per cent in recent months.

Chart 9: US Confidence Indicators



Source: Reuters EcoWin

United Kingdom

Economic output contracted by 2.4 per cent in the first quarter of this year, recording the sharpest decline in output in more than fifty years. The pace of decline in real GDP, however, is expected to have moderated somewhat in the second quarter. On the upside, business survey indicators for the second quarter have been generally stronger than expected, and industrial production, while still very weak, is showing signs of improving. A recovery in household spending, however, is likely to take some time given the fall in employment, lower housing and financial wealth and tighter credit conditions. Nevertheless, there have been tentative indications that house prices may be beginning to stabilise, although this is at extremely low levels. In recent weeks, the Bank of England acknowledged that the UK economy is showing some signs of ''beginning to stabilise'', but, at the same time, also noted that ''the path to full recovery could be protracted''. Overall, the IMF estimates a 4.2 per cent contraction in GDP this year and modest growth of 0.2 per cent in 2010.

Inflationary pressures have eased significantly in the past eight months or so, with annual CPI inflation falling by 3 percentage points since reaching a peak of 5.2 per cent in September of last year, to stand at 2.2 per cent in May of this year. The largest downward pressures have come from transport costs, reflecting declines in fuel prices, while there have also been further large downward contributions from housing and household services. Against the background of a very difficult economic environment and substantial risks of undershooting the 2 per cent CPI inflation target in the medium term, the Bank of England has taken exceptional measures, including cutting the main policy rate to 0.5 per cent, and embarking on a £125bn asset purchase programme.

Japan

The drop in real GDP deepened further in the first quarter of 2009, with output contracting by 3.8 per cent, following a decline of 3.6 per cent in the final three months of last year. This marked a fourth consecutive quarter of negative growth. The deterioration in economic conditions is, however, starting to show some signs of easing in the second quarter, with industrial production and exports showing indications of recovering. Over the coming quarters, exports and production are expected to continue improving, mainly due to progress in inventory adjustments, while on the other hand, domestic demand is expected to continue weakening, with corporate profits, employment and incomes deteriorating. The latest estimates from the IMF project that output will contract by 6.0 per cent this year, before growing by 1.7 per cent in 2010.

Since last summer, inflation has eased considerably. The core consumer price index, which excludes volatile fresh food prices, declined by a record 1.1 per cent in May from a year earlier, marking the third straight month of decline, while producer prices have also fallen substantially, declining by 5.4 per cent. After lowering its target rate to 0.1 per cent in December of last year, the Bank of Japan decided to leave its main policy rate unchanged at its most recent meeting in June. The Bank of Japan has also introduced a number of non-standard policy measures, such as the purchase of corporate bonds.

Emerging Asia

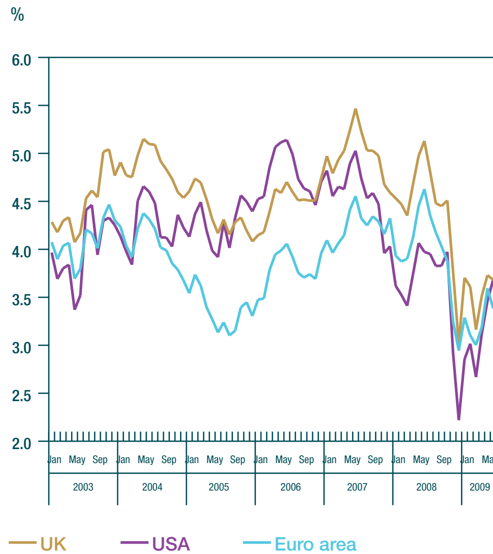
In emerging Asia, economic activity deteriorated in the first quarter of 2009, with small open economies, in particular, suffering from the global economic downturn owing to their high level of dependence on external demand. Domestic demand was also weak in many countries, as labour market conditions deteriorated. In China, real GDP expanded by 6.1 per cent in the first quarter of 2009, a marked slowdown from 9 per cent in the third quarter of 2008, driven by a sharp fall in exports. In India, meanwhile, economic activity has also slowed, with annual GDP growth at 5.8 per cent in the first quarter of 2009, compared with 7.1 per cent for 2008 as a whole, while in Korea, real GDP contracted at an annual rate of 4.2 per cent in the first three months of the year.

In recent months, however, the Chinese economy is showing signs of beginning to rebound, reflecting sizeable monetary and fiscal stimuli, which are boosting public investment and offering some support to consumption. The latter has remained surprisingly resilient in recent months. The latest IMF forecasts estimate 7.5 per cent growth in China this year, and 8.5 per cent expansion in 2010, marking a strong performance in the global context. For emerging Asia as a whole, the early indications are that economic growth appears to be rebounding gradually. Meanwhile, inflationary pressures have continued to ease over the past number of months, a trend that is evident across the global economy.

Financial Markets

Since the beginning of March (the period under review), ***equity markets*** in the euro area, Japan and the US have all shown clear signs of picking up, reversing the sharp downward trend observed since the autumn of 2008. Some indications of an improvement in financial market conditions, survey evidence of a pick up in business and household confidence and, reflecting this, a growing market perception that a possible turning point in the global crisis was approaching, increased risk appetite among investors. Over the review period, both share prices of financial and non-financial sectors improved, although the former by a greater amount. Meanwhile, ***bond markets*** have also been affected by the general improvement in market sentiment and risk appetite, with long-term government bond yields across the major economies increasing, albeit with some volatility. The general easing of financial uncertainty has led to a downward pressure on long-term government bond prices and upward pressure on yields, although expectations about future issuance and, in some cases, reduced risks of deflation may also have played a role. At the same time, the improvement in sentiment has tended to lead to spreads across countries contracting somewhat.

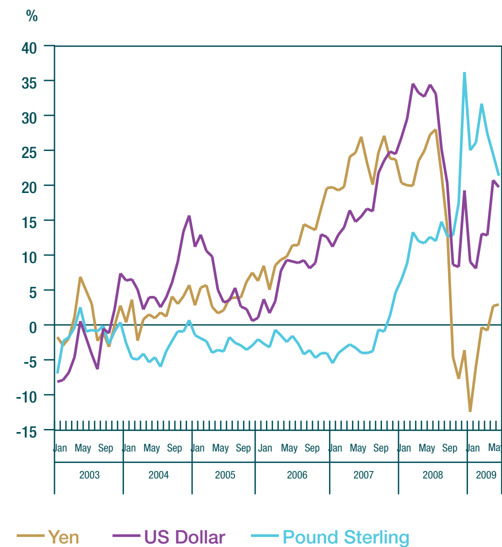
Chart 10: Bond Yield: 10-year



Source: Reuters EcoWin

With respect to ***foreign exchange rate*** movements, the euro generally strengthened against the dollar since early March, reaching 1.41 USD, having started the review period at around 1.25 USD. A number of factors have lent support to the euro, including some more positive economic data globally as well as significant declines in risk perceptions, which appear to have led investors out of currencies perceived to have a safe-haven status, notably the US dollar. Against sterling, meanwhile, the euro was generally weaker, with the strengthening of the pound possibly derived from signs of stabilisation in the UK macroeconomic outlook.

Chart 11: Exchange Rate Changes for the Euro



Note: This chart shows percentage changes in Euro exchange rates by reference to 31 December 1998.

Source: Reuters EcoWin