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BUDGET 2011: Economic Perspective

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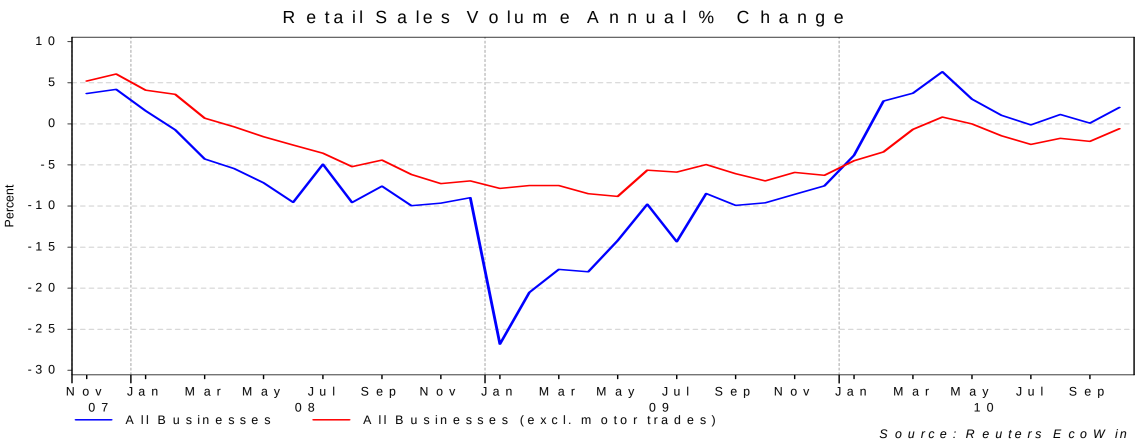
Executive Summary

•Following today's fiscal measures, ***the Government is aiming for a post-Budget General Government Deficit of €15,180m or 9.4% of GDP in 2011 compared with the opening White Paper figure of €20.0bn (-12.2% of GDP) as published on Saturday.*** Meanwhile, the Exchequer budget deficit for next year is projected at €17,670m as against an opening deficit of €22,445m, pointing to a saving on this basis of €4,775m from today's fiscal changes.

•Of course, today's measures are the first part of the *National Recovery Plan* aimed at bringing Ireland's budget deficit back to below 3.0% of GDP by the end of 2014. At the end of November the Government published its €15bn four-year fiscal consolidation strategy, with €10bn to come from expenditure cuts and €5bn in tax increases over the 2011-2014 period. Although all the major political parties appear committed to the overall €15bn adjustment over the next four years, there may be some tweaking to the composition of the €15bn when a new government is elected after the expected General Election in the first quarter of 2011. Labour in particular would like to see more emphasis on tax hikes and less on spending cuts than either Fianna Fail or the main opposition party Fine Gael. ***We would be concerned at over-taxing workers/households at this juncture given the current fragility of the economy.***

•As was well signposted in advance, the majority of the fiscal adjustment in Budget 2011 came on the expenditure side, with a significant cut in social welfare spending. However, taxpayers didn't avoid the pain, with the tax bands and tax credits being reduced by 10%, bringing more workers into the tax net. ***Further bad news on the taxes front is scheduled over the next three years, with a property tax being introduced from 2012.***



•Although we recognise that the Government needs to make a serious fiscal adjustment over the next four years, we are somewhat concerned that it is over-doing it in the short-term, and potentially causing more damage than good to an economy that is still stumbling around post-recession and trying to find its feet. ***A €6bn fiscal adjustment in today's Budget without any real stimulus measures to boost activity in the short-term apart from the extension of the car 'scrappage scheme' for another six months, could easily crush any prospect of a pick-up in domestic demand and send the Irish economy backwards rather than forwards in 2011.*** That said, the export side should be strong enough to see real GDP growth of just under 1.5% next year as against an estimated contraction of 0.4% in 2010.

•The Government expects the Irish economy to increase by 1.7% in real GDP terms next year, which is slightly higher than our own projection. However, given that the main impetus to growth is due to come from the external side of the economy, Ireland's growth projections are heavily dependent on what happens to global demand, and the reality is that could go either way at this stage. ***Still, we are confident that although the expected increase in world GDP in 2011 may not be as high as in 2010, it will be strong enough to boost Irish exports and help get the economy back on a positive growth trajectory, the first step in bringing the budget deficit back to the required 3.0% of GDP limit by 2014/2015.***

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Post-Budget Comment:

• ***filling in the blanks***

Today's Budget was in many ways only filling in the blank spaces on page one of the recently published four-year fiscal consolidation plan. The *National Recovery Plan* outlined a fiscal adjustment of €15bn in the 2011-2014, with a front-loading of the initial €6bn in today's Budget. The key messages from the plan are that revenue measures will provide one third of the budgetary adjustment over the next four years, with 40% of total revenue measures being adopted in 2011. The income tax system is unsustainable if 45% of tax units pay no income tax, and therefore radical base broadening across the tax system is needed. At the end of the day, all taxpayers must contribute. By overhauling tax expenditures, those that can afford to pay more will pay more. ***So today we saw a broadening of the tax base and tax credits being reduced by 10%, although rates themselves weren't touched.*** Many had feared that a property tax would be introduced in Budget 2011, though as detailed in the *Recovery Plan* that's a measure for Budget 2012. Funding of local service provision must be addressed, and an interim Site Value Tax will be introduced in 2012, applicable to all land other than agricultural land and land subject to commercial rates. The interim measure will involve a fixed local service contribution of about €100 per annum (€2 per week) which will raise €180m from households. The final Site Value Tax will be introduced in 2013 when valuations have been completed.

• ***corporation tax left alone***

However, on the taxation front, the Government has made it clear that the corporation tax rate will not be touched as part of the budgetary adjustment process. Corporation Tax receipts have been particularly strong this year, running almost €600m ahead of target at end-November, which is very positive, and a clear justification for Ireland not to cede any ground to the EU/IMF on the low 12.5% rate. Ireland has strong economic reasons for wanting to keep a low rate that has attracted US multinationals such as Google, Microsoft, eBay and Intel into the country, creating tens of thousands of jobs in the process. Any simple textbook will tell you that a small, open economy built heavily on foreign capital should set a low corporate tax rate. There are also political arguments. The corporate tax rate has become a symbol of sovereignty in a nation that had to fight hard for independence from Britain a century ago. The Irish were promised before they ratified the EU's Lisbon treaty at the second attempt in a referendum last year that they would retain full freedom to set their own taxes. The low corporate rate creates jobs and spending in the economy, and the importance of the low corporation tax rate is underlined by anecdotal evidence that the sort of foreign direct investment (FDI) on which the prosperity of the 1990s was built is flooding in once again. ***IDA Ireland, the agency that targets such investors, says FDI in 2010 will be the best for seven years, a very encouraging development amid all the doom and gloom.*** One also has to question the premise that Ireland is drawing investment away from other European countries. Many of the global firms with operations in Ireland are in fact selling software services such as online advertising back to the United States. Furthermore, some European multinationals take advantage of Ireland's system to reduce their tax bill at home, enabling them to keep less profitable production in other EU countries. Only Bulgaria and Cyprus, which charge 10%, have lower corporate tax rates in the European Union. Latvia takes 15% and most "*emerging Europe*" economies, which compete with Ireland for foreign investment, have rates around 19-20%. However, OECD figures show the effective tax take on business in Ireland is closer to the European average because there are fewer exemptions and allowances than, say, in Germany. ***The low corporation tax rate is a key cornerstone of Irish industrial/economic policy, and should be left well alone in our view.***

• ***Budget to be passed***

Ireland's deeply unpopular Government has begun to unravel, with the junior coalition party (The Greens) demanding an early election in 2011. Meanwhile, two independent politicians on whom the Government relies for its parliamentary majority have been keeping their powder dry as regards committing to supporting today's Budget, casting doubt on its passing. Although there were cuts in social welfare spending in today's measures, the fact that the old-aged pension was left alone should please the independents, as should the further reductions announced in Ministerial pay. At the end of the day when push comes to shove, we think the Budget will get through as politicians recognise the seriousness of the situation and the damage it would do to Ireland's reputation on financial markets if the fiscal austerity measures were defeated. ***A General Election early next year is likely to see a Fine Gael/Labour coalition coming to power, but we don't think it will make too much difference to the EU/IMF bailout and/or the four-year fiscal consolidation plan.***

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Irish Economy:

- ***hard to be optimistic on the economy in the short-term***

The Irish economic outlook remains clouded in uncertainty. After a strong start to 2010, with an increase in real GDP of 2.2% quarter-on-quarter in the January-March period, the economy fell back into negative territory in the second quarter. However, with signs of a revival in the US economy, and the Irish manufacturing sector posting a year-on-year increase of over 12% in the third quarter, things appear to be moving in the right direction again. Exports have been the shining light in recent quarters, and they will continue to be the key driver of economic activity in the months and years ahead. Whatever, about the external side of the economy, there is little to be optimistic on the domestic side, with demand likely to remain muted for some time to come. Ireland's economy has contracted significantly more sharply than other deficit countries during the economic/financial crisis. GDP has posted a 14.5% fall in real terms from peak to trough, with domestic demand down over 26% since the final quarter of 2007. The building sector is out of the equation for the next couple of years, with house completions set to total 10,000-15,000 on average over the 2010-2012 period, way down on the 93,000 houses built in 2006 at the height of the boom. For builders, the cuts in capital spending in Budget 2011 are a concern in terms of what this will mean for activity in the industry in the coming year. It is against this backdrop that confidence in the construction sector is now at its lowest level so far in 2010. ***As regards personal expenditure, today's increase in personal taxes and cuts in welfare benefit rates don't augur well for consumer spending prospects in 2011.*** Ireland's personal savings rate jumped to 12% in 2009 from 4% in 2008, and it is difficult to see the personal sector changing their cautious approach in the short-term even allowing for the 2 percentage point increase in DIRT. We think personal savings rates will remain at fairly elevated levels given the need for households to repair their balance sheets.

Bloxham Main Economic Forecasts

%	2009	2010 (f)	2011 (f)	2012 (f)
GDP	**-7.6**	**-0.4**	**1.4**	**2.5**
Consumer Spending	-7.0	-1.3	-0.5	2.0
Fixed Investment	-31.0	-24.0	-7.0	0
Government Spending	-4.4	-3.8	-3.0	-3.0
Exports	-4.1	7.5	6.5	5.5
Imports	-9.7	3.5	2.8	3.0
Consumer Prices	-4.5	-0.9	1.1	2.0
Unemployment Rate	11.8	13.4	13.8	13.0

- ***car 'scrappage scheme' extended***

On the positive side we are glad to see that the car 'scrappage scheme' has been extended for another six months until the end of June 2011. Despite scepticism among some economists when this scheme was announced in last December's Budget on the grounds that it was subsidising imports, it has in our opinion achieved its main objective of providing a psychological boost to consumers. Keeping the scheme in place until the middle of 2011 should help to keep car sales strong for another few months at least. The bottom line is that amid all the doom and gloom, the household sector needs to be given some incentive to spend. After all, it is estimated that there is around €95-100bn held on deposit at financial institutions (including credit unions) that can be tapped into. ***What's also somewhat worrying is the fact that the Government doesn't appear to have a coherent plan as regards the household sector,*** with the introduction of the 10-year National Solidarity Bond earlier this year a clear incentive for consumers to save rather than spend. And the Government in its *National Recovery Plan* is now talking about introducing a new shorted-dated 4-year Solidarity Bond. What in effect we need in our opinion is an SSIA scheme in reverse, rewarding consumers who spend rather than save. Of course, the other crucial determinant of how the household sector will behave in 2011 is what happens as regards employment prospects, and developments don't look overly encouraging on this front in the near-term.

- ***price pressures to remain subdued***

The increase in excise duties on petrol/diesel in today's Budget will add to the CPI in 2011, but the overall thrust of the fiscal austerity measures announced by the Minister for Finance Brian Lenihan is deflationary rather than inflationary. As such, we expect price pressures to remain fairly subdued over the next twelve months. The main upward pressure on the Irish CPI in the months ahead will come from mortgage interest rates and food/energy costs. Overall, the risks to the inflation outlook for 2011 appear to be broadly balanced and relate in main to how the domestic economic recovery evolves and what happens to international energy/food prices. ***We are now expecting headline prices to be up 1.1% on average next year as against a fall in prices of 0.9% in 2010 and the record post-War contraction of 4.5% in 2009.***

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Irish Economy:

Despite all the doom and gloom in the economy at the moment, Ireland's export sector continues to thrive. Exports of goods and services were up 6.9% in volume terms year-on-year in the first half of 2010, with goods up 4.2% and services up 10.1%. Encouragingly, Ireland has a higher weighting of exports in services (48%) than any other Western economy. Furthermore, almost half the multi-national companies in the State expect to increase the amount they export in 2011. A recent survey by the Irish Management Institute (IMI) and National Irish Bank found 47% of multi-nationals expect turnover to increase in 2011, while 11% are anticipating a decrease. Ireland's immediate economic prospects are highly dependent on the ability of Irish exporters to take advantage of the upturn in the global economy. There is some uncertainty regarding the sustainability of the buoyant performance of the pharmaceuticals sector, as output from this industry tends to be inherently volatile due to such factors such as patents and product cycles, but we remain confident that it can continue to prosper in the coming year. On the domestic side, the worrying aspect for indigenous Irish exports in particular is the softness in the dollar and sterling, making it more expensive for exporters to sell their goods into the United States and UK. But, whatever about the near-term, we still think the greenback and the British pound will strengthen against the euro on a 6-month view as the Eurozone's mounting government debt problems and a slowdown in the German economy start to weigh on the single currency. The bottom line is that the export sector offers the one ray of light at the moment in a fairly gloomy economic picture, and will be the key driver of the Irish recovery story in the years ahead. We are looking for a volume increase in goods and services of 7.5% in 2010 and another healthy increase of 6.5% in 2011. We also think the overall merchandise trade surplus will break through the €40bn level this year. Meanwhile, ***one of the most important economic factors for Ireland over the next twelve months or so will be the return of a current account surplus on the balance of payments.***

- ***exports the key to Irish recovery***

Employment & Unemployment (Annual Average)

(000s)	2009	2010 (f)	2011 (f)	2012 (f)
Industry	411	366	360	365
Services	1,422	1,402	1,395	1,420
Agriculture	96	85	85	85
Total	**1,929**	**1,853**	**1,840**	**1,870**
Unemployment (LFS basis)	259	287	295	280
Labour Force	2,187	2,140	2,135	2,150
Jobless Rate (% of labour force)	11.8	13.4	13.8	13.0

Getting people back to work and reducing the numbers of unemployed is a key aim of government policy over the next few years, and while the job placement schemes are a positive move, it is debatable as to whether today's Budget has done enough on labour market initiatives. Reducing the minimum wage by one euro to €7.65 per hour should make it easier for employers to hire staff down the road. However, the key to boosting job prospects going forward is the availability of credit from the banking system. And only time will tell if money starts flowing back into the economy. Following today's fiscal measures, the Department of Finance is projecting an average unemployment rate next year of 13.2%, though we think this is too low, and we reckon it will be closer to 13.8%, especially given the likelihood of further job losses in the short-term, particularly in the banking industry. All in all, the outlook for employment remains fairly downbeat in the immediate future, with the numbers on the Live Register still extremely high despite a fall in the seasonally-adjusted total signing on in the past three months. A pick-up in the labour market tends to lag recovery in output/GDP by six to nine months, so it is likely to be the middle of 2011 at the earliest before there is an underlying improvement in employment conditions. Indeed, further losses in the construction, financial services and retail sectors look inevitable over the next few months. ***Looking at all the relevant factors, we now think the jobless rate will end this year at 13.5%, but even with further severe fiscal austerity in 2011, we don't see it going much above the 14.0% level.*** However, increased emigration will be a key factor in limiting the rise in the unemployment rate. The weak state of the labour market was reflected in the latest annual population estimates. Following net outward migration of 7,800 in the year to April 2009, the first net outflow since 1995, a much larger figure of 34,500 was recorded in the year to April 2010. This was the biggest outflow of people from the State since 1989. An outflow of over 50,000 is projected for the year to April 2011, though the risks are tilted to the upside rather than the downside.

- ***unemployment to be higher than officially projected***

NTMA Funding:

• funding needs already taken care of

In normal circumstances the Exchequer budget deficit target of €17,670m would have to be financed by the National Treasury Management Agency (NTMA) going to the market to borrow the money, but as we all know these are extraordinary times, and the call from Ireland for emergency outside help has completely changed the picture as regards the country's funding requirements in the short-term. The Government agreed on November 28 to the provision of a €85bn financial support programme for Ireland by members of the EU and the International Monetary Fund (IMF). The State's contribution to the programme will be €17.5bn while the external support will amount to €67.5bn. The external support will be made up as follows; (i) €22.5bn from the IMF; (ii) €22.5bn from the European Financial Stability Mechanism (EFSM) and (iii) €22.5bn from the European Financial Stability Fund (EFSF) and bilateral loans from the UK, Sweden and Denmark. ***The average interest rate on the €67.5bn available to be drawn from these three external sources under the EU-IMF programme is 5.82% on the basis of market rates at the time of the agreement. However, the actual cost will depend on the prevailing market rates at the time of each drawdown.*** The average life of the borrowings, which will involve a combination of longer and shorter-dated maturities, under each of these sources is 7.5 years and the interest rates applying to borrowings from each are as follows, based on market rates at the time of the agreement: (i) IMF: 5.7% per annum; (ii) EFSM: 5.7% per annum and (iii) EFSF: 6.05% per annum. In order to obtain funds for on lending to Ireland the EFSF will borrow on the international capital markets on the strength of guarantees provided by Eurozone countries (excluding Ireland and Greece). In order to obtain the top AAA rating from the credit rating agencies it was necessary for the EFSF to put in place certain credit enhancements in the form of collateral and the cost of this arrangement is reflected in the interest rate charged by the EFSF on its lending. Meanwhile, it is being assumed that the bilateral loans from the UK, Denmark and Sweden will be on the same terms as the funds from the EFSF.

Irish minus German 10-Year Bond Yield Spread %

Source: Reuters EcoWin

• consumers being encouraged to save more

Due to the stressed conditions which have been seen in the bond markets in the past few months, it has frequently been suggested that the State use the resources of the National Pensions Reserve Fund to support the Irish government bond market, though recent events have now overtaken this. But, such a step would be very beneficial to the markets in the long-run and in any future crisis and would demonstrate the Government's willingness to ensure the funding of the Exchequer's needs. Accordingly, it is hoped that legislation can be enacted to enable the NTMA to deploy the resources of the NPRF in future to support the Exchequer's funding programme to the extent required going forward. The Government also feels that it is important that ordinary citizens be given the opportunity to invest in Ireland for the benefit of the Irish State. Last year a new Solidarity Bond was announced for this very purpose which was very successful and has raised €300m since its launch last May. For some investors the investment period of 10 years for the existing Solidarity Bond may be a disincentive. It is therefore intended to launch a new 4-year Solidarity Bond shortly with a similar structure to the 10-year bond. It will pay a coupon each year and a bonus for those who hold the bond to maturity. ***Although we can fully understand the desire of the Authorities to boost retail savings to ease the burden on the Exchequer of being overly dependent on external financing to meet its funding needs, we are worried that consumers will continue to increase their savings and not spend in the economy, which in turn will be detrimental to Ireland's economic growth/budgetary prospects over the next few years.***

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Public Finances:

- ***General Government Deficit target set at 9.4% of GDP in 2011***

Following today's fiscal measures, the Government is aiming for a post-Budget General Government Deficit of €15,180m or 9.4% of GDP in 2011 compared with the opening White Paper figure of €20.0bn (-12.2% of GDP) as published on Saturday. Meanwhile, the ***Exchequer budget deficit for next year is projected at €17,670m as against an opening deficit of €22,445m, pointing to a saving on this basis from today's fiscal changes of €4,775m.*** As was indicated in advance, the main focus of today's fiscal austerity measures was on the spending side. Ideally, it would have been nice to have avoided any further tax increases at this juncture given the fragile nature of the economy, but it was not to be. We can only hope that the tax hikes in Budget 2011 don't knock the stuffing out of the consumer and domestic demand completely. The National Pensions Reserve Fund (NPRF) Act 2000 provides for pre-funding part of the future cost of social welfare and public service pensions and the setting aside of 1% of estimated Gross National Product (GNP) annually for this purpose. The 2010 contribution was made in 2009, and therefore no further contribution was required in 2010. In 2009 and 2010, the Government assumed the assets and liabilities of the funded pension schemes of the five older universities, and of certain non-market public corporations. These pension funds, with assets of approximately €2bn were transferred to the NPRF, and this more than represents the annual contribution of 1% of GNP in 2011.

Summary Budget 2010/11 €m

	2010 (e) Out-turn	2011 Pre-Budget Opening Position	2011 Post-Budget forecast (f)
Central Fund	6,390	6,794	6,675
Supply Services	40,955	42,229	41,725
Total Current Spending	**47,345**	**49,023**	**48,400**
Tax Revenue	31,530	33,110	34,900
Non-Tax Revenue	2,695	1,915	1,970
Total Revenue	**34,225**	**35,025**	**36,870**
Current Budget Deficit	**-13,120**	**-13,998**	**-11,530**
Capital Deficit	**-5,635**	**-8,446**	**-6,140**
Exchequer Balance	**-18,755**	**-22,445**	**-17,670**
(% of GDP)	-11.9	-13.7	-10.8
General Government Balance	**-50,115**	**-22,445**	**-15,180**
(% of GDP)	-31.9	-12.2	-9.4

- ***current net day to day spending set to be 1.9% higher in 2011***

After the significant Budget changes on the current spending side, net supply services are still forecast to increase by almost 2.0% in nominal terms next year. The sharp fall in capital spending will do little to boost the prospects of the building sector, but on a more positive note the significant reduction in stamp duty should give a lift to the housing market. However, the overall cut in capital expenditure is disappointing, and only underlines our view that the building sector will be making little or no contribution to Irish economic growth prospects in the short-term. Although a lot of uncertainty remains about the likely performance of the Irish economy in 2011, we are optimistic that a solid and sustainable global recovery can be achieved next year, boosting Ireland's economic prospects in the process. But whether a strong export performance can generate the projected tax receipts for next year and compensate for any shortfall on the taxes from the domestic side of the economy remains to be seen. ***Looking at the overall picture, we think the risks to the budget deficit target are to the upside rather than the downside, but it will be a close call, and we are not writing off the Government just yet from being able to achieve its budgetary targets for next year without further fiscal adjustment.***

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