

Quarterly ECONOMIC OUTLOOK



January 2013

2013 can be turning point for the domestic economy

Ireland recorded its second successive year of reasonably solid economic growth in 2012 on the back of another record performance by the export sector. There were a number of indicators in the second half of the year, however, that the domestic economy has stabilised and is now poised to begin recovery. Private sector employment improved significantly in the third quarter and retail sales finished the year on a positive note. The housing sector, which is central to consumer confidence, experienced price stability and increases in both housing transactions and new mortgage activity. While many Irish households continue to grapple with debt and unemployment concerns, there is growing evidence that 2013 could be a turning point for the domestic economy. We are steadily edging towards a banking debt deal involving improved terms and conditions for the promissory notes and this could well be the spark for a revival in consumer sentiment.

We estimate that Irish GDP expanded by 1.2% in volume terms last year and by almost 4% in value, making Ireland the second fastest growing eurozone economy in 2012, behind only Slovakia. During 2013 we expect economic growth to become somewhat better balanced with domestic demand and exports both making a contribution. We forecast GDP to grow by 1.8% this year and for the recovery to gain further momentum in 2014.

Business performance and outlook

Ireland's export sector performed strongly in difficult trading conditions during 2012. Demand from our main export markets was subdued but unit cost reductions and more favourable exchange rates boosted competitiveness and enabled firms to grow market share. More businesses have successfully made the transition from domestic sales to exports and progress continues in developing new markets. Manufactured goods exporters suffered most from the eurozone crisis and weak demand from the UK; however, the sector has remained incredibly resilient and has clearly benefited from the restructuring efforts during the 2008-2010 period. Internationally traded services businesses remain the main driver of both export and employment growth for the Irish economy. The FDI pipeline was very solid again in 2012 and services companies led the way in terms of green-field and expansion activity. Overall, the confidence of Irish business leaders improved in the final quarter of 2012 with the IBEC Business Sentiment Report showing an increase in the current conditions index to +15 from +10 in the previous quarter.

Consumer prospects

Irish consumers experienced unprecedented difficulties between 2009 and 2011. During 2012, however, the fundamentals for many households improved, as incomes stabilised and mortgage costs fell. The significant cohort of mortgaged households experienced an improvement in their purchasing power during 2012 of about 3%. Despite the misleading claims of some research, the cost of living in Ireland has fallen in recent years and the official CSO inflation data show that it was 1.3% lower in 2012 than prior to the economic crisis in 2008. Stubbornly high unemployment, debt worries and high savings are the primary reasons for the continued weakness in consumer spending. Higher taxes also continue to eat into consumer spending power but during 2013 these are likely to be offset by increases in incomes. Inflation will remain modest this year at about 1.5%. Labour market performance has a significant impact on prospects for the domestic economy and again there are more positive than negative straws in the wind. Private sector job creation will maintain the momentum seen in late 2012 and the majority of public sector job losses are now behind us. The most difficult determinant of consumer spending to forecast for 2013 is consumer confidence. It was volatile during 2012 with many flashes of renewed optimism offset by concerns about higher taxes and the eurozone crisis. An improvement in Ireland's sovereign debt prospects should see consumer sentiment stage a more sustained recovery this year.

Forecasts for 2013

Both exports and domestic demand will contribute to the forecasted GDP growth of 1.8% in 2013. Goods exports will regain momentum as the eurozone recovers during the second half of the year and services trade will again drive overall export growth of 4%. The investment sector of the economy finished 2012 strongly and recovery will be maintained into 2013. Construction activity has stabilised and for the first time since 2007 is unlikely to be a drag on growth this year, while investment by Irish businesses in equipment and machinery is growing strongly. Following a number of years of postponed investments, there was a sharp improvement during 2012 and limited spare capacity will mean further investment growth by firms this year. Surging international investment in the sovereign, banks and utilities demonstrates that those outside of Ireland have growing confidence in Ireland's economic recovery. When Irish households themselves become more confident about their prospects the recovery will gain greater momentum.

Economic growth

The Irish economy outperformed consensus expectations again in 2012. Despite very challenging international trading conditions, exports achieved another record performance while the domestic economy showed signs of recovery in the second half of the year. GDP growth for the year is likely to have averaged a little over 1% and this compares very favourably in an EU context. Ireland's GNP performance was remarkably buoyant during 2012, with estimated growth of 2.5%, but the reading should be treated with caution due to the inclusion of significant profit inflows by companies headquartered in Ireland. Nevertheless, the GNP recovery does reflect an improvement in fortunes for the domestic economy and bodes well for more balanced economic growth over the coming years.

Economic growth data are now available for the first three quarters of 2012. The overall economic performance in Q3 remained relatively stable, with GDP up 0.2% on Q2 and 0.8% higher on an annual basis. For the first time since the start of the economic crisis the volume of activity in the domestic economy was higher in annual terms. Both consumer spending and investment recorded annual growth in Q3 and a range of indicators suggest that this momentum was maintained in the final quarter of the year. Spending by Irish consumers was 0.2% higher on an annual basis in Q3 but remained 1.4% down over the first three quarters of the year. With retail numbers indicating a relatively strong finish to the year we estimate that the total volume of consumer spending fell by 1.2% last year. The improvement in consumer spending in the third and fourth quarters of the year also provides some positive momentum for 2013.

The investment sector of the economy also recorded a very strong Q3 as output was up almost 9% annually. Investment in equipment and machinery was boosted by strong aeroplane purchases but even excluding these investment by businesses in equipment and machinery was buoyant in the quarter. The construction sector is also showing further signs of stabilisation. While house building continues to contract somewhat, other building and construction fell by just 1.5% over the first three quarters of the year.

GNP and its components

Annual % change	2011	2012	2013	2014
Consumer spending	-2.4	-1.2	0.0	1.0
Government spending	-4.3	-4.0	-3.5	-2.0
Investment	-12.6	-0.7	6.0	6.2
Exports	5.1	3.0	4.0	4.5
Imports	-0.3	0.6	3.0	3.8
GDP	1.4	1.2	1.8	2.6
GNP	-2.5	2.5	0.7	2.1

Table 1

In contrast to the strengthening performance of the domestic economy during 2012, the export sector lost momentum. Goods exports were down 3.4% annually in Q3 and were 2.5% lower over the first three quarters. Services exports remain a star performer for the economy, however, and grew by 9.4% in the January-to-September period. Overall, exports were up 3.2% over this period and an estimated 3% in 2012 as a whole.

We expect continued stabilisation of the domestic economy in 2013 but consumer sentiment remains fragile and recovery is susceptible to further domestic or international shocks. The export sector finished 2012 on a fairly weak note as the eurozone economy flagged but we expect it to regain momentum in the second half of this year. Domestic economy stabilisation and reasonable export growth, which will again be largely driven by the internationally traded services sector, will result in GDP growth of 1.8% this year.

Business outlook

The Q4 IBEC Business Sentiment Survey was conducted in late November, ahead of Budget Day. Confidence in the overall business environment improved slightly in the final quarter of the year, with the current conditions index at -13 and the forward-looking index at -14. Both had recorded a reading of -19 in Q3. Encouragingly, CEOs' assessment of both the current state and future outlook of their own businesses also improved. The current conditions index rose to +15 from +10 in the previous quarter and was substantially higher than the reading of +4 recorded in Q4 2011. However, the improvement in the three-month outlook was more muted, with the index rising to +10 from +6 in the previous quarter and -3 in Q4 2011.

The most positive signal from the survey is the rebound in export expectations; the index strengthened to +33 in Q4 from +12 in the previous quarter and +29 at the end of 2011. The shift is driven by improved sentiment across a range of sectors, but especially those where sales forecasts had

IBEC business sentiment indicator

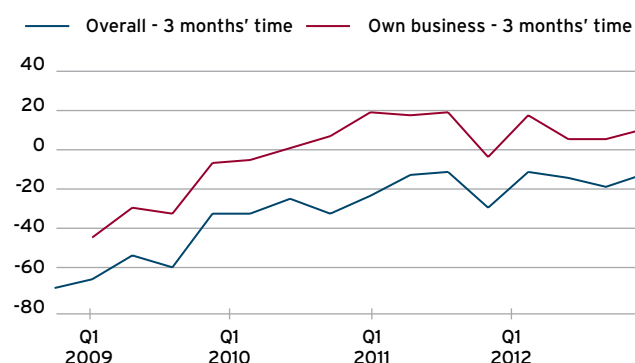


Figure 1

softened in the middle quarters of the year. Of the modern sectors, med tech has consistently reported strong sales expectations. ICT services and pharma had shown a more muted (though positive) sentiment in the middle quarters, but rebounded in Q4. Of the traditional sectors, food and drink also recorded a strong, positive reading. The recovery in metals and engineering manufacture as well as rubber and plastics products is particularly encouraging; these sectors had appeared to suffer most from the eurozone downturn.

Consumer spending

The first half of 2012 was relatively challenging for the consumer market, and the CSO's national accounts show that the volume of consumer spending fell by 2.1% when compared with the first six months of 2011. However, activity picked up in Q3, with sales volumes up 0.5% in the quarter, pushing the annual trend into marginally positive territory at 0.2%. The improved performance was driven by more positive consumer sentiment, a pick-up in private-sector job creation and a temporary boost from the summer's sporting events.

Retail sales were fairly mixed in October and November (latest data available at the time of writing). The digital switchover boosted electrical goods sales in October, but the momentum was reversed in November. Nonetheless, when averaged across the two months sales were up on the same period of 2011, and additional anecdotal evidence points towards a relatively robust Christmas period. This indicates that the fourth quarter upturn for the consumer market will have continued the more benign trend from the previous quarter. Overall consumer spending will have fallen by about 1.2% during 2012, with increasing signs of stabilisation evident in the latter half of the year.

Looking out to 2013, we note the coincidence of a number of positive indicators for the first time since the onset of the recession. House prices showed increasing signs of stabilisation during 2012 and activity appears to have picked

up particularly among first-time buyers in Dublin. Mortgage approvals also increased last year and were up 25% year-on-year in November. A return to more normal levels of transactions in the housing market would have substantial benefits for the domestic economy, given that each house purchase is associated with about €20,000 additional expenditure. Other fundamentals driving the stabilising trend in consumer spending include the upturn in private sector employment and a recovery in household gross disposable income (the improved performance of financial markets during the year was a contributing factor here).

With income and employment trends now stabilised, confidence will be a key determinant of consumer spending in 2013. However, as evidenced by the sharp drop in the KBC/ESRI Consumer Sentiment Index in December, the situation remains fragile. The survey was conducted at the start of the month and the sharp decline in confidence was likely influenced by fears about the Budget, the incoming property tax in particular. January should see a rebound in the index, if the pattern from previous years continues. A deal on promissory notes would obviously provide a strong boost to confidence, while the property tax will likely continue to drag on sentiment. Householders will get clarity on their tax liability in March; while the initial effect will be negative, the impact should fade over the next couple of months as the impact is absorbed.

Overall, we have pencilled in no change in consumer spending in 2013, before a return to modest growth in 2014. Further negative shocks either in the real economy or sentiment pose downside risks, but likewise it now seems possible that the domestic economy will gain some momentum during 2013.

Investment

For the first time since 2007 the investment sector of the economy was not a significant drag on growth in 2012. Output last year was almost flat and based on the data for the first three quarters of the year we estimate a contraction of just 0.7%. The sector also gained momentum as the year progressed and output was 9% higher annually in Q3. The improvement was partly related to a spike in aeroplane purchases but even excluding these, investment by business was up 17% in the quarter and 8% in the January-to-September period. Construction activity also appears to be getting close to stabilisation and there was a number of more positive indicators for both housing and commercial property development as the year progressed. Our overall assessment of the sector is that following four years of sharp decline, it has now stabilised and will slowly recover towards more normal levels of activity over the coming years.

Feedback from IBEC members has indicated for some time that many businesses, and in particular exporters, had limited spare capacity. This suggested to us that investment in equipment and machinery was likely to increase in line with continued export growth. Despite the difficulties in the

Retail sales and consumer confidence

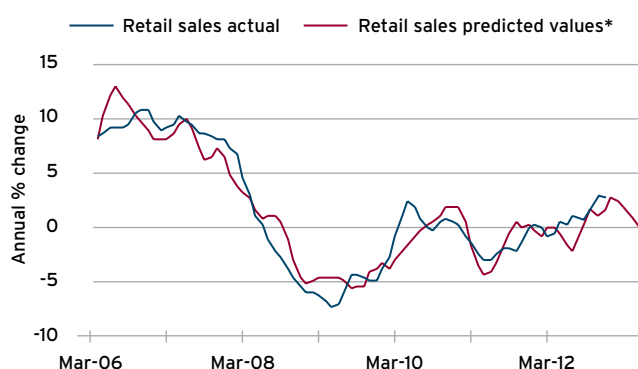


Figure 2

*Retail sales predicted value based on a simple regression of the future expectations component of the KBC Bank Ireland/ESRI Consumer Sentiment Index

Growth prospects for emerging economies

Asia

Last year was relatively challenging for Asia's major emerging economies due to a slowdown in international trade and domestic pressures across the region. Prospects for 2013, however, are brighter. Both the IMF and OECD expect that Asian economies will be at the centre of world growth in 2013 and the IMF projects that Asia will outpace the global economy by about 2%.

In China weaker external demand coupled with domestic attempts to cool inflationary pressures saw growth decelerating to less than 8% in 2012, the slowest in a decade. However, the OECD forecasts that the economy will regain momentum this year, returning to growth of about 8.5-9% in 2013 and 2014. This positive outlook is supported by recent trade data showing that exports in December were up 14.1% from the same period in 2011 and the Purchasing Managers Index (PMI) at year-end recording a seven-month high.

India has also experienced a slowdown with the economy expanding by only 4.4% last year. The OECD expects that growth will accelerate to 6.5% in 2013; this, however, remains below potential. Inflation reached 8.2% in 2012 but is predicted to ease in 2013. However, concerns remain about the fiscal deficit, which has widened to 8.5% of GDP due to a shortfall in tax revenues. Among the ASEAN countries the IMF expects a relatively weak performance from trade-driven economies such as Singapore (growing at only 2.9%) while Vietnam, Indonesia and Thailand will continue to perform strongly, growing by 6-8% in 2013 thanks to strong domestic demand. The possibility of financial shocks and deleveraging in Europe, however, may slow growth in emerging Asian economies as credit flows tighten.

Sub-Saharan Africa

The IMF expects a two-speed economic story for the region in 2013. GDP in low-income countries is expected to grow steadily, driven by domestic demand and investment. On the other hand, middle-income countries with stronger European trade links are expected to perform less robustly. The region as a whole is expected to achieve steady growth of around 5% this year. South Africa, the region's largest economy, saw growth fall below expectations to 2.6%. Economic performance should pick up in 2013; however, this will depend heavily on external trade conditions and the resolution of continuing industrial relations unrest.

The economic turbulence in South Africa is not likely to adversely affect the whole region, as linkages to countries outside the Southern African Customs Union, although growing, remain relatively weak. Oil-producing countries are projected to outperform; for instance Nigerian GDP is expected to increase around 7% in 2013.

Expanding regional operations by Nigerian banks and complex sub-regional trade make Nigeria's economy increasingly important for both neighbouring economies and the region as a whole.

Latin America

Output in Latin America is set to grow by about 4% in 2013. However, real challenges remain for the pace of expansion in the region as questions are raised over the sustainability of the dominant credit-led growth model in some major economies. These worries are particularly acute in Brazil, where household debt levels have doubled since 2005. The situation is coming into sharper focus as any deterioration in the eurozone crisis will put additional pressure on credit flows to the region. The IMF has flagged the importance of Spanish banks to the South American market as a particular downside risk in this regard. On a more positive note, the IMF suggests that opportunities for growth continue to exist through continued high commodity prices and credit growth which has remained stable for now.

In Chile, GDP is expected to grow 4.5-5.5% in 2013. Mexico is also set to perform steadily, but remains vulnerable to external shocks, particularly from changes in the US economy. GDP growth in oil-exporting countries such as Bolivia, Ecuador and Venezuela will be strong at around 5%, although Venezuela remains vulnerable to external shocks. The outlook for 2013 looks poor for the Argentine economy, with a sluggish GDP forecast of 2.4% and inflation persistently bordering on double figures.

GDP growth

(Annual % change)	2012	2013	2014
USA	2.2	2.1	2.9
Germany	0.9	0.9	1.4
China	7.8	8.2	8.5
South Africa	2.6	3.0	3.9
Brazil	1.5	4.0	4.2
India	4.9	6.0	6.4

GDP - share of world total

(Percentage)	2012	2013	2014
USA	18.9	18.7	18.4
Germany	3.9	3.8	3.7
China	15.0	15.6	16.3
South Africa	0.7	0.7	0.7
Brazil	2.9	2.9	2.9
India	5.7	5.8	6.0

Source: IMF World Economic Outlook October 2012.

Investment

Annual % change	2011	2012	2013	2014
Building & construction	-15.8	-7.8	2.3	4.2
Plant & machinery	-8.3	8.0	10.0	8.0
Total	-12.6	-0.7	6.0	6.1

Table 2

eurozone, it appears that 2012 was the year when capital deepening really gained momentum in the business sector. Investment in machinery and equipment is estimated to have increased by close to 10% last year. It grew by 6% in Q2 and recorded particularly strong growth of 18% in the third quarter. This capital deepening appears to be spread across a number of manufacturing sectors with both traditional sectors, such as food and drink, and modern sectors such as medical devices and pharma, making significant investments during the year. Investment in aeroplane purchases was also very strong during the year and was up 17% over the January-to-September period. This component of investment remains highly volatile, however, and it is difficult to forecast trends.

The construction sector continues to edge towards stabilisation but house building recorded another very difficult year in 2012. The number of new houses built is estimated at just 8,500, based on Department of Environment, Community and Local Government data for the first 11 months of the year. This represents a drop of over 90% on the 2006 peak completions level. It is clear that the housing sector is effectively at a standstill with the exception of a relatively small number of one-off builds. A number of indicators during the past year, however, suggest that house prices have now stabilised and market reports suggest that housing supply remains tight in the Dublin area in particular. While it is likely to take a number of years of improved housing transactions before construction activity increases, further declines are unlikely.

Activity in the home improvements sector was weaker than expected during 2012 but official statistics for the sector remain notoriously difficult to compile. The national accounts data suggest that home improvement works were down 9% over the January-to-September period and recorded a particularly weak Q2 and Q3. Non-housing construction and building activity recorded significant stabilisation during the year and was down just 1.5% during the first three quarters of the year. This compared to an annual decline of 22% in 2011. The improved outlook for public-private partnership (PPP) projects should give a boost to the infrastructure sector over the coming years and we expect the improved outlook to gain traction during 2013.

Overall, the investment sector is likely to contribute to economic growth in 2013. We expect the building and construction sector to be largely flat with some modest

improvement in non-housing-related construction. The growth in investment in machinery and equipment by business is likely to be maintained as the sector gears up for economic recovery and credit conditions ease, including the cost of borrowing for the utility sector. We are forecasting an overall increase of 6% in the investment sector during 2013.

Prices and wages

Subdued consumer demand continues to weigh on price pressures in the Irish economy. In 2012 the consumer price index (CPI) recorded an annual average increase of just 1.7%. Housing costs fell sharply as a result of further reductions in mortgage interest rates, while prices for most consumer goods remained fairly flat. Energy and insurance were the main drivers of inflation during the year and the CPI excluding energy was unchanged in the most recent 12-month period. Despite the fact that consumer prices have now increased over the past two years, the price level in the economy at the end of 2012 remained about 2.5% below where it was at the start of the global economic crisis in autumn 2008. This indicates that the change in the purchasing power of many consumers, particularly those on fixed incomes, did not fall as much as is generally perceived.

The monthly observations of the change in the CPI fell quite sharply during the year from 2.2% in January to 0.8% in November. The further cuts in the ECB base rate had a direct impact on the tracker mortgage component of housing costs in the CPI while some reductions were also delivered to variable rate mortgage holders. Energy inflation remained high through most of the year as a combination of the weaker euro and some modest global price rises resulted in higher fuel prices for Irish consumers. The price of a litre of petrol increased from €1.55 in January to a peak of €1.70 in September. A stronger euro in the latter part of the year was largely responsible for the price dipping below €1.60 in December. Irish motorists also received a somewhat unexpected boost of no additional fuel taxes in Budget 2013. A combination of global energy trends, including the continued growth in shale gas output, exchange rates and the economic outlook will be the key determinants of energy prices this year. In the short term, the renewed strength of the euro is likely to bring price relief for energy and other imported consumer products.

Despite the sharp rise in global commodity prices and the exceptionally poor weather which affected crop yields in Ireland and the UK, average food prices on the supermarket

Inflation forecasts

Annual % change	2011	2012	2013	2014
Consumer price index	2.6	1.7	1.5	1.9

Table 3

shelves remained fairly static. Products most exposed to the commodity price fluctuations and weather factors such as cereals and vegetables recorded some sharp price rises but these were somewhat offset by reductions in prices for many processed foods. Cereal prices jumped 7% over the past 12 months, while the price of potatoes was particularly influenced by the poor weather in 2012 and is up over 20%. While the commodity price increases of last year remain in the supply chain, the recent appreciation of the euro will help offset some of this pressure.

Rising insurance costs will remain a significant price pressure for Irish consumers in 2013 and further sharp increases are expected for health insurance, in particular. Overall though, a combination of the stronger euro and a fragile domestic economy is likely to result in modest price growth for consumers this year. We expect the CPI to increase by an average of 1.5% this year and estimate inflation of less than 2% in 2014. The price level by the end of this year is therefore likely to remain below where it was five years ago.

IBEC's most recent survey on employer pay intentions for 2013 shows that the majority of companies plan to freeze basic rates for another year. In our end-2012 survey, almost six out of ten companies indicated that their pay rates would remain unchanged during 2013. This reflects the on-going need for competitiveness improvements in some sectors of the economy and the difficult trading conditions which many exporters and domestic firms are facing. The percentage of companies planning a pay increase in 2013 (39%) is somewhat higher than in recent years (30% in 2011). Those companies planning to award pay increases this year reported an average expected increase of 2%. The average pay rate change across all private sector employers in 2013 is estimated at 0.6%, marginally higher than that recorded in 2012.

While Ireland has regained substantial labour cost competitiveness over recent years, resulting in a reduction in unit labour costs of about 15%, labour cost levels remain relatively high in an EU context. Ireland now has the ninth highest labour costs in the EU compared to fifth two years ago and the average cost of labour remains 16% above the eurozone average. Further improvements relative to our trading partners are therefore required in order to fully claw back the lost competitiveness of the pre-crisis years.

Labour market

The CSO's Quarterly National Household Survey for the third quarter of 2012 shows an annual decline in employment of 0.2%, the slowest since job losses commenced in 2008. Although the individual quarters show considerable fluctuation - the annual change in Q1 was -0.9%, but accelerated to -1.2% in Q2 - the overall trend points towards a stabilising labour market. The average fall in employment for the first three quarters of 2012 was about a third of that recorded in the same period of 2011. A similar trend of slowing pace of decline is evident in the seasonally adjusted

series; the quarter-on-quarter fall of 0.3% in Q3 is marginally improved on the previous two quarters.

The Irish labour market is at present characterised by considerable churn, a feature concealed by the headline data. Industry continues to lose jobs, now broadly balanced between construction and other industrial activity. The services sector was very close to stability during the first three quarters of 2012, and gained nearly 9,000 jobs on an annual basis in the third quarter.

Of the detailed categories, hospitality is one of the bright spots and employment in the sector increased by 4.2% in the first three quarters of the year. The survey information coming in from the tourism bodies is fairly strong and with the Gathering providing an additional boost, the sector should add further jobs during 2013. A recovery in the catch-all category other services, which includes arts, entertainment and sports, is indicative of an uptick in the domestic economy; employment in the sector was up 3.4% in the first three quarters.

Given the strong performance of services exports, it is not surprising that information and communication employment recorded growth, up 4.5% in the first three quarters. Professional and scientific activities recorded a weaker outturn at the end of 2011, a base effect which carried over into 2012. However, the latest quarterly data point to an improvement in the trend. The FDI pipeline is particularly strong for services companies, so these two sectors should continue to generate jobs in the coming years. Financial services, insurance and real estate are all combined together in the CSO's classification. Although restructuring of the banking sector is a drag on domestic financial sector employment, this has been broadly outweighed by growth in international activity and employment in the sector has remained fairly stable for the past three years. A rebound in the housing market would also result in some job gains in real estate.

From the CSO's data we can estimate that the private sector added about 20,000 employees in Q3 2012 when compared with 2011, while public sector employment was down 16,000. The staff reductions in the public sector will ease over

Employment

000s annual average	2011	2012	2013	2014
Agriculture	83	83	84	84
Industry	348	337	332	332
Services	1,418	1,415	1,426	1,442
Total	1,849	1,835	1,842	1,859
Unemployed	317	322	315	309
Unemployment (%)	14.6	14.9	14.6	14.2
Labour force	2,166	2,157	2,157	2,168

Table 4

the next two years to about 5,000 per annum. Overall, we expect that 2012 will have been the last year of falling employment, with a return to marginal growth of 0.4% in 2013. Unemployment likewise will stabilise, but will remain high over the forecast period.

Exports and exchange rates

Ireland recorded another record year of exports in 2012, despite difficult trading conditions in many of our main markets. There was a sharp contrast in the performance of goods and services exports, however. Goods exports had a difficult 2012 due to a combination of a weak performance from the large pharma sector and the overall anaemic demand for Irish goods in Europe. Over the January-to-September period the volume of goods exports was down 2.5% annually and in the third quarter was 3.4% below the corresponding period last year. The most recent monthly trade data for November, however, showed that the value of exports recorded a strong performance in that month and offset much of the losses experienced in previous months. The monthly trade data, which are not always the most accurate guide for exports recorded in the national accounts, show that the total value of goods exports increased by 1.3% in the January-to-November period. The value of chemical and related goods products fell by 3.5% in November, compared to a 15% drop in September. While the patent cliff issue is clearly providing a significant headwind for Irish goods exports, it still remains to be seen precisely how severe this impact will be. The exports of food and the other large manufactured goods categories held up reasonably well during the year.

The internationally traded services sector performed exceptionally well last year. Services exports increased by close to 10% as a result of a strong performance by the high-tech foreign-owned multinational sector, in particular. Services exports in the January-to-September period increased by 9.4% and the performance in the third quarter of the year remained very strong with annual growth of almost 8%. We expect that total goods and services exports increased by about 3% in 2012 and forecast growth of 4% in 2013 as goods exporters in particular benefit from a eurozone recovery in the second half of the year.

One of the major challenges facing Irish exporters in 2013 could be a stronger euro. During 2012 a significant silver lining in the eurozone crisis was that the annual average value of the euro lost 7% against sterling and 9% against the dollar. Between early October 2012 and the middle of January 2013, the euro has gained about 4.5% against both the dollar and sterling. Recent gains have been largely due to an easing of the eurozone crisis and signals from the ECB that interest rates may now be at the bottom of the cycle. The market had been pricing in a further rate reduction and renewed optimism from the ECB on the eurozone crisis led to a fairly sharp rise in the euro in the early weeks of 2013. Many risks remain in Europe's economy, however, and some of the recent gains could well be given up as the year progresses.

Public finances

Ireland will have fully met its 2012 deficit target under the EU-IMF loan agreement. Although a final figure won't be available until later in the year, the deficit is likely to have come in at under 8%, less than the target of 8.6%. Adjusting for some one-off timing and reclassification effects, tax revenues in 2012 were up more than 5% on 2011, and were marginally ahead of the Department of Finance forecast. Expenditure was slightly ahead of target, mainly because of a shortfall in PRSI receipts (which count as an offset in social protection expenditure) and some spending overruns in health and social protection. Most of the government departments were at or below budget, and lower-than-expected capital spend also helped contain overall voted expenditure.

In terms of the fiscal trend, 2012 was somewhat mixed. The year got off to a good start, with tax returns growing above expectations across most of the important categories. The pace of increase slowed from the middle of the year, but recovered in December. Income tax was marginally below target, but nonetheless up nearly 8% relative to 2011 on a like-for-like basis. VAT receipts were up 4%, owing to the increase in the VAT rate to 23%. On the spending side, it appears that the new expenditure control frameworks are working across most of the public sector, with the exception of health and social protection. However, it should also be recognised that these two departments, social protection in particular, also have faced the greatest, and most unpredictable, increases in demand for services.

Despite the good performance to date, meeting the 3% deficit target by 2015 is not without its challenges. It requires that Government keeps to the fiscal plan even once the troika has departed for the final time; however, bond market vigilance (in the event of a successful re-entry) and the new European fiscal frameworks should provide ample motivation to see through the consolidation process. Finally, a sustained rebound in growth is also necessary.

Exchange rates - monthly averages

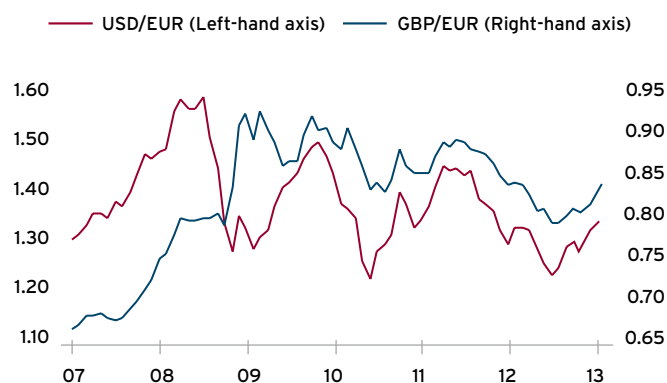


Figure 3

International economies

Uncertainty surrounding the US fiscal cliff deal and the prospect of continued economic recession in Europe suggest concerns about the performance of the world economy will persist into early 2013. In December the OECD forecast recession in the eurozone for 2013 with GDP contracting 0.1%. This is supplemented by forecasts of slowing growth in the US and Japan and anaemic growth in the OECD as a whole. Lack of coherent policy responses to the crisis, household deleveraging, continued fiscal consolidation in major economies and high unemployment will result in poor consumer sentiment and low consumer demand worldwide.

United States

Moderate GDP growth of 2% is predicted in the US in 2013. Much of the immediate prospects for the US economy rely on future negotiations around the political and economic issues which saw tensions elevated in Washington over the Christmas period. The Congressional Budget Office announced that it expects growth in 2013 to be higher under the current partial fiscal cliff deal than the counterfactual scenario, but lower in the longer term as an additional \$4.6 trillion deficit will be accumulated between now and 2022. However, these deficits are unlikely to come to pass as it is probable that another standoff on the subject will emerge in February or March when many of the provisions of the current deal expire. On a more positive note, US and EU leaders seem to be inching closer to a trade deal between the two economic blocks, a move which could potentially be a major boost for growth on both sides of the Atlantic.

Eurozone

December's Economic Sentiment Indicator (ESI) for the eurozone improved by 1.3 points, to 87.0. The figures, however, reveal a 6.5 point drop from the start of 2012, underlining the fragile state of confidence in Europe's economy. Weak sentiment is also reflected in a predicted 0.6% drop in real domestic demand in the eurozone as a whole. This year small rises in domestic demand in France and Germany will be offset by falling domestic demand in the periphery, adding credence to the notion of a two-speed recovery in Europe. However, 2013 may be an inflection point of sorts with domestic demand predicted to return to growth in 2014. This again will depend much on how policymakers react to the crisis as the year progresses and how household debt and confidence issues are resolved, particularly in the periphery. It is not all positive news for core countries either. In December Germany's Bundesbank cut its growth projections for 2013 to 0.4% from the 1.6% it had predicted in June and even suggested that Germany may fall into recession in the early part of 2013.

United Kingdom

The OECD has forecast that the UK will emerge from recession in 2013. However, growth will be relatively disappointing at only 0.9% owing to weak exports and flagging consumer demand. Given that the eurozone accounts for almost half of all UK goods exports, developments in the bloc will be an important determinant of the UK's economic performance this year. The three months to October saw exports to EU countries down 7.2% on the same period a year earlier, but sales to the rest of the world up 4.3%. On the domestic front, December's CIPS/Markit report on the services sector reported a fall in business activity figure from 50.2 to 48.9, the fourth consecutive monthly decline. Firms suggested that economic uncertainty, budgetary tightening and low credit growth constrained consumer spending toward the end of the year. Additionally, real pay has now dropped 8% since 2008 due to persistent inflation and stagnant nominal wage growth.

Real GDP growth - selected countries

Annual % change	2012	2013	2014
Australia	3.7	3.0	3.2
France	0.2	0.3	1.3
Germany	0.9	0.6	1.9
Italy	-2.2	-1.0	0.6
Japan	1.6	0.7	0.8
United Kingdom	-0.1	0.9	1.6
United States	2.2	2.0	2.8
Russia	3.4	3.8	4.1
Eurozone	-0.4	-0.1	1.3
Total OECD	1.4	1.4	2.3

Table 5

Domestic demand growth - selected countries

Annual % change	2012	2013	2014
France	-0.4	0.3	1.2
Germany	0.0	1.1	2.6
Italy	-4.5	-1.9	0.0
Japan	2.4	0.8	0.5
Spain	-3.9	-4.0	-0.9
United Kingdom	0.8	1.0	1.1
United States	2.2	2.1	3.0
Eurozone	-1.9	-0.6	1.0
Total OECD	1.0	1.3	2.2

Table 6

Source: OECD Economic Outlook December 2012.



Further information:

Fergal O'Brien, chief economist
Tel: 01 - 605 1544
Email: fergal.obrien@ibec.ie

Reetta Suonperä, senior economist
Tel: 01 - 605 1603
Email: reetta.suonpera@ibec.ie

Website: www.ibec.ie/economics
www.ibec.ie/drivingirelandsrecovery
Twitter: @ibec_econ