

## BUDGET 2010: Economic Perspective

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### Executive Summary

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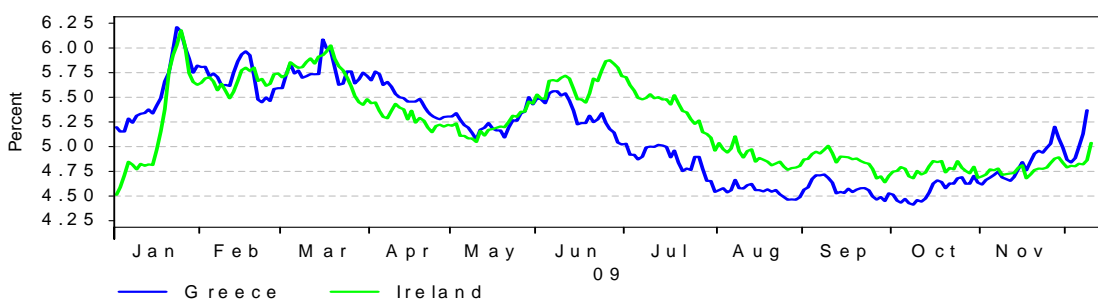
- Following today's fiscal measures, the Government is aiming for a post-Budget General Government Deficit of €18,720m or -11.6% of GDP in 2010 compared with the opening White Paper figure of €21.8bn (-13.5% of GDP) as published on Saturday. Meanwhile, the Exchequer budget deficit for next year is projected at €18,780m as against an opening deficit of €21,938m, pointing to a saving from today's fiscal changes of €3,158m.

- We have felt all along that the main focus of today's Budget had to be on the spending side, with little scope for more significant tax increases at this juncture. The Government has duly obliged with cuts in the public sector wage bill, social welfare outlays, and savings on capital expenditure. However, that is not to say that further tax increases won't be needed over the next few years to get the public finances back into balance. Indeed, the Budget signaled that a property tax and water charges are on the way in the foreseeable future.

- It is hard to see how the Government can seriously address the public finances problem without a large reduction in the level of spending, and unfortunately for those concerned, the expenditure issue cannot be tackled without cutting public sector pay and social welfare outlays. Before today's budgetary changes, social welfare spending made up the largest single block of Exchequer gross voted current expenditure, accounting for 36% of the total, while the Exchequer pay and pensions bill accounted for a further 35%, and other programme spending (not including pay) taking up the remaining 29%. And the reality is that more expenditure cuts will be required over the next few years. Although large expenditure reductions are not ideal from Ireland's growth prospects point of view (2.5% of GDP being taken out of the economy), it is very much a case of the "lesser of two evils".

- Stimulus measures related to the motor and drinks industry and the reversal of last year's half point hike in the standard rate of VAT should boost personal spending and GDP in 2010.

Irish & Greek 10-Year Government Bond Yields



Source: Reuters EcoWin

- Debt servicing costs are on the rise, with the figure forecast to increase to €4.6bn in 2010, from €2.7bn in 2009. With interest-rate charges rising, it is therefore imperative that Ireland sends the right signal to financial markets. The bond market vigilantes appear to be back on the prowl in Europe as evidenced by yesterday's latest credit downgrade, for Greece. While Ireland still remains vulnerable to more downgrades itself, today's Budget should go some way towards appeasing bond investors, and with stronger underlying economic fundamentals than many of the other Euroland countries, the spread of Irish bonds versus German bunds should narrow in over the next twelve months. Furthermore, by this time next year, Irish bond yields should be lower in our view than the likes of Italy and Portugal.

- **The Government expects the Irish economy to contract by 1.25% in GDP terms next year, but we now think the fall will be less than 1.0% on the assumption of a solid and sustained rebound in the global economy, which will boost Irish exports. A stronger economic performance than what the Department of Finance is factoring in should see a lower fiscal deficit than outlined in the Budget. Overall, we think today's Budget is another positive step in Ireland's recovery process.**

## Post-Budget Comment:

As he said he would, the Minister for Finance Brian Lenihan stood up in the Dail today and delivered a Budget aimed at saving €4bn, in the main through expenditure cuts. And he has to be admired for that because the pressure must have been immense not only from the trade unions but within the Government itself to take the 'soft' option and push more taxes on to already hard-pressed consumers. **Although the Government and Mr Lenihan personally are likely to face the wrath of the public sector trade unions after the announcement of a 5-8% reduction in the pay bill of public servants earning up to €125,000 and greater cuts on earnings after that, it was the right thing to do in the current circumstances in our view.** Evidence from international organisations, such as the IMF, European Commission and the OECD, suggests that consolidation driven by cuts in expenditure is more successful in reducing budget deficits than consolidation based on tax increases. But that is not to say we are against further tax hikes per se, just not at this point in time when the economy and the consumer remain in a fragile state. Indeed, the Minister indicated that a property tax for all homeowners and water charges will be introduced before 2014, the deadline for Ireland's public finances to be restored to order.

- **Government took the right options**

The vast majority of Central Fund spending relates to the cost of paying interest on servicing the National Debt. With the volume of debt rising rapidly, the cost of servicing the debt is also rising significantly and for the foreseeable future will absorb an ever increasing amount of resources. A common measure of debt servicing costs is the ratio of interest paid to tax revenue collected. The cost of the interest element in servicing the country's debt represented about 3.5% of tax revenue in 2007, having been declining for more than a decade. In 2009, it is estimated that debt interest at €2.7bn will account for almost 8.5% of tax revenue, rising to €4.6bn or 14.8% of tax revenue next year. The bottom line is that Ireland is now in a position where it needs to borrow more to fund a larger budgetary deficit, while paying higher costs for this borrowing. This means that ever increasing proportions of the country's tax revenues will be needed to service the national debt, possibly rising to as high as 20% by 2013/2014. However, as the NTMA has pointed out, while the interest burden will increase substantially over the next few years, it will be no greater than the levels experienced in the mid-1990s. That said, Ireland still needs to keep its interest costs down as much as possible. **To put it bluntly, the more the country spends on servicing the National Debt, the less money it will have to spend on the areas that really matter to the public, like health and education.** The NTMA has been successful in 2009 in meeting its €30bn funding target through a combination of syndicated bond issues and regular monthly auctions, but it has had to pay a significant premium over benchmark German government bonds to attract overseas investors. **It is essential that this premium is kept to a minimum, and hopefully today's Budget will help in that regard.**

- **debt servicing costs taking up an ever increasing portion of tax revenue**

In the recent *Pre-Budget Outlook* the Minister for Finance set out three preconditions for a return to sustainable economic growth: (1) Restoring order to the public finances over the coming years; (ii) Regaining international competitiveness to copper-fasten a return to solid employment growth; and (iii) A properly functioning banking system. Of course, this latter aim is the most important because if credit does not freely flow back into the economy, particularly to small to medium-sized enterprises and businesses it is hard to see job creation picking up and the economy returning to sustainable growth. However, in our view the Government is doing all it can to stabilise the banking system. Although the main focus of today's Budget was on cutting public spending, there were some initiatives aimed at boosting personal spending. The cut in excise duty on alcohol, the introduction of a car 'scrappage' scheme, and the reversal of last year's half percentage point hike in the standard rate of VAT should boost overall consumer expenditure in 2010 despite the likely negative impact on spending by public servants as a result of further wage reductions. However, we find the move to cut excise duty on alcohol as somewhat strange. Strong lobbying from the Vintners Association was probably a factor, but clearly the move was mainly aimed at counteracting people in the Republic going to Northern Ireland to buy their Christmas drink. Still, purely on health grounds it is hard to understand. On the other hand, the car 'scrappage' scheme is a positive development in our opinion given that new car sales are such a big part of retail spending. The critics would argue that this money will go out of the country as Ireland imports all of its cars, but we would counter that by saying that the jobs lost in the motor trade from the slump in sales are mainly Irish ones, and psychologically the lift given to consumers will be huge. **Taking everything into account, we think these stimulus measures are extremely positive.**

- **Budget should help to meet Government's goals**

## Irish Economy:

The Irish economy has faced extremely difficult conditions over the past couple of years and is headed for the second year of contraction in 2009. However, following an exceptionally weak first half of the year, there are clear signs of a moderation in the rate of decline in activity in the second half of the year both internationally and domestically. Recent Irish indicators suggest that the worst of the downturn is over, but how soon the economy recovers remains open to debate. Interestingly, though, the median forecast in the latest *Reuters* Irish economists' poll is for modest quarter-on-quarter growth in GDP in the third quarter, which technically would mean that the recession is over. While today's spending cuts are contractionary, we think the stimulus measures announced will boost the Irish economy overall next year. Following the Budget, **we are now looking for an average fall in real GDP of 0.8% next year, a slight improvement on the 1.0% GDP contraction forecast in our most recent Quarterly Economic Outlook. It is also worth noting that in the latest European Commission economic forecasts, Ireland is along with Slovakia predicted to have the highest growth of any of the Euroland countries in 2011.**

- **momentum in the economy is upward**

## Bloxham Main Economic Forecasts

%	2008	2009 (f)	2010 (f)	2011 (f)
<b>GDP</b>	<b>-3.0</b>	<b>-7.2</b>	<b>-0.8</b>	<b>3.0</b>
Consumer Spending	-1.0	-7.3	-1.8	2.2
Fixed Investment	-15.5	-29.5	-19.0	3.0
Government Spending	2.6	-0.2	-2.8	0
Exports	-1.0	-2.4	0.5	3.5
Imports	-2.1	-9.7	-3.0	1.5
Consumer Prices	4.1	-4.5	-0.5	2.5
Unemployment Rate	6.3	11.7	12.8	11.7

The decline in consumer expenditure since the beginning of 2008 has been driven by a combination of a fall in disposable income arising from a drop in employment income, and a rise in incomes taxes and levies. In addition, the erosion of personal wealth due to declining asset prices, together with increased uncertainty as reflected in the indicators of consumer confidence, has prompted an increase in precautionary saving by households. However, consumer confidence hit an 18-month high in October before dipping slightly in November and it will be interesting to see if this greater optimism feeds through into increased personal spending in the coming months. Although today's cut in public sector wages and social welfare entitlements will clearly weigh negatively on consumer expenditure in the coming months as will the introduction of a carbon tax, the positive stimulus measures as regards alcohol and cars may well more than offset this. Assuming new car sales take off, then the boost to consumer spending both in real terms and psychological terms should be significant. Consumers will also benefit from the fact that there were no more income levies introduced and the VAT changes in Ireland/UK should also help to boost spending in the Republic. Following the latest Budget measures, **we are now forecasting an overall decline in personal spending next year of 1.8% as against a projected decline of 7.3% in 2009.**

- **stimulus measures to boost personal spending**

The construction sector has been the biggest loser from the recession, and while there are some initiatives in Budget 2010 that should help the building industry, there is not enough here to warrant optimism for next year. All in all, the building sector will continue to be the biggest drag on GDP in 2010, with civil engineering the only real area that should see decent activity despite the reduction in capital spending. Both residential housing/commercial are likely to remain subdued for some time to come. Activity in the residential sector has slowed this year, although not yet to the extent necessary to reduce the size of the current excess in supply, an important factor in re-establishing equilibrium in the market. **Available house-building statistics and forward-looking indicators suggest that there will be around 25,000 new house completions this year, less than half the total of 2008, as developers finish existing projects. As regards 2010, house completions are predicted to amount to 15,000, with one-off housing accounting for an increasing proportion of the total as commencements on new schemed housing and apartments decelerate rapidly.** With demand likely to remain muted for some time to come, output may stay at around this level for a number of years before the excess supply of housing is cleared. Meanwhile, the situation on the commercial front is not much better. Although there is anecdotal evidence of less speculative building than in the residential sector, activity remains depressed, as curtailed bank lending and a lack of clarity regarding values impacts the market. Falling capital values and rental income and credit constraints are likely to see significant fall-offs in commercial investment both this year and next.

- **little reason to be optimistic for the building industry**

## Irish Economy:

The trend in Irish exports in the year to date has been better than expected. Of course, most of the demand has come on the pharmaceuticals side, with indigenous exports suffering as a result of the adverse trading conditions in Britain. Indeed, the Irish Exporters Association has been calling for export stimulus packages to help indigenous Irish companies. Two-thirds of all indigenous exports go to the UK, with Britain taking 43% of our food exports. Despite indigenous exporters going through difficult times, the Government resisted the call to introduce stimulus aid in today's Budget. **The bottom line is that exports will be the main driver of the economic recovery when it comes, and we wouldn't be at all surprised to see the sector performing better overall than generally expected in 2010.** However, a lot will depend on what happens to the UK economy and sterling in particular. It is hard to predict with too much confidence what direction sterling will take over the next twelve months, with a lot depending on how Bank of England monetary policy plays out. However, as the UK economy recovers, we believe the pound will appreciate versus the euro. Furthermore, prospects of high profile merger and acquisition activity in the British corporate spectrum, along with rising inflation, and increased UK asset purchases by Asian investors should all lend support to the pound. **We continue to look for sterling to appreciate to the 0.80 level against the euro by the end of next year, offering some relief to hard-hit indigenous exporters in the process.**

- **exports the key to Irish recovery**

## Employment & Unemployment (Annual Average)

(000s)	2008	2009 (f)	2010 (f)	2011 (f)
Industry	520	440	400	410
Services	1,465	1,400	1,375	1,415
Agriculture	115	100	100	100
<b>Total</b>	<b>2,100</b>	<b>1,940</b>	<b>1,875</b>	<b>1,925</b>
Unemployment (LFS basis)	141	258	275	255
Labour Force	2,241	2,198	2,150	2,180
Unemployment Rate	6.3	11.7	12.8	11.7

Getting people back to work and reducing the numbers of unemployed is a key aim of the Government. Whether today's Budget has done enough on labour market initiatives is debatable. However, as we mentioned already, 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 unemployment rate next year of 13.2%, though we think this is too high. On the surface the Live Register numbers over the past three months have been very encouraging and would tend to suggest that the jobless rate has peaked. However, anecdotal evidence points to increased emigration and higher numbers returning to education being the main factors behind the underlying improvement in the Live Register data rather than more jobs coming available. Another key element in the improvement in the numbers on the Live Register are the Government schemes announced to support employment. There is no doubt that these schemes are distorting the Live Register figures, but they at least buy the Government some time. It is also worth noting that according to the latest figures from the Department of Enterprise, Trade and Employment, new redundancies notified last month were below claims being paid out for the first time in fifteen months, another encouraging sign. **As things currently stand, there are now question marks over whether the jobless rate will actually break the 13.0% level, and even if it does, it is hard to see it going much higher than 13.5%, a far cry from the pessimistic forecasts of a 17.0% jobless rate which was being suggested by some economic analysts earlier this year.**

- **unemployment unlikely to be as high as officially projected**

Today's excise duty/VAT changes and introduction of a carbon tax will impact on the CPI next year. With the recovery in the global economy gaining momentum and conditions in many financial markets getting back to normal, the threat of a prolonged bout of world deflation would seem to have receded. But, the main problem is that the vast amount of economic slack that has built up during the recession, will take years to work off, so in our view deflation still looks like a bigger risk than runaway inflation in the short-term. **The headline CPI is forecast to be down 4.5% on average this year as against an average increase of 4.1% in 2008. Ireland is projected to post another overall fall in consumer prices next year, though the extent of the decline won't be anywhere near as high as in 2009.**

- **deflation still a bigger concern than inflation**

## NTMA Funding:

The NTMA raised €33.8bn in the bond markets this year, with further funding of €1.4bn having also been raised in the small or retail debt market. If one allows for an overall funding requirement for 2009 of €30bn (€25bn budget deficit and €5bn bond redemption), the Agency has in effect pre-funded €5bn of next year's requirement. Debt redemptions amount to less than €800m in 2010, so it is really only the budget deficit (€19bn) that has to be funded. The bottom line is that Ireland is in a reasonably strong funding position going into next year, and shouldn't have too much difficulty in raising the money it needs. The NTMA has been very successful in raising funds this year, and should be more than happy with the job it has done in 2009. Indeed, Michael Somers can retire as NTMA chief in the knowledge that he has made a significant contribution to Ireland raising money on the bond markets to meet its spending requirements, in what has been a very difficult year. Although the NTMA has been successful in raising the government's shortfall between spending and tax revenue in 2009, we as a nation shouldn't become complacent and believe that the answer to all our problems is to keep on borrowing. Quite simply, the huge levels of debt we are building up are unsustainable in the long-run. As stated earlier, Ireland is now in a position where it needs to borrow more to fund a larger budgetary deficit, while paying higher costs for this borrowing. This means that ever increasing proportions of the country's tax revenues will be needed to service the national debt. **Although the contents of today's Budget were well sign-posted in advance, we think the bond markets will react favourably to the fiscal measures announced, and would expect yield spreads over Germany to narrow in over the coming months. Meanwhile, the NTMA will also be involved in the issue of a new National Solidarity Bond aimed at small investors who want to lend money to the State to fund its capital investment programme.**

- **NTMA in comfortable funding position for next year**

### Irish minus German 10-Year Bond Yield %



Source: Reuters EcoWin

The bond market vigilantes appear to be back on the prowl in Europe. A first frisson of market anxiety about sovereign debt risk in peripheral Eurozone countries early in the financial crisis faded after Germany made it clear that any Eurozone state which got into serious payments difficulties could count on help. But now a second wave of concern is starting to wash over Europe as evidenced by yesterday's latest credit downgrade, for Greece. Investors' love affair with riskier Eurozone government bonds has cooled and with the European Central Bank looking to unwind its liquidity support, rekindling that relationship will not be easy. With less of the cheap central bank money which has boosted many asset classes around next year, economic fundamentals will become the key guide to which bonds to buy, especially as debt supply is set to rise from already elevated levels in 2009. Recently, ECB Council member Axel Weber said the central bank and government support has reached its limit and exit strategies cannot be deferred into the never-never. For many of the weaker members of the Eurozone, this is not good news as it means their funding costs may well rise because investors will demand higher yields on their bonds to compensate for the perceived greater risk. While Ireland still remains vulnerable to more downgrades itself, today's Budget should go some way towards appeasing bond investors, and with stronger underlying economic fundamentals than many of the other Eurozone countries, the premium paid for investing in Irish bonds versus benchmark German bunds should decrease. Although all of the talk regarding Ireland's economic collapse appears centred on the building sector/property boom, people tend to forget that the 'Celtic Tiger' era was in its initial stages built by a robust export sector and low corporate tax regime, and that is still in place now. **Indeed, our stronger fundamentals should by this time next year see Irish bond yields lower than the likes of Italy and Portugal.**

- **bond market vigilantes back in force**

## Public Finances:

Following today's fiscal measures, the Government is aiming for a post-Budget General Government Deficit of €18,720m or -11.6% of GDP in 2010 compared with the opening White Paper figure of €21.8bn (-13.5% of GDP) as published on Saturday. Meanwhile, the Exchequer budget deficit for next year is projected at €18,780m as against an opening deficit of €21,938m, pointing to a saving from today's fiscal changes of €3,158m. As he promised, tax changes were kept to a minimum this time round, with the main emphasis on reducing expenditure, particularly in regard to public sector pay and social welfare spending. **Although the trade union movement was keen to see expenditure reductions kept to a minimum, and further tax hikes introduced, the Minister resisted their calls and rightly so in our opinion. To put it bluntly, the economy cannot afford more income tax increases at this juncture, and had the Minister decided to head down that road, he would have put the economy backwards instead of forwards in 2010.** According to a recent briefing document, the Department of Finance believes that the higher marginal tax rates are increased, the more likely Ireland will lose high-income earners. The consequence of losing one worker from the top 1% of income earners means an additional 132 workers would have to be taken into the tax net. It must be remembered that the highest income earners tend to be highly skilled and also highly mobile, and therefore they are likely to move abroad if severe levels of taxation are imposed on them. Given the mobility of such income earners it is imprudent to rely too heavily on them as revenue generators. **Emigration of a very small number of such income earners would have a disastrous effect on the income tax base that is desperately required to fund public services.** We couldn't agree more with the Department, supporting the view that there was limited scope to hit domiciled higher-income earners further at this juncture.

- **General Government Deficit target set at 11.6% of GDP in 2010**

## Summary Budget 2009/10 €m

	2009 (e) Out-turn	2010 Pre-Budget Opening Position	2010 Post-Budget forecast (f)
Central Fund	5,152	7,132	6,932
Supply Services	40,368	43,068	40,191
<b>Total Current Spending</b>	<b>45,520</b>	<b>50,520</b>	<b>47,123</b>
Tax Revenue	32,570	31,930	31,050
Non-Tax Revenue	834	2,355	2,355
<b>Total Revenue</b>	<b>33,404</b>	<b>34,285</b>	<b>33,405</b>
<b>Current Budget Deficit</b>	<b>-12,116</b>	<b>-15,915</b>	<b>-13,718</b>
<b>Capital Deficit</b>	<b>-13,145</b>	<b>-6,023</b>	<b>-5,062</b>
<b>Exchequer Balance</b>	<b>-25,261</b>	<b>-21,938</b>	<b>-18,780</b>
(% of GDP)	-15.4	-13.6	-11.6
<b>General Government Balance</b>	<b>-19,300</b>	<b>-21,800</b>	<b>-18,720</b>
(% of GDP)	-11.8	-13.5	-11.6

After the significant Budget changes on the current spending side, net supply services are now forecast to decrease by 0.4% in nominal terms next year. Meanwhile, capital spending is also being hit, with the projected deficit for 2010 in this part of budgetary expenditure set to be less than half what it was in 2009. Given the reduction in building costs, the Government was able to reduce the capital spending budget in nominal terms without it having the full effect on the volume of projects that need to be completed. **Although a lot of uncertainty remains about the likely performance of the economy in 2010, we are optimistic that a solid and sustainable global recovery can be achieved next year, boosting Ireland's economic prospects in the process. As such, we think the overall budget deficit in 2010 may not be as high as predicted by the Government in today's Budget, therefore easing the further pain that will have to be delivered in Budget 2011.**

- **current net day to day spending set to be 0.4% lower in 2010**

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