

## Irish economy/euro

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Following a record contraction in national output last year, the latest indications are that the Irish economy will be out of recession sooner than most analysts thought, boosted in the main by the external trade sector, and the fall in the euro against both the dollar and sterling.

Exchange rates have fluctuated significantly during the global financial crisis, reflecting turbulence in the markets. The euro had been exceptionally strong against both the greenback and sterling, but has weakened sharply this year in the wake of the Greek debt crisis. So far in 2010, the euro has fallen 16.5% versus the dollar and almost 7% versus sterling.

There has been a close relationship between annual changes in Irish export growth and the exchange rate in the past, suggesting that the weaker euro could provide exporters with a significant lift. What's more, deflation and rising productivity suggest that the real exchange rate is likely to fall even more sharply than the nominal exchange rate this year.

Ireland's economy is one of the most open in the world, meaning it will benefit more than most from the weak euro. Irish exports to non-Eurozone economies account for over 50% of GDP, compared to around 20% to 25% in Germany and the other northern economies and just 10% or so in Southern Europe. In addition, it has a high exposure to the US economy (exports to the US are equal to nearly 20% of GDP), which looks set to perform especially well over the next year or two. The upshot is that if the euro continues to weaken and head down towards the \$1.10 level over the coming months, which many analysts are forecasting, and the US recovery continues, then Ireland could soon begin expanding again despite its severe domestic problems.

Whatever about the dollar, the euro/sterling exchange rate is particularly important for Ireland's 'indigenous' exporters (food, drink, tourism) given that over half of these goods and services go to the UK. We have consistently said that we thought the pound would strengthen to the 0.80 level against the euro by year-end, and we have no reason to change that view at this juncture all things considered. In fact, if the euro were to fall to \$1.10 versus the dollar, then sterling could possibly appreciate to the 0.75-0.80 level against the single currency.

The recovery in external demand seems set to be complemented by the improving competitiveness of Irish exporters—the lowering of the cost base arising from the decline in wages and prices across the economy is expected to place Ireland in a very favourable position to benefit from the recovery in trade flows. However, the expected rebound in exports may be held back somewhat by sector-specific effects. For instance, the chemicals sector, which accounts for around half of overall Irish merchandise exports, is expected to face somewhat limited upside potential amid the recovery in world trade in view of the slightly acyclical nature of demand for its output.

***Still, the strongest element of the Irish economy going forward is expected to be the traded sector. Following a volume decline of 2.3% in exports of goods and services in 2009, a volume increase of 2.3% is projected for 2010, rising to 4.3% in 2011, according to the latest DKM survey of Irish economists. But a weakening euro means the risks to these forecasts are tilted to the upside. The weak euro could add up to half a percentage point on to Irish GDP growth this year, pushing the full year projection for 2010 into positive territory from the slight negative median forecast of up to 0.5% contraction being factored in by the market at the moment.***

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