

Q2 Ibec Quarterly Economic Outlook

Choose growth and jobs

Economic growth

Economic revisions give greater budget room

Page 2

Labour market

Weaker Q1 growth underlines need for continued focus

Page 5

Budget 2015

Ibec has launched its 2015 Budget Submission

Page 9

Business credit conditions

Business credit conditions remain tight

Page 10

The economy is now well in recovery mode. More confident consumers are spending again; investment is recovering strongly and exports have been boosted by a better than expected recovery in the UK. Unemployment is still far too high, however, and the leading policy priority for the new Cabinet must be to put more people back to work. Ibec estimates that Budget 2015 only needs to deliver a net fiscal adjustment of €200 million. Adopting this lower amount would mean that almost 10,000 additional people would go back to work in 2015.

GNP and its components

Annual % change	2012	2013	2014	2015
Consumer spending	-1.2	-0.8	1.9	2.9
Government spending	-2.1	1.4	-0.9	-0.5
Investment	5.0	-2.4	14.2	13.6
Exports	4.7	1.1	4.8	4.2
Imports	6.9	0.6	5.1	4.1
GDP	-0.3	0.2	3.1	3.9
GNP	1.9	3.2	2.5	3.3

GDP and components

Economic Growth

Ireland's economy began the year on a strong footing. Preliminary estimates for Q1 2014 show that GDP increased by 2.7% compared with Q4 2013 and by 4.1% year-on-year. Exports were the main driver of growth in Q1; they increased by 7.4% year-on-year. Private consumption grew by 0.2% year-on-year, the first increase in five quarters, and investment increased by 2.9%. The economic outlook is positive. This is supported by leading indicators such as the purchasing managers' index which signals strong activity in industry. On the basis of an expected stronger increase in net exports we have raised this year's GDP forecast from 2.9% to 3.1%. For 2015 we forecast GDP to grow by nearly 4%. This projection is on the basis that the planned fiscal measures for 2015 will be reduced from €2 billion to €200 million. A less restrictive fiscal policy will have positive feedback effects on domestic demand.

The impact of revisions

Eurostat has adapted a new standard for national accounting which has led to substantial changes in the level of GDP. One of the major changes is that R&D expenditures are now treated as investment and therefore are included in the calculation of GDP. Other changes involve the inclusion of estimates for certain illegal activities which are legal in some member states. All in all, this has led to an upward revision of the level of GDP by 6.5%. R&D contributed 4.1% to GDP in 2013 and illegal activities 0.7%. Other regular revisions resulted in a different growth pattern of GDP than previously announced by the CSO. For 2013 annual growth of real GDP was revised from -0.3% to 0.2% and for 2012 from 0.2% to -0.3%.

Outlook for exports

Revisions to 2013 export figures have led to an increase in last year's export growth figure to 1.1%, up from a previous estimate of 0.2% growth. Despite this, last year was a poor year for exports with the pharma patent cliff and international demand conditions setting back an export led recovery which has seen average annual growth of 5.5% between 2010 and 2013. Q1 figures for exports have shown a much more promising start to 2014 with the effects of the patent cliff beginning to wane and a recovering global economy boosting Irish exports. Exports rose by 7.4% year-on-year in Q1 with strong performances for goods (10.3%) and services (4.3%). Conditions for Irish exporters will be buoyed for the rest of the year with strong recovery in key markets allied to increasingly favourable exchange rate conditions (particularly with sterling). As a result we expect to see export growth of 4.8% in 2014.

Figure 1: Economic growth

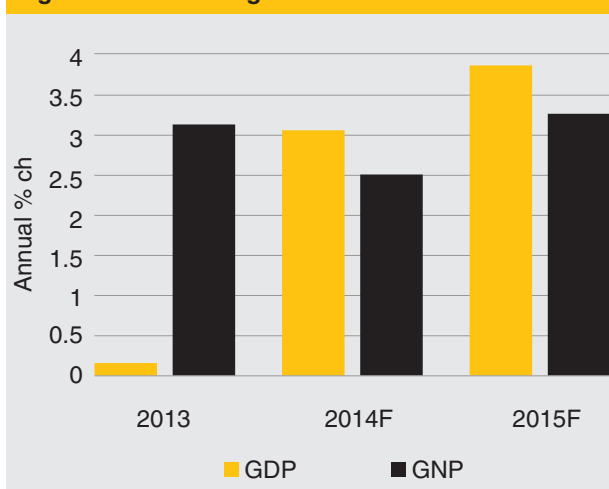


Figure 2: The impact of revisions on growth

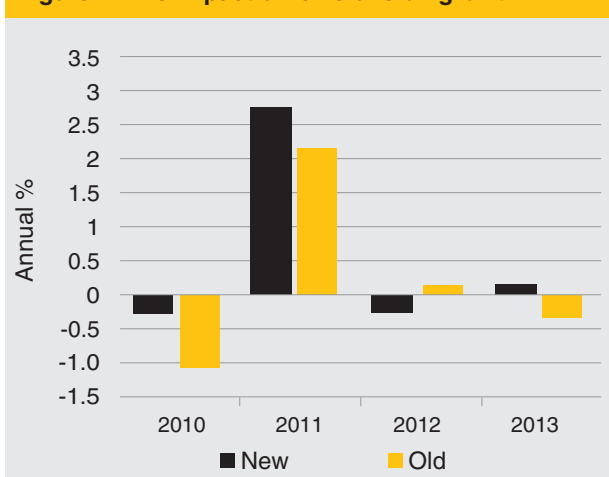


Figure 3: Export components



Investment outlook

Ibec's outlook for investment remains positive for this year and next. After a period of prolonged weakness in investment spending on equipment which led to a depletion of capital stock we expect a gradual increase in 2014 and 2015. The environment definitely is supportive for an increase in overall investment. Global demand is picking up, interest rates are low and business confidence is strong. Together, these factors support a positive development in investment of machinery and equipment. The conditions for strong recovery in construction are also positive. The rise in property prices points to a shortage of supply due to a lack of construction activity in the last few years. At the same time, higher prices make construction investments more profitable and we expect strong growth for this year and next.

Investment revisions

For 2013 the extensive revisions due to the inclusion of R&D expenditures into investment resulted in a downward revision of annual growth of investment from +4.2% to -2.4%. Yet, the headline figure does not tell the whole story. If one analyses the composition of investment in 2013 it is clear that the reason for the decline was investment in R&D. In volume terms it fell by over 19% compared with 2012. Investment excluding R&D, on the other hand, increased. Thereby, machinery and equipment spending rose by nearly 2%, while total construction increased by 14% year-on-year. For this year and next we continue to forecast a strong increase in investment. Due to the substantial revisions of total investment for 2013 we now forecast an increase of 14.2% for this year. For 2015 we expect investment to grow by 13.6%.

Consumer spending

Despite strong employment growth last year consumer spending in the economy contracted by 0.8%. This puzzling lack of growth in consumer spending reflects a lagging effect of employment growth on consumption. Employment growth will be the major driver of consumer spending in 2014. Although employment growth slowed somewhat in Q1 we still expect it to pick up during the year. Additionally, the savings rate of households has begun to fall as the pace of deleveraging and precautionary saving eases off. We expect the savings rate to continue its downward trend toward 8% of disposable income over the coming year. As a result private consumption should rise by around 1.9% during 2014 indicating the beginning of the recovery for the consumer economy.

Figure 4: Investment

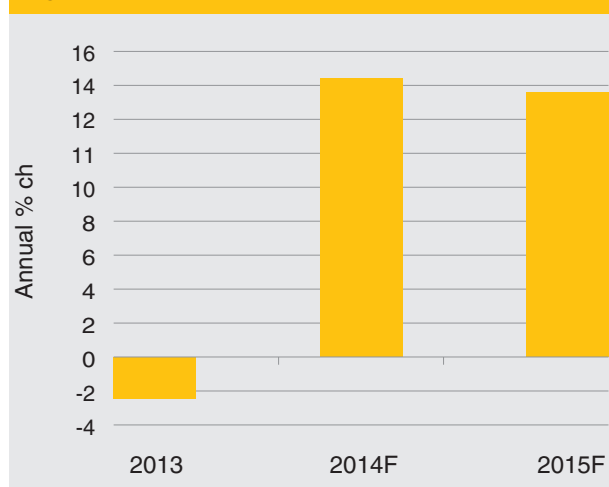


Figure 5: R&D contributions to investment

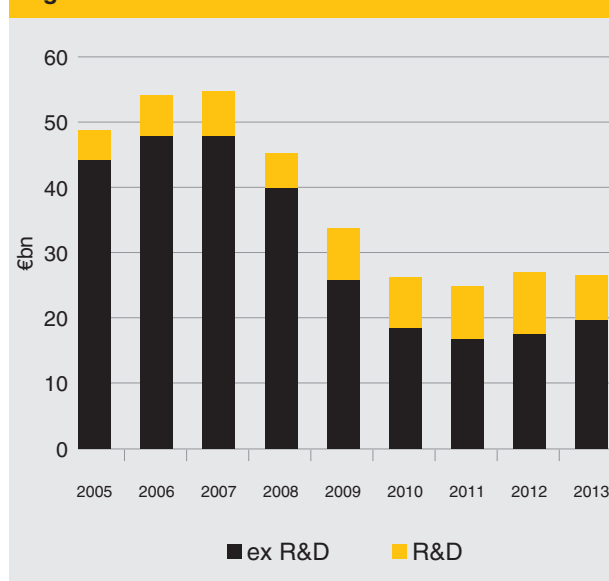
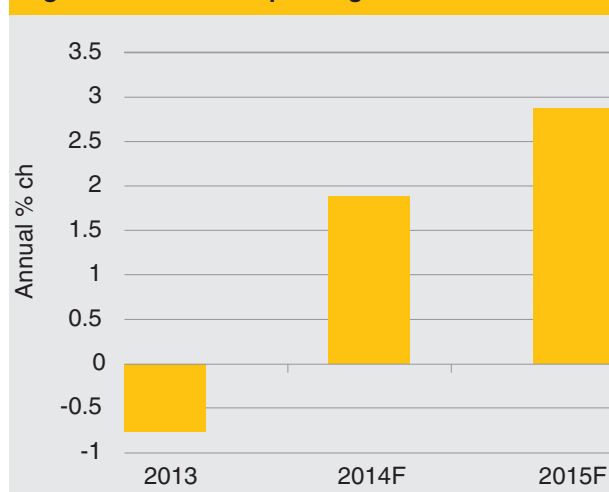


Figure 6: Consumer spending

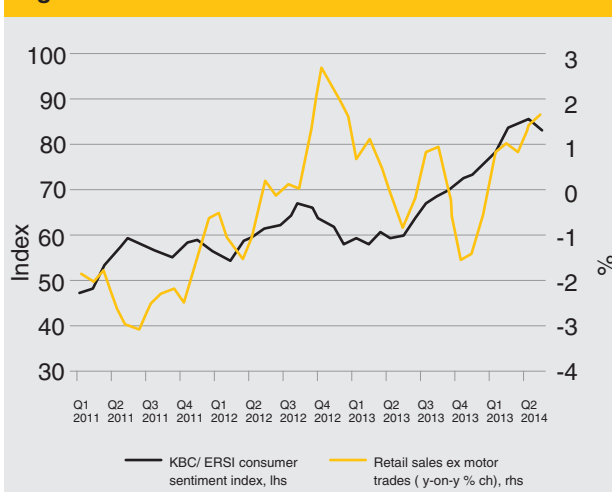


Consumer confidence and retail sales

Despite some volatility surrounding the local elections consumer sentiment remains at levels last seen in early 2007. The average value for the ESRI/KBC consumer sentiment index at 83.5 for the first half of 2014 is now 13.2% above where it was in the same period in 2013 signalling a broad increase in confidence in the Irish economy and the conditions of households.

Retail sales have also seen a strong positive start to the year with average annual growth of 4.8% in the value of retail sales in the first half of the year. Excluding exceptional sales in the motor trades this growth is a more moderate 1.1%. Ibec expects that with continued employment growth and an easing of the tax burden on households in the upcoming budget the retail sector could see a sustained recovery this year as households begin to see the recovery in their disposable income.

Figure 7: Retail sales and consumer sentiment



Summary of contributions to growth

Ireland's economy is in a good position to continue its recovery and, even more importantly, the base of growth should become broader. We expect that alongside exports, business investment and private consumption will contribute positively to economic growth. Moreover, the negative impact of fiscal policy should diminish. For this year we expect GDP to increase by 3.1%. We have revised our forecast upwards from 2.9% as we forecast a more favourable development of net exports. For 2015 Ibec forecasts economic growth of close to 4%. This forecast takes into account that an expected reduction in the budget adjustment will have positive feedback effects on private consumption and business investment.

Figure 8: Contributions to growth

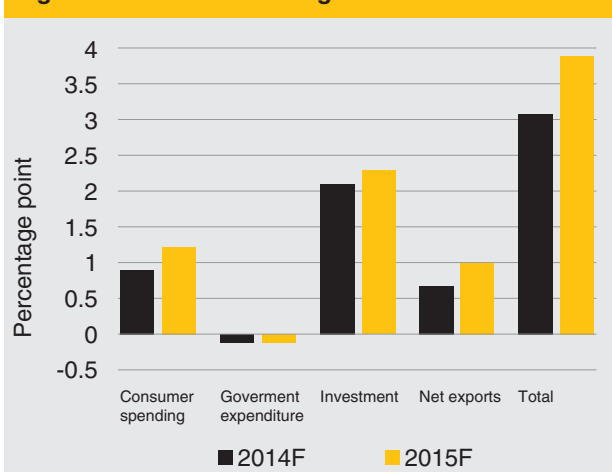


Table 1: Risk assessment for the remainder of 2014

Factors	Probability		
	High	Medium	Low
Financial Market stability			■
Fiscal pressure			■
Wage pressures	■		
Global oil prices			■
Exchange rate	■		
Bank lending conditions		■	
International economy		■	
Labour market conditions	■		

■ Downside risk ■ Upside risk

Labour market

Employment forecast

The total number of people in employment was up 42,700 (2.3%) in the year to Q1 2014. This mainly reflects the strong employment growth toward the end of 2013. There was, however, a slowdown in the rate of employment growth in the first quarter of 2014. Employment increased by only 1,700 (0.1%) in Q1 2014. This represents a sharp decrease from an average quarterly increase of around 15,000 during the four quarters of 2013. We expect employment to grow by 1.9% in 2014 down on 2013 (3.3%). Despite the setback in Q1 other leading indicators such as Live Register numbers and Ibec's own business sentiment surveys suggest that employment growth will continue at a faster pace in the coming months. Additionally, a reduction in the planned budgetary adjustment should lead to a further reduction in unemployment. Our analysis based on IMF studies on the effect of fiscal consolidation on employment suggests that going ahead with the full €2bn adjustment rather than Ibec's €200mn baseline (c 1% of GDP) would add 0.4pp to our underlying 2015 unemployment rate or around 10,000 jobs. The slowdown in Q1 underlines the need for the Government to continue to support business in creating jobs.

Private sector employment

Ibec's business sentiment employee index, which has continued to track private sector employment closely, fell from a recorded series high reading of +16 in Q4 2013 to +13 in Q1 2014. Employment sentiment continues to be strongly positive among a broad cross section of employers; however, there have been some less positive trends in private sector employment in the past two quarters. Although private sector employment has grown year-on-year for ten consecutive quarters quarter-on-quarter growth has actually been negative in the previous two quarters with a loss of 12,700 employees in Q1 2014. Ibec sees no reason to place too much emphasis on these figures in isolation, however, as reductions in private sector employment in Q4 and Q1 broadly track patterns seen in previous years due to seasonal effects. We expect private sector employment to grow strongly in Q2 and Q3 of this year with a knock-on positive effect on overall employment.

Figure 9: Employment

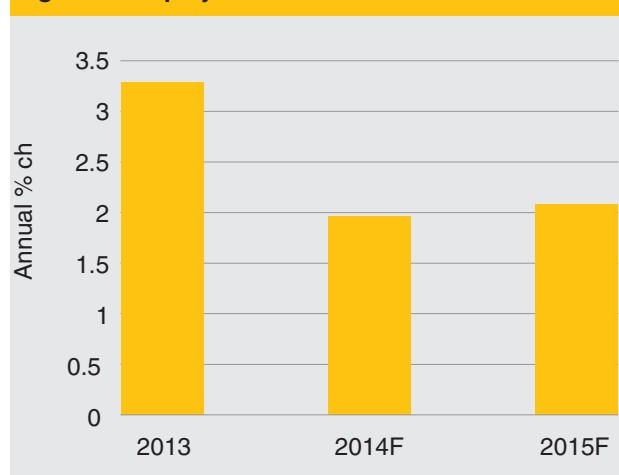


Figure 10: Private sector employment and Ibec hiring intentions index

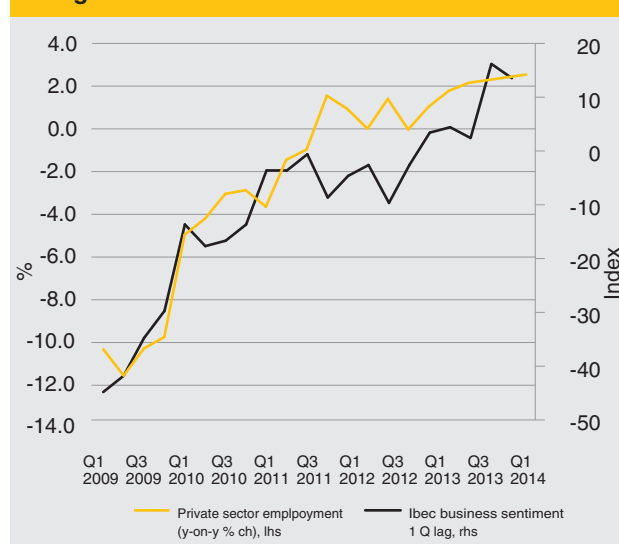


Table 2: Labour market summary

Employment 000s annual average	2013	2014	2015
Agriculture	107	117	118
Industry	342	362	378
Services	1,431	1,452	1,476
Total	1,880	1,931	1,971
Unemployed	282	235	209
Unemployment rate (%)	13.0	10.9	9.6
Labour force	2,163	2,166	2,175

Source: Ibec forecasts

Prices and business costs

Inflation outlook

The overall price of goods and services rose by an annualised average of just 0.2% in the first half of 2014 when compared with 2013 price levels. This followed benign price inflation of only 0.5% in the full year of 2013. We continue to expect that despite low interest rates and rising employment inflationary pressures will remain low in 2014. This expectation is driven by sustained price competition in key consumer markets and falling mortgage interest rates. Price inflation has picked up as the year has progressed, however. As a result we have forecast price inflation in the region of 0.5% for the full year of 2014. The benign cost of living environment has some positives from a business point of view as it takes pressure off wages and business costs; however, a lack of inflation is also a challenge from the perspective of nominal (turnover) growth of the economy. This is particularly important where high debt levels remain a challenge for government and households. We expect that as the economy recovers some modest inflation will return with 1.4% inflation forecast in 2015.

Contributions to cost of living growth

Despite the annual increase in the cost of living being only 0.2% in the first half of 2014 there was a large level of divergence between different classes of goods and services. The price of services contributed +1.1% to overall inflation levels with services now costing 2% more than during the same period in 2013. This has been driven by increases in the cost of restaurants and hotels, in education and in the 'other' category which is mainly reflective of the continued major increases in health insurance costs.

On the other hand total goods contributed -0.9% to overall inflation over the same period. The price of goods is down 2% on prices in 2013 due to strong price discounting seen in the grocery, household durables and clothing sectors.

Labour costs and wages

CSO data show labour costs have increased by 0.2% year-on-year in Q1 2014 following growth of 0.4% in 2013. Average hourly labour costs in the private sector are now back to levels seen in the same period in 2009. This, however, should be taken with some note of caution as it does not take account of changes in the composition of the workforce during the intervening period. Ibec survey data continue to suggest that there may be some moderate wage growth in strongly performing sectors of the economy during 2014. There will, however, be a large amount of divergence between firms and industries as the recovery is still quite uneven. The National Competitiveness Council has recently raised concerns that the hard won competitiveness gains of recent years are being slowly eroded, including in labour costs. A number of these costs have been driven by Government policy decisions in recent years. The government must heed these warnings and ensure it does not add to wage pressures in the coming budget.

Figure 11: Inflation

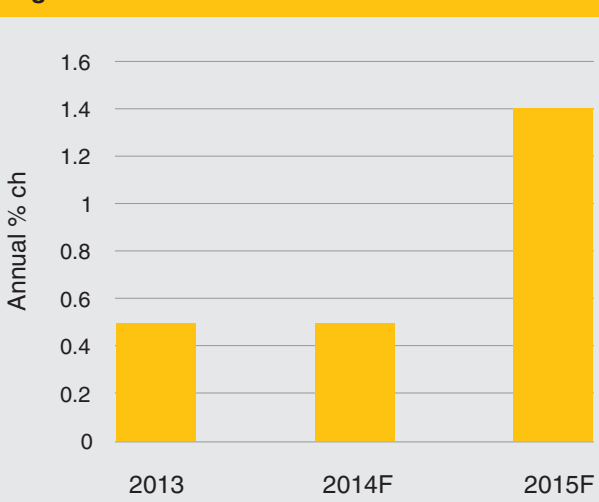


Figure 12: Contributions to annual increase in the cost of living H1 2014

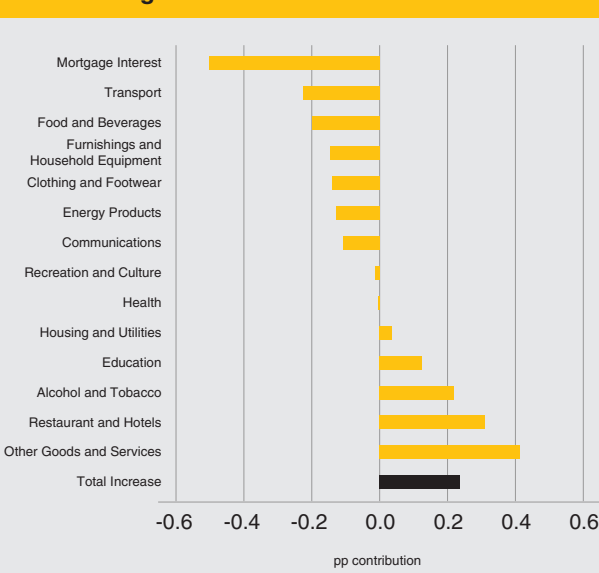
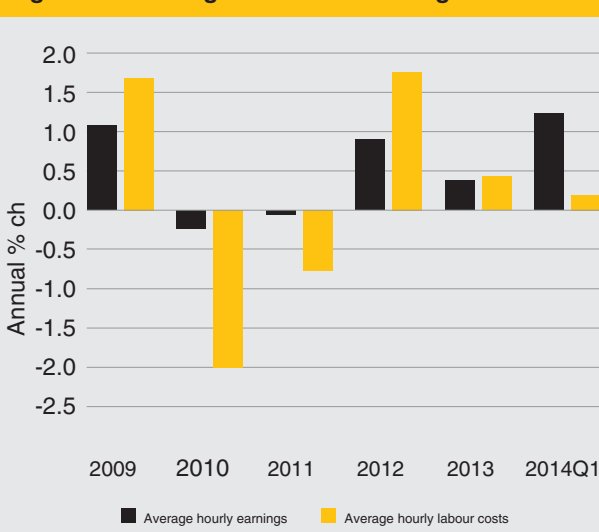


Figure 13: Earnings and labour costs growth



International economies

International economy is improving

Global demand is strengthening. As a result, recovery in industrial economies is gaining momentum, while the development amongst emerging and developing countries is heterogeneous. However, growth in these countries – the IMF expects around 5% for this year and next - will be faster than in the advanced economies. In the USA the recovery is becoming broad based and more sustainable. Industrial production and new orders are trending upwards. Sentiment among US SMEs is improving and the labour market is strengthening. This year and next, US GDP should increase by around 3%. In the UK the outlook is also very positive. GDP is expected to grow by nearly 3% in 2014 and 2.5% in 2015. The eurozone remains fragile, as the unemployment rate is high and the private sector especially in the periphery continues to deleverage. After two years of decline the eurozone's GDP should grow by over 1% in 2014 and 2015.

Euro remains strong

Exchange rates are developing favourably for Irish exporters. Since July 2013 the euro-sterling exchange rate fell from over £0.86 to under £0.79. Sterling's appreciation against the euro comes on the back of UK's positive economic development. The strong recovery continues this year with an expected increase of real GDP of 2.9% after 1.7% in 2013. Moreover, the inflation rate is climbing towards the Bank of England's (BoE) inflation target of 2%. As a result, in June the BoE took markets by surprise and hinted at a possible rate hike towards the end of this year. In contrast, the European Central Bank (ECB) stepped up its expansive measures and lowered its deposit rate to below zero. This has also helped to weaken the euro against the dollar. Additionally, in the coming months the dollar should benefit from a stronger US economy. All in all, Irish exporters will benefit from the weakening of the euro against their main trading partners.

Figure 14: Growth in major economies

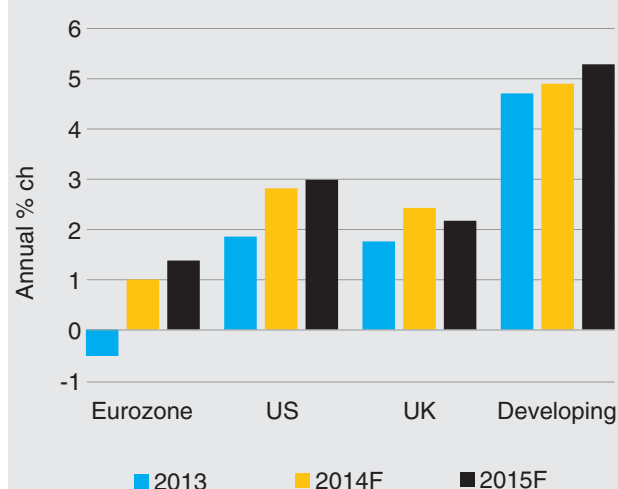


Figure 15: Exchange rates

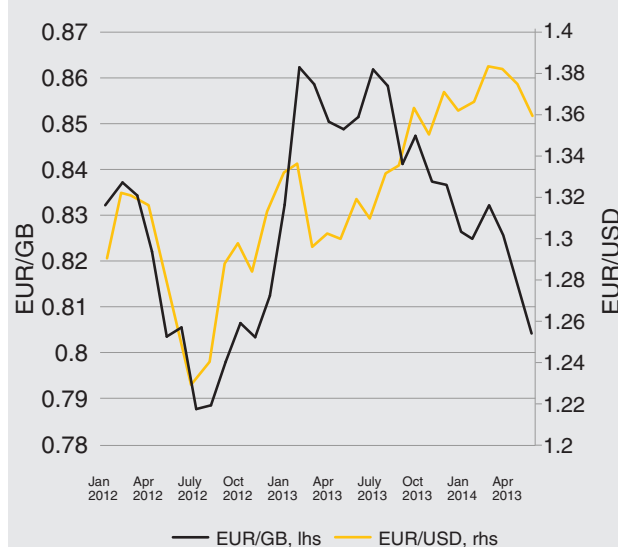


Table 3: International economies summary

	Real GDP, y-on-y % ch			Inflation, y-on-y % ch		
	2013	2014	2015	2013	2014	2015
Eurozone	-0.5	1.2	1.5	1.3	0.9	1.2
UK	1.8	2.9	2.5	2.6	1.9	1.9
US	1.9	2.8	3.0	1.5	1.4	1.6
Emerging markets	4.7	4.9	5.3	5.8	5.5	5.2
World	3.0	3.6	3.9	3.6	3.5	3.4

Source: IMF economic outlook

Regional focus

Positive growth outlook for Central and Eastern Europe

The region of Central and Eastern Europe (CEE) comprises of 20 countries. Four of which (Estonia, Latvia, Slovakia and Slovenia) are members of the eurozone. The other states are either members of the European Union (EU) or candidate countries on the road to EU membership. Compared to other emerging and developing regions such as Asia and Latin America the economic performance in the last couple of years was slow. As trade and financial links to the eurozone are very strong eurozone's debt crisis and recession negatively affected growth in CEE. The economic prospects for the coming quarters have brightened as stronger growth in the eurozone will lift activity in CEE. Growth in Poland and the Baltics, for instance, is forecast to strengthen in 2014 to 3% and 3.2%, from 1.6% and 2.9% in 2013, respectively.

Trade to CEE increases

The IMF's trade data show that the CEE region is gaining importance for Irish exporters. From 2003 until 2013 the volume of Irish exports to CEE climbed from €0.9 billion to €2.1 billion. During the same period, exports to CEE as a percentage of total Irish exports rose from 1% to 2.6%. For Ireland the trade to this region is not only interesting because of its geographic proximity, but also because these countries are gaining wealth and spending power. Income in CEE countries has risen. Between 2003 and 2013, GDP per capita in Slovenia and Poland, for instance, rose by over 32% and 102%, respectively. Nevertheless, GDP per capita for all CEE countries still remains below the EU average. In Slovenia, the richest of all CEE countries, it reaches nearly 67% of EU average and in Poland it amounts to about 39%. However, this gap should gradually close in the coming years as CEE economies converge with Western Europe.

Figure 16: GDP in CEE countries

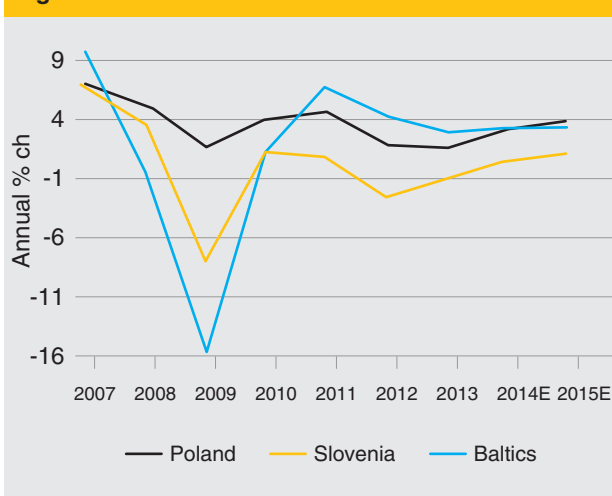


Figure 17: Irish exports to Central and Eastern Europe

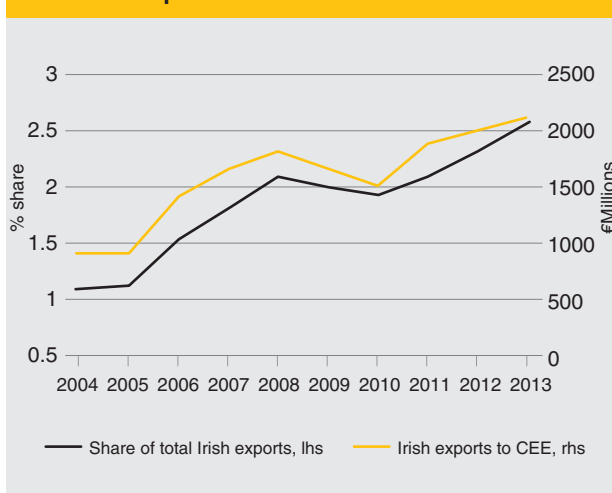


Table 4: CEE economy summary

	Real GDP			GDP per capita		
	y-on-y % ch			\$USD		
	2013	2014	2015	2013	2014	2015
Poland	1.6	3.1	3.3	13,394	14,136	15,012
Latvia	4.1	3.8	4.4	15,205	16,620	18,145
Lithuania	3.3	3.3	3.5	16,003	16,742	18,143
Estonia	0.8	2.4	3.2	19,032	20,179	22,207
Hungary	1.1	2.0	1.7	13,405	13,363	14,112
Czech Republic	-0.9	1.9	2.0	18,858	18,846	19,497
Slovakia	0.9	2.3	3.0	17,706	18,792	19,999
Slovenia	-1.1	0.3	0.9	22,756	23,702	24,669

Source: IMF economic outlook, April 2014

Tax less, invest more: Ibec budget submission 2015

A combination of revisions to Ireland's GDP numbers, a stronger than expected Exchequer performance in the first half of this year and a much improved economic outlook means that an adjustment of much less than the planned €2 billion is now needed. Based on a prudent 2.7% deficit target, Budget 2015 needs to deliver a net fiscal adjustment of just €200 million.

The much improved fiscal and economic outlook means that the resources are now available to support tax reductions and to help deliver a break for consumers and those looking for work. This will move the domestic economy into a more virtuous cycle. In our submission we have set out how a combination of tax rate reductions and new investment initiatives will provide improved momentum for the economy and accelerate the reduction in unemployment. The recommendations will require the pre-announced implementation of water charges in 2015 and some further current expenditure reductions. This overall package will be growth enhancing, however, and the approach is supported by extensive international evidence which supports a shift from labour taxes to property-based taxes and other user charges. Ibec's budget proposals, therefore, represent an opportunity to deliver a step-change in Ireland's economic recovery:

1. Reduce the net fiscal adjustment to just €200 million:

Stronger than expected economic growth and tax revenues, combined with large statistical revisions to Ireland's GDP level, means that substantially less than the €2 billion planned fiscal adjustment is needed to reach the EU required budget deficit target for 2015. A lower fiscal adjustment will boost confidence and support a recovery in tax revenue through buoyancy rather than through raising tax rates. Ibec recommends a net adjustment of €200 million in order to reach a prudent 2015 deficit target of 2.7%.

2. Cut personal taxes: The improved fiscal outlook provides the opportunity to reduce personal taxes in Budget 2015. Government should:

- Increase public investment in infrastructure to 4% of GDP by 2020
- Streamline the planning process, particularly for energy projects and show greater leadership on community acceptance for infrastructure projects
- Ensure public private partnerships (PPPs) are the key delivery mechanism for investment
- Develop a new national spatial strategy, which supports balanced regional development
- Involve more employers in the reform and roll-out of activation and training programmes

- Increase effective investment in education and skills and put in place a sustainable funding model for the third-level sector
- Implement a co-ordinated strategy for further education and training, and update the second-level curriculum so school leavers have core employability skills

3. Reduce consumer taxes: Drawing on the success of the 9% VAT rate for the hospitality sector, Budget 2015 should reduce other consumer taxes in order to support personal spending power and the domestic economy. It should reverse recent alcohol excise increases which have significantly added to inflation, squeezed overall consumer spending and damaged Ireland's international price competitiveness. The 9% VAT rate should also be continued.

4. Enhance investment in enterprise and infrastructure:

Budget 2015 should deliver measures to enhance investment in enterprise and much needed infrastructure. Business investment can be supported by rebranding and enhancing the Employment Investment Incentive Scheme (EIIIS) and reforming the capital gains tax regime to encourage reinvestment by enterprise. Infrastructure investment should be increased by bringing a greater number of Public Private Partnership (PPP) projects to the market to take advantage of low financing costs and by packaging innovative financing models for projects such as social housing.

This new campaign will form the basis for our policy and lobbying efforts over the next two years or so and we will be rolling-out a series of publications, research material and events to drill into all of the issues addressed above. We look forward to engaging with our members and policy stakeholders on the detail of this work.

5. Improve Ireland's international tax offering:

The competitiveness of Ireland's tax offering for mobile investment has declined in recent years, particularly compared with the UK. Budget 2015 must set out a medium-term business tax strategy for Ireland based on:

- A commitment to the 12.5% rate brand
- An improved intellectual property tax offering
- Greater certainty in the R&D tax credit scheme
- Competitive personal taxes.

Credit conditions

Credit conditions for business

Lending to Irish companies is weak as can be seen by the low volume of new lending to large companies and to SMEs. It is constrained by tight credit conditions. This is especially the case for SMEs for which bank loans are the major source of external finance. Though the latest Bank Lending Survey (BLS) reports that in the last few quarters banks have not tightened credit conditions any further, they have not loosened them either. The interest rates on new loans up to €1 million, which are generally used as an indicator for lending rates to SMEs, are higher than for interest rates on loans over €1 million. Moreover, both increased gradually in the last couple of months which puts extra strain on credit demand.

Debt situation of SMEs

Debt indicators for the corporate sector have improved in recent years. For instance, debt as a percentage of financial assets fell to below 50% in Q4 2014 from nearly 70% in 2009. Another important debt measure is the debt-to-turnover ratio which for nearly 84% of Irish SMEs is lower than one third. Moreover, roughly one third of Irish SMEs have no debt at all. A recent analysis by the Central Bank of Ireland shows that medium sized firms, those with between 50 and 250 employees, are more indebted than small and micro firms. Nearly 12% of medium sized firms have a debt-to-turnover ratio greater than one, compared to 5.4% and 5.9% for smaller and micro firms. Looking at sectors reveals that the hotels and restaurant sector has the highest share of heavily indebted companies, while the financial and real estate sector have the highest percentage of zero-debt firms.

Lending to private households still weak

The volumes of new loans to households for house as well as for consumer purchases remain on historically low levels. One reason is that private households are focused on deleveraging as the level of debt at close to 200% of disposable income is high by international standards. Another reason might be that interest rates on new bank loans remained broadly stable despite the fact that the ECB lowered its policy rates. Although the interest rates on non-tracker variable rate products, which are the majority of loan products to private households, usually follow the ECB's rate changes, they remained broadly stable. Nevertheless, in the medium- to long-term lending to households should recover as labour market conditions are improving steadily and consumers' confidence is increasing.

Figure 18: Interest rates for business

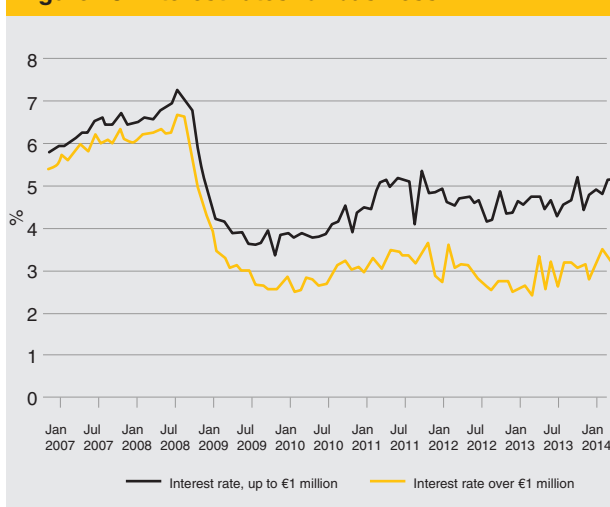


Figure 19: Loans to households, new business, volume (€ millions)

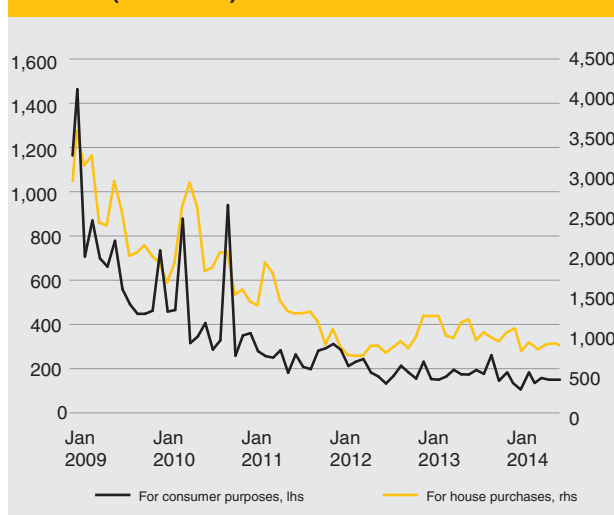
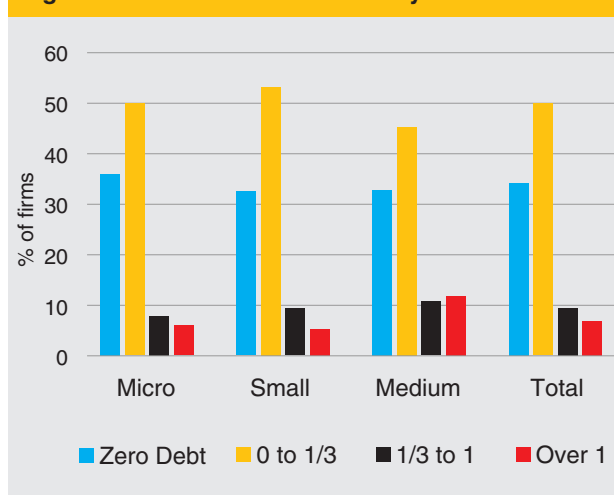


Figure 20: Debt to turnover ratio by SME size





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