Q1
2015

Ibec Quarterly Economic Outlook

Sustaining economic recovery

The combination of favourable exchange rates, quantitative easing and lower oil prices will result in robust economic growth this year and next. Strong growth can also be sustained when the current stimulus measures subside but only if we manage the recovery sensibly.

Two-thirds of domestic services business will not be in a position to award wage increases in 2015 because their turnover remains up to 20% below the pre-crisis peak. Economic recovery is gaining momentum but it has not yet benefited all sectors or regions. This reality must be reflected in wage expectations and other cost pressures.

GNP and its components

Annual % change	2013	2014	2015	2016
Consumer spending	- 1.2	1.1	2.3	2.6
Government spending	- 2.1	0.1	0.5	0.7
Investment	5.0	11.3	11.7	9.6
Exports	1.1	12.6	9.4	6.5
Imports	6.9	13.2	8.7	6.3
GDP	0.2	4.8	5.4	4.7
GNP	3.2	5.2	5.1	4.4

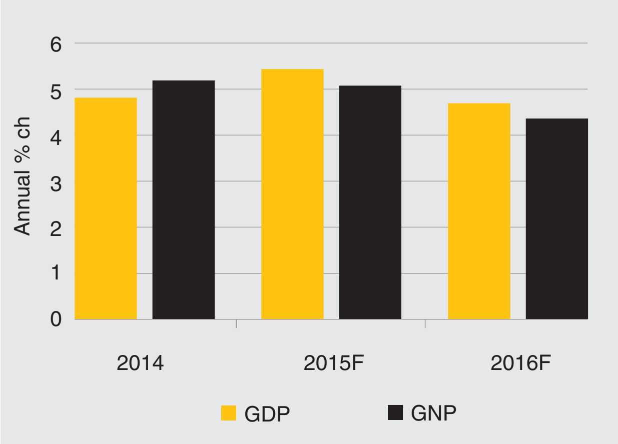
Ibec
For Irish Business

GDP and components

Economic Growth

Growth figures for 2014 showed a domestic economy firmly in recovery. The rebalancing of growth toward the domestic economy was evident in the full year figures, with GDP growth of 4.8% outshone by 5.2% growth in GNP. This was driven by surging investment in Irish companies and consumer demand which has begun to normalise. Growth remains, however, very urban centric with households and firms in many areas of the country still treading water. The 2014 GDP growth was by far the strongest in Europe. Investment, exports, employment and consumer demand were in line with our expectations. Rising service imports and royalty payments seem to support the view that the impact of contract manufacturing on GDP is being broadly washed out over the course of a full year as gains are redistributed throughout company supply chains.

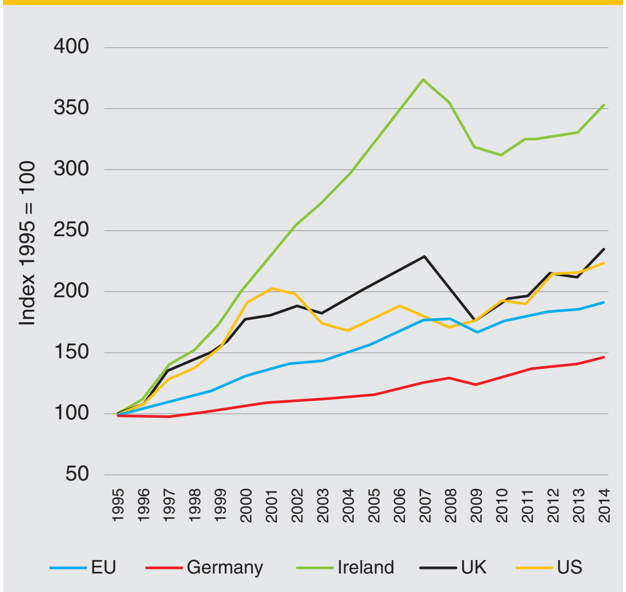
Figure 1: Economic growth



Long-term growth

Ireland's economy in turnover terms remains 5.7% below its peak 2007 level. The EU economy on the other hand has grown by 7.9% over the same period with the German economy 15.7% larger than in 2007. The divergence in international growth over the past few years is best exemplified by the fact that the US economy has grown by almost a quarter over the same period – three times the rate of growth of the EU. The recent setback, however, masks a trend over the long term where Ireland has been a standout economic performer over a 20 year period. Ireland's economy going into 2015 is 3.5 times larger in turnover terms than it was in 1995 even after the large correction in recent years for the property boom. The UK on the other hand is only 2.3 times its 1995 size with the EU economy just less than twice its size. Given the scale of Ireland's recent recession and the underlying strength of its business model, Ibec expects that potential volume growth in the economy over the coming years could well be in excess of 4% annually as the economy recovers to its potential level of activity.

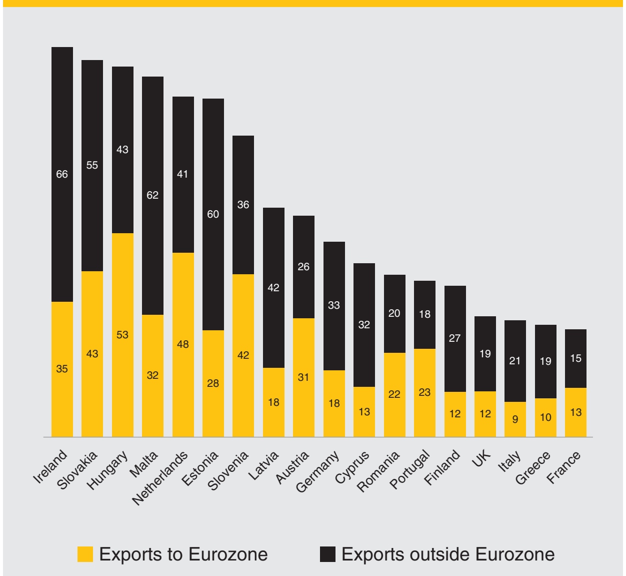
Figure 2: Long term economic growth (value)



Outlook for exports

Exports and imports (although not GDP) figures for 2014 were buoyed by the rise in contract manufacturing and large carry over effects. Import growth (13.2%) was stronger than that of exports (12.6%) although the balance of trade remained positive at €3.8bn. The outlook for net exports in the coming year looks even more positive than in 2014. The substantial downward shift in euro-dollar and euro-sterling exchange rates over the last few months will benefit the Irish economy more than most. Irish exports are equivalent to around 101% of GDP, the highest level in the eurozone, meaning Ireland stands to benefit from any relative competitiveness improvement. In addition exports outside the eurozone are a eurozone high of 66% of GDP. As a result Irish exporters have a potential opportunity to aggressively expand their export base in the coming year particularly for those selling into the UK, US and emerging markets.

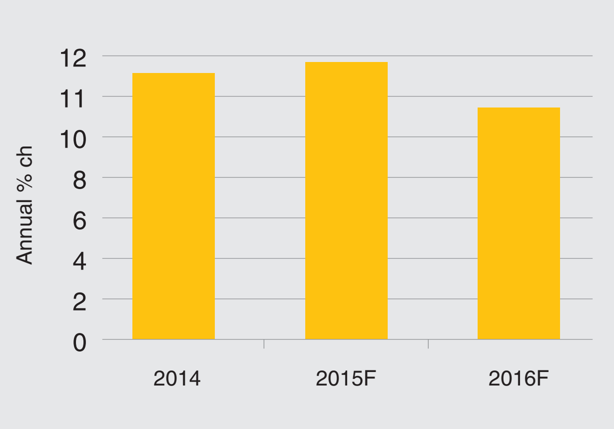
Figure 3: Exports as % of GDP



Investment outlook

Investment in the full year of 2014 rose by 11.3%, in line with our expectations. Despite high headline rates of growth in residential construction (26%) year-on-year in 2014 it contributed just less than 15% of total investment growth due to its low base. Total construction activity in 2014 is still just below half of its 2007 peak, driven by a precipitous (82%) fall in residential construction investment. On the other hand business investment in machinery and transport equipment rose by 31% during the year accounting for in excess of 70% of total investment growth. Business investment excluding the volatile movements in aeroplanes investment is now just 1% below its 2006 peak. Overall we expect both categories to grow strongly in 2015 as business investment responds to capacity constraints in the economy and construction normalises. We expect investment growth of 11.7% for the year ahead.

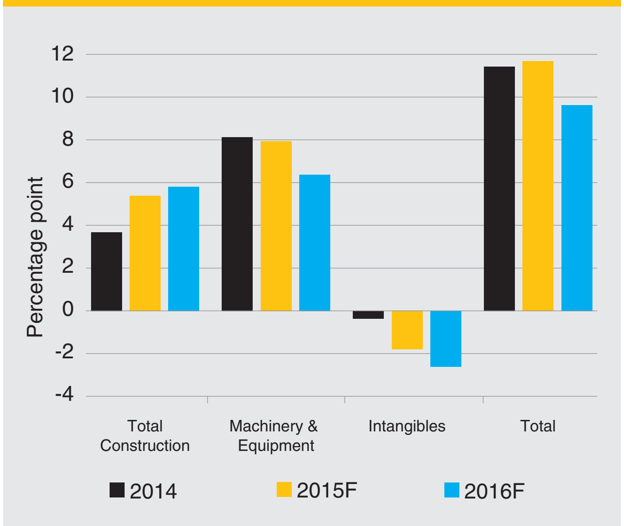
Figure 4: Investment



Investment components

Normalising activity in construction and continued solid business investment should mean investment will again contribute strongly to growth in 2015 and 2016. The year has started slowly in construction with the Ulster Bank Construction PMI slowing for the fourth successive month in February. This slowdown seems to be reflective of both the uncertainty introduced to the residential market following the introduction of the Central Bank's new mortgage regulations and also broader slowdown in the recovery of commercial construction. Despite this we expect growth in construction volumes to be up moderately on 2014 with further recovery as the market normalises in 2016. Positive export opportunities as well as a recovering domestic demand should also see strong business investment in the year ahead. Leading indicators such as high levels of new goods vehicle registrations suggest business have continued to invest in new machinery and transport goods in the opening months of 2015.

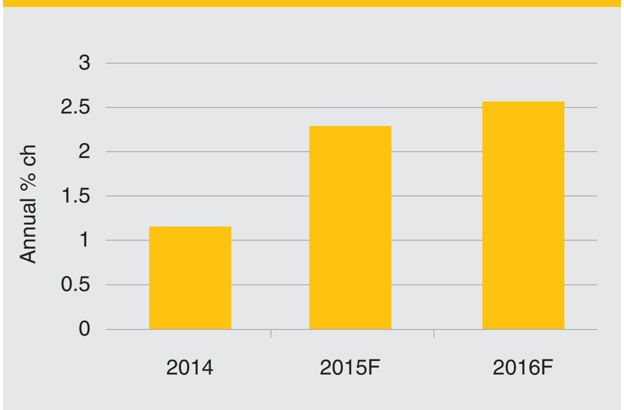
Figure 5: Contributions to investment growth



Consumer spending

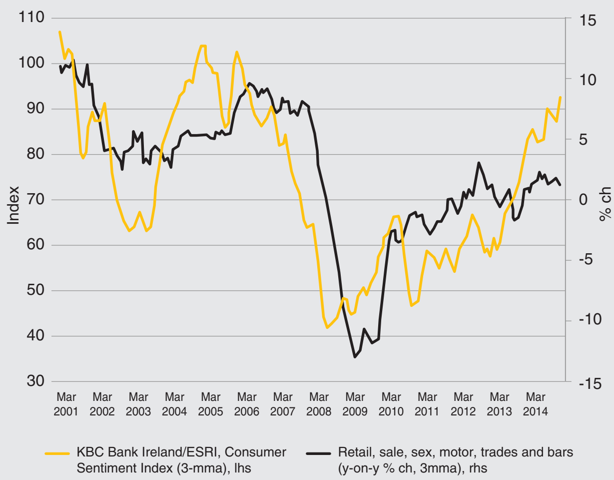
Personal consumption increased by just over 1% in 2014 - a result which seemed at odds with consumer fundamentals and leading indicators from retail, housing and consumer services data. The outlook for 2015 continues to suggest re-emergence of the consumer economy. Employment as well as the population continues to grow meaning consumer spending should increase in volume terms. Additionally, consumer incomes should continue to recover over the coming years. Wages data suggests some moderate wage growth will emerge during 2015 in addition to already signalled reductions in taxation. Additionally, leading indicators such as tax receipts and consumer sentiment indicators show no sign of a slowdown in the consumer recovery in Q1. As a result of these improving fundamentals we believe consumer spending will increase by 2.3% in 2015.

Figure 6: Consumer spending



Consumer confidence and retail sales
Consumer confidence has continued to rise throughout the year with the three-month moving average reaching a measure 95.9 in February its highest level since 2007. Retail sales over the Christmas period were in line with our expectations that we would see the strongest Christmas sales since 2007 and the positive momentum has continued since then. Retail volumes excluding cars were up 4.8% in both December and January when compared to 12 months previous. Excluding cars average retail volumes were up 3.6% in 2014 on 2013, including cars this number rose by over 6%. Volumes do not tell the full story, however, aggressive discounting means that the value of sales (excluding cars) in the full year of 2014 was up only 1.5% and the turnover in the sector this January remains 20% below the same month in 2008 whilst many costs and wages remain broadly the same.

Figure 7: Retails sales and consumer sentiment



Summary of contributions to growth
The trend of a re-balancing of the sources of economic growth seen in 2014 should continue into 2015 and 2016. Household purchasing power has seen a strong improvement given the rises in employment, small reductions in the tax burden, low inflation and moderate wage growth. As a result private consumption which had been a drag on growth up until 2013 and contributed just 0.5 percentage points to the growth rate in 2014 should contribute about 1 percentage point to the growth rate in 2015 and 2016. Elsewhere, strong prospects for net exports should see the internationally traded sector continue to be the main driver of Ireland's economic recovery; whilst the rapid convergence of investment towards long-term and European norms should leave plenty of space for continued contributions of investment to overall growth.

Figure 8: Contributions to growth

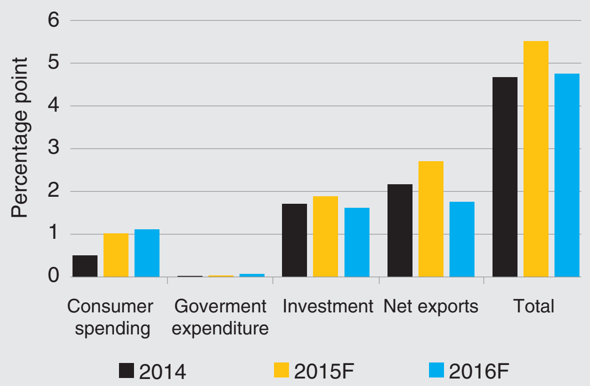


Table 1: Risk assessment for 2015

Factors	Probability		
	High	**Medium**	**Low**
Financial market stability			■ (Downside risk)
Fiscal pressure		■ (Upside risk)	
Wage pressures	■ (Downside risk)		
Global oil prices	■ (Upside risk)		
Exchange rate	■ (Upside risk)		
Bank lending conditions			■ (Downside risk)
International economy			■ (Downside risk)
Labour market conditions		■ (Upside risk)	

■ Downside risk ■ Upside risk

Source: Ibec assessment

Labour market

Employment forecast

Employment growth slowed to 1.7% for the full year of 2014 following growth of 2.4% in 2013 due to a switch from part-time to full-time hiring. Despite this the growth rate in the second half of the year was over 1 percentage point higher than in the first half, signalling an improvement in labour market momentum as the year wore on. Ibec expects that employment growth will again rise by just over 40,000 for this year and next with much of this growth in full-time employment. We expect employment to have grown by 180,000 in the four years to the end of 2016. Additionally the unemployment rate should fall below 9% this year and to just above 8% by the end of 2016, from a high of 15% in 2011. However, the labour force will remain below its peak size despite returning net inward migration in the coming years due to falling 1990s birth-rates which were 25% below their 1970s levels. This trend should reverse later in the decade on the back of consistently high birth rates from 2000 onward.

Sectoral employment trends

Construction, professional services and accommodation and food continue to be the standout performers in terms of employment growth. The importance of the upturn in construction for the employment prospects of those currently unemployed was seen in the Q4 figures. Long-term unemployment fell by over 32,000 year-on-year on the back of a 13,100 increase in construction employment. Long-term unemployment still constitutes 58% of total unemployment and will remain a key issue for the coming years. We expect the sectoral composition of employment to remain broadly stable over the coming year with construction again having considerable upside potential, albeit at much lower levels than in recent years. Services will add at least two in every three jobs added to the economy next year with an even split between positions in high value-added and low value-added sectors.

Figure 9: Annual avg. employment, % ch

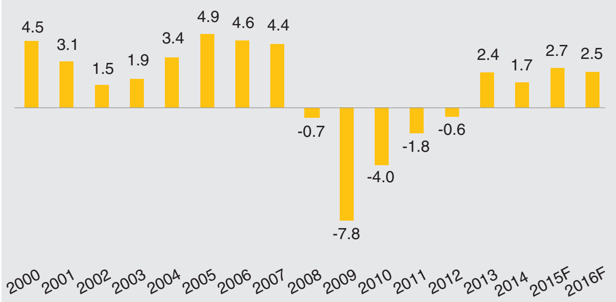


Figure 10: Annualised sectoral employment, y-on-y % ch, 2014

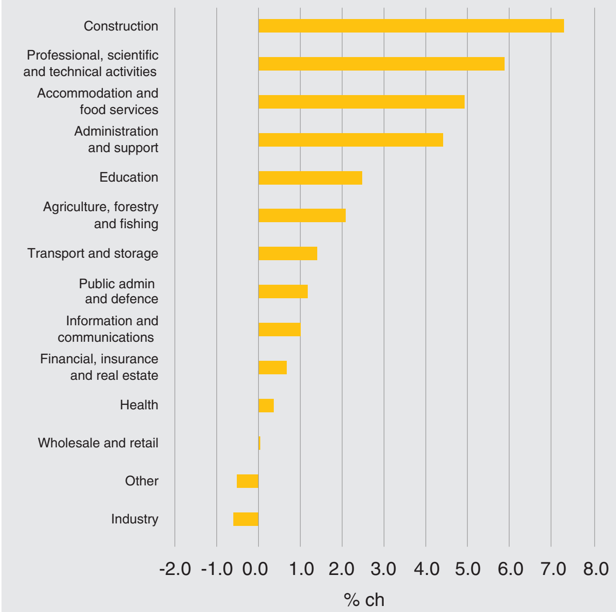


Table 2: Labour market summary

Employment 000s annual average	2014	2015	2016
Agriculture	109	105	103
Industry	348	373	387
Services	1,454	1,488	1,525
Total	1,911	1,966	2,015
Unemployed	243	201	183
Unemployment rate (%)	11.3	9.3	8.3
Labour force	2,157	2,167	2,198

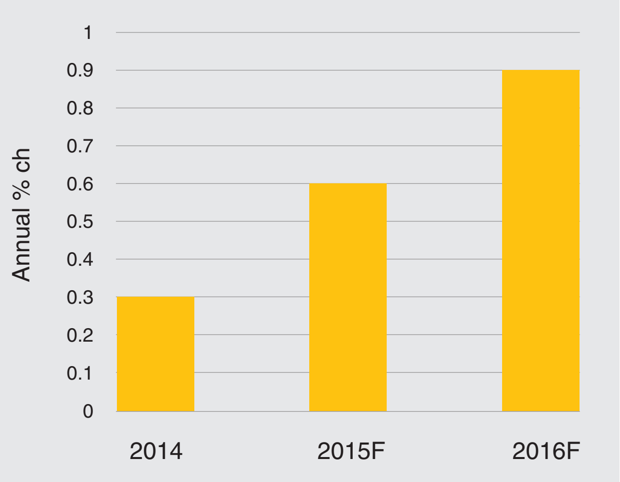
Source: Ibec forecasts

Prices and labour costs

Inflation outlook

Inflation in 2014 was almost imperceptible at 0.2%. This was due to falling energy prices and heavy price discounting in retail. Falls in global oil prices, the possibility of reduction in mortgage interest rates and further price competition in traded services will provide some downward pressure on inflation in the coming months. The combination of these factors will boost consumer purchasing power and thus GDP. Their effect on inflation, on the other hand, will be tempered by the falling euro, as imports will become more expensive. Irish imports from outside the eurozone are equivalent to 21% of GDP, with Ireland particularly reliant on fuel imports. This imported inflation will negate some of the downward pressures. We expect inflation of 0.6% in 2015.

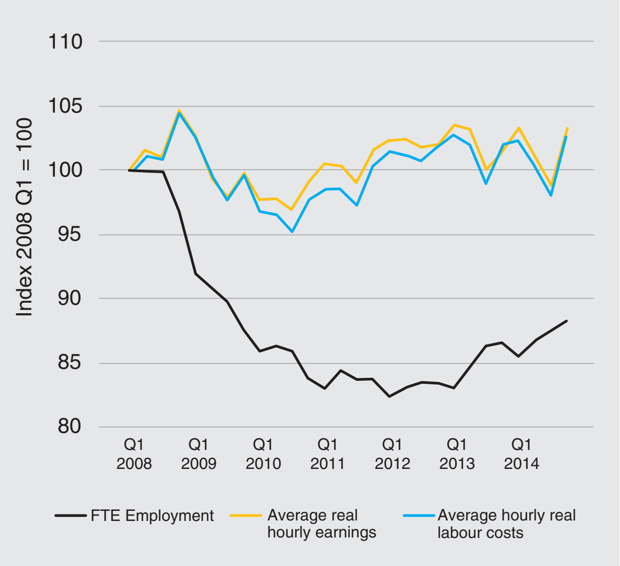
Figure 11: Inflation



Labour costs and wages

Average weekly earnings in the private sector rose by 3% year-on-year in Q4 2014 on the back of a 0.6% increase in average weekly paid hours and a 2.4% increase in average hourly pay. Inferring too much from one quarterly observation, however, may be misleading. Average private sector earnings across the whole year of 2014 increased by just 0.6% on a weekly basis and 0.3% on an hourly basis despite the strong Q4 performance. The average figures may also hide some of the underlying trends in the private sector with employment growth in relatively lower paid sectors such as construction and hospitality meaning that averages may be biased downward as the labour market recovers.

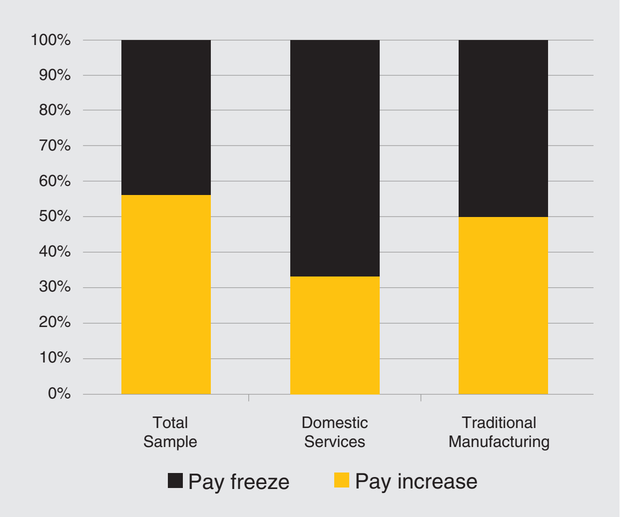
Figure 12: The cost of employment and labour demand



Sectoral pay trends

Ibec surveys suggest that pay demands are emerging in the economy. Ibec's most recent HR update survey of over 500 members showed 57% of firms expected to have some pay increase this year, with the median pay increase across those firms who were increasing being 2%. At a national level the average pay increase expectation was close to 1.1%. There is large sectoral divergence between sectors, however, with the majority of firms in high value-add sectors increasing pay in the face of skills gaps, labour market competition and increased productivity. On the other hand many firms in domestic facing sectors are experiencing different challenges. For example only 33% of firms in the domestic services sector expect to be in a position to give pay rises this year and less than half of traditional manufacturing firms. Wage demands must reflect this reality.

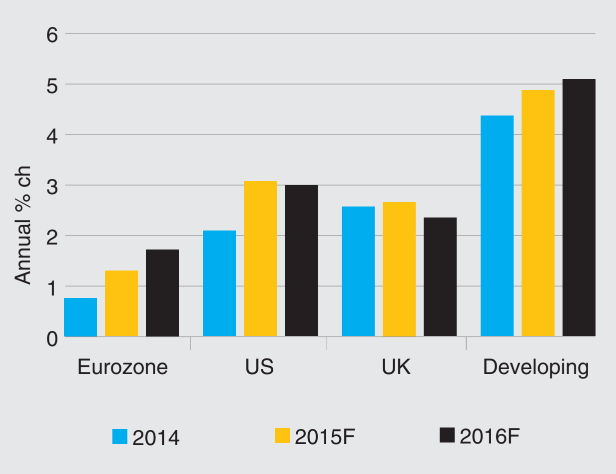
Figure 13: % of firms giving some pay increases in 2015 by sector, Ibec HR update survey



International economies

World GDP growth in 2014 remained broadly stable at around 3.3%. Current forecasts expect that growth this year and next year will be considerably higher across the majority of major markets. The regional composition of global growth remains unbalanced, however, with the eurozone continuing to lag the US, UK and emerging markets. One of the major developments at a global level this year is the large falls in oil price we have seen since the tail end of 2014. The IMF has suggested that price movements will result in a gain for World GDP of between 0.3 and 0.7 percent in 2015. The gains will be unevenly distributed, however. Major developing economies and net energy importers in the developed world will gain from the fall in oil prices. Oil exporters on the other hand will suffer from losses in revenue and their external balances will come pressure. As a result risks to financial stability have increased in some oil exporting countries such as Russia, Nigeria, and Venezuela.

Figure 14: Growth in major economies



Euro is weakening

The consequences of the ECB's QE programme are most obvious from an Irish point of view in the precipitous drop in the euro relative to sterling and dollar in the past few months. The euro is now trading at just above £0.70 sterling, its lowest rate since late 2007 and is likely to reach well below this level by the end of the year. In dollar terms the euro is trading at just above parity, its lowest level since just after the euro's introduction. Various commentators have suggested it may fall as low as 85c by 2017. This has several implications for Irish business. Firstly, there will an unambiguous boon to Irish exports as our relative competitiveness improves. Secondly, some input costs may increase; particularly for companies reliant on commodities which are traded in dollars. Finally, there may be some good news for non-exporting SME's as goods and services imported by multinationals and major multiples will become relatively dearer when compared to their Irish alternatives. This may lead some companies to rethink their sourcing strategies if the lower euro is the new status-quo.

Figure 15: Exchange rates

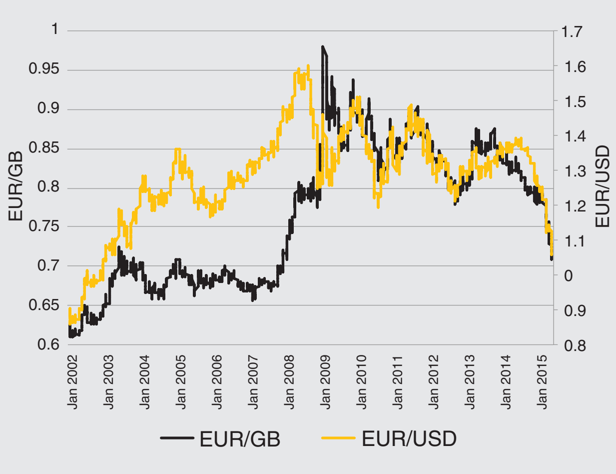


Table 3: International economies summary

	Real GDP, y-on-y % ch			Inflation, y-on-y % ch		
	2014	2015	2016	2014	2015	2016
Eurozone	0.8	1.3	1.7	0.5	0.9	1.2
UK	3.2	2.7	2.4	1.6	1.8	2.0
US	2.2	3.1	3.0	2.0	2.1	2.1
Emerging markets	4.4	4.9	5.1	5.5	5.6	5.2
World	3.3	3.8	4.0	3.8	3.9	3.8

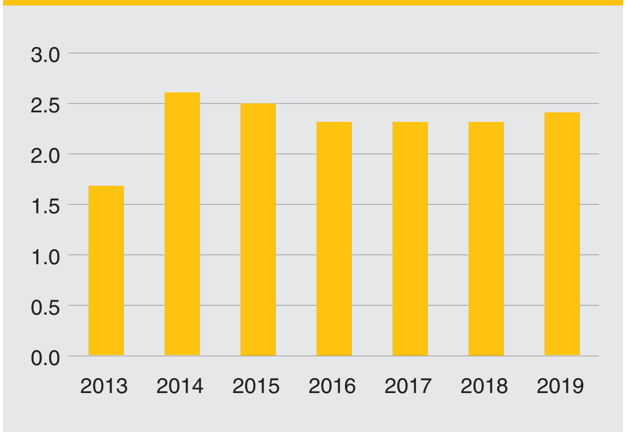
Source: IMF economic outlook

The UK budget

UK economic outlook

GDP in the UK grew by 0.5% in the final quarter of 2014 with economic growth for the full year at 2.6%. The Office of Budgetary Responsibility (OBR) forecasts which accompanied the budget suggest stable growth at above 2.3% each year to 2019. In general government consumption is forecast to contract over the coming years with government investment slowing considerably. On the other hand, household investment (2.6%) and business investment (5.1%) will expand at relatively stronger rates. On the international trade front the struggles of North Sea oil will see the UK remain a net importer of goods for the coming years. As a result of this moderate growth and a tight fiscal stance the OBR expects the UK's fiscal deficit to continue falling over the next five years, reaching small surpluses by the end of the decade.

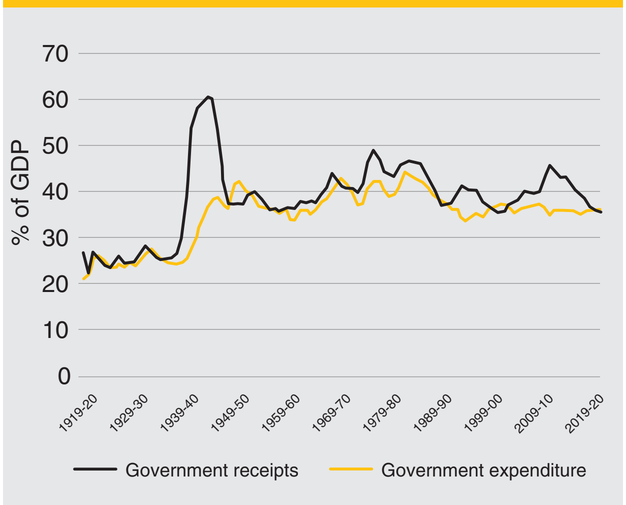
Figure 16: GDP growth (% ch) UK (OBR budget forecasts)



The budget

The UK budget saw no major policy moves with small income tax changes, marginal reductions in excise, support for the North Sea Oil industry at the core of the package and an SSIA style saving scheme for first time buyers. The major change, however, was signalled on a more macro level with the government committing to austerity and a reduction in the size of the state for the foreseeable future. Government spending and investment are to be pared back in the coming years with the size of state expenditure, at 36% of GDP, falling to levels comparable with 1999 and not seen before that since the 1960's. With considerable government commitment to fiscal retrenchment over the coming years, the OBR expects the UK's net debt to GDP ratio to fall to 71% by 2019 from 80.4% today. The makeup of those cutbacks may have consequences for competitiveness and Irish business interacting with the state in the UK.

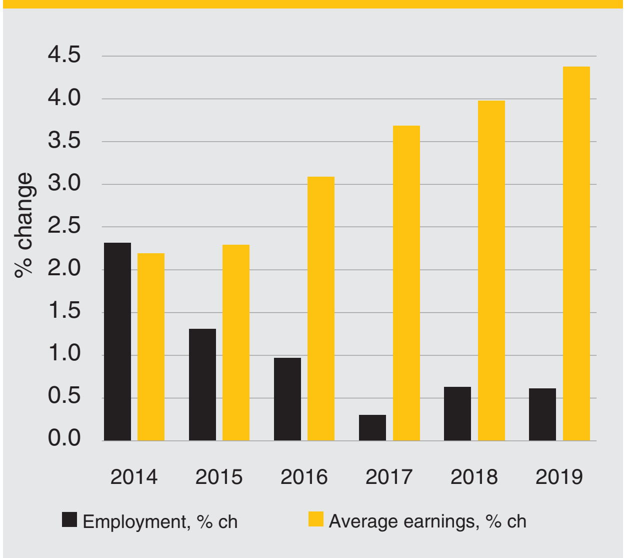
Figure 17: Fiscal stance in the UK



The UK consumer

The UK budget saw some fairly marginal boosts for the UK consumer. The personal tax allowance rose to £10,800 (€14,754); in addition the earnings threshold at which people pay the higher rate of income tax also rose to £42,385 (€57,905). Unemployment in the UK fell to 5.7% by the end of 2014 with a further fall to 5.3% expected in 2015. Full employment will mean a slowdown in employment growth to an annual average of 0.6% in the years between 2016 and 2019. On the other hand, the tighter labour market will lead to wage pressures seeing average earnings growth rising from 2.3% in 2015 to an average of 3.8% per year until 2019. In addition lower oil prices have led to a boost in consumers' real incomes with household consumption growth of 2.6% forecasted for 2015.

Figure 18: Employment and earnings in the UK



Ibec priorities for the Governments' Spring Statement

As we emerge from the economic crisis it is clear the State is faced with a number of challenging resource allocation choices. Limited fiscal space means that these choices will be more difficult than in the Celtic Tiger period. The forthcoming Spring statement gives the Government an opportunity to set out its priorities in this regard. Strong growth can be maintained as long as we manage the recovery sensibly. Ibec has identified the following medium-term priorities:

1. Income tax: According to the OECD our income tax system is the most progressive in the developed world. There is, however, a clear trade-off between this redistribution, people's incentive to work and companies' ability to attract and retain high skilled staff. The case for reducing marginal rates of tax is clear. High marginal rates of tax disincentivise people from taking on extra work, from increasing their skills and from working in Ireland at all. In this context, it was disappointing that the Government created a third higher rate of tax for workers in Budget 2015 by retaining a higher rate of USC for those earning over €70,000. Putatively this caps the 'gains' which would go to higher earners, in reality though it is damaging companies' ability to attract and retain high skilled workers. In a new post-BEPS world it is by creating an attractive country for high skilled workers from home and abroad that Ireland will increase its productivity and subsequently grow its economy. There is no economic justification for maintaining penal income tax rates on these workers.

2. Taxation of entrepreneurship: Policymakers over the past decade have often lauded entrepreneurs as being central to developing indigenous firms which can compete globally. The signal we send through our tax system, however, differs greatly from the rhetoric. The Taoiseach in his recent speech at Ibec's CEO conference acknowledged as much by referring to the higher rate of tax for the self-employed as "discriminatory". With the higher rate of USC, the lack of an equivalent to the PAYE credit and the higher rates of CGT introduced in recent years our tax system has gone in the opposite direction to much of enterprise policy. If we are truly serious about creating a high skilled entrepreneurial economy these issues should be central to future taxation policy.

3. Capital expenditure: We need to dramatically ramp-up capital spending if we are to avoid the mistakes of the past, when significant infrastructure gaps constrained growth and created bottlenecks. At the moment, however, we're not investing nearly enough. Record low interest rates offer a once in a generation chance to invest ambitiously in the country's future. The Government should commit to spending 4% of GDP on infrastructure by 2020. Housing under supply in key urban centres has the potential to undermine competitiveness and make it more difficult to attract and retain talented workers. The Government needs to do much more to address supply shortages. Our transport network is also far from complete. During the boom years we successfully connected Dublin to the other main cities, but there is still a job to do to better connect all of our major cities to each other. Significant infrastructure gaps also exist in health, education, energy and environmental services sectors, which should be addressed as a priority.

4. Education and research investment: he education system has an essential role to play in supporting economic growth through the development of new knowledge and the provision of skilled workers. Unfortunately Ireland has reached a tipping point in terms of the impact of recent cuts on quality in key areas and the process of reversing these cuts must begin:

- An increase in resources to support ongoing school reforms such as the literacy and numeracy strategy, changing the junior cycle and transforming maths and science curricula
- An ambitious programme of continuous professional development for teachers in recognition that teaching quality is the greatest influence on student outcomes
- A robust financing model and a process of reversing recent cuts in higher education funding to address quality and future demand
- A rebalancing of investment priorities in the forthcoming National Skills Strategy towards in-employment development programmes (e.g. Skillnets) and training programmes with demonstrable labour market outcomes (e.g. apprenticeships)
- An ambitious long-term vision for science, technology and innovation funding by resetting the R& D intensity target to 3% of GDP in line with the Europe 2020 strategy.

5. Public sector pay: public sector workers have made a central contribution to Ireland's fiscal recovery through pay reductions, productivity and their ongoing commitment to the delivery of public services. As economic circumstances improve it is appropriate that public sector pay rates should be reviewed. The process must take into account the following factors:

- the State's limited ability to finance pay increases, despite the emergence of economic recovery
- relative pay levels in the public and private sectors, and international competitiveness issues
- the need for pay differentiation within the public sector which reflects labour market circumstances
- the need to deliver OECD recommended pension reforms.

Credit conditions

Credit conditions for business are tight

Credit conditions continue to disadvantage Irish companies relative to their EU counterparts. Interest rates for new loans of up to €1 million remain 195 basis points above the eurozone average and 241 basis points above similar rates charged to German companies. ECB actions late last year have seen the eurozone average interest rate fall by over 70 basis points over the twelve months to January 2015; on the other hand the interest rates on similar loans for Irish companies rose by 25 basis points. As a result the cost of funding gap between Irish and other eurozone companies is now at its largest since the introduction of the euro; limiting the expansion of Irish SMEs relative to their European peers. The gap has now widened to 100 basis points, a difference in annual servicing costs of €19,500 or 39% on every €1 million borrowed.

House prices

After strong increases in property prices nationally for most of 2014 the market has seen a strong slowdown since the announcement of the Central Bank's new lending regulations. Monthly price increases across the country averaged 1.4% in the months up to November but reversed to -0.2% in the months since then. For Dublin the change was even more pronounced with increases averaging 2% falling off to -0.6% post the announcement. In the month of January residential property prices fell by 1.4% nationwide, the largest fall in national prices observed in a single month since February 2012. Despite this fall, residential property prices remain up 15.5% over the twelve months to January. It remains to be seen, however, whether this is a long-term moderation or merely a temporary adjustment while cash buyers, so prevalent in the market last year, assess the impact of the new regulations.

Mortgage arrears

Total mortgage arrears for principal dwelling houses (PDH) have come down in Q4, continuing the reduction present in the previous five quarters. The total number of PHD accounts in arrears, representing 14.5% of all mortgage accounts, has declined by 6.4% quarter-on-quarter to 110,366. The value of arrears over 90 days saw a decline of 7.4% in Q4 compared to Q3. Meanwhile the value of arrears over 720 days has risen, though at an increasingly slower pace compared to previous quarters. While overall the balance and the number of accounts in arrears are falling, long-term arrears are still high as borrowers move from short-term to long-term arrears. As the number of borrowers entering arrears shrinks the long-term balance (over 90 days) will continue to decline. Separately the level of buy-to-let mortgage accounts in arrears (over 90 days) has seen a decrease of 7.6% in this last quarter.

Figure 19: Interest rates for new business (up to €1 million, 3mo mav)

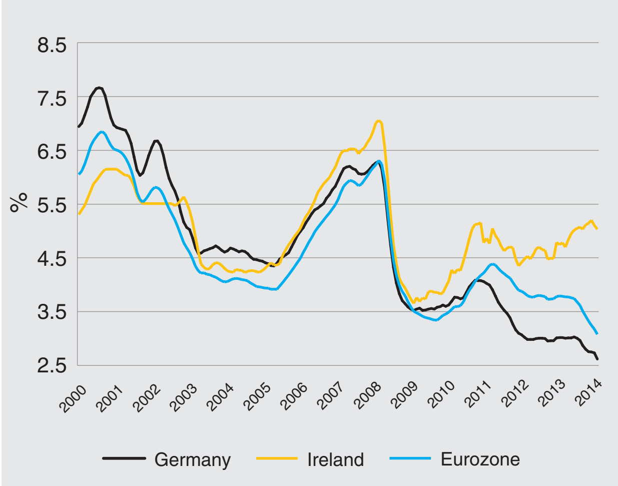


Figure 20: House prices

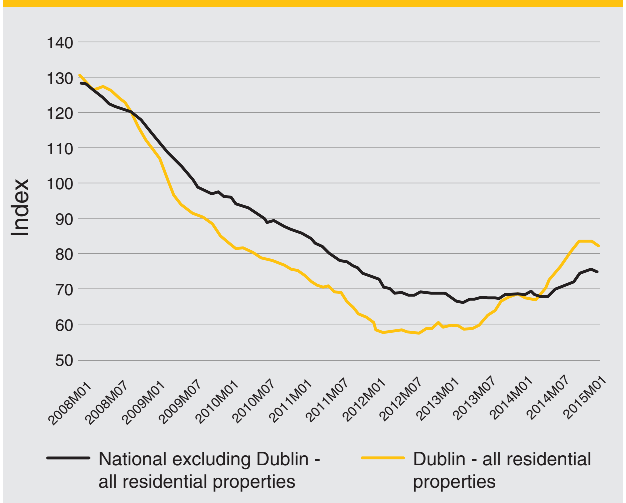
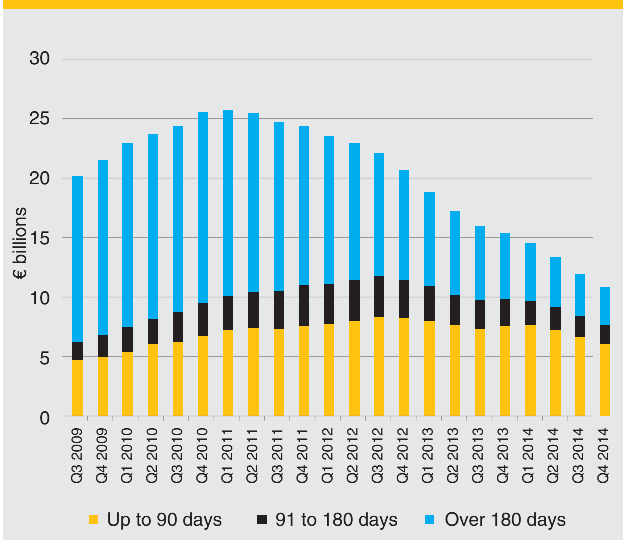


Figure 21: Mortgage in arrears



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