Q4

2015

Ibec Quarterly Economic Outlook

Growing pains

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Economic growth has surpassed expectations again this year with the likelihood now being that the economy will grow by above 7%, its fastest rate in 15 years. In addition, employment, incomes and tax returns are all well ahead of expectations. This new phase in our economic development will bring new challenges.

Caution is needed as a large chunk of this growth has been driven by temporary factors outside of our control while underinvestment means the expanding domestic economy will bring growing pains in housing and infrastructure.

GNP and its components

Annual % change	2014	2015	2016
Consumer spending	2.0	3.7	4.4
Government spending	4.6	1.4	3.1
Investment	14.3	27.2	13.1
Exports	12.1	13.7	9.1
Imports	14.7	15.9	11.5
GDP (Volume)	5.2	7.1	4.3
GNP	6.9	5.9	4.4
GDP (Value)	5.3	11.7	7.2

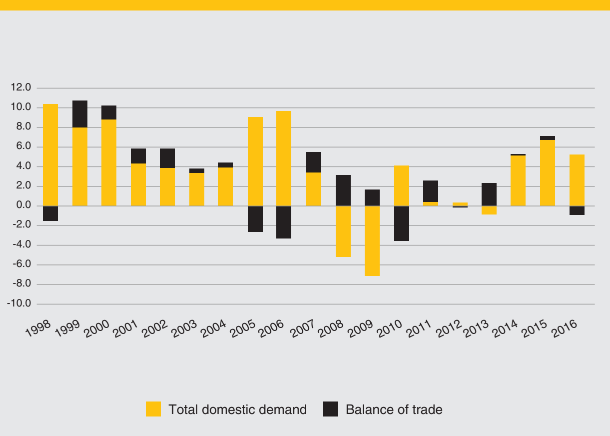
Ibec
For Irish Business

GDP and components

Economic growth

GDP in the first three-quarters of 2015 was up 7% annually. We now expect the 2015 GDP growth outturn to be 7.1% somewhat ahead of our Q1 expectation of 5.4%. The main reason GDP growth is set to exceed previous forecasts is due to stronger than expected consumer spending, which looks set to grow by over 3.5% in 2015. A number of leading indicators for the second half of the year, particularly the strong performance in the government's tax take as well as employment figures, have provided further evidence of an economy which grew rapidly in 2015. The Irish economy is now in a sweet spot with the confluence of favourable exchange rates, low interest rates and falling oil prices benefiting us more than any other European country. In addition, the return of some moderate wage growth and strong increases in employment mean that the domestic economy will account for the majority of total growth both this year and next. It is important to remember, however, that many of the drivers of Irish output growth this year are both external and temporary. In this context retaining underlying competitiveness will be key to sustaining prosperity once the effect of these temporary factors recedes.

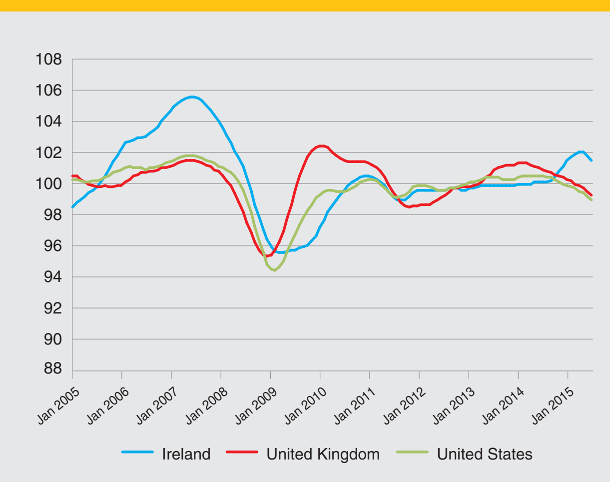
Figure 1: GDP growth contributions



Leading indicators

The OECD's CLI (composite leading indicator) is a composite of a number of timely indicators which have proven useful in detecting turns in the business cycle in Ireland six to nine months in advance. Following a notable upturn in the first half of the year the indicator has fallen slightly in recent months in line with falls in the same series for the UK and US. As a result of Ireland's extreme openness to trade estimates of the elasticity of Ireland's GDP to changes in global GDP growth suggest a 1% fall in global GDP growth could knock about 1% off Ireland's GDP growth rate. Given that IMF forecasts for global growth next year have fallen by 0.5 percentage points over the past 12 months it is likely we will see some moderation of Irish economic expansion in the first half of 2016 if problems in the global economy persist.

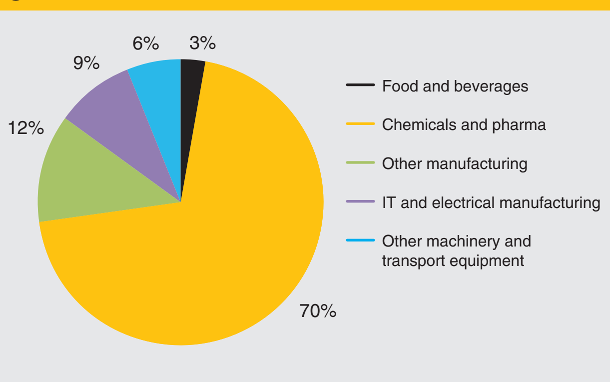
Figure 2: OECD composite leading indicators



Exports

Favourable exchange rates have meant that Irish export volumes are likely to grow by 13% in 2015 with the value of Irish goods and services exports rising in the region of 24%. Almost two-thirds of this growth will come from goods exports which have been the main beneficiaries of favourable trading conditions. Merchandise exports in the first nine months of the year were up €12 billion on the same period last year suggesting a bumper year for companies trading abroad. This growth in exports should be met with some caution, however, with 70% of the growth coming from the pharma sector where the majority of exports are priced in dollars (with the weak euro inflating their euro value). This has led to a substantial boost in profits in the economy which is heavily concentrated in a relatively small number of sectors; this is playing a major factor in the rising corporate tax take in the country. Exports from indigenous dominated manufacturing sectors on the other hand have grown by 10% in value terms with food and beverages exports, for example, rising by 5.2% over the period.

Figure 3: Contribution to 2015 goods exports growth, %



Investment outlook

Investment growth is expected to be relatively strong with total investment up by 26.3% in the first three quarters of 2015. Some once off activity surrounding patents has boosted headline investment, well above previous expectations of 11.5%, but this has been offset by a corresponding patent import and will have a limited impact on GDP. In a historical context overall investment in the economy is now at its lowest level on record. Business investment, while down significantly on 1970's levels (due to the increase in services as a proportion of economic activity from 43% in 1970 to 69% today), is now at its highest level since 1990 as a proportion of GNP and is the significant driver of investment growth.On the other hand it is clear that housing has over-corrected in recent years following the housing bubble. Housing investment currently accounts for about 2.3% of GDP; this is compared with averages of between 4% and 6% during the pre-bubble period. As a result, current levels of housing investment in Ireland are about 40% of the twenty year norm in other European countries. The consequences of this over-correction can be seen in rising rents and lack of suitable accommodation in urban areas. Given the intractable nature of house undersupply this is likely to continue to be a major issue in the labour market over the coming years.

Pre-crisis investment comparison

Ireland's case is unique when looking at the fall in investment across Europe since 2008. In particular, the divergence between private and public investment in Ireland since 2008 has been far more stated than in other European countries. Public investment in Ireland has fallen by 57% between 2008 and 2015; this is somewhat ahead of a fall of 4.1% in the other PIIGS countries which also have suffered similar severe budget constraints over the period. On the other hand, private (non-housing) investment in Ireland is now 64% higher than in 2008 and almost 90% higher than its lowest post-crisis level in 2010. By comparison private investment (non-housing) has grown by only 5.1% in the non PIIG EU15 countries and is 82% below its 2008 level in Greece. This significant bounce back in Irish private sector investment has been one of the major drivers of the Irish recovery with space evident for further investment growth of 7.6% being driven by the private sector in 2016.

Consumer spending

Rising employment along with a return of moderate wage growth will see the volume of consumer spending rise by 3.7% in 2015 and 4.4% in 2016. National accounts figures for the first half of the year showed total aggregate disposable income of all households rising by 7.7% on the same period in 2014. This rise in disposable incomes will not necessarily translate directly to expenditure growth with household expenditure growing by only 3.6% over the same period as households committed over half of the additional income to saving and paying down debt. Loans outstanding to households fell by over €65 billion (41%) from its peak while down almost 8% in the past year. The pace of household deleveraging will be a key tension between growing consumer income and spending in the coming years. It has shown some signs of abating, however, with the household savings rate down to 10.7% of disposable income in the first half of 2015 from 17.2% at its peak in 2009.

Figure 4: Long run rates of investment, % of GNP

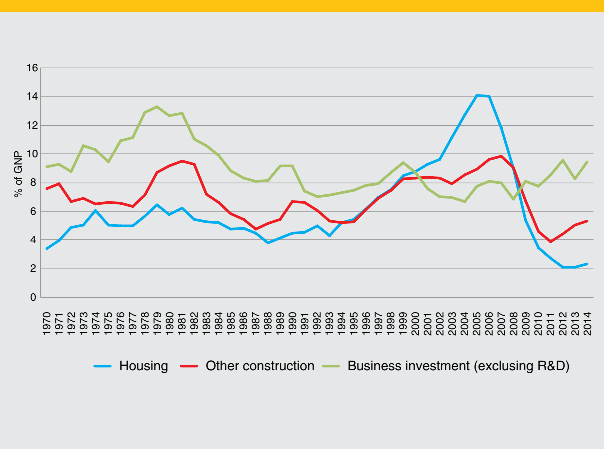


Figure 5: Investment change comparison, 2008 - 2015, %

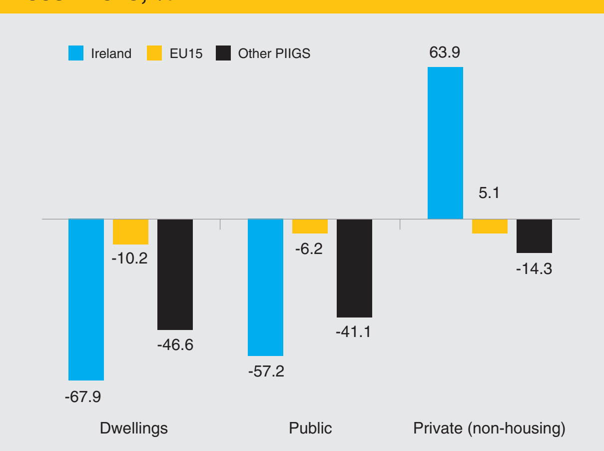
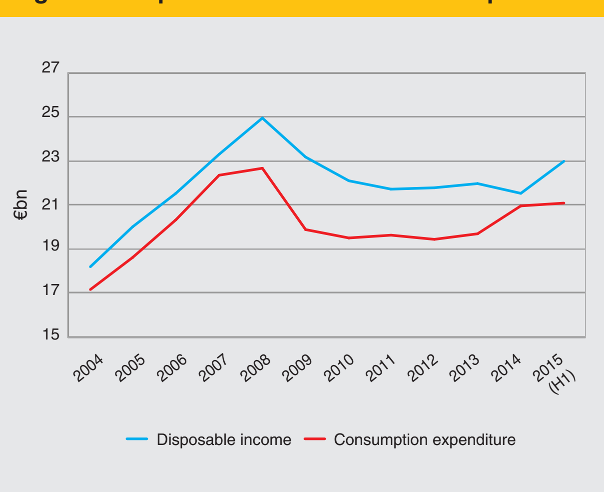


Figure 6: Disposable income and consumption



Retail sales

Retail sales (excluding cars and bars) volumes grew by 6.2% while values increased by 2.3% in the first ten months of this year. While the upturn in the economy is resulting in many economic variables returning to pre-crisis levels, retail sale values (excl. cars and bars) in October this year were still 14% below values in October 2007. Breaking this down and looking at different categories of goods, retail sale volumes for electrical, clothing and household equipment have returned to their 2007 levels. On the other hand, values for these groups have deteriorated significantly and are currently 29% (electrical), 21% (clothing) and 33%(household equipment) below the level they were at in October 2007. This underlines the fact that while the recovery in sales volumes has been impressive this year, it is being achieved primarily through lower prices.

Summary of growth outlook

Growth in 2015 will be driven by a strong mix of domestic demand and trade. Total domestic demand will add in the region of 6.8 percentage points to total growth during the year as the domestic recovery becomes further engrained across sectors of the domestic economy which have struggled in recent years. Net trade on the other hand will add only 0.3 percentage points to GDP despite strong export growth of 13.7%. This is due to a number of significant once-off patent imports during the year. On the other hand there are a number of downside risks to Ireland's economic positon. These risks mainly stem from the fact that the drivers of the contribution of exports to economic growth are temporary in nature. It is unlikely that exchange rates or oil prices will move significantly against Ireland in 2016 but the global economy is showing signs of slowing just as we emerge from the crisis. Transitory competitiveness gains should be treated as what they are; building in higher costs domestically on the back of these temporary gains has the potential to leave Ireland exposed when the temporary factors recede in future years.

Figure 7: Retail sales

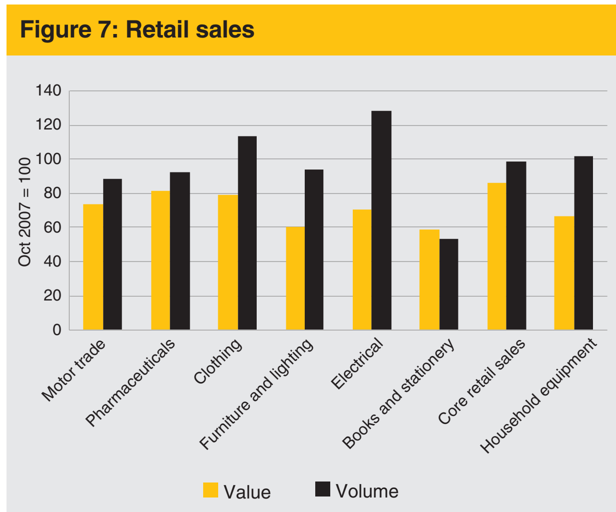


Figure 8: Contributions to growth

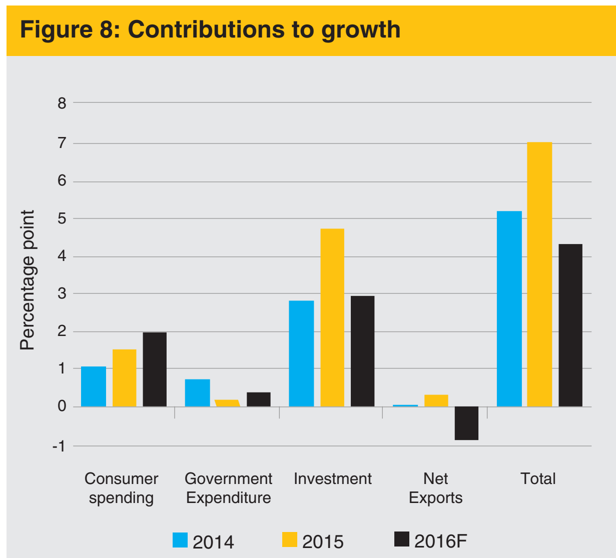


Table 1: Risk assessment for 2016

Factors	Probability		
	High	**Medium**	**Low**
Financial market stability			Downside risk
Infrastructure gaps	Downside risk		
Fiscal pressure	Upside risk		
Wage pressures		Downside risk	
Global oil prices		Upside risk	
Exchange rates	Upside risk		
Geo-political conditions		Downside risk	Downside risk
International economy	Downside risk		
Labour market conditions		Upside risk	

■ Downside risk ■ Upside risk

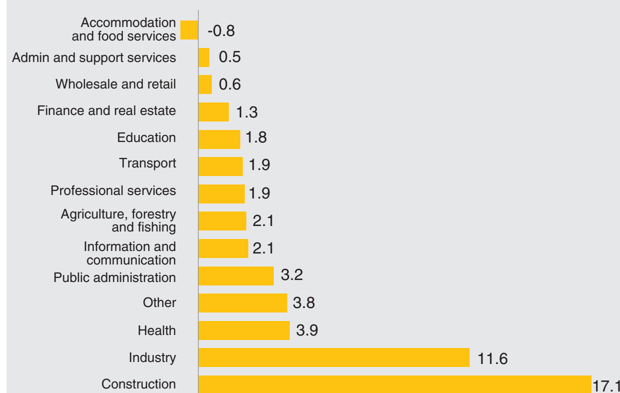
Source: Ibec assessment

Labour market

Employment forecast

CSO figures for Q3 showed employment growth of 2.9% annually, providing the best measure of the positive momentum in the domestic economy. Employment is now likely to reach 2 million, for the first time since early 2009, over the coming months. In addition, unemployment will now be below 9% by the end of 2015 with preliminary CSO estimates suggesting this milestone may have been reached in October. Encouragingly employment growth in Q3 came in 12 of 14 sectors, with strong annual increases in construction (+14,900) and industry (+13,500) reducing damaging long-term unemployment to its lowest level since 2009. The regional spread of the recovery remains a challenge, however. Most parts of the country are now seeing some recovery with employment growing annually in every region bar the West. Despite this, the difference in the pace of employment growth between Dublin and the regions has widened significantly in recent quarters. Employment is now growing at 5% annually in Dublin compared to 2% in the rest of the country.

Figure 9: 2015 Employment growth by sector, forecast



Labour market transitions

Another useful way of looking at the churn in the labour market is to examine transitions between employment and non-employment (and vice-versa). In effect these show the number of persons in each quarter either moving from employment into unemployment or out of the labour force along with the number of people moving into employment over the same period. The most striking feature of these figures is the fact that the number of people moving into employment each quarter has remained relatively steady since 2010 despite the marked upturn in the labour market. The majority of net employment growth in the period since 2012 has actually been achieved due to a dramatic fall in the number of persons losing or leaving employment. This suggests that growth in the number of companies able to retain existing headcount, rather than the creation of new jobs, has been the single most important factor in the labour market upturn of recent years.

Figure 10: Quarterly labour market transitions, thousands

Table 2: Labour market summary

Employment 000s annual average	2013	2014	2015	2016
Agriculture	107	109	111	112
Industry	343	348	377	400
Services	1,430	1,454	1,473	1,506
Total	1,879	1,911	1,962	2,018
Employment growth (%)	2.4	1.8	2.8	2.6
Unemployed	282	243	201	174
Unemployment rate (%)	13.0	11.3	9.3	8.0
Labour force	2,163	2,157	2,166	2,192

Source: Ibec forecasts

Prices and labour costs

Inflation outlook

Overall inflation for 2015 is forecast to be -0.2%, having fallen by -0.3% in the first 11 months of this year. This aggregate deflation captures two diverging trends. On the one hand, goods prices are falling (-3.8% YTD) while on the other service prices are rising (2.3% YTD). Goods prices are highly influenced by the global economy, particularly by commodity prices and therefore the falling oil price had a substantial impact on recent deflation. Both energy prices and transport costs have had a negative impact on goods inflation this year, as has increased competition in the retail sector. Service prices on the other hand are highly influenced by housing and labour costs. In 2008, the economic slowdown and falling rents caused this measure to fall. During the past year it has risen quite sharply, however, suggesting that the upturn in the economy is being reflected in prices despite overall low inflation that is being driven by low world oil prices and strong retail competition.

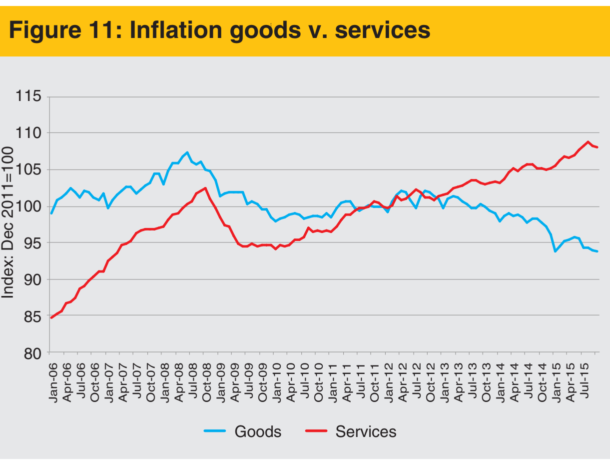


Figure 11: Inflation goods v. services

Wages

Ibec's most recent HR Update survey of 350 HR managers suggests that some moderate pay growth is returning to the Irish economy. Seven out of ten (71%) companies surveyed expect to increase basic pay in 2016; this is an increase from 67% in 2015 from the same survey. The median increase of 2% remained relatively unchanged from recent years. Given that the remainder of respondents expected basic pay to remain unchanged, the average expected pay increase across the economy was 1.75% in both 2015 and 2016. There remains large differences between sectors, however, with upwards of 90% of firms in some high-tech manufacturing sectors expecting to give pay increases in the coming year. On the other hand, only half of employers in some domestic services sectors planned to give a pay rise in 2016. This divergence in wage trends, which reflects both skills gaps and the relative recovery of domestic versus exporting sectors of the economy, is a key driver of divergence in the recovery in incomes between households over the coming years with particular impacts on local consumer demand.

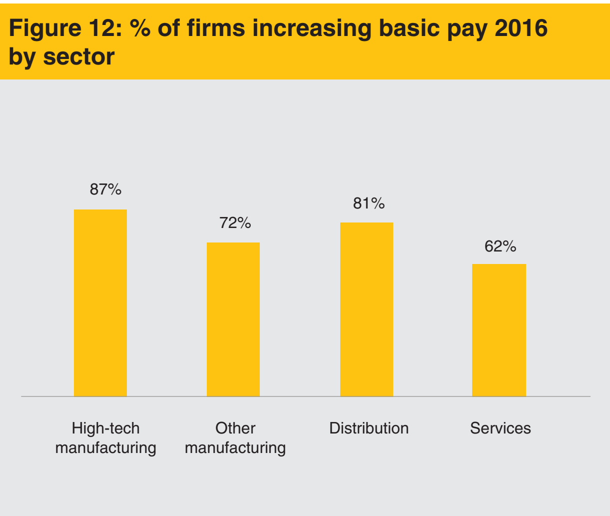


Figure 12: % of firms increasing basic pay 2016 by sector

Labour market tightness

The unemployment to vacancy ratio measures how many unemployed people there are per job vacancy. The lower this ratio is, the harder it is to fill a job vacancy and the more likely it is that wage pressures will begin to emerge in the economy. In Ireland, this ratio has fallen substantially from 55 unemployed persons per vacancy in 2009 to 15 people per vacancy in 2015. While this drop is significant, the ratio is still elevated, particularly in a European context. In Greece and Spain this ratio is still very high (69 and 61 people per vacancy) as they have not experienced the same growth in employment that was seen in Ireland. By contrast, compared to the UK and Germany (2 people per vacancy) the ratio is still quite high suggesting the Irish labour market has some way to go yet to return to equilibrium.

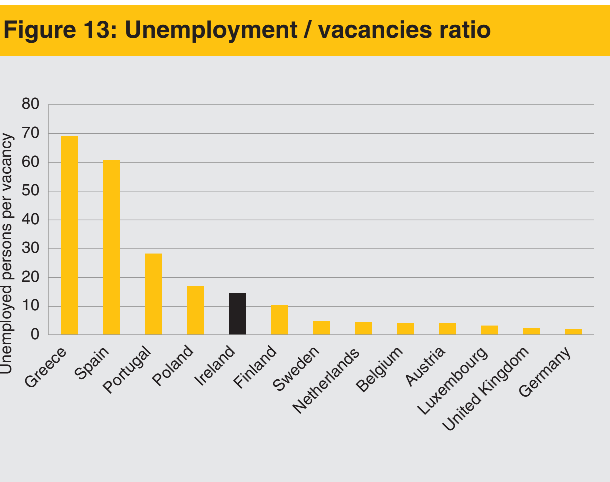


Figure 13: Unemployment / vacancies ratio

International economies

International Economies
Global growth is expected to be 3.1% in 2015, marginally lower than in 2014. This captures expected growth of 2% in advanced economies and growth of 4% in emerging market economies. The primary cause of the fall in world GDP growth is the slowdown in emerging market economies. Growth in emerging economies has slowed (it was 6.3% in 2011); this trend is worrying given that in recent years emerging markets have accounted for a greater share of world GDP growth. Between 2010 and 2015 emerging markets accounted for 77.2% of world GDP growth. In the coming years, this share is likely to fall as China's growth stabilises at a new lower rate with lower demand for commodity imports which will affect other developing countries.

Currency movements
The euro continues to remain weak against both the dollar and sterling, having depreciated by an additional 4% against the dollar and 3% against sterling in November. This depreciation was largely brought about by speculation that the ECB would extend its quantitative easing programme and the increasing likelihood that the US will raise interest rates in the next month. While the euro did appreciate temporarily following the ECB's announcement that its quantitative easing programme would not be as extensive as had been predicted, over the medium term this combined with higher interest rates in the US will see the euro depreciate further against both currencies which would provide exports with an additional boost in 2016. Irish exports are extremely vulnerable to movements in exchange rates and the weak euro has been a significant boost to Ireland. In the first nine months of this year the value of exports to the UK was 9.1% higher and exports to the US 20% higher than the same period last year. While a future depreciation in 2016 will lead to some level of export growth, it is unlikely to be of the same magnitude that was seen in 2015.

Figure 14: Growth in major economies, % ch

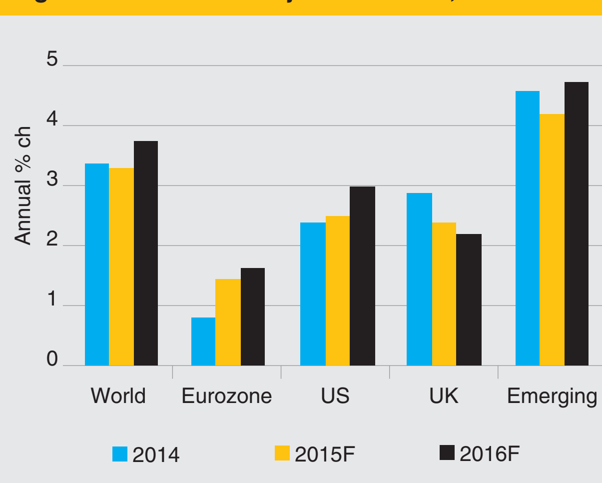


Figure 15: Euro exchange rates

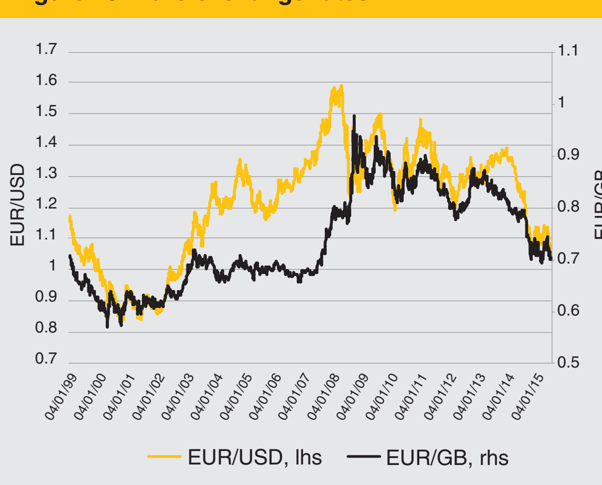


Table 3: International economies summary

	Real GDP, y-on-y % ch			Inflation, y-on-y % ch		
	2014	2015	2016	2014	2015	2016
Eurozone	0.9	1.5	1.6	0.4	0.2	1.0
UK	3.0	2.5	2.2	1.5	0.1	1.5
USA	2.4	2.6	2.8	1.6	0.1	1.1
Emerging markets	4.6	4.0	4.5	5.1	5.6	5.1
World	3.4	3.1	3.6	3.5	3.3	3.4

Source: IMF economic outlook

Oil and OPEC

Oil prices

Up until 2015, there had been a relatively close relationship between oil price and supply. Typically a low price would lead to a fall in investment which would reduce output. Since 2015 this trend hasn't held up as low prices haven't resulted in falling supply. While the US has reduced its production, OPEC member countries have been maintaining their existing levels of output in the hope that the low oil price will push some high cost producers out, thus increasing their market share. This increased supply has meant that oil prices have fallen further. Since October 2014 the oil price has fallen by almost 50% but over the same period supply has risen by 4%. Oil importers like Ireland benefit from this, as it puts downward pressure on the cost of living and also reduces the value of imports which has positive effects on the country's current account.

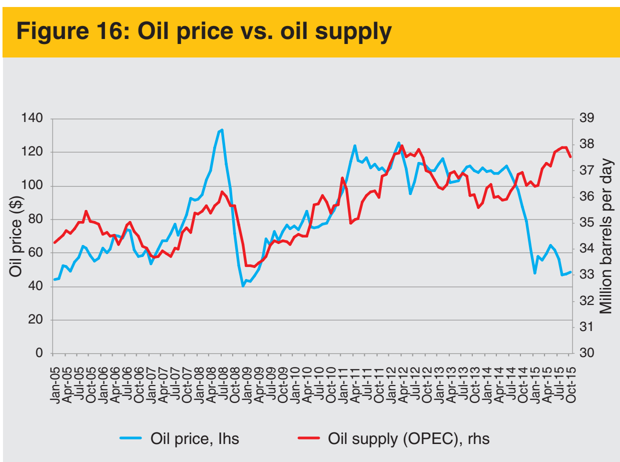


Figure 16: Oil price vs. oil supply

Oil Exporting Countries

The break-even oil price is the price which must prevail to ensure that states, whose budgets are heavily dependent on Oil related tax revenues, have sufficient funding to pay for public services. The reason why this price differs amongst different countries is due to the fact that different countries depend to varying degrees on oil revenues to finance public spending. Some countries are therefore more reliant then others on oil generated revenue to sustain public expenditure.
The IMF estimates that current oil prices are below this level in all OPEC countries, but those with a higher break-even price will be more adversely affected by the recent dip in the oil price. Kuwait, Qatar and UAE are in a relatively good situation but Algeria and Saudi Arabia have a breakeven price of more than €100 – meaning that the current low oil price will be putting significant strain on public resources in those countries.

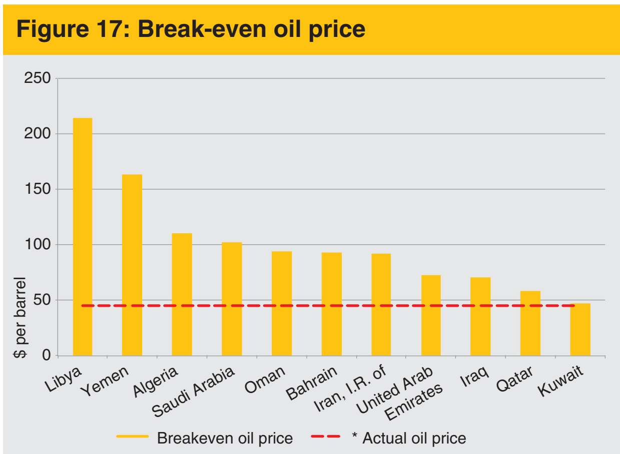


Figure 17: Break-even oil price

Fiscal Balance

This strong reliance on oil revenue can be seen by looking at the non-oil fiscal deficit which is almost -60% of GDP for certain oil exporting countries. Looking at the general government balance (including oil revenue), the only countries that will be running a government surplus in 2015 are Qatar and Kuwait. Saudi Arabia will suffer the largest deterioration in its budget balance (fallen from 30% in 2008 to -22% in 2015). Those who will experience the smallest movements are Indonesia (0.05% to -2.3%) and Iran (0.6% to -2.9%). Angola will be the only OPEC country that will see an improvement in its fiscal balance this year compared to 2008. Venezuela (not included in chart) is most at risk as it was struggling to keep its budget balanced even when the oil price was high. This deterioration in oil prices may result in further instability in countries more heavily reliant on oil revenues in the coming years.

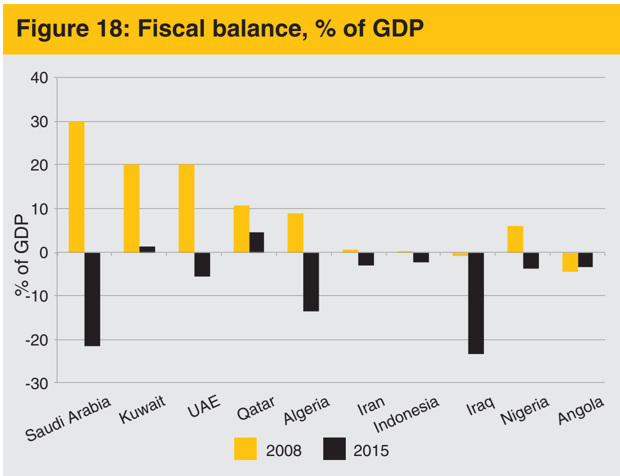


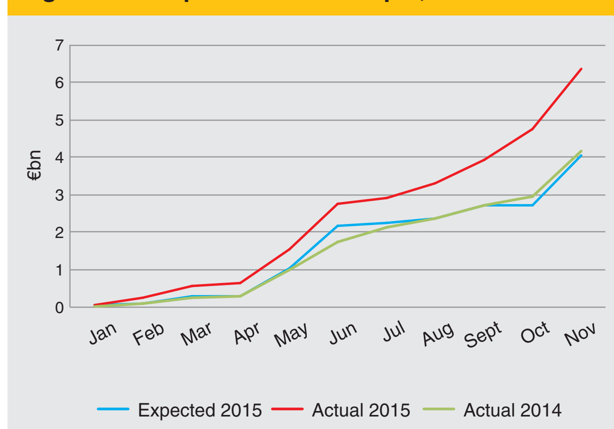
Figure 18: Fiscal balance, % of GDP

Corporation tax

Trends in corporation tax

Total tax returns for the year until November are almost €3 billion ahead of targets set for Budget 2015. Of this, just over €2.3 billion or 79% is accounted for by a massive overrun of corporation tax receipts. Total corporation tax receipts in the year so far are now up 58% on expectation and 52% (€2.2 billion) ahead of the same period in 2014. This over-performance has been driven in particular by rising profits in a relatively small cohort of firms. Gross operating surplus (or gross profits) across the economy increased by €7 billion or 20% annually in the first half of 2015. This was driven by a number of factors including nominal output growth in the economy of 12%, exchange rate factors benefiting profitability (as we have drawn attention to previously many multinational companies operating in Ireland sell their produce in dollars boosting trade, turnover and profits) as well as some structural changes in the multinational sector. This growth should be taken in context; however, with tax returns broadly reflecting output in the multinational dominated sectors which is now well above pre-crisis levels.

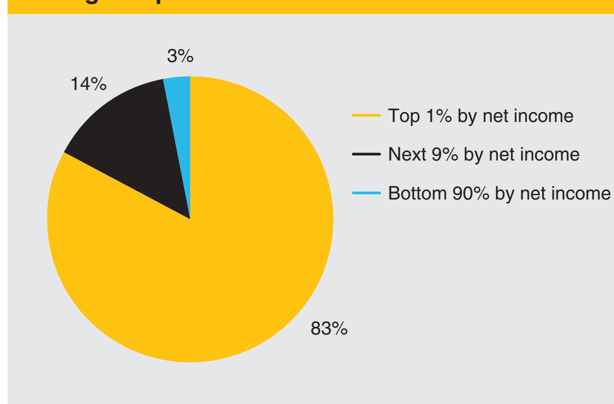
Figure 19: Corporation tax receipts, 2015



Corporation tax distribution

Some volatility in corporation tax take is not to be unexpected given the fact that a relatively small number of companies pay the vast majority of the tax take. The top 1% of companies by net income paid 83% of total corporation tax in 2013 the most recent year for which data was available. The top 10% (circa 5,000 companies) paid 97% of the total tax take; while the remaining €122 million (3%) of the €4.07 billion tax take was paid by 90% of companies. This extreme concentration of corporate taxation in a small number of firms means that policy issues affecting them can have serious fiscal consequence. This is increasingly the case in the context of growing global competition for FDI from countries such as the UK. In a post BEPS world, where global FDI decisions will increasingly be based on the individual rather than the corporate, retaining our competitive edge will involve enhancing our attractiveness as a place to live and work as well as our long-standing attractiveness as a business location.

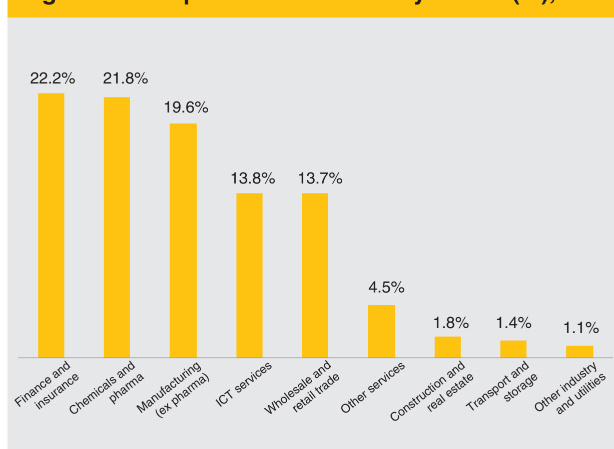
Figure 20: Distribution of corporate tax take among companies



Sectoral shares of corporation tax

Those sectors which make up the majority of corporation tax receipts are an important focus for public policy for good reason. Many of these sectors, however, are capital rather than labour intensive meaning that policies which increase investment may not necessarily lead to a similar scale of employment growth. For example, the chemicals and pharma sector employs in the region of 30,000 persons but makes up 22% of the corporation tax take. Wholesale and retail on the other hand has 275,000 employees and pays less than 14% of the corporation tax take. Despite the return of strong employment growth, the dual nature of the economy has been one of the key drivers of the disconnect between the spectacular economic growth and a broad swath of households not experiencing the pace of the recovery. Gains in the last number of years have been concentrated in a relatively small number of sectors and therefore employees. 2015 has been a turning point in this context with the return to growth in the domestic sectors of the economy in the past year likely to lift more boats than the export led growth of previous years.

Figure 21: Corporation tax share by sector (%), 2012



Housing market

House Prices

Despite the fact that house prices are still 34% below 2007 levels, they have been rising steadily since 2013 when they were almost 50% below peak values. While prices fell to a greater extent in Dublin following the crisis, the rebound in prices in Dublin has also been greater than elsewhere in the country. Much of the revival in overall house prices was made in 2014 when prices grew by 12%. Since then, house prices have stabilised, and prices in October this year were only 8% higher than they were in the same month last year. This moderation in house prices in recent months was largely due to the Central Bank's new mortgage lending rules which have essentially pegged credit to income with the aim of avoiding another credit fuelled bubble in house prices.

Rents

The moderation of prices in the housing sector has not been reflected in rents. While house prices are still below 2007 levels, rents have made a full recovery and are now 7.5% higher than they were in October 2007. While rents did not fall to the same extent as house prices during the crisis, since the new Central Bank rules came in, growth in house prices has slowed relative to rents (8% v 8% in the first 9 months of 2015, reversing the relationship in 2014 when it was 8% v 12%). These rising rents have been heavily concentrated in Dublin where rents have gone up by €1,000 per annum on average. This recent trend is worrying as it has an adverse impact on our competitiveness as firms are faced with difficulties in retaining staff, higher wage expectations and costs.

House Completions

The primary factor driving rents is the shortage in the supply of housing. House completions in 2014 (11,016) were 88% lower than they were in 2006. While the pre-crisis level was unsustainable in the long run, house completions from 2010 to 2014 have been at the lowest level since 1975. The ESRI estimate that 25,000 new houses need to be built each year in order to meet demand, while some analysts suggest this number could be higher. What is clear, however, is that only 65,000 new houses were built between 2010 and 2015 when a minimum of 100,000 were needed in order to facilitate population growth. At current rates of construction it would take 4 years just to clear this backlog – that before catering for any of the current growth in population. While there has been uplift in 2015 with house completions up 14% in the first nine months compared to the same period last year, it will come nowhere near what is needed. While recent rental measures have been introduced with the aim of ensuring rents remain more stable in the long run they do not address the shortage in supply which is the root of the problem. In addition, they seem to have already suffered from the law of unintended consequences. Evidence from Daft.ie has suggested that rents from June to September experienced their largest jump since 2007, partly as a result of landlords anticipating the new two year rent freeze periods and as a result building any possible loss of rent for 2016 into current prices.

Figure 22: House prices

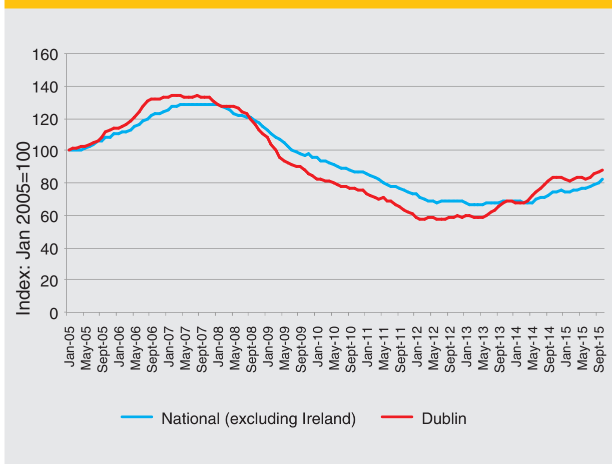


Figure 23: Rent

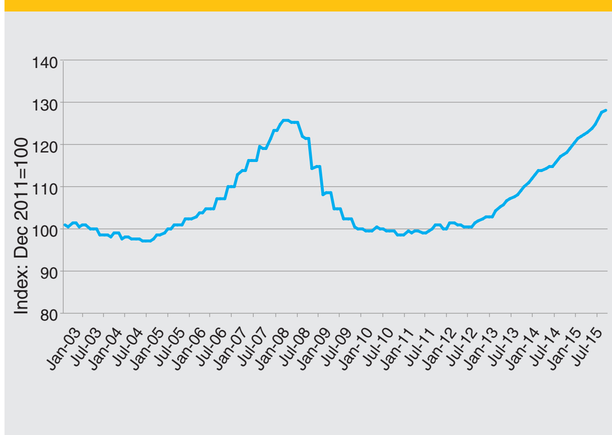
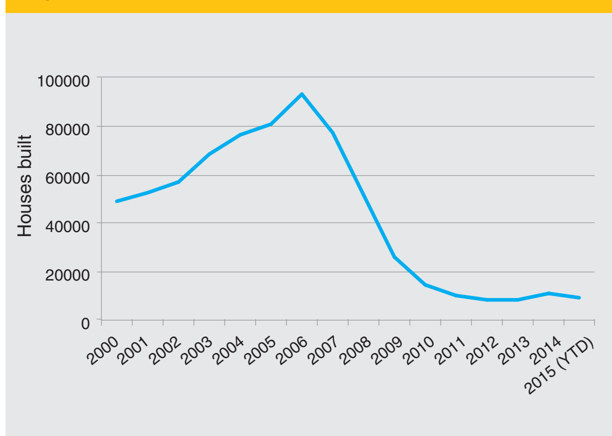


Figure 24: House completions



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