

Budget must not add to labour costs

The Irish economy is currently performing about as good as can be expected in difficult conditions. A combination of austerity and weak consumer confidence weigh heavily on the domestic economy, while export growth has been constrained by slowing external demand. Economic sentiment in the eurozone has weakened sharply over the past quarter and the ripples of Europe's crisis have been felt throughout the global economy. Ireland's competitiveness improvements have left it well placed to exploit global opportunities but strong growth will remain elusive until the global economic situation improves. Reflecting this weaker external short-term economic outlook, we have therefore pared back our 2013 GDP growth forecast to 1.8%.

Budget 2013 priorities

While the broad parameters of Budget 2013 are unlikely to change from those in the medium-term plan, the detail of the individual fiscal measures will still have a significant impact on growth and employment. Budget 2013 marks a significant change from recent budgets as we will see a more appropriate balance of two-to-one between expenditure cuts and tax increases. Despite this, however, the new taxes of almost €1 billion have the potential to significantly dampen the domestic economy. In our Pre-Budget Submission we state that the most important priority for Irish business is that Government does not place any additional charges on labour costs. Any levies or taxes on work will cost the economy jobs. Recent research from the OCED shows that a 1% increase in labour taxes results in a 0.4% reduction in employment. Any increase in employer PRSI or job levies such as those outlined in the statutory sick pay proposals would be particularly damaging to firm hiring plans over the coming years.

The budget must also focus on supporting activity in the domestic economy. Consumer spending will drop by a further 2% this year and domestic demand remains fragile. IBEC believes that there are a number of innovative Exchequer positive policy measures which Government could implement in order to support confidence and spending in the domestic economy. The early release of some non-core pension funds is a win-win for the Exchequer and consumer spending, while an incentive for home improvement works could be funded by incentivising a shift in activity away from the informal economy. The nature through which Government delivers spending cuts also matters to consumer spending and we have suggested an alternative to the across-the-board cuts proposed for child benefit supports.

The fragile nature of SME financing remains a significant constraint on economic recovery. Irish SME lending conditions are the second most difficult of all eurozone member countries. The budget can help address the issue through a number of taxation policies. The introduction of a roll-over tax relief for entrepreneurs selling a business would provide an incentive for the sales proceeds to be reinvested in Irish start-ups and growth enterprises. Some alterations to the Employment Investment and Incentive Scheme (EIS) are needed in order to attract greater investor interest. The scheme would also greatly benefit from improved branding and promotion.

Economic outlook

Forecasts for European and global economic growth have fallen sharply over recent quarters. In the eurozone, economic performance in all of the programme countries, with the exception of Ireland, will be much weaker than expected. Spain, in particular, has experienced a sharp slowdown while the unemployment and debt positions in Greece continue to deteriorate. While the ECB decision in September to increase its support for sovereign bonds has eased market concerns somewhat, considerable risks remain for the eurozone. Activity has also slowed sharply in the UK and it now looks likely that it will struggle to reach its fiscal targets. The key policy issue, both in the UK and across the eurozone, is the extent to which Governments are willing to chase down fiscal deficits in the face of collapsing economic activity.

The Irish economy was one of the better performing European economies last year and is expected to be the only eurozone programme country to record GDP growth this year. The eurozone and global slowdown has taken its toll on Irish exports, however, and goods exports have been stagnant this year, notwithstanding a much stronger than expected performance in the August export data. The services exports sector remains the shining star of the economy, however, and strong growth in technology exports in particular will drive GDP growth this year of about 0.8%. The global uncertainty will delay a more buoyant recovery but both the domestic economy and the export economy should expand in 2013. The labour market has remained difficult this year as the gains made by the private sector export economy have been offset by job losses in the public, financial and other domestic economy sectors. Following three years of export recovery, we anticipate that in 2013 we will begin to see the benefits of this spill-over to the domestic economy.

Economic growth

Although Ireland has returned to economic growth as measured by GDP, the recovery remains modest as domestic demand continues to shrink. The 1.4% increase in GDP in 2011 was well ahead of consensus forecasts and Ireland remains the only eurozone bailout country not in recession. However, renewed weakness in external demand means that our growth forecast for next year has been pared back somewhat. Irish businesses and the Irish economy have restructured and regained competitiveness but a meaningful economic recovery is being delayed due to a lack of demand both domestically and internationally.

The national accounts data show that the economy remained relatively stable in the first half of 2012. On a seasonally adjusted basis GDP was down 0.7% in Q1 and was flat in Q2 while compared to first half of 2011 GDP grew by 0.5% over the two quarters. Both exports and investment have shown some volatility in recent quarters while personal consumption has remained consistently weak. On an annual basis exports were up 5.7% in Q1 but increased by just 2.1% in Q2. Investment recorded its first annual increase since 2007 in Q1 but dipped significantly again in Q2 - largely due to the erratic nature of aeroplane investments.

While exports have continued to contribute to annual GDP growth, there has been a marked divergence in the performance of goods and services exports. Services exports grew by over 10% in the first half of the year while goods exports declined by about 2%. It is clear that the technology services sector, in particular, continues to perform very strongly but manufacturing has been relatively stagnant in the face of weaker international demand. Emerging issues in relation to the patent cliff in the pharmaceutical sector also appear to have resulted in slower output growth.

One of the most significant developments in the national accounts over the past year or so has been the acceleration of price growth in national output, particularly in the export sector. Nominal GDP is therefore performing much stronger than constant price GDP and this is very positive for both debt dynamics and the annual budget deficit

GNP and its components

| Annual % change | 2010 | 2011 | 2012 | 2013 |
|---------------------|-------|-------|------|------|
| Consumer spending | 1.0 | -2.4 | -2.0 | 0.0 |
| Government spending | -6.5 | -4.3 | -4.0 | -3.5 |
| Investment | -22.6 | -12.6 | -2.2 | 5.3 |
| Exports | 6.2 | 5.1 | 3.5 | 4.0 |
| Imports | 3.6 | -0.3 | 1.0 | 3.0 |
| GDP | -0.8 | 1.4 | 0.8 | 1.8 |
| GNP | 0.9 | -2.5 | -0.3 | 0.7 |

Table 1

target. The money size of GDP grew by 4.5% in Q1 and 1% in Q2. The price improvement in output has arisen from the combination of a weaker euro and higher inflation in our main trading partners. The euro will average about 10% weaker against both sterling and the dollar this year and this boost to export earnings is a welcome development at a time of weak international demand.

GDP remains on track to grow by just short of 1% this year but we expect growth next year to be a little weaker than previously forecast. The weakness in global activity seen over the past two quarters is likely to continue into 2013 and this will likely impact on both Ireland's export and domestic economies. We are currently forecasting GDP growth of 1.8% for 2013.

Business outlook

The Q3 IBEC Business Sentiment Survey, conducted in September, indicates that confidence has stabilised following the decline recorded in Q2. CEOs' perceptions of the current environment were broadly stable at -19, while the three-month expectations reading declined slightly to -19 also. Confidence in managers' own business ticked up to +10, while expectations about the three-month outlook remained stable at +6. As has been the trend since the survey began, exporting firms were more optimistic than non-exporting firms.

The most worrying reading of the survey is the sharp decline in export expectations; at +12 the index is down substantially from +20 in the previous quarter and +31 recorded in the third quarter of 2011; this is the lowest level since Q3 2009. The change is mainly a result of a jump in the proportion of firms anticipating a decline in exports, up to 27% from 21% in the previous quarter. However, 39% of firms expect export sales to increase in the coming quarter. Weaker demand arising from the slowdown in the UK and eurozone economies is clearly taking its toll on firms in sectors more sensitive to swings in the global business cycle.

IBEC business sentiment indicator

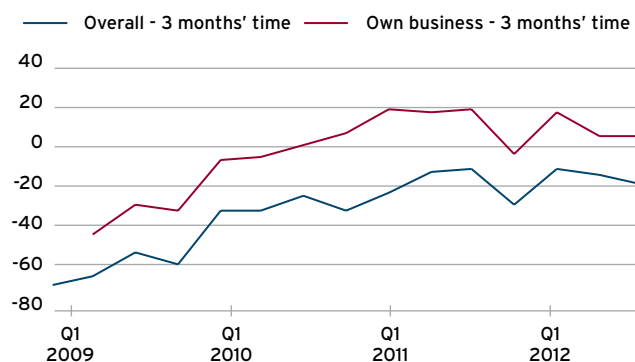


Figure 1

Nonetheless, the continuing strong performance of the modern manufacturing sectors and international services will continue to drive export growth, though at a somewhat slower pace.

Consumer spending

The first half of 2012 has proved challenging for businesses in the domestic consumer market. National accounts show that the volume of consumer spending fell by 2.3% compared to the first six months of 2011, while the value of sales declined by 0.5%. This more benign trend on the money side of the economy has been evident for some time now; however, the January VAT hike is a contributing factor this year and it is clear that in the domestic economy business turnover and volume of activity both remain under pressure.

On a seasonally adjusted basis, the quarter-on-quarter drop in consumer spending eased from 1.9% in Q1 to 0.4% in Q2. The trend in retail sales (excluding cars) has also shown tentative improvement in the third quarter, with volume and value both posting monthly gains in July and August. Unless September data turn out very weak, the sector should have posted a welcome quarterly increase in sales; with goods accounting for about half of total consumer spending this would be a positive indicator for overall consumer expenditure.

As Figure 2 shows, sentiment is a key driver of spending behaviour. Consumers' expectations for the future strengthened throughout the first half of 2012 and into the summer; the improvement was reflected in retail sales with a lag of about five months. However, the recovery was fragile, as was demonstrated by the sharp decline in the September sentiment reading. The chart shows a three-month moving average and one single monthly observation is not enough to derail the trend, but with Budget speculation now rife until December, it is likely that consumer confidence will weaken

Retail sales and consumer confidence

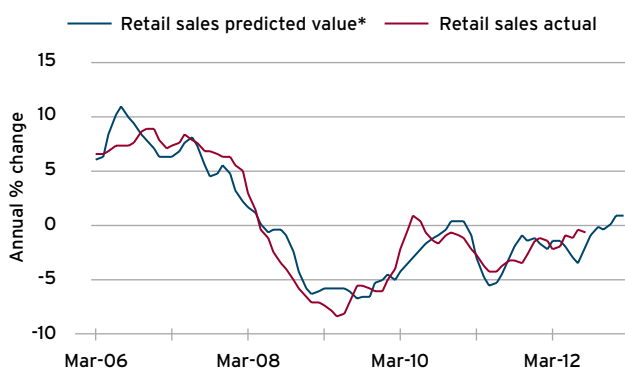


Figure 2

*Retail sales predicted value based on a simple regression of the future expectations component of the KBC Bank Ireland/ESRI Consumer Sentiment Index

further. This, in turn, would mean that the final quarter of the year could turn out challenging.

This year, we expect that consumer spending will fall by 2%. Although the Budget will eat into disposable incomes, the employment situation should be marginally improved next year, and some moderate pay increases in well-performing sectors will boost household incomes. As a result, we expect consumer spending to remain flat in 2013.

Investment

Following four years of sharp decline, the investment sector of the Irish economy is now approaching stabilisation. With house building activity down by 90%, there is limited room for any further decline. The official numbers show that the number of new homes constructed has fallen from 90,000 to 9,000 but it is likely that the actual fall in building activity has been even greater than this. The official statistics which are based on new electricity connections most likely underestimated completions at the peak of activity and are currently overestimating activity in the current trough as some previously built houses are connected to the electricity mains. Little or no housing scheme activity is currently in progress and one-off houses account for the majority of total new builds.

While there is a significant stock of unsold residential property in the State, it is predominantly either the wrong type or in the wrong location. There is growing evidence that the stock of family homes in the main cities is exceptionally tight and some new building activity is likely to return to meet this market demand in the medium-term. The outlook for new home building in 2013 remains flat but at least the sector will no longer be a drag on economic activity.

The CSO estimates the household repair, maintenance and improvement (RMI) sector is now about 50% greater than the new house building sector. RMI activity grew by about 5% last year following sharp declines in both 2009 and 2010. Mortgage lending data for the second quarter of the year and more recent reports from estate agents and the property websites indicate that housing transaction levels have increased somewhat, albeit from exceptionally low levels. This is likely to result in some further improvement in RMI activity over the coming quarters. Tight consumer credit conditions remain a significant barrier to a meaningful recovery in activity in this sector, however, as it remains difficult for either purchasers or existing home owners to obtain credit for renovation works. We expect to see the improvement in transaction volumes result in an increase in RMI activity of about 5% this year and 10% in 2013.

The non-residential construction sector has shown some stabilisation in recent quarters. Following a decline of over 20% in 2011, activity in the first quarter of this year was down 5% and in Q2 it slipped by just 1%. The medium-term

IBEC priorities for Budget 2013

To date, IBEC has been broadly supportive of the scale of fiscal adjustment implemented: meeting the deficit targets under the EU-IMF-ECB loan arrangements is essential for regaining market access. We welcomed the rebalancing of the adjustment outlined in the November 2011 Medium-Term Fiscal Statement in favour of expenditure reductions rather than tax increases. However, with a further fiscal consolidation of €8.6 billion for the period 2013-2015 remaining, the task is becoming more challenging.

Economic growth is ultimately the determinant of Ireland's debt sustainability and it is essential that the adjustment is delivered in a way that is least damaging to growth. However, austerity alone is not the answer; we also need Government to deliver the conditions for economic growth. Measures to balance the budget must be complemented with an ambitious growth strategy, involving no net additional cost to the Exchequer, to support investment, address the weakness in the domestic economy and rebuild confidence. Read IBEC's full Budget 2013 submission at www.ibec.ie/O/Budget2013.

Priority recommendations for Budget 2013

1) **Do not increase labour costs in any way** - either through changes to the PRSI regime or through measures such as a statutory sick pay levy on employment. Research from the OECD shows that a 1% increase in taxes on labour reduces an economy's employment rate by about 0.4%. The Government's proposal for an extra tax on jobs through a statutory sick pay scheme would cost at least 3,500 jobs both directly and indirectly in the economy. Any hike in PRSI would have a similarly negative effect. During the global crisis the trend internationally has been to reduce taxes on employment in order to get people back to work. Any PRSI increase would fly in the face of international best practice. Supporting job creation is the Government's stated aim; it must recognise that adding to the cost of doing business and employment is not the way to achieve jobs growth.

It is also crucial that Government ensures that the property tax is not seen as a tax on work. Collecting the property tax through the income tax system will discourage work and fuel wage pressures, which will make creating new jobs all the more difficult. This method is not the norm internationally, but does happen in Sweden and Denmark. Government understandably wishes to be certain of its ability to collect the revenue, and the tax credit system is attractive from this point of view, despite the negative

impact on the incentive to work. If it is the chosen system, it should have very few exemptions and its purpose communicated clearly, so that the tax is not viewed as simply an additional tax on workers.

- 2) **Introduce innovative measures to support the domestic economy.** The domestic sectors of the economy remain in recession, but, given the public finance constraints, a conventional stimulus package is not an option. Government does nonetheless have several Exchequer-neutral or revenue-generating policy levers at its disposal that would boost the domestic economy. Budget 2013 should facilitate the early access of non-core pension funds, i.e. additional voluntary contributions (AVCs) and personal pension funds; introduce a grant or tax credit package to incentivise home improvement works during a three-year window of opportunity; and switch universal social welfare payments such as child benefit to an electronic payment card model in order to maximise economic impact for the domestic economy.
- 3) **Improve Ireland's tax offering for international business** through enhancements to the R&D tax credit scheme, the intellectual property (IP) tax offering and the tax treatment of mobile specialist workers. These are all essential components of Ireland's strategy to attract mobile, high-value projects and people. It is critical that Ireland continues to refine the tax offering in order to compete effectively internationally. The changes required to the special assignee relief scheme (SARP), the R&D tax credit scheme and the IP regime, which would ensure that Ireland continues to attract mobile investments in a competitive world, are mostly technical in nature and would pose no net additional cost to the Exchequer.
- 4) **Support investment in Irish SMEs.** Access to funding remains problematic for Irish businesses, particularly SMEs seeking to expand and grow. To remedy the situation requires a range of initiatives, including strengthening of the existing commercial banks and the introduction of new capital funds. However, there is also a gap in the Irish market for a state-backed enterprise or investment bank.

Other measures include the introduction of a roll-over tax relief for entrepreneurs to encourage reinvestment into Irish start-ups and growth companies and the extension and improvement of the Employment Investment and Incentive Scheme (EIS) by introducing a risk-sharing model targeted at a wider group of new investors.

Investment

| Annual % change | 2010 | 2011 | 2012 | 2013 |
|-------------------------|-------|-------|------|------|
| Building & construction | -30.1 | -15.8 | -8.0 | 2.3 |
| Plant & machinery | -8.5 | -8.3 | 5.0 | 10.0 |
| Total | -22.3 | -12.6 | -2.2 | 6.0 |

Table 2

prospects for the sector have also improved somewhat due to the investment stimulus package announced by Government in July. The commercial property sector is also experiencing some shortages of high quality stock in certain market segments. December's Budget presents a threat to some of the core Exchequer funded capital investment projects but overall this sector is likely to experience a more modest decline in 2012 and stabilisation in 2013.

Investment by business in equipment and machinery fell by some 30% in 2009 and has remained relatively stable since then. Weak credit availability and an uncertain economic outlook have led many businesses to either postpone or abandon capital investments. Given the significant growth in goods exports since 2009, however, many Irish firms have limited spare capacity and a period of catch-up will inevitably emerge in the business investment sector. Total investment in machinery and equipment was up 22% in the first quarter of this year - largely on the back of higher aeroplane purchases - but the volatile nature of the sector was evident in the 26% drop in Q2. Core business investment in equipment and machinery was flat in Q1 and dropped by 5% in Q2. Despite the weaker-than-expected first half of the year we expect to see an increase of 5% in total equipment and machinery investment this year and growth of 10% in 2013. We are forecasting a drop of 2% in total investment in the economy this year and a modest recovery of 6% next year.

Prices and Wages

The persistent weakness in Irish consumer spending and extensive spare capacity in the domestic economy has resulted in subdued consumer price developments over the past number of years. The current consumer price level remains lower than it was prior to the global economic crisis in 2008. While some price growth has returned in more recent quarters, this has been predominantly driven by imported energy costs and prices of most Irish goods and services have remained relatively flat. However, a weaker euro and renewed high global commodity inflation is likely to impact on the costs of imported goods over the coming quarters.

Following an increase in the Consumer Price Index (CPI) of 2.6% in 2011, we are forecasting an increase of 2% in 2012. While the higher inflation rates last year were driven

by a combination of mortgage interest and energy cost increases, mortgage interest costs have fallen significantly in 2012, while energy inflation has remained stubbornly high. Electricity and gas inflation is currently running at 11% while the cost of transport fuel is up 9% over the past 12 months. In addition to increases in direct energy costs, the indirect impacts are also evident in transport costs which are up 20% in the year. Bus fares are 12.5% higher while air fares are up 9%. Overall, energy has accounted for over half of the inflation increase in the past year. Further utility price increases have been flagged for the coming months and energy price inflation is set to remain fairly elevated over the next year or so.

Medical insurance price increases have made a significant contribution to inflation over the past number of years. As Government continues to pursue its policy of risk equalisation the levy on health insurance has been a large cost burden for both householders and employers who provide medical insurance for their employees. The cost of medical insurance is up 16% in the year and more increases are expected in 2013 due to both a further increase in the levy and medical cost inflation. Medical insurance costs have almost doubled over the past five years and have become unsustainably high for many people. Many employers are also reviewing the medical insurance benefits they provide to staff.

A combination of the weaker euro and the recent spike in food commodities is likely to result in higher food price inflation in 2013. There is typically a lag of about six months between food commodity price increases and consumer price changes. The Economist Food Commodity Price Index recently reached an all-time high and US cereal prices have jumped about 50% since the start of the year. These commodity price developments have not yet been reflected in Irish food prices - annual food price inflation is running at just 0.4% - but some price increases can be expected to filter through over the coming months. We are currently forecasting a 1.7% increase in the CPI for 2013, but recent

Inflation forecasts

| 2012 | Year-on-year quarterly average | Annual average |
|-------------|--------------------------------|----------------|
| March | 2.2% | 2.0% |
| June | 1.8% | |
| September | 1.9% | |
| December | 2.1% | |
| 2013 | | |
| March | 1.9% | 1.7% |
| June | 1.6% | |
| September | 1.7% | |
| December | 1.5% | |

Table 3

commodity price trends suggest that there are growing risks to the upside for this forecast.

A higher percentage of businesses delivered basic pay rate increases in 2012 than in any year since the global crisis began. IBEC research shows that some 30% of Irish firms awarded pay increases this year and the median increase was 2%. The vast majority (69%) of firms froze basic pay rates again - for most of these businesses 2012 was the fourth year in succession in which pay rates were unchanged. The percentage of firms cutting pay rates fell dramatically this year to just 1%. The average pay rate change for all firms was an increase of 0.6%.

At the time of writing, the latest survey research for 2013 pay rate expectations was not yet available. Some of the factors which will influence decisions will include the length of the pay freeze period already experienced by the majority of companies; skills shortages in high tech sectors; the global pay, inflation and economic growth outlook; and economic prospects in the domestic economy. Average pay rates in the eurozone are forecast to increase by just short of 2% in 2013 while the UK is likely to see pay growth of over 2.5% and the US over 3%.

Labour Market

The CSO's Quarterly National Household Survey reveals that, following a period of tentative stabilisation, the pace of job losses in the economy accelerated again in the second quarter of 2012. On an annual basis employment fell by 33,400 or 1.8%, almost double the job losses recorded in Q1 and only slightly less than the 37,800 jobs lost in the year to Q2 2011.

The net change in employment in any given quarter always consists of some people losing their employment, while others gain jobs. Nearly two-thirds of the deterioration in the Q2 net reading is caused by a slowdown in job creation, while only slightly more than a third is attributable to an increased pace of job losses. The latter, a jump in the number of jobs

lost, can be linked to specific sectoral trends, such as public and financial sector job losses, and may thus have a transient impact on the overall trend. However, the slowdown in job creation, if it continues, could point to an overall weakening trend in the labour market.

Notably, the number of employees in the public sector fell by 25,800 or 6.3%, with education and health recording the largest staff reductions. The number of employees in the private sector, having recorded gains for two consecutive quarters, fell marginally by 0.3% when compared to Q2 2011. However, self-employment continues to decline and is the driving factor behind the overall fall in private sector employment. A more detailed sectoral breakdown reveals that job losses in construction, wholesale and retail, financial services and industry account for the bulk of the decline in private sector employment, while hospitality and ICT services added jobs.

Overall, the outlook for the second half of the year is mixed, but with risks to the downside. Public sector job losses were likely to have been concentrated primarily in the early part of the year, so the drag on aggregate employment should ease. However, as a result of restructuring of the domestic banking sector, financial services is likely to continue to lose jobs at least until the end of 2013. The eurozone crisis continues to weigh on activity in the more labour-intensive manufacturing sectors, so a recovery in industrial employment is unlikely to materialise in the short term. The outlook for services exports remains bright, but the upswing in the hospitality sector has largely come from domestic sources. Should consumer confidence deteriorate sharply, this could pose a threat to the recovery the sector has experienced. Overall, we have pared back our employment forecasts somewhat: we now expect employment to fall by 1.2% this year, before a stabilisation in 2013.

Despite the acceleration in job losses, the unemployment rate in Q2 remained at 14.8%, unchanged from the Q1 reading. Labour market dynamics have played a significant role in containing the rate of unemployment, which is up only slightly more than a percentage point on the 2010 level, despite an on-going fall in employment. While employment fell by over 70,000 in the two years to Q2 2012, the increase in the number unemployed at 17,000 was considerably less. However, as a result of emigration and lower participation, the labour force is down nearly 60,000.

While long-term unemployment has climbed steeply, the rate would be substantially higher without the existence of the emigration safety valve. Ireland has always had an extremely open labour market. Historically, this meant Irish people looking for work in Britain and beyond; in the period before the crisis, this reversed as Irish emigrants returned and non-Irish saw Ireland as an attractive destination. While emigration necessitated by economic circumstances can be the source of distress at a personal level, it nonetheless allows individuals to retain skills and gain new expertise.

Employment

| 000s annual average | 2010 | 2011 | 2012 | 2013 |
|---------------------|-------|-------|-------|-------|
| Agriculture | 85 | 83 | 81 | 81 |
| Industry | 360 | 341 | 334 | 333 |
| Services | 1,403 | 1,385 | 1,374 | 1,377 |
| Total | 1,848 | 1,810 | 1,789 | 1,791 |
| Unemployed | 292 | 304 | 310 | 302 |
| Unemployment (%) | 13.6 | 14.4 | 14.8 | 14.4 |
| Labour force | 2,140 | 2,114 | 2,099 | 2,093 |

Table 4

With inflows of both Irish and non-Irish nationals remaining strong at about 50,000 per year, despite the current environment, it is likely that substantial net inward migration will take place again once Ireland's economic fortunes turn.

Exports and exchange rates

Data from the national accounts show that exports grew by 2.1% in Q2 compared with the same period last year, although this conceals contrasting developments across goods and services. Service exports, led by computer services, continue to hit record levels, growing over 10% in the first six months of the year. Weaker external demand is beginning to have an impact on Ireland's goods exports, which fell 2.1%. The weaker euro exchange rate was an important factor in the value of goods exports rising 2.6% over the same period. Indeed, the value of all exports increased by some 7% in the first half of the year. It is this measure that is important in terms of boosting nominal GDP and meeting the troika targets.

After consecutive declines in June and July, industrial output from the export-intensive modern sector rebounded strongly in August growing 5.1% on the previous quarter, and 7.1% on the same period last year. Monthly trade data show the effect of high-value drugs coming off patent, with the value of pharmaceuticals to the United States falling some 55% in the first seven months of the year. The volume of output, however, remains robust and on annual basis is up 4.3% in the year to August. The worrying trend in the traditional sector continued in August, with output falling 0.9% on the previous quarter, and down by about 5% in the first eight months of the year. This sector exports mainly to the UK and eurozone, and is clearly feeling the effects of weaker demand from those economies.

The Purchasing Managers Index (PMI) points to moderate growth, with the headline manufacturing index in expansion mode for the fifth consecutive month in September. New export orders, however, fell for the first time in seven months as difficulties for Ireland's main trading partners limit growth in export sales.

The euro recently strengthened against a basket of currencies as investors overlook weak economic activity in favour of the ECB's recent policy actions to help alleviate the region's debt crisis. After falling to \$1.21 in July, the euro strengthened to \$1.30 in October, although this remains nearly 7% lower than the 2011 average. The exchange rate relative to sterling, on the other hand, remained at around £0.80 over the same period, and this will continue to benefit indigenous Irish exporters whose main market is the UK. At the September meeting, ECB president Mario Draghi indicated that the ECB might consider cutting interest rates again in the future, but gave no sign that such a cut was imminent. High inflation and concerns about the effectiveness of recent reductions suggest that no cuts

are forthcoming until next year. In the near term, the euro is likely to come under pressure as Spain resists calls for financial assistance. However, the currency will continue to have some support as long as there are expectations of quantitative easing in the UK and the US.

Public finances

Exchequer returns for the year to September confirm Ireland remains on track to meet its commitments to the troika. Tax revenue for the first nine months of the year was €385 million ahead of budget. Corporation tax receipts generated the highest surpluses for the year to date, and are €251 million ahead of target. Income tax receipts showed signs of weakness in Q3, running €114 million behind profile, and could be related to recent softness in the labour market. Importantly, however, income tax for the year to date is still €100 million ahead of target. Excise duty is running well off target and is €135 million behind profile, with €100 million of the shortfall occurring in Q3. Stamp duty is €54 million ahead of target, and September also saw the deadline for payment of the pension levy. VAT, the second largest revenue generator continues to beat expectations, and is €94 million ahead of target after a strong third quarter.

The underlying expenditure position, adjusting for the shortfall in PRSI receipts of €245 million, was €93 million above target. This marks an improvement of €102 million from the €195 million overrun at the end of June. Health and social protection continue to run over budget and the past three months has seen the deficit grow even wider to €285 million and €400 million respectively. It is also important to acknowledge the significance of the final quarter in terms of tax collection. Around €6 billion is profiled for collection in November, and this will have a considerable role in determining the end-year outturn. Nonetheless, the good performance to date suggests the overall deficit target will be met.

Exchange rates - monthly averages

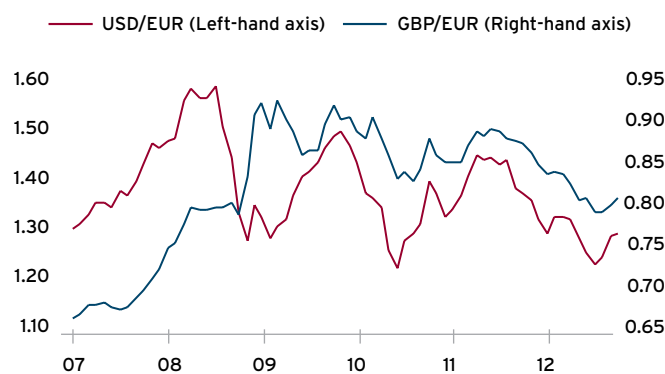


Figure 3

International economies

Growth in the world economy continues to slow as concerns about the eurozone economy persist. Even countries not previously affected by the crisis such as Canada, Australia, Singapore and South Korea are beginning to feel the effects of reduced global demand. Furthermore, the recent series of Purchasing Managers Indices (PMIs) from around the world, combined with continuing fiscal retrenchment point to a difficult period ahead. China appears to have reached the end of its current round of aggressive stimulus as inflation pressures begin to emerge. Interest rates, however, remain high across most of Asia increasing the scope for stimulus in the region. In October, the IMF revised down their 2013 growth forecast for the second time this year.

United States

The worrying signals coming from the US were confirmed when growth disappointed in Q2, as the economy grew at an annual rate of just 1.3%, down from the previous estimate of 1.7%. Recent data, however, suggest the economy will begin to regain some of its early-year momentum. In September, the manufacturing PMI expanded after three months of contraction, and consumer sentiment rose to a four-month high. Increasingly confident consumers are also spending on big-ticket items, with car and housing sales strong in recent months. The unemployment rate fell to 7.8% in August, the lowest in nearly four years, adding to the renewed sense of optimism. Uncertainty over the looming fiscal cliff and the slowdown in the European economy will remain the biggest limiting factors on growth.

Eurozone

The eurozone economy contracted 0.2% in Q2, although strong export growth of 1.5% limited the extent of the contraction. Recent data suggest that the economy will contract again in Q3 and fall back into recession. In Germany, goods exports rose on an annual basis by 5.8% in August. Revealingly, exports to the eurozone declined and the headline number was led by increased trade with the rest of the world. Nonetheless, these exports are unlikely to be sufficient to spur growth, as slower global growth weighs on other member states. Unemployment rose to 11.4% in August and double-digit unemployment is now a feature in ten member states. Spain recently came under pressure over concerns about its capacity to meet its revised budget deficit targets. The inability to meet new targets combined with high government bond yields has prompted speculation that the government will shortly request financial assistance. The ECB's new bond purchase programme which, unlike previous programmes, has no limit on the amount of

transactions, provided markets with a boost. This willingness of the ECB to use more effective policy levers is positive.

United Kingdom

Data from the national accounts show that the economy continued to contract in Q2, with output falling 0.4%. The largest drag on growth came from net exports which cut growth by one percentage point. Inflation eased to 2.5% in August, and should allow for the Bank of England to engage in further asset purchases later this year. However, rising oil and food commodity prices have the potential to keep inflation higher than anticipated over the next few months. The numbers unemployed fell by 46,000 in Q2, bringing the unemployment rate down to 8% from 8.2% in Q1, its lowest level in nearly a year. Furthermore, employment rose by 236,000 in the three months to July, the third-largest increase on record.

Real GDP growth - selected countries

| Annual % change | 2011 | 2012 | 2013 |
|-----------------|------|------|------|
| World | 3.8 | 3.3 | 3.6 |
| Advanced | 1.6 | 1.3 | 1.5 |
| Emerging | 6.2 | 5.3 | 5.6 |
| Euro area | 1.4 | -0.4 | 0.2 |
| US | 1.8 | 2.2 | 2.1 |
| Germany | 3.1 | 0.9 | 0.9 |
| France | 0.1 | 0.4 | 1.9 |
| Italy | 0.4 | -2.3 | -0.7 |
| China | 9.2 | 7.8 | 8.2 |
| Japan | -0.8 | 2.2 | 1.2 |
| UK | 0.8 | -0.4 | 1.1 |

Table 5

Private consumption - selected countries

| Annual % change | 2011 | 2012 | 2013 |
|-----------------|------|------|------|
| Euro area | 0.1 | -1.1 | -0.3 |
| US | 2.5 | 1.9 | 2.2 |
| Germany | 1.7 | 0.7 | 1.0 |
| France | 0.3 | -0.2 | 0.2 |
| Italy | 0.2 | -3.3 | -1.2 |
| Spain | -1.0 | -2.2 | -2.4 |
| Japan | 0.1 | 2.5 | 1.0 |
| UK | -1.0 | -0.2 | 0.9 |

Table 6

Source: IMF World Economic Outlook, October 2012.



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