Q3 2016 Ibec Quarterly Economic Outlook

Rising to the challenge

The 26% GDP growth recorded in 2015 is a function of a highly globalised economy and an unparalleled period of change in international tax and corporate structures. It is clear alternative measures are now needed in order to understand the performance of the domestic economy. This is all the more pressing in the context of Brexit. The coming years will see significant change in the relationship with our largest trading partner. We expect the momentum in the Irish economy will help us weather the Brexit impact through 2016 but future years are now much more uncertain. Government must respond in the upcoming budget.

GNP and its components

Annual % change	2015	2016	2017
Consumer spending	4.5	4.9	3.5
Investment	34.5	7.9	7.2
Exports	34.4	5.9	5.2
Imports	21.7	7.1	6.6
GDP	26.3	3.9	3.2
Underlying domestic demand	4.6	3.9	4.3
Employment	2.6	2.8	2.1

Ibec
For Irish Business

GDP and components

Economic growth

The first half of the year saw strong domestic growth across a number of categories including retail sales (3.3% turnover and 5.5% volume ex cars), tax receipts (8%) and employment (2.9%). The external environment, however, has changed irrevocably. No matter what happens in the coming years the Brexit referendum will have significant implications for Ireland and Europe over the long term. Although exchange rate volatility is likely to damage exports from indigenous sectors there remains strong momentum in the domestic economy. As a result we continue to expect strong economic growth in 2016 (although measuring that activity has become even more problematic. See page 9). Estimates suggest that the impact of a 1 percentage point fall in UK GDP growth would lead to a knock on fall in Ireland of between one-quarter and one-third of a percentage point. As a result our outlook for 2017 is much more uncertain.

Ibec Brexit Survey

Two weeks after the Brexit result Ibec conducted a survey of over 450 Irish CEOs across the economy. Companies with fewer than 50 employees accounted for over half of the respondents (57%) and a similar proportion (56%) were exporting companies; two thirds of the respondents (66%) were Irish-owned. The opening question looked at the impacts of Brexit on their own company and Irish business in general. Of twelve potential options exchange rate volatility was idenftified as the key immediate challenge for 22% of respondents and was a top three concern for 60% of firms. Investment confidence is the second most highly rated challenge among respondents with 19% identifying this as their top challenge with both it and cost competitiveness coming among the top three challenges for over a third of firms. Longer-term challenges such as potential tariff barriers and limits on freedom of movement were also in the top five priorities but the focus of most firms is on the more tangible and immediate challenges ahead.

Exports

The value of Ireland's goods exports was just over €55 billion in the first six months of 2016, €653 million (1.2%) higher than a year previous. This slowdown in trade growth was driven by a fall-off in the value of pharma exports which had seen a record year in 2015 on the back of movements in the dollar against the euro. The volatility in the euro-sterling exchange rate has already become a real a challenge for exporters, yet only 12.6% of our total merchandise exports were to the sterling area in the first half of 2016. Euro and dollar exports on the other hand will continue to perform strongly. What is concerning is that those industries which have greater employment and domestic supply chain linkages are signficiantly impacted by sterling. Just over half of indignenous exporters expect a negative export impact from Brexit compared to only 31% of MNEs. The employment multiplier from a drop in demand for goods produced by these indigenous firms is over three times larger than for non-Irish companies.

Figure 1: Year-on-year growth in main tax heads

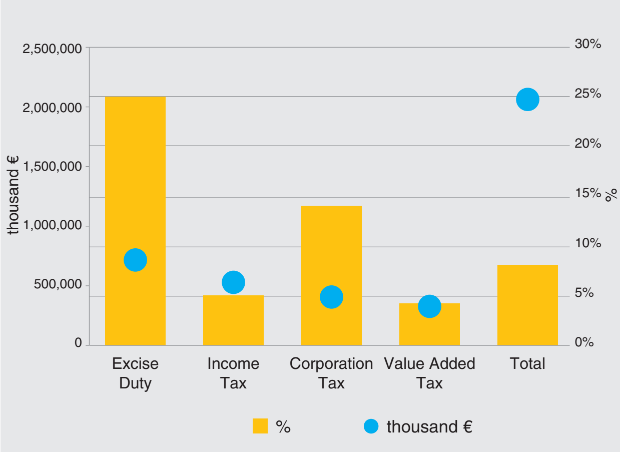


Figure 2: Firms identifying issues as among top 3 Brexit challenges (%)

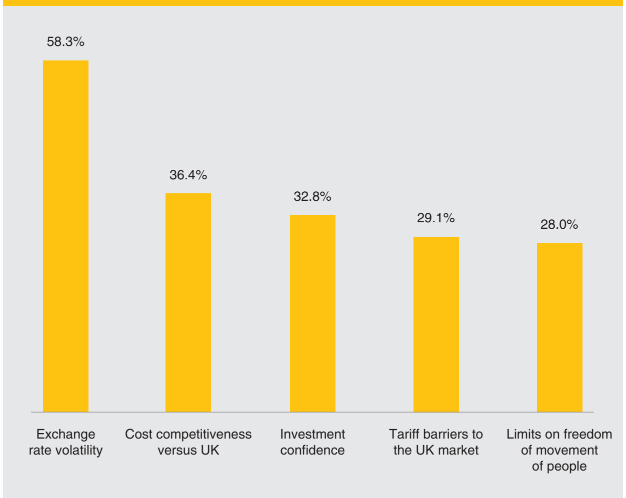
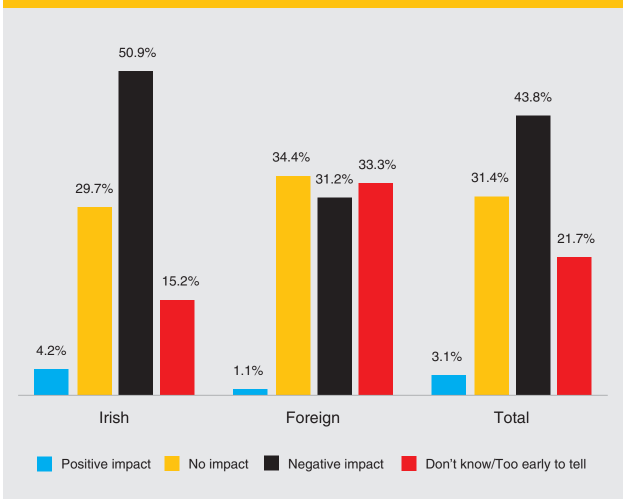


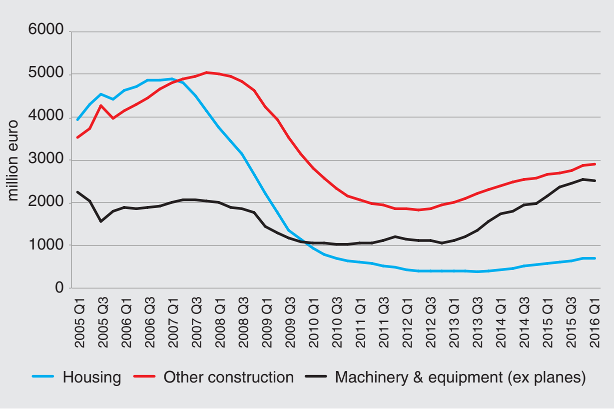
Figure 3: The impact of Brexit on export volumes by ownership



Investment outlook

Overall investment was up 9.5% in H1 compared to the same period last year. However, excluding volatile intellectual property, it only increased by 2.5%. These figures capture many different trends with investment in housing up a staggering 23%. This is coming off a very low base as it is still nowhere near pre-crisis levels. Investment in other forms of construction was only up 1.6%. Business investment in machinery and equipment fell by 4% and was down even more when planes are excluded. It remains to be seen what impact Brexit will have on investment but it is notable that investment confidence is the second most highly rated Brexit related challenge among 450 CEOs who responded to Ibec's Brexit survey, with 19% identifying this as their top challenge.

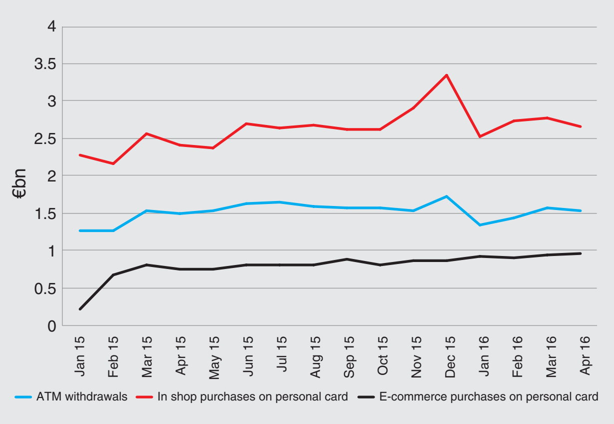
Figure 4: Components of investment excluding intangibles



Consumer spending growth

National accounts data shows that total consumer spending, which remained untainted by distoritions elsewhere in the data, increased by 3.5% during H1. These signs of a broad based consumer recovery are similar to Central Bank statistics on consumer credit and debit card use. Spend on consumer cards rose by €4.2 billion year-on-year in H1 with over 39% of the increase due to rising e-commerce purchases. This growing online spend is underlined by the fact it has increased from 14.4% of all card purchases in H1 2015 to 18% in the same period this year. The impact of Brexit on consumer spending is likely to take some time to filter through with leading indicators of consumer confidence fairly muted. The real impact will only be known when the immediate impact on employment and incomes becomes apparent sometime in 2017. For 2016 we expect the strong momentum in the consumer recovery which saw volume growth of 4.4% during 2015 to continue unabated with growth of almost 5%.

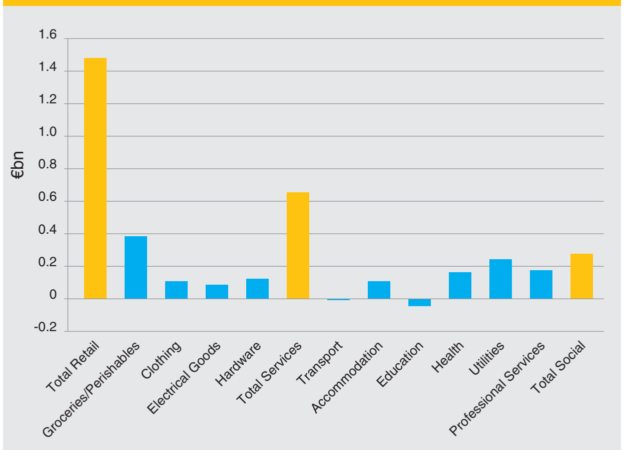
Figure 5: Consumer spending by type



Card activity

Central bank data on credit and debit cards allows us a more granulated view on consumer spending patterns. H1 saw a €1.5 billion increase in card spend in the retail sector (including sales of cars) with almost €383 million of this coming in the grocery sector. The strong year-on-year increase in consumption of social activities (€280 million) is a positive sign for the economy as disposable incomes improve with expenditure in restaurants accounting for three quarters of the total. Meanwhile spending on essentials such as health, utilities and transport was up by €400 million. Broadly retail took up 47% of card spending of which 22% was spent on groceries or perishables. Services and social spending on the other hand took up 25% and 9.2% respectively.

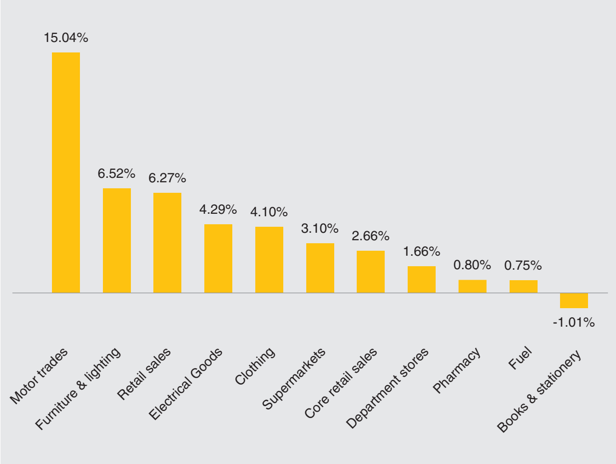
Figure 6: Card transactions annual growth, Jan to April 2016



Retail sales

Irish Consumers weren't too put off by Brexit as July retail sales volumes were 6.3% higher than they were in the same month last year. This strong growth was primarily driven by car sales which were up 15% on July last year. Other durables such as household goods along with clothing and electrical goods also experienced strong growth. Core retail sales which exclude car sales were only up 2.7%. Core retail sales had experienced strong growth up until this point as they grew by 5.5% on average in the first six months of this year but did slow notably in July following the referendum. It will be some time before the full effect of Brexit will be evident in Irish consumer spending. In the immediate term the greater danger is the effect of exchange rates on cross-border shopping, although evidence for this is very mixed at this stage.

Figure 7: Retail sales (July 2016 vs. July 2015)



Exchange rate

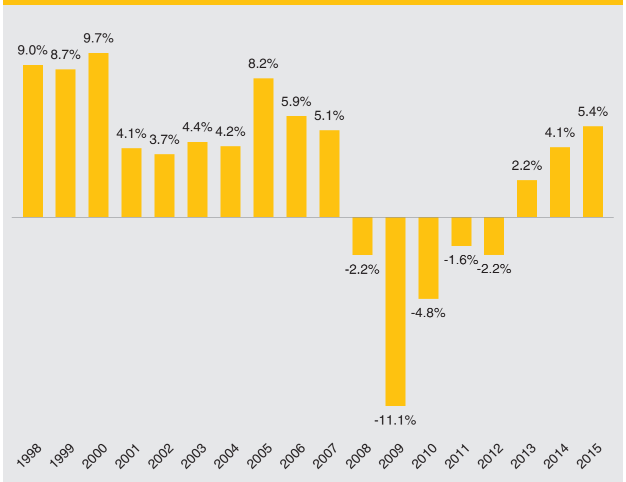
Since the Brexit vote, sterling has depreciated by 13% versus the euro. The day before the vote happened one euro bought 76p but at the end of August it bought 86p. Those most affected by this depreciation are firms in food, other manufacturing and services where the majority of exports go to the UK. Over the coming months it is likely that sterling will continue to weaken and the exchange rate will move towards 90p with the economic situation in the UK expected to deteriorate. Those selling goods in Ireland will also face challenges due to increased competition from cheaper imports. The UK accounts for almost 1/3rd of Irish imports and up to 56% in the food sector. Along with weaker exports and the possibility of cross-border shopping the weaker sterling may also see some multinational retailers re-examine their sourcing strategies for the Irish market over the coming months.

Figure 8: Euro/Sterling exchange rate

Summary of economic outlook

Extreme volatility in the national accounts (see page 9) have made it more difficult to understand the nature of growth in the Irish economy. We have revised our growth forecasts downward marginally but the effect of a handful of large companies on Ireland's recorded growth levels mean the band of uncertainty around forecasts for GDP, investment and trade are very large. What is clear is that the domestic economy is growing at a steady pace with all domestic indicators pointing toward a strong recovery. Indicators from the first half of 2016 suggest that economic momentum – particularly that in the labour market – will see the Irish economy weather the impact of Brexit fairly well through 2016. This momentum, however, can only take us so far and the weak sterling will cause problems for indigenous exporters. This will likely mean some slowdown in the pace of export growth in the second half of 2016 and early 2017. The impact of Brexit on the domestic economy will take some time to filter through and will be determined by politics as much as economics. When it comes to longer term Brexit impacts the unknowns outnumber the knowns by some distance.

Figure 9: Domestic demand (minus planes and intangibles)



Labour market

Employment forecast

CSO figures showed annual employment growth of 2.9% (56,200) in Q1 bringing total employment to over two million for the first time since 2009. Recent rapid falls in the unemployment rate stalled in Q1 figures but this is wholly due to large numbers returning to the labour force which grew at its fastest rate since Q1 2007. At this stage it is our expectation that the current economic uncertainty will slow this employment growth somewhat, in 2017, but will not reverse it. Unemployment will continue to fall under 8% by the end of 2016 although its fall toward 7% may slow as greater numbers return to the labour force. Employment growth will slow marginally from 2.8% in 2016 to 2% in 2017. The Q2 data while providing more evidence of the strong positive momentum in the domestic economy, underlines the growing skills challenges facing some sectors. The end of net emigration, which was evident in our most recent mid-year estimates, will relieve some but not all of these pressures.

Employment by sector

The regional spread of employment growth is also quite even. Employment in Q2 increased on an annual basis in all eight regions. The Mid-West, Mid-East, and South-East regions all saw employment growth rates comparable to that of Dublin. On the other hand, the performance of the West in particular continues to be a worry. The Western region (Galway, Mayo, Roscommon) has experienced a considerable lag over the past four years when compared to other regions. In sectoral terms there was growth in almost all sectors with the exception of financial services and professional services. The largest sources of jobs growth over the past year were manufacturing, tourism and construction which together accounted for over half of total employment growth. Given that two of these industries are likely to be hardest hit by Brexit it is likely there will be some slowdown in hiring over the next year.

Figure 10: Employment growth by year, %

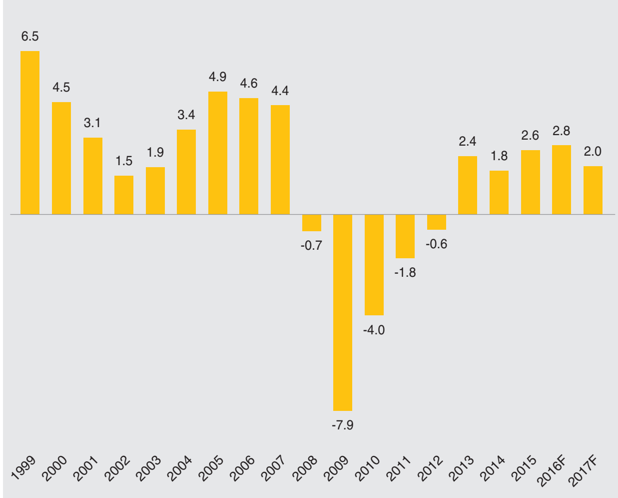


Figure 11: Employment growth by region

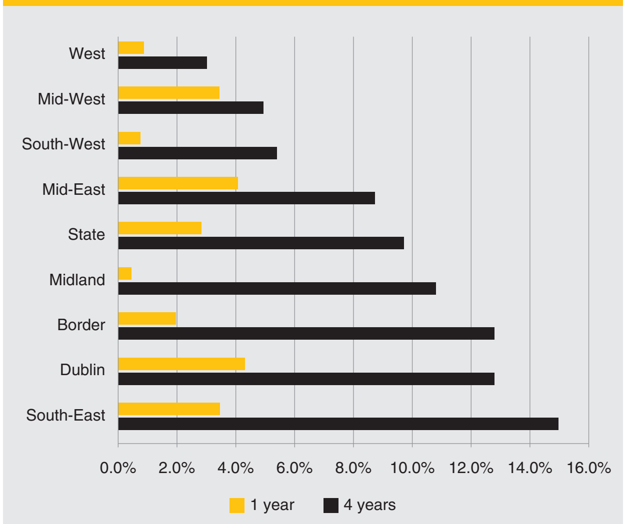


Table 1: Labour market summary

Employment 000s annual average	2015	2016	2017
Agriculture	110	116	119
Industry	374	395	411
Services	1,474	1,501	1,523
Total	1,958	2,011	2,053
Employment growth (%)	2.6	2.8	2.1
Unemployed	204	180	168
Unemployment rate (%)	9.4	8.2	7.5
Labour force	2,167	2,197	2,228

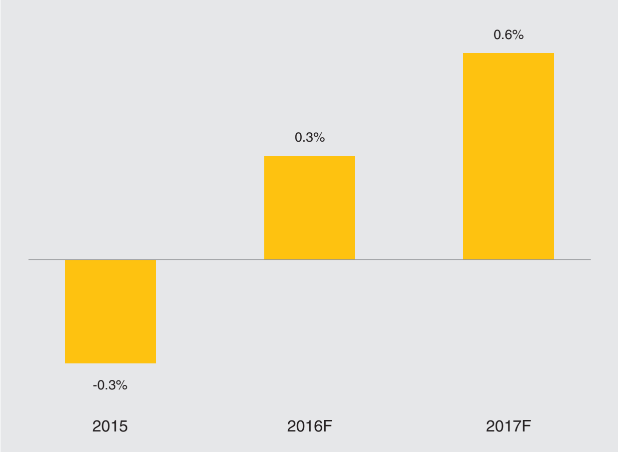
Source: Ibec forecasts

Prices and labour costs

Inflation outlook

Prices in the first seven months of this year are only 0.1% higher than they were in the corresponding period last year. This is due to a combination of factors as there continues to be a divergence between the price of goods and services. Falling fuel and food prices continue to keep the price of goods low as inflation excluding these items is 1%. The prices of services on the other hand, are up 2.4% on the same period last year. This weak inflationary environment is expected to continue out to next year. The depreciation of sterling is likely to dampen the potential for price growth further given that 26% of our imports come from the UK. As a result we expect inflation of 0.3% this year and 0.6% next year.

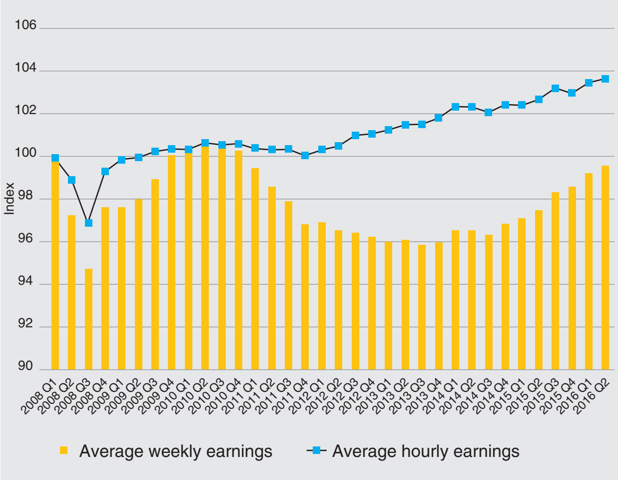
Figure 12: Inflation (y-o-y % ch)



Wages

Last year, wages across the economy increased by 1.2%. Given that we also had deflation of 0.3%, this was the largest inflation adjusted wage increase in the past five years. The first half of 2016 saw some continuation of this trend with average weekly earnings rising by 2.2%, driven by both increasing hours and a 1% rise in average hourly earnings. As the economy continues to improve with substantial gains achieved in the labour market in the first half of this year, wage growth is expected to be even higher in 2016. Ibec's recent HR update survey found that 69% of companies were awarding pay increases this year with a median increase of 2% where one was being given. This combined with low inflation will see even greater real wage growth.

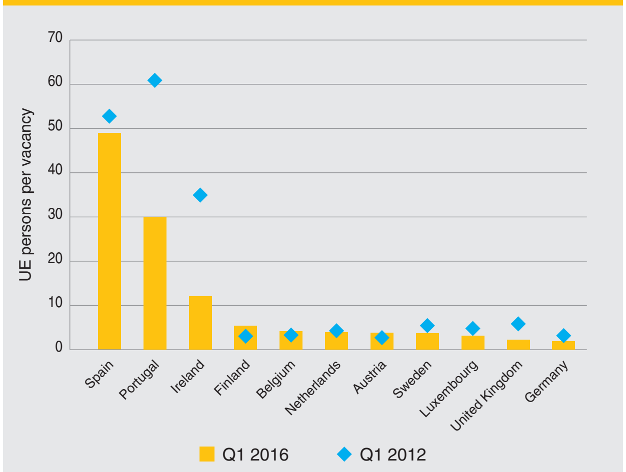
Figure 13: Real weekly and hourly earnings (4 quarter moving average)



Labour market slack

The number of unemployed people for each job vacancy is a good measure of how tight the labour market is and whether we are entering into a period of high wage pressures. In Ireland, improvements in the labour market have meant that the number of unemployed people per vacancy has fallen significantly from 35 four years ago to 12 today. This is still relatively high, however, as in many other European countries this measure is well below 5. This suggests that wage pressures shouldn't be as high compared to these countries – but as shown above, wage inflation is still relatively high in Ireland. This is largely because there is a skills mismatch between the sectors with vacancies and those who are unemployed. Sectors with the highest vacancies continue to be ICT and financial services, while a large share of those who are unemployed are still former construction workers.

Figure 14: Unemployment to vacancy ratio



International economies

International economies

Global growth is expected to be 3.1% this year and 3.4% in 2017. This year it will be primarily driven by emerging and developing economies but conditions across these countries vary with relatively high growth rates in China and other emerging Asian economies but tough conditions in Brazil, Russia and other commodity exporters. Side effects from Brexit will mostly be felt in advanced economies. In light of this, the IMF revised its 2017 forecast for the UK down by 0.9% to 1.3%. It also revised its eurozone growth forecast down from 1.6% in April to 1.4% in July. It will have little effect on the US where the economy continues to perform steadily.

Emerging economies

2015 was a bad year for both Brazil and Russia as the size of both economies declined by more than 3.5%. This year, however, looks a bit more promising due to the modest recovery in oil and commodity prices. Growth will still be negative this year but it won't be as bad as initially thought; the IMF predicts that both countries should return to positive growth in 2017. However the high level of debt and the large cost of servicing this debt combined with political uncertainty will continue to be a problem for Brazil. China on the other hand, continues to experience strong growth in the region of 7%. This is lower than previous years but is happening as its economy rebalances with growth driven by consumption as opposed to investment.

Figure 15: Growth in major economies, % ch

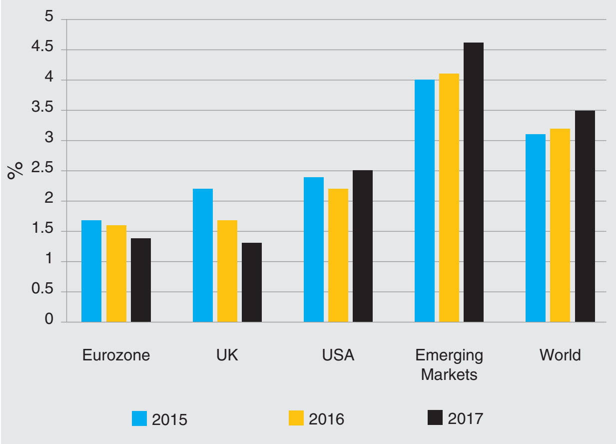


Figure 16: Growth in emerging economies, % ch

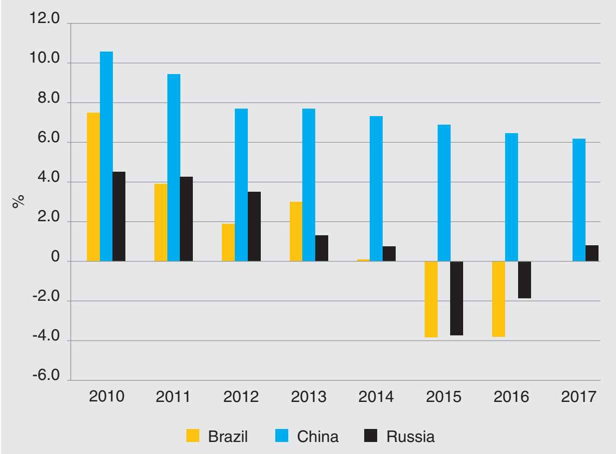


Table 2: International economies summary

	Real GDP, y-on-y % ch			Inflation, y-on-y % ch		
	2015	2016	2017	2015	2016	2017
Eurozone	1.7	1.6	1.4	0.9	1.0	1.3
UK	2.2	1.7	1.3	0.1	0.8	1.9
USA	2.4	2.2	2.5	0.1	0.8	1.5
Emerging markets	4.0	4.1	4.6	4.7	4.6	4.4
World	3.1	3.2	3.5	2.8	2.5	2.9

Source: IMF economic outlook

Brexit reaction

The fallout

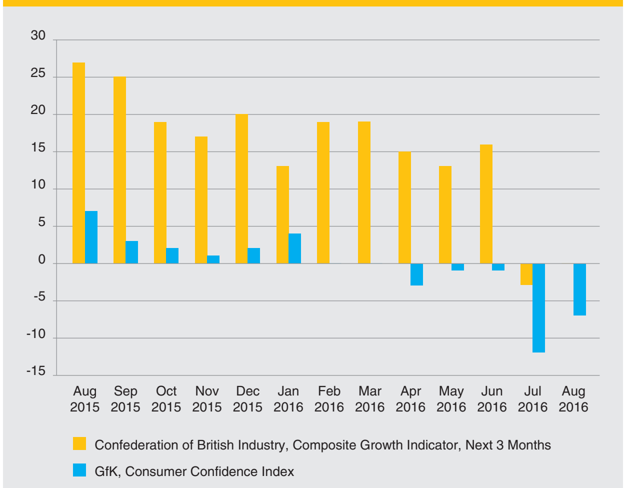
At this stage the long-term fallout from Brexit is just as unclear as it was after the vote. It will take some time for the political apparatus in both the UK and Europe to negotiate a new relationship; the implications of which, for Ireland and our all-Island economy, will depend on the political approach taken by all sides. Whatever the outcome of negotiations, the vote will fundamentally change our relationship with our nearest neighbour and most important trading partner. Brexit is clearly a negative event for the Irish economy. We believe, however, that Ireland will remain one of the EU's strongest growing economies over the coming years.

The Bank of England has cut its growth forecasts for 2017 from 2.3% to 0.8%, the largest downgrade for a single observation in more than 20 years. A potential slowdown of this scale in the UK would bring many challenges for Ireland. A clearer picture of the impact of Brexit on the UK will unfold over the coming months, however, as more data is released. Expectations of a slowdown have emerged but early indicators have seen little signal of a recession. In July, business and consumer confidence indices fell significantly but both recovered some lost ground in August. Talk in some quarters of a Brexit 'soft landing', however, seems premature when early mixed indicators are just as likely to be indicators of a 'dead cat bounce'. Companies have not overreacted but are maintaining a holding position. If this is maintained over the long-term we may not see a Brexit shock but a sustained slowdown in activity. If hiring and investment slows over the coming months, it is only then we will see 'real economy' impacts. It is likely to take a year or more to understand the true magnitude of the immediate fall-out.

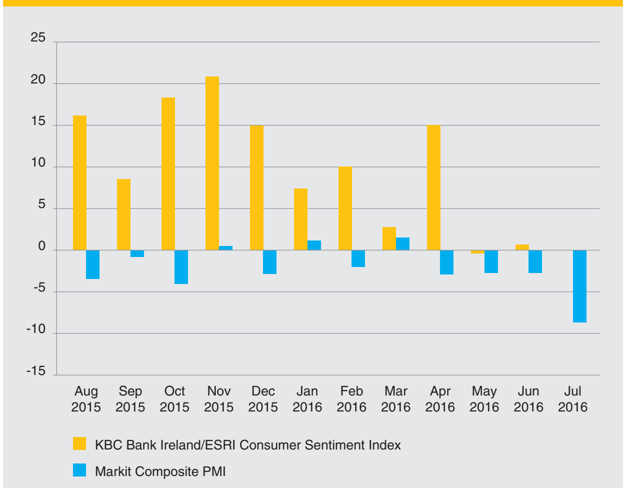
In previous sections we have set out what we believe is the most likely impact of Brexit on Ireland. At this stage it is likely that existing momentum will carry the economy through 2016. We expect the economy will experience a slowdown in 2017 on the back of a weaker UK economy and a continued weak sterling. The impact will differ by sector too. We know from enterprise agency figures that indigenous firms only account for around 11% of exports; as such aggregate exports may still experience strong growth to the EU, US and elsewhere. This must be seen in context, however, indigneous exporters spend as much in the domestic economy through purchases and wages as the multinational exporters and employ as many people. These indigenous exporters are also much more reliant on the UK than the multinational sector. 43% of output from indigenous manufacturers goes to the UK, compared with only 10% of that from non-Irish companies. The impact of Brexit on that 11% of our overall export base will be almost as important for the domestic economy as the fortunes of the other 89%. Ibec has set out to stakeholders the key short-term challenges which will face Ireland, that being the depreciation in sterling and the weakening of investment confidence at home. To combat these challenges we must:

- Be vigilant on cost competitiveness and Government must ensure that enterprises do not face any regulatory, labour cost or tax increases while the current period of uncertainty and exchange rate volatility exists.
- It is vital that available budgetary resources are invested wisely in the economy through infrastructure, housing, education, innovation and labour market measures which will underpin competitiveness.
- Provide support to those industries for which the immediate fall-out from Brexit is greatest. Potential trade restrictions post Brexit and the more preferable tax treatment of SMEs in the UK raise the possibility of Irish SMEs servicing that market from within the UK itself rather than by exporting from Ireland. As such, the need to level the playing field in relation to the tax offering for indigenous business has never been more urgent. We must radically reform our entrepreneurs' CGT regime, along with improving our incentives for investment and innovation.
- Accelerate non-exchequer fiscal measures to support the economy: the flow of financing and investment resources available through the Ireland Strategic Investment Fund (ISIF) and other non-exchequer sources should be accelerated for enterprise and infrastructure projects.

UK Brexit indicators: Consumer and business confidence in the UK (balance of respondents)



Ireland Brexit indicators: Consumer and business confidence, y-on-y % ch



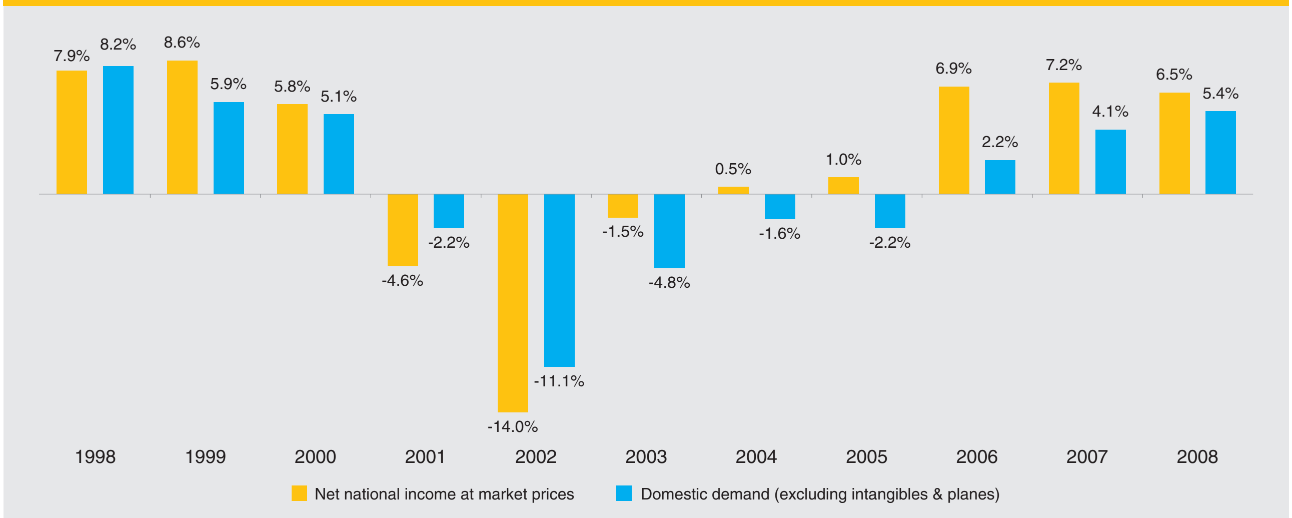
Irelands GDP figures

What happened?
In July the CSO published final full year economic growth data for 2015 and first estimates on growth for Q1 2016. The provisional estimate for 2015 GDP growth had been 7.8% - July's revision saw this jump to over 26%.
While Irish GDP estimates have always been subject to revision and some volatility due to the large impact of multinational activity on the data; a revision of this nature (and the final estimate of GDP growth) was unprecedented in Ireland and internationally. Indeed, it represented the largest single year GDP growth ever in a developed economy. The CSO has complied with normal Eurostat accounting methodologies but the resultant figures clearly do not reflect the trend in other economic metrics such as employment.

What caused this?
In effect this volatility is the product of the relatively small and hyper-globalised nature of the Irish economy juxtaposed with accounting methodologies designed for larger, less globalised states. Although it cannot be fully confirmed (due to confidentiality of the data) it seems that the revision to the GDP figure mainly arises from the impact of recent changes to international and national tax rules on the structure of global corporates. There are other factors which played a role such as re-domiciling of whole corporates to Ireland but these appear to be secondary in nature. These effects cumulatively added €300 bn (circa 40%) to the country's capital stock; this off a €700 bn base. This resulted in major one-off resultant income, depreciation and profit impacts in 2015 which led to a spike in measured GDP. As many of the assets are now owned by Irish domiciled companies there is no profit repatriation effect and the GNP metric (which has previously been seen as a more accurate benchmark) also jumped spectacularly (18.7%).

What happens now?
As we have repeated over recent years, employment remains the best measure of the relative strength of Ireland's economic recovery. There are also a number of alternative indicators of growth which, although imperfect, strip out some of the volatility in the recent data. The first - underlying domestic demand - is essentially the sum of unaffected consumer spending, government spending and investment in the domestic economy (less the impact of intangibles and volatile aeroplane investment). Presented below, this suggests growth in the region of 5.4% in 2015. The other approach would be to present a net measure of national product (NNP as opposed to GNP). The large increase in capital stock in the most recent figures led to large depreciation impacts. Net of this depreciation, measures of national product suggested a growth rate closer to 6.5% of GDP. The reality is likely somewhere in between these two measures. The CSO is convening a special group of forecasters and reporters on the Irish economy (of which Ibec is one) which will look at how best to measure progress in the Irish economy while reflecting real economic activity. While the recent volatility in the GDP figures presents a challenge for policy makes it is ultimately a reflection of Ireland's globalised business models. Clearly, however, parallel metrics are also needed which more accurately reflect trends in the domestic economy.

Figure 17: Alternative measure of economic activity

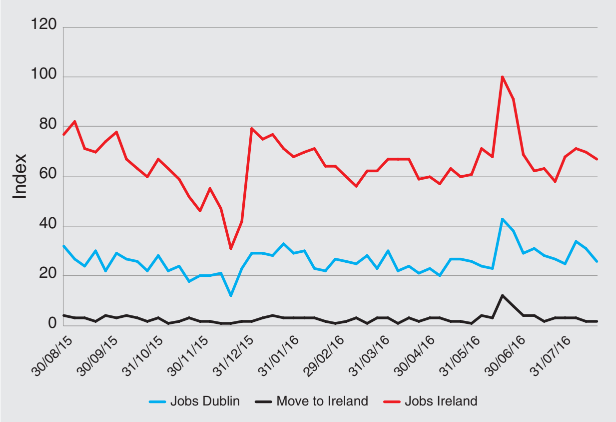


Housing market

House completions

Most analysts agree that between 25,000 and 30,000 new houses need to be built each year to meet new demand. In the past five years less than half of this number has been built annually. This year it only looks like 12,000 houses will be built given that just over 6,500 houses were built in H1. One often cited upside of Brexit is the possibility that companies will relocate to Dublin from London to retain EU access. Data from Google trends shows that immediately after the referendum there was a sharp increase in the number of people in the UK thinking about moving to Dublin. This interest has fallen off in recent months but if the longer term trend is toward movements of firms into Dublin it is unlikely we will be able to exploit this opportunity fully unless more houses are built.

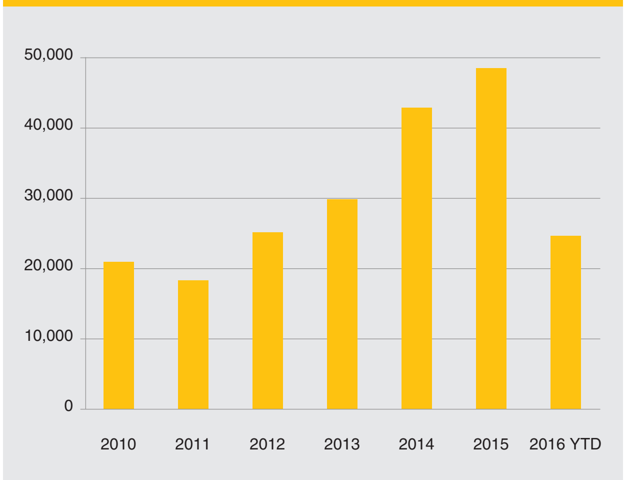
Figure 18: Google searches in the UK



House transactions

Data from the property price register shows that the number of housing transactions has picked up significantly in recent years with twice as many going through last year than in 2011. This, however, is off a very low base. So far in 2016, however, there has been a slight slowdown with the number of transactions in the first seven months 8% lower than last year. Most analysts have suggested stricter deposit requirements under the Central Bank mortgage regulations as the reason for this fall off. There was also a notable drop off in June with 40% fewer transactions than the same month last year. A slight pickup in the coming months may emerge, however, as the number of mortgage approvals was 6% higher in the first six months suggesting that more people are planning on buying as the year continues.

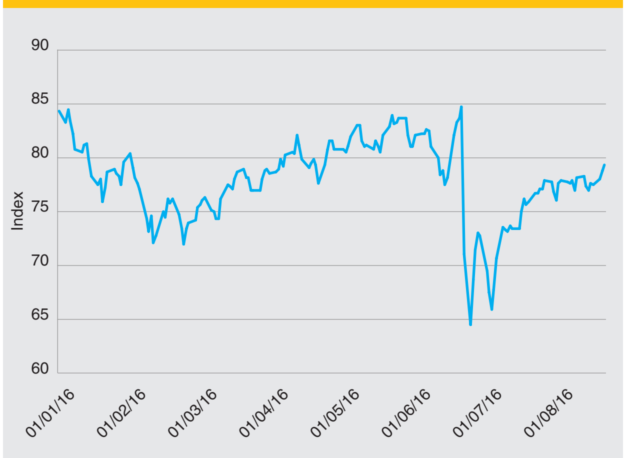
Figure 19: Property transactions



UK Property Market

The housing market is usually the first to suffer in an economic downturn. Immediately after the Brexit vote the UK REITS index fell by 24% in value as many investors sold off in the aftermath of the vote. Indeed, some major propertry linked investments were closed to trading. Since then the REITS index has picked up but is remains 8% lower than it was before the vote. In July the number of housing transactions was the same as June, but was down 8% on the same period a year earlier. The Frank Knight sentiment Index measures what households expect will happen to house prices in the future. It fell post Brexit from readings above 70, which signals strong house price growth, to 50 in July and August. If past patterns between the index and house prices continue then it is likely house price growth in England will slow significiantly over the coming months. The implications, in particular of an end to London's property bubble, would result in large wealth effects for UK consumers and potentially large capital outflows with knock on weakening of sterling.

Figure 20: REIT Index



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