Q1 2019

Ibec Quarterly Economic Outlook

Exceptional momentum slowing

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The Irish economy is in a sweet spot, with growth in employment and wages both hitting close to 3% in 2018. Household incomes are growing by 6% and disposable income per person is now back above its peak levels for the first time. No other economy in Western Europe has greater momentum coming into 2019, but this pace of growth will not last indefinitely. The six months of additional time given to the Brexit process is welcome as it avoids an imminent cliff-edge. However, it has also left business to manage the rolling, costly uncertainty. Outside of Brexit there are signs of a slowdown coming in many of our other key trading partners. Germany has flirted with recession over recent months, Chinese growth last year was its lowest since 1990, and US financial markets are beginning to show signs of strain. For 2019 Ibec forecasts that growth will slow to 4% and to 2.7% in 2020 as the Global economy softens. If a solution to Brexit is not found before October then we expect significant impacts from a sterling depreciation, cancelled investment, falling consumer confidence, rising prices, and significant trade disruption in 2020.

Key indicators

Annual % change	2018	2019(F)	2020(F)
Consumer spending	3.0	2.5	2.0
Investment	9.8	12.4	12.0
Exports	8.9	3.8	2.3
Imports	7.0	5.4	4.6
GDP	6.7	4.0	2.7
Inflation	0.5	1.0	1.3
Employment	2.8	2.0	1.7

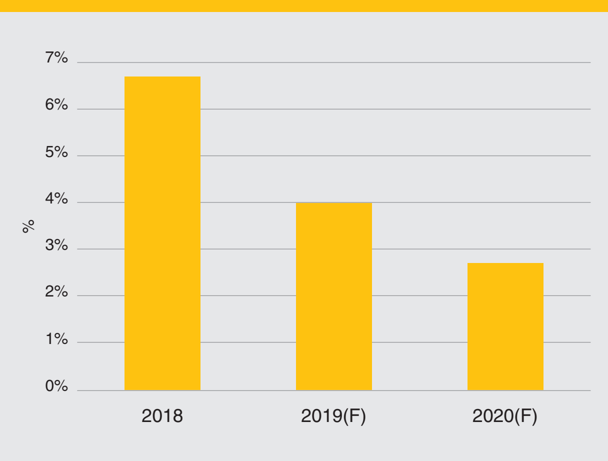
Ibec
For Irish Business

Macro-trends

Economic growth

Preliminary estimates show that the economy grew by 6.7% last year. This growth was broad based and was driven by strong growth in consumer spending, investment, and exports. In the fourth quarter, GDP growth slowed to 3% annually. This was largely driven by a surge in imports (IP related), as the other components remained unchanged. Modified domestic demand (which excludes aircraft, IP investment and net-trade) which provides a good measure of underlying growth in the domestic Irish economy, grew by 4.5% in 2018. For 2019, Ibec forecasts that growth will slow to 4% and to 2.7% in 2020 as both the Irish and Global economies reach a mature stage of the business cycle. Our forecasts for 2020 assume a deal on Brexit is reached. If there is a no-deal exit, growth will still be positive, but it will be half what it would have been as there will be negative movements in sterling, investment and prices and trade disruptions.

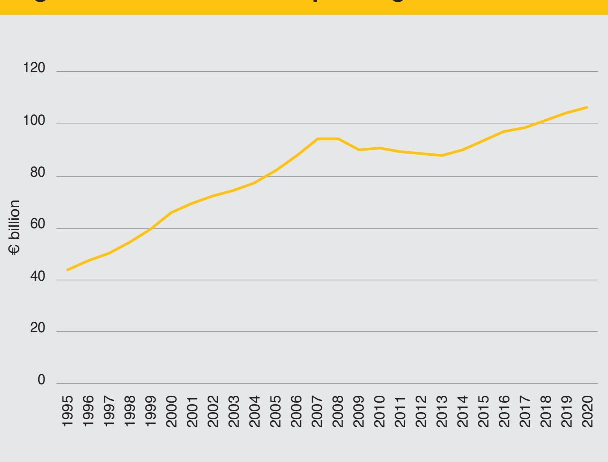
Figure 1: GDP growth



Consumer spending

In the latter part of 2018 consumer sentiment fell quite rapidly due to Brexit. However, this was not reflected in consumer spending which grew by 4.4% in 2018 in value terms, up from 3.1% in 2017. The sentiment indicator showed that while consumers were positive about their present situation, many expressed increased concerns about the future of the economy. In early 2019, consumer spending has remained buoyant as core retail sales grew by 3.2% in the first two months. However, there was a reduction in car sales (3% lower in January). This was the first time since 2013 that car sales in January were weaker than in the corresponding month in the previous year. While this appears to be a global trend, it could be a sign that consumers are delaying big-ticket purchases on the back of increased uncertainty. For 2019, Ibec forecasts consumer spending growth of 2.5%.

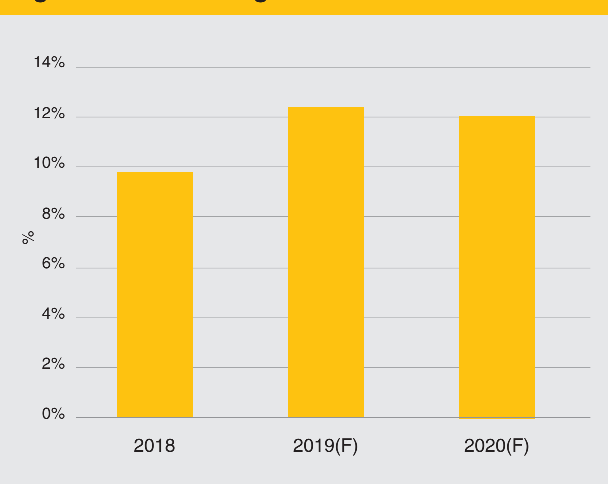
Figure 2: Irish consumer spending



Business investment

Investment in Ireland continues to grow at a rapid pace, expanding by 10% last year. This meant that total investment averaged €1.4 billion a week (including IP) which is exceptional given the size of our economy. Residential construction experienced strong growth and is now growing twice as fast as commercial (26% v 12%). Investment in machinery and equipment (excluding aircraft) grew by 12%. The investment component that experienced the strongest growth was aircraft which grew by 60%. Any 'no-deal' Brexit could significantly reduce investment in 2020. If a deal is reached, however, we expect investment to grow by 12% both this year and next.

Figure 3: Investment growth



Trade

Ireland's goods export performance in 2018 was exceptional by any international standard. Final figures, based on customs declarations, show that Irish goods exports to non-EU countries grew by €10.1 billion in 2018. To put this in context, Europe's manufacturing powerhouse of Germany saw its goods exports outside the EU increase by €10.4 billion. This exceptional story has been driven mostly by strong growth in sales values and volumes of pharmaceutical and medical goods by MNCs based in Ireland. There are two trends likely to drive Ireland's exports in the year ahead. Firstly, the nature of MNEs in Ireland (who account for 90% of exports) is changing rapidly due to technological upgrading, productivity gains, and a more significant services element to inward FDI. Secondly, there is a broader global context (see pages 6 and 7) where global growth is likely to slow as we reach the top of the business cycle. Even in the event of a no-deal Brexit we expect total export values to grow through 2020, albeit much more slowly, due to the outsized impact of MNE exports to global markets on our export growth.

Fast growing markets

In total, Irish merchandise goods exports increased by €51.6 billion in the past five years. Just under 80% of those net export gains have been to other EU countries and the US. Exports to other EU countries grew by €19.9 billion (dominated by Germany, and Northern Europe through the Benelux ports), while exports to the US have grown by €20.7 billion over the same period. Gains in non-EU and non-US goods exports were driven by exports to countries in East Asia. Since 2013 annual exports to China increased by €3.2 billion driven by micro-chips and medical exports. In addition, exports to Japan increased by €2.2 billion. Over €1 billion more has gone to other East Asian markets predominantly South Korea, Hong Kong, Singapore, and Taiwan. Over the coming years these markets will continue to be of growing importance to Ireland particularly with the implementation of the EU/Japan trade agreement, in addition to agreements with Vietnam, Singapore, and ongoing negotiations with other ASEAN countries.

Government Finances

Irish Government bond yields remain subdued at their lowest level on record. At the time of writing, the Irish Government could borrow ten-year money for under 1%. While our public debt relative to Government revenue remains elevated at a ratio of 2.2, when compared to other EU countries this is tempered by high potential output growth, long-debt maturity, and a young and growing population. In our view, there are more pressing concerns about our fiscal health in the day-to-day spending category. In particular, the use of a cumulative €14.3 billion in unexpected corporate tax overruns since 2015 to fund unexpected current spending (mainly in the health vote) is a major concern which Ibec continues to highlight. There are significant, and growing, risks that corporate tax income will see significant volatility over the coming years as the OECD's Base Erosion and Profit Shifting (BEPS) process enters its second phase.

Figure 4: Growth in non-EU goods exports (2018)

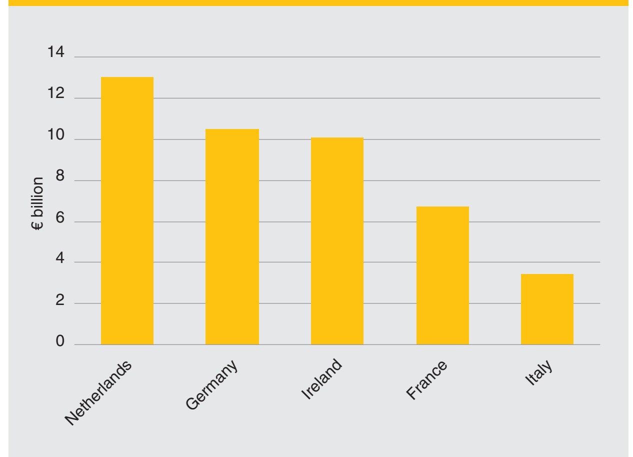


Figure 5: Share of export growth to non-EU countries since 2013

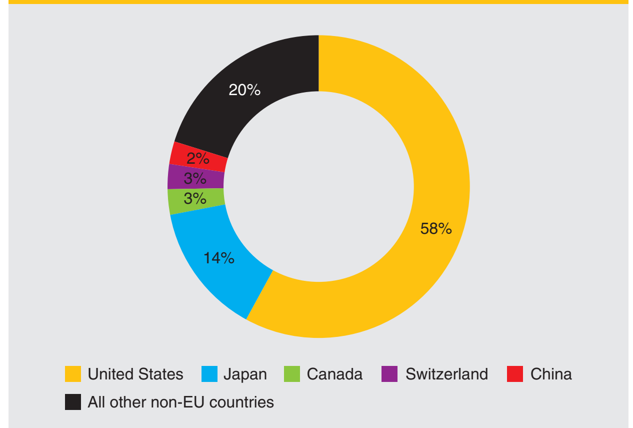
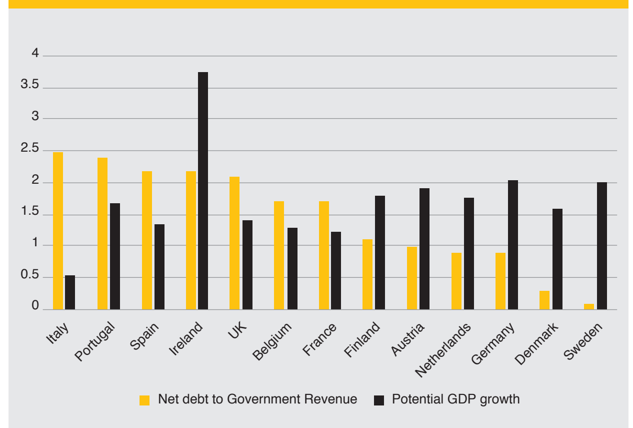


Figure 6: Debt size relative to Government Revenue and potential medium-term GDP growth, %



Labour market and inflation

Employment
For the past few years, skills shortages within certain sectors was the main challenge facing the Irish labour market. However, with the economy now close to full employment, these skills shortages have turned into labour shortages. Ibec forecasts that this will cause employment growth to slow in 2019 as we reach full employment and firms struggle to fill vacancies. There was some evidence of this in the fourth quarter of 2018 as annual employment growth slowed from 3.1% in the first three quarters to 2.3% in the fourth quarter. The administrative sector showed the strongest growth in 2018 at 13%. Construction (8%) and education (7%) were the next two highest growth sectors. For this year, Ibec forecasts that employment growth will slow to 2% as the increase in the number of workers in the country struggles to keep pace with demand. Ibec's expectation is that employment would still grow out to the end of 2020 in every Brexit scenario. However, the pace of growth would slow significantly in 2020 to 0.5%.

Employment to population ratio
Ireland's participation rates are still lower than a decade ago. This is because younger cohorts are spending longer in education. However, Ireland's prime age (aged 25-54) participation rate has never been higher. Ireland's prime age participation rate reached 83.5% in Q4 2018, up from 80.6% in 2012. This was the fourth largest increase in the EU. This increase was primarily driven by higher female participation rates (particularly for those in their 40s), as male prime age participation rates are still lower than 2007. As an indicator of labour market slack, this suggests that there are very few additional 'easy to reach' workers likely to come into the domestic labour market over the coming years. However, increased participation amongst older cohorts could alleviate some of these pressures.

Figure 7: Employment growth Q4 2018

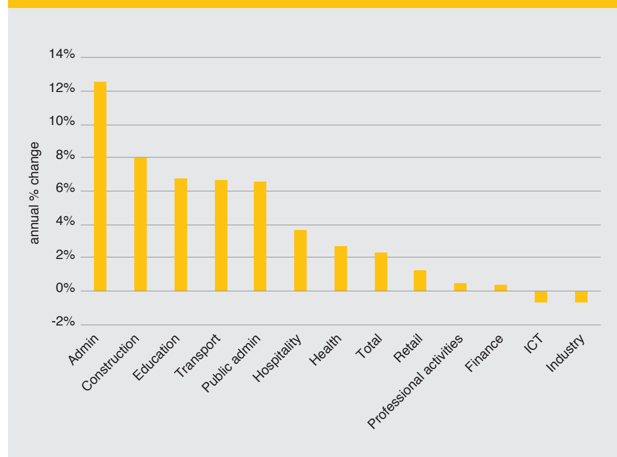


Figure 8: Prime age participation rate (25-54 year olds)

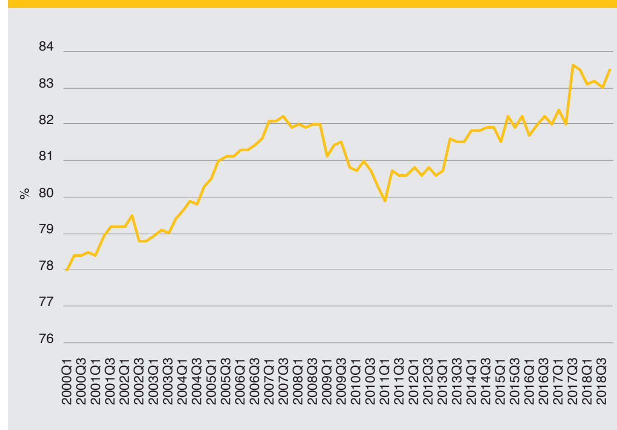


Table 1: Labour market summary

Employment 000s annual average	2018	2019	2020
Agriculture	107	104	104
Industry & Construction	423	434	437
Services	1,719	1,762	1,770
Total	2,250	2,300	2,311
Employment growth (%)	2.8	2.0	1.7
Unemployed	140	133	132
Unemployment rate (%)	5.9	5.5	5.4

Source: Ibec forecasts

Wages

Average hourly earnings grew by 3.5% in Q4 2018. This is a real signal of the difficulties in hiring being reported by companies across the country. As we have drawn attention to previously, this decade also remains on track to have experienced the lowest price inflation of any since independence. Inflation in 2018 rose by only 0.5%. Although there is no single consistent time-series on Irish hourly wages it appears that 2018 saw Irish workers get their largest annual real (inflation adjusted) wage increase since the late 1990s or early 2000s. Over the medium-term this pace of real wage increases will mean margin compression for business, and ultimately sharper increases in inflation, unless we have much greater success in improving productivity in our domestic sectors.

Inflation

Inflation came in at 0.5% for 2018 on the back of continued falls in the price of domestic goods and global energy over recent years. Our expectation is that growing wages and business costs mean that a stronger pace of inflation will be inevitable in 2019, even though it may remain comparatively muted. The changing environment is reflected in household expectations. A European Commission survey shows that the proportion of households expecting strong increases in consumer prices has risen from 16.2% in February 2018 to 33.6% in February of this year. We expect price inflation in 2019 to come in around 1%. In the event of a no-deal Brexit, however, rising trade and tariff costs could significantly lift the prices of key items in 2020.

Household incomes

Over the period between 2000 and 2015 Irish and UK households saw similar growth in disposable income (per capita), in both nominal (3.5% per annum) and real (1.5% per annum) terms. While Ireland's growth was more volatile, with households gaining more during the boom and losing more during the crisis, households in both countries remained equally better off over those fifteen years. This trend has diverged significantly over the past four years. Since 2015, Irish households have seen growth of real income, per person, of just over 11% cumulatively. UK households on the other hand saw their incomes fall by 1.2% over the same period. About half of this growth differential has been driven by diverging inflation between the two jurisdictions, with the remainder driven by a slowdown in nominal income growth. Nominal disposable income growth, per capita, has remained just above its long-term average at 3.7% in Ireland, whilst in the UK it has fallen to just above 2%. On the other hand, inflation in Ireland has averaged at just above 0.2% since 2015, with the depreciation of sterling seeing an increase in UK inflation to 1.5% (and northward to 2.5% since 2017).

Figure 9: Private sector average hourly wage growth

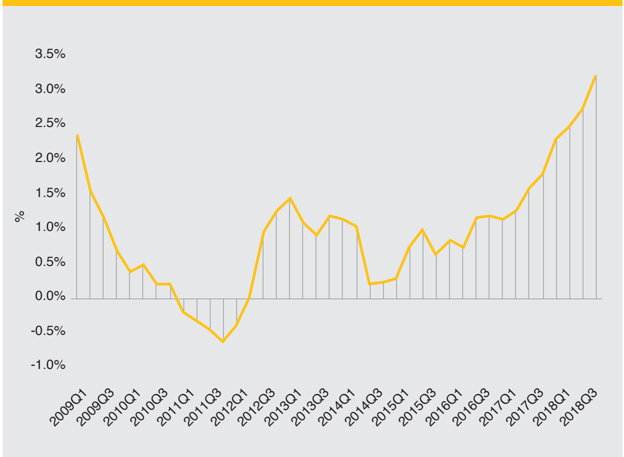


Figure 10: Annual changes in the price of goods and services

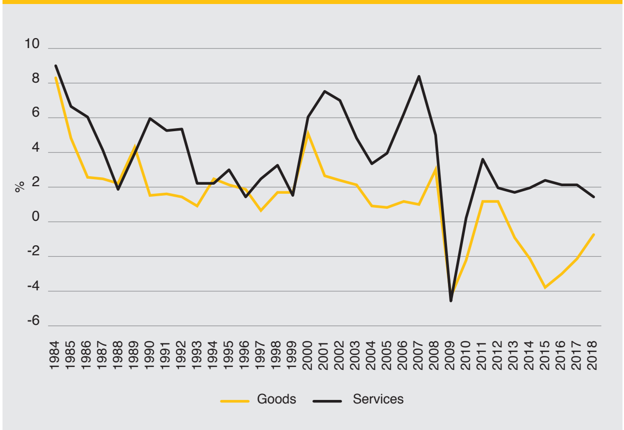
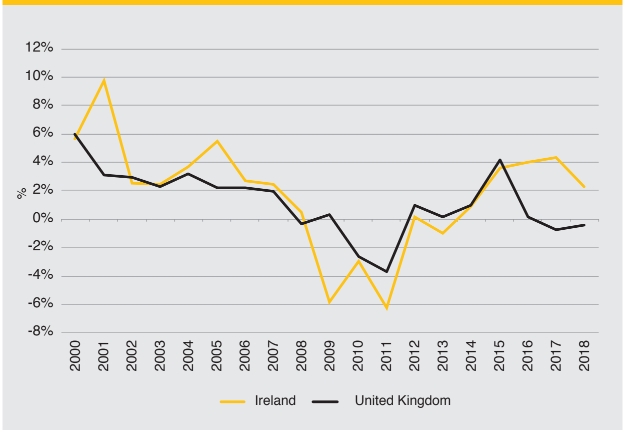


Figure 11: Growth in real disposable household income per capita

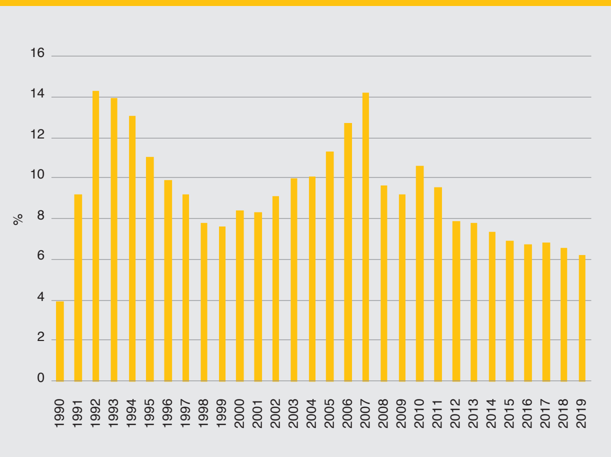


China Shock

China growth slowdown

Last year the Chinese economy grew by 6.6%, its slowest rate since 1990. While global trade tensions hurt growth in 2018, it is likely that this slowdown will continue over coming years. This structural slowdown will be driven by an ageing population and a higher level of development in the country. Investment growth is also likely to slow as it will be difficult for the country to maintain its current levels of investment as it moves towards a more market orientated economy. China's investment to consumption ratio is the third highest in the World. In the long-term it remains to be seen if efforts to boost higher-value added activities through the 'Made in China 2025' strategy will succeed. While growth will continue to be significant and positive, this slowdown will have an impact on the global economy, given that over the past eight years China accounted for more than a quarter of total global growth.

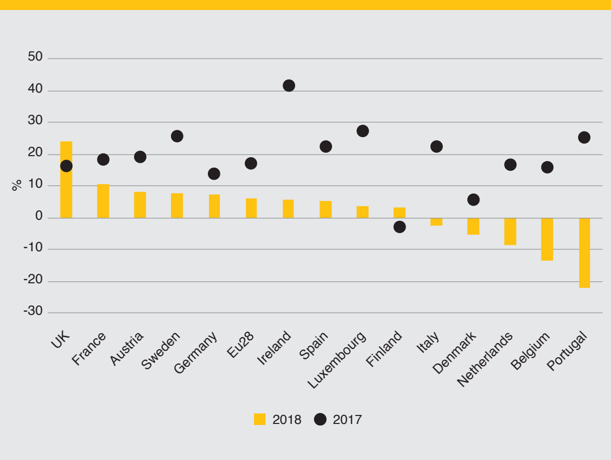
Figure 12: China GDP growth



EU trade with China

In 2018, China accounted for 3.8% of total EU goods exports. Germany is the most reliant on China as it exported the largest share of its goods there (6.8%) while Lithuania has the lowest exposure (0.7%). In 2018, EU exports to China grew by 6% which was sharply weaker than growth in 2017 (16%). Only two countries reported stronger growth in exports to China (UK and Luxembourg) while many countries saw a reduction in their exports as the Chinese economy slowed. While China accounts for a relatively small share of Irish exports (3.3%), it played an important role in export growth in recent years as China accounted for a fifth of net-growth in Irish goods exports in 2016 and more than a third in 2017. However, growth slowed in 2018 (from 41% to 6%) and therefore did not account for the same share of total growth in exports.

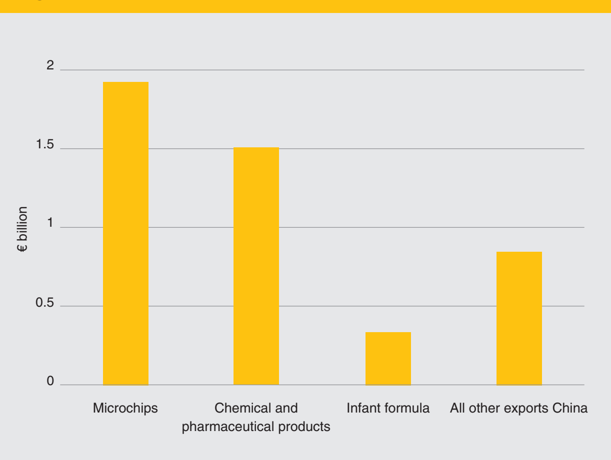
Figure 13: Annual growth in exports to China



Irish trade with China

Ireland's exports to China are dominated by a small number of high value products. Despite falling by 12% last year, microchips are still Ireland's largest export to China accounting for 41% of goods exports. Ireland is also the largest exporter in the EU of these products to China (followed by Germany). Chemical and pharmaceutical products account for 32% of exports and grew by 88% last year. Were it not for this strong growth, Irish exports to China would have fallen by 13%. Finally, infant formula accounts for 7% of Irish exports to China. Taking microchips, pharmaceuticals, and infant formula together, these products account for 80% of Ireland's total goods exports to China.

Figure 14: Irish exports to China



German slowdown

In the second half of 2018, several leading survey-based indicators suggested that growing trade tensions globally, labour shortages, and one-off production issues (such as revised auto-emissions standards) were weighing on growth in Germany. This came through in official statistics in Q4 with Germany only narrowly avoiding following Italy into a 'technical recession', of two consecutive quarters of negative growth. As a result of the growing risks in the global economy the German Council of Economic Experts cut its growth forecast for 2019 to 0.8%. This compares to an average of 2% growth in each year between 2013 and 2017. Given the ongoing trade tensions with the US (accounting for 8.8% of German exports), and precarious economic positions in China (6.8%), UK (6.6%) and Italy (5.1%) the downside risks to the German export model will be considerable over the coming year.

US economy

The US economy remains the most robust of any G7 nation. Growth is expected to hit 2.5% in 2019 following growth of 2.9% in 2018. In addition, unemployment is now at its lowest rate in 50 years for most groups of workers. Whilst this has been welcomed as a strong positive by many commentators, it is not built on solid foundations. A better measure of joblessness is to look at employment rates among the whole population between ages 25 and 54 (to avoid distortions from trends of longer education and working lives). By this measure, the overall 'prime-age' employment to population ratio (79.9%) remains below its 2000 peak of 81.9%. For women, the rate at 73.4% remains marginally below peak of 74.9%. For men, on the other hand, the rate of employment to population is now at 86.5%. This is about ten points below its 1950s peak and is still below its average of 87.1% seen between 2000 and 2007.

Figure 15: GDP growth forecasts

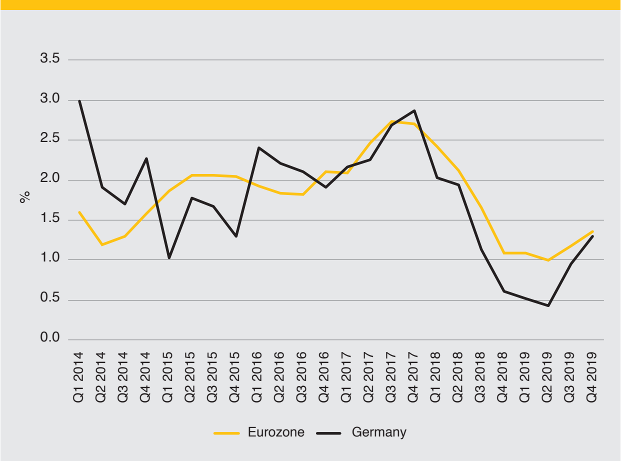


Figure 16: Employment to population ratio for those aged 25 to 54, %

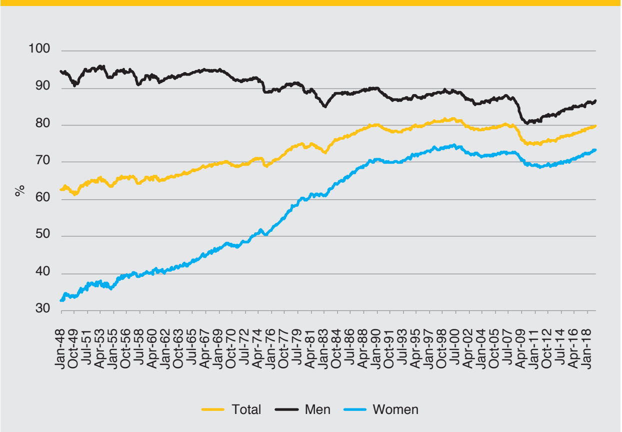


Table 2: International economies summary

	Real GDP, y-on-y % ch			Inflation, y-on-y % ch		
	2018	2019	2020	2018	2019	2020
Eurozone	1.8	1.3	1.5	1.8	1.3	1.6
UK	1.4	1.2	1.4	2.5	1.8	2.0
USA	2.9	2.3	1.9	2.4	2.0	2.7
Emerging markets	4.5	4.4	4.8	4.8	4.9	4.7
World	3.6	3.3	3.6	3.6	3.6	3.6

Source: IMF economic outlook

Brexit and the UK economy

Business investment

In 2018, there were signs that uncertainty was hurting investment decisions in the UK. Last year business investment in the UK fell by 0.4% which was driven by a slowdown in the latter part of the year. In Q4 business investment was 2.5% lower than it was in the same period in 2017. This slowdown was driven by a weakness in tangible fixed capital investments, particularly transport, equipment, and machinery. Excluding investments in intangible assets (intellectual property), business investment fell by 1.8% last year. This slowdown is most likely due to increased uncertainty that is causing firms to postpone investment decisions. This slowdown in investment is likely to continue, which will inevitably have a negative impact on productivity and the labour market.

UK consumers

Consumer sentiment in the UK has fallen over recent months on the back of growing political malaise. It is now at its lowest level in five years. Despite this, retail sales in the UK have held up well. In the three months to February, retail sales rose by 3.7% in volume terms and 4.2% in value terms. On the face of it, this would seem to be a similar story to the divergence between Irish consumer confidence and retail sales. There are differences, however. Irish consumer spending is holding up due to rising wages. On the other hand, UK consumer spending is holding up due to falling savings by British households. UK households were saving around 10% of their disposable income before the referendum, this has now fallen to only 4%. This reliance on dipping into savings will leave consumer spending in the UK much more vulnerable in the case of any economic shock.

UK net migration

Net migration (the difference between the number of people immigrating and emigrating) to the UK is still positive. However, since the Brexit referendum there has been a change in migration patterns to the UK depending on nationality. For those from outside the EU, net migration increased. However, for those from the EU it is still positive but has started slowing. In 2015, 171,000 more people from the EU moved to the UK than left. In 2018, this fell to 57,000 people (a reduction of 65%). This was driven by a slight rise in the number of people emigrating (2.1%) and a significant decrease in the numbers immigrating (-18.5%). For those from Central and Eastern European countries, net migration is now negative with more people leaving than moving to the UK. This contrasts with Ireland, where net migration from the EU-28 was negative in 2015 but has since turned positive and continues to grow (albeit still lower than in 2007).

Figure 17: UK Business investment

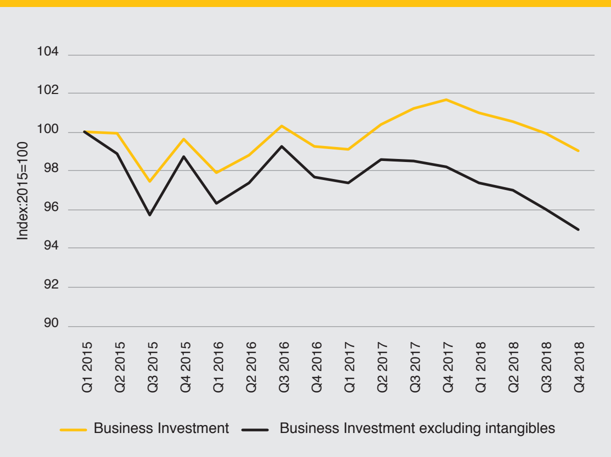


Figure 18: UK and Irish household savings rates

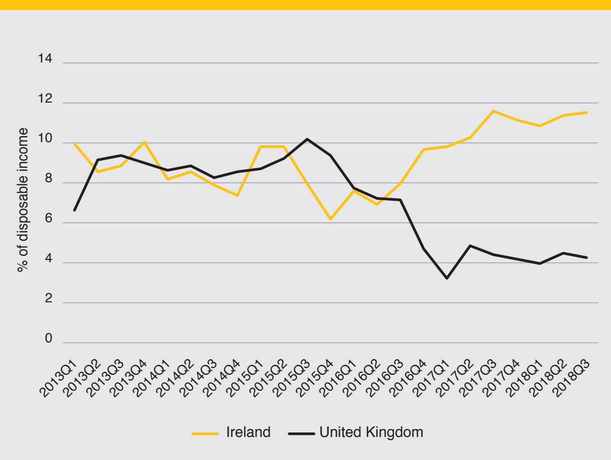
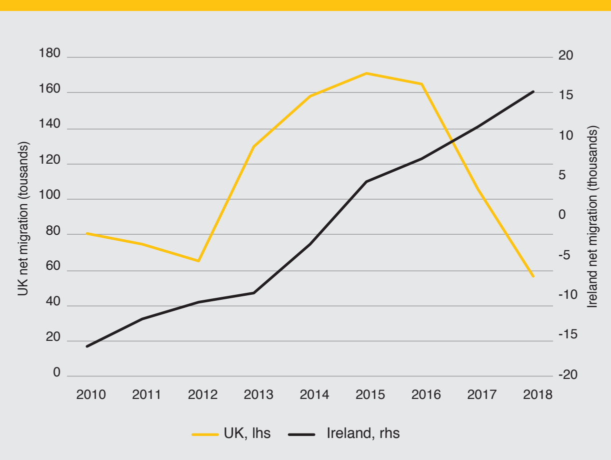


Figure 19: Net migration from EU-28



Brexit and Ireland

EORI registrations

One of the main things companies can do to prepare for Brexit is to register for an Economic Operators' Registration and Identification (EORI) number. Companies need this number to trade with any non-EU country, including the UK after Brexit. As such the run-rate of EORI registrations is a good read of how well-prepared companies are for Brexit. Around 90,000 Irish companies will need one according to customs returns for recent years. Since the EORI was introduced in 2009, there has been an average of 250 registrations a month. In February of 2019, following Revenue's Brexit letter to SMEs, there were 2,223. This shows the significant impact of that letter. However, when firms which registered in February are included, there have been a total of 42,662 EORI registrations since its introduction, far short of the 90,000 companies which will need one. It is unlikely customs agents alone will be able to cover this volume of work on behalf of business. A significant number of businesses will need to register through their Revenue Online Services (ROS) account.

Brexit exposed workers

Previous Ibec work has shown that employment in the most Brexit exposed sectors was mainly focused on rural areas, rather than urban ones. Up to 30% of workers in Cavan/Monaghan work in the most Brexit exposed sectors, whilst fewer than 8% do in any of our cities. New research undertaken by Ibec has also shown that workers in the most Brexit exposed sectors also finished school younger than the average across the economy. For example, only 17% have a third-level qualification. This is compared to 40% of workers in all other sectors. The most common level of qualification for workers in the most Brexit exposed sectors is their leaving certificate or lower. Just under 60% have a highest qualification of technical or vocational training.

Demographics

It is also the case that, that those working in the most Brexit exposed sectors tend to be older than average and are far more likely on average to be male. One-in-three workers in the most Brexit exposed sectors are over the age of 50. They are also predominantly male, due to the predominance of agri-food and manufacturing. Three-quarters of workers in the most Brexit exposed sectors are men. One-in-every-five male workers is employed in one of these sectors, with much higher rates in rural areas. This, along with lower levels of academic qualifications, will have consequences for re-training and their ability to move to find work. This will be a significant challenge for regional and industrial policy no matter what form Brexit takes.

Figure 20: Average monthly EORI registrations

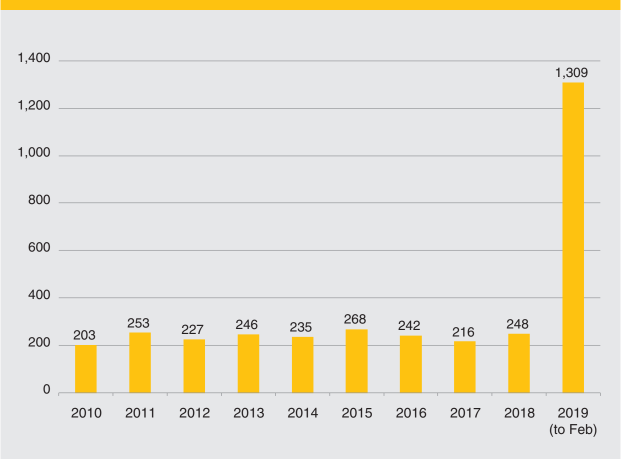


Figure 21: Highest level of education

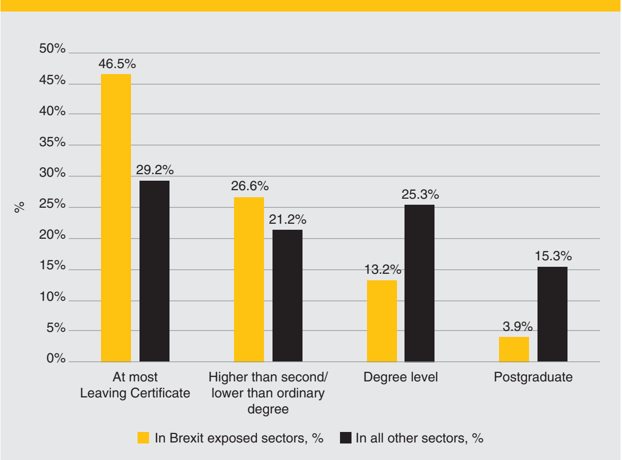
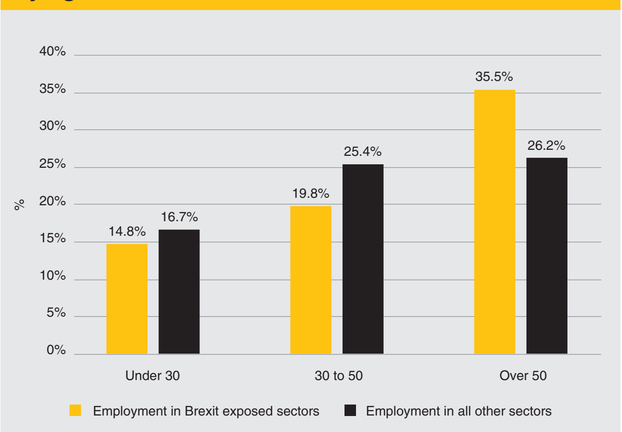


Figure 22: Employment in Brexit exposed sectors by age



Financial indicators

Business deposits

With the onset of Brexit, cashflow will be a growing issue for many firms, particularly SMEs. Although there is no one reliable data source on cashflow in Irish companies, we can get some idea of the position of firms by looking at their deposits held on account in Irish financial institutions. These figures include overnight, agreed maturity, and redeemable-at-notice deposits. At the peak of the boom Irish resident companies held €100 billion on deposit in Irish banks. This fell as far as €75 billion at the lowest point of the crisis. Since then, it has recovered to €91 billion in 2018. This recovery trend is offset, however, if we compare it to the number of companies in the State (measured by corporate tax registrations). By this measure average deposits per-company have continued to fall in recent years, to around €530,000 last year.

House prices

Over recent months we have witnessed a significant slowdown in the growth of house prices, particularly in the Dublin area. Outside of Dublin house prices, while slowing, still rose by 9.5% per annum in January. In Dublin, on the other hand, they rose by only 1.9%. Meanwhile the total share of new units being delivered in Dublin has remained between 35% and 40% since 2016. The 2018 review of mortgage lending rules showed that approximately 67% of first time buyers (FTBs) in Dublin in the first half of 2018 had a loan-to-income ratio over 3.25 times their income with 30% being above the 3.5 times limit. This compared 40% with a loan above 3.25 income and 11% above the 3.5 times income limit in areas outside Dublin. This regional pattern is consistent with the view that the Central Bank's mortgage lending rules are beginning to bind selling prices to income growth in the Dublin area. This is no bad thing, but it will need to be matched by a significant effort to reduce the cost of development land in Ireland over the coming years. With a greater share of cash buyers at the affordable end of the market this may also result in lower price differentials between different areas and house types into the future.

US Yield curve

In March the 3-month/10-year yield curve on US bonds inverted for the first time since 2008. As a financial indicator of the US business cycle it has been as good as any in the post-war era. The logic goes, that when the yield on 3-month treasury bills is greater than the yield on ten-year bills it suggests that people have lost confidence in growth into the future. Every time this has happened since the mid-1950s the US economy has fallen into recession within eighteen months. The recent turn is not unexpected given the decade long growth spurt the US economy has witnessed since the 2008 recession. It underlines our existing expectation that the fuel poured on the US economy by the Trump tax cuts will run short by late next year at the latest.

Figure 23: Deposits held by Irish resident firms in Irish bank accounts

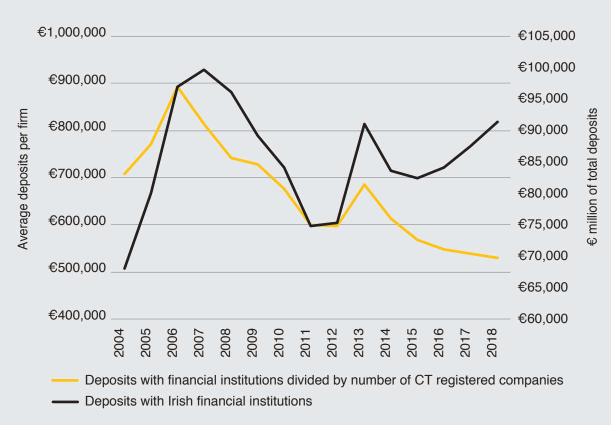


Figure 24: House prices, y-on-y, % ch

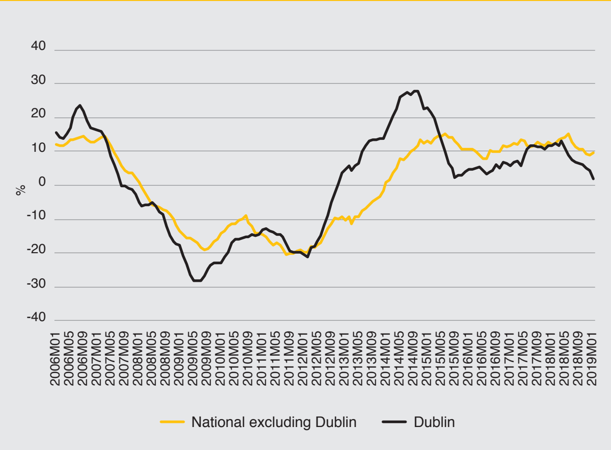
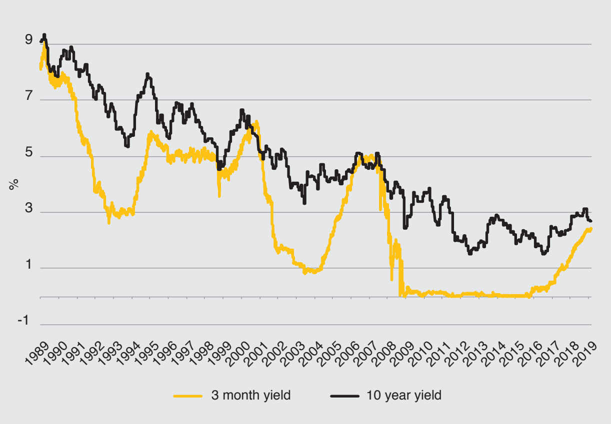


Figure 25: Difference between 3-month and 10-year US yields



Date for your diary:

European Parliament Political Debate

Ibec are holding debates with MEP candidates, which are taking place in Dublin, Cork and Galway, in advance of European Parliament elections on Friday 24 May.

The events, moderated by Newstalk's Kieran Cuddihy, will provide an important opportunity to hear what candidates have to say on the key issues for business. A questions and answers session will allow you to raise issues of specific concerns.

Galway (Midlands - North-West constituency)	4:00 - 5:30pm Wednesday 8 May, Clayton Hotel Galway
Cork (South constituency)	9:00 - 10:30am Friday 10 May, Kingsley Hotel Cork
Dublin	8:30 - 10:00am Monday 13 May, Ibec Head Office Dublin

The debate series is part of our wider European Parliament campaign, which will run up to election day on Friday 24 May and beyond. The campaign aims to engage the public, introduce key business priorities into the political debate and promote wider engagement on EU issues.

To book your place, please visit
www.ibec.ie/events

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