Q3 2017

Ibec Quarterly Economic Outlook

A pivotal year ahead

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Ireland's economy is in a good place. We are experiencing exceptional growth, driven by a resurgent private sector. The Government deficit will close next year and the State plans to invest more in our future. The risk of our growth being derailed over the coming years is rising however. Brexit negotiations are stuck, and the lack of progress increases the likelihood of a 'no deal' outcome. In addition, our business model continues to be challenged by external threats. The coming years are becoming increasingly difficult to predict.

Key indicators

Annual % change	2016	2017	2018
Consumer spending	3.3	2.8	2.2
Investment	61.2	8.0	3.5
Exports	4.6	4.1	3.8
Imports	16.4	2.6	2.9
GDP	5.1	4.8	3.9
Inflation	0.0	0.4	0.9
Employment	2.9	2.6	2.2

Ibec
For Irish Business

GDP and components

Economic growth

The Irish economy continues to perform exceptionally well despite great uncertainty. In the first half of this year, GDP grew by 5.5%, broadly in line with what was experienced in 2016. Exports, which were up 3.2%, were the main driver of this growth. Imports and investment were slightly lower than expected due to fewer Intellectual Property movements into the country in the first half of this year. This may change, however, as end of year adjustments in the past resulted in large upward revisions as new information became available. There are many downside risks facing the Irish economy but the positive news is that they will be faced from a position of strength. Ibec forecasts GDP growth of 4.8% this year and 3.9% for 2018 on the back of a recovering consumer economy and continued strong export growth to the US, EU and developing markets.

Government finances

October's budget was a muted affair with limited fiscal space resulting in only incremental changes. Nonetheless, the picture painted for the public finances over the coming years was a promising one. The Department of Finance expects the economy to grow by an average of 3% annually over the coming four years, despite major external risks. This means that the Government deficit will fall to only 0.2% of GDP next year. In effect the Government's books will be balanced for the first time since the crisis. Excluding capital expenditure, the State will run a day-to-day surplus of €22 billion over the next five years. In a positive development, capital expenditure will increase strongly to €8.8 bn by 2021 (2.6% of GDP) reflecting key Ibec asks over several years and the net national debt will fall to under 60% of GDP next year. A ten-year capital plan outlining the projects that will be funded with these new resources will be laid out before the end of 2017.

Investment

Total investment increased by 3.1% in the first half of this year. Investment in housing grew by 36% over this period. However, this is from a low base as it is still 69% lower than 2007 and lower than any period from 1997 to 2008 in real terms. On the other hand, investment in non-residential property is only 5% lower than 2007, and continues to experience strong growth. This is driven by the urban office market and a continued strong demand for space from both domestic and multinational companies. Investment growth in machinery and equipment was very strong up until last year. Business has invested almost €15 billion in machinery and equipment (excluding planes) over the last 18 months alone. However, this slowed in recent months, with a noticeable drop of 10.6% in the first half of this year. This would tie in with anecdotal evidence that businesses are delaying investment decisions due to Brexit and international uncertainties.

Figure 1: GDP growth, % annual change

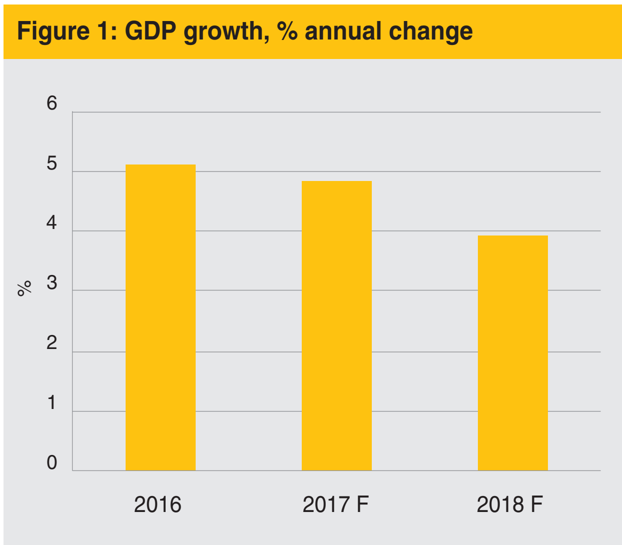


Figure 2: Net debt (% of GDP)

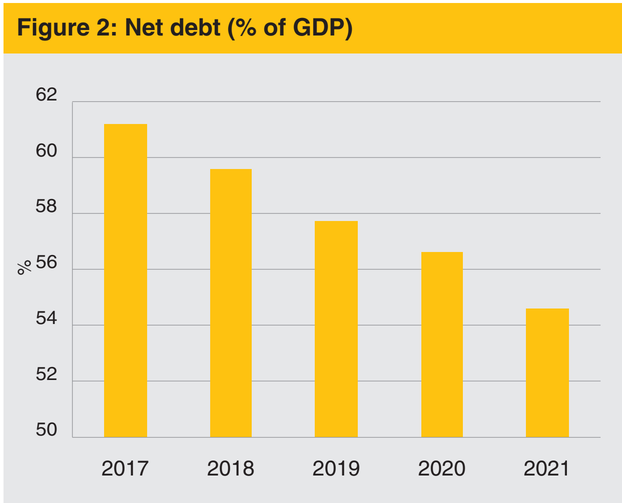
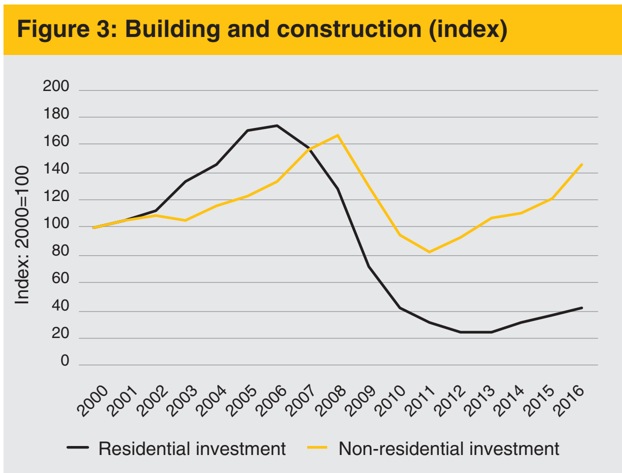


Figure 3: Building and construction (index)



Export market growth

In recent years, Ireland reduced its reliance on the EU market as goods exports to other non-EU destinations experienced significant growth. Last year, these export values grew by 9.2%, and in the first 8 months of this year they were up 5%. Figure 4 shows the six countries that accounted for the largest increase in exports last year. Exports to the US grew by 13% and this represented the largest increase in value as exports grew by €3.5 bn. However, growth rates were much stronger for other new emerging markets. Exports to China increased by 84%, and this was largely driven by medical devices. Other fast-growing markets included Israel (up 70%) and Korea (up 72%) both of which were also driven by exports of medical devices. Exports to Australia grew by 60%, mostly related to pharmaceutical products.

Export diversification

A recent report by Intertrade Ireland and the ESRI estimated the impact of a hard Brexit (introduction of WTO tariffs) on Irish trade with the UK. Overall it found that Irish exports to the UK would fall by 20%. This accounts for a relatively small proportion of our total exports and therefore wouldn't have a significant impact on our headline export figures. Assuming non-UK exports continue to grow at their current rate, it would take less than one year to offset this loss in other markets. However, certain sectors are more reliant on the UK than others and are also subject to higher tariffs under WTO rules. For these goods, market diversification is essential, however, it will take time. Assuming non-UK exports for dairy and meat and fish continue to grow at the 10-year average rate, it would take five (dairy) and nine years (meat and fish) to make up for lost trade with the UK. There is also the strong possibility that it could take even longer than this, as without the UK the EU would run a trade surplus for food (it currently runs a deficit), which would put downward pressure on food prices in the EU.

Consumer spending growth

CSO growth figures for Quarter 2 of 2017 showed that the economy continued to perform well. However, there was a significant weakness evident in consumer spending which did not sit well with leading indicators. Consumer spending grew by only 1.8% in the first half of the year. This was noticeably weaker in recent months than the leading indicators such as employment and wages would suggest. It is likely that cross-border trade in cars and other goods, accompanied by strong growth in cross-border online shopping, has driven this phenomenon. This shows that the exchange rate effect of Brexit is already having an impact. Increased saving amongst consumers also played a significant role. The savings rate jumped from 6.2% of disposable income in Q1 to over 14% in Q2. Overall consumer spending is now 3% above where it was in the first half of 2008 and consumer fundamentals remain strong. Rapid employment growth and an increase in disposable income of 5.4% in H1 together mean that overall consumer spending for the year should increase by around 2.8%.

Figure 4: Growing export markets (2016 vs 2015)

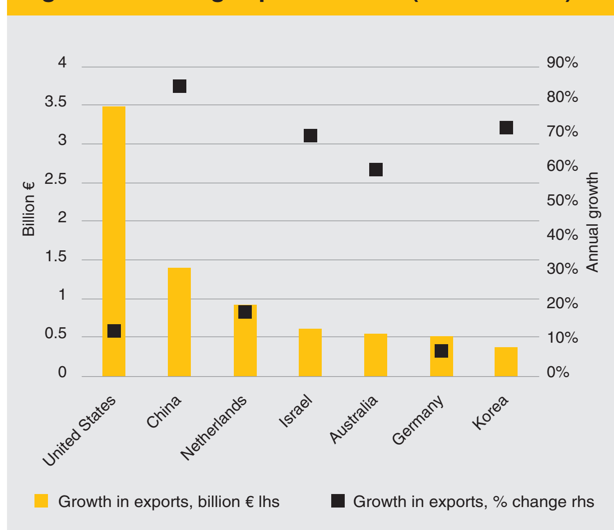


Figure 5: Brexit diversification timeframe

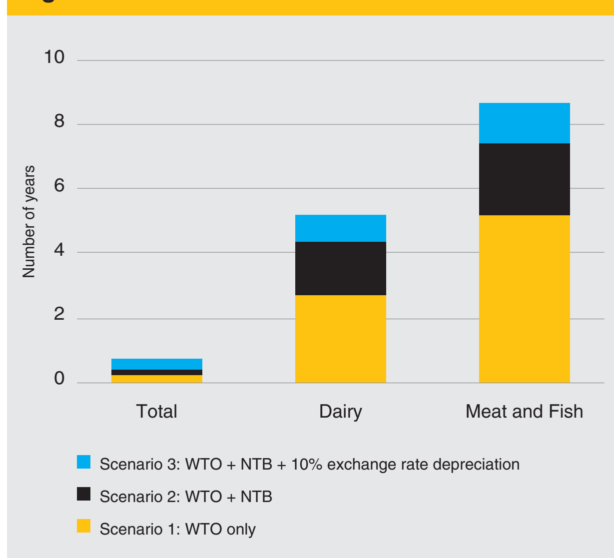
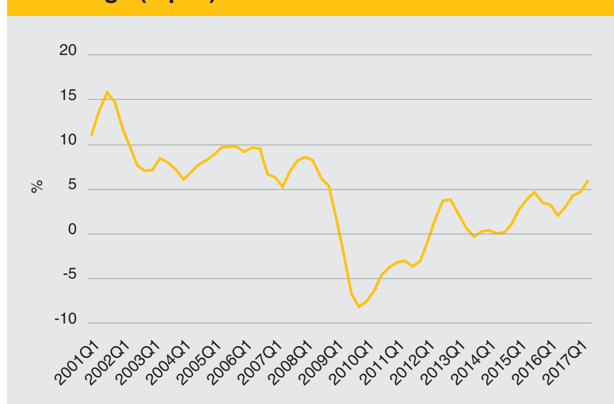


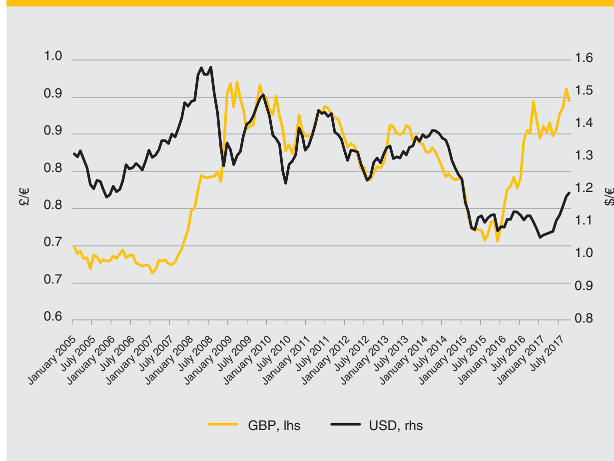
Figure 6: Real disposable income growth - total, % change (3qma)



Exchange rate

The euro-sterling exchange rate has remained close to or above 90p for much of Q3 and into Q4 as continued uncertainty emanating from the UK impacts on the pound. With the eurozone economy continuing to strengthen, further developments in the currency's relationship with the euro over the coming year will have as much to do with politics as economics. Interest rates, set by the Bank of England, will also play a significant role. Most analysts had priced in an 80% probability that interest rates in the UK would increase in November and the Bank of England followed through, albeit cautiously. The 25-basis point increase in rates announced saw sterling weaken slightly as the Bank struck a downbeat tone. It was notable the Bank's forecasts implied a potential output estimate for the UK of only 1.5% which is extremely low (Ireland's by contrast is somewhere between 3% and 4%). This was driven by concerns that Brexit would lower long-term investment and labour supply in the UK thus making inflation more likely at lower levels of growth.

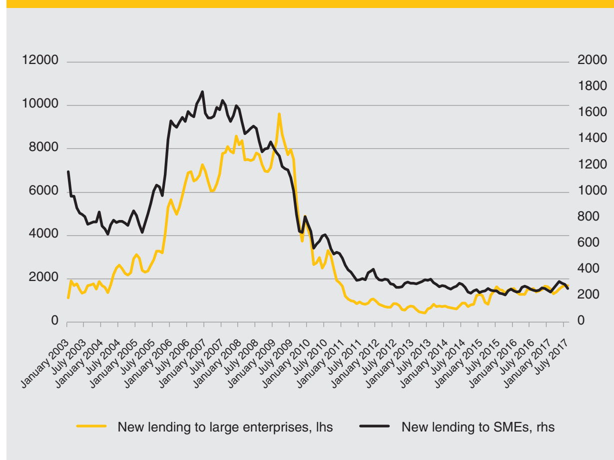
Figure 7: Euro exchange rates



Credit

Net lending to business remained subdued in the first half of the year. The overall trend reflects some pick-up in appetite for credit with new lending to business growing by 8.4% year-on-year in H1. This, however, remains someway short of the continued deleveraging by many firms. As a result, net lending to non-property related business rose by only 1.3% in H1 and fell by 3.3% when the construction and development sectors are included. The overall level of lending over the past 12 months remains about €86 billion lower than the excessive lending of the same period 10 years ago. In positive news, the average interest rate on new lending has fallen by almost one percentage point between Q2 2015 and Q2 2017. Initiatives to reduce the cost of credit for small businesses in recent years have had some impact with the average interest rate on new business loans under €1 million reaching 4.45% in the year to August, down from 5.8% in the same period in 2014.

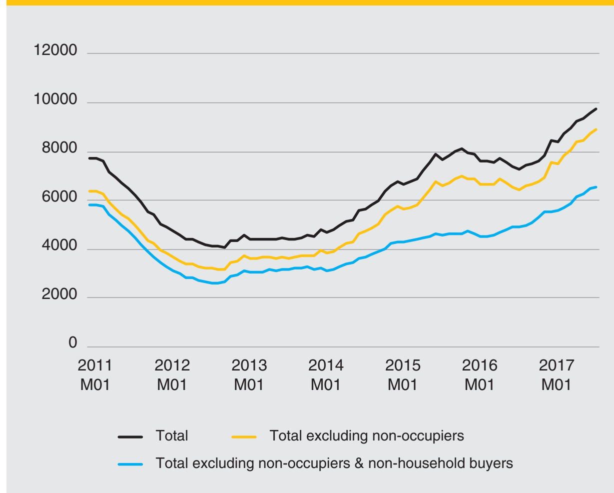
Figure 8: New lending to enterprise (€mn, 3 mma)



Housing

Recent evidence, including the Census data, shows that the official practice of using ESB connections as a proxy measure for house completions has grossly overestimated the level of housing supply nationally since the crisis. This was driven by the large-scale reconnection of previously built homes and ghost estates along with a pick-up in work on existing residential buildings. As such other indicators are needed to understand supply in the market. One of the most important is stamp duty transactions on new units. This measure has the attraction of being legally binding, consistent, detailed and reflecting supply brought to the market although it is not perfect as it excludes self builds. The figure of 7,800 units for 2016 is reasonably consistent with the Goodbody tracker based on building energy rating registrations (5,377) but well below the ESB connections figure (14,932) used by Government. The most recent release of the new stamp duty data suggests in the region of 9,800 units were sold in the last 12 months. This represents a significant pick-up but from a very low base. It is notable, however, that one-third of the units sold over the past twelve months were purchased by buy-to-let or non-household investors. As such the gap between supply and household demand (estimated by various bodies to be in the region of 40,000 units annually) will take some time to close yet.

Figure 9: Total stamp duty events on new houses (cumulative total over previous 12 month period)



Labour market

Employment forecast

Jobs figures for Q2 continue to provide evidence of broad positive momentum in the economy, despite Brexit uncertainty. Employment grew by 2.9% in the first half of the year, closely in line with Ibec forecasts. The strongest growing sectors were ICT and construction which experienced growth of 9.3% and 7.7% annually in the second quarter. The labour market is now approaching full employment with unemployment at its lowest rate since 2008. However, despite these gains, our labour-force participation rate is still at 2012 levels. In a European context, this rate is very low. It is currently the fourth lowest in the EU and more than 10 percentage points lower than the top performing countries. For 2018 we expect employment growth to slow somewhat due to Brexit related uncertainty but remain above 2%.

Employment by region

All regions, except the Border, experienced positive employment growth in the first half of this year. Of the 48,000 net new jobs created since Q2 2016 over 80% were created outside Dublin with the labour market recovery now firmly benefitting households in all regions. The region with the strongest growth was the South-West (6.8%) followed closely by the Midlands (5%). Given the survey is household based it is still likely that many of the jobs in the Midlands region are based in Dublin. Employment in the Border region grew by 1.6% in 2016, however, it fell marginally in the first half of this year. This may be the first sign that Brexit is having a negative impact on the labour market. This is particularly worrying given that the Border region remains the furthest below its pre-crisis employment levels of all regions.

Figure 10: Unemployment rate and employment growth

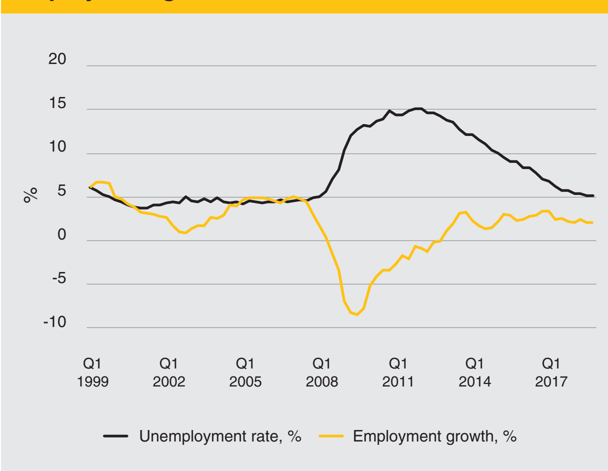


Figure 11: Employment change over 1 year and 10 years

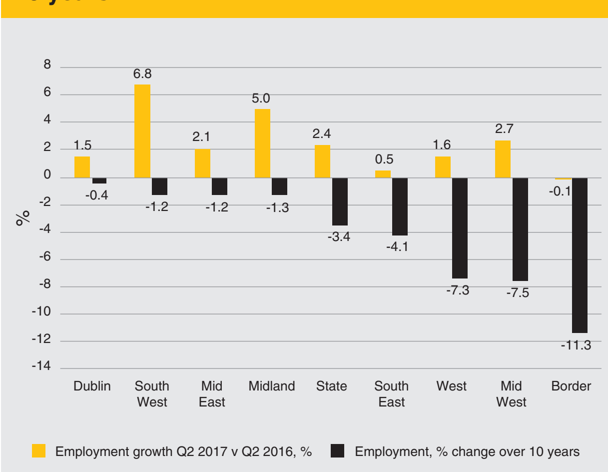


Table 1: Labour market summary

Employment 000s annual average	2016	2017	2018
Agriculture	113	110	109
Industry	394	412	429
Services	1,507	1,545	1,573
Total	2,013	2,067	2,111
Employment growth (%)	2.9	2.6	2.2
Unemployed	173	135	118
Unemployment rate (%)	7.9	6.1	5.3
Labour force	2,193	2,209	2,236

Source: Ibec forecasts

Prices and incomes

Inflation outlook

In the first 9 months of this year inflation ran at only 0.2%. This weak price growth is in line with recent years and overall this means that the cost of living is still the same as 2008. Conversely, in the rest of the EU, inflation picked up to 1.7%, the fastest growth since 2012. Furniture, clothing and food were the primary driver of low inflation in Ireland compared to other European countries. This can be explained by greater competition in the retail sector which is causing deflationary pressures for these goods. This price competition is remarkably durable despite a pickup in consumer incomes and rising costs. For services, price growth in Ireland is higher than the European average (growth of 2.6% compared to 1.6%).

Wage growth

Ibec's most recent HR update pay survey found that 75% of firms were planning on increasing basic pay in 2018. This was based on a sample of over 400 senior HR contacts. The median increase was 2%, down from 2.2% last year. High-tech manufacturing firms were the most likely to award a pay increase (84%) while personal services were the least likely (69%). Larger firms with more than 100 employees were just as likely to increase pay in 2018 as they were in 2017. For small firms however, only 60% of firms with less than 50 employees were planning on increasing pay in 2018 compared to 66% in 2017. This slowdown may be due to greater risk and uncertainty faced by smaller firms as they are generally more reliant on the UK for exports and are also witnessing increased costs in insurance, commercial rates, rents and other areas of their business.

Tax changes

As outlined in the previous section, wages are growing in line with previous years. For net take home pay to grow by this amount, tax bands and credits would need to increase by the same amount. Otherwise, more taxpayers may be pushed into higher tax brackets and would start paying a larger proportion of their income at the higher rate of tax. In Budget 2018 there were some small changes to the rates of USC and the entry point to the marginal rate of tax. Combined, these will reduce effective tax rates (depending on salaries) by between 0.1% and 0.6%. However, when wage growth for 2018 is considered, effective tax rates for most workers are expected to increase by between 0.1% and 0.5% as more people are dragged into the higher rates of tax.

Figure 12: YTD Inflation (Ireland vs EU)

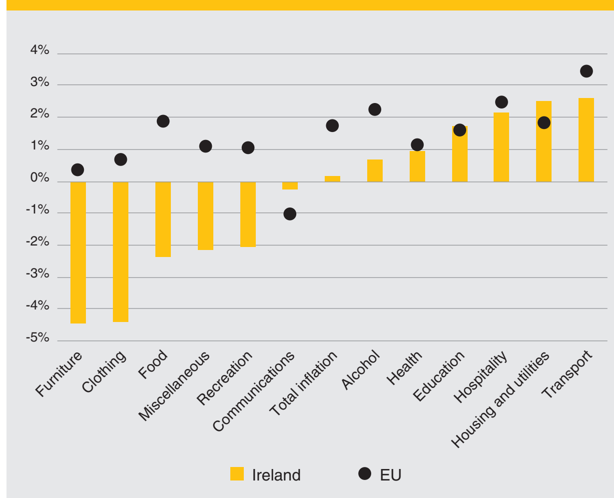


Figure 13: % of firms increasing basic pay

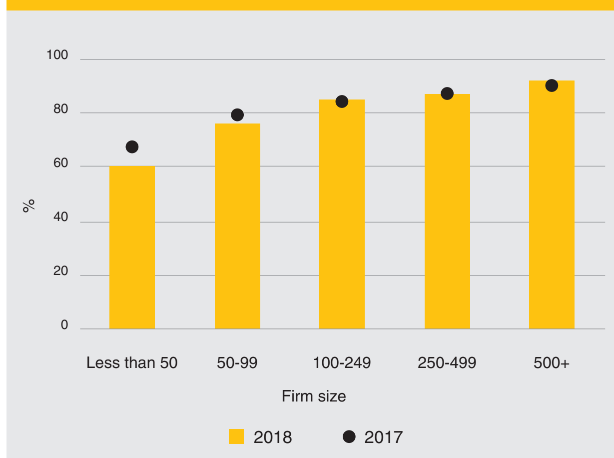
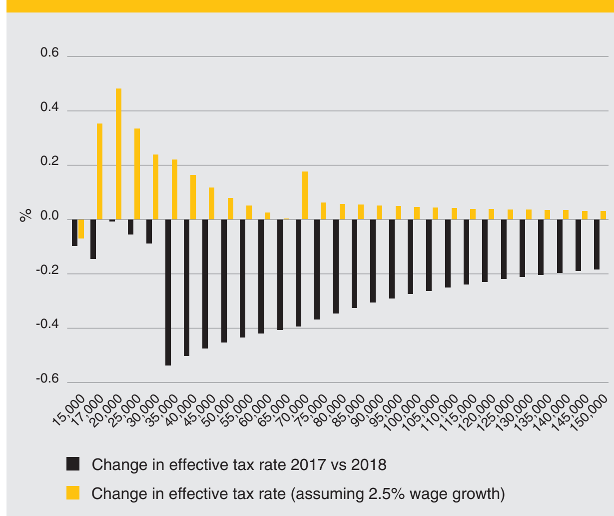


Figure 14: Effective tax rates 2017 vs 2018



International economies

The UK

In the first 9 months of this year inflation in the UK was 2.6%. This is a significant increase on previous years. In the past, items that were sourced domestically (such as services) experienced relatively high inflation, but this was offset by the price of imported goods which were falling. Since the beginning of this year, post Brexit currency movements have made a bigger impact on inflation. Items that are more likely to be imported are now contributing to a 1 percentage point increase in inflation, with energy costs contributing to a further 0.4 percentage point increase. In September, inflation reached 3%, which is well above the 2% inflation target set by the Bank of England.

US

In 2013 the S&P 500 reached its highest point in history. Since then it grew by 63% and in the first 10 months of this year it is up 14%. Price Earning Ratios (measure how expensive stocks are) were only higher on two previous occasions. The first was in 1929 and the other was just before the dotcom bubble. The primary cause of high valuations is low long-term interest rates which are partly driven by quantitative easing and low short-term interest rates. The Federal Reserve is now beginning to reverse QE and increase interest rates. Given that inflation remains relatively weak in the US, it is likely that these changes will be gradual which would reduce the probability of a significant correction in the market.

Figure 15: Contributions to UK inflation

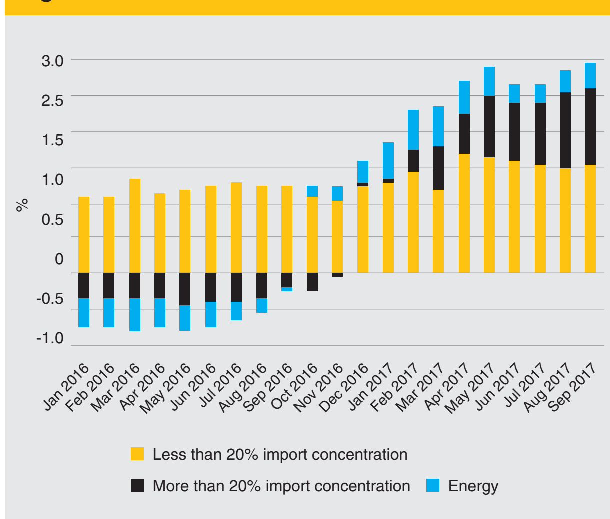


Figure 16: S&P 500

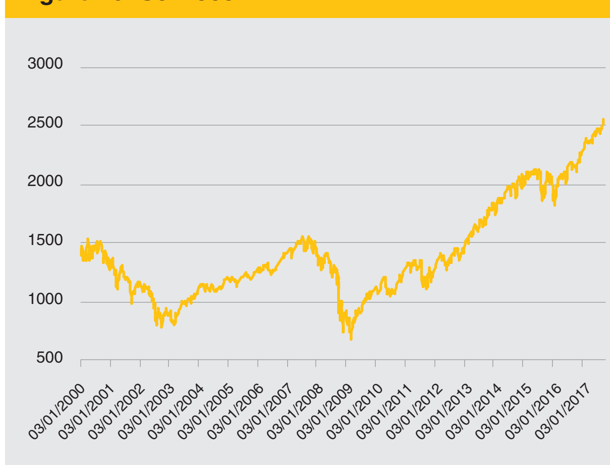


Table 2: International economies summary

	Real GDP, y-on-y % ch			Inflation, y-on-y % ch		
	2016	2017	2018	2016	2017	2018
Eurozone	1.8	2.1	1.9	0.2	1.5	1.4
UK	1.8	1.7	1.5	0.7	2.6	2.6
USA	1.5	2.2	2.3	1.3	2.1	2.1
Emerging markets	4.3	4.6	4.9	4.3	4.2	4.4
World	3.1	3.5	3.6	2.8	3.5	3.3

Source: IMF economic outlook

Brexit tracker

Overview

EU-UK negotiations are stuck at a preliminary stage and agreement on even relatively simple issues remains elusive. We may be inching towards an acceptance of a transition phase, which would provide some breathing space for several years, but the end destination is far from clear. While still not the most likely outcome, the lack of progress has inevitably increased speculation of a "no deal" outcome.

Negotiations phase 1: The bill, citizens and Ireland

Before talks on the future EU-UK relationship can begin, both sides have accepted that exit terms need to be agreed. That's where negotiations are currently stuck.

Area	Issue	Update
The bill	The UK is expected to, and has agreed in principle to settle outstanding and future financial commitments it has made to the EU upon departure.	**Limited progress:** The UK has publicly accepted the need to settle the bill, but there is no agreement on a figure, or even a process to arrive at a figure. The UK is trying to link a budget deal to an agreement to progress other parts of negotiations. The EU wants more clarity first. The issue has a real potential to derail negotiations.
Citizen rights	The legal rights of EU citizens in the UK and UK citizens in the EU post-Brexit needs to be agreed.	**Solvable:** One of the easiest problems to solve, but despite significant agreement there is no deal yet. The UK is moving towards the EU position, but the right to reunite families post-Brexit remains a contention along with judicial oversight.
The Irish border	All accept that managing the trade relationship between Ireland and Northern Ireland warrants unique solutions to avoid the need for a physical border. But what are they?	**No simple solution:** There are no easy answers. The use of technology and checks along the supply chain to avoid the need for a physical border has been suggested. But even this is far from straightforward. Proposals to keep Northern Ireland in the EU customs union have not gained traction. It is likely that a final decision will ultimately be deferred until more clarity is brought to the terms of the EU-UK future trade relationship.
The Common Travel Area (CTA)	Brexit and the end to EU freedom of movement in the UK calls into question the future functioning of the British-Irish Common Travel Area, and the broad range of rights Irish citizens currently enjoy in the UK, including the right to work and live, and vice versa.	**All agree:** Both the UK and EU agree on the need to preserve the rights conferred by the British-Irish CTA. Legal obstacles remain, but these should be relatively easy to overcome given the political consensus.

Brexit tracker

Negotiations phase 2: The future relationship

After phase 1 the real job begins, what will the future EU-UK relationship look like? The UK has been vague on details, but essentially wants a deal that will provide as many of the collaborative benefits of EU membership as possible, with far less of the financial, legal and political obligations that come with being in the EU. How that circle can ultimately be squared remains a guessing game.

Area	Issue	Update
Transition period	Business will need a transition period to prepare and adjust to a new EU-UK relationship.	🟠 **A question of timing:** Both the EU and UK acknowledge the need for a transitionary period. The UK has come to the acceptance that this period must essentially mirror existing EU membership arrangements, with all the associated obligations. But the EU is holding out for agreement on other elements of negotiations before engaging on transitional arrangements. The leverage this presents in negotiations means a quick deal may be illusive.
Tariffs and customs	A poor post-Brexit EU-UK trade deal, or no deal, could result in very significant tariff barriers on certain products moving between the EU and UK. New customs checks will be needed to monitor the movement of goods.	🔴 **Unknown:** Negotiations have not yet begun. Tariff free trade is in the interests of both parties, but politics and disagreements in other areas of negotiations could yet get in the way of such an outcome. While substantial talks have not begun on how to manage an EU-UK customs border, talks on how to best manage the Irish / Northern Irish land border have made no practical progress.
Regulatory divergence	Regulatory divergence could become a significant barrier to EU-UK trade post-Brexit.	🔴 **Unknown:** Negotiations have not yet begun. The UK however plans to put EU regulations into UK law as a starting point; so any change is likely to be incremental. The UK also increasingly recognises the advantages of staying close to EU regulatory standards to facilitate market access. A highly political and complex issue with endless scope for disagreement.
Energy	UK withdrawal from EU's Internal Energy Market (IEM) would leave Ireland physically disconnected from the wider IEM and undermine the functioning of Ireland's Single Electricity Market (SEM).	🟠 **Grounds for optimism:** Negotiations have not yet begun. However, the UK has expressed the importance of continued facilitation of the SEM and need to prioritise discussions on North-South cooperation including energy. The EU has acknowledged the need to protect North-South cooperation as a central part of the Good Friday Agreement.

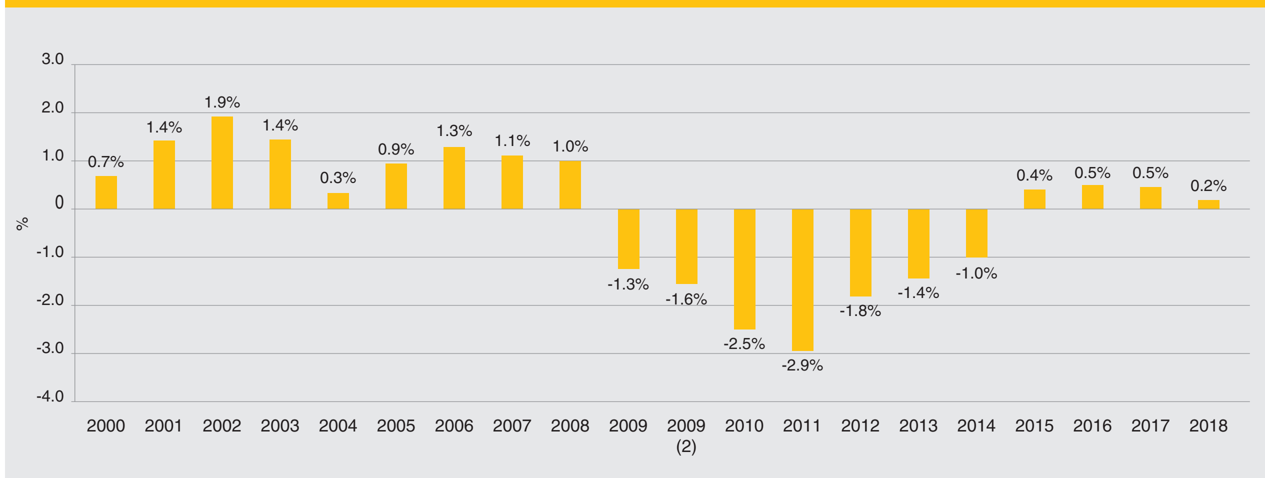
🔴 **No progress** 🟠 **Limited progress** 🟢 **Good progress**

Business and Budget 2018

Overview

Overall the reaction to the Budget from a business point of view is relatively positive and Ibec believes that it will help support further job creation and business investment. While the scale of resources for new measures was limited this year, important policy shifts on personal tax and infrastructure will underpin business confidence. Total unallocated fiscal space (after public sector pay, demographics and carryover costs) totaled to €320 mn. Added to this was €820 mn in new tax measures (almost half of which related to stamp duty on commercial property) to bring the total available resources to €1.15 bn. The split of these resources resulted in €684 mn in current spending increases, €214 mn in additional capital spending and €335 mn in income tax reductions.

Figure 17: Budget day measures, % of GDP



Taxation

There were several welcome tax initiatives. While the scale of resources for new measures was limited this year, the income tax package is a welcome change of direction. Specifically, Government has changed its position on tax since the general election by dropping plans to abolish the USC (taking more workers out of the tax net completely) and focusing resources on making sure fewer workers pay the higher rate of tax. This will ensure that those on an average income will not be taxed at the marginal rate in future and sends out a positive message that work will be rewarded. From a business tax perspective there were some welcome initiatives. The most promising of these was the 'KEEP' share options incentive which will be introduced from January 2018. This will facilitate the use of share-based remuneration for SMEs by reducing the effective income tax rate by up to 25%.

Brexit proofing

One of the more disappointing elements of the Budget was a lack of clear Brexit proofing initiatives. Further resources will be needed over the coming years to support innovation and investment in companies most affected by Brexit. The Government did, however, announce that €300mn in loans will be made available at a competitive rate to SMEs in Brexit impacted sectors to assist with short-term working capital needs. The retention of the 9% VAT rate on tourism was also welcome at a time when a weakened sterling has caused a significant fall off in UK tourists to regional destinations.

Investment and next steps

Ibec has continually highlighted that a low level of infrastructure investment continues to be one of the key challenges facing the Irish economy. Gross capital expenditure will now increase strongly to €8.8 bn by 2021 (2.6% of GDP), this represents a doubling on 2015 levels. The increased resources are an important step in the right direction. The progress made in the Budget will embed confidence that following the publication of the new 10-year capital spending plan later this year, Ireland will be on the way to making real progress in delivering an ambitious investment program which will improve the quality of life for all.

Dates for your diary:

Ibec Regional Business Summit and AGM Series 2017

The Ibec Regional Business Summit and AGM Series 2017 will take place in November in seven different locations around the country. These will be insightful events which will provide a picture of the future landscape for Irish business and an overview of the key challenges facing business. These events also present a great networking opportunity for Ibec member companies.

South East	7 November	Tower Hotel, Waterford
Cork	8 November	Kingsley Hotel, Cork
Mid West & Kerry	14 November	Castletroy Park Hotel, Limerick
West	15 November	Ardilaun Hotel, Galway
North West	16 November	Harvey's Point Hotel, Donegal
Midlands	22 November	Hodson Bay Hotel, Athlone
Greater Dublin	29 November	Ibec, 84-86 Lower Baggot Street, Dublin 2

All events will commence at 10.30am, conclude at 1.00pm and will be followed by lunch. There is no charge to attend.

To reserve a place, please book online at
www.ibec.ie/0/businesssummitagms

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