Economy Watch

Snapshot of Irish Economic Forecasts

DKM ECONOMIC CONSULTANTS

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Incoherent Policies Are a Result of Leading From Behind

Doctors call it "referred pain". It occurs when pain is felt in an area away from the underlying source. The well supported and peaceful protests over the water charges are an example of referred pain. Listen to the voices of the majority of protestors and a litany of complaints about the tax system pours forth. The public want to see the improvement in economic conditions reflected in lower taxes. The later more violent protests reflected a minority of anarchists and extreme leftists (vying for control of the left opposition with Sinn Féin) emboldened by the weak-kneed Government response to the original protests. By becoming a "listening" Government ministers are acknowledging that they have given up any attempt at leading from the front. We can expect to see more public protests as the mob tries to alter policies it does not like. Yet it need not have come to this. In Budget 2015 over €700 million in annual tax "relief" along with over €70 million in child benefit increases were announced. This was probably *three times* the combined level of water charges being proposed at that stage, yet this message was completely lost in the subsequent public debate.

At one level it is not difficult to understand why. The tax concessions granted in the 2015 Budget were an administrative and political dog's dinner. No simple message such as a lower USC rate across the board or lower income tax rates. Instead the entire tax, PRSI and USC system (itself a monstrosity that runs counter to every recommendation by tax reformers) is being debased in order to produce the tables at the back of the Budget speech which shows that every income group benefits by the same percentage. It does not require an economic expert to note that it is difficult to give tax relief to those who do not pay tax. The OECD have noted the distorted nature of the Irish direct tax system with a substantial proportion of the workforce paying little or no income taxes and another substantial proportion paying very high rates of direct taxes on incomes which are modest by European standards. There was no rush to assure the OECD or the Irish population that things would change in the future. Far from it. The Minister indicated that he would continue to play around with the income tax rate and the USC rate to effectively maintain the 52% marginal tax rate for high incomes - defined in Ireland as €70,000 per annum.

In 1977 Fíanna Fáil were elected with a massive majority by promising to abolish road tax and domestic rates. These taxes had one important feature in common. They were lump sum annual payments which everyone who paid them knew exactly how much they would save. A promise to abolish water charges (and possibly property taxes) in the 2016 elections could have the same dramatic effect. And no amount of hypothetical Budget tables showing that everyone has had a gain of 1 per cent or so in after tax income is likely to trump the easy calculation of gains from abolishing annual charges.

The impact of the water protests and the consequent Government capitulation on this issue is difficult to determine. By abandoning the principle of a rational economic policy towards water supply and usage in favour of an incoherent poll tax the Government has given the green light to every crazy protest that can command enough supporters. Whether it can hold the line on managing the public deficit remains to be seen. Certainly the auguries for a post 2016 Government are not good. We may yet see these concerns reflected in interest rates on Irish Government bonds unless the ECB rides to the rescue.

In this issue:

- **GDP to increase by 4.6% in 2014 and by 3.4% in 2015.**
- **Strong increases in investment and private consumption combined with expanding exports should contribute to growth in 2014 and into 2015.**
- **The *DKM Snapshot* projects a General Government Deficit of 3.7% of GDP in 2014 and 2.6% in 2015, both inside target levels.**
- **The unemployment rate is expected to average at 11.3% in 2014 and 10% in 2015.**

Forecasts At a Glance

	2013	2014f	2015f
	%	%	%
GNP	3.3	4.4	3.2
GDP	0.2	4.6	3.4
Domestic Demand (ex. Stocks)	-0.7	3.5	3.3
Private Consumption	-0.8	1.4	1.8
Public Expenditure	1.4	1.5	0.2
Investment	-2.4	11.8	10.3
Exports	1.1	7.7	4.7
Imports	0.6	7.0	4.7
Unemployment Rate	13.1	11.3	10.0
Employment Growth	2.2	2.1	2.1
Wage Growth	2.0	0.9	1.6
CPI Inflation	0.5	0.4	1.1
General Gov. Balance	-7.0	-3.7	-2.6

Snapshot of Irish Economic Forecasts

Annual real % change

	GNP		GDP		Private Consumption		Public Expenditure		Investment		Exports		Imports		Forecast Date
	2014	2015	2014	2015	2014	2015	2014	2015	2014	2015	2014	2015	2014	2015	
AIB	4.0	3.5	4.5	4.0	1.0	1.5	3.5	1.5	9.0	6.5	9.0	5.5	8.3	4.5	Oct-14
BOI	4.2	3.8	5.0	4.2	1.4	2.0	2.0	1.5	12.0	12.0	7.5	5.5	6.3	5.1	Oct-14
Central Bank	4.9	3.1	4.5	3.4	1.4	1.6	-1.7	-1.1	11.9	9.2	7.3	5.1	6.3	4.8	Oct-14
Davy			3.5	3.0	1.5	1.9	-0.7	-1.3	14.5	8.6	3.5	4.0	2.9	3.5	Aug-14
Dept Finance	4.1	3.6	4.7	3.9	1.7	2.7	4.8	2.3	14.6	12.7	8.3	4.8	8.8	5.3	Oct-14
ESRI	4.9	5.2	5.0	5.3	1.5	2.0	0.0	0.0	14.2	12.8	5.6	6.0	4.5	5.0	Oct-14
EU			4.6	3.6	1.4	2.0	1.5	-0.5	9.3	12.3	8.0	5.3	7.3	5.6	Nov-14
IBEC	5.4	4.0	6.1	4.5	1.5	2.9	3.6	2.2	14.2	13.8	12.2	7.6	11.1	8.2	Oct-14
IMF			3.6	3.0							6.3	3.4	6.0	2.9	Oct-14
KBCI	4.0	2.8	5.0	3.0	1.5	2.0	1.0	-1.3	10.0	16.7	9.0	5.2	8.0	6.7	Oct-14
Investec	2.9	2.8	2.5	2.8	1.4	1.7	-1.6	-1.1	10.5	9.3	4.0	3.0	3.5	3.0	Aug-14
OECD			1.9	2.2	0.9	1.0	-1.8	-1.5	14.1	8.0	2.8	3.1	4.0	2.9	May-14
Ulster Bank	3.4	3.3	3.1	3.2	1.1	2.0	-0.3	-1.1	8.5	8.1	4.9	4.7	4.5	4.5	Aug-14
Average	**4.4**	**3.2**	**4.6**	**3.4**	**1.4**	**1.8**	**1.5**	**0.2**	**11.8**	**10.3**	**7.7**	**4.7**	**7.0**	**4.7**	

Government implements neutral Budget 2015...

GDP and GNP both revised upwards, but concerns over domestic water charges dominate

Budget 2015 marked a turning point in the Irish economic recovery, yet mounting opposition to proposed domestic water charges has dominated headlines and cast a shadow over the government parties. On foot of stronger than expected GDP figures and expanded tax returns the coalition opted to implement a broadly neutral budget in October, thus bringing to an end the latest era of economic austerity. Government GDP growth forecasts for 2014 were revised upwards to 4.7%, with GNP rising to 4.1% for the year. This growth spurt will last into 2015 according to consensus forecasts, with GDP and GNP expected to expand by 3.4% and 3.2% respectively.

... As exports and investment drive growth

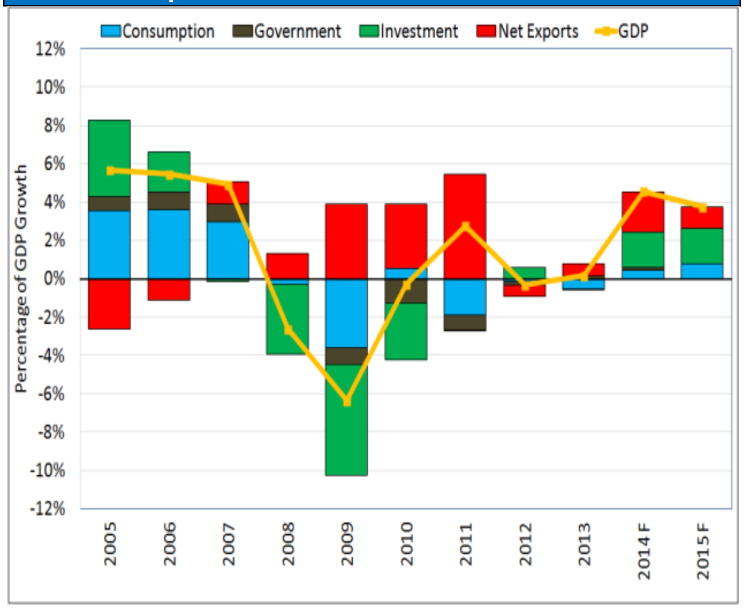
Exports benefit from a weakened Euro, while planned government expenditure will bolster investment

As shown in the chart to the right, consensus forecasts highlight that investment increases of 11.8% in 2014 and 10.3% in 2015 will be of specific importance to growth. Public expenditure – assisted by the government's loosening budget measures – will also be a driver in specific areas with the Department of Finance stating that such spending will increase by 4.8% in 2014 and 2.3% in 2015. Current expenditure on the provision of social housing services, Irish Water related costs and health services will both increase over the coming years, and this will support private consumption which – stimulated by recent tax cuts – is expected to increase by 1.4% - 1.8% between this year and 2015. External trade will provide added impetus to growth through the remainder of 2014 and into 2015 as the export sector continues to thrive.

Exports

Exports remain a fundamental driver of growth, spurred by a weakening of the Euro over the past seven months. The Euro currently stands considerably below its 12 month average versus both the Pound and the Dollar, meaning exports are more affordable in the key Irish trading markets of the UK and the US. This will be particularly important in trade with the UK given the slow growth rate reported in that market in Q3 2014. The strength of the Irish export sector was reflected in the Q2 2014 trade results which reported exports at +13% versus Q2 2013, and +13.7% versus Q1 2014. Goods and services were equal contributors to this growth which generated a €3.3bn seasonally adjusted trade surplus in August 2014 alone. Consensus forecasts of 7.7% export growth in 2014 followed by 4.7% growth in 2015 indicate that exports will continue to perform strongly in the medium term.

Expected Contribution to GDP Growth



Consumer sentiment reaches modest heights...

Confidence strengthens on the back of positive macroeconomic factors

Consumer Sentiment

The KBC/ESRI Consumer Sentiment Index hit its highest level since January 2007 when it increased to 92.8 in September 2014 from 87.1 the previous month, but subsequently declined to 85.5 in October 2014. The 3-month moving average remains strong at 88.5. Increases in the quarter were driven by the recent positive macroeconomic developments, as well as sustained increases in employment and the improving fiscal deficit. October's decline could be reversed when the positive budget measures are reflected in the November Index, but ongoing issues related to domestic water charges may also be influential.

DOMESTIC PERFORMANCE

Snapshot of Irish Economic Forecasts

Annual real % change * year average;
**Underlying GGB as % of GDP (excluding State support to the banks)

	Unemployment Rate*		Employment Growth		Wage Inflation		CPI Inflation		HICP Inflation		General Govt. Balance**		Forecast Date
	2014	2015	2014	2015	2014	2015	2014	2015	2014	2015	2014	2015	
AIB	11.5	10.5							0.5	1.0	-3.5	-2.5	Oct-14
BOI	11.3	10.0	2.0	2.3			0.5	1.3	0.5	1.3			Oct-14
Central Bank	11.1	10.3	1.6	1.7	1.8	1.8	0.4	1.1	0.6	1.2			Oct-14
Davy	11.0	9.6	2.8	2.3			0.7	1.7			-3.9	-2.9	Aug-14
Dept Finance	11.4	10.2	1.8	2.4	1.8	2.4			0.5	1.1	-3.7	-2.7	Oct-14
ESRI	11.3	9.6	1.8	2.7	1.3	1.3	0.3	1.0	0.4	1.2	-3.8	-2.1	Oct-14
EU	11.1	9.6	2.0	2.2	-1.3	0.8			0.4	0.9	-3.7	-2.9	Nov-14
IBEC	10.9	9.6	2.7	2.1			0.3	0.8			-3.6	-2.5	Oct-14
IMF	11.2	10.5	2.2	1.8					0.6	0.9	-4.2	-2.8	Oct-14
KBCI	11.5	10.0	2.0	2.0					0.5	1.0	-3.5	-2.7	Oct-14
Investec	11.4	10.0	2.4	2.2			0.4	1.0	0.5	1.0	-4.0	-2.5	Aug-14
OECD	11.4	10.4	2.2	1.7					0.3	0.7	-3.9	-3.2	May-14
Ulster Bank	11.5	10.4	1.9	1.9			0.4	1.0	0.5	1.1	-3.9	-2.5	Aug-14
Average	**11.3**	**10.0**	**2.1**	**2.1**	**0.9**	**1.6**	**0.4**	**1.1**	**0.5**	**1.1**	**-3.7**	**-2.6**	

... As retail sales reflect the improved outlook

Car sales provide the main impetus, supported by household and electrical goods sales

Retail Sales

Improvements in consumer sentiment are important to overall retail sales which have recovered markedly over the past year. Although still 15% below the 2008 peak, the August 2014 Retail Sales Volume Index was 6.9% higher than the August 2013 equivalent and marked the 10th consecutive month in which a YoY increase was recorded. The value of retail sales in August 2014 was also higher YoY (+5.3%). The main driving force of these increases was a substantial expansion of car sales with new vehicle registrations in the year to September up 30% on the same period last year according to SIMI. Excluding motor trades, the volume index was still 3.6% higher in August 2014 than it was a year earlier.

Strong YoY increases were also recorded for Furniture and Lighting (+21.2%), Electrical Goods (+10.6%), Household Equipment (+9.1%) and Retail Sales in Department Stores (+4.4%). The only YoY decreases recorded in August 2014 were in sales of Pharmaceutical, Medical and Cosmetic Articles (-1.1%) and Books, Newspapers, Stationery and Other Goods (-0.7%).

SME Sector

The DKM/BPFI November 2014 SME Market Monitor reported the best set of indicators for almost six years with sustained increases in employment fuelling consumption which in turn contributed to expanded domestic demand in Q2 2014. Construction is rebounding and will be spurred by expansive budgetary measures, but earnings and disposable income have yet to show meaningful signs of recovery and this may hinder the SME sector.

Agriculture continues on a recovery path...

Livestock products show strong growth with the removal of milk quotas to provide opportunities in 2015

The agricultural sector has performed well since a slump in 2009, with the value of total outputs increasing by 52.6% since the trough. Livestock Products were the drivers of growth in 2013 with the value of output from this segment alone expanding by 26% YoY from 2012, mainly due to a substantial uplift in milk production.

Difficulties have been encountered in 2014 from low beef production returns (leading to factory protests in recent times), poor grain prices arising from a high annual yield and a Russian import embargo which could affect c.€70m of Ireland's exports to the country (particularly implicating €40m of dairy exports). The removal of European milk quotas in 2015 will provide a stimulus for the sector overall and milk production is expected to rise considerably. Expansions into new milk export markets such as China have gathered pace, but increased production costs are a concern. Despite the level of credit advanced to agricultural SMEs declining consistently over the past four years, the sector continues to perform strongly with exports of food and live animals amounting to €6.1bn in the year to date (+7.8% YoY).

... As construction and property re- emerge

Construction to benefit from budgetary stimuli while house prices nationwide show first growth since 2007

Construction

Several measures to promote construction were introduced in Budget 2015 as the sector slowly recovers from the property crash. Year-to-date housing completions to August 2014 have shown some revival, increasing by 31.9% or 1,597 units versus the same period last year, but output remains far below both the 2005 peak and current Irish housing requirements. The abolition of an 80% windfall tax on land disposals, plans to provide 7,500 new social housing units in 2015 and the extension of the Home Renovation Incentive Scheme will provide stimuli for the sector. However, the Housing Agency has estimated that an annual average of 16,000 new units will be required in Irish urban areas up to 2018, so the private construction sector will be expected to provide a greater proportion over time.

MyHome.ie Property Barometer

House prices across the country have continued to rise according to the MyHome.ie Property Barometer with Q3 2014 showing the first positive YoY national price growth since 2007. Housing shortages continue to drive price increases, particularly in Dublin where prices rose by 9.6% in the year to Q3 2014. The value of new mortgage lending also accelerated by 44.3% between Q1 and Q2 2014 according to an IBF/PWC Mortgage Market Profile and this will have provided further upward price pressure, yet proposed new mortgage lending rules from the Central Bank may curb more substantial expansions in lending in the New Year.

FOCUS ON THE EXTERNAL ENVIRONMENT

Global growth slowed to 2.7% in the first half of 2014 but is expected to recover to 3.5% for the remainder of the year before strengthening to 3.8% in 2015. Growth has proven to be uneven across geographical spheres with a weak first quarter in the US and a lethargic recovery in the Eurozone contributing to lower GDP growth rates. Expansive economic measures in China boosted growth following a sluggish first quarter, but tensions in the Russia-Ukraine region continue to stifle economic expansion in that area. Worldwide growth will be primarily driven by emerging and developing markets in the medium term as developed economies continue on a slow recovery path.

Euro Area

Low inflation and a multispeed recovery contribute to overall stagnation in Q2 2014

The IMF forecasts that GDP will rise by a mere 0.8% in 2014 (reduced from 1.2% in its April 2014 forecast) as low inflation and the prospect of a protracted recovery period dampen expectations. Housing market risks are emerging in some advanced European economies while a multispeed recovery has taken hold with the traditional powerhouse economies of Germany and France recording only minimal growth rates. Financial markets have remained resilient but stagnation in Q2 2014 was caused by reduced investment in several large economies and poor demand levels, while tensions and related trade restrictions in the Russia- Ukraine region remain problematic. Deficient demand has been partly driven by unemployment which stands at in excess of 11% in the Eurozone as a whole. The large economies of Spain and Greece are particularly problematic with joblessness rates of 24.6% and 25.8% projected for 2014 respectively.

Inflation is a persistent concern as price increases in the Euro Area are falling well below the ECB's target rate of 2%. The IMF forecasts that inflation will not surpass the target rate this year or into the medium term. No country within the Euro Area is expected to experience inflation of more than 2% in 2014 despite the ECB's expansionary monetary policy, with the largest economies of Germany (0.9%), France (0.7%), Italy (0.1%) and Spain (0%) all struggling to battle stagnation and recession.

United States

Growth strengthens, driven by increased investment and payroll gains; asset purchases expected to end

The US economy has rebounded following a slowdown in the first quarter of 2014 which was caused by severe weather conditions and an inventory correction. Growth reached a seasonally adjusted annual rate of 3.5% in the third quarter of the year on the back of improved investment levels and sustained payroll gains. A narrower trade deficit (adding 1.32 percentage points to GDP growth) and improvements in government spending – particularly in the area of defence – have been cited as significant contributors in Q3 2014. The stronger labour market is expected to underpin growth for the rest of 2014 and into 2015, with improved household balance sheets, easing financial conditions and a more robust housing market fuelling the expansion. Residual slack in the labour market and minimal wage increases mean price inflation rates remain somewhat depressed though personal consumption has made a positive contribution to growth.

The housing market is showing signs of a continued revival following a weather- inflicted dip in Q1 2014. Quarter on quarter real residential fixed investment rose by 7.2% in Q2 2014 following a decrease in Q1 2014. Housing starts in September 2014 were also up, rising to a seasonally adjusted annual rate of 1,017,000, which is above both the August 2014 (+6.3%) and September 2013 (+17.8%) equivalents.

The Federal Open Market Committee (FOMC) announced at a September meeting that it would be tapering back its purchases of both mortgage-backed securities and longer term Treasury securities. On foot of improvements in labour market conditions and inflation gradually returning back towards its longer- term target rate, it is expected that the FOMC will soon end its programme to stimulate the economy via asset purchases.

Major economies GDP growth forecasts

	2013 (%)	2014f (%)	2015f (%)
UK	1.7	3.2	2.7
US	2.2	2.2	3.1
Euro area	-0.4	0.8	1.3
Germany	0.5	1.4	1.5
Japan	1.5	0.9	0.8
China	7.7	7.4	7.1
India	5.0	5.6	6.4

Forecasts' source: IMF October 2014.

United Kingdom

Services and consumer spending dominate but exports continue to struggle

Services and consumer spending continue to provide the main stimuli for growth in the UK, as the IMF expects GDP to expand by 3.2% in 2014 on foot of these drivers. Investment increased 9.1% in the year to Q2 2014 compared to the same period in 2013, with the majority of this growth coming from business investment (+11% YoY). The Bank of England's monetary policy remains accommodative while unemployment has continued on a steep downward trend over the past year, standing at 5.9% in August 2014. A depressed household saving ratio of just 6.7% in Q2 2014 suggests that consumers are spending a far greater share of their disposable income, and this has clearly contributed to growth.

Exports have struggled in recent months as the Pound Sterling has gained in strength against the Euro and Dollar. In June-August 2014 the value of total exports fell by 1.7% compared to the previous three months and by 7.4% versus June-August 2013. Non- EU exports were most severely affected, reaching a 4- year low in August 2014. The slowdown in the European economy combined with an appreciating Pound will have impacted upon the margins of the UK export sector and its contribution to GDP.

NOTE: The average figures presented in this report represent a weighted average of the latest forecasts for the Irish economy from 13 independent sources, compiled by DKM. Older forecasts are given a lower weighting in calculating this average. Figures quoted represent the latest available from each source at the time of going to press. DKM would like to thank those who kindly contributed their economic forecasts for inclusion in this report.

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