DKM ECONOMIC CONSULTANTS

Economy Watch

Snapshot of Irish Economic Forecasts

Issue 16, October 2015

Election Considerations Likely to Trump Reform Opportunity

As we expected, the macroeconomic forecasts for 2015 and 2016 have been revised upwards. However most forecasts continue to see a sharp decline in growth in 2016. This is in part a reflection of concerns about the world economy and partly due to an ingrained belief in forecasters that the stellar growth of 2015 cannot be repeated. When comparing the forecasts made last spring and those being made today perhaps the most significant variation has been in the Government deficit. The surge in Exchequer revenue has been remarkable: the deficit is now expected to be well under 2% of GDP and could come close to 1%. That said, expected supplementary budgets for health and other areas will offset some of the improved buoyancy.

The improved fiscal situation has increased prospects of a pre-election give away Budget. However, the public at large is probably unaware that the fiscal surveillance that Ireland signed up to as part of the "bailout" greatly restricts the scope for this. The ESRI, Central Bank and the Fiscal Advisory Council all expect that economic output by end 2016 will be at or close to potential output as determined by the EU fiscal model. This means that when Budget 2017 comes around the deficit will have to be eliminated.

It is reasonable to wonder why the potential output of the economy is achieved with unemployment of 8 to 8.5 per cent. Are there factors unique to Ireland that require an unemployment rate over 300 basis points higher than Germany at potential output? Or is the EU model hopelessly mechanistic and not fit for purpose? It would be interesting to know what the unemployment rate throughout Europe would be if all economies were operating to potential output as determined by the EU model. One suspects it would be at rates which would be unacceptable to domestic electorates. It may be that labour market policies such as training and education and improved placement policies would reduce the unemployment rate consistent with potential output. But it may also be the case that the EU model is in need of revision. In the meantime the Government is preparing a Budget broadly within the constraints imposed by the EU. However it is likely that that pin-up of boom era budgeting, Rosy Scenario, will re-emerge, thus allowing a degree or two more freedom. This will be an election budget so expect some eye-catching giveaways. Unfortunately the scope for tax cuts will probably be frittered away in marginal changes rather than be used to implement a more comprehensive tax reform. Reforming PRSI and USC into a comprehensive system for funding future pension costs and current and future health and welfare costs will only be possible in the context of significant tax concessions to offset the losers from such reforms. However it is likely that the electoral focus of the Budget will trump economic reform.

In this issue:

- **Consensus forecasts show GDP is expected to increase by 5.6% in 2015 and by 4.0% in 2016.**
- **Consumer spending is forecasted to increase 3.1% in 2015 and 2.7% in 2016.**
- **With neutral inflation in August the deflationary cycle which has existed for all of 2015 to date.**
- **Tourists visits to Ireland reached an all-time high in Q2'15 of 2.1 million a 2.2% QoQ increase.**
- **General Government Gross Debt is expected to fall to 97.8% of GDP by 2016.**

Forecasts At a Glance

	2014	2015e	2016f
	%	%	%
GNP	5.2	5.6	4.0
GDP	4.8	5.6	4.0
Domestic Demand (ex. Stocks)	5.2	5.4	4.2
Private Consumption	1.1	3.1	2.7
Public Expenditure	0.1	2.0	1.3
Investment	11.3	14.2	9.4
Exports	12.6	10.3	5.5
Imports	13.2	10.8	5.7
Unemployment Rate	11.3	9.4	8.3
Employment Growth	1.5	2.6	2.4
Wage Growth	0.0	1.9	2.1
CPI Inflation	0.2	0.1	1.3
General Gov. Balance	-3.7	-1.8	-1.1
General Gov. Debt	109.7	102.5	97.8

Snapshot of Irish Economic Forecasts

Annual real % change

	GNP		GDP		Private Consumption		Public Expenditure		Investment		Exports		Imports		Forecast Date
	2015	2016	2015	2016	2015	2016	2015	2016	2015	2016	2015	2016	2015	2016	
AIB	5.5	4.5	6.0	5.0	3.0	3.0	2.5	2.0	14.5	7.0	13.0	7.5	13.5	6.7	Sep-15
BOI	5.8	4.6	6.2	4.8	3.2	3.2	2.2	2.0	14.2	8.5	12.0	6.5	13.2	6.7	Oct-15
Central Bank	5.3	4.4	5.8	4.7	3.0	2.5	0.5	0.9	15.8	13.2	11.1	6.7	11.9	7.4	Oct-15
Davy	5.9	3.6	6.5	4.0	3.4	3.2	2.1	1.3	19.2	7.9	12.8	4.5	13.5	4.0	Sep-15
Dept Finance	3.9	3.5	4.0	3.8	2.4	2.5	1.1	1.6	15.3	12.1	7.6	4.8	8.7	5.4	Oct-15
ESRI	5.9	4.0	6.0	4.5	2.8	3.0	1.0	0.7	11.9	9.5	11.1	7.0	10.5	7.3	Sep-15
EU			3.6	3.5	2.1	1.9	1.7	2.9	9.8	9.9	5.6	5.4	6.0	6.1	May-15
Goodbody	6.0	4.2	5.5	4.0	3.6	3.1	3.2	2.3	9.4	11.8	10.5	5.1	10.9	5.7	Aug-15
IBEC	4.9	5.3	5.9	5.0	3.1	3.5	1.8	1.4	11.5	7.6	12.6	7.8	12.4	7.6	Sep-15
IMF			4.8	3.8			0.7	0.7			5.0	4.5	6.0	4.5	Oct-15
KBCI	6.5	4.1	6.0	4.2	3.0	3.5	2.5	1.5	17.0	13.9	8.0	5.5	9.0	7.0	Sep-15
Investec	6.5	5.2	6.1	5.0	3.5	2.8	2.0	1.6	16.5	12.6	10.0	7.5	10.3	8.0	Sep-15
OECD			5.0	4.0	2.9	3.1	4.0	1.6	15.1	7.7	11.9	4.6	13.3	4.4	Sep-15
Ulster Bank	5.6	4.7	5.2	4.5	3.7	2.6	2.3	0.8	10.1	9.5	7.8	6.0	7.8	5.8	Aug-15
Average	**5.6**	**4.0**	**5.6**	**4.0**	**3.1**	**2.7**	**2.0**	**1.3**	**14.2**	**9.4**	**10.3**	**5.5**	**10.8**	**5.7**	

Upward adjustment to 2014 GDP figures…

Finalised GDP growth rates for 2014 stronger than previously expected.

The finalised national accounts for 2014 presented by the CSO on July 30th showed that Ireland returned to strong GDP growth in 2014, and exceeded expectations. The annual growth rates of GDP and GNP were positively adjusted to 5.2% and 6.9% year-on-year (from initial estimates of 4.8% and 5.2%) respectively. Personal consumption was the largest contributor, especially due to increases in automobile purchases. GDP and GNP levels now exceed their previous peaks in 2007, confirming a robust recovery of the Irish economy. The unemployment rate contributes to this story and was down to 9.5% (seasonally adjusted) in August 2015 from its peak of 15.1% in February 2012. The budget deficit also decreased to 4.1% of GDP in 2014 from 5.8% in 2013, while the ratio of government debt to GDP fell from 123.2% in 2013 to 109.7% in 2014.

Additionally the National Accounts reveal that all components of GDP in expenditure terms were positive in 2014 which is a welcome change from previous years. The figures were most positive for Investment (+14.3%), Government Consumption (+4.6%) and Personal Consumption of Goods and Services (+2%), followed by Net Exports (+0.3%).

The revision of the national accounts growth rates resulted in Ireland having the highest YoY GDP growth in Europe by quite a margin. Ireland is thus growing faster than the runner-up Hungary (3.6%) as well as Poland (3.4%), Luxembourg (3.0%) and the UK (2.9%).

… as the recovery takes hold in Ireland.

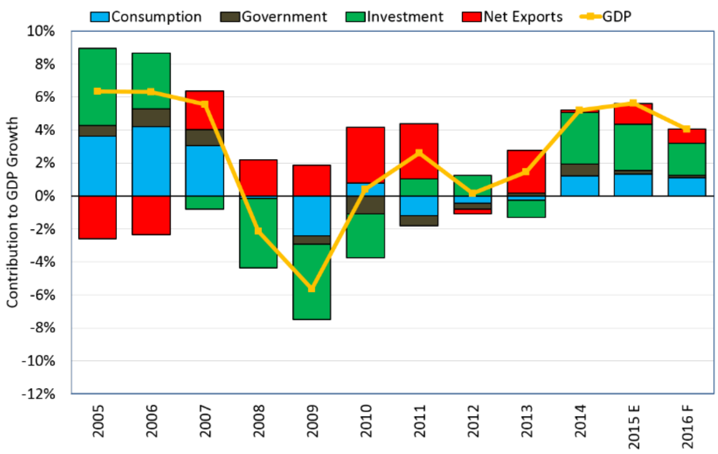
Economic indicators show continuous signs of recovery which consumers in particular are beginning to experience.

The consensus forecasts show that the Irish economy is expected to grow by 5.6% in 2015 and 4.0% in 2016, significantly higher than the forecasts published in the previous Economy Watch (3.9% and 3.2% respectively). Ireland is experiencing a faster than expected recovery primarily due to substantial investment growth (14.2% in 2015 and 9.4% in 2016). Furthermore, GDP growth is being primarily driven by domestic sources (consumption, investment and government expenditure) rather than external demand which Ireland had previously been relying on for growth.

Thus the recovery seems to have spread to the domestic market, as seen in the effect on consumer spending. As price inflation remains almost non-existent, wages are increasing (by 1.9% in 2015 and 2.1% in 2016) and the unemployment rate continues to fall (9.4% in 2015 and 8.3% in 2016), consumers are experiencing favourable market conditions. As a result private consumption is expected to grow 3.1% in 2015 and 2.7% in 2016, indicating that households are starting to feel the recovery. Net exports are expected to contribute positively to GDP in 2015 and 2016 as exports - with YoY growth of 10.3% in 2015 – continue to benefit from the weak Euro, a recovering Europe and growth in the US and UK. Exports are expected to increase at a somewhat lower rate in 2016 (5.5%) as interest rates in Ireland's major trading partners are forecast to rise. Government spending is forecast to grow 2.0% in 2015 and 1.3% in 2016 thereby contributing modestly to GDP growth.

With such favourable conditions and domestically driven growth one may question the need for additional expansionary fiscal policy which has been indicated for the upcoming Budget. A number of commentators have suggested that a counter-cyclical fiscal stance might be preferable at this point in time, though, it being an election year the budget presented on October 13th is likely to include tax cuts and expenditure increases.

Historic & Expected Contribution to GDP Growth



Source: CSO 2005-2014, DKM Economy Watch 2015E-2016F

Snapshot of Irish Economic Forecasts

Annual %real change * year average; **Underlying GGB as % of GDP ***GG Gross Debt as % of GDP

	Unemployment Rate*		Employment Growth		Wage Inflation		CPI Inflation		HICP Inflation		General Govt. Balance**		General Govt. Debt***		Forecast Date
	2015	2016	2015	2016	2015	2016	2015	2016	2015	2016	2015	2016	2015	2016	
AIB	9.5	8.3							0.2	1.0	-1.8	-0.5			Sep-15
BOI	9.6	8.3	2.7	2.4			-0.2	1.4							Oct-15
Central Bank	9.5	8.5	2.4	2.2	2.3	2.4	0.3	1.5	0.3	1.5					Oct-15
Davy	9.4	8.2	3.0	2.5	2.2	2.5					-1.7	-1.1	98.9	93.6	Sep-15
Dept Finance	9.6	8.8	2.2	2.2					0.2	1.1	-2.3	-1.7	105.0	100.3	Oct-15
ESRI	9.5	8.4	2.8	2.4	2.0	2.3	0.1	1.0	0.1	1.2	-1.8	-1.2	102.5	96.0	Sep-15
EU	9.6	9.2	1.6	1.5	3.2	2.8			0.4	1.5	-2.8	-2.9	107.1	103.8	May-15
Goodbody	8.8	7.3	2.5	2.6	1.5	1.7	0.0	1.3			-2.0	-1.4	100.0	96.0	Aug-15
IBEC	9.3	8.0	2.6	2.6	1.3	1.6	0.0	1.0			-1.5	-0.9			Sep-15
IMF	9.6	8.5	2.5	2.0					0.2	1.5	-2.0	-1.3	100.6	95.9	Oct-15
KBCI	9.5	8.2	2.4	2.5					0.1	1.0	-1.3	-0.7			Sep-15
Investec	9.5	8.1	2.8	2.5			0.0	1.0	0.0	1.0	-1.4	-0.8	106.7	102.8	Sep-15
OECD	9.6	8.4	2.2	2.5			0.0	1.6			-2.2	-1.7	103.7	99.9	Sep-15
Ulster Bank	9.4	8.4	2.8	2.7					0.3	1.5	-1.9	-1.2			Aug-15
Average	**9.4**	**8.3**	**2.6**	**2.4**	**1.9**	**2.1**	**0.1**	**1.3**	**0.2**	**1.0**	**-1.8**	**-1.1**	**102.5**	**97.8**	

Consumer sentiment dips in September…

The 3-month moving average of the KBC ESRI Consumer Confidence Index falls after a 9 year high in August.

The KBC/ESRI Consumer Sentiment Index decreased to 100.6 in September from 101.1 in August. The dip in September leaves the 3-month moving average at 100.5 from 101.2 in August, which was the highest value in nine years. By contrast the results come against the backdrop of a quarterly increase in consumer spending of 0.4% (sa) in Q2'15. The index therefore indicates that consumers feel somewhat cautious about personal finances and future prospects, possibly due to the economic turmoil in emerging markets and its potential negative effect on the recovery. Although the index has been on an upward trend since the financial crisis it is experiencing some volatility due to global economic turmoil.

… and the cycle of deflation has been broken.

Consumer Price Index (CPI) was neutral in August ending eight months of price deflation.

The month of August saw a flat CPI thereby breaking the deflationary trend which has existed for all of 2015 to date. This is despite continuing price decreases in Clothing and Footwear (-4.9% YoY) and in Furnishings, Household Equipment and Routine Household Maintenance (-2.6% YoY). Both categories as well as Transport and Food and Non-alcoholic Beverages have experienced a continuous deflationary trend since 2008.

Private debt is an ongoing impediment…

Non-performing loans and household debt remain high despite overall downward trend.

Total private sector debt (households and non-financial corporations) remained high at 290% of GDP in 2014, significantly above the Euro Area average of 165%. That said, total household debt has been on a downward trend since its peak in Q3'08 (€204bn or 69.3% of total assets) and was at €155bn (42.7% of total assets) in Q1'15. The proportion of non-performing loans has followed a similar negative trend from its peak of 25.7% in Q4'13 to just under one fifth of all outstanding loans in Q4'14. Despite these developments, concern surrounds Dublin house prices due to strong demand and limited supply. If the house price increases cause new indebtedness, households will become more vulnerable to possible future economic distress. However the macro-prudential rules imposed by the Central Bank appear to be having an effect on minimising this vulnerability.

… as Investment dominates expenditure growth in Q2'15…

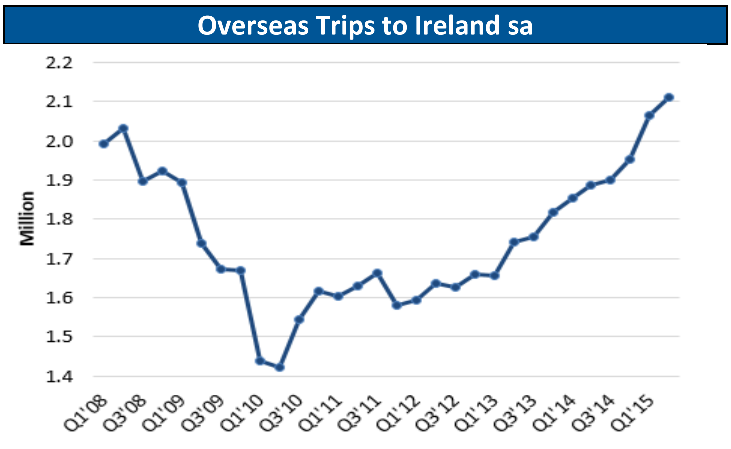
Machinery and Equipment as well as Intangibles accounted for the majority of growth in expenditure.

Capital investment (+19.2%) was the largest contributor to QoQ growth of 1.9% in Q2'15, with further increases in net exports (+0.3%) and personal consumption (+0.4%). This Capital Investment growth comes from increases in Building and Construction of 2.4% and Machinery and Equipment of 11.6%, but most of all in Intangibles which grew by 83.9%. This is due to significant intellectual property (IP) rights transactions in the quarter which substantially inflated the figure.

… and tourist visits to Ireland reach an all-time high.

The number of overseas trips into Ireland increased in Q2'15.

Q2'15 saw the highest number of trips to Ireland since quarterly records began in Q1'08. Some 2.1 million trips were recorded in the quarter, an increase of 2.2% on Q1'15 (seasonally adjusted). Of these, 842,200 were from Great Britain, with a further 736,000 from Other European countries and 374,000 from North America. Trips from North America increased QoQ by 19.5%, likely encouraged by the weak Euro and the marketing efforts of Tourism Ireland. Such an inflow of tourists will have enabled firms in the sector to contribute significantly to the economy and job creation throughout 2015.



Source: CSO

FOCUS ON THE EXTERNAL ENVIRONMENT

Global growth was weaker than expected in the first half of 2015, leading the IMF to lower its annual forecast for the second time, to 3.1% in October from 3.3% in July. Advanced economies are forecast to drive global growth due to favourable financial conditions, low energy prices and more neutral fiscal policies in the Eurozone. Additionally the Euro remains weak against the dollar boosting exports in the Euro Area. However, low energy prices have caused a decline in GDP in Canada in Q1 2015, contributed to the recession in Brazil and have increased pressure on other oil-producing countries. China is still experiencing stock market unrest, whereas Japan exceeded growth expectations in the first quarter. Global growth is expected to pick up in 2016 to 3.8%.

Euro Area

Economic improvement despite persistently high levels of unemployment and debt; QE programme to continue

The European Commission revised its initial GDP growth forecasts upward for the Euro Area to 1.5% in 2015 and 1.9% in 2016, indicating that the economic recovery is strengthening. The revision is based on the continued weakness of the Euro which has boosted exports. Low energy prices have stimulated real household incomes and consumer confidence, which resulted in a 1.7% YoY growth in private consumption in Q1 2015. Inflation was 0.2% YoY in July in the Euro Area, which is a welcome change after deflation in the beginning of 2015. Low interest rates and reduced fiscal austerity have also contributed to the revised growth rates. The ongoing Quantitative Easing (QE) programme of the European Central Bank (ECB) is a significant factor in stimulating growth and keeping real interest rates at a low level. The ECB's President Mario Draghi has confirmed that the QE programme will continue as expected until September 2016, as the speed of the economic recovery is uncertain and developments in China increase downside risks for the global economy. The option to extend the programme is available, if needed.

The Euro Area is still suffering from very high unemployment rates which in Q2'15 stood at 22.5% in **Spain**, 24.9% in **Greece**, 12.2% in **Portugal** and 9.5% in **Slovenia**. This is partly due to a lack of public and private investment. Jobs created are often temporary or of poor quality, while the emergence and popularity of zero hour contracts have added flexibility for employers but pose new challenges for employees. Government debt is still high for many economies but the Euro Area debt-to-GDP ratio is expected to have peaked at 94.2% in Q1 with substantial reductions in 2015 and 2016.

United States

GDP for Q2 revised upward for the third time as market conditions continue to improve; interest rate increases are expected

Q2'15 GDP has been revised again to 3.9% YoY (sa) from 3.7% due to increases in exports, investments and government spending. Consumer spending growth increased as well to 3.6% from 3.1%. Additionally the labour market continues to recover with unemployment falling to 5.1% in August 2015 (which the Federal Reserve categorises as full employment). This is the lowest rate since 2009, and is partially due to low energy prices and reduced interest rates which have driven sustained increases in aggregate demand, especially in the areas of consumer spending and residential construction. These improvements have fuelled speculation that the Fed will raise interest rates (for the first time in a decade) at its key meeting on October 27-28th. Wage growth is expected to rise this year, and inflation could approach its 2% target, thus providing conditions for modest interest rate increases. Any such move would be delicate as stock markets have been very sensitive to interest rate expectations in recent months. Additionally, emerging markets may be concerned that an increase in the interest rate will create substantial capital outflows from emerging markets to dollar-denominated assets, which could cause market disturbances and lower growth rates. The impact on the substantial dollar-denominated debt in emerging markets is also a concern, as an interest rate increase may cause corporate failures and restrict bank lending. This consideration is especially important in the wake of the economic downturn in China, which may already be affecting the US market as wages stagnated and the jobless rate was unchanged at 5.1% in September, suggesting that it may be wise to postpone an interest rate increase.

Major economies' GDP growth forecasts

	2014 (%)	2015f (%)	2016f (%)
Global	3.4	3.1	3.6
UK	3.0	2.5	2.2
US	2.4	2.6	2.8
Euro area	0.9	1.5	1.6
Germany	1.6	1.5	1.6
Japan	-0.1	0.6	1.0
China	7.3	6.8	6.3
India	7.3	7.3	7.5

Source: IMF October 6th 2015.

United Kingdom

Continuing economic recovery; interest rate hikes are expected

In 2014 the UK recorded strong GDP growth which is expected to continue with expansions of 2.5% and 2.2% forecast for 2015 and 2016 respectively. Unemployment - which has been on a downward trend since December 2011 - is expected to fall to 5.4% by the end of this year. The current account deficit narrowed in Q1 2015 to 5.8% of GDP from 6.4% in Q4'15, and this development is expected to continue as the Euro Area recovers. According to the March 2015 Budget further fiscal consolidation is planned for 2016 and 2017. As with the United States, the UK is expected to increase interest rates in early 2016 as inflation approaches its 2% target. Any such normalization would come against the backdrop of improving public finances, with the government deficit expected to fall to 4.1% of GDP in 2015 due to further fiscal consolidation. When the interest rate normalization will occur is highly dependent on both the recovery in the Euro Area and global financial markets, as an interest rate hike may have undesirable effects for growth.

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.

Telephone: +353 1 6670372; Fax: +353 1 6144499; Email: info@dkm.ie; Website: www.dkm.ie