Goodbody

Irish Economy

Q1 2015 Health Check

Consolidating gains

Economic Research 12 Jan 2015

Ireland's recovery is real

Scepticism about Ireland's GDP growth is unjustified in our view. Ireland is set to be the fastest-growing economy in the euro area for the second consecutive year in 2015. We are forecasting growth of 4% in GDP terms, following a 5% expansion in 2014. Ireland's recovery is a real and sustainable one.

Domestic demand now driving growth

The recovery is now being led by domestic demand, which is expected to grow by 4.1% in 2015. Investment growth will continue at a stellar pace, with construction taking over as the main driver. The Irish consumer recovery has been lacklustre thus far but is also expected to pick up this year on the back of an improving labour market, modest wage increases and a falling tax burden.

Deficit to fall below 3%, but spending pressures are evident

Strong growth in taxes contributed to another year of deficit reduction in 2014. The deficit will fall below 3% in 2015, but there are clear spending pressures becoming evident due to public sector pay talks and an upcoming general election. It is important that sensible fiscal policy is not abandoned, undoing the hard-won gains of recent years.

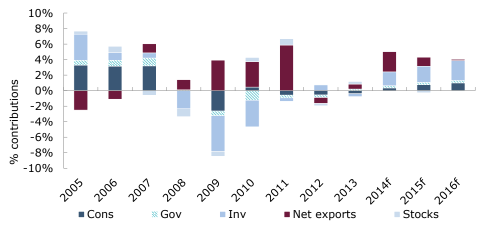
Seven key issues for 2015

We look at seven issues that investors interested in the Irish economy should be aware of for the next twelve months: (i) Politics; (ii) Euro area issues; (iii) Sovereign funding; (iv) Selling the bank stakes; (v) Housing and construction recovery; (vi) Corporation tax, and; (vii) Managing the boom.

Economic Indicators

	2013	2014f	2015f	2016f
Growth Components				
Consumption	-0.8%	0.7%	1.7%	2.2%
Government	1.4%	1.9%	2.0%	2.0%
Investment	-2.4%	11.7%	12.9%	14.1%
Domestic Demand	-0.7%	3.1%	4.1%	4.9%
Exports	1.1%	11.7%	4.8%	4.1%
Imports	0.6%	11.6%	4.7%	4.9%
GDP	0.2%	5.0%	4.0%	3.8%
GNP	3.2%	4.9%	4.2%	4.0%
Prices				
Consumer Price Inflation	0.5%	0.2%	0.2%	1.2%
House Price Inflation (end-year)	6.4%	17.2%	7.1%	6.2%
Wage Inflation (GBS)	-0.7%	-0.5%	1.3%	1.6%
Fiscal				
GGB / GDP	-5.7%	-3.9%	-2.8%	-2.2%
Debt/GDP	123%	109%	107%	105%
Consumer Profile				
Employment Growth (end year)	3.2%	1.3%	2.5%	1.6%
Unemployment Rate (end-year)	12.2%	10.8%	9.2%	8.1%
Exchange Rates (Avg for the year)				
€/$	1.33	1.33	1.18	1.15
€/£	0.85	0.81	0.78	0.79

Contributions to Irish growth



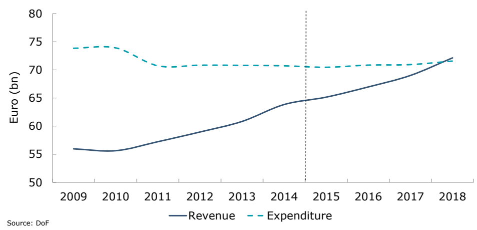
Source: CSO, Goodbody estimates

Growth forecast changes

	2015		2016	
	Old	New	Old	New
Consumption	1.8%	1.7%	2.0%	2.2%
Government	1.5%	2.0%	1.2%	2.0%
Investment	9.3%	12.9%	9.4%	14.1%
Dom Demand	3.3%	4.1%	3.5%	4.9%
Exports	4.9%	4.8%	3.7%	4.1%
Imports	3.9%	4.7%	3.2%	4.9%
GDP	**4.2%**	**4.0%**	**3.8%**	**3.8%**
GNP	**4.3%**	**4.2%**	**3.9%**	**4.0%**

Source: Goodbody

Growth in revenues expected to close the deficit



Source: DoF

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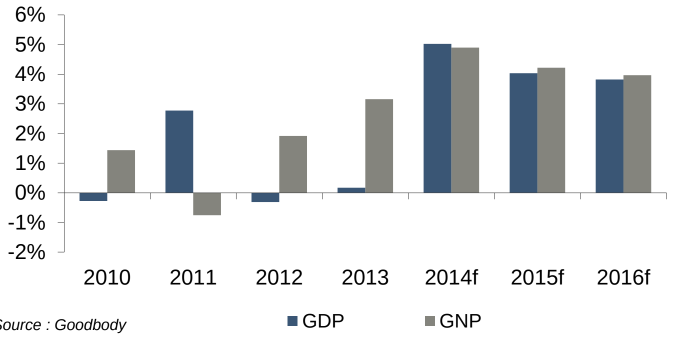
DOMESTIC MACRO DATA	2012a	2013a	2014f	2015f	2016f
Growth Components					
Consumption	-1.2%	-0.8%	0.7%	1.7%	2.2%
Government	-2.1%	1.4%	1.9%	2.0%	2.0%
Investment	5.0%	-2.4%	11.7%	12.9%	14.1%
Domestic Demand	-0.2%	-0.7%	3.1%	4.1%	4.9%
Exports	4.7%	1.1%	11.7%	4.8%	4.1%
Imports	6.9%	0.6%	11.6%	4.7%	4.9%
GDP	-0.3%	0.2%	5.0%	4.0%	3.8%
GNP	1.9%	3.2%	4.9%	4.2%	4.0%
Housing Statistics					
Completions	8,488	8,301	11,021	13,782	16,168
Average House Price (€k)	167,860	178,575	209,374	224,239	238,068
House Price Inflation (end-year)	-4.5%	6.4%	17.2%	7.1%	6.2%
Mortgage Credit Growth (end-year)	-2.9%	-3.3%	-1.9%	-1.3%	-0.5%
Prices					
Consumer Price Inflation	1.7%	0.5%	0.2%	0.2%	1.2%
Wage Inflation (GBS)	0.5%	-0.7%	-0.5%	1.3%	1.6%
Fiscal					
Exchequer Balance	-14,823	-11,495	-8,068	-7,190	-4,216
Exchequer Balance / GNP	-10.4%	-7.7%	-5.1%	-4.3%	-2.4%
General Government Balance	-13,913	-10,005	-7,253	-5,480	-4,521
GGB/GDP	-8.1%	-5.7%	-3.9%	-2.8%	-2.2%
GGB/GDP - ex banking costs	-8.1%	-5.2%	-3.9%	-2.8%	-2.2%
Debt/GDP	122%	123%	109%	107%	105%
Consumer Profile					
Employment Growth (end year)	-0.1%	3.2%	1.3%	2.5%	1.6%
Employment Growth (Full-year avera	-0.6%	2.4%	1.7%	2.2%	1.9%
Unemployment Rate (end-year)	14.2%	12.2%	10.8%	9.2%	8.1%
Debt/Disp. Income	210%	196%	185%	177%	171%
Interest Rates (At year end)					
ECB	0.75%	0.25%	0.05%	0.05%	0.05%
BoE	0.50%	0.50%	0.50%	1.25%	2.25%
Fed	0.25%	0.25%	0.25%	1.00%	2.25%
Trade					
Current Account (€m)	2,700	7,638	10,524	12,397	11,848
CA as a % of GDP	1.6%	4.4%	5.7%	6.4%	5.8%
Exchange Rates (Average for the year)					
€/$	1.29	1.33	1.33	1.18	1.15
€/£	0.81	0.85	0.81	0.78	0.79

SOVEREIGN ANALYSIS	2012a	2013a	2014f	2015f	2016f
Debt/GDP					
Austria	82%	81%	87%	86%	84%
Belgium	104%	105%	106%	107%	108%
Cyprus	80%	102%	108%	115%	112%
Finland	53%	56%	60%	62%	62%
France	89%	92%	96%	98%	100%
Germany	79%	77%	75%	72%	70%
Greece	157%	175%	176%	169%	158%
Ireland	122%	123%	109%	107%	105%
Italy	122%	128%	132%	134%	133%
Luxembourg	21%	24%	23%	24%	25%
Malta	68%	70%	71%	71%	70%
Netherlands	67%	69%	70%	70%	70%
Portugal	125%	128%	128%	125%	124%
Slovakia	52%	55%	54%	55%	55%
Slovenia	53%	70%	82%	83%	81%
Spain	84%	92%	98%	101%	102%
Eurozone avg.	91%	93%	95%	95%	94%
GGB/GDP					
Austria	-2.3%	-1.5%	-2.9%	-1.8%	-1.1%
Belgium	-4.1%	-2.9%	-3.0%	-2.8%	-2.8%
Cyprus	-5.8%	-4.9%	-3.0%	-3.0%	-1.4%
Finland	-2.1%	-2.4%	-2.9%	-2.6%	-2.3%
France	-4.9%	-4.1%	-4.4%	-4.5%	-4.7%
Germany	0.1%	0.1%	0.2%	-	0.2%
Greece	-8.6%	-12.2%	-1.6%	-0.1%	1.3%
Ireland	-8.1%	-5.7%	-3.9%	-2.8%	-2.2%
Italy	-3.0%	-2.8%	-3.0%	-2.7%	-2.2%
Luxembourg	0.1%	0.6%	0.2%	-0.4%	-0.6%
Malta	-3.7%	-2.7%	-2.5%	-2.6%	-2.0%
Netherlands	-4.0%	-2.3%	-2.5%	-2.1%	-1.8%
Portugal	-5.5%	-4.9%	-4.9%	-3.3%	-2.8%
Slovakia	-4.2%	-2.6%	-3.0%	-2.6%	-2.3%
Slovenia	-3.7%	-14.6%	-4.4%	-2.9%	-2.7%
Spain	-10.3%	-6.8%	-5.6%	-4.6%	-3.9%
Eurozone avg.	-3.6%	-2.9%	-2.6%	-2.4%	-2.1%

10Y Spread to Germany	2011a	2012a	2013a	2014f	Current
Austria	113.75	43.74	32.00	16.86	12.88
Finland	45.76	19.26	17.73	24.86	20.45
France	131.06	56.37	43.40	29.20	29.00
Netherlands	35.29	17.05	29.60	13.80	9.60
Belgium	221.53	73.31	62.00	29.50	25.80
Spain	324.52	392.10	223.80	107.10	122.20
Italy	513.69	313.40	216.40	132.40	141.90
Portugal	1,096.01	554.13	417.20	213.60	221.46
Greece	2,986.98	892.10	632.10	888.90	995.80
Ireland	642.69	n/a	148.90	70.23	73.62

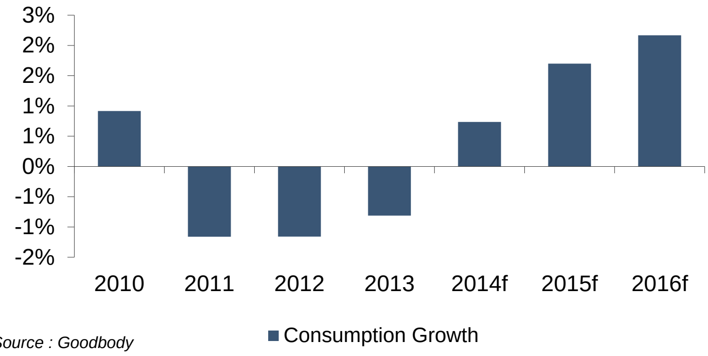
Source: FactSet & European Commission

Irish economic growth



Source : Goodbody

Consumption Growth



Source : Goodbody

Ireland 2015 – Key themes

Ireland to be the fastest growing economy in the euro area again in 2015…

With growth at a premium in the euro area, Ireland's 5% GDP expansion in 2014 can be described as nothing short of spectacular. While we expect a moderation in this growth rate in 2015, our 4% GDP forecast still puts Ireland at the top of the growth league table in the euro area for the second consecutive year.

…with domestic demand set to lead the way

Domestic demand is estimated to have grown by 3.1% in 2014, its first year of growth since 2007. As expected, investment is the key driver of this domestic expansion. Domestic demand growth is expected to strengthen further in 2015 and 2016, with investment again being the main driver, but will be accompanied by contributions from both the consumer (1.7%) and government spending (2.0%).

Investment will continue to drive the domestic expansion

In 2015 (12.9%) and 2016 (14.1%), we anticipate that double-digit growth in investment will continue. While this will be aided by aircraft purchases by Ryanair, underlying investment spending is expected to remain strong (averaging 9% per annum). The recovery in business investment is being driven by both FDI and indigenous businesses and is expected to continue in 2015. We also expect that the recovery in the construction sector will step up a gear in 2015 and 2016, with growth of 12% and 14%, respectively, expected. This comes on the back of growing supply shortages in some areas of the market, fast price growth and the entry of foreign capital into the sector. While there have been more positive signs recently that new lending is picking up, we would have some concerns that the interest rates charged in Ireland, being significantly ahead of the other euro area average, may hold back investment over the medium-term.

Consumer to enjoy a modest recovery

In light of the improved labour market situation, consumer spending has remained rather muted, with growth of just 0.7% estimated in 2014. We expect growth to pick-up in 2015 (1.7%) and 2016 (2.2%), with the key drivers being a better labour market (employment to grow by 2.2%), modest wage increases (1.3%) and a small reduction in the tax burden.

Too early to loosen the purse strings

2014 was another year of deficit reduction, with impressive growth in tax revenues in particular pulling down the deficit to 3.9% of GDP (from 5.8% of GDP). The deficit should fall below 3% in 2015 (2.8% expected), but the government has left itself little room for manoeuvre following the measures included in Budget 2015. Spending pressure will come by way of public sector pay negotiations and an upcoming election. In this regard, it is important that sensible fiscal policies are not abandoned, undoing the hard-won gains of recent years.

Seven key issues for 2015

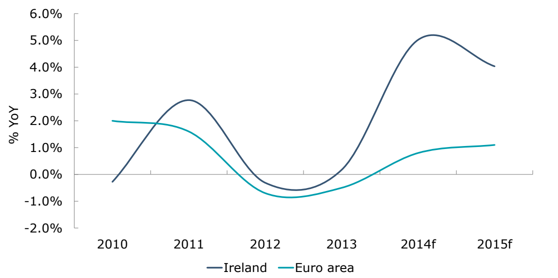
At the beginning of the year, we take the opportunity to frame some of the major issues that are expected to have the biggest impact:

- (i) **Politics:** Policy may be increasingly dictated by politics with an eye on Election 2016.
- (ii) **Euro area:** Deflation, economic stagnation and QE all have important implications.
- (iii) **Sovereign funding:** Opportunity to lock low interest costs well into the future.
- (iv) **Bank stakes:** Opportunity to recoup bailout costs and return banks to private market.
- (v) **Housing recovery:** The price rebound should be accompanied by a return of the crane.
- (vi) **Corporate tax:** With OECD measure to be announced, Ireland will remain in the spotlight.
- (vii) **Managing the boom:** Different challenges will be faced by Irish policy makers in trying to manage expectations associated with the return of economic growth.

Ireland 2015 – Consolidating gains

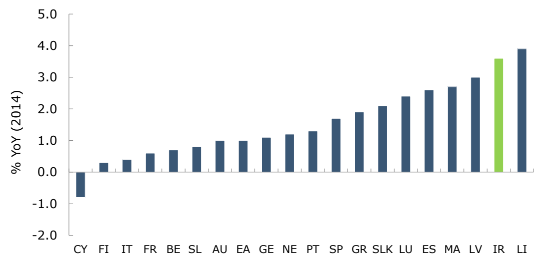
In the context of yet another year of dismal growth in the euro area in 2014, the performance of the Irish economy can be described as spectacular. The numbers speak for themselves. Following the release of Q3 data prior to Christmas, we estimate that the Irish economy grew by 5% in GDP terms in 2014. This compares to growth of less than 1% in the euro area as a whole. We noted during the year that Ireland was the growth beacon in a European context. Nothing over recent months has done anything to change that view.

GDP growth gap widened in 2014...



Source: CSO, European Commission, Goodbody

...with domestic demand growing strongly



Source: European Commission, Goodbody

Given the scale of outperformance, there have been justifiable questions about the accuracy of the data and thus the sustainability of the recovery. These questions have largely focused on the effect of the multinational sector on the GDP data in general and the rise of "contract manufacturing" in particular. We believe that these issues do not change the underlying narrative of the economic recovery in Ireland as the net impact is marginal.

In any case, our preference has always been to focus on domestic demand as gauge of economic activity. In 2014, domestic demand is estimated to have grown by 3.1%. This is slightly down on our previous estimate due to surprising weakness in consumer spending, but will still represent the best performance since 2007. It also means that Ireland had the second-fastest growing *domestic* economy in the euro area in 2014 (behind Lithuania).

Investment continues to be the key driver of this domestic expansion. Led by strong growth in business investment and construction, we expect this recovery to continue in 2015. We are forecasting investment to grow by 13% and 14% in 2015 and 2016, respectively. While this will be boosted somewhat by aircraft orders by Ryanair, underlying investment trends are also expected to be very robust, growing by 9% per annum on average. While these are, once again, the most impressive rates of growth in the euro area, it must be noted that investment is still recovering from an exceptionally large downturn, so is thus coming from a low base.

What may disrupt this positive growth trajectory for the Irish economy? A notable one is both the cost and availability of credit to fund the investment-led recovery. Despite some recovery in 2014, Ireland's investment boom has largely been credit-less thus far. Funding for investment projects has largely come from own resources or external capital. This will continue to be a feature, but for a sustainable and broad-based investment rebound, the banking system will play a major role. While the pillar banks have a growing appetite to grow their loan books, interest rates for new borrowers remain high in an international context.

We deal with some other risks in this note, but we believe that the primary risks to the Irish story are external, whereby a flare-up of financial market tensions in the euro area, caused by political uncertainty or fear of deflation, has knock-on implications for investment and spending in Ireland. While we have faith that ECB President Mario Draghi will ensure that a repeat of the tensions of 2010/2011 does not occur, there are some events, such as elections in Greece and Spain, which provide very real threats.

Key issues for investors in 2015

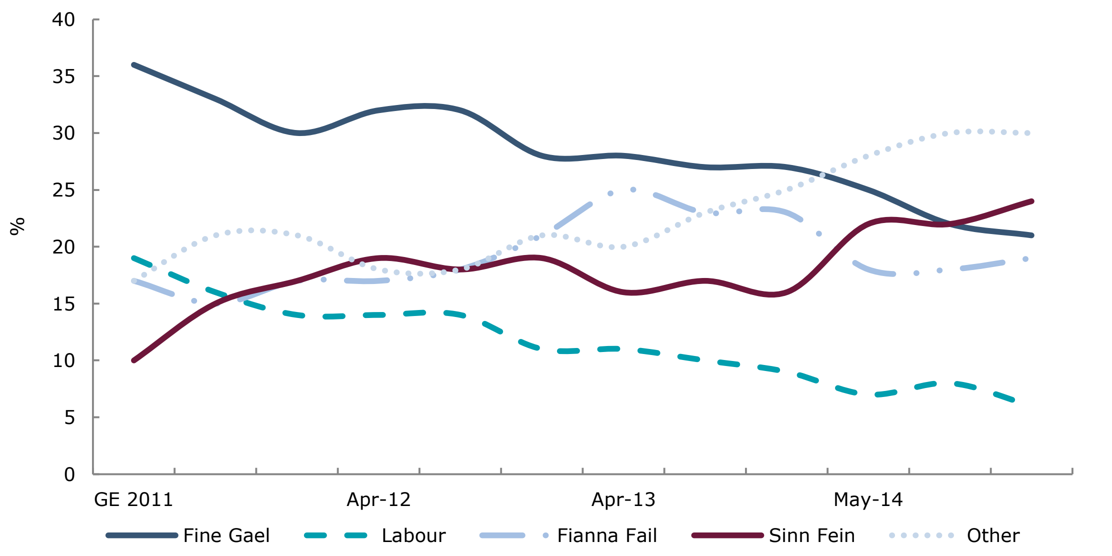
What are the key issues that investors interested in the Irish economy should be looking out for in 2014? The list below is not intended to be exhaustive but is meant as a guide to the topics that are likely to be most important for the year ahead.

1. Political situation
2. Euro area issues
3. Sovereign funding
4. Selling the bank stakes
5. Ongoing recovery in housing and construction
6. Corporation tax
7. Managing the boom

1. Political situation

Support for the incumbent Irish government went in the opposite direction to the trajectory of the economic recovery in 2014. Continuing a theme of dwindling support in the polls that has occurred since the 2011 general election, the government parties of Fine Gael and Labour lost a combined 18 percentage points of support in 2014. This takes the combined loss in support since the general election to 28 percentage points.

Government support has dwindled despite the strong economic recovery



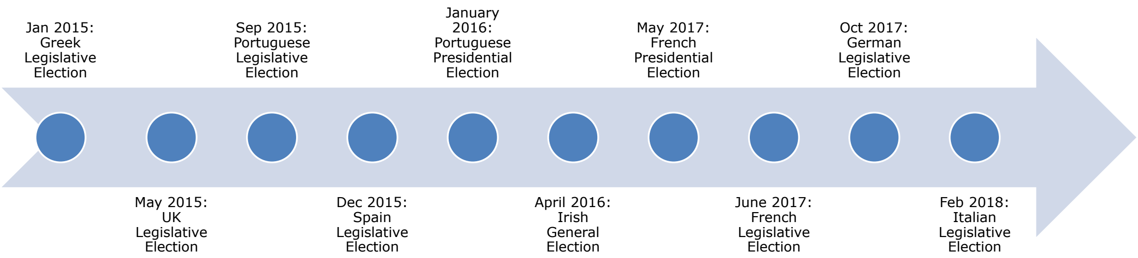
Source: RedC

Despite this, it must be noted that the coalition government still holds a large majority in the Dail (Irish Parliament), while a general election is not formally due until April 2016. However, it is clear that politics has moved to the foreground of investor interest for a number of reasons:

- **Government will position for next year's general election -** Dwindling government support has already started to have an impact on policy implementation. Protests against the introduction of water charges contributed to a change in the rules and amount raised from the measure, with still a large public protest against the charges present. More significantly, Budget 2015 treaded a less prudent course than we would have preferred, with perceived political imperatives playing a role in some of the decisions made. In this context, it is likely that policy implementation over the coming twelve months, most notably in Budget 2016 in October, will be heavily influenced by the need to bolster voter support ahead of a general election next year. Prudence and economic rationale may suffer as a result.

- **Make-up of next government very uncertain -** Given the current poll standings, the make-up of the next government is very uncertain and could potentially lead to what may be a rather unstable coalition of parties and/or independent politicians. While we are loathe placing too much emphasis on polls at this stage, especially when a significant proportion (12%) of voters have yet to decide, there is potential for a significant shift in policy to the left in the next Irish government after almost two decades of centre-right led policy. According to the latest poll (RedC), Sinn Fein is the largest party at 24%, but Independents and other may hold the balance of power, with support rising to 30%, from just 17% at the 2011 general election.
- **Politics to feature prominently around Europe -** Ireland is far from the only country in the euro area that is facing into a more difficult political environment. Austerity policies of recent years have predictably taken their toll on incumbent politicians, and this is set to feature prominently in elections due over the coming twelve months. This will feature early on in the year in the form of early Greek elections, but important elections will also take place in the UK (May), Portugal (September/October) and Spain (December). There has already been a clear shift to anti-EU rhetoric. Elections will give voters the opportunity to express their sentiments at the ballot box and will lead to increased market uncertainty.

Political timeline in Europe



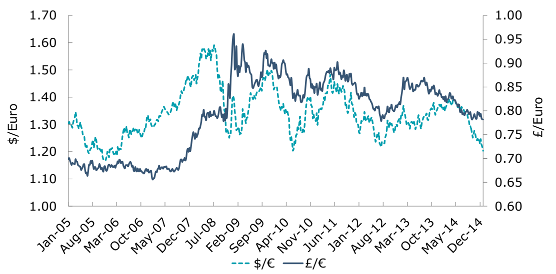
2. Euro area issues – a double-edge sword

Events – political, economic and monetary- in the euro area will be the most important external issue for Ireland in 2015. While the fall-out from the announcement of snap elections in Greece has been contained thus far, there is no guarantee that contagion risks will not present themselves once again in the event of further upheaval or threats of an exit from the euro area of Greece.

Prior to that, Irish borrowing costs will be influenced by the actions of the ECB over the coming weeks. Due to the increased expectation of the ECB making a decision to buy government bonds in the euro area, Irish borrowing costs have fallen to record lows. Whether these low rates will continue will depend on how aggressive additional measures will be.

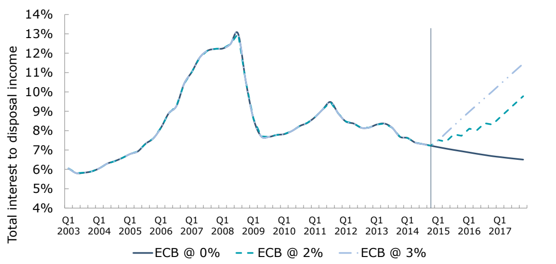
These issues are a double-edge sword for Ireland. On the one hand, demand for Irish exports to the euro area will be hampered. On the other, expected actions by the ECB over the coming weeks will mean a further easing of monetary policy and additional weakening of the euro. For Ireland, continuation of a zero-interest rate policy over the coming years is important in the context of a still very large private sector debt burden, while a lower euro should help demand for Irish exports

Significant currency weakening in train



Source: FactSet

Household interest rate burden



Source: ECB, CSO, Central Bank, Goodbody

3. Sovereign funding – repaying the IMF

2014 was a year of success in terms of funding for Ireland, with all bond sales meeting strong demand and at progressively lower interest rates. The final bond sale of the year (4 November 2014) saw Ireland issue its longest maturity bond (15-year) since 2009. In December 2014, Ireland took the first positive step of starting to repay the IMF loans. These loans carry an average interest rate of 4.99%. The NTMA plans to raise €12bn-€15bn in 2015, following the €12bn raised in 2014. It has already raised €4bn of this target through the successful sale of 7-year debt on 7th January at a yield of just 0.87%.

In terms of funding needs for 2015, Ireland has a very low redemption hurdle to overcome, with only €2.2bn maturing in February. While an Exchequer deficit of €7bn must also be financed, a significant proportion of the funding in 2015 will go towards the repayment of IMF loans (€9bn).

Buoyed by strong demand for peripheral debt and a host of ratings agency upgrades, Irish funding costs are now at record low levels. While the spread relative to Germany may contract further, an additional decline in the nominal yield is dependent on the extent of ECB action in the sovereign debt markets. We believe much of this is priced in, but it is also unlikely given this ECB support that bond yields will rise sharply for the foreseeable future. Irish bonds should be supported further by way of ratings upgrades by either Fitch (A-) or Moody's (Baa1) at some stage during the year (Moody's will report next on January 16th with Fitch on February 13th).

Composition of Irish Government debt

	End-2013	Latest:
Government Bonds	111,010	116,860
EU/IMF	66,940	58,790
Other medium/long term	770	930
State Savings Schemes	15,510	16,370
Short-term debt	3,320	6,680
Cash & other fin. Assets	(23,850)	(16,410)
National Debt	**173,700**	**183,220**
Cash & other fin. Assets	23,850	(16,410)
Adjustments	18,000	5,460
General Government Debt	**215,550**	**172,270**
Net General Government Debt	**191,700**	**188,680**

Source: NTMA, Goodbody

4. Selling the bank stakes

Following the expensive bailout in 2009/2010, Ireland has gradually clawed back c.€10bn of the costs of the banking crisis over recent years. While monies associated with Anglo Irish Bank and Irish Nationwide are now lost, the Irish government retains valuable stakes in Bank of Ireland and AIB.

The table on the next page shows that the total gross cost of the Irish banking crisis amounted to €64bn. Allowing for money collected by way of sales to date and fees collected from the banks, the net cost is estimated at €54bn. Based on current valuations (market value in the case of Bank of Ireland and the NTMA valuation for AIB), the net cost could end up at €40bn.

Net Irish state investment into the banking sector

	AIB/EBS	BoI*	PTSB	IBRC	Total	% of GDP**
Total recap from State	**20.7**	**4.7**	**4.0**	**34.7**	**64.1**	**37%**
Sales/Redemptions	0.0	4.7	1.3	0.0	6.0	
Fees (ELG etc)	1.7	1.5	0.6	0.5	4.3	
Total Received	*1.7*	*6.1*	*1.9*	*0.5*	*10.3*	*6%*
Net Cost to State	**19.0**	**-1.5**	**2.1**	**34.2**	**53.8**	**31%**
Value of stakes	11.6	1.4	0.4	0	13.4	8%
State position on stakes	**7.4**	**-2.8**	**1.7**	**34.2**	**40.5**	**23%**

Source: Dept of Finance, Dail questions, Goodbody — Bank of Ireland stake calculated at 31c share price

The major unknown in this calculation is both the timing and valuation of the remaining stakes in AIB. Along with the 99.8% equity stake, the government also owns €3.5bn in preference shares and €1.6bn in contingent convertible notes. These coupons are worth €440m to the Irish government per annum, although coupon payments from the preference shares have been paid in shares in recent years.

5. Ongoing recovery in housing & construction – the cranes are back

The recovery in Ireland's property market gathered steam in 2014, with strong momentum entering the New Year. It remains an uneven recovery, but is becoming increasingly broad-based, with other major urban centres now following the lead of the capital. Macro-prudential measures to be implemented by the Central Bank have the potential to throw a spanner in the works by way of restricting demand. In our note in December (*Right tools, but in need of some sharpening*, 1 December 2014), we noted that while we are in favour of these types of measures, our preference would be for a more dynamic approach that takes account of the prevailing market conditions at the time. The Central Bank is due to announce its final decision on the matter in January, and this will have a large bearing on our forecasts for prices, mortgage lending and housing activity in general this year.

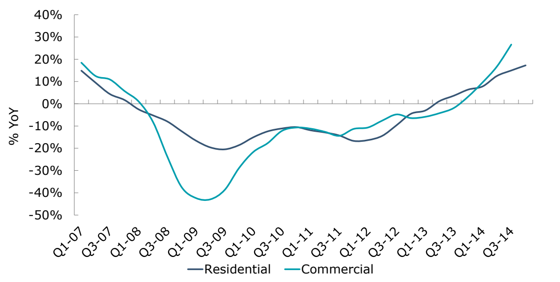
Key Irish housing metrics

	2012	2013	2014f	2015f	2016f
House completions	8,488	8,301	11,021	13,782	16,168
Average house price (€, end-year)	167,860	178,575	209,374	224,239	238,068
Price inflation (% YoY, end-year)	-4.5%	6.4%	17.2%	7.1%	6.2%
- Dublin (% YoY, end-year)	-2%	16%	24%	9%	6%
- Non-Dublin (% YoY, end-year)	-6%	0%	11%	6%	6%
Gross mortgage lending (€m)	2,636	2,495	3,858	4,595	5,497
Growth in gross lending	7%	-5%	55%	19%	20%
Net mortgage lending growth (end -year)	-2.9%	-3.3%	-1.9%	-1.3%	-0.5%
Gross rental yield (end-year)	5.5%	5.6%	5.3%	5.2%	5.1%

Source: DoELG, CSO, IBPF, Central Bank, Goodbody

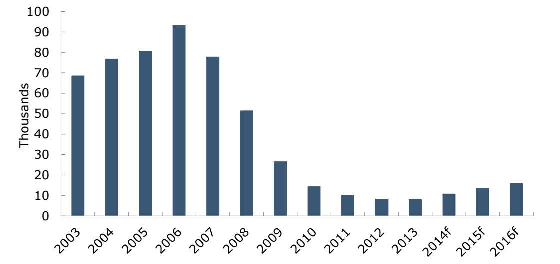
Encouragingly, prices have now recovered to such an extent in parts of the country that it is spurring an increase in construction activity. This is the next stage of the recovery that will see residential and commercial construction grow strongly over the coming years. The residential construction recovery is already in train in Dublin, while there are signs that the same is now happening in the commercial office sector.

Strong growth in property prices…



Source: CSO, IPD

…to trigger construction rebound



Source: Goodbody

6. Corporation tax

Corporate tax will be towards the top of the international policy debate once again this year. Triggered by the requirements of the G20, the OECD will finalise its conclusions on Base Erosion and Profit Shifting (BEPS) later this year. Ireland will be a very keen observer.

Over the past eighteen months, Ireland has been consistently cited in relation to issues associated with the tax practices of some of the largest multinational companies in the world. Ireland is not alone in this regard, with the recent Luxleaks scandal diverting attention to Luxembourg. Nevertheless, it is likely that the constant reference to Ireland and companies with operations in Ireland has done some damage to Ireland's reputation as a destination for foreign direct investment. The Irish government has done a good job in reacting to the issue, by way of policy changes announced in Budget 2014 and Budget 2015, but it will need to continue to push the case for Ireland as a destination for FDI.

7. Managing the boom

Ireland has been justifiably lauded for its efforts in coming out of its economic, fiscal and banking crises since 2010. This involved some painful and politically damaging choices, but has resulted in banking stability being restored, a fiscal deficit expected to be below 3% of GDP in 2015 and the fastest growing economy in the euro area.

One could say that the tough job is now done, but the challenge for Irish policymakers, although different, could be as difficult over the coming twelve months and beyond. On the back of this recovery and with a general election around the corner, expectations in Ireland have clearly changed. Among workers, content in job security has been replaced with aspirations of pay increases that are only going to grow as the unemployment rate continues to fall.

Pressure from public sector unions will also something that the Irish government will have to deal with this year. The Haddington Road Agreement, hammered out between the government and unions in 2013, set out pay and productivity developments for the period to July 2016. With a general election to take place a few months prior to this, the government will want to get an agreement on pay developments well before this date. In this regard it must be noted that Budget 2015 included a "technical assumption" of no change in public sector pay in the period post-2015. This is not a realistic assumption in our view, so the discussions in relation to public sector pay in 2015 will have important fiscal consequences.

Private sector pay pressures are also starting to emerge on the back of tighter labour market conditions in some sectors in particular. The rise in the cost of housing is also playing a role in inflating salary expectations. Following the hard-won gains in competitiveness over the 2009-2014, policymakers must be wary of losing some of these gains in better economic times. From the government's perspective, the most direct way it can manage salary expectations in the private sector is by reducing the income tax burden. This process begun in Budget 2015, and will continue in Budget 2016.

Economic Outlook - Ireland to remain Europe's growth beacon in 2015

Ireland's economic recovery exceeded all expectations in 2014. We began the year with an expectation that GDP would grow by 2.6% in 2014, but after a series of better than expected data, we now estimate that the Irish economy grew by almost double that rate last year (5.0%), compared to expected growth in the euro area of less than 1%.

Irish growth forecasts

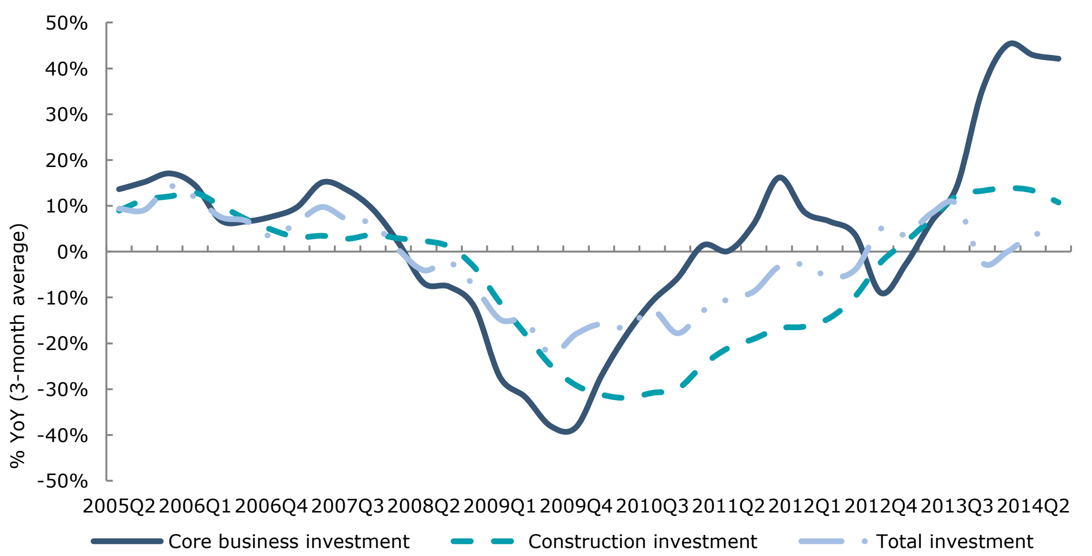
	2012	2013	2014f	2015f	2016f
Consumption	-1.2%	-0.8%	0.7%	1.7%	2.2%
Government	-2.1%	1.4%	1.9%	2.0%	2.0%
Investment	5.0%	-2.4%	11.7%	12.9%	14.1%
Domestic Demand	-0.2%	-0.7%	3.1%	4.1%	4.9%
Exports	4.7%	1.1%	11.7%	4.8%	4.1%
Imports	6.9%	0.6%	11.6%	4.7%	4.9%
GDP	**-0.3%**	**0.2%**	**5.0%**	**4.0%**	**3.8%**
GNP	**1.9%**	**3.2%**	**4.9%**	**4.2%**	**4.0%**

Source: CSO, Goodbody

Before we address the questions around the reliability of the Irish data, it is worth repeating that we have always advocated using domestic demand as the most appropriate gauge of growth in the Irish economy and remain of this view. After six consecutive years of decline, we estimate that domestic demand grew by 3.1% in 2014, with investment being the key driver of the expansion. We estimate that investment spending grew by 12% in 2014, but the underlying growth is even more impressive, with a fall in aircraft investment (which can be extremely volatile) acting as a drag for the second consecutive year. If one excludes this and the other volatile component – research and development – core investment is estimated to have grown by 18% in 2014, following growth of 21% in 2013.

Some moderation is expected in 2015, but we still expect robust investment growth to continue. Total investment is expected to grow by 13% and 14% in 2015 and 2016, respectively, but this will be boosted by the expected delivery of large aircraft orders by Ryanair. Excluding aircraft, we expect investment to grow by 9% per annum. While growth in business investment is expected to moderate, this will be replaced by a more vigorous recovery in construction spending, which is expected to grow by 12% and 14% in 2015 and 2015, respectively.

Core business investment is booming



Source: CSO Core business investment excludes planes

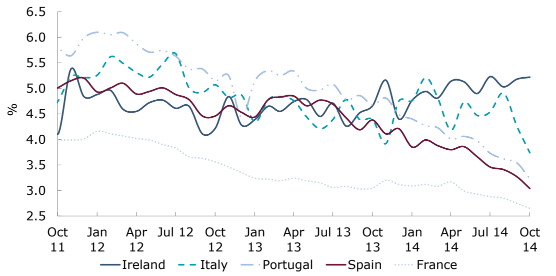
Components of investment

	2013	2014f	2015f	2016f
Investment	**-2%**	**12%**	**13%**	**14%**
Construction	13%	9%	12%	14%
Residential	3%	17%	16%	13%
Non-residential	18%	6%	9%	14%
Machinery & Equipment	2%	27%	23%	24%
Core	21%	18%	14%	13%
Aircraft	-66%	-9%	100%	100%
R&D	-19%	1%	3%	3%

Source: CSO, Goodbody estimates

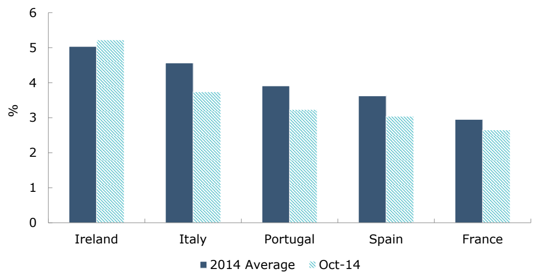
Although there is clear momentum in investment entering 2015, the biggest risk to this continuing is both the cost and availability of credit. We have seen an improvement in new lending to SMEs (+49% yoy in Q3 2014), this is coming from a very low base. Interest rate costs in Ireland are also high compared to other European countries, as can be seen in the two charts below. In the context of looser ECB monetary policy, the transmission to the end customer is clearly still constrained in Ireland.

Irish SME lending rates increased in 2014…



Source: ECB

…and are highest among peripherals



Source: Goodbody

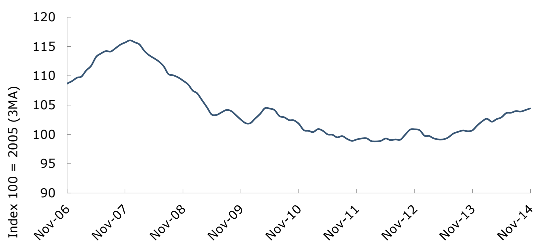
Consumer spending has been disappointing, but key drivers are pointing to improvement

While consumption has lagged the overall recovery in the Irish economy the underlying drivers are supportive of a more solid recovery in 2015. Following two consecutive quarters of annual growth (Q1 0.7%, Q2 1.2%), consumption was disappointingly flat in Q3 which sees our forecast for 2014 pulled back to 0.7% from 1.6%. Retail sales have outperformed consumption overall with volumes rising by 4% in the year to October. However, the headline number is flattered by strong car sales, with core sales rising by a more modest 1.6% over the same period. In fact, since troughing at the end of 2011, core sales have only risen by 6% and they remain 11% below peak levels.

Consumer spending remains muted

Source: CSO

Core retail sales improving gradually



Source: Goodbody

Our *Consumer Checklist*, below, highlights the positive momentum across a range of indicators that has been building over the past 12 months, supporting our view that consumption will rise by 1.7% yoy in 2015. Of the drivers of consumption the improvement in the labour market is the most important. Employment has been growing on an annual basis since the beginning of 2013 and although the rate has slowed in recent quarters, growth remains solid at 1.4%. This in turn has helped the unemployment rate fall from a high of 15% in Q1 2012 to an estimated 10.6% currently.

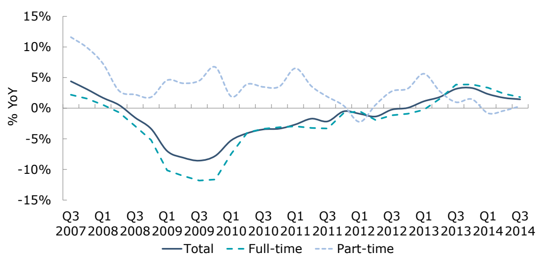
Consumer Checklist shows underlying drivers trending positively

	2013Q1	2013Q2	2013Q3	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4	Trend
Consumption (yoy)	-0.8%	-1.2%	-0.7%	-0.6%	0.7%	1.2%	0.0%		Positive
Retail Sales 3MA (yoy)	-1.3%	-0.3%	2.9%	1.6%	7.5%	5.6%	6.9%	5.2%	Positive
Savings ratio (SA)	9.7%	10.1%	10.7%	12.5%	12.3%	12.4%	12.2%		Neutral
New credit card spending (yoy)	-8.3%	-5.3%	-6.6%	-6.1%	-1.0%	-4.8%	-3.0%	-0.2%	Negative
Employment (yoy)	1.1%	2.0%	3.1%	3.2%	2.3%	1.8%	1.4%		Positive
Unemployment (yoy)	-9.5%	-7.4%	-12.8%	-13.4%	-11.9%	-15.7%	-13.1%		Positive
Average weekly earnings (yoy)	-0.6%	0.4%	-2.1%	-0.4%	0.0%	-1.5%	-0.8%		Negative
Disposable Income 4Q (yoy)	-1.6%	-1.4%	0.4%	3.2%	3.5%	3.9%	3.0%		Positive
Inflation (yoy)	0.9%	0.5%	0.4%	0.2%	0.1%	0.4%	0.3%	0.2%	Positive
Interest Burden	8.3%	8.4%	8.2%	7.7%	7.6%	7.4%	7.3%	7.2%	Positive
VAT 3MA (yoy)	0.2%	-0.9%	5.2%	0.7%	2.0%	16.6%	5.3%	13.9%	Positive
Consumer Confidence 3MA	61.2	63.6	69.4	75.7	84.4	82.6	89.8	87.1	Positive

Source: CSO, Central Bank, Factset, Goodbody estimates

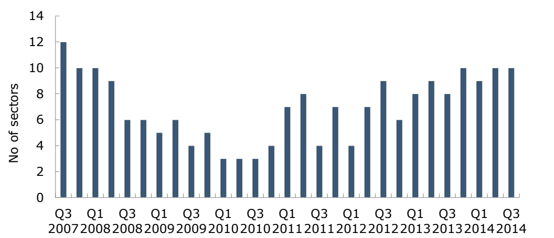
While part time job creation drove employment growth in the initial stages of the jobs recovery in 2012, growth in full time employment has been the main driver since H2 2013. Of the c100k jobs created since the labour market troughed in Q1 2012, almost 80% are full time. The recovery is also broadly based in terms of sectors, with ten of fourteen CSO categories in Q3 reporting employment increases over the last twelve months.

Full-time employment growth leading the way



Source: CSO

No of sectors* seeing annual employment growth



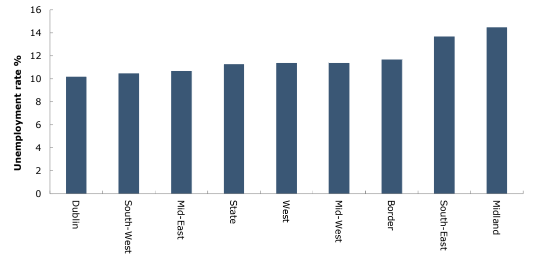
Source: CSO

*14 sectors analysed

However, the recovery is not evenly distributed either in terms of geography or demography. Nationally, the unemployment rate has fallen from its peak level of 15.1% in Q3 2011 to 11.3% in Q3 2014. However, the spread between the lowest rate (Dublin at 10.2%) and the highest rate (Midlands at 14.5%) is over 4 percentage points, demonstrating the different labour market conditions that exist across the regions and underlining the perceived uneven regional recovery in consumption.

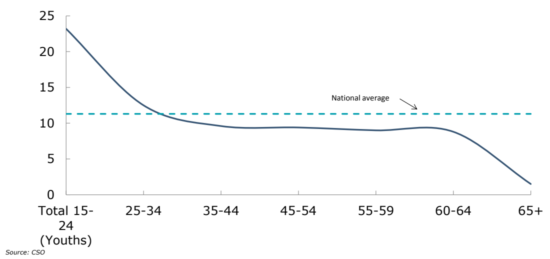
The same variation can be seen in age cohorts, with the youth (15-24 year olds) unemployment rate at 23.2%. At 12.5%, 25-34 year olds also have a higher unemployment rate than the average. As this cohort is the age group that are the largest discretionary spenders this may partly explain the ongoing weakness in consumer spending.

Unemployment rates vary across the country



Source: CSO

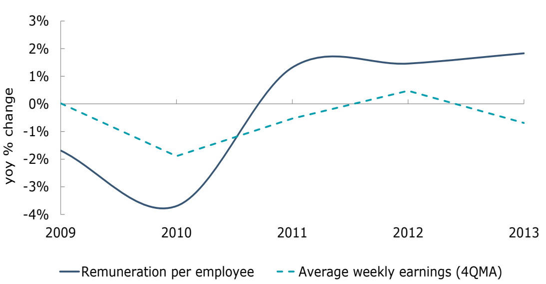
& are highest amongst younger age groups



Source: CSO

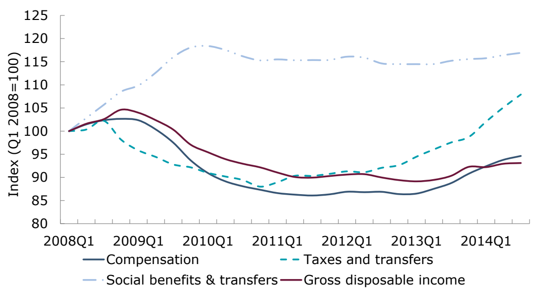
Another factor may be the ongoing weakness in earnings. In Q3 2014, average weekly earnings fell by 0.8% yoy, continuing a trend in existence for most of the past five years. However, these figures do not tell the whole story. Separate data (from the National Income & Expenditure (NIE) accounts and the Institutional sector accounts) show that *aggregate* income is rising. According to the NIE, domestic non-agricultural remuneration rose 3% in 2013, which follows a 1% increase in 2012. On a per employee basis - a measure more comparable to the average earnings number- remuneration rose by 1.8% in 2013 whereas average earnings fell by almost 1% in the same period. While there has been a gap between remuneration and average earnings statistics since 2009, momentum has been similar up until 2012. In 2013 this changed, with a dichotomy opening up between the two data sets.

Weekly earnings trends are weaker than those seen for remuneration



Source: CSO, Goodbody

Disposable income growth has been curtailed by tax increases in recent years

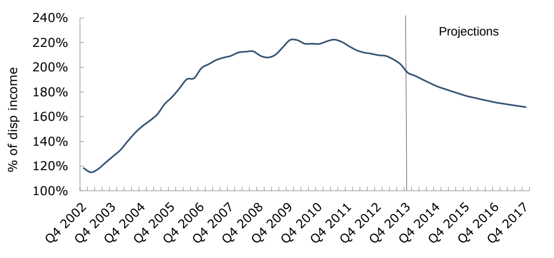


Source: CSO

Similar to remuneration, disposable income, as measured by the Institutional Sector Non-Financial Accounts, has been displaying positive trends since Q3 2013 and in Q3 2014, the date for which the most recent data is available; it rose by 3% yoy. This was driven by a 7% yoy increase in compensation which was partially offset by a 11% increase in taxes & benefits. Disposable income should get a modest boost in 2015 due to the first non-austerity budget in seven years, which will see the net income of a one income, one child family on the average wage improve by 0.4%.

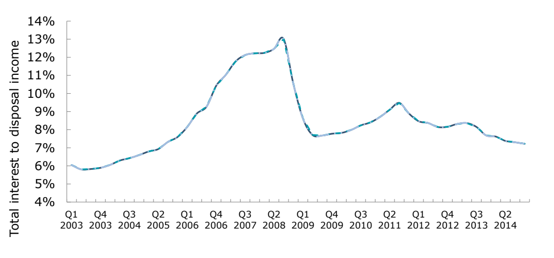
While the improvement in disposable income helped consumer confidence hit an 8 year high in September (and remains at this level in December) it has not as yet fed into consumption. Instead much of it is being siphoned into "savings" which can be seen in the stubbornly high savings ratio. This peaked in H2 2009 at just over 16% and came down slowly until it dipped below 10% in Q1 2013 before rising above 12% again at the end of 2013. In Q3 2014 it stood at 12.2%. While there is a precautionary element to this increase in savings, deleveraging is playing a large role. We estimate that just over half of savings are been used in this way. With total household liabilities still c.190% and set to fall slowly (we expect it to be 168% at the end of 2017) this dynamic will continue to act as the major headwind to the consumer recovery.

Irish household debt levels set to remain high



Source: Central Bank, Goodbody

Irish household interest rate burden is reducing



Source: ECB, CSO, Irish Central Bank, Goodbody

Households are getting some relief from ECB rate cuts over recent years. Changes in the interest rate disproportionately impact Irish households due to the high level of tracker mortgage debt. We estimate that for every 1 percentage point change in the base rate, the proportion of disposable income used on debt servicing changes by 1.8 percentage points. As this rate has fallen from 4.25% at the start of the crisis in Q3 2008, to its current level of 0.05%, the proportion of Irish disposable income being used to service debt has fallen from 13% to 7% over that timeframe.

We expect the positive momentum in the labour market to continue in 2015, albeit at an uneven pace across the country. Employment is expected to grow by 2.5%, while the unemployment rate is expected to fall to 9.2%.

Labour market forecasts

	2010	2011	2012	2013	2014f	2015f	2016f
Employed (Q4)	1,857	1,845	1,843	1,902	1,926	1,973	2,005
% yoy	-3.4%	-0.7%	-0.1%	3.2%	1.3%	2.5%	1.6%
% yoy (4 Q average)	-4.0%	-1.8%	-0.6%	2.4%	1.7%	2.2%	1.9%
Unemployment rate (Q4)	14.7%	14.9%	14.2%	12.2%	10.8%	9.2%	8.1%
Wage growth	-1.9%	-0.5%	0.5%	-0.7%	-0.5%	1.3%	1.6%

Source: CSO, Goodbody

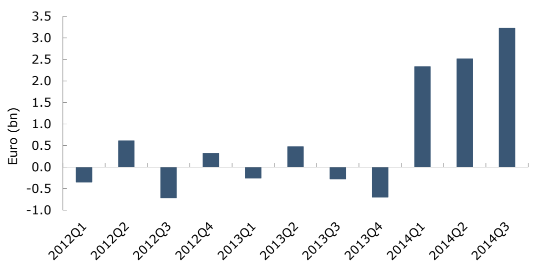
Is the data inflating the growth picture?

While statistical noise is nothing new in Irish economic data, there was more scrutiny than usual in 2014. This is primarily due to unusually large adjustments to the export data due to a phenomenon called "contracted production". Essentially, contracted production is when an Irish entity contracts a plant abroad to produce a good or service to supply to another country. This transaction would not be captured in the monthly trade data as no goods crossed the border, but would show up in the national accounts data as the economic ownership of the good prior to sale is Irish. While this is not a new issue, the adjustments seen in the first three quarters of 2014 are large in an historical context.

In the Budget 2015 document, the Department of Finance cautioned on these issues and stated that *"contracted production involves very little employment effect or second-round impact on the wider economy".* This may indeed be the case, but looking at this issue on its own may be overly simplistic. While contracted production is counted as an export in the national accounts, there is also likely to be royalty payments associated with this type of activity, thus the effect on GDP will be reduced. The following two charts attempt to capture these two issues.

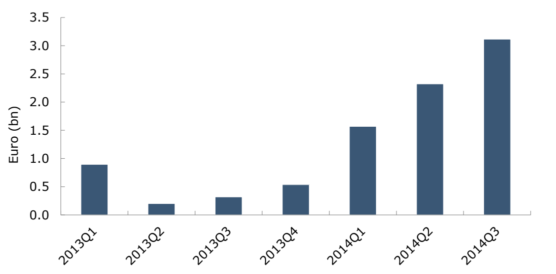
The first chart shows the growing difference between the monthly merchandise trade statistics and the broader national accounts data. There has been a clear step-change since the first quarter of 2014 in this adjustment. However, as the chart on the right shows, this has been accompanied by a large increase in the net imports of royalty payments, which subtract from GDP growth. While it is very difficult to link the two directly, it is likely that the two issues are related.

Annual adjustment to trade data



Source: CSO

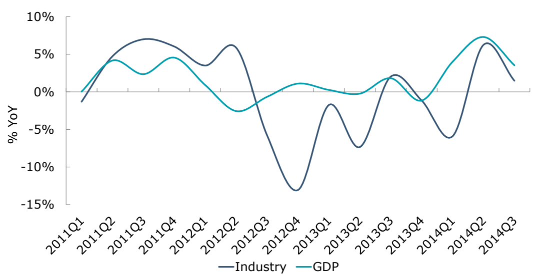
Annual change in import of royalties



Source: CSO

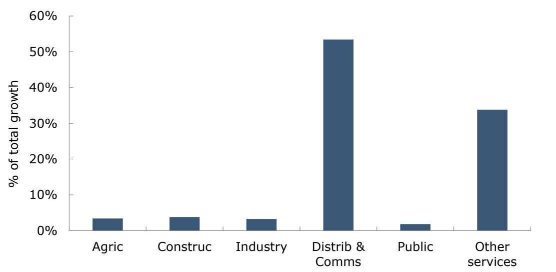
An additional factor that leads us to believe that the issue of contract manufacturing is being overstated is the fact that industry is not making a significant contribution to Irish output.

Industry growing slower than GDP



Source: CSO

Contribution to 2014* growth by sector



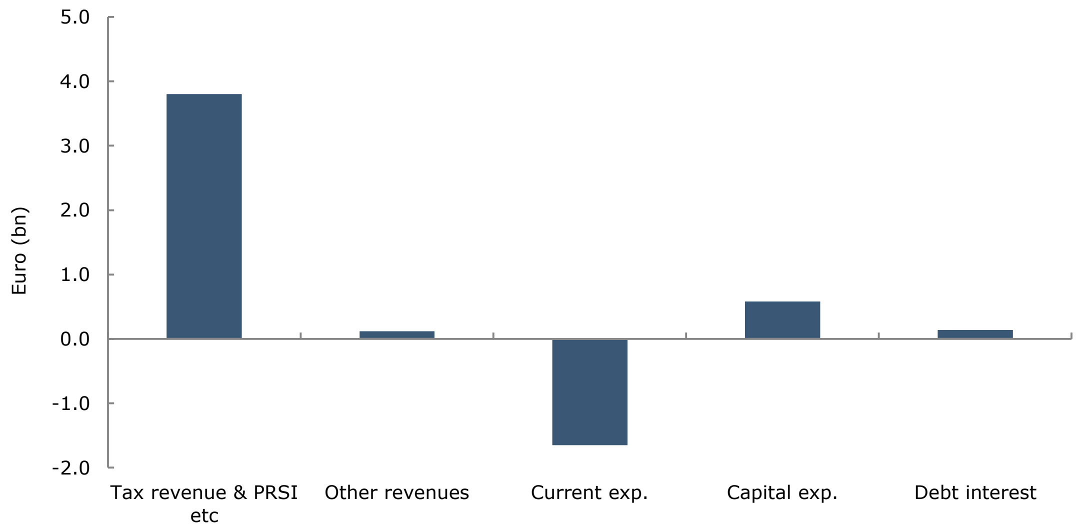
Source: CSO, Goodbody * Q1-Q3

Public finances – strong trends but complacency must be avoided

Ireland has continued to make strong progress in reducing its budget deficit. In 2014, the deficit is estimated at 3.9% of GDP, down from 5.7% in 2013. This is well inside both the original government forecast (4.8%) and the target set for Ireland by the EU under the Excessive Deficit Procedure. This has continued a theme since 2011 and acted to enhance the credibility of Ireland and its fiscal policymaking.

With final Exchequer data now available for 2014, we can see strong economic growth was the major reason for the closing of the deficit. The chart below captures these moving parts. Total revenues grew by 8% last year to €56bn, with tax revenues being the primary contributor to this performance. Tax revenues grew by 9% in 2014, with all the major tax headings growing impressively.

Components of change in public finances - 2014

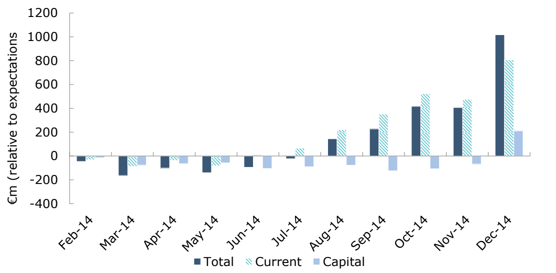


Source: DoF

Lower spending also contributed to the fall in the deficit in 2014, falling by 1.4% to €64bn. However, much of this can be attributed to the absence of the payment for the liquidation of IBRC that occurred in 2013. Gross voted spending fell by 1% (-€506m) but this was €1bn (2%) ahead of government expectations. There was also an unexpected payment of €461m to Irish Water. Although this is said to be a one-off payment, the treatment of that entity in the government accounts is uncertain at this point in time. Relative to government expectations, the biggest underspend came on the interest bill, as Ireland was able to take advantage of record low sovereign funding costs. The interest bill on the national debt was up by €150m but this was €700m below expectations.

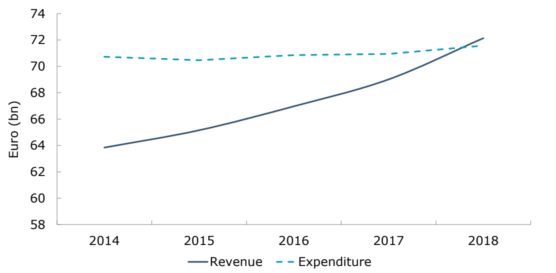
The key point here is that there was a slippage in spending prudence seen in 2014, with this slippage occurring in the second half of the year in particular (see chart below). Some loosening of the purse strings is to be welcomed on the capital spending side but the majority of the spending overshoot was current spending, which is more difficult to correct. For 2015 and beyond, Budget 2015 forecast that spending would remain flat at 2014 levels all the way out to 2018. This included the technical assumption of no increase in the public sector wage bill following the end of the Haddington Road Agreement. This appears to be an unrealistic assumption given the improving labour market. Moreover, the government is likely to be under pressure to loosen the purse strings ahead of next year's General Election, not to mention the growing costs associated with the aging of the population over the coming years.

Spending overruns in H2 2014



Source: DoF

Revenue growth expected to close deficit



Source: DoF

Although we believe that the strength of the economy will be sufficient to bring the budget deficit below 3% of GDP next year, we would caution against abandoning fiscal prudence after the hard work of recent years, especially in the context of public expenditure which remains historically high.

Debt levels have indeed peaked, with 2014 being an important line in the sand in this regard. Gross debt stood at 108% of GDP at the end of 2014, down from 123% at the end of 2013. Netting off the cash holdings (€13bn) and the bank and other assets (€20bn), net debt is c.90% of GDP, close to the European average. However, debt is still high in an historical context, thus giving little room for manoeuvre in the event of another economic shock, from Europe or elsewhere. The government has also committed to reach a structural primary balance by 2018 under the Fiscal Treaty.

Goodbody fiscal forecasts

	2010	2011	2012	2013	2014f	2015f	2016f
Budget Deficit (% of GDP)	-30.1%	-12.6%	-8.1%	-5.7%	-3.9%	-2.8%	-2.2%
Excluding Banking costs	-11.0%	-8.6%	-8.1%	-5.2%	-3.9%	-2.8%	-2.2%
General Government Debt (% of GDP)	87%	111%	122%	123%	109%	108%	105%
Interest/GDP	2.5%	3.1%	3.6%	4.4%	4.0%	3.6%	3.5%
Primary balance	-8.5%	-5.6%	-4.4%	-0.8%	0.1%	0.8%	1.2%
Average interest rate	3.9%	3.6%	3.3%	3.6%	3.4%	3.5%	3.3%
Assumed interest rate on new debt	5.0%	4.0%	4.0%	3.0%	3.0%	3.0%	3.4%
GDP growth (real)	-0.3%	2.8%	-0.3%	0.2%	5.0%	4.0%	3.8%
GDP growth (nominal)	-1.9%	3.7%	1.0%	1.2%	6.2%	5.1%	4.0%

Source: DoF, Goodbody

Conclusion

2015 is set to be an interesting year. It is clear that the Irish economy has significant momentum and will be the fastest growing economy in the euro area, but that doesn't mean there are no challenges to be faced. We have highlighted some of these challenges in this report, ranging from the rising political difficulties both domestically to effect of deflation and QE in the euro area. Irish policymakers have been correctly lauded for their management of the bust over recent years. Its challenge now is to manage the boom and ensure that the recovery remains a sustainable one.

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