

# Irish Business Making Slow Progress As Uncertainty Hits Activity



- Business activity increased again in the third quarter but the pace of improvement has slowed of late.
- Further modest output gains seen in final months of 2012.
- Domestic activity may be stabilising but the consumer sector is showing renewed weakness.
- Hesitant recovery means job market remains under pressure.
- Increased uncertainty emerging as the key issue for Irish business at present—as spending and hiring are postponed.

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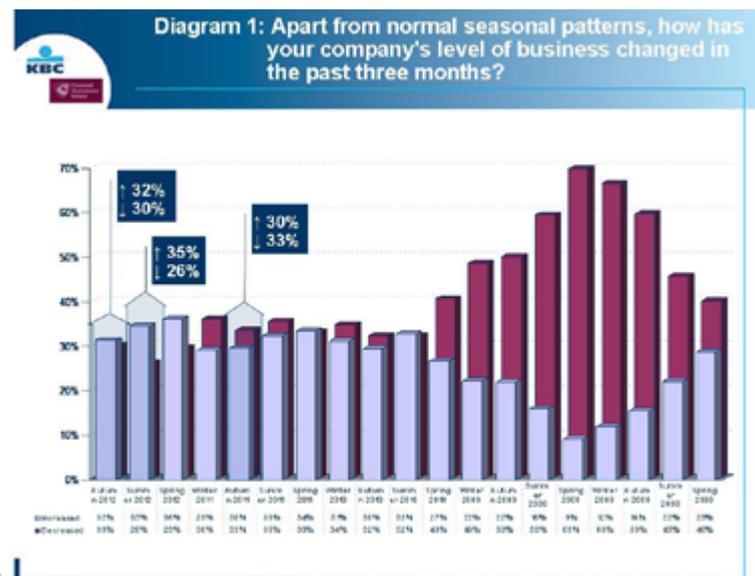
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## Section I: Irish Business Sentiment in Autumn 2012

### Activity Improving Slightly

The Autumn 2012 results for the KBC Bank Ireland/Chartered Accountants Business Sentiment survey suggest the Irish economy may be growing marginally but it is struggling to build any substantial forward momentum. Although diagram 1 below shows that companies reported a modest improvement in their business volumes in the past three months, the balance between positive and negative responses was smaller than in either of the two previous quarters. The Autumn survey shows both a decline in the number of positive responses and an increase in negative responses compared to the summer survey. Slightly fewer firms are reporting further growth and increased numbers are seeing renewed weakening than was the case in the Summer survey even if positive responses continue to exceed negative responses overall. So, the Irish economy appears to be inching forward rather than seeing a clear broadening and strengthening of activity that would normally be expected in a recovery phase of the typical economic cycle.

As noted elsewhere in this report, the Autumn results may be heavily influenced by the impact of increased uncertainty in relation to the economic outlook both in Ireland and elsewhere of late. Current conditions where future 'visibility' is much reduced run contrary to the recovery phase seen in a normal cycle. In a recovery phase, uncertainty usually diminishes and firms tend to make forward-looking decisions on their output and employment levels. In the absence of clarity in regard to the future, firms are now likely to adopt more 'defensive' positions in terms of spending and hiring as the consequences of being too 'lean' are perceived as less threatening to the company's prospects than the impact of having to cut capacity in the future. In this manner, increased uncertainty may represent a significant impediment to the emergence of stronger conditions across the Irish economy at present. The Autumn survey suggests that companies are cautious and reluctant to commit in terms of additional activity and hiring. As this hesitancy seeps through the Irish economy, it acts as a significant obstacle to the progressive step-up in growth usually seen in an upswing.

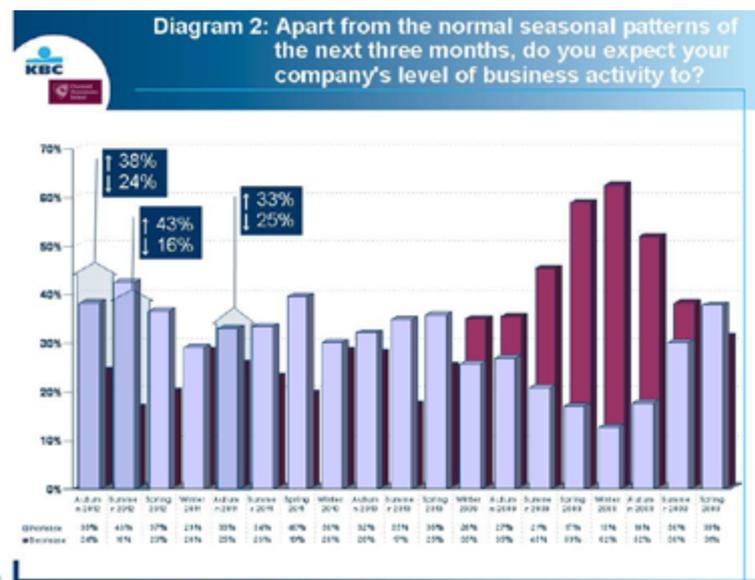


The Autumn survey results suggest renewed softness in activity was particularly evident in those sectors supplying the domestic market. In turn, this weakness was principally

**focussed on the Irish consumer.** This is disappointing given that tentative evidence of an improvement in these areas reported in the Summer survey appeared to have been confirmed by recent official data such as service sector output and retail figures for July and August. The Autumn Business Sentiment survey does point towards ongoing growth in areas such as business services that have a significant domestic component but at a slower pace than previously seen. It also points to a broadly flat outturn in construction that is broadly consistent although marginally weaker than the Summer quarter. However, this quarter's survey shows renewed weakness in those companies focussed on the Irish consumers. A decline in the domestic market was also the main driver of a poorer outturn in food related companies. **In contrast, manufacturing companies reported some acceleration in growth** following a more modest expansion reported in the Summer survey. This is encouraging but slightly surprising in the context of most global indicators of late. However, it seems consistent with other evidence suggesting a measure of resilience in Irish manufacturing.

## Modest Improvement In Business Expected By End Year

The Autumn survey suggests that business volumes are expected to increase again in the final quarter of 2012 but, again, the pace of expansion is somewhat slower than envisaged three months ago as diagram 2 shows. While there was a small decline in the number of firms reporting an expected increase in activity, the most notable aspect of responses to this question was a significant increase in the number of companies that expect weaker activity in the final three months of the year.



The further softening in the growth outlook anticipated for end 2012 was fairly broadly based. **The notable exception was manufacturing**, where there was a slight increase in the number of firms forecasting stronger activity but, interestingly, there was also a much larger decline in the number of companies anticipating weaker business volumes at the end of 2012. This result contrasts with the general tone of the survey and also with the tone of manufacturing responses in the Summer survey. **In these respects the Autumn survey points towards an increased convergence across manufacturing towards healthier growth but it also suggests a more notable divergence in business conditions between manufacturing and most other areas of the Irish economy in late 2012.**

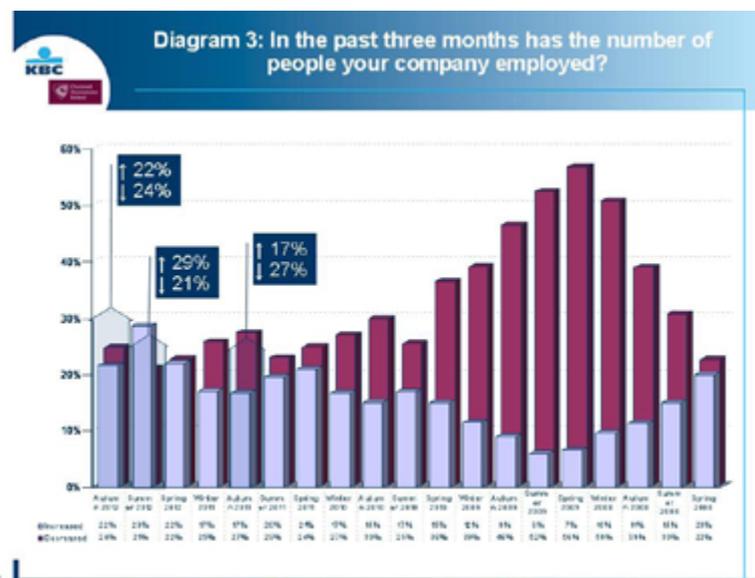
As has been the case for the past couple of surveys, construction companies again reported

expectations of modest increases in activity between now and end year. This is encouraging but it has to be seen in the context of the scale of the decline in this area in recent years—a drop of about two-thirds both in terms of construction output and employment in the sector since 2007. So, it shouldn't be entirely surprising to find some signs of stabilisation in activity five years into the downturn. **Companies in the business services area continue to report expectations of solid growth** in the coming quarter but the tone of the Autumn survey was somewhat weaker than three months ago. There was a slight drop in the number of firms expecting stronger activity and a somewhat larger increase in firms expecting weaker conditions.

**Arguably, the most disappointing aspect of the Autumn survey is the weakness of responses coming from firms focussed on the Irish consumer.** Having reported a notably poorer outlook for the past three months, these anticipate a further weakening in the final three months of 2012. **At the margin, this deterioration may reflect some increase in living costs of late but it probably owes more to growing nervousness among consumers that is causing all but the most necessary elements of spending to be deferred until uncertainty about the possible range and scale of austerity measures in Budget 2013 diminishes.**

## Irish Jobs Market Still Soft

With business volumes showing only modest growth in the past three months and expectations of only a limited improvement before end year, it is scarcely surprising that **companies reported that job market conditions weakened in the most recent quarter.** As diagram 3 shows, there was a drop in the number of firms reporting increased employment and a broadly similar scale increase in the number of firms where employment fell in the past three months. While the overall change in employment levels is marginal, **the Autumn survey does suggest something of a setback for the Irish jobs market** in the light of a tentative improvement three months ago.

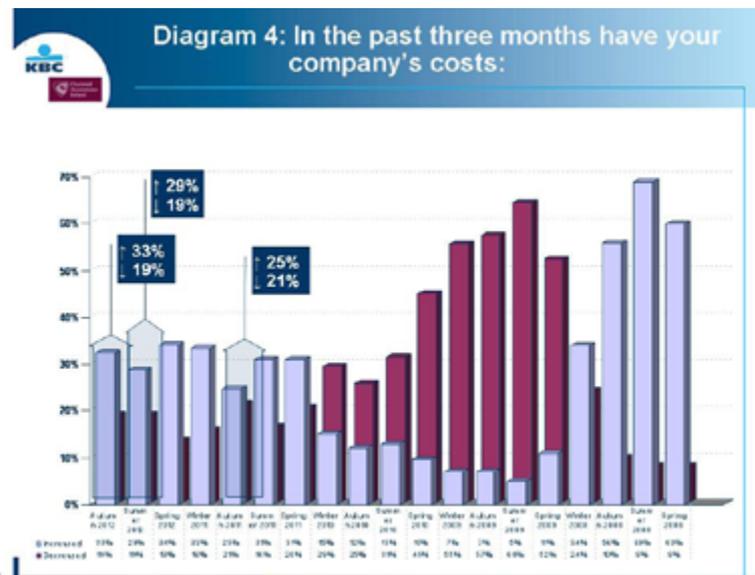


**The softer jobs market responses appear to be largely the result of poorer domestic conditions.** Manufacturing firms again reported a very positive jobs performance with 50% of firms in this sector indicating their headcount had increased in the past three months. Somewhat surprisingly, in view of the reasonably healthy trend in activity in the business services area, companies in this area reported a fall in payrolls while twice as many companies

in the consumer area reported declining employment as indicated they had increased headcount. **These responses** to the jobs component of the Autumn Business Survey **are not entirely surprising**. In tandem with answers given to the activity questions, **the survey highlights that a damaging circular linkage between weak domestic activity and poor jobs market performance remains firmly in place**. Increased uncertainty of late is adding to this problem as firms are likely to postpone additional hiring until the outlook for activity becomes clearer.

## Costs Rising In Some Areas

As diagram 4 shows there **has been a continuing if modest pick up in business costs in the past three months**. This increase was largely concentrated in three sectors and may reflect the influence of somewhat similar factors. Far and away the sharpest increase in costs was reported by firms in the food sector. The majority of companies in this area reported that their costs had risen in the past three months. A poorer cost environment was also reported by consumer-focused firms where there was a significant drop in the number of firms reporting lower costs and a slightly larger increase in companies signalling higher costs of late. As a result, this sector moved from one of generally declining costs to modestly higher costs in the Autumn quarter. Although cost developments were not the dominant factor, this poorer cost climate likely contributed to the very disappointing business volumes reported by consumer focused firms. This is because rising costs make it harder for firms to provide the sort of heavy price discounting needed to lure hesitant consumers into making additional purchases.



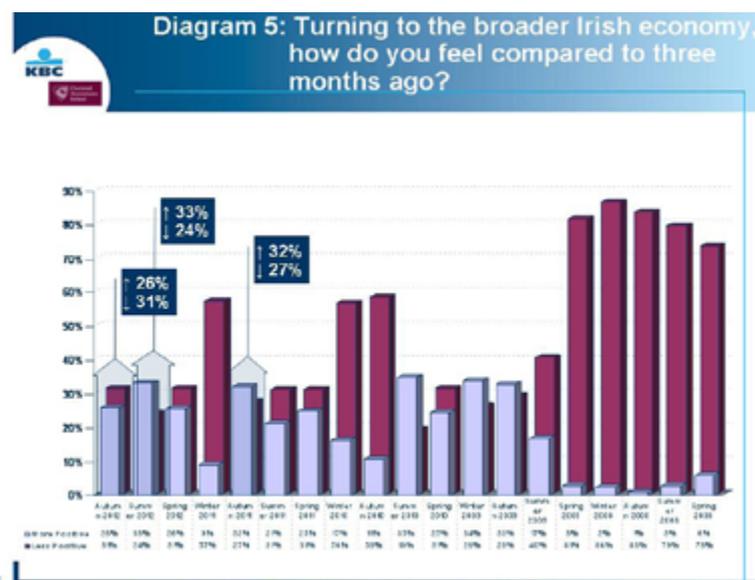
Manufacturing firms also reported a poorer cost environment of late. The number of manufacturing firms reporting lower costs declined sharply and while the number of firms reporting higher costs rose only marginally, this was enough to move that sector into modestly increased costs overall. In contrast, responses by firms in business services and construction showed little change in costs from the Summer survey. This might suggest that **increases in global food and energy prices, possibly augmented by the weakening of the euro on FX markets, have been more important to the uptick in Irish business costs than changes in the prices of domestic inputs**. It may also be that relatively weak activity levels are acting against rising costs in domestic focussed sectors.

## Economic Sentiment Weakens Sharply

While growth in business activity has continued, the tone of the Autumn survey is marginally softer in terms of the performance of Irish companies of late. As such, **the survey results appear consistent with marginally positive growth in the Irish economy as a whole in the past three months. However, business sentiment in relation to the broader economic situation saw a significant deterioration** that reversed the improvement in confidence reported in the previous survey.

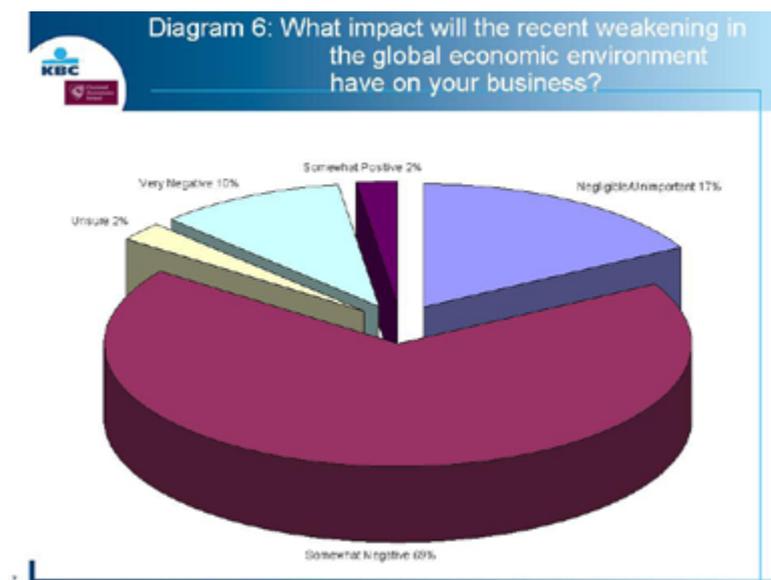
**The renewed pessimism** shown in diagram 5 was broadly based but the change was **most marked in those companies with a significant exposure to domestic economic conditions.** In the Summer survey, nearly twice as many firms in the business services sector had reported increased optimism as reported reduced optimism. This balance has turned negative in the Autumn survey. Similarly, three months ago companies focused on Irish consumers reported a marginally positive balance in their answers to this question. However, in the Autumn survey three times as many consumer firms reported reduced confidence as reported an improvement. So, it would appear that sentiment towards the domestic economy has undergone a sharp deterioration in recent months. An analysis of responses to supplementary questions asked in the Autumn survey is set out in Section II of this report and appears to offer some specific reasons for this worsening of sentiment. It should also be recognised that poorer sentiment also partly stems from disappointment with the business environment that companies face at present.

It is important to note that **the Business Sentiment survey was carried out in the second week in October.** This meant **perceptions of the Irish economy were likely influenced by very gloomy comments on the global economy by the IMF, some weaker Irish growth and jobs data for the second quarter, doubts about whether Ireland would win significant concessions from Europe on its banking related debt and, importantly, a flurry of recent speculation about how awful Budget 2013 might be.** Against this backdrop, the weakening in business sentiment can't be regarded as surprising. The problem is that poorer sentiment will tend to influence the level of spending and hiring that companies will undertake in the months ahead.



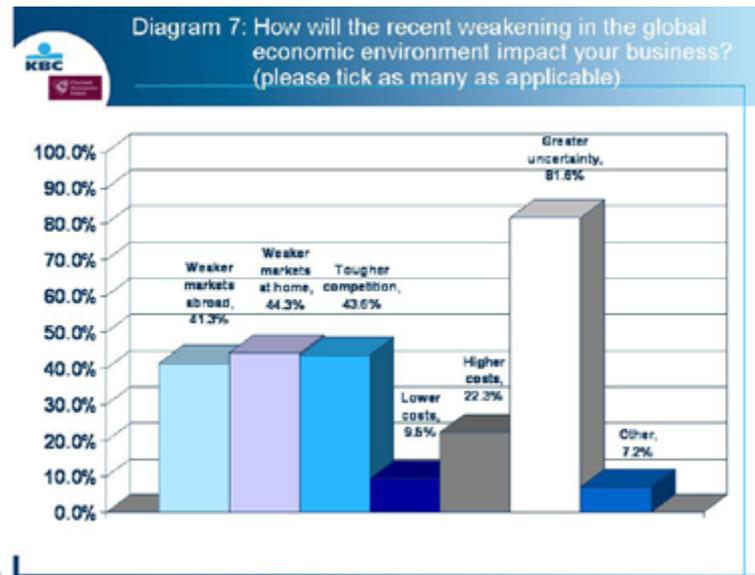
## Section II: Supplementary Questions

As usual, the Autumn Business Sentiment survey included a number of supplementary questions that are intended to shed some light on the importance or otherwise of various topical economic issues. We first asked whether respondents felt the recent deterioration in global economic conditions was of importance to the outlook for their own businesses. As diagram 6 shows, the vast bulk of firms see a poorer global backdrop having a negative effect on their activity levels. Only 10% see a very negative effect but a very large 69% see some negative impact. **The open nature of the Irish economy and its current fragile condition are underlined by the fact that only 17% of companies see a poorer global backdrop as unimportant to the performance of their business.**



We then asked companies to indicate how a poorer global environment would affect their business. In their answers to this question shown in diagram 7, we allowed companies to give multiple responses to get some sense of the range of channels through which a weaker global economy might translate into pressure on Irish companies. As diagram 7 indicates, **far and away, the most broadly based concern for Irish business at present is the impact of increased uncertainty. Some 82% of the firms that responded to the Autumn survey indicated that greater uncertainty would have an effect on their business.**

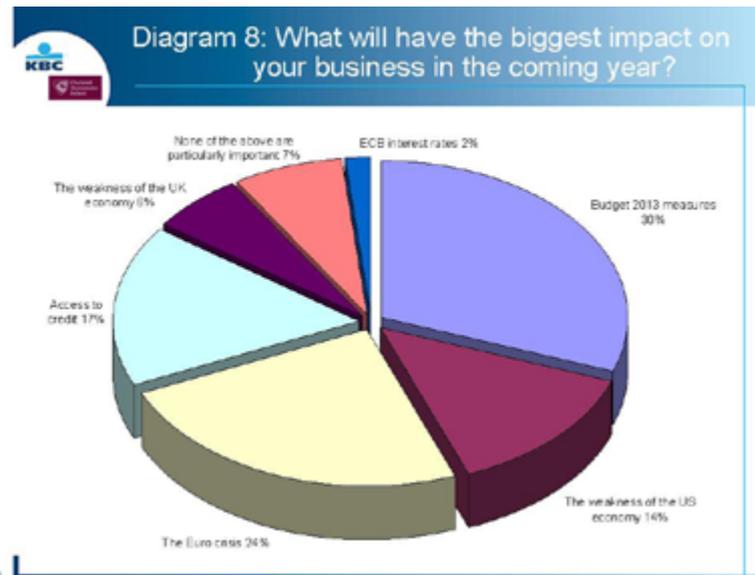
As noted in the analysis of recent trends in business activity set out in Section I of this report, the current economic situation is abnormal in the sense that there are a few signs of a progressive improvement in economic conditions that builds confidence and reduces nervousness and in this manner causes companies to step up their production and employment and consumers to step up their spending. Instead, **widespread and increasing uncertainty is leading to an economic ‘stand-off’ in which households and businesses postpone all but essential outlays until the economic environment becomes clearer. Unfortunately, in a fragile economy, this could threaten the fledgling recovery.** The Irish economy may struggle to generate sufficient momentum to reach ‘escape velocity’ from the downturn and move into a clear recovery as long as uncertainty and nervousness dampens spending.



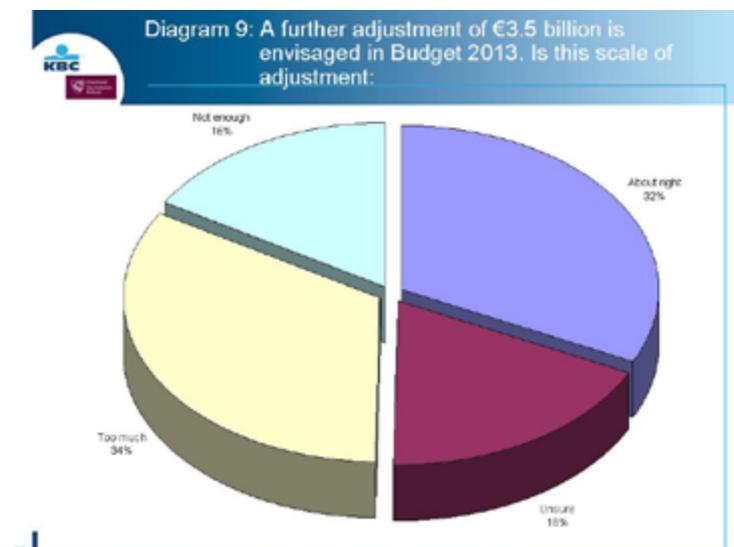
The Irish economy faces many headwinds but the Autumn survey suggests the economic and business consequences of uncertainty may be substantial. The evidence of the Business Sentiment survey and many other indicators suggest **the Irish economy entered a ‘bottoming out’ process as far back as Summer 2010 and this quarter’s survey implies it remains at the broadly same stage more than two years later. In part, this extended process reflects a range of ‘known’ constraints on growth both at home and abroad in the aftermath of the crisis but it may also owe an increasing amount to the influence of ‘unknowns’ as uncertainty dominates the planning environment. The Autumn 2012 Business Sentiment survey suggests reduced visibility in terms of the economic outlook is causing businesses to move very cautiously.**

Of course, Irish companies face many forms of fallout from a difficult global backdrop with weaker markets and tougher competition all expected to weigh on business volumes. However, across all sectors, heightened uncertainty was regarded as the most important negative influence at present by some distance. Understandably, weaker markets abroad and increased competition figured relatively heavily as a concern for manufacturers while weaker home markets was a key concern for consumer focussed companies. Similarly the diverse nature of the business services sector means it is not surprising that broadly similar numbers of companies cited weaker home markets, weaker markets abroad and tougher competition as the second major concerns after increased uncertainty.

We then asked companies to identify the key economic factor that they thought would have the biggest bearing on their business in the coming year. The answers shown in diagram 8 suggest **Budget 2013 is regarded as the single most important determinant of business prospects in the year ahead**, with 30% of companies identifying it as the key influence. The Euro area crisis was also regarded as the key issue for the coming year by only slightly fewer companies (24%). Lagging somewhat behind these issues there was broadly similar emphasis on access to credit (17%) and the weakness of the US economy (14%). Perhaps surprisingly the weakness of the UK economy did not feature prominently as a concern and was cited by just 6% of companies. This may reflect the improvement in Irish competitiveness as well as an expected improvement in UK consumer spending. Even less significance was attached to the ECB interest rate environment presumably reflecting the view that official ECB rates are set to remain very low for the foreseeable future.



As might be expected, there were some sectoral differences in response to this question. Understandably, the Budget was a particular concern of domestic focussed companies. 51% of consumer companies cited the Budget as the key factor as did some 44% of construction companies. In contrast, only 23% of business services companies and just 7% of manufacturing firms identified the Budget as the key factor for their prospects. The Euro crisis was seen as the most important issue for companies in business services and food sectors. For manufacturing firms, the weakness of the US economy and the Euro crisis were of equal importance. Access to credit was relatively important to construction and property firms (although not as important a factor as Budget 2013) and, perhaps surprisingly, also cited somewhat more frequently by manufacturing firms than by companies in other areas. It might be speculated that this reflects credit-related issues in these companies' export markets rather than their own funding circumstances but the survey doesn't provide clear answers in this regard. Concerns about the UK economy did not figure widely but were cited more frequently by construction companies than by those in the manufacturing or food sectors. This may reflect the increased importance of the UK economy as an alternative 'home' market for some Irish building firms. Presumably reflecting the current low level of ECB interest rates and broadly based expectation that official rates will remain low, ECB interest rates did not feature significantly as a major concern for the coming year.



**We also asked companies about their views on Budget 2013.** As diagram 9 indicates, opinion is very much divided as to how large the looming adjustment in the Public Finances should be. Not surprisingly, a relatively small 16% of those surveyed suggest the Government should contemplate a larger adjustment than the €3.5 bio currently envisaged. However, the fact that only 34% of companies feel the adjustment should be smaller than currently envisaged implies that there is a reasonable level of support for the current target. The survey also asked whether the €3.5 bio adjustment was too heavily weighted towards increases in taxation or cuts in public spending. Again, the composition of this particular survey means the finding that 68% of companies felt the Government were placing too much emphasis on tax increases while only 8% felt the burden fell too heavily on public spending cuts is not particularly surprising. Irish companies are likely to feel taxation increases have a more direct impact on domestic demand and/or their cost base and their responses reflect this concern.