IRISH CONSUMER MONITOR

FEBRUARY 2013

Driving Ireland's Recovery

Consumer spending power to improve in 2013 and 2014

On average, the spending power of Irish households will remain almost unchanged in 2013, with a marginal increase of 0.2%, and we have pencilled in slightly stronger growth of 0.7% for 2014. Mortgaged working households will again see the greatest gain in their discretionary incomes or spending power. However, many costs such as health will increase again in 2013, and the spending power of households on fixed incomes will fare worse than working households, although unemployed households will be the only ones recording significant drops in income.

Crucially for the year ahead, we argue that many observers have overstated the impact of the local property tax. As it replaces the existing flat household charge of €100, and is only charged for a six-month period this year, we estimate that the additional cost for working households will be €150 in 2013, or 0.3% of after-tax income, and a further €150 in 2014.

Nonetheless, such an emotive issue may have an effect through a negative impact on consumer confidence, and the KBC Bank/ESRI Consumer Sentiment Index in December 2012, just ahead of the budget, recorded one of the biggest declines on record. However, despite the initial reaction, the drag on confidence should diminish as householders assess and absorb the real impact on their finances.

Overall, many of the fundamentals for the domestic economy are now stabilising. The private sector began to add jobs during 2012, a tentative bottoming-out of house prices means that household net wealth is no longer falling and indebtedness is on a downward path, albeit from high levels. Consumer confidence and its interaction with the savings rate, which is at a high level, will be crucial determinants of household spending decisions for the next few years.

It is likely that, in the absence of further bad news, consumer sentiment should recover during 2013. In particular, if a deal can be reached on promissory notes, this could provide a substantial boost for confidence – but any unforeseen shocks likewise pose a risk to the fragile recovery seen to date. It appears that the worst is now over for the consumer market, but a more substantial improvement in both fundamentals and sentiment is required before more robust growth in spending will emerge. For this year we have pencilled in no change in consumer spending and growth of 1% in 2014.

Factors influencing consumer spending	2013	2014		2013	2014
Gross income	Positive change	Positive change	Employment	No change	No change
After-tax income	No change	No change	Net migration	Negative change	Negative change
Mortgage interest	Positive change	No change	Savings ratio	Positive change	Positive change
Discretionary income	No change	No change	Consumer confidence	?	?

● Negative change ● No change ● Positive change

Consumer spending power stabilised in 2012

Average Irish consumer spending power during 2012 was essentially flat; this follows a very difficult 2011, when spending power fell by about 6%. Modest income growth last year for some working households coupled with a significant drop in interest costs saw mortgaged households record a 2.6% improvement in their discretionary income or spending power. However, other household types saw varying degrees of decline in their discretionary incomes. The savings ratio is now the main moveable part determining consumer spending and remains high. Despite a much better second-half performance in 2012, annual consumer spending is estimated to have fallen by 1.2% in volume terms but increased by 0.5% on a value or turnover basis.

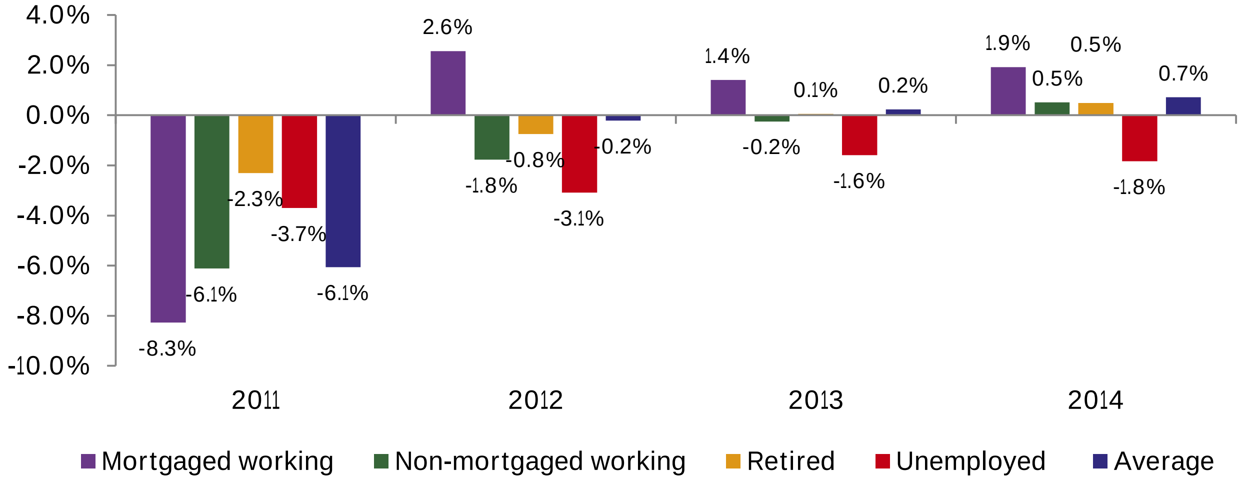
In our analysis we consider four distinct household types – mortgaged working, non-mortgaged working, retired and unemployed/other – which we see facing very different income and expenditure trends. We examine the change in after-tax income for each household type, factoring in developments in major cost items such as mortgages, energy and health. This enables us to estimate the movement in discretionary income or spending power. Along with developments in the savings ratio and employment, our estimate of discretionary income changes is used to forecast overall consumer spending for the economy.

Average gross incomes for working households increased marginally during 2012 and the bulk of the tax increases were accounted for by the VAT hike rather than directly out of income. Mortgaged working households (31% of total) recorded an average gross household income of just short of €76,000, about €20,000 greater than that for non-mortgaged working households (34% of total). The average annual mortgage cost for the 520,000 households making mortgage payments was €9,650 in 2012, about €1,000 lower than in 2011, mainly due to the impact of falling interest rates.

Although inflation was relatively modest last year, averaging at 1.7%, there were some significant increases in the largest household bills such as energy and healthcare. Utility costs were up 8.5%, while the price of motor fuel increased by about 9%. Following further sharp increases in medical insurance, average healthcare costs were about 15% higher in 2012. Despite these higher bills, the total discretionary income of mortgaged working households was 2.6% higher last year. For non-mortgaged working households, which did not experience the bounce of lower mortgage interest, discretionary income fell by 1.8%.

For households on fixed incomes 2012 was more difficult. Retirees had an average household income of €38,885, made up of a combination of occupational pensions, state pensions and other income sources (including investments). While state pensions were static, many with occupational pensions would have benefited from an index-linked increase and may also have experienced some modest increases in other income. Nonetheless, higher costs meant that the discretionary income of retired households fell by 0.8% last year and was down 3.1% for unemployed households.

Change in discretionary income by household type



Outlook for consumer spending in 2013 and 2014

The average discretionary income for Irish households will be almost unchanged in 2013 (+0.2%) and is forecast to grow by about 0.7% in 2014. Mortgaged working households will see the greatest gain in spending power. However, many costs such as health will increase again in 2013, and the spending power of households on fixed incomes will fare worse than working households.

Working households	2011	2012	2013(f)	2014(f)
Home fuel and light	2,325	2,558	2,686	2,686
Motor Fuel	2,936	3,200	3,040	3,040
Health Costs	3,233	3,718	4,016	4,418
Pension and life insurance	4,395	4,395	4,439	4,483
Mortgage payments	10,967	9,650	9,200	9,100
Mortgaged households				
Gross income	75,133	75,884	76,643	78,176
Post tax income	60,661	61,267	61,657	62,740
Discretionary income	36,805	37,747	38,277	39,014
% change	-8.3%	2.6%	1.4%	1.9%
Non-mortgaged households				
Gross income	55,000	55,550	56,106	57,228
Post tax income	43,706	44,143	44,377	45,115
Discretionary income	30,817	30,272	30,197	30,354
% change	-6.1%	-1.8%	-0.2%	0.5%

Gross incomes for working households will rise by about 1% in 2013 as a result of some modest wage growth and other income increases. Direct taxes in 2013 will be higher, with the greatest impact arising from the Budget 2013 changes to PRSI. However, we argue that the impact on spending power of the local property tax, only charged for a six-month period this year, has been overstated by many observers. As the property tax replaces the existing flat household charge of €100, we estimate that the additional cost for working households will be €150 in 2013, or 0.3% of after-tax income, and a further €150 in 2014.

Mortgaged households will again record the largest improvement in spending power in 2013 as the lower mortgage interest costs of 2012 carry over into 2013. We have not factored in any further reduction in the ECB base rate, but this cannot be ruled out and thus represents a potential upside for mortgaged households for the year ahead. We expect utility costs to increase by an average of 5% this year, but have pencilled in a similar reduction in motor fuel costs, largely on the back of currency factors.

We estimate that mortgaged households will experience a 1.4% increase in spending power this year and an improvement of about 2% in 2014. At this stage we do not envisage meaningful changes to either interest rates or energy costs in 2014 and we expect that income growth will more than offset any further increases in taxation in Budget 2014.

Retired households will fare somewhat better this year than in 2012. They will benefit from marginal income increases but will also experience higher outgoings in utilities and health care. Overall, we estimate their spending power to increase by just 0.1% in 2013 and 0.5% next year. Income of unemployed households will continue to fall due to social welfare cuts and various changes to scheme eligibility and spending power will decrease by 1.6% this year and 1.8% in 2014.

Retired and unemployed	2011	2012	2013(f)	2014(f)
Retired households				
Gross income	38,500	38,885	39,274	39,863
Post tax income	36,612	36,985	37,274	37,863
Non-discretionary costs	6,638	7,238	7,511	7,953
Discretionary income	29,974	29,747	29,763	29,910
% change	-2.3%	-0.8%	0.1%	0.5%
Unemployed households				
Gross income	29,400	28,959	28,669	28,383
Post tax income	29,400	28,959	28,669	28,383
Non-discretionary costs	3,944	4,290	4,393	4,551
Discretionary income	25,456	24,669	24,276	23,831
% change	-3.7%	-3.1%	-1.6%	-1.8%

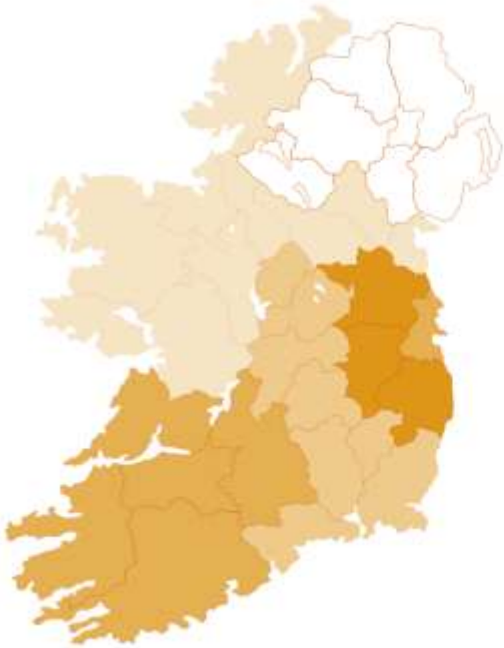
Since the start of the economic crisis, the living standards of households mainly dependent on social welfare payments have been somewhat protected by low inflation. During 2009-2010 average prices fell sharply and despite a more recent return of inflation, the price level in the economy remains 2.5% below where it was in summer 2008. However, over the coming years social welfare will remain fixed at best and price increases will continue to reduce spending power.

Income and household spend show sharp regional variation

The CSO's 2010 Household Budget Survey shows that weekly disposable household income (earnings and state transfers minus income taxes) rose only slightly from 2005, up 5% or €42. This is in sharp contrast to a 53% increase between 2000 and 2005. The five years between 2005 and 2010 of course contain two very different periods, with incomes rising initially, but recording sharp falls during 2009 and 2010. More recent data from the CSO indicates that incomes have now largely stabilised.

Income as % of national average

110-120% | 100-109% | 90-99% | 75-89%



The pattern of household income varies significantly across Ireland. Mid East has the highest disposable income at 120% of the national average. Households in Dublin have highest earned income, but also the highest income tax and social security deductions, and disposable income is 109% of the national average. At 25% below average border counties have lowest household incomes, followed by the West at 11% below average.

Despite the dramatic changes over the last few years, average disposable income remains higher than total weekly household expenditure. Once spending on food, clothing, heat and light, mortgages, rent and house-related payments, transport, medical outlays, education and holidays has been taken into account, households are left with €75 per week from the average weekly income of €885.

Transfer payments from the state have played an important role in supporting household incomes, an average 6.1% or €53 decrease in weekly earnings was offset by a 73% or €92 increase in transfer payments between 2005 and 2010. At €217 per week, state payments now make up 21% of gross household incomes. The role of state transfers also has a strong regional component, with nearly 28% of total household income in the Midlands and Border regions coming directly from the state. In Dublin and the Mid East this figure was around 15%, a marked difference. Some of this may be attributed to demographic differences with the level of retirees relatively high in the Border counties (15%) and persons working in the home high in the Midlands (19%).

Household weekly spending is highest in Dublin and the Mid East, driven by higher rent and mortgage costs. Digging deeper, the percentage of total income spent on food and drink is highest in the Midlands and Mid West; transport places the lowest burden in Dublin and highest in the Midlands and Border counties; and spending on childcare as a proportion of income is higher in predominantly rural regions.

Dublin has the greatest market size; annual household spend in the region (€22 billion) is more than double the second biggest market in the South West (€10 billion). The smallest market size is the Midlands with total spend of €3.6 billion. Looking at market density, Dublin is again in the lead with an annual spend of €24 million per km^2. The lowest spending density is in the West at only €450,000 per km^2. The stark difference between these figures underlines the challenges faced in doing business in rural areas, particularly for the retail sector.

Household expenditure by region in 2010

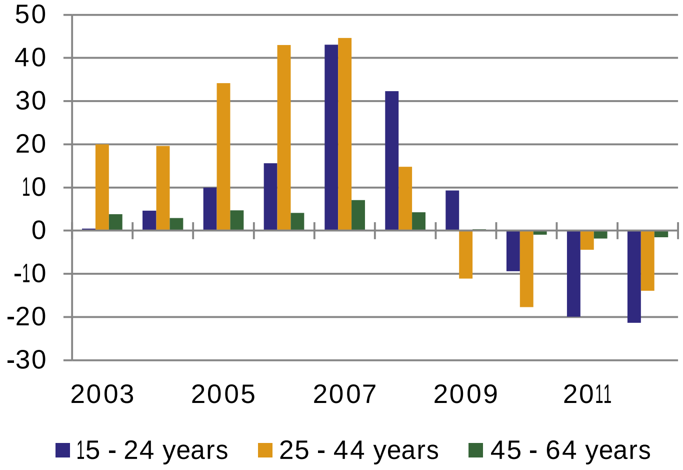
	Border	Dublin	Mid East	Mid West	Midlands	South East	South West	West	State
Household spend (€ per annum)	38,878	47,924	46,363	39,572	36,643	35,470	41,865	38,423	42,151
Market density (€1,000/km^2)	594	24,274	1,382	662	561	682	831	447	1,006
Market size (€ million)	7,222	22,375	8,377	5,460	3,660	6,416	10,103	6,163	69,726

Migration remains key determinant of demographic trends

The major demographic trend to emerge as a result of the economic crisis is the return of emigration. Just over 50,000 people moved to Ireland in 2012, a third of the inflow at the peak, while emigration at 87,000 was three times higher than before the recession. As a result, net emigration in 2012 was the highest since 1989.

The bulk of those departing the country have been in younger age groups, which traditionally tend to spend a larger proportion of their income. Net emigration in 2012 was highest among 14-24-year-olds, followed by 25-44-year-olds. This latter group also recorded the highest immigration, slightly offsetting the impact of accelerated emigration. In other age groups migration flows are negligible, though there remains a small positive inflow of children below the age of 15.

Net migration by age group (000s)

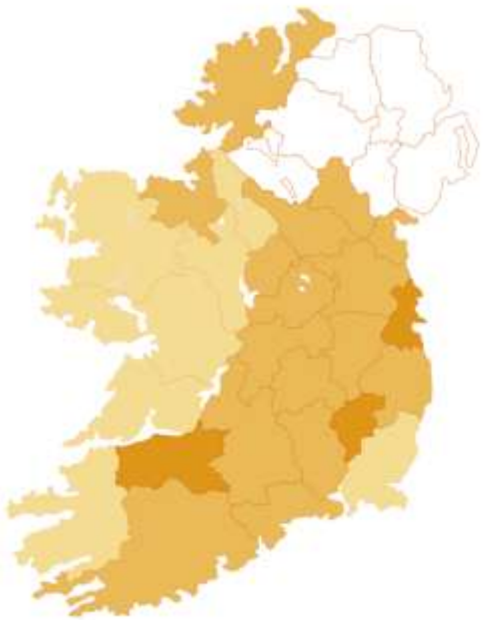


These trends are not only socially important, but also affect the consumer landscape; in particular, older age groups now constitute an increasing proportion of the market. Cities such as Galway (23%), Dublin (21%) and Cork (20%) have the highest numbers of people aged 20-29. Connaught and the West on the other hand have the lowest share of residents in this important consumer demographic: Clare, Roscommon, Mayo, rural Galway and Leitrim all have less than 12% of their population in the age group. As well as migration patterns, the changes reflect increased job opportunities in urban areas and consequently greater numbers of younger consumers.

The abrupt reversal in migration patterns that resulted from the crisis demonstrates the extraordinary openness of the Irish economy. Emigration will remain dominant for the next few years; however, when the economy gains momentum, Ireland may well see the return to net immigration. It is likely that many Irish emigrants will return as prospects here improve, but given the high living standards, Ireland is also an attractive destination for non-Irish migrants. Two policy challenges stand out: ensuring that Ireland remains open to high-skilled individuals, and the need to address sharp regional disparities.

% of 20-29-year-olds by county

10-11.9% 12-13.9% 14-18%



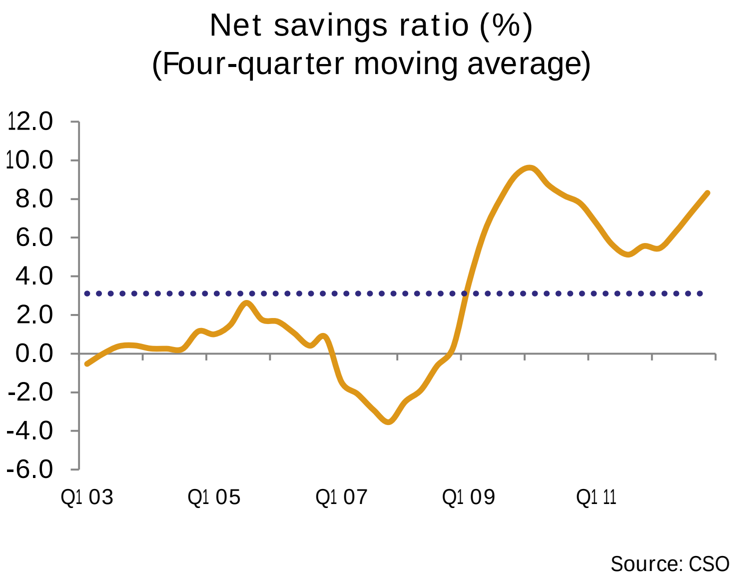
Changes to the labour market as a result of the crisis have formed a second important trend both economically and socially. A sharp rise in unemployment to nearly 15% has had a significant effect on disposable incomes and has been a major contributor to loss of consumer confidence during the recession.

Long-term unemployment has been steadily rising, reaching 8.9% in 2012; compared to a figure of 3.5% in 2009. This is important from a consumption perspective as people in short-term unemployment often use savings to maintain expenditure between jobs. With time, however, savings diminish and people adjust consumption accordingly.

Despite high levels of emigration and uptake of education, youth unemployment has risen sharply; in 2011 Ireland's youth unemployment ratio (15-24-year-olds unemployed as a share of the age group) was 12%, the fifth highest in the EU. Unemployment at a young age has a well-established negative effect on lifetime earnings; this means that the current downturn may have a negative impact on consumer spending in the longer run.

Household deleveraging: how much further to go?

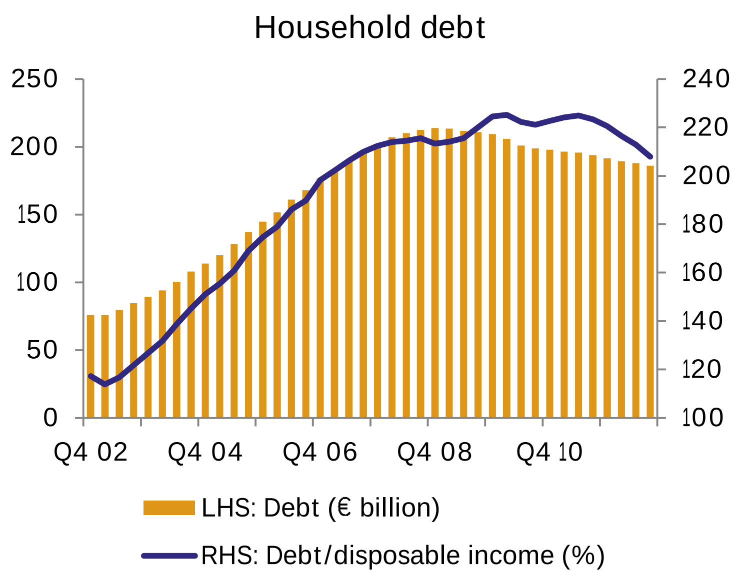
The savings ratio in Ireland has fluctuated over the recent years, rising to a peak at close to 10% at the end of 2009, dipping to just above 5% in 2011, but rising again in 2012 to over 8%. At present, the gap between Irish households' income and expenditure is about €1.8 billion per quarter, which means that savings decisions have a crucial impact on consumer spending. Unlocking some of this, with savings returning to a more normal level could mean a boost of about 3% for the domestic economy.



However, any radical shift is unlikely during 2013. In the December 2012 ESRI/Nationwide (UK) Ireland savings survey 50% of people reported that they would use any surplus money to pay down debt, 38% would save it and just 6% would spend it. The proportions remained fairly constant throughout the year, and correspond with Central Bank data on the balance between debt repayment and saving; in Q2 2012, households remained net creditors, with about a third of financial transactions going towards savings or assets, and about two-thirds towards debt repayment. This is a marginal shift towards saving and away from debt repayment, but not yet an indication of a changing pattern.

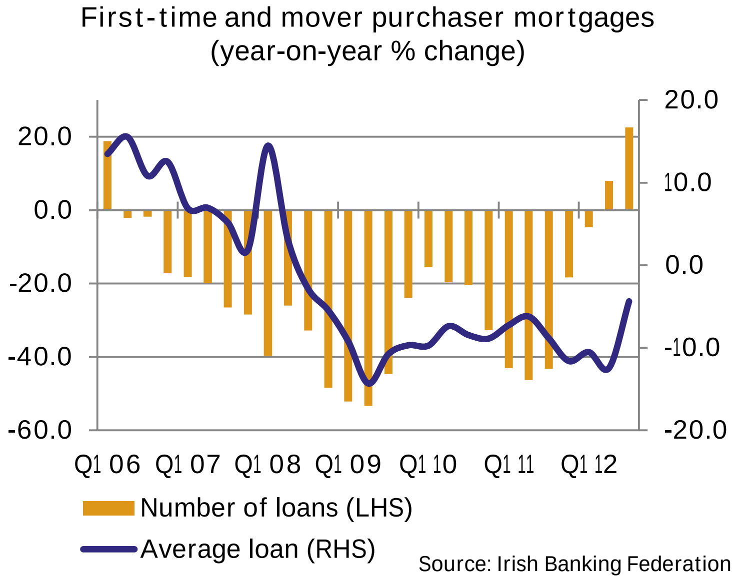
Irish households have been reducing their debt levels since 2009, and by Q3 2012 gross debt was down almost 15% from the peak. However, because of falling incomes consumers made little headway in reducing the debt/income ratio until mid-2011. Over the last few quarters, as incomes have stabilised, households have made more substantial progress, and the debt/income ratio in Q3 2012 stood at 208%, down from 225% at the peak. International data show that a typical deleveraging cycle lasts for five to seven years. The IMF forecasts that the debt burden in Ireland will remain relatively high, reaching 185% of income by 2017. However, this may be overly pessimistic, as it allocated only half of savings towards debt repayment. The forecast also does not take into account the impact of any debt write-downs; however, as banks make headway in dealing with distressed mortgages, in a case-by-case manner, this will have a positive impact on overall household debt levels.

A large share of Irish households' assets is tied up in property, and falling prices have meant that net wealth continued to deteriorate up until Q3 2012. Overall, net worth is down almost 40% from the peak in 2007, with a dramatic decline in housing wealth dominating. However, property wealth has now stabilised, financial assets are growing and liabilities are decreasing and Q3 2012 marked the first time since 2008 that the net wealth position of Irish households improved.



Overall, many of the fundamentals driving precautionary saving, such as incomes and employment, have stabilised, and may begin to have a positive contribution. Two key factors will drive savings behaviour over the next few years: the housing market and consumer confidence. Both are discussed further in the next sections; however, it is worth noting that fundamentals, house price trends and confidence are all interlinked, with positive developments in one having knock-on effects on the others.

The housing market: the new normal?

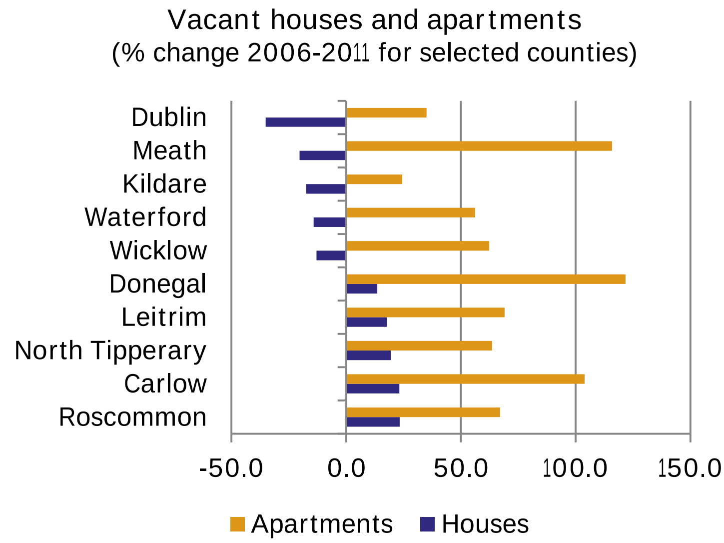


For the first time since the housing market crisis began in 2007, a number of indicators are pointing towards stabilisation and recovery. In 2011, just over 10,000 first-time buyer and mover-purchaser mortgages were taken, down from over 80,000 at the peak in 2005-2006. The flow turned, however, in Q2 2012, when loan drawdowns increased by 8% year-on-year. The trend strengthened in Q3, with growth accelerating to 23%. The final quarter of the year is also likely to have been strong; the more recent data on approvals show that the number of mortgages granted was growing at a rate of 30% the end of 2012.

Over half of transactions at the moment are cash sales, and the new property price register shows that at almost 25,000, the number of transactions in 2012 was up 35% on 2011. In addition to a pick-up in activity, house prices also appear to be stabilising. The CSO's data show that prices in December 2012 were down less than 3% on January, and that the last three quarters of the year recorded little change. Finally, the EBS/DKM index on affordability shows that the cost of a mortgage is now just 14% of disposable income for Dublin first-time buyer couples and less than 12% nationally. Pent-up demand, easing credit conditions and rising rents in some areas should all contribute to increasing transactions.

There is no long-run data series to inform us on a sustainable level of housing transactions in Ireland, but data from the Department of the Environment on mortgage drawdown shows that during 1995-2001 an average of 60,000 mortgages were taken per year. Irish Banking Federation data show that before the crisis about 20% of mortgages were for refinancing; plugging in this estimate implies that a sustainable level for first-time and mover-purchaser mortgages could be in the region of 45,000-50,000 per year. Likewise, new house building averaged about 40,000 during 1995-2001. For a more pessimistic outlook, we could consider the first half of the 1990s, when house completions averaged 20,000 per year and total mortgage drawdowns were almost 40,000, pointing to 30,000-35,000 transactions per year. Even taking the more cautious outlook would imply trebling in the level of mortgages and an almost 50% increase in transactions from current levels.

Nonetheless, this nascent recovery in the housing market will be uneven across Ireland and will in particular be characterised by an urban/rural divide, but also a mismatch between demand and supply. In Dublin and near-by counties the number of vacant houses fell from 2006 to 2011, despite the crisis, while the number of vacant apartments is up across the country.



The housing market interacts with the rest of the domestic economy in a number of important ways. Each transaction results in additional spend of about €20,000 in fees, refurbishment and decorations. Many younger people have been saving towards a deposit and a nest egg towards renovation costs; while they will of course want to keep on saving after the house purchase, it may be at a reduced rate. Finally, construction remains one of the most labour-intensive sectors and a return to a normal level of activity will help make inroads into unemployment.

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What will drive consumer confidence in 2013?

Last year was one of two halves for consumer confidence. Beginning in January with a seasonal post-budget bounce, the KBC Bank/ESRI index of consumer sentiment began to improve. This trend continued up until August, when sentiment recorded the highest reading since 2007. However, with intensification in speculation about Budget 2013 in general, and the property tax in particular, the index began to slide in September and recorded a particularly sharp decline in December, just ahead of the budget.

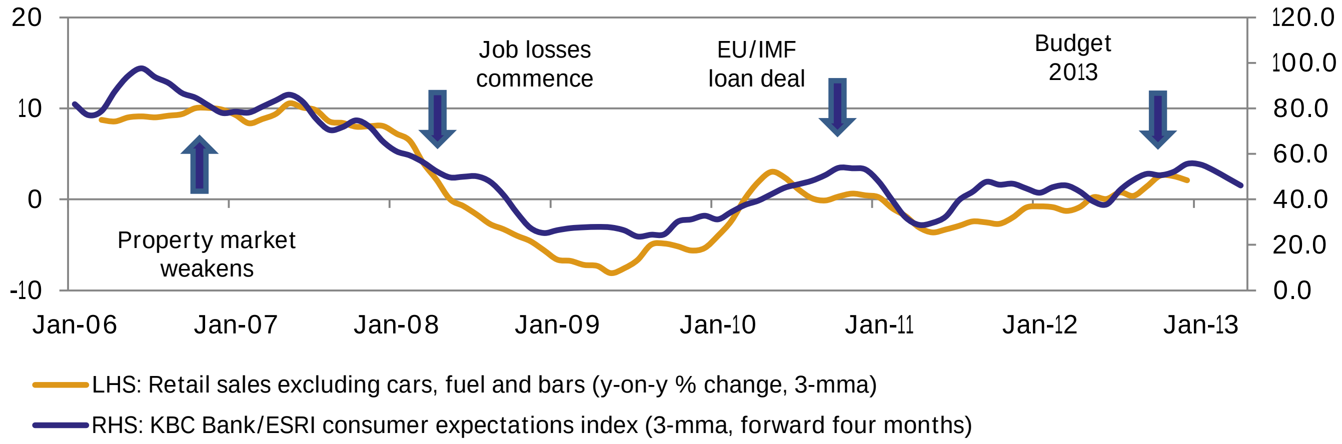
During the year, as sentiment was trending upward, the component measuring consumers' expectations for the future showed particular improvement; the current conditions index in contrast has shown much less fluctuation. However, the sharp December fall in the overall level of confidence reflects declines in both current conditions and expectations indices.

Current events and media coverage have a direct impact on consumer confidence, which remains highly fragile. Nonetheless, the drop in the December 2012 reading is likely to have been somewhat exaggerated, given the intense and emotional connection to the property tax. The hit on incomes, and consequently on consumer spending, will not be as severe as the income tax hikes seen during 2009. The distribution of house price is highly skewed, which means that 85-90% of households be in tax bands paying €495 or less in a full year, and the mode (the tax paid by the largest number of households) will in a band lower than that. The drag on confidence caused by the property tax should diminish as householders assess and absorb the real impact on their finances.

It is likely that, in the absence of further bad news, consumer confidence should recover during 2013. The outlook for the labour market is now one of stabilisation and the private sector is adding jobs, while a tentative bottoming-out of house prices will mean that negative wealth effects should no longer pose a drain on sentiment. External developments, especially from the eurozone, will also be crucial. In particular, if a deal can be reached on promissory notes, this could provide a substantial boost for sentiment – but any unforeseen shocks likewise pose a risk to the fragile recovery seen to date.

While the correlation between consumer sentiment and real activity is not perfect, the KBC/ESRI index on consumer expectations does contain useful information for the future outlook for the consumer market. The chart below shows the relationship between the two, mapping the annual change in retail sales to the left side and the index of consumer expectations, advanced by four months, to the right. The decline in sentiment during 2006 clearly anticipated the fall-off in retail sales, while the recovery seen during 2012 is also reflected as an improvement in sales. At its current level, the sentiment index points to retail sales remaining in marginally positive territory during the early part of 2013. However, given that a recovery in sentiment does not always translate to a pick-up in activity, consumer confidence will need to recover further to herald a return to robust growth in consumer spending.

Consumer confidence and retail sales



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