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Ireland's creditless recovery set to continue

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DAVY VIEW

In this edition of *Davy Economics Monthly,* we focus on two issues. Firstly, we look at the outlook for Irish mortgage lending, with the stock set to continue contracting as households continue to de-leverage. Secondly, we analyse recent developments in the Spanish economy.

In our first article this month, we look at the outlook for Irish mortgage lending. Irish banks have made significant progress in improving their profitability by raising net interest margins. But having seen banks meet their EU/IMF de-leveraging targets, investors are now looking to see how they can stabilise their lending. However, Irish households and companies continue to pay down debt at a rapid pace, with little sign that the process of balance sheet repair is complete. That puts the onus on banks to gain market share in a shrinking pool of credit, posing the risk that competition for new business may intensify.

In our second article, we analyse recent developments in the Spanish economy, and how they compare to Ireland.

Ireland's creditless recovery set to continue

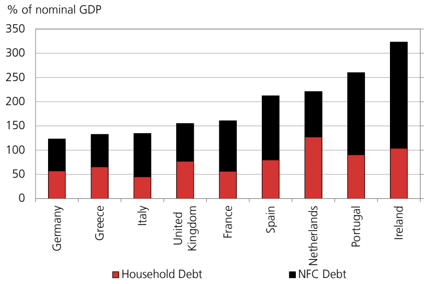
Irish households have reduced debt by 17% to €168bn since 2008. But pressure from tax rises and lower wages means that the ratio of household debt to disposable income peaked later, at 211% in 2011, only falling to 196% in 2013. That is still an exceptionally high level of indebtedness by international standards. In comparison, UK household debt relative to income has fallen for six years, from 170% in 2008 to 140% in 2013. This suggests Irish households are only at an early stage of de-leveraging. As they have done so, the stock of mortgage lending by Irish banks has declined, by around €8bn in 2013.

With half of mortgage balances associated with loans in negative equity, the existing cohort of mortgaged households is extremely unlikely to increase its debts. Instead, new mortgage lending will mainly depend on first-time buyers. In 2013, 7,500 loans to first-time buyers comprised just €1.2bn of new credit. Should first-time buyer loans rise towards 25,000, facilitated by a sharp expansion of construction output, they will still be insufficient to offset current repayments by existing mortgaged households. So, the stock of mortgage debt looks set to continue contracting, placing greater pressure on Irish banks to attract new business.

The pain slowly eases in Spain

After a painful recession, Spain returned to modest growth in 2013, providing a good news story for European authorities after the bailout of the country's financial sector. While labour market reforms have helped improve competitiveness and boosted exports, the domestic economy remains weak with unemployment at 25%. However, Spain's debt burden is well below Ireland's and the de-leveraging process should be shorter for both the public and private sectors. But longer-term fundamentals do not look favourable, with a declining population and poor education system holding back growth.

Irish household and corporate debt



Source: Central Statistics Office

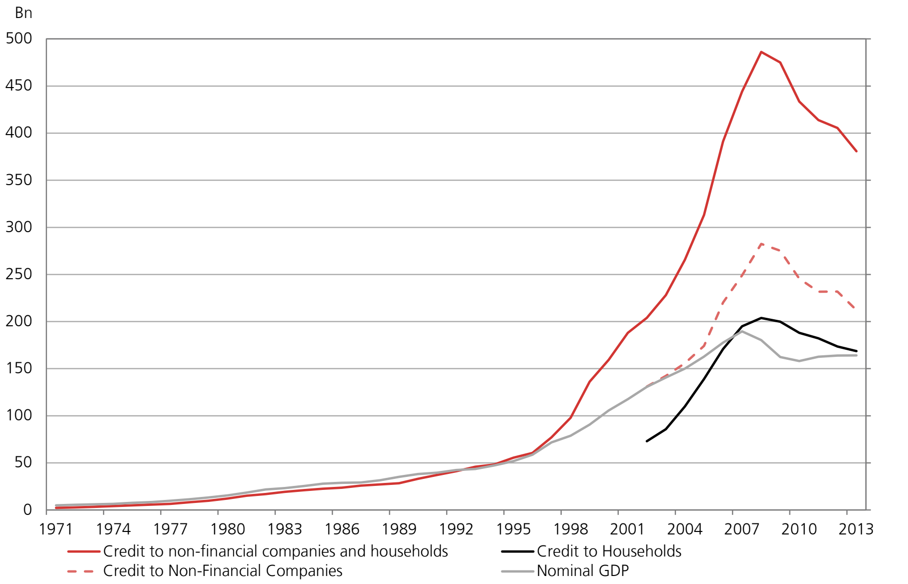
See the end of this report for important disclosures and analyst certification

Introduction – Ireland's creditless recovery set to continue

Ireland's 'credit-less recovery' looks set to continue

Irish debt levels remain exceptionally high by international standards (Figure 1). Although Irish nominal GDP has expanded for three consecutive years to 2013, and with employment growing again, the stock of credit to households and non-financial companies (NFCs) continues to contract – by 3.8% and 5.6% respectively in the year to February 2014. This is not too surprising. There is no stable relationship between nominal GDP and credit. Research by the IMF amongst others suggests that economic recovery in the aftermath of a property price bubble or financial crisis is generally associated with shrinking bank lending, and commensurate in size with the preceding build-up in debt.

*Figure 1: Irish household and corporate debt**



* We have adjusted non-financial corporate debt data for rising liabilities relating to the multi-national sector

Source: Central Statistics Office

The overhang of debt from the property bubble will hold back credit demand

Ireland's 'credit-less recovery' looks set to continue for the foreseeable future. Irish household debt is still €169bn, or 196% of disposable income. The overhang of mortgage debt from the bubble years – of which 50% is associated with negative equity – will continue to be paid down, with new first-time buyers (FTBs) insufficient to stabilise the stock of lending. Irish NFC debt levels are inflated by the presence of multinationals. Nonetheless, the bulk of Irish bank lending to NFCs (€51.5bn) is linked to property-related sectors. The remaining €36.7bn of non-property-related lending continued to shrink through 2013 and shows little sign of stabilising.

There is a risk that banks will compete for new business, hurting profitability, as the pool of credit shrinks

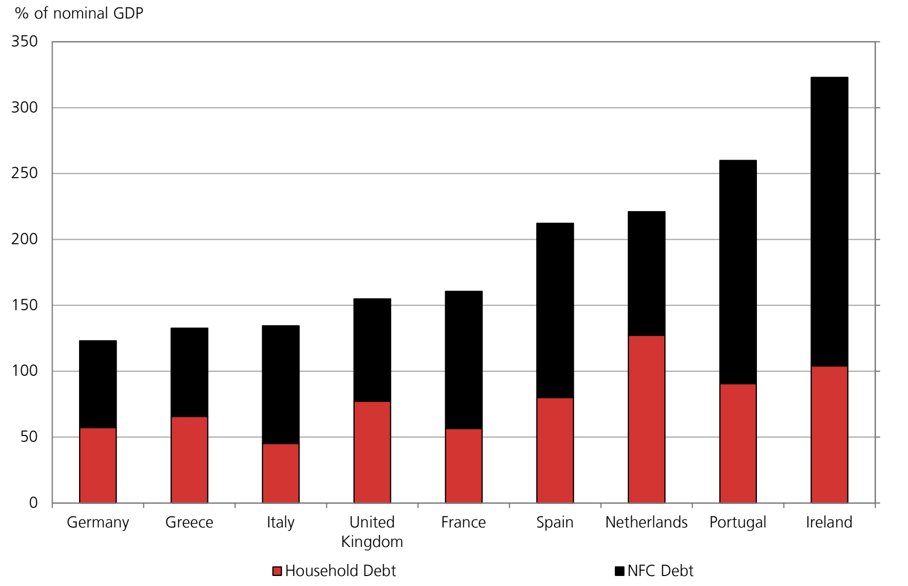
The past year has seen considerable progress in improving Irish banks' profitability through net interest margins. However, investors are now focused on how banks can stabilise their interest-earning assets. In an economy where both households and companies continue to de-leverage, banks will be under greater pressure to gain market share, which will in part be facilitated by the exit from the market of certain players. However, the risk must surely remain that having competed for deposits as they de-leveraged, Irish banks will now compete for new business as the pool of lending to households and companies shrinks. In the first article in this issue of *Davy Economics Monthly*, we focus on the outlook for Irish mortgage lending. Our analysis suggests that it may be at least 2018 before the stock of mortgage lending stabilises. In the second article, we compare Spain's recent economic recovery to Ireland's.

Irish mortgage debt levels look set to fall

Irish household debt levels still look exceptionally high by international standards and historically

Lending to Irish households fell by 3.8% in the year to February 2014: mortgage lending by 3.1% and consumer lending by 6.3%. Corporate loans fell by 5.6%. So there is little sign that the process of balance sheet repair is slowing. Moreover, Irish household and corporate debt levels remain exceptionally high historically (Figure 1) and by international standards (Figure 2). This suggests that de-leveraging by Irish households will continue.

Figure 2: Irish household and corporate debt



Source: Central Statistics Office

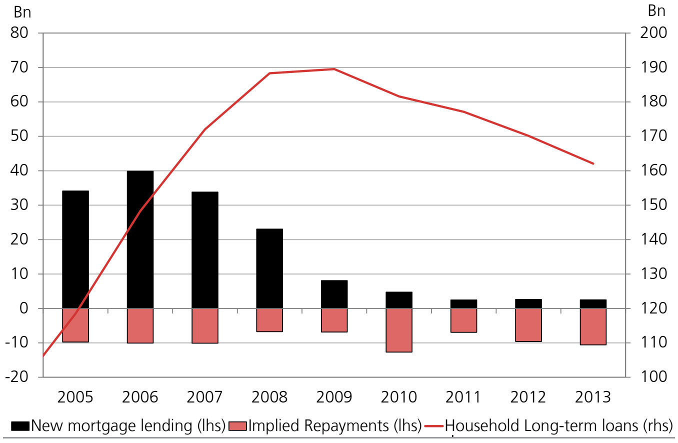
The process of household de-leveraging looks to be at an early stage.

Irish household debt has fallen substantially from peak, down from just over €204bn in Q4 2008 to €168bn in Q3 2013, a 17% contraction. However, pressure from the fiscal adjustment and declining wages mean that the debt/disposable income ratio peaked later in Q2 2011, at 212%, declining over two years to 196% in Q3 2013. This is still exceptionally high. UK household debt, for example, has fallen from 170% of disposable income in Q1 2008 for six years to 140% in Q4 2013. And in the early 1990s, UK household debt fell for seven years from 112% of disposable income in Q3 1990 to 100% in Q1 1998. Such comparisons clearly suggest that the process of de-leveraging by Irish households is at an early stage.

The stock of household debt continued to decline in 2013, with €2.5bn of new lending well below repayments over €10bn

As households have reduced their debt levels, the stock of mortgage lending by Irish banks has contracted. In 2013, new mortgage lending was just €2.5bn, offset by €10.6bn of repayments, so that the stock of mortgage debt fell by €8bn (Figure 3). This means that approximately 6% of the mortgage stock is being repaid each year. New mortgage lending comprised €1.2bn to FTBs and €1.1bn to mover-purchasers. Anecdotal evidence suggests that a normalised property market would see transactions rise to €6-10bn – at face value sufficient to meet current repayment levels and stabilise the stock of mortgage lending. This would mean that housing turnover would return to around 4-6% of stock, up from levels close to 1.5%. However, this view confuses transactions in the market with positive net flows into the stock of Irish mortgage lending.

Figure 3: Irish household debt



Source: Central Bank of Ireland, Irish Banking Federation

*Table 1: Irish household debt (€bn)**

	Total household debt	o/w long-term loans (mortgage debt)	New mortgage lending (IBF)	Implied repayments	Repayments as % of stock of loans
2005	127.2	118.5	34.1	-9.8	-10.4
2006	158.3	148.3	39.9	-10.1	-8.5
2007	185.9	172	33.8	-10.1	-6.8
2008	201.4	188.3	23	-6.7	-3.9
2009	201.2	189.5	8.1	-6.9	-3.6
2010	191	181.6	4.7	-12.7	-6.7
2011	185.4	177.1	2.5	-6.9	-3.8
2012	177	170.1	2.6	-9.6	-5.4
2013	170.3	162.1	2.5	-10.6	-6.2

** We use long term loans as a proxy for mortgage debt*

Source: Central Bank of Ireland, Irish Banking Federation

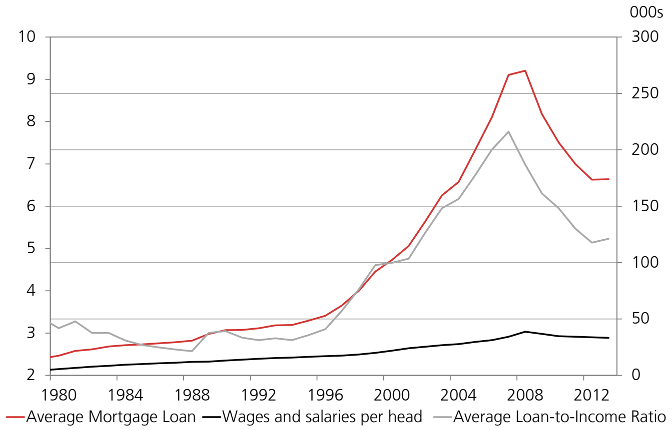
Mortgage lending can expand as:

- Population expansion leads to construction of new homes;
- House prices rise in line with incomes; and
- The cohort of mortgaged households raises its leverage, increasing their debt levels relative to income.

A pick-up in housing market transactions may have no impact on the stock of mortgage lending

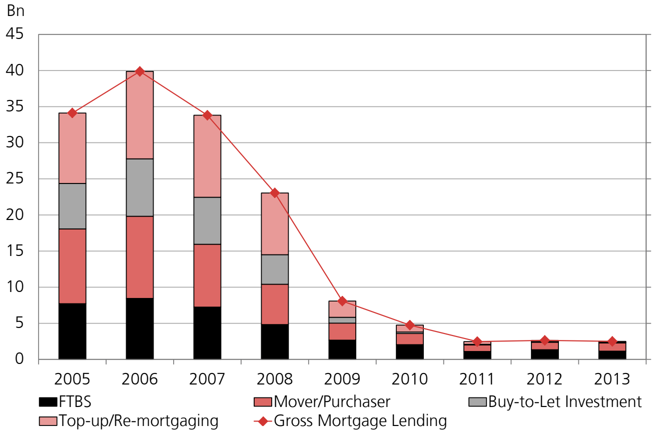
Transactions may pick-up as existing mortgage holders move home, refinancing their mortgage debt as they do so. But mover-purchasers will also typically make commensurate debt repayments. That is to say that currently depressed amortisation rates will pick up as mover-purchasers refinance. So there may be no positive impact on the stock of mortgage debt from higher transaction levels.

Figure 4: Average mortgage loans and income



Source: Central Statistics Office; Davy

Figure 5: New mortgage lending



Source: Irish Banking Federation

The growth in mortgage lending during the boom years was driven by rising household leverage, which is now in reverse

Figure 4 illustrates that during the boom years, average mortgage loans were pushed up as banks lent at ever higher multiples of income. During these years, mover-purchasers may have added to the stock of debt as they borrowed at higher income multiples. In 2013, close to 50% of mortgage lending was for mover-purchases (Figure 5), but looking forward, many mover-purchasers may even trade down, reducing their leverage. The average mortgage loan to mover/purchasers in 2013 was €209,800, down from the €281,900 peak in Q1 2008.

This is all the more likely in the aftermath of a property bubble. The 17.9% owner-occupier arrears rate in Q4 2013 is indicative of stressed household finances. Moreover, with over 60% of boom era mortgages on variable interest rates, the most indebted households will be aware that they are exposed to any tightening of ECB policy, making them less likely to take on additional mortgage debt should they move home. Furthermore, gross disposable income per head employed is down 5% from peak levels. These factors all suggest that existing cohorts of mortgaged households in Ireland are unlikely to increase their mortgage debt.

Table 2: Irish mortgage loan books by LTV ratio

	Owner-occupiers	Buy-to-let	Total
LTV Ratios by balance (Bn)			
Positive equity, LTV < 100%	35.4	6.6	41.9
Negative equity, LTV > 100%	33.4	13.6	47.0
101-120%	11.2	3.4	14.6
120-150%	12.9	5.6	18.5
150%+	9.3	4.6	13.9
Total	**68.8**	**20.1**	**88.9**
LTV Ratios, % of total balance			
Positive equity, LTV < 100%	51.4%	32.6%	47.2%
Negative equity, LTV > 100%	48.6%	67.4%	52.8%
101-120%	16.3%	16.7%	16.4%
120-150%	18.7%	28.0%	20.8%
150%+	13.5%	22.8%	15.6%
Total	**100%**	**100%**	**100%**

Source: Bank of Ireland; AIB and PTSB annual reports; Davy calculations

Negative equity and vulnerable household finances associated with high leverage, will both hold back demand for new lending from existing mortgaged households

Table 2 shows loan-to-value (LTV) ratios across the three main banks, Allied Irish Banks, Bank of Ireland and PTSB. At end-2013, 52.8% of mortgage loans by balance are in negative equity: 48.6% amongst owner-occupiers and 67.4% of buy-to-let (BTL) loans. The banks' annual reports also show that the average LTV on new mortgage lending was 70% in Bank of Ireland and PTSB and 71.9% at Allied Irish banks.

Tighter credit constraints relative to the boom years will also hold back the growth of mortgage lending. Households may be unwilling to move home for fear they will lose their tracker mortgage, or because of collateral constraints associated with negative equity. New mortgage products designed to allow households keep their tracker for a period of time, or bring negative equity with them as they move home, could allow transactions to pick up. But households are still unlikely to significantly increase their leverage if they move home. Crystallising losses from negative equity and taking on additional mortgage debt are key factors likely to hold back demand for new negative equity mortgage products.

New mortgage lending will depend on first-time buyers

With existing mortgaged households unlikely to raise their leverage, Irish banks will clearly need to rely on FTBs for new business. Table 3 shows that the €1.2bn of new mortgage lending to FTBs in 2013 comprised 7,570 loans with an average value of €152,000, down from the €251,000 peak in 2008. Banks' annual results suggest that new lending is at relatively low average LTVs, close to 70%. Even with strong house price inflation and construction output expanding to meet demand, mortgage lending to FTBs looks unlikely to exceed €5bn in the near future.

Table 3: Potential mortgage lending to first time buyers (€bn)

Home loan	**€152,000**	**€160,000**	**€168,000**	**€184,000**	**€201,000**	**€230,000**
Price inflation	**0%**	**5%**	**10%**	**15%**	**20%**	**25%**
Loan volumes						
7,570	1.2	1.2	1.3	1.4	1.5	1.7
10,000	1.5	1.6	1.7	1.8	2.0	2.3
15,000	2.3	2.4	2.5	2.8	3.0	3.5
20,000	3.0	3.2	3.4	3.7	4.0	4.6
25,000	3.8	4.0	4.2	4.6	5.0	5.8
30,000	4.6	4.8	5.0	5.5	6.0	6.9
35,000	5.3	5.6	5.9	6.4	7.0	8.1

Source: Davy calculations

Home ownership rates have fallen from 74.7% in 2006 to 69.7% in 2011, so there may be latent demand over and above the 25,000 natural growth in first-time buyers

Demographic trends suggest that homebuilding needs to equal 25,000 per annum to meet natural demographic demand. However, there may be additional latent demand. FTBs were squeezed out of the market during the boom years and have been reluctant to buy when house prices are falling. As a result, home ownership rates have fallen sharply from 74.7% in 2006 to 69.7% in 2011. A rise in the house ownership rate back to its 2006 level of 74.7% would imply that an additional 82,000 households would need to purchase a home.

Table 4: Census results on population and home ownership

	Population (m)	**Housing stock**	**Households**	**Mortgaged households**	**Outright owners**	**Owners**	**Renters**	**Home ownership rate**
2006	4.24	1.77	1.46	0.57	0.498	1.07	0.323	74.7%
2011	4.59	1.99	1.65	0.583	0.566	1.09	0.0475	69.7%

Source: Central Statistics Office

However, even if latent demand for housing exists, it will require the construction sector to expand activity rapidly. Of the 290,000 housing completions through 2006-2013, just 68,000 occurred between 2009 and 2013. Housing completions in 2013 were just 8,300. Credit constraints may be one factor holding back the construction sector from gearing up sufficiently to meet demand, while supply constraints in urban areas may constrain a pick-up in completions. The government's housing agency has estimated that an additional 80,000 housing units are required by 2018. The government has also indicated that it will publish a new construction strategy in the coming weeks.

Credit and supply constraints in urban areas could hold back the construction sector from building sufficient new homes

This suggests that the stock of Irish mortgage lending will contract for some time. New lending to FTBs looks unlikely to compensate for repayments on the large overhang of mortgage debt. This could lead to competition between banks for new mortgage lending business as the pool of mortgage loans contracts.

Figure 6: Irish residential construction activity

Source: Central Statistics Office

Conditions have gradually improved in Spain, but many challenges remain

The pain slowly eases in Spain

Spain, along with Ireland, has been billed as one of the success stories of the euro-zone over the past year as the economy returned to modest growth. This was no doubt helped by ECB support through OMT, but also by significant labour market reforms which have improved competitiveness and driven export growth as part of the ESM programme of support in the financial sector. Nevertheless, significant challenges remain, particularly in relation to the current high level of unemployment. In February, unemployment was 25.6%, having fallen only marginally from peak levels. The youth unemployment rate was 54.6%. In total, 5.8m people are currently unemployed.

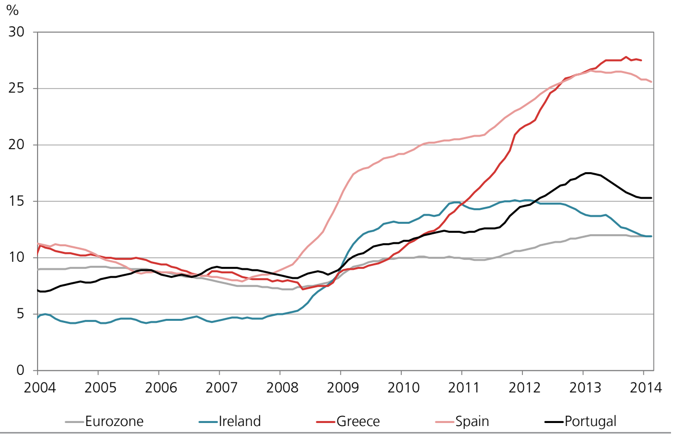
Despite a modest recovery in the export sector (4.9%), domestic demand continued to contract last year (-1.2%), pushing down on GDP growth. House prices also continue to fall, while problem loans remain at high levels. Looking ahead, exports will continue to drive economic growth as the domestic economy remains weak. Moreover, long-term growth fundamentals do not look favourable. Spain has an ageing and shrinking population while education and skills remain close to the bottom of most OECD rankings, which will hold back growth in the long term.

Table 5: Economic indicators

	Spain	Ireland	Eurozone
GDP yoy % (Q4)	-0.2	-0.7	0.3
Unemployment % (Feb)	25.6	11.9	11.9
PMI - Services (Mar)	54.0	60.7	52.4
PMI - Manu (Mar)	52.8	55.5	53.0
Industrial production yoy % (Feb)	3.1	5.3	1.7
Retail sales yoy % (Feb)	-0.3	5.0	0.8
Consumer confidence (% bal, March)	-8.3	11.7	-9.3

Source: Factset, Datastream

Figure 7: Unemployment remains at elevated levels



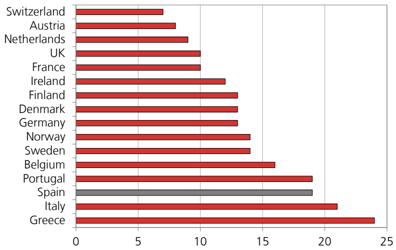
Source: Eurostat

Labour market reforms have helped re-balance competitiveness against European peers

While the enforced internal devaluation of recent years has contributed to the collapse in domestic demand, the reforms have also made Spain more competitive versus its euro-zone peers. Unit labour costs have declined by 17.8% since Q1 2008 compared to a 2.4% fall in Germany and a 9.5% fall in the euro-zone as a whole. This also compares favourably to the adjustment in Ireland, where the 21% decline in unit labour costs was in part inflated by the collapse in the low-productivity construction sector and the growth in the high-productivity pharmaceuticals sector. The improvement in these metrics stems from major labour market reforms introduced in mid-2012 following the request by the Spanish authorities for financial sector assistance. The key labour market reforms included:

- Watering down of sectoral collective bargaining agreements in favour of enterprise-level wage agreements;
- Reduction in dismissal costs for permanent workers;
- Provision for longer trial periods and temporary employment; and
- Cuts to public sector wages and pensions.

Figure 8: Shadow economy (% GDP)



Source: Shadow economy in Europe, 2013

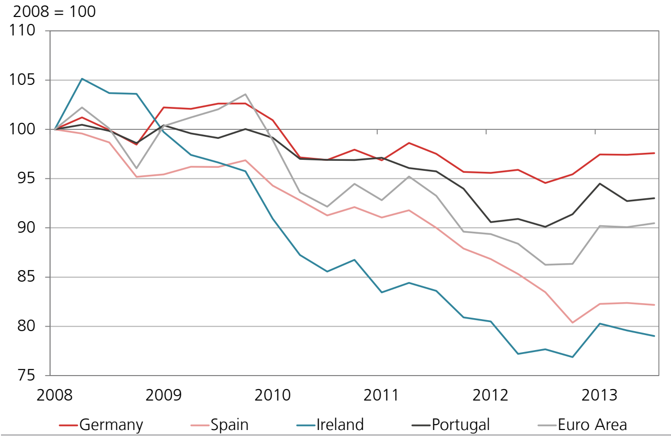
The effect of the reforms has been to increase permanent hiring by firms and led to a significant reduction in unit labour costs. The OECD estimates that the reforms are responsible for about 25,000 new permanent contracts each month. The reduction in unit labour costs was also helped by cuts in public sector wages. Nonetheless, the rise in taxation in recent years and the lack of enforcement by tax authorities means that a significant proportion of Spain's economy – and labour force – remains underground.

A recent report put Spain's shadow economy at 18.7% of GDP in 2013[1]. This is almost unchanged against the 2008 estimate of 18.6% despite the sharp decline in the construction sector during that period, a sector that accounted for the one of the largest shares of the shadow economy. This partly explains why Spain's unemployment rate will probably remain at relatively high levels in the coming years even as the economy begins to recover, as many businesses choose to keep activity in the shadow economy. However, the labour market reforms and proper enforcement by authorities may help to stem the tide.

The reforms have contributed to 25,000 extra jobs each month

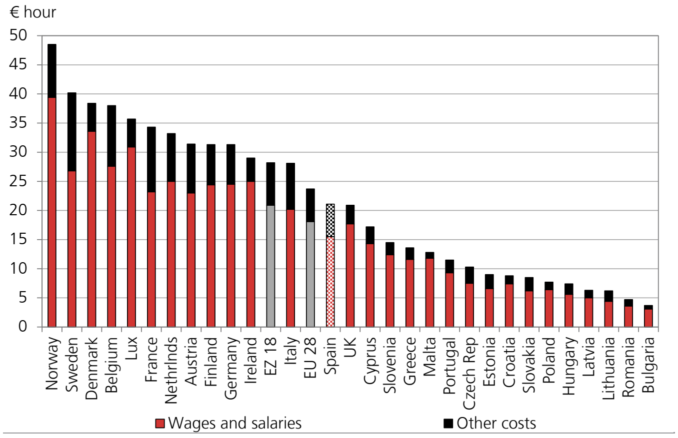
The reorientation towards export-led growth has also boosted the current account surplus. Spain is expected to run a current account surplus worth 1.5% of GDP in 2014, compared to a deficit of 10.7% in 2006. While much of this improvement has been driven by the collapse in import demand, Spain is one of the few peripheral nations to boost its current account balance through a rise in exports since the crisis began (Figure 11). Exports are now 17% above their pre-recession peak, the strongest recovery of any peripheral nation.

Figure 9: Unit labour costs have fallen significantly …



Source: ECB

Figure 10: … and now compare favourably to EU peers



Source: Eurostat

European markets have provided the biggest uplift to exports

The markets that have provided the biggest uplift to Spanish exports are on its doorstep. The euro-zone accounts for 50% of all Spanish goods exports, so the uplift in these markets suggests that falling unit labour costs versus its euro-zone peers has made Spanish goods more competitive. Exports to France and Germany, Spain's largest export markets, grew by 4.3% and 1.2% respectively last year. Growth has come in high-value-added sectors such as industrials, automobiles and chemicals, while traditional exports in the food space and tourism have also performed well. Tourism in particular will contribute a growing share of output and employment as key European markets recover this year. Tourism accounts for 6% of GDP and just less than a million jobs.

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1 http://www.protisiviekonomiji.si/fileadmin/dokumenti/si/projekti/2013/siva_ekonomija/The_Shadow_Economy_in_Europe_2013.pdf

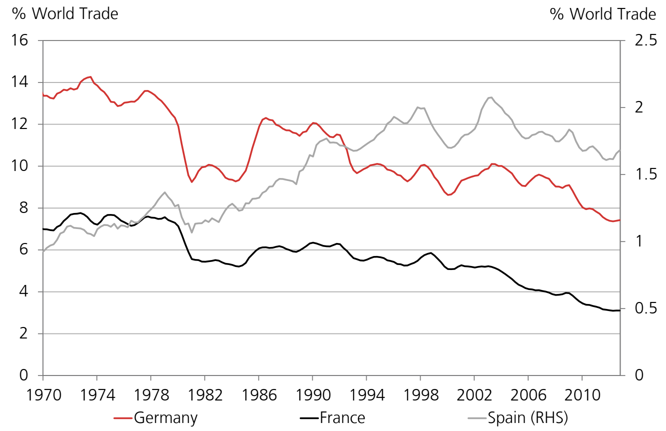
Indeed, the early tourism data for this year look very positive. In the first two months of 2014, foreign tourists spent €6.1bn, a 9.1% rise on the same period in 2013.

Table 6: Growth in export markets in 2013

	Value (€bn)	Growth (%)
France	37.6	4.3
Germany	23.6	1.2
Portugal	17.5	14.6
Africa	16.5	8.4
Italy	16.4	-0.4
UK	15.8	14.2
Latin America	15	8.6
Asia	13.1	3.2
US	8.7	-3.7
Middle East	7.7	24.9

Source: Bank of Spain

Figure 11: Exports share has been resilient

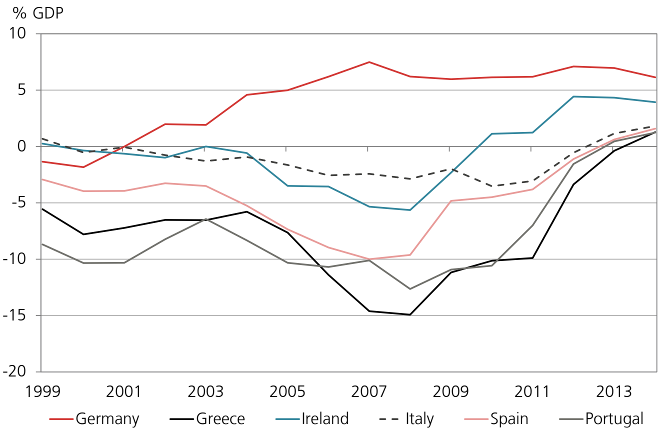


Source: Datastream

Spain's share of world exports has been very resilient

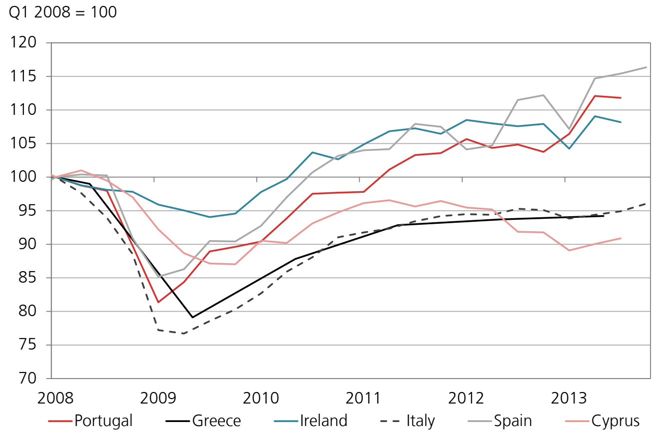
Indeed, even before the crisis began Spain managed to grow its share of world exports while other European nations lost market share to China. Since 1999, Spain's share of world goods exports has declined to 1.7% from 1.9%, having peaked at 2.1% in 2004, while Germany's share declined from 10.1% to 7.4%. The competiveness gains of recent years mean that Spain's share of exports is now growing again, while other European nations' shares stagnate at best.

Figure 12: Current account back in surplus



Source: Datastream

Figure 13: Export growth in periphery since 2008

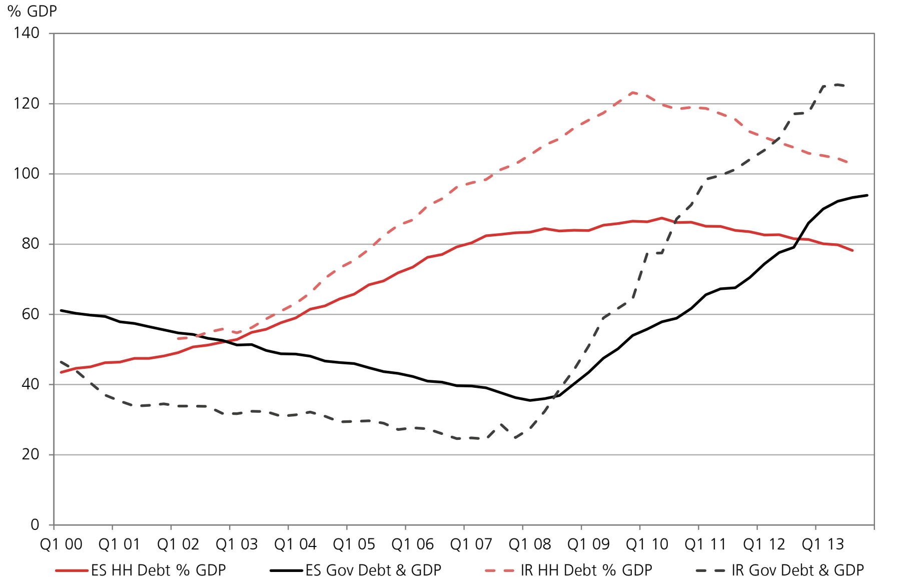


Source: Datastream

While exports have performed well, the domestic economy remains weak

However, the recovery in the short term will be lopsided. Current high levels of unemployment, elevated public and private debt, the squeeze on wages and falling house prices mean that domestic demand growth will be subdued at best. The weakness of the domestic economy is illustrated by the fact that inflation fell into negative territory in March at -0.2%. While Spain successfully exited its €39bn financial sector bailout programme in January, uncertainty surrounds the future of the banking system and its ability to channel credit to the economy while remaining firmly on a de-leveraging path. The upcoming ECB stress tests should shed more light on the resilience of the Spanish banking system going forward. But Spain does have a head start on other nations, having already completed a comprehensive review of its banks, while the debt burden is not nearly as onerous as in Ireland (Figure 14)

Figure 14: Debt levels remain elevated but compare favourably to Ireland

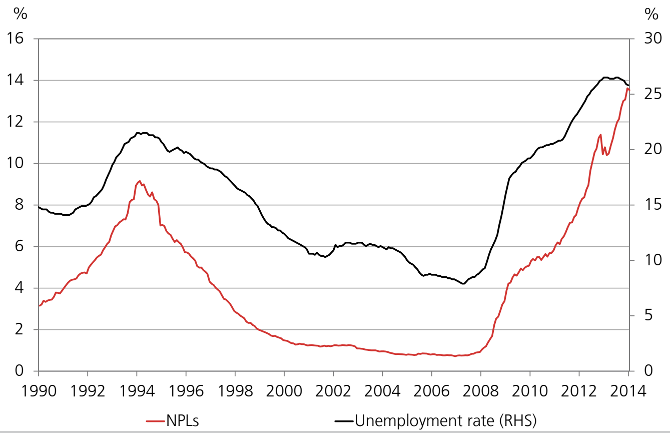


Source: Datastream

Spain has successfully exited its €39bn financial sector bailout

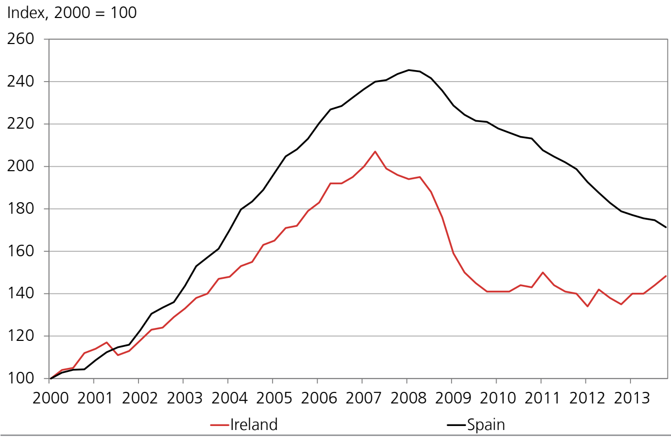
As in Ireland, the Spanish authorities have already completed a comprehensive bank asset quality review and created a NAMA-style bad bank (SAREB) for troubled assets as part of the ESM-supported programme. Moreover, the sector has been given a clean bill of health under the terms set out in the support programme. So, much of the heavy lifting on the restructuring of the banking sector may already be done – depending of course on the parameters of the upcoming ECB stress tests. However, non-performing loans (NPLs) have continued to rise in recent times (currently at 13.4%) and have been closely correlated to the deterioration in the labour market in recent years (Figure 15). The corollary of this link is that the recent, albeit modest, improvement in the labour market means that NPLs may soon reach their peak, while a flood of foreign capital may help the property market find a floor, as has been the case in Madrid and Barcelona. At national level, however, property prices continue to fall.

Figure 15: Non-performing loans remain at high levels



Source: Datastream

Figure 16: House prices continue to fall



Source: Datastream

Exports will support the recovery in the near term

Looking ahead, Spain's recovery is expected to be sluggish in the near term, although forecasts have been revised up in recent months. In the IMF's April forecasts, GDP growth is now expected to be 0.6% in 2014 and 0.8% in 2015, revised up from 0.2% and 0.5% respectively in October. Industry forecasts are a good deal stronger than the IMF's at 1.0% and 1.5% for 2014 and 2015 respectively. Growth projections for this year are split between near-flat domestic demand (+0.2%) and a strong rise in exports (+5.2%). So, exports will almost entirely support growth in the coming years, as the domestic economy slowly recovers.

Table 7: Consensus forecasts for Spain, April 2014

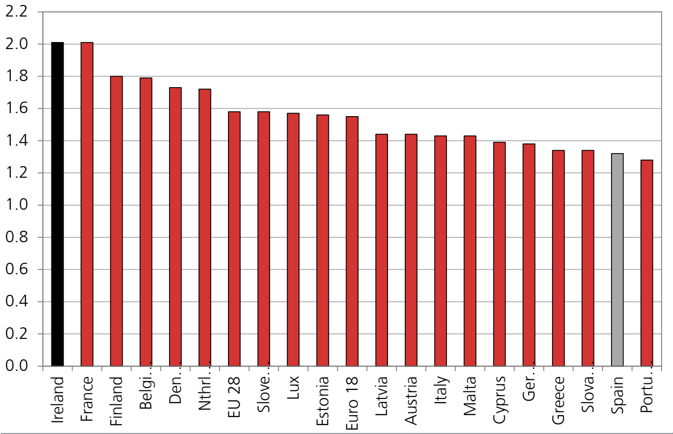
	2014	2015	2016
GDP	1.0	1.5	1.7
Domestic demand	0.2	1.0	1.4
Exports	5.2	5.0	5.0
Imports	3.4	3.9	4.1

Source: Focus Economics

But long-term growth fundamentals do not look favourable

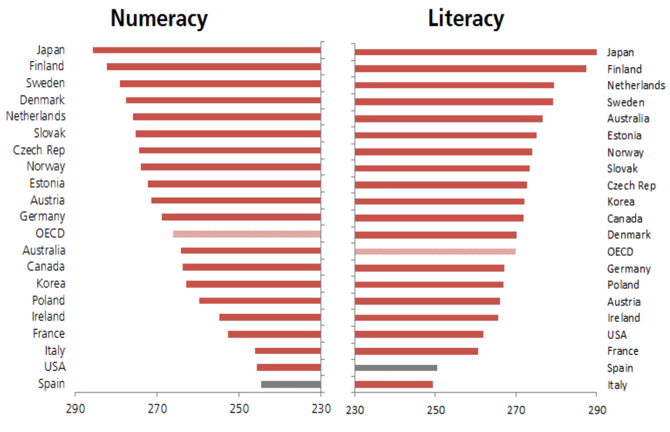
However, longer-term fundamentals do not look favourable. Spain has one of the lowest fertility rates in Europe, second only to Portugal, and the population is expected to decline to 44.6m by 2040 from 46.7m today. Moreover, the country scores badly on educational attainment. Just 54% of adults have a third-level qualification compared to an OECD average of 75%. Spain also ranks well below the OECD average on numeracy and literacy amongst the adult population, ranking second from bottom on literacy and bottom in numeracy in the OECD in 2013. A damning finding of recent OECD education surveys was that on average, Japanese and Dutch 25-34 year olds who have only completed second-level education easily outperform Spanish university graduates of the same age on literacy and numeracy. A relatively poorly educated and declining population does not bode well for an economy which needs to grow at a faster pace in the long term to restore unemployment and debt to sustainable levels.

Figure 17: Fertility rate one of the lowest in Europe



Source: Eurostat

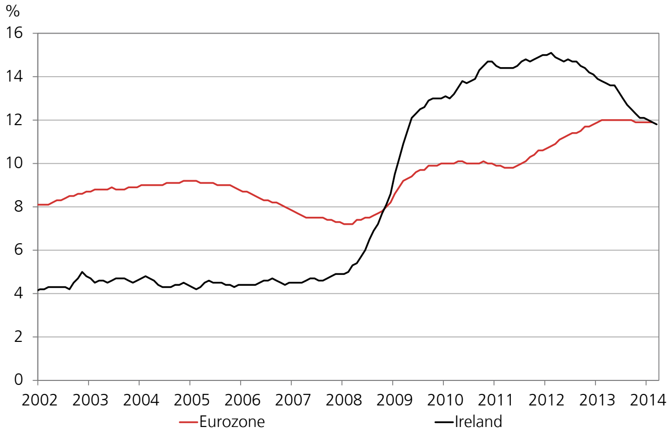
Figure 18: Spain ranks poorly on skills



Source: OECD Skills Outlook

Irish economy

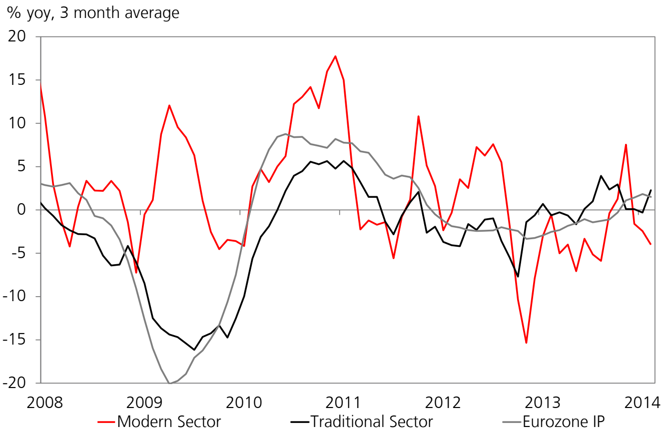
Figure 19: Irish unemployment rate versus eurozone



Source: CSO; Eurostat

Unemployment down to 11.8%, the lowest level since April 2009. Surveys of Irish business sentiment indicated that Irish employers expected to add jobs heading into 2014. The drop in the unemployment rate through Q1 to 11.8%, down from 12.1% in Q4 2013, suggests that improving confidence is translating into further job creation. The unemployment rate has now fallen by 3.3pp from its 15.1% peak in February 2012 and from 12.1% in Q4 2013. Total numbers on the Live Register have fallen by 33,900 over the past 12 months, an 8% decline in claimants. Clearly, this will also be welcome news for the government in reducing its spending on unemployment claims. Irish employment grew by 3.3% in the year to Q4 2013 and by 2.4% in calendar year 2013; we expect that it will grow by close to 3% in calendar year 2014.

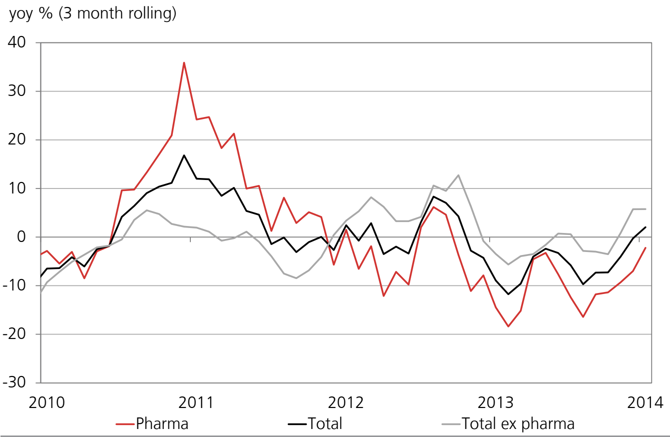
Figure 20: Industrial production growth



Source: Eurostat; CSO

Industrial production up 5.3% over the month and year in February. Industry should add to GDP growth in Q1 following the sharp fall in Q4. The Q4 decline was entirely driven by the pharmaceuticals-dominated modern sector, with output down 4.8% compared to a 0.1% rise in the labour-intensive traditional sector. Encouragingly, both sectors are now contributing to growth. Output in the modern sector was up 5.5% (+1.9% yoy) in February, while traditional sector output was up 3.2% (+4.8% yoy). Nevertheless, we cannot discount another dip in pharmaceuticals output in March affecting the final Q1 out-turn. However, the key point is that the patent cliff has had little impact on employment in industry (up +2.7% yoy) or on the real economy, while the traditional sector is strengthening in-line with the eurozone recovery.

Figure 21: Nominal goods exports; pharma/non-pharma

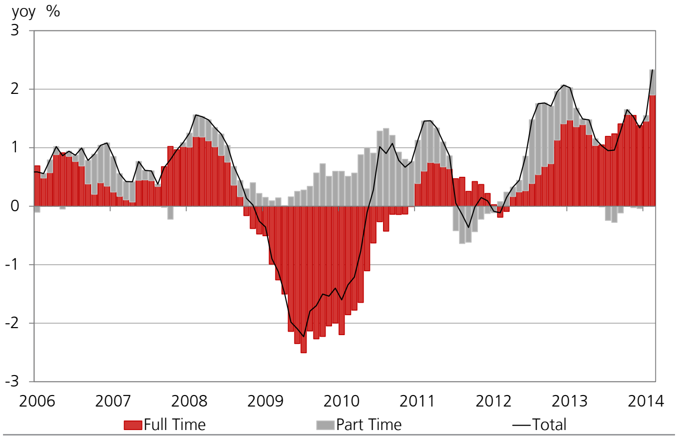


Source: CSO

Goods exports recover in first quarter. The trade surplus rose to €3.2bn in February from €3.1bn. In the three months to February, nominal goods exports were up 6.6% yoy – the fastest pace of growth since September 2012. This was split between a 7.3% rise in pharma exports and a 6% increase ex-pharma. Exports are not only benefitting from less of a drag from the pharma sector but also from improved demand in Ireland's main export markets in Europe. Nominal exports to the eurozone were up 1.2% yoy to end-February. Indeed, recent PMI surveys have cited improved demand in Europe and the US as a key driver of new orders for Irish manufacturing firms, boosting output and employment expectations for the coming year.

UK economy

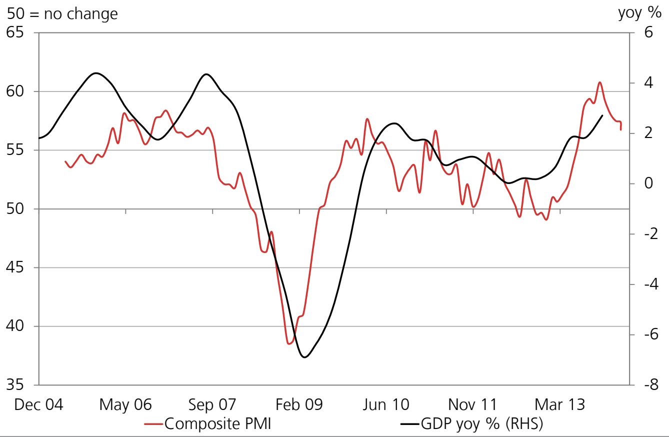
Figure 22: Employment growth



Source: ONS

Unemployment rate falls to 6.9% in February from 7.2% in January. Employment growth was 2.3% in the year to February, the fastest pace of growth since the recovery began. A total of 239,000 extra people were in employment over the year. The number of unemployed fell by 320,000 in the same period. Average weekly earnings were up 1.7% yoy, in-line with February inflation of 1.7%. We should therefore see real earnings growth in March given the subsequent fall in CPI to 1.6%. Nonetheless, regular earnings (ex-bonuses) were up 1.4%, still marginally below inflation. Despite the pick-up in hiring, wage growth has remained pretty subdued. Looking ahead, the timelier claimant count measure for March pointed to further falls in the unemployment rate in the months ahead. The number of people claiming unemployment benefits fell 30,400 on February, a 386,100 decline on the year.

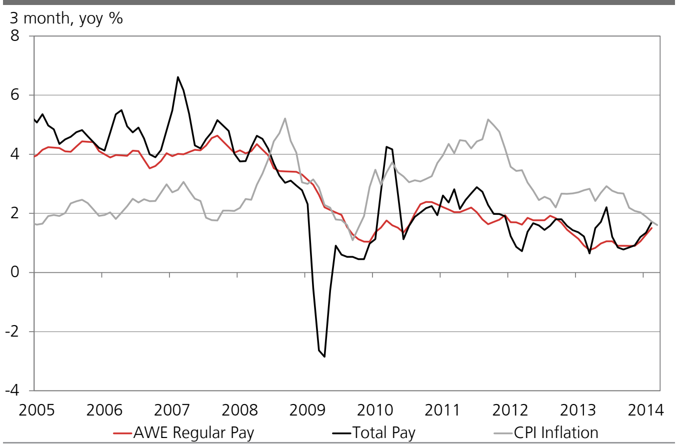
Figure 23: Composite PMI and GDP growth



Source: ONS; Bloomberg

PMIs dip in March. UK PMIs still pointed to a strong start to the year across all sectors. The services index fell slightly to 57.6 from 58.2 but was still consistent with strong growth. New business growth remained robust over the month and employment growth was the strongest in four months. The manufacturing index fell to 55.3 from 56.2 as new orders growth dipped slightly. Employment also grew for an 11th consecutive month. The construction index fell to 62.5 from 62.6. The survey pointed to expansion across the three main sectors of activity – housing, commercial and civil engineering work – and a marked pick-up in employment. As has previously been the case, housing continued to provide the biggest uplift to the construction sector.

Figure 24: CPI and average earnings



Source: ONS

Real wage squeeze at an end as inflation falls to 1.6%. Inflation fell to 1.6% in March from 1.7%, the lowest rate since October 2009. The decline was largely driven by a fall in motor fuel costs. Petrol prices were flat over the month compared to a 2.2p rise in March 2013. Weaker clothing and footwear and household equipment price increases also contributed to the fall in headline inflation. These weaker price pressures were partially offset by higher restaurant and hotels and alcohol and tobacco prices. With inflation expected to continue on the current weak trajectory, this means that real wage growth should materialise in the next few months. With average weekly earnings up 1.7% yoy in February, in-line with inflation in that month, the first real term rise in wages since 2008 is likely in March.

Databank

Table 8: Rolling twelve month databank

	Apr 13	May 13	Jun 13	Jul 13	Aug 13	Sep 13	Oct 13	Nov 13	Dec 13	Jan 14	Feb 14	Mar 14
Activity												
GDP (quarterly) (%)			1.1			2.1			-2.3			n/a
Consumption			0.6			1.0			-0.6			n/a
Investment			4.8			13.0			3.1			n/a
Government			-0.8			1.1			0.2			n/a
Exports			4.6			-0.5			2.1			n/a
Imports			0.9			0.1			5.8			n/a
PMI-manufacturing	48.0	49.7	50.3	51.0	52.0	52.7	54.9	52.4	53.5	52.8	52.9	55.5
PMI-services	55.2	52.7	54.9	57.6	61.6	56.8	60.1	57.1	61.8	61.5	57.5	60.7
PMI-construction	41.9	42.0	43.4	47.5	49.7	55.7	59.4	58.8	58.3	56.4	56.2	60.2
Industrial production	2.2	-2.3	8.9	-6.9	-0.9	2.4	-4.9	3.4	-2.2	-0.3	4.9	n/a
Retail sales	0.4	0.6	-1.4	5.9	-1.8	0.5	-0.2	0.7	1.0	1.9	-1.5	n/a
Trade balance (€m)	3288	3060	2953	3169	3172	3204	2996	2549	3410	3098	n/a	n/a
Sentiment												
Consumer sentiment	58.9	61.2	70.6	68.2	66.8	73.1	76.2	71.0	79.8	84.6	85.5	83.1
Labour market												
Jobless claims	426.0	425.1	421.9	419.0	415.5	413.3	409.4	406.2	403.2	401.0	398.7	396.9
Unemployment rate	13.6	13.6	13.3	13.0	12.7	12.5	12.3	12.1	12.1	12.0	11.9	11.8
Employment (quarterly)			1869.9			18993			1909.8			n/a
Public finances												
Exchequer balance (cumulative YTD, €bn)	-6.1	-5.3	-6.6	-5.2	-7.3	-7.1	-10.5	-8.6	-11.5	-1.1	-1.7	-2.3
Inflation												
Consumer prices - Main	0.5	0.4	0.7	0.7	0.2	0.2	0.1	0.3	0.2	0.2	-0.1	0.2
Consumer prices - HICP	0.5	0.5	0.7	0.7	0.0	0.0	-0.1	0.3	0.4	0.3	0.1	0.3
House prices	0.8	0.3	1.2	1.2	0.9	1.8	1.8	0.6	0.3	-0.7	0.1	n/a
Banking - Irish Headquartered Group €bn												
Irish private sector lending	155	154	155	154	153	155	154	153	151	150	150	n/a
Non-resident lending	64	63	60	58	58	59	56	56	56	56	55	n/a
Government lending (NAMA bonds)	25	25	24	24	24	24	23	23	23	23	23	20
Total assets	396	393	388	384	383	385	377	378	377	374	372	n/a
ECB borrowing	39	36	35	34	33	33	31	30	28	27	27	n/a
ELA borrowing	0	0	0	0	0	0	0	0	0	0	0	0
Customer deposits	153	151	152	152	153	154	153	153	154	154	154	n/a
Banking - domestic Ireland												
Deposit rate - weighted average outstanding	1.38%	1.31%	1.26%	1.22%	1.16%	1.12%	1.07%	1.05%	1.00%	0.97%	n/a	n/a
Loan rate - weighted average outstanding	3.69%	3.64%	3.68%	3.68%	3.67%	3.68%	3.68%	3.64%	3.64%	3.65%	n/a	n/a
H/hold loans Irish res. (inc. securitised, €bn)	151	150	151	150	149	149	149	148	148	147	146	n/a
NFC loans Irish res (inc.securitised, €bn)	83	82	82	82	82	82	81	81	80	79	78	n/a
Household deposits (€bn)	92	92	91	91	91	91	92	91	91	92	91	n/a
NFC deposits (€bn)	32	31	31	31	32	32	32	33	34	34	34	n/a
Homeowner arrears >3mths			12.7%			12.9%			12.6%			n/a
Irish Government bond holdings (€bn)												
Debt outstanding	115.5	115.4	115.5	114.9	114.8	114.9	114.9	115.1	111.0	112.0	n/a	n/a
Domestic holdings	51.6	52.1	52.3	51.7	52.1	52.6	53.0	52.9	52.5	51.5	n/a	n/a
MFIs/Central Bank	49.4	49.8	49.8	49.8	49.8	50.1	50.6	50.4	50.1	49.3	n/a	n/a
Gen Govt and Fin Intermediaries	2	2.1	2.3	1.7	2.0	2.3	2.2	2.2	2.2	1.9	n/a	n/a
H/holds and Non-Fin Corporates	0.2	0.2	0.2	0.2	0.2	0.2	0.3	0.3	0.3	0.3	n/a	n/a
Non-resident holdings	63.9	63.4	63.2	63.2	62.7	62.2	61.9	62.2	58.5	60.5	n/a	n/a
Market data												
2 year government yield	0.82	0.75	1.02	0.72	0.88	0.69	0.38	0.96	0.83	0.80	0.58	0.57
5 year government yield	2.31	2.3	2.81	2.55	2.79	2.52	2.09	2.17	2.03	1.71	1.50	1.39
10 year government yield	3.53	3.7	4.08	3.87	4.09	3.87	3.52	3.51	3.41	3.30	3.10	3.01
15 year government yield	3.82	4.00	4.42	4.26	4.56	4.31	3.95	3.93	3.84	3.50	3.30	3.20
5 year CDS	159	152	165	146	150	142	129	120	119	108	91	78
B/mark GGB yield (BKIR 4 15)	2.1	1.9	2.1	2.0	1.9	1.9	1.2	1.1	1.0	1.0	0.7	0.8
B/mark covered yield (AIB 3.125 18)*	1.8	1.7	2.0	1.9	1.9	1.6	1.6	1.1	1.1	2.0	1.8	1.6
B/mark senior unsecured yield (BKIR3.25 19)*	4.2	3.3	3.6	3.3	3.2	3.1	2.3	2.2	2.0	3.0	2.6	2.4

Source: Davy

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