

Steady As She Grows; Irish Economy On Improving Trend



Introducing the new KBC Bank Ireland/Chartered Accountants Ireland Business Sentiment Index

- Business sentiment hits highest level in seven and a half years in early 2014.
- Activity levels improving while confidence remains strong.
- Confidence up sharply in recent years as fears about economy ease
- Increase in business activity suggests steady rather than surging growth.
- Irish economy seen at early stage of upturn but many companies feel they are at a more advanced point.
- New index shows smoother but similar upturn to official data.
- Business sentiment at 122.2 in Q1 2014 v 121.8 in Q4 2013 and 83.7 in Q1 2013.

Austin Hughes Mobile 087 669 6972
Chief Economist Work 01 664 6889
KBC Bank Ireland

Brendan O'Hora Mobile 086 2432 428
Director of Communications Work 01 637 7298
Chartered Accountants Ireland

Section I: Introducing the KBC Bank Ireland/Chartered Accountants Business Sentiment Index

This paper describes a new indicator of Irish economic and business conditions. This index of business sentiment shows that the business climate in Ireland both in terms of activity levels and confidence has been improving consistently if cautiously since the second half of 2012. This improvement has continued through the first three months of 2014 and is now fairly broadly based. However, the sentiment index also suggests that the pace of recovery is fairly steady at present. There is little indication of any marked 'lift-off' of activity in the Irish economy.

The new index is broadly consistent with the underlying trend in official measures of Irish economic growth but is notably less volatile largely because of the nature of its construction. It also provides some sense of the range of conditions being experienced across various sectors. As such, it presents a complementary picture of evolving economic conditions in the Irish economy to that provided by official indicators. In a dynamic economy there is a need for multiple perspectives on evolving business conditions. Compared to most other advanced economies, Ireland has relatively few indicators of this form.

Why Is Business Sentiment Important?

The idea that waves of optimism or pessimism exert an important influence on economic activity is not at all new. As is the case with several other economic concepts, most discussion of this topic today begins with an acknowledgement of the contribution of John Maynard Keynes who famously described the role of confidence in business decision-making:

'Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as the result of animal spirits- a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities'

JM Keynes, General Theory

In recent years in Ireland and elsewhere, focus turned from questions of 'irrational exuberance' to concerns that a loss of confidence and weakness in economic activity could be mutually reinforcing, putting individual businesses and the broader economies in which they operate on a notably poorer path. Even if worries about this sort of 'doom loop' have eased of late, a notably increased degree of uncertainty about the future threatens to weigh on business planning and investment decisions.

Some sense of how confidence or its absence could be impacting on

corporate Ireland can be gleaned from a formal measure of business sentiment of the type being presented in this paper. As noted above, most advanced economies tend to have numerous official and private sector surveys that shed additional light and colour on developing economic conditions. At the very least, making sense of business actions and their implications for the Irish economy as a whole might be easier if we have some sense of the range of factors motivating them.

A related rationale for the construction of the Business Sentiment Index is that the structure of the Irish economy is such that summary measures of economic activity, such as official estimates of GDP or GNP growth, may not be entirely representative of conditions across broad swathes of business activity, particularly in respect of period to period changes. For this reason, a business sentiment index, like its consumer sentiment counterpart, might be thought of as complementary to official statistics and therefore helpful to an understanding of a diverse and dynamic Irish economy measure.

How Is The Business Sentiment Index Constructed?

The KBC Bank Ireland/Chartered Accountants Ireland Business Sentiment Survey canvasses the views of chartered accountants working in senior positions (CEOs, MDs and FDs) in Ireland's leading companies. Each quarter, the survey asks a number of questions about trends in output, employment and costs in respondents' companies in the preceding and current quarters as well as one question in regard to their thinking on the broader Irish economy. Separately, respondents are asked each quarter about significant topical business issues such as the Budget or the financing conditions their companies face. The survey is usually taken in the middle of the first month of each quarter and the average sample size is 375 completed surveys.

The new KBC Bank Ireland/Chartered Accountants Ireland Business Sentiment Index is constructed on the basis of responses given to questions on (1) companies' activity levels in the previous quarter, (2) planned activity levels in the coming quarter, (3) changes in employment levels in companies in the previous quarter and (4) sentiment in relation to the broader Irish economy. As a result, the index strikes an intended balance between companies' activity outturns and plans specific to companies and broader economic sentiment. The index is derived by setting the balance of positive and negative responses given to each of these questions in the winter 2006 survey to 100 and rebasing subsequent quarters' results accordingly. We then aggregate these results to arrive at the overall Business Sentiment Index.

How Has Irish Business Sentiment Changed In The Past Eight Years?

Diagram 1 shows the evolution of the KBC Bank Ireland/Chartered

Accountants Ireland Business Sentiment Index since the final quarter of 2006. Not surprisingly, sentiment fell sharply through 2007 and 2008 in line with the general deterioration in economic conditions and reached its lowest point in late 2008/early 2009 as the Irish economy suffered its sharpest fall in output and employment.

Diagram 1: KBC Bank Ireland/Chartered Accountants Ireland Business Sentiment Index



Source: Macrobond

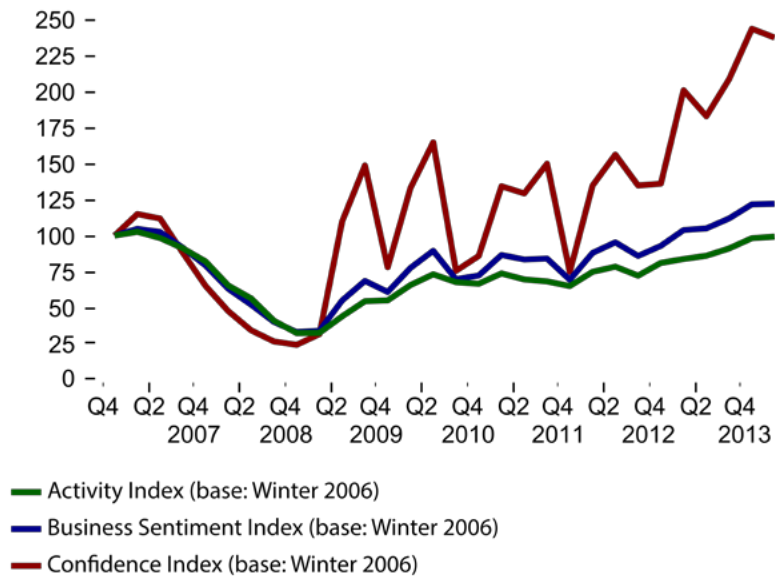
The manner in which the survey is constructed means that it focuses on period to period changes in business conditions. As a result, some stabilisation in the global economy and hopes that the worst was over for the Irish economy in terms of output and job losses meant the index improved somewhat into 2010 and remained around similar levels into the middle of 2012. While this was a period of pronounced weakness in the Irish economy, firms focused on overseas sales, particularly Irish based multinationals with strong market positions, saw some improvement in trading conditions. A gradual broadening of recovery emerged later in 2012 and through 2013.

What Drove The Turnaround In Business Sentiment?

Diagram 2 shows the trends in the overall Business Sentiment Index and in two of its components that relate to company activity levels and broader economic sentiment. As diagram 2 indicates, far and away the strongest element of the sentiment index in the past couple of years has been the component relating to business sentiment. This is not to say that Irish companies are extremely optimistic about the broad Irish economy. Instead, it largely reflects the extent to which companies were concerned about the emerging outlook in late 2006 and the gradual easing in these

fears that has occurred in the interim. Through the same period, the turnaround reported in activity has been notably more modest. This is not a surprising result. Typically, swings in 'pure' sentiment might be expected to be greater in both directions than changes in activity levels. As we wanted the sentiment index to reflect the broad business environment, we constructed it as a composite of confidence and activity measures.

Diagram 2



Source: Macrobond

How Does The Business Sentiment Index Compare To Conventional Measures Of Economic Growth?

Diagram 3 compares the Business Sentiment Index to quarterly changes in real GDP, the standard measure of economic growth worldwide. As the diagram indicates, the sentiment index is altogether less volatile than the official measure. For most companies, business conditions generally tend to exhibit some element of stability or inertia rather than a sequence of large and random two way movements. In addition, Irish growth data are frequently buffeted by developments in a small number of large multinationals. The exceptional size of these companies relative the Irish economy as a whole mean these developments can mean quarterly changes in GDP data while statistically correct are not reflective of developing conditions across the broad spectrum of Irish business.

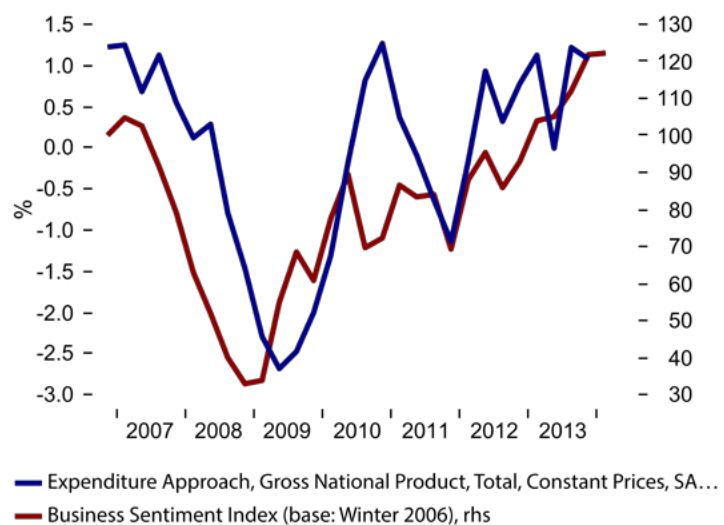
Diagram 3



Source: Macrobond

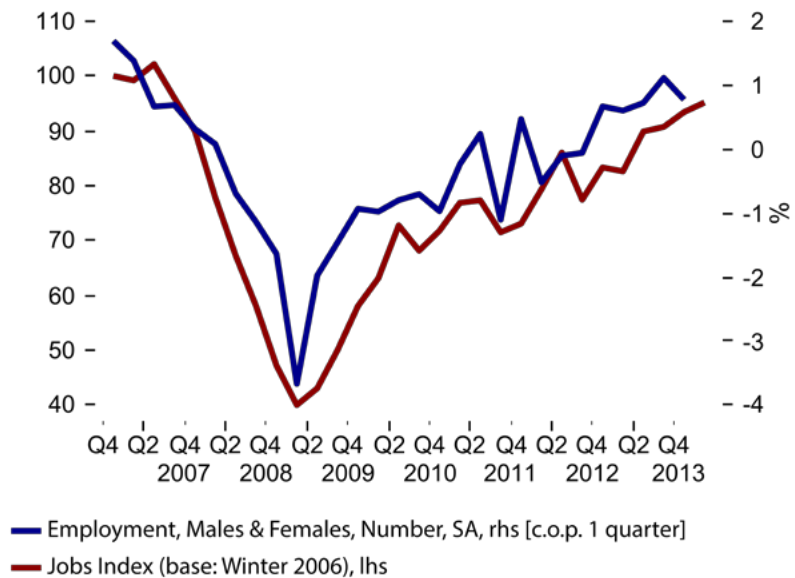
The stark contrast between the sentiment index and GDP data through 2013 can be attributed to the two issues mentioned above. To illustrate this, diagram 4 compares the Business Sentiment Index to a four quarter moving average of the quarterly changes in real GNP. This suggests a reasonably close relationship between the sentiment index and the underlying trend in Irish economic growth through the history of the sentiment index. A strong correlation between the sentiment index and the broader Irish economic environment is also indicated by a comparison of the jobs component of the sentiment index and the CSO's estimates of quarterly changes in employment as seen in diagram 5.

Diagram 4



Source: Macrobond

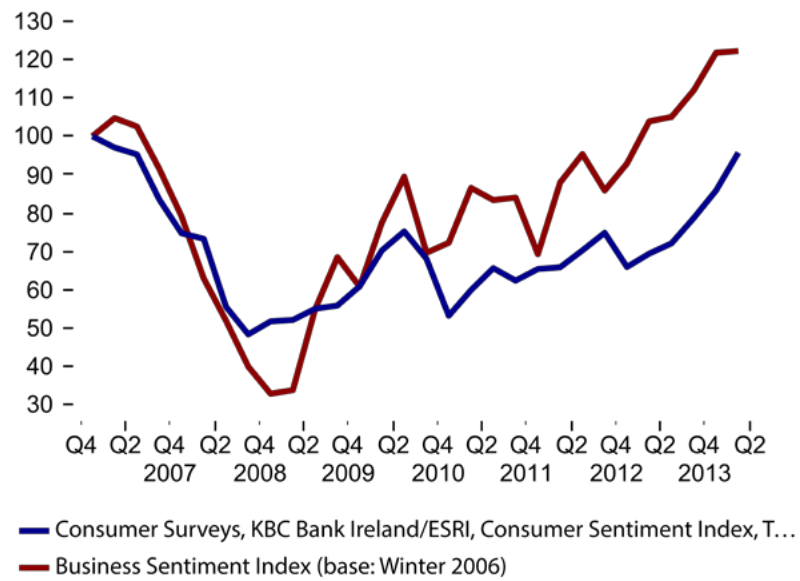
Diagram 5



Source: Macrobond

Finally, diagram 6 compares the trend in the Business Sentiment Index with that in the KBC Bank Ireland Consumer Sentiment Index. For the purposes of comparison, we took the quarterly average of the consumer sentiment index and rebased it to the fourth quarter of 2006. As can be seen from the diagram, the two series show a comparable deterioration into 2008 but the intensity of the global crisis and its immediate impact on orders in particular and business conditions more generally resulted in a relatively large deterioration in business sentiment in late 2008 and early 2009. Our sense is that the rapid drop in European Central Bank interest rates that offered some support to consumer sentiment in late 2008 did not have a comparable impact on business sentiment. More recently, the exposure to a somewhat healthier international economy and a less direct impact from fiscal austerity measures meant business sentiment moved onto a more positive trajectory earlier than its consumer counterpart.

Diagram 6



Source: Macrobond

Section II: Repeated Questions

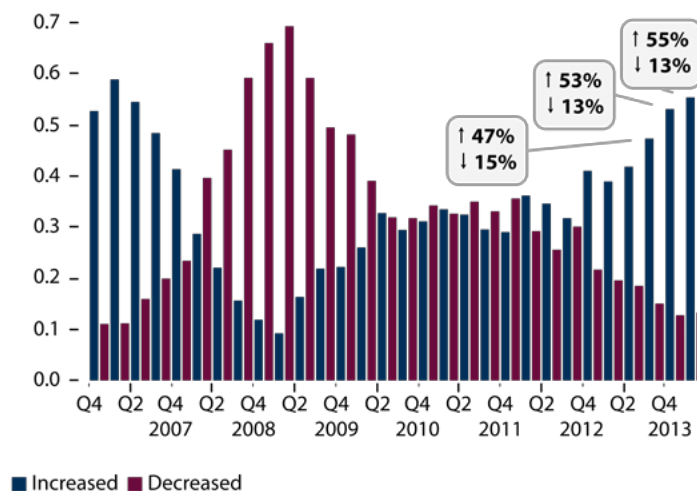
Activity Continues To Improve

We now turn to a detailed examination of the forces influencing the Business Sentiment Index of late. Irish business sentiment has continued to improve in early 2014 but recent changes in business conditions have been fairly modest. These results suggest the persistence of fairly healthy activity trends across the spectrum of companies operating in Ireland but they don't point towards any marked acceleration in the pace of growth of late.

The new KBC Bank Ireland/Chartered Accountants Ireland Business Sentiment Index reached a level of 122.2 in the first three months of 2014 up from 121.8 in the final three months of 2013. These are strong results and entirely consistent with a range of indicators pointing towards improving conditions across Irish companies but there is little indication of any sea-change in the business climate that might suggest anything approaching boom conditions might be underway.

As was the case three months ago, just over half of the companies surveyed reported an increase in their activity levels—more than four times the number that reported a drop in their output. As diagram 7 indicates, this positive balance is very similar to that seen in the winter survey, with only a fractional increase in the number of companies reporting stronger business volumes of late. This is not unexpected.

Diagram 7: Apart from normal seasonal patterns, how has your company's level of business changed in the past three months?



While there are signs of improvement in key trading partners such as the UK and US, global economic conditions remain somewhat fragile. Similarly,

constraints on household spending power continue remain an important issue for companies focussed on the domestic market. As such, the spring 2014 results should be regarded as signalling steady progress in an ongoing recovery that has been increasingly evident in these survey data since the end of 2012.

A key element of the business sentiment survey is the light it shines on divergences in the conditions facing companies in different sectors. All areas reported notably more firms seeing increases rather than decreases in their business volumes in the past three months. However, both food and other manufacturing saw the margin between positive and negative responses somewhat smaller than three months ago, hinting at continuing constraints on export market growth.

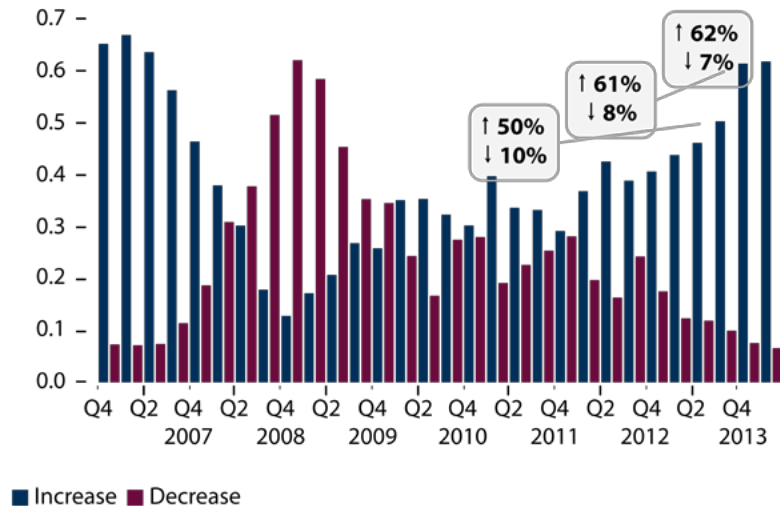
The most notable aspect of the spring 2014 results is a further improvement in responses from companies focussed on the domestic economy. Firms selling to the Irish consumer reported notably stronger trading conditions of late, with 58% of respondents indicating a rise in activity levels in the first early 2014 compared to 45% three months earlier. The number of negative responses was marginally lower than in the previous survey at 16%.

Firms in the business service area were even more upbeat with a ratio of positive to negative responses of six to one. Construction companies also remained strongly positive although the ratio of firms reporting stronger conditions to those reporting weaker conditions fell from five to one in the previous survey to around five to two in spring 2014.

A Further Albeit Modest Improvement Is Expected

Some further broadening of the recovery is expected in the next three months as diagram 8 indicates. The expectations of business volumes in the coming quarter depicted in diagram 8 are not that markedly different from those reported in the most recent quarter (shown in diagram 1 above). So, it seems that momentum is expected to build relatively modestly in the coming quarter. Again, the strongest sentiment is found in sectors with domestic exposure; around two-thirds of construction, consumer-oriented and business service firms signalled expectations of stronger activity levels in the next three months.

Diagram 8: Apart from the normal seasonal patterns of the next three months, do you expect your company's level of business activity to increase or decrease?

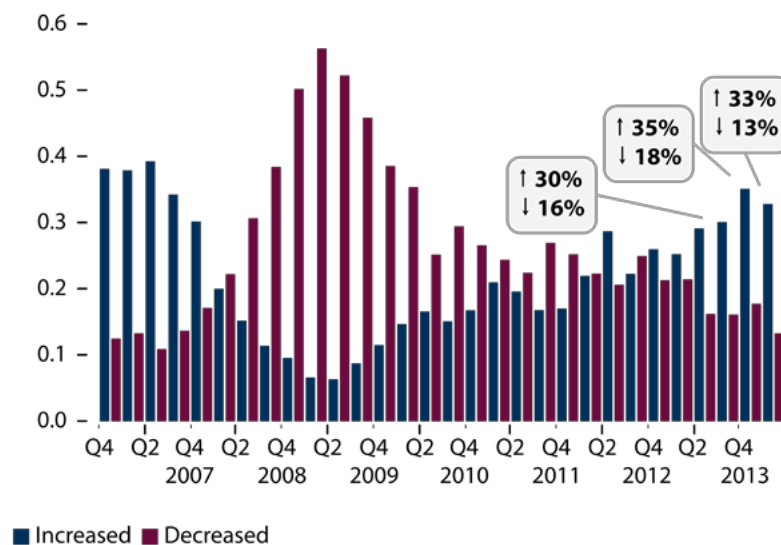


Source: Macrobond

Jobs Market Steady In Early 2104

The employment component of the survey reports only a marginal strengthening in job market conditions in the past three months, an outturn that is entirely consistent with the relatively stable pace of growth seen in activity. Again, it should be emphasised that the spring 2014 results shown in diagram 9 represent an improving situation in relation to the Irish jobs market but this improvement is incremental rather than sharply picking up pace at present. Compared to the previous quarter, the number of firms increasing payrolls was marginally down but the number of firms cutting headcount fell somewhat faster. It would seem early 2014 saw some slight easing in jobs turnover but the limited nature of these changes mean this result is probably best regarded as signalling no change in job market conditions of late.

Diagram 9: In the past three months has the number of people your company employs increased or decreased?



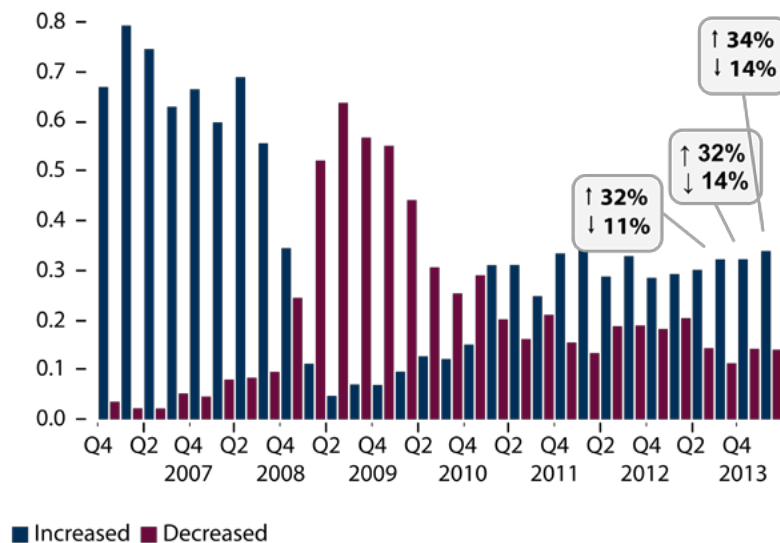
Source: Macrobond

As has been the case for several quarters, all sectors reported a positive jobs balance in the past three months. The strongest hiring was in business services but manufacturing firms also reported a very positive jobs balance that is somewhat surprising given the reported modest gains in output. This might suggest that many of these firms are already operating at capacity in terms of manpower. This result could also be consistent with improving conditions in more 'traditional' manufacturing companies, possibly related to stronger UK demand, as these companies tend to be more labour intensive than some of the more 'modern' manufacturing firms.

Costs Remain Subdued

With activity growing modestly and no marked change in labour inputs, it's not entirely surprising that cost trends showed no substantive change in the past three months. Diagram 10 shows only one in three companies experienced rising costs with a small but not insignificant 14% reporting declines and just over half of respondents seeing no change in their costs in the past three months. Some perspective is provided by a comparison of current cost readings with those from the early part of the survey when typically 60-70% of companies reported rising costs. While the survey responses don't allow us to determine how near or far from deflation we might be, circumstances in which two thirds of Irish companies are not reporting rising costs emphasises how subdued the pricing environment is at present.

Diagram 10: In the past three months have your company's costs increased or decreased?



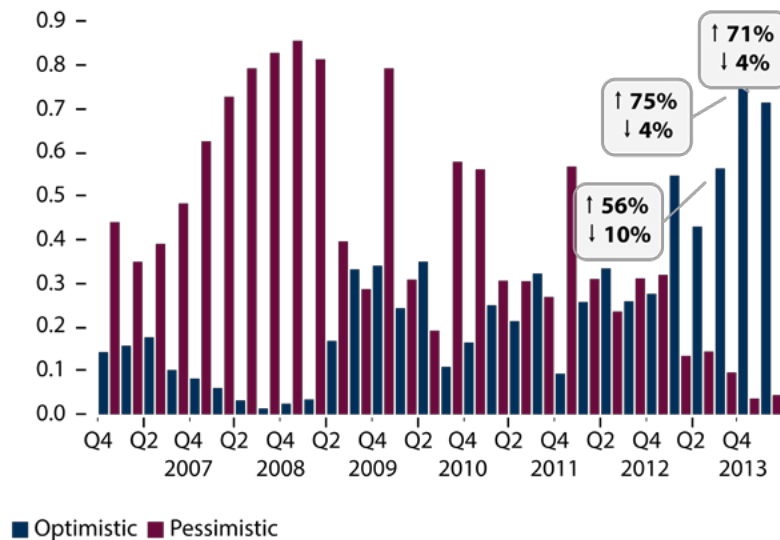
Source: Macrobond

Business Confidence Continues To Strengthen

The main focus of the business sentiment survey is on the immediate operating environment of the companies in which respondents work (thereby ensuring the survey taps into their particular expertise). However, it is also useful to measure their sentiment in relation to the broader Irish economy as a barometer of business thinking about the broader environment in which they operate. Through much of the survey's history, respondents have been notably more negative about the Irish economy as a whole than they have been about their own businesses. However, for the past year or two, confidence in the broader economic outlook has improved markedly and this has been sustained in the current survey.

The spring 2014 survey shows 71% of respondents have become more optimistic about the Irish economy in the past three months compared to just 4% who became less optimistic. This is similar to the results of the previous survey and, as diagram 11 shows these results are notably stronger than at any other time through the seven year history of the survey. It should be noted that the question asked provides an insight into the change in sentiment rather than the absolute level of confidence, (i.e. it measures flows rather than stocks) but these results imply very strong positive momentum in sentiment of late.

Diagram 11: Turning to the broader Irish economy how do you feel compared to 3 months ago?



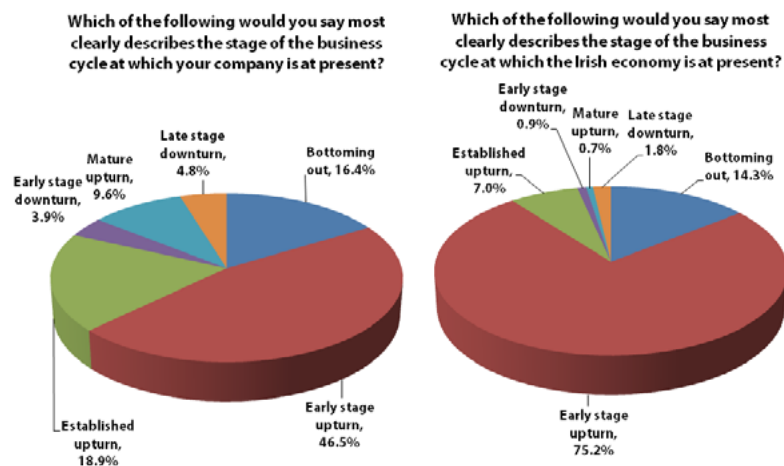
Source: Macrobond

A comparison of responses given to this question and those reported for companies' own recent activity and job trends suggests confidence may now be running ahead of current conditions. This is not entirely surprising given the collapse in sentiment in recent years. A sense that the economy is making progress and seems set for stronger growth in coming years would underpin responses to this question. However, companies are not seeing this transition to a healthier economic path immediately translate into markedly stronger trading conditions for them.

Section III: Supplementary Questions

As usual, the survey asked a number of supplementary questions intended to shed light on particular aspects of the current business landscape. With most economic forecasts envisaging a marked step-up in GDP growth in 2014 from the marginally negative outturn posted in 2013, we thought it might be interesting to get a sense of where respondents thought their companies and the broader Irish economy stand in the business cycle. Diagram 12 compares the answers given to these two questions.

Diagram 12



Irish Economic Upturn Still In Early Stages But Many Companies More Advanced

It would seem there is a fairly broadly held view that the Irish economy is now in the early stages of an economic upturn. A fairly small 14% think the bottoming out process has not been completed while only 7% of those surveyed judge that the upturn is clearly established. Only negligible numbers suggest the downturn is continuing or at the other end of the spectrum judge that the recovery is now mature.

While there is a strong consensus in regard to the Irish economy's current position in the business cycle, companies see their own businesses at varying stages. Not surprisingly, the most common position is at the early stages of an upturn, mirroring broader economic conditions. However, 29% see their companies at a more advanced stage of the upswing—four times as many as judge that to be the current position of the economy as a whole.

At the other end of the spectrum, some 9% of companies feel they are

still in a downturn phase. These responses tended to be more prevalent among companies in manufacturing and consumer focussed areas. In the case of the former, this might reflect specific cyclical developments in areas such as pharmaceuticals and IT. In view of a still tentative turn in consumer spending, it is not at all surprising that some companies in this area are still reporting a weakening trend in their markets.

Varied Concerns Hint That Economy Past The Worst But Many Issues To Be Faced

We also asked companies what issues were concerns for them at present and how these had developed in the past twelve months. Diagram 13 shows respondents' assessments of the relative importance of various issues and shows how respondents judge these issues to have moved through the past twelve months.

Diagram 13: Rank each of the following as concerns for your business at present from not important to most important. Through the past year, have the problems eased, increased, or remained the same.

	Very Important	Eased	Increased	Remained Unchanged
Inadequate demand	18.3%	29.1%	15.6%	55.4%
Increased competition	7.8%	3.9%	36.7%	59.4%
Constraints on physical capacity	4.9%	8.8%	16.4%	74.8%
Constraints on availability of suitably qualified employees	5.6%	8.3%	23.5%	68.2%
Access to bank funding	14.4%	12.4%	12.7%	74.9%
Cost of bank funding	11.2%	8.3%	18.2%	73.4%
Access to alternate funding sources	12.9%	8.8%	12.3%	78.9%
Regulatory burden	18.2%	0.9%	43.1%	56.0%
Legislative burden	10.3%	1.2%	31.1%	67.7%

The results shown in diagram 13 suggest there is no single issue overriding all other concerns at present. This seems consistent with the range of views offered on where companies are in their business cycle. That said, it is not entirely surprising that inadequate demand is the most frequently cited issue but at just 18% of responses its importance is not notably greater than a wide range of other issues. Indeed, the almost identical weighting attached to regulatory issues and the prominence attached to legislative issues suggests that a significant number of companies do not see market conditions as their key concern at present. Perhaps surprisingly, these responses were more prominent among firms focussed on the domestic market.

Various concerns about funding figure prominently as do competitive

threats. A sense of the still early phase of the cycle as well as the overhang from the downturn is suggested by the relatively limited focus on bottlenecks in the shape of physical capacity or personnel. However, the most notable feature of responses to this question is the divided nature of Irish business concerns at present. This can be interpreted in various ways and the range of concerns cited argues against any complacency. However, we tend towards the view that these responses suggest conditions are 'normalising' with no one overarching impediment to business growth looming large in the current landscape.

Diagram 13 shows these concerns have changed significantly in the past twelve months. It seems clear that improving economic conditions have eased worries about demand and have, at the margin, increased the focus on capacity constraints. A somewhat healthier economic environment is more likely to be one in which companies individual metrics matter more to their results. So, it is not that surprising that there is an increased focus on competitive issues. However, responses to this question give far more prominence to an increased regulatory and legislative burden in the past twelve months. How companies and policymakers negotiate this landscape may be a far greater influence on the vitality of Irish business in coming years than is generally recognised.