Banking & Payments Federation Ireland

Record employment and rising earnings

Inflation pressures easing

Focus on labour costs

SME Monitor

APRIL 2024

Structural measures rather than one-off initiatives are needed to help SMEs

Commentary

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Structural measures rather than one-off initiatives are needed to help SMEs

The Irish economy shrank by 3.2% in 2023 in terms of Gross Domestic Product (GDP) according to the latest provisional figures from the Central Statistics Office (CSO). The contraction in the economy was mainly driven by the decline in economic activity, in the industry sector, dominated by multinational companies, which dropped for the first time since 2013.

At the same time, modified domestic demand, a narrower measure of underlying domestic activity, grew by 0.5% in 2023. Personal spending on goods and services, which accounts for 46% of domestic demand in the economy, further increased during 2023 and was 10.2% higher than the pre-pandemic levels observed in 2019.

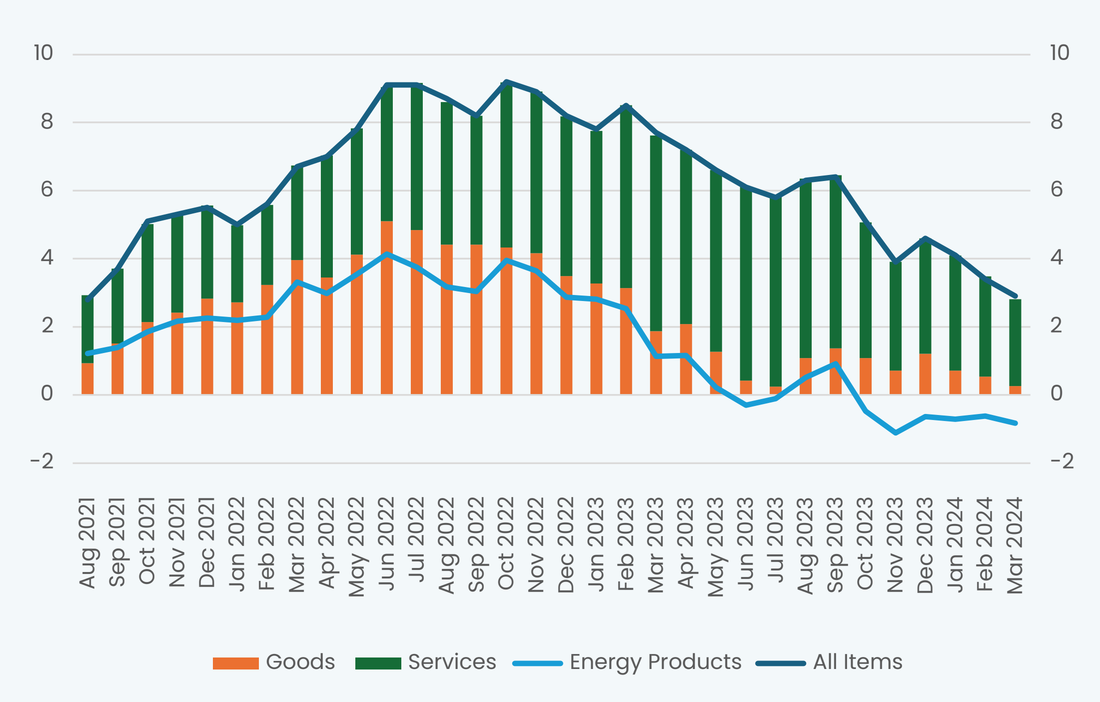
Comparing the economy of 2023 with previous years, Irish GDP has increased by 30% since 2019. This growth in economic activity is also reflected in resilient employment numbers. The employment rate hit 74% in Q4 2023, the highest point since the current series began 25 years ago, with the estimated number of people in employment rising to just over 2.7 million at the end of 2023. There were around 329,000 more people employed in the Irish economy at the end of 2023 than at the end of 2019, prior to the pandemic.

Some of the sectors which were heavily affected by the pandemic, such as accommodation and food services and administrative and support services, seem to have recovered in employment terms as of end of 2023 compared with significant job losses until the middle of 2022. While employment creation rates are moderating, unemployment remains relatively low. The domestic economy is expected to grow at a moderate level at around 2% per year with unemployment at around 4.5% in the next three years according to the latest Central Bank of Ireland (CBI) forecasts.

Almost 58,000 businesses were availing of the Revenue Commissioners' debt warehousing scheme by the end of January 2024. Some €1.7 billion in tax liabilities had been warehoused, however detailed analysis at sector level by Revenue show that the wholesale and retail trade, the accommodation and foods service sector and construction sectors, mainly made up of SMEs accounted for nearly 54% of the total warehoused tax debt that remained. The bulk of the debt (€1.5 billion) is warehoused by 5,347 customers, who have outstanding balances greater than €50,000 however these companies in total employ nearly 160,000 people. The extension to the scheme announced in October 2022 means that businesses need to commence repaying their warehoused debt from 1 May 2024, with the interest rate applicable to warehoused debt reduced to 0% once businesses make payment arrangements with Revenue along with keeping their current tax liabilities up to date.

Inflation pressures are easing

Contribution to Annual Consumer Price Inflation (%)



Source: Central Statistics Office (CSO).

Average annual inflation hit a 38-year high in 2022 mostly driven by rising energy costs and food prices, peaking at 9.2% in October 2022. The latest data from the CSO shows that inflation, measured by the consumer price index, declined to 2.9% as of March 2024. The most significant price rises in the 12 months to March 2024 were in recreation and culture and restaurant and hotels sectors. Average inflation is still mainly driven by the services sectors, however inflationary pressure seems to have eased. CSO analysis suggests that producer prices were 3.3% higher when compared with a year earlier in February 2024, albeit with food products and wholesale electricity prices falling by 9.3% and 46.8%, respectively. Construction material prices fell by 0.7% year on year as well as dairy products by 28.5% over the same period. Even though average consumer price inflation has gradually declined over the past year, price levels are on average 19% higher than pre pandemic levels.

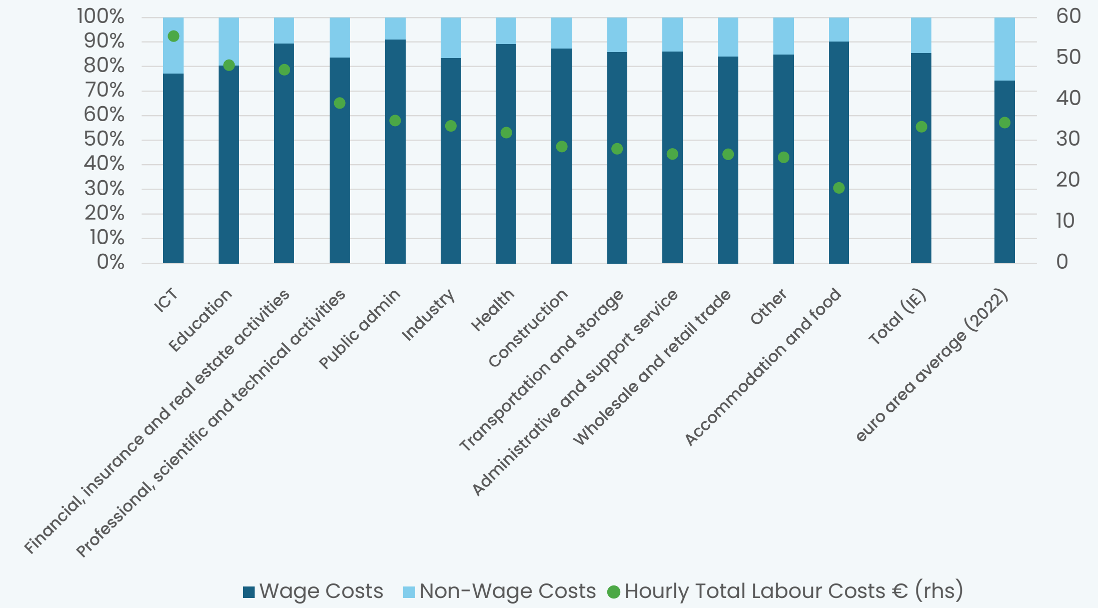
The ECB Survey on Access to Finance for SMEs (SAFE) has traditionally identified finding customers as the most pressing problem for SMEs in Ireland. However, only 16.7% of respondents in the latest survey (conducted in February/March 2024), cited finding customers as the most pressing problem. Availability of skilled staff or experienced managers was the main concern for 28.1% of respondents in the survey, followed by costs of production or labour (17.4%).

Non-wage labour costs are likely to increase

Wage costs in Ireland account for 85% of total labour costs, as opposed to around 75% in the EU, on average with the remainder made up of costs to the employer such as PRSI and private pension contributions (non-wage costs). Sectoral breakdowns show the share of non-wage costs vary ranging from 23% in ICT to 10% in accommodation sectors. The recently announced taxation changes in relation to higher employer PRSI rates which will be effective from October 2024 and the proposed pension auto-enrolment scheme is likely to add to the non-wage cost levels in Ireland and the effect can be disproportional in sectors where non-wage cost shares are low, and these sectors are mainly dominated by SMEs. In addition, rises in wage costs such as minimum wage adjustments to a living wage will push up total labour costs.

Budget 2024 package introduced a new Increased Cost of Business Scheme with a one-off grant to benefit up to 130,000 small and medium businesses at a cost of €250 million. At the start of January 2024, the minimum wage

Labour Costs (wage and non-wage) (Q4 2023)



Source: Based on CBI Quarterly Bulletin Q1 2024

increased to €12.70 per hour, with the government committing to the introduction of a living wage set at 60% of the median wage by 2026 which will require further increases in minimum wage in the next two years. The minimum wage represents 55.1% of the hourly median wage. Along with the proposed pension auto-enrolment scheme and higher employer PRSI contributions, these measures will add to the total labour costs of many small and medium enterprises particularly by increasing non-wage costs in the near future. One-off government support schemes in the form of grants or long-term loans can help many businesses in the short term, however if businesses do not increase productivity or adjust profit expectations, particularly for businesses in the domestically traded services sectors, these additional costs are likely to create structural long term imbalances and put upward pressure on average prices at a time where overall average inflation seems to be driven by mostly services sector inflation.

Market Analysis

Anthony O'Brien,
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SMEs and the wider economy

Growth in economic activity slowed in 2023 amid subdued business expectations on the global economic outlook albeit with positive indicators especially in tax revenues and employment through to the end of 2023. The effects of the European Central Bank's tightening of monetary policy to regain price stability have placed downward pressure on demand with increased consumer prices while businesses face higher operating costs.

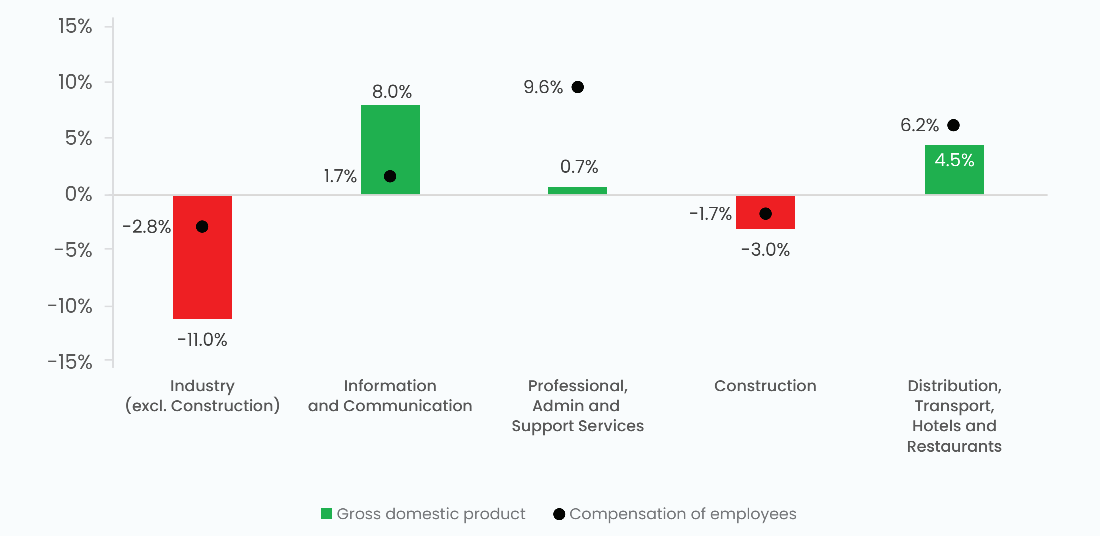
Gross domestic product (seasonally adjusted) fell by 3.4% in volume terms in Q4 2023, according to the Central Statistics Office (CSO), driven by a decline in industry (excluding construction), a sector dominated by multinational firms. The industry sector contracted by 7.7% while construction also contracted by 1.9% quarter to quarter in Q4 2023.

Modified final domestic demand, which excludes globalisation effects such as trade in intellectual property and aircraft leasing, fell by 0.4% in Q4 2023. Consumer spending remained constant quarter on quarter at €32.3 billion.

Strong recovery in services continued

The number of small and medium-sized enterprises (SMEs) – those businesses employing fewer than 250 persons – reached about 365,000 at the end of 2021. They employed almost 1.4 million people (including business owners). Key SME sectors include the service sectors construction, accommodation and food service activities, arts, entertainment and recreation and wholesale and retail trade as well as the repair of motor vehicles. SMEs accounted for at least 70% of employment in each of these sectors.

Economic Performance in Selected Sectors
% Change 2023 vs 2022



Source: CSO.

Both industry and construction recorded annual contractions in gross domestic product based on constant market prices in 2023, falling by 11% and 3% respectively compared to 2022. Agriculture, forestry and fishing increased significantly by 15.4% year on year while information and communication and distribution, transport, hotels and restaurants expanded by 8% and 4.5% respectively in Q4 2023. Professional, administration and support services saw a 9.6% growth in incomes through compensation of employees while real estate activities earnings fell by 23% when compared when 2022.

Substantial government supports have been introduced since early 2020 to absorb the impact of firstly, the Covid health restrictions and, more recently, rising energy prices on consumers and businesses, including the Increased Cost of Business grant announced in Budget 2024.

The total tax take in 2023 was €88.1 billion, according to the Department of Finance, 6% more than 2022. Income tax receipts were up 7.1% year on year to €32.9 billion in the year, on the back of strong employment figures. Corporation tax also grew, by about 5.3% year on year, to €23.8 billion.

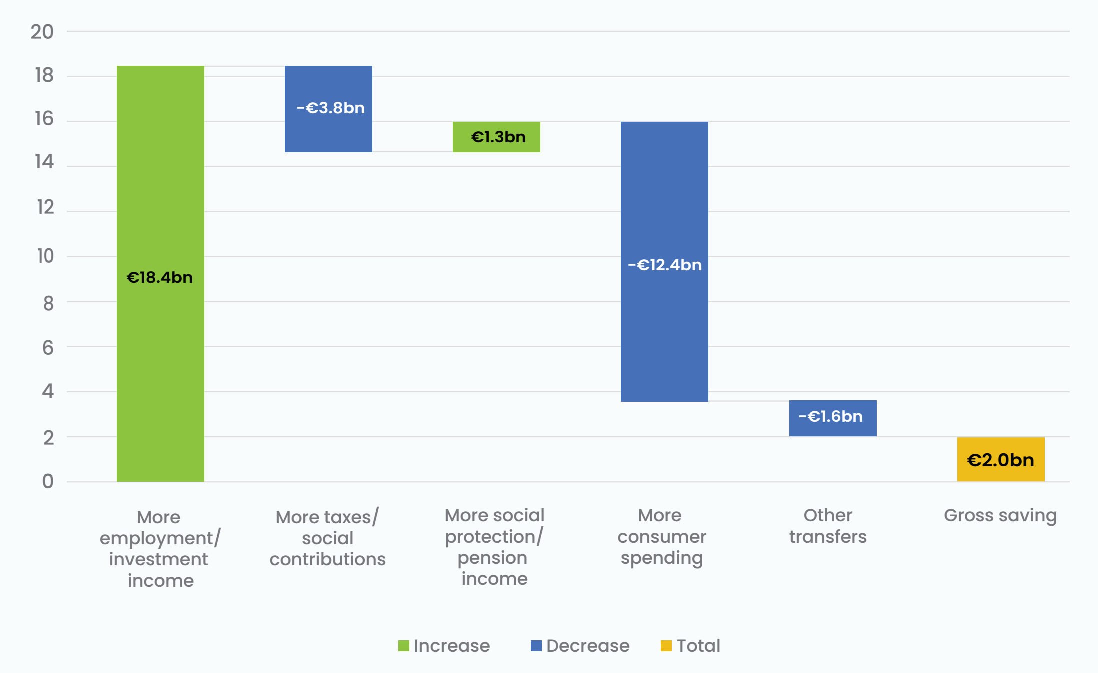
On the expenditure side, value added tax (VAT) receipts increased by 9.4% year on year to €20.3 billion in 2023, likely reflecting higher personal spending as well higher consumer prices. Prices for consumer goods and services rose by 4.6% on average in December 2023 compared with December 2022, according to the

CSO's consumer price index (CPI). Inflation continued its general downward trend into 2024, with the CPI rising by 2.9% in March 2024, the fifth consecutive month in which the CPI was below 5%.

The increased income tax take was driven a combination of higher employment and increased earnings. Unemployment levels were relatively stable in 2023 although the CSO's seasonally adjusted unemployment rate rose from 4.1-4.3% in the first half of the year to 4.4-4.6% in the second half. By the end of Q4 2023, more than 2.7 million people were in employment, the highest level since the data series began in 1998. Employment and investment income increased by €18 billion in 2023, compared with the same period of 2022. Investment income jumped by 46% in 223 partly reflecting the higher interest rates and an increase in total financial assets.

Consumer spending was some €12.4 billion higher than in 2022 but saving remained strong with the seasonally adjusted household saving rate at 10.2% in Q4 2023, making it the 18th quarter in a row with a gross saving rate of at least 10%. The CSO estimates that €10 billion was invested on capital assets such as dwellings and improvements, while household deposits in credit institutions were €4.4 billion higher than in 2022.

Change in Household Income and Expenditure
€billions (2023 vs 2022)



Source: BPFI estimates based on CSO data.

Weaker demand amid continued employment growth

Growth in services activity continued throughout 2023 and into 2024, according to the AIB Irish Services purchasing Managers Index (PMI) and the CSO monthly services index. However, the CSO analysis shows that the accommodation and food service activities sector recorded sharp drops in outputs in late 2023, especially in value terms. Employment in services continued to increase according to the PMI.

Inflationary pressures in the services sector eased but remained elevated. CSO analysis suggests that producer prices were 3.3% higher when compared with a year earlier in February 20234, albeit with food products and wholesale electricity prices falling by 9.3% and 46.8%, respectively. Construction material prices fell by 0.7% year on year as well as dairy products by 28.5% over the same period.

A fall in output and new orders has led to the weakening in Irish manufacturing conditions in March as the AIB Manufacturing PMI fell from 52.2 to 49.6 in February 2024. Declines in manufacturing orders and output reflected subdued demand but there was modest growth in employment with supplier delivery times shortening as supply chain issues ease and input cost increases slowed. Employment continued to increase for the third consecutive month in March.

Weaker business activity expectations have now been recorded in six of the past seven months amid concerns about the outlook of the global economy and subdued prospects for export sales.

The construction sector remained in contraction at the end of February 2024 according to the BNP Paribas Real Estate Ireland Construction PMI. Activity in residential and commercial sectors of construction covered by the survey saw the pace of decline ease in February partly due to more stable housing activity in the month. Companies expressed optimism that demand conditions would improve with more than 40% of respondents predicting a rise in output outlook.

Consumers expect both their incomes and their expenditure to increase in the next twelve months, according to the European Central Bank's Consumer Expectations Survey. Consumer expectations for nominal income growth increased to 2.5% in February 2024, while nominal spending growth expectations increased to 4.3%.

Finding Customers

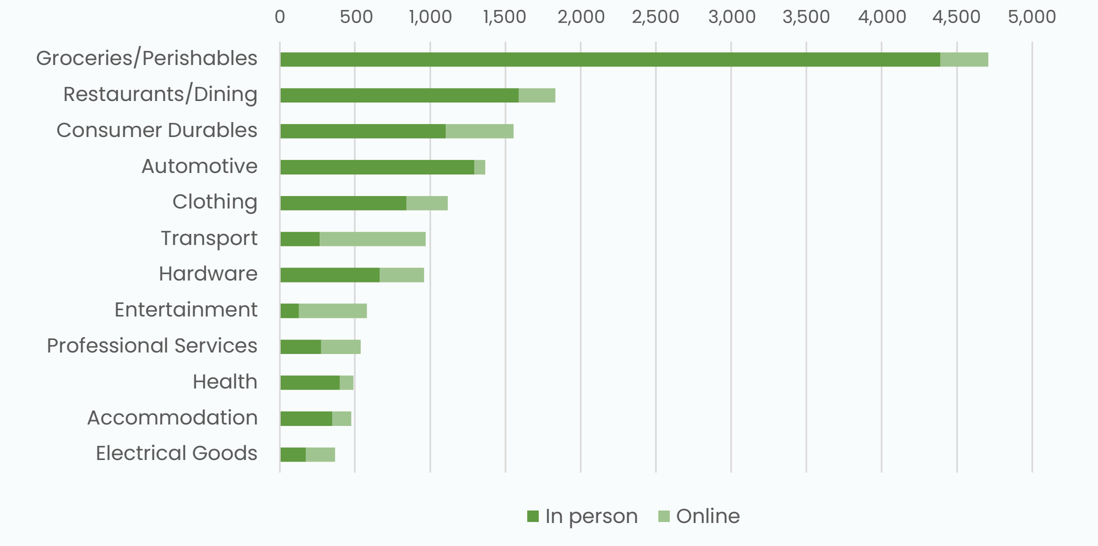
The ECB Survey on Access to Finance for SMEs (SAFE) has traditionally identified finding customers as the most pressing problem for SMEs in Ireland. However, only 16.7% of respondents in the latest survey (conducted in February/March 2024), cited finding customers as the most pressing problem. Availability of skilled staff or experienced managers was the main concern for 28.1% of respondents in the survey, followed by costs of production or labour (17.4%).

Consumer spending grows

The CSO's retail sales index indicates the volume of retail sales increased in the last three months of 2023. The seasonally adjusted retail sales were 5.3% higher year-on-year in January 2024.

Domestic spend on credit and debit cards reached €20.7 billion in Q4 2023, of which €12.1 billion was in stores and other physical points of sale such as cafes, restaurants and cinemas. Almost €4.4 billion was spent on groceries and perishables

Card Spend by Sector (€m)
Q4 2023



Source: BPFI analysis of CBI monthly payment cards data and almost €1.6 billion was spent on dining out, while nearly €1.3 billion was spent in the automotive sector, mainly on motor fuel. The clothing, hardware and consumer durable sectors each saw in-store spend of over €600 million.

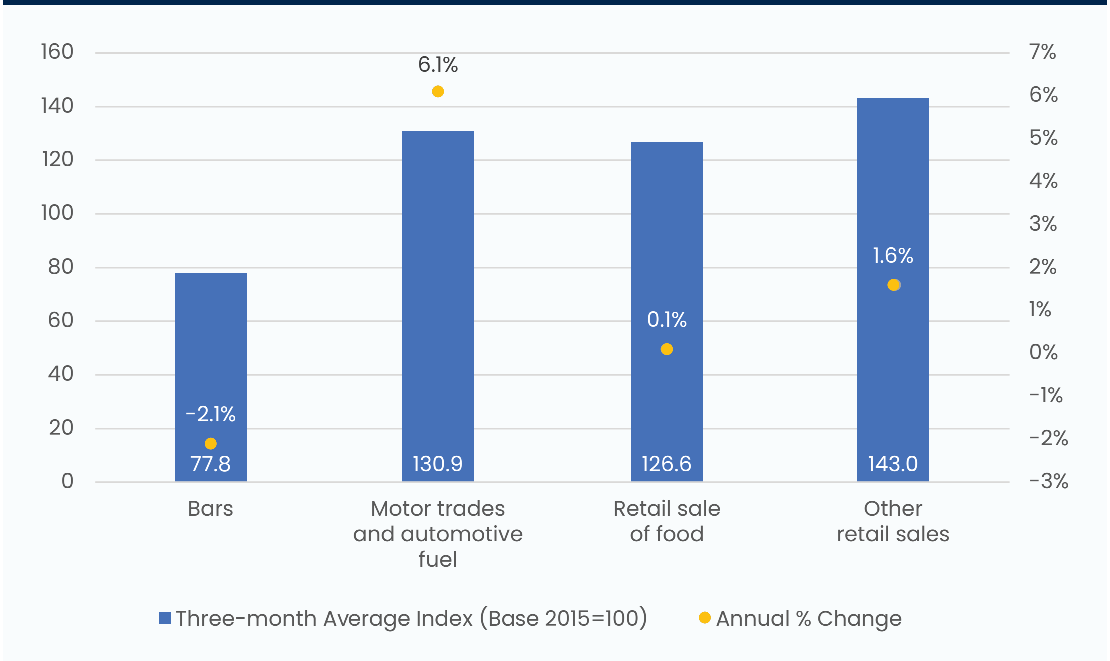
The volume of retail sales in February 2024 was 1.1% higher than in January 2024, on a seasonally adjusted basis, while the value of retail sales rose by 3% in the 12 months from January 2023.

Retail sales in the three months ending February 2023 increased by 3.1% year on year, however, performance varied significantly by sector. The largest increases compared with December 2022-February 2023 were electrical goods, motor trades and clothing, footwear and textiles growing by 6.7%, 6.2% and 3.4% respectively.

Sales in department stores and food, beverages and tobacco saw the biggest declines at 11.2%, and 5.6% respectively.

Bar sales remained well below pre-Covid levels and fell by 2.1 % year on year in the period December 2023-February 2024.

Retail Sales Indices by Broad Sector
(December 2023-February 2024)



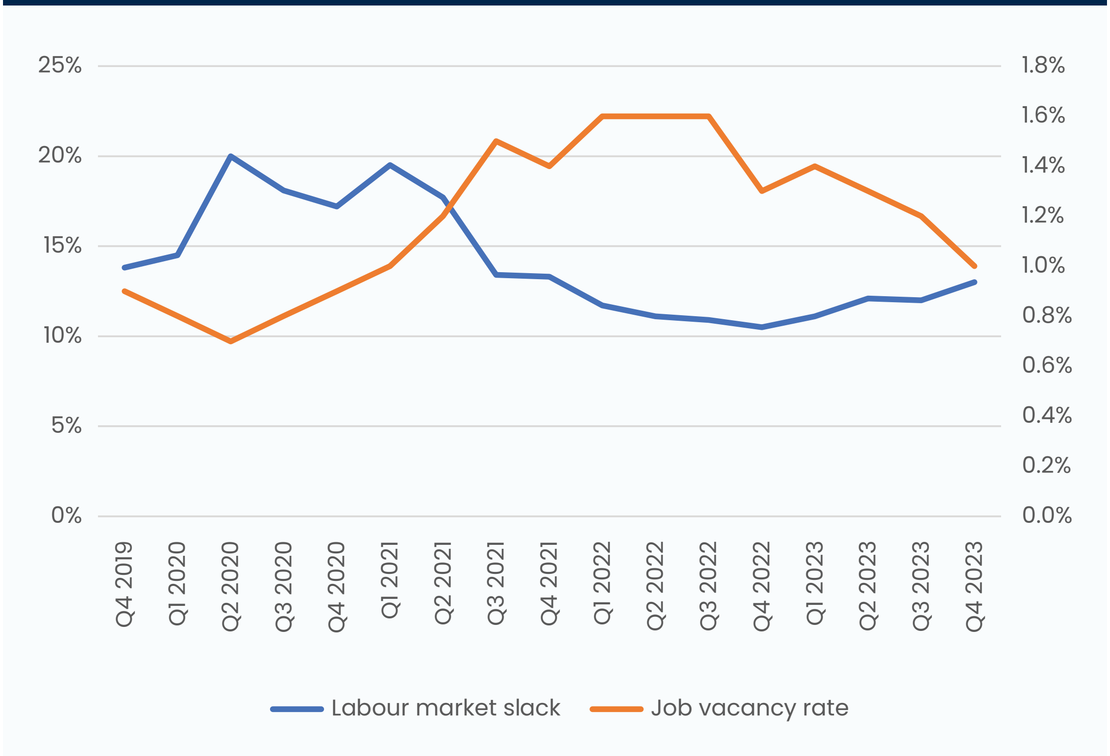
Source: CSO

Availability of skilled labour

Employment grew strongly and reached historical highs in 2023. The number of people in employment reached rose by 3.4% in the year to Q4 2023, reaching more than 2.7 million the highest employment since the data series began in 1998.

Employment rose by 14.8% or more than 349,100 people between Q4 2019 and Q4 2023. While most sectors saw employment growth over that period employment fell by 4.7% in and by 4.3% in administrative and support services. The information and communication and professional, scientific and technical activities sectors had the highest growth rates at 32.6% and 32.2% respectively.

Job Vacancies and Labour Market Slack



Source: CSO/Eurostat

Record employment and increasing earnings

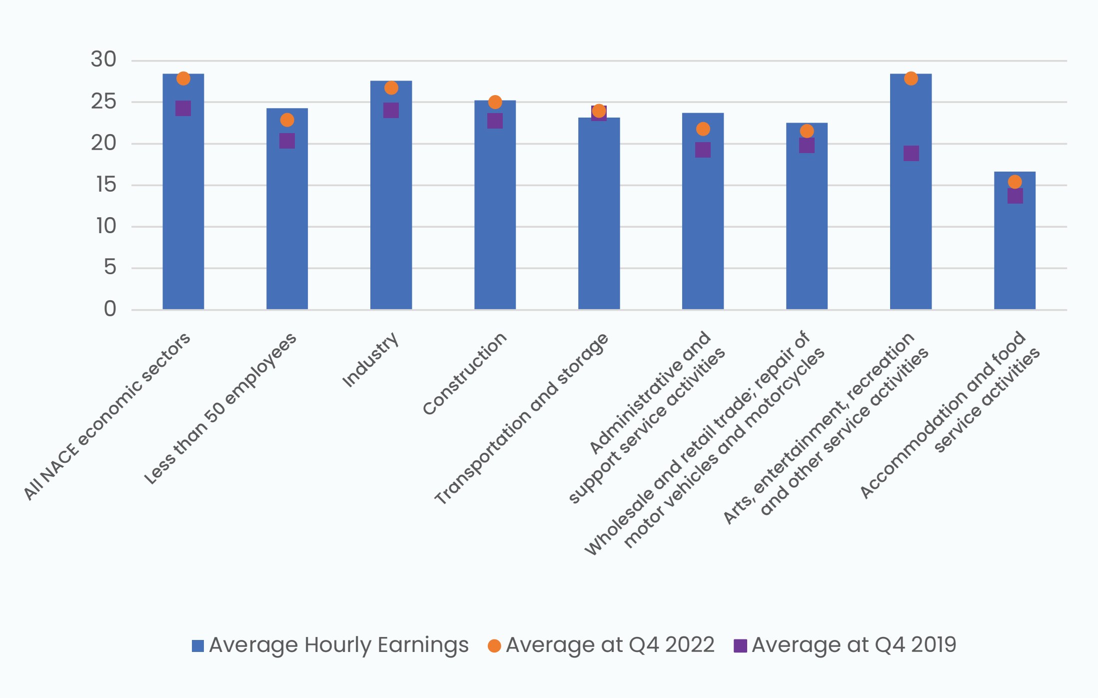
With employment at historically high levels and the employment rate at 74% in Q4 2023, businesses were reporting challenges in hiring suitably trained and skilled staff, as evidenced by the ECB SAFE Survey.

The job vacancy rate fell 1% in Q4 2023, 0.3 percentage points lower than the corresponding quarter in Q4 2022, according to CSO.

The number of vacancies fell to 23,100, the lowest level since Q1 2021 although the number of public sector vacancies increased by 800 year on year to 7,300.

Labour market slack, which Eurostat suggests reflects the unmet need for employment, increased to 13% of the extended labour force (which includes underemployed part-time workers and those either not available for or not seeking work) in Q4 2023, up from 10.5% in Q4 2022.

Average Hourly Earnings (€)
(Q4 2023)



Source: CSO

Average weekly earnings rose by 2.1% year on year to €921.81 while average hourly earnings increased by 2.1% to €28.43. Enterprises with fewer than 50 employees reported lower average weekly and hourly earnings at €760.37 and €24.26, respectively.

Average weekly earnings in the accommodation and food services were less than half the all-sector average at €437.37. This was partly related to the low average weekly paid hours (26.3 compared with 32.4 for all sectors combined) and the relatively low hourly earnings of €16.63. The national minimum wage increased by €1.40 per hour to €12.70 per hour in January 2024.

Earnings have increased significantly since 2019. Average hourly and weekly earnings rose by 17.3% and 17.2%, respectively, between Q4 2019 and Q4 2023. All sectors saw increases of over 12% in weekly earnings over the same period except for Transportation and Storage which increased by 5.4%. Information and communication saw the largest increase at 27.1%.

The consumer price index rose by 3.4% between February 2023 and February 2024 while the annual rate of inflation has only been below 5% four times since September 2021.

"With employment at historically high levels and the employment rate at 74% in Q4 2023, businesses were reporting challenges in hiring suitably trained and skilled staff."

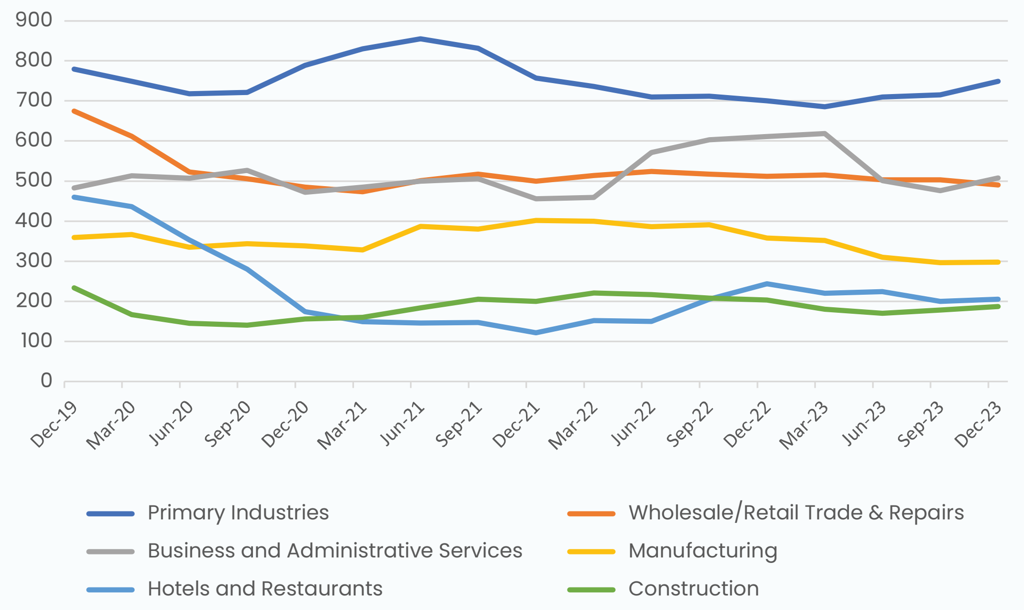
Accessing finance

SME demand for bank credit was unchanged in the second half of 2023 according to the Central Bank of Ireland (CBI) bank lending survey. Gross new lending to SMEs (including €23 million in financial intermediation) reached almost €4.1 billion in 2023, 4.1% less than in the twelve months ending December 2022. SMEs continued to deleverage with estimated repayments by SMEs increasing by €622 million to €4.9 billion in 2023.

Real estate activities (mainly property investment/development) and primary industries (mainly agriculture) accounted for €861 million and €749 million, respectively, of gross new lending in 2023.

Drawdowns in the transportation and storage sector increased by 83% to €317 million in 2023. Annualised gross new lending in the wholesale/retail trade and repairs sector fell to their lowest levels since the twelve months ending March 2021.

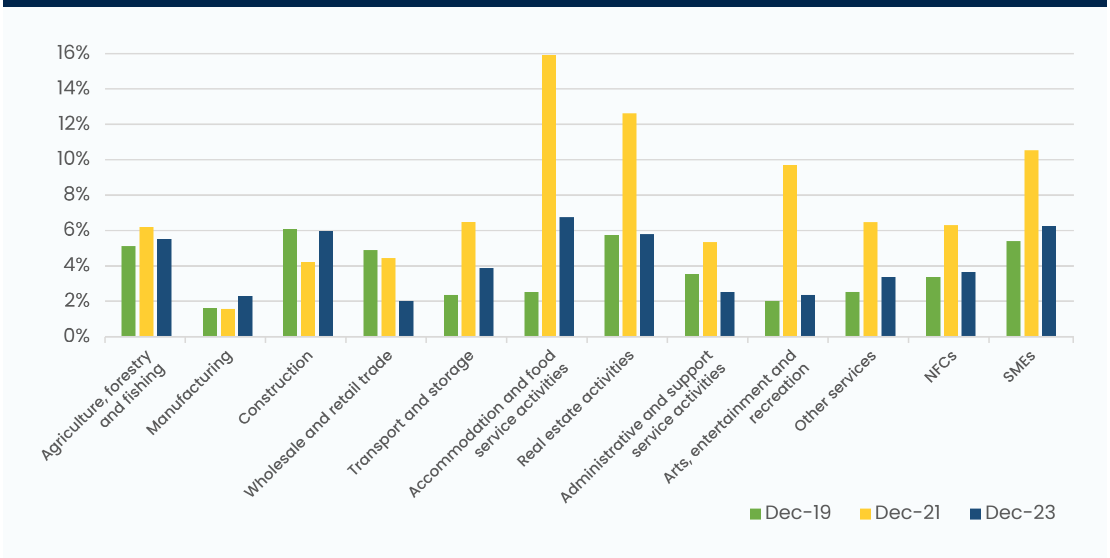
Gross New Lending to SMEs, €m
(Annualised - Selected Sectors)



Source: Central Bank of Ireland

The value of outstanding credit to core SMEs (excluding property-related sectors and financial intermediation) fell by €924 million in the twelve months ending December 2023 to about €11.6 billion. Three sectors (primary industries including agriculture, wholesale/retail trade and repairs and hotels and restaurants) accounted 56.2% of outstanding credit to core SMEs (excluding property-related sectors) at the end of December 2023, with 25.2%, 19.3% and 11.7% of outstanding credit, respectively. The outstanding stock of lending to SMEs involved in real estate activities (mainly property investment or development) increased by 5% year on year to over €5.4 billion. Non-performing loan (NPL) ratios on business loans rose during the Covid-19 pandemic but they had declined significantly by the end of December 2023, according to the European Banking Authority (EBA). The NPL ratio for all SME loans was 6.3% at December 2023, down from 10.5% at December 2021 but higher than the December 2019 level of 5.4%. The NPL ratios in the accommodation and food service activities were still significantly above their December 2019 levels at 6.7%.

NPL Ratios for Selected NACE Sectors



Source: European Banking Authority

Financial supports

The government announced additional support to businesses through Budget 2024 including the Increased Cost of Business Scheme, a once-off grant to benefit up to 130,000 rate-paying SMEs at a cost of €250 million. The rates grant is expected to be paid through local authorities. While the closing date for registration is 1 May 2024, payments under the scheme are expected to begin in late April.

Among the tax measures announced were an increase in R&D Tax credit from 25% to 30%. The credit, a new targeted Capital Gains Tax relief for angel investors has been announced which will provide for a lower rate of 16% (18% for partnerships) for disposals of qualifying investments for gains up to a value of two times the initial investment. The Employment Investment Incentive scheme which provides tax relief for risk capital investments in qualifying SMEs has been enhanced to allow investors to claim relief of €500,000, up from €250,000.

A number of loan schemes are managed by the Strategic Banking Corporation of Ireland (SBCI). The Ukraine Credit Guarantee Scheme which facilitates the provision of working capital and medium-term investment finance for businesses adversely affected by the war in Ukraine. By the end of March 2024, 3,007 loans valued at almost €279 million had been approved, of which €238 million had been drawn down.

The first phase of the Growth and Sustainability Loan Scheme opened in 2023 for climate action and environmentally sustainable investment loan applications. By the end of March, 391 loans valued at almost €63 million had been approved, with €32.8 million of this drawn down. The Energy Efficiency Loan Scheme launched in July 2022 closed for new applications at the end of 2023.

Most government financial supports for businesses affected by Covid-19 have effectively wound down. Almost 60,000 businesses were availing of Revenue's debt warehousing scheme by the end of August 2023. Some €1.9 billion in tax liabilities had been warehoused, of which VAT and employers' PAYE and PRSI accounted for about €950 million and €800 million respectively. The wholesale and retail trade and the accommodation and foods service sector accounted for 21% and 16%, respectively, of the warehoused debt.

The extension to the scheme announced in October 2022 means that there is no obligation on some businesses to commence repaying their warehoused debt until 1 May 2024. In February this year, the Minister for Finance announced that the interest rate applicable to warehoused debt will be reduced to 0%. Revenue has confirmed that it will operate the reduced interest rate on an administrative basis pending the legislative change.

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