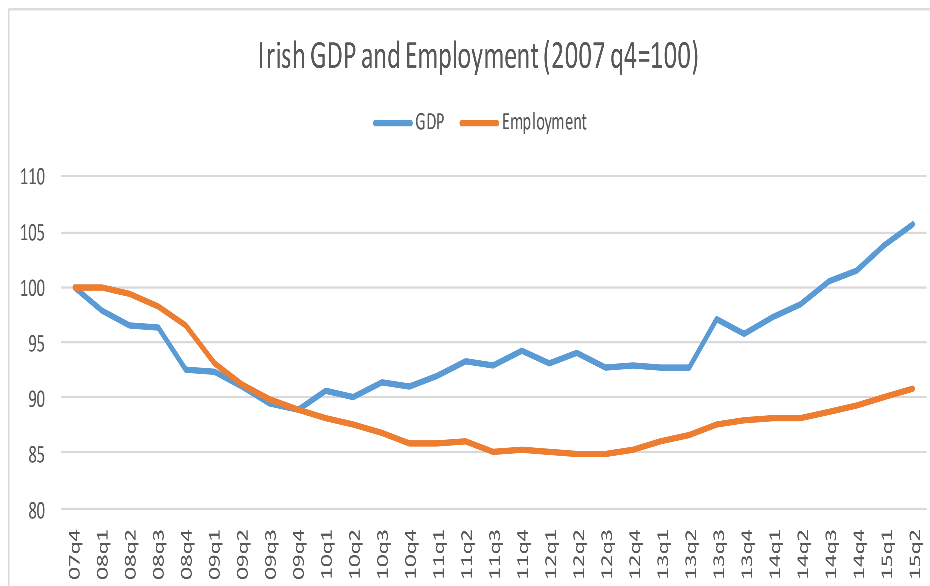
Economic Research

Irish GDP growth now forecast at 6.5% 18 September 2015

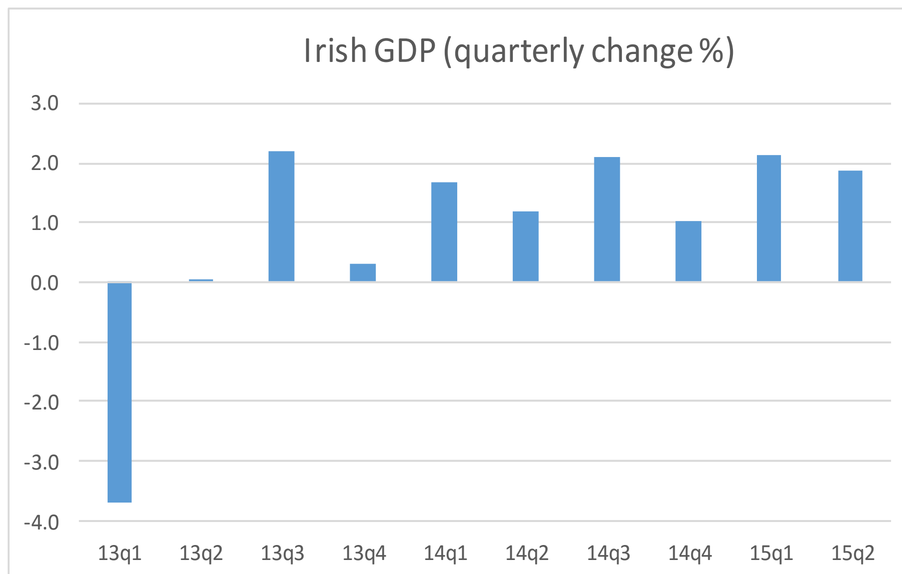
The Irish economy is now growing at a rapid pace and much stronger than envisaged by consensus forecasts or by the Department of Finance in framing the 2015 Budget. Real GDP expanded by 1.9% in the second quarter according to the latest national accounts, following an upwardly revised 2.1% increase in q1, leaving GDP 5.7% above the previous cyclical peak. The annual pace of growth averaged 7% in the first half of the year and although we expect some modest deceleration in H2 it is difficult to conclude , absent some sizeable data revisions ,that growth for the full year will be less than 6.5%. The GDP deflator is also much stronger than envisaged, largely due to a big rise in export prices, and so we now expect nominal GDP growth of 12.9%, taking the level of GDP in 2015 to over €213bn.



That in turn implies that the Budget deficit may well end the year at under 2% of GDP and that the General Government debt ratio may fall back below 100%, with every prospect of a 2016 reading below 95%. In the past strong economic growth has often resulted in a pro-cyclical Budget but under new EA rules the authorities are constrained in terms of the permitted expenditure rise in the 2016 Budget, due next month, with a likely net spending and tax package of €1.2—€1.5bn, equivalent to 0.6% of GDP, consistent with a further fall in the fiscal deficit. Monetary policy is very loose and there is now a positive output gap , using the EU's definition of potential growth, so the case for a fiscal stimulus is not strong, although political realities will no doubt prompt the Government to use all the fiscal space available.

The Irish economic recovery was initially driven solely by the external sector, but that is no longer the case. Exports exceed imports by a sizeable amount (122% of GDP versus 100%) so it requires a very strong outperformance from the latter to prevent a positive stimulus from net trade to GDP but that has indeed been the case of late; in q2, for example, export growth of 5.4% was offset by import growth of 6.3%. Similarly, in the year to the second quarter of 2015 imports grew by 16.9% against 13.6% from exports. Recent changes to the Balance of Payments methodology is having a strong impact on the external accounts and the difference between the trade figures as recorded monthly and that published in the GDP data is large, but we expect annual import growth to slow a little in H2, due to base effects, with the result that although outpacing exports there will still be a positive GDP contribution from net trade of around 1.5% of GDP. Stock building is also making a positive contribution , 0.6 percentage pints in our forecast, so the implication is that most of the growth this year is coming from domestic demand.

The plunge in Irish GDP through 2008 and 2009 was driven by the collapse of capital formation but investment spending has recovered strongly of late (albeit again affected by changes in GDP methodology) and is forecast to grow by over 15% this year, following a similar rise in 2014.



Construction spending started rebounding from extremely low levels in 2013 but the pace of annual growth has slowed , averaging just over 4% in the first half of this year and we expect a similar figure for 2015 as a whole. Spending on machinery and equipment , in contrast, has picked up momentum, averaging 30% annual growth in H1 and we forecast over 20% growth for the full year. The series is extremely volatile, with large swings in R+D outlays and high value aircraft orders, so alongside exports represents another area prone to large forecast errors.

Government spending is expected to grow by 2.5% in 2015, based on a similar outturn over the first two quarters, while consumer spending is forecast to grow by 3.5% . The latter would represent a significant acceleration relative to last year although we have revised down our estimate following a disappointing q2 outturn, with consumption rising by just 0.4%. This was surprisingly soft given the retail sales data, a common divergence of late, but a number of factors are now much more supportive of household real incomes, including strong employment growth (we expect an average rise of around 50k this year, or 2.5%), some signs of a modest pick up in wages, flat consumer prices and the prospect of a small reduction in the average tax rate. Households are still deleveraging, however, with debt down by some €50bn over the past six years and net credit is still contracting so it is impossible to say when that process may end. Consequently, it is unwise in our view to project a significant fall in the savings ratio, which would obviously lead to stronger consumption growth.

Overall then, real GDP is projected to rise by 6.5%, with domestic demand making most of the contribution, a marked departure from the early years of the recovery. The GDP deflator is also growing at a very rapid pace (an annual 5.3% in q2), reflecting very strong export prices, and so we project a rise in nominal GDP in excess of 13%, taking the 2015 figure to over €213bn. That is good news for Ireland's fiscal ratios, with the debt figure likely to fall to 99.5% this year and the Budget shortfall under 2%. The household and corporate sectors are now running strong surpluses so Ireland is no longer borrowing from the rest of the world; the Balance of payments surplus in H1 amounted to €4.3bn.

Irish Real GDP(% change)	**2014**	**2015**	**2016**
Personal Consumption	2.0	3.5	3.5
Government Consumption	4.6	2.5	2.0
Capital Formation	14.3	15.0	11.3
Construction	9.7	4.1	5.0
Machinery + equipment	16.7	23.0	15.0
GDP	5.2	6.5	4.5
GNP	6.9	6.0	4.0

The Irish economy was universally expected to perform well this year but the 2015 outturn is now likely to be much stronger than even the most optimistic forecast earlier in the year. It also raises an interesting question about Ireland's potential growth rate, which the EU believes is 1.8% in 2015. If true, that implies that the economy is now operating with a positive output gap of over 4%, which is not consistent with the wage and price data. This is more than a debating point as the EU's measure of long term potential growth is used to determine the permitted rise in real government expenditure, Similarly the EU's forecast for inflation (as measured by the GDP deflator) is also used to convert that real spending figure into a nominal spending rise. In Ireland's case the deflator forecast is 1.6% for 2016, which appears too low now given the data of late. In other words Ireland probably has greater fiscal space than envisaged under the exiting EU forecast although whether that should be used is another question, given the surge in growth over the past 18 months.