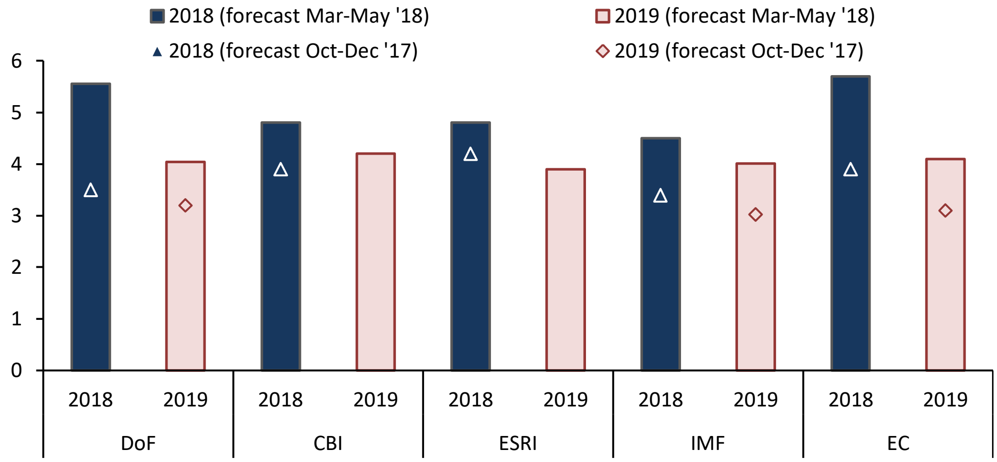
**Figure 2.3: Real GDP Growth Forecasts**

Percentage change (year-on-year)




*Sources:* Department of Finance, *Budget 2018* and *SPU 2018*; Central Bank of Ireland, *Quarterly Bulletin* (4 for 2017 and 2 for 2018); Economic and Social Research Institute, *Quarterly Economic Commentary* (Autumn 2017 and Spring 2018); International Monetary Fund, *World Economic Outlook* (October 2017 and April 2018); and European Commission, *European Economic Forecast* (Autumn 2017 and Spring 2018).

### 2.3.4 *SPU 2018* Medium-Term Forecasts, 2020–2021

#### Forecast Horizon

As discussed earlier in relation to the endorsement of macroeconomic forecasts, the Council notes that forecasts published in *SPU 2018* cover only the period 2018–2021. While not a legal requirement, recent forecasts by the Department have extended to five years ahead (t+5), which in this case would imply forecasts to 2023. Forecasts for *Budget 2018* similarly did not cover the period of five years ahead. As well-founded forecasts are a key input for setting the economy and the public finances on a sustainable path, and identifying potential imbalances, forecasting out to t+5 should be resumed, even if it requires stylised assumptions.

### Box D: New Alternative Supply-Side Estimates

This box outlines the Department of Finance's development of its new alternative estimates of the supply side as part of *SPU 2018*. These comprise alternative estimates of potential output and of the output gap to those typically produced for Ireland using the EU Commonly Agreed Methodology (CAM). The CAM has a number of shortcomings that can lead to implausible results for Ireland.

#### Background to the New Alternatives

Since at least 2003, the Department has been critical of the supply-side estimates produced for Ireland under the CAM. Despite this, little progress had been made to develop an alternative set of estimates considered more appropriate. An unhelpful situation emerged in subsequent years whereby the Department considered its own published CAM-based estimates of the cycle to be uninformative or misleading, yet no alternative estimates were given. The published commentary about the supply side was limited to dismissals of the CAM's results rather than a more fully formed discussion of the Department's actual views of the supply side of the economy. The Department had published some related work for *SPU 2016*, yet the subsequent publication of the *National Income and Expenditure* for 2015 disrupted its work on alternatives.

This continued until April 2017, when the Council – as part of its endorsement of the macroeconomic forecasts underpinning *SPU 2017* – welcomed a commitment from the Department to develop "an alternative to the CAM for medium-term forecasts in the coming twelve months, alongside continuing to produce the CAM estimates to meet legal requirements" (IFAC, 2017a). The Department shared preliminary plans on what might be achieved during this time and updated the Council in terms of its progress in later months.

IFAC (2017c) noted that the Council's endorsement of the Department's forecasts in future endorsement rounds would be "at risk if progress is not achieved in developing a better basis for the Department's view of medium-term growth and the cyclical position of the economy".

In March 2018, the Department participated in a conference on the subject of Ireland's economic cycle that was arranged by IFAC. The Department outlined some of the preliminary outputs from its recent work on advancing alternative estimates of the output gap for Ireland, while the Council presented its own suite of models of the output gap and the working paper produced on the subject (Casey, 2018).

### The New Alternatives

The alternatives produced by the Department rely on filtered estimates of both real GDP and real domestic gross value added (GVA), which is also used by the Council in its own estimates. A Kalman filter or HP filter is applied to estimates along with additional variables as indicators of the cycle. The additional (demeaned) indicators used by the Department include house price growth; private sector credit growth; real domestic private sector credit growth; core Consumer Price Index inflation; the share of employment in the construction sector; unemployment; and migration as a share of the labour force.

**Figure D.1: Alternative Estimates of the Output Gap in *SPU 2018***

**A. Domestic GVA Output Gap Midpoint**
Per cent of potential GDP

**B. GDP Output Gap Midpoint**
Per cent of potential GDP


*Sources:* Department of Finance, *SPU 2018*.

In terms of the results, the alternatives produced by the Department (Figure D.1) show a broadly similar pattern to that shown in the suite of models used by the Council. The initial 2000s show a slight positive output gap that turns increasingly more positive as the credit/property bubble forms, before collapsing through 2008–2009. A subsequent stagnation then gives way to a rapid recovery from 2014 onwards. *SPU 2018* notes that "the mid-point estimate outlines a GDP output gap path that is broadly in line with the Department's assessment", shown in Figure D.1B.

### What's Next?

The progress made by the Department in terms of developing the new alternative set of estimates of Ireland's output gap, as published in *SPU 2018*, is a significant step. It should help in terms of developing and communicating the Department's analysis of the cycle. It should provide for more well-founded medium-term forecasts. It should also ensure that potential signs of overheating are communicated publicly and acted upon if necessary.

While the standard CAM approach is still likely to be the main tool used by the European Commission for assessing cyclical developments and the cyclical component of the budget deficit, there is scope for this approach to be amended or for alternative estimates to be used by the Commission in terms of its overall assessments of compliance. The fiscal rules do not explicitly preclude the use of alternative measures. Even if the CAM continues to apply, the Department should emphasise its own alternative views in its publications. Country-specific amendments are possible within the framework, provided that there is a reasonable evidence base supporting the use of alternatives proposed. However, such country-specific changes are subject to a number of governance requirements that might imply insufficient scope to cover the inclusion of the new alternative approaches for the purposes of the Commission's assessments of compliance with the fiscal rules.

In terms of their application, these new alternative estimates should form a core part of future publications by the Department. As is common among other EU finance ministries, and to avoid confusion, the Department's preferred estimate of the output gap should be included in the headline table of macroeconomic aggregates as a way of describing cyclical developments, while CAM-based estimates should be given relatively more limited coverage (e.g., in an Appendix).[26] The Department has committed to publishing a working paper detailing the alternative estimates during the summer. This should help to clearly set out the methods by which it assesses the relative merits of the models it has adopted, and should give a clear indication of the Department's preferred set of supply-side estimates and how they are estimated.

### Application of the Commonly Agreed Methodology in *SPU 2018*

Despite the long-standing concerns with the CAM, it remains the European Commission's primary means of assessing Member States' economic performance from the perspective of aggregate supply. Given the CAM's role in assessing compliance with the EU fiscal rules, the Department is obliged to show CAM-based supply estimates in its budget and SPU publications. However, the updated estimate continues to suggest an implausible path for the output gap, showing an overheating economy in 2015, which cooled in 2016 and 2017.

### Supply-Side Estimates: Comparing *SPU 2018* to *Budget 2018*

As there are clear limits to the informational content of any individual approach to supply-side estimation, the Department's publication of a range of alternative estimates is an encouraging development. The alternative estimates are developed in

[26] Box B of the November 2015 *FAR* explores the presentational approaches adopted by other EU finance ministries when it comes to showing alternative estimates of the output gap (IFAC, 2015b).