

Looking ahead to 2014 and 2015, there is a clear downside risk based on the recent pattern of forecast revisions that the upturn in the economy may not materialise at the pace forecast by the Department of Finance and other agencies. The Department of Finance forecasts of real GDP growth of 2.5 percent in 2014 and 2.9 percent in 2015 essentially repeat the two- and three-year ahead forecasts that have been present in most forecasting reports since 2010. As discussed in previous *Fiscal Assessment Reports*, the prolonged nature of the economic downturn has meant that the anticipated return to higher levels of growth has been continually pushed out.

BOX A: A DECOMPOSITION OF FORECAST ERRORS

The outturns for real GDP (and employment) have often differed from official forecasts in recent years. Such divergences are a regular and normal feature of forecasting. However, Figures A1–A3 seek to shed further light on whether certain tendencies in the sources of GDP forecast errors can be identified, in the case of current, one-, and two-year-ahead Department of Finance forecasts respectively.¹⁰

Although the errors in forecasting the components have often been quite large, they have tended to offset each other. A clear pattern is apparent—there has been a systematic tendency to overestimate domestic demand. The opposite holds true for net exports. This pattern may be of some surprise. Weak growth in both the UK and the Euro Area has sometimes been suggested as the source of Ireland’s sluggish overall performance, contributing to a disappointing export performance relative to forecasts. However, Figures A2 and A3 show that net exports were actually overperforming relative to forecasts in contrast to domestic demand which has underperformed due to factors such as low consumer confidence and the personal debt burden.

The final strand in our look behind the forecasts of the Department of Finance considers employment forecasts. It can be seen from Figure A4 that employment levels between 2008 and 2012 have been consistently overestimated.^{11,12} This reflects, to a large extent, the fact that GDP growth has lagged behind expectations.

¹⁰ The years on the horizontal axis refer to the year for which the forecast is published. Forecasts are taken from Budget publications. Current year forecasts for 2012, for example, were published in December 2012. By that stage, a considerable amount of economic data for 2012 was available. Thus, the “forecast” is a combination of estimation and forecasting. The forecasts for 2012 that were made one-year-ahead were published in December 2011.

¹¹ For example, the one-year-ahead forecast for 2009 (i.e., the forecast made in 2008) overestimated the rate of employment by almost 7 percent.

¹² The outturn is the QNHS average annual growth rate of persons aged 15 years and over in employment. The forecast error is calculated as the difference between actual growth in employment and the employment growth rate forecast by the Department of Finance. Thus, a positive forecast error indicates that the outturn was greater than the forecast.

FIGURE A1: CONTRIBUTION TO THE DEPARTMENT OF FINANCE REAL GDP FORECAST ERRORS: FORECASTS MADE IN THE CURRENT YEAR

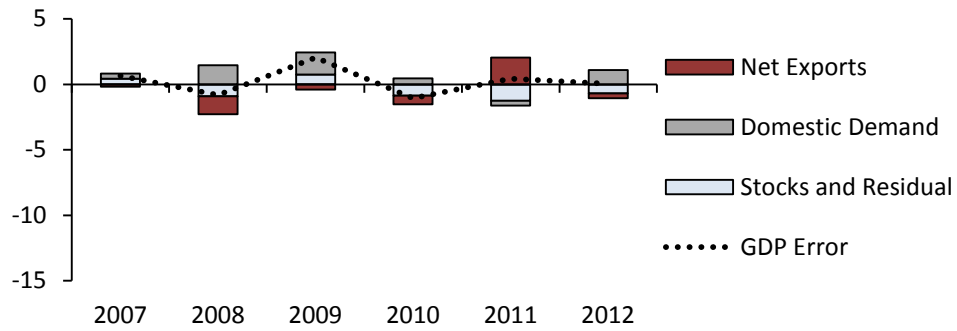
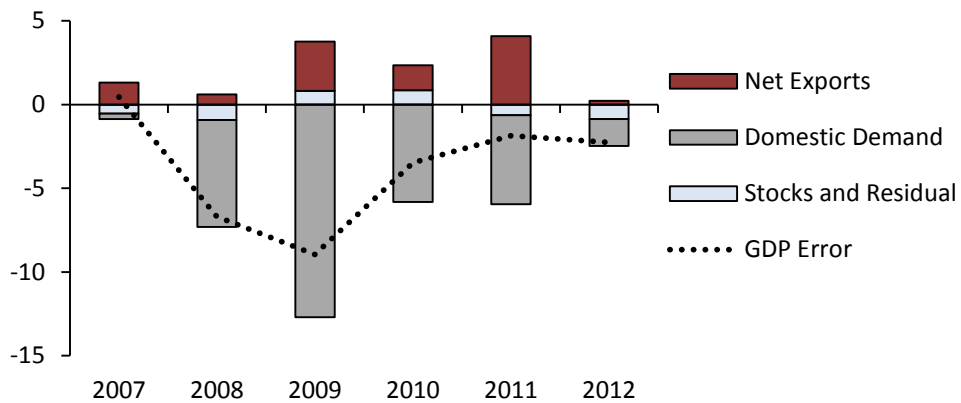
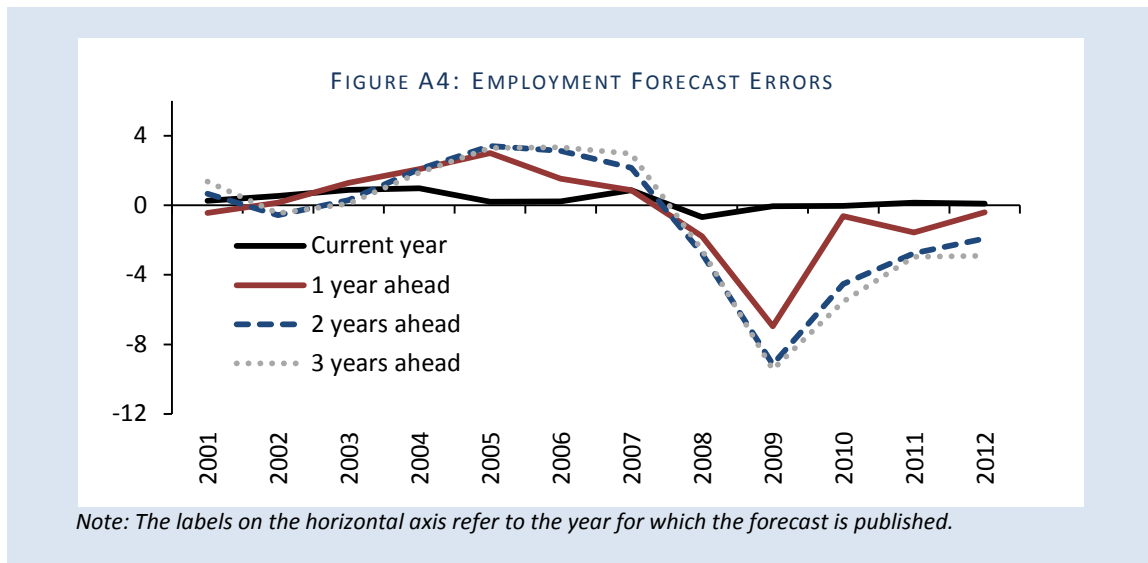


FIGURE A2: FORECASTS MADE ONE YEAR AHEAD



FIGURE A3: FORECASTS MADE TWO YEARS AHEAD





1.5 FORECASTING METHODS

1.5.1 INTRODUCTION

This section provides the results of an exercise undertaken to establish the methods used by the Department of Finance in arriving at its macroeconomic forecasts. One objective was to provide a better basis for assessing the appropriateness of the forecasting methods.

1.5.2 THE APPROACH

Representatives from the Council met with a relevant official in the Department of Finance so that the process could be explained. Discussions were also held with the CBI and the ESRI so that comparisons could be made. The description that follows is based on these discussions.

1.5.3 THE DEPARTMENT OF FINANCE'S SHORT-TERM FORECASTING METHODS

The Department of Finance forecasts are prepared by a small team of about four economists.¹³ Publications such as the *SPU* contain the Department's forecasts with a four year time horizon. For example, in *SPU 2012*, forecasts for 2012, 2013, 2014 and 2015 were provided. Forecasts for 2013, 2014 and 2015 were published in *Budget 2013*. The forecasts for the current year and the subsequent year are considered "short-term", while the forecasts for the later years are "medium-term". For the three Irish forecasting agencies considered here, the approach to short-term forecasting can be characterised primarily as being judgement based rather than model based.

¹³ Similarly sized teams produce the short-term forecasts in the ESRI and the CBI.