S1. Endorsement

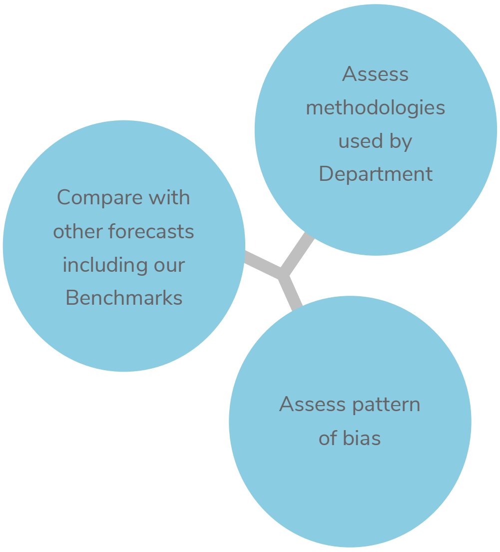
The Council's most recent endorsement exercise of the Department of Finance's macroeconomic forecasts was undertaken in March and April 2021. This section explores the key issues that arose in this latest endorsement exercise.

Background

The Department's provisional macroeconomic forecasts were completed on 26th March 2021 (see table S1a for details of the endorsement timeline). The Council and Secretariat discussed the forecasts with Department staff on 1st April 2021. On 13th April, following the publication of *SPU 2021*, the Department provided a final update of forecasts reflecting the estimated impact of policy changes envisaged.

The Department's medium-term macroeconomic forecasts for 2021 to 2025 were judged as being within an endorsable range, taking into account the methodology and plausibility of the judgments made. The Council noted that the endorsement of the Department's economic forecasts was conditioned on the Government's assumptions about vaccination progress and the easing of restrictions.

The endorsement process focuses on three main aspects: the appropriateness of the methodology used; the pattern of recent forecast errors; and comparisons with the Council's benchmark projections and other forecasts.



Real GNI*

The Council welcomed new work by the Department to develop real GNI* forecasts for the first time with *SPU 2021*. This followed the Department's introduction of nominal GNI* forecasts in 2019 (for *Budget 2020*).

The move to presenting real GNI* forecasts represents a key shift in focus for the Department. Irish economic data has long been bedevilled by the globalisation effects, with activities by foreign companies leading to large net factor income flows to the rest of the world. The inclusion of enormous amounts of depreciation on intellectual property assets led to both GNP and GDP ballooning in recent years. As a result, neither GNP nor GDP are considered reliable proxies for the Irish tax base as is the case in other countries (see Box C, Fiscal Council 2018 for a discussion).

Labour market and incomes

The Department projects a modest year-on-year improvement in labour market conditions in 2021. Despite employment increasing in 2021, the Department is forecasting a fall in personal disposable income (net of consumption of fixed capital), due to a subdued forecast recovery in compensation of employees and a fall in transfer payments. Employment is forecast to grow more strongly in 2022, almost reaching 2019 levels. At 4 per cent (unchanged from 2021), the Department's forecast for labour income growth in 2022 is considerably weaker than employment growth of 11 per cent. This could reflect that the jobs lost during and regained after the pandemic are predominantly in lower paying sectors. However, continued earnings growth for other sectors that were less affected by the pandemic would suggest that an acceleration in earnings growth in 2022 is more likely. The resilience of these less-affected sectors in 2020 was a key source of upside surprise to the Department's labour income forecasts.

Taxes and government transfers play an important role in forecasting household income. Forecasts of taxes and net social transfers are often compiled in a separate process to the macroeconomic forecasts. As a result, these forecasts can potentially be inconsistent with the broader macroeconomic forecasts. In the later years of the Department's projections, taxes paid by households are forecast to grow faster than compensation of employees or nominal GNI*. Were taxes projected to grow at a more moderate pace, household disposable income would be higher. From 2022 to 2025, personal disposable income (net of consumption of fixed capital) is forecast to grow at an average rate of 3.7 per cent. This is well below GNI* growth on average over the period (5.3 per cent).

Personal consumer spending

On balance, the Council assessed that the Department's forecasts for consumer spending were initially softer than might be justified by recent data, whereas its forecasts for the medium term seemed to be driven by falls in the savings ratio to levels lower than had been seen in the years preceding the crisis.

The Department forecast a sharp fall in personal consumer spending in Q1 2021 (-10.2 per cent year-on-year), followed by a rebound in Q2. While the levels of consumer spending ended up at a similar place to other forecasts, including the Council's Benchmark projections, the contraction in Q1 seemed large. Indeed, retail sales data available at the time for January-February 2021 suggested an annual fall of -4.8 per cent assuming sales volumes were no worse in March than they were in February. This chimed with Central Bank card data that suggested a contraction in annual (value) terms of -5.1 per cent.[72]

The Department's expectation of a weaker outturn for Q1 than high-frequency indicators like the cards and retail sales data indicated appeared to be driven by use of new data sources. The Department's use of Revolut data on spending, which indicated a weaker Q1, was one factor. The Council noted that there were both advantages and potential risks to relying on this data, notably that it appeared to be dominated by younger cohorts, which would have made for a less representative picture than other sources.

Supporting the consumer spending picture was the Department's view that savings would remain elevated initially but fall over the forecast years. High savings rates partly reflected Covid-19 restrictions, which limited people's spending behaviour. Precautionary motives also likely played a role — consumers saving due to fears about future income prospects. The Department argued that Brexit and the macroprudential regulations had led to higher savings rates since 2015, but that Brexit fears would become less of an issue for the forecast horizon. The Department's projections implied

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[72] This is based on Central bank card data up to March 22nd 2021. The average daily card spending from March 1st-22nd was used to extrapolate for the remaining days in March. This figure is adjusted for the additional day in Q1 2020 due to 2020 being a leap year.

that, as Covid-19 restrictions and associated health risks eased, savings rates would fall to levels lower than in the pre-Covid years.

A possible alternative to this scenario could see faster growth in real incomes as the driver of consumption growth over the medium term. Continued elevation for the savings ratio could be expected if macroprudential regulations retain influence over the flows of savings and consumption. While the stock of savings built up during the pandemic could partly be used to fund consumption in the nearer term, it seems less likely that it will still be relevant to consumption by 2025. To the extent that it is also used for non-consumption purposes, such as investment in property or deleveraging, this would also mitigate against a lasting fall in the savings ratio over the medium term.

Investment

The Department's view underpinning its medium-term forecasts was that underlying machinery and equipment would recover strongly from low levels over the forecast horizon. This reflected its assessment that underinvestment was a factor in the years following the financial crisis and that there was evidence of a strong pipeline of investments planned by multinational enterprises based on discussions with IDA and IBEC. This led to their forecasts showing a substantial uptick in machinery and equipment investment spending as a share of GNI* (Figure S1a).

Figure S1a: Underlying machinery and equipment investment

Sources: Department of Finance forecasts in *SPU 2021*; and Fiscal Council workings.
Notes: Underlying machinery and equipment is total machinery and equipment investment spending excluding that on other transport equipment (mainly planes).

Trade

The Department projected continued strong growth in total exports over the forecast horizon, especially due to services exports. However underlying imports — excluding aircraft and intangibles — were projected to grow more rapidly than underlying final demand over the forecast horizon, resulting in a rising share of imports in underlying final demand (Section 1).

If this import content were instead to be held constant at the historical ten-year average (44 per cent), it would have resulted in a faster rate of GDP growth of 1.3 percentage points on average for 2021–2025, or a level of real GDP 6.4 per cent higher than in the Department's forecasts.

The Department forecasts a decline in the modified current account (CA*) balance over the medium term, which is a familiar projection since its published forecasts of CA* began, in *Budget 2019*. However, since then, CA* has consistently increased rather than declined as expected (see S5). For 2020, the Department's forecast shows a small decrease of €0.8 billion, whereas in-year forecasts contained in *SPU 2020* and *Budget 2021* showed larger declines of €4.7 billion and €3.3 billion, respectively. These large forecast revisions have important implications for the sustainability of economic growth over the medium term.

It is likely that a top-down forecasting approach for GNI*, which estimates CA* in a consistent manner, contributes to some of these large revisions. This relates to the magnitude of the distortions to the economy as measured by GDP, since the modified current account combines several large components of GDP that are subject to considerable forecast and estimation error. Instead, a bottom-up forecast of GNI* would have the advantage of arriving at a CA* balance that is consistent with undistorted components of GNI*, whose forecasts do not rely on adjustments to net factor income from abroad, gross imports, or gross exports — the latter of which is projected to reach 242 per cent of GNI* by 2025. The Council welcomed the Department's efforts to develop bottom-up forecasts for GNI* in *SPU 2021*, similar to the Council's approach (see Box E in Fiscal Council, 2020a).

Table S1a: Timeline for Endorsement of SPU 2021 Projections

5 March	The CSO released its Quarterly National Accounts estimates for Q4 2020.
9 March	The Council's Secretariat and Department staff met with the CSO to clarify technical details of latest Quarterly National Accounts estimates.
19 March	The Department sent its technical assumptions underpinning its forthcoming forecasts.
26 March	The Department sent the Council preliminary forecasts in line with Memorandum of Understanding requirements.
1 April	The Department of Finance presented its latest forecasts to the Council and Secretariat and answered questions. It agreed to follow up on some queries from the Council. After the meeting the Council had a preliminary discussion on its endorsement decision.
6 April	The Council received updated and final forecasts from the Department of Finance. After reviewing these, the Council finalised a decision on the endorsement. The Chairperson of the Council wrote a letter to the Secretary General of the Department of Finance endorsing the set of macroeconomic forecasts underlying *SPU 2021*.
13 April	The Department's forecasts were published in *SPU 2021*, updated for the impact of policy changes, and the Council received final forecasts from the Department in line with Memorandum of Understanding requirements.