Macro Assessment

Economy outperforms despite repeat Covid waves

1. MACRO ASSESSMENT

Economy outperforms despite repeat Covid waves

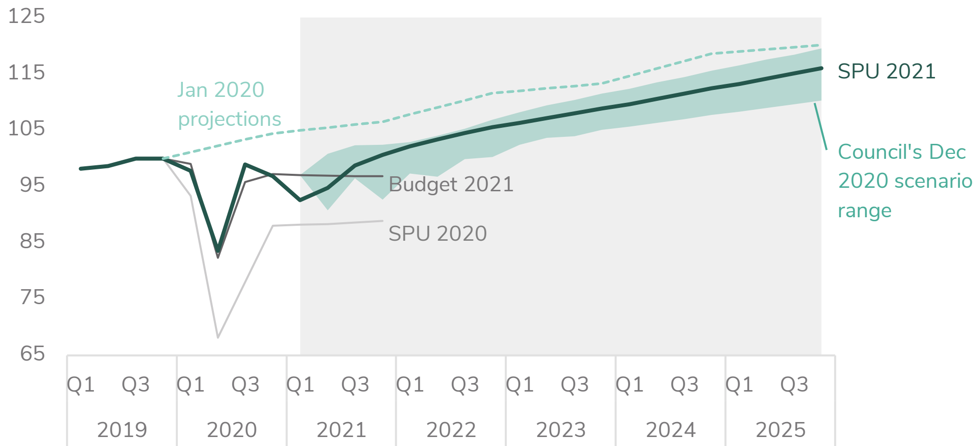
Covid-19 led to an extraordinary shock in 2020 and continues to have major impacts on the Irish economy. The need for additional restrictions to respond to recurring waves of the pandemic has seen stop-start re-openings of a broad range of activities across the economy as well as in Ireland's key trading partners.

Covid-19 led to an extraordinary shock in 2020 and continues to have major impacts on the Irish economy

In *Stability Programme Update 2021* (*SPU 2021*), the Department of Finance forecasts a partial recovery in underlying domestic demand (UDD), but with permanently lower output over the medium term compared to previous trends (Figure 1.1).[1] This section discusses the economic outlook and assesses the SPU projections. Section S1 of Supporting Information provides additional information on the Council's endorsement of the *SPU 2021* macroeconomic projections.

Figure 1.1: Official forecasts imply significant scarring despite strong recovery in near term

Real underlying domestic demand, Q4 2019 = 100



Sources: CSO; Department of Finance; and Fiscal Council workings.
Notes: Scenario range based on the Council's extension of *Budget 2021* forecasts, encompassing "Milder" and "Repeat Waves" scenarios (Box D of December 2020 *FAR*). The Department's quarterly modified domestic demand profiles are applied to annual UDD forecasts. The "Jan 2020" projections are based on the Department's modified domestic demand forecasts. Get the data.

---

[1] Figure 1.1 presents recent forecast vintages of UDD by the Department of Finance, including the Council's scenarios at the time of *Budget 2021*. This illustrates that over the short term, the SPU forecast for the economic recovery is closest to the "Milder" scenario included in the Council's December 2020 Fiscal Assessment Report, which was based on an assumption of very little permanent impacts on the domestic economy due to the pandemic (although Brexit impacts were included which assumed a free-trade agreement would be reached, as transpired). By 2025, the SPU forecast lies 3 per cent below the "Milder" scenario.

The economy has proven more resilient to additional disruptions due to the repeat waves of Covid-19, when compared to the early lockdown months of 2020 (Section 1.1). While employment remains heavily affected for many sectors, especially for consumer-facing services including hospitality, other sectors including technology and the manufacture of pharmaceuticals have grown. High-frequency indicators of consumer spending have all but recovered to pre-pandemic levels despite ongoing restrictions. The rollout of multiple vaccines will likely lead to a sharp rebound in activity from the second half of this year, if not even sooner.

The short-term outlook for 2021 and 2022 reflects an expectation for pandemic-induced restrictions to ease (Section 1.2). The speed and durability of the easing of restrictions remains hard to predict. While the SPU projects a rapid recovery, some short-term indicators and substantial household savings could point to an even stronger outcome this year.

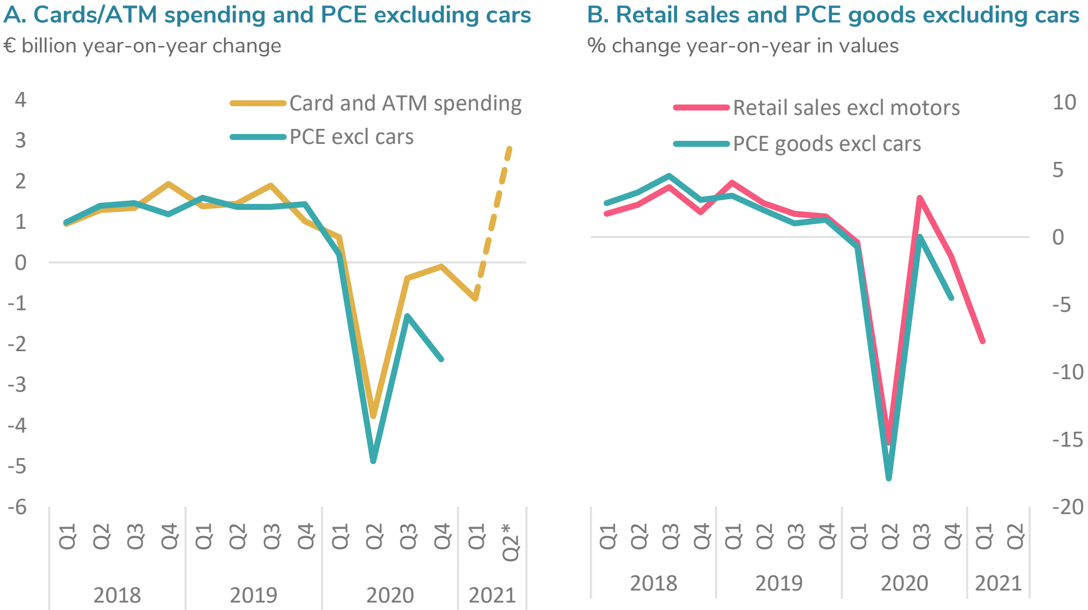
Further ahead, a major source of uncertainty concerns the extent of lasting damage on the economy resulting from the pandemic and Brexit (Section 1.3). The impact on firms and workers of Covid-19 has few precedents. The *SPU* assumes a permanent loss of around 5 per cent of output due to the pandemic, but it may be that the better-performing sectors are able to pick up the slack more quickly than projected.

1.1 Recent activity in the Irish economy

Consumers have found ways to adapt their spending habits around the constraints caused by the pandemic. This is encouraging for the economy's short-term prospects. High-frequency indicators such as retail sales and debit/credit card spending/ATM withdrawals are consistent with a less-severe decline in consumer spending in early 2021 relative to the initial fall in Q2 2020 (Figure 1.2). Central Bank of Ireland data show that an increased share of spending has taken place online (Figure 1.3), and that the pandemic has seen an acceleration of this trend.

Consumers have found ways to adapt their spending habits around the constraints caused by the pandemic

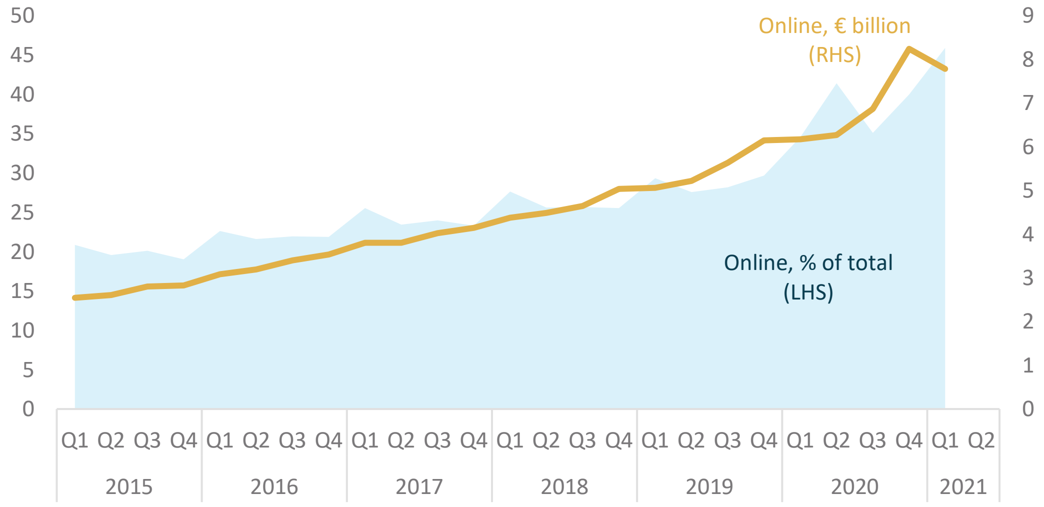
Figure 1.2: This year's lockdown has had less of an impact on consumer spending



Sources: CSO; Central Bank of Ireland; and Fiscal Council workings.
Note: Q2* 2021 reflects the quarter-to-date increase compared to 2020 to 17th May. The panels portray a generally close link between the high-frequency measures and their corresponding personal consumption measures. However, differences between the measures increased last year, especially in Q4. This relates to weighting issues, although it is also possible that personal consumption will be revised. Get the data.

Figure 1.3: Lockdowns have accelerated a move towards online spending

Percentage of total card spending and ATM withdrawals (LHS) and € billion (RHS)



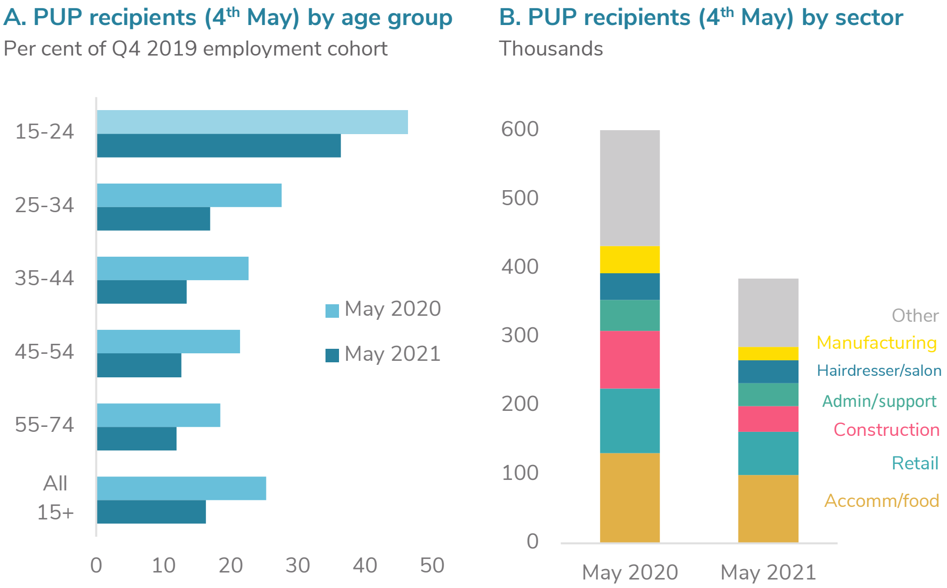
Sources: Central Bank of Ireland; and Fiscal Council workings. Get the data.

The labour market has borne the brunt of the pandemic. The number of workers in receipt of the Pandemic Unemployment Payment (PUP) has risen sharply with each wave of the virus leading to lockdowns. In early May, despite some decline reflecting the gradual easing of restrictions, the number of workers in receipt of the payment remains very high at more than 400,000 (Figure 1.4).[2] This is gradually reducing each week. In terms of PUP recipients, younger workers are the most-affected age group, while accommodation and food services remains the most-impacted sector. More than 100,000 of those aged 15–24 are currently out of work, compared to 264,000 of that age in pre-pandemic employment in Q4 2019.

The labour market has clearly borne the brunt of the pandemic

[2] In addition to those being supported by the Pandemic Unemployment Payment, just over 300,000 individuals were being supported by the Employment Wage Subsidy Scheme at the time of writing.

Figure 1.4: Younger workers and those in hospitality still worst affected



Sources: Department of Employment Affairs and Social Protection; CSO; and Fiscal Council workings. Get the data.

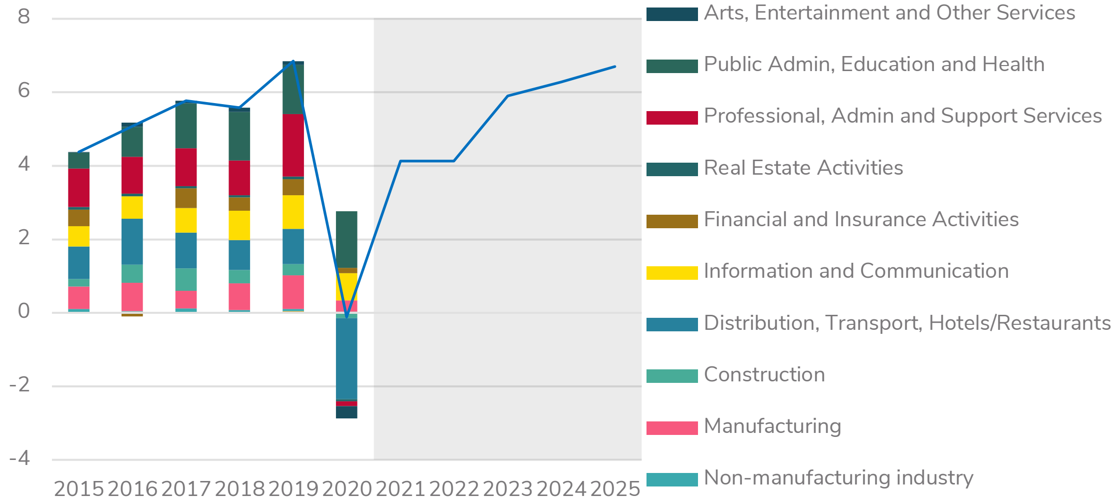
Construction activity fully restarted in April. Despite widespread restrictions for the first quarter of 2021, close to 4,000 new dwellings were completed. While this was 20 per cent fewer than in Q1 2020, it nonetheless compares favourably to the 33 per cent fall in Q2 2020. Furthermore, a rapid rebound in construction last summer resulted in 21,000 completions for the full year — in line with 2019, albeit well below estimates of medium-term demand of 35,000. The ongoing demand for house purchases has been clear from strong mortgage activity, as the volume of drawdowns in Q1 by first-time buyers was the highest in 14 years. This is likely to reflect a combination of pent-up demand, excess savings, and the relatively low incidence of income loss in sectors with higher average earnings (discussed further in Box A).

The pandemic has caused largely sector-specific shocks to the economy, rather than having a broader-based impact. Figure 1.5 presents the contributions of sectors to the change in total compensation of employees for 2015–2020, with SPU forecasts included for 2021–2025. The sector most affected by the pandemic in terms of wages is distribution/transport/hotels/restaurants, while compensation also contracted in construction, professional/administrative/support services, and arts/entertainment/other services. These sectors typically comprise 38 per cent of national wages and 43 per cent of employment.

The pandemic has caused largely sector-specific shocks to the economy, rather than having a broader-based impact

Figure 1.5: The sector-specific nature of the shock to wages in Ireland

€ billion



Sources: CSO; Department of Finance, *SPU 2021*; and Fiscal Council workings.
Notes: Although NACE A*10 provides a breakdown to ten industry groupings, the CSO provides a sub-grouping within industry (B-E) for manufacturing (C). The residual non-manufacturing industry is also shown. Compensation of employees in 2020 was €100 billion and includes about €4 billion supported by the Government's wage subsidy schemes. Get the data.

In 2020, declines in the wage bill for certain sectors were offset in full by increases elsewhere. Incomes grew in information and communication, and public administration, education, and health. This was driven by strong increases in earnings in the second half of the year, and it was significantly more favourable than the forecast fall in the wage bill of €10.9 billion in *Budget 2021*. *SPU 2021* forecasts an increase of €4 billion in compensation of employees in 2021 and again in 2022.

There is considerable upside potential to the Department's relatively cautious short-run assumptions. If the higher-paid sectors that grew in 2020 continue to do so at a similar pace, as would seem to be a plausible baseline assumption, then a catch-up increase in sectors that contracted in 2020 would deliver a higher increase in the wage bill for both 2021 and 2022. In light of estimated lost potential earnings in 2020 for recipients of PUP amounting to €7 billion (IBEC, 2021), there is likely to be a faster increase in economy-wide earnings — especially if unemployment falls rapidly over the coming 18 months, as is forecast in *SPU 2021*.

There is considerable upside potential to the Department's relatively cautious assumptions

Multinational companies have acted as a shock-absorber during the pandemic. A key foundation of Ireland's economy is the strong demand from abroad for the goods and services produced by multinational entities, especially foreign-owned firms in manufacturing and information and communication technology, and food and beverages in terms of domestic firms. The shock-absorption capacity provided by the presence of these IDA-supported firms in Ireland during the pandemic has been a crucial support to the domestic economy, reflecting both high employee earnings and spillovers to employment in domestic businesses.[3]

Brexit, however, has already resulted in large shifts in Ireland's external trade. The transition period preceding the UK's exit from the European Union ended on 31st December 2020, and this was succeeded by a new free-trade agreement. In the first quarter of 2021, a large fall in Ireland's merchandise trade with Great Britain took place.[4] Exports of chemicals and related products were the main exception with a strong year-on-year increase, mitigating the overall decrease to 3 per cent. However, imports fell by 48 per cent, and the permanent rise in trade barriers will have lasting impacts. Imports of food and live animals were particularly affected, falling by 61 per cent.

However, Brexit has already resulted in large shifts in Ireland's external trade

[3] Brady (2019) estimates that three additional jobs are created in a county for each job created in an IDA-supported business in the same county. However, in terms of productivity spillover effects, Di Ubdalo et al. (2018) find limited evidence between the presence of foreign-owned firms and the productivity of domestic firms in the same industry or region.

[4] This fall includes an exaggerated impact in January which reflected largely temporary disruption. A further factor includes a reaction to stockpiling that was seen in latter stages of the transition period.

1.2 The short-term outlook

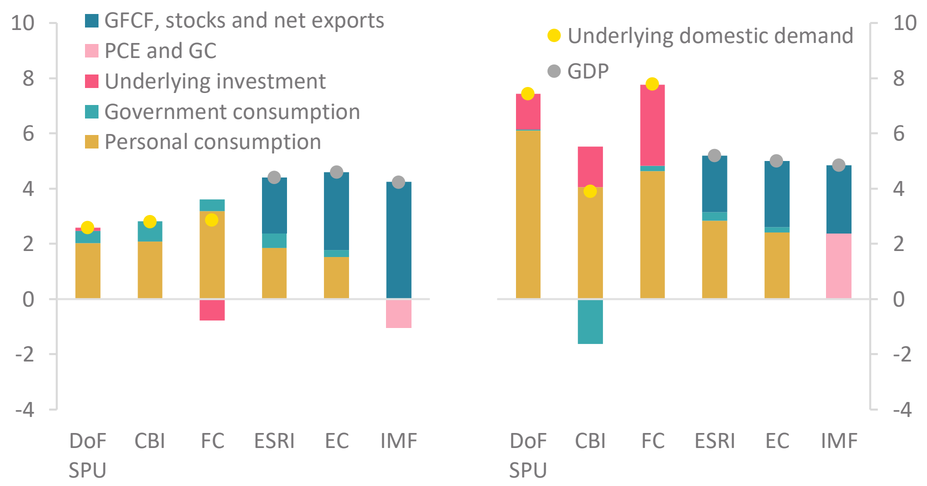
The Irish economy is expected to rebound rapidly over 2021 and 2022. This is in line with other recently available forecasts, as shown in Figure 1.6. The Department of Finance expects a relatively stronger recovery in 2022 compared to 2021, mainly driven by consumer spending, while growth in underlying investment is forecast to resume next year.

The Irish economy is expected to rebound rapidly over 2021 and 2022

Figure 1.6: The Irish economy is expected to rebound rapidly over 2021 and 2022

Percentage-point contributions and year-on-year percentage change in volumes

A. 2021 B. 2022



Sources: Economic and Social Research Institute (ESRI), *Quarterly Economic Commentary, Spring 2021*; Central Bank of Ireland (CBI), *Quarterly Bulletin No 2 2021*; Department of Finance (DoF SPU), *SPU 2021*; International Monetary Fund (IMF), *World Economic Outlook, April 2021*; European Commission (EC), *European Economic Forecast, Spring 2021*; and Fiscal Council (FC) workings.
Note: For the IMF forecast, contributions from Personal Consumption Expenditure (PCE) and Government Consumption (GC) are residually determined. Get the data.

The economic recovery is likely to be uneven across the economy. Besides the pandemic, this is also due to the negative impact of Brexit on many of Ireland's exporting SMEs. Nonetheless, growth drivers will outweigh such headwinds in the near term. Low interest rates remain beneficial, and the significant support to household incomes and businesses provided by the Government has ensured a far less damaging impact of the pandemic on household consumption, incomes, and savings. Meanwhile, the massive fiscal stimulus in the US and measures in the euro area may at least partly offset the short-term negative impacts of Brexit on the external sector.

The economic recovery is likely to be uneven across the economy

Table 1.1 presents *SPU 2021* macroeconomic forecasts for the Irish economy, which imply a gradual, and ultimately incomplete, recovery in the economy from the pandemic. The Council assessed the SPU forecasts as being within an endorsable range, taking account of the assumptions and judgments made (the Supporting Information S1 details the Council's endorsement exercise for *SPU 2021*). The contraction in activity in the first half of 2021 due to Covid-19 restrictions distorts the patterns of year-on-year growth, and this base effect underpins the rapid annual growth forecast for the economy in 2022 — with personal consumption growing by 10 per cent, employment by 11 per cent, and the unemployment rate reducing by half to 8.2 per cent.

Table 1.1: *SPU 2021* key macroeconomic forecasts

Year-on-year % change in volumes, unless otherwise stated

	2019	2020	2021	2022	2023	2024	2025
Modified gross national income (GNI*)	1.7	-4.2	2.5	5.5	3.0	2.7	2.7
Underlying domestic demand (UDD)	4.1	-4.9	2.6	7.4	3.6	3.2	3.2
Personal consumption	3.2	-9.0	3.5	10.4	3.2	2.8	2.9
Underlying investment	4.7	-6.7	0.6	6.8	7.1	5.9	5.7
Non-agri wage bill (nominal)	7.3	-0.1	4.1	4.0	5.4	5.5	5.6
Employment[a]	2.9	-15.1	4.0	11.0	3.3	2.3	2.2
Unemployment rate[a] (% labour force)	5.0	18.7	16.3	8.2	6.7	6.0	5.5
Inflation (HICP)	0.9	-0.5	1.1	1.9	1.5	1.6	1.9
Modified current account (% GNI*)	7.7	7.6	8.1	6.4	5.5	4.7	3.9
Output gap (% potential GDP)	0.1	-2.4	-2.1	-0.6	-0.1	0.4	0.5

Source: CSO; Department of Finance, *SPU 2021*; and Fiscal Council workings.
Notes: [a] The unemployment rate and employment growth shown are based on the CSO's "upper bound" Covid-19 unemployment data.

Ireland's vaccination delivery has been progressing since January, broadly in line with other EU countries for much of the period. However, as shown in Figure 1.7, stated monthly vaccination targets have proven elusive (except for January), and the cumulative shortfall as of early May 2021 is over half a million doses (or about a fortnight of vaccinations at the current pace). This has partly reflected changes in guidance and production delays for some vaccines.

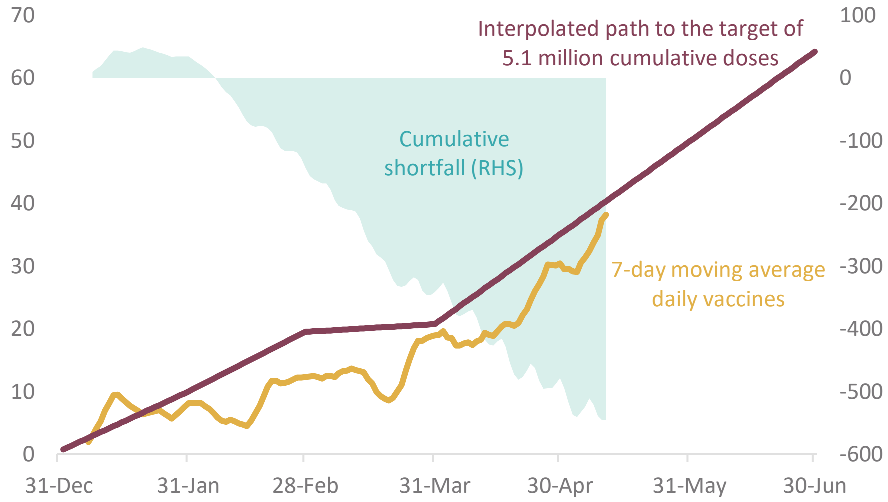
Uncertainty over the short-term path of the economy has reduced considerably compared to early in the pandemic

Uncertainty over the short-term path of the economy has reduced considerably compared to early in the pandemic. Brexit has taken place and progress has been made in the management of Covid-19, including the roll-out of effective vaccines. Meanwhile, risks to the outlook have become more balanced. There is upside potential linked to the resilience of spending despite the latest lockdown, a potential acceleration fuelled by excess household savings, and a favourable international context for growth, including the US and EU policy measures that were not factored into the

SPU 2021 forecasts.[5] Despite these benign factors, a number of adverse developments could also affect the strength of the immediate recovery from Covid-19.

Figure 1.7: Ireland's vaccine progress

Thousands of vaccines (first and second doses combined) — daily (LHS) and cumulative daily (RHS)



Source: HPSC Ireland; *COVID-19 Resilience and Recovery 2021 - The Path Ahead*; and Fiscal Council workings.
Note: The target shown is a daily interpolated line such that the total number vaccinated is consistent with monthly targets for January–March, and the Q2 total, assuming a rising daily target for vaccine delivery. Get the data.

It is likely that annual inflation in consumer prices will show higher volatility and may strengthen this year as a result of base effects from 2020 and short-run supply pressures. As restrictions are eased, demand for certain goods and services (especially hospitality) may rise rapidly owing to the build-up of savings and a reduction in risk aversion as vaccination rates climb, outpacing the recovery in supply. The higher recent trend for inflation expectations has resulted in modest increases in government bond yields across the Euro Area.

[5] Box I.2.1 in the European Commission's *European Economic Forecast, Spring 2021* estimates spillovers from US fiscal policy on EU27 GDP of 0.3 and 0.2 percentage points for 2021 and 2022, respectively. Ireland is listed as a member states with greatest export sensitivity to higher US demand.

The impact of Brexit on the economy is also difficult to predict with confidence. Although a free-trade agreement was negotiated, meaning a disorderly Brexit did not take place, it remains to be seen how the Irish economy will be affected. For example, the UK's new Border Operating Model will commence in October 2021, resulting in non-tariff barriers to trade and higher costs for Irish exporters selling to Britain. In addition, trade in services is not covered by the free trade agreement. The Council has previously considered the possibility of adverse impacts due to interactions between Brexit and the pandemic, concluding that there was likely to be relatively limited overlap between the shocks across broad sectors.[6] However, it is clear that both Covid-19 and Brexit impart negative impacts of varying magnitudes on a range of activities in the Irish economy.

Notwithstanding headwinds, increased consumer spending and investment driven by excess household savings and pent-up demand is likely over the coming months

Notwithstanding a number of possible headwinds to growth, an increase in consumer spending and investment driven by excess household savings and pent-up demand is likely over the coming months. The speed and amount of excess savings that are used up will have an important bearing on how fully Ireland's economy recovers from Covid-19, but could add as much as 2 per cent to the level of household consumption in the short term. As discussed in Box A, the recovery of consumption and investment is likely to have a powerful impact on domestic activity, given the low import content of activities that have been worst affected by Covid-19. Furthermore, the Department's short-term projections for consumption assume that more than 75 per cent of excess savings from 2020 will not be spent, which could mean a considerable degree of upside to the projections. This dynamic also has important implications for medium-term economic growth, as discussed in section 1.3.

Net inward migration has provided the Irish economy with a steady increase in labour supply since 2015. However, preliminary indications from the CSO's analysis of administrative records show a reversal to net emigration took place in Q2 last year, coinciding with the first Covid-19 lockdown.[7] While it is possible that these effects will prove transitory and that a resumption of high net inward migration will be possible as pandemic-

---

[6] The Council's analysis in the Pre-Budget 2021 Statement (Box A) noted a relatively limited overlap for broad sectors in terms of their export intensity to the UK compared to their employment exposures to the pandemic (Fiscal Council, 2020d). This finding was in line with a more detailed examination of the issue by Daly and Lawless (2020).

[7] For further details, see: https://www.cso.ie/en/releasesandpublications/fp/fp-miads/migrationestimatesforirelandfromadministrativedatasources2014-2020/

induced travel restrictions ease, the timing of this has important implications for economic growth over the medium-to-long term.

Box A: Excess household savings could substantially boost economic activity

Irish households saved €29.6 billion in 2020. This was close to a quarter of total disposable income, double the gross savings in 2019, and quadruple the corresponding 2016 amount. Last year included a record-high €11.8 billion (37 per cent) in the second quarter alone, much of this down to restrictions and the sudden changes to everyday life caused by the pandemic.

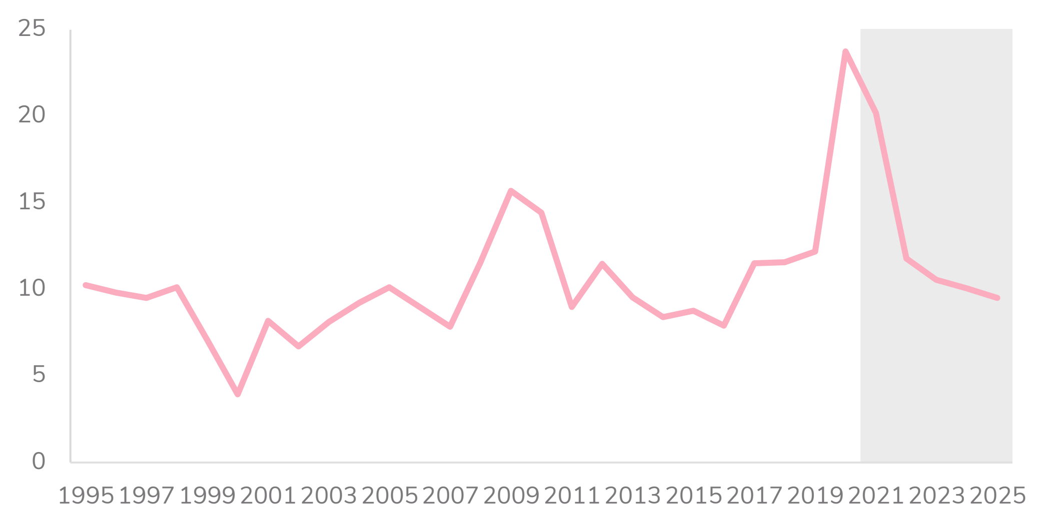
This box first assesses how much of the savings in 2020 were "excess" due to the pandemic, before analysing what an unwinding of these excess savings would imply for consumer spending and imports. If half of the excess savings were spent in the short term, this could add up to 2 per cent to household consumption. Based on the expected usage of excess savings, it is likely that the vast majority of what is consumed will contribute directly to the Irish economy (i.e., to GNI*). This reflects the relatively low import share of the activities most affected by the pandemic.

Assessing excess savings in 2020

Figure A1 presents Ireland's household savings ratio since 1995, supplemented with *SPU 2021* forecasts. The increase in savings in 2020 far exceeds any previous increase over recent decades. Although large increases in savings were observed in other countries across the developed world in 2020, Ireland's increase stands out as the highest among OECD countries.[8]

Figure A1: Household savings rose to 24 per cent of disposable income in 2020

Household savings as a percentage of gross disposable income



Source: CSO; and Department of Finance, SPU 2021.

One challenge for assessing excess savings is that the savings rate rose sharply to a higher level in 2017 before remaining well above its long-term average. The reasons for this shift are unclear. It could be related to some precautionary saving following the Brexit referendum, the impact of higher deposit requirements for mortgages, or the impact of an ageing population. This uncertainty makes it harder to assess what a "normal" post-Brexit savings rate would be.

A benchmark estimate of excess savings in 2020 can be found by applying the same savings ratio in 2019 to 2020 household gross disposable income. In this scenario, households would have

[8] Many factors could contribute to this relatively high saving in an international context including the support by Government to household incomes and the extent of restrictions during lockdowns.

saved €15 billion less in 2020. Lydon and McIndoe-Calder (2021), applying a more sophisticated methodology, recently estimated that €11 billion of excess savings were accumulated by Irish households in 2020 as a result of the pandemic.

Using CSO *Household Budget Survey* data across the distribution of income to identify typical spending in restricted parts of the economy, Lydon and McIndoe-Calder estimate that half of excess pandemic savings could have been accumulated by the top three deciles by household income. Although households with higher income generally have lower marginal propensities to consume, the authors note that this is not necessarily the case for transitory or unexpected income. They also cite evidence from the CSO's *Household Finance and Consumption Survey 2018* and suggest that at least half of excess pandemic savings could be spent on consumption over the coming years. This is based on responses to the survey about expectations for spending versus saving in the event of winning one month of household income in a lottery.

In a typical downturn, savings rise largely due to precautionary motives, and this is undoubtedly a factor for many Irish households over the past year. However, given the concentration of job losses due to the pandemic among younger workers and those employed in sectors with lower earnings, it is likely that the rise in savings has instead been driven by households whose incomes were not directly affected thus far.[9] This is more likely to reflect pent-up demand related to Covid-19 restrictions on activities and mobility.

What could an unwinding of excess savings imply for consumption?

The pace at which excess savings are unwound in a re-opening is an important factor in the economic recovery from the shock of Covid-19. Much uncertainty remains over the strength and timing of a savings-driven boost to personal consumption expenditure, and indeed the ability of businesses to accommodate higher demand after a long year of disruptions caused by the pandemic.

Nonetheless, assuming that half of €11-15 billion in excess savings will be spent by consumers in 2021 and 2022, this would represent an upside risk to *SPU 2021* forecasts, which only factor in about €2½ billion of consumption out of excess savings.[10] If a higher figure such as €6.5 billion (the mid-point of €5.5–7.5 billion) is assumed to be spent, this could add up to 1.5 per cent to the level of consumption across 2021 and 2022. In terms of the savings ratio, this would imply a temporary reduction of 2 percentage points on average across 2021 and 2022 — albeit this would still mean a high household savings ratio this year.

While some households have paid down debts or replaced durable goods, it is likely that most households will increase their spending on higher-priced services in a re-opening of the economy. These services include restaurant dining, hotel accommodation, and entertainment (such as theatre, music, or sporting events). However, goods consumption could also rise, given non-essential retail has now re-opened. While some forms of missed spending due to the pandemic will not be recovered due to inability to substitute over time, Lydon and McIndoe-Calder note that additional spending by households on a broader basket of goods and services, or more expensive alternatives within an unchanged basket, cannot be ruled out.

What is the likely import share of higher consumption?

One aspect of the overall gains arising due to any increase in personal consumption in Ireland concerns the import content of the goods and services. For decades, globalisation and technological change have seen an increasing number and volume of imported goods and services available to consumers in Ireland. As a small open economy reliant on trading partners abroad for many everyday products — for example, cars are not manufactured in Ireland and therefore must be imported — it appears reasonable to assume that the import content of households' final

[9] Lydon and McIndoe-Calder (2021) observe the correlation between tightening and loosening of Covid-19 restrictions with daily cards and ATM spending, concluding that excess savings are more likely to resemble "additional income" rather than precautionary savings.

[10] This lower expected amount by the Department reflects recent KBC survey evidence.

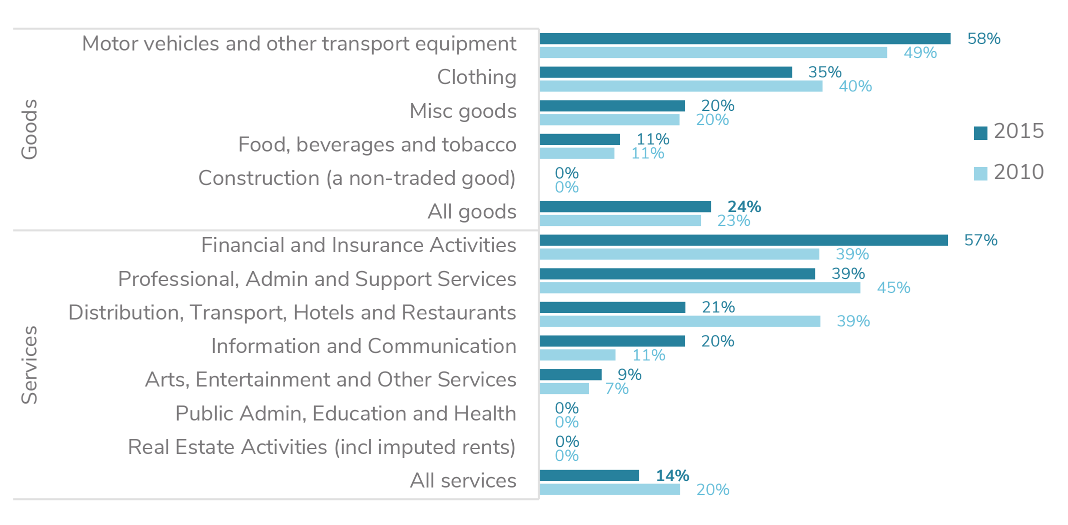
consumption expenditure is high. However, the import content of final consumption expenditure appears to be less than 20 per cent.

Most consumer goods in Ireland are imported. However, only a small share of the value of consumer spending on goods is spent on imports overall. This reflects the inclusion of the cost of government product taxes on consumer goods (such as Value Added Tax) and the costs charged for wholesale and retail services. In 2015, 58 per cent of consumer spending on goods was on imports before product taxes and markups of wholesalers and retailers were taken into account. However, once these were included, only 24 per cent of consumer spending on goods was spent on imports (little changed from 2010), with 34 per cent of consumer spending on goods going to the Exchequer and domestic wholesalers and retailers.

Figure A2 compares the import contents of selected final household consumption categories based on data from the CSO's Input-Output Tables for 2010 and 2015.[11] The chart shows that the highest import content has remained motor vehicles including other transport equipment (58 per cent in 2015, from 49 per cent in 2010), while other largely imported items include financial and insurance services (57 per cent), professional, administrative and support services (39 per cent), and clothing (35 per cent).

Figure A2: How much final consumption expenditure is imported

% of final household consumption expenditure



Source: CSO, Supply and Use and Input-Output Tables 2010 and 2015; and Fiscal Council workings.

Overall, services consumption is shown to have an average import content of 14 per cent, down from 20 per cent in 2010. (As noted above, goods consumption is somewhat higher at 24 per cent, little changed from 2010). For the sectors within services consumption worst affected by Covid-19 — distribution, transport, hotels, and restaurants; and arts, entertainment, and other services — the combined import content is 18 per cent, meaning most of the increase in consumption on these activities contributes directly to national income.

It is also likely that some households will use savings for investment purposes, such as home renovations, or as a deposit for a house purchase. Although related products for such usage of savings have relatively high import shares — for example, financial and insurance services — the direct import share of a new house purchase as it affects consumption is zero given construction

[11] This uses the imports at basic prices attributed to households by two-digit CPA product code, as a share of final household consumption expenditure at purchasers' prices (reflecting margins earned by wholesalers/retailers, and product taxes such as value-added tax — we thank Eóin Flaherty in the CSO for assistance with interpreting these data).

and real estate services (including imputed rents) are not traded. However, investment spending on such products requires significant imports of indirect inputs such as steel.[12]

If excess savings are instead utilised to go on holidays abroad, this would effectively extinguish the benefit to the Irish economy of these savings. Although holidays overseas count directly towards personal consumption expenditure, the import content of this spending is very high, and the income and activity is gained by the destination abroad.

However, the return of overseas trips to Ireland can partly offset this effect, aided by high-spending visitors (especially those from the US), and visiting emigrants. Virus fears and the current impracticality of international travel due to quarantine and other restrictions mean that pent-up demand for travel to and from Ireland is likely to be significant over coming years. As noted by FitzGerald (2021), a relevant precedent for this dynamic is the exceptional number of visitors to Ireland following World War II.

Construction has been disrupted by the pandemic, with the outlook for non-residential construction uncertain

Investment in building and construction has been significantly disrupted by the pandemic. Lockdowns have prevented the completion of ongoing construction projects, while commencements of new units have slowed significantly. Nonetheless, demand for residential construction in Ireland remains strong, and the sector has been quite agile in responding rapidly once restrictions have eased. The Department forecasts a fall in new dwelling completions to 18,000 units in 2021 and 20,000 in 2022, compared to the 21,000 units completed in 2020. However, as discussed in Section 1.1, completions were reasonably strong in the first quarter despite Level 5 restrictions being in place for the quarter. This could imply a faster delivery of new dwellings than is forecast, especially if excess savings are channelled into housing investment.

However, the outlook is far more uncertain for non-residential construction. This is due to its high share in total output (10 per cent of GNI*) prior to the pandemic, and the possibility that construction of office units may scale back considerably as a result of the pandemic and its lasting impact on remote working. In contrast, the Government's fiscal projections indicate a large ramp-up in public investment (see Figure 2.6). Depending on the extent of delivery, this could make up for some of the likely reductions in office building over the coming years.

[12] The expenditure-side components of modified gross national income (GNI*) reflect final goods and services, and the allocation of imports between the components of final demand determines the import content of each of consumption, investment, and exports. However, a higher import content for investment and intermediate consumption is relevant for multiplier effects of increased domestic demand; all else equal, a country with greater domestic industrial capacity will benefit more from higher demand if this results in larger spillover effects for the domestic value chain.

1.3 The medium-term outlook

This section assesses the prospects for Ireland's medium-term economic growth, with emphasis on the likelihood and extent of lasting damage due to Covid-19. This is also investigated in terms of modified gross national income (GNI*), and its main components of underlying domestic demand (UDD) and the modified current account (CA*, a relevant measure of net external demand).[13]

A key question for the medium-term is how much permanent loss in output and employment, known as "scarring", will result from changes brought about by the pandemic. Demand may switch between activities; for example, if people permanently switch to remote working tools, this will reduce the need for some travel, office space and city-centre facilities. Cashflow difficulties may also lead some firms to close. As a result, workers may lose their jobs and struggle to find new occupations, while business capital and know-how may be lost.

As discussed in Section 3, there is an important role to be played by the Government in minimising the impact of disruptions due to both Covid-19 and Brexit. The longer that disruptions to the economy last, the more likely it is that scarring effects will become more significant through lost investment and hysteresis. This could be most relevant from a sectoral perspective, as the worst-affected parts of the economy — especially tourism, hospitality, construction, and the arts — could fail to reach their previous share of total activity. Instead, these sectors could recover to much-reduced levels of output only after an extended period of time.

The negative shock caused by Covid-19 to some sectors could largely be compensated by growth in other sectors

However, the negative shock caused by Covid-19 to specific sectors will, to some extent, be compensated by growth in other sectors. Growth in sectors not affected by the pandemic could offset, or possibly even exceed, lost output elsewhere. Analysis of the UK economy from the Bank of England (Ramsden, 2020) supports the view that the labour-market recovery following the pandemic could be quite fast, based on the relatively low degree of occupational change required to meet sectoral shifts in

[13] These measures adjust GDP and other traditional economic indicators for distortions arising due to the effects of globalisation and multinational entities in Ireland. See ESRG (2016) for further details.

production.[14] Based on ONS estimates of tasks involved across different jobs, the research finds that even in an extremely negative scenario, the extent of "task re-allocation" required in the recovery from the pandemic is likely to be far lower than the historical average. This suggests a more limited degree of friction for substitution across occupations within labour supply.

By contrast, the Department's SPU projections do not appear to allow for a significant degree of substitution in Ireland over the medium term. Instead, it assumes a less dynamic response of workers to the changes brought about by Covid-19.

The Government's forecasts show domestic demand and employment remaining 4-5 per cent lower than pre-pandemic forecasts

In *SPU 2021*, the levels of UDD and employment are projected to remain 4 – 5 per cent lower than in the Department's pre-pandemic forecast update in January 2020.[15] The scar on employment is attributed primarily to a permanent decline in the labour force of roughly 3 per cent. This impact on output is beyond the largest estimates noted in the SPU, and a far higher impact of the pandemic on the Irish economy relative to the IMF's average estimate for advanced economies (1 per cent).[16] It is not clear why a greater degree of "scarring" due to the pandemic should be expected in Ireland compared to other countries for which estimates are available. In light of the relatively resilient performance of the economy as a whole — helped by the presence in Ireland of multinational firms, as argued in Section 1.2 — the Department's relatively adverse medium-term expectations appear rather pessimistic on economic activity.

The Council's Benchmark projection for the level of real GNI* is close to 6 per cent higher than *SPU 2021* has it by 2025. Figure 1.8 presents the SPU medium-term forecasts for real GNI*, with the Council's Benchmark forecasts also shown. The Council's assessment is more optimistic and

[14] The intuition for this is that it is very rare in developed economies for labour-market transitions to occur between fundamentally different occupations — for example, a specialist role such as a coalminer re-training and re-skilling for an office-based services role.

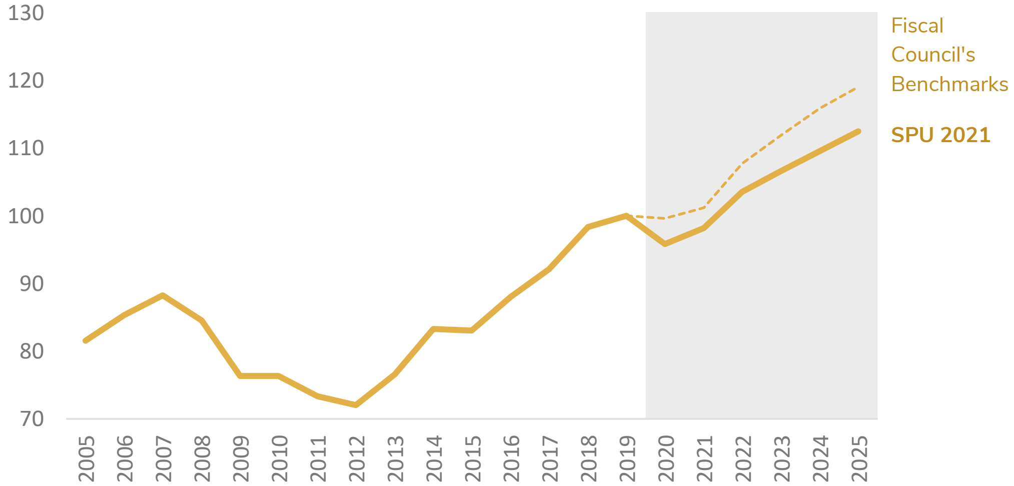
[15] The basis for this assumption is set out in supporting documentation to the SPU by Rehill and Sweeney (2021). The authors consider transmission channels for the pandemic to affect potential output via capital, labour, and productivity, concluding that on balance, the impacts are likely to prove negative overall. The authors also survey international evidence of scarring effects as estimated by various researchers for a selection of economies.

[16] Table 5 includes estimates by the IMF for advanced economies (1 per cent), and the Bank of England, the Office for Budgetary Responsibility, and the National Institute for Economic and Social Research for the UK (1.8, 3, and 4 per cent respectively).

considers there to be upside risks to the official forecasts (discussed further in Section 1.4).

Figure 1.8: The SPU projects an incomplete economic recovery

Real GNI*, 2019 = 100

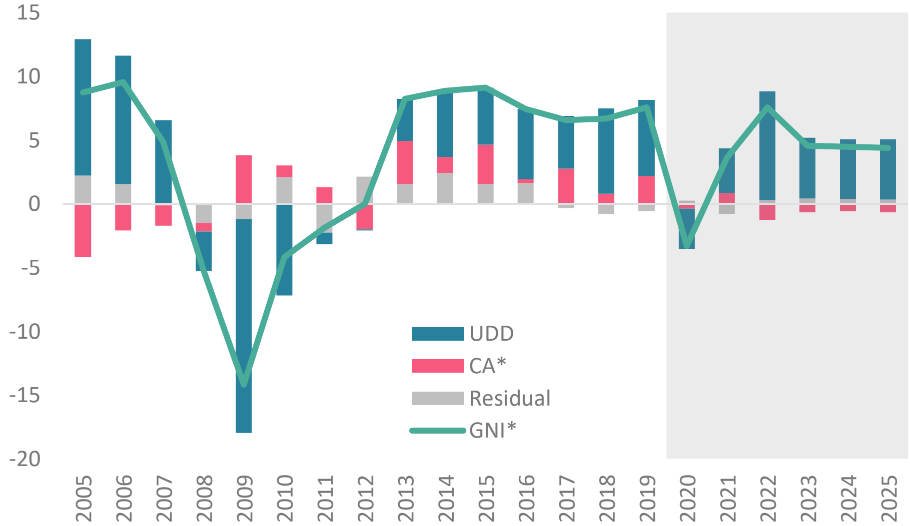


Sources: Department of Finance, *SPU 2021*; CSO; and Fiscal Council workings. Get the data.

In terms of the composition of demand in the domestic economy, Figure 1.9 shows the growth in nominal GNI* due to UDD, CA*, and a residual category including the change in inventories. This portrays how far the growth of GNI* is driven by domestic components (UDD) and how much by other factors, including the implied relevant measures of exports and imports (CA*). The Department's SPU projections suggest that UDD will increase more rapidly than GNI*. This is at variance with the recent historical experience. Typically, net foreign demand has tended to contribute to the growth of national income, except for in the mid-2000s prior to the global financial crisis. If the contribution of CA* turns out to be more in line with recent historical precedent, this would lead to a higher rate of GNI* growth than allowed for in the Department’s forecasts.

Figure 1.9: The SPU projects medium-term GNI* growth dominated by domestic demand, with a drag from net foreign demand

Year-on-year percentage change in values and percentage-point contributions



Source: CSO; Department of Finance, *SPU 2021*; and Fiscal Council workings.
Notes: This chart presents CSO outturns up to 2019 for the change in nominal GNI*, as explained by the contributions of nominal UDD, CA*, and a residual (which includes stocks, EU subsidies less taxes, statistical discrepancy, secondary income balance, and two components of modified investment that are excluded from underlying investment (namely non-R&D-IP intangibles and non-leasing aircraft)). Shaded years reflect *SPU 2021* forecasts, except for the change in UDD for 2020 (which is a preliminary CSO outturn). Get the data.

With net foreign demand acting as a drag on growth, the Department projects a decline in Ireland's large CA* surplus. Figure 1.10 presents a decomposition of Ireland's CA* balance as represented by savings less investment of institutional sectors.[17] This shows that CA* has increased significantly since 2013, at a time when UDD was also growing rapidly. As such, the positive contributions shown for Irish households and domestic firms are indicative of the rapid underlying growth rate of the Irish economy in recent years.

The underlying current account balance has tended to perform better than expected

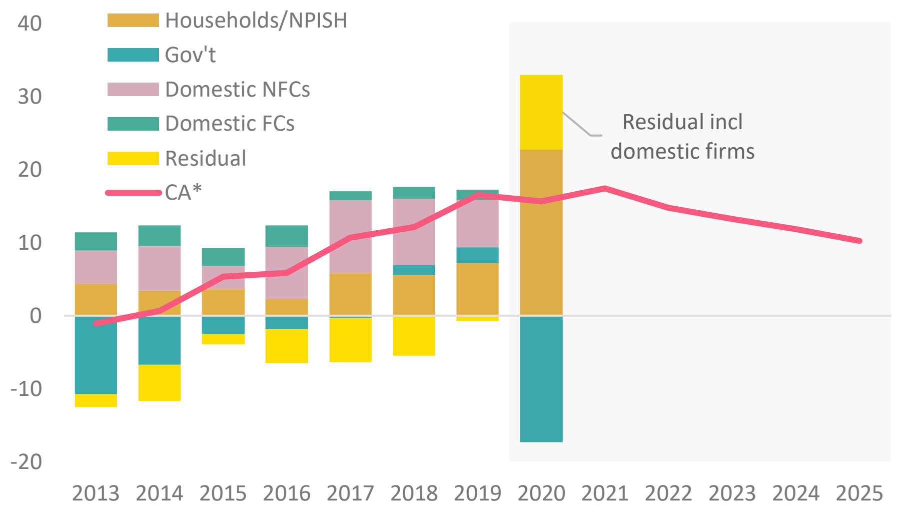
In recent years, CA* has provided largely unanticipated support to GNI*. A downward bias to the Department's CA* forecasts has been evident in recent years. This is shown in Supporting Information S5. Underestimating the increase in CA* has accounted for most of the underprediction of GNI*, and by very significant amounts in 2019 and 2020 (this assumes the Department's SPU estimate for 2020 matches the outturn, which has yet to

[17] From an income perspective, the CA* surplus represents national income that has not been spent on consumption or investment — instead, it has been accumulated as savings.

be published).[18] The unexpected extent of the surplus has corresponded to faster growth in "adjusted" exports over time compared to corresponding "adjusted" imports (with net relevance to GNI* — described in Box E of Fiscal Council, 2020a).

Figure 1.10: A current account surplus is forecast to remain by 2025

€ billion



Source: CSO; Department of Finance, SPU 2021; and Fiscal Council workings.
Notes: CSO data are shown for 2013–2019 and 2020 sectoral balances for household/NPISH, general government, and not sectorised. Get the data.

Over the medium term, it is possible that international trade could slow down, leading to a reduction in adjusted exports and a fall in Ireland's large CA* surplus, as projected in *SPU 2021*. Alternatively, if recent patterns of adjusted trade prove more persistent than allowed for by the Department, there is space for upside risk to the outlook for GNI*. This interpretation is supported by the findings of Box A regarding the relatively low import content of household final consumption expenditure. An acceleration in UDD would not necessarily be reflected in faster growth for adjusted imports. Depending on the composition of higher UDD and the associated multiplier effects, this could also imply faster medium-term GNI* growth rates than forecast in the SPU — for example, closer to pre-pandemic real GNI* growth rates of about 4 – 4½ per cent a year, rather than the 2¾ – 3 per cent growth rates forecast by the Department.

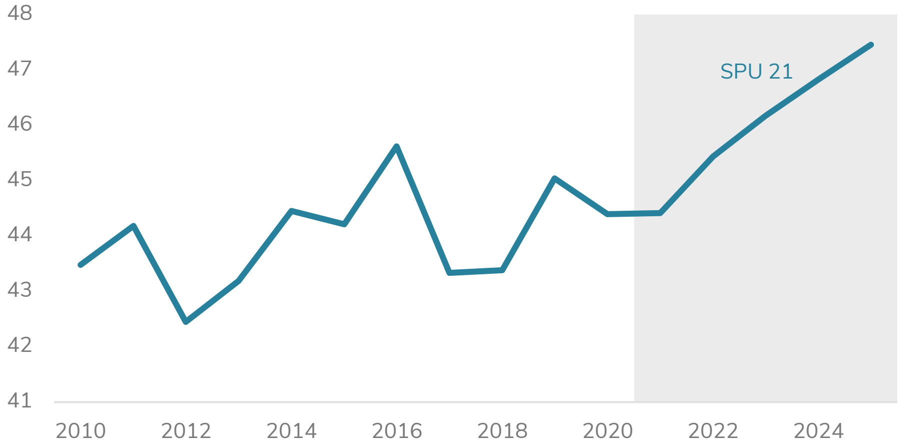
The Department's forecasts of imports are likely to be overestimated

[18] Although GNI* and CA* have only been published by the CSO since summer 2017, the Department has been including GNI* projections since *Budget 2018* — albeit initially included on a purely technical basis, grown in line with GNI — and CA* projections have been included since *Budget 2019*.

The Department's forecasts of imports, included in GDP, are likely to be overestimated. Underlying domestic demand has a relatively low import content. The Department forecasts modified imports based on their estimated relationship with final modified demand (that is, modified domestic demand and total exports).[19] However, this approach implicitly assumes an equivalence between the import content of modified domestic demand and that of total exports, despite the heavy distortions of high-import-content export sales activities of foreign-owned multinationals.[20] As a result, for a given rise in modified domestic demand, the projected rise in imports is likely to be overestimated. This is illustrated in the projected underlying imports content of final underlying demand shown in Figure 1.11. By 2025, this ratio is significantly higher than suggested by historical norms. The SPU forecast for real GDP would be over 6 per cent higher by 2025 if the underlying import content of final underlying demand were to remain stable, rather than rising to the historically high share shown in Figure 1.9.

Figure 1.11: *SPU 2021 forecasts for imports are likely to be too high*

% of final underlying demand (underlying domestic demand plus exports)



Sources: Department of Finance forecasts in SPU 2021; and Fiscal Council workings.
Notes: Underlying imports is total imports excluding investment on other transport equipment (mainly planes) and intangibles. Get the data.

A decomposition of the real GNI* growth is shown in Figure 1.12, with contributions from labour productivity and hours worked shown. This

---

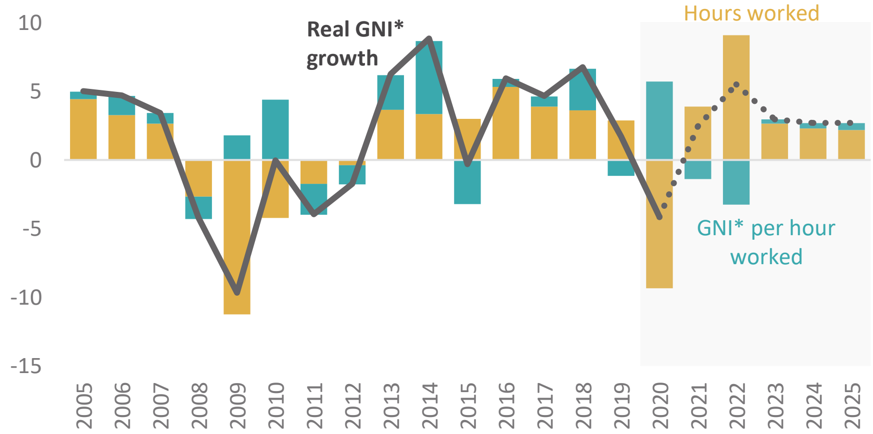
[19] See Supporting Information S1. Although the Department uses modified measures — which exclude more specific subcategories of intangibles and aircraft — the Council prefers to assess on the basis of underlying measures which exclude all intangibles and aircraft, as sub-categories within the CSO's modified series are frequently unavailable as a result of confidentiality issues.

[20] The effective import content of total exports is higher considering net factor income from abroad is equivalent in character to imports of royalties, when viewed from the perspective of the import content of final underlying demand in GNP rather than in GDP — see Figure E.1 in Fiscal Council (2020a).

highlights that, since 2005, labour productivity growth in the Irish economy has typically been positive, in particular during the recovery period following the global financial crisis.[21] Hours worked have also generally grown strongly, with the exception of 2008–2012.

Figure 1.12: *SPU 2021* projects slower growth in hours worked and productivity after 2022

% of final underlying demand (underlying domestic demand plus exports)



Sources: Department of Finance forecasts in *SPU 2021*; and Fiscal Council workings.
Notes: Underlying imports is total imports excluding investment on other transport equipment (mainly planes) and intangibles. Get the data.

As discussed further in Box B, the path for Ireland's medium-term productivity has moved considerably higher as a result of the pandemic. Over the medium term, the Department's forecast for growth in hours worked falls towards 2 per cent, down from a pre-pandemic rate of over 3.5 per cent per annum.

[21] Two exceptions are 2015 and 2019, when large distortions to Ireland's national accounts were caused by activities of foreign-owned multinational firms. However, the economy's underlying growth rate in these years was strong, as discussed by FitzGerald (2021). Therefore, it is more likely that both productivity and hours worked grew in these years.

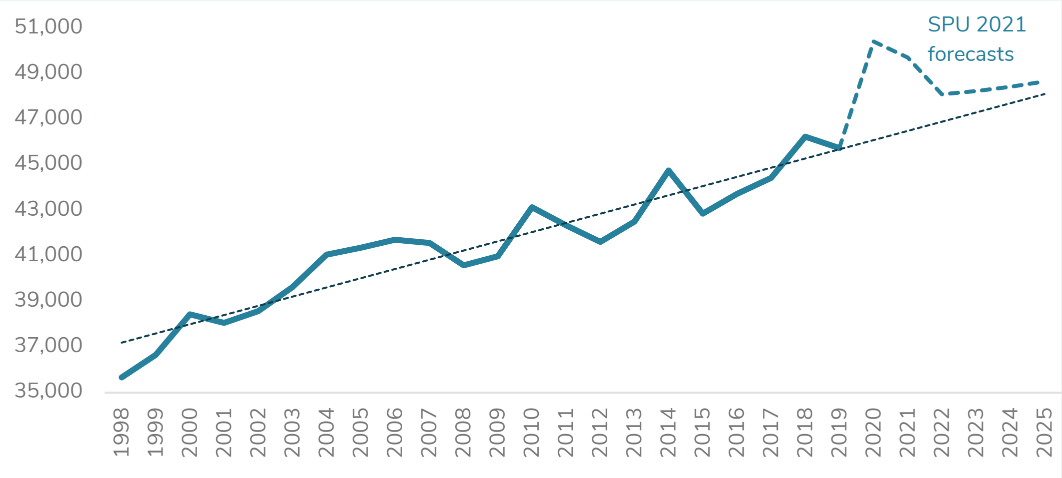
Box B: Higher productivity is an artefact of the pandemic

One of the interesting aspects of the pandemic and its effects on the economy is that overall productivity has risen; something that is expected to persist. This box explores some of the reasons for this and the outlook for productivity in Ireland.

A standard measure of productivity is output per hour worked. Figure B1 shows the recent performance for the Irish economy and the official *SPU 2021* forecasts on this basis. It shows that productivity levels are expected to be significantly higher for a time following the pandemic.

Figure B1: Productivity is expected to be on a higher path post-Covid

Real GNI* per hour worked



Sources: CSO; Department of Finance (SPU 2021) forecasts; and Fiscal Council workings.
Notes: The linear trend shown is for the period 1998–2019. Get the data.

The overall effects of Covid-19 on productivity mask some large and offsetting forces. There are two key reasons why productivity levels have increased.

First, the compositional nature of the shock has played a major role. Relatively low productivity sectors, such as construction, have seen employment plummet, whereas higher productivity sectors, such as the manufacturing of pharmaceuticals, have been less effected. This phenomenon could be temporary: as lower productivity sectors recover, this should reduce overall productivity levels. Yet with more severe scarring forecast for lower productivity sectors, it is possible that the economy will end up on a somewhat higher path with overall productivity higher than pre-crisis trends would have suggested. Exploring evidence for UK firms, Bloom et al. (2021) find similar effects using survey data for a large panel of UK firms. In this case, they find the increased share of work being done in higher productivity sectors partly offsets productivity losses elsewhere caused by higher costs associated with Covid containment measures.

Second, sectors that have been able to continue work throughout the pandemic relatively unperturbed have seen a rise in output per worker. This could be due to the positive aspects of work-from-home practises. For instance, Barrero et al. (2020) expect a 1 per cent productivity boost in conventional productivity measures post-pandemic for individuals engaged in work-from-home practises. The authors use a large survey of 30,000 US individuals over multiple waves and find most respondents adopting work-from-home practices report higher productivity than pre-pandemic expectations.

There are risks to this outlook. If firms reduce research and development or investment spending to cover costs associated with containment measures or losses made during the pandemic, this could hamper medium-term growth. There is also a risk that the natural destruction of inefficient firms—so-called "zombies"—is halted due to emergency supports introduced during the pandemic, which could arrest productivity growth.

1.4 Risks to the outlook

The Council assesses that risks to the economy over the medium term are broadly balanced.[22] While the Department notes that risks are "tilted to the downside", there are a number of reasons why both short- and medium-term growth may be higher than assumed. For instance, growth could be higher due to less scarring or lower-than-assumed levels of imports. Compared to the situation over the past year, uncertainty is now lower as Brexit has taken place and progress has been made in the management of Covid-19, including the roll-out of effective vaccines.

The Council assesses that risks to the economy over the medium term are broadly balanced rather than "tilted to the downside" as the SPU suggests

A faster and larger unwinding of savings owing to pent-up demand could provide a significant boost to consumption in 2021 and in 2022. The relatively low import content of higher consumption, especially for restricted services such as hospitality, imply a greater domestic content, and higher domestic multiplier effects, of an increase in domestic consumption.

Spillover effects from expansionary fiscal policy in the US could also provide a substantial boost to the Irish economy. The National Institute for Economic and Social Research estimates that the US stimulus will raise growth outside the US by about ½ of a percentage point in 2021. Given Ireland's openness and links to the US through exports and multinational firms, the spillovers to Ireland may be even bigger.

A key downside risk is the potential for virus mutations, which could require new vaccine development, and necessitate further lockdowns.

The risk that global and international tax reforms will reduce foreign direct investment and reduce government tax revenues has increased. This could slow down or reverse growth in earnings for high-pay sectors of the economy, with considerable negative risks for local enterprises, as discussed further in Box F.

Risks remain around Brexit that existing arrangements could unwind, and it is also possible that negative impacts on the Irish economy of the new free-trade agreement with the EU will be larger than projected.

[22] See Supplementary Information S4 for the Council's assessment of macroeconomic risks.