Irish Fiscal Advisory Council

Endorsement of Stability Programme Update 2024 macroeconomic forecasts

April 2024

The Fiscal Council has a mandate to endorse the macroeconomic forecasts underpinning each Budget and stability programme.[1]

To set out how each endorsement process is carried out, the Council and the Department of Finance have an agreed Memorandum of Understanding.[2]

This document gives an overview of some of the key aspects and discussions that took place during the latest endorsement process. It replaces the section that would previously have appeared in the Macroeconomic Assessment chapter of the Council's Fiscal Assessment Reports. The Council felt it would make for a more coherent discussion in the Fiscal Assessment Report to keep this part of the discussion separate so that the Fiscal Assessment Report could focus on more timely assessments of the macroeconomic environment.

This exercise

The Council's most recent endorsement exercise of the Department of Finance's macroeconomic forecasts was undertaken in March 2024.

The Department's provisional macroeconomic forecasts were completed on 21 March 2024 and shared with the Council. The Council and Secretariat then met with Department staff to discuss its forecasts on 28 March ahead of making its endorsement decision.

The key dates underpinning the Council's endorsement of the Department of Finance's macroeconomic projections for Stability Programme Update 2024 are set out in Appendix 1.

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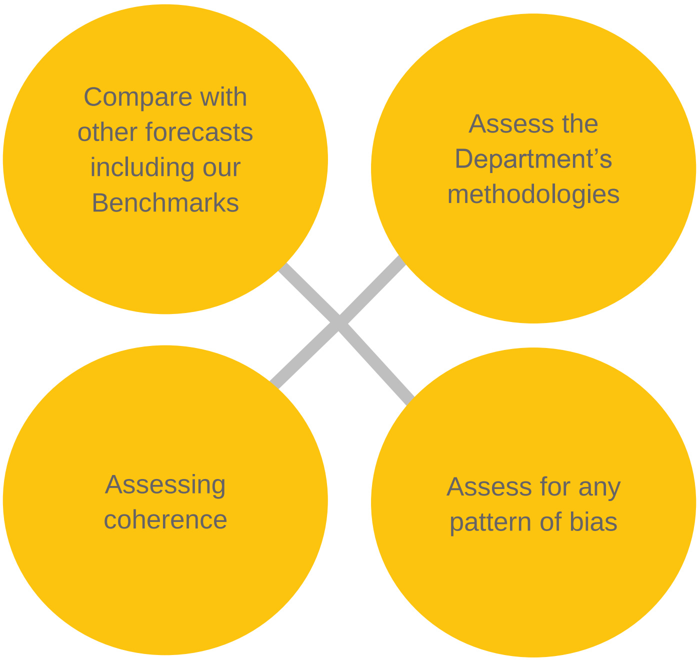
[1] This follows the agreement at European level on the Regulation on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area (EU Regulation No 473/2013), Ireland is required under Article 4.4 to have its national medium-term fiscal plans and draft budgets based on independent macroeconomic forecasts, which means macroeconomic forecasts produced or endorsed by an independent body. In Ireland's case, this endorsement function is set out in the Fiscal Responsibility Acts 2012 and 2013 that entered into force on 23 July 2013. Under the Act, the Council as an independent body (as defined in Article 2.1.a of Regulation No 473/2013) has been assigned the endorsement function, and shall "endorse, as it considers appropriate, the macroeconomic forecasts prepared by the Department of Finance on which the Budget and stability programme will be based".

[2] This sets out the timelines, data, and nature of interactions. It is available online at: https://www.fiscalcouncil.ie/fiscal-responsibility-act/

Approach

The Council's approach to endorsement has four main aspects: assessing the methodologies employed; detecting potential patterns of forecasting bias; assessing the coherence of the forecasts and comparing to other forecasts.[3] The comparison with other forecasts includes an assessment against the Council's own Benchmark projections. These Benchmark projections are developed and finalised before assessing the Department's forecasts.



[3] Previously, the Council listed three aspects to the endorsement process. A fourth aspect has been added here, assessing the coherence of the forecasts. This has become an increasing part of the Council's deliberations, and hence has been added as a key aspect of the endorsement process.

Overall endorsement decision

Taking account of the plausibility of the judgements made, the Council assessed that the Department's macroeconomic forecasts were within an endorsable range. The Council's assessment of the Department's macroeconomic forecasts was favourable regarding the processes and methodologies used.

In *SPU 2024*, the Department produced forecasts out to 2030, six years ahead. The Council welcomes this forecast horizon. The Council is of the view that the appropriate horizon for macroeconomic forecasts is at least five years.

Key issues this endorsement

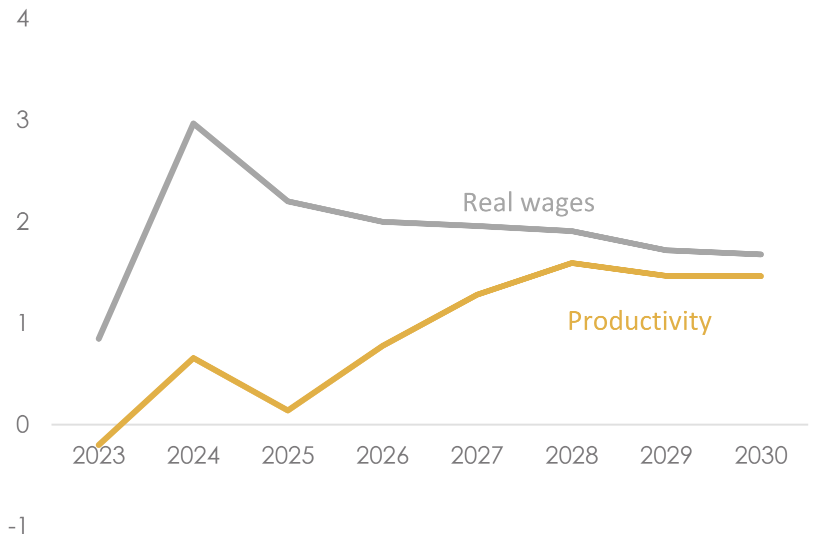
A key focus of the latest endorsement process was how consistent the forecasts were, in the context of the economic cycle. This included the interaction between the growth in real hourly wages, productivity and services inflation, and the path for the current account. Two further issues which were explored were government expenditure projections, and the forecast errors for goods inflation.

Real hourly wage growth and productivity and services inflation

A natural assumption is that forecasts for real wages and productivity growth would tend to move together in the medium and long-run. However, an issue considered by the Council during this endorsement was the Department's projection for stronger real wage growth relative to labour productivity.

This is mainly visible in growth rates. The Department forecasts moderate labour productivity growth as measured by real GNI* per hour worked. Growth of 0.5% per year is forecast for 2024-2026. As shown in Figure 1, real hourly non-agricultural pay is forecast to grow much more rapidly, averaging 2.4% per year over the same period. After 2027, real wages and productivity are more closely aligned.

Figure 1: Pay forecast to grow faster than labour productivity
% change, year on year



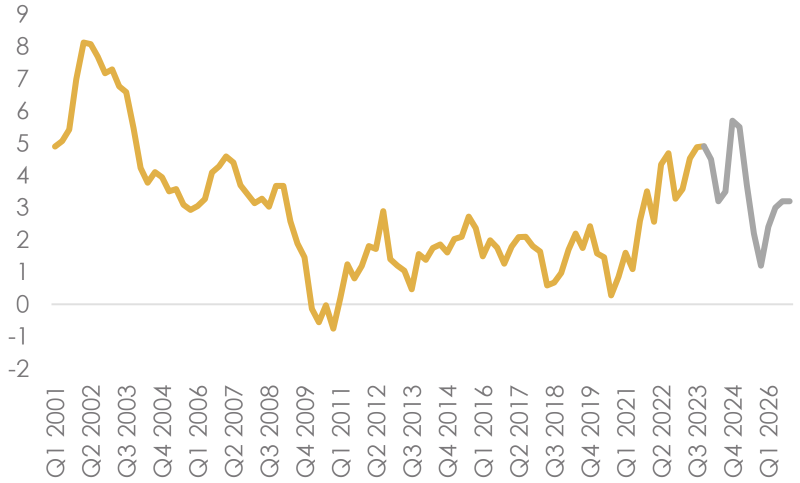
Sources: Department of Finance and Fiscal Council workings.

Faster growth in hourly wages relative to labour productivity implies an increase in unit labour costs over the *SPU 2024* forecast horizon. This could potentially result in lower margins for businesses if they were to absorb this higher wage bill in the absence of higher output. Otherwise, were firms to pass on this higher cost, it would imply higher inflation. This would particularly be apparent in services inflation which is more domestically driven than other components of inflation.

Figure 2 shows the Department's forecast for services inflation (excluding rents). The Department expects services inflation to average 3.1% per year over 2025-2026. Given the expected differential between real wages and productivity, there could be an upside risk to the Departments forecast of services inflation (excluding rents).

Figure 2: The Department expects services inflation to moderate in 2025

% change year on year, services excluding rents



Sources: Department of Finance and Fiscal Council workings.

The Department anticipates a slower growth trajectory for real GNI* over the forecast horizon, with an average of just 2.2% growth expected for 2024–2030. This would be lower than the growth rates achieved in 18 of the previous 27 years. This would be consistent with a maturing economy with lower growth from labour supply. If imports decline from their current high level, GNI* could grow strongly for longer than the Department expects.

Government consumption and social benefits

Since *SPU 2023,* the medium-term forecasts for nominal government consumption growth have been revised down by 1.1pp (0.9pp in real terms) on average for 2027-2030. Nominal growth in government consumption is now set to average 3.9% per year for 2027-2030, below the 5% rate set out in the National Spending Rule (see Figure 3).[4]

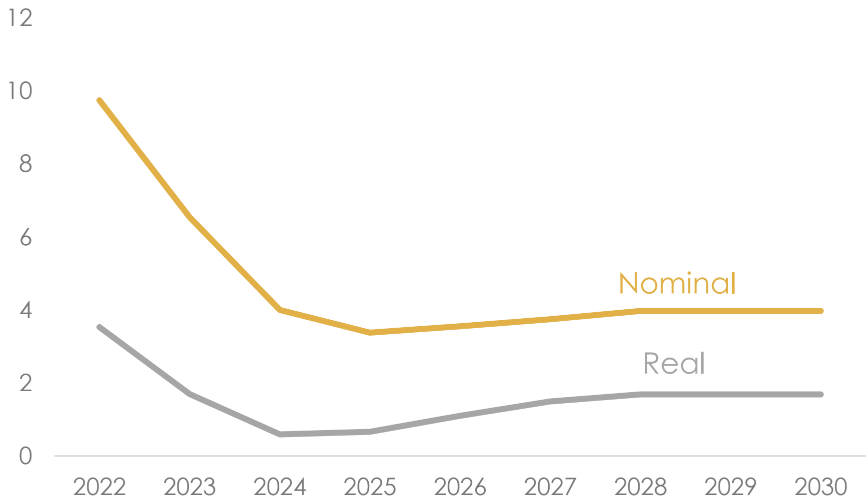
Government consumption is just one part of core government spending. Government consumption growing by less than 5% could

[4] The National Spending Rule refers to core spending rather than total spending.

still be consistent with core spending growth of 5% if other parts of core spending are expected to grow by more than 5%. The 5% growth rate set out in the National Spending Rule is a limit rather than a target, so core spending growth below 5% would still be consistent with the National Spending Rule.

Figure 3: Government consumption growth forecast to moderate

% change, year on year



Sources: Department of Finance and CSO.

For example, an ageing population will result in significant increases in social benefits (specifically pensions). Increases in the number of pensioners combined with price pressures would drive significant spending growth. The Department are forecasting growth in social benefits averaging 5% over 2025-2030.

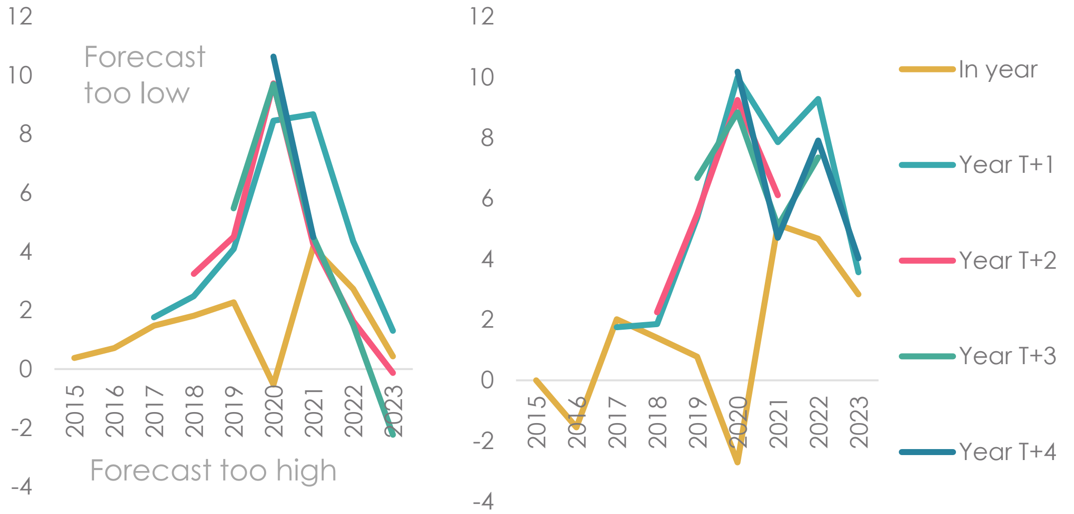
For capital spending, the National Development Plan suggests capital spending growth over 2025-2030 to average 3.5%. Instead, the Department used judgement to increase government capital spending, so that it reaches 5% of GNI*.

Overall, it appears that forecasts of government consumption could have been higher, without implying breaches of the National Spending Rule. In recent forecast rounds, there has been a pattern of underestimating government consumption growth, both in real and nominal terms (Figure 4.A and 4.B).

Figure 4: Government consumption forecasts have been too low recently

A. Real government consumption
Percentage point error, forecast - outturn

B. Nominal government consumption
Percentage point error, forecast - outturn



Sources: Department of Finance, CSO and Fiscal Council workings.

The modified current account

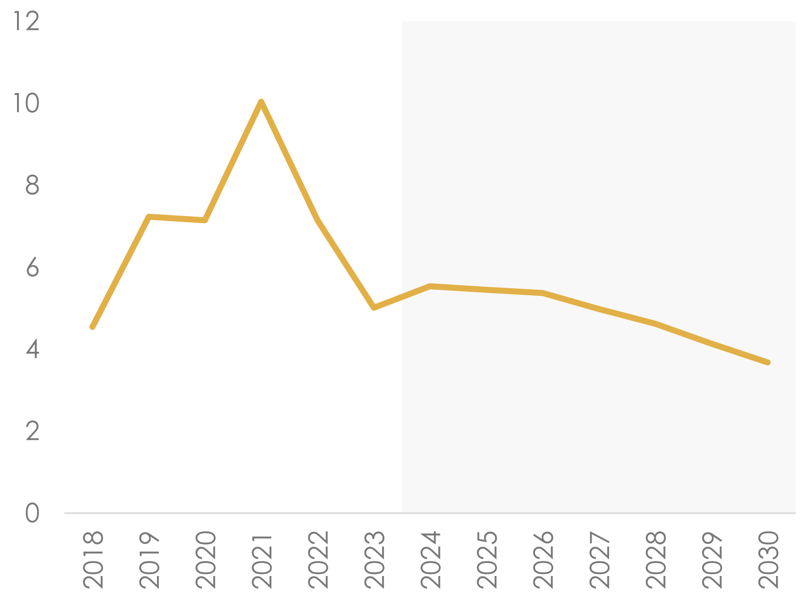
One of the more useful measures for looking at imbalances in the economy is the modified current account (CA*). *SPU 2024* projections show a reduction in the modified current account surplus (Figure 5).

While some of this is due to reduced savings by the household sector, other sectors of the economy need to be considered. The government is likely to run substantial surpluses over this period, which would continue to support a large current account surplus. The path for savings in the corporate sector is less certain. If wages increase faster than productivity as forecast in *SPU 2024*, then profit margins for firms would likely decrease.

An alternative way to assess the modified current account is savings minus investment. Examining the trade balance is another method, using exports minus imports.

Figure 5: Modified current account (CA*)

% change, year on year



Sources: Department of Finance and Fiscal Council workings.

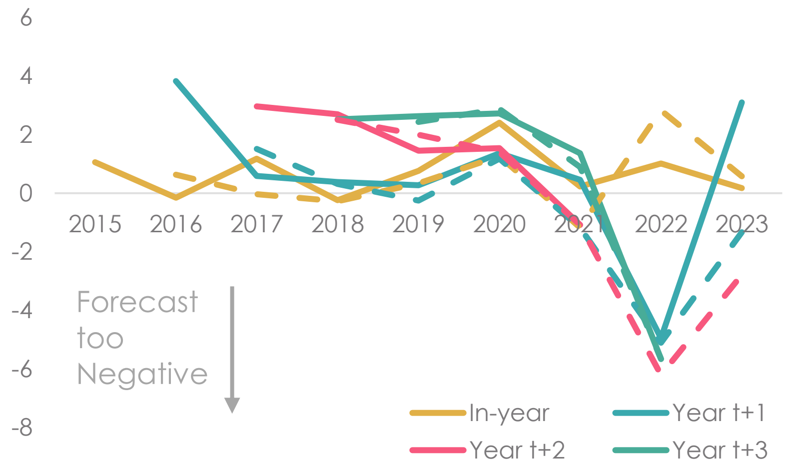
Goods consumption deflator forecast errors

As highlighted at the start of this note, the Council also considers any pattern of bias in its endorsement decision. A key consideration in this endorsement was the pattern of forecast errors for non-energy industrial goods (NEIG) and the direction of the forecast. Non-energy industrial goods are the largest component of personal consumption of goods.

Figure 6 shows the forecast errors for the deflator for personal consumption of goods for each of the Department's forecasts since *Budget 2016*. During normal times, prior to the pandemic, the forecast errors all pointed in the one direction, with the Department overestimating goods inflation. With the onset of the pandemic, the resultant supply chain disruptions and the war in Ukraine, the forecast errors have pointed in the other direction, with the Department underestimating goods inflation.

Figure 6: Goods consumption deflator has shown a pattern of errors

Percentage point error, forecast - outturn



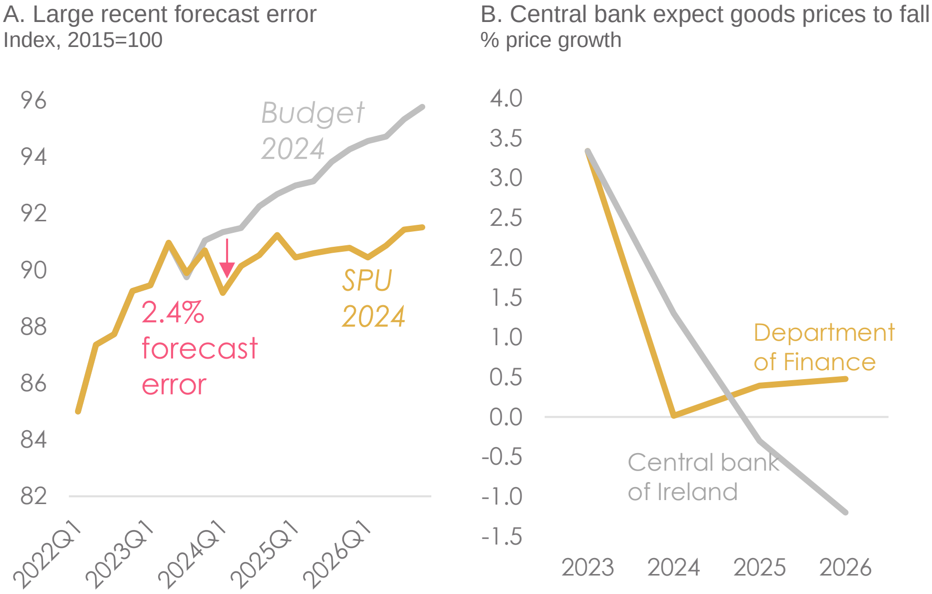
Note: Solid lines relate to Budget forecasts. Dashed lines relate to SPU forecasts.

However, recently the Department has overestimated goods inflation. The forecasts for *Budget 2023*, *SPU 2023* and *Budget 2024*, have all been in the direction of overestimating goods inflation. Figure 7.A shows the forecast error for non-energy industrial goods from *Budget 2024* for Q1 2024 was 2.4%, in the space of two quarters.[5] The Department are also forecasting continued growth in goods prices out to 2026. This continued growth in goods prices is unusual given

[5] This is relative to the Department's *SPU 2024* forecast of NEIG for Q1 2024. The error is larger, at 2.9% when compared to the latest outturn data. At the time of compiling *SPU 2024* forecasts, only data for January and February were available, meaning the Department had to forecast data for March. The outturn for March was lower than what the Department's forecast implied.

historical precedent, with 19 of the last 21 years having prices fall, the two exceptions being 2022 and 2023.

Figure 7: NEIG forecasts

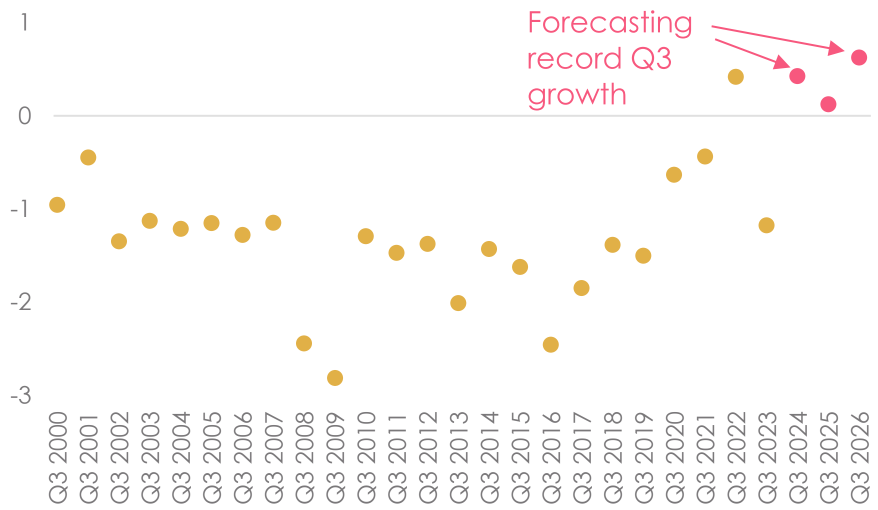


The price for non-energy industrial goods exhibits a strong seasonal pattern. Typically, the price for non-energy industrial goods increases in the 2nd quarter and the 4th quarter, while it falls in the 1st quarter and the 3rd quarter. Figure 8 shows the quarter-on-quarter growth rates for each 3rd quarter since the year 2000. In all bar one 3rd quarter, the quarter-on-quarter growth was negative. The single exception was in 2022, which was heavily influenced by supply chain disruptions and the fallout from the war in Ukraine. Since then, the 3rd quarter in 2023 returned to negative quarter-on-quarter growth.

Despite this, the Department is forecasting quarter-on-quarter increases for the third quarter in 2024-2026, with record quarter-on-quarter increases for the 3rd quarter of 2024 and the 3rd quarter of 2026 (Figure 8).

Figure 8: The department is forecasting record Q3 growth rates

% quarter on quarter growth for the third quarter of each year



Sources: Department of Finance, CSO and Fiscal Council workings.

This recent return to overestimating goods inflation concerned the Council given the historical pattern of errors and forecasts by other bodies. Figure 7.B shows the Department's forecast for non-energy industrial goods alongside the Central bank of Ireland's forecast for non-energy industrial goods. The Central Bank is forecasting a return to goods deflation in 2025 and 2026, in contrast to the Department's forecast.

If inflation for non-energy industrial goods were to be lower than the Department are forecasting, that would provide a downside risk to the overall forecast of inflation.

The Department cited methodological changes to the calculation of the price changes in part of the goods basket as a factor influencing the growth in goods prices out to 2026, as well as deglobalisation factors and a no longer depreciating sterling to euro exchange rate.[6]

[6] The methodological changes impacted roughly a quarter of the non-energy industrial goods basket.

Appendix A

Timeline for Endorsement of *SPU 2024* Projections

1 March	The CSO released its Quarterly National Accounts estimates for Q1 2024.
6 March	The Council's Secretariat and Department staff met with the CSO to clarify technical details of latest Quarterly National Accounts estimates.
21 March	The Department sent the Council preliminary forecasts in line with Memorandum of Understanding requirements
25 March	The Department presented its preliminary forecasts to the Council's Secretariat.
27 March	The Department sent updated forecasts.
28 March	The Department of Finance presented its latest forecasts to the Council and Secretariat and answered questions. After the meeting the Council had a preliminary discussion on its endorsement decision.
2 April	The Council finalised a decision on the endorsement. The Acting Chairperson of the Council wrote a letter to the Secretary General of the Department of Finance endorsing the set of macroeconomic forecasts underlying *SPU 2024*.
23 April	The Department's forecasts were published in *SPU 2024*.