Comment

Assessing both the performance and prospects for the Irish economy has been made more problematic, respectively, by the scale of revisions to the 2015 National Accounts data and the outcome of the UK referendum on membership of the European Union. In terms of economic performance, while compiled on the basis of international standards, the 2015 National Income and Expenditure accounts are not reflective of actual economic activity taking place in Ireland. Instead, these developments reflect the statistical ‘on-shoring’ of economic activity associated with a level shift in the size of the Irish capital stock arising from corporate restructuring and balancing sheet reclassification in the multinational sector and also growth in aircraft leasing activity (see Box A, page 11). As a result, National Accounts data now include a very significant amount of activity carried out elsewhere, but formally recorded as part of Irish GDP and GNP.

In addition to distorting the reality of what is happening in the economy, metrics derived from these measures, such as the various fiscal ratios-to-GDP, measures of potential output, the output gap, the structural deficit and the expenditure benchmark, have become much less meaningful. In terms of one of the most commonly used gauges of the fiscal stance, the general government deficit-to-GDP ratio, the volatility of GDP now argues for focussing in the near-term on the actual deficit in nominal terms rather than relying solely on the ratio itself or a structural deficit target, while working to develop a meaningful cyclically-adjusted measure of fiscal sustainability appropriate to Ireland’s circumstances. In the absence of the latter, the government’s stated goal of achieving structural balance by 2018 should be interpreted as a goal of achieving actual budget balance by 2018.

National Accounts developments also highlight the potential fragility of some rapidly growing sources of recent Exchequer revenues, such as corporation tax receipts, which grew by almost 50 per cent in year-on-year terms in 2015. Past experience highlights the danger of relying on volatile and potentially transitory revenue sources, which can quickly melt away, to fund increased levels of public spending or reductions in tax rates, which can prove hard to reverse.

While the recent National Accounts data seriously misrepresent the overall growth of domestic economic activity in Ireland in 2015, a wide range of more reliable spending and activity indicators suggest that economic activity continues to expand at a reasonably healthy pace. In particular, consumer spending has continued to grow at a relatively strong pace, supported by solid gains in employment and rising earnings. Underlying domestic demand, comprised of the sum of personal expenditure on goods and services, net government expenditure on goods and services and investment excluding in aircraft and intangible assets, grew by close to 5 per cent in 2015. Together with employment growth of 2.5 per cent and growth in compensation per employee of 2.7 per cent, this points to growth in domestic activity broadly in the region of 5 per cent.

However, such estimates are only rough approximations and, in view of the distortions now associated with the conventional GDP and GNP aggregates, there is a need to develop a more meaningful, commonly agreed measure of the actual level of Irish economic activity that accurately mirrors developments within the economy. Constructing such a measure is made all the more important given the potential for greater volatility in conventionally measured GDP in the future, taking account of the growing influence of corporate restructurings and balance sheet reclassifications on this aggregate.

Looking ahead, assessing the outlook for the economy is further complicated by the outcome of the Brexit referendum in the UK. The close relationship between the Irish and UK economies creates a particular exposure for the Irish economy from Brexit. Both in the short-term and in the longer-term, the economic impact of Brexit on Ireland is set to be negative and material. Quantifying the impact with much precision, however, is difficult. In the transition period to establishing new arrangements between the UK and the EU, there is the potential for a protracted period of heightened uncertainty and risk aversion. Beyond that, potential long-run arrangements encompass a wide range of possible outcomes, also making quantification difficult. Qualitatively, however, both in the short-run and the longer-term, Brexit is likely to adversely affect the Irish economy.

The long-run economic impact of Brexit on Ireland will be influenced by the nature of the withdrawal agreement between the EU and the UK and the subsequent evolution of both economies. The nature and scale of the eventual macroeconomic impact of Brexit for the Irish economy will reflect the extent to which the exit arrangements bring about any change to the free movement of goods, services, capital and labour, currently facilitated through the operation of the EU Single Market. Trade, FDI and the labour market are the key channels for the macroeconomic effects of Brexit.

In the near term, the downside risks for the Irish economy, as is also the case for the UK and broader European economies, arise mainly from the potential macroeconomic, financial and currency market effects of the increase in uncertainty related to giving effect to Brexit. An important element of this uncertainty revolves around the terms of the future relationship between the UK and the EU, in part, related to questions about how long it will take to decide those terms and the impact of the new relationship.

Analysis undertaken in the Central Bank suggests that Brexit would have a negative impact on the Irish economy through a range of channels (see Box B, page 13). The scale of this negative impact depends on the extent to which UK-EU trade, labour mobility and financial interactions would become more restricted after Brexit. While the Irish economy has become less reliant on the UK for trade over recent decades, the UK remains a particularly important market for indigenous firms. Some sectors, including agri-food, clothing and footwear and tourism continue to have a relatively high dependency on exports to the UK and, consequently, could be affected disproportionately.

Taking account of these considerations, relative to a no-Brexit baseline, projected Irish GDP growth has been revised down by 0.2 and 0.6 per cent in 2016 and 2017, respectively. On this basis, and subject to the caveats expressed earlier about conventional National Accounts measures, GDP is projected to grow by 4.9 per cent this year and by 3.6 per cent in 2017. Supported by continued solid gains in employment, underlying domestic demand is projected to grow by close to 4 per cent this year, slowing to 3 per cent in 2017. This slowdown reflects a projected negative impact from Brexit-related factors.

Notwithstanding these downward revisions, the outlook for the Irish economy remains broadly favourable, with unemployment set to continue to fall further. However, risks to the projections are clearly weighted to the downside, reflecting the possibility of a more adverse impact on the UK economy, a larger spill-over to the broader international economy or the potential for more negative domestic confidence and labour market effects than incorporated in the forecasts. Taking account of these risks and given the potential for Brexit to have a negative and material impact, policies should remain focussed on underpinning stability and reducing uncertainty.