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Assessing the Cyclical Position of the Irish Economy

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The Irish economy experienced a rapid recovery from the pandemic with activity (measured by GNI*) growing at an annual average rate of 7.8 per cent since 2021. An important question for policymakers is what the recent realised growth in the economy implies for the overall cyclical position of the economy, i.e. whether economic activity is above or below its sustainable level. If the economy is operating above its sustainable capacity, overheating risks and imbalances could emerge. Among other implications, this could manifest in growing wage or price inflationary pressures leading to a loss of competitiveness and a crowding out of the traded or export-oriented part of the economy.

The cyclical position is not directly observed and there is no single approach for assessing overheating pressures. Moreover, for a small open economy such as Ireland, assessing the cyclical position is complicated given the flexibility of labour supply through migration in particular. This flexibility means that estimates of the economy's sustainable growth rate are uncertain, therefore making it difficult to decipher the extent to which current actual economic activity is consistent with its sustainable level.

Given these uncertainties, a useful approach is to inspect a broad range of indicators. This data-driven approach can be used as a preliminary analysis, but has obvious shortcomings as no single indicator can fully capture conditions in the overall macroeconomy. Nevertheless, it is useful to monitor these data to check for signs of imbalance in different parts of the economy alongside the use of formal model-based estimates. For this purpose, Figure 1 shows a range of indicators for the Irish economy.

The unemployment rate (A) is close to an all-time low and stood at 4.5 per cent in Q3 2024 with the employment rate (B) near its previous historic peak. Coupled with high levels of net inward migration

(C), these indicators would suggest that the labour market is operating at or above capacity at present. The job vacancy rate, which experienced a large increase during the pandemic, declined in 2023 but remained elevated. More recently the job vacancy rate has fallen further, suggesting a closer match between the supply and demand for labour in 2024. Although the data are somewhat volatile, labour productivity growth (D) in the domestically oriented parts of the economy picked up from late 2022, measuring 3.9 per cent in 2023. The growth in productivity adds to the capacity of the labour market, along with the increases in labour supply.

After experiencing a large external shock to commodity prices, inflationary pressures have eased with headline inflation (E) falling to 2.3 per cent on average in 2024, down from over 8 per cent in 2022. The most recent data for October signal a further decline in headline inflation to 0.7 per cent. While externally driven price pressures have abated somewhat, domestically driven (services sector) inflation remains slightly above 3 per cent in the latest data. Inflation in rents (F) has also come down from its post-pandemic peak to around 5 per cent per annum but remains elevated and well above general inflation.

Hourly wage growth (G) has stood at around 4.6 per cent throughout 2024. This is about one percentage point ahead of 2019 hourly earnings growth, reflecting the continued strength in the labour market. Compensation per employee (G) depicts a similar trend, albeit with a pronounced slowdown in the most recent data.

Having declined to very low levels in the years following the financial crisis, housing completions have recovered gradually and exceeded 32,000 in 2023. House price growth increased in 2024, however, in part due to continued issues with inadequate supply (H). While the level of construction activity has picked up, overall modified investment remains low as a proportion of modified national income (GNI*) (I) at close to the level observed in the mid-1990s and over 10 percentage points below its 2006 peak.

In terms of fiscal developments, the headline General Government balance (J) has been in surplus over recent years reflecting the strong growth in tax revenue, particularly corporation tax, and overall economic activity. Stripping out estimated excess CT, the General Government balance has remained in deficit over recent years. This implies that excluding the effect of windfall CT receipts which are generated outside Ireland, the government remains a net borrower.

While the run up to the global financial crisis was characterised by rapid expansion of credit, the current cycle does not appear to be supported by a similar trend. Turning to international financial flows, the modified current account (CA*) (K) is in surplus up to 2023 but the size of the surplus has declined sharply since 2021, and is in deficit when excess corporation tax (all of which is paid by foreign-owned firms) is excluded. The household savings rate (L) has declined from the high levels observed during the pandemic but remains above its long run average in 2024.

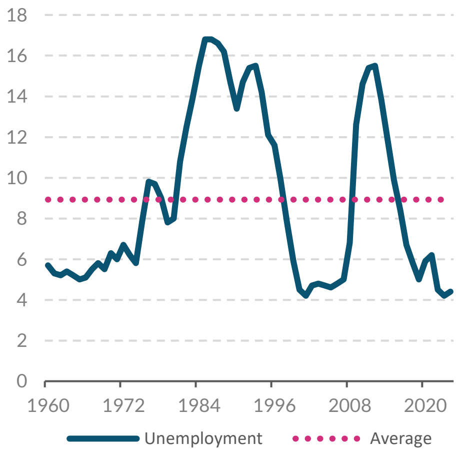
To derive a single indicator of the cyclical position by drawing on the information contained in the broad range of indicators discussed above, we use more formal methods to calculate estimates of the output gap – the estimated gap between the current level of output in the economy and what could be produced if all resources in the economy were employed at a sustainable level. An average of output gap estimates calculated from a range of models is used to provide a single summary indicator of the cyclical position of the economy (M). The estimate is calculated using a range of univariate and multivariate statistical filters, as well as a production function approach. Since this method is still subject to uncertainty due to the unobservable nature of potential output, we present the median as well as the interquartile range of the estimates. As of late 2024, the output gap is estimated to be lower than in 2023 but still positive, indicating that overheating risks are present.

In summary, the range of indicators present a mixed picture as to the degree of overheating pressures currently. Labour market data provide the clearest signals that the economy is operating close to its sustainable capacity. Looking at other indicators such as inflation and wages, there is less evidence of pronounced overheating pressures at present consistent with the strength of the labour market. At least part of the explanation for this is likely to be due to the response of labour supply to the growth in the economy. As shown above, as labour demand has increased, there has been a significant rise in labour supply through both higher labour force participation and a large increase in net inward migration. Along with improvements in productivity, this has helped to expand the capacity of the economy as demand has increased. This does not mean that overheating pressures are absent in all parts of the economy. Price signals from the housing market (rents, house prices) are consistent with binding capacity constraints in this part of the economy.

Looking ahead, the central projections in this Bulletin indicate that the economy will continue to grow strongly in 2025 at around 3 per cent in MDD terms. Thereafter, the pace of growth is expected to moderate to below 2.5 per cent by 2027. Among other factors, this growth profile is influenced by the projected easing of wage growth – in line with inflation remaining below 2 per cent – and the savings rate staying above its long-run average. Conditional on this central projection for growth, the level of output in the economy should converge to close to its long-run sustainable level over the coming years. However, stronger demand and inflationary pressures than projected in current central forecasts, for example as a result of a looser than currently assumed fiscal stance, could trigger overheating risks. Conversely, if higher tariffs or other fragmentation risks materialised resulting in slower economic growth over the coming years, there is the potential for activity to fall below its sustainable level leading to some spare capacity in the economy.

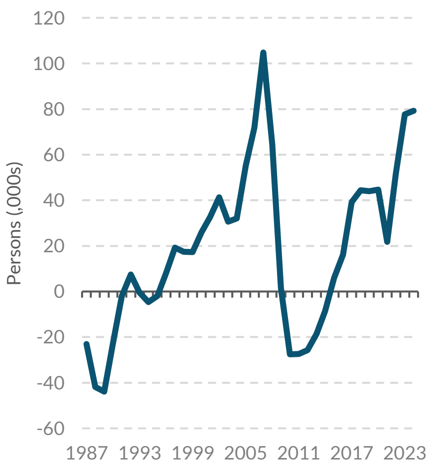
Figure 1: Indicators of the Position of the Economy in the Economic Cycle

A) Unemployment is close to all-time low

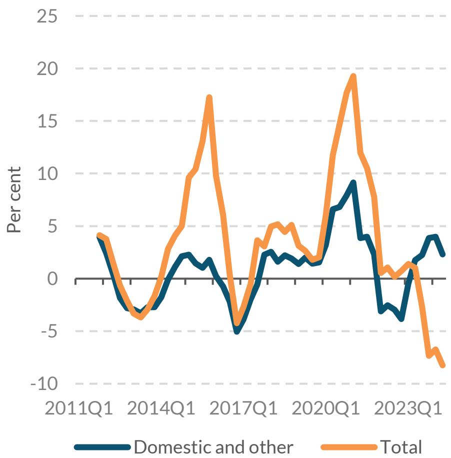


B) Employment rate near record high

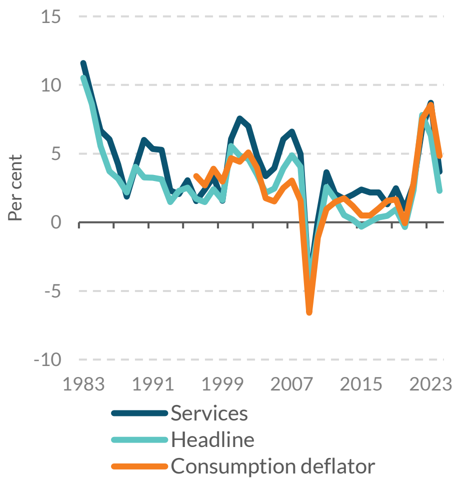
C) Net inward migration has increased sharply since 2019



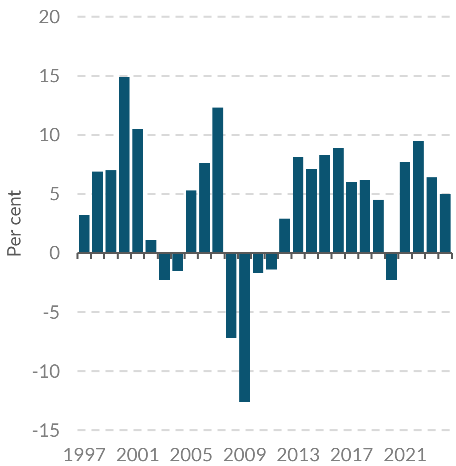
D) Labour productivity growth (4qma)



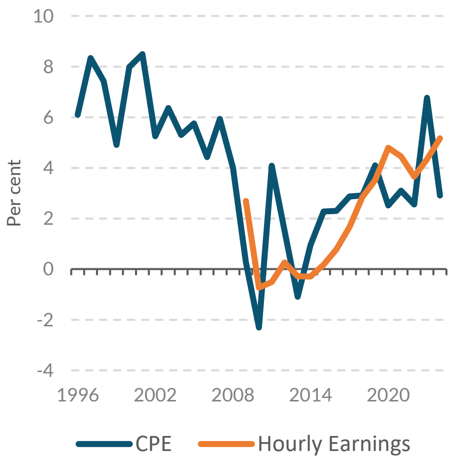
E) Inflation (Headline and Services) has eased since 2022 peak



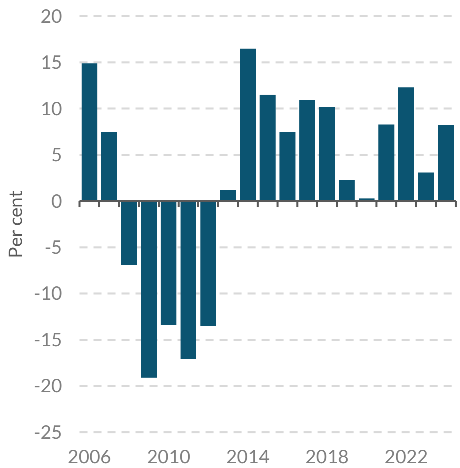
F) Rental inflation remains elevated in 2024



G) Nominal wage growth has increased since pre-pandemic

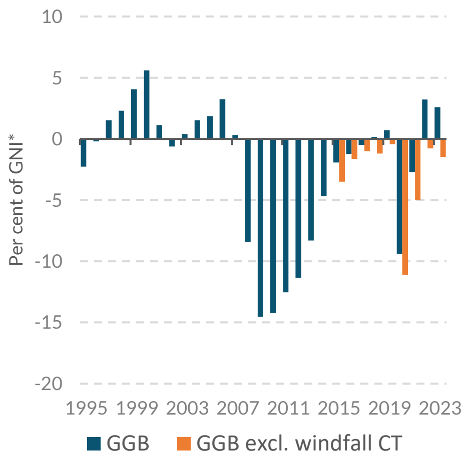


H) House price growth accelerated in 2024

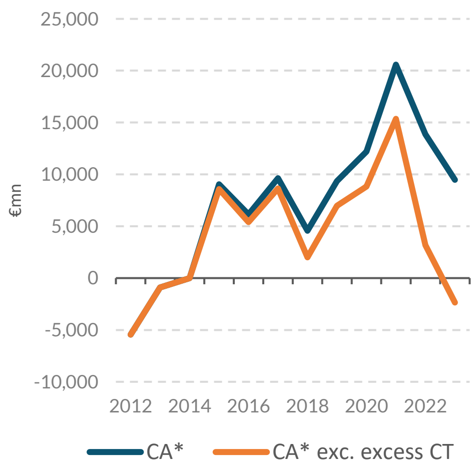


I) Modified investment ratio at mid-1990s levels

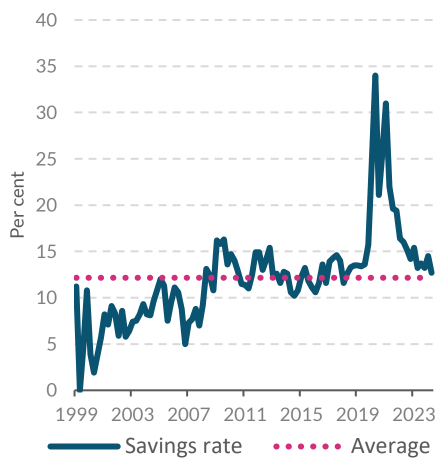
J) General Government Balance excluding excess CT in deficit



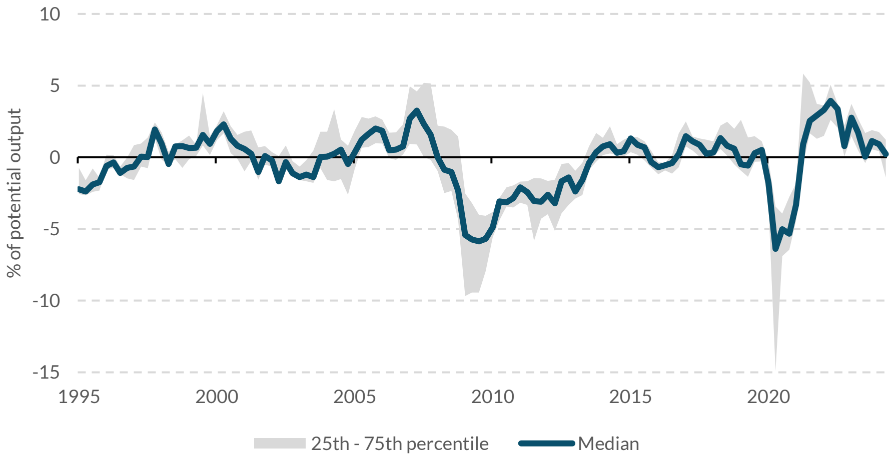
K) Modified current account surplus has declined since 2021



L) Household saving rate above long-run average



M) Output gap estimates for 2024 consistent with presence of overheating risks



Note: Where possible, figures for 2024 are included using year to date figures. No forecast values are used.

Source: CSO, Eurostat, Central Bank of Ireland, Department of Finance, author's calculations