Comment

The outlook for the Irish economy continues to be broadly favourable. Following GDP growth of 7.8 per cent in 2015, the Bank's latest forecast is for GDP to grow by 5.1 per cent this year and by 4.2 per cent next year. Economic growth has strengthened and broadened over the last 12-18 months, with National Accounts data indicating that growth gathered pace in second-half of 2015 and that domestic demand is now firmly the main driver of expansion. While the outlook for 2016 and 2017 is for a moderation in the pace of growth from last year's exceptionally strong rate, the broadening of the recovery, beyond the initial net export-driven rebound, enhances its sustainability. Looking ahead, domestic factors are set to continue to be the main drivers of growth over the forecast horizon, with potential risks to the outlook coming mainly from external factors.

The strengthening of economic growth over the past year has been underpinned by relatively strong and broad-based growth in employment, which has been reinforced by a pick-up in earnings and the further boost to purchasing power from lower energy prices. The improvement in the labour market situation, which has probably been the most important factor in driving the recovery in recent years, has been particularly marked, with average annual employment growth of over 2 per cent since employment troughed in early 2012. In addition to the positive impact of the cumulative effect of these gains, growth has also been stimulated by continuing favourable financial conditions, a less constrained policy environment and some improvement in the financial situation of households and firms.

Reflecting these supports, both consumer spending and investment have played prominent roles in driving strong growth over the past year. However, some care needs to be exercised in interpreting the recent strength of headline measures of domestic demand and also GDP and GNP growth. In particular, company and sector-specific developments, related to investment in intangibles and purchases of aircraft, are affecting both the level of investment and imports in the economy and distorting standard measures of the composition of growth. More generally, the strength of GDP, or even GNP, growth does not reflect the degree to which underlying economic well-being is improving. Nonetheless, supported by an evident improvement in employment and incomes, there has been a significant strengthening of underlying domestic demand, that is abstracting from investment in aircraft and intangibles, which is currently growing at close to 4 per cent.

Looking ahead, the main impetus to growth in 2016 and 2017 is projected to come from the continued strength of demand within the economy in the form of solid growth in consumer spending and investment. The main driver of that growth will be the continuing recovery in employment and incomes, although following its very strong growth in recent years, employment growth is projected to gradually moderate over the forecast horizon. Notwithstanding this gradual slowing, underlying domestic demand is projected to grow by close to 4 per cent again this year and by over 3 per cent next year. On the basis of the latest forecasts for growth in trading partner countries, export growth is set to remain favourable in 2016 and 2017, however, the impact of this on overall economic growth is projected to be largely offset by continued strong growth in imports. On this basis, the main contribution to growth, this year and next, will continue to come from the domestic side of the economy.

Taking account of developments and prospects since the last Bulletin, the latest forecast is for slightly higher GDP growth in 2016 and marginally lower growth in 2017 compared to the previous projections. GDP growth of 5.1 per cent is now forecast for 2016, 0.3 per cent higher than the previous projection, largely reflecting some carryover from the exceptionally strong growth in the second half of 2015. In 2017, on the basis of the latest forecasts of growth in trading partner countries and reflecting some moderation in the growth of domestic demand, GDP is projected to grow by 4.2 per cent, 0.2 per cent lower than the Bank's last published forecast.

While the growth outlook is relatively favourable and domestic economic momentum is strong, risks to the projections, related mainly to external factors, are tilted to the downside. Domestically, while improving, levels of private sector indebtedness are still high, although the favourable growth outlook provides an opportunity to continue to lower these further. Externally, there is the potential for economic and financial conditions in the broader international economy to be weaker than currently projected. More specifically, in relation to the outlook for the UK, as the forecasts in this Bulletin are predicated on current institutional arrangements, the forthcoming Brexit referendum creates uncertainty and is a downside risk factor.

Reflecting the strong economic performance, developments with respect to the public finances have been relatively favourable. Strong, domestic-led growth has both boosted tax revenues and had a dampening effect on some of the counter-cyclical components of public spending. In addition, last year saw an exceptionally strong rise in nominal GDP of 13.5 per cent, the strength of which would have contributed to greater than expected falls in fiscal deficit and debt ratios in 2015, through its impact in boosting the denominator in those ratios. With nominal GDP projected to grow by 7.0 per cent and 6.6 per cent, respectively, in 2016 and 2017, continued strong growth should help improve the public finances further. However, the level of public indebtedness still remains very high, emphasising the importance of continuing to reduce debt to lower and safer levels. At a minimum, policy should adhere to ensuring compliance with the relevant fiscal rules, ensuring steady progress towards the objective of achieving a budget balance in structural terms by 2018.

As the economic recovery has broadened and gained more traction, there has been some rebound in wages and momentum is building for further movement in this direction. After a long period of adjustment, it is natural that there be some recovery in wage growth; however, it is important that that this process does not lead to overshooting. Despite low levels of inflation in recent years, Ireland remains a relatively high cost location in terms of the broad cost environment. While gaining momentum, Ireland's economic recovery is not complete. Lasting improvements in productivity and competitiveness would boost Ireland's growth potential and support sustainable employment growth into the future.