7. IRELAND

Ireland decouples as growth picks up sharply

Ireland is decoupling from the euro area, as its recovery broadens and gathers firm momentum. This robust and faster-than-expected expansion should bolster government revenues and facilitate a reduction of the deficit.

Broad momentum is now well established

National accounts data for the second quarter of 2014 took observers by surprise, displaying significant momentum across the board. Real GDP was up 5.8 % y-o-y in the first half, with the turning point for the Irish economy likely having occurred in the latter part of 2013. The recovery is being fuelled by strong goods exports, some of which likely resulted from temporary factors (export activities with a deferred impact on the import side) that will not be sustained.

The latest national accounts data and high frequency indicators suggest that domestic demand is also gathering steam. Business and consumer confidence increased in 2014. Retail sales are on a firm upward trend and private consumption growth (year-on-year) turned positive for the first time since 2012 in the first quarter of 2014. Although starting from a very low base, gross fixed capital formation grew a sharp 11.3 % y-o-y in the first half of 2014, a clear sign of emerging business confidence, including among SMEs.

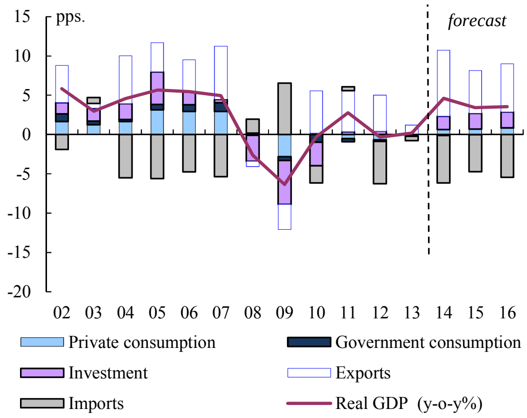
Employment growth has persisted in 2014, with the fall in the standardised unemployment rate continuing apace from a peak of 15.1 % in February 2012 to 11.1 % in September 2014.

Decoupling is set to continue

The business cycle is decoupling from that of the euro-area, with Ireland benefiting from its strong trade links with the more dynamic UK and US markets. Net exports and the recovery in domestic demand are likely to fuel real GDP growth of 4.6 % in 2014. Sustained growth is set to continue in 2015 and 2016 at around 3.6 %, with some stimulus provided by tax cuts and expenditure increasing measures in 2015.

The unemployment rate should fall further but remain above 8 % over the forecast horizon, putting a lid on wage demands. Inflation is expected to increase moderately, deviating little from euro area levels. This should preserve recent competitiveness gains and support export growth. Imports should also rise with domestic demand and the current account surplus is expected to stabilise at around 5.5 % of GDP.

Graph II.7.1: **Ireland - Real GDP growth and contributions**



Employment and wage growth should facilitate the household deleveraging process and foster private consumption growth, but high levels of indebtedness are likely to make the recovery of household spending gradual. In turn, gross fixed capital formation is expected to grow strongly after years of historically low levels of investment, including in construction, where supply now lags well below demand. Although gross credit to SMEs remains subdued, there is survey-based evidence that access to finance is improving, with new government initiatives being established.

The risks to the forecast are balanced. On the upside, the construction sector could provide additional momentum if supply constraints are swiftly resolved, and the drag of deleveraging might ease faster than expected if consumer confidence remains high and the savings rate eases from its recent historic highs. On the downside, low growth in the euro area is the main risk to the medium-term sustainability of the recovery and decoupling may generate policy challenges.

Buoyant tax revenues help deficit reduction

In 2014, the general government deficit is forecast at 3.7 % of GDP, down from 5.7 % of GDP in

2013, a significant improvement compared with the Commission services' 2014 spring forecast of 4.8 % of GDP. The expected improvement reflects a combination of factors, notably the stronger-than-expected recovery, some windfall revenues beyond the growth surprise and expenditure restraint.

Tax revenues increased by 7.4 % y-o-y in the first three quarters of 2014 and are expected to exceed the government's yearly target by 0.6 % of GDP. Personal income tax and VAT have been more buoyant than suggested by the improved macro-economic outlook. Temporary effects (0.3% of GDP) known already at the time of the Commission services' 2014 spring forecast, such as increased dividends and higher Central Bank income also contributed to the deficit outlook. In addition, since the last forecast, interest expenditure declined due to the favourable market environment by close to 0.2% of GDP, and primary expenditures have been in line with targets except in the health care sector, where overruns are once again significant (around 0.2 % of GDP). Finally, the transition to ESA 2010, including a higher GDP level, is estimated to improve the 2014 budget balance by around 0.5 % of GDP.

The improved position for 2014 is also expected to boost the outlook in 2015 and beyond. In spite of various tax cuts and expenditure increases in the 2015 budget of around 0.5 % of GDP, the general government deficit is expected to improve further to 2.9 % of GDP next year on foot of the projected economic recovery coupled with a broadly stable level of total government expenditure. Under a no-policy-change assumption, the deficit is forecast at 3.0 % of GDP in 2016. Risks around this projection mainly relate to the sustainability of recent macroeconomic developments. The structural deficit is forecast to decrease to 3.3 % of GDP in 2015 from 3.8 % of GDP in 2014 and is projected to remain stable in 2016.

Gross public debt is projected to fall to 106 % of GDP in 2016, down from 123.3 % in 2013. This marked improvement largely reflects the accounting treatment of gross debt related to the Irish Banking Resolution Corporation (IBRC). With the transition from ESA 95 to ESA 2010, IBRC became part of general government. However, the liquidation of IBRC initiated in early 2013 is projected to reverse the effect of its inclusion in the general government perimeter on the debt level.

Table II.7.1:

Main features of country forecast - IRELAND

	2013			Annual percentage change					
	bn EUR Curr. prices	% GDP	95-10	2011	2012	2013	2014	2015	2016
GDP	174.8	100.0	5.1	2.8	-0.3	0.2	4.6	3.6	3.7
Private Consumption	78.7	45.0	4.6	-1.1	-1.4	-0.4	1.4	2.0	2.0
Public Consumption	30.6	17.5	4.0	-2.2	-1.3	0.0	1.5	-0.5	1.8
Gross fixed capital formation	26.5	15.2	4.7	-2.2	5.2	-2.8	9.3	12.3	9.5
of which: equipment	6.8	3.9	4.8	2.1	-2.5	1.8	11.5	13.0	8.5
Exports (goods and services)	184.1	105.3	9.2	5.5	4.7	1.1	8.0	5.3	5.6
Imports (goods and services)	147.7	84.5	8.3	-0.6	6.9	0.6	7.3	5.6	6.1
GNI (GDP deflator)	148.7	85.1	4.4	-0.6	1.2	3.2	5.1	3.5	3.5
Contribution to GDP growth:	Domestic demand		4.0	-1.3	-0.1	-0.6	2.3	2.8	2.8
	Inventories		0.0	0.7	-0.3	0.4	0.0	0.0	0.0
	Net exports		1.7	5.7	-0.8	0.6	2.3	0.8	0.8
Employment			2.7	-1.8	-0.6	2.4	2.0	2.2	2.2
Unemployment rate (a)			7.2	14.7	14.7	13.1	11.1	9.6	8.5
Compensation of employees / head			4.4	1.2	0.8	2.0	-1.3	0.8	2.1
Unit labour costs whole economy			1.9	-3.2	0.5	4.2	-3.8	-0.6	0.7
Real unit labour cost			-0.7	-4.1	-0.8	3.2	-4.3	-1.5	-0.7
Saving rate of households (b)			-	11.2	10.2	9.4	8.4	8.2	8.3
GDP deflator			2.7	0.9	1.3	1.0	0.5	0.9	1.4
Harmonised index of consumer prices			2.4	1.2	1.9	0.5	0.4	0.9	1.4
Terms of trade goods			0.0	-6.2	-0.7	0.5	-1.4	-0.1	-0.5
Trade balance (goods) (c)			21.2	25.3	24.5	20.7	21.0	19.8	18.6
Current-account balance (c)			-1.3	0.1	0.9	3.8	5.5	5.5	5.3
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-0.8	0.2	0.9	3.8	6.3	6.0	5.7
General government balance (c)			-2.4	-12.6	-8.0	-5.7	-3.7	-2.9	-3.0
Cyclically-adjusted budget balance (c)			-2.7	-12.0	-7.1	-4.4	-3.5	-3.2	-3.3
Structural budget balance (c)			-	-8.0	-7.1	-4.8	-3.8	-3.3	-3.3
General government gross debt (c)			45.9	111.1	121.7	123.3	110.5	109.4	106.0

(a) Eurostat definition. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.