Banc Ceannais agus Údarás
Seirbhísí Airgeadais na hÉireann

Central Bank &
Financial Services
Authority of Ireland

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PO Box No 559
Dame Street,
Dublin 2, Ireland
T +353 1 434 4000
F +353 1 671 6561
www.centralbank.ie

Mr Brian Lenihan T.D.
Minister for Finance
Department of Finance
Upper Merrion Street
Dublin 2

Dear Minister

As is normal practice, I am writing to you in advance of the forthcoming Budget to put forward the views of the Central Bank and Financial Services Authority of Ireland (CBFSAI) on budgetary and economic matters.

The current economic and financial environment presents unprecedented challenges for budgetary and broader economic and financial policy. In the face of these challenges, the policy requirements are clear – to consolidate the stabilisation and return to health of the banking sector so that it underpins growth, to restore order to the public finances and to regain competitiveness. Budget 2010 must play an important part in building on the steps already taken towards fiscal consolidation and the broader restoration of stability. It is vital that it does so in order to begin the urgent process of reducing the General Government Deficit (GGD) towards 3 per cent of GDP, as agreed with the European Commission, as well as to improve both domestic and international confidence in the credibility and likely success of the adjustment process.

The goal should be to rebalance public spending and taxation through setting both of them at levels that are sustainable over time and not sensitive to cyclical economic conditions. In particular, this means using a return to growth to reduce the very high deficit and the unsustainable level of debt that is now been built up. In doing so, maintaining a fiscal restraint on public spending for the foreseeable future will be vital. Any additional resources acquired by more buoyant growth cannot be used to fuel new spending growth.

With regard to current economic performance and prospects, following a decline in GDP of 3 per cent last year, a further decline of around 7¾ per cent seems likely in 2009. While there is the prospect of stabilisation followed by a return to modest growth during the course of next year, in year on year terms, growth for 2010 is set to remain negative, with GDP projected to decline by about 2¼ per cent. However, this outlook is contingent on the sustainability of the incipient recovery in growth in our main trading partners, which should support some growth in Irish exports. Domestic demand is likely to remain weak until 2011 at the earliest. Given this background, the outlook for the labour market remains exceptionally weak with the unemployment rate projected to average around 14 per cent in 2010. As a result, wage and inflationary pressures are likely to be subdued with nominal wage decreases projected for those in the private sector. This should help to reverse some of the substantial deterioration in competitiveness relative to our main trading partners that has occurred since the early years of this decade, which, more recently, has been exacerbated by the strengthening of the euro against the US dollar and sterling.

The contraction in the economy has had a very significant impact on the fiscal position both in terms of increased spending and sharply reduced tax receipts. The latter has been amplified considerably by the increased reliance during the boom years on taxes that are highly sensitive to economic conditions, particularly asset market conditions such as property market values and transactions. With the collapse in revenues, it is now necessary to strike a new balance between expenditure and taxation. The scale of the increase in public spending during the boom period adds to the scale of the needed adjustment. Significant efforts have been made in this regard, over the past year, in the form of the series of sizeable consolidation measures adopted and signalled for future years. Nonetheless, many more critical decisions remain to be made. Most pressing among these are the requirement to adjust the level of public expenditure, the need to create a wider, more stable and reliable tax base and the need to control expenditure over time taking account of the resources available. This urgent and unavoidable process of adjustment will involve difficult choices, both in terms of revenue and expenditure decisions emphasising the importance of reducing the cost of providing public services and finding ways of delivering these services more efficiently.

Debt considerations also emphasise the need to restore balance. The deterioration in the fiscal deficit in recent years, the rise in the level of public debt and the costs and uncertainties associated with support for the banking sector have transformed the long-term fiscal position. This leaves Ireland very vulnerable to adverse interest rate movements and a widening of spreads and also exposed to external funding risk. Allied to the uncertainties with regard to the future growth potential of the economy, this argues for a high degree of restraint in fiscal planning and also for framing budgetary policy on the basis of realistic and modest rather than optimistic recovery scenarios.

Turning to the situation at present, the latest data point to the likelihood of a significant overshooting in the General Government Deficit this year from the target set out in the Supplementary Budget. This mainly reflects a likely shortfall on the revenue side. In light of the likely overshoot in the 2009 deficit target, the opening position for next year will be correspondingly worse. Stabilisation of the deficit in 2010 followed by further adjustments over the coming years are required if the deficit is to be brought below 3 per cent of GDP by 2013 as planned. Given how important the well-flagged 2010 adjustment of €4 billion has been in influencing expectations, it will be key not to deviate from this immediate goal of deficit stabilisation.

The natural goal is to achieve needed fiscal adjustment without threatening medium-term recovery and with the minimum of hardship. Taking account of recent tax rate increases, and the fall in many consumer prices over the past year, this should be possible with greater reliance on expenditure adjustments at this time. A focus on containing expenditure would also accord with the lessons from Ireland's experiences in the 1980s, and also from international evidence, that carefully targeted and prioritised expenditure-based consolidation measures are generally more effective in the medium-term than over-reliance on tax based solutions.

In this respect, the recent 'Report of the Special Group on Public Service Numbers and Expenditure Programmes' provides a valuable framework. While raising a number of clearly difficult and sensitive policy options, very significant savings are required to ensure that Ireland moves towards meeting its Stability and Growth Pact obligations within the agreed timetable. Decisive action of this magnitude would also send a clear signal to international investors with beneficial effects on the cost of Government borrowing and on the funding costs of banks.

Given the size of the public sector pay bill, a lasting reduction in its level would be necessary to affect any significant reduction in the overall level of government expenditure. In the light of labour market developments over the past year, the fall in the price level that has occurred and, more fundamentally, the fact that attainable living standards nationally have been lowered decisively as a result of the ongoing economic adjustment, a reduction in public sector pay rates is warranted. Notwithstanding the introduction of the pension levy, pay premia in the public sector relative to private sector comparators would appear to persist. More generally, a recovery of international price and wage competitiveness demands lower wage and salary levels across the economy, public and private.

In regard to social transfers, whose real value has also increased again over the past year given the overall fall in prices as well as taking account of the Budget day increases, targeting available resources as effectively as possible would, at a minimum, be essential. In this regard, consideration should be given to tackling universalism in terms of certain benefits, a point that has been raised in both the 'Report of the Special Group on Public Service Numbers and Expenditure Programmes' as well as by international market commentators such as the IMF and OECD. In determining the evolution of benefit levels, against the background of a changing labour market, care should also be taken to avoid the emergence of unemployment and poverty traps in the years ahead and in this regard consideration of the replacement ratio will be important.

Capital expenditure has increased significantly in recent years, driven by the need to close the infrastructural deficit in Ireland, which necessitated significant investment. It is, of course, important to ensure that the infrastructure needed to support a resumption of economic growth is ensured and maintained. But the changed fiscal and external environment implies that many planned projects should now be deferred. Only such projects as pass a rigorous cost-benefit test and support the productive side of the economy should be allowed to proceed and given the changed economic climate, greater value for money could be achieved.

The Bank welcomes the recent publication of the 'Commission on Taxation Report' which provides valuable analysis of taxation reforms. There is a pressing need to broaden the tax base in Ireland particularly given the need to keep tax rates low, a factor that has been integral to Ireland's attractiveness as a location for foreign direct investment. Furthermore, it is now clear that fiscal policy became too reliant on tax categories which have proven to be unstable, much of which related to the housing market. The Bank notes the economic and fiscal merits of a property tax, which could provide a stable source of revenue while not affecting labour market incentives and whose design should be both equitable and practical. Furthermore, it is important that the "user pays principle" becomes further ingrained in Irish society and, in this context, the proposals for a carbon tax and for water charges appear reasonable, while again not impacting on the labour market and also promoting intergenerational equity and economic efficiency.

Given the need to improve competitiveness there is a need to act, where possible, to reduce the cost base of the economy. The recent 'Annual Competitiveness Report' by the National Competitiveness Council (NCC) drew attention to the fact that, over the past year, administered prices have continued to increase quite rapidly, despite price and wage reductions in other areas of the economy. In this context, it would be important that the sheltered sectors of the economy are subjected to greater competition and rigorous public procurement standards, for instance in the areas of health care, health insurance, education, legal and other services, energy, public transport and other utilities. Professional fees in a number of service sectors remain very high in Ireland, a point also stressed by the OECD, the NCC and the Competition Authority. Not only are excessive costs in these areas burdensome to the budget and damaging to the rest of the economy, but a perception that sheltered sectors are not sharing the burden of adjustment will undermine public support for needed policy action.

It is appropriate to make reference to the likely implications of bank recapitalization for the government's finances over the coming year. The banks participating in NAMA will have to take sizable write-downs on that part of their loan portfolio that is purchased by NAMA. In addition, these purchases – and the valuation work that underpins them – will provide a clearer picture as to the recoverable value of other loans in the banks' portfolio. This will complement parallel work at present under way in this institution to assess the needs of the banks for additional Core Tier 1 capital. While it is too soon to specify an exact sum, it is clear that a multi-billion euro injection of capital will be required, presumably during 2010, if these banks are to be compliant with regulatory requirements. It may prove possible for the banks to raise some of this by way of debt-equity swaps with subordinated debt-holders or through other market sources, but the bulk of it is likely to have to come from the State. The additional borrowing that this will entail underlines the necessity of adhering to the rest of the medium-term budgetary strategy in a credible way. Two additional points need to be borne in mind in this context. If due diligence results in loan valuations deviating from the estimates already indicated, it would be important that the purchase prices should be set so as to ensure that there is no net additional long-term cost or risk to the State. Furthermore, action to ease the difficulties of mortgage holders need to be carefully designed in order to ensure that they do not imply a new and additional open-ended contingent liability for the State.

In summary, it is clear that, in recent years, the fiscal position in Ireland and specifically, government expenditure grew too rapidly and became too reliant on "asset taxes" and unsustainable sources of growth. In light of an extremely challenging economic outlook, the widening gap between revenue and expenditure will need to be closed, through further expenditure consolidation and tax increases, which although painful in the short-term, will lead to long-term benefits far in excess of the costs. In so far as tax increases are concerned, there are good conceptual and empirical grounds for placing more reliance on property-ownership taxes, carbon taxes and user charges, rather than on income taxes which have negative effects on economic performance and work incentives. That said widening the income tax base, while taking account of the incentive to work also should be considered. Furthermore, evidence points to the benefits arising from expenditure-based consolidation measures as opposed to an over reliance on taxation-based solutions.

The income tax/levy measures in the Supplementary Budget of April 2009 went some way to spreading the burden of adjustment to higher income earners. Continued efforts to ensuring a perception of fairness in budgetary measures will remain a vital ingredient if the multi-year fiscal adjustment on which the Government has embarked is to be successfully delivered.

While there are very substantial challenges facing the economy at present and immeasurable demands on the public finances, the economy has time and time again proven resilient and flexible. Moreover, in spite of a very turbulent economic environment, many of the strengths of the Irish economy remain in place, not least in terms of a highly educated and adaptable workforce, a relatively flexible economy, a significant comparative advantage in high productivity modern sectors and ease of access to European and US markets.

In conclusion, may I take this opportunity to wish you every success with the forthcoming Budget.

Yours sincerely

Patrick Honohan

Governor