Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

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Gobharnóir / Governor

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22 July 2022

Dear Minister,

RE: Budget 2023

I am writing to you in advance of September's Budget, in line with the Central Bank's mandate to provide analysis and comment to support national economic policy development.

The economic backdrop for Budget 2023 is challenging and highly uncertain. The economy began 2022 with strong momentum as the impact of the pandemic subsided and the benefits of the counter-cyclical policy response were realised. However, it now faces numerous headwinds. The Russian war in Ukraine has produced a major shock to international energy prices, which were already at elevated levels as the global economy adjusted through the pandemic. It has also amplified supply chain pressures that are affecting the price and availability of other commodities. The resulting higher inflation is weighing on growth amid an uncertain domestic and international economic outlook. And as the ECB's Governing Council noted at its meeting yesterday, these factors are evident across the Euro area

Against this backdrop, there are four priorities I suggest should be addressed in framing the fiscal policy stance in Budget 2023:

- Ensuring those most vulnerable to the inflationary shock are supported through temporary, targeted supports to limit adding to existing excess demand and inflationary

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pressures;

- Increasing government investment and supporting public services while ensuring value for money, reducing fiscal vulnerabilities, including reliance on excess corporation tax receipts, and keeping the economy on a sustainable growth path;

- Building resilience in the public finances, by ensuring the capacity is there for fiscal policy to respond in a countercyclical way in the future;

- Building resilience in the economy, reducing the impact of future adverse shocks by sustainably addressing the structural challenges around infrastructure, climate change and population ageing.

Economic outlook

As outlined in our Quarterly Bulletin (published on 7 July), high-frequency data suggest a weakening in activity in some parts of the economy as the year has progressed, tempering the strong post-pandemic recovery that had been underway. High inflation and heightened uncertainty are reducing consumer and business confidence with signs that this is having a negative effect on spending by households and firms. Projections for growth in domestic economic activity remain positive but have been revised down relative to previous expectations.

Employment and labour market data have been strong and tax revenue continues to grow at a fast pace in 2022. The key export sectors of the Irish economy have performed strongly in the first half of the year. These indicators are consistent with continued overall growth in the economy but the outlook is uncertain and downside risks have increased. The outlook for the international economy has deteriorated and more adverse conditions could impinge on Irish export growth.

Increases in energy prices have driven the rise in inflation in 2022. As a net energy importer, this presents a negative supply-side and terms of trade shock for the Irish economy. The costs of this energy price shock to the economy must ultimately be met out of collective resources domestically. Measures of underlying inflation (excluding energy and other volatile components) have also trended upwards in recent months. Current financial market

expectations are for oil prices to decline in the second half of the year and gas prices to follow suit in 2023. However, energy prices are expected to remain above pre-pandemic levels through to 2024. Supply-side constraints affecting other commodities are expected to gradually dissipate but will contribute to continuing high inflation in 2023. I should note that uncertainty over these assumptions is high and more adverse outcomes are possible.

At yesterday's meeting, the Governing Council continued its normalisation of monetary policy. The main policy rate was increased by 50 basis points following an updated assessment of inflation risks. This decision will support the return of inflation to our medium-term target (of 2 per cent) by strengthening the anchoring of inflation expectations and by ensuring that demand conditions adjust appropriately. The aim is to ensure that the benefits of price stability for households, businesses and the wider economy are realised. However, it is also increasingly clear that we are in a different inflation/interest rate environment than has been the case in the years leading up to the pandemic. At its upcoming meetings, the Governing Council expects that further normalisation of interest rates will be appropriate with the future policy rate path continuing to be data-dependent and focused on delivering our 2 per cent inflation target over the medium term.

In these circumstances, households, businesses and governments will likely see a further increase in financing costs over the coming period.

Fiscal policy

The improvement in the public finances that has occurred over the past 18 months is a notable achievement, with a balanced budget or even small surplus now appearing likely for this year. At the same time, fiscal policy continues to face a number of challenges.

The key role that corporation tax continues to play in supporting overall revenue growth represents a significant budgetary risk. Having increased by more than 40 per cent between 2019 and 2021, corporation tax receipts have continued to grow rapidly and surpass expectations in the first half of this year. Research by Central Bank staff suggests that €8bn – more than half of last year's receipts – cannot be explained by developments in the underlying economy and therefore could be considered as potentially unsustainable. There are also large concentration risks given the very high proportion of the tax paid by a relatively small number of companies in a limited number of sectors such as ICT and pharmaceuticals: just 10

companies now account for 1 euro in every 8 of Exchequer tax revenue. This leaves the public finances highly exposed to business decisions of a small number of firms, or negative firm or sector-specific shocks.

In my view, these developments point to the need for a clear strategy to manage unanticipated large inflows of corporation tax revenue. Developments in the Irish economy in the late 2000s underscore the risk of treating potentially transitory revenue flows as permanent receipts. In particular, it is important that any unanticipated corporation tax receipts are used to rebuild fiscal buffers rather than finance additional permanent expenditure on the basis of a relatively narrow tax base.

Public debt remains at an elevated level. Having ended last year at over 100 per cent of GNI*, the Irish debt ratio is one of the highest among small open economies in Europe. While such a ratio is significantly lower than the highs that occurred during the financial crisis, more than €30bn has been added to an already-high nominal stock of debt during the pandemic. Debt dynamics are projected to remain relatively favourable in the coming years, but there is considerable uncertainty over the main factors driving the anticipated improvement, namely high nominal growth and historically low interest rates. A shock to the primary balance – such as an unexpected decline in corporation tax receipts – could also result in a less favourable debt trajectory.

With monetary policy normalising, financial markets may be more likely to focus on fundamentals such as relative debt levels when pricing sovereign bonds. Accordingly, the reduction of public debt, supported by a sustainable funding base for public expenditure, should remain a key priority in the years ahead.

In relation to public expenditure, the latest Government projections show that total 'core' expenditure will continue to increase significantly in the coming years, with permanent spending set to be €26bn (or 30 per cent) higher in 2025 compared with before the pandemic. This partly reflects ambitious targets for capital spending as part of the National Development Plan. Efficient and productive public capital investment can yield benefits for the economy and society as a whole, including delivering higher levels of output, reducing costs and enhancing competitiveness.

Ensuring the public receives value for money from increases in capital spending in the current high-inflation environment will be a significant challenge. If nominal capital expenditure ceilings are to remain fixed – given the higher inflation environment that is projected out to 2024 – real expenditure (and the actual delivery of specific projects) will be lower than originally planned. This points to the need for careful planning and management to assess priority projects in the areas where most substantial progress is deemed necessary.

Temporary measures have played a key role in limiting the impact of recent economic shocks on households, businesses and the economy more generally. The introduction of income support schemes limited the emergence of scarring effects and facilitated the strong rebound in economic activity that has occurred.

Given the scale of measures that have been introduced, however, a key challenge will be ensuring that supports designed to be temporary unwind as planned and do not become permanent. Recent analysis by Central Bank staff shows that with capital spending already forecast to grow by 13 per cent per annum out to 2025, and with capacity constraints and high inflation affecting the economy, further stimulating economic activity with additional permanent current spending would risk creating excess demand and add to existing price pressures. The analysis points to the need to ensure that any additional increases in current spending – to, for example, address cost of living pressures – are temporary and targeted. Should there be any risk of temporary measures ultimately resulting in increases in core permanent expenditure, further sustainable revenue raising measures to compensate would have to be considered to avoid introducing a vulnerability in the public finances, as well as avoiding creating excess demand.

Weighing up these risks, I would encourage consideration of actions in the upcoming Budget that set out a sustainable path to a more resilient position for the public finances over the medium term. Clearly articulated sources of funding for permanent current expenditure increases will help to demonstrate long-term sustainability and reduce the risk of fiscal policy adding to inflationary pressures.

The projections in the Summer Economic Statement (SES) 2022 indicate a deviation from the Government's medium-term expenditure strategy in SES 2021 which set a benchmark for core expenditure growth linked to the potential growth rate in the economy and trend inflation. In

both 2022 and 2023, spending is projected to grow faster than the 5 per cent limit set out in this strategy, with core spending growth forecast to return to 5 per cent in 2024 and 2025. Ensuring that the rate of spending growth is kept in line with the economy's nominal trend growth rate is important to safeguard the sustainability of the public finances. This could be reinforced by addressing weaknesses in the current medium-term expenditure strategy and through more effective use of existing expenditure ceilings.

Promoting resilience through transitions

Decisions regarding Budget 2023 should also be seen in the context of medium-to-longer term issues – and shocks with potentially structural and longer term consequences – coinciding more frequently with day-to-day economic conditions.

The current experience of energy prices is a case in point, where the challenges and opportunities presented by the necessary transition to a less carbon-intensive economy are becoming evident in a more condensed time period than previously expected. In such circumstances, what would previously have been considered trade-offs between actions now and actions in the future are not as distinct. Consequently, anchoring public policy to building economic resilience in light of the significant global and domestic transitions taking place may deliver better outcomes for the community both today and in the future.

I would draw particular attention to two such transitions that will add to demands on government resources.

First, changing demographic trends will result in an ageing population and an increase in demographic-sensitive spending areas such as pension and health care costs. Acting now, when the demographic structure is still relatively favourable would reduce the overall eventual cost of adjustment.

Second, while significant investment (both public and private) will be required to ensure the delivery of Ireland's Climate Action Plan, delaying the necessary measures would result in a more costly transition – environmentally and economically – in the longer term.

Building resilience across households, businesses and the wider economy in the face of these transitions should be a distinct priority when framing Budget 2023. Aligning this with current economic conditions and the state of the public finances points to the benefit of establishing a

consistent framework linking (1) the resources needed for sustainable growth in core current and capital expenditure, and (2) diverting revenues that are surplus to those needs into the so-called 'rainy day' fund, which may more appropriately be considered a *resilience fund.*

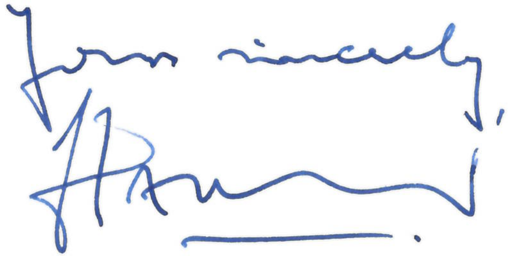
Such an approach could prove most effective in building resilience across the economy through achieving a two-fold purpose. First to build necessary buffers for the public finances, enabling the State to respond appropriately when shocks materialise in the future. And second to facilitate the necessary and capital expenditure (both now and in the future) which would ultimately reduce the cost of such shocks when they occur. I suggest that the unexpected gains from corporation tax receipts provide a strong basis for this approach: surplus tax receipts over and above what is necessary to fund expenditure growth (that is benchmarked to the future potential nominal growth rate of the economy) could inform the amount of resources diverted to a resilience fund in any given year.

Moreover, the importance of credible benchmarks and a rules-based framework for the conduct of economic policy in the EU cannot be overstated. The ongoing discussion around reforms of the Stability and Growth Pact and the completion of Banking and Capital Markets Union provides an opportunity for our policy frameworks to work more effectively in achieving stable and sustainable growth. Sufficient progress on these matters will also enable a more even transmission of our common monetary policy in the euro area. A fiscal policy framework that incentivises achieving longer-term objectives while ensuring an appropriate stance at Member State level at all stages of the economic cycle is, in my view, necessary. Our experience of the Recovery and Resilience Facility may also provide some lessons on the benefits of EU-level fiscal resources in adapting and promoting resilience through the key transitions facing citizens in Ireland and across the EU.

Conclusion

The success of the Government's large-scale counter-cyclical response to the Covid-19 pandemic – as evidenced by the rapid rebound in the economy and the fall in unemployment – clearly demonstrates the benefits of using budgetary policy to cushion the effects of a downturn on the community. Such action is only made possible if the State's finances and the economy are sufficiently strong in advance of the downturn so that resources are available to fund the measures which help households and firms to withstand the impact of a crisis.

These considerations emphasise the need for budgetary policy to rebuild the resilience of the public finances which has been damaged by successive negative shocks over the last 15 years. This can help ensure the State has the resources in the coming years both to mitigate the effects of future economic downturns and also make progress on addressing the challenges of the significant economic transitions ahead.



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