



Banc Ceannais na hÉireann
Central Bank of Ireland

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Mr Michael Noonan, TD
Minister for Finance
Government Buildings
Upper Merrion Street
Dublin 2

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Dear Michael,

As is traditional, I am writing with some observations which may be helpful to you in formulating the Budget for 2016. Given that the Fiscal Council is well established and has the primary mandate in these matters, it does not seem necessary for the Central Bank to offer a comprehensive discussion.

The improvement in the underlying budget deficit – from 11½ per cent of GDP to 4 per cent last year – has been a very impressive achievement, and consistently out-performing EDP targets has played an important role in rebuilding our fiscal credibility. With the economy growing strongly once again I know that you share my view that it is important that discussions on future fiscal policy in the run-up to the Budget do not put this hard earned credibility at risk, and that the public finances continue their evolution towards sustainable levels.

Following robust growth last year, economic indicators remain encouraging. However, I would be concerned that the degree and pace of the recovery be not overstated. The interpretation of both GDP and GNP statistics as measures of economic performance is seriously complicated by the way in which the activities of multinational corporations are measured, and a significant part of the recent growth in these production numbers can be attributed to these distorting features. Neglecting these measurement issues has led some commentators to think that the economy is back to pre-crisis performance. The employment statistics paint a more subdued picture; although job numbers have been growing in the past



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three years by about 2 per cent per annum, total employment is still more than 10 per cent below the previous peak with the result that the unemployment rate has only just fallen below 10 per cent despite emigration.

That being so, it is evident that the need to retain the improved financial market and general business confidence as well as to bolster competitiveness will need to be guiding principles for economic policy and budgetary policy if the recovery is to be fully delivered. A temporary boost to demand coming from fiscal sources would not improve, and might disimprove, this prospect. Quite clearly, from the point of view of stabilisation of the economy, it is imperative to avoid a return to the type of procyclical fiscal policies observed in the past.

Financing conditions for the Irish Government are better than they have been for years. This reflects both the improved confidence in Ireland, which has helped narrow spreads for Irish debt vis-à-vis those of the German Federal Government, and the effects of the ECB's accommodative monetary policy, including the expanded asset purchase programme (QE). Against this background I am sure that you will be taking every opportunity both to ensure that the confidence that underpins the narrowing of spreads is maintained, and that the opportunity for locking in low funding costs at what could prove to be exceptionally low yields is not missed.

All things considered, you will be alert to the danger of using windfall fiscal gains to justify long-lasting spending commitments. Distinguishing between revenue sources that can be considered as stable (such as the taxes on personal income) and those which have a one-off or transitory characteristic is a challenge of which I am sure that your Department is cognizant, especially given the speed at which transitory revenue sources associated with the housing bubble evaporated in 2009 and 2010.

As I have previously observed, there is much to be said for applying windfall gains to debt reduction, given what is still a very high debt ratio. Failing this, any expenditures or tax reductions financed by windfall gains should be temporary in character.

Clearly, there has been a very significant improvement in the general government balance in recent years. But, despite our expected exit from the corrective arm of the stability and growth pact this year, the fiscal job is not yet done. Achieving the medium term objective of structural balance at an early date would bolster external confidence, bring the debt ratio closer to a sustainable level and reduce the vulnerability of the public finances and the economy more generally to future shocks. Such an outcome would be supported by continued prudence in fiscal policy, particularly in the current environment of strong growth.

Yours sincerely,

Paul