

Sharon Donnery Gobharnóir Gníomhach/Acting Governor

T +353 (0)1 224 6001

Sráid Wapping Nua Cé an Phoirt Thuaidh Baile Átha Cliath 1 D01F7X3 New Wapping Street North Wall Quay Dublin 1 D01F7X3

www.centralbank.ie

Mr Paschal Donohoe, T.D.,
Minister for Finance and Public Expenditure and Reform,
Department of Finance and Public Expenditure and Reform,
Merrion Street,
Dublin 2
D02 R583

26 July 2019

Dear Minister,

In line with the Central Bank's mandate to provide analysis and comment to support national economic policy development, I am writing to you in advance of October's Budget. I take note of the fiscal plans laid out in the Stability Programme Update (SPU) and the Summer Economic Statement (SES), together with the analysis provided by the Irish Fiscal Advisory Council.

Macroeconomic environment

Economic conditions are currently favourable and the underlying outlook remains broadly positive, though subject to heightened levels of uncertainty. On the one hand, this uncertainty relates to the future path of the Brexit process, tensions in relation to international trade, and a more unfavourable outlook for the global economy.



In the euro area, for example, the risks to the macroeconomic outlook are to the downside and the ECB Governing Council is now discussing ways to adapt their instruments commensurate to the severity of the risk to price stability. There is also, however, the risk that continued above-trend growth in the economy will give rise to overheating pressures. While the full set of risks facing the economy are varied and complex, fiscal policy decisions will play a key role in how these risks can be managed and mitigated.

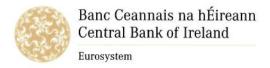
The UK's departure from the EU

Research published by Central Bank staff in recent months has analysed the impact of both orderly and disorderly Brexit scenarios in the short and medium term. In the former, the presence of a transition agreement implies that trading arrangements between Ireland and the UK would be unchanged for a period, allowing preparation to be made for the transition to the new trading relationship. A no-deal Brexit, on the other hand, would have an immediate and severe impact on almost all areas of economic activity. Certain sectors such as agriculture, food production and manufacturing have particularly strong links to the UK, both as an export market and as an important source of intermediate inputs into their supply chains. These sectors would be disproportionately affected by the imposition of tariffs and non-tariff barriers such as increased border delays and significantly increased administrative requirements for firms exporting goods both to the UK as a final destination and through the UK to continental Europe.

The Central Bank estimates that a disorderly Brexit could reduce the growth rate in the Irish economy by four percentage points in the first year. If this scenario occurs at the end of October, this would result in a reduced outlook for GDP growth in 2019 and 2020 compared to our central forecast. Our latest estimates² suggest growth would be 4.5 per cent in 2019 and 0.7 per cent in 2020, albeit these estimates are subject to considerable uncertainty. Over the long run, the estimates suggest that such a scenario would reduce the level of GDP by 6.1 per cent compared with a no-Brexit baseline.

¹ See Central Bank of Ireland Quarterly Bulletin 04 2018 (Box A) and Quarterly Bulletin 01 2019 (Box B).

² See Central Bank of Ireland Quarterly Bulletin 03 2019 (Box B).



Overheating pressures

In the event that a disorderly, no-deal Brexit can be avoided, underlying economic activity is expected to perform strongly in 2019 and 2020. Given the already cyclically advanced stage of the economy, the pace at which demand can grow without generating sustained wage and price pressures will depend on the remaining amount of spare capacity in the economy. Under the baseline forecast, already limited domestic spare capacity will continue to be reduced and there will be a material risk that continued expansion would give rise to overheating pressures.³ Evidenced by the continued declines in the unemployment rate as well as broader measures of economic slack, conditions in the labour market are now close to full employment.⁴ This implies that employment growth in the coming years is likely to be increasingly reliant on net inward migration.

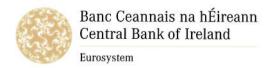
Without this, there is a risk that future growth will be impeded by labour supply constraints rather than demand shortfalls. This implies that continued strong employment growth in the coming years is likely to be increasingly reliant on labour coming from abroad.

Fiscal policy

The current constellation of risks and uncertainties facing the economy increases both the challenge and importance of charting the appropriate fiscal policy path. If a disorderly Brexit can be avoided, the underlying outlook and, in particular, the risk of overheating, emphasises the importance of a more ambitious improvement in the fiscal position. With output at or close to potential, a tighter fiscal policy would help to manage demand pressures. The uncertain environment also highlights the necessity of reducing the dependence on potentially transitory revenues and building buffers to facilitate a stabilising countercyclical fiscal expansion in the event of a future downturn. Failure to run sufficient surpluses during phases of good economic performance may limit the Government's room to manoeuvre in the future.

³ The latest forecast, assuming an orderly Brexit and a transition agreement, is for GDP growth of 4.9 per cent and 4.1 per cent in 2019 and 2020, respectively.

⁴ Byrne. S and McIndoe Calder. T. (2019) Employment Growth: Where do we go from here? Central Bank of Ireland Quarterly Bulletin 3.



If a disorderly Brexit were to occur, on the other hand, the fiscal environment would be significantly more challenging. Such a situation would lead to a material deterioration in the fiscal position, with internal work pointing to around a 2 per cent decline in the general government balance as a percentage of GDP, relative to baseline, in the medium term. This outlook assumes automatic stabilisers are allowed to operate fully, as would be appropriate. There may also be the need to provide temporary and targeted support to the sectors most affected. In the case of a wider, more severe economic impact, it may be appropriate to provide a broader fiscal support package. It is important that any fiscal response is consistent with long-run debt sustainability and does not undo the hard work in re-establishing Ireland's fiscal credibility and risk the emergence of unsustainable debt dynamics.

Public debt

The reduction of public debt ought to remain a key priority given its very high level. While financial market conditions are currently favourable, market sentiment could change quickly were downside risks to materialise. Furthermore, the factors that have supported the gross debt decline in recent years, including high growth and low interest rates, are unlikely to remain as favourable in the future. Budget 2017 included proposals to introduce an Irish specific debt target of 45 per cent of GDP, to take account of both the very open nature of our economy and statistical measurement issues. These proposals should be formalised by the Government as soon as possible. Similarly, given the risk associated with high debt, improvement towards this new target should take place at a quicker pace than is required under fiscal rules. Fiscal windfalls could also be ring-fenced to play a part in reducing the public debt burden.

Corporate tax

The most notable of these windfalls is corporation tax revenue but the public finance position has also benefited from lower interest payments. The unpredictability of corporate tax revenues in recent years points to the danger of relying on, what might prove to be, a partly transitory surge in revenues to fund lasting spending commitments. It would be more prudent to save rather than spend windfalls to mitigate pro-cyclical dynamics and build up buffers to limit the cost of future downturns.

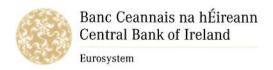


A clear strategy should be established as soon as possible to manage the unanticipated large inflows that have occurred in recent years. The SES refers to 'using revenue surprises...to reduce our debt burden'; it would be very positive to see this principle applied to upside surprises that occur this year. A recent Economic Letter by the Central Bank

provided a model-based analysis of the economics of such fiscal windfalls.⁵ This work found that choosing to spend the extra revenues rather than running a larger surplus has a very different impact if the economy is far away from capacity limits than if there are conditions of full employment. Furthermore, failure to run surpluses during windfall phases may limit the capacity of the Government to offset negative cyclical or structural shocks in the future through fiscal loosening. If it turns out that concerns about the fiscal balance or the public balance sheet mean that the Government must temper its fiscal response to an adverse shock, the decline in employment and output will be larger than if the state of the public finances permitted a full-scale fiscal response.

Any strategy on corporation tax receipts should work in tandem with the medium term expenditure framework to ensure that revenue windfalls are used to strengthen the resilience of the economy rather than finance permanent expenditure growth. Effective medium term expenditure ceilings are a key part of the fiscal architecture, allowing flexibility within a clear budgetary constraint and ensuring that spending remains consistent with overall budgetary policy. In relation to capital spending, an increase in investment is certainly warranted given the large decline in the public capital stock that occurred during the fiscal consolidation period. A critical challenge in the current environment, however, is how to boost the public capital stock while not adding to capacity constraints and generating overheating pressures. The introduction of offsetting fiscal measures can ensure that investment delivers the long-term gains to potential output, without inducing short-term overheating.

⁵ Conefrey, O'Reilly and Walsh: 'Fiscal Windfalls: A Model-Based Analysis', Central Bank of Ireland Economic Letter series, 2019 No. 3.



Navigating a path for fiscal policy in the face of these contrasting potential outcomes presents substantial challenges. A prudent approach is therefore critical in your October budget to ensure public policy has sufficient resilience and room to manoeuvre.

Yours sincerely,