Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

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Gobharnóir / Governor

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Department of Finance
Upper Merrion Street
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Dear Minister,

Re: Budget 2021

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

The context for the Budget is of course the response to the pandemic. The significant policy actions taken by the Government, including the broad range of measures introduced in the July stimulus, have supported households and firms against loss of income and helped businesses to put themselves in a better position to recover from the shock.

The scale of the policy support has helped to contain the extent of the downturn and mitigate some of its impact but as I noted in my letter to you of 2 July, there are three areas that I suggest continue to deserve careful consideration. First, policy should focus on supporting the productive capacity of the economy (in particular to avoid scarring effects such as long-term unemployment). Second, the rise in the deficit and debt ratios has been both warranted and necessary but a path to lower and more sustainable levels will eventually have to be taken. Third, there needs to be a continued focus on building resilience to future shocks, such as the ongoing impact of the UK's withdrawal from the EU, the looming challenges of international tax reform, climate change and, in the longer-term, demographic change.

Economic outlook

The actions taken to contain Covid-19 has caused a sudden and severe contraction in economic activity across the world and has posed an unparalleled challenge to governments and policymakers everywhere. The response has also been unprecedented. Both domestically and globally, a range of extensive fiscal, monetary, macro-prudential and micro-prudential policy actions have helped to contain the extent of the downturn and support households and businesses.

Real-time data for the Irish economy point to a trough in activity being reached in April, with current activity now above this low point, as the economy has started to re-open. Reflecting this, there has been a strong rebound in some elements of spending but with continuing weakness still evident in other areas. Though moderating, the impact on the labour market remains severe and while the shock to household incomes has been mitigated by the provision of large-scale income supports, precautionary behaviour has intensified, evidenced most clearly by the sharp rise in household savings. How these savings are used will be important in shaping the recovery from the current downturn.

At the sectoral level, the hardest hit sectors continue to be those with a high dependence on face to face contact or physical interaction. Regionally, there has been some variation in impact, explained largely by differences in industry and occupation composition across regions, with the impact being greatest where employment has less 'work from home' potential. Although there have been some signs of improvement – following the phased reopening of the economy – the overall level of activity still remains well below pre-Covid-19 levels and the challenge ahead will be to move from tentative re-opening to sustainable recovery.

The outlook is highly uncertain. As the Central Bank has said before, the path ahead for the economy will depend on the future path of the virus, the immediate and longer-lasting effects on behaviour and economic activity and the extent to which there is lasting damage to the productive capacity of the economy. Moreover, the projections set out in July's Quarterly Bulletin assume that a Free Trade Agreement between the EU and the UK, with no tariffs and quotas on goods, takes effect in January 2021. If such an agreement is not reached – and on the evidence so far it would appear wise to plan on the basis that it will not be achieved – we estimate that could subtract between 1-2 percentage points off the growth rate of the Irish economy in 2021.

In summary, our July scenarios point to a deep downturn in 2020, with a gradual recovery in coming years. Economic output is projected to return to its pre-crisis level by 2022 at the earliest. (We intend to publish our next assessment of the outlook in early October.)

Supporting the productive capacity of the economy

The fiscal response to Covid-19, including the July stimulus, and the consequential rise in the Government deficit and debt ratios, has been both warranted and necessary to mitigate the worst effects of the pandemic. Fiscal measures have focussed on three areas: providing income supports for those whose employment has been affected by Covid-19; business supports in the form of direct and indirect funding and supports, including credit guarantees and rates deferments; and additional health spending.

These supports have provided an important measure of relief and stability but additional policy action is likely to be required to give some impetus to recovery. Any measures should continue to focus on supporting the productive capacity of the economy, mitigating scarring effects and reducing the risk that otherwise viable firms become insolvent. Given the sharp increase in the numbers out of work, labour market activation and training programmes can have a positive impact, as can bringing forward planned investment programmes where possible. In addition to boosting demand in an economy with spare capacity, measures that address structural challenges should also increase the economy's productive capacity and benefit the Government's future fiscal position, notwithstanding the short term costs.

There has been a lot of focus – including by the Central Bank – on the impact of the pandemic on SMEs. In this context, a number of key principles are worth highlighting. Undoubtedly some enterprises entered the Covid-19 shock with unsustainable business models and during a typical downturn the closure of such companies can be seen as part of the overall process of economic restructuring and dynamism. However, identifying such firms is difficult given the nature of the Covid-19 shock and some businesses that are struggling at the moment may in fact be viable over the longer-term. They will only be able to survive as going concerns if support and protection are provided.

Second, an enterprise is more than a revenue stream for its owner. It is often an eco-system within a local economy, with relationship-specific capital tied up in its links to employees, suppliers and customers. These 'externalities' and their link to the productive capacity of the economy should be kept in mind when deciding on support policies for firms.

Third, the prudent use of public money must also be ensured to the extent possible. Grant or grant-like supports for SMEs are beneficial in that they will reach firms more widely and more rapidly than support through bank lending (for example). However, they come with additional fiscal risk which would ideally be managed – either through the targeting of recipient firms, or elements of equity – in the form of 'upside' or clawback for the State built into the grant support. Debt is unlikely to suffice as the predominant form of support for SMEs given issues around the scarring effects of the previous crisis on their owners' demand for credit, bank lending appetite and operational capacity, and debt overhang during the recovery.

Fourth, we must also acknowledge that there is an adverse scenario in which some sectors cannot get back to previous financial health – even over the medium term – due to the ongoing need for physical distancing. In such a scenario, more difficult decisions may need to be made about the balance between company closures and further fiscal outlay to support their survival. It is not in the community's interest that it supports loss-making enterprises.

Finally, with regard to investment, it is important to retain a long-term perspective. The social return from high-quality public investment accrues over many decades and the improvements it brings are more likely to be felt gradually rather than instantaneously. This argues for maintaining a steady pace of public investment over time, in both good times and bad. The type of cyclicality which has seen sizeable reductions in long-term investment projects in bad times should be avoided.

A path to more sustainable deficit and debt ratios

The large fiscal supports introduced to date are currently affordable, reflecting positive budgetary conditions prior to the pandemic and the very favourable funding environment. Assuming that policy measures are temporary in nature, favourable debt dynamics in the coming years should support a decline in the public debt ratio from the very high levels it has now reached.

Such a decline is necessary. The current debt ratio means the economy is more vulnerable to future shocks – such as lower growth, changes to the tax base, higher funding costs or primary balance shocks – with less room for manoeuvre if circumstances were to change. In the circumstances, it remains important for the Government to provide a clear, credible and time-bound return to much lower and sustainable deficit and debt positions.

In the short term this could involve indicating that, once the outlook was clearer, the Government would be prepared to deliver a more ambitious reduction in the debt ratio than required under fiscal rules, along with a firm commitment to use any future windfall revenues to reduce debt rather than support increased expenditure. In these circumstances, policy support may need to rebalance to focus on improving productivity, facilitating movement to sectors with growing demand and ensuring that opportunities for both young and displaced workers to undertake further education, apprenticeships and re-training are put in place.

The plan for greater sustainability in thc public finances could include both a broadening out of the tax base and a more effective medium term expenditure framework. The most significant windfall we have seen in recent years is, of course, corporation tax receipts. The role these receipts have played in supporting revenue growth in recent years is well established. However, their unpredictability points to the danger of relying on them to fund lasting spending commitments. Work on the issue undertaken by your Department at the time of last year's Budget was very welcome and the recommendation to set aside windfalls should be revisited once the current crisis is over. Any strategy on corporation tax receipts should work in tandem with the medium-term expenditure framework to ensure that revenue windfalls arc used to help strengthen the resilience of the economy. Effective medium term expenditure ceilings should be a key part of the fiscal architecture, allowing flexibility within a clear budgetary constraint and ensuring that spending remains consistent with overall budgetary policy. This will become increasingly important as pressures from longer-term challenges intensify in the years ahead.

Building economic resilience

The path ahead for policy must also focus on addressing longer-term challenges as well as building economic resilience to future shocks. In particular, it is important to take into account two inescapable constraints. One is the ageing of the population and its implications for the growth of the economy, and the cost of pensions and healthcare.

The second relates to the need to make the transition to a low carbon economy and to move towards more environmentally sustainable activities. It is important that policy – and structural change would appear to be necessary and inevitable – is framed to meet these challenges: delaying or failing to address them would, ultimately, be more costly. In this context you may want to consider broadening the medium-term expenditure framework so that longer-term intergenerational issues are recognised explicitly, explained to the community and addressed in a planned and managed way.

Conclusion

I welcome the sizeable, temporary, and targeted measures that have been put in place to mitigate the impact of Covid-19 while also pointing to the need, in time, to bring down the deficit and debt ratios to more sustainable levels and doing so in a way that builds economic resilience to future shocks.

Ireland's ability to manage the immediate impact of the Covid-19 shock is partly a result of the policy actions taken over the last decade and there needs to be a continued focus on the longer term structural changes that would help to manage future challenges, both known and unknown. Given the tremendous uncertainty ahead, policy will need to be flexible and ready to adapt as necessary.

Yours sincerely,

Gabriel Makhlouf