



Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

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Mr Michael Noonan, TD
Minister for Finance
Government Buildings
Upper Merrion Street
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4th August 2016

Dear Michael,

Following the tradition set by my predecessors, I am writing to you in advance of October's Budget with some observations on the current macro-financial outlook. Since the Irish Fiscal Advisory Council has the primary role in providing an independent assessment of the fiscal position, I will not offer a comprehensive analysis of budgetary policy. At the same time, it is worthwhile to offer some comments on the domestic and international macroeconomic environment and the state of the financial system, since these are important factors in determining fiscal strategy.

In relation to the broad euro area macroeconomic environment, the latest assessment of the ECB Governing Council is that the economic recovery is expected to proceed at a moderate pace, supported by accommodative financial and monetary conditions. Turning to the Irish economy, even allowing for the negative impact of Brexit, the Bank's latest Quarterly Bulletin conditionally projects output growth rates of 4.9 percent and 3.6 percent for 2016 and 2017 respectively, with unemployment declining to 7.2 percent next year. At both European and domestic levels, the balance of risks is clearly tilted to the downside. Ireland is especially exposed due to the legacy of high public and private sector debt levels, the sensitivity of small, highly-open economies to international shocks and Brexit-related vulnerabilities.

In similar vein, the economic recovery has also fostered a marked improvement in the state of sectoral balance sheets and progress in strengthening of the banking system. In addition, our



assessment is that the credit cycle remains subdued, which is reflected in the current zero value for the counter-cyclical capital buffer. At the same time, the results of the recent stress tests confirm that the financial system remains vulnerable in the event of a downturn and/or a deterioration in the international financial environment.

Given this assessment, it is clear that a prudent fiscal strategy remains essential, given the feedback loops between fiscal stability, financial stability and macroeconomic stability. In particular, it is desirable to establish long-term targets that can act as an anchor for annual budgetary decisions. Indeed, the greater the commitment to attaining the long-term targets, the more is it possible to run a flexible, counter-cyclical fiscal policy in response to temporary shocks. While the European fiscal framework prescribes a target ceiling for the stock of public debt (at 60 percent of GDP), there are compelling reasons to develop a national target for the stock of public debt. First, the target stock of public debt naturally varies across countries in line with different risk exposures: the volatile nature of the Irish macro-financial system and the history of crises suggests a debt target that should be materially below the appropriate level for a larger, more stable economy. Second, the well-known interpretation issues with measured GDP for Ireland makes it obvious that standard fiscal indicators (expressed as ratios to GDP) need to be supplemented with locally-developed targets that are robust to statistical issues. Of course, a target for the stock of public debt should be appropriately interpreted in the context of the wider public sector balance sheet, with due allowances for the holdings of various types of financial and non-financial assets and various contingent and implicit liabilities.

Let me offer a few other observations on budgetary policy. First, it is important to differentiate between temporary and permanent influences on the trajectories for revenue and expenditure. While the volatility of the Irish economy does not make it easy to calculate the underlying sustainable path for tax revenues, it would be prudent to assume that some fraction of the recent surge in corporation tax revenues might be temporary in nature. In relation to non-tax revenues, you will be quite aware that the high current level of net surplus income from the Bank will decline over the medium term. In similar vein, in relation to expenditure, the low interest rate environment currently limits debt servicing costs, especially if the opportunity is taken to lengthen the maturity structure of Irish public debt. At the same time, interest rates will eventually re-normalise, even if the speed of reversion is quite uncertain. Budgetary decisions should also be embedded in a long-term strategy that recognises the implications of an ageing population for expenditure on pensions and healthcare. Finally, at the microeconomic level, any fiscal measures in support of the government's housing strategy should be sufficiently targeted to avoid material aggravation of current distortions in the residential property sector.

Yours sincerely,