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Irish Debt Dynamics over the Medium Term

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The Covid-19 pandemic will have a significant and lasting impact on the public finances. In light of the unavoidable deterioration in many of the key fiscal aggregates, the general government balance is expected to be somewhere in the region of -13 to -18 per cent of GNI* in 2020. With deficits likely to persist into the medium term, debt financing will therefore be necessary to bridge the gap between revenue and expenditure. Debt sustainability depends on a number of factors – including the growth rate of the economy, funding costs, debt structure and contingent liabilities. In this Box, debt projections are extended out to 2025 and a number of shocks are applied to key economic variables. This analysis highlights the risks associated with the high debt level in the severe scenario.

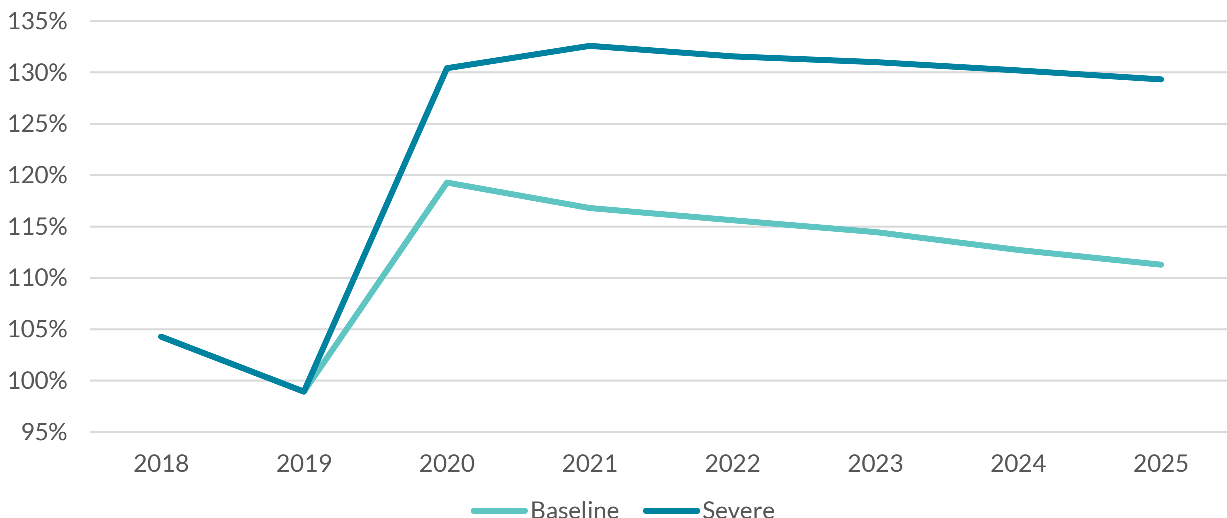
Debt Developments in Ireland over the Medium Term

Understanding the sustainability of government debt is vital for policy makers, as governments around the world are increasing borrowings in response to the rising costs of the pandemic. While debt financing in the short term is both warranted and necessary to support the economy, it is equally important that government debt is sustainable over the medium term. In this Box, we extend the debt projections presented earlier in the Chapter out to 2025 by incorporating a number of macroeconomic and fiscal assumptions. This enables us to undertake a longer, medium term assessment of Irish debt dynamics[1] which, alongside factors such as debt structure, funding costs and contingent liabilities, are an important consideration in assessing sustainability.

[1] Public debt dynamics are driven by developments in three key variables: (i) the primary balance, which is the headline government balance excluding interest payments; (ii) the snowball effect, which reflects the difference between the nominal interest rate paid on government borrowing and the nominal GNI* growth rate; and (iii) the

Under the baseline scenario, we expect general government debt (GGD) to rise from 99 per cent of GNI* in 2019 to 120 per cent in 2020.[2] This would still be lower than the peak of 166 per cent reached following the financial crisis. Beyond the initial spike this year, and under the assumption that the fiscal supports introduced are temporary in nature, the debt ratio is expected to decline in 2021 and continue on this path as the macroeconomic environment recovers and the fiscal position improves. Under the severe scenario, additional debt financing will be required, pushing the debt ratio above 130 per cent of GNI* in 2020. Moreover, as additional spending on health and social transfers would be required in the event of second wave taking hold, the debt ratio is projected to rise to 132 per cent next year, before resuming its downward trajectory thereafter. As Figure 1 illustrates, the estimates imply that in both scenarios, the debt to-GNI* ratio would eventually begin to decline after an initial sharp increase in 2020 and 2021. The decline in the debt ratio in the medium-term is driven by a resumption of economic growth, low interest rates and favourable deficit-debt adjustments, which are sufficient to offset the negative impact of running primary deficits. In both scenarios, vulnerabilities persist however. The pace of improvement in the debt-GNI* ratio in the coming years is relatively gradual – particularly compared to developments after the financial crisis (see Figure 2). Moreover, high debt ratios leave the economy vulnerable to future or more persistent shocks, the potential impact of which are examined in more detail below.

Figure 1: General government debt as a percentage of GNI*



Source: CSO, Central Bank of Ireland Calculations

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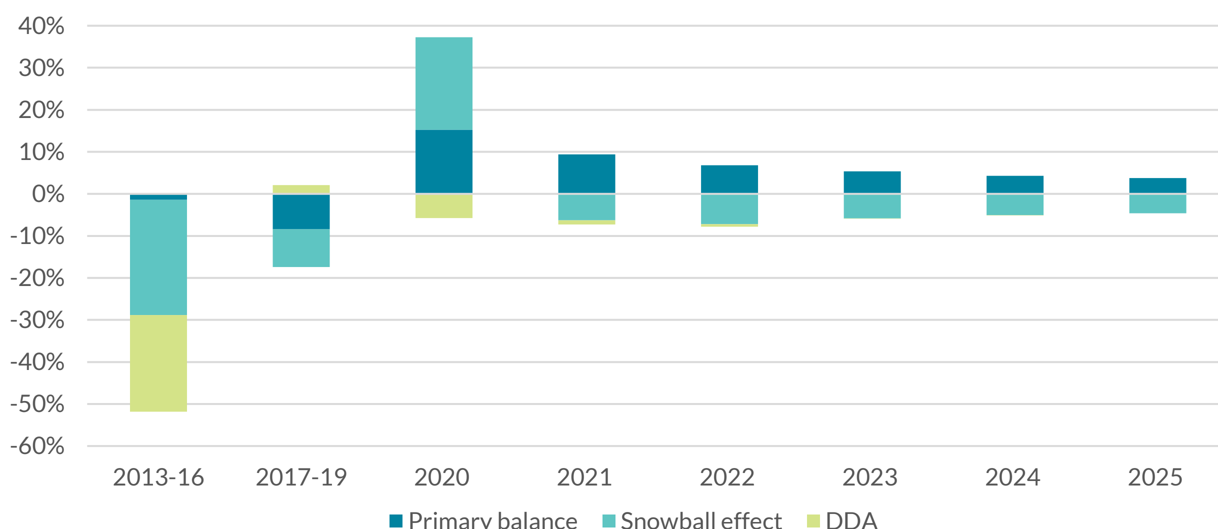
deficit debt adjustment (DDA), which incorporates factors that affect debt but are not included in the budget balance – such as the rundown of cash balances or the divestment of banking assets.

[2] For a detailed explanation of the assumptions used to produce the Baseline and Severe scenarios see Box B.

Figure 2: Decomposition of changes in the Irish debt ratio (Severe Scenario)[3]



Source: CSO, Central Bank of Ireland Calculations

Scenario Analysis and Debt Dynamics

Debt dynamics over the medium term are inherently sensitive to key macroeconomic and fiscal assumptions. This is particularly the case when the improvement in the debt ratio is expected to be relatively gradual, as the downward momentum is more vulnerable to changes in interest rates, growth and the budget balance. As a result, it is useful to incorporate a range of shocks to assess how debt dynamics react to less benign developments. The shocks we apply are:

- Standard interest rate shock, which assumes interest rates on new sovereign borrowing increases by 200 basis points from 2022 onwards.
- Severe interest rate shock, which assumes interest rates on new sovereign borrowing increases by 400 basis points from 2022 onwards.
- Constant primary balance shock, where there is no change in the primary balance post 2022.
- Historical growth shock, where the nominal growth rate in output (GNI*) reverts to its long run (10-year) average post 2022.

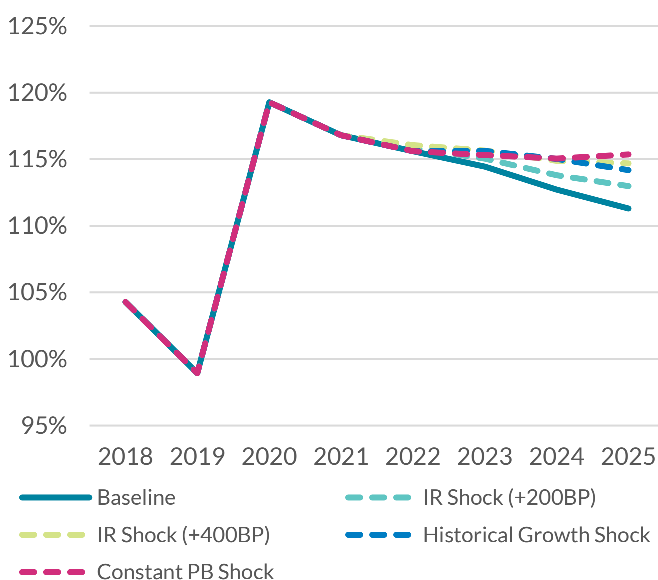
The interest rate shocks begin in 2022 to account for the current favourable funding environment. This is a purely technical assumption for the purposes of the analysis and should not be seen as a prediction of future rate movement or policy change - forward rates remain extremely low for the entire projection horizon assessed in this Box. Rather, it allows us to see what could happen if funding conditions were to deteriorate in the future. Similarly, the constant primary balance shock does not

[3] We assume that the deficit debt adjustment is zero over the period 2023 to 2025

pre-empt any future decisions on budgetary policy – deficit reduction could occur faster as well as slower - and does not take in to account any changes that might be required under the national and European fiscal rules.

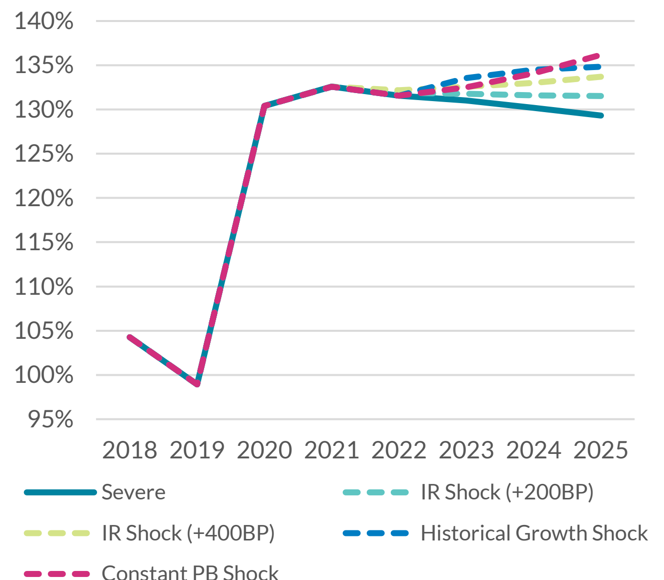
Figure 3a and 3b show how the projections for the debt-GNI* ratio respond to these shocks. Broadly speaking, in the baseline scenario the debt-to-GNI* ratio would continue to decline even when higher funding costs and lower growth are incorporated. The pace of improvement would be slower than in the absence of these shocks, however, with risks more apparent in the constant primary balance shock. In the severe scenario, by comparison, all four of our shocks could lead to unfavourable debt dynamics, pointing to risks to sustainability over the medium term.

Figure 3a: Baseline shocks



Source: CSO, Central Bank of Ireland Calculations

Figure 3b: Severe shocks



Source: CSO, Central Bank of Ireland Calculations

Conclusion

In this Box, the Quarterly Bulletin fiscal projections are extended out to assess debt dynamics over the medium term. The analysis shows that negative shocks to growth, interest rates or the primary balance could result in the debt-GNI* ratio remaining elevated for a prolonged period, particularly in the severe scenario. It is also worth noting that, while we have assessed them in isolation here, the shocks we have outlined could occur in some combination resulting in a less favourable outcome. More generally, the high level of debt at the end of the projection horizon would leave the economy more vulnerable to additional shocks such as those caused by Brexit or a decline in corporation tax revenue linked to changes in international tax policies.