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Fiscal Assessment Report, April 2012

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Press Release

This Fiscal Assessment Report is the second assessment report of the Irish Fiscal Advisory Council. The report assesses the macroeconomic and budgetary projections set out by the Government in *Budget 2012*, including the appropriateness of the overall fiscal stance over the period to 2015, in advance of the Stability Programme Update (SPU) which will be published in April.

Macroeconomic Assessment

The Irish economy grew by an estimated 0.7 per cent in Gross Domestic Product (GDP) terms in 2011, although it contracted in the second half of the year. The return to positive annual growth for the first time since 2007 was helped by a robust export performance, as domestic demand contracted further.

In *Budget 2012*, the Department of Finance projected real GDP growth of 1.3 per cent for this year together with average annual real GDP growth of 2.8 per cent for the period 2013 to 2015. In the Council's view, the macroeconomic projections in *Budget 2012* were broadly appropriate at the time of publication. However, the latest economic data and more recent external growth projections suggest that the Department of Finance's real GDP forecast for 2012 is now on the high side. The high degree of uncertainty in the global economy, particularly in the Euro Zone, means that prospects for Irish exports and domestic demand for this year are now more muted than was the case when the Budget was published. This has been reflected in the more recent forecasts of other agencies where growth prospects for 2012 have been revised downwards. These downward revisions have been a feature of recent forecasts for Ireland. While the Council shares the emerging consensus that growth in 2012 will now be lower than that envisaged in *Budget 2012*, it is difficult at this early juncture to assess the extent of the shortfall.

For the period 2013 to 2015, there is an unusually high degree of uncertainty surrounding Irish growth prospects. This partly reflects unknowns relating to possible external developments. In addition, from a domestic perspective, the behavioural dynamics – of households, investors and financial institutions – in the "post-bubble" Irish economy are quite some way from being understood at this stage. Some time is likely to be required before the implications of these elements can be fully factored into a more solidly based assessment. Against this background, the Council is of the view that it would be helpful if the presentation of forecasts were to give greater prominence to uncertainty and include a clear assessment of the overall balance of risks. This could be done through the use of error bands around forecasts as well as a more detailed assessment of alternative short- and medium-term scenarios.

Budgetary Assessment

The latest information suggests an estimated underlying General Government deficit of approximately 10 per cent of GDP in 2011, which is in line with the Budget and *SPU* projections. All quarterly fiscal targets under the EU/IMF programme in 2011 were complied with, despite the contraction in the economy in the second half of the year. The end-2011 Exchequer deficit was about €300 million better than had been anticipated in the Budget.

Budget 2012 involved a consolidation package of €3.8 billion, with €3.2 billion in new tax and expenditure measures aimed at achieving a General Government deficit target of 8.6 per cent of GDP this year. This adjustment package was higher than had been initially planned in last April's *SPU* (€3.6 billion) and reflected, in part, a weaker outlook for growth. The need for larger fiscal adjustment to meet existing targets had been signalled prior to the Budget in the Council's first assessment report (IFAC 2011).

The main tax change in *Budget 2012* was the increase in the standard rate of VAT. Analysis undertaken by the Council indicates that the Budget projection for VAT receipts in 2012 was broadly appropriate. The macroeconomic outlook for 2012 has weakened since the Budget was published and it now appears that the risks of attaining a General Government deficit of 8.6 per cent of GDP in 2012 are weighed to the downside. This may point to the need for additional fiscal restraint during 2012, although it is too early in the year to provide a firm assessment.

For 2013 to 2015, the broad consensus across official forecasters projects a fall in the General Government deficit to GDP ratio to approximately 3 per cent in 2015. These forecasts take into account the sharp rise in interest expenditures from 2013 onwards, partly due to the ending of the interest holiday on the promissory note issued by the Government. The gross debt to GDP ratio will remain elevated and is expected to peak in 2013 at 119 per cent of GDP. Simulations undertaken by the Council highlight the sensitivity of budgetary forecasts to changes in the macroeconomic outlook. For example, in the event that nominal GDP growth were to end up 1 per cent weaker per annum over the period 2012 to 2015 than envisaged in *Budget 2012*, the debt to GDP ratio would not stabilise by 2015 without additional discretionary measures. In any event, debt levels will remain high over the medium-term and vulnerable to negative growth shocks.

More broadly, the introduction of expenditure ceilings for the years 2012-2014 as part of the 2011 *Comprehensive Expenditure Report* was a significant development in further strengthening the budgetary architecture in Ireland. The recent NTMA bond switch exchange offer has reduced the projected funding requirements in 2014, while a restructuring of the current promissory note arrangement could have a similar positive effect on the public finances. Finally, the size and composition of the Government's balance sheet, and the associated exposure to risk, can have an important impact on the public finances. In this regard, a clear and comprehensive regular assessment of the elements involved is warranted in budgetary and SPU documents.

Assessment of the Fiscal Stance

Policy makers face a clear and unenviable dilemma when choosing the appropriate medium-term fiscal stance. On one hand, more ambitious fiscal adjustment weakens demand and slows the economy. On the other hand, slower fiscal adjustment reduces fiscal sustainability, putting the economy on a higher debt/GDP path. Higher debt levels can be unsafe insofar as they undermine credibility and jeopardise both market and official funding. Such a path can also be unfair in that it pushes burdens to younger generations. There is also a growing body of international evidence that suggests that high debt levels undermine longer-run growth prospects. At the same time, most international evidence, as well as simulations for the Irish economy, do not indicate that the current Irish adjustment path is self-defeating in terms of reducing deficit and debt ratios. There is more uncertainty in the international debate about effects of fiscal adjustment on creditworthiness, although the Irish experience supports the beneficial impact of adjustment on this dimension as well.

The Government's plan to reduce the General Government deficit from approximately 10 per cent of GDP in 2011 to 8.6 per cent of GDP in 2012 was based on a real growth rate of 1.3 per cent in 2012. However, some deterioration in growth prospects since the Budget announcement raises a question mark as to whether this deficit target can be attained with currently planned consolidation measures. Given the continuing fragile nature of Ireland's creditworthiness (despite some recent improvement), it is important that, if necessary, measures be taken to ensure that the General Government deficit target of 8.6 per cent of GDP is adhered to.

As regards 2013-2015, the headline targets for the General Government deficit set out in *Budget 2012* remain within the range of appropriate courses of action. Nevertheless, the Council continues to believe, on balance, that there is a strong argument for greater consolidation than currently envisaged by the Government. This assessment takes into account factors such as the deterioration in the growth outlook, some improvement in Ireland's creditworthiness and the Government's choice of a less ambitious budgetary target for 2012 than that underlying the Council's October 2011 analysis. An alternative adjustment path could involve cumulative additional budgetary adjustments of the order of €2.8 billion compared with those currently envisaged by the Government. Simulations indicate that such an adjustment path would yield a General Government deficit of 1.7 per cent of GDP in 2015 (compared to the Government's target of 2.9 per cent and the Council's October 2011 proposal of 1 per cent) and a primary surplus of 4 per cent of GDP (see Summary Table).

Policies can be considered that aim to preserve credibility while retaining policy flexibility. Assuming shorter-term creditworthiness constraints and programme commitments are not overriding, fiscal consolidation paths could be outlined in terms of discretionary measures, rather than the actual deficit to GDP ratio. Such an approach could lessen the possible downward spiral effects of negative growth surprises and better facilitate the operation of automatic stabilisers.

Summary Table:

Alternative General Government Deficit Targets and Discretionary Adjustments

General Government Balance, % of GDP	2012	2013	2014	2015
SPU (April 2011)	-8.6	-7.2	-4.7	-2.8
IFAC October 2011 Alternative Adjustment Path	-8.4	-6.4	-3.6	-1.0
Budget 2012 (December 2011)	-8.6	-7.5	-5.0	-2.9
IFAC April 2012 Alternative Adjustment Path	-8.6	-7.4	-4.6	-1.7
Assumed Consolidation, € billions				
SPU	3.6	3.1	3.1	2.0
IFAC October 2011 Alternative Adjustment Path	4.4	3.9	3.8	3.7
Budget 2012	3.8	3.5	3.1	2.0
IFAC April 2012 Alternative Adjustment Path	4.2*	3.9	3.8	3.7

*Using *Budget 2012* projections as a benchmark and assuming zero buffers, Council simulations indicate that an additional discretionary adjustment of €0.4 billion would be required to achieve the GGB target of -8.6 per cent of GDP for 2012.

Media Briefing

Members of the media are invited to attend a briefing to be held on **Tuesday 3rd April at 10.30am** in the ESRI, Whitaker Square, Sir John Rogerson's Quay, Dublin 2.

Notes to Editors

1. Fiscal Assessment Report, April 2012 is embargoed until 11.00am Tuesday 3rd April. The report will be available to download from www.fiscalcouncil.ie from 11.00am Tuesday 3rd April.
2. The report will be laid before the Oireachtas.
3. Council members and authors of the publication: Professor John McHale (Chair, and Head of Economics NUI Galway), Mr Sebastian Barnes (OECD), Professor Alan Barrett (TCD, on secondment from ESRI), Dr Donal Donovan (adjunct professor University of Limerick and formerly IMF staff), Dr Róisín O'Sullivan (Associate Professor, Smith College, Massachusetts).

Ends

Irish Fiscal Advisory Council, Whitaker Square, Sir John Rogerson's Quay, Dublin 2.