An Roinn Airgeadais
Department of Finance

Professor J McHale
Irish Fiscal Advisory Council,
Whitaker Square (ESRI Building),
Sir John Rogerson's Quay,
Dublin 2.

19 December 2013

Dear Professor McHale,

I refer to the Irish Fiscal Advisory Council's November 2013 Fiscal Assessment Report which was published on Friday the 22nd of November last. I am pleased to see that the Report gained a great deal of media coverage as this helps to widen the discussion of fiscal policy beyond those of us with a professional interest.

Government policy has been to restore budgetary balance in a gradual and phased manner. I stand in agreement with the Council that the process of restoring stability to the public finances requires on-going focus. Sustained reduction in the deficit inevitably involves a trade-off between the pace of consolidation and the need to support domestic demand.

The process of restoring stability to the public finances however is already paying dividend with the deficit for 2013 expected to come in well ahead of the -7.5% ceiling, and the gross debt ratio expected to peak this year. Investor confidence is returning as evidenced by recent bond yields, and today's Quarterly National Accounts data indicate further growth fuelled by recovery in domestic demand.

During the passage of the Fiscal Responsibility Act 2012, I made a commitment in the Oireachtas that I and my Department would respond to the Reports produced by the Fiscal Advisory Council in a substantive way. At the time, the intention was to ensure that the next major budgetary publication of the Department of Finance would include such responses. However, as the next such publication will not be until the Stability Programme Update next April, the passage of time could result in much of any such response being out of date or no longer relevant.

Accordingly, I am sending you my response in the appendix attached to this letter. I presume that the Members of the Fiscal Advisory Council will have no objections to the publication of this letter and its appendix on the Department of Finance's website. I have no objection to the Council putting it on your website as well, should you wish to do so.

Yours sincerely,

Michael Noonan T.D.
Minister for Finance

Appendix – Response of the Minister for Finance to the November 2013 Fiscal Assessment Report published by the Irish Fiscal Advisory Council

Before addressing the key points raised by the Council in the summary bullet points at the start of each Chapter of the Fiscal Assessment Report (FAR), I welcome the Council's endorsement of the macroeconomic forecasts underlying Budget 2014 and its assessment that:

- the fiscal stance is conducive to prudent economic and budgetary management; and
- Ireland's budgetary projections are both appropriate and consistent with compliance with all national and European fiscal rules, including these set out in the Fiscal Responsibility Act 2012.

Chapter 1

1. As outlined in the FAR, this was the first occasion the Council endorsed the macroeconomic forecasts in accordance with the requirements of the "Two-pack" of EU Regulations adopted earlier this year. The Report sets out in considerable detail the process, background and context surrounding the endorsement. I welcome the smooth running of this process between the Council and officials from my Department, even taking account of the significant reservation that was resolved in accordance with the Memorandum of Understanding agreed between the Department and the Council. I note that discussions about the next iteration of the macroeconomic endorsement process in relation to the April 2014 Stability Programme Update have already commenced between the Council and my officials. I look forward to this process continuing in a clear and transparent manner. I note the Council produced its own baseline forecasts for the first time as part of its work under the macroeconomic endorsement function.

2. I note the Council's comments regarding the growth estimate for 2013. The analysis presented by the Council is similar to the views set out by my Department and I note that the Council shares my Department's assessment (as outlined at the time of the Budget) regarding the risks to the 2014 growth forecast.

Chapter 2

1. I welcome the fact that the Council shares the Budget Day view that the deficit outturn for 2013 would be 7.3% of GDP. The Council highlighted three sources of risk to this projected outturn. These were expenditure pressures in the Health budget, increased uncertainty about the forecast outturn for taxes in light of the earlier Budget in October and the

potential needs for ongoing supports to the banking sector. I am pleased to report that there is no sign of these risks coming to pass in the period since the Budget. The end-November Exchequer Returns show tax revenues are out-performing expectations while expenditure at an aggregate level remains under control despite spending pressures emerging in specific Departments. I am informed by my colleague, the Minister for Public Expenditure and Reform, that overruns, including those in Health, will be more than offset by savings elsewhere.

There is no additional regulatory capital requirement for the banks as a result of the recent Central Bank of Ireland Balance Sheet Assessment exercise. The Irish banks have, as at the end of June, strong capital ratios compared to the European average and are making good progress in returning to profitability which is a necessity if they are to meet the new higher capital standards under CRD IV. While there is no evidence that the European Banking Authority stress tests in 2014 will result in additional capital requirements for Irish banks, it has been suggested in some quarters that the Irish taxpayer should be the first port of call should any capital requirements surface. This is not the case. The Irish banks have a number of options open to them if they need to raise capital in the future. Access to capital markets be it debt or equity for the banks is far better now than it has been for a number of years as evidenced by the increase in Bank of Ireland's share price in recent months, the disposal of the State's preference shares in Bank of Ireland, and the disposal of contingent convertible notes (CoCos) in that institution earlier this year. The ESM is another potential source of capital for banks and there is still considerable negotiation to take place at Eurogroup to agree the terms of that facility which will be available after the Single Supervisory Mechanism has been put in place.

2. In terms of increased risks to breaching the 3% of GDP deficit ceiling in 2015, it is quite apparent that a change in the expected deficit from 2.4% of GDP in the SPU to 2.9% of GDP in the Budget represents an increased risk of missing the target in the event of negative shocks. There is a reduced "buffer".

   However, perhaps the greatest driver of this deterioration is the significantly lower tax revenue projection which derives from lower macroeconomic forecasts. This further reinforces the importance of tailoring the consolidation packages in as growth friendly a manner as possible in order not to hamper the economic recovery.

As is the usual practice, decisions on the required level of consolidation to comply with our obligations will be taken in the Budget 2015 process taking account of the macroeconomic and fiscal performance during 2014, the forecasts for 2015 and subsequent years and the advice received from other bodies such as the Council, the European Council and the European Commission.

Finally, I would emphasise that the Government has consistently over achieved on the deficit targets since the programme began and the Government remains firmly committed to do whatever is necessary to comply with the 3% of deficit target in 2015.

3. I note the Council's comments that the budgetary projections are contingent on the delivery of significant expenditure savings and the achievement of the projected acceleration in economic growth. In terms of expenditure savings, the budgetary projections are of course predicated on effective delivery of expenditure measures. Given the success of my colleague Minister Howlin in driving expenditure reform and efficiencies, I am confident that these measures will be implemented successfully. Regarding the importance of growth in the economy for the public finances, this is quite clearly crucial in achieving our deficit targets. Economic growth drives tax revenues in addition to the denominator used in expressing the deficit. With this in mind, Budget 2014 sought, insofar as possible, to protect the nascent economic recovery.

   With regard to the comments on additional risks, I welcome the Council's focus on the importance of risk management in relation to the public finances. In recent years, my Department has devoted considerably more resources to the risk function and officials in my Department are constantly monitoring emerging fiscal risks and the evolving macroeconomic situation. The presentation and information contained in the risk sections of major publications will be considered going forward, although I would point out that codes of conduct govern the content of documents submitted to the European Commission and the ECOFIN Council.

4. I would like to acknowledge, as the Council point out, that some aspects of the Budget documentation and presentation could be improved. I agree that the composition of the €3.1bn adjustment could have been presented in a clearer fashion in the Budgetary

documentation. However, your Report states that the €0.6bn in other *"savings should not be considered 'consolidation measures'"*. As at no stage in the process have I referred to these other savings and measures as consolidation, I have to disagree with your text on this matter. Indeed, in my Budget speech, I specified that the adjustment package of €3.1bn is composed of €2.5bn in consolidation measures and €0.6bn in other measures.

5. I welcome the Council's acknowledgement of the improvements my Department has implemented in terms of fiscal reporting. I recognise that this is something which is always evolving and where improvements are continually being made. In that context and looking to the future, as the FAR correctly points out, Ireland will publish a standardised draft budgetary plan next year which will provide additional detailed tables of key fiscal metrics. This is something which the Government has actively signed up to, something which will enhance transparency and is to be welcomed.

6. The Council also criticise my Department's record of forecasting non-tax revenues, specifically stating that Central Bank surplus income and bank guarantee fees were underestimated while interest expenditures were over-estimated. I would take issue with the statement. In terms of non-tax revenues, as referenced in the FAR, one of the major components of this over recent years has been ELG fees. The ELG Scheme was rolling on a six month basis, on approval from the European Commission, and as such, fees had to be forecast on the assumption that the scheme ended in June / December each year. To make an assumption that the scheme rolled indefinitely would not have been prudent budgetary planning. This is perhaps the greatest contributor to the variation on expectation. The estimate for Central Bank surplus income comes from the Central Bank themselves. Figure 2.1, shows that the greatest variance from profile came in 2011. In addition to the ELG fee issue which makes up the bulk of the variance, a delayed repayment from the Social Insurance Fund also contributed. In summary, the reasons why non-tax revenues vary from Budget day estimates, can be easily explained. Regarding the general forecast methodology for non-tax revenue, my officials will share this information with the Council in bilateral discussions.

7. With regard to the Council's comments about debt servicing costs, it is the case that the task of projecting such costs has become more difficult in recent years for a number of reasons. These include market volatility, the substantial changes that have taken place in Ireland's

debt profile, as well as revisions to the terms of elements of the EU/IMF Programme. In terms of Budget 2014, the Council benchmarks debt service costs in 2013 against those estimated in the SPU last April. There are several reasons why the Budget 2014 estimate is lower than the SPU estimate. These include favourable interest rate developments generally, the decision by the NTMA not to issue debt in the fourth quarter given its healthy funding position as well as debt management activity. The NTMA projects debt servicing costs in line with best international practice and one of its key objectives is to keep costs to a minimum over time, subject to an acceptable level of risk.

8. Finally, the Council comment that "*current expenditure ceilings have not been binding with aggregate revisions to ceilings of €0.6 billion in 2013 and €0.9 billion in 2014. The majority of this 'slippage' appears to arise from weaker economic conditions and policy decisions*." The circular in relation to expenditure ceilings details the rules and arrangements for planning and managing current expenditure within the new fiscal structures in place at European level. It includes provisions to assist with management of Departmental expenditure including control measures to ensure compliance with Ministerial Expenditure Ceilings. The circular sets out the limited circumstances under which the Government may vary Government and Ministerial expenditure ceilings. Any change to the Government expenditure ceiling is subject to compliance with the overall European and National Fiscal rules. A variation in the ceiling was possible for Budget 2014 in the context of a 2014 deficit/GDP ratio of 4.8%, well within the EDP target. Consequently, while there was a revision to the expenditure ceiling, there was no "slippage" versus the 2014 fiscal targets. The ability of Government to vary the expenditure ceilings in specific limited circumstances has not been an "escape clause" but rather has enabled significant expenditure consolidation over the last number of years and the achievement of fiscal targets, while allowing for the maintenance of social cohesion and the delivery of key public services.

Chapter 3

1. As stated before, I welcome the Council's assessment that the fiscal stance is conducive to prudent economic and budgetary management, and their finding that Ireland's budgetary projections are both appropriate and consistent with compliance with all national and European fiscal rules. I also note the comments made on the margin of safety available to Government in the next Budget, and have responded above.

2. Since the April 2013 FAR, Ireland's MTO was tightened from a structural deficit of 0.5 per cent of GDP to a balanced budget in structural terms. The Council states that moving

towards our new MTO in structural terms would *'all other things equal require close to an additional €0.8 billion in consolidation after 2016'*. My Department have previously clarified to the Council that this requires additional structural correction but that this <u>will not necessarily require further consolidation</u>. From our calculations, and as noted in your previous report, compliance with the expenditure benchmark from 2016 onwards will contribute towards structural budgetary improvement. Compliance with our fiscal requirements in the post-2015 period *should not necessarily* require either tax increases or nominal expenditure cuts, provided the economy's growth potential remains strong.

3. Criticism is levelled at my Department for not including updated estimates of the structural balance in Budget 2014. The Report maintains '*this is a serious gap in the information provided by the Department of Finance, given the Budgetary rule uses this measure.'* As Ireland was subject to a Financial Assistance Programme at the time of the Budget, we were not required to submit a formal Draft Budgetary Plan (DBP) to the Commission this year, which would have contained this information. As part of the European Semester and binding DBP commitments, structural balance estimates will be published in the context of both the April 2014 SPU and Budget 2015. There was no requirement to publish such data as part of Budget 2014. Notwithstanding this, officials supplied this data to the Council shortly after the Budget on request. As my Department have emphasised, estimates are subject to wide margins of uncertainty. Work on refining the methodology is ongoing and in this context the publication of such figures often raise more questions than it answers.

4. Elsewhere in the document, the Council states that *'Efforts to improve Department of Finance and EU [structural balance] methodologies are welcome. A more comprehensive set of methodologies is needed to improve the understanding of the cyclical position of the economy and the public finances'*. I would agree, and my Department continues to improve the empirical rigour of its output gap methodology. Officials hosted a post-Budget seminar in mid-November elaborating on the EU-consistent methodology used to generate these structural balance estimates. A Departmental Working Paper reviewing the impact of methodology chosen on the estimate of the structural balance is planned for the first half of 2014. At EU level, the Commission is investigating alternate model-specifications to improve estimates of the output gap, particularly around turning points in the economic cycle. I

would point out that potential output is particularly difficult to measure during spells of nominal wage rigidity such as that currently experienced in Ireland.

Chapter 4

1. As stated before, the Council's comments on the fiscal stance and future adjustments are noted.

2. The Council's extended projections out to the end of the decade show that the most difficult phase of the adjustment should be broadly complete in 2015/2016, which is consistent with my Department's forecasts.

3. Finally, with regard to the Council's comments about the precautionary credit line, I will reiterate that this was a finely balanced decision, but Government looked at the best alternative for Ireland and our future progress both domestically and internationally.