Summary Assessment

Introduction

This report is the third assessment by the Irish Fiscal Advisory Council. It assesses the macroeconomic and budgetary projections set out by the Government in the *Stability Programme Update (SPU)* 2012. In advance of *Budget 2013*, the appropriateness of the fiscal stance over the period to 2015 is also assessed. In a preliminary exercise, the report also considers the longer-term implications of compliance with the fiscal rules in the Fiscal Responsibility Bill (FRB).

A number of themes are developed. These include the *uncertainty* that surrounds economic and budgetary forecasts, the *large size of remaining adjustments required for debt sustainability* and the importance of *transparency* in the recording of revisions in the Government's fiscal accounts and plans.

Assessment of Macroeconomic Forecasts

To assess the macroeconomic forecasts, the report: (i) reviews the performance of past forecasts; (ii) compares the *SPU* forecasts with the contemporaneous forecasts of other agencies; (iii) examines the recent pattern of forecast revisions; and (iv) graphically illustrates the uncertainty surrounding official forecasts using a fan chart.

The National Income and Expenditure Accounts for 2011, released in July 2012, estimate that annual real GDP growth in 2011 was 1.4 per cent. This was higher than official forecasts while real GNP growth in 2011 was almost three percentage points lower than forecast by the Department of Finance in 2011. The large under prediction of real GNP highlights the difficulties in anticipating accurately the component "net factor income from abroad", which is the difference between GNP and GDP. The level of nominal GDP was also underestimated by the Department of Finance.

An analysis of forecast errors over the period 1995 to 2011 indicates that the pattern of past forecast errors is similar across agencies. Current Department of Finance forecasts for 2012-2015 are also similar to forecasts of other agencies. In general, forecasters remain of the view that growth rates of about 3 per cent will return over a two- to three-year horizon, although earlier forecasts of such a rebound have not materialised.

In recent years, the forecast levels of GDP and GNP have generally been lowered by the Department of Finance (and other agencies) in each successive forecast. This pattern is more apparent for nominal GNP than it is for nominal GDP.

The uncertainties surrounding the growth outlook for the Irish economy, highlighted in the Council's previous report (IFAC, 2012a), remain and are illustrated in this report through the use of fan charts. The fan chart for nominal GDP attaches a probability to each of a wide range of possible outcomes over the coming years. Although the fan chart is symmetric by construction, the Council sees the risks to growth to be weighted to the downside. While the enhanced discussion of risks included in *SPU 2012* is welcome, uncertainty should be more explicitly factored into the presentation of official forecasts through a more detailed sensitivity analysis.

Assessment of Budgetary Forecasts

To assess the budgetary forecasts the report: (i) reviews the accuracy of past Department of Finance forecasts; (ii) examines the latest set of projections in *SPU 2012* using the most recent Exchequer data; (iii) compares the *SPU* forecasts with the contemporaneous forecasts of other agencies and (iv) analyses the uncertainty surrounding budgetary forecasts using fiscal fan charts and sensitivity analysis.

The Government complied with the deficit targets set for Ireland under the Excessive Deficit Procedure in 2011. The General Government deficit adjusted for the impact of banking related transfers is estimated to have improved to 9.0 per cent of GDP last year. This was approximately €1.2 billion better than had been anticipated in last December's *Budget*.

For 2012, the forecast for the General Government deficit was revised to 8.3 per cent of GDP in *SPU 2012*, from 8.6 per cent in *Budget 2012* despite a downward revision in forecast growth. This reflected, in part, revisions to interest payments and the impact of banking-related revenues. A General Government deficit of 8.3 per cent of GDP for 2012 looks achievable at this stage based on the cumulative trends in the Exchequer data and the economic outlook. That said, there have been significant spending overruns in Health and Social Protection over the first eight months of the year. The current year overrun in Health reflects a pattern in recent years. There has also been a notable increase in non-tax revenues, partly related to the State's involvement in the banking sector. These sources of income should be closely monitored.

There were a number of significant changes to budgetary data and forecasts over the past year. To facilitate adequate assessment of budgetary projections, the Council urges that comprehensive and timely explanations be provided publicly on methodological changes and data revisions that impact on the fiscal outturn or official forecasts, on sources of major modifications to forecasts and on the components of non-tax revenues.

For the period 2013 to 2015, the *SPU* projections are in line with forecasts from other agencies. This outlook is heavily dependent on achieving significant reductions in Government expenditures and a sustained upturn in growth. Given the extent of the required total adjustment, the Council again urges that all adjustment margins be kept under close review, including tax rates, public-sector pay/pensions, and welfare rates.

The debt to GDP ratio is expected to peak in 2013 at just over 120 per cent of GDP. The fan charts and sensitivity analysis undertaken in this report reveal risks around the budgetary targets and the fragility of debt sustainability.

Assessment of the Fiscal Stance

As in earlier reports, the appropriateness of the fiscal stance is analysed in terms of a trade-off between supporting domestic demand and ensuring debt sustainability.

The Council assesses the Government's fiscal stance, as set out in *SPU 2012*, to be – in the language of the FRB – "conducive to prudent economic and budgetary management". However, debt sustainability and creditworthiness remain fragile. Weighing the risks to debt sustainability and ongoing weakness in the real economy, the Council supports an alternative fiscal stance involving a total of €1.9 billion of additional adjustments in the period to 2015 compared to the Government's baseline (see Summary Table). Due to continued weakness in demand and some further improvement in market assessments of Ireland's creditworthiness, the amount of additional adjustment is scaled back by €0.9 billion since the previous *Fiscal Assessment Report*, with no additional adjustments for 2013 in the Council's alternative scenario. Model-based projections indicate that this alternative scenario would yield a primary budget surplus of 3.7 per cent of GDP in 2015, which is 0.9 per cent of GDP higher than under current plans. This would also help to put the debt to GDP ratio on a faster downward trajectory and would provide additional insurance, albeit limited, in the effort to ensure debt sustainability.

While recognising possible rationales for a separate stimulus programme, balancing various considerations, the Council is of the view that any relaxation sought by the Government in the overall fiscal stance should be examined within the context of the main fiscal adjustment programme. However, the Council does not see a case for a relaxation of the fiscal stance as set out in the SPU.

Debt sustainability remains fragile and judgements on this issue are coloured by whether it is believed GDP or GNP provides the most appropriate measure of Ireland's fiscal capacity. Each of these measures has limitations. Recognising this, the Council explores a "hybrid" measure that puts differential weight on the fiscal capacity of a euro of GNP and a euro of the GDP-GNP excess. The required fiscal adjustment appears challenging under all three measures, and most so under GNP. A more encouraging perspective emerges when the additional adjustments are compared to what has been already achieved in the fiscal adjustment process. While relief on the banking-related part of Ireland's debt is unlikely to be a panacea, any relief would increase the chances of a successful adjustment, measured by a robust return to market creditworthiness.

Summary Table: Alternative General Government Deficit Targets and Discretionary Adjustments

General Government Balance, % of GDP	2013	2014	2015
SPU 2011 (April 2011)	-7.2	-4.7	-2.8
IFAC October 2011 Alternative Adjustment Path	-6.4	-3.6	-1.0
Budget 2012 (December 2011)	-7.5	-5.0	-2.9
IFAC April 2012 Alternative Adjustment Path	-7.4	-4.6	-1.7
SPU 2012 (April 2012)	-7.5	-4.8	-2.8
IFAC September 2012 Alternative Adjustment Path	-7.5	-4.5	-1.9

Assumed Consolidation € billions	2013	2014	2015	2013 - 2015
SPU 2011 (April 2011)	3.1	3.1	2.0	8.2
IFAC October 2011 Alternative Adjustment Path	3.9	3.8	3.7	11.4
Budget 2012 (December 2011)	3.5	3.1	2.0	8.6
IFAC April 2012 Alternative Adjustment Path	3.9	3.8	3.7	11.4
SPU 2012 (April 2012)	3.5	3.1	2.0	8.6
IFAC September 2012 Alternative Adjustment Path	3.5	3.5	3.5	10.5

Compliance with Fiscal Rules: A Preliminary Examination

Ireland has an obligation to comply with the *EU Stability and Growth Pact*, which was revised in 2011, and the "Fiscal Compact" which is being implemented in national law through the FRB. As part of its mandate under the latter, the Council would be required to provide an assessment, at least once a year, of compliance with the fiscal rules. While the details are complicated, the rules in essence relate to the budget balance, the structural budget balance (consistent with the EU's Medium-Term Objective or "Budgetary Rule") and a debt reduction requirement (i.e. the "Debt Rule").

The *SPU* projections to 2015 show that the projected adjustment to the structural balance would be more than in line with the required adjustment path under the Budgetary Rule. The Debt Rule would not apply until after 2018. To get an early sense of the implications of the rules, the Council explores a policy and economic scenario that extends to 2020. This illustrative scenario is consistent with compliance with all rules, but implies a sustained period of expenditure restraint – effectively flat expenditure in real terms – in the absence of discretionary tax increases.