Irish Fiscal Advisory Council

Fiscal Assessment Report

November 2013

CONTENTS

4. ASSESSMENT OF THE FISCAL STANCE

SUMMARY

- The planned fiscal stance for 2014 and 2015 is assessed to be conducive to "prudent economic and budgetary management". However, the Council remains of the view that the most appropriate policy for *Budget 2014* was to continue with the previously planned adjustment of €3.1 billion rather than the reduced amount of €2.5 billion. The main arguments in favour of the larger adjustment are the value of a margin of safety in meeting the key EDP deficit targets in a highly uncertain growth environment and the credibility gains that come with successfully delivering on previously announced adjustment plans.

- There should be no reduction in the previously announced discretionary adjustments of €2 billion for 2015. To reinforce credibility gains, any future upward revisions in growth projections should be used to provide a margin of safety to ensure that the key EDP deficit ceiling of 2.9 per cent of GDP for 2015 is complied with. Additional adjustments may be required to ensure the target is achieved if growth projections are reduced or other contingencies raise the projected deficit for 2015.

- The fiscal adjustment programme is working in terms of stabilising the public finances and restoring the creditworthiness of the State. Market perceptions of sovereign default risk have fallen sharply. Simulations indicate that in the absence of fiscal adjustment from 2008 to 2013, this year's deficit would have been close to 20 per cent of GDP with the debt ratio close to 160 per cent of GDP (and rising).

- Extended projections out to the end of the decade indicate that the most difficult phase of the adjustment – which has involved large annual nominal expenditure and revenue changes – should be broadly complete in 2015/2016. Modest increases in nominal expenditure should be feasible post-2016, while meeting all domestic and European fiscal rules. However, the extent of the tightness of the fiscal stance should not be underestimated, as the scope for real expenditure increases will be limited. Significant risks also surround this scenario given the length of the projection horizon.

- As well as fiscal adjustment, various "self-protection" strategies could be used to minimise the risks to future borrowing capacity. A precautionary credit line with reasonable terms and conditions would have provided valuable additional protection against renewed funding pressures as Ireland exits the EU/IMF assistance programme. Two further "self-protection" strategies are also examined: extending and smoothing the maturity profile of the debt and holding cash reserves. Each of these self-protection strategies involves costs as well as benefits, and the optimal approach is likely to have involved a mix of all three.

4.1 INTRODUCTION

The setting of fiscal policy during the crisis has required a difficult balancing of the need to support domestic demand/employment, the need to restore the State's creditworthiness and the need to put the public finances on a sustainable path. While the Government faces a trade-off between demand support and creditworthiness/sustainability in the short to medium term, reducing the perceived risk of default and unstable debt dynamics is critical to laying a stable foundation for longer-term growth and employment.[113]

This chapter takes up a number of issues relevant to the trade-off and thus the Council's identification of the appropriate fiscal stance. In the next section, we first assess the Government's planned fiscal stance out to 2015 as set out in *Budget 2014* and last April's *Stability Programme Update (SPU, 2013)*. As required under the *Fiscal Responsibility Act*, an assessment is provided as to whether the Government's fiscal stance is "...conducive to prudent economic and budgetary management". A number of broader issues relating to the conduct and prospects for fiscal policy over the next number of years are then taken up.

It is often claimed that "austerity is not working". If the definition of "working" is that fiscal adjustment is leading to faster short-term growth, then such claims are almost certainly justified.

[113] Much of the international discussion of the trade off between demand and creditworthiness/sustainability focuses on countries with an independent central bank and monetary policy, but facing a zero lower bound on nominal interest rates. The trade off is likely to be considerably more benign in the context of an independent monetary policy and a zero lower bound for two reasons. First, perceptions of default risk appear to be considerably lower where a central bank can print money to meet debt obligations in extremis. The ability to use quantitative easing type policies can also lower financing costs to the consolidated Government. The different level of bond market pressure faced by the United Kingdom during the crisis – which has a deficit and debt ratio not too dissimilar to Irelands – is a case in point. Second, the operation of an independent monetary policy gives the country the scope to offset the negative impact of fiscal tightening when the country is no longer constrained by the zero lower bound. This can create a significant asymmetry between the costs of fiscal tightening today (when the zero lower bound is binding) and later (when it is not), increasing the relative attractiveness of back-loaded fiscal adjustment. For a small country in a large monetary union, later monetary policy can largely be viewed as exogenous to its fiscal policy.

The available evidence on multipliers suggests that fiscal adjustment does slow the economy in the short term (IFAC, 2013a). However, the core instrumental purpose of the adjustment is to put the public finances on a sustainable path and ensure the borrowing capacity of the State. While the direct short-term effects on growth are likely to be negative, maintaining borrowing capacity – both from market and official sources – is essential:

- to allow the adjustment to be phased over time (forestalling the need for even greater adjustment),
- to avoid a disruptive State default,
- to support access to affordable funding for the banking system, and
- to underpin long-term sustainable growth.

In Section 4.3, the "self-defeating austerity" argument is examined using the Council's Fiscal Feedbacks model to compare the actual evolution of key fiscal and creditworthiness variables since Ireland's fiscal adjustment began with predicted outcomes under the counterfactual scenario of no adjustment.

Another worry concerning the current fiscal adjustment strategy is that it will be so prolonged that it is not economically or politically feasible. Such expectations of unending austerity sap confidence and also the credibility of the adjustment programme itself. Building on work done by the Department of Finance in *SPU 2013*, Section 4.4 looks ahead to the fiscal adjustments that are likely to be required to ensure compliance with all fiscal rules post-2015.

The revealed fragility of Ireland's creditworthiness within the monetary union is likely to be an enduring constraint on Irish fiscal policy making. Drawing in part on the experience of emerging markets that have faced "sudden stops" of capital inflows, Section 4.5 examines self-protection strategies – in addition to reducing the deficit and debt – that offer the potential to reduce the vulnerability of future market access.

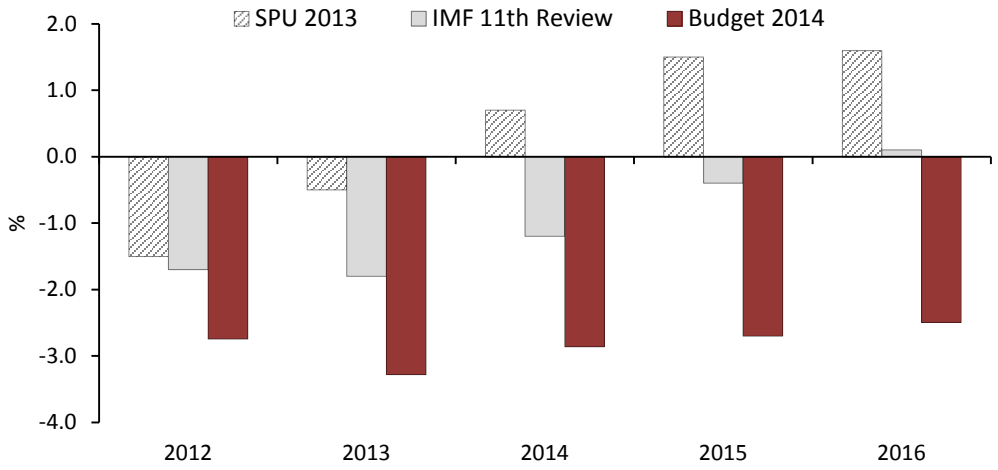
4.2 Review of the Fiscal Stance

In this section, recent developments affecting the demand/creditworthiness trade-off are first briefly reviewed. The appropriateness of the planned fiscal stance for 2014-2015 is then assessed.

The current official estimate of the output gap—the difference between actual and potential GDP expressed as a percentage of potential GDP—is -3.3 per cent for 2013 (see Chapter 3). As a result of changes to estimates of the underlying equilibrium unemployment rate (or non-accelerating wage rate of unemployment, NAWRU), the Department of Finance has significantly revised its estimates and projections of the output gap compared to those provided in *SPU 2013*.[114] Both sets of output gap numbers are shown in Figure 4.1 and were discussed in Chapter 3.

According to *SPU 2013* the output gap was projected to turn positive in 2014. As discussed in the last *Fiscal Assessment Report* (IFAC, 2013a, Chapter 3), the Council did not find these output gap estimates and projections to be plausible. One indication that the previous official numbers understated the size of the real GDP shortfall was the European Commission's projection that the NAWRU would rise to close to 16 per cent by 2017. This view was not shared by experts on the Irish labour market (see, e.g., ESRI 2013, *Medium-Term Review*). The Department of Finance had also itself expressed reservations about the estimated size of the current and projected output gap that results from the use of the EU methodology (see, e.g., *SPU 2013*).

Figure 4.1: Estimates and Projections of Ireland's Output Gap



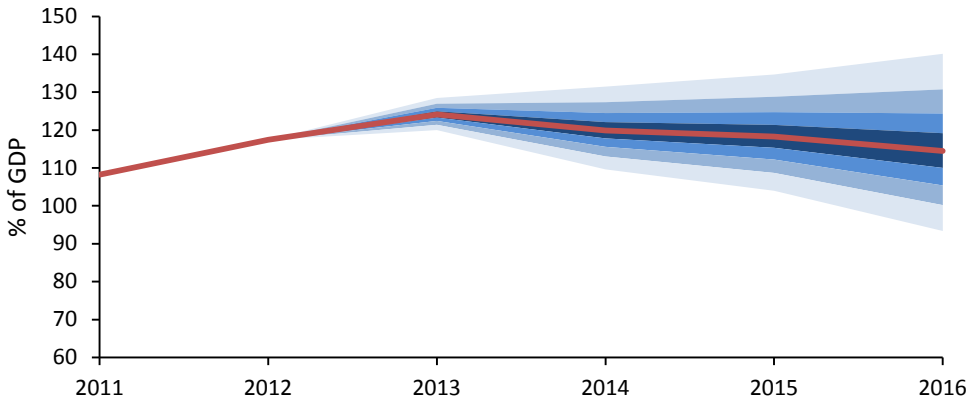
Note: A negative output gap indicates actual real GDP is below potential real GDP.

[114] The Department of Finance uses a common EU methodology in estimating potential output and the associated output gap.

The new Department of Finance output gap estimates and projections are now closer to those provided by the IMF, although they are more pessimistic (see Figure 4.1). They show an economy that is significantly underperforming relative to its potential, and is likely to continue to do so over the next number of years. The output gap is now projected to still be at a level of -2.5 per cent of potential GDP in 2016. This underperformance is in significant part due to weak domestic demand in the context of a balance sheet recession (see Chapter 1). Lacking a country-specific monetary policy instrument, standard demand management considerations would tend to favour a delay of fiscal adjustment measures in the absence of other constraints.

Unfortunately, other constraints are present. One constraint is the need to ensure that the debt to GDP ratio is on a sustainable path. Under the extended projections out to the end of the decade from *SPU 2013*, this ratio is expected to peak this year and then begin to fall. However, given the volatility of Irish growth and resulting high forecast errors, there is no guarantee that debt is on a sustainable path. Figure 4.2 reproduces the debt ratio fan chart from Chapter 2. Each band represents 10 per cent of the distribution. The chart indicates that there is a 1-in-3 probability that the debt ratio will fail to stabilise by 2015 under current fiscal plans.

FIGURE 4.2: DEBT TO GDP RATIO FAN CHART



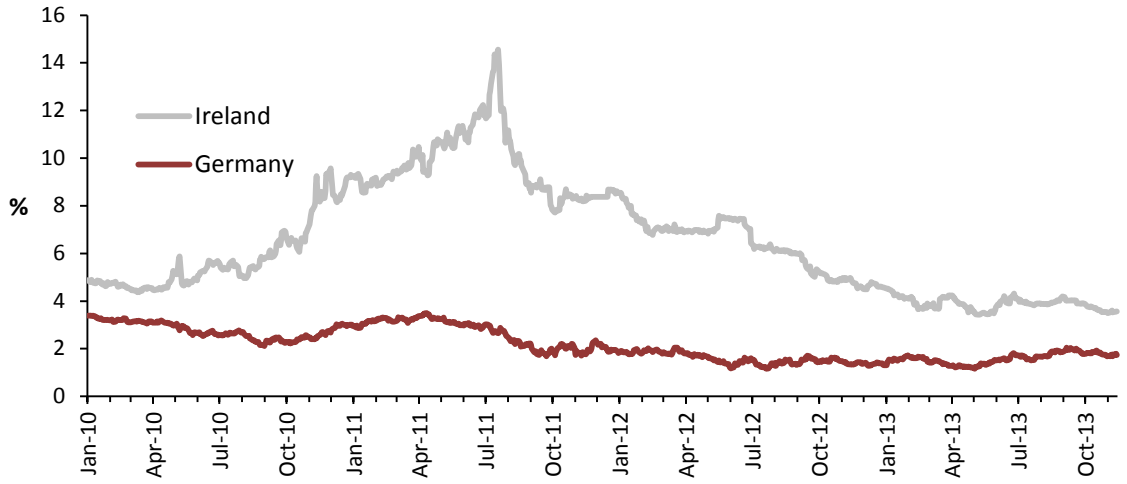
Even the reasonable likelihood of a stable or declining debt ratio under fiscal plans might not be sufficient to ensure the creditworthiness and consequent borrowing capacity of the State. This can reflect doubts about the Government's capacity to avoid a future default.[115] This in turn may

[115] This is an example of the well known time-inconsistency of optimal Government plans (see Kydland and Prescott, 1977, for the classic exposition). A Government may state its intention to pursue fiscal policies that will ensure the avoidance of default. If such plans are credible, expectations of default will be low and allow the Government to borrow

necessitate a tighter fiscal stance than would be warranted by purely demand-management considerations in order to underpin the credibility of the State's capacity to avoid default. The difficult trade-off between demand and sustainability/creditworthiness has made fiscal policy making in recent years extremely challenging.

In Ireland's case, market perceptions of default risk rose steadily from 2010 through the first half of 2011 (see Figure 4.3). However, successful implementation of fiscal adjustment efforts combined with improvements in official supports have substantially lowered the yield spread between Irish and German bonds. As a result, market perceptions of sovereign risk default have fallen sharply. The policy challenge now is to sustain the improvement in creditworthiness and borrowing capacity while limiting the contractionary drag caused by tight fiscal policies in a balance-sheet recession.

FIGURE 4.3: IRISH AND GERMAN 10-YEAR BOND YIELDS



Source: Datastream.

at low interest rates. However, the later fiscal adjustment policies required to avoid default could be highly costly, and the Government might choose subsequently to default, even where the costs of the default are themselves high. Recognising this later incentive, the announced plans may not be credible. To reduce expectations of default the Government can attempt to change the expected *ex post* costs and benefits of default. Putting the debt ratio on a lower trajectory can reduce the expected benefits of a default. Taking difficult actions now can also help signal the Government's strong intention – and political capacity – to take the difficult fiscal actions required to avoid default. Other actions that the Government can take to change perceptions of the later cost-benefit calculation include putting the Government's reputation as a no-default Government firmly on the line (thus raising the political costs of default), putting in place a fiscal framework of strong fiscal rules and institutions that raise the political costs of weak fiscal policies, and choosing a debt structure that is costly to restructure.

In previous *Fiscal Assessment Reports*, the Council argued for the importance of meeting targets under the Excessive Deficit Procedure (EDP), and in particular for attaining a deficit at or below the EDP ceiling of 2.9 per cent of GDP in 2015. This is a requirement for exiting the EDP, which is part of the corrective arm of the Stability and Growth Pact (SGP). To enhance the credibility of the fiscal stance, and recognising the uncertainty surrounding economic growth and other contingencies, an argument was made for providing a margin of safety relative to just meeting the target under the central growth forecasts. The credibility of the stance should further be enhanced by following through on planned discretionary adjustments. These discretionary adjustments are closely related to adjustments in the structural deficit, which are a key focus of both the European Commission and the IMF.

In response to an improvement in forecasts for the General Government deficit, partly as a result of the promissory notes transaction (see IFAC, 2013a, and Barnes and Smyth, 2013), the Government made the decision in *Budget 2014* to reduce the €3.1 billion in previously planned adjustment to €2.5 billion. The Council in its most recent report had urged that the target of €3.1 billion be retained. Based on the growth forecasts from *Budget 2014* – which have been endorsed by the Council (see Chapter 1) – the planned adjustment set out in the Budget is consistent with keeping the deficit at the EDP deficit ceiling of 2.9 per cent of GDP in 2015, and thus consistent with meeting this criterion for exit from the EDP. However, the Council is of the view that the likely benefit from reducing the planned adjustment for *Budget 2014* in terms of improved short-term growth (estimated to be approximately 0.2 percentage points of GDP) is unlikely to have been worth the cost in terms of the elimination of the margin of safety and lessened credibility. Overall, however, given that the EDP deficit target for 2015 is expected to be met, the Council continues to assess that the planned fiscal stance is "...conducive to prudent economic and budgetary management".

Even though the planned fiscal stance is consistent with meeting the EDP deficit ceiling for 2015 under the *Budget 2014* forecasts, it leaves limited room for adverse growth shocks (as was outlined in Chapter 2). The Government should implement the €2 billion in adjustments previously announced for 2015. Given the importance, from a credibility viewpoint, of meeting the deficit ceiling for 2015, increased adjustments would likely be required if there is any material deterioration in the growth forecasts or other deficit/debt-affecting contingencies. Moreover, any upward revisions to growth forecasts should be used to restore a valuable margin of safety in

relation to the 2015 EDP deficit ceiling and to ensure that the debt-GDP ratio remains on a sustainable path.

4.3 Has Fiscal Adjustment Worked to Stabilise the Public Finances and Restore Creditworthiness?

As discussed above, the choice of fiscal stance in current circumstances involves a difficult balancing act of supporting domestic demand and credibly stabilising the public finances. Although it is often stated that there is a trade-off between "growth and austerity", discretionary fiscal adjustment – austerity – is better viewed as the instrument available to policymakers to move along the domestic demand and sustainability/creditworthiness trade-off.

Much discussion of appropriate fiscal strategy has essentially amounted to a denial that this trade-off exists. The denials have taken two quite different forms: the expansionary fiscal contraction (EFC) hypothesis and the self-defeating fiscal adjustment hypothesis. Under the EFC hypothesis, discretionary fiscal contractions are assumed to increase growth. This might happen, for example, because fiscal adjustments reduce interest rates or reduce fears of a disruptive State default. Discretionary adjustments would then lead to improved fiscal performance both directly and also indirectly through improved growth performance. In the previous *Fiscal Assessment Report* (IFAC, 2013a), available evidence on the size of short-term fiscal multipliers was reviewed. Although there is evidence that short-term multipliers are lower when debt to GDP ratios are high, or the country is in a debt crisis, the weight of the evidence does not support the EFC hypothesis.

The second way in which the trade-off might not exist is if discretionary fiscal adjustments are not working in terms of improving the fiscal situation and ultimately the State's creditworthiness. Under such "self-defeating austerity", discretionary efforts to curb the deficit would result in both lower growth and a worsening in the key fiscal aggregates. The remainder of this section examines possible evidence of self-defeating fiscal adjustment in the Irish context. It considers the post-2008 evolution of key variables: the underlying primary deficit (i.e., the primary deficit excluding banking-related recapitalisation costs); the underlying General Government deficit; the debt to GDP ratio; and the 10-year bond yield.

An obvious drawback of this approach is that the counterfactual – that is, how these variables would have evolved in the absence of fiscal adjustment – is not observable. The Council's Fiscal

Feedbacks model is thus used to examine how the fiscal variables are likely to have evolved in the absence of discretionary adjustment.[116]

Figures 4.4a to 4.4c show the actual/predicted evolution of the four variables between 2009 and 2013. (Figure 4.3 previously showed the evolution of market assessments of creditworthiness). The prediction for the fiscal variables for 2013 is taken from *Budget 2014*. Despite significant non-austerity related growth headwinds, the underlying primary deficit has fallen from 9.2 per cent of GDP in 2009 to a projected 2.7 per cent of GDP in 2013. The underlying actual deficit has fallen from 11.2 per cent of GDP to a projected 7.3 per cent of GDP over the same period. Given that the Government was running a primary deficit over this period and the nominal interest rate has exceeded the nominal growth rate, it is not surprising that the debt to GDP ratio has increased over the period. The increase in the debt to GDP ratio has also reflected substantial supports to the banking system and increases in the State's cash reserves. In terms of secondary market bond yields, the implied 10-year bond yield increased steadily until mid-2011, but has fallen dramatically over the last two years.

As noted, the more interesting question is what would have happened to these variables in the absence of fiscal adjustments. The total discretionary adjustments undertaken between 2009 and 2013 add up to approximately €28 billion. For the fiscal variables, a useful counterfactual scenario can be run assuming that no discretionary adjustments were undertaken. It should be stressed that this scenario assumes that growth would have evolved in the same way as under the actual scenario other than through the effects of the discretionary fiscal adjustment on growth given the assumed deficit multiplier. The simulations also assume that the interest rate on outstanding debt would not have been affected by the absence of fiscal adjustment. These two assumptions mean that the simulations are likely to underestimate the levels these fiscal variables would have reached in the absence of the discretionary adjustments. Of course, it is highly unlikely that such a "no-adjustment" path would have been feasible.

Figures 4.4a to 4.4c also show the predicted counterfactual evolutions for the three fiscal aggregates in the absence of fiscal adjustment. The underlying primary deficit would have risen to a

[116] These simulations assume a reduced form deficit multiplier of 0.5 and an automatic stabiliser coefficient of 0.5, where the latter is based on new European Commission estimates of this coefficient (Mourre *et al.* 2013).

projected 14 per cent of GDP in 2013.[117] The underlying actual deficit would have risen to 20 per cent of GDP. Finally, the debt to GDP ratio would have risen to a projected 158 per cent. Taken together, these results indicate that, even under what could be viewed as rather optimistic assumptions, the fiscal adjustment effort has not been self defeating in terms of improving the key underlying fiscal aggregates.[118]

Absent a credible model of perceived creditworthiness, it is not possible to conduct a defensible counterfactual simulation of market assessments of default risk based on underlying bond spreads.[119] However, the sharp reduction in the secondary market bond yield does not suggest that the fiscal adjustment effort has been self-defeating on this measure either. The combination of the demonstrated capacity to gain control of the public finances, together with developments in European-level official support policies (which are themselves conditional on fiscal effort), appears to have supported a sharp fall in perceived default risk.

Overall, the evidence indicates that the fiscal adjustments pursued since the crisis erupted in 2008 are working to stabilise the public finances and to restore the creditworthiness of the State.

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[117] Figures 4.4a and 4.4b show the underlying primary and General Government deficits, that is, the deficits excluding the effect of capital injections into financial institutions as defined by the Department of Finance.

[118] One possible objection to these counterfactual simulations is that the effects of discretionary fiscal adjustment could be non-linear, with possibly larger multiplier effects at the margin. In the context of the Fiscal Feedbacks model, it should be noted that discretionary adjustments improve the underlying primary balance for any chosen (positive) deficit multiplier. However, for large enough multipliers, discretionary adjustments could lead to a higher debt to GDP ratio for a period of time if the adverse effects on the denominator through reduced growth offset the positive effect on the numerator through an improved primary deficit. It is useful, then, to ask how large the multiplier would have to be for additional discretionary adjustment in year t to actually lead to a larger debt to GDP ratio in year t+1. We again use the Fiscal Feedbacks model to examine how large the reduced-form multiplier would have to be for an additional €1 billion in adjustments in 2014 to lead a higher debt to GDP ratio in 2015, all else equal. The multiplier would have to be 1.8 or larger – values that are in excess of any available estimate for Ireland's deficit multiplier given the openness of the economy.

[119] Some empirical models of the risk premium postulate a simple linear relationship between the risk premium and current and/or lagged values of fiscal variables such as the deficit as a share of GDP and the debt to GDP ratio. However, bond market investors are likely to adopt a more forward looking approach, and in particular to form expectations of how fiscal variables will evolve in the future in an uncertain economic and political environment. Another complication, further discussed in Section 4.5.2, is that the risk premium may be subject to multiple expectations-based equilibria. This can lead to discontinuous jumps in the premium, even with limited changes in contemporaneous fiscal variables. The experience of a rapidly rising risk premium between mid-2010 and mid-2011 is a case in point, as is the subsequent fall. Although a reliable predictive model is thus difficult to estimate, an understanding of the broad forces leading to a "good" equilibrium do point to the importance of the credibility of the planned deficit- and debt-reduction stance and perceptions of the Government's commitment to avoid default. In Section 4.5.2 we discuss further policies that could increase the robustness of an equilibrium with low perceived default risk.

FIGURE 4.4a: PRIMARY DEFICIT,
ACTUAL AND COUNTERFACTUAL SCENARIO

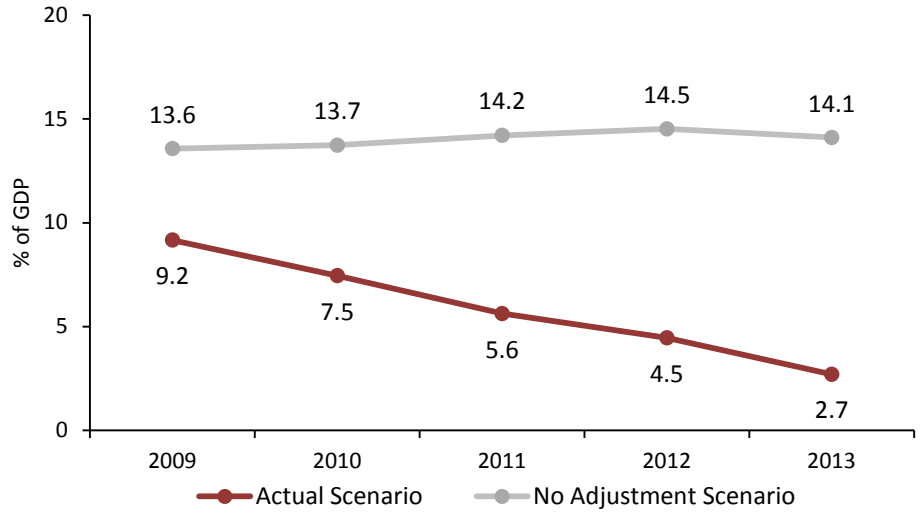


FIGURE 4.4b: GENERAL GOVERNMENT DEFICIT,
ACTUAL AND COUNTERFACTUAL SCENARIO

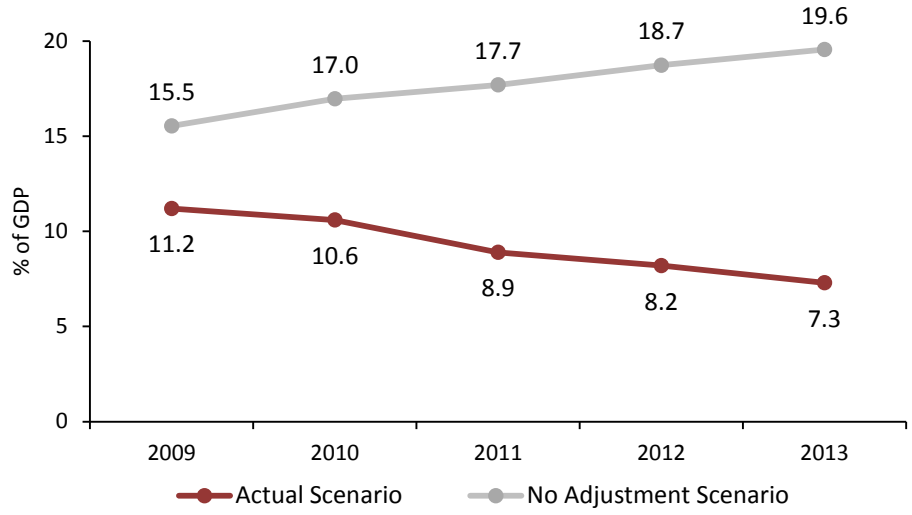
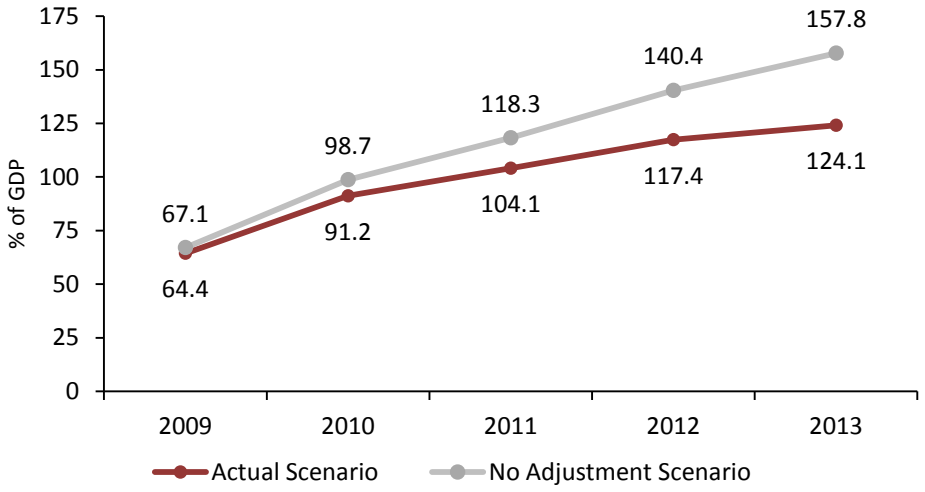


FIGURE 4.4C: GENERAL GOVERNMENT DEBT TO GDP RATIO, ACTUAL AND COUNTERFACTUAL SCENARIO



4.4 BEYOND 2015: POLICY REQUIREMENTS AND EXTENDED FISCAL PROJECTIONS

The requirement to bring the deficit to below 3 per cent of GDP by 2015 has been the focus of much recent fiscal policy discussion.[120] As 2015 nears and as the Programme ends, it will be increasingly important for the Government to set out its medium-term fiscal plans for 2016 and beyond. This would provide additional credibility for future policy actions, helping to support creditworthiness as the Government returns to the market, and greater certainty to consumers, businesses and the Government sector about future prospects.

The domestic and European fiscal rules provide a minimum standard for future policy, but it would be useful for the Government to articulate whether more ambitious goals should be set and what meeting these standards would actually imply in terms of policy. Of course, the actual size of required future measures will depend on such factors as future growth, interest rates and any realised costs associated with contingent liabilities. These risk factors were discussed in Chapter 2.

The *SPU 2013* outlined an illustrative scenario for key fiscal and economic variables to 2019. The authors of the scenario stressed that the policy assumptions underlying the scenario were purely illustrative and did not reflect policy decisions. The illustrative scenario assumed no discretionary tax changes (and thus tax revenues growing at the same rate as nominal GDP) and voted nominal

[120] This is a requirement under the Excessive Deficit procedure (EDP), which is part of the corrective arm of the SGP.

expenditure growing at an average of one per cent per annum, compared to assumed positive inflation of between one and two per cent. Key fiscal and economic outcomes associated with this scenario are reproduced in Annex J.

The scenario considered in *SPU 2013* would be consistent with compliance with all fiscal rules. In particular, in 2019 the structural budget balance is projected to show a surplus of one per cent of GDP (which compares with the Medium Term Objective (MTO) of a balanced structural budget), the General Government deficit shows a surplus of 0.8 per cent of GDP (well below the deficit ceiling for the corrective arm of the SGP), and the debt to GDP ratio is below the backward-looking benchmark of the SGP's new debt rule (see Chapter 3 for details on these rules).[121]

This section takes the Department of Finance's illustrative scenario as a baseline and then examines the implications of alternative policy stances using the Council's Fiscal Feedbacks model.[122]

One feature of the Department's scenario in *SPU 2013* is that it involves a quite uneven adjustment of the structural balance across different years, and also leads to overachievement of the required structural balance under the MTO set for Ireland under the preventive arm of the SGP and the domestic Budgetary Rule.[123]

Two alternative policy scenarios associated with a smoother adjustment path for the structural balance are examined: improvements of 0.5 percentage points of GDP per year and 0.75 percentage points of GDP per year. The results are recorded in Figure 4.5 and Figure 4.6. An adjustment of 0.5 percentage points per year in the structural balance would still leave an estimated structural deficit of roughly 1 per cent of GDP in 2019 (and thus fail to meet the MTO).

[121] It should be noted that the Department of Finance has recently revised its estimates and projections for the output gap, which will have implications for estimates and projections of the structural budget balance (see Chapter 3). As a revised longer-term scenario is not yet available, this section uses the *SPU 2013* illustrative scenario as a baseline. Recognising that the revised output gap estimates will, all else equal, lower the projected structural deficit, the requirement to achieve a structural budget balance would be achieved earlier than in the illustrative scenario. All else equal, this would raise the feasible expenditure increases in the later years of the scenario under the assumption of minimal compliance with all fiscal rules.

[122] The Fiscal Feedbacks model implicitly assumes an exogenous path for the GDP deflator (or equivalently no output gap term in the Philips curve for GDP deflator inflation), so that changes in the nominal growth rate are equal to changes in the real growth rate.

[123] The illustrative scenario in the *SPU 2013* projects that the structural balance will improve by 0.5 percentage points of GDP in 2016, 0.7 percentage points of GDP in 2017, 1.3 percentage points of GDP in 2018, and 1.4 percentage points of GDP in 2019.

An adjustment of 0.75 percentage points per year would bring the structural deficit to roughly zero. The 3 per cent deficit limit and the debt rule are complied with under both policy scenarios.

Figures 4.5 and 4.6 also show the level of nominal discretionary budgetary adjustments required to meet the target for the adjustment in the structural budget deficit (see panel f in each figure). For the illustrative scenario in *SPU 2013*, the required discretionary adjustment is equal to the increase in nominal primary expenditure (excluding unemployment benefit costs) given the assumption of no change in tax rates.[124] For the other policy scenarios, the additional discretionary adjustment required to reach the alternative targets for the change in the structural balance is calculated using the Fiscal Feedbacks model.[125]

In the three scenarios considered, required discretionary adjustments generally turn negative in 2016. In other words, the simulations suggest that modest increases in nominal discretionary expenditure are feasible post-2015 consistent with compliance with the fiscal rules. However, the extent of the tightness of the fiscal stance should not be underestimated given the assumed positive inflation of between 1 and 2 per cent per year over the period 2016 to 2019.

On the assumption that tax rates remain unchanged, we can calculate the implied feasible percentage increases in nominal and real primary expenditure (excluding cyclical unemployment benefit expenditures).[126] These are shown in Table 4.1. It must be underlined that the results are based on specific assumptions relating to growth and other contingencies. However, if these assumptions are met, these scenarios indicate that the most difficult phase of the fiscal adjustment should be broadly complete in 2015/2016.

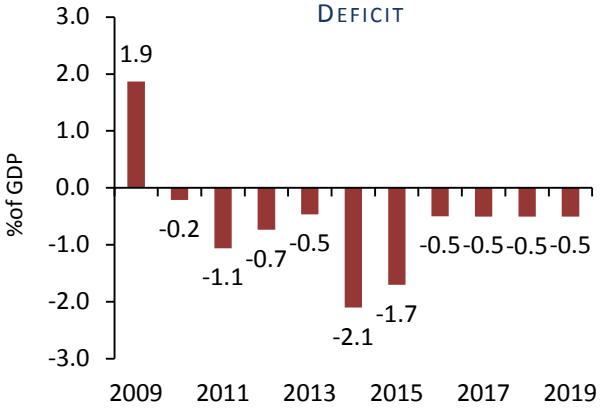
[124] This assumes that there is no feedback other than through the cost of unemployment benefits from the state of the economy to the level of primary expenditure. In other words, the actual change in primary expenditure (excluding unemployment benefits) is assumed to be equal to the discretionary change in primary expenditure (excluding unemployment benefits).

[125] The required discretionary adjustment under each alternative policy scenario is equal to the required adjustment under the baseline in *SPU 2013* and any additional adjustment (potentially negative) due to the change in policy assumption relative to the baseline.

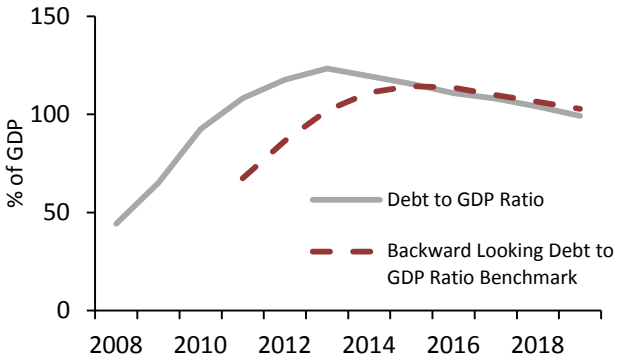
[126] The GDP deflator is used to infer projected increases in real expenditure. Projections of the inflation rate (as measured by the consumer price index) out to 2019 were not provided in *SPU 2013*.

FIGURE 4.5: ASSUMED ANNUAL ADJUSTMENT IN STRUCTURAL DEFICIT = 0.5 PERCENTAGE POINTS, 2016 – 2019. ALL OTHER ASSUMPTIONS ARE AS IN *SPU 2013* ILLUSTRATIVE SCENARIO

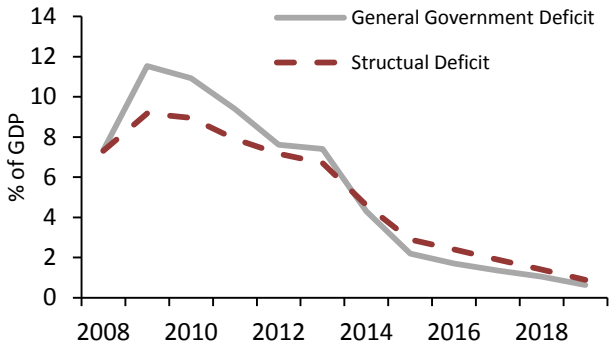
a. CHANGE IN STRUCTURAL BUDGET DEFICIT



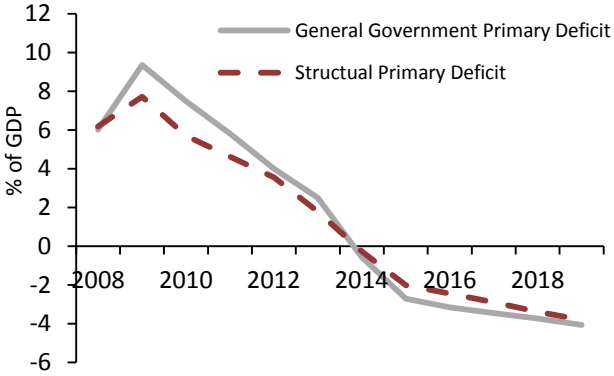
b. DEBT TO GDP RATIO



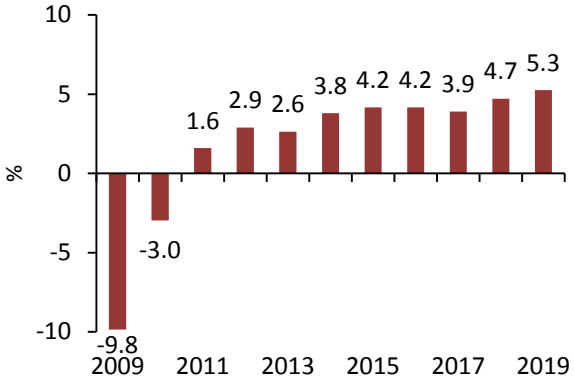
c. ACTUAL AND STRUCTURAL DEFICIT



d. ACTUAL AND STRUCTURAL PRIMARY DEFICIT



e. NOMINAL GROWTH RATE



f. REQUIRED DISCRETIONARY ADJUSTMENT

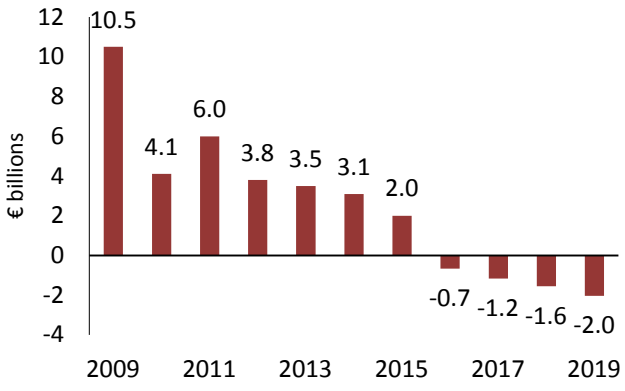
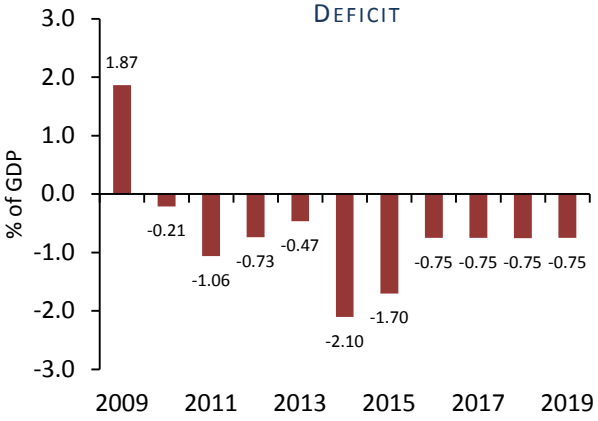
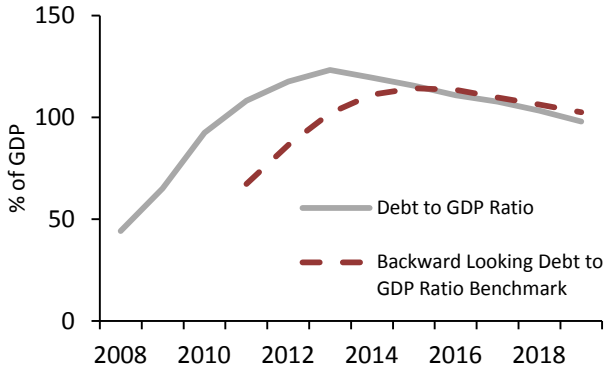


FIGURE 4.6: ASSUMED ANNUAL ADJUSTMENT IN STRUCTURAL DEFICIT = 0.75 PERCENTAGE POINTS, 2016 – 2019. ALL OTHER ASSUMPTIONS ARE AS IN *SPU 2013* ILLUSTRATIVE SCENARIO

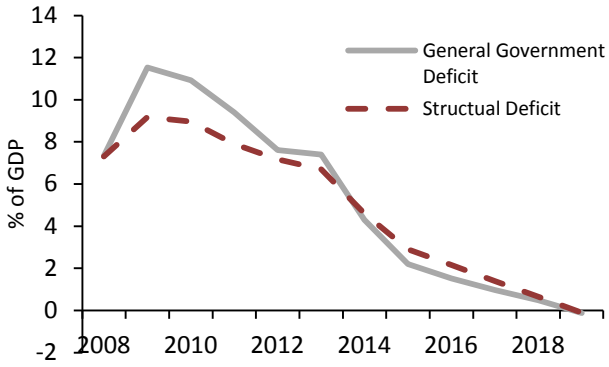
a. CHANGE IN STRUCTURAL BUDGET DEFICIT



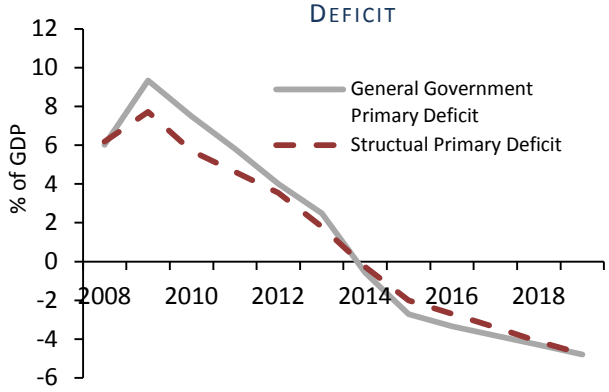
b. DEBT TO GDP RATIO



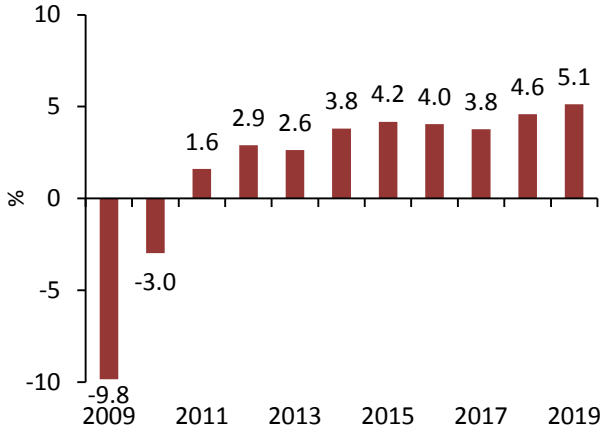
c. ACTUAL AND STRUCTURAL DEFICIT



d. ACTUAL AND STRUCTURAL PRIMARY DEFICIT



e. NOMINAL GROWTH RATE



f. REQUIRED DISCRETIONARY ADJUSTMENT

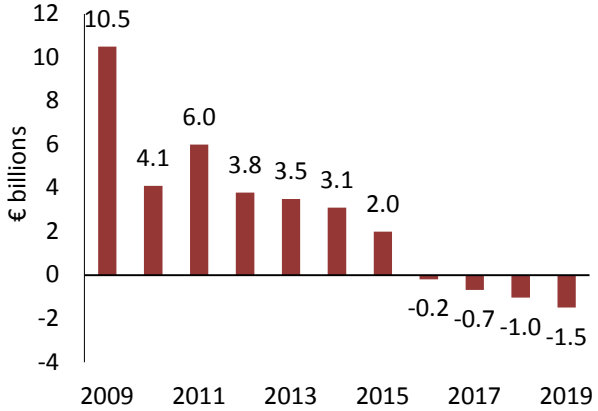


TABLE 4.1: FEASIBLE PRIMARY EXPENDITURE INCREASES FOR 2016-2019: STABILITY PROGRAMME UPDATE 2013 ILLUSTRATIVE SCENARIO AND ALTERNATIVE POLICY SCENARIOS

Feasible Primary Expenditure Growth, Percentage Changes (Excluding cyclical unemployment benefit costs)	2016	2017	2018	2019
SPU 2013 "Illustrative Scenario" Baseline				
Nominal	1.1	1.3	-0.1	0.1
Real	-0.3	-0.2	-1.4	-1.2
0.5 Percentage Point Per Annum Reduction in Structural Balance				
Nominal	1.1	2.0	2.6	3.3
Real	-0.3	0.5	1.3	2.0
0.75 Percentage Point Per Annum Reduction in Structural Balance				
Nominal	0.3	1.1	1.7	2.5
Real	-1.1	-0.4	0.4	1.2

Source: SPU 2013 and IFAC calculations.

Note: Calculations do not reflect post-SPU revisions to projected structural balances (see Chapter 3). These revisions suggest that, all else equal, a structural budget balance (Ireland's Medium-term Objective) will be achieved earlier than projected in *SPU 2013*. This could allow for larger feasible percentage expenditure increases in the later years of the projection period than identified above.

4.5 BEYOND THE BAILOUT: REDUCING THE FRAGILITY OF IRELAND'S CREDITWORTHINESS

4.5.1 INTRODUCTION

As Ireland's programme of official funding assistance nears its end, and the recent success in issuing bonds at affordable yields indicates a return to market access, attention has turned to what needs to be done to ensure that the return to market access is sustained. The background to this policy discussion includes the revealed fragility of creditworthiness for countries with high deficits and debts within the EMU. The absence of a domestic central bank capable of acting as lender of last resort to Government has been shown to leave a country's capacity to borrow from market sources quite vulnerable (see, e.g., DeGrauwe, 2011). Ireland's recent return to market access has resulted from a positive interaction between its demonstration of economic and political capacity to adjust an unsustainable fiscal stance – including meeting the conditions for official funding support – together with improvements in systems for providing that support. These improvements include the establishment of a permanent Euro Area bailout fund (the European Stability Mechanism (ESM)) and a weakening of demands for official-creditor seniority. Indications are that

the ECB's introduction of its Outright Monetary Transactions (OMT) programme has further underpinned market confidence.

This section briefly reviews the components of a possible strategy to help ensure robust market access given current official support systems. (Policies to strengthen these support systems – for example, the introduction of some form of Eurobonds or a debt redemption fund – are not considered, although such policies could further reduce fragility.) It must be recognised that self-protection strategies involve both benefits and costs. The main benefit is the reduced susceptibility to funding crises and a brief discussion of the susceptibility to self-fulfilling funding crises is first provided. The nature of the costs will depend on the self-protection approach pursued. Three elements of a possible strategy to support robust market access are then discussed.

4.5.2 Self-Fulfilling Funding Crises: The Problem of Multiple Equilibria

Much of the recent literature on the fragility of creditworthiness within the Euro Area has focused on the possibility of multiple expectations-based equilibria (see, e.g., DeGrauwe, 2011; and Corsetti and Dedola (2013)). The classic "bad equilibrium" story focuses on the effects of fears of default on interest rates and consequent debt dynamics. Fears of default lead to a large risk premium on Government borrowing; the resulting high interest rate then worsens the country's debt dynamics, and validates the initial fears (see Calvo, 1988, for the classic multiple-equilibria model).

In Ireland's case, the relatively long average maturity of outstanding debt should have provided a degree of protection against a sudden shift to a bad equilibrium in 2010. However, another channel seems to have been at work. Fears that the country would enter a bailout programme, and that such a programme could come with a forced restructuring of privately held debt (with official lender seniority), made it difficult to access new borrowing, which itself would be subject to losses in the event of restructuring. Although there were real concerns about fundamental insolvency – in part due to the costs of the banking-system bailout – the concerns about the implications of a bailout for restructuring may have made fears of a bailout self-fulfilling in late 2010. Indeed, in Ireland's case, concerns relating to a forced restructuring appear to have grown over the first half of 2011 even as the average interest cost remained low due to access to official funding. A similar dynamic may have been present for Portugal, with the country losing market access in 2011 and also requiring a bailout programme. From mid-2011 onwards, perceptions of the nature of the evolving bailout/bail-in regime began to change, with the likelihood of a forced restructuring receding for countries that seemed capable of stabilising their debt dynamics. This stabilisation has

been reinforced by the announcement of the OMT programme by the ECB. Overall, there has been a dramatic fall in Irish yields as programme conditions have been consistently met.

4.5.3 Self-Protection Against Funding Crises: Elements of a Strategy

Although the evolving European lender-of-last resort regime should be less susceptible to the multiple equilibria problem than was the case in 2010/11, the uncertain domestic and international macroeconomic environments – and lingering doubts about the strength of the Euro Area's lender of last resort function – are likely to keep creditworthiness fragile. This raises the question of what countries can do in addition to stabilising their public finances to self-protect against a bad equilibrium.

A similar question was widely debated in emerging market economies following a series of crises that included Mexico (1994), East Asia (1997-98), Russia (1998), Brazil (1999) and Argentina (2002). A common feature of these crises was the existence of large amounts of short-term debt in foreign currency relative to foreign-currency reserves. This led to susceptibility to roll-over crises, where investors worried about the willingness of other investors to roll over loans, leading to a "run" on the country and a "sudden stop" of capital inflows. In the aftermath of these crises, many emerging market Governments adopted self-protection strategies to protect against such roll-over crises (Feldstein 1999; Chang and Velasco, 1999).

Three possible elements of a self-protection strategy against self-fulfilling liquidity crises in a Euro Area context can be considered.[127] In assessing the appropriate mix of elements, it is important to recognise that each element is costly, and the marginal cost of additional protection along each dimension is likely to rise with the level of protection already secured. The optimal strategy is therefore likely to involve a mix of the elements.

(i) Extend and Smooth the Maturity Structure of Outstanding Debt

It has long been recognised that a short and/or bunched maturity structure can increase the risk of a roll-over crisis (see, e.g., Alesina *et al.* 1990; and Giavazzi and Pagano, 1990). The basic idea is that the probability of falling into the type of bad equilibrium discussed above increases when a large amount of debt has to be refinanced in a short period of time, potentially quickly raising the average interest rate on outstanding debt. However, extending the maturity structure can also be

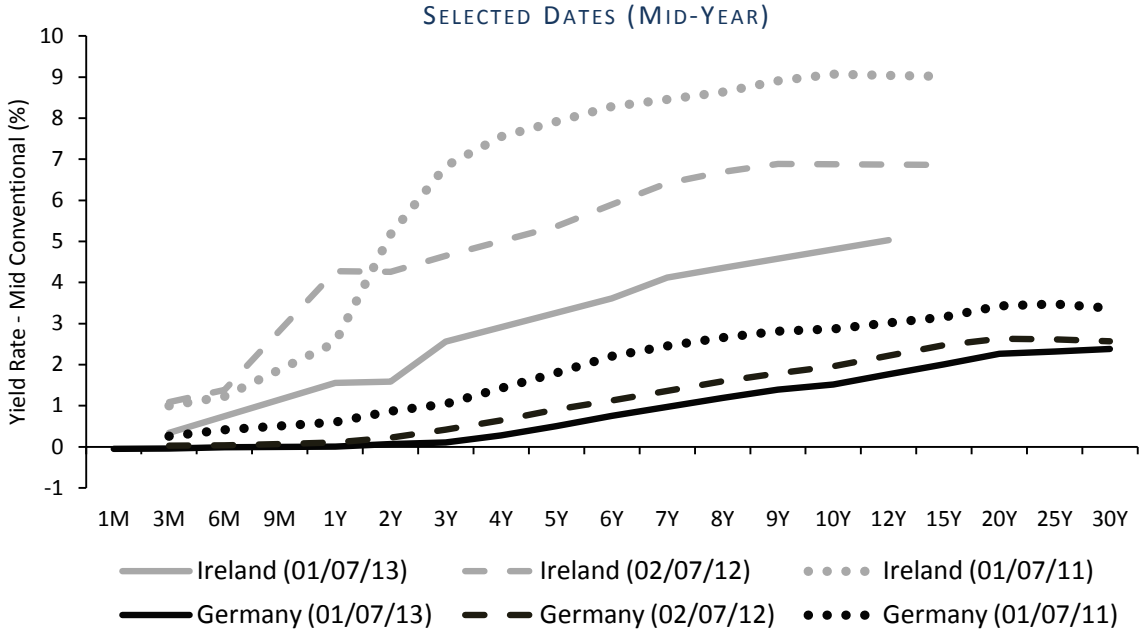
[127] Although Ireland borrows mainly in Euro, it shares with the crisis-affected emerging markets the fact that it is borrowing in a currency it does not control.

costly where the Government faces a term premium on longer-maturity debt (see Figure 4.7 for the Irish and German yield curve at selected points in time.)[128] One element of a strategy to reduce fragility is then to extend and smooth out the maturity structure, and also to limit the amount of debt that is maturing in the short to medium run, during which time funding markets are likely to remain volatile.[129] (See Figure 4.8 for the maturity structure of long-term and official debt following the June 2013 extension of EFSF loans). The marginal benefits of this self-protection strategy (reduced susceptibility to roll-over crises) must be weighed against the marginal costs (higher overall funding costs), and also compared to other available options for self protection.

[128] Different explanations have been given for the existence of such a term premium and the consequent relative costliness of longer-term debt. A term premium may simply result from investor preferences. Particular investors may have a preference – or "preferred habitat" – for a given part of the yield curve. This can lead to a segmented market with yields that are sensitive to relative supplies at different maturities. Increasing the relative supply of longer-maturity debt would then steepen the yield curve. In the context of bank funding, Diamond and Rajan (2001) emphasise the positive incentive effects of having a fragile short-maturity structure that must be rolled over frequently. Jeanne (2009) applies this idea of a short maturity structure as a commitment device to sovereign debt. Effectively, Governments on such a "short leash" have a stronger incentive to pursue fiscal policies that lowers investor risk. The term premium may rise as the Government deviates further from the optimal maturity structure from an incentive perspective. Another interesting explanation for a term premium is given by Alfaro and Kanczuk (2006). In the context of a model with imperfect information on the Government's type, they note that, conditional on the Government being viewed as a low-default type at present, the probability of the Government continuing to be a low-default type is higher in the near term than in the more distant future. This is based on the assumption that the probability of the current Government being in power is higher in the short term. This would again lead to a term premium and a consequent cost advantage to short-term debt.

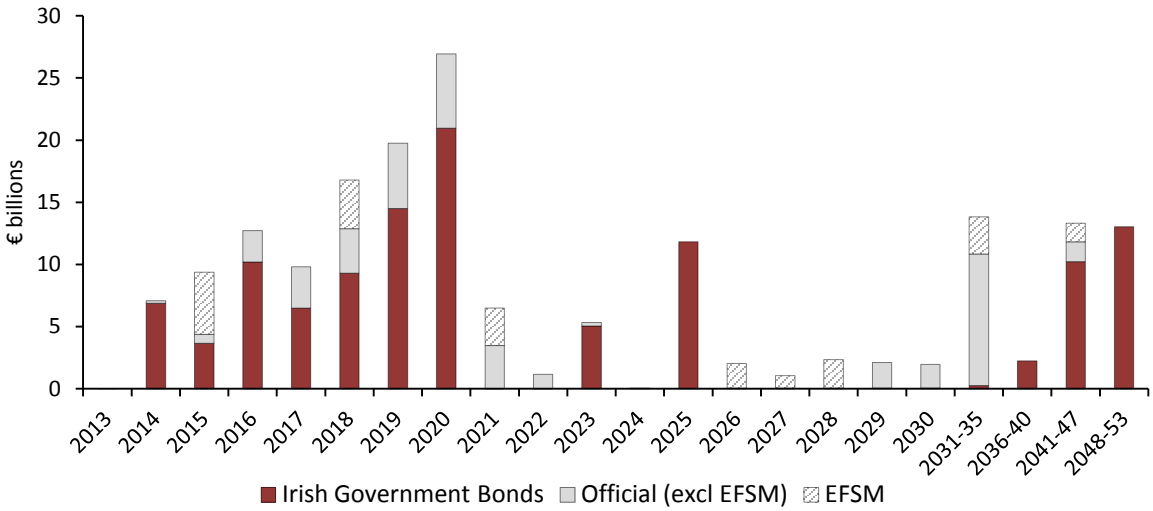
[129] It should be noted that an upward sloping yield curve does not necessarily imply the existence of a term premium. If it is expected that short-term rates will rise, the yield curve with slope upwards even without a term premium. The ECB is presently keeping short-term rates very low in the context of liquidity trap conditions. Although it has stated its expectation that short-term rates will remain low for some time under its new forward-guidance policy, short-term rates should rise as Euro Area economic conditions eventually normalise.

FIGURE 4.7: SOVEREIGN YIELD CURVES, IRELAND AND GERMANY, SELECTED DATES (MID-YEAR)



Source: NTMA and IFAC Calculations.

FIGURE 4.8: LONG-TERM AND OFFICIAL DEBT MATURITY[130]



Source: NTMA, end-October 2013.

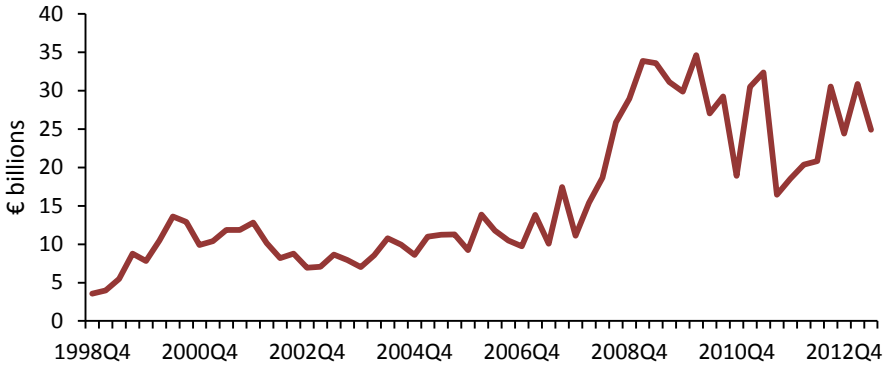
[130] Note: this figure reflects EFSM loan original maturity dates. As with EFSF loans, EFSM loans are also subject to a 7 year extension. While the revised maturity dates of individual EFSM loans will only be determined as they approach their original maturity dates, it is not expected that Ireland will have to refinance any of its EFSM loans before 2027.

(ii) Accumulate Cash Reserves

Rodrik (2006) documents the large increases in reserves held by emerging market economies following the sequence of crises of the 1990s and early 2000s. He also reviews evidence on the role that such reserve accumulation can play in crisis mitigation and prevention.

In preparation for a return to full market access, the NTMA has already accumulated significant cash reserves (see Figure 4.9). Compared to other European economies, these reserves are at a high level as a share of total financing requirements over the period to 2015 (see Figure 4.10).[131] Of course, such cash reserves come with a cost to the extent that the marginal interest rate on new borrowing is above the return on investments in the cash-like assets in which the reserves are held. The marginal cost of reserve accumulation is also likely to rise with the level of reserves to the extent that the interest spread on the resulting higher debt and the liquid assets worsens underlying debt dynamics.

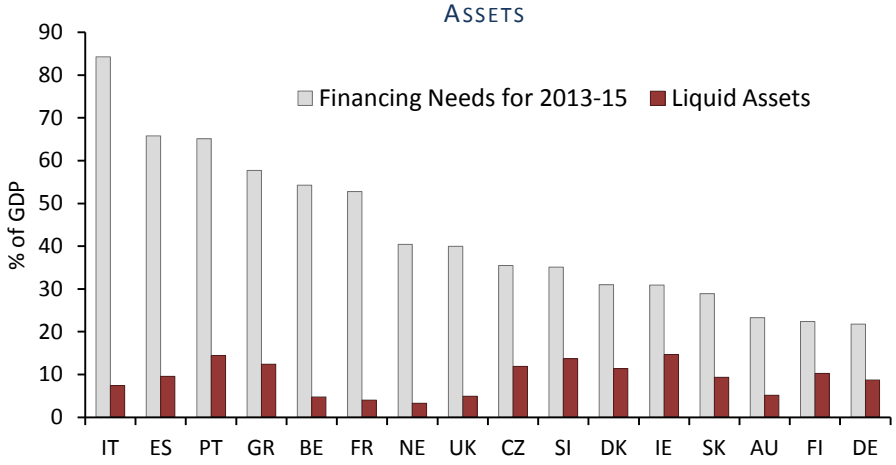
Figure 4.9: Government "Cash" Reserves: Currency and Deposits 1998Q4 to 2013Q2



Source: Eurostat, Quarterly Financial Accounts for General Government.

[131] It should be noted that Ireland has a significant amount of maturing debt post-2015. According to the NTMA, €86 billion of long-term and official debt matures between 2016 and 2020 (see footnote 130 regarding EFSM maturities).

FIGURE 4.10: MATURING DEBT AND LIQUID GOVERNMENT ASSETS



Source: Internal Calculations based on Eurostat and IMF data.

However, the existence of such balances also means that the Government should have more time to demonstrate its fundamental solvency before having to enter a programme that could involve restructuring privately held debt. This gives protection against sudden shifts in market sentiment, following, say, from contagion from a crisis flare-up in another Euro Area country. The current plan is to accumulate large cash reserves to ease the difficult transition back to full market access. However, the ongoing fragility of creditworthiness may mean that significant reserve holdings would be needed for a period of time, although the size of the optimal holdings will depend on the other elements of the self-protection strategy and macroeconomic developments.

(iii) NEGOTIATE PRECAUTIONARY FUNDING LINES WITH OFFICIAL LENDERS

The final potential element is access to a pre-arranged precautionary (conditional) credit line. The basic idea is that, provided the country is pursuing appropriate policies, official lenders agree in advance to meet specified funding needs if market access is lost. As discussed above, an important feature for such a credit line to be successful in avoiding a bad equilibrium is that a country meeting its conditions would not be forced to restructure existing privately held debt; or, at least, such restructuring would be subject to a high trigger.

The extent to which this self-protection strategy can be used is likely to be limited by the size of available credit lines. The marginal cost of such protection may also rise with the level of protection to the extent that larger lines come with higher fees and/or more conditions. Again, given a rising

marginal cost, such advance provision for liquidity support is likely to be just one element of an optimal diversified self-protection strategy.

As regards potentially available precautionary credit lines from official lenders, the ESM offers two precautionary facilities: the Enhanced Conditions Credit Line (ECCL) and (with more stringent qualifying conditions) the Precautionary Conditioned Credit Line (PCCL).[132] In addition to its Stand-By Arrangement (SBA),[133] the IMF also offers two precautionary credit lines: the Precautionary and Liquidity Line (PLL)[134] and (again with more stringent qualifying conditions) the Flexible Credit Line (FCL).[135]

Precautionary facilities would have come with conditions and monitoring. However, the conditions would have been likely to be broadly in line with commitments already in place under national and European fiscal rules. The Government is also planning to put in place a medium-term strategy to maintain reform momentum after the current programme ends. The elements of this strategy could have overlapped with any additional conditionality. Moreover, post-programme monitoring by the EU is set to take place in any case until 75 per cent of their programme loans have been repaid, with similar arrangements in effect with respect to IMF loans.[136]

Given a fragile international financial environment, the Council would thus have supported an application for a precautionary credit line as part of a broader self-protection strategy. Provided it had come with reasonable terms and conditions, such a facility would have provided valuable additional protection against any renewed funding pressures as Ireland exits the EU/IMF assistance programme. The Government announced its decision not to seek such a facility on November 14.

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[132] For details, see: http://www.esm.europa.eu/pdf/ESM%20Guideline%20on%20precautionary%20financial%20assistance.pdf.

[133] For details, see: http://www.imf.org/external/np/exr/facts/sba.htm.

[134] For details, see: http://www.imf.org/external/np/exr/facts/pll.htm.

[135] For details, see: http://www.imf.org/external/np/exr/facts/fcl.htm.

[136] Confidence in Ireland's capacity to achieve sustained bond market access could further be reinforced through ECB commitments to support secondary market bond yields through its Outright Monetary Transactions (OMT) programme. A precautionary programme from the European Stability Mechanism (ESM) is one of the requirements for access to the OMT programme.