

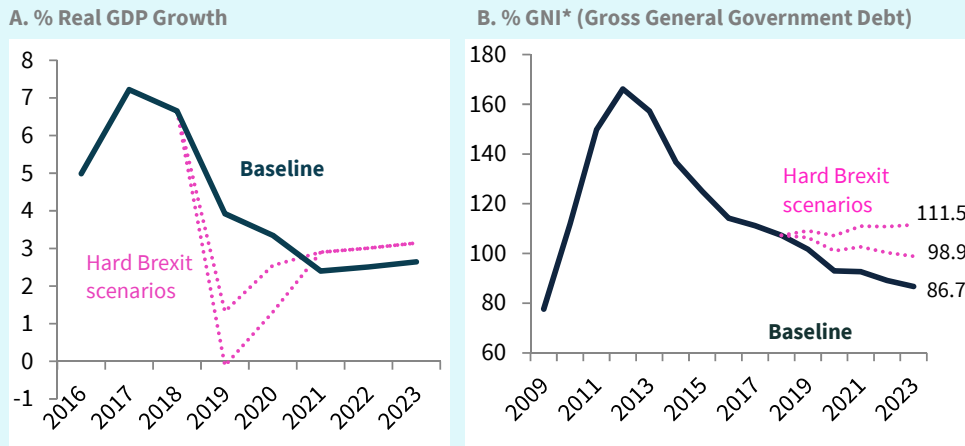
Box C: Fiscal Impacts of Hard Brexit Scenarios

This box considers the fiscal impacts from alternative scenarios of how the economy might evolve in coming years, given the uncertain outlook.

Alternative Scenarios

The two alternative “Hard Brexit” scenarios considered are based on the ESRI/DoF (Bergin *et al.*, 2019) and Central Bank of Ireland (2019) scenarios for a disorderly Brexit. Figure C1.A shows the implied growth rates under each scenario relative to the baseline.

Figure C1: Alternative Growth and Debt Ratio Scenarios



Source: Internal IFAC calculations based on CBI and ESRI/DoF; CSO.

Note: The baseline is taken as *SPU 2019* estimates. CBI shock is initially the more adverse of the two “Hard Brexit Scenarios”. ESRI scenario is based on Box 1, McQuinn *et al.* (2019). Scenario growth rates are higher in later years to allow for the fact that the *SPU 2019* forecasts already incorporate a soft Brexit after 2020 leading to a free trade agreement between the UK and EU. As noted in Chapter 3, the baseline debt ratio projections over the medium term may be unrealistic due to the technical nature of expenditure forecasts.

Fiscal Impacts

The shock impacts from the scenarios are taken and modelled through the Council’s Fiscal Feedbacks Model (IFAC, 2012). The model applies the difference in real GDP growth rates under each scenario relative to the Department’s baseline macroeconomic forecasts as the basis for a growth shock. It models the cyclical impact on the primary balance (lower tax revenues and higher cyclical unemployment spending) and the feedback to nominal GDP growth from this. This is consistent with a situation in which the automatic stabilisers are allowed to work. The model does not take into account any change in marginal borrowing costs on Irish government debt, or changes in the exchange rate (which might dampen nominal growth), or possible direct costs related to Brexit, such as infrastructure costs or support to specific sectors. Furthermore, it assumes an average response whereas actual effects may be quite different to a standard shock. Lastly, the model assumes that shocks are permanent (i.e., that there are no offsetting responses in later years to the initial shock to the level of economic activity).

The scenarios highlight just how sensitive Ireland’s public finances are to alternative outcomes. We can see that the hard Brexit scenarios considered would imply debt-to-GNI* ratios remaining close to 100 per cent by 2023 or rising to almost 112 per cent (assuming no policy response). The effects come about from much bigger deficits being run and also from less favourable GDP growth.

The budget balance and funding costs would also be affected (Table C1). The baseline scenario sees the budget balance rise gradually to 2.3 per cent by 2023 (albeit that this is based on

unrealistic expenditure assumptions as noted in Chapter 3). The hard Brexit scenarios paint a much more adverse picture. The ESRI/DoF scenario would see the budget balance swing back to deficit rapidly (-1.9 per cent in 2019 with a deficit persisting out to 2022). Funding requirements would be estimated to average 8.1 per cent of GNI* per annum (for context, advanced economy median requirements are around 6 per cent on average over 2019–2021).¹⁷ The CBI scenario shows even more adverse outcomes, given a deeper growth shock early on.

Table C1: Estimated Fiscal Outcomes

% GNI*

	2019	2020	2021	2022	2023
Budget Balance					
Baseline	0.3	0.6	1.2	1.7	2.3
Hard Brexit (ESRI/DoF)	-1.9	-2.3	-1.4	-0.4	0.5
Hard Brexit (CBI)	-3.2	-4.7	-3.8	-2.8	-2.1
Gross Debt Ratio					
Baseline	101.7	93.0	92.7	89.2	86.7
Hard Brexit (ESRI/DoF)	106.4	101.1	102.6	100.3	98.9
Hard Brexit (CBI)	109.1	107.2	111.0	110.8	111.5
Funding Requirements					
Baseline	7.2	9.9	1.2	5.8	3.8
Hard Brexit (ESRI/DoF)	9.6	13.2	3.8	8.0	5.7
Hard Brexit (CBI)	11.0	15.8	6.2	10.6	8.4

Source: Internal IFAC calculations based on CBI and ESRI/DoF; CSO.

Notes: Budget balance and gross debt ratio are in general government terms. Funding requirements are estimated as the Exchequer borrowing requirement + maturing debt + anticipated buybacks of floating rate bonds.

Stabilising Debt Ratios

A common response to adverse shocks is to allow revenue to temporarily decline and cyclical spending to rise. However, in a situation where the debt ratio might begin to climb on an unsustainable trajectory, more active measures to stabilise debt ratios might be warranted. The growth shock based on the ESRI/DoF Hard Brexit scenario implies a debt ratio that remains relatively stable. By contrast, the shock based on the CBI estimates would see debt rising over the medium term.

A question worth considering is what level of adjustment to the structural primary balance would be required to stabilise the debt ratio. This can be considered in the Fiscal Feedbacks Model by exploring the required additional discretionary adjustments that would be needed to keep debt ratios at or below end-2018 levels over the medium term (107 per cent of GNI*). Based on the model, this could be achieved with a front-loaded adjustment of almost €4 billion in 2020 or with a cumulative adjustment of €5 billion phased evenly over the three years 2020–2022.

Caveats to the Analysis

There are several final caveats to note. First, the analysis here is based on an assumed deficit multiplier of 0.5, which is consistent with recent research based on SVAR-based approaches and COSMO estimates that assume no endogenous policy responses (Ivory *et al.*, 2019; Carroll, 2019). This gives different results to those produced in the ESRI/DoF analysis, which implies a lower sensitivity to growth shocks (at peak, the general government balance in the latter is

¹⁷ This is based on the IMF’s April 2019 Fiscal Monitor, which takes “total financing needs” as maturing debt + budget deficits. It includes the refinancing of short-term debt outstanding. By comparison, the Council’s estimates for Ireland refer solely to medium- and long-term maturing debt rollovers + Exchequer borrowing requirements.

assumed to worsen by 0.9 percentage points relative to the baseline scenario, whereas the medium-term five-year impact is 0.5 percentage points). The lower sensitivity in the latter reflects two aspects: (1) lower sensitivity of the deficit to growth shocks in general in the model, and (2) moderate wage, and hence income tax, responses in a Brexit scenario (higher import prices lead to higher consumer prices, which offsets the downward pressure on wages). Second, the Council's scenario is based solely on a growth shock aggregated to the economy-wide level so that the exact nature of impacts from the hard Brexit scenarios on tax headings, cyclical expenditures, and economic behaviour is not considered. Third, the model assumes that the shock takes place in 2019, though the effects could obviously be assumed to take place over the course of 2019–2020, given the current timing.

Box D: Reforms to the European Stability Mechanism (ESM)

Last December, euro area heads of state and government endorsed a set of proposals that may have fiscal implications for Ireland. The goal of the reforms is to enhance the ESM's capacity as a crisis resolution fund—a provider of emergency support programmes—to help the euro area to withstand future crises (ESM, 2018).

The ESM

The ESM is a lender of last resort for countries that lose market access, or are close to losing market access. This is a function that did not exist before the recent crisis and the lack of which was considered a key failing in terms of how quickly and efficiently euro area institutions could respond (Baldwin and Giavazzi, 2015). The ESM was set up in October 2012, has a maximum lending capacity of €500 billion, and finances its activity by issuing bonds and other debt instruments. Its creditworthiness is supported by €705 billion of support from euro area member states: €80.55 billion paid-in capital, and €624.25 billion of callable capital. The callable capital serves as an additional buffer that the ESM can call on member states to contribute as and when necessary. It reinforces the ESM's creditworthiness further should a borrower of ESM funds have to default on a loan payment and should paid-in capital and other reserves prove insufficient to cover losses.

A common backstop to the Single Resolution Fund (SRF)

A key reform to how the ESM operates is the implementation of a common financial backstop for the Single Resolution Fund (SRF) so that it has enough cash to deal with a very big crisis from 2024 at the latest. The SRF is an EU fund for resolving failing banks and is financed by bank contributions. The backstop should mean that the ESM would be able to lend necessary funds to the SRF should the SRF's bank-provided resources prove insufficient to avert major bank failures in future.¹⁸

It is expected that the SRF bank-provided resources will be around €60 billion (or 1 per cent of deposits covered in the Banking Union) by 2024, while ESM loans available would be about the same size. If the ESM loans were to be used, the SRF would be required to pay back the ESM loan with money from bank contributions within three years (subject to an extension of up to two years). This means that it is intended to be fiscally neutral over the medium term.

The common backstop has several fiscal implications for Ireland:

There are obvious benefits to Ireland arising from the euro area architecture being made more robust. A common concern relating to the last crisis was that individual Member States—by

¹⁸ Loans would have to be mutually agreed by the ESM's Board of Directors, consisting of euro area finance ministry officials, but the plan is that approvals could be made swiftly (in as little as 12 hours).