Summary Assessment

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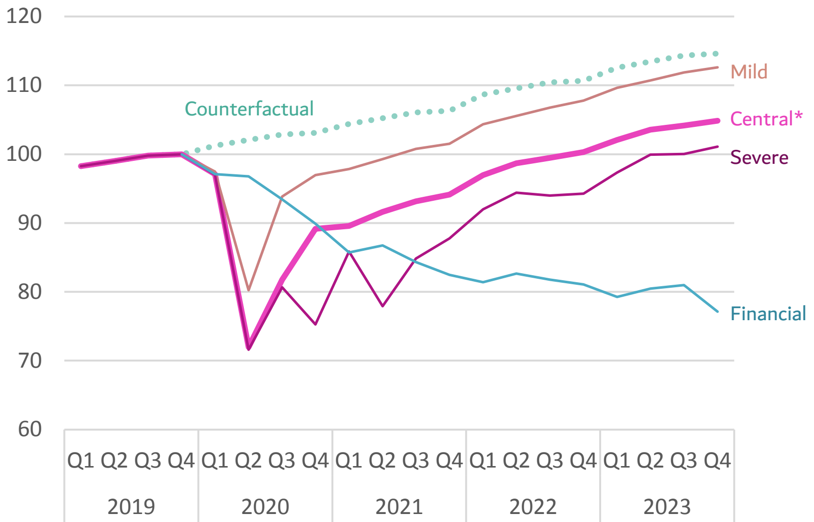
The Government based its *Stability Programme Update* (*SPU*) *2020* on a scenario where the Covid-19 crisis would result in a deep economic downturn in the first half of the year. The Irish economy was in good shape when the Covid-19 shock hit, but the global health pandemic and necessary policy measures have had a major impact. Official *SPU 2020* projections envisage a 15 per cent decline in underlying domestic demand in 2020. This reflects a sharp impact from containment measures in Q2 2020 and lasting adverse economic impacts, despite policy measures taken, with unemployment projected to be 9.1 per cent in Q4 2021. Developments since *SPU 2020* have been broadly consistent with the official projections.

The macroeconomic backdrop is exceptionally uncertain as a result of health and economic uncertainties around Covid-19. The Council endorsed the *SPU 2020* macroeconomic forecasts as being within an endorseable range, noting the wide range of outcomes that are possible. Yet there are also other major risks surrounding the economic outlook beyond Covid-19. These include risks relating to a hard Brexit, possible changes to the international tax system, and further disruptions to global trade.

Given the uncertainties, many different paths of the economy are possible. This report develops three economic and fiscal scenarios to 2025: a "Mild" scenario, where conditions improve rapidly and lasting damage is kept to a minimum; a "Central" scenario, building on the official *SPU 2020* forecasts and where confinement measures are eased as planned but there are some lasting effects; and a "Severe" scenario where the recovery is protracted and marred by repeat lockdowns and wider financial distress. The scenarios imply that it could take between 2 and 3½ years to return to pre-crisis levels of activity depending on health outcomes. By contrast, the Irish economy took 11 years to recover after the financial crisis.

Economic scenarios for Covid-19 vary widely
Underlying domestic demand (Index: Q4 2019 = 100)



Sources: CSO; Department of Finance; and Fiscal Council workings.
Note: * The Central forecasts are a replica of the official Department of Finance projections published in *SPU 2020* (see Box D). The 2008 Financial crisis is indexed to Q1 2008. The "Counterfactual" is based on the pre-Covid-19 path for the economy.

Large-scale policy support measures have been introduced for 2020 to manage the Covid-19 crisis. The Government is implementing some €7 billion of additional spending on healthcare, income supports, wage subsidies, and cash supports to business. A further €7 billion of additional supports includes guarantees, loans, and investments. *SPU 2020* projects a government deficit of €23 billion in 2020 (13.3. per cent of GNI*). This reflects €9.6 billion of additional spending and a €14.9 billion fall in general government revenue. For 2021, the deficit should improve if economic activity recovers and policy measures are scaled back as assumed, but the deficit is nevertheless projected to remain large at 7.3 per cent of GNI*. The Council assesses that the actions taken in 2020 thus far are conducive to prudent economic and budgetary management.

There are many risks around the *SPU 2020* fiscal projections. These include more severe health and economic outcomes, and larger shortfalls in revenue or higher costs. In addition, *SPU 2020* forecasts do not incorporate the impact of any future stimulus or economic recovery plan.

The appropriate fiscal stance for the coming years will depend on how the crisis evolves. This can be assessed in terms of three broad phases. A new government will need to balance the goals of supporting the economy, minimising permanent damage to productive capacity and achieving its social objectives, while maintaining creditworthiness and sound economic management. While the timing is uncertain, the next few years are likely to be characterised by three broad phases: (1) the immediate crisis; (2) the recovery period; and (3) the new normal or "steady state" that the economy finds itself in over the medium term.

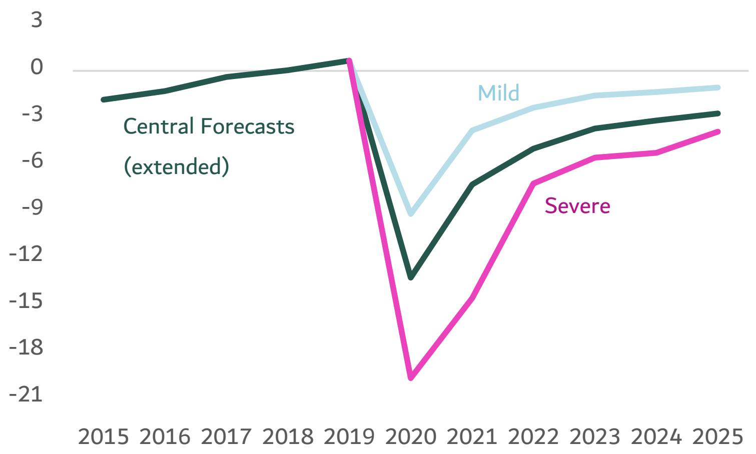
In the immediate crisis (Phase 1), the Government should seek to limit negative health and income impacts and promote as quick a rebound as possible by continuing direct spending measures and other supports. This will help to limit lasting economic damage, support incomes, and safeguard long-run debt sustainability. The immediate fiscal costs will be high, but temporary. While policy needs may evolve, and policies should be adjusted as appropriate to fit these needs, support should be provided on a large-scale for as long as is needed to avoid lengthening and deepening the economic crisis.

During the recovery period (Phase 2), the economy will be below its potential, although growth could initially be quite fast as sectors reopen. Unemployment will be higher than it was pre-crisis, there will be significant unused resources, and productivity will be lower than usual as firms adapt. Some sectors, such as tourism and food services, will fare worse than others. Some job losses will be permanent, and some retraining of workers will be necessary if the economy is to recover its lost potential.

A sizeable fiscal stimulus would help support activity during the recovery phase. Borrowing to support weak demand would be an appropriate countercyclical approach for the government to manage the economy. It should be temporary, targeted and conditioned on the likely state of the economy. It should be phased appropriately over time so that demand can adjust gradually. A stimulus might not be able to support demand in sectors where social distancing is more difficult, but it could boost demand in other parts of the economy.

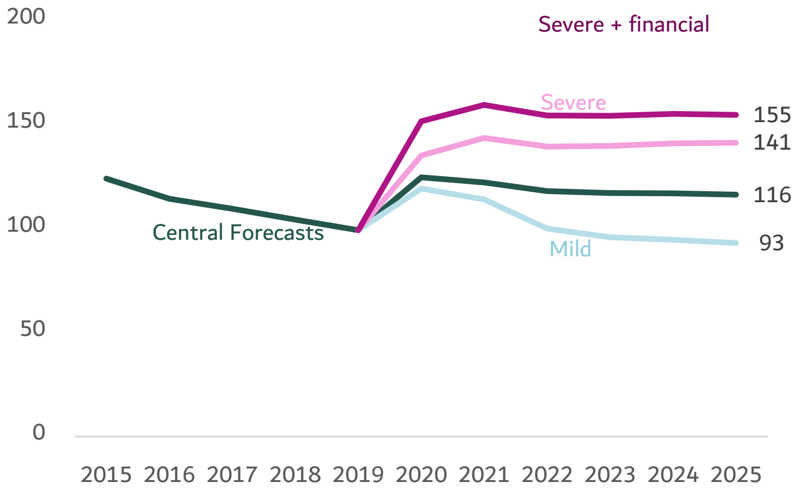
The deficit is likely to be large for many years

Budget balance, % GNI*



The debt ratio could evolve along very different paths under different scenarios

Debt ratios % GNI*



Sources: CSO; Department of Finance; and Fiscal Council workings.
Note: Scenarios are consistent with the macroeconomic and fiscal assumptions set out in Boxes D and I. The Severe + scenario includes a financial sector shock that assumes a recapitalisation of domestic banks equivalent to 10 per cent of the value of their assets (€27.8 billion) in 2021.

As the economy settles on a new growth path (Phase 3), the government debt-to-GNI* ratio could be near post-financial crisis historic highs. The scenarios explored in this report suggest that the debt-to-GNI* ratio could be in the range of 114 to 160 per cent in 2021, up from 99 per cent in 2019.

Given the very high level of debt and lower revenues, some fiscal adjustment is likely to be required in Phase 3 to put the debt-to-GNI* ratio on a downward path towards safer levels. With debt at near record levels, the economy will be more vulnerable to further adverse shocks in future. To safeguard the funding of public services and supports, the government should set a credible path for a prudent fiscal policy. One way to achieve this would be to reinforce the budgetary framework. Three reforms would help: (1) meaningful debt ratio targets; (2) saving temporary receipts through a redeveloped Rainy Day Fund; and (3) using sustainable growth rates to guide net policy spending growth along with more realistic medium-term budgetary forecasts.

Decisions will need to be made around the fiscal adjustment amid competing objectives in terms of spending and taxation. The scale of the adjustment that might eventually be required is uncertain. The scenarios considered in this report suggest that getting the debt-to-GNI* ratio to fall at a pace of 3 percentage points annually by 2025—similar to previous plans— would require total adjustments ranging from €6 to €14 billion over the period 2023–2025. New commitments will likely require reductions in other areas of spending or higher taxes. Nonetheless, ambitious policies can still be achieved in areas like health, housing and climate change.

It should be possible to avoid a return to severe fiscal adjustments. Even in the Severe scenario, the adjustments required are less than half the €30 billion of consolidation measures introduced after the financial crisis. The adjustments would also likely be easier to achieve as they could be conducted at a time when the economy would be growing again and closer to its full capacity, especially as there is scope for a substantial stimulus in the near term to support the recovery. The low cost of borrowing should play a key role in returning the debt ratio to a downward path, though interest rates can change quickly. This risk is amplified by the fact that large funding requirements may be needed in the coming years. An increase in interest rates or a fall in corporation tax receipts would make for a more challenging environment.

The domestic and EU fiscal rules create leeway for the required response to both the public health emergency and the severe economic downturn in 2020. The Council assesses that Ireland was compliant with the fiscal rules for 2019. For 2020, the Council deems that "exceptional circumstances" exist, while the European Commission has separately activated the "general escape clause" of the Stability and Growth Pact (SGP). These flexibilities allow for some deviation from the normal rules. Depending on the future path of Covid-19, "exceptional circumstances" might persist into 2021 and a further deviation from usual requirements may be appropriate.