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Mr Paschal Donohoe
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3 August 2018

Dear Minister

In line with the Central Bank's mandate to provide analysis and comment to support national economic policy development, I am writing to you in advance of October's Budget. I take note of the fiscal plans laid out in the Stability Programme Update and the Summer Economic Statement, together with the analysis provided by the Irish Fiscal Advisory Council.

In relation to the broad euro area macroeconomic environment, the latest assessment of the ECB Governing Council is that the ongoing economic recovery is anticipated to continue at a moderate pace, supported by accommodative financial and monetary conditions. Turning to the Irish economy, the near-term and medium-term central projections indicate significant expansion. At the same time, risks to growth remain clearly tilted to the downside at both



European and domestic levels. Ireland is especially exposed due to the legacy of high public and private sector debt levels and the sensitivity of small, highly-open economies to international shocks.

Currently, the international risk factors that are at the top of our monitoring list include: (i) the risk of an unexpectedly-sharp tightening in international financial conditions, as might be triggered by an increase in risk aversion among investors; (ii) a downgrading of future global growth prospects, with an international trade war one possible catalyst; (iii) a shift in global tax practices that adversely affects small countries that host global multinational firms; and (iv) hard Brexit scenarios. While the first two risk factors are common across all economies, Ireland is especially exposed to the second pair of risk factors. The potential adverse impact on the Irish economy and Irish financial conditions if any of these scenarios were realised calls for the accumulation of financial and fiscal buffers that would help to limit the damage.

In relation to financial-sector buffers, the Central Bank is working to ensure that the capital positions of banks are sufficiently strong to withstand the losses that could be triggered by a negative shock. Our policy interventions include the recent activation of the counter-cyclical capital buffer: in the event of a downturn, this capital buffer can be released, thereby avoiding a pro-cyclical withdrawal of credit supply under adverse conditions. In relation to new mortgage lending, our borrower-based measures that impose (flexible) ceilings on loan-to-value (LTV) and loan-to-income (LTI) ratios are designed to limit the risks of over-borrowing by households and over-lending by banks.

Turning to fiscal buffers, the running of budget surpluses that fund some combination of reducing the stock of public debt and building up a rainy day fund of liquid assets would allow the government to implement a stabilising, counter-cyclical fiscal expansion in the event of a future downturn. If fiscal buffers are not built up in good times, there is a risk of repeating the costly experience of past episodes by which economic downturns were amplified by pro-cyclical fiscal austerity.

The latest data show that the unemployment rate in June 2018 stood at 5.1 percent; the Central Bank forecasts that unemployment will further decline and will average 4.8 percent during 2019. This welcome decline in unemployment is ahead of the forecasts in the government's *Stability Programme Update 2018* (SPU2018) that was published in April, suggesting that the economy is more cyclically-advanced than is assumed in SPU2018.



In view of the prospect of further economic expansion during 2019-2021, a revision in the budget balance targets for 2019-2021 (compared to those laid out in SPU2018) may be in order if a cyclically-appropriate policy stance is to be attained. In particular, the projection of a general government deficit of €350 million in 2019 is not sufficiently ambitious, given the cyclical conditions. As noted in the government's *Summer Economic Statement 2018* (SES2018), a number of small European countries with similar unemployment rates (and, indeed, much lower public debt ratios) have already been running fiscal surpluses, such that the Irish fiscal projections also look mis-aligned in a comparative perspective.

There are four further reasons to set more ambitious fiscal targets. First, the unexpected surge in corporation tax revenues may have some one-off elements, indicating that some part of these revenues should be categorised as a windfall. Second, to the extent that the current low interest rate environment is not expected to persist indefinitely, a tighter non-interest budget balance offers protection against future increases in debt servicing costs. Third, the legacy of high public and private debt levels mean that Ireland is relatively more vulnerable to reversals compared to other countries with healthier public and private balance sheets: at 111 percent of GNI*, the stock of public debt remains at an elevated level. Fourth, the predictable trend increase in ageing-related public spending in the coming decades calls for a degree of pre-funding, if sharp future tax increases are to be avoided.

The potential contribution of fiscal policy to macroeconomic stabilisation extends beyond striking the cyclically-appropriate budget balance. Especially for a country in a monetary union, fiscal instruments can be deployed to replicate some of the features of a national shift in the interest rate or the exchange rate. For instance, adjusting the VAT rate on labour-intensive activities in line with cyclical conditions would proxy a cyclical role for currency adjustment, with increases in the VAT rate contributing to the moderation of labour market pressures during good times and cuts in the VAT rate helping to boost labour demand during downturns.

Proxies for national interest rate adjustment include shifting the tax rates on investment and consumption in line with cyclical conditions. During upswings, spending pressures can be alleviated by raising taxes on investment and consumption, with these taxes lowered during slowdowns. Examples include cyclical adjustment of asset taxes in the property sector and a cyclically-sensitive regime for the tax treatment of savings.



Finally, the additional spending pressures associated with an increase in public investment require offsetting balancing fiscal measures if the economy is operating in the neighbourhood of full capacity. Otherwise, there is the prospect of short-term crowding out, with exporting sectors especially affected by the loss in competitiveness associated with a deficit-financed surge in public investment. In contrast, a fiscally-neutral increase in public investment would deliver the long-term gains without inducing short-term overheating.

Yours sincerely

Philip Lane