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Mr Paschal Donohoe, TD
Minister for Finance
Department of Finance
Government Buildings
Upper Merrion Street
Dublin 2

18th July 2017

Dear Minister,

Following the tradition set by my predecessors, I am writing to you in advance of October's Budget with some observations on the current macro-financial outlook. Since the Irish Fiscal Advisory Council has the primary role in providing an independent assessment of the fiscal position, I will not offer a comprehensive analysis of budgetary policy. At the same time, it is worthwhile to offer some comments on the domestic and international macroeconomic environment and the state of the financial system, since these are important factors in determining fiscal strategy. In addition, I will address some issues raised in the *Summer Economic Statement*.

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 projections are for significant expansion. The economic recovery has also fostered a marked improvement in the state of sectoral balance sheets, including the financial state of the banking system. While new lending is picking up, our assessment is that the credit cycle remains subdued, which is reflected in the current zero value for the counter-cyclical capital buffer.

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, the sensitivity of small, highly-open economies to international shocks and Brexit-related vulnerabilities.

Given this assessment, it is clear that a prudent fiscal strategy remains essential, especially in view of the feedback loops between fiscal stability, financial stability and macroeconomic stability. In terms of the public finances, a long-term debt target can provide an important anchor for annual budgetary decisions. Indeed, the greater the commitment to attaining a long-term debt target, the more is it possible to run a flexible, counter-cyclical fiscal policy in response to temporary shocks. The case for a prudent target for public debt is further reinforced by the trend implications of an ageing population for expenditure on pensions and healthcare.

While the European fiscal framework prescribes a target ceiling for the stock of public debt (at 60 percent of GDP), there are compelling reasons to develop a national target for the stock of public debt. In this respect, I welcome the commitment in the *Summer Economic Statement* to maintain a long-term debt target of 45 percent of GDP. At the most basic level, the new CSO calculations indicate that the underlying size of the Irish economy (as captured by GNI*) is about one-third smaller than GDP, such that an adjusted target of 60 percent of GNI* would map into a debt target of 40 percent of GDP. More generally, the prudent stock of public debt naturally varies across countries in line with different risk exposures: the volatile nature of the Irish macro-financial system and the history of crises suggests a debt target that should be materially below the appropriate level for a larger, more stable economy. Of course, a target for the stock of public debt should be appropriately interpreted in the context of the wider public sector balance sheet, with due allowances for the dynamics of various types of financial and non-financial assets (including public capital) and the range of contingent and implicit liabilities.

In relation to the cyclical budgetary stance, the pursuit of macro-financial stability requires that the government runs a counter-cyclical fiscal policy. In addition to the mechanical operation of the automatic stabilisers that are embedded in budgetary dynamics, this may require the government to take active measures to tighten budgetary policy during phases of robust economic growth. This possibility is recognised in the *Summer Economic Statement* but it may be desirable to develop further the scenario analysis under which the government would seek to run a substantial fiscal surplus as a counter-cyclical macroeconomic measure. The development of a counter-cyclical fiscal strategy should also include a more comprehensive policy in relation to striking the balance in the allocation of surplus revenues between the proposed rainy day fund and reducing the gross stock of public debt.

Although this may not be an immediate issue in relation to Budget 2018, determining the counter-cyclical fiscal stance may be quite relevant for subsequent budgets if the economy hits full employment. It is also relevant in working out the macroeconomic implications of the projected further expansion in public investment during 2019-2021 that is signalled in the *Summer Economic Statement*. While additions to the public capital stock can be expected to raise the productive capacity of the economy and/or assist in the attainment of social objectives over the medium term, the process of adding to the public capital stock through a public investment programme acts to raise aggregate demand in the near term.

While the demand-raising impact of public investment can be stimulative during recessionary periods, a surge in public investment under conditions of full employment requires counter-vailing measures to limit the risk of costly over-heating dynamics. Alternatively, stretching out a planned public investment programme over a longer horizon can limit pressures on the absorptive capacity of the economy.

Finally, at the microeconomic level, capacity constraints in the economy can be mitigated through greater efficiency in the use of the resources in both the private and public sectors. In relation to the private sector, rigorous evaluation of "tax expenditures" should take into account the implications of expansion in selected sectors for the rest of the economy. In relation to the public sector, the successful implementation of the Medium-Term Expenditure Framework and Public Sector Reform Framework outlined in the *Summer Economic Statement* can help improve efficiency in the public sector, creating more room for new initiatives and/or releasing resources to the private sector.

Yours sincerely,

Philip Lane