



**Irish Fiscal  
Advisory Council**

**Fiscal Assessment Report**  
October 2011

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Finally, the Council would like to thank the Council Secretariat - Diarmaid Smyth (Chief Economist and Head of Secretariat), Eimear Leahy and Rachel Joyce - for their extensive contributions to the report. Producing the report on a tight time line would not have been possible without their wide-ranging assistance. Of course, all remaining errors and omissions are the responsibility of the Council.

## Glossary

**Cyclically Adjusted Budget Balance (CABB):** This is the actual budget balance net of the cyclical component. The CABB gives a measure of the underlying trend in the budget balance. The structural budget balance is the CABB excluding one-off items.

**Cyclical Component of Budget Balance:** This is the part of the change in the budget balance that follows automatically from the cyclical conditions of the economy, due to the reaction of Government revenue and expenditure to changes in the output gap.

**Exchequer Balance:** The traditional domestic budgetary aggregate which measures the Central Government's net surplus or borrowing position. It is the difference between total receipts into and total expenditure out of the Exchequer Account of the Central Fund.

**Expansionary Fiscal Contraction:** An expansionary fiscal contraction is said to occur if a period of fiscal consolidation leads to an economic expansion.

**Fiscal Space:** This is the difference between the current level of public debt and the debt limit implied by the country's historical record of fiscal adjustment.

**Fiscal Stance:** This is a measure of the effect of discretionary fiscal policy. It is defined as the change in the primary structural budget balance relative to the preceding period. When the change is positive (negative) the fiscal stance is said to be expansionary (restrictive).

**General Government Balance (GGB):** The GGB measures the fiscal performance of all arms of Government. It provides an accurate assessment of the fiscal performance of a more complete "Government" sector. The GGB does not reflect the position of commercial State sponsored bodies as these agencies are classified as being outside the General Government sector.

**Gross General Government Debt:** The total gross debt of the Irish State. The National Debt is its principal component.

**Output Gap:** This is the difference between actual output and estimated potential output at a particular point in time.

**Potential Output/GDP:** The level of real output/GDP in a given year that is consistent with a stable rate of inflation. If actual output rises above its potential level, then constraints on capacity begin to bind and

inflationary pressures build. If output falls below potential, then resources are lying idle and inflationary pressures abate.

**Primary Balance:** This is Government net borrowing or net lending excluding interest payments on consolidated Government liabilities.

**Stock-Flow Adjustment:** This ensures consistency between the net borrowing (flow) and the variation in the stock of gross debt. It includes the accumulation of financial assets, changes in the value of debt denominated in foreign currency, and remaining statistical adjustments.

**Structural Budget Balance:** see CABB

## **Foreword**

The Irish Fiscal Advisory Council was established in June 2011 as part of a wider agenda of reform of Ireland's budgetary architecture as envisaged in the Programme for Government. Forthcoming legislation under the Fiscal Responsibility Bill will recognise the Council as an independent body.

The role of the Council is to independently assess, and comment publicly on, whether the Government is meeting its own stated targets and objectives. The Council will measure the appropriateness and soundness of the Government's macroeconomic projections, budgetary projections and fiscal stance. The Council will also examine the extent of compliance with the Government's fiscal rules. The Council will perform other functions, including an assessment of the implications of budgetary plans for economic growth, investment and employment, as may be assigned by the Minister for Finance.

The Council is initially being funded through a grant-in-aid provided by the Irish Government. The Council's long-term funding will be considered in the context of the Fiscal Responsibility Bill.

The Council is chaired by Professor John McHale, Head of Economics at National University of Ireland, Galway. Other Council members are Mr Sebastian Barnes, Organisation for Economic Co-operation & Development; Professor Alan Barrett, Trinity College Dublin (on secondment from the Economic & Social Research Institute); Dr Donal Donovan, University of Limerick (formerly International Monetary Fund staff) and Dr Róisín O'Sullivan, Associate Professor, Smith College, Massachusetts.



## Summary Assessment

### Introduction

The Irish Fiscal Advisory Council was established in June 2011, with the mandate to assess, and comment publicly on, whether the Government is meeting its own stated budgetary targets and objectives. Core elements of the Council's mandate are to provide an assessment of the appropriateness of the fiscal stance set out by the Government in the Budget and the Stability Programme Update (SPU) and to provide an assessment of the economic and budgetary projections.

With Budget 2012 imminent, this first Fiscal Assessment Report seeks to provide an assessment of the fiscal stance set out in the SPU last April, taking into account more recent macroeconomic and budgetary developments.

### Assessment of Macroeconomic Developments

The macroeconomic forecasts within the SPU were broadly appropriate at the time of publication. Since April, however, most of the main forecasting agencies have revised projected growth rates for Ireland downwards, in part reflecting increasing uncertainties about the global economic environment.

There have been very significant data revisions by the Central Statistics Office (CSO) to the Irish output figures, notably with nominal GDP in 2010 revised upwards by 1.3 per cent. In addition, the most recent preliminary Quarterly National Accounts (QNA) data for the first half of 2011 were stronger than anticipated for real GDP. This means that the SPU outlook for real GDP growth this year of 0.8 per cent looks achievable, even with flat GDP in the second half of the year. That said, the QNA data are volatile, and more recent monthly and international indicators have been weak.

The most recently available growth forecasts were published by the Central Bank of Ireland in October 2011. These forecasts have the advantage that they incorporate both the recent QNA data and the softening of global growth prospects. Overall, the Central Bank projects real GDP growth of 1 per cent for 2011, marginally higher than the SPU forecast (0.8 per cent). Of potentially greater significance for the budgetary projections, however, is the Central Bank forecast for a 0.2 per cent decline in nominal GDP in 2011. This compares with a forecast of 1.4 per cent growth in nominal GDP in the SPU. For 2012, the Central Bank forecasts that real and nominal GDP will grow by 1.8 and 2.2 per cent respectively. For the purposes of updating the SPU to reflect recent developments, the Council uses the Central Bank growth forecasts for 2011 and 2012, and the SPU forecasts for 2013-2015.

## Assessment of Budgetary Developments

The SPU budgetary projections to 2015 were broadly appropriate at the time of publication, albeit with some downside risks.

For 2011, the projected General Government deficit target of 10 per cent of GDP looks achievable given Exchequer tax and expenditure data in the first three quarters of the year and reduced interest expenditures. Much will depend, however, on revenue developments in the final quarter of the year.

There have been significant developments that impact on the budgetary projections since the SPU was published in April. Although details are still to be finalised, the National Treasury Management Agency estimates that changes agreed by European leaders in July 2011 will lower the average interest rate on outstanding debt by 0.3 percentage points in both 2011 and 2012. The average interest rate will be 0.4-0.5 percentage points lower for 2013-2015. When compared with the SPU, this will result in interest savings of approximately €1 billion per year between 2012 and 2014.

Successful private capital raising by Bank of Ireland and greater than anticipated burden sharing with junior bond holders resulted in savings of €3.5 billion on the costs of bank recapitalisation.

On the downside, the lower path for nominal GDP has caused some deterioration in the deficit outlook for 2012-2015. Based on the Exchequer returns for the first three quarters of this year, the Council anticipates that both the projected General Government deficit and nominal primary deficit targets for 2011 will be achieved, despite the small fall in nominal GDP expected for this year.

The Council has developed a 'fiscal-feedback model' which suggests that the General Government deficit target of 10 per cent of GDP for 2011 will most likely be achieved. However, available data and estimates suggest that the 8.6 per cent of GDP deficit target for 2012 would be narrowly missed. However, it must be stressed that there is a substantial degree of uncertainty around these projections and the Council looks forward to the Government's Pre-Budget Outlook bringing further clarity to the impact of the post-SPU developments.

Combining the various post-SPU developments, the discretionary deficit adjustments outlined in the SPU should be sufficient to bring the General Government deficit below 3 per cent of GDP by 2015. However, based on currently available information, the Council assesses that an additional discretionary adjustment of approximately €400 million would be required in Budget 2012 to meet the 8.6 per cent of GDP target for 2012.

## Assessment of the Fiscal Stance

The Government faces an unenviable balancing act in deciding the appropriate fiscal stance to be included in the forthcoming Pre-Budget Outlook and subsequently Budget 2012. The domestic economy remains weak, while prospects for export growth are clouded by uncertainties in both the European and global environments. Unemployment looks set to remain very high for some years ahead, although the gap between the potential and actual output of the economy should decline over time. Further pro-cyclical measures would tend to increase this output gap.

Nevertheless, under current plans the debt situation will remain fragile for some time to come, with the debt to GDP ratio projected to decline slowly from a very high level in 2015. This level of debt leaves the economy vulnerable to adverse shocks to funding and growth.

Weighing up the different elements involved, retaining the current SPU deficit targets as a percentage of GDP is viewed as within the range of appropriate courses of action. Relaxing these targets is not considered to be a viable option, given the need to safeguard hard won gains and the creditworthiness constraints imposed by both the market and official creditors.

While staying the course with current programme targets is one possibility, after considering various relevant factors, the Council sees a strong argument for strengthening the fiscal consolidation effort beyond that targeted in the SPU. In particular, the current targets would leave the debt to GDP ratio on a relatively slow downward path. The Council believes that a General Government deficit target of the order of 1 per cent of GDP for 2015 would be appropriate, which compares to the current SPU target of 2.8 per cent.

This suggestion is not made lightly, given the major painful adjustment measures already taken since 2008. On balance, however, the Council believes that a more rapid restoration of sound public finances, as well as being highly desirable in its own right, will have important favourable effects on the country's creditworthiness. It would also provide a degree of insurance that the existing programme targets will be met. The longer term implications for the economic and financial health of the country should not be underestimated.

For the four-year period 2012-2015, the suggested adjustment profile would imply total adjustment measures of €4 billion when post-SPU adjustments are also taken into account (see Summary Table). In the case of 2012, the suggested adjustment path would require only a relatively modest reduction in the targeted General Government deficit, from 8.6 to 8.4 per cent of GDP. However, this would imply increasing the required adjustment measures from

the SPU plan from €3.6 billion to €4.4 billion once the post-SPU developments are included. Most importantly, the primary surplus reaches 4.7 per cent of GDP in 2015, compared to 2.9 per cent under the updated SPU. This implies that the debt ratio would be falling by an additional 1.8 percentage points per year, even in the absence of any additional post-2015 adjustment.

**Summary Table: Alternative General Government Deficit Targets and Discretionary Adjustments**

	2012	2013	2014	2015
<b>General Government Deficit Target (GGD) (% of GDP)</b>				
Original GGD Targets in SPU	8.6	7.2	4.6	2.8
Alternative Deficit Targets to get to GGD of 1% in 2015	8.4	6.4	3.6	1.0
<b>Estimated Discretionary Deficit Adjustments (€ Billions)</b>				
Planned Adjustment in SPU	-3.6	-3.1	-3.1	-2.0
Additional Adjustment Required for Original Targets	-0.4	0.4	-0.1	0.0
Additional Adjustment Required for Alternative Targets	-0.4	-1.2	-0.6	-1.7
<b>Total Additional Adjustment</b>	<b>-0.8</b>	<b>-0.8</b>	<b>-0.7</b>	<b>-1.7</b>
<b>Total Adjustment Required to Reach a 1% GGD in 2015</b>	<b>-4.4</b>	<b>-3.9</b>	<b>-3.8</b>	<b>-3.7</b>

Uncertainty about the future of the economy and fiscal burdens can lead to high levels of precautionary saving. This points to the need to provide as much certainty as possible in regard to the details of the planned adjustments. Another argument for providing details of the measures to be taken is that it helps reinforce market-and official-lender confidence. While a government might announce ambitious plans for reducing the deficit, it might not be evident in advance that they have the political capacity to push through with the adjustments once specific painful measures are announced. Providing detail on the proposed adjustments helps build confidence that the Government has the capacity to impose losses on specific groups. While the Council recognises the practical and political difficulties of outlining the details of multi-year measures in advance, the Council recommends that the Government errs on the side of providing as much detail as possible in the upcoming Pre-Budget Outlook and Budget 2012, going beyond the high-level revenue and current and capital expenditure figures outlined in the SPU.

At the same time, it is important for policymakers not to reduce their margins of manoeuvre to achieve the necessary consolidation by selectively putting certain measures – e.g., tax rates, social welfare rates, and public sector pay rates – out of bounds. This may make future decisions in other areas more complicated as well as detracting from the credibility of overall plans.





## 1. Introduction

This Fiscal Assessment Report is the first report of the Irish Fiscal Advisory Council (hereafter referred to as 'The Council'). The report assesses the macroeconomic and budgetary projections set out by the Government in the Stability Programme Update (SPU) in April 2011 including the appropriateness of the overall fiscal stance. As it is beyond the Council's mandate to produce an independent set of macroeconomic forecasts, a range of existing forecasts serve as a benchmark for making this assessment. Over time, it is envisaged that the Council will expand its analysis to include an evaluation of the soundness of the models and methodologies behind the SPU and Budgetary projections.

In Chapter 2, the Council reviews macroeconomic forecasts that have been produced by the Economic and Social Research Institute (ESRI), the Central Bank of Ireland, the International Monetary Fund (IMF) and the European Commission (EC) since the publication of the SPU. It considers whether, and to what extent, revisions to the SPU forecasts may be appropriate for framing Budget 2012 and the budgetary trajectory for 2012-2015.

Chapter 3 first summarises the budgetary outlook for 2011-2015 as set out in the SPU. Since the publication of the SPU, a number of alternative fiscal forecasts for 2011 (and partly for subsequent years) have been published, principally by the IMF, the EC and the ESRI. Exchequer data for the first three quarters of 2011 have also been released and these are reviewed. In addition, this chapter analyses the quantitative impact of several significant economic developments affecting the budgetary outlook since the publication of the SPU: the revision of nominal GDP for 2010; the EU Council Agreement in July, which will result in much lower interest costs on EU-related borrowing; and the lowering of the financing requirement to meet banking recapitalisation needs.

Chapter 4 provides a discussion of the appropriateness of the Government's fiscal stance, referring to the targets for the General Government deficit for the period 2012-2015. The restoration of the public finances, the enhancement of the credibility and creditworthiness of the State, as well as domestic demand concerns are weighed in assessing the appropriate fiscal stance. The report indicates the likely levels of discretionary adjustments that now appear to be required to meet the budgetary targets that the Council judges appropriate.

## 2. Macroeconomic Assessment

### 2.1 Introduction

A key element of the Council's mandate is to provide an assessment of the soundness of the macroeconomic projections set out by the Government in the annual budget and the Stability Programme Update (SPU). Since a considerable time has passed since the publication of the SPU in April 2011 (before the establishment of the Fiscal Council), this report does not provide an assessment of the projections prepared at that time. Rather, it concentrates on assessing the extent to which, in light of intervening developments, the SPU forecasts merit revision at this stage.

The chapter is structured as follows. In Section 2.2, the SPU forecasts for the short term (2011 and 2012) are set out. In Section 2.3, the most recent forecasts from the following four agencies: the ESRI, the IMF, the EC and the Central Bank are discussed, with the main emphasis on the 2011 and 2012 period. In Section 2.4, the Council assesses the extent to which growth needs to be revised in formulating Budget 2012, before Section 2.5 concludes.

### 2.2 Stability Programme Update: 2011-2012

As shown in Table 2.1, the SPU envisaged that real GDP would grow by 0.8 per cent in 2011 and by 2.5 per cent in 2012. In both years GNP was projected to grow more moderately, by 0.3 per cent and 2 per cent respectively.

Analysis of these forecasts by expenditure heading reveals the two track (i.e., domestic demand and net exports) experience of the Irish economy in recent years. For 2011, all three components of domestic demand were forecast to fall. Private consumption has fallen each year since 2008 and another decline was envisaged for 2011, before consumption was expected to stabilise in 2012. Investment has also been falling since 2008, with an extraordinary fall of over 28 per cent recorded in 2009. The Department of Finance anticipated another double-digit fall in investment for 2011, at 11.5 per cent, but envisaged a modest pick-up in 2012. While consumption was expected to stabilise in 2012 and investment was expected to increase, public consumption was also forecast to fall in both 2011 and 2012 as a result of the on-going austerity programme.

The rebound in exports which began in 2010, when exports grew by 6.3 per cent, was forecast by the Department of Finance to persist and, indeed, to strengthen marginally in 2011. Export growth was forecast at 6.8 per cent in 2011 while imports were expected to grow by 4.7 per cent. This positive net export performance in 2011 was expected to be sufficiently strong to offset



the negative impact of falling domestic demand on growth. As a result, the Department anticipated positive GDP growth of 0.8 per cent in 2011. For 2012, another year of strong export growth was envisaged with export growth of 5.7 per cent. With domestic demand no longer falling in 2012, according to the SPU forecast, this export growth was expected to translate into more robust GDP growth of 2.5 per cent in 2012.

**Table 2.1: Macroeconomic Prospects 2011 and 2012**

% change unless otherwise stated	SPU		CBI		ESRI		EC		IMF	
	April 2011		October 2011		Sept 2011		Sept 2011		Sept 2011 <sup>1</sup>	
	2011	2012	2011	2012	2011	2012	2011	2012	2011	2012
Real GDP	0.8	2.5	1.0	1.8	1.8	2.3	0.6	1.9	0.4	1.5
Real GNP	0.3	2.0	-0.4	0.7	0.2	0.7				
Consumption	-1.8	0.0	-2.6	-0.8	-1.3	0.0	-2.4	-1.0	-2.4	-0.4
Investment	-11.5	1.0	-9.2	-0.5	-6.7	-2.8	-10.7	1.6	-10.7	1.3
Government	-3.0	-2.3	-3.8	-3.6	-3.3	-4.0	-3.0	-1.5	-3.6	-1.9
Exports	6.8	5.7	5.3	5.2	7.0	7.4	6.0	5.2	6.0	5.2
Imports	4.7	4.1	2.7	3.2	4.9	5.8	3.2	3.8	3.0	4.0
Current account (% GDP)	1.2	2.1	0.3	2.0	1.0	1.6	1.8	2.7	1.8	1.9
Employment	-1.6	0.5	-1.7	0.1	-2.4	0.7	-1.9	-0.1	-1.5	0.7
Unemployment rate	14.4	13.7	14.2	14.0	14.3	14.5	14.3	13.8	14.3	13.9
HICP Inflation	1.0	0.9	1.2	0.7	1.3	1.0	1.1	0.6	1.1	0.6
Nominal GDP (€bn)	156.1	160.9	155.7	159.1	157.2	161.1	157.7	162.1	157.7	162.2
Nominal GDP (% change)	1.4	3.1	-0.2	2.2	0.7	2.5	1.1	2.8	1.1	2.8

Sources: SPU, April 2011; Central Bank of Ireland Quarterly Bulletin 4, 2011; ESRI Quarterly Economic Commentary, Summer 2011; IMF Country Report for Ireland No. 11/276 and IMF Fiscal Monitor September 2011; EC Economic Adjustment Programme for Ireland Summer 2011 Review, Occasional Papers 84, September.

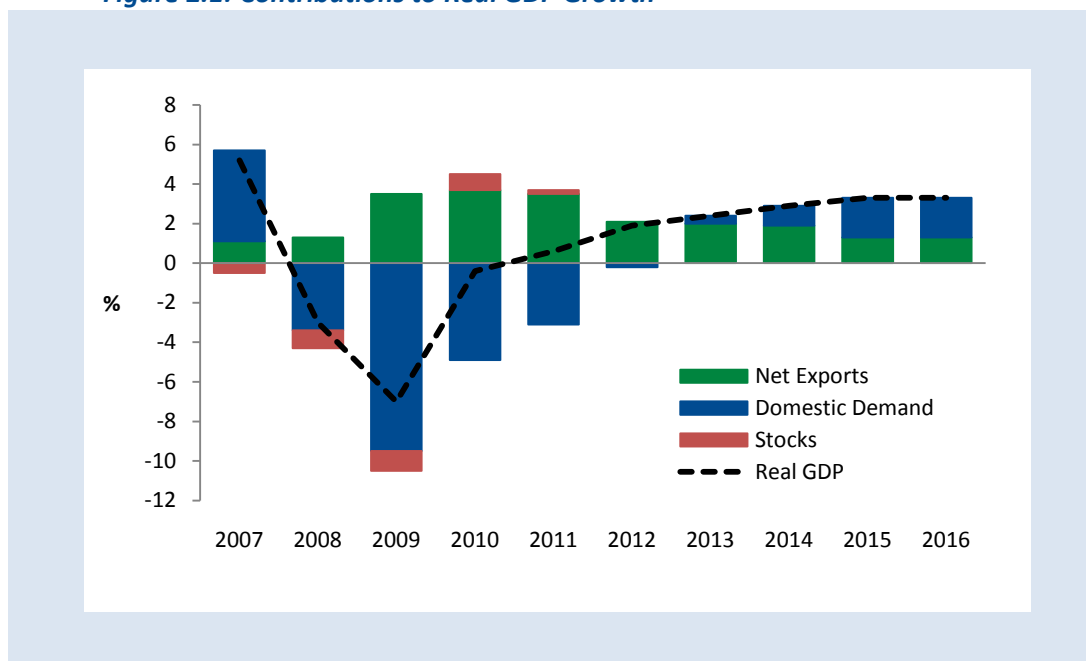
Although the SPU forecast envisaged a return to positive GDP growth in 2011, the slow pace of growth and its export intensity meant that employment was expected to contract further. The level of employment was forecast to fall by 1.6 per cent and the annual average rate of unemployment was expected to increase from 13.6 per cent in 2010 to 14.4 per cent in 2011. For 2012, a return to employment growth was anticipated with growth of 0.5 per cent forecast. The rate of unemployment was expected to fall to 13.7 per cent.

<sup>1</sup> The World Economic Outlook, published by the IMF in late September 2011, contained forecasts for Ireland for real GDP growth, the current account as a percentage of GDP, the unemployment rate and HICP. The remaining IMF forecasts displayed in Table 2.1 are taken from IMF Country Report No. 11/276 which was also published in September 2011.

## 2.3 Recent Forecasts

Since the publication of the SPU, a number of forecasts have been produced by the IMF, the EC, the Central Bank and the ESRI. Central to these projections is the expected outlook for domestic demand. Figure 2.1 plots the contributions to GDP growth using the September IMF forecast. The twin-track experience of the Irish economy is evident, with domestic demand exerting a sharply negative influence on growth since 2008 which more than offset the positive contribution from net exports, with this pattern projected to unwind over the medium term.

**Figure 2.1: Contributions to Real GDP Growth**



Source: IMF Country Report for Ireland No. 11/276.

### 2011

From Table 2.1 it can be seen that the most recent forecasts from the EC and the IMF point to a less optimistic outlook for 2011 when compared to the SPU. Both the IMF and the EC published forecasts in September in which they shared the view that real GDP would grow by about 0.5 per cent in 2011, lower than the SPU forecast of 0.8 per cent. The Central Bank, in its October publication,<sup>2</sup> projected real GDP growth of 1 per cent in 2011. This was an upward revision to its previous forecast when they had expected real GDP to grow by 0.8 per cent. This upward revision seems warranted due to the rates of growth that emerged from the publication of the latest CSO Quarterly National Accounts (QNA) data for the second quarter of 2011. While the Central Bank has raised its forecast for real GDP in 2011, it has lowered its

<sup>2</sup> Quarterly Bulletin 4, 2011.

forecast for the GDP deflator (from -0.7 per cent to -1.1 per cent). This revision partly reflected changes in the relative prices for imports and exports, due to energy price changes and currency movements in the first half of the year. This revision to the deflator is important because it means that the Central Bank's forecast for nominal GDP in 2011 is now lower than the 2010 outturn (-0.2 per cent). A more detailed discussion of revisions to Irish growth forecasts is presented in Box 2.1.

For 2012, the Central Bank forecasts a return to positive nominal GDP growth (2.2 per cent). The performance of nominal GDP, which is central to the budgetary projections, is discussed in Chapter 3.

The ESRI published their latest forecast before the release of the latest QNA data but, even then, they were relatively more optimistic about the prospects for growth than other agencies. The ESRI projects that real GDP will grow by 1.8 per cent in 2011,<sup>3</sup> driven largely by its outlook for consumption. All the agencies included in Table 2.1 expect consumption to fall in 2011 but the ESRI expects a decline of just 1.3 per cent. This would be a lower rate of decline compared to the SPU forecast of -1.8 per cent. The Central Bank, the EC and the IMF anticipate a faster rate of consumption decline relative to the SPU, with all envisaging a fall of about 2½ per cent in 2011.<sup>4</sup> The ESRI is also more optimistic on export growth in 2011 and projects a growth rate of 7 per cent. The SPU figure was 6.8 per cent but the Central Bank, the EC and the IMF all hold a less positive view as of September/October with their export forecasts now ranging from 6 per cent to 5.3 per cent.

Despite the ESRI's relative optimism on the prospects for real GDP growth in 2011, it is the most pessimistic of the agencies in Table 2.1 on the outlook for employment. The ESRI expects employment to fall by 2.4 per cent in 2011 which represents a faster rate of employment decline relative to that forecast in the SPU (-1.6 per cent). The forecasts of the Central Bank, the EC and the IMF range between -1.9 and -1.5 per cent. Thus, the SPU figure falls within the range of the non-ESRI forecasters.

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<sup>3</sup> The SPU forecast for real GNP growth in 2011 was 0.3 per cent. While the EC and IMF do not provide a GNP forecast, the ESRI and the Central Bank do. The latest ESRI forecast (0.2 per cent) is almost identical to the SPU forecast. However, the Central Bank expects real GNP to decline by 0.4 per cent in 2011.

<sup>4</sup> Exchequer data released in October, which is discussed in Chapter 3, showed that consumption remains weak. VAT returns were running 3.6 per cent behind expectations. The CSO Retail Sales Index, which was published in September 2011, showed that the volume of retail sales decreased by 3.6 per cent year-on-year in August 2011 and were also down 1.5 per cent in the three month period to August 2011 compared to the same period last year. The demand for property also remains weak. The CSO Residential Property Price Index, which was published in September 2011, showed that in the year to August residential property prices fell by 13.9 per cent nationally.

## 2012

The SPU forecast real GDP growth of 2.5 per cent in 2012. Table 2.1 shows that the corresponding, and more recent, forecasts of the other agencies are relatively lower. The ESRI expects real GDP to grow by 2.3 per cent in 2012 while the Central Bank projects growth of 1.8 per cent. The EC and the IMF expect real GDP growth of 1.9 per cent and 1.5 per cent in 2012 respectively.

In terms of the outlook for GNP in 2012, the forecasts are as follows: SPU: 2 per cent; ESRI: 0.7 per cent; Central Bank: 0.7 per cent. This means that the difference in forecasts for 2012 between the SPU and the ESRI/Central Bank is greater in GNP terms than in GDP terms. As GNP is likely to be more tax sensitive than GDP, this difference is potentially important from a public finance perspective.

As is the case with the 2011 projections, much of the differences across the growth projections can be traced to forecasts for consumption. The SPU projected that consumption would stabilise in 2012. Only the ESRI now shares that view, with the other three agencies forecasting on-going declines ranging from -0.4 per cent in the case of the IMF to -1 per cent in the case of the EC.

The forecast for 2012 export growth in the SPU was 5.7 per cent but the other agencies now differ on whether this forecast is too low or too high. The ESRI is more optimistic on this element of demand and forecasts an export growth rate of 7.4 per cent. However, the Central Bank, the EC and the IMF are less optimistic on exports for 2012, with all three forecasting growth rates of 5.2 per cent.

The SPU forecast a return to employment growth in 2012 but there is not unanimity across the agencies on this point. The EC expects employment to continue to decline in 2012. However, other forecasters expect employment to grow; the ESRI and the IMF expect an increase of 0.7 per cent. Were this to be realised, it would be above the SPU forecast of 0.5 per cent. The most recent Central Bank forecast envisages a modest increase in employment of 0.1 per cent in 2012.

## 2013-2015

In Table 2.2, a comparison of forecasts for the years 2013-2015 from the SPU and the September publications of the EC and the IMF are provided.<sup>5</sup> The SPU forecast that GDP would grow by 3 per cent in each of the three years 2013-2015. While both the EC and the IMF are now more pessimistic about growth prospects in 2013 compared to the SPU (2.4 per cent for both the EC and IMF

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<sup>5</sup> The ESRI has not published a medium-term forecast in the past few months while the Central Bank only publishes short-term forecasts.

versus 3 per cent for the Department), it seems reasonable to conclude that the EC and the IMF have not diverged in any noteworthy way from the medium-term picture presented in the SPU. Table 2.2 shows that forecasts for nominal GDP in 2015 lie within a very tight range, from €183 billion to €185 billion.

### **Box 2.1: Irish Growth Forecasts**

There are a number of institutions currently producing growth forecasts for the Irish economy. The ESRI and the Central Bank of Ireland (CBI) typically produce four sets of forecasts per year. The Department of Finance produces forecasts in the Pre Budget Outlook and in the annual Budget. As part of the move towards the European Semester,<sup>6</sup> the Department is now also required to submit a Stability Programme Updates (SPU) in April of each year. Prior to this, the SPU, which also contains a set of macroeconomic forecasts, was published with the annual Budget. Since 2010, the IMF and the EC have begun to produce forecasts for Ireland on a more regular basis than was previously the case. In this Box, the degree to which forecasts have been revised over the past 18 months is considered.

#### 2011

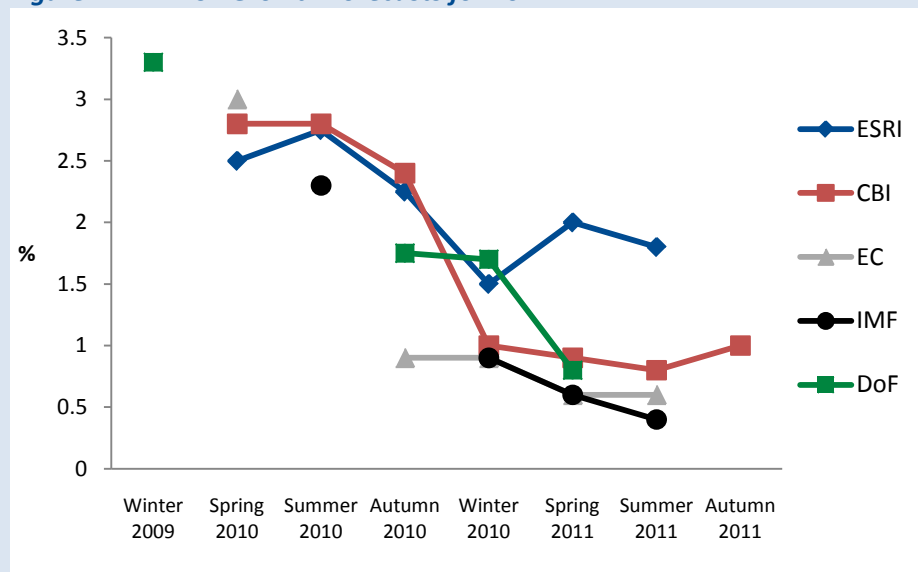
Figure 2.1.A shows GDP growth forecasts for 2011, starting with the Budget 2010 projection of 3.3 per cent. The forecasts that emerged in the first half of 2010 from the ESRI, the CBI and the EC were lower, with GDP growth expected to be between 2.5 per cent and 3 per cent in 2011. Further downward revisions were implemented by these agencies throughout 2010, driven by increasingly weaker prospects for domestic demand. By December 2010, the Department of Finance's 2011 forecast was adjusted to 1.7 per cent, before being revised downwards again to 0.8 per cent in April 2011. By the spring of 2011, the Department of Finance's forecast was close to those of the IMF, the EC and the CBI which ranged between 0.6 per cent and 0.9 per cent. The ESRI forecast, however, was higher at 2 per cent. In the summer of 2011 both the ESRI and the CBI revised their GDP forecasts further to 1.8 per cent and 0.8 per cent respectively. The IMF published another downward revision to its GDP forecast in September 2011. In October of this year, however, the CBI revised its GDP forecast for 2011 upwards by 0.2 per cent.

The general pattern suggests that as more information has become available, forecasts for 2011 GDP growth have been revised downwards systematically.

<sup>6</sup> The economic crisis revealed a need for stronger economic governance and coordination at EU level. A new governance architecture, the European semester, was approved by EU Member States in September 2010. As part of the new structure, the EU and the euro area will coordinate *ex ante* their budgetary and economic policies, in line with both the Stability and Growth Pact and the Europe 2020 Strategy.

The ESRI and the CBI were the only agencies to have diverged from this path.

**Figure 2.1.A: Irish Growth Forecasts for 2011**



## 2012

The degree to which GDP forecasts for 2012 have been revised is displayed in Figure 2.1.B. The IMF began forecasting 2012 GDP growth in the summer of 2010 while the EC issued their first such forecast in the autumn of 2010. The Central Bank, the ESRI and the Department of Finance issued similar forecasts 3 months later. It is also evident from Figure 2.1.B that downward revisions have been made by the Central Bank in each of their latest three forecasts, from 2.3 per cent in January 2011 to 1.8 per cent in October. The Department of Finance’s projection was revised downwards by 0.7 per cent between December 2010 and April 2011, driven mainly by a large downward revision of investment expectations. The IMF’s initial forecast for 2012 was 2.5 per cent. This has since been revised downwards to 1.5 per cent, 0.4 per cent lower than that of the EC. The downward revision was due to lower expectations for private consumption.

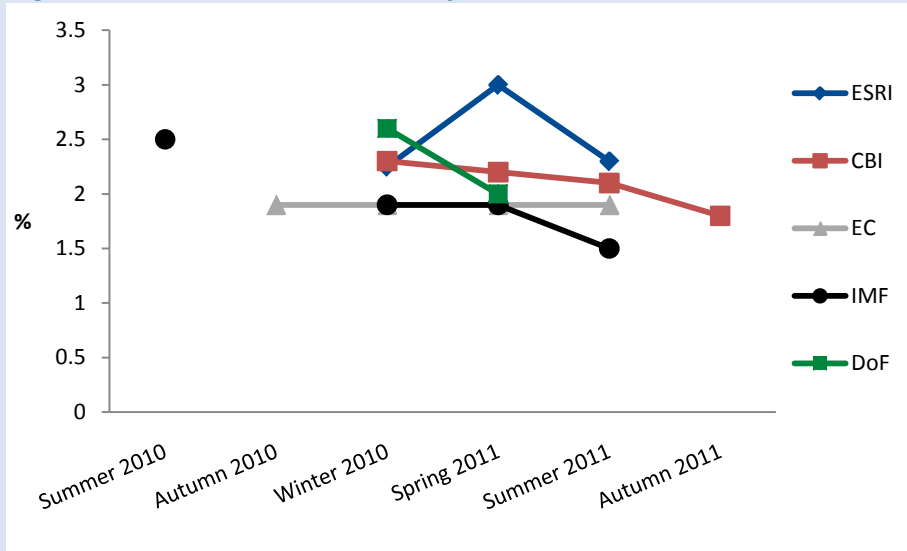
As was the case with the 2011 forecasts, the ESRI’s spring 2011 forecast was revised upwards and was also the highest of all forecasts issued at that time. The ESRI has since been revised GDP growth downwards to 2.25 per cent, due mainly to weaker domestic demand expectations.

## 2013-2015

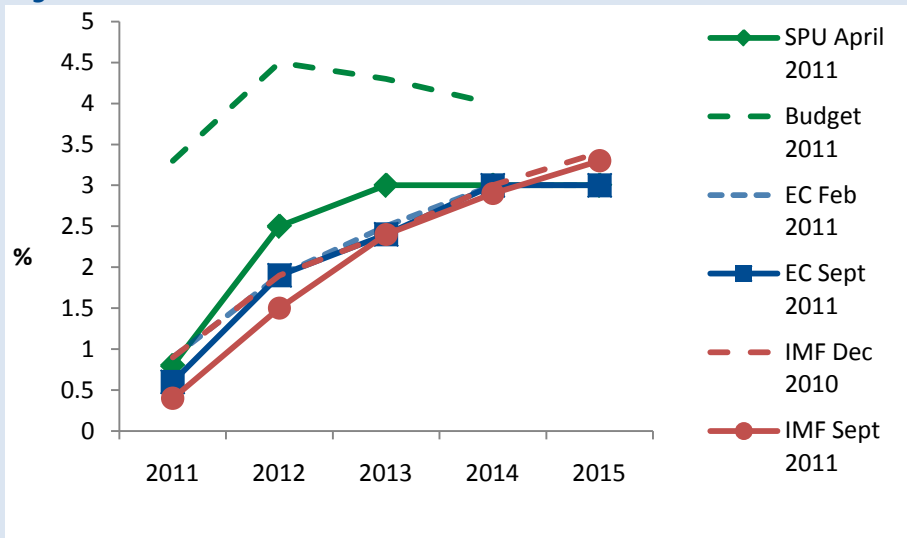
The Department of Finance, the IMF and the EC issue forecasts for GDP growth out to 2015. Figure 2.1.C shows that these medium term forecasts have also been subjected to downward revisions in recent months. The IMF and the EC have implemented minor revisions to date. The Department of

Finance’s forecast, however, was revised significantly downward since the publication of Budget 2011. There is a growing consensus that GDP will grow by approximately 3 per cent per annum in both 2014 and 2015.

**Figure 2.1.B: Irish Growth Forecasts for 2012**



**Figure 2.1.C: Growth Forecasts 2011-2015**



**Table 2.2: Macroeconomic Prospects 2013-2015**

% change unless otherwise stated	SPU April 2011			EC Sept 2011			IMF Sept 2011		
	2013	2014	2015	2013	2014	2015	2013	2014	2015
Real GDP	3.0	3.0	3.0	2.4	3.0	3.0	2.4	2.9	3.3
Real GNP	2.5	2.5	2.6						
Consumption	1.0	1.3	1.4	0.5	1.8	1.7	0.5	1.2	2.2
Investment	4.4	5.1	5.5	4.8	5.1	5.5	3.5	6.0	9.0
Government	-2.2	-2.2	-2.0	-3.0	-4.8	-2.9	-1.5	-1.5	0.0
Exports	5.0	4.5	4.1	4.9	4.9	4.9	5.1	5.0	4.9
Imports	3.7	3.3	3.1	3.7	3.7	4.1	4.2	4.3	4.9
Current account (% GDP)	3.0	3.7	4.1	3.2	4.0	4.7	2.0	1.7	1.3
Employment	1.2	1.8	2.0	0.5	1.3	2.2	1.9	1.8	2.1
Unemployment rate	12.7	11.5	10.0	13.3	12.6	11.5	13.0	12.3	11.2
HICP Inflation	1.5	1.7	1.8	1.4	1.6	1.8	1.4	1.6	1.8
Nominal GDP (€bn)	167.4	174.7	182.7	168.3	176.1	184.7	168.4	176.0	185.0
Nominal GDP (% change)	4.0	4.3	4.6	3.8	4.6	4.9	3.8	4.5	5.1

Source: See Table 2.1.

## 2.4 Suggested Direction of Revisions to the SPU

### 2011

In framing Budget 2012, an estimate for the outturn for 2011 will be needed. With the exception of the Central Bank, all of the forecasts for 2011 were produced before the publication of the second quarter QNA which showed that GDP grew by 1.6 per cent (quarter-on-quarter, seasonally adjusted) between Q1 and Q2. In addition, growth for Q1 was revised upwards and the CSO report that GDP grew by 1.9 per cent (quarter-on-quarter, seasonally adjusted) between Q4 2010 and Q1 2011.

These data proved a positive surprise to most observers and suggested that, even if there was modestly negative growth during the second half of 2011, compared to the second half of 2010, year on year growth would quite easily turn out to match, or exceed, the SPU estimate of 0.8 per cent. It should be noted, however, that quarterly GDP data are volatile, with special factors such as stock-building sometimes distorting the true underlying trend.<sup>7</sup> The QNA

<sup>7</sup> For example, non-seasonally adjusted stocks grew by €750 million between Q1 2011 and Q2 2011 compared to €21 million between Q4 2010 and Q1 2011.



growth figures are also subject to revision. The magnitude and direction of revisions to recent QNA GDP and GNP growth figures are shown in Table 2.3.

**Table 2.3: QNA Revisions in 2010 and 2011**

		Annual GDP	Annual GNP	Quarterly GDP	Quarterly GNP
Q1 2011	Provisional	0.1	-0.9	1.3	-4.3
	Revision	0.3	1	1.9	-3
Q4 2010	Provisional	-0.7	2.8	-1.6	-2
	Revision	-0.2	4.8	-1.4	0.6
Q3 2010	Provisional	-0.5	-1.6	0.5	1.1
	Revision	0.3	2.7	0.2	2.6
Q2 2010	Provisional	-1.8	-4.1	-1.2	-0.3
	Revision	-0.7	-1.9	-0.4	1

*Note: Provisional estimates are the first published estimates for a specific quarter. For example, the Q1 2011 provisional estimate was published on 23 June 2011. The revised estimates are those that were published at a later date. All of the revised estimates included in this table were published on 22 September 2011 with the release of the Q2 2011 figures.*

Given the apparent slowdown in many of Ireland's trading partners and the growing uncertainty arising from the sovereign debt crisis, a stalling in economic activity cannot be ruled out and a decline may even be possible in the latter part of 2011. For example, the most recent data from the CPB<sup>8</sup> World Trade Monitor (shown in Figure 2.2) showed that world trade has been effectively flat in the most recent three month period to end-July 2011.

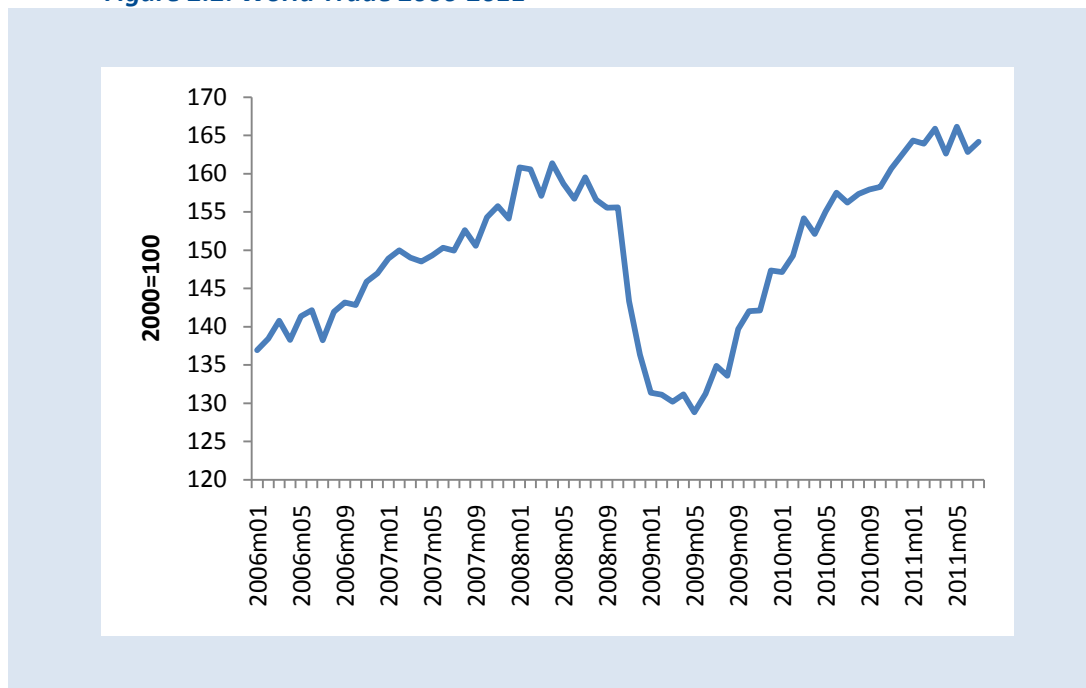
In the latest World Economic Outlook, the IMF reported that both global activity and confidence have weakened. Global growth is now projected to slow from 5.1 per cent in 2010 to 4.0 per cent in 2011 and 2012.<sup>9</sup> The outlook for advanced economies (and hence Ireland's main trading partners) is worse with real GDP expected to grow by only 1.6 per cent in 2011 and 1.9 per cent in 2012.

Combining these considerations, the Council thinks that a marginal upward revision to the SPU forecast for 2011 may be warranted, such as the revision made by the Central Bank in its latest forecast for real GDP growth.

<sup>8</sup> Netherlands Bureau for Economic Policy Analysis.

<sup>9</sup> The forecasts for World output were revised downwards by 0.3 per cent for 2011 and 0.5 per cent for 2012 since the June publication of the World Economic Outlook.

**Figure 2.2: World Trade 2006-2011**



Source: World Trade Monitor.

## 2012

For 2012, it appears that the rate of GDP growth will be lower than that envisaged at the time of the SPU (2.5 per cent) and so a downward revision seems appropriate. The on-going uncertainty in European sovereign debt markets looks set to persist and possibly to worsen. This is likely to depress both consumer and investor confidence throughout Europe and also in the US. To the extent that any solution to the debt crisis will involve accelerated austerity on the parts of national governments, this too will weigh down on international growth prospects.

One possible factor that would lead to an upward revision in 2012 forecasts is interest rates. For much of 2011, forecasts have been based on an expectation that the European Central Bank would be raising rates during 2011 and into 2012. While this process had begun, there is now an expectation that the process will not be pursued further in the near term and that cuts in rates could even be possible.

## 2013-2015

The similarities in the forecasts across the SPU, the EC and the IMF (as outlined in Table 2.2), suggest that no radical alteration is required to forecasts for 2013 to 2015, for the purposes of framing Budget 2012. When looking out to 2015, in particular, forecasts of GDP tend to be influenced by one's view of potential output as opposed to the movements in the

components of aggregate demand. In Chapter 3, the question of potential output is considered in more detail.

## 2.5 Conclusion

The macroeconomic forecasts within the SPU were broadly appropriate at the time of publication. Since April, however, most of the main forecasting agencies have revised projected growth rates for Ireland downwards, in part reflecting increasing uncertainties about the global economic environment.

There have been very significant data revisions by the CSO, notably with nominal GDP in 2010 revised upwards by 1.3 per cent. In addition, the most recent preliminary QNA data for the first half of 2011 were stronger than anticipated for real GDP. This means that the SPU outlook for real GDP growth this year of 0.8 per cent looks achievable, even with flat GDP in the second half of the year. That said, the QNA data are volatile, and more recent monthly and international indicators have been weak.

For the purposes of updating the SPU to reflect recent developments, the Council uses the Central Bank growth forecasts for 2011 and 2012, and the SPU forecasts for 2013-2015.

## 3. Budgetary Assessment

### 3.1 Introduction

This chapter assesses the budgetary outlook set out in the Stability Programme Update (SPU), which is the most recent Government publication on budgetary projections. Since the publication of the SPU, a number of fiscal forecasts have been published, principally by the IMF, the EC and the ESRI, which are compared with the SPU outlook in this chapter. Furthermore, there have been several significant developments, particularly the EU Council Agreement in July which will result in lower interest costs on EU-related borrowing. Financing costs to meet banking recapitalisation needs are also now likely to be lower than previously anticipated. In addition, the level of nominal GDP in 2010 was revised upwards by approximately €2 billion to €156 billion. All of these developments need to be quantified. In Section 3.2, a brief summary of the SPU is provided, while the fiscal outlook for 2011 is assessed in Section 3.3. In Section 3.4, the medium-term budgetary projections are examined, with debt dynamics outlined in Section 3.5. The effects of the latest developments on the fiscal outlook are assessed in Section 3.6.

### 3.2 The Stability Programme Update

The principal SPU budgetary projections for 2011 to 2015 are set out in Table 3.1.<sup>10</sup> The projections for 2011 include the €5.3 billion (3.4 per cent of GDP) permanent consolidation package announced as part of Budget 2011, comprising €3.9 billion in expenditure based measures and revenue adjustments amounting to €1.4 billion. These measures resulted in a projected General Government deficit (GGD) of 10 per cent of GDP in 2011 and a Gross Debt to GDP ratio of 111 per cent. The latter included a provision for €10 billion in Exchequer funding for bank recapitalisation.

The cyclically adjusted estimates in the SPU projected a structural budget deficit of 8.3 per cent of GDP in 2011, a decline of 1.7 percentage points from 2010. However, structural budget estimates for Ireland are subject to a high degree of uncertainty at present (see Box 3.1). Consequently, in this report the Council focuses on nominal budgetary adjustments and the targeted GGD.

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<sup>10</sup> The Government will publish updated budgetary projections in the Pre-Budget Outlook (PBO) ahead of Budget 2012.

**Table 3.1: SPU Budgetary Outlook to 2015**

€ Billions	2011	2012	2013	2014	2015
Gross Debt	173.2	186.6	197.5	202.6	202.8
Change in Gross Debt	26.3	13.4	10.9	5.1	0.2
Primary Deficit	9.7	6.3	1.8	-3.0	-6.2
Interest Expenditure	5.9	7.6	10.3	11.1	11.3
Stock-flow Adjustment	10.7	-0.5	-1.2	-3.0	-4.9
Nominal GDP	156.1	160.9	167.4	174.7	182.7
Nominal GDP Growth (%)	1.4	3.1	4.0	4.3	4.6
Gross Debt to GDP (%)	111.0	116.0	118.0	116.0	111.0
Primary Deficit /GDP (%)	6.2	3.9	1.1	-1.7	-3.4
General Government Deficit/GDP (%)	10.0	8.6	7.2	4.6	2.8
Structural Budget Deficit/GDP (%)	8.3	8.1	7.7	5.9	4.6
<i>Memo items:</i>					
Assumed Discretionary Fiscal Adjustment	-6.0	-3.6	-3.1	-3.1	-2.0
Implicit interest rate (%)	4.0	4.4	5.5	5.6	5.6

*Notes: The €6 billion budgetary adjustment for 2011 contains €0.7 billion of temporary measures. The adjustment for 2012 includes a carryover of €0.6 billion from 2011 measures. Source: SPU and internal calculations. Rounding may affect totals.*

### 3.3 Budgetary Outlook in 2011

#### 3.3.1 Exchequer Outturn to end-September

Since the publication of the SPU, the main source of budgetary information has been the monthly Exchequer returns, which can be compared with planned tax and expenditure levels.<sup>11</sup> So far this year, the Exchequer tax and expenditure data have performed broadly in line with Department of Finance expectations. Furthermore, the second quarterly review of Ireland by the EU/IMF (which was completed in July), confirmed that the fiscal quantitative criteria were met in the first half of the year.<sup>12</sup>

The latest Exchequer outturn for the third quarter of 2011 shows that taxes were up 8.7 per cent year-on-year and were also 0.7 per cent ahead of target (Table 3.2). The tax outturn was helped by robust receipts from income tax

<sup>11</sup> The planned Exchequer tax take is generally published by the Department of Finance in the early part of the year, with the 2011 profile published in February. The planned Exchequer expenditure profile was published in March but was updated following the publication of the Revised Estimates for the Public Services in July.

<sup>12</sup> The Exchequer primary deficit in the first half of 2011 amounted to €8.4 billion, as against an adjusted target of €10.1 billion. The other main quantitative criterion is the ceiling on the stock of central Government net debt. In the first half of the year, the stock of this debt amounted to €91.7 billion, as against a target of €94.6 billion.

and stamp duties, although the former was helped by earlier than expected DIRT payments which, if excluded, show income taxes 0.9 per cent behind target. VAT receipts, the largest tax category, were 3.6 per cent behind target in the year to end-September, which amounted to a shortfall of €300 million.

**Table 3.2: Exchequer Outturn to end-September**

€ Billions	2010q1-q3	2011q1-q3	Year-on Year %	Compared to Target %
Tax Receipts	22.2	24.1	+8.7	+0.7
Voted Expenditure	33.2	33.4	+0.6	-2.2
<i>Current</i>	30.2	31.2	+3.2	-1.5
<i>Capital</i>	3.0	2.2	-26.7	-11.3
Exchequer Deficit	13.4	20.7		

Source: Exchequer Outturn, September 2011.

Total voted spending<sup>13</sup> in the first three quarters of the year was €33.4 billion, which was up 0.6 per cent year-on-year. Spending was running 2.2 per cent below the expected target in the first three quarters of 2011. Capital and current spending were 11.3 and 1.5 per cent behind target respectively in the first nine months of the year.<sup>14</sup>

Quarterly trends since the SPU was published in April indicate that the Exchequer data were broadly on target, with taxes approximately €300 million ahead of profile in the second and third quarters, although the weakness in VAT receipts is a source of concern. The overall Exchequer deficit for the first three quarters of the year amounted to €20.7 billion, up from €13.4 billion over the same period in 2010. Much of the increase reflected promissory note (€3.1 billion) and banking recapitalisation payments in July (€7.6 billion). The third quarter Exchequer returns also indicated a primary deficit (excluding banking payments) of €10.7 billion, as compared with the EU/IMF quantitative target of €12.9 billion.

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<sup>13</sup> Voted spending refers to expenditure determined by the Dáil. Non-voted expenditure which includes national debt interest can also be significant. Year-on-year expenditure comparisons in 2011 are distorted due to the introduction of the Universal Social Charge (USC), which has the effect of increasing current spending.

<sup>14</sup> Timing effects can also distort annual comparisons in the Exchequer returns particularly for certain tax categories and for capital spending.

**Box 3.1: Cyclically Adjusted Balances and the Output Gap**

The fiscal balance can be divided into a cyclical and a structural component. The change in the structural balance is often used internationally to assess the stance of fiscal policy. A variety of approaches can be used to estimate the cyclically-adjusted budget balance.

The Department of Finance uses a harmonised methodology (developed by the European Commission) to estimate the cyclically adjusted balance. This involves using a production function approach based on estimates of the potential output of the economy, given the amounts of labour and capital available as well as estimates for total factor productivity. The difference between actual and potential output is termed the output gap. The budgetary impact of the economy deviating from its trend is then calculated assuming the sensitivity of the budget balance to changes in the cycle is 0.4. The cyclical budget component is then subtracted from the unadjusted balance to determine the structural balance.<sup>15</sup> The SPU cyclically adjusted figures are provided in Table 3.1.A and show a sizable, albeit declining, structural deficit over the period.

**Table 3.1.A: Structural and Cyclical Budget Estimates in the SPU**

<b>% of GDP</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>
General Government Deficit	32.4	10.0	8.6	7.2	4.7	2.8
Underlying Deficit <sup>16</sup>	12.1	10.0	8.6	7.2	4.7	2.8
Potential GDP Growth	-1.4	-1.2	-0.6	0.5	1.1	1.7
Output Gap	-6.1	-4.2	-1.2	1.2	3.1	4.5
Cyclical Component	-2.4	-1.7	-0.5	0.5	1.2	1.8
Structural Budget Deficit	10.0	8.3	8.1	7.7	5.9	4.6

Source: Stability Programme Update.

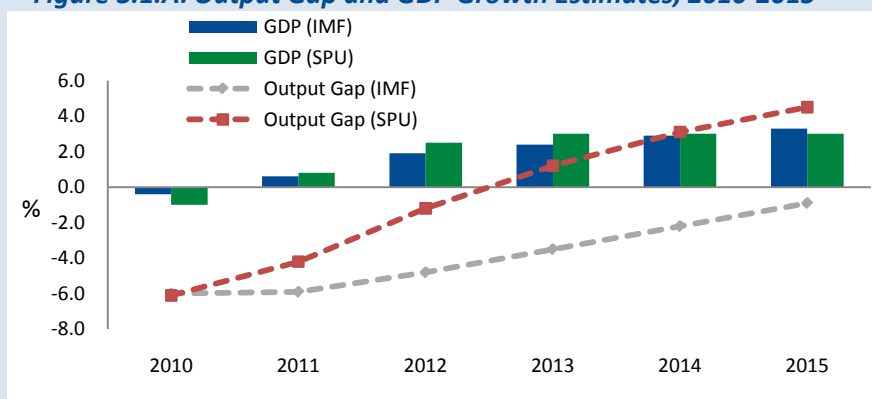
<sup>15</sup> For a more detailed description of the methodology used, see Pre-Budget Outlook, November 2009, Annex 3.

<sup>16</sup> The General Government Deficit in 2010 was estimated at 32.4 per cent of GDP, which includes approximately €31 billion issued in Promissory Notes to recapitalise certain financial institutions. When these banking related measures and associated interest costs are excluded, the underlying estimate for the General Government deficit was €18.5 billion, or 12 per cent of GDP. These ratios have since changed following the publication of fourth quarter National Accounts Data, which resulted in nominal GDP being revised upwards from €154 billion to €156 billion. As a result the General Government Balance, improved to -32 per cent of GDP in 2010.

There are well recognised problems associated with measuring cyclically adjusted balances, particularly for a small open economy undergoing significant structural change, mainly due to difficulties surrounding potential output estimates. The approach adopted in the SPU envisages a potential annual average growth rate for Ireland of 0.7 per cent from 2012 to 2015. Given the forecast for actual growth, this would suggest, in a mechanical sense, significant overheating by 2015, with a positive output gap of 4.5 per cent of potential output. As economies generally converge to trend over a few years, there seems to be an inconsistency between the path of actual growth in the SPU and the much weaker numbers assumed for potential output. It is noteworthy that the Department of Finance does not consider these results to be plausible under the current conditions of large-scale structural change.<sup>17</sup>

The problems associated with estimating potential output (and the structural balance) are also evident from alternative estimates of the output gap. In Figure 3.1.A, the projected paths of actual output (real GDP) and the output gap are presented for the SPU projections as well as for the latest IMF forecasts. Since the forecast paths for actual output are quite similar, the differences in the output gap are due to very different projected paths for potential output. Despite this, the approaches of the IMF and the Department of Finance both project sizable structural deficits in 2015, ranging from 4.6 per cent in the case of the SPU to 3.4 per cent in the case of the IMF.

**Figure 3.1.A: Output Gap and GDP Growth Estimates, 2010-2015<sup>18</sup>**



<sup>17</sup>On page 47 of the SPU 2011, it was stated that: "...issues arising out of the current methodological framework have resulted in substantially reduced potential output figures for Ireland, with the knock on effect that the output gap for 2015 is positive at around 4½ per cent of GDP. Given that this figure would suggest a rapidly overheating economy with resulting inflationary pressures; this result is not viewed as plausible."

<sup>18</sup>The IMF figures for the output gap are taken from the IMF Country Report No. 11/276 which was published in September 2011.



### 3.3.2 Current Expected Outlook for 2011

There are a number of more recent budgetary forecasts for 2011. The latest ESRI<sup>19</sup> projections forecast a GGD this year of 14.2 per cent of GDP. However, this assumes that payments of approximately €7.8 billion to the banking sector this year will be reclassified within the General Government, although this is not yet clear. Excluding such payments, the projected deficit falls to 9.3 per cent of GDP, below the SPU projection. The most recent EC and IMF estimates envisage<sup>20</sup> budget deficits in 2011 of 10.2 per cent and 10.3 per cent of GDP respectively.

Overall, the Exchequer data for the first three quarters of the year suggest that the 2011 GGD target of 10 per cent is achievable. The main uncertainties are associated with the potential for weaker growth in the second half of the year and the fact that a third of all taxes are due for collection in the final quarter of 2011.

## 3.4 SPU and Budgetary Forecasts for 2012-15

### 3.4.1 The SPU Outlook to 2015

The SPU projections include a provision for additional consolidation efforts of €3.6 billion in 2012, and €3.1 billion in both 2013 and 2014 (Table 3.3). These amounts are consistent with a planned consolidation adjustment of €15 billion, outlined in the National Recovery Plan (NRP) over the period 2011-14. In addition, the SPU projections include a further €2 billion adjustment in 2015, to ensure a deficit below 3 per cent of GDP.<sup>21</sup>

The consolidation measures set out in the Programme agreed with the EU/IMF (Table 3.3) result in the GGD falling steadily to 2.8 per cent of GDP by 2015 (Table 3.4). The debt ratio is projected to peak at 118 per cent of GDP in 2013, before declining to 111 per cent of GDP in 2015.

The SPU envisages a significant fall in the expenditure to GDP ratio, from 45.5 per cent of GDP in 2011 to 37.8 per cent of GDP in 2015. This amounts to a cumulative decline from 2012-2015 of about €2 billion. The major expenditure categories, with the exception of interest payments (which are projected to rise sharply), are all projected to register large cumulative declines (Table 3.5).

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<sup>19</sup> ESRI Quarterly Economic Commentary, Summer, September 2011.

<sup>20</sup> European Commission, 'Economic Adjustment Programme for Ireland, Summer 2011 Review', Occasional Papers 84, September 2011. IMF, Country Report No. 11/276, Ireland, 'Third Review Under the Extended Arrangement', September 2011

<sup>21</sup> No detail is provided on the composition of the €2 billion adjustment in 2015. The consolidation measures over the period to 2015 will be subject to revision upon completion of the Comprehensive Review of Expenditure (CRE) and also given the commitment in the Programme for Government to review budgetary progress in preparing Budget 2013.

In the SPU, two of the largest expenditure heads, compensation of employees and intermediate consumption, are projected to decline by a cumulative €3.4 billion from 2011 through to 2015, with welfare related spending down €2.5 billion. Planned expenditure reductions are offset by higher interest payments, which were projected to increase by €5.4 billion over the same period.<sup>22</sup> On the revenue side, the SPU projects that the overall revenue to GDP ratio falls marginally, from 35.5 per cent of GDP in 2011 to 35.1 per cent in 2015.

**Table 3.3 Indicative Consolidation Measures Underlying the SPU**

€ Billions	2011	2012	2013	2014	2015
Total Consolidation (Full-Year Impacts)	6.0	3.6	3.1	3.1	2.0
Expenditure	3.9	2.1	2.0	2.0	
Current	2.1	1.7	1.6	1.6	
Capital	1.8	0.4	0.4	0.4	
Taxation	1.4	1.5	1.1	1.1	
Other <sup>23</sup>	0.7				

Source: National Recovery Plan and SPU April 2011.

**Table 3.4 SPU and Alternative Budgetary Estimates 2011-15**

% of GDP	Date	2011	2012	2013	2014	2015
<i>General Government Balance</i>						
SPU	April	-10.0	-8.6	-7.2	-4.7	-2.8
IMF	Sept	-10.3	-8.6	-6.8	-4.4	-4.1
EC	Sept	-10.2	-8.6	-7.5	-4.6	-2.9
<i>General Government Debt</i>						
SPU	April	111	116	118	116	111
IMF	Sept	109	115	118	118	117
EC	Sept	110	116	119	118	114

Source: IMF, *Fiscal Monitor, Addressing Fiscal Challenges to Reduce Economic Risks*, September 2011, European Commission *Economic Adjustment Programme for Ireland, Summer 2011 Review*, September 2011.

<sup>22</sup> This excludes any savings from the new interest rate arrangements.

<sup>23</sup> "Other" here relates to one-off measures affecting 2011, which included of income from asset disposals, mobile telephony licences and debt servicing savings.

**Table 3.5: SPU Projected Changes in Government Primary Expenditure 2011-15**

€ Billions	2011	2012	2013	2014	2015	Cumulative 2012-15
Compensation of employees	0.1	-0.6	-0.1	-0.5	-0.5	-1.7
Intermediate Consumption	-0.5	-0.6	-0.5	-0.6	-0.1	-1.7
Social Payments	-1.0	-0.6	-0.6	-0.8	-0.5	-2.5
Investment	-1.3	-0.3	-0.3	-0.4	-0.2	-1.2

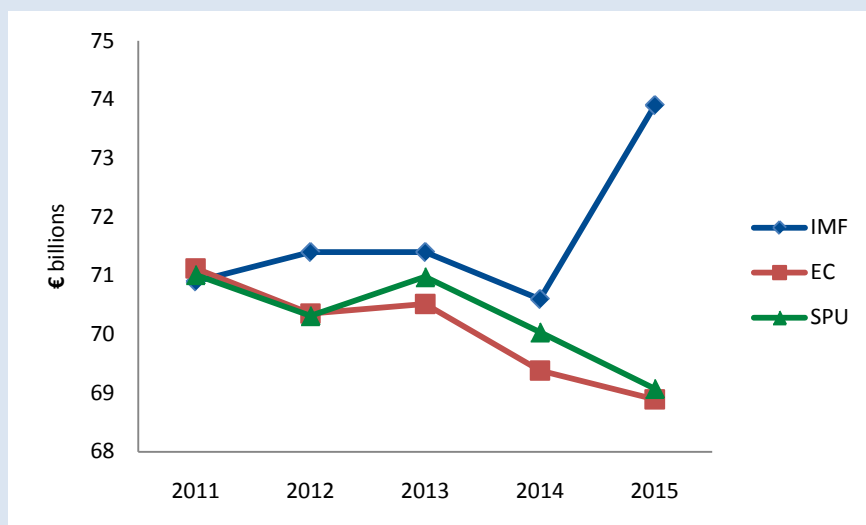
Source: SPU 2011 and internal calculations.

As regards the other main forecasts, Table 3.4 presents the latest fiscal projections of the EC and the IMF, both showing a declining GGD over the period. The Commission projects a deficit of 2.9 per cent of GDP by 2015, which is comparable with the figure of 2.8 per cent in the SPU. The IMF projection has the deficit at 4.6 per cent in 2015, although this does not include any additional consolidation in 2015, whereas the Commission includes €2 billion in consolidation (the same as in the SPU). Apart from this, the projections are quite similar (Figures 3.1 and 3.2).

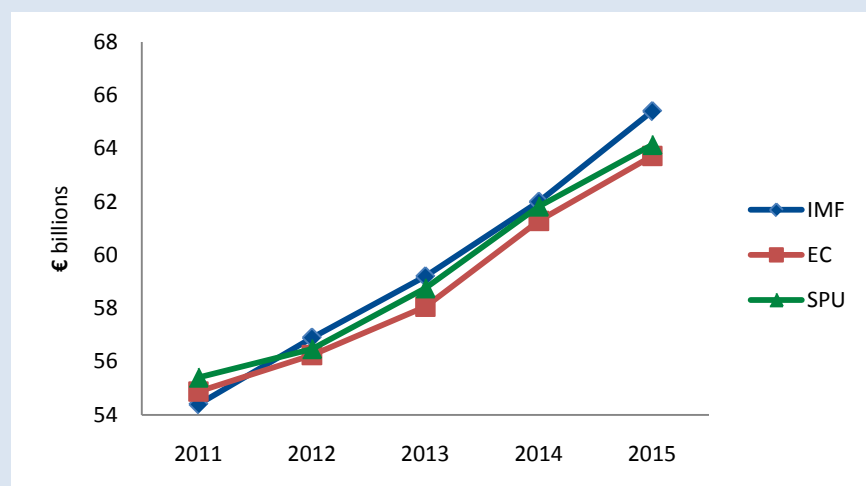
There would appear to be an emerging consensus on the outlook for the public finances, certainly out to 2014 when forecasts are more comparable. This is not altogether surprising given that Ireland's medium-term budgetary programme is financially supported by the EU/IMF. The three sets of projections also point to a large structural deficit in 2015, which would indicate the need for further corrective action in order to achieve the objective of a balanced budget in cyclically adjusted terms.

It is difficult to comprehensively assess the SPU outlook post-2011 because there is no detail provided on the specific budgetary measures that will be used to meet the consolidation objectives.

**Figure 3.1: Total Government Expenditure**



**Figure 3.2: Total Government Revenue**



### 3.5 Government Debt Dynamics

As a result of the sharp deterioration in the public finances, the level of gross debt increased sharply between 2006 and 2010, reaching 96 per cent of GDP. This large increase was driven primarily by budgetary deficits and payments to the banking sector. The SPU debt projections are replicated in Table 3.6. The

debt ratio is projected to peak at approximately 118 per cent of GDP in 2013, which is similar to the outlooks of the EC and the IMF.<sup>24</sup>

**Table 3.6: SPU General Government Debt Dynamics**

% of GDP	2011	2012	2013	2014	2015
Gross Debt	111	116	118	116	111
Change in Gross Debt Ratio	14.6	5.6	1.9	-2.6	-4.3
1. General Government Deficit	-10.0	-8.6	-7.2	-4.7	-2.8
2. Stock-flow Adjustment <sup>25</sup>	5.9	0.3	-0.8	-2.3	-2.0
3. Nominal GDP	-1.3	-3.3	-4.5	-4.9	-5.1

Source: SPU 2011.

The net debt to GDP ratio, that is, debt net of financial non-bank assets, was significantly below gross debt at 76 per cent, or €117 billion at end-2010. This reflected holdings of just over €31 billion in financial (non-bank) assets by the Government, of which liquid assets amounted to €16 billion and non-bank National Pension Reserve Fund (NPRF) assets of €15 billion.

### 3.6 Recent Developments Affecting the SPU Outlook

There have been a number of important economic developments since the publication of the SPU which affect the fiscal outlook. These arise in three main areas; interest rate costs, banking recapitalisation payments, and revisions to broader macroeconomic data. In order to quantify the impact of these developments, a fiscal-feedback model was developed by the Council (Box 3.2).

<sup>24</sup> A recent paper by FitzGerald and Kearney (2011), examined debt dynamics over the period to 2015 and projected that the gross debt to GDP ratio would peak in 2012 at between 110 and 115 per cent of GDP, with interest costs about €1.5 billion per annum lower than under the SPU. The latter factored in the July 21 Council Agreement among other things.

<sup>25</sup> The stock-flow adjustment is the difference between the change in government debt and the GGD. It is possible to further breakdown the change in debt into GDP and interest rate components.

**Box 3.2: Fiscal-Feedback Model**

To complement the SPU projections, the Council has developed a model that allows a two-way relationship between nominal GDP and the nominal primary deficit. These variables are thus determined simultaneously in the model. When parameterised (using assumptions in line with those of the Department of Finance), the model provides a useful aid for assessing the potential impacts of macroeconomic/budgetary developments and also of changes in the fiscal policy stance.

The basic version of the model is captured by two equations:

$$(1) Y = Y_0 + mPD$$

$$(2) PD = PD_0 - bY,$$

where Y is nominal GDP, PD is the primary deficit,  $Y_0$  is autonomous nominal GDP (i.e. the part of nominal GDP that is independent of the primary deficit),  $PD_0$  is the discretionary primary deficit (i.e. the part of the deficit assumed to be independent of nominal GDP), m is the deficit multiplier, and finally b is the automatic stabiliser coefficient. It is assumed that both m and b are positive.

Solving this pair of equations yields reduced-form expressions for the equilibrium levels of nominal GDP and the primary deficit.

$$(3) Y = \left(\frac{1}{1+mb}\right)Y_0 + \left(\frac{m}{1+mb}\right)PD_0.$$

$$(4) PD = \left(\frac{-b}{1+mb}\right)Y_0 + \left(\frac{1}{1+mb}\right)PD_0.$$

Choosing values of  $m = 0.5$  and  $b = 0.5$  produces reduced-form coefficients that are broadly in line with Department of Finance assumptions. Letting  $\Delta$  represent the nominal change in a variable, equations (3) and (4) imply,

$$(3') \Delta Y = 0.8\Delta Y_0 + 0.4\Delta PD_0,$$
 and

$$(4') \Delta PD = -0.4\Delta Y_0 + 0.8\Delta PD_0.$$

The coefficients imply that: (i) a €1 change in autonomous nominal GDP yields an €0.80 change in actual nominal GDP; (ii) a €1 change in the discretionary primary deficit yields a €0.40 change in nominal GDP; (iii) a €1 change in autonomous nominal GDP yields a -€0.40 change in the primary deficit; (iv) a €1 change in the discretionary primary deficit yields a €0.80 change in the primary deficit (owing to a revenue/expenditure buoyancy effect).

Given these relationships, the effects of alternative scenarios for nominal

growth and discretionary fiscal adjustments can be examined. Moreover, when combined with an equation showing debt dynamics (equation 5), it is possible to explore the effects of changes in interest rates and alternative stock-flow adjustments that relate to factors such as borrowing requirements for bank recapitalisation.

$$(5) \Delta D = PD + iD_{-1} + SFA,$$

where  $D$  is the gross debt,  $i$  is the average nominal interest rate on outstanding debt, and  $SFA$  is the stock-flow adjustment.

The model can be used first to replicate the SPU baseline projections (Table 3.1). One can then consider the impact of alternative economic and policy scenarios while keeping everything else the same as in the SPU. In Table 3.2.A, an illustrative scenario is presented assuming €1 billion in additional adjustment for every year between 2012 and 2015. Under this scenario, the primary balance and GGD would be 5.2 per cent of GDP and 0.9 per cent of GDP respectively in 2015. The debt to GDP ratio declines more rapidly than in the SPU baseline reaching 107 per cent by 2015.

**Table 3.2.A. Scenario with €1 Billion of Additional Annual Discretionary Adjustment, 2012-2015**

€ Billions	2011	2012	2013	2014	2015
Gross Debt	172.8	185.4	194.6	197.1	193.8
Change in Gross Debt	25.8	12.6	9.2	2.5	-3.3
Primary Deficit	9.7	5.5	0.2	-5.4	-9.4
Interest Expenditure	5.4	7.6	10.2	10.9	11.0
Stock-flow Adjustment	10.7	-0.5	-1.2	-3.0	-4.9
Nominal GDP	156.1	160.5	166.6	173.5	181.1
Nominal GDP growth (%)	1.4	2.8	3.8	4.1	4.4
Gross Debt to GDP (%)	110.7	115.5	116.8	113.6	107.0
Primary Deficit /GDP (%)	6.2	3.4	0.1	-3.1	-5.2
General Government Deficit/GDP (%)	9.7	8.1	6.3	3.2	0.9
<i>Memo items:</i>					
Assumed Discretionary Fiscal Adjustment	-6.0	-4.6	-4.1	-4.1	-3.0
Implicit Interest Rate (%)	3.7	4.4	5.5	5.6	5.6

Source: Internal calculations.

### 3.6.1 Interest Expenditure Savings

Under the Programme supported by the EU/IMF, Ireland (as of end-July) had drawn down €23 billion in loans at an average interest rate of 5.58 per cent. In July, the euro area Heads of State and Government agreed to reduce the interest rate on loans to Ireland, Portugal and Greece (and to extend their maturity) under a revised European Financial Stability Facility (EFSF). The UK also announced that it would reduce the margin on its loan to Ireland in line with the EFSF. In September, the European Commission proposed improved financial terms, in line with the EFSF for EU loans to Ireland and Portugal, under the European Financial Stabilisation Mechanism (EFSM).<sup>26</sup> In total, the new loan arrangements under the EFSF, EFSM and bilateral loans with the UK, as of end-September, were projected (subject to possible revision), to result in annual savings of €365 million in 2011, €875 million in 2012, €1,110 million in 2013 and €1,180 million in 2014.<sup>27</sup> Although details are still to be finalised, the NTMA estimates that changes agreed by European leaders in July 2011 will lower the average interest rate on outstanding debt by 0.3 percentage points in both 2011 and 2012 and between 0.4 and 0.5 percentage points for 2013-2015.

### 3.6.2 Banking Recapitalisation

The Prudential Capital Assessment Review (PCAR), published by the Central Bank in March, indicated that a further €24 billion was required by the banking sector, with €10 billion sourced from the National Pension Reserve Fund (NPRF). For the purposes of the SPU, it was assumed that approximately €10 billion would be funded from the Exchequer. The actual funding requirement is, however, now likely to be below €18 billion. This partly reflects savings of approximately €3.5 billion due to a combination of burden sharing (€2.4 billion) and private injections into Bank of Ireland (€1.1 billion).<sup>28</sup>

### 3.6.3 Macroeconomic Revisions

As discussed in Chapter 2, nominal GDP in 2010 was revised upwards by the CSO to €156 billion which shifts the entire path of GDP in the SPU upwards. In addition, the 2010 revision implied a reduction in the estimated GGD last year as a share of GDP from 32.4 per cent to 32 per cent. It is assumed that the 2010 GDP revision only affects the denominator in the deficit to GDP ratio. In other words, the SPU projections for the nominal General Government and primary deficits for 2011-2015 are assumed not to be affected by the revised

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<sup>26</sup> This amounts to a reduction of 292.5 basis points (the current margin on loans to Ireland), with an extended loan maturity of up to 12.5 years.

<sup>27</sup> See House of the Oireachtas, "Written Answers - Exchequer Savings", 22 September 2011, Ref No: 25498/11.

<sup>28</sup> See Department of Finance press release, 25 July 2011, "Bank of Ireland Capital Investment".



GDP figures. The revision does mechanically change the projections for the deficit as a share of GDP, which is reflected in the Council's update of the SPU.

In order to update the macroeconomic outlook in the SPU, the Council includes the revised 2010 GDP figure, as well as the latest Central Bank growth outlook for 2011 and 2012. For 2013 to 2015, the growth projections from the SPU are used.

### 3.6.4 Summary of the Implications of Post-SPU Developments

The Council's estimate of the combined effect of the post-SPU developments is shown in Table 3.7.<sup>29</sup> Overall, the Council's model-based assessment suggests that the GGD target of 10 per cent of GDP for 2011 will most likely be achieved. However, available data and estimates suggest that the 8.6 per cent of GDP target for 2012 would be narrowly missed. It must be stressed that there is a substantial degree of uncertainty around these projections. The Council looks forward to the Government's Pre-Budget Outlook, which should bring further clarity to the impact of the post-SPU developments.

**Table 3.7: Revised Projections Based on Post-SPU Developments 2011-2015**

€ Billions	2011	2012	2013	2014	2015
Gross Debt	169.9	183.4	194.6	201.5	203.5
Change in Gross Debt	22.9	13.5	11.2	6.9	2.0
Primary Deficit	9.7	7.1	2.7	-2.0	-5.2
Interest Expenditure	5.4	7.0	9.2	10.1	10.3
Stock-flow Adjustment	7.8	-0.5	-0.7	-1.2	-3.1
Nominal GDP	155.7	159.0	165.3	172.4	180.3
Nominal GDP Growth (%)	-0.2	2.1	4.0	4.3	4.6
Gross Debt/GDP (%)	109.1	115.4	117.7	116.9	112.9
Primary Deficit /GDP (%)	6.2	4.4	1.6	-1.2	-2.9
General Government Deficit/GDP (%)	9.7	8.8	7.2	4.7	2.8
<i>Memo items:</i>					
Assumed Discretionary Fiscal Adjustment	-6.0	-3.6	-3.1	-3.1	-2.0
Implicit Interest Rate (%)	3.7	4.1	5.0	5.2	5.1

Source: Internal calculations.

Table 3.8 details the discretionary adjustments that would be required to meet the original SPU targets. Combining the various post-SPU developments, the discretionary deficit adjustments outlined in the SPU should be sufficient to bring the GGD below 3 per cent by 2015. However, based on currently available information, the Council assesses that an additional discretionary

<sup>29</sup> Following discussions with the NTMA and the Department of Finance, also included are corrections to the SPU stock-flow adjustments for 2011-2015 for the treatment of interest on the promissory notes.

adjustment of approximately €400 million would be required in Budget 2012 to meet the 8.6 per cent of GDP target for 2012.

**Table 3.8: Discretionary Adjustment Required to meet Original SPU Targets 2011-2015**

€ Billions	2011	2012	2013	2014	2015
Gross Debt	169.9	183.1	194.3	201.1	203.0
Change in Gross Debt	22.9	13.2	11.2	6.8	1.9
Primary Deficit	9.7	6.7	2.7	-2.1	-5.2
Interest Expenditure	5.4	7.0	9.2	10.1	10.3
Stock-flow Adjustment	7.8	-0.5	-0.7	-1.2	-3.1
Nominal GDP	155.7	158.8	165.3	172.3	180.2
Nominal GDP Growth (%)	-0.2	2.0	4.1	4.3	4.6
Gross Debt/GDP (%)	109.1	115.3	117.5	116.7	112.6
Primary Deficit /GDP (%)	6.2	4.2	1.6	-1.2	-2.9
General Government Deficit/GDP (%)	9.7	8.6	7.2	4.6	2.8
<i>Memo items:</i>					
Assumed Discretionary Fiscal Adjustment	-6.0	-4.0	-2.7	-3.2	-2.0
Implicit Interest Rate (%)	3.7	4.1	5.0	5.2	5.1

Source: Internal calculations.

## 4. Assessment of Fiscal Stance

### 4.1 Introduction

Consistent with the Council's mandate, this chapter provides an assessment of the appropriateness of the fiscal stance set out by the Government in the Budget and Stability Programme Update (SPU). In this context and given the issues raised in the previous chapter, the Council takes the basic measure of the fiscal stance to be the path for the General Government deficit (GGD) as a share of GDP over the period to 2015.

Given the challenges posed by the fiscal deterioration experienced in Ireland and the need to put the economy back onto a sustainable growth path, it is imperative that a balance is struck between restoring the public finances, improving the credibility and creditworthiness of the State, and avoiding undue harm to the economy at a time of weak domestic demand.

The fiscal stance should allow the public finances to be rebuilt to a sustainable level. Maintaining a high level of borrowing today implies higher debts in the future, which will have to be paid for via higher taxes or lower expenditure for a given level of national income. This raises issues on the stability of the fiscal position at high levels of debt as well as inter-generational equity concerns. The ongoing absence of fiscal space<sup>30</sup> will also constrain the ability of governments to undertake counter-cyclical fiscal policies (including allowing automatic stabilisers to work) in the face of future negative shocks and the absence of an independent monetary policy.

Restoring credibility – both domestically and externally – is crucial. This implies that a government needs to meet ambitious targets that it has set itself, independently of whether or not these are established in agreement with external providers of emergency funding. On the other hand, it is important that the targets are not overly ambitious, as a failure to meet them might also cause reputational damage. Improving credibility will also enhance creditworthiness, in the sense of reinforcing the perception by official and private lenders that the Government will honour its obligations fully in the

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<sup>30</sup> Ostry et al. (2010) define fiscal space as the "... scope for further increases in public debt without undermining sustainability." More concretely, they define it as the "... difference between the current level of public debt and the debt limit implied by the country's historical record of fiscal adjustment". However, the assessment of fiscal space may have a more forward-looking component, as credit markets assess the capacity of countries to make fiscal adjustments.

future. This will be particularly important if Ireland is to return to international market finance in 2013.

Section 4.2 discusses arguments that favour an acceleration of the fiscal consolidation effort compared to the path laid out in the SPU. Section 4.3 provides the Council's own assessment of the appropriate fiscal stance over the period 2012-2015, including the appropriate target to set for the upcoming year in Budget 2012. Relaxing the fiscal stance relative to existing commitments is not considered a viable option by the Council given credibility gains achieved to date and need to meet agreed targets with the EU/IMF.

## 4.2 Faster Fiscal Adjustment in the Irish Context

This section considers the case for accelerating the fiscal adjustment relative to the path set out in the SPU. This would require achieving the best balance between strengthening the public finances, improving credibility and creditworthiness, and the negative implications for domestic demand.

### 4.2.1 Strengthening the Public Finances

Under the simple update of the SPU projections set out in Chapter 3, the debt to GDP ratio would peak at approximately 118 per cent in 2013. This implies a substantial increase in the amount of debt from its 2011 level. Furthermore, while the debt to GDP ratio would be declining by 2015 to 113 per cent given the assumed path of the deficit, this would still be above its 2011 level. The deficit would still stand at almost 3 per cent of GDP in 2015.

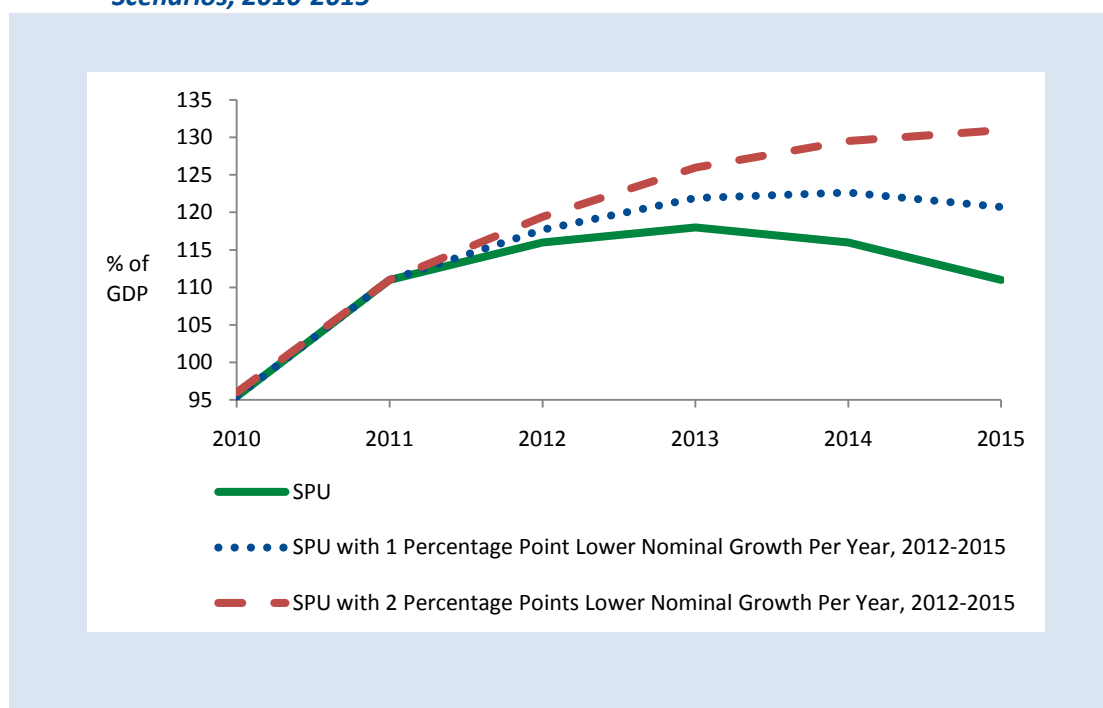
The high level of debt in Ireland emphasises the need to recognise the fragility and potential instability associated with debt dynamics; a risk underlined by this summer's heightened uncertainty about global economic growth and the escalation of the euro area sovereign debt crisis. This can be illustrated using the fiscal-feedback model described in Chapter 3. In Figure 4.1, the contrasting time paths for the debt to GDP ratio are shown under three growth scenarios. A reduction of one percentage point in the rate of nominal GDP growth for each year from 2012 to 2015, relative to that assumed in the SPU, would imply that the debt ratio would peak one year later than in the SPU at the significantly higher level of approximately 123 per cent in 2014. If the growth path were to be two percentage points lower than the SPU forecast, the debt ratio would reach over 130 per cent by 2015 and would still not have stabilised. These simple scenarios emphasise the fragility of debt dynamics in the Irish case.

Analysis of debt dynamics further illustrates how more rapid adjustment can have significant implications for long-term debt sustainability by placing the debt ratio on a steeper downward path after 2015. As an illustration, the

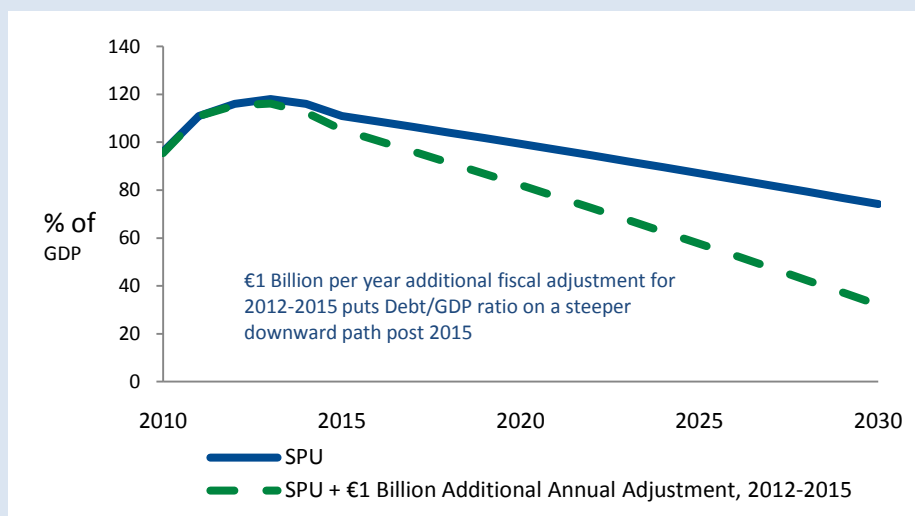
fiscal-feedback model is again used to show the *longer-term* implications of a hypothetical additional €1 billion of additional fiscal adjustment each year during 2012 -2015 (Figure 4.2). With the additional adjustment, the primary surplus in 2015 would be 5.2 per cent of GDP, which compares to a baseline SPU projection of 3.4 per cent. If the primary surplus remained at this level from 2015 onwards and with a constant one percentage point gap between the nominal interest rate and the nominal growth rate, the effect of the early additional consolidation is striking. Under the SPU trajectory, the debt to GDP ratio would still be at 74 per cent in 2030 (well above the Maastricht target of 60 per cent). With the assumed faster fiscal adjustment, however, the debt ratio falls to 41 per cent of GDP by 2030.

The size of the projected GGD in the SPU at 2.8 per cent of GDP is a concern. While there is some divergence in measures of the structural deficit for Ireland across different institutions due to differences in measures of the output gap (see Chapter 3), even the most optimistic measures indicate that a structural deficit will remain in 2015, which would require further consolidation to comply with EU rules. Furthermore, irrespective of what path actual growth follows, it is likely that any overhang of excess capacity would largely have been eliminated by 2015.

**Figure 4.1: Medium-Term Evolution of Debt to GDP Ratio: Alternative Scenarios, 2010-2015**



**Figure 4.2: Alternative Long-Run Scenarios for the Debt to GDP Ratio**



Notes: Nominal Interest Rate - Nominal Growth Rate = 1 pp, 2016-2030. Primary surplus held constant as a share of GDP at 2015 Level, 2016-2030.

#### 4.2.2 Enhancing Credibility and Creditworthiness

Over the past year, it has become increasingly evident that euro area countries face heightened market discipline relating to their fiscal performance. However, this offers opportunities for countries to differentiate themselves through a stronger fiscal performance. This is borne out by the experience in recent months, whereby meeting the targets in the Government’s programme has contributed to a significant fall in Irish bond yields.

The economics literature also suggests that new governments can face a particularly difficult reputational challenge in establishing a track record of credibility of their commitments to undertake unpopular but necessary measures. A government in such circumstances may find it beneficial to separate themselves from less committed governments via an early signal of their determination – in effect, by actions that a less committed government would be reluctant to take.

Furthermore, Ireland’s continued dependence on official funding implies that *official creditworthiness* must be sustained, alongside efforts to return to borrowing in the market as planned and at an acceptable rate. Ireland has already amassed goodwill for taking difficult adjustment measures, underscored by the successful completion of three programme reviews with the EU/IMF. However, the broader euro area crisis is far from resolved, implying that the official funding environment may remain fragile. The adoption of more ambitious targets than those previously agreed to at the

outset of the programme could help ensure that support could continue to be made available should that turn out to be necessary.

Ireland's creditworthiness depends in part on the projected time path of the debt to GDP ratio. However, it is also evident that external developments can affect creditworthiness for any anticipated debt time path. The European crisis-resolution debate appears to be moving increasingly to distinguish between countries that should be treated as illiquid and those that should be treated as insolvent. The former would be provided with additional support as needed, but *without* a requirement of debt restructuring. In contrast, debt restructuring would be required for countries deemed insolvent. However, expectations of a restructuring can become self-fulfilling, as markets demand a premium to compensate for additional risk, potentially forcing countries out of the market and into a support programme that has restructuring as an element. There is potentially a significant benefit to staying on the "right list" – the list of countries deemed not to have a solvency problem.

#### 4.2.3 Demand Effects of Stronger Consolidation

The main argument against faster fiscal adjustment is that it will delay the recovery. Although estimates of Ireland's output gap differ for the period 2012 to 2015, there is more general agreement across methodologies that there is a negative output gap of about 5 per cent of potential output in 2011. While the current unemployment rate of 14.3 per cent undoubtedly has a large structural element, some part of it reflects domestic demand falling below its sustainable level.

The international evidence on the real effects of austerity policies is reviewed in Box 4.1. The economic literature and the Council's own assessment suggests that the overall deficit multiplier is likely to be positive but relatively low under current Irish conditions. In its past projections, the Department of Finance has found that a multiplier of around 0.5 has worked reasonably well, which is broadly consistent with the international evidence given current conditions. In the fiscal-feedback model, a discretionary reduction in the deficit equal to 1 per cent of GDP reduces the growth rate (real and nominal assuming a path for the GDP deflator) by 0.4 of a percentage point. This is a significant impact on the real economy.

A frequently expressed concern about further austerity measures is that they could be self-defeating in purely budgetary terms; that is, they could cause the overall deficit to rise instead of fall. The idea is that the austerity measures slow the economy to such an extent that automatic stabilisers dominate the direct impact of discretionary measures. However, the Council does not share this view, as the consolidation measures are likely to be only partly offset by lower activity, of which, only a fraction is reflected in lower revenues or higher

cyclical expenditures.<sup>31</sup> However, in the recent international debate on austerity, it has been argued that austerity measures could lower the economy's long-term supply capacity (e.g. through lower capital spending or the damaging effects on employment prospects of long periods of unemployment). These impacts could damage long-term fiscal performance (see, for example, Krugman, 2011). To the extent that this undermines confidence, it could have further negative effects on output (and thus the deficit) in the present. If these impacts were strong enough it is possible that austerity could be self defeating but the conditions for this seem unlikely.<sup>32</sup>

While there is not too much doubt that the adverse growth effects of austerity are real (Box 4.1), recent Irish developments do not appear to support the more extreme self defeating hypothesis. Even though domestic demand has fallen significantly (at least in part due to the austerity measures undertaken) and domestic demand has remained weak, the General Government deficit is improving. The underlying deficit<sup>33</sup> has declined from 14.3 per cent of GDP in 2009, to 12 per cent in 2010 and to a projected 10 per cent this year. Austerity measures are working to reduce the deficit.

#### **Box 4.1: The Real Effects of Austerity**

The size of fiscal multipliers is one of the most contentious questions in macroeconomics. An issue is the impact on GDP and other macroeconomic variables of discretionary changes in government spending or taxation. Unfortunately, efforts to identify the size of these effects are bedevilled by the two-way causality running from the macroeconomic to the fiscal variable. A cut in government spending, for example, can lead to a fall in domestic demand and GDP; but a fall in GDP can also lead to an increase in government spending through automatic stabilisers (notably an increase in social welfare spending) and also through discretionary changes in spending implemented to counteract a recession. To further complicate the identification effort, both fiscal variables and GDP can be affected by a common third factor. A relevant

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<sup>31</sup> From a modelling perspective, the static model outlined in Box 3.2 reflects this idea: the reduced-form deficit multiplier is positive for any size of the (positive) deficit multiplier and (negative) automatic stabiliser coefficient.

<sup>32</sup> Another way in which austerity might be self defeating is that austerity measures adversely affect the debt to GDP ratio. This could happen even if the primary deficit falls as a result of these measures. If the adverse growth effects are strong enough, the standard equation for the change in the debt to GDP ratio shows that the debt to GDP could rise despite a fall in the primary deficit. Thus austerity is still self defeating in terms of the goal of stabilising (and then reducing) the debt to GDP ratio. However, simulations do not indicate that this is the case given the parameter assumptions of the fiscal-feedback model used here.

<sup>33</sup> This is the General Government deficit excluding promissory note payments and assistance to Anglo Irish Bank in 2010.



example for Ireland is the collapse in property prices, which led to both a large fall in construction output and a collapse in property-related taxes.

The recent empirical literature has used four main methods to try to credibly identify the causal effects that matter in assessing the implications of any change in the fiscal policy stance. First, the cyclically adjusted primary balance is used to eliminate the impact of automatic stabilisers. Key papers in this tradition are Alesina and Perotti (1995) and Alesina and Ardagna (2010). A drawback is that changes in the cyclically adjusted balance might partly reflect discretionary responses to the state of the economy.

Second, the statistical method of structural vector autoregression (SVAR) is used to further eliminate the contaminating effects of discretionary adjustments made in response to the state of the economy. The common identifying assumption is that discretionary fiscal policy cannot respond quickly to the state of the economy (say within a quarter). A classic paper in this tradition is Blanchard and Perotti (2002). A more recent study based on a cross-section of countries is Ilzetzki et al. (2010). However, studies based on this approach have also been criticised on the grounds that fiscal policy may be set in anticipation of changes to GDP – e.g., Government spending might be increased based on forecasts of a pending slowdown in the economy.

Third, the narrative (or action-) based approach uses the historical record (e.g., budgetary documents) to identify changes in fiscal policy that are pursued for reasons other than the cyclical state of the economy. Examples include increases in defence spending in response to a war (Barro and Redlick, 2011; Ramey, 2011) and changes in taxes motivated by the need to reduce an inherited budget deficit or improve long-run economic growth (Romer and Romer, 2010). A comprehensive action-based study using 137 identified episodes across a range of countries has recently been undertaken by researchers at the IMF (Guajardo et al., 2011; IMF, 2010). The Council draws heavily on their findings in our discussion below. Finally, dissatisfaction with all the statistically based methods has recently led Roberto Perotti to eschew econometric modelling altogether and focus on a detailed case study-based approach (Perotti, 2011).

The most extensive empirical analysis has taken place for the United States. Unfortunately, even there the range of multiplier estimates remains wide, showing the sensitivity of the results to the precise methods and data used. Given the limited work that has been done for Ireland (the SVAR paper by Bénétrix and Lane, 2009, is a notable exception), the recent IMF cross-country study appears to offer the most defensible available estimates.<sup>34</sup> Adopting a

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<sup>34</sup> See, however, the critical discussion of the IMF's analysis in Perotti (2011).

version of the narrative-/action-based approach, the IMF's findings support the standard Keynesian assumption that fiscal adjustments are contractionary. Even so, the identified fiscal multipliers are generally small and vary based on country characteristics. Although it uses the SVAR method, Ilzetzi et al., (2010) is also useful in showing the country characteristics that influence the size of the fiscal multiplier. Multipliers tend to be smaller for small open economies, countries facing market concerns over debt and countries with a flexible exchange rate.

While it is unfortunate that there is not a better knowledge base to work from for Ireland – a future task for the Council – a review of the literature makes the Council reasonably confident that the overall deficit multiplier for Ireland is positive though small under current conditions. From its experience with budgetary projections, the Department of Finance has found it useful to assume an overall deficit multiplier in the region of 0.5. While there must be significant error bands around this estimate, it is used in this report for simulations of alternative fiscal stances.<sup>35</sup>

The most significant influence of the expansionary fiscal contraction literature has been on perceptions of the relative macroeconomic merits of expenditure- and revenue-based adjustments.<sup>36</sup> Although the design of an adjustment programme must look beyond macroeconomic effects and consider the fairness of the package of measures, there is a significant literature that points to the macroeconomic superiority of the expenditure-based option (see Alesina (2010) for a compact summary).

The hypothesised macroeconomic superiority has both supply-side and demand-side rationales. On the supply side, revenue-based adjustments are likely to raise marginal tax rates and act as a disincentive to labour supply. This effect could be especially severe for a country with an internationally mobile

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<sup>35</sup> Not surprisingly, the literature finds that the multiplier is not constant over time. In the IMF study, the impact of GDP is at its maximum after two years with an elasticity of 0.62 in the standard specification. With Government spending equal to approximately half of GDP, this would translate into a levels multiplier – i.e. the effect of a euro change in Government spending on GDP – of roughly unity. After making adjustments for Irish conditions, a levels multiplier of 0.5 is a reasonable estimate.

<sup>36</sup> An alternative distinction is between Type 1 and Type 2 adjustments (Alesina and Perotti, 1995). Type 1 adjustments focus on reductions in current expenditure (notably the Government wage bill and transfer payments); Type 2 adjustments focus on raising revenues and cutting capital expenditure. Type 1 adjustments are viewed as doing less damage to the supply potential of the economy and are also viewed as being more sustainable and thus more likely to have positive confidence effects for households, businesses, and financial investors in Government bonds.

labour force, with tax rates affecting both the stock of immigrants and emigrants, with higher-skilled individuals likely to be the most internationally mobile. On the demand side, there is evidence that revenue-based adjustments are less likely to be sustained, limiting the confidence boost that comes with a successful adjustment. Doubts about sustainability could also affect the creditworthiness boost that comes with fiscal adjustment, limiting the fall in interest rates and thus the positive offsetting effect on demand through this channel.

Alesina and Ardagna (2010) provide evidence of the superiority of expenditure-based adjustments using the cyclically adjusted primary balance method and focusing on “large” adjustments.<sup>37</sup> Indeed, they find that it is only expenditure-based adjustments that are associated with expansionary contractions. It was already noted that recent work by IMF researchers has cast doubt that either type of adjustment is actually expansionary (Guajardo et al., 2011; IMF, 2010). The IMF study does find, however, that expenditure-based adjustments are less contractionary. One important caveat introduced in the IMF study is that much of the superiority of expenditure-based adjustment is explained by the response of the Central Bank to the fiscal adjustment. Possibly believing that revenue-based adjustments are more sustainable, central banks are more likely to offset any direct contractionary effects with lower interest rates. Once the response of the Central Bank is controlled for, a large part of the difference between the two types of adjustment disappears.

Caution must be exercised in depending too much on one study to dismiss the case for the superiority of expenditure-based adjustments (see Perotti, 2011, for a detailed critique of the IMF study). Economic theory and micro-based evidence also point to the likely macroeconomic superiority of this form of adjustment. Nonetheless, the case for this superiority is less securely founded than once believed, strengthening the argument for reasonably balanced adjustments, especially where there are political limits in the size of feasible adjustment.

## 4.3 The Appropriate Fiscal Stance

### 4.3.1 The Scale of Adjustments

The Government faces an unenviable balancing act in deciding the appropriate fiscal stance to be included in the forthcoming Pre-Budget Outlook and

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<sup>37</sup> They argue that large adjustments are less likely to be contaminated by reverse causality and omitted variable biases.

subsequently Budget 2012. The domestic economy remains weak, while prospects for export growth are clouded by uncertainties in both the European and global environments. Unemployment looks set to remain very high for some years ahead, although the gap between the potential and actual output of the economy should decline over time. Further pro-cyclical measures would tend to increase this output gap.

Under current plans the debt situation will remain fragile for some time to come, with the debt to GDP ratio projected to fall only quite slowly from a very high level in 2015 using standard economic assumptions. The current and projected level of debt leave the economy vulnerable to adverse shocks to funding and growth. It is also the case that recent experiences have highlighted the susceptibility of the Irish economy to economic shocks.

Weighing the different elements involved, retaining the current SPU deficit targets as a percentage of GDP is viewed as within the range of appropriate courses of action. Relaxing these targets is not considered to be a viable option, given the key need to safeguard hard won gains and the creditworthiness constraints imposed by both the market and official creditors.

While staying the course with current programme targets is thus one possibility, after considering various relevant factors, the Council sees a strong argument for strengthening the fiscal consolidation effort beyond that targeted in the SPU. In particular, the current targets would leave the debt to GDP ratio on a relatively slow downward path. The Council believes that a GGD target of the order of 1 per cent of GDP for 2015 would be appropriate, which compares to the current SPU target of 2.8 per cent. A summary of the implications of the more ambitious targets is provided in Table 4.1.

This suggestion is not made lightly, given the major painful adjustment measures already taken since 2008. However, on balance the Council believes that a more rapid restoration of sound public finances, as well as being highly desirable in its own right, will have important favourable effects on the country's creditworthiness and provide a degree of insurance that the existing programme targets will be met. The longer-term implications for the economic and financial health of the country should not be underestimated.

Under the targets outlined, the debt to GDP ratio would peak at 117 per cent of GDP in 2013. Most importantly, the primary surplus would reach 4.7 per cent of GDP in 2015, compared to the primary surplus of 2.9 per cent of GDP under the revised SPU. This implies that the debt ratio would be falling by an additional 1.8 percentage points per year, even in the absence of any additional post-2015 adjustment.

Figure 4.3 shows the path of the debt to GDP ratio under current SPU targets (adjusting for the post-SPU developments discussed in Chapter 3) and the path with the more ambitious targets. The figure is drawn on the assumption that the primary surplus as a share of GDP is held constant after 2015. Under the existing GGD targets, Ireland would still be well short of the 60 per cent limit even by 2030. However, under the more ambitious targets for the 2012-2015 period, the debt to GDP ratio declines to 52 per cent of GDP by 2030.

In the case of 2012, the suggested adjustment path would require only a relatively modest reduction in the targeted GGD, from 8.6 to 8.4 per cent of GDP. However, this would imply increasing the required adjustment measures in the SPU from €3.6 billion to €4.4 billion in 2012, once the post-SPU developments are included. For the four-year plan period 2012-2015, the suggested adjustment profile would imply total adjustment measures of €4 billion when post-SPU adjustments are also taken into account. The proposed trajectory of the additional discretionary deficit reduction would be broadly balanced over the years 2012-2014 (€0.7–0.8 billion per year), with more significant additional adjustment required in 2015 (€1.7 billion) to reach the 1 per cent GGD target (Table 4.2).

**Table 4.1: Discretionary Adjustment required to meet Revised Targets 2011-2015**

€ Billions	2011	2012	2013	2014	2015
Gross Debt	169.9	182.8	192.7	197.6	196.2
Change in Gross Debt	22.9	12.9	9.9	5.0	-1.4
Primary Deficit	9.7	6.4	1.4	-3.9	-8.4
Interest Expenditure	5.4	7.0	9.1	10.0	10.1
Stock-flow Adjustment	7.8	-0.5	-0.7	-1.2	-3.1
Nominal GDP	155.7	158.7	164.7	171.5	178.7
Nominal GDP Growth (%)	-0.2	1.9	3.8	4.1	4.2
Gross Debt/GDP (%)	109.1	115.2	117.0	115.3	109.8
Primary Deficit /GDP (%)	6.2	4.0	0.9	-2.2	-4.7
General Government Deficit/GDP (%)	9.7	8.4	6.4	3.6	1.0
<i>Memo items:</i>					
Assumed Discretionary Fiscal Adjustment	-6.0	-4.4	-3.9	-3.8	-3.7
Implicit Interest Rate (%)	3.7	4.1	5.0	5.2	5.1

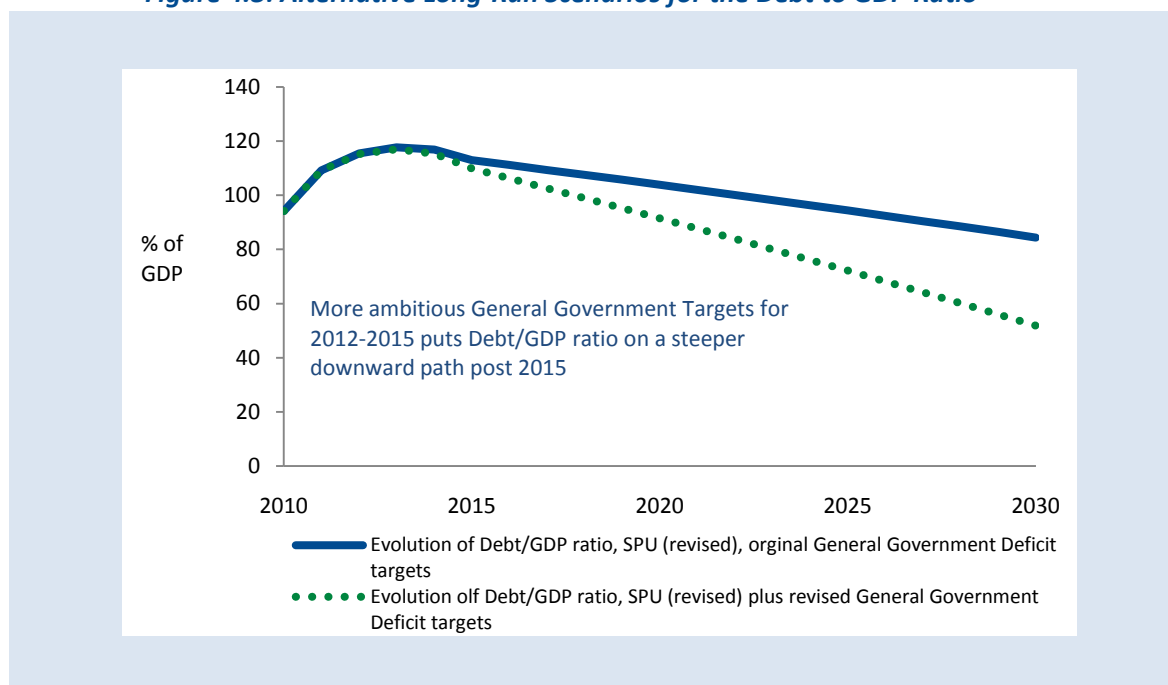
Source: Internal calculations.

**Table 4.2: Alternative General Government Deficit Targets and Discretionary Adjustments**

	2012	2013	2014	2015
<b>General Government Deficit Target (GGD) (% of GDP)</b>				
Original GGD Targets in SPU	8.6	7.2	4.6	2.8
Alternative Deficit Targets to get to GGD of 1% in 2015	8.4	6.4	3.6	1.0
<b>Estimated Discretionary Deficit Adjustments (€ Billions)</b>				
Planned Adjustment in SPU	-3.6	-3.1	-3.1	-2.0
Additional Adjustment Required for Original Targets	-0.4	0.4	-0.1	0.0
Additional Adjustment Required for Alternative Targets	-0.4	-1.2	-0.6	-1.7
<b>Total Additional Adjustment</b>	<b>-0.8</b>	<b>-0.8</b>	<b>-0.7</b>	<b>-1.7</b>
<b>Total Adjustment Required to Reach a 1% GGD in 2015</b>	<b>-4.4</b>	<b>-3.9</b>	<b>-3.8</b>	<b>-3.7</b>

Source: Internal calculations.

**Figure 4.3: Alternative Long-Run Scenarios for the Debt to GDP Ratio**



Notes: Nominal Interest Rate - Nominal Growth Rate = 1 pp, 2016-2030. Primary surplus held constant as a Share of GDP at 2015 Level, 2016-2030.

### 4.3.2 The Importance of Detailed Multi-Year Expenditure and Revenue Plans

Uncertainty about the future of the economy and fiscal burdens can lead to high levels of precautionary saving. Moreover, even when the overall level of fiscal adjustment is well anticipated, uncertainty about how it will be distributed can lead risk-averse households to build their saving buffers and businesses to postpone investments. While a review of the international literature suggests that it is unlikely that austerity could actually expand the economy, it remains true that reducing the uncertainty households and businesses face should have a beneficial effect for any given level of planned deficit reduction. This recommends providing as much certainty as possible in regard to the details of the planned adjustments.

Another argument for providing more detail of the measures to be taken is that it helps reinforce market- and official-lender confidence. While a government might announce ambitious plans for reducing the deficit, it might not be evident in advance that they have the political capacity to push through with the adjustments once specific painful measures are announced. Providing detail on the proposed adjustments helps build confidence that the Government has the capacity to impose losses on specific groups. Overall, while the Council recognises the practical and political difficulties of outlining the details of multi-year measures in advance, the Council recommends that the Government errs on the side of providing as much detail as possible in the upcoming four-year plan and Budget 2012, going beyond the high-level revenue and current and capital expenditure figures outlined in the SPU.

At the same time, it is important for policymakers not to reduce their margins of manoeuvre to achieve the necessary consolidation by selectively putting certain measures – e.g., tax rates, social welfare rates, and public sector pay rates – out of bounds. This may make future decisions in other areas more complicated and detracts from the credibility of the overall plans.

For this report, the Council has not considered in detail the appropriate mix of adjustments from a macroeconomic perspective. Debate in this area has been dominated by international findings that point to the superiority of expenditure-based adjustments (Box 4.1 contains a review and discussion of the evidence). However, the Council notes that recent work by IMF researchers has found that a significant part of the superior performance is explained by different reactions by the Central Bank depending on the form of adjustment. In the case of Ireland, the lack of domestic control over interest rates may take away at least part of the assumed macroeconomic advantage of the expenditure-based alternative. This is a question that the Council expects to return to in future reports.

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