



Opening Statement by John McHale, Chair of the Irish Fiscal Advisory Council

Joint Committee on Finance, Public Expenditure and Reform

26 April 2012

Introduction

Good afternoon. I'd like to thank you on behalf of the Council for inviting us to appear again before the Committee. I would like to introduce you to the other Council Members in attendance today, Sebastian Barnes, Alan Barrett and Donal Donovan. Unfortunately, due to a pre-existing commitment, Roisin O'Sullivan cannot attend today. Two of the Council Secretariat are also present, namely, Eimear Leahy and Diarmaid Smyth. [I would also like to point out that Sebastian will have to leave by 4pm, in order to return to Paris.]

Today, I would like to cover our second Fiscal Assessment Report.

Fiscal Assessment Report, April 2012

The Council published its second Fiscal Assessment Report, on April 3. The main purpose of this report was to assess the macroeconomic and budgetary projections set out by the Government in *Budget 2012*, including the appropriateness of the overall fiscal stance over the period to 2015, in advance of the Stability Programme Update (SPU), which will be published later this month.

Macroeconomic Assessment

The report firstly assessed macroeconomic developments since the Budget. The economy returned to growth in 2011 following 3 years of contraction. *Budget 2012* projected real GDP growth of 1.3 per cent for this year with average annual growth of 2.8 per cent for the period 2013-15. While the macroeconomic projections in the Budget were broadly appropriate at the time of publication, recent developments suggest that the growth outlook underlying the Budget, particularly for 2012, looks to be on the high side.

More broadly, a central theme to our report was the unusually high degree of uncertainty surrounding growth prospects over a two to three year period, in part reflecting possible external developments. In addition, from a domestic perspective, the behavioural dynamics – of Irish households, investors and financial institutions are some way from being understood at this stage. The Council believes that for future Government reports, it would be helpful if the presentation of forecasts were to give a greater prominence to uncertainty and to include a clear assessment of the balance of risks.

Budgetary Assessment

In terms of the budgetary outlook, last year's Budget involved a consolidation package of €3.8 billion, which was higher than had been initially planned in the 2011 *SPU*. The need for larger fiscal adjustment to meet existing targets had been signalled by the Council in our first assessment report. The main tax change in the Budget was the increase in the standard rate of VAT. Our own analysis indicated that the projection for VAT in 2012 was broadly appropriate.

As mentioned, the macroeconomic outlook for the economy has weakened since the Budget was published which pointed to some downside risks of attaining the General Government deficit target for this year. The simulations in the Fiscal Assessment Report were based on the *Budget 2012* baseline. The latest information to hand, which was published by the Department of Finance on Monday of this week, points to very significant revisions to the deficit and debt figures for Ireland in 2011 and 2012. The *Maastricht Returns Information Note* estimates an overall General Government deficit of 13.1 per cent of GDP in 2011 and 8.2 per cent for 2012, as opposed to 10.1 per cent and 8.6 per cent respectively in the Budget. I am happy to take questions on these revisions.

For 2013 to 2015, there appears to be a broad consensus among official agencies that the General Government deficit will steadily improve to 3 per cent of GDP in 2015. These forecasts take account of a projected sharp rise in interest expenditures in part reflecting the ending of the promissory note interest holiday. Debt levels in the economy are projected to remain elevated with a gross debt to GDP ratio projected to peak at 119 per cent of GDP in 2013 according to *Budget 2012*.

In light of the uncertainty surrounding the growth outlook and also a suggestion from this Committee at our last visit, the report also considered the sensitivity of the budgetary projections to changes in the macroeconomic outlook. These simulations highlighted the sensitivity of the budgetary forecasts to changes in the macroeconomic outlook. For example, one simulation showed that in the event that nominal GDP was 1 percentage point weaker per annum over the period 2012 to 2015 than envisaged in *Budget 2012*, the debt to GDP ratio would not stabilise by 2015 without additional discretionary measures. In any event, debt levels will remain high over the medium-term and vulnerable to negative growth shocks.

Assessment of Fiscal Stance

The Council's view on the appropriate fiscal stance was again widely reported. Clearly, policy makers face an unenviable dilemma in this regard as, on the one hand, more ambitious fiscal adjustment slows the economy. On the other hand, slower fiscal adjustment reduces fiscal sustainability, leaving the economy on a higher debt/GDP path. Higher debt levels are unsafe in so far as they undermine credibility and jeopardise access to funding. Higher debt levels are also unfair in that the burden is shifted to younger generations.

For 2012, the Council is of the view that the General Government deficit target of 8.6 per cent of GDP is adhered to. As regards 2013-2015, the headline budgetary targets set out in *Budget 2012* remain within the range of appropriate courses of action. Nevertheless, weighing up the arguments,

the Council continues to believe in the need for more ambitious consolidation than currently envisaged by the Government. This assessment was not arrived at lightly. The Council factored in the deterioration in the growth outlook, the fragility of debt sustainability, the improvement in Irish creditworthiness, the short-term costs of additional austerity, and the Government's own choice of a less ambitious budgetary target for 2012 than that underlying the Council's October 2011 analysis. The Council favours an alternative adjustment path with additional cumulative budgetary adjustments of €2.8 billion compared with those currently envisaged by the Government. Simulations indicate that such an adjustment path would yield a General Government deficit of 1.7 per cent of GDP in 2015 (compared to the Government's target of 2.9 per cent and the Council's October 2011 proposal of 1 per cent) and a primary surplus of 4 per cent of GDP.

Finally, the report also argued for the need for policies which preserve credibility while retaining flexibility. To elaborate, provided existing programme commitments are not overriding, the Council favours setting out fiscal adjustment paths in terms of discretionary measures in absolute terms, rather than focusing on specific deficit to GDP targets. Such an approach could reduce the possible downward spiral effects of negative growth surprises and better facilitate the operation of automatic stabilisers.

Conclusion

I would like to conclude by thanking the Committee for providing us with the opportunity to meet with you today. The Fiscal Council has been up and running now for effectively nine months, in which we have produced three reports. We believe that the Council has already begun to have an impact on the budgetary architecture in Ireland. Our appearance before you today is part of this process. Above all, the Council's main value will be in the long-term. It is imperative that the budgetary mistakes of the past are not repeated and the costs and risks inherent in pursuing bad fiscal policy are highlighted. At all times, we will strive to be independent, objective and to provide a voice in the best interests of the Irish public.