

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

Joint Committee on Finance, Public Expenditure and Reform

17 November 2011

Introduction

Good afternoon. I'd like to thank you on behalf of the Council for inviting us to appear before the Committee today. We very much welcome the opportunity to share our views with the Oireachtas committee and respond to your questions.

I would like to introduce you to the other Council Members, Sebastian Barnes (OECD), Alan Barrett (Trinity College Dublin, on secondment from the ESRI), Donal Donovan (University of Limerick and former IMF staff), and Roisin O'Sullivan (Smith College, Massachusetts). The Council Secretariat are also present, namely, Rachel Joyce, Eimear Leahy and Diarmaid Smyth. Today, I would like to draw your attention to four areas:

1. The mandate of the Irish Fiscal Advisory Council.
2. The Council's first Fiscal Assessment Report, which is the main purpose of our visit.
3. The Council's initial reaction to the Medium-Term Fiscal Statement.
4. An update on the process of inputting into the Fiscal Responsibility Bill.

1. The Irish Fiscal Advisory Council

The Irish Fiscal Advisory Council was established in June 2011. As you aware, forthcoming legislation in the form of the 'Fiscal Responsibility Bill' (FRB) will establish the Council on a statutory basis. The Council is initially being funded through a grant-in-aid provided by the Government, with long-term funding to be considered in the context of the FRB. The Council is currently being supported by a three person secretariat. The secretariat has been in full-time operation since September.

The Council's mandate has four elements:

- To assess the Government's macroeconomic projections.
- To assess the Government's budgetary projections.
- To assess the Government's fiscal stance in light of its own objectives.
- To assess compliance with fiscal rules (forthcoming as part of the FRB).

2. The Fiscal Assessment Report

The Council published its first report, the 'Fiscal Assessment Report' on October 12. The purpose of this report was to assess the fiscal stance as set out in April's 'Stability Programme Update' (SPU), which was the most recent Government budgetary publication at the time, with a view to the

appropriate fiscal stance for Budget 2012. With developments unfolding so rapidly, this included updating for developments over the intervening months.

Macroeconomic Assessment

The Report firstly assessed macroeconomic developments since the publication of the SPU. The Council felt that the SPU macroeconomic forecasts were appropriate at the time of publication. However, since then, most forecasting agencies have revised growth rates for Ireland downwards reflecting increasing uncertainties about the global economy. This was reflected in the Report.

Budgetary Assessment

In terms of the budgetary projections, the Council felt that the SPU projections to 2015 were broadly appropriate at the time of publication, albeit with downside risks. Since the SPU, there has been a series of significant developments impacting on the budgetary outlook. It was a particular focus of the Report to try to reflect these. In particular, the changes agreed by European leaders in July will lower the average interest rate on outstanding debt by a significant margin. Furthermore, banking recapitalisation costs are now lower than had been anticipated. However, these developments are being offset by weaker (and more uncertain) economic activity.

For 2011, the Council felt that the General Government deficit target of 10 per cent of GDP looked achievable, particularly given the Exchequer data available in early October. The Medium-Term Fiscal Statement published on November 4, projected that the deficit is now likely to be 10.3 per cent of GDP.

Assessment of Fiscal Stance

Over the medium term to 2015, to meet the deficit targets agreed with the EU/IMF, the Government faces an unenviable balancing act in deciding on the appropriate fiscal stance. Domestic demand remains weak, unemployment levels are elevated and the global economic environment remains uncertain. The domestic economy is operating well below its potential and further pro-cyclical budgetary measures will negatively impact on demand. The debt situation remains fragile, with the debt to GDP ratio projected to decline slowly from a very high level in 2013. This leaves the economy vulnerable to adverse growth and financing shocks.

For 2012, the Council suggested that the 8.6 per cent deficit target would be narrowly missed on current policies (that is based on the SPU). It was the Council's view, that additional discretionary adjustments will be needed (above the initially planned €3.6 billion) to meet the 8.6 per cent target in 2012. We had estimated the need for additional measures of €400 million. The Department of Finance in the Medium-Term Fiscal Statement puts this figure at €200 million, meaning a consolidation package of €3.8 billion for next year.

Over the four year period to 2015, the Council saw strong merit in strengthening the fiscal consolidation effort beyond the targets set out in the SPU. In particular, the current plans 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 in 2015 would be appropriate. This suggested the need for additional consolidation measures of €4 billion over a four year period.

Retaining the current SPU deficit targets (as a percentage of GDP), however, was also viewed by the Council as within the range of appropriate courses of action.

The Council's recommendations for more consolidation have been the subject of much debate. The call for additional consolidation was not made lightly particularly given the very painful measures taken since mid-2008. The massive rise in the rate of unemployment and the surge in emigration levels bear testament to the real and tangible costs associated with the severe and unprecedented economic downturn. On balance, however, the concerns over the fragility of debt sustainability, the slow path of debt reduction under current plans, and the market/official lender funding vulnerabilities facing the Irish State, led to the proposal for a more rapid restoration of sound public finances and specifically a General Government deficit target of 1 per cent of GDP in 2015.

Following the publication of the Report we became aware of two errors, including the figure quoted for the 2009 General Government deficit on page 34 of the original Report which wrongly identified the *unadjusted* deficit (inclusive of bank recapitalisation costs) for 2009 as the *underlying* deficit. The Council is committed to upholding the highest standards of accuracy and transparency. These errors were corrected and a correction published on the IFAC website. We would like to stress that these errors in the presentation do not change the conclusions of the Report.

3. Medium-Term Fiscal Statement

Since the publication of the Report, the Government has published its Medium-Term Fiscal Statement (MTFS), which updates the projections and fiscal stance set forth in April's SPU.

Although the MTFS revises upwards the forecast for the real GDP growth rate in 2011, concerns about global growth and continued weaknesses in domestic demand have led to downward revisions for growth in 2012 and 2013. The required budgetary adjustment to meet a General Government deficit target of 8.6 per cent of GDP was revised upwards to €3.8 billion from €3.6 billion. On the fiscal stance, the Government reaffirmed its target of a General Government deficit of just below 3 per cent of GDP in 2015.

The Council will be providing a full assessment of the MTFS and the forthcoming Budget 2012 in its Spring Fiscal Assessment Report. The Spring report is timed so as to provide timely input into the next Stability Programme. However, we would like to briefly make some initial comments on the MTFS ahead of the Budget:

- There is a pattern of downward revisions to growth forecasts for the upcoming two years, while assuming that growth will return to an underlying GDP growth rate of 3 per cent in subsequent years. For reasons of prudent planning, the Council believes that it would be worthwhile to explicitly consider a low-growth scenario for the budgetary projections, under which potential growth remains low over a medium-term horizon.
- Although the MTFS does provide a broad disaggregation of proposed fiscal adjustments out to 2015, the level of detail does not go sufficiently far in providing certainty to households, businesses and financial investors in terms what measures to expect.
- While the Council appreciates that the chosen fiscal adjustment path reflects a difficult balancing act between the costs/risks of austerity and the costs/risks of debt build-up, we

would like to have seen a more detailed response to the Council's arguments for a moderately faster adjustment.

4. The Fiscal Responsibility Bill

The FRB is due to be published in the first quarter of 2012. The Bill will provide for the establishment of the Council on a statutory basis. The draft FRB also proposes three numerical fiscal rules, namely the public finance correction rule, the prudent budget rule and a sustainable expenditure growth rule.

The Council is actively considering the FRB and it is our intention to publish our views by mid December.

Conclusion

Finally, I would like to conclude by thanking the Committee for providing us with the opportunity to meet with you today. It is our firm belief that the Council will have an important role in the years to come. It is imperative that the budgetary mistakes of the past are not repeated and that Ireland regains full control of its public finances. The Council's main value will be in the long-term. At all times, we will strive to be independent, considered and, above all, to ensure that fiscal policy is conducted in the best long-term interests of the Irish public.

We hope that regular interaction with the Joint Committee will be a key part of our role and one of the pillars of strengthening the fiscal institutions in Ireland.