CUSTOMER TREASURY SERVICES

Economist's Weekly Market View

Tuesday, 24th August 2021

Strong case for increased Capital spending

The ESRI, in its Quarterly Economic Commentary published in June, argued the case for increased government capital spending in the present very low interest rate environment. It acknowledged the need for prudent management of current spending to bring the budget deficit down and put the public finances back on a sustainable footing after the sharp rise in government borrowing in 2020-21 as a result of the Covid-19 pandemic.

However, it believes that government borrowing is a viable option for funding "critical capital" projects given the expected strong growth rate of the economy over the coming years and likely continuing very low cost of sovereign debt financing. Increasing public capital spending can help address bottlenecks and infrastructure deficits in areas such as climate change, healthcare provision, technology and, in particular, argues the ESRI, housing, which would positively impact the long-term productivity and competitiveness of the economy.

The government appears to have taken this advice on board in terms of its latest medium-term projections for the public finances. In its update on the fiscal outlook in April, the Department of Finance projected a sharp fall in the budget deficit to 1.2% of GDP by 2023, with the public finances moving close to a balanced budget by 2025. In its July update, though, the Department recalibrated the government's medium-term fiscal framework to provide for additional spending to "increase the supply of housing and other critical infrastructure".

As a result, the government now plans to run significantly higher budget deficits over the next five years. The projected budget deficits for both 2024 and 2025 now stand at circa €7.5 billion or 1.5% of GDP. This is well above the deficits of €3 billion in 2024 and just under €1 billion in 2025 set out in last April's update.

Obviously, there are some concerns that this will increase the high level of government debt even further and add to annual interest payments. However, with strong growth anticipated in the coming years, the government debt ratios are still projected to decline. Annual debt interest payments are also expected to remain very low, helped by the fact that maturing debt with higher annual coupon payments is being replaced with new debt with much lower interest rates.

Governments are also able to lock into very low interest rates for a long time period. Indeed, the Irish authorities can issue ten year bonds at a negative interest rates, while 30 year bonds carry a yield of 0.6%. These very low funding costs are a direct result of the ECB's loose monetary policy. Official ECB rates are pitched at -0.5%, while it is also engaged in large scale purchases of government debt or quantitative easing (QE).

These accommodative policies are expected to remain in place over the next number of years. Markets do not expect the ECB to begin to raise rates until well into 2024, with rates remaining negative out to 2027. Meanwhile, the ECB's bond purchases are also set to continue over the next number of years.

Thus, there is an opportunity for the Irish government to raise long term debt at very low interest rates for productive capital investment purposes in the period ahead. The long duration and low interest rates are key to the sustainability of the debt, as well as the strong growth rate of the economy.

It means that the government will not face a wall of maturing debt that might be challenging to refinance in a short timeframe, or large annual bills for interest payments. The real challenge will be to ensure the borrowed funds are invested wisely.

Oliver Mangan
AIB Chief Economist,
AIB

* *

R:mrk-com/Mlt View/Mkt View2021/.doc

This publication is for information purposes and is not an invitation to deal. The information is believed to be reliable but is not guaranteed. Any expressions of opinions are subject to change without notice. This publication is not to be reproduced in whole or in part without prior permission. In the Republic of Ireland it is distributed by Allied Irish Banks, p.l.c. In the UK it is distributed by Allied Irish Banks, plc and Allied Irish Banks (GB). In Northern Ireland it is distributed by First Trust Bank. In the United States of America it is distributed by Allied Irish Banks, plc. Allied Irish Banks, p.l.c. is regulated by the Central Bank of Ireland. Allied Irish Bank (GB) and First Trust Bank are trademarks used under licence by AIB Group (UK) p.l.c. (a wholly owned subsidiary of Allied Irish Banks, p.l.c.), incorporated in Northern Ireland. Registered Office 92 Ann Street, Belfast BT1 3HH. Registered Number NI 018800. Authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. In the United States of America, Allied Irish Banks, p.l.c., New York Branch, is a branch licensed by the New York State Department of Financial Services. Deposits and other investment products are not FDIC insured, they are not guaranteed by any bank and they may lose value. Please note that telephone calls may be recorded in line with market practice.