Irish Economic Update
AIB Treasury Economic Research Unit

AIB

10th October 2017

Budget 2018

Deficit Close To Being Eliminated

The Irish economy has performed strongly in recent years, which has helped to boost tax receipts. Meanwhile, debt interest costs have fallen quite sharply, helped by QE and negative ECB interest rates. Control has also been kept on public spending. As a result, the budget deficit has declined at a much quicker than expected pace. The Government is forecasting that the deficit in 2017 will equate to just 0.3% of GDP.

Stronger EU fiscal rules, which focus on the structural budget balance and expenditure controls, have made it difficult for governments to introduce very stimulatory budgets. Thus, despite the marked improvement in the public finances, the Government had limited room for manoeuvre in today's budget, with much of the fiscal space of €1.2 billion already pre-committed. Overall, the 2018 budget is mildly expansionary, containing some small cuts to taxes on income, as well spending increases partly funded by a number of tax raising measures. The Government is targeting a budget deficit to 0.2% of GDP in 2018, with a small surplus being forecast by 2020.

Budget 2018: The Key Figures

- **The Irish budget deficit has fallen to a very low level.** It is forecast at 0.3% of GDP for 2017 and is predicted to fall slightly to 0.2% in 2018. This compares to a deficit of 0.7% last year and 2.0% in 2015. The deficit was as high as 8% of GDP as recently as 2012. In absolute terms, the general government deficit is forecast at €1bn for this year and €0.5bn in 2018, down from €1.9bn in 2016 and €5bn in 2015. It stood at €14bn in 2012.

- **The budget is mildly expansionary for the fourth year in a row.** This is in marked contrast to the severe fiscal tightening of the 2008-2014 period when some €30 billion of austerity measures had to be implemented to restore order to the public finances. The so-called fiscal space for 2018, though, is quite small at €1.2bn. Much of this was already pre-committed, leaving less than €350m in net terms at play in today's budget. The Minister, though, included some **significant tax raising measures** amounting to €830m in the budget. Thus, he was able to announce a €1.2bn budget day package of additional spending and small cuts to taxes on income.

- The budget figures in 2017 are evolving very much in line with forecast, with both revenue and expenditure very close to target so far this year. **The projections underpinning the 2018 budget look reasonable and our best judgement is that the outturn will be close to target again next year**. GDP growth is forecast by the Dept. of Finance to slow somewhat to 3.5% next year from 4.3% in 2017. Tax receipts are forecast to rise by 4.9% in 2018 before today's changes, just slightly ahead of the expected growth in gross national income.

- **Ireland's general government gross debt/GDP ratio has been in marked decline since 2012/13** when it hit 120%. It is expected to fall to 70% by end 2017 from 73% last year. However, it should be noted that inflated GDP figures in 2015 overstate the rate of improvement and underestimate the size of the actual debt burden. A better measure, as used by the Irish Fiscal Council, is **government net debt to GNI*** (modified Gross National Income), with the ratio put at 93% at end 2016. We estimate that it will have declined to 89% by end 2017.

- **EU fiscal rules mean that the Government's room for manoeuvre on the public finances is limited,** resulting in a relatively prudent budget for 2018. This would seem appropriate given the uncertainties for the economy posed by Brexit and the still high level of public debt. Nonetheless, significant milestones are within reach, with the budget deficit close to being eliminated, with an expected move into surplus by 2020.

Oliver Mangan
Chief Economist
oliver.n.mangan@aib.ie

John Fahey
Senior Economist
john.j.fahey@aib.ie

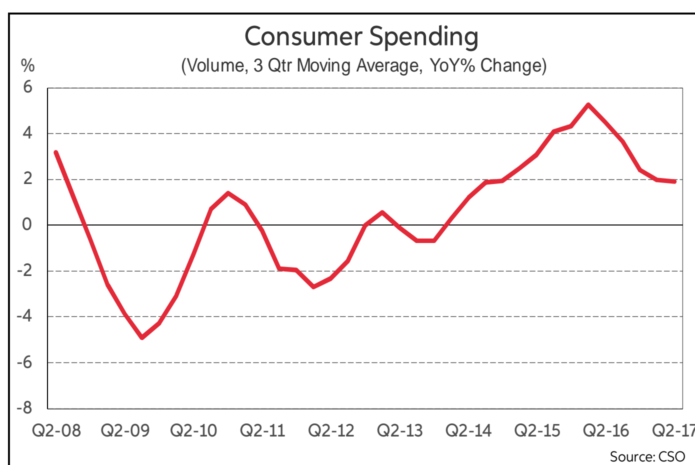
Dara Turnbull
Economist
dara.c.turnbull@aib.ie

Growth Remains Strong, but Slowdown in Domestic Demand This Year

- **The past number of years have seen a strong recovery by the Irish economy that has surpassed all expectations**. This has been led by robust export growth, but there has also been a strong rebound in domestic demand, including business investment, construction and consumer spending.

- The **latest National Accounts data show that the economy grew by 5.5% year-on-year in the first half of 2017.** However, owing to base effects, annual GDP growth is likely to slow sharply in H2 2017 - GDP rose by 2.2% and 5.8% in the final two quarters of 2016, which is unlikely to be repeated this year. Hence, GDP growth is forecast to average around 4.5% for 2017 as a whole, with some forecasts of 5%. It grew by 5.1% in 2016.

- **Exports have continued to perform strongly in 2017,** with service exports up by 15% year-on-year in H1. However, there has been **a significant slowdown in the rate of growth in domestic demand**. Growth in core domestic spending—consumer and government spending plus core investment (i.e. excluding aircraft and intangibles) - slowed to 2.7% year-on-year in H1 2017 from an average rate of 4.8% over the previous three years. Construction has continued to grow strongly, rising by over 20% yoy in H1 2017. However, core business investment has fallen back, having doubled in the previous four years.



- Meanwhile, **consumer spending rose by 1.75% yoy in H1 2017, well below the strong growth rates of 4.2% and 3.3% seen in 2015 and 2016, respectively.** Core retail spending (i.e. excluding the motor trade) has continued to grow strongly, rising by 6.5% year-on-year in H1. However, there has been a marked slowdown in the growth in car sales (new and second-hand imports) this year. **Spending on services has been sluggish**, rising by just 1.2% in H1'17. The weakness of consumer spending is at odds with the strong growth in employment, pick-up in wage growth and near zero rate of consumer price inflation evident this year. Thus, we would not be surprised to see this year's consumer spending figures revised upwards, especially for services.

DEPT OF FINANCE ECONOMIC FORECASTS

(%)	2015	2016	2017(f)	2018(f)	2019(f)
GDP	25.6	**5.1**	**4.3**	**3.5**	**3.2**
GNP	16.3	9.6	0.0	3.3	3.0
Private Cons	4.2	3.3	2.3	2.3	2.2
Gov Expd.	1.8	5.3	2.0	2.0	2.0
Fixed Inv.	27.9	61.2	-3.7	6.1	5.6
Exports	38.4	4.6	3.5	4.8	4.3
Imports	26.0	16.4	-1.0	5.5	4.9
HICP	0.0	-0.2	0.2	0.8	1.4
Employment	2.6	2.9	2.8	2.3	2.1
Unemploy. Rate	9.5	7.9	6.3	5.7	5.5

- **Labour market data remain strong,** with employment up 3% year-on-year H1 2017. Meanwhile, the **unemployment rate had declined to 6.1% by September,** down from 6.9% at end 2016.

- Overall, despite the weakening in growth in domestic demand, **the economy has continued to perform well this year.** GDP growth is now being widely forecast at between 4.5-5.0% for 2017, leaving Ireland as still one of the fastest growing economies in Europe. This is despite the considerable uncertainty caused by Brexit and very sharp rise in the euro exchange rate against sterling in 2016-17.

Slower GDP Growth Expected in 2018 and 2019

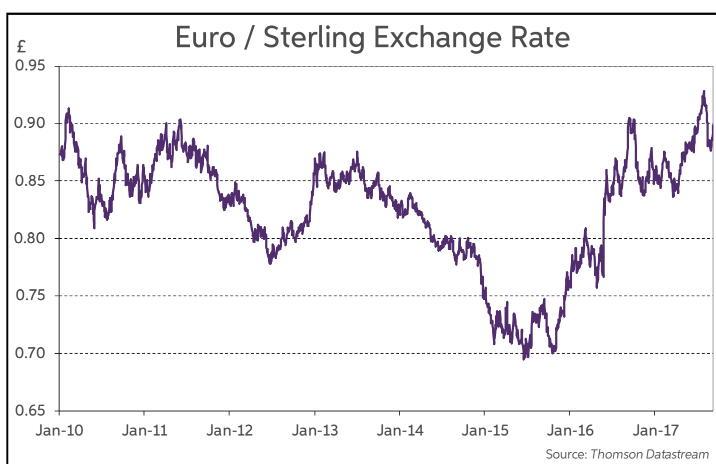
- An analysis done by the ESRI suggests that **Brexit will significantly impact the growth rate of the Irish economy,** with activity obviously being more negatively affected by a hard than a soft Brexit. The impacts are also front-end loaded, being mainly felt in the first couple of years after Brexit. The **uncertainty around Brexit and associated weakness of sterling** are also likely to be a headwind for growth in the run-up to March 2019, when the UK is due to leave the EU.

COMPARATIVE ECONOMIC FORECASTS 2018/2019

%	AIB	Dept. of Finance	ESRI	Central Bank
2018				
GDP	**3.5**	**3.5**	**4.0**	**3.6**
GNP	3.0	3.3	3.9	3.4
Private Cons.	2.5	2.3	2.8	2.7
Gov. Expd.	2.0	2.0	3.6	1.5
Fixed Inv.	6.0	6.1	12.0	8.5
Exports	4.0	4.8	4.9	4.1
Imports	4.3	5.5	7.7	5.3
2019	AIB	Dept. of Finance	IMF	
GDP	**3.0**	**3.2**	**3.0**	
GNP	2.5	3.0	n.a.	
Private Cons.	2.5	2.2	1.8	
Gov. Expd.	2.0	2.0	2.7	
Fixed Inv.	5.0	5.6	4.4	
Exports	4.0	4.3	4.3	
Imports	4.2	4.9	4.7	

- **There are a number of factors, though, which should be supportive of activity in the next couple of years. The external environment is expected to remain favourable.** Global growth is picking up momentum, most notably in our main export market, the Eurozone. However, growth in the UK is likely to be subdued in 2018-19.

- **Meanwhile, fiscal policy is likely to stay mildly expansionary. Interest rates have fallen to record low levels** and are expected to remain very low over the next couple of years. **Real incomes are also increasing,** with wage growth picking up and continuing good growth in employment anticipated in 2018/19. Inflation is expected to remain subdued, helped by the sharp weakening of sterling. We expect the construction sector to make a significant contribution to economic growth over the next couple of years, in particular house building activity, which is continuing to recover from very low levels of output. Ireland is also benefitting from large inflows of FDI, which could receive a further boost from Brexit.



- **Both AIB and the Dept. of Finance are forecasting 3.5% GDP growth for next year,** with the Central Bank at 3.6% and the ESRI slightly higher at 4%. **GDP growth in 2019 is forecast at 3%** by AIB and the IMF, with the D/Finance at 3.2%.

- **There are downside risks to the above growth forecasts, in particular from Brexit**. Sterling's slump and Brexit uncertainty could weigh on activity to a greater extent than expected. Difficult negotiations over Brexit could put even more downward pressure on sterling and cause a further slowdown in the UK economy, hitting Irish exports. A hard Brexit in early 2019 that delivers a major shock to key sectors of the Irish economy cannot be ruled out. Meanwhile, geopolitical risks are elevated at the present time, and the world economy remains vulnerable to financial shocks. However, if a soft Brexit materialises, then growth could again surprise to the upside, as has been the case in recent years.

Tax Hikes Give Scope for Spending Increases in Today's Budget

- **Fiscal rules mean that the Government had limited room for manoeuvre in today's budget.** The so-called fiscal space is defined as the projected amount of resources available to the Government for additional expenditure and/or tax reductions, while ensuring compliance with the fiscal rules, specifically the so-called Expenditure Benchmark and the preventive arm of the Stability and Growth Pact, which gives primacy to the structural budget balance. The Government is required to reduce the structural budget deficit by 0.6% of GDP per annum until it falls to 0.5% of GDP, a target that is expected to be reached next year.

- **The fiscal space available in 2018 is put at €1.2 billion. However, all but under €350 million of this was pre-committed.** Spending increases were already required to cover demographic pressures, public sector pay increases, higher capital spend, most notably on housing, and some other expenditures. The Government, though, did **increase a number of taxes today, which gave it room for some small cuts in income tax and significant additional spending in a budget day giveaway package totalling over €1.2 billion in gross terms.**

- Today's budget contained a **slight easing of the income tax burden**. Two lower USC rates were cut by 0.25% and 0.5% to give relief to low to middle income earners, with a widening of the standard tax band by €750 also. However, marginal income tax rates still remain very high for middle income workers in Ireland, at 48.75% on earnings between €34,550 and €70,044 and 52% on income above €70,044. There were some significant tax hikes announced in the budget, with increases in excise duty on cigarettes, a new sugar tax, a marked rise from 2% to 6% in the stamp duty rate on commercial property transactions, an increase in the National Training Fund levy for employers, plus some changes to capital allowances for intangible assets. Overall, Government revenue is set to rise by some €500 million net as a result of today's tax changes .

- Additional spending totalling €900 million was announced in today's budget, including increases in areas such as housing, health and child services. Social welfare benefits are also being increased by €5 per week. The biggest increases in spending in 2018 are in health, education, housing and child services.

- Overall, total gross voted government current spending will rise to €55.6 billion next year from €53.8 billion in 2017, an increase of 3.4%. Meanwhile, gross voted Exchequer capital spending is projected to rise by €700 million or 17.4%, to €5.3 billion, but it is still at quite a low level.

- Today's **budget giveaways amount to over €1.2 billion.** This cost is reduced, though, to €263m when one allows for the tax hikes, which will bring in €830m and effect of the giveaways on tax revenue buoyancy. The **Government has set a very low budget deficit target of 0.2% of GDP for 2018.**

- **The Government is adhering to EU fiscal rules** to reduce the structural budget deficit by at least 0.6% of GDP. It will fall from 1.1% of GDP in 2017 to 0.5% in 2018 according to the Dept. of Finance projections. This means the Government is set to **meet its so-called Medium Term Budgetary Objective of a balanced budget by 2018,** which is defined as structural deficit of 0.5% of GDP.

BUDGETARY PROJECTIONS : 2017 - 2019

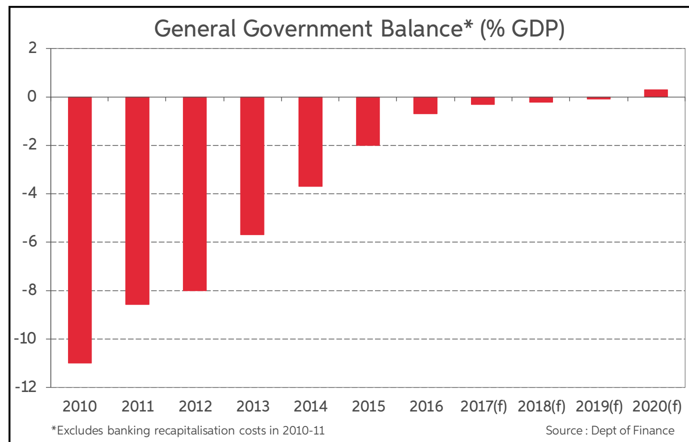
(€ bn)	2017	2018	2019
Net Current Expenditure	51.3	53.1	54.1
Net Current Revenue	53.4	56.0	58.3
Current Budget Balance	**2.2**	**2.9**	**4.2**
Capital Budget Balance	**-0.7**	**-5.2**	**-6.2**
EXCHEQUER BALANCE	1.5	-2.3	-2.5
GEN GOV BALANCE	**-1.0**	**-0.5**	**-0.3**
% of GDP			
Gen Gov Balance	-0.3	-0.2	-0.1
Interest Expd	2.0	1.9	1.8
Primary Balance	1.7	1.7	1.7

Source: Dept of Finance (Rainy Day fund adds €0.5bn to 2019 Exchequer deficit)

- The **primary budget** balance (i.e. excluding debt interest payments) moved into a small surplus in 2014 for the first time since 2007. The surplus is put at 1.7% of GDP this year. This compares with a peak deficit of 9.3% in 2009. In total, the primary budget balance has improved by some 11% of GDP in the period 2009-2017, or an average 1.4% per annum. **The primary surplus is forecast to remain at 1.7% of GDP in 2018 and 2019.**

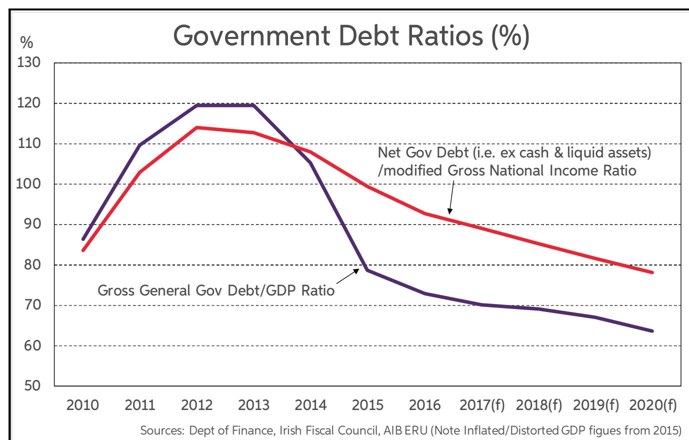
- While the level of government debt is still very high, **debt interest payments by the Exchequer are actually falling as a percentage of GDP.** They fell to 2.2% of GDP last year from 2.6% in 2015 and are estimated at 2.0% in 2017 and 1.9% in 2018. This is much lower than in the 1980s, when debt interest costs hit over 9% of GDP.

- The **greatest uncertainty around the Dept.'s budget projections, as always, is in relation to tax receipts.** In recent years, the Dept.'s tax projections have been prudent and erred on the side of caution, with revenues coming in around or ahead of forecast. A cautious approach is warranted again given the uncertainty attached to the economic outlook as a result of Brexit. Furthermore, there is also the on-going question about whether the surge in corporation tax receipts since 2015 will prove sustained or could they fall back again as the global corporate tax regime is tightened up.



- Gross national income is forecast to rise by 4.5% next year, while tax receipts are projected to increase by 4.9%, before today's budget changes. As was the case with the 2017 budget, it is **difficult to say where the balance of risk lies with regard to the 2018 budget forecasts.** The projections appear reasonable and our best judgement is that like this year, the budget deficit will be close to target again in 2018. The **risks are probably tilted slightly towards a higher deficit**, though, given that Brexit uncertainty and sterling weakness could have a greater impact on the economy and public finances than allowed for in the forecasts.

- **Ireland's general government gross debt/ GDP ratio has been in marked decline since 2012/13** when it hit 120%. It is forecast to fall to 70% by end 2017 and 69% by end 2018. However, inflated GDP figures in 2015 overstate the rate of improvement and underestimate the size of the actual debt burden. A better measure, as used by the Irish Fiscal Council, is Government net debt to GNI* (modified Gross National Income), with the ratio put at 93% at end 2016. We estimate that it should have fallen to 89% by end 2017.



- The Exchequer deficit for 2018 is forecast at €2.3 billion, while close to €9 billion in long term government bonds mature next year. **This gives a funding requirement of €11.3 billion in 2018, which is not overly demanding.** The Government, though, has very high balances of cash and other liquid assets. It may opt to reduce these somewhat next year, lowering its funding needs in 2018.

- The improvements in the Irish economy and public finances have been recognised by the market in recent years. Ten year Irish government bond yields are less than 0.7%, while yields on five year paper are negative. Irish bond yield spreads have narrowed considerably to core Eurozone markets, standing at 40bps over Germany and less than 15bps above France for the benchmark 2026 Irish bond, significantly lower than for Italy and Spain. Today's cautious budget should help underpin these narrow spread levels.

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 trade marks 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.