Irish Economic Update 14th October 2014

AIB Treasury Economic Research Unit

Budget 2015

Fiscal Policy Turns The Corner

It is now expected that the budget deficit in 2014 will be around 3.7% of GDP, much lower than the original 4.8% forecast. It means that there is no longer a need to implement €2 billion of fiscal tightening in 2015 to get the budget deficit down below 3% of GDP. Thus, the fiscal austerity programme that has been in place since 2009 is now at an end. Instead, the Minister for Finance was able to introduce a broadly neutral budget today, with tightening measures already in place for 2015, such as water charges and savings on public sector pay, being largely offset by increases in spending and tax cuts.

The reason for the more benign fiscal policy is that the economy is performing much better than expected, with GDP growth in 2014 put at 4.5-5.0%. GDP growth could average around 4% in the next couple of years. Government tax receipts, in particular, will benefit as a result. Hence, the Minister is forecasting that the budget deficit will fall to 2.7% of GDP in 2015 and 1.8% in 2016, and be in surplus by 2018.

Budget 2015: The Key Figures

- **The Irish budget deficit remains on a firm downward path.** It is forecast to fall to 2.7% of GDP in 2015 and 1.8% in 2016, down from 3.7% in 2014 and 5.7% last year. In absolute terms, the general government deficit is forecast at €5.3bn in 2015 and €3.9bn in 2016, down from €6.9bn in 2014.

- A €30 billion fiscal austerity programme was implemented over the period 2009-14 to restore order to the public finances. It had been envisaged that a further €2 billion adjustment would be required in the 2015 budget to get the deficit below 3% of GDP. However, this is no longer required, given the much better than anticipated budgetary outturn for this year.

- **Some of the 2015 fiscal tightening measures, though, are already in place**, such as the introduction of water charges and further savings in public sector pay. **However, these are being offset by spending increases and tax cuts announced in today's budget.**

- **Today's neutral budget is a big shift in the stance of fiscal policy** after the severe fiscal tightening implemented in the past six years. The €30 billion austerity programme equated to 18% of GDP.

- **A key part of today's budget is a proposed new road map for corporate tax** to ensure Ireland remains an attractive destination for foreign direct investment. **Ireland's 12.5% corporate tax rate will not change.** However, the so called "double Irish" aspect of corporate tax is to be phased out by end 2020. Consultations are to take place on a proposed new low rate of corporate tax for earnings from IP (intellectual property) or patent type rights.

- **Ireland's general government gross debt/GDP ratio is now in decline.** It is forecast at 110.5% in 2014, down from 123.3% in 2013. However, these figures include borrowings which are being held as cash and other financial assets. These are still at high levels, currently amounting to €20 billion or 11% of GDP. Excluding these, the net government debt ratio would stand at under 100% of GDP in 2014.

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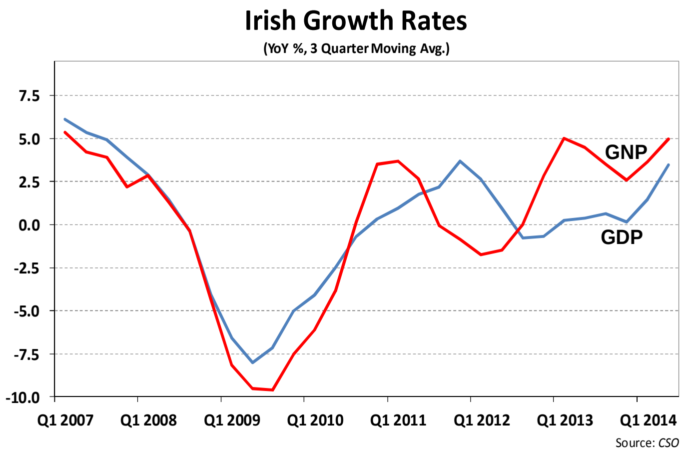
Strong Rebound By Irish Economy

- **This year has seen a lot of very robust data published on the Irish economy, pointing to a strong rebound in activity.** This was confirmed by recent National Accounts data published for the first half of the year. These showed that GNP rose by 6% year-on-year in the first half of 2014, with GDP up by 5.75%. It makes Ireland the strongest growing economy in the EU. The figures were well ahead of expectations and have caused economists to mark their growth projections for Ireland significantly upwards.

- **Exports have been the main engine of growth in the Irish economy in recent years,** and they performed particularly strongly in the opening half of 2014, rising by some 10%. There was a rebound in goods exports as the impact of the expiry of patents on pharmaceutical output abated. Meanwhile, service exports continued to grow strongly.

- **A recovery in consumer spending got underway this year**. It rose by 1.8% year-on-year in the second quarter. This reflects strong growth in spending on goods. Retail sales, excluding the auto sector, were up by 4% year-on-year in quarter two, while car sales are up 30% year-to-date. However, consumer spending on services remained flat in H1 2014.



- **Investment activity has risen strongly over the past two years.** Business investment rose by one-third and construction spending increased by 10% in the opening half of 2014 from year earlier levels. Housing data have been strong this year, with a large increase in new housing registrations and a jump of over 30% in completions in the first half of 2014.

- The impressive economic growth has seen **a marked improvement in labour market conditions.** Employment rose by 2% year-on-year in the first half of 2014. There has been a sharp drop in the unemployment rate, which was down to 11.1% in September from a peak of 15.1% in early 2012, a fall of four full percentage points in the past two years.

- **The outlook for the Irish economy is favourable.** Economic conditions in key export markets, such as the UK and USA, have improved considerably. On the domestic front, sectors which were very depressed, such as construction and retail spending, are starting to recover.

- Meanwhile, the austerity programme, which has been in place since 2009, is at an end. Interest rates are set to remain very low in the next few years, while the euro is weakening, helping the traded sector of the economy.

- **The Dept of Finance sees GDP growth of 4.7% in 2014 and 3.9% in 2015.** Thus, the economy is forecast to grow strongly again next year.

DEPT OF FINANCE ECONOMIC FORECASTS

(%)	2012	2013	2014	2015	2016
GDP	-0.3	0.2	4.7	3.9	3.4
GNP	2.0	3.3	4.1	3.6	3.1
Private Cons	-1.2	-0.8	1.7	2.7	1.4
Gov Expd.	-2.1	1.4	4.8	2.3	0.0
Fixed Inv.	5.0	-2.4	14.6	12.7	7.6
Exports	4.7	1.1	8.3	4.8	4.3
Imports	6.9	0.6	8.8	5.3	3.6
BOP (% GNP)	1.6	4.4	4.9	4.4	4.9
HICP	2.0	0.5	0.5	1.1	1.4
Employment	-0.6	2.4	1.8	2.4	1.9
Unemploy. Rate	14.7	13.1	11.4	10.2	9.4

Source: Dept of Finance, October 2014

- **Domestic demand is rebounding strongly and could grow by around 3.5% this year. The outlook is positive for the domestic economy.** Fiscal policy is no longer contractionary, with modest tax cuts being implemented in 2015. The sharp decline in Irish construction activity has run its course and the sector has started to recover. House building looks set to pick up over the next few years as a shortage of supply has emerged in parts of the market, boosting prices. House building should also be helped by the initiatives announced in today's budget to stimulate activity in the sector.

- Meanwhile, business investment is already growing strongly. Consumer spending will be helped by the improvement in labour market conditions, rising consumer confidence, the end to fiscal austerity and low interest rates. Meanwhile, exports should continue to benefit from an improving global economic environment, the influx of new foreign direct investment in recent years, and the recent weakening of the euro.

- In terms of the other main macro indicators, the Dept expects a continuing large balance of payments surplus of 4.4% of GDP in 2015. Meanwhile, **the unemployment rate is forecast to fall further to 10.2% in 2015,** down from 11.4% this year and 13.1% in 2013. **Employment is forecast to rise by 2.4% next year.** Inflation is expected to remain subdued, with the HICP rate forecast to average 1.1% in 2015.

COMPARATIVE ECONOMIC FORECASTS 2014/2015

%	Central Bank	Dept of Finance	AIB	ESRI
2014				
GDP	4.5	4.7	4.5	5.0
GNP	4.9	4.1	4.0	4.9
Private Cons.	1.4	1.7	1.0	1.5
Gov. Expd.	-1.7	4.8	3.5	0.0
Fixed Inv.	11.9	14.6	9.0	14.2
Exports	7.3	8.3	9.0	5.6
Imports	6.3	8.8	8.3	4.5
2015				
GDP	3.4	3.9	4.0	5.3
GNP	3.1	3.6	3.5	5.2
Private Cons.	1.6	2.7	1.5	2.0
Gov. Expd.	-1.1	2.3	1.5	0.0
Fixed Inv.	9.2	12.7	6.5	12.8
Exports	5.1	4.8	5.5	6.0
Imports	4.8	5.3	4.5	5.0

- The Dept's 2014 growth projections are in line with the forecasts published in the past couple of weeks by the Central Bank and ESRI. These see GDP growing by 4.5-5.0% this year. **The Dept's 3.9% GDP growth forecast for 2015 is above the Central Bank projection of 3.4%, but well below the ESRI, which is looking for growth of 5.3% next year.**

- AIB is forecasting GDP growth of 4% over the next couple of years after an increases of 4.5% in 2014. The somewhat slower growth expected going forward is due to the fact that export growth is likely to ease back after the outsized gains recorded in 2014. The big jump in exports this year is partly due the rebound in pharmaceutical output as the impact of the expiry of patents in the sector abates.

- **We view the risks to our growth forecasts as being balanced.** On the downside, the recovery in the global economy, especially in the eurozone, remains fragile and could easily falter, hitting exports and endangering the rebound in the Irish economy. On the other hand, **export growth could continue to exceed expectations** given the large influx of FDI in recent years and the gains made in Irish competitiveness. **Investment is also rebounding from very depressed levels** and so could register much stronger growth rates than embodied in the above forecasts. The construction sector, in particular, could rebound more strongly than currently anticipated, especially if house building has the capacity to respond quickly to meet the pent-up demand in the sector. We also note that the ESRI has been proved correct in the past couple of years in regard to its more optimistic forecasts on the Irish economy.

- Given the experience this year, it is fair to say that **Irish economic forecasts carry a wide margin of error**, reflecting in particular, the very large size of the export base at over 100% of GDP, with imports at 85% of GDP. Even small deviations from forecasts for the traded sector of the economy have a big impact on GDP. Furthermore, some sectors of the economy are rebounding from a very low base so it is more difficult than usual to make precise forecasts.

- **The key message is that a strong recovery has taken hold in the Irish economy which has extended to the domestic sector. The recovery is expected to continue as long as the external environment remains reasonably favourable,** given that the key macro policy drivers in terms of interest rates, the exchange rate and fiscal stance are all now working in favour of continuing strong economic growth.

Robust Recovery Permits Broadly Neutral 2015 Budget

- A very large €30 billion fiscal consolidation programme was implemented over the 2009-14 period. It had been expected that a further €2 billion of budget cuts would be needed in 2015 to bring the fiscal deficit down below 3% of GDP, as required by the EU. However, **this year's budget deficit has turned out to be much lower than forecast,** thanks to stronger than expected economic growth. The Dept now believes the budget deficit in 2014 will be 3.7% of GDP, well below the original 4.8% target. Allowing for the tax buoyancy associated with continuing strong economic growth next year, takes the budget deficit down below 3% of GDP in 2015, without implementing any further fiscal tightening.

- Thus, **the government has been able to introduce a broadly neutral budget today after six years of severe fiscal retrenchment.** Some of the fiscal tightening measures planned for 2015 have already been put in place, such as the introduction of water charges and further savings in public sector pay. However, these will be largely offset by **spending increases and tax cuts announced in today's budget.**

- There have been very sharp increases in direct taxation since 2009. **Today's budget provided some modest relief for taxpayers.** The top rate of income tax was cut from 41% to 40%, lowering the marginal tax rate, including USC, from 52% to 51%. There is a claw back, though, with a 1% hike in the USC charge on earnings above €70,000. The standard tax band was widened by €1,000 to €33,800. Some USC bands were also widened, while the lower USC rates were cut by 1% to give relief to low income earners. A tax credit of €500 at the standard 20% tax rate is also being introduced for water charges.

- The government is retaining the low VAT rate applying in the tourism sector. Meantime, the Pension Fund Levy is being reduced from 0.75% to 0.15% as had been promised.

- **The government is also proposing to make significant changes to the corporation tax regime** to ensure Ireland remains an attractive destination for foreign direct investment. **Ireland's 12.5% corporate tax rate will not change.** However, the so called **"double Irish" aspect of corporate tax is being phased out**. Consultations are to take place on a proposed new low rate of corporate tax for earnings from IP (intellectual property) or patent type rights.

BUDGETARY PROJECTIONS : 2014 - 2016

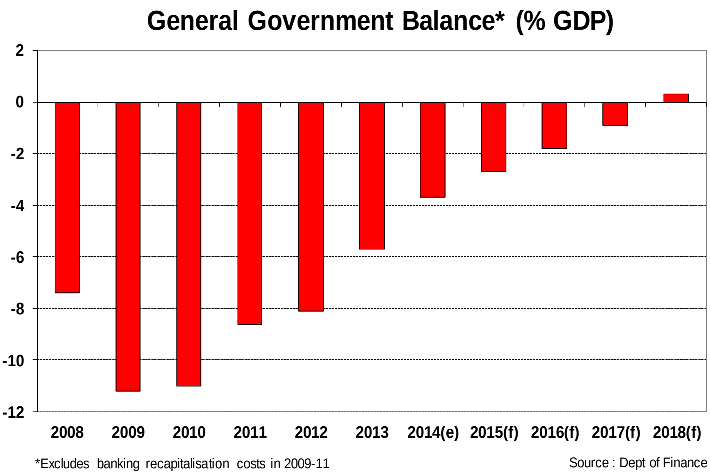
(€ bn)	2014	2015	2016
Net Current Expenditure	49.7	49.0	49.1
Net Current Revenue	44.1	45.3	46.9
Current Budget Balance	**-5.6**	**-3.7**	**-2.2**
Capital Budget Balance	**-2.3**	**-2.7**	**-1.0**
EXCHEQUER BALANCE	**-7.9**	**-6.5**	**-3.1**
GEN GOV BALANCE	**-6.9**	**-5.3**	**-3.9**
% of GDP			
Gen Gov Balance	*-3.7*	*-2.7*	*-1.9*
Interest Expd	*-4.0*	*-3.8*	*-3.8*
Primary Balance	*0.3*	*1.1*	*1.9*

Source: Dept of Finance

- House building is running at very low levels and needs to increase significantly to meet pent-up demand and ease the upward pressure on house prices. **A number of measures were announced today**

aimed at boosting activity in the construction sector. The 80% windfall tax on land development is being abolished. Instead, the standard 33% capital gains tax rate will apply. The Government announced a capital investment programme of €2.2 billion for social housing over the next three years to deliver 6,700 housing units by 2017.

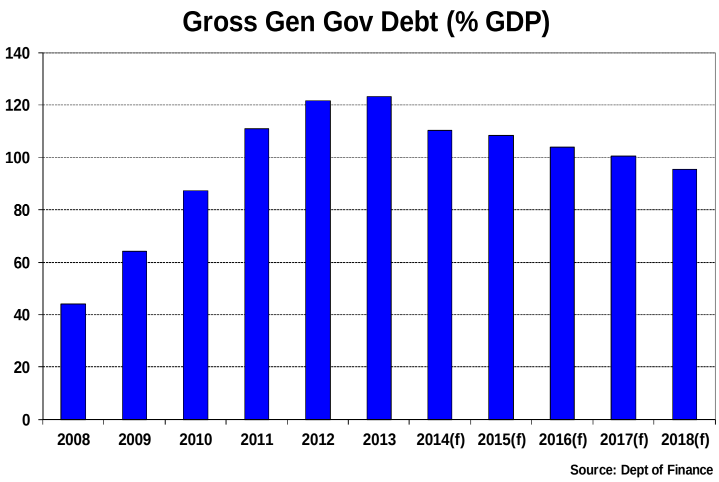
- **The government is also providing additional spending for education, justice and social welfare**, including a new €100 payment to welfare recipients to help meet the water service charge, as well as an increase in child benefit payments. Overall, though, there is little change to total gross voted government spending in 2015, which remains at €50.1 billion. Gross voted capital spending will rise by over €100 million.



- **Overall, today's neutral budget marks the end of austerity. The General Government budget deficit target has been set at 2.7% of GDP for 2015**. The Minister sees the deficit falling to 1.8% of GDP in 2016 and 0.9% in 2017, with a small budget surplus forecast by 2018.

- **The primary budget balance has moved into a small surplus this year of 0.3% of GDP for the first time since 2007. The surplus is projected to rise to 1.1% of GDP in 2015.** This compares with a peak deficit of 9.3% of GDP in 2009. In total, then, the primary budget balance will improve by some 10.5% of GDP in the six year period 2010-2015, or an average 1.7% per annum.

- The level of government debt is very high. We would point out, though, that **debt interest payments by the Exchequer are put at less than 4% of GDP in 2015.** This is considerably lower than in the 1980s, when debt interest rose to over 9% of GDP. We are now in a very low interest rate environment globally, and this is reflected in the low yields on Irish government bonds. Furthermore, the government has been able to refinance a significant portion of debt at much lower interest rates, a process that is expected to continue with the proposed early redemption of IMF loans.



- The principal risk to the Dept's budget projections for 2015 relate to the forecast rise in tax revenues, largely driven by an expected continuation of strong economic growth. **We have to say, though, that the Dept's tax projections are prudent and err on the side of caution**. In terms of the base in 2014, the Dept is not allowing for a continuation in Q4 of the trend of taxes running significantly ahead of schedule, as has been the case year-to-date. Thus, tax receipts in 2014 could be several hundred million higher than forecast in this budget, which would have positive carryover effects into 2015.

- Tax receipts were forecast to rise by 4.2% in 2015, before the tax cuts announced today, or by some 5.5% allowing for the sharp reduction in the Pension Fund Levy. Given that nominal GDP growth could be 5% next year, the projected rise in tax revenues looks reasonable. However, if economic growth projections disappoint, then tax receipts will not grow by as much as forecast. On balance, though, we think that tax receipts may slightly exceed target. This would push the budget deficit down below 2.5% of GDP in 2015, if the other budget projections on spending and non-tax revenue are close to target.

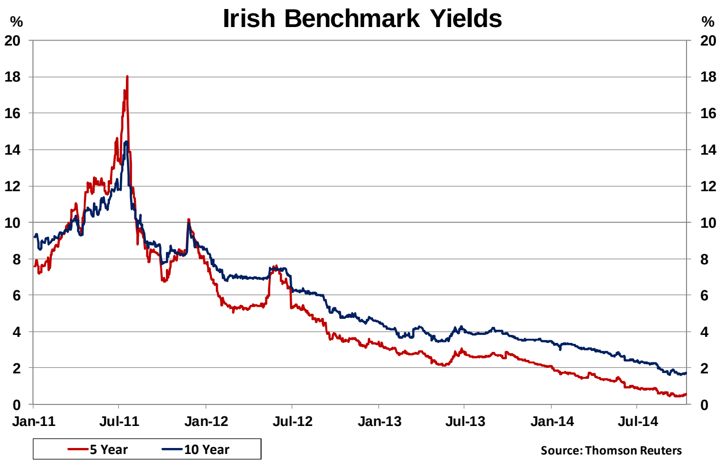
- **The gross general government debt ratio is put at 110.5% of GDP by end 2014, down from 123.3% in 2013** according to the Dept's figures. It expects the ratio to decline to 108.5% at end 2015 and 104% in 2016. **However, these figures do not allow for Exchequer cash balances and deposits** and other financial assets. These are very high at present, standing at €20 billion or 11% of GDP, at end September 2014.

- Allowing for these large liquid balances means that **the net general government debt ratio would stand at under 100% of GDP at end 2014.** This is a better figure to use than the gross ratio, as the State, in effect, has been doing considerable pre-funding and thus building up large cash balances and deposits, which have boosted the gross debt figure.

High Cash Balances Ease Funding Requirement

- There has been strong demand in markets for Irish paper again this year, and **yields on Irish government bonds have continued to fall sharply.** Five year yields are now down at 0.6%, with ten year bond yields at 1.7%, both historically low levels.

- The Exchequer deficit for 2015 is put at €6.5 billion, while just €2.7 billion of long term debt matures next year. **This gives a funding requirement of €9.2 billion in 2015. On top of this, the government expects to refinance a large portion of the IMF loans** drawn down under the bail-out programme. Some €18 billion of IMF loans could be refinanced in the next couple of years. Subject to satisfactory progress with respect to the protocols required to facilitate early repayment of part of Ireland's IMF programme loans, the NTMA expects to execute a syndicated bond transaction of benchmark size before year end, to begin this refinancing process. Further bond issuance for this purpose is likely in 2015, adding to the sovereign's funding requirement.



- **The government, though, has very high balances of cash and other liquid assets**, which totalled some €20 billion at end September. These are expected to be partially run down next year, meeting some of the NTMA's funding requirement. Overall, we anticipate **that the NTMA may raise about €10-12 billion in the bond market in 2015,** which would still leave the Exchequer with relatively high cash balances.

- Turning to 2016, the Exchequer deficit is forecast at €3 billion, while over €10 billion in long term debt matures. This gives a funding requirement of over €13 billion in 2016. Further issuance to refinance IMF loans is also likely. Again though, Exchequer cash balances are likely to be run down further, easing the funding requirement and leaving the NTMA with a manageable issuance agenda.

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