Irish Economic Update

AIB Treasury Economic Research Unit

8th October 2019

Budget 2020
Cautious Brexit Budget

The Irish economy has performed strongly in recent years, with favourable effects on the public finances. Meanwhile, debt interest costs have fallen quite sharply, helped by QE and negative ECB interest rates. As a result, the budget deficit declined at a much quicker than expected pace, with the government finances returning to a small surplus of €170m last year. A modest surplus of €670m is expected this year (0.2% of GDP).

Budget 2020 is based on the assumption that the UK will leave the EU without a deal at end October. Thus, it is a cautious, low-key budget, with a notable absence of income tax cuts in particular. Carbon taxes and some other taxes are being increased, while €650m in contingency funding is pencilled in to support industries that would be severely impacted if there is a no-deal Brexit. The Irish economy is expected to show very little growth next year in the event of a no-deal Brexit. The Government is projecting that the public finances will move back into a deficit of €2 billion (or 0.6% of GDP) in 2020 in this scenario.

The 2020 Brexit Budget: Key Points

- **Today's budget was framed on the basis of a hard Brexit,** with the UK leaving the EU without a deal at end October. **This is seen as having very negative consequences for the Irish economy.** GDP growth is forecast to slow to 0.7% next year, down from a forecast 5.5% in 2019. The unemployment rate is projected to rise to an average of 5.7% in 2020 from just above 5% currently.

- This obviously **has negative knock-on effects for the public finances.** The Government expects a budget surplus this year of around €670m, or 0.2% of GDP. However, **the public finances are expected to move back into deficit** in the event of a no-deal Brexit. The Government is forecasting a budget deficit of €2 billion next year, or 0.6% of GDP.

- **It is hard to argue with the low growth forecast for 2020,** which underpins the budget arithmetic. We will have not experienced an event like a no-deal Brexit before, but most analysis suggests that it would have a severe impact on the economy virtually immediately. **Tax receipts might struggle to grow by 4% in 2020, though, as predicted in the pre-Budget White Paper, given the economy virtually stalls in such a scenario.**

- **Total voted government spending is forecast to rise by 5% next year, largely reflecting increases that were already pre-committed** for capital projects, public sector pay and for demand led services as the population grows and ages. Further spending increases were announced in today's budget. The government is also pencilling in €650m of contingency funding to support sectors that would be hardest hit by a no-deal Brexit.

- **Tax raising measures in today's budget amounted to €450m,** including higher carbon taxes and increases in commercial stamp duty, dividend withholding tax and excise duty on cigarettes. Overall, while the Government opted for a cautious approach in today's budget, it still had **the feel of a tax and spend budget,** with tax hikes and an increase in core spending of €3.4bn, excluding no-deal related Brexit expenditure.

- **Finally, Ireland's public debt remains at a high level.** The National Debt currently stands at €189 billion, close to the level of modified gross national income in 2018, which is estimated at €197.5 billion.

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

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

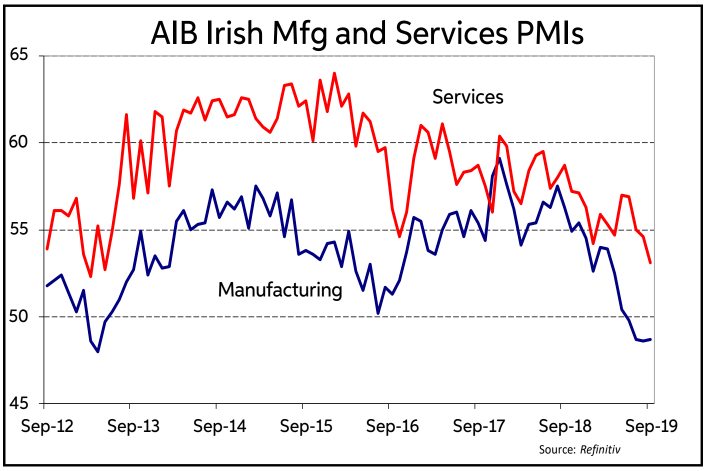
Conor Beakey
Economist
conor.x.beakey@aib.ie

Pace of Activity Slows During 2019

- **The past number of years have seen strong growth by the Irish economy**. This economic recovery was initially led by robust export growth, but there has been strong growth in domestic demand in recent years also, including business investment, construction and consumer spending. However, **the pace of activity has slowed this year,** reflecting the weakening of the global economy and the impact of continuing Brexit uncertainty, especially on investment activity.

- The latest National Accounts data show that GDP grew by over 6.6% year-on-year in the first half of 2019. However, the National Accounts continue to be distorted by the activities of some multi-national companies. We note that **GNP rose by just over 3% in H1 2019.** Meanwhile, **modified final domestic demand,** which excludes some distortionary effects on the National Accounts (e.g. certain intellectual property rights), rose **by 2.9% year-on-year in Q2.** This is a marked deceleration from the growth of 4.7% seen in 2018.

- **Other indicators point to a loss of momentum in the economy as the year has progressed. The PMIs** for the manufacturing and services sectors have weakened year-to-date, with the former moving into contraction territory in Q3. Total **car sales** are also down by over 3% so far this year. Meanwhile, **employment** growth slowed to 2% year-on-year in Q2, the weakest rate since 2013. The pace of decline in unemployment has also eased this year.



- Overall though, **the economy has continued to perform solidly in 2019, with good growth in consumer spending, exports and construction output.** The best indication of the continued good performance by the economy is tax receipts, which were up over 8% yoy to end September. Excluding robust corporation tax receipts, the other main tax heads are performing in line with expectations.

Very weak growth forecast for 2020 in a no-deal Brexit

- The studies carried out by the ESRI, Central Bank and Copenhagen Economics all suggest that a no-deal hard **Brexit would have a severe impact on the Irish economy, lowering the level of output by 5-7%.** Furthermore, the impacts are very much front-end loaded in the first couple of years following Brexit.

- The Government decided that the most prudent approach to the budget would be to **base it on the assumption of a no-deal Brexit. Hence, the Dept. is forecasting very weak growth for next year,** with GDP rising by just 0.7% and GNP essentially flat. It sees GDP growth picking up to 2.5% in 2021 and 2.8% in 2022. We are not convinced that growth would rebound as quickly in 2021, but the 2020 forecast looks reasonable.

DEPT OF FINANCE ECONOMIC FORECASTS*

(%)	2018	2019(f)	2020(f)	2021(f)	2022(f)
GDP	**8.2**	**5.5**	**0.7**	**2.5**	**2.8**
GNP	6.5	4.3	-0.1	2.4	2.5
Private Cons	3.4	2.7	1.4	1.9	2.1
Gov Expd.	4.4	4.5	3.5	2.0	2.0
Fixed Inv.	-21.1	50.4	-24.0	-3.6	3.9
Exports	10.4	10.2	0.9	4.2	4.1
Imports	-2.9	22.6	-6.5	2.9	4.4
HICP	0.7	0.9	1.3	1.4	1.8
Employment	2.9	2.4	0.8	1.1	1.5
Unemploy. Rate	5.8	5.2	5.7	5.9	5.9

*Assumes a no-deal Brexit

Source: Dept. of Finance, October 2019

- **As the accompanying table shows, the economy could be expected to register solid growth next year if a no-deal hard Brexit is avoided.** These forecasts are all based on the assumption that the UK leaves with a deal that includes a two-year transition period in 2020-2021. This would allow EU-UK trade to continue in a smooth fashion during the transition period.

ECONOMIC FORECASTS
(based on a soft Brexit where UK leaves EU with a deal)

%	AIB	Dept. of Finance	ESRI	Central Bank
2020				
GDP	**3.25**	**3.3**	**3.1**	**4.1**
GNP	3.0	3.1	2.6	2.6
Private Cons.	2.8	2.5	2.5	2.4
Gov. Expd.	4.0	2.7	3.6	3.1
Fixed Inv.	6.0	5.5	4.6	5.9
Exports	8.0	4.5	6.3	4.5
Imports	8.5	5.0	7.3	4.6

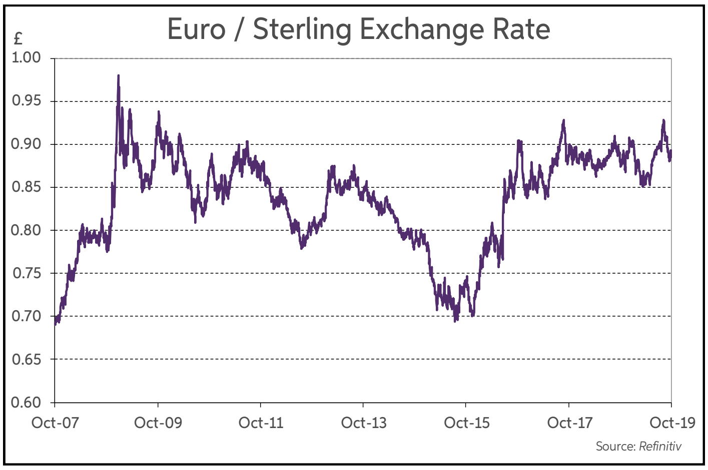
- **GDP growth is forecast by the D/Finance, ESRI and AIB at 3.1-3.3% in 2020 in such a scenario.** The Central Bank is predicting 4.1% GDP growth for next year, but its GNP forecast is much lower at 2.6%. These forecasts mark quite a deceleration from the rate of growth seen in recent years, reflecting the much weaker global backdrop, with the world economy having lost considerable momentum in the past year, as well as capacity constraints emerging in the domestic economy as it nears full employment and some small negative impacts from a soft Brexit.

Return to a Budget Deficit in the event of a no-deal Brexit.

- 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 EU fiscal rules. **The Dept. of Finance has put the fiscal space available in 2020 at €2.8 billion. However, €2.1bn of this was already pre-committed before today's budget.** Spending increases are required to cover carry-over costs from previous budgets, demographic pressures, public sector pay increases, higher capital spending and a big rise in Ireland's contribution to the EU budget. This left some €700m available for budget day changes.

- Net tax hikes in the budget amounting to €340m, increased the **fiscal space available to circa €1 billion,** allowing for spending increases in a number of areas. The Government has also **allowed for borrowing of €650m for contingency funding to provide assistance to the sectors that would be hardest hit by a no-deal Brexit, if it materialises.** An immediate challenge for those exporting to the UK in a no-deal Brexit is likely to be a sharp fall in sterling, which has shown the capacity in the past to fall very quickly in a short period of time. There is every chance that that the euro could rise to parity with sterling in a no-deal Brexit.

- **Overall, additional spending amounting to €930m was announced in today's budget**. This includes a modest package of increases in some social welfare payments totalling €170m, and extra health spending of €240m. Overall, **total gross voted current government spending will rise by €2bn to €62bn** next year, an increase of 3.4%. Meanwhile, **gross voted Exchequer capital spending is projected to rise by €750m or 10%, to €8.15bn**.



- **There were a number of tax hikes announced today, totalling €450m.** These include higher carbon taxes (€90m) and Excise duty on cigarettes (€57m). The 20% dividend withholding tax rate is to be raised to 25% (€80m) and the rate of commercial stamp duty is being increased from 6% to 7.5% (€141m). The help-to-buy scheme for home buyers is also being extended for another two years to end 2021.

- The **greatest uncertainty around the Dept.'s budget projections is generally in relation to tax receipts.** Corporation tax receipts have been stronger than expected in recent years. A cautious approach to tax forecasts is warranted given the uncertainty attached to the economic outlook. Furthermore, there is also the on-going question about whether the surge in corporation tax receipts since 2015 will prove sustained. The Pre-Budget White Paper provided for a **4% rise in tax receipts next year. This may prove a challenge given that the economy is forecast to virtually stall** in a no-deal Brexit scenario.

BUDGETARY PROJECTIONS : 2019 - 2021

(€ bn)	2019	2020	2021
Net Current Expenditure	55.1	57.4	58.3
Net Current Revenue	61.7	63.2	65.0
Current Budget Balance	6.6	5.8	6.7
Capital Budget Balance	-7.6	-6.1	-7.3
Brexit Contingency	0.0	1.2	0.8
EXCHEQUER BALANCE	-1.0	-1.6	-1.4
GEN GOV BALANCE	0.7	-2.0	-0.7
% of GDP			
Gen Gov Balance	0.2	-0.6	-0.2
Interest Expd	1.4	1.1	1.0
Primary Balance	1.6	0.6	0.8

Source: D/Finance

- Overall, the **general government budget balance is projected to return to deficit next year in a no-deal Brexit scenario.** The Dept. is forecasting a deficit of €2bn compared to a projected surplus of €670m in 2019. There will still be a large **current budget surplus of €5.8bn, with a capital account deficit of €6.1bn.** The Exchequer balance will be helped next year by the transfer of €2bn of NAMA's surplus to the central government's accounts—hence, there is a far smaller deterioration in the Exchequer balance in 2020 than the general government balance, which is not impacted by the transfer.

- **Ireland's general government gross debt/GDP ratio has been in marked decline since 2013** when it hit 120%. It is forecast to fall to 59.3% by end 2019 and 56.5% by end 2020. However, inflated GDP figures since 2015 overstate the rate of improvement and underestimate the size of the actual debt burden. A better measure is the level of the National Debt, which takes into consideration cash balances, to GNI* (modified Gross National Income). The National Debt currently stands at €189 billion, close to the level of modified gross national income in 2018, which was estimated at €197.5 billion. The Dept of Finance estimates GNI* at €203.3 billion in 2019, which would give a national debt ratio of circa 93%.

- **The NTMA faces a very large redemption schedule in Q4 2019 and 2020, with €25 billion of debt maturing.** However, the NTMA has been very active in the market in pre-funding this large amount of maturing debt. This has seen its **cash balances increase to €25 billion by end September 2019.** The Exchequer deficit for 2020 is forecast at €1.6 billion, which is a modest sum in the context of the amount of debt maturing next year. We expect the NTMA will remain active in the market to maintain cash balances at a comfortable level, as well as to fund next year's Exchequer borrowing requirement. However, cash balances are likely to be allowed to run down to a much smaller amount in 2020, given that just €3.5 billion of debt matures in 2021.