27th April 2021

Opening Statement of the Minister for Finance,
Paschal Donohoe T.D.
to the Meeting of the Budget Oversight Committee on the
Stability Programme Update, 2021

Introduction

I thank the Chairperson and the Committee for the opportunity to be here today to discuss the draft *Stability Programme Update*.

The *Stability Programme Update* – the SPU – sets out the Government's macroeconomic and fiscal forecasts for Ireland for the next five years.

The final version will be submitted to the EU Commission later this month.

At the outset, I will stress that this is a purely technical document, with the projections based on existing government policies.

In accordance with the requirements under European legislation, the macroeconomic forecasts set out in the SPU have been endorsed by the *Irish Fiscal Advisory Council*.

Government response

Speed and scale of response to the supply and demand shocks created by the pandemic have been the theme of the Government's economic response.

Since March last year, we have moved rapidly, using the strength of our public sector balance sheet, to replace lost private sector demand in order to ensure that firms, workers and incomes were supported and protected through wage subsidies, deferrals of liabilities and income supports.

Our overarching objective has been to support households and firms, as well as to limit the 'scarring', or permanent, effects of the pandemic.

And as we look towards a cautious reopening of the economy over the weeks and months ahead, it is clear from the Stability Programme Update that the relationship between economic activity and public health restrictions has weakened over each successive wave of the pandemic.

Certain sectors of our economy have been better able to adapt to living with Covid.

The adaptability and innovation shown by businesses and consumers is borne out by the high frequency, real-time economic data published by my Department, which shows that the impact of the current set of restrictions is around half that of the spring 2020 lockdown.

Much of this is down to the flexibility of our domestic enterprises.

Firms and consumer have innovated and adapted.

Last month's VAT data, up 8 ½ per cent on the first quarter last year, shows that people have altered their behaviour.

They are buying local, buying online and have shifted their consumption habits.

However, the pandemic has not impacted everyone equally.

Those in contact-intensive employment have suffered the most, while many others, especially those with the ability to work from home, have had very little or indeed no reduction in income and — financially speaking — are as well off as before.

Equally, those who have continued to work have continued to pay income tax and many businesses that have been able to operate through the public health restrictions continue to pay corporation tax.

The strength of these revenues, as well as the extraordinary easing of monetary policy by the ECB, have enabled the Government to support jobs, incomes and businesses throughout the crisis.

This is only right, as the disproportionate impact of the crisis has demanded a forceful response from the Government.

This is what we have done.

Support measures

The overall budgetary strategy remains one of providing strong, counter-cyclical budgetary support to the economy.

The Government has used the full suite of budgetary tools available to it, including direct public expenditure, tax expenditures and 'below the line' supports, such as loans and guarantees.

With a value of almost €38 billion, or nearly a fifth of national income (GNI*), the budgetary support provided by Government has been extraordinary.

We are only in a position to do this because of the sensible and sustainable management of the public finances over recent years.

The total value of payments made to-date under the Government's three main support schemes – the PUP, EWSS (or the TWSS prior to that) and the CRSS is around €13 ½ billion, or nearly 6 ½ per cent of national income (GNI*).

We have spent over €7 billion on Pandemic Unemployment Payments, around €5½ billion on wage subsidies, as well as introducing a whole host of business supports aimed at keeping businesses going, maintaining employment links for employees and making it easier for firms to re-open when it is safe to do so.

While the response has been both appropriate and necessary, the cost continues to be significant. Last year, a general government deficit of €18½ billion, or 5 per cent of GDP, was recorded.

Vaccination Programme

In the medium—term, the speed at which the economy can recover will, of course, depend on the success of our vaccination programme.

A consistent theme of the IMF and World Bank Spring meetings that I attended recently is that vaccine policy is economic policy.

And our vaccination programme will be the touchstone for the domestic recovery.

The programme is being accelerated over the coming months.

Of course there will be week-to-week fluctuations, and vaccine supply remains volatile, but we must keep in mind the bigger picture; we are on-track to vaccinate a large majority of the adult population by the end of this quarter.

This rising vaccine coverage should allow for a more significant easing of containment measures over the summer, and with that a sustainable recovery can begin.

A conditioning assumption underpinning the projections in the SPU is that low levels of public health restrictions will be in place in the second half of the year, with minimal restrictions next year, which should allow economic activity to normalise.

However, it is likely that this ‘new normal’ may be somewhat different to the pre-pandemic norm.

Short-term economic outlook

Based upon this scenario, Modified Domestic Demand (MDD)– what we see as the best indicator of economic trends – is projected to increase by 2½ per cent this year. This will accelerate to 7½ per cent next year.

The release of pent-up consumer and business demand will be the key driver of the economy in the near-term.

The recovery in consumer spending next year is also assumed to be supported by an unwinding of part of the excess household savings built up during the pandemic.

Of course, given the degree of uncertainty at present, the margin of error around these projections is sizeable.

Labour market

The economic fall-out from the pandemic is most evident in the labour market.

When those in receipt of the Pandemic Unemployment Payment are added to the standard unemployment rate, the unemployment rate is projected to average around 16¼ per cent this year, before declining to 8¼ per cent next year as the economy is fully re-opened.

The level of employment is projected to increase by around 80,000 this year and 225,000 next year, though the level of employment will still remain below its pre-crisis peak until 2023.

Medium-term outlook

Over the medium-term, an important but still open question relates to the extent of any permanent destruction to the economy's productive capacity from the pandemic, so-called 'scarring' effects.

At this stage, the evidence base is extremely limited and the scale of 'scarring' will only become clear over time, as more data become available.

Indeed my Department published a short note on this topic in its most recent Economic Insights release last week.

As a very preliminary estimate, my Department is projecting domestic demand to grow at around 3 ½ per cent over the medium-term.

This means that, notwithstanding a reversion to trend growth over the medium-term, domestic activity would still be lower by the end of the projection period than the level suggested by the pre-pandemic trend, with employment also lagging.

Risks

But let me reiterate, the outlook remains highly uncertain, not least as it pertains to vaccine supply and efficacy, including against variants, both domestically and internationally.

For instance, under a more severe scenario, one where the current, stringent restrictions need to remain in place for a prolonged period, the Irish economy would be approximately 4½ per cent smaller by the end of next year than it would under the main scenario.

Fiscal developments

Turning to the fiscal outlook, on a technical basis, a deficit of €18 billion, or 4.7 per cent of GDP, is estimated for this year.

This is based on existing Government policies but I would repeat what I have said previously, namely that there will be no 'cliff-edge' to the most important supports.

Any extension to these supports will, of course, worsen the deficit.

This year's deficit will bring our overall debt levels to just under €240 billion, or almost 112 per cent of national income (GNI*). Let me put this another way: our public debt is approaching a quarter of a <u>trillion</u> euros.

So, once the worst of the pandemic has passed, it will be necessary to address this by eliminating the deficit over time in a way that balances supporting the economy with continued fiscal sustainability.

A deficit of just under 3 per cent of GDP is projected for next year, on the basis that most of the temporary supports will have been withdrawn.

Beyond 2022, all Covid-specific supports are assumed to have been unwound.

With a recovering economy, withdrawal of these supports should be sufficient to better align revenue and expenditure by the mid-part of the decade.

In other words, economic growth — via increased tax revenues — will be enough to close the gap between what that State earns and what it spends.

There are, however, clear downside risks for the public finances. In particular, international corporate tax reform could weigh more heavily on this revenue stream than is currently assumed.

Having said that, the public finances are in a much better position to absorb the expected shock to corporate tax revenue than, say, a decade and a half ago.

The tax base is much wider than prior to the global financial crisis and, importantly, there is time to build up the resilience of the public finances before international reforms move to the implementation phase.

Conclusion

The pandemic has taken a severe toll on the domestic economy and the public finances.

However, the continuing progress of the vaccination programme and the collective effort of the Irish public provides reason for optimism.

We entered into this crisis from a position of strength and our economic model has proven its resilience.

Together, we will overcome the pandemic, rebuild our economy and return our people to work.
Thank you.

Ends