

**Opening Statement by Robert Kelly, Director of Economics & Statistics, Central Bank of Ireland
at the Budget Oversight Committee**

19 September 2023

Good afternoon, Chair and Members of the Committee.

We welcome the opportunity to discuss the economic and fiscal outlook with the Committee. In my opening statement, I will outline our latest macroeconomic assessment and focus on the implications for the public finances.

Economic Outlook

[Updated figures on Modified Domestic Demand taken from the Central Bank's Quarterly Bulletin will be provided to the Committee at tomorrow's appearance]. This outlook is shaped by ever more binding capacity constraints and the impact of monetary policy tightening on demand, both in Ireland and globally.

The economy demonstrated remarkable resilience to the overlapping shocks of the pandemic and Russia's invasion of Ukraine. Demand for labour surged as the reopening of close-contact service sectors amplified strong employment growth across sectors more adaptable to remote working. As a result, vacancy rates rose substantially above trend level even as the number of workers reached historical highs and unemployment fell to 20-year lows - pointing to an economy operating at full capacity.

Reflecting these capacity constraints, the determinants of the inflation outlook are evolving from external to domestic factors. Although the spillover of higher energy costs to the broader consumer basket continues, input price pressures are fading. Domestic factors, specifically the interplay between profit margins and wage pressures resulting from labour market tightness, will largely determine the persistence of inflation. *[Updated figures on Ireland's consumer price inflation taken from the Central Bank's Quarterly Bulletin will be provided to the Committee at tomorrow's appearance].*

In order to reinforce progress in bringing euro area inflation toward its 2 per cent target in a timely manner, the ECB governing council last week decided to raise interest rates by 25 basis points, bringing the total increase to 450 basis points since the start of the hiking cycle last year. Based on its current assessment, the Governing Council considers that policy rates are now at levels that, if maintained for a sufficiently long duration, will make a substantial contribution to bringing euro area inflation back to target. In order to determine the

appropriate level and duration of restriction, the Governing Council will continue to take a data-dependent approach going forward, taking regard of the inflation outlook given incoming data, the path of underlying inflation, and the strength of monetary policy transmission.

Monetary policy works through multiple channels, and the overall impact is only seen with a considerable lag. The first phase of transmission can be seen in financial conditions where higher bank funding costs, increased loan pricing, tighter credit standards and weakening loan volumes are already evidentⁱ. Central Bank analysis shows initial Irish interest rate pass-through is underway. Still, it appears to be slower for new mortgage lending and household deposits relative to historical precedent and euro area peersⁱⁱ. Further, scenario analysis based on historical relationships suggests that inflation in Ireland would have been between 2 and 2.5 percentage points higher over the last and next 12 months in the absence of policy rate increases since July 2022.

The export orientated nature of the Irish economy yields a high degree of sensitivity to the external outlook. Global growth has displayed resilience, but it is projected to slow over the next year as the higher policy rate environment weighs on activityⁱⁱⁱ. The decline in Irish net exports in the first half of 2023 was partly due to sector-specific factors, such as vaccine demand normalisation following the pandemic. Still, global headwinds provide a high degree of uncertainty for both exports out of the State and contract-manufacturing exports undertaken abroad on behalf of Irish resident entities.

Managing the Public Finances in a Full-Employment Economy

Overall, the public finances are in a broadly healthy position, as evidenced by the government running a headline surplus last year after providing a total of €20 billion in temporary support in 2021 and 2022^{iv}. In addition, as expected, the higher interest rate environment has led to a notable increase in Irish sovereign yields over the past year. Still, the relatively low number of bonds maturing in the coming years, coupled with large cash balances, provide funding flexibility.

Fiscal policy underpinned the economic resilience since 2020; the agility of the employment supports avoided labour market scarring from pandemic restrictions, and temporary supports protected those most vulnerable in our society from the energy price shock. Given the scale of these shocks, permanently offsetting the real income falls and maintaining current and capital spending in real terms, especially in light of growing demands from evolving demographics, requires significant spending increases. Increasing current spending in this nature, in the

absence of offsetting revenue raising measures risks creating inflationary pressures and feeding overheating risks. This would ultimately reducing the real value of public, in particular capital, spending. The core consideration is not whether ‘catch-up’ is achieved - it will be - but the calibration of the appropriate pace.

Let me first highlight the importance of policy cohesion to avoid the costs of persistently higher inflation.

The focus of ECB monetary policy is on achieving price stability in the euro area. The effectiveness of monetary policy in Ireland will depend, in part, on the relative strength of domestic demand compared to the euro area. Fiscal policy must avoid working at cross-purposes to monetary policy and providing additional stimulus to an economy currently operating at capacity.

The Summer Economic Statement (SES) signals that Budget 2024 will increase core expenditure by €5.5 billion (6.4 per cent), an additional €250 million windfall capital investment spend, €4 billion in non-core current spending, and a doubling of the tax cut package, before considering the potential for additional measures that may be introduced on Budget day. The overall budgetary package is significantly more expansionary than outlined in April’s Stability Programme Update (SPU 2023). Revisions of this nature amplify demand in an economy already operating at capacity and shift the stance of fiscal policy in a pro-cyclical direction. Scenario analysis shows the upward revision to permanent core spending adds to short-run inflation^v - which, if allowed to persist over the medium term, will damage Ireland’s competitiveness, and the real gains in living standards Ireland benefits from having vibrant export-oriented businesses operating in the State.

The revised spending for next year and the projections out to 2026 breach the Government’s Net Spending Rule. The Net Spending Rule was adopted in the 2021 SES to stabilise expenditure based on trend growth (3%) and the price stability target for inflation (2%)^{vi}. The spending rule is expressly designed to support counter-cyclical fiscal policy. The rule allows fiscal expansion when inflation is low, frequently during periods of low demand. When inflation exceeds trend, notably during periods of strong demand, the rule becomes more binding, requiring expenditure mix decisions. This rule automatically sets the appropriate pace for ‘catch-up’ outlined above^{vii}. Further, it is important to establish credibility in the framework, especially as common fiscal sustainability tools, such as debt-to-GDP and deficit limits provided for in the revised EU fiscal framework, will not provide appropriate guidance for fiscal policy in Ireland. This is because of the distortions to GDP figures and the specific risks

posed by windfall corporation tax that undermine the usefulness of the common EU framework in an Irish context.

Secondly, there is an opportunity to enhance medium- to longer-term resilience in both the public finances and the economy as a whole.

A lesson from the years preceding 2008 was the vulnerability created by additional spending linked to a growth in property-related tax revenues, which turned out to be transitory.

Exchequer tax revenue growth over the last 5 years is almost identical to the 2002-2007 period but significantly more concentrated. Corporation Tax (CT) accounts for 45 per cent of the overall revenue growth and is further concentrated on receipts from a small number of firms.^{viii} A second consideration is the detachment of these receipts from domestic activity, with up to half of current annual CT revenue could be considered as excess or windfall receipts. This revenue is subject to unpredictability – as evidenced by the recent frequency of upward revisions and the most recent fall in August CT receipts. Still, most importantly, the sustainability of this revenue over the long term is not assured. The SES adjusts the headline budget balance to exclude excess CT, a welcome development considering the uncertainty over this revenue source.

While these excess corporate receipts are a source of risk if used to fund tax cuts and permanent spending increases, if these revenues are saved, they provide an opportunity to build the capacity to address medium-term challenges. The SES provides for careful consideration of such challenges, namely the 4D's: adverse demographics, possible de-globalisation, decarbonising economic activity, and acceleration of digitalisation.

In response to these challenges, proposals to establish a long-term savings fund are outlined in the SES, with the Minister for Finance set to bring proposals to Government later in the autumn. Establishing such a fund is a welcome development. A long-term savings fund reduces the risk of linking core spending to transitory revenues that are potentially susceptible to a 'sudden stop', and it builds capacity to meet such medium-term challenges. It will be crucial to establish the instalment schedule, the specifics of the fund's investment strategy, and the policies governing withdrawals from the fund once it has been established.

I thank the Committee members for their attention. I, and my colleagues, are happy to take the members' questions.

ⁱ See [Lane \(2023\)](#), “The banking channel of monetary policy tightening in the euro area”, NBER Summer Institute 2023 Macro, Money and Financial Frictions Speech

ⁱⁱ See [Byrne and Foster \(2023\)](#), “Transmission of monetary policy: Bank interest rate pass-through in Ireland and the euro area”, *Economic Letter*, Vol. 2023, No 3. Official data is published with a 30-day lag, and this analysis would not account for the recently announced changes to the interest rates on some retail bank deposit products.

ⁱⁱⁱ See IMF World Economic Outlook, July 2023. Global growth is projected to fall from an estimated 3.5 percent in 2022 to 3.0 percent in both 2023 and 2024.

^{iv} See Table 2, [Conefrey et al \(2023\)](#) “Managing the Public Finances in a Full-Employment Economy”, Quarterly Bulletin Signed Article, Q2 2023

^v See [Conefrey et al \(2023\)](#) “Managing the Public Finances in a Full-Employment Economy”, Quarterly Bulletin Signed Article, Q2 2023

^{vi} See [Summer Economic Statement, 2021](#)

^{vii} The Irish Fiscal Advisory Council’s ‘Stand-Still’ scenario provides analysis on the maintaining existing services in light of inflation and demographic pressures. Under the net spending rule, real demographic adjusted increases in expenditure would resume by 2028. See ([IFAC Fiscal Assessment Report, 2023](#))

^{viii} Ten firms accounted for almost three-fifths of all corporate tax revenue in 2022 ([Summer Economic Statement, 2023](#)), with research suggesting that as few as three large payers account for approximately one-third of total corporate tax revenue (See [Cronin \(2023\)](#), “Understanding Ireland’s Top Corporation Taxpayers”, Irish Fiscal Advisory Council Working Paper No. 20.)