Oireachtas Budgetary Oversight Committee

20 March 2024

Central Bank of Ireland Opening Statement

Robert Kelly, Director of Economics & Statistics

Good afternoon, Chair and Members of the Committee. I am joined today by Martin O'Brien, Head of the Bank's Irish Economic Analysis Division. In my opening remarks, I will outline our latest macroeconomic assessment before turning to our outlook for the public finances and the implications for fiscal policy.

Economic Outlook

Our latest Quarterly Bulletin[1] forecasts the domestic economy to grow at a moderate pace, in the region of 2 per cent annually to 2026[2]. Modest growth for consumer spending underpins the outlook as household purchasing power recovers with wage growth, averaging 4.7 per cent in the coming years, once again outpacing inflation. In contrast, the outlook for domestic investment is relatively constrained despite anticipated increases in residential construction[3]. Our expectations for wage growth arise from the outlook for the labour market, which remains relatively tight despite some easing in recent quarters. We forecast the unemployment rate to remain in the region of 4.5 per cent out to 2026.

The disinflation process in Ireland has progressed faster than previously anticipated. In the main this reflects the abatement of externally-driven price pressures, most notably for energy. In Ireland, the outlook for headline HICP inflation has been revised down relative to our previous forecasts to 2 per cent in 2024. In contrast, more domestically-driven price developments, such as services price inflation, are proving more sticky - currently running about 5 per cent - and are expected to decline more gradually over the forecast horizon.

Risks to the Irish growth outlook are tilted to the downside. Most notably, an escalation in geopolitical tensions could see renewed inflationary pressures from rising energy prices and disruptions to world trade. Given the open nature of the Irish economy, such potential disruptions to the exports weigh heavily on output. Labour costs outpacing productivity or

[1] Published on 12 March and available at https://www.centralbank.ie/publication/quarterly-bulletins/quarterly-bulletin-q1-2024.
[2] As measured by Modified Domestic Demand (MDD)
[3] The latest Quarterly Bulletin forecasts housing completions of 37,000 by 2026.

delayed progress in addressing capacity constraints in housing and other infrastructure could generate higher and more persistent price and wage inflation and damage competitiveness.

Since the summer of 2022, the ECB has increased interest rates by 4.5 percentage points – the fastest rate hiking cycle since the start of the euro 25 years ago.

The ECB's baseline projections for euro area inflation look very similar to our own: that is, for inflation to decline gradually throughout 2024, reaching the 2% target during 2025. But there are risks to this outlook. Similar to Ireland, domestic price pressures remain elevated, especially in services which account for around half of the spending basket for headline inflation. For services firms in particular, wages tend to account for a large share of overall costs, which is why wage growth also matters for inflation. In addition, and as we outline in our Quarterly Bulletin, profit margins and labour productivity are other important factors.

Looking ahead, the Governing Council continues to follow a data-dependant approach, focusing on incoming economic and financial data, the dynamics of underlying inflation and the strength of monetary policy transmission to determine the path for interest rates that will sustainably return us to our 2% target.

Public Finances

Turning to public finances, the headline outlook is positive, as evidenced by the government's running of a headline surplus last year while continuing to provide temporary supports to households and firms.

The significant increase in core or permanent spending measures in Budget 2024 (€5.3b or 6.2 per cent) is partially offset by a decline in non-core spending. The net effect is an expected headline surplus of 2.5 per cent of GNI* this year. Looking further ahead, most of the remaining non-core expenditure - which includes humanitarian support for Ukrainian refugees, cost of living supports and legacy spending related to the Covid-19 pandemic - is due to be withdrawn in 2025. As a result, the surplus is projected to strengthen to 3.8 per cent of GNI* in 2025 before stabilising in that region for 2026. These sizable primary budget surpluses - projected to average 4.5 per cent of GNI* - are the most significant factor driving the reduction in the debt ratio to 66 per cent of GNI* by 2026.

However, it would be remiss to focus entirely on the relatively positive outlook for the headline surplus, given the role played by the growth in corporation tax receipts. These receipts are highly concentrated, partly decoupled from the Irish economy, and subject to sudden reversal. Data from the Revenue Commissioners shows that 60 per cent of corporation tax revenue arises from just ten multinational firms, leaving the public finances excessively sensitive to firm or sector-specific developments, including how firms respond to international tax reforms[4].

At the core of the issue are the "excess" corporate tax receipts - those that cannot be explained by Irish economic activity – accounting for 45 per cent of total corporation tax receipts and just over 10 per cent of all tax receipts. Excluding these receipts presents a much less favourable outlook for the underlying General Government Balance. It would remain in deficit this year at -1.2 per cent of GNI* and broadly in balance in 2025 and 2026. On this basis, the underlying General Government Balance would have consistently been in deficit since the financial crisis.

Policy Implications

Considered choices are necessary for domestic policy to support macro-financial stability over the near-to-medium term. Maintaining an appropriate fiscal stance that does not unnecessarily aggravate any remaining imbalances between domestic demand and supply conditions can align with achieving near- and longer-term priorities.

The challenge for policymakers in the immediate future is creating the space and enablers for the necessary investment to address housing needs and climate change.

This involves considering (1) the relative role of specific tax and expenditure measures to create the space within an economy with limited capacity while ensuring the public finances are kept on a sustainable footing, (2) prioritising investment delivery while being mindful of the most effective ways to incentivise and enable private sector investment, and (3) initiating reforms to enable more efficient investment delivery.

It is also essential to focus on other known pressures on the public finances, such as those related to the ageing population. Creating the Future Ireland Fund in Budget 2024 is a significant and welcome step to prepare for the cost of an ageing population. The recent scenario analysis from the Department of Finance highlights the size of the challenge, with projected drawdowns from 2035 falling short of the additional ageing demands[5].

As Ireland and other countries struggle to reach decarbonisation targets, the pace of investment in climate change mitigation will likely need to increase above what is currently envisaged. This is in addition to the investment required to assist the transition to net zero. It is appropriate to consider this likelihood in the design of the Infrastructure, Climate and Nature Fund.

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[4] See OECD/G20 Inclusive Framework on BEPS

[5] See Table 4: https://assets.gov.ie/256707/ae2b2fc8-1411-4a64-9425-b3a42e1b6423.pdf

Over the coming years, the projected health of the public finances leaves Ireland in an enviable position to address these multifaceted challenges. Still, given the critical need to sustainably fund and prioritise public capital expenditures in a way that creates economic capacity instead of absorbing it, the government would gain from renewing its commitment to a domestic expenditure rule.

Such a rule is fundamental, particularly as sustainability measures in the recently agreed-upon EU economic governance framework reforms are expressed as a proportion of GDP. The mix of distortions in GDP figures and excess corporation tax receipts means the new rules are not currently binding and are unlikely to be an effective anchor for the public finances over the medium term.

The existing rule could be strengthened in a couple of ways. The distinction between "core" and "non-core" expenditures has blurred and could be re-examined. The rule should also be re-defined in general government terms to cover all government expenditures.

In conclusion, a sustainable response to the challenges of housing, climate change, and related infrastructure needs in energy, transport, water and communications requires a renewed focus. This focus should be on innovation, human capital development and productivity growth. Delivering progress in these areas can create the foundations for sustainable economic growth. Combined with maintaining sound public finances, this can ensure sustained growth in employment and incomes over the long term for the population as a whole.

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