Central Bank of Ireland submission to the Special Oireachtas Committee on Covid-19 Response

9 June 2020

Introduction

The Central Bank of Ireland welcomes this opportunity to provide a written submission to the Special Oireachtas Committee on Covid-19 Response. The analysis contained in this submission is largely based on scenarios contained in the last Central Bank Bulletin, published in April, updated to take into consideration the latest available data. The Central Bank will update the scenarios, related analysis and commentary in relation to the economic outlook and fiscal developments in the upcoming Quarterly Bulletin, which is due to be published on 3 July. We will be happy to provide updated information and analysis at that time.

2. Central Bank policy actions in response to COVID-19

2.1 The Central Bank of Ireland is focused on promoting the welfare of the people of Ireland as a whole, and through our membership of Europe's Monetary and Banking Unions, the welfare of the wider people of Europe. The Central Bank has taken actions within all aspects of our mandate in response to the pandemic, including through participation in decision-making regarding monetary policy through the Eurosystem[1], banking supervision through the ECB Single Supervisory Mechanism (SSM)[2], macroprudential issues through the European Systemic Risk Board (ESRB)[3] and wider supervisory issues – ranging from securities and markets to insurance - through the European System of Financial Supervision, The Central Bank has also taken other steps relating to macroprudential policy and various supervisory actions. These actions have helped to maintain financial sector liquidity and ensured supportive financing conditions for all sectors in the economy, including households, firms, banks and governments. Further details on all of these measures be found on our COVID-19 Consumer Hub. A summary of key consumer and investor protection measures can also be found here.

2.2 With regard to macroprudential and supervisory measures, the Central Bank of Ireland, in its role as the Irish macroprudential authority responded to the outbreak of the virus and containment measures by cutting the Irish Countercyclical Capital Buffer (CCyB) rate from 1 per cent to 0 per cent. The CCyB is part of the Central Bank's macroprudential toolkit and is an instrument to promote a stable financial system for times of financial and economic distress. The CCyB is a time varying capital requirement, which applies to banks and investment firms. It aims to promote a sustainable provision of credit to the economy by making the banking system more resilient and less pro-cyclical. The release of the CCyB in the context of the current shock limits the

[1] The Eurosystem comprises the European Central Bank (ECB) and the national central banks of all 19 member countries of the euro area. As a member of the Eurosystem, the Governor of the Central Bank of Ireland is a member the ECB Governing Council, which is the main decision making body tasked with formulating monetary policy for the euro area.
[2] The Single Supervisory Mechanism (SSM) refers to the system of banking supervision in Europe. It comprises the ECB and the national supervisory authorities of the participating countries.
[3] The ESRB is responsible for the macroprudential oversight of the EU financial system and the prevention and mitigation of systemic risk
https://www.esrb.europa.eu/news/pr/date/2020/html/esrb.pr200608~c9d71f035a.en.html

potential that regulatory capital buffers will hamper the supply of credit to the economy and amplify the difficulties facing households and businesses.

Another complementary element of the supervisory response is a recommendation issued by the ECB-SSM at the end of March prohibiting the distribution of dividends by banks until at least October. This ensures that capital is conserved in order to support the functioning of the banking sector at this time of economic stress.[4] In addition, the European Banking Authority has decided to postpone the EU-wide stress test to 2021 as a measure to alleviate the immediate operational burden for banks at this challenging juncture.

2.3 With regard to the monetary policy response, there has been a broad response by the ECB Governing Council (of which Governor Makhlouf is a member) across a number of dimensions. These measures have been taken in pursuit of our mandate to maintain price stability over the medium term and provide significant support to the real economy. Firstly, measures to provide liquidity to the banking sector were expanded and the terms eased. Specifically, pandemic emergency longer-term refinancing operations (PELTRO) were introduced to ensure sufficient liquidity and smooth money market conditions during the pandemic period and conditions. In addition, to ensure a sufficient supply of credit to firms and consumers, the conditions on the third series of targeted longer term refinancing operations (TLTRO-III) were eased and amount of liquidity available in the operation was increased. Asset purchases were expanded and in particular a new programme called the pandemic emergency purchase programme (PEPP) was introduced. This programme involves the purchases of €1,350 billion in private and public sector securities, and will last at least the end of June 2021. It was introduced in response to the pandemic-related downward revision to inflation forecasts over the projection horizon and aims to counter the serious risks to the monetary policy transmission mechanism and the outlook for the euro area posed by the outbreak. In addition, Eurosystem net purchases under the existing Asset Purchase Programme, of which the Public Sector Purchase Programme is the largest component, will continue at a pace of €20bn per month, together with the additional temporary purchase envelope of €120bn until the end of this year. As of end May 2020, Eurosystem cumulative net purchases of Irish government bonds amounted to €36.8bn, of which €3bn has been purchased under the PEPP.

2.4 The liquidity and purchase programmes are intended to ensure supportive financing conditions for all sectors in the economy, including households, firms, banks and governments. To date, purchases of Irish sovereign debt by the Eurosystem have played a significant role in helping to maintain favourable market access conditions for Irish sovereign debt issuance at lower interest rates, which in turn has reduced Ireland's debt servicing costs. The impact of this can be seen in the historically low levels of Irish yields and in the relatively stable yield differentials to core euro area sovereign markets. Recent high volumes of sovereign debt issuance continue to be well supported by investors, as the Eurosystem's presence as a large buyer in the secondary market has provided a considerable backstop to sovereign debt investors. Overall, monetary policy conditions are expected to remain highly accommodative until more favourable economic conditions re-emerge in the euro area. The volume of Irish government bond purchases is expected to be large and supportive of sharp increases in net new sovereign debt issuance.

[4] For a more detailed discussion of these measures, see: Releasing the CCyB to support the economy in a time of stress by Giorgia De Nora, Eoin O'Brien and Martin O'Brien, Financial Stability Notes, Vol. 2020 No. 1

2.5 Regarding fiscal policies, for the euro area and the EU as a whole, the ECB Governing Council has stated that an ambitious and coordinated fiscal stance remains critical, in view of the sharp contraction in the euro area economy. The three safety nets endorsed by the European Council for workers, businesses and sovereigns, amounting to a package worth €540 billion, provide important funding support in this context. At the same time, the Governing Council has urged further strong and timely efforts to prepare and support the recovery. It has also strongly welcomed the European Commission's proposal for a recovery plan dedicated to supporting the regions and sectors most severely hit by the pandemic, to strengthening the Single Market and to building a lasting and prosperous recovery.

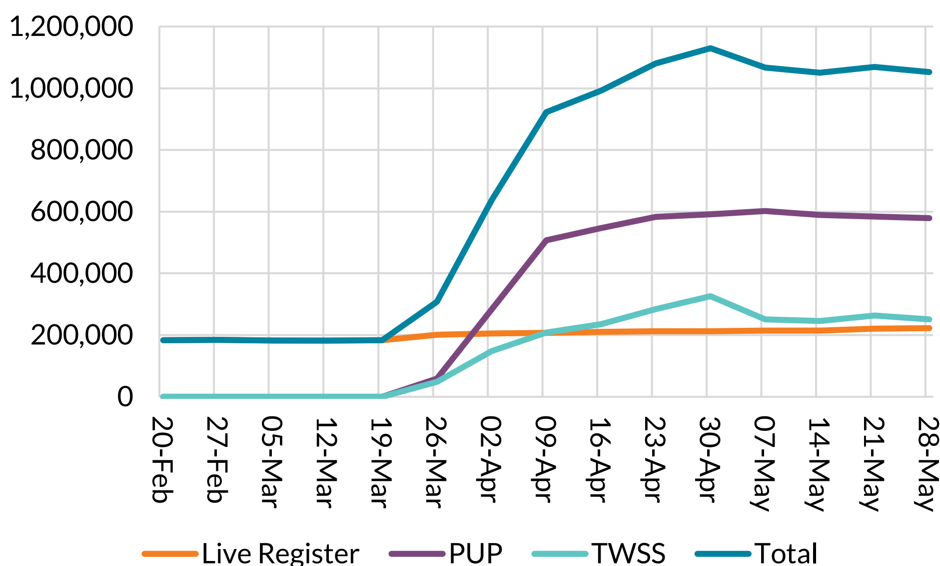
2.6 All euro area countries have introduced fiscal support packages in response to Covid-19. The bulk are emergency measures which address the immediate health and economic consequences of the pandemic and are assumed to be phased out at the end of 2020. Only a few measures have been announced which provide economic stimulus beyond 2020, most notably the German stimulus package announced in early June. While the size of packages relative to the size of the economy differs significantly across countries, as of end-May the direct support measures introduced in Ireland (3.8 per cent of GNI*) were estimated to be broadly in the same range as the average for the region as a whole (3.5 per cent of GDP).

3. Economic Overview

3.1 The outbreak of the COVID-19 pandemic has dramatically affected global and Irish economic activity since late February. Following strict containment measures implemented from the 27th of March until May 18th, National Accounts data show that consumption declined by 4.7per cent in the first quarter. While a phased relaxation has commenced, a further significant decline is expected for the second quarter. The outlook thereafter is subject to unprecedented uncertainty, depending on the path of the virus and containment measures.

3.2 The decline in activity in March and April was unprecedented, with almost all sectors of the economy affected. Job losses came in waves, with 543,000 people now in receipt of the Pandemic Unemployment Payment, and a further 410,000 now in receipt of the temporary wage subsidy scheme (TWSS) (Figure 1). The number of job losses are largest in those sectors with high degrees of face-to-face contact. Approximately 70 per cent of those who worked in accommodation and food services in Q4 2019 are now in receipt of the pandemic unemployment payment.

Figure 1: Numbers in receipt of state payments by scheme



Source: CSO, DEASP, Revenue

3.3 Consumer sentiment declined to levels similar to the trough of the global financial crisis. This, combined with the strict containment measures which resulted in the closure of non-essential retail, meant retail sales declined sharply in April.

Figure 2

Fig 1a: Consumer Sentiment declined sharply

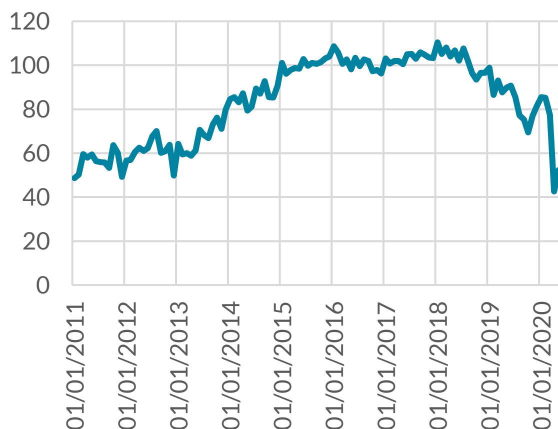
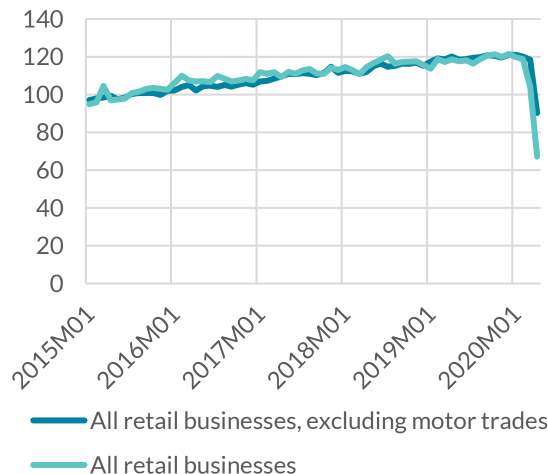
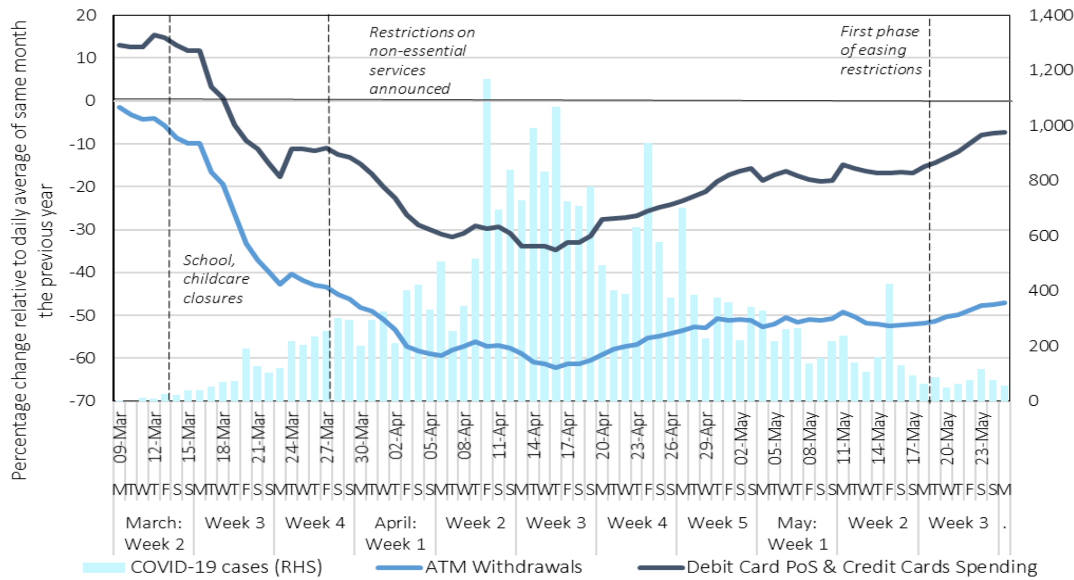


Fig 1b: Retail sales, particularly motor trades declined by close to 40 per cent



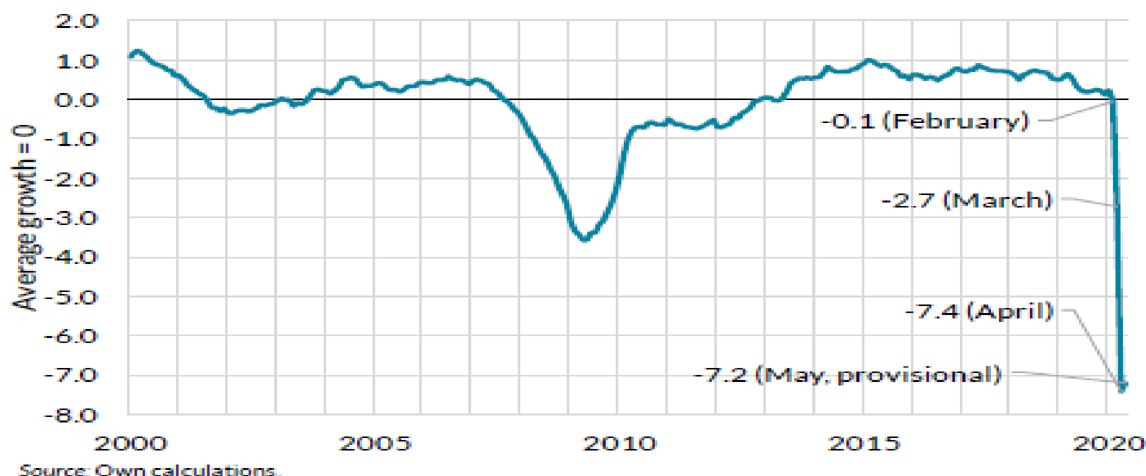
3.4 Payment card data have shown similar patterns, with card spending in mid-April approximately 30 per cent lower than on the same days in 2019 (Figure 3). The largest spending declines have occurred in "travel" and "restaurants", in which card payments were approximately 90 and 70 per cent lower during April than in 2019. The data suggests that there has been some gradual recovery throughout May, particularly since the first phase of easing occurred on the 18th

of May. In the last week of May, the value of card payments had recovered to approximately 10 per cent below the same period in 2019. Since consumption has fallen by more than incomes this has led to a significant increase in savings. Deposits from Irish resident households increased by €3 billion in April.[5] This was the largest monthly increase in household deposits since the series began.



A timely measure of domestic economic activity, the Central Bank's Business Cycle Indicator (BCI), paints a similar picture. At the peak of the containment measures in April, the BCI dropped to an unprecedented low. The decline in the indicator in April suggests that the initial economic impact of the COVID-19 pandemic was both sharper and deeper than the financial crisis of 2008/09. The latest preliminary estimate of the BCI for May 2020 points to some stabilisation in economic conditions, but the overall level of activity remains substantially below that observed prior to the COVID-19 outbreak.

Figure 4: Business Cycle Indicator (BCI) 2000-2020



Source: Own calculations.

[5] Central Bank Credit, Money and Banking Data

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4. Economic scenarios

4.1 The Bank's most recent Quarterly Bulletin, published on 2 April, sets out the Central Bank's assessment and estimate of the economic impact of Covid-19 under certain assumptions. It is important to stress that this is a scenario and not a forecast, given the high level of uncertainty. It assumed that containment measures remained in place for one quarter and were gradually eased thereafter.

4.2 In this scenario, underlying domestic demand and GDP were projected to fall by 8.9 and 8.3 per cent, respectively. Unemployment was forecast to rise to approximately 25 per cent during the second quarter. On the assumption that both domestic and global economic activity begin to recover during the second-half of the year, the unemployment rate could then begin to move lower, though in this scenario it still remained over 10 per cent by the end of the year.

Table 1 – Macroeconomic Outlook from April's Quarterly Bulletin

Quarterly Bulletin Scenario (April 2020)	**2019**	**2020f**
Underlying Domestic Demand	**3.2**	**-8.9**
GDP	**5.5**	**-8.3**
Employment	2.9	-12.0
Unemployment rate	4.9	14.1
Inflation (HICP)	0.9	-0.6

Source: Central Bank of Ireland

4.3 At the time of publication, it was noted that the risks to this outlook were tilted to the downside, and we referenced that in a more severe scenario the decline in GDP in 2020 might be closer to 15 per cent.

4.4 The path ahead for the economy depends on the path of the virus. As there is a high degree of uncertainty regarding both the duration and scope of containment measures and, in turn, the timing and pace of the recovery, it is important to think about a range of scenarios. At present, the Bank is in the process of updating its scenarios. In that context, the assessment to be published in the next Quarterly Bulletin on July 3 will examine the outlook under a number of different scenarios.

4.5 The scenario approach was followed in the recent Eurosystem staff macroeconomic projections, published on 4 June, which were produced jointly by Eurosystem and ECB staff, including staff from the Central Bank of Ireland. The projections contained a baseline scenario and also, given the high uncertainty surrounding the impact of Covid-19 on the euro area economic outlook, alternative mild and severe scenarios, relative to the baseline. The scenarios differ with regard to assumptions about the future evolution of the pandemic, as well as the necessary containment measures, their impact on economic activity and the behavioural responses of households and firms.

4.6 The baseline scenario assumes only partial success in containing the virus, with some resurgence in infections necessitating recurring containment measures until mid-2021. Elevated uncertainty and weak labour market conditions adversely impact spending by households and firms, although substantial support from monetary, fiscal and labour market policies mitigates some of the negative impact. Under these assumptions, GDP in the euro area is projected to fall by 8.7 per cent in 2020 and to rebound by 5.2 per cent in 2021 and by 3.3 per cent in 2022. In this scenario, by end-2022, the level of real GDP would have returned to its pre-crisis level.

4.7 With regard to the alternative scenarios, the mild scenario assumes a successful containment of the virus, resulting in a less damaging impact on economic activity. In this scenario, euro area GDP would decline by 5.9 per cent this year, and rebound in coming years, with the level of GDP returning to its pre-crisis level in 2021. In contrast, the severe scenario assumes a strong resurgence of infections and an extension of stringent, albeit gradually loosening, containment measures until mid-2021. In this scenario, euro area GDP falls by 12.6 per cent in 2020 and by end-2022 is still 5 per cent below its pre-crisis level.

5. Implications for the public finances

5.1 The Central Bank of Ireland's last Quarterly Bulletin, published in April, outlined a fiscal outlook for 2020 underpinned by the published macroeconomic scenario and the Government support measures announced at the time. It projected a very sharp deterioration in the general government balance (to -10 per cent of GNI*) and a significant increase in the debt ratio (to 112 per cent of GNI*), and included the caveat that the outlook was surrounded by much greater uncertainty than would normally be the case.

5.2 Updated fiscal projections will be published in the upcoming Quarterly Bulletin, to be published on 3 July, incorporating two macroeconomic scenarios, medium and severe, based on assumptions which are broadly consistent with those underlying the Eurosystem's baseline and severe scenarios, outlined earlier. They will also incorporate the latest estimates of the cost of the support measures introduced by the Government. To ensure we are providing the Committee with the most up to date information (as of 3 June), we present our latest working projections for the two new scenarios here, noting that they are subject to revision before their final publication.

5.3 In the baseline scenario, we assume that the income support measures announced by Government will end in mid-June as is currently planned. The estimated total direct cost of the measures announced is approximately €7 billion, in line with the expectation of the Department of Finance in April's Stability Programme Update. The series of loans, guarantees and tax deferrals introduced by the Government – valued at an additional €7 billion - do not have an immediate impact on the general government balance but could do so at a later date if, for example, guarantees were called or deferred payments were not made.

5.4 The support measures introduced mainly impact government expenditure, which is projected to grow by 12 per cent this year (compared with an average of 4.5 per cent in the previous three years). The operation of automatic stabilisers, as economic activity deteriorates, primarily affects revenue – through lower tax receipts, but also expenditure as social payments increase. Total revenue is expected to decline by 14 per cent this year (compared to an average increase of 6 per cent in the previous three years), with developments in tax revenue driving three-quarters of this. The operation of automatic stabilisers, meanwhile, is responsible for around 60 per cent of the deterioration in the budget balance.

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5.5 Combined, these factors result in a general government deficit of €21.5 billion or 11½ per cent of GNI* in 2020. The increase in general government debt is somewhat lower as the Government is expected to use significant cash reserves and other sources to finance part of the gap between revenue and expenditure, but it nevertheless increases to €215 billion or 116 per cent of GNI*. Assuming the support measures are time limited, and the economy returns to growth in 2021, both ratios are expected to decline in 2021 but to remain high. The general government deficit would still be around €13 billion or 6½ per cent of GNI* next year, while the general government debt would be around 115 per cent of GNI*.

Table 2 – Fiscal projections under a 'medium' scenario

	2019	2020	2021
GG Balance (€bn)	1.4	-21.5	-12.9
GG Balance (% GNI*)	0.6	-11.6	-6.5
GG Debt (€bn)	204.1	215.7	226.9
GG Debt (% GNI*)	98.9	116.2	114.8

5.6 Over the medium term both the deficit and debt should continue to improve, but remain at an elevated level. This assumes that no additional fiscal policy takes place – stimulus or consolidation – with only fully agreed policy measures included. The expected modest decline in the gross debt ratio is in contrast to the sharp fall that occurred after the financial crisis. Between 2013 and 2015 the gross debt ratio fell by 40 per cent, driven by very strong economic growth, low interest rates and a divestment of banking assets, and it was not until 2016 that running primary surpluses started to have a significant impact on debt reduction. As previous research by the Central Bank has shown these favourable factors were unique compared to the rest of the euro area. Debt dynamics are expected to be more normal in the coming years, with a favourable interest growth differential and the deficit-debt adjustment only just offsetting the negative impact of primary deficits[6].

5.7 Risks to the medium scenario are considered to be strongly on the downside, reflecting the very high level of uncertainty surrounding the outlook and the potential for a stronger economic downturn and the need for additional support measures. Risks over the medium term are also considered on the downside; alongside the potential need for additional health spending are Brexit related risks and uncertainties over future corporation tax receipts.

5.8 The severe scenario is underpinned by a more pessimistic economic outlook and assumes that the cost of government support measures increases to €10 billion. This is primarily due to higher health spending and the extension of some income support schemes. Accordingly, the severe scenario can be seen as incorporating much of the downside risk surrounding the medium scenario. The impact is a more significant deterioration in the public finances, with the general government deficit increasing to €30.5 billion or 17½ per cent of GNI* and a gross debt of €225 billion or 127 per cent of GNI*.

[6] The interest growth differential captures the difference between the interest rate paid on public debt and the nominal GNI*growth rate. If the growth rate is higher than the interest rate it generates favourable debt dynamics. The deficit debt adjustment captures developments that impact debt but not the deficit, such as the run-down of cash balances or sale of banking assets.

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Table 3 – Fiscal projections under a 'severe' scenario

	2019	2020	2021
GG Balance (€bn)	1.4	-30.5	-19.4
GG Balance (% GNI*)	0.6	-17.3	-10.1
GG Debt (€bn)	204.1	224.4	241.9
GG Debt (% GNI*)	98.9	127.1	125.4

5.9 Similar trends to those in the medium scenario would occur over the medium term, but at a much higher level. The general government deficit would still be around 10 per cent of GNI* in 2021 before gradually declining in subsequent years. The public debt ratio would fall modestly to 125 per cent of GNI* next year, before experiencing a similar gradual decline.

6. Some general considerations in relation to budgetary matters

6.1 Given the severe and rapid effect of the pandemic on the economy, the decision to provide significant fiscal support was necessary. The measures introduced provide vital income and liquidity support to households and businesses, ensure that those with Covid-19 symptoms can isolate without financial concerns, and will facilitate economic recovery at the earliest opportunity. While 'hard' economic data is so far limited, the very large number of people requiring income supports – nearly half of the labour force - clearly shows the extent of the shock.

6.2 The ability to provide this support over the short term has, and will be, facilitated by a number of favourable factors. On the domestic side, these include the return of the general government balance to surplus in recent years, the large cash reserves built up by the National Treasury Management Agency, the establishment of the Rainy Day Fund and the expected surplus payment by the National Asset Management Agency. On the international side, it includes increased funding from the European Investment Bank. Among other things, monetary policy will ensure supportive financing conditions for governments, mainly via its asset purchase programmes, which include the purchase of sovereign bonds in secondary markets. In particular, €1,350 billion in euro area assets will be purchased in the Pandemic Emergency Purchase Programme (PEPP) until the end of June 2021, and this will contribute to stable market funding conditions for the government.

6.3 Any extension of the income support schemes, which are a matter for government, should be partly facilitated by sectors opening up and the positive impact that this would have on employment. Internal calculations suggest that the weekly cost of the schemes could decline by up to 40 per cent over the course of a three-month extension, although once again an important caveat is the high level of uncertainty surrounding this outlook.

6.4 It is possible that broader fiscal stimulus measures may be required – this will depend on developments in the coming months and the pace at which recovery takes hold. If some additional support is required, the magnitude would need to be considered in terms of the trade-off between supporting growth and incomes and higher public sector debt. Measures introduced, while a matter for the Government, should preferably help increase the potential output of the economy.

6.5 Over the medium-term, domestic and European fiscal rules will require sufficient progress towards Medium Term Objectives. The State's capacity to borrow on financial markets will depend on our creditworthiness, and credible economic policy will be a key element in this. Furthermore, a high level of public debt would also leave the economy vulnerable to future shocks, and concerns

that existed before the pandemic – such as Brexit, future ageing costs and the potential loss of corporation tax receipts – will still be factors post-Covid.

7. Specific issues on social protection questions

7.1 The timing and approach to tapering the COVID-19 unemployment and income supports, such as the Temporary Wage Subsidy Scheme (TWSS), is a matter for government policy. However, for both budget and work incentive reasons, it is important that these supports are gradually tapered and can be removed as the impact of the Coronavirus on the economy recedes.

7.2 The issues note raises the question of the impact of various support schemes on work incentives. It is too early to be definitive on this issue. However, that is not to say that the Covid scheme support framework could not become an issue in the future. There is an extensive economic literature which shows the impact of benefits on work incentives and job search effort.[7]

7.3 The issues note asks about sector specific supports (or programmes), after PUP/TWSS have ends. Active Labour Market Policies (ALMP) can have an important role in supporting the return to work of former workers who permanently lose their job because of the Covid-19 shock. The state has a long history with training and reskilling programmes, including after the financial crisis. ALMPs can help to avoid long-term detachment from work of certain groups. In the past, these policies have helped bring down long-term unemployment. Two key issues in relation to ALMPs are size (i.e. budget) and effectiveness. In 2012/13, €1.5 billion was spend on various forms of ALMPs. Given potentially higher levels of unemployment arising from Covid-19, the costs now could be higher. To support both programme design and value-for-money, it is vital that data on the experiences of individuals is collected throughout. This will allow for robust and timely evaluation of the impact of ALMPs.[8]

[7] For example, Doris, O'Neill and Sweetman (2017) show that benefit cuts for younger people at the time of the financial crisissignificantly reduced unemployment durations. Marinescu and Skandalis (2019) show that French unemployed workers increased their search intensity by 50% in the year before their benefits end.

[8] See for example the review of ALMPs in O'Connell and Kelly (2014).