



Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

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Mr Michael Noonan, TD
Minister for Finance
Government Buildings
Upper Merrion Street
Dublin 2

18 September 2013

Dear Minister,

With the Budget just a few weeks away, it is time for me to write to you with relevant views on budgetary and economic matters.

In previous years the Central Bank's communication around budget time emphasised three main macroeconomic challenges for ensuring as strong an economic recovery as possible. These remain the key areas of our focus and they are budgetary balance, competitiveness of wages and prices, and banking soundness. More than five years into the adjustment process, the scorecard is in positive territory, but not conclusively. While much has been achieved, there is danger in easing back now. More progress is required on all three fronts to improve the prospects for a successful exit from the EU/IMF Programme and, most importantly, to create the conditions for a sustainable economic recovery.

Meeting and, indeed, beating the targets set out in the EU-IMF Programme has helped Ireland go a long way towards establishing its reputation for credible policymaking and, in turn, has contributed significantly to lowering Irish bond yields. This has helped to contain borrowing costs and put Ireland in a position where exit from the Programme on schedule is now in prospect. However, the targets set by the Troika for Ireland were less demanding relative to the pace of adjustment set for other stressed countries. Ireland's position was helped by the fact that high cash balances at the time of entry into the Programme allowed an extra year for the consolidation at the total official funding available. This postponed completion of the fiscal adjustment, relative to what might have been required, has prolonged the period of negative budgetary shocks and left two years of fiscal adjustment still to be completed.

While very significant action has been taken in recent years to lower the fiscal deficit and contain the growth in public debt, the levels of both, in relative and absolute terms, remain extremely high. On the basis of the latest forecasts, Ireland's fiscal deficit, while shrinking, is set to remain among the highest in the euro area both this year and next. Similarly, Ireland's public debt is also set to remain among the largest in the euro area for some time to come.



To be sure, projections suggest that the debt ratio should peak this year and then gradually fall. Nevertheless, the sustainability of the debt path, in the sense of being consistent with market creditworthiness and long-run solvency, cannot be taken for granted. Scaling by GDP, the gross debt ratio will rise to 124 per cent this year and, even in the relatively benign baseline scenario, is not expected to fall below 100 per cent until 2020. Scaling by GNP, which many consider should be taken into account when assessing Ireland's fiscal capacity, the debt ratio will rise to 153 per cent this year and will not fall below 100 per cent until 2026.

These are extremely high debt levels and the projected decline in debt which emerges from baseline forecasts is vulnerable to future lower growth, higher interest rates and any negative shocks emanating from contingent liabilities, such as shortfalls in the crystallised value of NAMA assets or further bank capital needs. That vulnerabilities are not confined to future events is evidenced by the impact of so called one-off shocks on the 2013 General Government Deficit, the target for which now looks much more challenging than appeared earlier.

These considerations clearly underpin the view that there should be no easing off in adjustment, with as much front-loading of what is left as is possible. Ireland is at the point at which it is about to exit the EU-IMF Programme, but is doing so at a time at which deficit and debt levels are very high and there are risks in the future. Markets will focus closely on how well Ireland will perform outside the Programme and whether it can do so on its own. In such circumstances, if there is any pull back from the full €3.1 billion adjustment in 2014, there is the risk of starting to unwind the positive effects of the considerable consolidation effort that has taken place to date, amounting to around €28 billion, for the sake of a relatively small short-term fiscal easing which would have little overall stimulatory impact. A negative market reaction could, for instance, lead yields and spreads on Irish Government debt to drift up were markets to become concerned about the 2015 commitments and, more specifically, about the prospect of reaching the 3 per cent target on time.

For these reasons, calls to scale back the fiscal consolidation effort in 2014 Budget on the basis of the interest savings from the promissory note transaction should be resisted. Rather, the restructuring which that transaction permitted provides an opportunity next year to accelerate the adjustment of the deficit and debt without increasing the planned consolidation effort in cash terms, striking a balance between managing the impact on domestic demand and the need to enhance debt sustainability. Accelerating the adjustment in this way would help to reduce uncertainty in relation to the public finances and would set the debt ratio on a clearer downward path. This would help to get the economy back on to a more stable and certain footing and would contribute to a faster and more sustainable recovery. Doing so would also provide a buffer in the event that future external conditions prove to be weaker than is now expected or if there are adverse shocks from contingent liabilities.

Separately, the rationale for the elimination of the Promissory Notes, both from our own and our partners perspectives, was to make Ireland's debt more sustainable, through lowering future funding needs and reducing the net present value of Ireland's debt. The underlying intention was to reduce the amount that Ireland had to borrow over time, not to increase the amount that Ireland would have available to spend in the immediate future without any long-term gain. Looking ahead, the further cooperation and support of our partners would help us to make meaningful progress on the important banking issues which remain to be resolved. If we are not seen to be committed to using the benefits of the Promissory Note restructuring to



the fullest extent possible to reduce the burden of debt, it could jeopardise that support in the future. More formally, both in our agreements with the Troika and under the Excessive Deficit Procedure there is a requirement to use windfall revenue proceeds for debt reduction purposes.

A further consideration is the fact that moving more quickly to reduce the deficit in the next few years will leave the Government with less to do to meet the requirements of the Fiscal Compact. Estimates indicate that it will not be until 2020 that Ireland's structural deficit will be compliant with the rules of the Compact, suggesting that a good deal of consolidation will remain to be done after 2015. There is now an opportunity to do more now and to make the task easier from 2015 onwards.

Turning to competitiveness, while there has been good progress in recent years, recovering more of the ground lost during the boom would help to boost Ireland's growth potential. This is especially important in circumstances where export growth, which is now slowing, has provided a significant offset to the weakness of domestic demand. While Ireland has recovered some of the competitiveness lost during the boom, as has been pointed out before, sectoral shifts in the economy away from labour-intensive, low productivity sectors, such as construction, means these overall measures overstate the improvement that has been made. Adjusting for these compositional effects, on a relative basis, Ireland's competitive position would seem to be back at around 2003-04 levels. Given this, further improvement is needed to restore the economy to the levels of competitiveness enjoyed at the start of the last decade. Further reducing the cost base of the economy, both public and private, would help in this regard. Reflecting this, the reductions in the public sector pay and pensions bill are serving to lower the price of delivering public services and should have a more limited impact on the provision of services, compared to a situation where equivalent savings were to be achieved through a reduction in public sector employment. Reducing the elevated cost base of the economy is beneficial to the process of recovery and, as I have pointed out before, budgetary measures, including tax measures, should be assessed for their potential impact on the cost base, both public and private.

Turning to banking, as I have mentioned above, there are a number of sources of contingent liabilities on this side with potential budgetary impact in 2014. Among these is the potential for a shortfall in the crystallised value of the residual assets arising from the liquidation of IBRC which, if there was to be one, would fall to be covered by the Government. A second complicating issue are the uncertainties surrounding the outcome of the 2014 stress tests to be conducted as part of the establishment of the Single Supervisory Mechanism. While banks are now beginning to make progress on the resolution of impaired loans and profitability is moving back towards a break-even level in the two main pillar banks, the continuing deterioration in asset quality raises the risk of additional capital needs for the sector. Were such needs to arise and were they unable to be met through private sector channels, there would be a need for public support. While it would be preferable to have such support come via ESM direct recapitalisation, such funding is unlikely to be easy to access. While the outcome of the stress tests cannot be pre-judged, to the extent that any further capital needs arise and cannot be met in the market or through ESM direct recapitalisation, there is the potential for a further injection of capital to be required from the State at some point.

I hope that these remarks are of assistance in drawing up the Budget.

Yours sincerely,

A handwritten signature in dark ink, appearing to be 'P. ...', located at the bottom left of the page.