



Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

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Dear *Michael* Minister,

You will be well aware of the intensive policy discussions over the past couple of months around developments in the euro area Government debt markets. The widening of spreads on the government debt of Spain and Italy has resulted in an expansion to those countries of ECB purchases under its Securities Market Programme, but not before the two Governments concerned agreed to adopt rather far-reaching fiscal and structural policy measures.

The relevance of these developments for Ireland needs close consideration. On the one hand, the ECB's resumption of purchases in the SMP has helped a more favourable pricing of Irish Government bonds, with spreads falling by over 600 basis points at the short end (2-year) and over 150 basis points at the long end. This is better than achieved by Portugal and may represent the beginning of a favourable decoupling of market perceptions with Ireland pulling ahead of Portugal in the recovery stakes. Still, the spreads for Ireland over Germany, at 650-750 basis points, are still far away from levels at which Ireland could re-enter the market.

Furthermore, the unscheduled fiscal tightening announced by Italy and Spain makes Ireland's programmed fiscal adjustment look very gradual. For example, Italy now promises a balanced budget in 2013 (following deficits of 3.8 per cent of GDP in 2011 and 1.4 per cent in 2012). For Spain, the Government has announced extra measures to ensure that the deficit does not exceed 6 per cent this year as well as longer term limits on the overall level of State and regional borrowing. The Portuguese Government has recently announced plans to reach a deficit of only 0.5 per cent in 2015. All of these goals are a lot tighter than those in our EU-IMF plan.

It may be that the market and European partners will ignore this unfavourable comparison and continue to look only at Ireland's full compliance with the EU-IMF Programme. Indeed, I have not heard any suggestion from central banking colleagues in Europe indicating that pressure might come on Ireland to do more. And I do not think that any such pressure would come from the IMF who are currently very concerned to avoid pushing governments to doing more than is necessary in fiscal adjustment for fear of a knock-on deflationary effect on output and employment.



Nevertheless, it would be prudent to assume that pressure may build in the coming months for a ramping-up of Ireland's fiscal effort. As we saw last year, opinion in such matters can turn sour very quickly. The Government needs to have its best response ready for any such pressure. Therefore it would be very useful for the Government to have a clear view now through to the detailed content of the total three year envisaged fiscal adjustment. This would allow the Government to remain in control over the design of the fiscal adjustment in terms of mix of policy measures, even if it should find itself having to respond to pressure by accelerating the implementation of this design.

The question also arises as to whether the balance of advantage for Ireland does not lie in actually getting "ahead of the curve" here and actually front-loading more of the fiscal adjustment. This would obviously defuse any criticism that Ireland's approach to fiscal adjustment was complacent in the face of changing circumstances. A preparedness to do more now on the fiscal front could also be a valuable bargaining chip in seeking further improvements in the financial relations with the EU lenders (building on the lower interest rates already achieved). I will write separately on this important dimension at a later date.

But would frontloading the fiscal adjustment, by making a larger fiscal effort in 2012 (more than the €3.6 bn currently envisaged), damage output and employment? There is no professional agreement among economists on this point. If convergence to the 3 per cent deficit target is frontloaded, Ireland will have accumulated less debt in the end, and therefore will suffer a lower burden of taxation to service that debt into the future. In addition, it will speed the return of external market confidence. The net result will be a faster return to a higher sustained rate of output and employment growth in the medium term. In the short run, the reduction in demand resulting directly from the fiscal adjustment will tend to dampen the economic recovery in 2012, if not offset by a reduction in the private savings rate. There was reason to spread out the fiscal adjustment when households and firms were unprepared for it; but now that several years have passed during which those that can do so, have been positioning their financial affairs to cope with this adjustment, there is little to be gained by further delay.

Therefore I would urge you to consider the benefits of moving quickly to a position in which the Government could announce a frontloading of the remaining fiscal adjustment, surprising markets and official partners to good effect.

Yours sincerely