Irish Economic Update
AIB Treasury Economic Research Unit

AIB

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Budget 2021

Spending Splurge to Counter Covid-19 Crisis

The Irish and world economies have been hit by a severe recession in 2020 as result of the global Covid-19 pandemic. The response of fiscal policy virtually everywhere has been to try and shield economies and labour markets from the full force of the recession. Governments have ratcheted up spending to support activity. As a result, there has been a blow-out in budget deficits. A general government deficit of €21.6bn (6.2% of GDP) is being forecast for this year in Ireland compared to the modest budget surplus of €1.9bn recorded last year.

Another large budget deficit lies in store for next year, with considerable support continuing to be provided to the economy. Budget 2021 is based on two cautious assumptions. First, that the UK and EU fail to conclude a trade deal, resulting in a damaging hard Brexit in 2021. Second, that a vaccine is not found next year for the Covid-19 virus. As a result, the economy is forecast to grow by just 1.7% in 2021 after contracting by 2.4% in 2020. The Government is projecting a deficit of €20.5bn (5.7% of GDP) in 2021 on this basis. The budgetary outturn should be more favourable if a hard Brexit is avoided and /or a Covid –19 vaccine becomes available.

2021 Budget: Key Points

- **Today's budget was framed on the basis of a hard Brexit in 2021,** with the UK and EU failing to conclude a trade deal this autumn, **as well as on no vaccine for the Covid-19** virus becoming available next year. As a result, the **Dept's 2021 forecasts on growth are quite downbeat**. GDP is projected to rise by just 1.7%, after contracting by 2.4% in 2020.

- The cautious forecasts obviously **have knock-on consequences for the public finances.** The Government expects another large budget deficit next year of €20.5bn, or 5.7% of GDP. This follows the deficit of €21.6bn (6.2% of GDP) being projected for 2020. Meanwhile, the public debt is back on a rising trend. Gross government debt is forecast to rise to €219bn by end 2020 and €239bn at end 2021 from €204bn at end 2019.

- **The focus of today's Budget was very much on dealing with the challenges posed by the Covid-19 pandemic,** with considerable additional resources provided for health spending and to assist those sectors of the economy hardest hit by the curtailment measures put in place to try and suppress the virus. A Recovery Fund of €3.4bn is also being put in place **to help the economy cope with the challenges of Covid-19 and Brexit.**

- **Total voted government spending is projected at €87bn this year and €87.8bn in 2021. This is up from €67.5bn in 2019.** This provides a good indication of the enormous level of spending support being provided by the government to deal with the impact of Covid-19 in 2020-21.

- **Tax receipts have held up much better than expected this year.** Total tax revenues are forecast at close to €57bn in 2020, down from €59.3bn in 2019, with VAT receipts seeing the biggest decline. Total tax receipts are forecast to rise to €60.4bn next year, with the VAT take recovering in particular.

- **A big challenge will be to bring the budget deficit back down post 2021.** The key focus will need to be on returning spending to more sustainable levels after the enormous increases in 2020-21. Unlike in the financial crisis over a decade ago, at least the tax base has remained largely intact on this occasion. Thus, there should not be the same need for the large scale fiscal retrenchment that was implemented a decade ago.

Oliver Mangan
Chief Economist
oliver.n.mangan@aib.ie

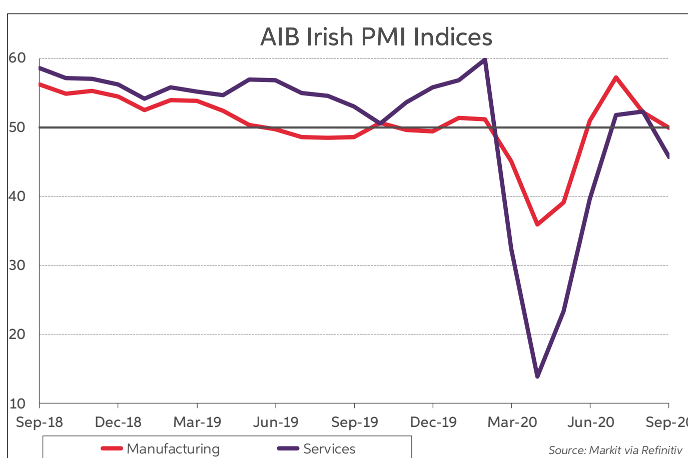
John Fahey
Senior Economist
john.j.fahey@aib.ie

Daniel Noonan
Economist
daniel.x.noonan@aib.ie

Budget assumes a no trade deal Brexit and no vaccine for Covid-19 virus

- **The Irish economy fell into recession in H1 2020 as the economy was put into lockdown to contain the spread of the coronavirus.** Modified final domestic demand contracted by 16.5% in Q2 after a fall of 1.3% in Q1. However, the fall in GDP was considerably less owing to the strength of net exports, with strong performances in particular by exports of pharma goods and computer services. GDP declined by 6.1% in Q2 after a fall of 2.1% in Q1. The economy rebounded strongly in Q3 as lockdown measures were lifted, which the PMI chart shows. However, the recovery is likely to run out of momentum in the fourth quarter, because of the sharp rise in the number of new Covid cases and the re-imposition of some restrictions on activity.

- The much better than expected National Accounts data for the second quarter mean that the **GDP decline in 2020 will not be anything like as severe as forecast earlier in the year,** when falls of between 7% and 10% were widely predicted. **The DoF now expects GDP will fall by 2.4% this year**, with the ESRI at -1.8% and the Central Bank forecasting a decline of just 0.4%.



- **Turning to next year, there is considerable uncertainty about the economic outlook.** The course of the coronavirus, developments in relation to a vaccine and whether or not the EU and UK can conclude a trade deal and avoid a hard Brexit, will have a big impact on the performance of the economy in 2021 and beyond.

- **In its baseline forecast, the Dept. assumes that a vaccine is not found and the EU and UK fail to agree on a trade deal.** On this basis, it seems GDP growing by just 1.7% in 2021. The CBI is more optimistic, forecasting that the economy will grew by 3.4% next year, on the assumption of no trade deal between the EU and UK. The ESRI is forecasting growth of 3.3% on the same basis.

- Obviously, if a trade deal is agreed and there is some progress in bringing the Covid-19 pandemic under control, growth should be stronger in 2021. The ESRI are forecasting GDP would increase by 6.3% in these circumstances, while the Central Bank is at 5.4%.

- The Central Bank sees strong growth continuing in 2022, with GDP forecast to rise by circa 5%. The ESRI and Dept. forecasts do not extend beyond 2021.

- **The Covid-19 pandemic has had other impacts on the economy, including a sharp fall in inflation**—partly due to a cut in the VAT rate. The HICP rate currently stands at –1.2%. The Dept. sees the rate averaging –0.3% this year before rising to 0.4% in 2021.

- **The Dept. sees the unemployment rate** averaging 15.9% this year, before falling to 10.3% in 2021. However, the 2020 figure includes all those on the Pandemic Unemployment Payment. The Dept notes that many of these do not meet the official definition of unemployed. The Central Bank does not include those on PUP in its latest forecasts as thus sees the unemployment rate averaging 5.3% this year.

DEPT OF FINANCE ECONOMIC FORECASTS*

(%)	2019	2020(f)	2021(f)
GDP	**5.6**	**-2.4**	**1.7**
Mod Dom Demand	3.3	-6.1	4.9
Private Cons	3.2	-7.5	7.0
Gov Expd.	6.3	15.2	-1.6
Mod. Fixed Inv.	1.2	-19.3	6.6
Exports	10.5	1.9	1.0
Mod. Imports	12.4	2.0	2,.6
HICP	0.9	-0.3	0.4
Employment	2.9	-13.7	7.6
Unemploy. Rate	5.0	15.9	10.3

*Assumes a no-trade deal Brexit, no Covid vaccine

Source: Dept. of Finance, October 2020

Another Large Budget Deficit in Store in 2021

- **The Budget deficit for 2020 is set to come in much lower than expected owing to the resilience of tax receipts.** There were forecasts that the General Government budget deficit could rise to as high as €30bn this year, but **the Dept. now expects it to come in at €21.6bn,** with tax receipts trending much higher than expected. Indeed, the Exchequer deficit will be even lower at €16.7bn as the Government was able to draw on the €1.5bn Rainy Day fund and a transfer of €2bn from NAMA, as well as some other non-tax State revenue sources, which reduced the Exchequer borrowing requirement.

- This left the Government with more room for manoeuvre in Budget 2021, allowing it provide additional spending next year. It certainly used the opportunity today. **The opening budget deficit for 2021 is €14bn. There was €7bn of spending increases in the budget, which takes the deficit to €20.6bn** after allowing for tax buoyancy effects.

- **Tax revenues are now forecast at almost €57bn this year, down 4% or €2.5bn on 2019,** a relatively modest fall given the severity of the recession that hit the economy in 2020. The Dept. sees tax receipts rising back up to €60.4bn in 2021. Corporation tax receipts continued to climb this year, rising to €12.5bn from just under €11bn in 2019. The Dept. sees a more modest rise in 2021 to just under €13bn. The Budget saw a cut in the VAT rate for the hospitality sector at a cost of €336m in 2021. The main budget tax raising measures were a hike on excise duty on cigarettes and some higher carbon taxes.

BUDGETARY PROJECTIONS : 2019 - 2021

(€ bn)	2019	2020	2021
Net Current Expenditure	54.8	69.6	70.3
Net Current Revenue	62.7	59.4	61.5
Current Budget Balance	7.9	-10.2	-8.8
Capital Budget Balance	-7.3	-6.5	-8.8
EXCHEQUER BALANCE	0.6	-16.7	-17.6
GEN GOV BALANCE	1.9	-21.6	-20.5
% of GDP			
Gen Gov Balance	0.5	-6.2	-5.7
Interest Expd	1.3	1.1	1.0
Primary Balance	1.8	-5.1	-4.7

Source: Dept .of Finance

- **The Budget today was all about providing additional spending supports for the economy and health service in 2021** to help cope with the Covid-19 pandemic. The Government is also putting in place a Recovery Fund of €3.4bn that will help the economy respond to the challenges of Covid-19 and Brexit. There was a modest package of increases in some social welfare payments. There was additional spending on the health service, with an increase in ICU and Acute bed capacity among a range of measures.

- **A wide variety of support measures were also announced to help businesses** impacted by the Covid-19 pandemic and to prepare for a major change in the trading relationship with the UK next year. As well as the cut in the VAT rate from 13.5% to 9% for the tourism and hospitality sector, the wage subsidy scheme will now run until end 2021, although its exact form next year remains to be decided. Further supports are being provided for business forced to close because of Level 3 Covid restrictions or higher, most notably in the live entertainment and hospitality sectors, under **a new Covid Restrictions Support Scheme**. Meanwhile, there is extra funding for public capital spending, including social housing. The increased tax rebate announced in July in the Help-to-Scheme is being extended to end 2021. Overall, total gross voted current government spending, which rose from €60bn in 2019 to €77.2bn in 2020, is forecast at €77.7bn next year. Meanwhile, gross voted capital spending is rising from €7.4bn in 2019 and €9.8bn in 2020 to €10.1bn by next year.

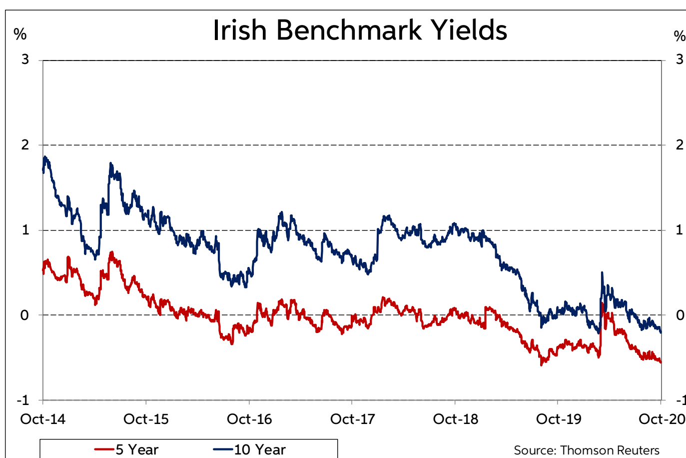
- **The greatest uncertainty around the Dept.'s budget projections is generally in relation to tax receipts. This was very much in evidence in 2020, when they held up better than expected.** Nonetheless, a cautious approach to tax forecasts is warranted given the uncertainty attached to the economic outlook and also the on-going question about whether the surge in corporation tax receipts since 2015 will prove sustained. The Pre-Budget White Paper provided for a 2% rise in tax receipts next year, but this carries a wide margin of error depending on how events unfold in 2021.

Much of next year's budget deficit pre-funded at super low interest rates

- Overall, the Dept. is forecasting a **general government budget deficit of €20.5bn (5.7% of GDP) next year in a no-deal Brexit scenario.** The actual Exchequer borrowing requirement is lower due to some sizeable State revenue receipts, such as transfers from NAMA. The Exchequer Borrowing Requirement is projected at €17.6bn in 2021. It should be noted that the budget projections are based on some cautious assumptions in relation to Brexit and a Covid-19 vaccine, so the outturn may be better than forecast.

- **Ireland's general government gross debt/GDP ratio had been in marked decline since 2013** when it stood at 120%. It fell to 57.4% at end 2019 before rising to a projected 62.6% in 2020 and 66.6% in 2021 However, inflated GDP figures since 2015 overstate the rate of improvement and underestimate the size of the actual debt burden. A better measure is the level of the National Debt to GNI* (modified Gross National Income). **The National Debt, which takes cash balances into consideration, stood at circa €200bn at end September.** The Dept. of Finance estimates GNI* at €203bn in 2020, which would give a national debt ratio of circa 98.5%, although by end 2020, the ratio is likely to be above 100%.

- **The NTMA faces just a small redemption schedule in 2021, with only €3.5bn of longer-term debt maturing.** It also continues to run very high cash balances, which stood at **€31.5bn at end September 2020. This will have been further boosted by bond sales of €1.5bn in early October.** There is a large government bond maturing in the fourth quarter (€6.5bn), while the Exchequer will also have a big deficit (circa €7.3bn) over the final quarter of the year. The Dept. estimates that cash balances will be down to circa €13bn by end year, although they could be nearer to €15bn.



- Regardless, much of **the projected Exchequer Borrowing Requirement in 2021 of €17.6bn, as well as next year's €3.5bn maturing debt is already pre-funded,** given the expected high level of end 2020 cash balances. The NTMA can be expected to remain quite active in the market next year to maintain cash balances at a comfortable level, helping to prefund much of 2022's maturing debt and budget deficit. The funding is being done at very low interest rates as the accompanying chart shows, with long term interest rates negative. The funds raised in this month's 10 year bond auction were done at a yield of –0.1%.

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