Irish Economic Update

AIB Treasury Economic Research Unit

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Budget 2022

Deficit in Sharp Decline

The focus of fiscal policy everywhere during 2020-21 has been to try and shield economies and labour markets as much as possible from the damage caused by Covid-19, as well as provide much greater resources for health services to allow them to cope with the pandemic. This saw governments ratchet up spending, resulting in a large rise in budget deficits, including in Ireland. As the pandemic begins to abate with the rollout of effective vaccines, economies are now rebounding. Fiscal policy is starting to normalise, allowing deficits to fall back.

The Irish budget deficit has fallen sharply this year. It was projected to rise slightly from its 2020 level of €18.4bn to over €20bn. It is now expected to come in at €13.25bn, with tax receipts surging as the economy recovers while Covid related spending is decreasing. It will decline further in 2022 as temporary supports put in place as a result of Covid-19 are phased out. However, the government is providing for non-Covid related spending to grow by circa 5% per annum between now and the middle of this decade, with strong growth in capital expenditure in particular. Thus, fiscal policy will remain supportive of economic activity. The budget deficit is projected to fall to €8.25bn in 2022 and just above €1bn in 2023.

2022 Budget: Key Points

- **Today's budget was framed against the backdrop of a strongly recovering economy and rapidly improving public finances** as Ireland emerges from the Covid-19 pandemic. The domestic economy is forecast to grow by 5.2% this year, 6.5% in 2022 and 4.2% in 2023. Meanwhile, GDP is projected to rise by 5% in 2022 and 4% in 2023, with the unemployment rate falling to 7.2% next year and 6% in 2023.

- **The general government budget deficit for 2021 is now put at €13.25bn, or 3.1% of GDP (5.9% of GNI*), well below the original €20bn forecast** and last year's deficit of €18.4bn. The recovering economy and phasing out of temporary government Covid-19 support measures will see **a further marked decline in the deficit over the next couple of years.** The Dept. of Finance expects the deficit to fall to €8.25bn, or 1.8% of GDP (3.4% of GNI*) in 2022 and €1.1bn in 2023, or 0.2% of GDP (0.4% of GNI*). The deficit is expected to be just €270m in 2024, with a surplus of €875m projected for 2025. The current budget deficit is forecast to fall from €4bn in 2020 to €2.2bn in 2021, with a move into a significant surplus of €3.3bn in 2022 and €10bn in 2023.

- **The level of public debt has risen sharply in the past couple of years** as the budget deficit soared. Gross government debt is forecast to rise to €237bn by end 2021 and €239bn at end 2022, from €218bn at end 2020 and €204bn at end 2019. The actual National Debt, which takes into account significant holdings of cash balances, is lower. It stood at €207bn in September, up from €200bn at end 2020. **Key public sector debt–to-national income ratios are set to decline from next year, but remain very elevated.**

- Unlike in the financial crisis over a decade ago, **the tax base has remained intact** on this occasion. Indeed, total tax receipts for this year are now forecast to surge by 15.5% to €66.1bn, and increase by 6.2% to €70.2bn in 2022. This is well above 2019's pre-pandemic level of €59.3bn. As a result, there is no need for the type of large scale fiscal retrenchment that was implemented over a decade ago, when the tax base collapsed.

- Indeed, the government has been able to provide for an increase of 5.5% in non-Covid spending next year. Overall, though, **total voted government spending is projected to decline from €89.3bn in 2021, to €87.6bn in 2022 before falling by €2bn to €85.6bn in 2023,** as temporary Covid-19 support measures are wound down.

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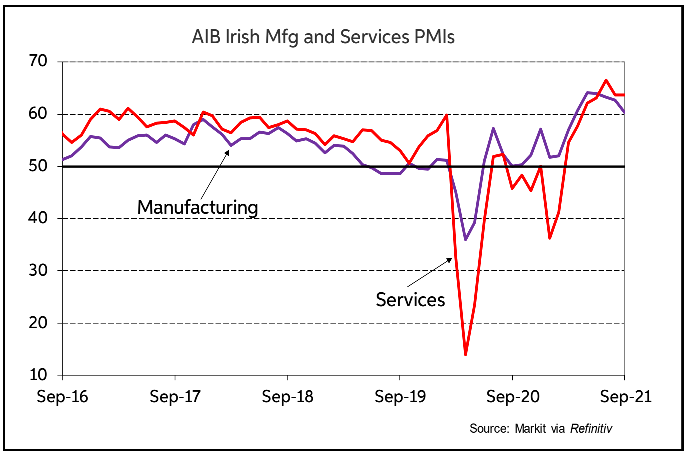
Economy expected to remain on strong recovery path

- **The phased re-opening of many sectors of the Irish economy, which began in April, has resulted in a very sharp rebound in economic activity.** Modified final domestic demand (MFDD) contracted by 4.9% in 2020 and 5% in Q1 2021, when large parts of the economy were again put back into lockdown. The economy rebounded strongly in Q2 and Q3 as lockdown measures were lifted. MFDD rose by 8.4% in Q2 and appears to have risen strongly again in Q3. Tax receipts were very buoyant in the third quarter, PMIs have remained at very elevated levels in recent months, while retail sales in July/August were up by 2.75% on the second quarter.

- Thus, the economy is set to record strong growth this year. National Accounts data in recent times have been badly distorted by the nature of some trade related flows in the multi-national sector, which has resulted in greatly inflated GDP growth rates. Exports figures have been impacted by contract manufacturing abroad, with import figures also distorted. The Dept. believes that GDP will rise by over 15% this year after growing by 5.9% in 2020—despite a recession! A better picture of economic activity is provided by modified final domestic demand, which is expected to grow by 5.2% in 2021.



- **Turning to next year, further strong growth is anticipated** as the economy continues to emerge from the recession caused by the Covid-19 pandemic. The Dept. is projecting GDP growth of 5% in 2022 (assuming no further trade flow distortions). Exports should perform strongly as the global economy continues to recover. Modified final domestic demand is forecast to expand by 6.5%, led by growth of 9.6% in consumer spending and a pick-up in house building activity. **The economy is expected to continue performing well during 2023-24,** with both GDP and MFDD forecast to grow by circa 4%.

- **The Covid-19 pandemic has had other significant effects on the economy, including on inflation.** The initial impact in 2020, which was downward pressure on prices, has been reversed this year. The HICP rate is likely to rise to over 4% before year end, up from a trough of –1.5% in October last year. The Dept. sees the HICP rate averaging 2.3% this year and 2.2% in 2022, up from -0.5% in 2020. The spike in inflation, then, is expected to prove transitory, falling back sharply next year to below 2% in H2 2022.

- The Dept. sees **the unemployment rate** averaging 16.8% this year. However, this figure includes all those on the Pandemic Unemployment Payment. Many of these do not meet the official definition of unemployed. The Central Bank does not include them in its much lower 2021 unemployment figure of 7.3%.

- **The numbers on the PUP have fallen sharply** since earlier in the year as the economy reopened. The jobless rate, including those on the PUP, fell from 27% in February to 10% by September. The PUP scheme will be phased out by the start of next year. The Dept. sees the **unemployment rate averaging 7.2% in 2022 and 6% in 2023, which is lower than previously expected,** reflecting the very rapid decline in the numbers on the PUP over the summer as the economy re-opened.

DEPT OF FINANCE ECONOMIC FORECASTS

(%)	2020	2021(f)	2022(f)	2023(f)
GDP	**5.9**	**15.6**	**5.0**	**4.1**
GNP	**3.4**	**9.1**	**4.5**	**3.6**
Mod Dom Demand	**-4.9**	**5.2**	**6.5**	**4.2**
Private Cons	-10.4	6.8	9.6	3.6
Gov Expd.	10.9	2.3	-1.8	2.0
Mod. Fixed Inv.	-3.6	4.0	6.4	7.6
Exports	9.5	16.1	5.7	5.1
Mod. Imports	1.6	11.3	7.0	5.9
HICP	-0.5	2.3	2.2	1.9
Employment	-16.7	7.8	13.2	2.7
Unemploy. Rate	19.2	16.8	7.2	6.0

Source: Dept. of Finance, October 2021

Budget deficit in sharp decline, current budget to return to surplus in 2022

- **The Budget deficit for 2021 is set to come in much lower than expected** owing to the strength of tax receipts and undershoots on Covid related spending. The projections, even up to this summer, were for a General Government budget deficit of over €20bn this year, but **the Dept. now expects it to come in at circa €13.25bn.**

- **The downtrend in the budget deficit is set to continue in the coming years. The Government is targeting a deficit of €8.25bn in 2022 and is projecting this will fall further to €1.1bn in 2023.** The deficits are forecast to amount to 3.4% of GNI* in 2022 and 0.4% in 2023. The deficit is seen at just €270m in 2024 before a return to a budget surplus of €875m in 2025.

- **The opening Exchequer deficit for 2022,** which is before any new policy measures or changes announced in the budget, **is €6.5bn.** There were €1bn of new spending increases announced in the budget and modest income tax cuts costing €500m. This takes the deficit to €7.75bn, after allowing for some tax hikes and buoyancy effects.

- **Tax revenues are now forecast at €66.1bn in 2021, up 15.5% or €9bn on 2020,** reflecting the strong rebound in the economy this year. Pre-pandemic, the tax take stood at €59.3bn in 2019. **The Dept. sees tax receipts rising by a further 6.2%, or €4bn to €70.2bn in 2022.** This is not surprising given the strong growth being forecast for the economy, especially domestic demand.

BUDGETARY PROJECTIONS : 2021 - 2023

(€ bn)	2021	2022	2023
Net Current Expenditure	70.8	68.8	66.1
Net Current Revenue	68.5	72.0	76.2
Current Budget Balance	-2.2	3.3	10.1
Capital Budget Balance	-9.9	-11.0	-11.8
EXCHEQUER BALANCE	-12.1	-7.7	-1.7
GEN GOV BALANCE	-13.3	-8.3	-1.1
% of GNI*			
Gen Gov Balance	-5.9	-3.4	-0.4
Interest Expd	1.5	1.4	1.4
Primary Balance	-4.5	-2.0	1.0

Source: Dept .of Finance October 2021

- Of the main tax heads, income tax, VAT and excise duties are forecast to register good growth in 2022. However, as usual, the Dept. is forecasting just a modest rise in corporation tax receipts as they are concerns that the sharp rise in revenues from this tax head in recent years will not be sustained. Forecasting corporation tax receipts in future years will become even more difficult given that **there is to be a major overhaul of the global corporate tax system that will have a significant impact on Irish tax receipts.** Meanwhile, the main tax raising measures announced in the budget were modest hikes in carbon taxes, VRT and on tobacco. The greatest uncertainty around the Dept.'s budget projections is usually in relation to tax receipts. They performed have much better than expected this year. Tax receipts are forecast to grow broadly in line with the economy in 2022.

- The Government recalibrated its fiscal policy framework earlier in the summer to allow for additional spending. The Budget allows fiscal policy to continue to provide considerable support to the economy, while targeting a marked decline in the deficit. **Core public spending (i.e. non-Covid related) is to rise by 5.5% to €80bn.** Within this, core capital spending is set to increase by 11%. Additionally, the Government is providing for a continuation of some temporary Covid supports amounting to €6.8bn, in areas such as health, public transport, education, unemployment payments and wage subsidies. This figure includes a contingency reserve of €4bn. However, overall **total voted government expenditure for next year is put at €87.6bn, a fall of €1.7bn from 2021 as most Covid supports will be wound down**, **with a further decline of €2bn to €85.6bn projected for 2023.**

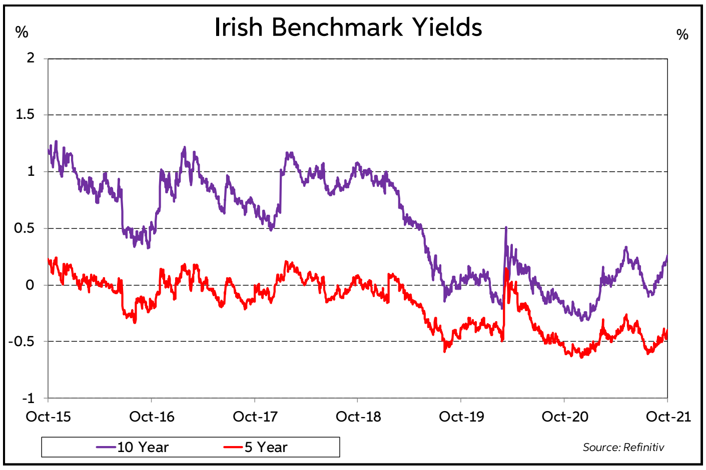
- In terms of the budget today, there was a package of social welfare increases amounting to €558 million, including targeted measures to help offset higher energy costs for low income households, as well as additional resources for education, child care and the Garda. **The Dept. is projecting that the current budget will return to a surplus, which is forecast at €3.3bn in 2022 and €10bn in 2023, compared to deficits of €2.2bn in 2021 and €4bn in 2020.** Thus, borrowing will be for capital purposes only in the coming years.

The 2022 budget deficit is already pre-funded

- Overall, the Dept. is forecasting a **general government budget deficit of €8.25bn next year.** The actual Exchequer borrowing requirement is slightly lower at €7.75bn in 2022 due to some State revenue receipts, such as transfers from NAMA, which boost the government's coffers.

- **Ireland's general government gross debt/GDP ratio had been in marked decline since 2013** when it stood at 120%. It fell to 57.2% at end 2019 before rising slightly to 58.4% in 2020. It is projected at 55.2% in 2021. However, greatly 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 Government Debt to GNI* (modified Gross National Income which excludes the distortionary effects in GDP caused by multi-nationals). On this basis, the gross debt ratio rose from 94.6% in 2019 to 104.7% in 2020 and is projected at 106.2% in 2021, falling back to 99.2% in 2022.

- Government debt is a gross figure and thus somewhat misleading as it includes significant pre-funding, which is held in cash balances. **The National Debt metric takes these cash and some other balances into account. It stood at €207bn at end September.** The Dept. estimates GNI* at €223bn in 2021, which would give a national debt ratio of circa 92.8% at the present time. The debt is likely to rise to €213bn (95.5% of GNI*) by end year.



- **The NTMA faces a redemption schedule of close to €12bn in government bonds in 2022 .** However, it continues to run very high cash and other balances, which stood at €31.5bn at end September 2021. These will be further boosted by bond sales of at least €1bn in October. The Exchequer will have a big deficit of circa €6bn over the final quarter of the year. The will reduce cash balances, while some short-term funding may not be rolled over. Nonetheless **by end year**, **cash balances could still be above €20bn.**

- This means that **the projected Exchequer Borrowing Requirement in 2022 of €7.75bn, as well as next year's near €12bn maturing debt, is already pre-funded**. The NTMA can be expected to remain active in the market next year to maintain cash balances at a comfortable level, thereby helping to prefund much of 2023's maturing debt and small budget deficit. However, with the deficit now in decline, it is likely that cash balances will be ran down from their high level in 2021, with the Dept.'s projected movement in the gross debt in 2022 suggesting they could fall by €7.8bn.

- **Funding is being done at very low interest rates,** as the accompanying chart shows. Ten year Irish bond yields are currently only slightly above zero at circa 0.25%, having being in negative territory as recently as August. Thirty year Irish bonds are yielding less than 1%. **The authorities should look to lock in as much government debt as possible at these very low long term rates.** With the current budget balance moving into surplus next year, **modest borrowing for productive capital purposes at these very low interest rates** in a strongly growing economy like Ireland makes perfect economic sense, notwithstanding the fact that the public debt is already at a very high level.