Opening Statement – Oireachtas Committee on Budgetary Oversight

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Introduction

Let me begin by thanking the Chair for the invitation to the ESRI to appear before the Committee. I am Dr. Kieran McQuinn, and I am joined by my colleague Dr. Conor O'Toole. We are grateful for the opportunity to appear before the Committee today to provide our views on the present economic and fiscal situation and to discuss some key issues and risks which the medium-term fiscal strategy should consider.

The Irish economy has emerged from the pandemic in a robust manner. Work conducted in the ESRI would suggest that the Irish economy grew by approximately 4.5 to 5 per cent per annum between 2013 and 2019. This meant that the economy went into the pandemic in a strong position which provided economic space to deal with the economic shock and emerge in a resilient fashion. However, there are a number of challenges set to confront the domestic economy and these have been exacerbated by the fallout from the recent invasion of the Ukraine by the Russian Federation. We will discuss the potential fallout from the invasion in the risks section below.

Fiscal and Economic Outlook

The improved situation with regards to the COVID-19 pandemic enabled the government to lift almost all of the public health restrictions as of the 28th February 2022. This has allowed for a re-normalisation of economic activity similar to that which operated before the onset of the global pandemic. The unwinding of public health restrictions through 2021 did result in strong recoveries in both consumption and underlying investment, while the export sector of the economy had performed robustly throughout the pandemic.

In 2021, we estimate that GDP grew by 13.6 per cent, with modified domestic demand (MDD) increasing by 6.2 per cent. For the present year, this trend is set to continue with MDD expected to grow by 7.1 per cent. In 2023 we believe the economy will continue to grow strongly. This reflects strong contributions from both domestic and external sources of growth.

The labour market experienced a sustained improvement throughout 2021; unemployment which peaked in February 2021 at 27 per cent fell to 7.0 per cent by February 2022. This strong recovery is set to continue and by the end of the current year, we expect the unemployment rate to fall to 5 per cent. The rapid decline in the unemployment rate, coupled with the strong domestic economic rebound, does give rise to the possibility of labour supply bottlenecks and associated risks for overheating in the domestic economy.

The strength of the economic performance is reflected in the improvement in the public finances. 2022 is likely to see the first positive General Government Balance (GGB) since 2019; this reflects both increased exchequer receipts and lower expenditure given the fall-off in unemployment during the pandemic.

Public Finances

2021 witnessed significant growth in almost all tax headings, with particularly large takings of income tax, VAT, and corporation tax. These three tax headings saw annual growth of 17.4 per cent, 24.3 per cent and 10.3 per cent respectively. The overall tax intake was €68.4 billion in 2021. Expenditure for year was 2.6 per cent higher in 2021 compared to 2020, however, it was €1.375 billion, or 1.5 per cent, lower than had been allocated for 2021.

This lower-than-allocated spending as well as the substantial tax intake produced a General Government Deficit of -3.1 per cent of GNI*, or -€7.3 billion, for 2021. This is significantly smaller than was expected. Debt levels have increased substantially over the last two years due to the large State intervention in response to the pandemic. However, the strong performance of the Irish economy has actually resulted in Ireland's debt-to-GDP and debt-to-GNI* ratios being somewhat lower in 2022 than they were in 2019 just before the pandemic.

It should be noted that the suspension of the Stability and Growth Pact has also contributed to the ability of governments to intervene during the public health crisis. At the moment, reforms of the European Union fiscal rules are being debated with some proposals suggesting that expenditure on climate-related matters should be excluded from the new rules that are proposed.

The return of the public finances to a sustainable path so soon after the significant costs of the pandemic does give rise to important policy questions concerning fiscal policy going forward. Given the Government's stated plans for expenditure levels[1] over the coming years,

[1] See the analytical box by Disch and McQuinn in the Winter Commentary (2021) for more on this.

improvements in the public finances are likely to see a persistent fall in the debt to output ratio, whether output is classified as GDP or GNI*. Indeed, if the current trajectory of the public finances were to continue, the debt to GDP ratio could, quite soon, fall to rates not seen since the mid 2000's. However, should Government policy be aimed at achieving as low a debt to output ratio as possible or should a certain target be set, as suggested by Furman and Summers (2020)[2]?

Risks in the Medium Term

Despite the significant upturn in the economy, there are a number of factors which pose challenges to the economy and living standards in the near future. In the short-term, rising inflation and the cost of living are particularly pressing. The most recent data indicates that the annual inflation rate was 5 per cent for both the CPI and the HICP in January 2022. This inflation is largely a result of international factors with energy and transport costs being the main driver of the rising cost of living. This is due to supply-chain disruptions during the pandemic and a faster-than-expected economic revival globally. The rising energy costs are putting pressure on households and on lower-income households in particular.

It is believed, however, that these inflationary effects are temporary, with many expecting the supply-chain issues and other pressures to ease throughout 2022. We have forecast an average inflation rate of 4 per cent in 2022, with a peak in Spring followed by decreases as base effects subside and supply-chain issues are resolved.

However, these forecasts were published before the recent crisis in the Ukraine; the price of oil and gas has already risen since the actions taken by the Russian federation. Sanctions have been placed on the Russian economy and although no sanctions have yet been placed on the energy sector of the country, this has been discussed as a possibility. It does seem likely that energy prices are set to increase further. Indeed, recent NIESR[3] research suggests the global inflation rate could rise by 3 percentage points this year alone. This could have significant implications for the recalibration of monetary policy by European Central Bank (ECB). To date the general assumption has been that the recent increase in inflation was temporary and hence, policy rates have been left unchanged in the short-term. This policy may change if higher

[2] Furman M. and L. Summers (2020). A Reconsideration of Fiscal Policy in the Era of Low Interest Rates, Brookings working paper, available online at: https://www.brookings.edu/wp-content/uploads/2020/11/furman-summers-fiscal-reconsideration-discussion-draft.pdf

[3] Liadze, I., Macchiarelli, C., Mortimer-Lee, P. and Sanchez Juanino, P. (2022) "The Economic Costs of the Russia-Ukraine Conflict", NIESR Policy Paper, 32, March.

inflation rates are expected to persist, although the ECB will also factor in the impact of the crisis on the growth performance of the Euro Area.

Over the medium-term, western authorities may decide to reduce European consumption of Russian gas and oil. This would almost inevitably lead to higher energy bills over the short to medium-term (see McWilliams, Sgaravatti, Tagliapietra and Zachmann (2022) for more on this[4]).

More generally, the radical shift in the geopolitical landscape will inevitably result in a sharp rise in international business uncertainty. This uncertainty is likely to drive growth lower in the general European economy though both investment and potentially precautionary savings channels. The Irish economy owing to its small and open nature is particularly sensitive to significant changes in global economic activity. Preliminary estimates from the European Central Bank (ECB) indicate that the conflict could reduce economic output in the Euro area by up to 0.4 per cent this year[5]. Previous modelling work done using COSMO, the largescale macro-econometric model of the Irish economy, (see Bergin, Garcia-Rodriguez, Morgenroth and Smith (2017)), would indicate a 1 for 1 relationship between global and domestic economic activity. The aforementioned study by NIESR in the UK indicates that the impact on global growth of the Russian invasion to be in the region of a reduction of 1 percentage point.

Most of the key drivers of the recent surge in inflation such as the increase in energy costs have been external to the domestic economy. However, one key element of recent increases in the cost of living which reflects domestic challenges is the cost of housing. Recent estimates from the CSO indicate that house prices are now growing by 14 per cent per annum, while rents according to the ESRI/RTB indicators are growing by 8 per cent. These increases are on top of sustained increases in both categories over the past 6 to 7 years. The pandemic, which had a negative impact on the supply-side of the housing market, has exacerbated the pre-existing imbalance which had existed between supply and demand in the economy. While there are a number of affordability-related issues associated with these increases, one area where it may have a direct impact on domestic economic performance is through a loss of competitiveness. The lack of adequate housing supply has been identified by a number of domestic and external

[4] McWilliams B., Sgaravatti G., Tagliapietra S. and G. Zachmann (2022). Preparing for the first winter without Russian gas, Bruegel blog, available online at: https://www.bruegel.org/2022/02/preparing-for-the-first-winter-without-russian-gas/

[5] See https://www.reuters.com/business/exclusive-ecb-policymakers-told-ukraine-war-may-shave-03-04-off-gdp-2022-02-25/

agencies as being one of the biggest challenges to our competitiveness as an economy (see Ireland's Competitiveness Challenge, 2020). The recent Housing for all initiative by the Government is welcome in terms of its multi-annual targets and expenditure commitments and the State must continue to focus on the delivery of social and affordable housing to tackle this issue.

Another significant challenge facing the economy over the medium-term is that of climate change and the green transition. Through the recent Climate Action and Low Carbon Development (Amendment) Act of 2021, the State has committed to an emissions reduction path of 51 per cent by 2030 and net zero emissions by 2050. The importance of such a commitment is widely recognised, but it is also acknowledged that meeting such targets along with tackling the housing issue will require significant investment by the State going forward.

Conclusion

The economy has recovered strongly from the pandemic and both it and the public finances are on a firm footing at present, however, there are international factors that could have large effects on the domestic economy. Inflation has already prompted a policy response from the government in the form of energy credit payments and it is not inconceivable that other policy responses will be required if these international circumstances worsen further, with particular attention being paid to the conflict currently ensuing in Ukraine.