

## **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 Prof. Kieran McQuinn, and I am joined by my colleague Dr. Claire Keane. We are grateful for the opportunity to appear before the Committee today to provide our views on the budgetary position.

In terms of Government budgetary policy, it is important to understand both the current and recent Irish macroeconomic context. The last number of years has seen the Irish economy perform particularly strongly even after experiencing the impact of the Covid-19 pandemic. It is of course difficult to get an accurate understanding of the underlying pace of growth of the economy especially as certain multinational related transactions can cause significant distortions to headline economic indicators. In that context, it is worth reflecting on the recent contribution by FitzGerald (2023)<sup>1</sup>, which seeks to estimate the underlying pace of growth in the Irish economy in the post great financial crisis era. FitzGerald (2023) indicates that the Irish economy has been increasing at somewhere between 4 and 4.5 per cent over that period. This correlates with work carried out by the ESRI to address this issue.

Presently, the Irish labour market is experiencing a degree of buoyancy unseen since the days of the Celtic tiger; the unemployment rate has been hovering around the 4 per cent rate since May 2022 and employment creation has been significant over this period. The recovery in the labour market since the challenges posed by Covid-19, when unemployment was in excess of 30 per cent, has been substantial.

Another indication of recent growth in the economy has been the strength of the public finances. After the Covid-19 shock, when the Government increased expenditure considerably to deal with the crisis, the general Government balance (GGB) experienced deficits of -5 per cent and -1.6 per cent in 2020 and 2021 respectively. However, since then the public finances

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<sup>1</sup> FitzGerald J. (2023). Understanding the Irish economy. Special article, Economic and Social Research Institute (ESRI) Quarterly Economic Commentary, Summer.

have benefitted from swift recoveries in income taxation, VAT and particularly corporation tax receipts. In 2022 a surplus in the GGB of 1.6 per cent of GDP or €8 billion was experienced and this was after €2 billion was diverted to a special reserve fund (SPF), which we will discuss later. In the present year, the expectation is that a GGB of 1.8 per cent of GDP or €10 billion will be achieved and this is after €4 billion has been diverted to the SPF.

### *Current challenges*

Notwithstanding the strength of the recent performance, it is now more than likely that the Irish economy will experience more moderate rates of growth going forward. There are a number of reasons for this. Much of the post Covid-19 growth performance had to do with the exceptional performance of the ICT and pharmaceutical sectors; sectors which have a significant presence in the domestic economy. While these sectors still perform well, it is highly unlikely that they will continue to sustain the rates of growth that characterised their recent performance. Therefore, as these sectors observe more modest rates of growth this will be reflected in the domestic economy. Indeed, the current moderation in exports in pharmaceuticals and the global challenges in the ICT sector highlight the reliance of our overall growth on these key sectors.

In addition, recent ESRI research<sup>2</sup> has shown that, after decades of falling income inequality, the latest data shows a fall in income growth for the lowest 10 per cent along with a stalling for others in the bottom half of the income distribution. This has been driven by a fall in work hours and months of full-time work per year which suggests an unequal labour market recovery.

The immediate aftermath of Covid-19 gave rise to a significant degree of volatility in economic data as the periods of lockdown resulted in significant base effects where growth rates oscillated depending on the nature of Government restrictions up to a year previously. As we move beyond that period, the underlying pace of growth is more readily apparent.

Inflation is still exerting a negative impact on the Irish outlook. While the pace of price increases, which had peaked at over 9 per cent in May 2022, has been declining on a persistent basis to its present rate of 6.3 per cent, the decline has been somewhat more gradual than what many had originally envisaged. Energy prices are coming down, however, inflation is now being driven by other factors like food and housing costs. Higher rates of inflation act as a drag

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<sup>2</sup> See <https://www.esri.ie/news/real-household-income-fell-for-the-poorest-10-between-2020-and-2021-and-income-inequality-rose>

on domestic consumption levels, in particular, as real household income levels are struggling to register positive growth.

Budget 2023 was unique in containing many one-off measures designed to provide relief to households experiencing strong cost-of-living challenges due to high inflation. While Budget 2023 met this challenge in a progressive manner this was driven by these once off measures. Most permanent tax-benefit measures were either frozen or increased below the forecast inflation rate and highlight the difficulties that will be faced in maintaining living standards once one-off measures expire.

Arguably, a greater challenge at the present time is that posed by the response of monetary authorities to the inflationary period through increases in official interest rates. This has been substantial with the official policy rate of the European Central Bank (ECB) increasing by over 400 basis points in the last year. This constitutes a major degree of monetary tightening which has also been observed in the United Kingdom and the United States. While this is aimed at curbing inflation, it does bring significant adverse side-effects as far as overall economic activity is concerned. These have been elucidated recently by contributions such as Ma and Zimmerman (2023) and Swanson (2023)<sup>3</sup> with investment, in particular, and economic growth, more generally, negatively affected. Rising interest rates across western economies inevitably has a contractionary impact on the global outlook through investment and consumption channels.

In a domestic context, higher interest rates will have negative implications for the housing market where the cost of finance has increased significantly in the last year. There is a generally acknowledged deficit between actual housing supply levels and the structural demand for housing where the latter is determined by trends in demography and net migration. Increasing interest rates will have negative repercussions for the construction sector as the cost of finance is clearly an important consideration in housing supply. Increasing interest rates also pose affordability challenges for households looking to secure mortgage finance and this comes against the backdrop of continuously increasing house prices over the past 10 years. The rising cost of finance will also pose challenges for other sectors of the domestic economy including

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<sup>3</sup> Ma Y. and K. Zimmermann (2023). Monetary policy and innovation, paper presented at the Jackson Hole Economic Policy Symposium: Structural Shifts in the Global Economy, Wyoming, USA, August.

Swanson E. (2023). The macroeconomic effects of the Federal Reserve's conventional and unconventional monetary policies. NBER working paper 31603.

small and medium-sized enterprises looking to access funding from debt financing. Recent research (Egan et al., 2023<sup>4</sup>) has quantified these effects and notes the drag on activity from the higher rates.

The impact of rising mortgage interest rates will also differ across the income distribution. Work by the Central Bank<sup>5</sup> may provide some reassurance as it shows that lower income quintiles are much more likely to have a fixed rate mortgage and are therefore less exposed to interest rate rises. Middle and higher-income groups, who may be more able financially to meet rising interest rates, are more likely to be exposed to interest rate increases due to a higher prevalence of tracker and variable mortgages amongst these income groups.

Another challenge on the horizon is the difficulties the Chinese economy is experiencing. While some believe that the present Chinese difficulties are somewhat transitory in nature, others such as Posen (2023)<sup>6</sup> are less sanguine and suggest more structural issues are at play. In particular, the increasingly autocratic nature of the Chinese regime appears to be impacting consumer and producer confidence with both Chinese consumers and companies increasingly prioritising short-term liquidity over longer-term investments. This trend of saving rather than investing in the Chinese economy could result in less spending by Chinese households on technology goods and other durable goods which require imports resulting in the Chinese trade surplus with the rest of the world continuing to grow. In that regard it is worth recalling that Chinese growth in the aftermath of the great financial crisis (GFC) was one of the main instruments of global recovery at that point.<sup>7</sup>

### ***Policy outlook***

Consequently, the present budget occurs at a time when the domestic economy is performing very close to capacity but also at a time when it is likely to transcend from a period of high growth to a more moderate pace of expansion. The substantial improvement in the public finances in recent years does present a certain opportunity for policy-makers to address key

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<sup>4</sup> Egan P, Kenny E. and C.O'Toole (2023). Interest Rate Snapback and the Impacts on the Irish Economy, Economic and Social Research Institute (ESRI) working paper, Number 757.

<sup>5</sup> <https://www.centralbank.ie/docs/default-source/publications/financial-stability-notes/the-interest-rate-exposure-of-mortgaged-irish-households.pdf>

<sup>6</sup> Posen A. (2023). The end of China's economic miracle. How Beijing's struggles could be an opportunity for Washington. Op-editorial in Foreign Affairs. Available online at: <https://www.foreignaffairs.com/china/end-china-economic-miracle-beijing-washington>

<sup>7</sup> See for example Wen, Y., Wu, J., (2017). Withstanding Great Recession like China, Federal Reserve Bank of St. Louis Working Paper 2014-007. URL <https://doi.org/10.20955/wp.2014.007>

infrastructural deficits in the domestic economy. In areas such as housing, healthcare and climate change it is clear that significant investment by the State is required if infrastructural bottlenecks are to be addressed. Unfortunately, due to the higher interest rate regime we are now in, investment in these key areas by the private sector is set to be more expensive; this may entail the State having to incur greater levels of expenditure than had been previously anticipated.

It is correct and prudent that a special reserve fund (SPF) has been established; this allows policy-makers to differentiate the recent surge in revenues between those that are sustainable over the medium-term and those that are more transitory or “windfall” in nature. This is particularly pertinent given that a large measure of the revenue surge is associated with increases in corporation tax receipts. Such transitory funds, clearly, should not be used to finance day-to-day current expenditure.

At the present time policy-makers must be aware of stimulating the economy at a time of record low unemployment, therefore, restraint is needed in other areas of fiscal policy in order to create the space for the investment that is necessary. In particular, taxation policy must be particularly prudent if this risk is to be avoided. While our experience with managing and delivering large-scale investment projects has been problematic in the past, the present budgetary position is relatively unique in terms of the opportunities it presents. It will take a considerable degree of judgement and discipline in realising this opportunity while maintaining stable and persistent growth in the overall economy.