

Budget 2017

Deficit Down to 0.4% of GDP

It is now expected that the budget deficit in 2016 will fall to less than 1% of GDP, with the deficit for 2017 forecast at just 0.4% of GDP. The Irish economy has performed much better than expected in recent years. Government tax receipts, in particular, have benefitted from this stronger than anticipated growth. Debt interest costs have also fallen quite sharply. As a result, the deficit has declined at a much quicker than expected pace.

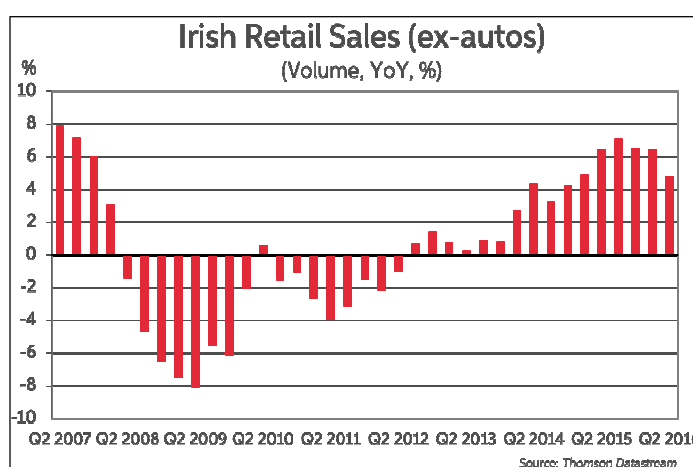
Stronger EU fiscal rules, which focus on the structural budget balance and expenditure controls, have made it more difficult for governments to introduce very stimulatory budgets. Hence, despite the marked improvement in the public finances, the Government had only limited room for manoeuvre in today's budget, with the so-called fiscal space put at €1.2 billion. Hence, the budget is just mildly expansionary, containing modest tax cuts and a moderate rise in spending. A prudent budget, though, is appropriate given the risks to the economy posed by Brexit, the uncertain global economic backdrop and still high level of the public debt.

Budget 2017: The Key Figures

- **The Irish budget deficit has fallen to a very low level.** It is forecast at 0.9 % of GDP for 2016 and is predicted to decline to 0.4% in 2017. This is down from 1.9% last year and 3.7% in 2014. The deficit was as high as 8% of GDP as recently as 2012. In absolute terms, the general government deficit is forecast at €2.4bn in 2016 and €1.2bn in 2017, down from €4.8bn in 2015 and €7.2bn in 2014.
- **The budget is slightly expansionary for the third year in a row.** This is in marked contrast to the severe fiscal tightening of the 2008-2014 period when some €30 billion of austerity measures had to be implemented to restore order to the public finances. The so-called fiscal space for 2017, though, is quite modest at €1.2 billion, or around 0.4% of GDP. Hence, the Minister was only able to provide for a modest reduction in the income tax burden next year, by reducing the three lowest USC rates by 0.5%. New spending increases announced in the budget for 2017 were also moderate enough, amounting to €1bn.
- **The projections underpinning the 2017 budget have been framed against a particularly challenging backdrop for macro forecasting.** The economy has lost some momentum over the course of 2016. Furthermore, distortions in National Accounts data, uncertainty about Brexit and doubts about the sustainability of a surge in corporation tax receipts in 2015/16, imply that the 2017 forecasts contain an unusually wide margin of error.
- Thus, unlike in recent years, it is **difficult to say where the balance of risk lies with regard to the 2017 budget projections.** The forecasts appear prudent and reasonable and our best judgement is that the budget deficit will be close to target next year. The risks are probably tilted slightly towards a higher deficit given that Brexit uncertainty and sterling weakness could have a greater impact on the economy and public finances than allowed for in the budget forecasts.
- **Ireland's general government gross debt/GDP ratio has been in marked decline since 2013** when it stood at 120%. It is forecast to fall to 76% by end 2016 and 74% by end 2017, although inflated GDP figures from 2015 overstate the rate of improvement and underestimate the size of the actual debt burden. Nonetheless, real progress has been made in recent years in reducing the high public debt level.

Irish Recovery Loses Some Momentum as Concerns Mount Over Brexit

- The past number of years have seen a strong recovery by the Irish economy that has surpassed all expectations. This has been led by robust export growth but there has also been a strong rebound in domestic demand, including both investment and consumer spending.
- The latest National Accounts data which are for the first half of 2016, show a **slowdown in the growth rate of the economy** compared to 2014 and 2015, with GDP growth decelerating to 4% year-on-year. There has been a significant slowdown in the rate of growth in underlying domestic demand. Growth in core domestic spending—consumer and government spending plus investment—slowed to around 2.5% year-on-year in the first half of 2016 from an average of 5.5% in the past two years. Business investment in particular has fallen back this year, after surging ahead in 2014 and 2015.
- Meanwhile, **consumer spending has not sustained the strong growth rate of 4.5% seen last year**. This is evident from many indicators. Indirect tax receipts are running behind schedule, while after a strong start to the year, new car sales have lost some of their upward momentum. Meantime, there has been a marked deceleration in growth in retail spending since the spring. The CSO has indicated that there has also been a fall-off in spending abroad by Irish tourists this year. Thus, a range of indicators suggest that consumer spending has lost momentum since the early part of the year.



- Meantime on the external front, CSO data show that **growth in service exports has slowed**. Furthermore, the PMI for the manufacturing sector has fallen to its lowest levels in more than three years following the Brexit vote in the UK, with the services PMI falling back in September also.

- Overall, there are a broad range of indications suggesting that growth in the Irish economy has lost some momentum this year. It would appear that the **uncertainty surrounding the vote for Brexit** in the UK is already having an impact on the Irish economy. The economy has also had to cope with a very **sharp fall in sterling** this year. The euro has risen from 70p to 90p since last December. Meantime, growth has also slowed in Ireland's three main export markets this year, with the **US, UK and Eurozone economies all losing momentum**.

- However, we **should not overstate the extent of the slowdown in the Irish economy**. GDP did grow by 4% year-on-year in the first half of the year and **many indicators are still pointing to a strong performance in 2016 overall**. The recovery in construction is continuing, albeit from a low base, with house building in particular remaining on a strong upward trajectory. Meanwhile, consumer confidence remains close to fifteen year highs.

DEPT OF FINANCE ECONOMIC FORECASTS

(%)	2014	2015	2016(f)	2017(f)	2018(f)
GDP	8.5	26.3	4.2	3.5	3.4
GNP	9.2	18.7	7.5	3.3	3.2
Private Cons	1.7	4.5	3.3	2.9	2.2
Gov Expd.	5.4	1.1	5.9	2.4	1.3
Fixed Inv.	18.2	32.7	15.8	6.0	4.7
Exports	14.4	34.4	3.6	4.5	4.8
Imports	15.3	21.7	5.9	5.1	4.8
BoP (% GDP)	1.7	10.2	9.4	8.2	7.8
HICP	0.3	0.0	-0.1	1.3	1.8
Employment	2.4	2.6	2.6	2.1	2.1
Unemploy. Rate	11.3	9.5	8.3	7.7	7.3

Source: Dept. of Finance, October 2016

- Labour market data also remain strong with employment growth being sustained at over 2.5% year-on-year in the first half of 2016, while the Live Register and unemployment rate remain on firm downward paths.

- Overall then, **the economy seems to be performing reasonably well in 2016, but growth has lost some momentum and will be lower than in the last two years.** We are forecasting that GDP growth for this year will average around 3.5%. However, GNP growth is likely to be higher, at c. 5.5%, because of a decline in profit repatriations by multinational corporations. The ESRI and Dept. of Finance estimate GDP growth at 4.3% and 4.2%, respectively for 2016, with the Central Bank at 4.5%.

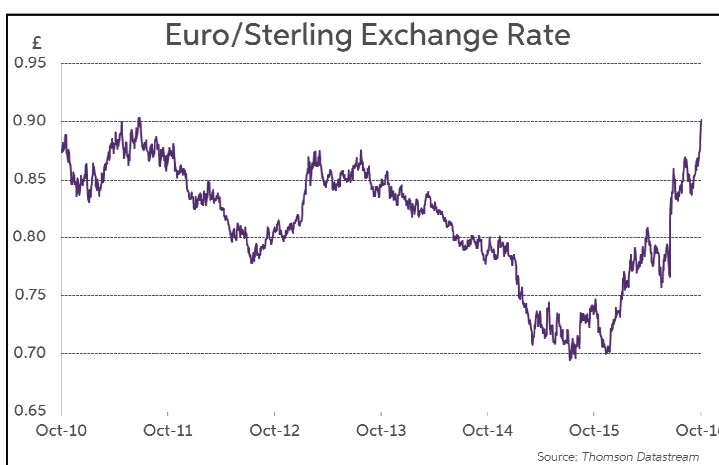
- With the uncertainty on Brexit likely to persist and global growth expected to remain subdued in the next couple of years, Irish growth is likely to slow further in 2017/18. **AIB is forecasting 3.5% GDP growth for next year**, with the Dept. of Finance also at 3.5% and the ESRI and Central Bank just slightly higher. GDP growth in 2018 is forecast at 3% by AIB and 3.4% by the Dept. of Finance.

- **There are a number of factors which should help to support activity. Fiscal policy has turned mildly expansionary. Interest rates have fallen to record low levels** and are expected to remain very low over the next few years. **Real incomes are also increasing**, with wage growth picking up and a continuing strong rise in employment. Inflation is expected to remain very subdued, helped by the sharp weakening of sterling this year. Meanwhile, we expect the construction sector to make a significant contribution to economic growth over the next couple of years, in particular house building activity, which is continuing to recover from very low levels of output. Ireland is also benefitting from large inflows of FDI which should help boost exports.

- **There are downside risks to the above growth forecasts**, in particular from external factors. Sterling's slump and Brexit uncertainty could weigh on activity to a greater extent than expected. There is now a **growing likelihood of a 'hard' Brexit that could see the UK lose access to the Single Market.** The UK is set to trigger Article 50 early next year and thus leave the EU in the first half of 2019. Difficult negotiations over Brexit could put even more downward pressure on sterling and cause a marked slowdown in the UK economy, hitting Irish exports. Meanwhile, the recovery in the global economy remains fragile and could lose further momentum, which again would weigh on Irish exports. Overall then, there is considerable uncertainty about the economic outlook, with some prominent downside risks.

COMPARATIVE ECONOMIC FORECASTS 2016/2017

%	AIB	Dept. of Finance	ESRI	Central Bank
2016				
GDP	3.5	4.2	4.4	4.5
GNP	5.5	7.5	4.1	4.5
Private Cons.	3.0	3.3	4.2	3.8
Gov. Expd.	3.0	5.9	1.0	2.5
Fixed Inv.	9.5	15.8	16.2	14.0
Exports	4.5	3.6	3.6	5.6
Imports	6.2	5.9	2.6	7.8
2017				
GDP	3.5	3.5	3.8	3.6
GNP	3.0	3.3	3.5	3.1
Private Cons.	3.0	2.9	4.0	2.2
Gov. Expd.	1.0	2.4	1.0	1.1
Fixed Inv.	6.0	6.0	18.6	7.0
Exports	4.5	4.5	7.6	4.4
Imports	4.8	5.1	11.9	4.7



Fiscal Rules Leave Limited Room for Manoeuvre in the Budget

- **Fiscal rules mean that the Government had only limited room for manoeuvre in today's budget.** The so-called fiscal space is defined as the projected amount of resources available to the Government for additional expenditure and/or tax reductions, while ensuring compliance with the fiscal rules, specifically the so-called Expenditure Benchmark and the preventive arm of the Stability and Growth Pact, which gives primacy to the structural budget balance. The Government is required to reduce the structural budget deficit by 0.6% of GDP per annum until it falls to 0.5% of GDP.
- The fiscal space available in 2017 is put at €1.2 billion, allowing the Government **room to introduce a number of modest expansionary measures through tax cuts and spending increases. This is on top of the spending increases already provided for in the Pre-Budget White Paper** for demographic pressures, the Lansdowne Road Pay Agreement, capital plans, most notably in housing, as well as certain other pre-committed policy decisions.
- There were very sharp increases in direct taxation during the economic crisis. The 2015 and 2016 budgets began to unwind some of these tax hikes, providing some modest relief for taxpayers. Today's budget has continued this process, with a further **slight easing of the tax burden**. The three lower USC rates were cut by 0.5% to give relief to low to middle income earners. There was no change to the top USC rate. Overall, marginal income tax rates still remain very high for middle income workers in Ireland, at 49% on earnings between €33,800 and €70,000 and 52% on income above €70,000.
- The additional spending announced today includes an increase in childcare support, with a new childcare subsidy for low to middle income families. Most social welfare benefits are also being increased. The biggest spending increases are in health, with additional resources also for Education and Housing. Additional funding is also being provided to help counter the challenges posed by Brexit. One other new measure announced today is a help-to-buy scheme for first-time buyers in the form of a tax rebate of up to 5% of the purchase price. It is confined to new-build homes and is capped at €20,000. The aim is to help first-time new home buyers meet the deposit requirement to get a mortgage, but there is a risk that it will also boost house prices.
- Overall, total gross voted government current spending will rise to €53.5 billion next year from €52 billion in 2016, an increase of just under 3%. Meanwhile, gross voted Exchequer capital spending is projected to rise by €370 million to €4.5 billion, but it still remains at a very low level.
- The gross cost of today's budget changes is €1.3 billion or about 0.5% of GDP. It is less, though, when one allows for the beneficial effect of the measures on tax revenue buoyancy, which is put at €0.3 billion. The Government set a very low budget deficit target of 0.4% of GDP for 2017, with a small deficit of 0.3% of GDP forecast for 2018, and a small surplus forecast for 2019. **The Government has adhered to EU fiscal rules** to reduce the structural budget deficit by at least 0.6% of GDP. It will fall from 1.9% to 1.1% of GDP in 2017 according to the Dept. of Finance projections.

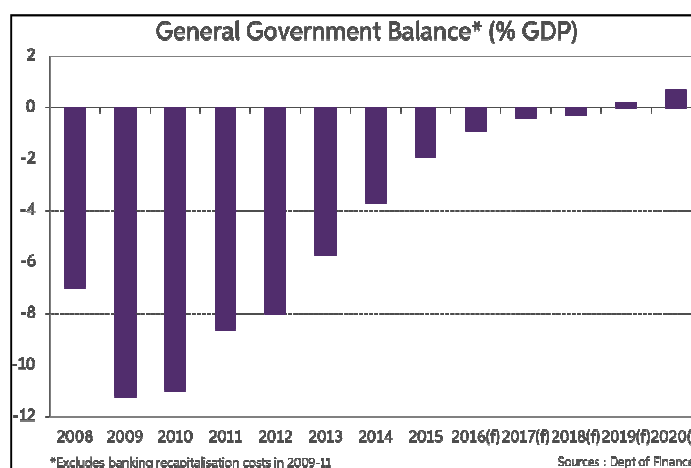
BUDGETARY PROJECTIONS : 2016 - 2018			
(€ bn)	2016	2017	2018
Net Current Expenditure	50.2	51.2	52.5
Net Current Revenue	50.9	53.2	55.4
Current Budget Balance	0.7	2.0	2.9
Capital Budget Balance	-2.1	-4.2	-5.2
EXCHEQUER BALANCE	-1.4	-2.2	-2.3
GEN GOV BALANCE	-2.4	-1.2	-0.8
% of GDP			
Gen Gov Balance	-0.9	-0.4	-0.3
Interest Expd	-2.4	-2.2	-2.1
Primary Balance	1.4	1.8	1.8

Source: Dept of Finance October 2016

- The primary budget balance (i.e. excluding debt interest payments) moved into a small surplus in 2014 for the first time since 2007. The surplus is put at 1.4% of GDP this year. This compares with a peak deficit of 9.3% in 2009. In total, the primary budget balance has improved by some 10.7% of GDP in the seven year period 2009-2016, or an average 1.5% per annum. The surplus is forecast to rise to 1.8% of GDP in 2017 and 2018.

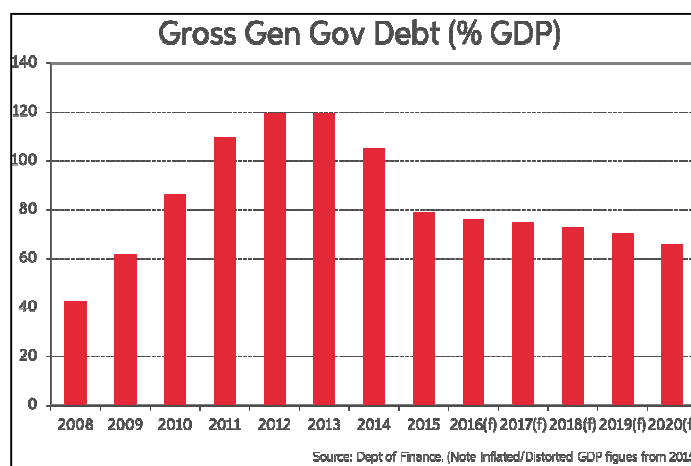
- While the level of government debt is still very high, **debt interest payments by the Exchequer are actually falling as a percentage of GDP**. They fell to 2.4% of GDP this year from 2.6% in 2015 and are forecast at 2.2% in 2017. This is considerably lower than in the 1980s, when debt interest costs rose to over 9% of GDP.

- The **greatest uncertainty around the Dept.'s budget projections, as always, is in relation to tax receipts**. In recent years, the Dept.'s tax projections have been prudent and erred on the side of caution, with revenues coming in ahead of forecast. A cautious approach is warranted again for 2017 given the increased uncertainty attached to the economic outlook as a result of Brexit and the slowdown in global growth. Furthermore, there is also a question mark over whether the surge in corporation tax receipts in 2015/16 will prove sustained or be just a blip which sees them fall back again.



- Nominal GDP is forecast to rise by 4.5% next year, while tax receipts are projected to rise by slightly more at 5.2%, before today's budget changes. It must be recognised that the forecasts for 2017 have a greater than usual margin of error. Unlike in recent years, it is **difficult to say where the balance of risk lies with regard to the 2017 budget forecasts**. The projections appear reasonable and our best judgement is that the budget deficit will be close to target next year. The **risks are probably tilted slightly towards a higher deficit**, though, given that Brexit uncertainty and sterling weakness could have a greater impact on the economy and public finances than allowed for in the forecasts.

- The **gross general government debt ratio is put at 76% of GDP by end 2016**, down from 78.6% at end 2015 and a peak level of 120% in 2012/13. However, the inflated GDP figures for 2015 give a misleading picture of the true trend in the debt position, with the ratio falling from 105% in 2014 to 78.6% last year. The Dept. expects the ratio to decline to 74.3% by end 2017 and 72.7% in 2018.



- The Exchequer deficit for 2017 is forecast at €2.2 billion, while some €6.4 billion of long term debt matures next year. **This gives a funding requirement of €8.6 billion in 2017, which is not overly demanding**. The Government, though, has very high balances of cash and other liquid assets. It may opt to reduce these somewhat next year, lowering its funding needs in 2017.
- The improvements in the Irish economy and public finances have been recognised by the market. Ten year Irish government bond yields are circa 0.5%, while yields on five year paper are negative. Irish bond yield spreads have narrowed considerably to core Eurozone markets, standing at 45bps over Germany and 15bps above France in the ten year area, significantly lower than for Italy and Spain. Today's cautious budget should help underpin these narrow spread levels.