Ireland

Beyond revisions

■ **The presentation of Ireland's 2017 budget proposal provides a good occasion to review the country's public finance situation. Recent revisions of the national accounts have muddled the reading of its public finance ratios.**

■ **Bolstered by a very vigorous economic recovery, the country's fiscal situation is improving rapidly. Ireland is also benefiting from a favourable environment for streamlining debt management.**

■ **The robust growth prospects in our central scenario are strong enough to predict a vast improvement in Ireland's public finances in the years ahead. Based on this assumption, and to take into account the impact of the revision of the national accounts, the government set a new debt-to-GDP target of 45% in the horizon 2025.**

■ **Despite all this, the situation is not risk free. The crisis has left its mark, limiting public finances capacity to absorb future shocks. The Irish growth model has also been weakened by the prospects of Brexit and the EU's dwindling tolerance for fiscal competition strategies among member countries.**

The presentation of Ireland's 2017 budget proposal provides a good occasion to review the country's public finance situation. Like the other executive arms of the eurozone member states, the Irish government presented the European Commission with the main elements of its budget proposal for 2017.

Robust growth prospects

On the whole, the fiscal situation seems to be very favourable, especially for a country whose public debt peaked at nearly 14% of GDP in 2009, that until recently was undergoing a European adjustment programme, and whose public debt-to-GDP ratio culminated at more than 120% in 2012. After exiting the European adjustment programme in late 2013, Ireland's extremely dynamic recovery has fuelled a rapid improvement in its public finance situation. The country has now exited the excessive deficit procedure as well, after reducing its public deficit well below 3% of GDP as of 2015 (to 1.9%).

That said, the reading of Ireland's economic situation and public finance ratios has been severely muddled by the recent revision of the national accounts. In summer 2016, the Central Statistics Office (CSO) published an in-depth revision of the national accounts that resulted in a very big increase in 2015 GDP. According to the revised accounts, GDP rose 32.4% in value and 26.3% in volume in 2015 (compared to previous estimates of 7.8%). Obviously these figures do not reflect the real dynamics of the Irish economy (see box), largely blurring the picture of economic activity that the national accounts are supposed to provide.

Economic forecasts

	2015			2016			2017		
	Gov.	IMF	EC	Gov.	IMF	EC	Gov.	IMF	EC
GDP (% of change)	26,3	26,3	26,3	4,2	4,9	4,1	3,5	3,2	3,6
Inflation (% of change)	0,0	0,0	0	-0,1	0,3	-0,2	1,3	1,1	1,2
Unemployment (%)	9,4	9,4	9,4	8,2	8,3	8,3	7,4	7,7	7,8
GGB (% of GDP)	-1,9	-1,9	-1,9	-0,9	-0,7	-0,9	-0,4	-0,5	-0,4
Public debt (% of GDP)	78,6	78,6	78,6	76	74,6	75,4	74,3	72,6	73,6

Table Sources: Finance Ministry, IMF, EC

Evaluating economic growth

How to provide an accurate assessment of the economic activity that is effectively carried out on Irish soil is a recurrent question given the country's fiscal model. Observers have already grown accustomed to completing GDP statistics (the sum of value added created in Ireland, including foreign companies located in Ireland) with Gross National Product (GNP) (which refers to the wealth created by national agents, including Irish companies located abroad, and excluding foreign companies located in Ireland). Yet this time the revisions also had a big impact on GNP, which increased 18.7% in volume in 2015.

As far as we know, based on available information, one of the main causes of this major revision is the reclassification of certain multinationals as resident Irish companies, and the reclassification of certain assets of these multinationals' Irish subsidiaries. A large part of the newly reported business activity pertained to contract manufacturing. . Consequently, the national accounts reported an increase in Irish exports of more than 14% in volume in 2014 and more than 34% in 2015. One of the biggest difficulties with this revision is that we do not know whether these reclassifications will result essentially in a one-time shock on Irish GDP, or if the reporting of contract manufacturing activities will give rise to a recurrent and growing overestimation of exports, creating a lasting distortion of the image provided by GDP growth figures. At this point, the data available for the first half are very volatile, with GDP down 2.1% q/q in Q1 2016, followed by an increase of 0.6% q/q in Q2, which suggests that the national accounts are still highly disrupted. Year-on-year GDP was up 4.3% at the end of H1 2016.

Box 1

These distortions do not call into question the assessment of rapid growth in 2015. Ireland's treasury, the National Treasury Management Agency, highlights other indicators that confirm the country's strong economic health and provide a more accurate image of growth trends. The agency calculates the underlying growth of domestic demand, which is not disrupted by the business of multinationals: it increased 2.2% in 2015 and 3.7% year-on-year in H1 2016. Employment also picked up rapidly, rising 2.6% in 2015 and 2.8% y/y in H1 2016. Lastly, the *Economic and Social Research Institute (ESRI),* Ireland's main centre for economic forecasting and policy analysis, estimated growth at nearly 5.6% in 2015 after adjusting for these effects (by estimating real industrial output). Building on these trends, the estimates used by the government in its 2017 budget proposal speak for themselves: this year GDP growth was probably closer to 4.2%, and could still reach 3.5% in 2017. This point of view is largely shared by the European Commission (Autumn

2016 Forecast) and the IMF (October 2016 World Economic Outlook), whose 2016 and 2017 forecasts are relatively close to the government's (see table on previous page). ESRI is projecting growth of 4.3% in 2016 and 3.8% in 2017.

Rapidly improving public finances

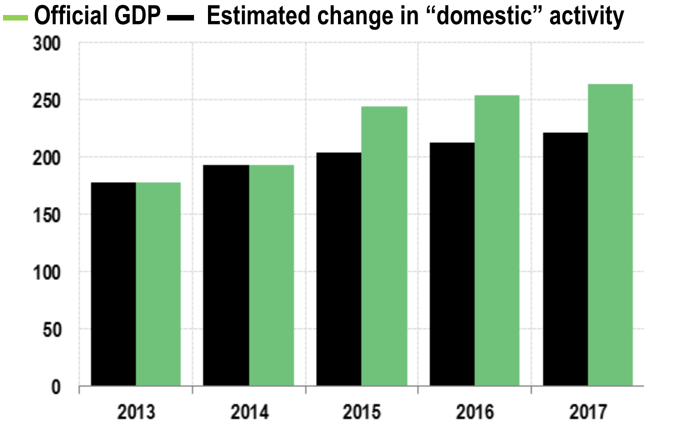
With real GDP rising at such a dynamic pace, public finances are bound to improve very rapidly. After bottoming out at 13.8% of GDP in 2009 (excluding the impact of bank recapitalisation), the general balance of public finances has turned around rapidly, thanks mainly to the discretionary measures implemented in 2012 and 2013, and even more so to the acceleration of growth ever since. Under these conditions, the debt-to-GDP ratio for all public administrations began to diminish, after peaking at 119.5% of GDP in 2013.

Last year's surge in GDP obviously resulted in a dramatic but artificial improvement in public finance ratios in 2015. The general public finance deficit narrowed by 1.8 percentage points of GDP, from -3.7% of GDP in 2014 to -1.9% of GDP in 2015. Over the same period, the public debt ratio also plunged by 26.6 percentage points to 78.6% of GDP in 2015. The improvement in the budget balance is better represented by the increase in the revenues of public administrations as a whole, which rose 7.6% and 7.3%, respectively, in value terms in 2014 and 2015 according to the IMF, while spending increased only 2.3% and 3.5%, respectively. All in all, spending accounted for only 107% of the revenues of all public administrations, down from 138% in 2011, and is now close to the EMU average of 104%.

The government esteems that the adjustment continued this year, with the public deficit narrowing to -0.9% of GDP in 2016, and it could fall as low as -0.4% of GDP in 2017. As to the public debt-to-GDP ratio, after the sharp drop reported in 2015, it should begin to diminish gradually again, narrowing to about 74% of GDP next year. To take into account the new metrics imposed by the revised national accounts, and to demonstrate the credibility of its public finance adjustments, the Irish government dramatically lowered its medium-term debt-to-GDP target. It is now targeting a public debt-to-GDP ratio of about 45% in 2025, which is much lower than the European Commission's recommended ceiling of 60%.

On the whole, the economic picture is very favourable. Ireland's robust growth prospects are strong enough to forecast a drastic improvement in the country's public finances in the years ahead. Even so, the situation is far from being risk free. First, the crisis has left its mark[2] and must still be absorbed, limiting the capacity of public finances to absorb future shocks. Nor is the horizon completely clear. Faced with the prospects of Brexit, the terms of which are still very uncertain, and the European Union's dwindling tolerance for fiscal competition among member countries, Ireland's growth model will have to evolve in the years ahead.

Official and estimated GDP (EUR bn)



The graph represents the change in Ireland's official Gross Domestic Product as published by the CSO, as well as estimates based on the ESRI calculations developed for 2015 growth. In 2016 and 2017, government estimates were used for the growth rates of each series. On this basis, we can estimate the increase in GDP that does not reflect domestic economic growth at about EUR 40 bn, or 20 percentage points of 2014 GDP (and 16 pp of 2015 GDP).

Chart Sources: ESRI, Finance Ministry

Extending debt maturity

In addition to the improvement in public finance ratios, we would also like to point out the favourable shift in the structure of the public debt. Taking advantage of the successful return to the financial markets and an extremely favourable interest rate environment, the Irish government made several early loan repayments to the IMF. Between December 2014 and March 2015, the country reimbursed the IMF EUR 18 billion four years ahead of schedule.

Consequently, the current composition of Irish debt only partially reflects the crisis years. To date, official loans account for only 25.3% of total public debt, which is comprised essentially of European loans (EFSF and EFSM) and the rest of market debt. This operation enabled the Irish Treasury to 1) extend the average maturity of its debt (now 13 years), 2) to reduce the implicit interest rate, which is now estimated at 3.1% by the European Commission[1], and 3) to spread out and smooth the medium-term repayment profile (after major repayment dates through 2020).

Box 2

[1] In December 2010, after Ireland borrowed EUR 22.5 billion from the IMF at a rate of 3.3%, money market rates for 10-year Irish bonds reached 8%. At the end of September 2016, they were below 0.4%, and after picking up in the past few days, they are still below 1%.

[2] Concerning the banking sector see our Eco Flash (November 2016), *Irish banks : on the road to recovery,* L. Nahmias