An Roinn Airgeadais
Department of Finance

Information Note

on the

Economic and Budgetary Outlook

2011 – 2014

(in advance of the publication of the Government's Four-Year Budgetary Plan)

4th November 2010

(Prn. A10/1600)

Summary and Outlook

The purpose of this note is to outline the emerging economic and budgetary situation in order to inform the public in advance of the publication of the Government's four-year budgetary and growth plan later this month. Figures are presented in broad terms on the basis of the necessary budgetary adjustments being made. In addition, the projections assume that various reform measures – to be specified as part of the Plan – are implemented. The detailed fiscal measures to reduce the deficit to 3% of GDP by 2014 will be contained in the Four-Year Plan.

1. Short term economic outlook

1(a) – the economy in 2010

Available data suggest that GDP will be broadly flat this year following sharp declines in the previous two years. The exporting sector looks set to record a fairly robust performance this year reflecting stronger than expected global growth and the significant improvements in competitiveness that have taken place. On the other hand, domestic demand continues to weigh on overall activity as imbalances built up during the boom are continuing to unwind. Consumption – private and public – is expected to fall, while investment looks set to record a double-digit contraction, largely due to the ongoing decline in housing output.

Price and wage data confirm that the necessary competitiveness adjustments are well underway, which is testament to the inherent flexibility of the Irish economy. For the year as a whole, the Harmonised Index of Consumer Prices (HICP) is projected to decline by around 1½%, compared with an increase of around 1½% in the euro area as a whole. Wage data are also consistent with competitiveness improvements, with hourly earnings declining on an annual basis in the first half of this year.

There is mounting evidence that the level of employment is beginning to stabilise, albeit at a much reduced level from its peak. For instance, the rate of employment loss in the second quarter of the year was the slowest since the first quarter of 2008. Nevertheless, employment looks set to decline by around 4% this year, with employment losses mainly concentrated in the construction, retail and manufacturing sectors. Labour supply has also fallen due to the decline in participation rates and, increasingly of late, a resumption of significant net outward migration, resulting in less of an increase in unemployment than might otherwise have happened. In terms of the latter, the decline in the live register in both September and October was more than would be suggested by seasonal factors, and unemployment is now likely to average around 13½% for the year as a whole.

1(b) – the economy in 2011

Macro-economic forecasts for next year are presented in Table 2. In a nutshell, the outlook is one in which (a) exports contribute positively to growth and (b) the drag from domestic demand is smaller than in the recent past.

external demand...

Global growth is expected to moderate next year before picking up in 2012. In terms of the advanced economies – which comprise the bulk of Ireland's export markets – headwinds stemming from fiscal consolidation and private sector balance-sheet repair will restrain the pace of expansion next year. In these circumstances, GDP in the advanced economies is projected to increase by 2.2% next year, compared with 2.7% this year, with global GDP growing by 4.2%. As a result, and taking into account competitiveness developments, exports of goods and services are projected to increase by around 5% next year.

Table 1: External assumptions underpinning the forecast

	2010	2011
External GDP Growth (Percentage Change)		
World	4.8	4.2
Advanced Economies	2.7	2.2
- UK	1.7	2.0
- US	2.6	2.3
- Euro Area	1.7	1.5
Emerging Economies	7.1	6.4
Technical Assumptions (Annual Average)[1]		
EUR / USD Exchange Rate	1.34	1.39
EUR / GBP Exchange Rate	0.86	0.88
Oil Price ($ per barrel)	77	85

Note: External growth projections are taken from the IMF World Economic Outlook (October 2010).

domestic demand...

Domestic demand is likely to fall once again next year, albeit at a more modest pace than over the past three years. Personal savings rates look set to remain at fairly elevated levels, given the need for households to repair their balance sheets. With household disposable income forecast to be broadly unchanged, consumer spending is projected to be flat in real terms next year. Government consumption is forecast to fall by 3%, due to the impact of further budgetary consolidation.

In terms of investment, housing start data are consistent with a further small decline in new house building next year. Other building and construction looks set to fall also, in part reflecting excess supply. Allowing for a small increase in machinery and equipment investment, overall investment is projected to fall by around 6% next year.

Imports are projected to increase in line with final demand so that in overall terms, real GDP is projected to increase by 1¾% next year (GNP by 1%). This takes account of budgetary adjustments amounting to €6 billion, which are estimated to reduce the rate of growth by somewhere in the region of 1½ - 2 percentage points. Nominal GDP is set to grow by 2.5% in 2011, implying a GDP price deflator of ¾%.

consumer prices...

Reversing the trend of recent years, consumer prices are forecast to increase next year, mainly on foot of base effects and commodity price developments. However, given muted domestic demand and considerable spare capacity in the economy, price increases are likely to be fairly modest – the HICP is projected to increase by ¾% next year.

labour market...

As is typically the case during a recovery period, employment is assumed to lag the increase in output so that a small reduction in employment – of around ¼% – is projected for next year. However, the decline in labour supply is expected to be somewhat larger, so that unemployment is expected to fall slightly next year, averaging 13¼% for the year as a whole.

[1] The technical assumption made is that exchange rates remain unchanged at their ten day average to the end of October level throughout the forecast horizon. Oil prices are assumed to move in line with the futures market.

Table 2: Short term economic outlook, % change (unless otherwise stated)

	2009	2010	2011
GDP real	-7½	¼	1¾
GDP level^ (€m)	159,600	157,300	161,200
GNP real	-10¾	-2	1
GNP level^ (€m)	131,200	125,500	127,900
	components of real GDP		
Domestic demand			
- consumption	-7	-1¼	0
- government	-4½	-4	-3
- investment	-31	-21¼	-6
Trade and external account			
- exports	-4	6¼	5
- imports	-9¾	2¾	2¾
- BoP current account,% GNP	-3¾	-1¾	¼
	price developments		
HICP	-1¾	-1½	¾
GDP deflator	-4	-1¾	¾
	labour market		
Employment	-8¼	-4	-¼
Unemployment (% labour force)	11¾	13½	13¼
Labour productivity*	-2¾	2	1¼

Source: Department of Finance forecasts and CSO outturns.
^ figures are rounded to the nearest €100 million.
* on a GNP per person employed basis.

2. Budgetary developments and outlook

2(a) – budgetary developments in 2010

End-October Exchequer Returns…

Tax revenues in the first ten months of the year, at €24.7 billion were €243 million or 1% above profile, further evidence of the stabilisation in tax revenues. Encouragingly, three of the “big four” tax-heads – corporation tax, excise duties and VAT – were ahead of profile in the first ten months of the year.

November is the largest tax collection month of the year, with 15% of total tax revenues profiled for collection. It is a significant month for income tax (in particular from the self employed), VAT and corporation tax and there are large targets to meet for all three of these tax-heads. While a small overall tax revenue surplus may emerge for the year as a whole, it is dependent on the November tax-take, and the technical projections set out in Table 3 are therefore based on tax revenues meeting the €31 billion Budget day target for 2010.

Turning to the spending side, total net voted expenditure at end-October 2010, at €37.2 billion was just over €1 billion or 2.7% below profile. This was driven by a shortfall against target for net voted capital spending of €1,025 million or 22.5%. It is now expected that there will be savings in capital spending at year-end and for the purposes of the technical projections set out in Table 3, it has been assumed that the level of saving is some €300 million compared to the estimate set out in the 2010 Revised Estimates Volume (REV). Net voted current expenditure was on target in the first ten months of the year. The capital savings will be offset by the significant one-off costs associated with the recently announced exit mechanisms from the HSE, along with shortfalls in Departmental receipts, most notably PRSI and health levy receipts. In aggregate terms, it is assumed that total net voted

expenditure in 2010 will be €46¾ billion, some €½ billion above the level originally estimated for the year in the REV.

Exchequer Borrowing Requirement…
The 2010 Exchequer Borrowing Requirement (EBR) was estimated at €18¾ billion at Budget time. The current estimate is for an EBR of around €19¼ billion in 2010 (see Table 3). Higher than expected non-tax revenue and lower than anticipated debt interest costs are offset by the expected overrun in net voted expenditure, the additional borrowing that has been conducted as part of Ireland's participation in the EU assistance to Greece and for the purchase of Special Investment Shares in Irish Nationwide Building Society (INBS) and Educational Building Society (EBS). However, the Exchequer is fully funded well into the first half of 2011.

General Government Deficit…
On a headline basis the 2010 General Government deficit is currently forecast to be 32% of GDP. This figure was announced in the end-September Statements on Banking and in the recent Maastricht Returns to Eurostat. The reason for an emerging headline deficit of such magnitude is the inclusion within the deficit measure of the full upfront capital support being provided by way of Promissory Notes[2] to Anglo Irish Bank, INBS and EBS which has been classified as a capital transfer. As has been previously outlined, while this €31 billion will be added to the stock of debt, it will only add incrementally to the flow of debt from 2011 onwards as its financing will be spread equally over a period of 10-15 years. This is a once-off spike in the deficit. On a cash basis, there is therefore no additional borrowing required in 2010 as a result of the magnitude of the headline deficit.

On an underlying basis, that is excluding the impact of the banking support measures, the General Government deficit in 2010 is now expected to be 11.9% of GDP, in line with the Budget 2010 forecast of a deficit of 11.6% of GDP. The main reason for the slight deterioration in the underlying position is a lower level of nominal GDP due to revisions to the National Accounts for previous years by the CSO, which worsens the deficit ratio. The underlying deficit for 2010 will thus have been stabilised at the underlying 2009 level.

2(b) – budgetary developments in 2011
Table 3 sets out the technical, current working budgetary projections for 2011 alongside the expected outturn for 2010. The 2011 technical projections are based on an indicative consolidation package of €6 billion, which is a significant frontloading of the overall adjustment required, and on the macroeconomic forecasts set out for 2011 in Table 2.

The 2011 technical projections of spending and revenues have been prepared on a pre-Budget basis i.e., the €6 billion adjustment for 2011 has not, for the purpose of these projections, been split between expenditure and revenue measures, although it is assumed in estimating the macroeconomic impacts that the majority of the adjustment takes place on the expenditure side. The technical budgetary projections are based on economic forecasts which take into account the €15 billion overall adjustment which has been signalled as being required over the forecast period in order to adhere to the 3% of GDP deficit reduction target by 2014.

[2] The Promissory Notes will be structured so that the accrued interest becomes fully accounted for post 2012. The impact of the accrued interest is fully reflected in the measures to bring the deficit below 3% of GDP by 2014. A more detailed note of the accounting treatment of the Promissory Notes is available on the Department of Finance website at www.finance.gov.ie.

Table 3: Technical Budgetary Projections 2010-2011

	2010 €billion	2011 €billion
CURRENT BUDGET		
Expenditure		
Gross Voted Current Expenditure	54¾	55*
Non-Voted (Central Fund) Expenditure	6¼	7½
Gross Current Expenditure	**61**	**62½**
less Expenditure Receipts and Balances	13¾	12¾
Net Current Expenditure	**47¼**	**49¾**
Receipts		
Tax Revenue	31	31¾
Non-Tax Revenue	2¾	1¾
Net Current Revenue	**33¾**	**33½**
CURRENT BUDGET BALANCE	**-13½**	**-16¼**
CAPITAL BUDGET		
Expenditure		
Gross Voted Capital	6¼	5½
Non-Voted Expenditure (*includes in 2011 €3.1bn borrowing to fund the first payment of the Promissory Notes*)	1½	4¼
less Capital Receipts	½	¼
Net Capital Expenditure	**7¼**	**9½**
Capital Resources	**1½**	**1½**
CAPITAL BUDGET BALANCE	**-5¾**	**-8**
Budgetary Adjustment (Technical assumption):		6**
EXCHEQUER BALANCE (cash terms)	**-19¼**	**-19¼**
GENERAL GOVERNMENT BALANCE	**-50¼**	**-15*** **
% of GDP	*-32%*	*-9¼ to -9½*
UNDERLYING GENERAL GOVERNMENT BALANCE	**18¾**	
% of GDP	*-11.9%*	

Rounding may impact on totals.
** A breakdown of Gross Voted Current Expenditure by Department is set out in detail in Appendix 1.*
***This €6 billion adjustment includes the €1 billion capital expenditure adjustment for 2011 signalled in Budget 2010 and already contained in the 2011 Gross Voted Capital Expenditure figure above.*
****The 2011 General Government deficit is not impacted upon by interest on Promissory Notes issued to financial institutions.*

3. Medium Term Economic and Budgetary Outlook

3(a) – economic outlook 2012-2014

Medium term projections are based on an assessment of the economy's trend growth rate and the amount of slack in the economy. On the demand side, the projections take account of the €15 billion budgetary adjustment as well as the need for households to rebuild their balance sheets, forces that will limit the contribution of domestic demand and keep the savings ratio at elevated levels. On the other hand, the outlook for the exporting sector is reasonably favourable, given the adjustment in competitiveness that has already been evident and the prospect of reasonably strong global growth. After moderating next year, the pace of global expansion is forecast to pick up once again in the following years. The medium term forecasts also assume a positive dividend to growth from the various structural reforms being implemented as part of the Government's Four-Year Plan to consolidate the budgetary position and to underpin future economic growth.

Net additional employment is forecast to begin increasing once again from 2012 onwards, although the additional employment-content of growth will be limited to some degree given the export-led nature of recovery. Net outward migration will restrain the pace of growth in labour supply, which combined with the increase in net employment will reduce unemployment to under 10% by the end of the forecast horizon. Unemployment could potentially fall further over the period, if various structural reforms being implemented as part of the Plan have a greater than expected impact.

Consumer price inflation is projected to be relatively modest over the forecast horizon – HICP inflation is projected to average 1½% per annum over the period.

Table 4: Medium term economic forecasts, % change

	2012	2013	2014
Real GDP	3¼	3	2¾
GDP (nearest €100 million)	168,100	175,400	183,500
Employment	1¼	1½	1¾
Unemployment, % of labour force	12	11	9¾
HICP inflation	1	1¾	1¾

3(b) – the budgetary outlook 2012-2014

For purely illustrative purposes, it is estimated that the General Government deficit would be approximately 12-12¾% of GDP in 2011 if no consolidation measures were implemented. In the event of none of the multi-annual consolidation measures being implemented over the course of the 2011-2014 period, a deficit of about 10% of GDP in 2014 could arise. It must be stressed that this is a simplistic static scenario that assumes no dynamic impacts (such as rising debt service costs and better economic growth) which would clearly materialise if such a policy was put forward. Furthermore, it is not Government policy to allow such a position to emerge. Table 5 shows the General Government deficit and debt levels over the forecast period, resulting from an overall adjustment package of €15 billion, a package which Government is committed to. While decisions have yet be announced regarding the breakdown of consolidation between expenditure and revenue measures, for the purposes of producing economic forecasts, it has been assumed that the ratio of expenditure to revenue measures is weighted 2:1. The forthcoming detailed Four-Year Plan will set out the actual measures.

Table 5: Technical Budgetary Scenarios - based on €15 billion adjustment

	2010	2011^	2012^	2013	2014
Indicative Annual Consolidation (€billion)		€6	€3-4	€3-3½	€2-2½
Emerging General Government Deficit (% of GDP) – following cumulative impact of indicative annual consolidation		9¼-9½%	6¾-7¼%	5¼-5½%	2¾-3%
Approximate General Government Gross Debt Level at end-year	98½%	105%	106%	105%	101%
Net Debt (GG Gross Debt net of value of NPRF)	83%	89½%	90½%	90½%	85½%

^ Impact of promissory note interest not included in these years.
* Forecasts of the Net Debt position for the years 2011-2014 are based on the technical assumption that the total value of the NPRF remains constant at 15½ of GDP.

4. Debt Levels and Dynamics

General Government Debt is the definition used for comparative purposes within the European Union. General Government Gross Debt at end-2009 was 66% of GDP. It is currently estimated that it will be 98½% of GDP at end-2010. The main reason for this large increase is that, as indicated above, all of the capital support – some €31 billion – being provided to Anglo Irish Bank, INBS and EBS in 2010 is being classified within the General Government Gross debt measure this year. While this is how the capital support is treated in General Government accounting terms, the money issued for the Promissory Notes has not yet been borrowed and this will be done on a phased basis over the next 10-15 years. When account is taken of the value of assets in the National Pensions Reserve Fund (NPRF) it is currently estimated that the net debt position will be 83% of GDP at end 2010. Furthermore this does not take account of cash reserves held by the NTMA. General Government Gross debt is forecast to peak at around 106% of GDP over the 2012-2013 period before declining thereafter to just over 100% of GDP by end-2014 as the substantial cash balances held by the NTMA are gradually unwound.

5. Magnitude of Budgetary Adjustment 2011-2014

Budget 2010 stated that a consolidation package of €7.5 billion over the four year period 2011-2014 would be required to reduce the General Government deficit to below 3% of GDP by 2014. The necessary adjustment has been revised upwards to some €15 billion over the period. There are a number of significant reasons why additional adjustments are now needed:

- The overall size of the economy is now smaller, reflecting revisions by the CSO to the level of GDP in 2009 and to previous years (a methodological change);
- The rate of nominal growth has been revised downwards as legacy effects of the bursting of the property bubble are weighing on economy-wide prices and activity to a greater degree than initially assumed;
- Lower nominal economic growth affects the fiscal position in two ways – it reduces the ability to generate resources and for a given nominal deficit, it raises its ratio to GDP;
- The impact of the Promissory Notes issued to Anglo Irish Bank, INBS and EBS, meaning that in order to achieve the budgetary targets by 2014 compensatory measures must be taken over the period 2011-2014. The costs will amount to approximately €1.8 billion in

2013 and €1.6 billion in 2014, and if not addressed by consolidation measures would add about 1% of GDP to the deficit figure in 2014.

- The additional adjustment, of itself, will have a negative impact on the pace of economic growth.

6. Budgetary Timeline

- The Government's four-year budgetary consolidation plan will be published later in the month;
- The November Exchequer returns will be published on 2 December;
- The White Paper on Receipts and Expenditure will be published on 3 December;
- The 2011 Budget, which will contain the first substantial phase of the Four-Year Plan, will be presented to Dáil Éireann on 7 December.

Appendix 1: Pre-Budget Voted Current Expenditure Breakdown 2011

These figures are on a pre-Budget basis and do not take account of any budgetary changes

		2011 *€m*
1	Finance	1,293
2	Taoiseach	209
3	Justice & Law Reform	2,330
4	Environment, Heritage & Local Government	682
5	Education & Skills	9,353
6	Community, Equality & Gaeltacht Affairs	285
7	Foreign Affairs Group	768
8	Communications Energy & Natural Resources	345
9	Agriculture, Fisheries & Food	1,411
10	Transport	713
11	Health & Children	14,887
12	Enterprise, Trade & Innovation	389
13	Tourism Culture & Sport	313
14	Defence	953
15	Social Protection	21,013
	Contingency	20
	Total Gross Voted Current Expenditure	**54,964**
less	*Appropriations-in-aid*	*12,712*
	Total Net Voted Current Expenditure	**42,252**
	Total Gross Voted Capital Expenditure*	**5,500**
less	*Appropriations-in-aid*	*337*
	Total Net Voted Capital Expenditure	**5,163**

** Includes the €1 billion capital expenditure adjustment for 2011 signalled in Budget 2010.*
Note that the Total Gross Voted Current Expenditure figure outlined in this table corresponds to the €55bn Gross Voted Current Expenditure figure in Table 3.