NATIONAL ECONOMIC DIALOGUE

WORKING FOR THE BEST, PREPARING FOR THE WORST: CHALLENGES TO OUR ECONOMIC AND FISCAL DEVELOPMENT

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Working for the best, preparing for the worst: Challenges to our Economic and Fiscal Development

This paper has been prepared as a contribution to the discussion in the breakout session at the National Economic Dialogue. It should not be seen as prescriptive but rather seeks to set out the current factual situation and to suggest some of the key questions which participants may wish to consider.

Key Guiding Questions:

- ***Horizon scanning – what are the key domestic, international and environmental risks and challenges to our economic future over the next ten years?***
- ***How can we most effectively prepare for these risks including climate change?***
- ***How should we manage and mitigate risk in designing economic and fiscal policy and in the annual budgetary process?***

BACKGROUND

Economic recovery is becoming more firmly established. GDP grew by close to 5 per cent last year and growth of 4 per cent is expected for this year. Over the remainder of the decade, Department of Finance estimates indicate that the economy has the capacity to grow by around 3 per cent per annum.

However, achieving these growth rates is not guaranteed and is contingent upon the implementation of the right policy mix. At the same time, non-policy related 'shocks' to the system have the potential to move the economy off the assumed growth path. In this context, the purpose of this paper is to highlight some of the risks and challenges that we will face over the medium and long term. (Shorter-term risks are addressed in the "*Being a small open economy: Charting our path in a changing global environment*" paper).

HORIZON SCANNING

Some risks are, of course, recurring in nature and reflect the structure of the Irish economy. For instance, Ireland is particularly vulnerable to external developments due to the small, open nature of the economy and the large share of trade in GDP. As a result, Ireland is disproportionately vulnerable to weaker-than-expected trading partner growth which could adversely affect exports, inward investment and result in lower economic activity. Leaving aside short-term, cyclical developments, it is clear that longer-term, trend growth in key export markets is slowing, which underpins the importance of diversifying our export base.

In a similar vein, the threat to Ireland's competitiveness is another recurring risk to economic performance. Membership of a currency union implies that Ireland is vulnerable to a loss in competitiveness through wage and/or productivity developments that are out of line with those in the euro area and elsewhere, or changes in the euro exchange rate vis-à-vis the dollar or sterling.

Uncertainty regarding the UK's future membership of the EU is an additional risk that could threaten Irish economic performance through possible effects on investment, trade and migration over the short-to-medium term.

High levels of indebtedness pose an additional vulnerability challenge. For instance, the household sector remains highly indebted (with a debt-to-disposable income ratio of 170 per cent), a legacy of the bubble years. The debt-servicing capacity of the household sector is vulnerable to *inter alia* increases in interest rates following a normalisation of monetary policy (which is possible over the medium term).

Beyond the medium term, it is clear that the demographic structure of the population will change, imposing significant additional fiscal costs.

In addition, climate change poses a risk to economic development over the longer term through increasing average temperatures, more extreme weather conditions, the increased likelihood of flooding, etc. There is also a significant fiscal risk associated with failing to reduce greenhouse gases in line with climate change targets. It is also worth pointing out that Ireland has committed to support developing countries in their mitigation and adaptation efforts which will require a greater mobilisation of climate finance to 2020 and beyond.

Finally, energy security is a key challenge as Ireland is heavily reliant on energy imports (more so than many other EU Member States). Energy consumption is rising and will continue to do so as the economy expands. Therefore, notwithstanding the increasing levels of electricity produced from renewable sources, over the medium and longer term the Irish economy will remain exposed to changes in supply conditions and prices in international markets.

PREPARATION FOR RISKS

Economic 'shocks' – both positive and negative – are inevitable. As the pace of globalisation increases, maintaining flexibility in labour and product markets and keeping public debt firmly on a downward trajectory will enhance the resilience of the Irish economy and boost its capacity to absorb shocks as they emerge. Achieving a balanced budget in structural terms – as is legally required – will help create a fiscal buffer and allow counter-cyclical fiscal policies play a supporting role.

In relation to climate change, the Government published its national policy position in April 2014 which established the fundamental objective of achieving transition to a low carbon economy by 2050. It clarifies the level of greenhouse gas mitigation ambition envisaged and the proposed process to pursue and achieve the overall objective. The Climate Action and Low Carbon Development Bill 2015 provides for recurring National Mitigation Plans and Sectoral Adaptation Plans. In anticipation of the planned legislation, preparatory work is already underway on these plans through the respective National Steering Groups, which includes representation from all the relevant sectors.

RISK MANAGEMENT: ECONOMIC AND FISCAL POLICY AND THE ANNUAL BUDGETARY PROCESS

The Government has prioritised the issue of risk management by putting in place a number of new structures as part of the response to failures in the past to identify and address risks beyond a short time horizon. For example, the annual National Risk Assessment is intended to offer a high-level strategic overview of the main risks facing Ireland and to help orientate the discussion on mitigation frameworks by focusing attention on potential gaps.

The Government has also introduced a number of wide ranging reforms to the budgetary architecture which will help manage the risk in designing economic and fiscal policy.

For instance, the Government has implemented a medium-term expenditure framework to enhance the management of public expenditure. This new framework, along with the two comprehensive reviews of expenditure, has provided the opportunity to move discussions about expenditure decisions away from the consideration of short-term issues and towards broader strategic debate about key challenges facing public expenditure and public services.

The Government has also established the Irish Fiscal Advisory Council (IFAC) on a statutory basis. The role of the Council is to independently assess the stance of fiscal policy and compliance with the fiscal rules.

The need for consistent and good quality data and for the continued development of the analytical capacity across Government Departments is essential in order to effectively manage risk in the economic policy making process. The Government has made significant progress on both fronts with the establishment of the Irish Government Economic and Evaluation Service (IGEES) and through the publishing of improved data about the State's future liabilities and exposures. This will assist towards achieving greater fiscal transparency into the future.

FURTHER GUIDING QUESTIONS

- As a small open economy, to what extent can Ireland influence its own economic future over the medium term?
- To what extent is the Irish economy prepared for a normalisation of monetary policy?
- What specific measures should be introduced, other than those already implemented by the Government, to address the risks mentioned (i.e. competitiveness, high household debt levels)?
- How can we best insulate ourselves from the fiscal risks associated with climate change?
- To what extent is the Irish economy vulnerable to disruptions in energy supply over the medium term?

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