Ulster Bank

Budgeting for a Hard Brexit: A Post-Budget 2020 Overview of the Irish Public Finances

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The key assumption underpinning Budget 2020 is that there is a Hard (Disorderly) Brexit

- **Budget 2020** is to a large extent defined by the decision to base it on the assumption that the UK leaves the UK in a disorderly fashion, and that this occurs at the end of October

- This compares to the previous assumption (set out in the Stability Programme Update from April and the Summer Economic Statement from June) of a softer form of Brexit i.e. that the UK leaves with a deal at the end of a transition period which ends at the end of 2020

- Note that
  - a Hard Brexit is not a forgone conclusion e.g. current betting market odds put the probability of a crashout this year at below 25% (down from ca.45% a few weeks ago)
  - Other outcomes (including softer forms of exit and no Brexit at all) remain possible

- However, such is the current state of the political dynamic in the UK, and between the UK and the EU that the risks of a crash out are clearly very (and uncomfortably) elevated

- And in this context the Government has taken the decision to plan, for the time being, on the basis of a disorderly departure in order to provide a degree of reassurance to households and to businesses that policy is being framed to deal with what could be a very unfavourable set of circumstances and that the government stands ready to support the economy in such a scenario

Implications of adopting a Hard Brexit assumption

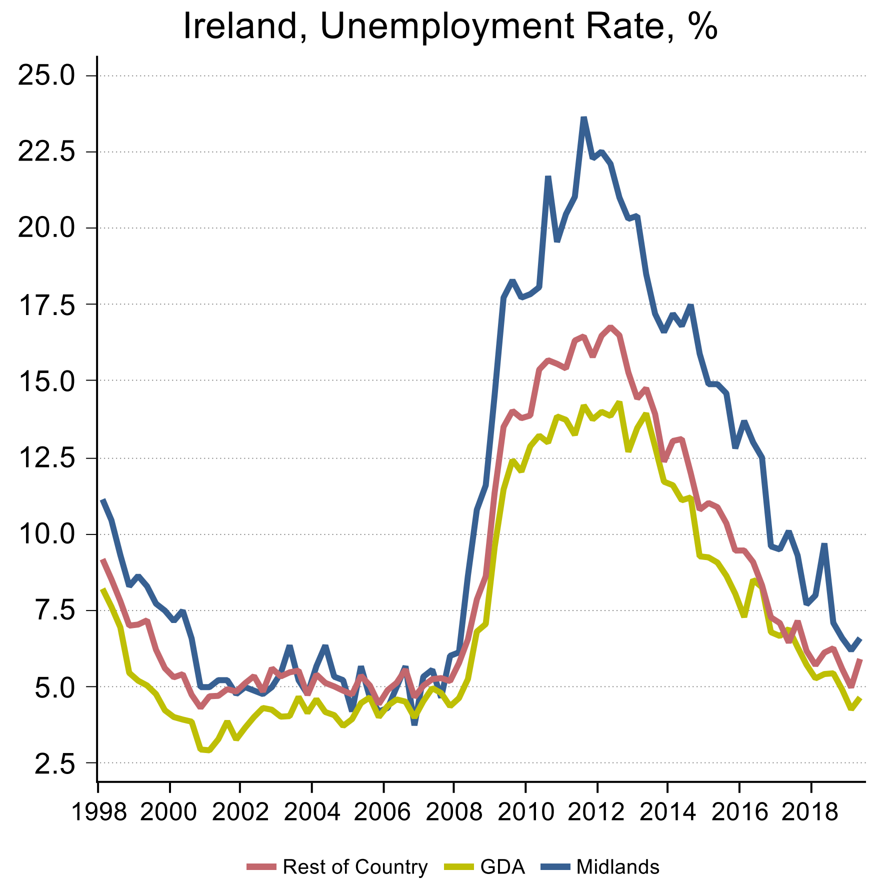
1. It results in a material downgrade to the economic outlook

2. It requires a reorientation of Budgetary strategy (and the associated Budget Day package) towards dealing with Brexit-related challenges

3. The consequences of 1. and 2. together is a meaningful deterioration in the outlook for the public finances

The domestic economy has been doing very well

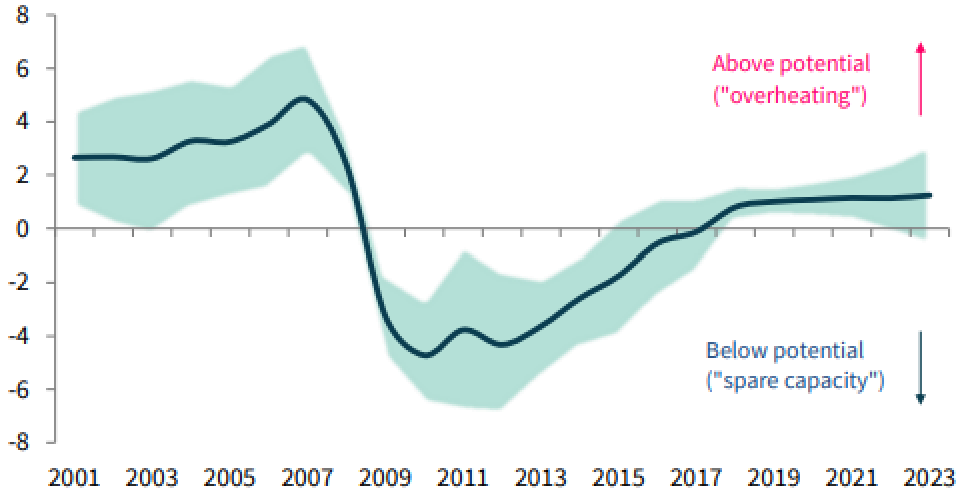
Source: UB / Macrobond



Source: UB / Macrobond

Indeed, on some estimates it looks like the economy is now operating at or slightly above its potential this year, thus pointing to possible overheating risks

Ireland, IFAC Output Gap calculations, %



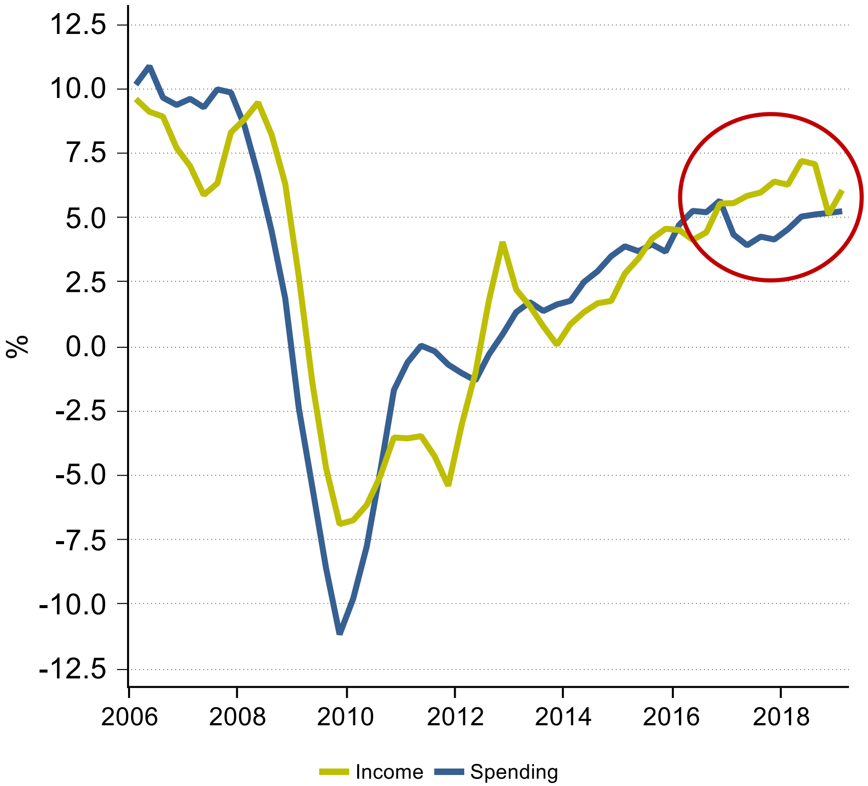
These estimates are based on the assumption of an orderly Brexit, in line with the SPU 2019

Source: IFAC calculations, Fiscal Assessment Report Jun. 2019

Note: The figure shows a range of output gap estimates (the shading) and the mid-range estimates (the line). Estimates are produced using a variety of methods based on IFAC's models and DoF forecasts.

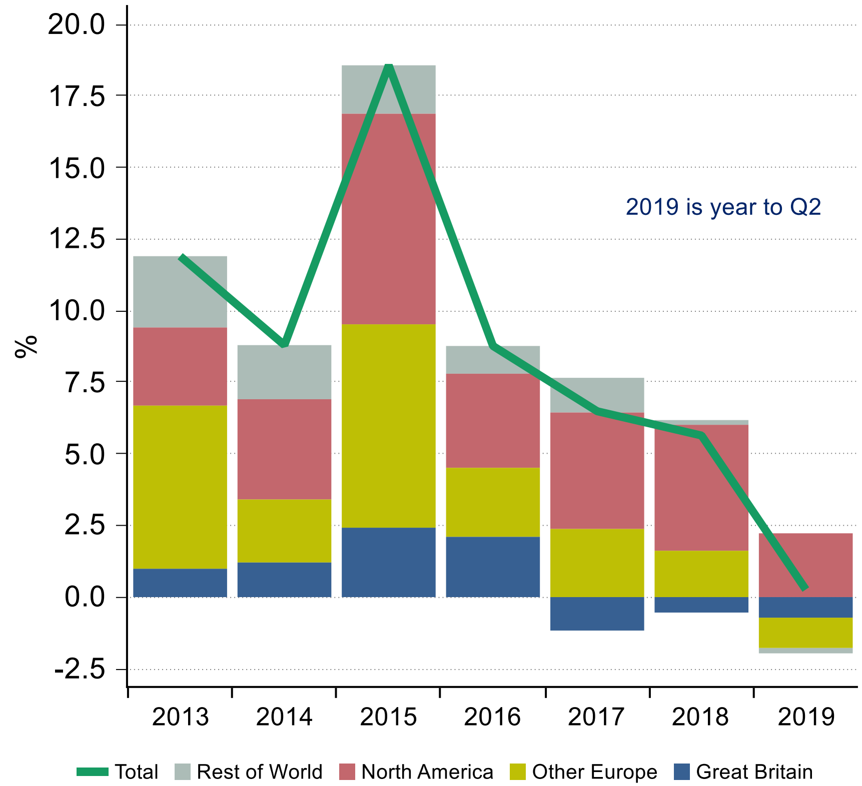
Brexit impacts have, up to now at least, possibly been playing a helpful role in dampening domestic overheating pressures

Ireland, Household Income & Spending (nominal, 4-q avg), y/y%



Source: UB / Macrobond

Ireland, Contributions to Total Spend (excl. fares) by Overseas Visitors to Ireland, y/y % points



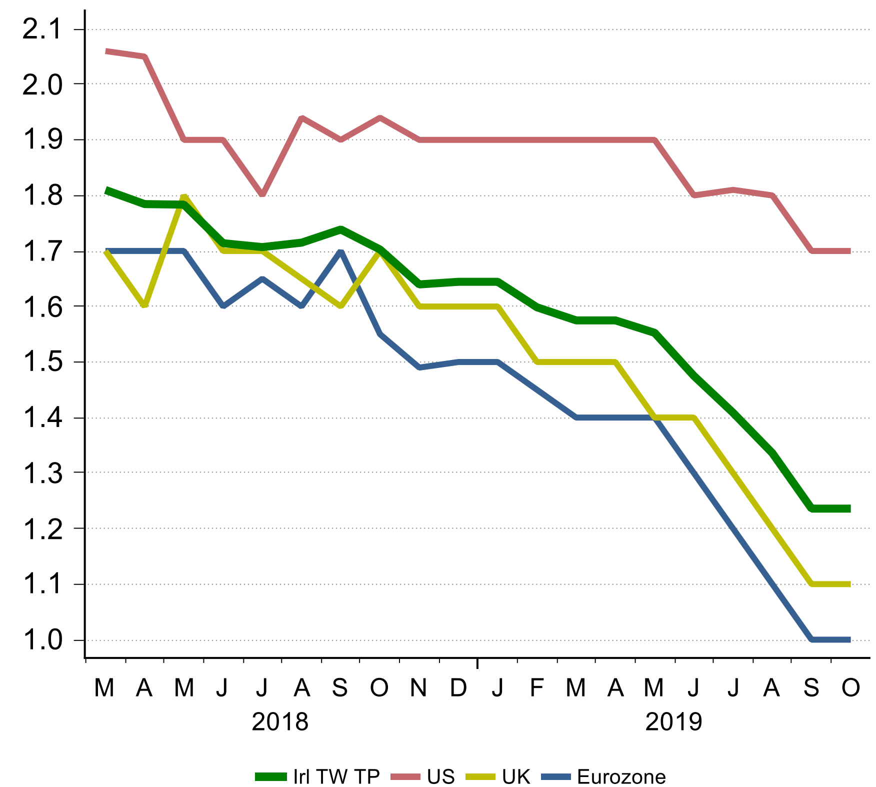
Source: UB / Macrobond

But it is not good news for Ireland that the international economic environment – even away from Brexit – has been weakening in recent months amid persistently high uncertainty

Global Economic Policy Uncertainty Index, 3m avg.

Source: UB / Macrobond

Bloomberg Consensus 2020 GDP Forecast (annual Y/Y %)



Source: UB / Macrobond

Taking the weaker global backdrop together with the particularly negative impact of the assumed hard Brexit has resulted in a significant downgrade to the economic outlook upon which Budget 2020 is based

	SPU 2019* April 2019	Budget 2020 October 2019	Difference (i.e. Budget - SPU), % Points
Real GDP % Growth			
2020	3.3	0.7	-2.6
2021	2.4	2.5	0.1
2022	2.5	2.8	0.3
Employment % Growth			
2020	2.1	0.8	-1.3
2021	1.5	1.1	-0.4
2022	1.6	1.5	-0.1
Unemployment Rate, %			
2020	5.2	5.7	0.5
2021	5.3	5.9	0.6
2022	5.2	5.9	0.7

*Stability Programme Update 2019 assumes an 'orderly' Brexit

The assumed Brexit impacts are based on recent ESRI modelling of a Hard Brexit scenario; however we think the risks are skewed to the downside and note that recent CBoI modelling points to the possibility of more severe impacts

- Updated ESRI modelling work on the economic impacts of different Brexit scenarios has been used by the Department of Finance to develop its macro forecasts, aiming to capture the impact of Brexit across several channels, including trade, FDI and domestic spending

- In particular, ***the ESRI work estimated that a Hard No-Deal Brexit would knock 5% points off real GDP*** over 10 years, relative to a baseline in which Brexit did not occur, with 2.4% points of that effect taking hold within the first 2 years and 3.3% points after 5 years

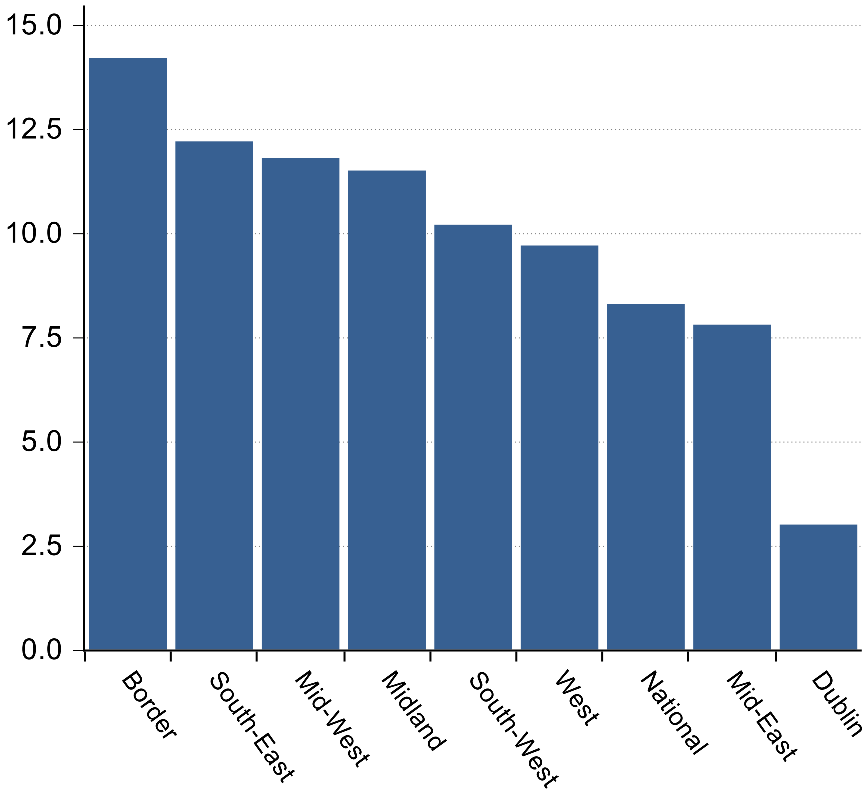
- Note that uncertainty around possible impacts is extremely high and it would be wrong to presume that such modelling can precisely predict the impact of an event as unprecedented or as complex as Brexit (as the Dept acknowledges)

- In this respect, it is important to note that more severe outcomes are certainly possible , and that the risks to the Budget macro forecasts are probably skewed to the downside in our view

- Indeed, alternative ***modelling done by the Central Bank of Ireland points to somewhat larger, and even more front-loaded, impacts, with a disorderly Brexit seen as knocking 6% points off real GDP*** over time, with 4% points of that occurring in the first year alone

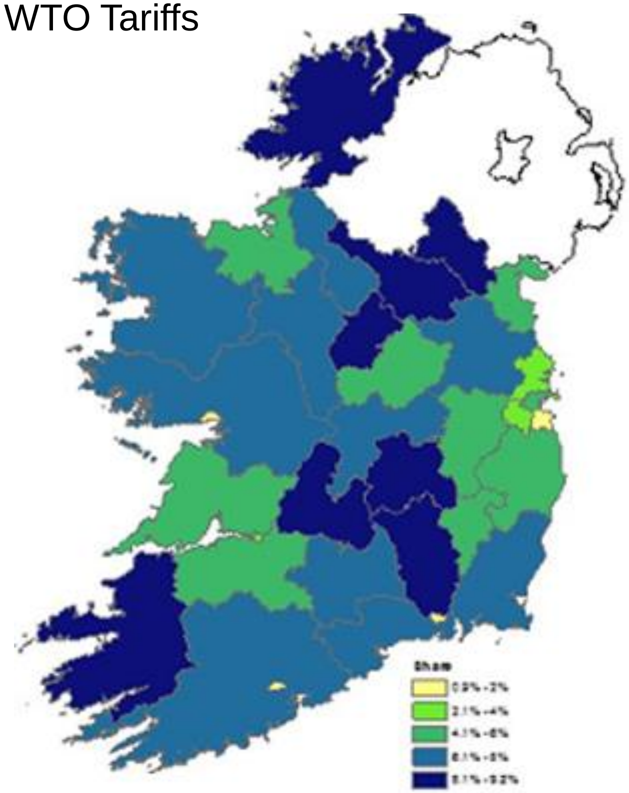
It is also important to recognise that such macro-modelling exercises don't tell the full story; some sectors (including Agri food are much more exposed to a Hard Brexit, which is one important reason why Brexit impacts are not likely to be felt evenly across the country, with regions outside Dublin looking particularly vulnerable

Agri-Food Employment As % of Total Employment, by Region



Source: CBoI, Census 2016, CSO

Reduction in Primary & Manufacturing Employment (%) due to WTO Tariffs



Source: Lawless and Morgenroth (2019)

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Budget 2020:
A look at some of the details

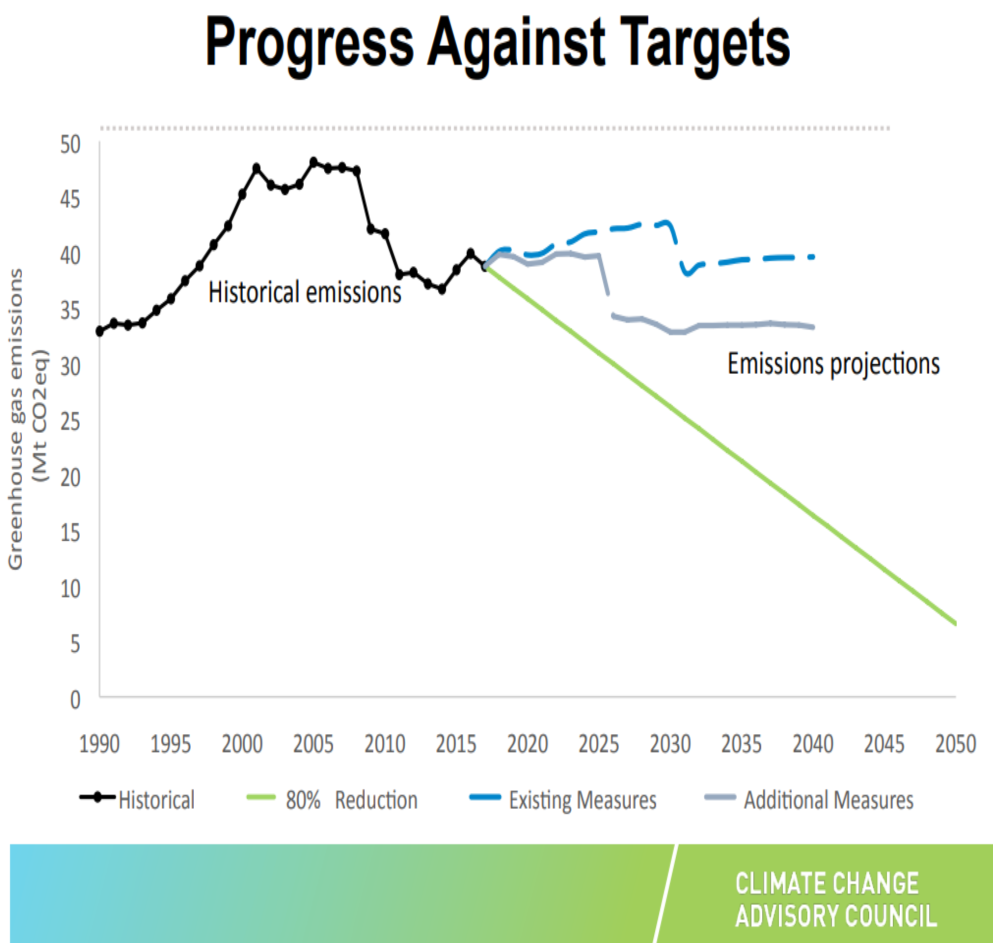
Adding to the €700m of resources available per the Summer Economic Statement, Budget 2020 included €490m of revenue-raising measures for next year resulting in a total package of almost €1.2bn, mainly used to fund extra spending but also featuring a small reduction in taxes

Budget 2020 Package	**€mn**
Resources Available per Summer Economic Statement	700
Additional Revenue Measures	490
Total Package	1190
Used to Fund:	
Tax Reductions	110
Extra Current Spending	860
Extra Capital Spending	70

Source: Department of Finance

- But note: this is an incomplete picture of government fiscal decisions & plans due to the extra ca. €440m of net spending for 2019 confirmed in the pre-Budget estimates last Friday (again, driven mainly by more over-runs in health, albeit not as large as in previous years)

The Carbon Tax hike – a first (but small) step on a long and challenging journey



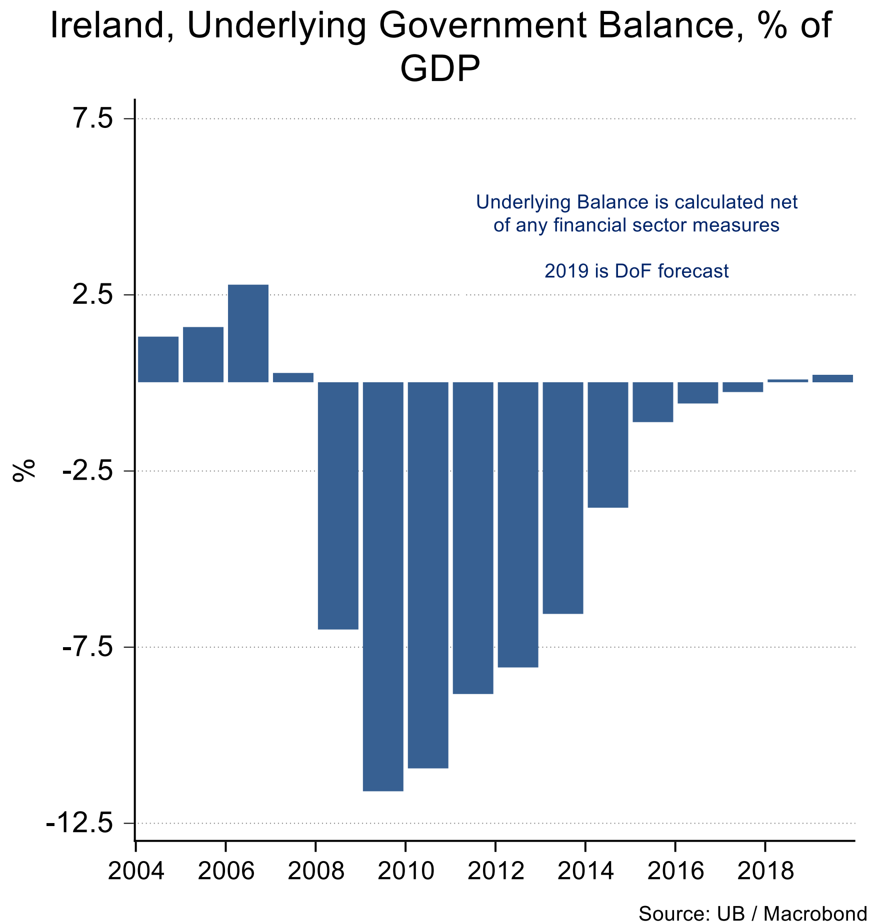
While it is extremely difficult to identify exactly where all of the new spending is being directed, a central feature of the budget is a Brexit spending package of over €1.2bn in total

Budget 2020, Overview of Brexit Spending Package For Next Year

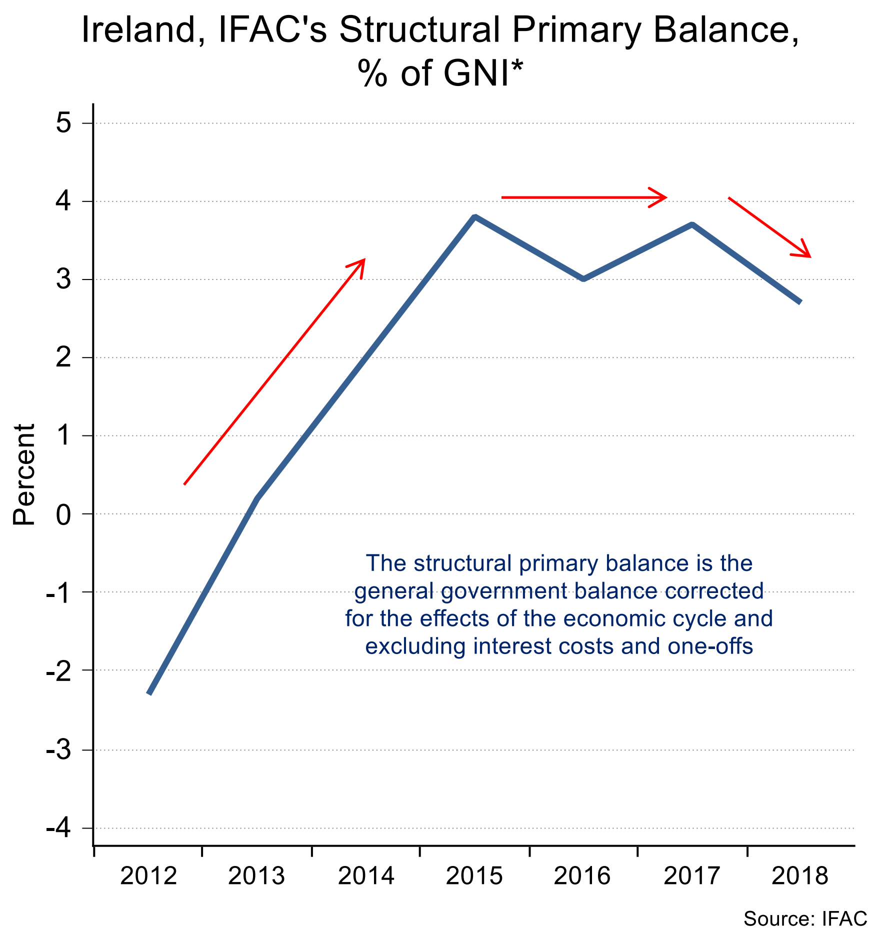
		Eur m
Extra general spending on planning & prep		200
No Deal Contingency		650
of which:		
Immediate Business Supports	110	
Immediate Agri Supports	110	
Extra support for Tourism	40	
Extra (yet to be determined) support measures	390	
Extra Spending on Social Protection / Employment Supports		405
Total		**1,255**

Source: Dept. of Finance

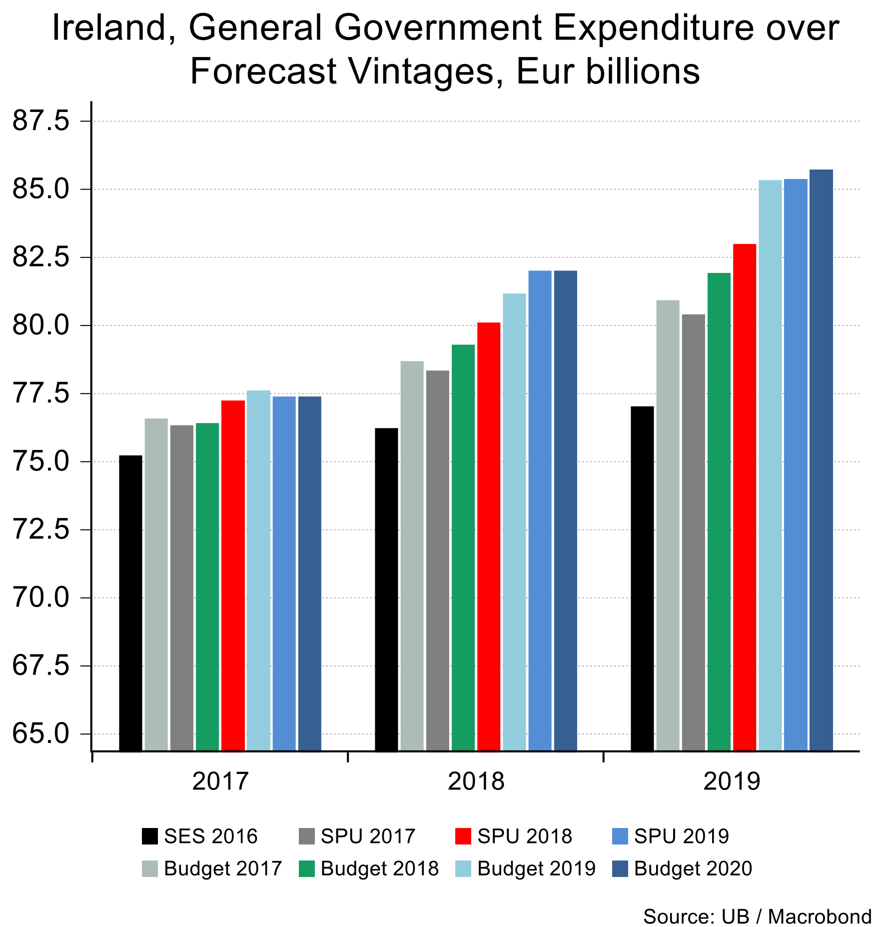
Trends in the public finances are greatly-improved following a sharp and painful adjustment during the crisis; the general government balance last year recorded its first surplus since 2007 and further improvement is expected this year, with a surplus of 0.2% of GDP projected for 2019



It is certainly very helpful that the starting point for Budget 2020 is one of budgetary surplus; however, despite recent fiscal tailwinds, the pace of improvement in the budget balance has eased significantly since 2015, and has even reversed modestly on some measures…

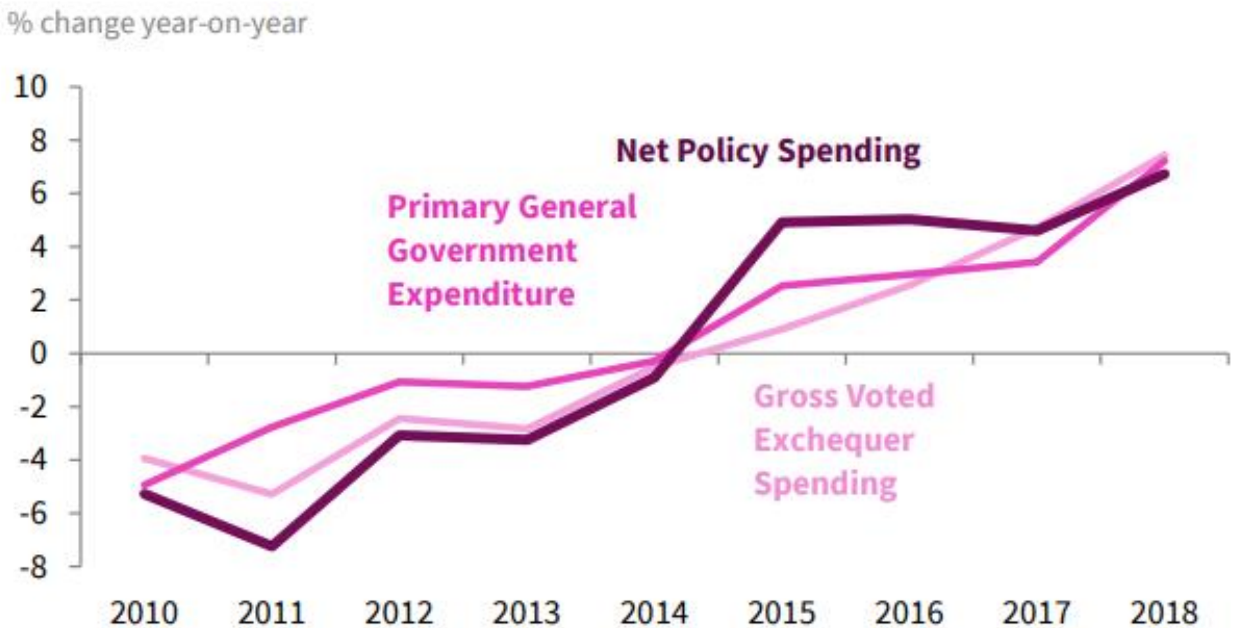


…this reflects the choice to use higher-than-expected (and potentially unsustainable) revenues to fund higher than planned non-interest spending (e.g. day-to-day Government spending is this year set to amount to ca. €60bn - €4.2bn higher than was projected for this year in 2016)



Indeed, severe expenditure cuts in 2008-14 have been followed by steady and accelerating increases in spending, which has recently been showing signs of growing beyond the economy's sustainable growth rate

Expenditure Growth, y/y %



Source: IFAC

Notes: Primary Expenditure is total general government expenditure less interest costs. Net Policy Spending reflects the level of spending that is under the control of government (i.e. excludes one-offs, interest costs, and recognises the impact of tax measures – for further detail see Box A of the November 2018 Fiscal Assessment Report from IFAC).

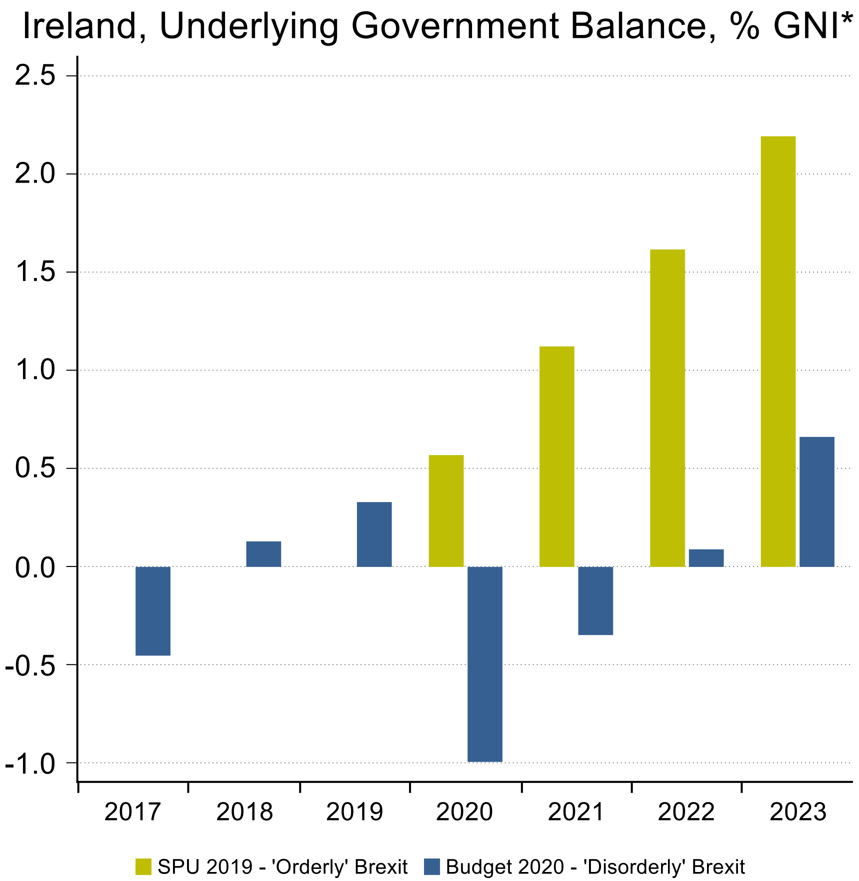
Had the spending plans set out in the 2016 SES been adhered to, the deficits that the economy now faces in the Department's Hard Brexit scenario would potentially have been avoided altogether

General Government Balance, Eur billions

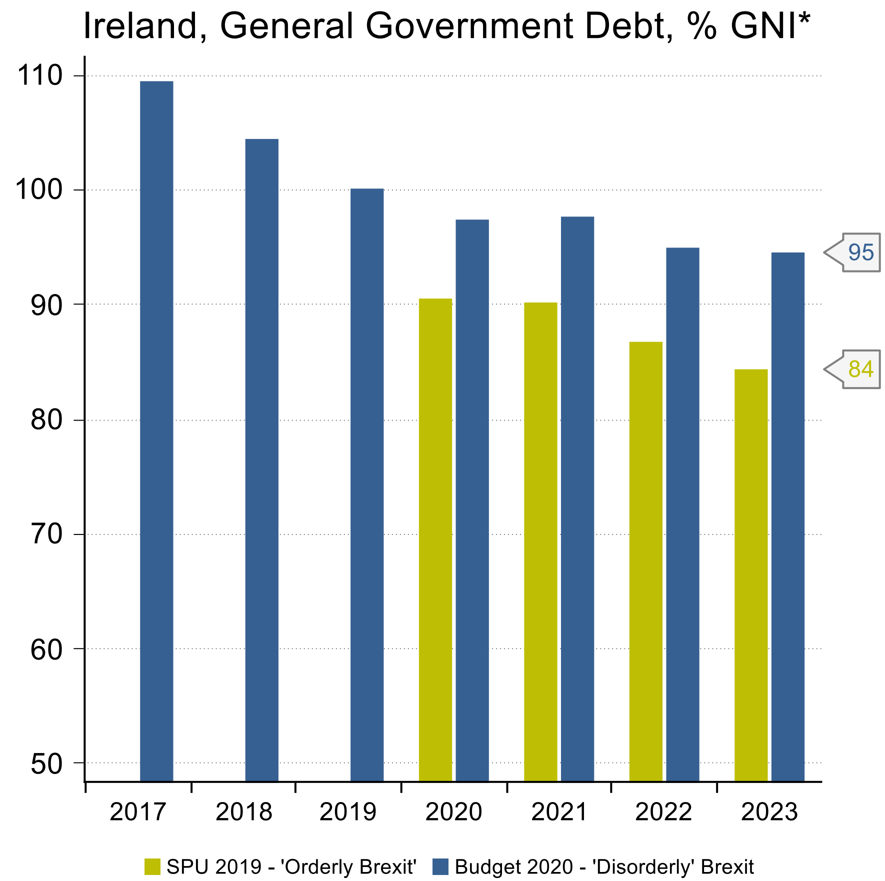
	SPU 2019* April 2019	**Budget 2020** October 2019	**Difference** (i.e. Budget - SPU), billions
2020	1.2	-2.0	-3.3
2021	2.5	-0.7	-3.3
2022	3.8	0.2	-3.6
2023	5.3	1.5	-3.9

*Stability Programme Update 2019, which assumed a 'soft' Brexit whereas the Budget 2020 assumes a 'Hard' Brexit

The deterioration in the budget balance also adversely impacts both the level and trajectory of Ireland's debt

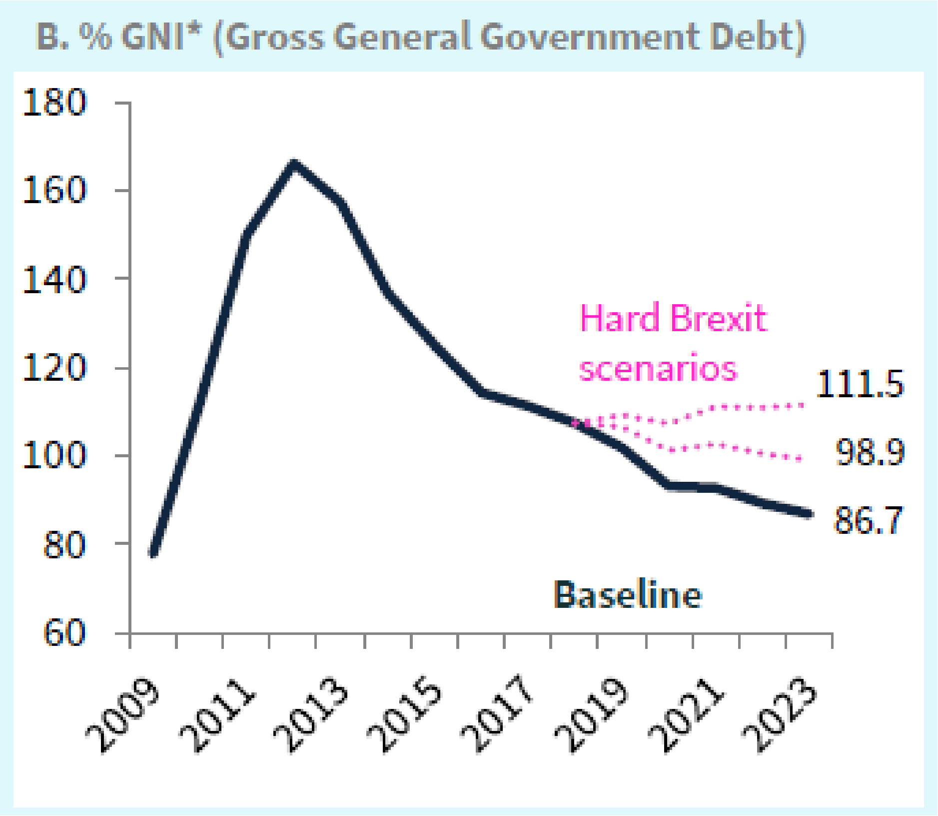


Source: UB / Macrobond



Source: UB / Macrobond

And worse outcomes are certainly possible: the alternative, more severe, modelling by the CBoI would result in much more negative impacts on the public finances, which could potentially involve rising debt ratios, thus putting sustainability at risk



Source: IFAC FAR June 2019, Box C

Summing Up

- Balancing the competing risks of overheating vs. hard Brexit in an environment of huge uncertainty makes for exceptionally difficult budgetary policy making
- The Government's overall approach and strategy is reasonable as it seeks to:
  - navigate what is exceptionally difficult economic terrain;
  - demonstrate a readiness and willingness to act in the event that the UK crashes out;
  - provide important reassurance and certainty to households and business.
- Recent trends in the public finances are relatively healthy and in the version of a Hard Brexit scenario which underpins Budget 2020, it looks like the shock may be manageable
- However, the starting position isn't as strong as might have been, and more severe outcomes for both the economy and public finances are certainly possible, especially given the deterioration in the international environment away from Brexit
- If such downside risks were to crystallise it could leave the the Government facing scenarios, decisions and trade-offs that are much more difficult (potentially including the need to tighten fiscal policy to prevent debt ratios from rising unsustainably).

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