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Michael Noonan TD
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Dear ~~Minister~~ Michael

It has been traditional for the Central Bank to provide some words of advice with respect to the overall shape of the budget in terms both of its short-term impact on macroeconomic conditions, its medium-term implications for the sustainability of debt, and also on the potential impact of budgetary measures on the efficient and internationally competitive functioning of the economy. Now that we are in the EU-IMF Programme, some of the functions of the Central Bank's annual pre-budget letter have to an extent been superseded by the regular discussions with the Troika and the budgetary conditions that have been agreed to. In addition, the new Fiscal Advisory Council, in its public reports, has been offering independent advice on budgetary strategy covering much of the ground traditionally addressed by the Central Bank in pre-budget letters.

Nevertheless, I feel I should write to emphasize a few particular dimensions which, I think, deserve particular attention as the 2013 budget is being prepared.

The first message I would like to deliver can be summarised as "Don't ease up now". The fiscal adjustment is gradually delivering the expected benefits in terms of a progressive return towards a sustainable configuration of taxation and public spending. Although borrowing is still at extremely high levels, the close adherence to the agreed budgetary targets of the EU-IMF adjustment programme has allowed Ireland to regain much of the lost ground in terms of its reputation for serious and reliable policy-making. The significance of this reputational value can hardly be overestimated. It has helped lower borrowing costs to the point where exit from the programme on schedule -- considered by some impossible only a few months ago -- can now be hoped-for, despite the continuing impact of the wider euro area crisis. Above all, it has enabled Ireland to qualify for a reconsideration of the banking debt (as agreed by the June 29 euro area summit). Turning this reconsideration into cash is an immediate challenge which would certainly be derailed by any slippage in the budgetary discipline shown to date.

Although the adjustment has a direct adverse impact on demand in the economy, it is important to recognize that fiscal adjustment in this situation has not been self-defeating. This is the second message of my letter. Sure enough, Irish output (GDP or GNP) is at present almost 2 per cent lower than it was expected to be when the EU-IMF programme was negotiated; but this undershoot is no worse - indeed slightly better - than has occurred in the rest of the euro area. The adverse effect of Irish fiscal contraction on domestic demand has not been worse than expected: the undershoot can instead be attributed largely to external factors. Rather than attempting an even more protracted adjustment path towards sustainability, there is still, as I suggested a year ago, a lot to be said for getting the contraction over with faster. Economic agents at home as much as abroad remain worried about how future policy during the period of adjustment will affect them: this is bad in itself and is sure to dampen investment and consumption plans. Reaching the target of 3 per cent deficit a bit faster would shorten the period of uncertainty, getting the economy back onto a footing that offers confidence to all and can underpin a faster recovery of jobs and output.

Third, competitiveness remains a weak element in the Irish recovery. The usual international comparisons suggest a much larger improvement in the relative position here than has truly occurred. There is a risk that policymakers may have been lulled into a false sense of security on this front. Much (though not all) of the apparent improvement in aggregate productivity – and in unit labour costs, a widely-used conventional measure of competitiveness – is attributable to the fact that the construction sector - a traditionally low productivity sector - has collapsed. The remainder of the economy has *not* experienced much productivity growth or much reduction in unit labour costs.

The difficulties and complications of addressing public sector pay rates are acknowledged, and it is recognised that the Government has chosen to cut numbers and seek operational efficiencies instead of making a further cut in pay rates. But pay remains high in both public and private sectors, adding to costs and prices in the economy and no doubt discouraging expansion and investment projects by exporting firms. The recovery of the Irish economy from the recession of the 1980s relied heavily on pay restraint in public and private sectors. It will have to be the same this time (even though policy measures used in the past, such as the devaluations of 1986 and 1993, and the "pay-restraint-for-tax-cuts" social partnership deals are not available today). All budgetary measures, including tax measures, should be assessed for their potential impact on the cost base, public and private, for production in Ireland.

This last idea can be generalised. While it may not have been stated in so many words as formal Government policy, the implicit goal of most is to get the economy back as closely as possible to the favourable budgetary and growth configuration that existed in the period of high and balanced growth of the mid-1990s. This is a point which I emphasized in my October 2010 letter to your predecessor, but which bears some repetition on this occasion.

In short, budgetary policy needs to be driven by a single-minded focus on restoring the conditions for economic recovery. Therefore, I suggest that each possible budgetary measure should be assessed by reference to two main touchstones: (i) does it contribute to a return towards what were sustainable tax and spending structures in the 1990s or, if not, (ii) does it represent a definite improvement in the economic and social efficiency of fiscal structures? Importantly, the budgetary strategy as a whole should of course be assessed for its fairness, recognizing that not all individual measures may seem fair in isolation.

If this strategic approach is adopted systematically in the design of this year's budget and the next, not only will recovery be speeded and long-term growth enhanced, but in addition, individually unpalatable measures will be accepted if they are understood as part of a coherent and balanced package with a clear and attainable goal of restoring something like the relative cost and incentive structures that prevailed in better times.

I hope that these remarks are of assistance in drawing up the Budget.

Yours sincerely

Patrick