An Roinn Airgeadais
Department of Finance

Taking Stock: The Fiscal Response to Covid-19

November 2020

Department of Finance
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Foreword

This year has been a very difficult one, both for our economy and for our society more generally. The term 'black swan' entered the discussion during the Global Financial Crisis a decade ago, to describe a highly infrequent, highly improbable event that had major consequences. Unfortunately, the Covid-19 pandemic, once again, fits this description.

In Ireland, as elsewhere, we have prioritised healthcare objectives: slowing the transmission of the virus in order to minimise loss-of-life and to ensure our intensive care capacity is not overwhelmed. Unfortunately, because this respiratory virus is so contagious, limiting its transmission across our population has necessitated stringent containment measures.

The Government is acutely aware of the unparalleled economic consequences arising from these containment measures. The fiscal response – to cushion household incomes, to provide life-lines to firms and to boost healthcare capacity – is also unparalleled.

This publication by my Department documents the full suite of fiscal supports that has been put in place. Put simply, Government has utilised its full fiscal toolkit – taxation, expenditure, guarantees – in order to bridge through the pandemic. This pro-active, counter-cyclical support is made possible because of the prudent management of the public finances in the pre-Covid years.

I have no doubt that our economy – and our society more generally – will rise to the challenge. But we will have to be flexible, we will have to adapt to a 'new normal', one which may be very different to the old. The pandemic will, for instance, fundamentally change many facets of our economy, accelerating pre-existing changes that were underway. Some sectors will be permanently 'down-sized', while others will expand. This will create both opportunities as well as challenges.

As we publish this document, hopes are rising that an effective vaccine may be on the horizon. Even if this was the case, it would be premature to withdraw fiscal support at this point, given substantial under-utilised resources. Over time, however, budgetary policy will need to be adapted as conditions change.

The Government is committed to providing further budgetary support in the years ahead while, at the same time, bringing the fiscal accounts back to a balanced position in a gradual, incremental manner.

Paschal Donohoe T.D.
Minister for Finance

Executive Summary

Fiscal support of over €25 billion has been provided for this year, mostly in the form of 'direct' taxation and expenditure measures. Indirect measures – including credit guarantees – have also formed part of the toolkit. Given the continuing presence of the pandemic and the economic disruption it continues to cause, the Government is committed to maintaining these supports for as long as necessary; accordingly, *Budget 2021* provides further stabilisation measures amounting to just under €12½ billion.

The immediate objective has been to limit the short-term economic fallout from the pandemic and, in parallel, to boost healthcare capacity. A secondary – though no less important objective – has been to limit the medium-term damage to the economy; in other words, to mimimise the possibility that firms and workers permanently exit the market.

While achieving these objectives does not come cheap, the cost of inaction would have been larger – in the form of higher unemployment, personal and corporate insolvency and permanent loss of productive potential.

Unlike the crisis of a decade ago, monetary policy during the pandemic has been working hand-in-glove with fiscal policy in the euro area. The balance sheet of the *Eurosystem* – the European Central Bank alongside the national central banks of the euro area – is being expanded further, with the *Eurosystem* using its money creation powers to purchase over €100 billion (under the various asset purchase programmes) of financial assets each month, mainly sovereign debt instruments of euro area Member States. In this way, sovereign borrowing costs have been kept at extremely low levels, while financing conditions have remained favourable.

This strong complementarity between fiscal and monetary policy has important implications in Ireland. For instance, the activist budgetary policy of Government is not being 'crowded out' by higher borrowing costs. This means that the Government – via appropriate tax and spending policies – can bridge through the pandemic and lay the foundations for recovery once the virus is brought under control.

A notable side effect, however, is that the *Eurosystem* (mostly the Central Bank of Ireland) now holds around €44 billion of Irish government paper, making it the single most important creditor of the Irish Government.

Once an effective vaccine (or other therapeutics) is rolled-out and economic recovery more firmly entrenched, fiscal support must be withdrawn in a gradual manner. That the cost of borrowing will no doubt rise as monetary policy becomes less accommodative, further emphasises the need to more closely align the revenue and expenditure sides of the fiscal accounts.

Contents

The data and analysis set out in this document are compiled by Department of Finance staff. Every effort is made to ensure accuracy and completeness. When errors are discovered, corrections and revisions are incorporated into the digital edition available on the Department's website. Any substantive change is detailed in the online version.

Table 1: Chronology of the pandemic

Date		Key development
December 2019	31	China informs WHO of a number of ‘flu-like’ cases in Wuhan
January	11	First confirmed death from coronavirus recorded in China
	13	First case outside of China detected in Thailand
	24	First confirmed European cases of Covid-19 reported in France
February	29	First case recorded in Republic of Ireland
March	8	Global confirmed Covid-19 cases surpass 100,000
	11	WHO declares ‘global pandemic’; first confirmed Covid -19 death in Ireland
	12	Schools, colleges, childcare facilities in Ireland shut for two-week period
	13	WHO declared Europe the ‘epicentre’ of the pandemic
	16	Irish Government establish pandemic unemployment payment (PUP)
	18	ECB announces €750 billion Pandemic Emergency Purchase Programme (PEPP)
	24	TWSS announced. All non-essential shops in Ireland close, all sporting events cancelled
	27	Ireland enters ‘lockdown’
April	2	Cases top 1 million worldwide
	10	Global death toll surpasses 100,000
May	1	Ireland extends lockdown to 18 May; 5-phase roadmap for easing restrictions (May–Aug)
	18	Phase 1 commences, including some easing of restrictions on workplace attendance
June	4	ECB boosts bond-buying PEPP stimulus package by €600bn to €1,350bn
July	20	EU leaders agree €750bn stimulus deal
	23	Government of Ireland announces *July Stimulus* package, worth €5.2 billion
September	29	Global deaths surpass 1 million
October	7	Ireland enters national Phase 3 lockdown
	13	Ireland unveils record budget package to tackle Covid-19 recession
	21	Ireland is first EU country to re-enter national lockdown - ‘Level 5’
	31	France, Germany, UK, Greece and Belgium follow Ireland in implementing fresh restrictions

Note: table does not purport to be fully comprehensive – its purpose is to provide an overview of the key developments, as they impacted on Ireland, and their timeline.
Source: Department of Finance.

Section 1: Background

On New Year's Eve last year, the Chinese authorities informed the *World Health Organisation* (WHO) of 'flu-like' cases in the city of Wuhan, and subsequently quarantined the province of Hubei. A fortnight later, on 13th January 2020, the first case outside of China was recorded in Thailand. On 11th March, the WHO formally declared a global pandemic which, at the time of writing, has claimed around 1¼ million lives worldwide (with an estimated 59 million cases).

The respiratory virus, formally named 'SARS-CoV-2' in mid-February, has proven highly contagious, even amongst the asymptomatic and pre-symptomatic. The disease it causes, Covid-19, has a wide range of symptoms and levels of severity. As it spread rapidly across the globe from the tail-end of the first quarter, most Governments prioritised health policy objectives: slowing the rate of virus transmission in order to minimise loss-of-life and to ensure that healthcare systems were not overwhelmed.

Flattening the so-called 'infection curve' necessitated the imposition of stringent containment measures in most countries during the second quarter of this year.[1] The read-across from these containment measures to the economy was severe and immediate: global economic activity is likely to decline by around 4½ per cent this year,[2] the bulk of which was concentrated in the second quarter. As well as its depth, the shock is notable for its breath, with a majority of economies likely to record a contraction in activity this year.

In most countries, the relaxation of restrictions during the third quarter triggered a rapid rebound in economic activity, although recovery was far-from-uniform across sectors. The initial rebound has proven temporary, however, as the second wave of the virus over the autumn prompted a re-introduction of containment measures in several jurisdictions, raising the probability of a 'double-dip'. That said, the shock to economic activity in the final quarter is unlikely to be as extreme as in the second quarter *inter alia* because schools and childcare facilities remain open (so that the output of working parents is less affected) while restrictions are more tailored than previously. Additionally, the disruption associated with transitioning to remote working will be less costly than during the first wave, given that most of the necessary infrastructure is now in place.

Closer to home, the first case of the virus in Ireland was recorded at end-February, with initial restrictions on activity introduced in mid-March. The severity of these measures was subsequently increased so that, during the second quarter, the Irish 'lockdown' was amongst the most stringent in Europe. This took an enormous toll on the economy: modified domestic demand declined by nearly one-fifth over the first half of the year, with the unemployment rate reaching 30 per cent in June. High frequency data – official as well as unofficial real-time data[3] – point to a rapid rebound in the third quarter but, like elsewhere, activity is likely to stall, if not reverse, in the fourth quarter on foot of second wave containment measures.[4]

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[1] This document refers to the second quarter for simplicity; of course, the introduction and subsequent relaxation of containment measures was quite heterogeneous across countries and does not in all cases fully align with the second quarter.

[2] Source: *World Economic Outlook*, International Monetary Fund, October 2020.

[3] See Department of Finance: https://www.gov.ie/en/publication/82326-emerging-economic-developments-real-time-economic-domestic-indicators-11th-november-2020/.

[4] The cut-off point for data included in this document is mid-November 2020.

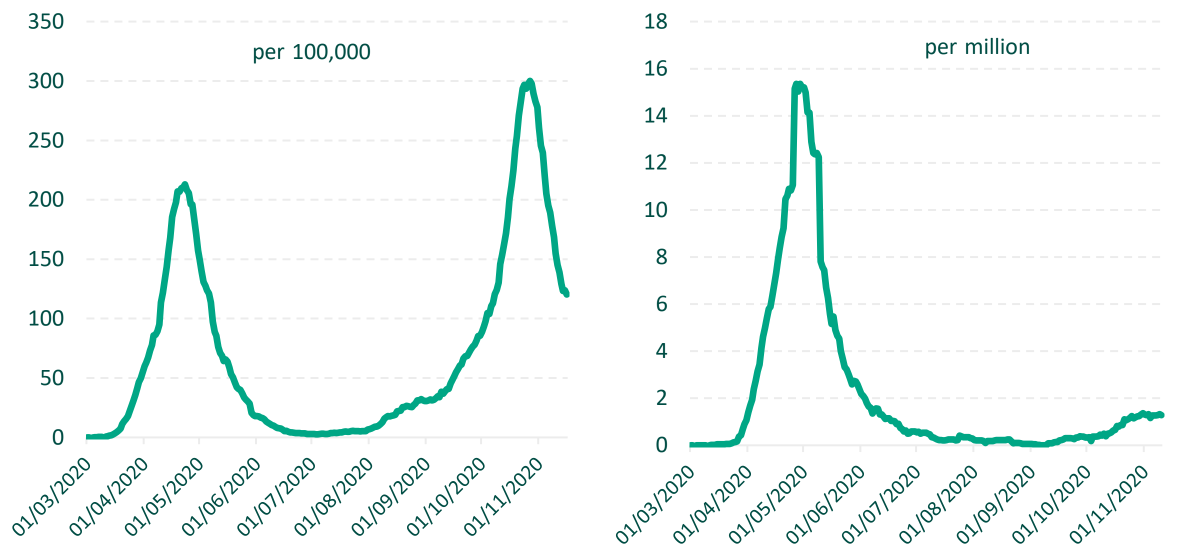
The macro-economic policy landscape has changed dramatically since the early part of this year, as governments everywhere have sought to bridge between the pre- and post-Covid economies. In Ireland, the Government has extended an unparalleled quantum of fiscal support while, unlike during the global financial crisis, the monetary policy stance – set independently of Governments in the euro area – has complemented the budgetary stance of all euro area Member States, including Ireland.

The purpose of this document is to take stock of the Irish Government's fiscal response to the pandemic. Section 2 briefly outlines the rationale and objectives behind the exceptional level of support while, in section 3, more granular detail is provided. Section 4 outlines the impact on the public finances in Ireland and puts this in international context. Section 5 provides a brief overview of other policies designed to cushion the impact of the shock. Section 6 concludes.

Section 2: Economic rationale for activist policy response

The pandemic is a truly exogenous global shock, and one that is unique in many ways. For instance, its sheer scale and speed set it apart from other economic shocks, as does the degree of global synchronicity. Perhaps the most unique feature, however, is its origin: it is a 'self-imposed' economic shock, in the sense that Governments everywhere have deliberately hibernated many sectors of their economies in order to achieve critical public health outcomes (figure 1). Indeed, available evidence suggests that Ireland has consistently had one of the most stringent set of restrictions (figure 2a); comparing the degree of stringency across countries shows a positive correlation with the degree of economic contraction (figure 2b).

Figure 1: 14-day cumulative a) infection rate in Ireland; b) deaths rate in Ireland



Source: European Centre for Disease Control, Dept of Finance calculations.

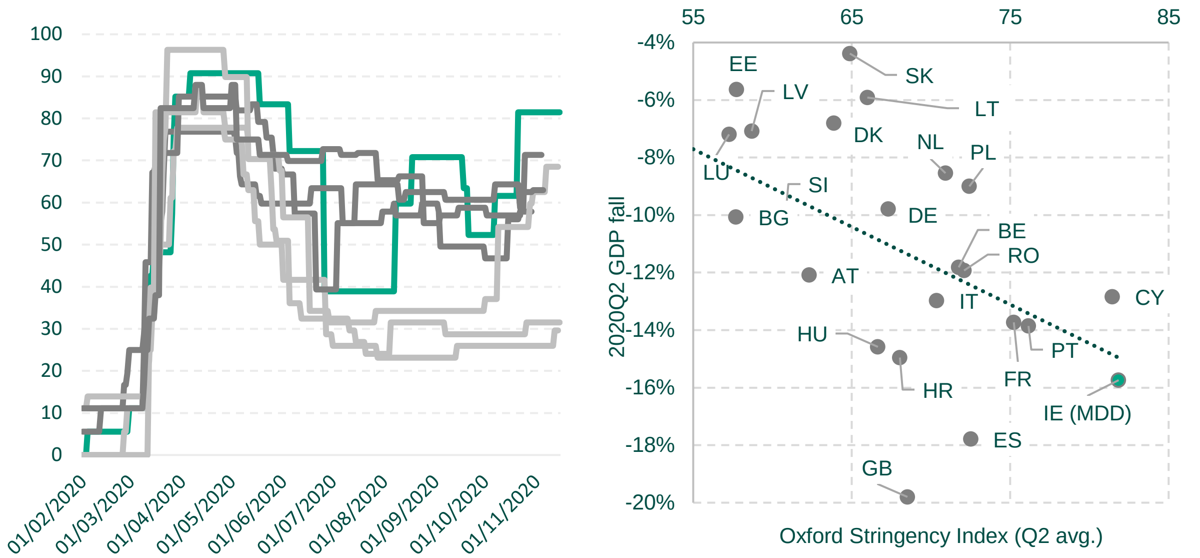
Given self-imposition by the public sector, the *quid pro quo* has been a ramping-up of financial support for the private sector, in order to bridge through the most acute phases of the pandemic. The approach in Ireland has been no different, with the Government deploying its balance sheet in a pro-active, counter-cyclical manner in order to limit the fallout from this once-in-a-century shock.

As always, the full and symmetric operation of the automatic stabilisers provided the first line of defense. Given the speed and scale of the shock, however, it was necessary to supplement the operation of automatic stabilisers with discretionary fiscal measures, the quantum of which is unparalleled in Irish economic history. For this year, measures amounting to over €25 billion have been provided, the equivalent of 12.4 per cent of national income (as measured by modified Gross National Income, GNI*). For next year, fiscal support measures will amount to an estimated €12.6 billion[5], or 6.2 per cent of GNI* (table 5).

[5] Includes measures announced in the July Stimulus, as well as Budget 2021.

While this level of support does not come cheap, the cost of inaction would have been even larger. These costs would have taken the form of even higher unemployment, alongside elevated personal and corporate insolvencies. This, in turn, could have generated second-round effects via the financial sector: higher levels of non-performing loans leading to a reduced supply of credit ('credit rationing') and this feeding back to the 'real' economy. This feedback loop between the real and financial sectors was an amplifier of the last crisis; the fiscal support has helped to prevent financial sector amplification during the current recession.

Figure 2: a) stringency index; b) stringency vs economic impact



Stringency graph shows Ireland (green), the three most restrictive European countries in dark grey (DE, ES, PT), and the three least stringent European countries in light grey (LT, EE, HR).
Source: Oxford University, Eurostat.

From a macroeconomic perspective,[6] the objective of the fiscal response is essentially two-fold: firstly, to jump-start the cyclical recovery once the virus is contained and, secondly, to limit so-called 'scarring effects' (and, in doing so, to preserve the tax base).

Put another way, the short-run objective has been to stabilise – in so far as possible – aggregate demand in the economy, i.e. to limit the short-term decline in economic activity from its full-employment level.

Equally important is the medium-term objective of preservation – again, in so far as possible – of the productive capacity of the economy (the 'supply-side'). Economic theory, accompanied by a wide body of empirical evidence, shows that cyclical variations in demand around its full-employment level can (endogenously) have lasting effects on the availability of capital and labour in an economy. There are several channels through which these so-called 'hysteresis effects' arise: periods of higher unemployment can lead to permanent detachment from the labour force; cash-flow difficulties lead to insolvency / firm exit (capital stock depletion). Economic history also shows that deeper and more prolonged shocks tend to be

[6] Clearly there are other objectives, most notably health policy and wider societal objectives that have underpinned the Government's response. The focus of this note, however, is on macroeconomic objectives, in line with the Department's mission.

associated with larger 'scarring' effects. As the scale of the shock inflicted by the pandemic is unparalleled outside of war-time, activist fiscal policy is justified in order to limit these scarring effects.

Box 1: Covid-19 impact on pharmaceutical exports

The pharmaceutical sector has remained resilient during a period where goods exports have generally been declining globally. In Ireland, this has supported GDP and corporation tax receipts amidst a severe decline in other parts of the economy. From January to September, the value of pharma-chem exports have increased by 15 per cent (year-on-year) to €81bn, driven by large growth in the medicinal and pharmaceutical products commodity group - typically comprised of final products, as opposed to ingredients used in the production of final products.

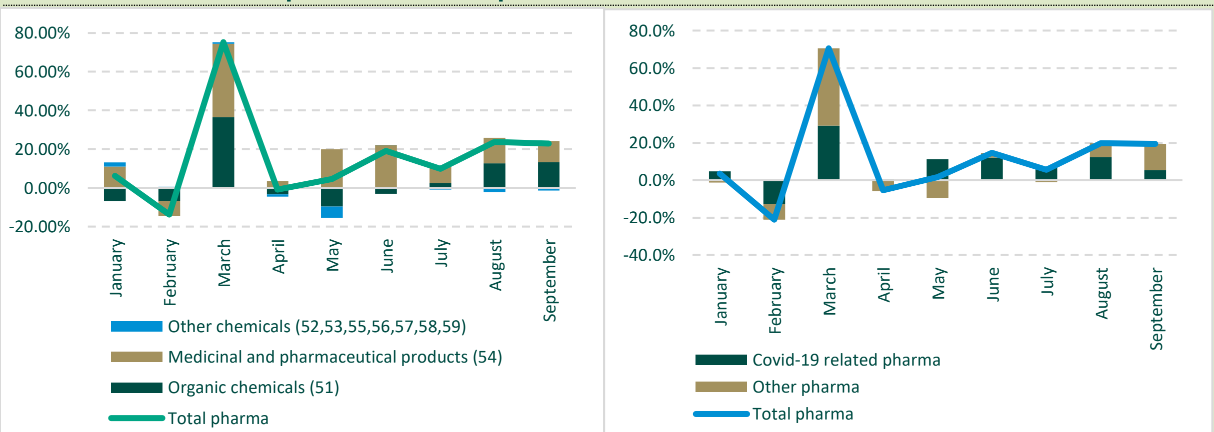
There was extraordinarily large growth of pharma-chem exports in March (75 per cent), as the pandemic started to spread across Europe and most of the world. This could be a result of stockpiling in response to concerns relating to potential supply chain disruptions and/or large public demand for pharmaceutical products. However the growth in March followed a 14 per cent decline in February, so it may have also been partly a result of timing issues.

The growth in pharma-chem was driven by strong growth in products used for Covid-19 related purposes. In year-to-date terms these exports have increased by approximately 18 per cent (€5.1bn). These are not necessarily newly created products, but rather products that already existed but which can be used for Covid-19 related purposes (e.g. treatment, sterilisation, testing, diagnosis etc.).

While other pharma products, i.e. non-Covid related, were the largest contributors to the significant pharma-chem growth in March, in the following months, pharma export growth was largely driven by the Covid-19 related exports. These exports have contributed around two-thirds of the pharma growth seen in 2020.

The Covid-19 related pharma export growth was primarily driven by commodities used for Covid-19 testing kits with the second largest contributor being medical consumables. There was also significant growth in export of disinfectants and sterilisation products, although its contribution to total pharma-chem growth for 2020 is negligible.

Contributions to total pharma-chem exports



Source: CSO (lhs) and Eurostat (rhs)

Section 3: Documenting the main supports

Broadly speaking, Government intervention has occurred on three separate occasions: the initial policy response adopted in the spring, a subsequent set of measures presented during the summer and, finally, the suite of measures introduced in the autumn budget. Importantly, the Government has adapted its approach *in tandem* with the epidemiology of the virus: for instance, focusing on income support in the initial phase before (when supply of many goods and services had moved off-steam) and, subsequently, switching towards boosting demand (once sufficient supply had come back on-steam).

The key measures are set out in chronological order in the tables below. A graphical representation of the overall direct supports is also provided in Annex 1. At the outset, it is important to stress the difficulties in costing some of these policy initiatives: these were designed at extraordinary speed and with considerable uncertainty regarding *inter alia* the degree of take-up.

Phase 1 – March / April 2020

A very stringent lockdown was introduced in Ireland from mid-March, which lasted until mid-May. The focus of budgetary support at the time was cushioning household incomes, maintaining the critical link between employees and their employers, and providing liquidity support for firms.

In order to incentivise self-isolation, unemployment benefits were fast-tracked for those employees needing to absent themselves from workplaces for fear of cross-contaminating co-workers. This was swiftly followed by the two most prominent Government supports for households: the *Temporary Wage Subsidy Scheme (TWSS)* and the *Pandemic Unemployment Payment (PUP).* The TWSS was designed to keep employees 'on the books' and, in doing so, maintain the important link with the labour market. The PUP is an income support measure which involves cash transfers from the general government sector to the household sector in order to cushion incomes. Households also benefitted from payment breaks on mortgages and personal loans, along with deferred payments on stamp duty and local property tax.

In order to maximise the firm survival rate, policy at this time also involved important liquidity supports for firms. These included deferred taxation payments (warehousing), payment breaks on business loans, and loan guarantees for micro-, small- and medium-sized firms. The over-riding objective of these liquidity supports was to ensure that viable, solvent firms did not exit the market because of short-term cash-flow difficulties. Direct transfers were also provided for, by way of 'Restart' grants and waivers on commercial rates.

Phase 2 – July stimulus

From mid-May, containment measures were relaxed in a gradual, incremental manner. As supply capacity came back on-stream, the focus of budgetary policy shifted towards boosting demand – counter-cyclical budgetary policy. The fiscal stimulus introduced in July amounted to €5.2 billion, the equivalent of 2.6 per cent of GNI*.[7] Taxation measures accounted for around €900 million of this, with the remaining €4.3 billion on the expenditure side.

[7] Some of the costs arise in 2022 and, for simplicity, are not included in table 2.

In terms of specifics, some of the measures built on earlier policies: duration extension for the PUP, important tweaks to the TWSS to create the *Employment Wage Subsidy Scheme* (EWSS), additional restart grants and further commercial rate waivers.

Taxation instruments were also deployed in a pro-active manner, with a tax rebate designed to boost out-of-season demand for accommodation and food ('stay-and-spend'), as well as a temporary reduction in the standard rate of VAT from 23 per cent to 21 per cent, designed to boost personal consumer spending. Enhanced corporate tax loss relief was introduced to provide additional liquidity supports for businesses.

Phase 3 – Budget 2021

Budget 2021 was prepared against a backdrop of extraordinary uncertainty regarding the epidemiology of the virus and the nature of bilateral trade between Ireland and the UK from the beginning of next year. Designing the optimal fiscal policy in these circumstances involved two key building blocks: firstly, the assumption of co-existence with Covid-19 and, secondly, the assumption that bilateral trade with the UK defaults to *World Trade Organisation* terms from January.

Table 2: taxation measures, € billions

	2020	2021
Phase 1: April / May	**2.0**	**-**
Tax warehousing	2.0	-
Phase 2: July stimulus	**0.9**	**0.32**
Loss relief		
: for self-employed	0.15	-
*: for corporations **	0.45	-
Stay and Spend initiative	-	0.14
VAT	0.28	0.16
Cycle-to-work	0	0
Interest reduction on tax liabilities	-	0.02
Help-to-Buy	0.02	-
Phase 3: *Budget 2021*	**0.5**	**0.4**
Reduced VAT rate for hospitality sector	0	0.34
Covid Restrictions Support Scheme **	0.5	-
Extension of stimulus Help To Buy enhancements	-	0.04
TOTAL TAX	**3.4**	**0.7**

Source: Department of Finance; rounding may affect totals.
* CT loss relief acceleration is cost neutral over two years.
** The cost of the CRSS scheme will be determined by the level and length of restrictions in place. 2020 costs are an estimate based on Level 5 nationwide restrictions. 2021 costs will be met from the *Recovery Fund*.

Against this backdrop, the overall budgetary strategy was to balance the need of providing further counter-cyclical support to the economy while ensuring that the public finances remained on a sustainable path. *Budget 2021,* therefore, prioritised a continued activist fiscal response to the pandemic. As set out in the *Programme for Government*, a 'Recovery Fund' was also established (see box 2).

A (net) budgetary package of approximately €17¾ billion was introduced in *Budget 2021*, the majority of which was allocated to expenditure measures. Of this, Covid-related expenditure amounted to €8½ billion. On the taxation front, a key innovation was the introduction of the *Covid Restrictions Support Scheme* (CRSS), aimed at supporting businesses which have either been prohibited from operating or are trading at significantly reduced levels as a result of the imposition of restrictions (the movement to 'level 5' restrictions on 21st October means that the cost of the CRSS is estimated at around €500 million over the six-week period).

Table 3: direct expenditure measures, € billions

	2020	2021	Total	% GNI
Social Protection	**10.37**	**3.18**	**13.55**	**6.7**
of which: Pandemic Unemployment Payment	5.09	0.65		
EWSS/TWSS	4.53	1.20		
Other (illness benefit, activation measures, etc.)	0.75	1.33		
Health	**2.54**	**1.88**	**4.42**	**2.2**
of which: capacity, equipment, PPE, testing	2.54			
Education	**0.32**	**0.23**	**0.55**	**0.3**
of which: Roadmap for Reopening Schools	0.14			
Further and Higher Education	**0.32**	**0.17**	**0.49**	**0.2**
Business, Enterprise & Innovation	**0.94**	**0.10**	**1.04**	**0.5**
of which: Liquidity supports and Business Restart Grants	0.49			
July Stimulus including additional funds for Restart Grants	0.45			
Housing, Local Government and Heritage	**1.10**	**0.05**	**1.15**	**0.6**
of which: Commercial Rates Waiver	0.90			
Transport/Tourism/Sport	**0.57**	**0.40**	**0.97**	**0.5**
of which: Public Service Obligation	0.46	0.39		
Other	**0.64**	**0.38**	**1.02**	**0.5**
Total allocated	**16.78**	**6.39**	**23.17**	**11.4**
Contingency		**2.10**	**2.10**	
Recovery Fund*		**3.40**	**3.40**	
TOTAL DIRECT EXPENDITURE	**16.78**	**11.89**	**28.67**	**14.1**

Source: Department of Finance, Department of Public Expenditure and Reform
Rounding may affect totals
GNI* relates to modified Gross National Income and is projected at c. €202 billion for 2020.
* The Recovery Fund can be used for either tax or expenditure measures

Finally, credit guarantees have been an important part of the Irish toolkit, albeit to a lesser extent than elsewhere. Because of this, there is a possibility that private sector losses migrate to the public sector balance sheet.[8] The key guarantees, as well as other 'below the line' supports are set out in table 4.

Table 4: contingent supports, € billions unless stated

	2020	2021	Total	% GNI
Credit Guarantee Scheme	2.00	0.00	2.00	1.0
Pandemic Stabilisation Fund (ISIF)	2.00	0.00	2.00	1.0
Future Growth Loan Scheme (longer-term loans)*	0.50	0.00	0.50	0.3
Liquidity support through SBCI - Working Capital Loan Scheme**	0.29	0.00	0.29	0.1
Sustaining Enterprise Fund	0.18	0.00	0.18	0.1
MicroFinance Ireland (loans)	0.04	0.00	0.04	0.0
Seed and Venture Capital Scheme (in relation to Covid-19)	0.01	0.00	0.01	0.0
TOTAL CONTINGENT SUPPORT	**5.02**	**0**	**5.02**	**2.5**

Source: Departments of Finance and of Public Expenditure and Reform.
Rounding may affect totals
For simplicity all supports are presented as accruing in 2020
GNI* relates to modified Gross National Income and is projected at c. €202 billion for 2020.
* €500m expansion in addition to original €300m giving the total scheme value of €800m
**€250m of the existing €300m Brexit Loan Scheme repurposed into WCLS for businesses impacted by Covid. The overall scheme is also being expanded by €37.5m to bring the total amount to €337.5m

[8] CGS take-up has been lower than expected at this point. Reasons for this could relate *inter alia* to a reluctance to accumulate additional debt in context of huge uncertainty coupled with reduced need due to the supports introduced by Government; however, once recovery sets in and there is greater certainty, it is anticipated that firms will draw down additional amounts under this scheme. In this context, the scheme is being extended thanks to the European Commission's decision to extend its Temporary Framework for State Aid to end-June 2021.

Section 4: Implications for public finances[9]

The cumulative amount of policy support implemented by Government is set out in table 5. The *direct* fiscal measures amount to just under €33 billion over the two-year period, or over 16 per cent of GNI*.

Table 5: total fiscal support, € billions unless stated

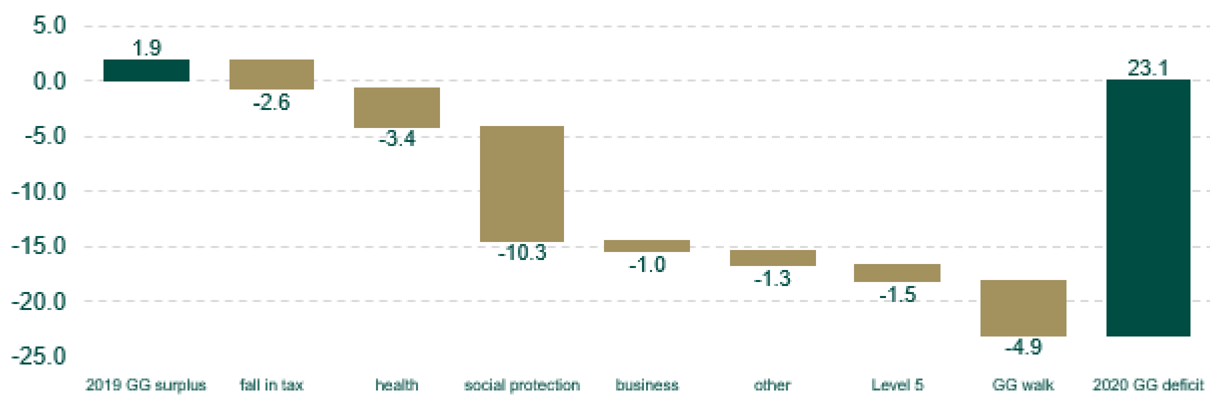
	2020	2021	Total	% GNI*
Taxation measures	3.4	0.7	4.1	2.0
Expenditure measures	16.78	11.89	28.67	14.1
Contingent measures	5.02	0	5.02	2.5
TOTAL FISCAL SUPPORT	**25.2**	**12.59**	**37.79**	**18.6**

Source: Departments of Finance and of Public Expenditure and Reform.
Rounding may affect totals
GNI* relates to modified Gross National Income and is projected at c. €202 billion for 2020.

In terms of absorbing the fiscal shock, the starting point for the public finances was reasonably solid, reflecting the Government's approach of running headline surpluses in 'good times'. Indeed, the pandemic further illustrates the importance of planning for a 'rainy day' and avoiding pro-cyclical fiscal policies when the economy is performing strongly.

Taking into account the headline surplus recorded last year, the direct fiscal stabilisation costs and the operation of the automatic stabilisers results in a general government deficit amounting to around 6½ per cent of GDP (11½ per cent of GNI* this year). These figures for the deficit are slightly higher than set out in the Department's autumn forecasts, and reflect the additional cost associated with the movement to 'level 5' restrictions. The evolution of the general government balance between last year and this is set out in figure 3.

Figure 3: evolution of the fiscal position from last year to this year, € billions



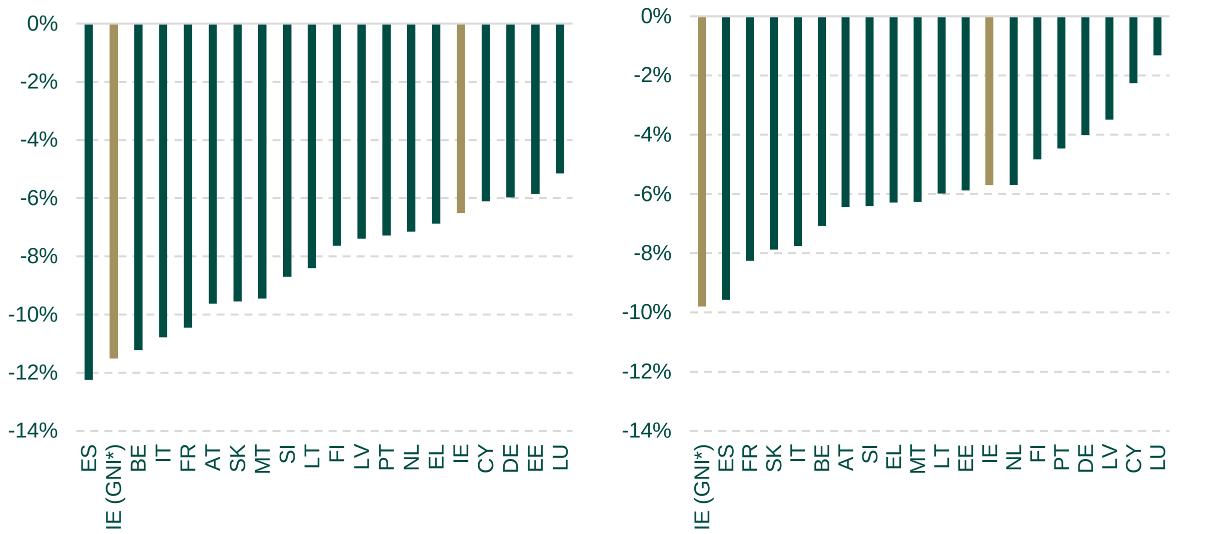
Source: Department of Finance calculations.

A deficit of 5.7 per cent of GDP is projected for next year, as many of the tax and expenditure measures will remain in place. Figure 4 puts the Irish deficit for this year and next into a euro

[9] The analysis in this document focuses solely on the flow (the general government balance); the Department's forthcoming *Annual Debt Report 2020* will detail the impact on public indebtedness.

area perspective. The key takeaway is that – in both years – the Irish deficit is in line with euro area norms in GDP terms, although at the upper end in GNI* terms.

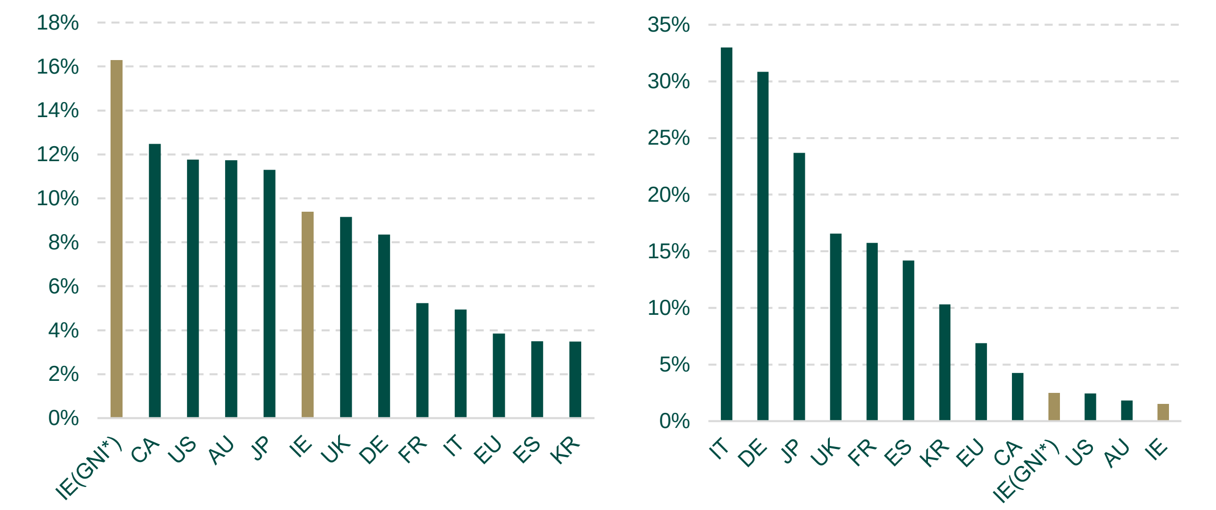
Figure 4: euro area Member States deficits a) 2020; b) 2021, per cent of GDP unless stated



Source: European Commission autumn forecasts and Department of Finance.

It is important to highlight that, at least in the Irish context, the bulk of these discretionary fiscal supports involve 'above-the-line' measures: supports that directly improve the financial situation of the private sector, while directly worsening the financial situation of the public sector. This contrasts with the situation in some other jurisdictions, where 'below-the-line' supports, such as loan guarantees, have been the main fiscal policy instrument. And, as previously outlined, these have formed part of the Irish policy response, the key point is that the scale of the direct supports means that the Irish fiscal response has been at the upper-end of the distribution of advanced economy responses (figure 5).

Figure 5: comparison of a) above the line; b) below the line measures, per cent of GDP unless stated



Source: IMF Fiscal Monitor database; measures in response to the Covid-19 pandemic.
CA=Canada, AU=Australia, JP=Japan, KR=South Korea.

Box 2: Recovery Fund

Budget 2021 includes provision for a €3.4 billion Recovery Fund, the equivalent to c. 1.7 per cent of GNI*. The purpose of the Fund is to provide maximum flexibility to allow Government respond swiftly and decisively to the evolving public health and economic situation, including the fall-out from the ending of the transition period (that governs bilateral trade with the UK) at end-December.

The Recovery Fund was designed to be flexible and is a deliberate effort by Government to allow, within the budgetary framework, for the unprecedented level of economic uncertainty that currently prevails. The uncertainty relates to both the trajectory of the virus and to the form that the post-transition trade with the UK takes.

The Fund is sufficiently large to provide a significant stimulus to the domestic economy, should it be needed. It will focus on three main areas: infrastructure development, reskilling and retraining and supporting investment and jobs. Importantly, the Fund can be deployed to finance direct public expenditure measures or taxation measures; the exact allocation will depend on what is the most appropriate policy instrument at the time.

By creating a Fund of this nature the Government achieves two key budgetary aims. Firstly, it provides the fiscal headroom to pro-actively respond to the emerging economic situation. The Fund creates 'space' in the fiscal arithmetic to provide further economic stimulus, or introduce labour market or business supports without impacting the underlying deficit projected at *Budget 2021.*

Secondly, when the public health situation improves, or the worst impacts of Brexit have passed, resources used under the Fund can be withdrawn in a timely manner. In other words, the €3.4 billion allocated under the Recovery Fund will not enter the expenditure or tax base. This is vitally important in relation to Covid expenditure, as once the current crisis has passed, such expenditures will need to be withdrawn or, alternatively, financed by taxation increases. This is because the *Fiscal Stability Treaty* is a legally binding instrument that requires balanced budgets in 'normal times'.

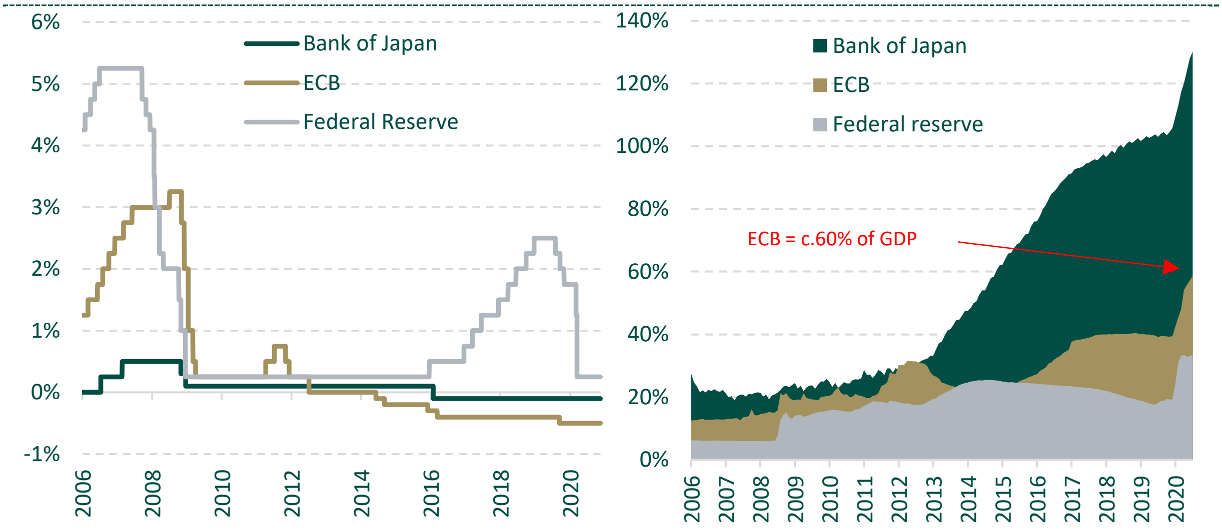
Section 5: Complementary policies

While fiscal policy has been center-stage during the pandemic, it is clear that other parts of the policy toolkit have played a supporting role. In terms of macro-economic stabilisation, a highly accommodative monetary policy stance has complemented the aggressive fiscal response. Before proceeding, it is worth stressing that the independence of the central banks in the euro area is enshrined in the Maastricht Treaty. Additionally, micro-economic – or sectoral policies – have also formed part of the toolkit.

Monetary policy in the pandemic

In pre-pandemic advanced economies, short-term policy rates had remained close to the (effective) lower bound in the decade since the Global Financial Crisis (GFC; figure 6a). This reflects a confluence of factors, including slow-moving structural factors (population ageing, global savings 'glut', etc.) that have put the (real) equilibrium interest rate on a downward trajectory. Accordingly, many central banks were approaching the limits of conventional monetary policy, with non-standard policies an increasingly common feature.

Figure 6: key central banks a) policy rates, per cent**; b) balance sheet,** per cent of GDP



Source: macrobond.

In response to the pandemic, an even greater reliance has been placed on unconventional monetary policy measures: those designed to achieve price stability (and, hence, support economic activity). In a nutshell, this involves expansion of central bank balance sheets (figure 6b), whereby central banks use their money creation powers (increased liabilities on their balance sheets) to purchase financial assets (mainly sovereign debt but also corporate debt securities).[10]

In the case of the euro area, on foot of persistently low inflation and concerns regarding the effectiveness of standard monetary policy instruments in stabilising short-term economic developments (and, hence, in achieving price stability), the European Central Bank (ECB)[11] has been rapidly expanding its balance sheet from end-2014 (figure 7a). The expansion –

[10] There is even discussion about central banks in some jurisdictions purchasing equities.
[11] More specifically, the *Eurosystem* which encompasses the ECB and the 19 national central banks of the euro area Member States.

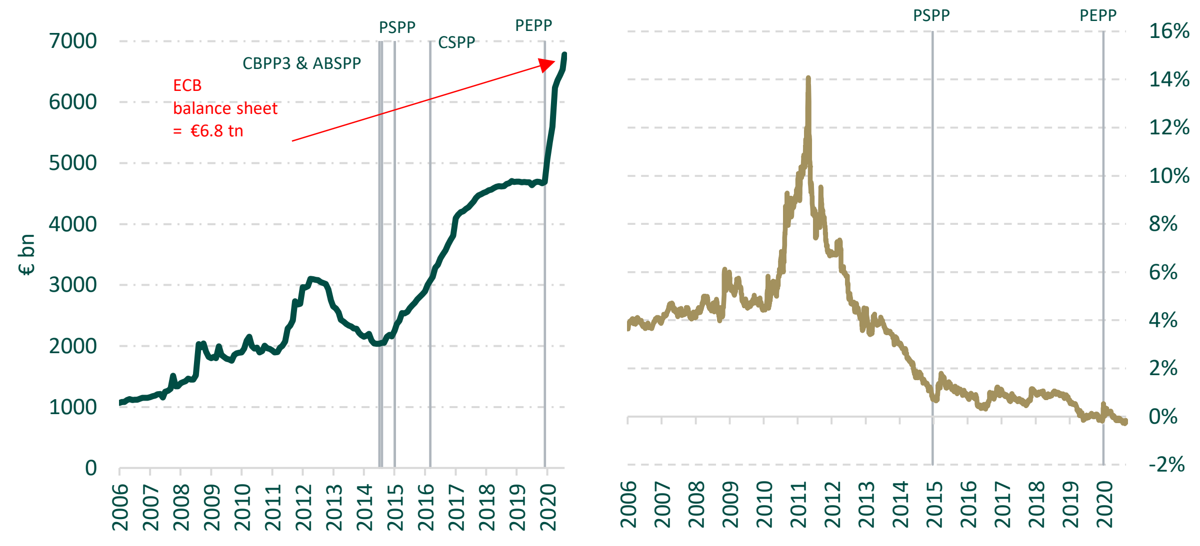
sometimes referred to as 'quantitative easing' – occurred through the purchase of bonds on secondary markets,[12] under a selection of asset purchase programmes, namely:

- Covered Bond Purchase Programmes (CBPP);
- Asset-backed Security Purchase Programme (ABSPP);
- Public Sector Purchase Programme (PSPP); and,
- Corporate Sector Purchase Programme (CSPP).

In response to the pandemic, further balance sheet expansion commenced in March through a new programme, the *Pandemic Emergency Purchase Programme* (PEPP). This involved an initial volume of €750 billion, and was subsequently increased by €600 billion in June of this year; at the time of writing, the PEPP provides for a €1,350 billion envelope over the period to (at least) June next year, covering purchases of both corporate and sovereign debt instruments.

The ECB's balance sheet has expanded to some €6.8 trillion (c.60 per cent of GDP) in the period from the commencement of PEPP. The main financial assets purchased through the PEPP are sovereign bonds. From an Irish perspective, some €8.1 billion in Irish sovereign debt instrument have been purchased to end-September, in addition to €36 billion already held under the PSPP to the same date. This means that the Central Bank of Ireland is the single largest holder of the Irish Government bonds, as is now also the case in many other euro area Member States. Indeed, around one-fifth of euro area sovereign debt is on the balance sheet of the *Eurosystem.*

Figure 7: a) ECB balance sheet, € billions**; b) Ireland 10yr yield,** per cent



Source: macrobond.

The upshot of these large-scale asset purchases is that sovereign borrowing costs – typically the benchmark for borrowing elsewhere in the economy – have remained at historically low levels, notwithstanding the substantial increase in supply of these debt instruments (the price of a debt instrument and its interest rate move in opposite directions). In this way, monetary

[12] Direct purchase of sovereign bonds in primary markets is illegal under the Treaty (on the Functioning of the European Union).

policy is playing a supportive role – in Ireland and in the rest of the euro area – so that the overall macroeconomic policy stance is strongly counter-cyclical.

Box 3: European centralised response to the Covid-19 crisis

While the focus has typically been on the policy response at a national level, several coordinated steps have been taken at a European level to help Member States to firstly, ensure their health systems are adequately funded and secondly, support the resumption of activities when safe to do so. In addition to these measures, the EU's State Aid rules have been temporarily amended so that governments can provide necessary supports without 'level playing field' concerns. The main support mechanisms at a centralised level are described below (the policy response in the monetary space is dealt with previously).

In March, the President of the European Commission announced the creation of the Coronavirus Response Investment Initiative which will advance €37 billion in funds to Member States from the European Structural and Investment Funds (ESIF). Also in March, the European Council agreed to the European Commission's proposal to activate the "general escape clause" of the Stability and Growth Pact (SGP). The activation of this clause temporarily suspends regular application of the EU fiscal rules and allows Member States to take all of the necessary expenditure and taxation measures in response to the pandemic.

A package of measures was agreed at the Eurogroup meeting in early April. This included a €25 billion pan-European guarantee fund proposed by the European Investment Bank (EIB) which will make up to €200 billion available to support companies impacted by the crisis in the EU. The European Stability Mechanism (ESM) has also tailored its Enhanced Conditions Credit Line (ECCL) to make a credit line of up to 2 per cent of a recipient's GDP available to euro area members. In addition, the European Commission created a new temporary instrument for Support to mitigate Unemployment Risks in an Emergency (SURE). This will provide assistance by lending up to €100 billion under favourable conditions to Member States to support temporary wage subsidy schemes.[13]

In July, EU leaders agreed to a new long-term budget for the EU with a total package of €1.824 trillion covering the period 2021 to 2027 focusing on investment in digital and green technologies. This includes the MFF at €1,074 billion and a new €750 billion recovery fund referred to as Next Generation EU. The latter is designed to tackle the Covid-19 pandemic and includes a €672.5 billion "Recovery and Resilience Facility" backed by loans of €360 billion and grants of €312.5 billion. There are six other additional programmes bringing the total funding to €750 billion. Funds will be directed towards Member States most affected by the pandemic with 70 per cent of the RRF grants to be allocated in 2021 and 2022. These amounts will be allocated by the European Commission according to set criteria – specifically around living standards and unemployment levels.

[13] To ensure a distribution of the funds, no more than €60 billion can go to any three Member States.

Micro-economic policies

For completeness, it is also worthwhile briefly touching on the supporting role of sector policies. Perhaps most important is labour market policy, where the centerpiece of the Government's response has been the TWSS.[14] The key objective of the scheme is to maintain the employee-employer link; in other words, to keep employees on the payroll and, hence, closer to the labour market than would be the case if they moved into unemployment.[15] In this way, Government is maximising the probability that employment levels return closer to pre-pandemic levels as soon as a vaccine or effective therapeutics are developed.

In terms of financial sector policy, the Central Bank has allowed banks to use some of the capital buffers they have built in recent years to support households and businesses. For example, the Bank released the Countercyclical Capital Buffer from 1 per cent to 0 per cent. It is estimated this will free approximately €940 million of capital across the Irish retail banks to facilitate lending or help banks absorb losses. Access to credit by SMEs is also supported by schemes such as the Covid-19 Working Capital Scheme, the Future Groups Loan Scheme and the Credit Guarantee Scheme (see table 4). Finally, the financial services sector also introduced measures such as payment breaks on mortgages, personal and business loans to assist existing borrowers affected by Covid.

[14] The TWSS was subsequently replaced by the *Employment Wage Subsidy Scheme*; while not identical twins, the two schemes are close, first cousins.

[15] See an overview of the economic rationale behind the EWSS, see box 1 of *July Stimulus Policy Initiative, Overview of economic support measures*, Department of Finance, available at: https://assets.gov.ie/81748/0f52c867-06a1-4bb1-b059-7c571ac2a1ee.pdf

Section 6: Conclusion

In common with elsewhere, the pandemic has inflicted a seismic shock on the Irish economy and, even when it has passed, will likely cast a shadow on economic developments for some time to come.

The Government has responded forcefully to limit viral transmission while, at the same time, stepping in to provide households and firms with a bridge through the pandemic; the scale of government intervention in the labour and capital markets would have been unthinkable even a year ago. These interventions prevented an even larger decline in activity, even higher rates of unemployment and even more rapid rate of firm-exit.

In doing so, Government has laid the foundations for a swifter recovery once effective treatments – including possible vaccination – are in place.

While fiscal policy has been centre-stage, monetary policy has played an important enabling role, by lowering borrowing costs and ensuring favourable financing conditions.

This comprehensive, and aggressive, fiscal policy response has prevented an even larger economic contraction, albeit at considerable cost. When the virus is effectively brought under control, there will be a need to pivot away from the blunt instruments towards more targeted intervention and, simultaneously, to put the debt-income ratio on a downward trajectory.

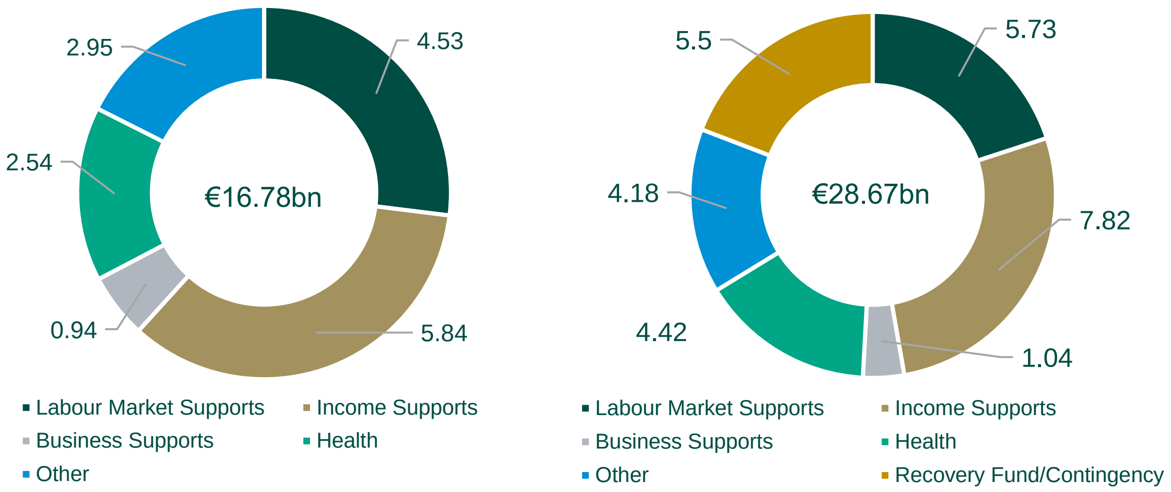
Even with effective viral control, it is clear that the pandemic has been an economic 'game-changer': permanent changes in the way goods and services are produced and traded appear inevitable. A non-exhaustive list includes:

- the possibility of a permanently larger state (which would have to be paid for);
- structural shifts in production structure (with some sectors permanently 'downsized');
- an acceleration of the trend towards e-commerce (more on-line at the expense of off-line);
- fundamental changes to working patterns; and,
- mis-match between the skills-set of workers and the needs of firms (at least in short-term).

The role for policy in these circumstances is to facilitate change rather than impede it: enabling the necessary reallocation of capital and labour from declining sectors to expanding ones.

Annex 1: Direct expenditure supports

Figure A1: Direct expenditure supports a) 2020; b) total, € billions



Source: Department of Finance, Department of Public Expenditure and Reform
Rounding may affect totals
The Recovery Fund can be used for either tax or expenditure measures

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