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ECONOMIC RECOVERY

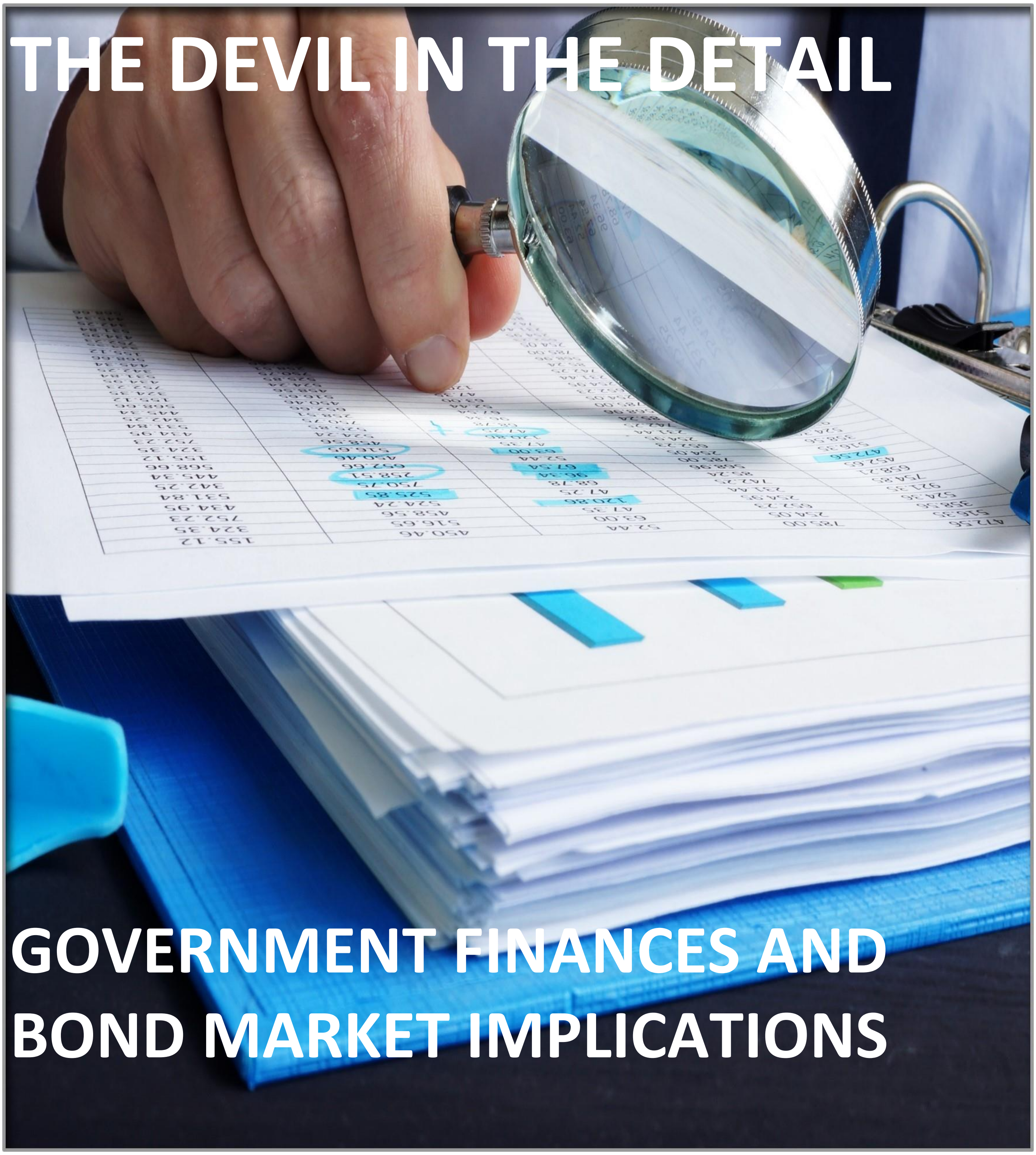
26th Feb – 4th March 2021

EXCHEQUER RETURNS: THE DEVIL IN THE DETAIL

RETAIL SALES COLLAPSE IN THE NEW YEAR

COVID-19 UPDATE

THE DEVIL IN THE DETAIL



GOVERNMENT FINANCES AND BOND MARKET IMPLICATIONS

Look closely. And carefully

Having tracked the state of government finances – and predicted with reasonable accuracy the current fiscal situation – our view is that it is better to wait and digest data before commenting. Haste is not speed.

This week's exchequer returns showing a dramatic fall in year-on-year revenue growth in February was accompanied also by Retail sales growth that confirm the picture of a dual economy as we reported last week: After a brief Christmas, the return of lockdown in January hit some sectors particularly severely and the sectors most affected are those closest to the relatively high employment domestic economy.

What is more the sectors where tax revenues appear to be holding up relatively well – income taxes for instance – are those dependent on the yawning exchequer deficit needed to sustain pandemic unemployment payments and wage subsidies. In summary the key reason that monthly exchequer returns are not significantly worse than they are – and they are already bad – is linked to a deteriorating government balance sheet. The lack of connection to date between the analysis of monthly performance on the tax side and the deteriorating debt position is worrying.

The key question is: When do deteriorating exchequer returns begin to affect government bond markets? For now, the tax decline in the year to February, just 9 per cent year on year, is manageable. But when the cumulative 12 month (to end February) tax decline of €14 billion is matched with a combined 20 per cent rise year on year in Total Gross Voted spending, it is hard not to see some bond market concerns arising by end year unless the trajectory improves. Then the core assumption underlying borrowing decisions could – as Paschal Donohoe warned this week – be undermined. As regards that €14 billion fall, by the way, our €11 billion forecast for the yearly revenue fall – laid out last April in *"An Economic Response to Covid-19"* – is closest to what has happened when lockdown is adjusted for.

Vaccine roll out cannot come soon enough. And while some tax increases may be needed to plug the unsustainable gap in public finances, it is hard to see how the expenditure side of the equation will not also be called upon to play a key role also. Comments that the state will inevitably get bigger have been heard. Equally there will be demands that the state become more efficient and more accountable to those whose taxes are about to rise.

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TAX RETURNS: THE DEVIL IN THE DETAIL

When looked at first, the overall fall in tax receipts in the first two months of 2021 does not look too bad: Given the year that's in it, a fall of 9 per cent in total taxation and a fall of 6.9 per cent in total taxes excluding corporation taxes suggests that, once lockdown is over, a return to revenues prevailing before the Covid-19 crisis looks possible.

On closer inspection, the trends are far more worrying. As pointed out in our briefing last week on Ireland's two economies, the external export oriented side of our economy is leading to the headline rate of Gross Domestic Product (GDP) actually *rising* last year by 3.4 per cent. This is reflected in the detail of exchequer returns which shows a strong increase in Customs Duties of 30 per cent in the first two months of 2021 compared to 2020.

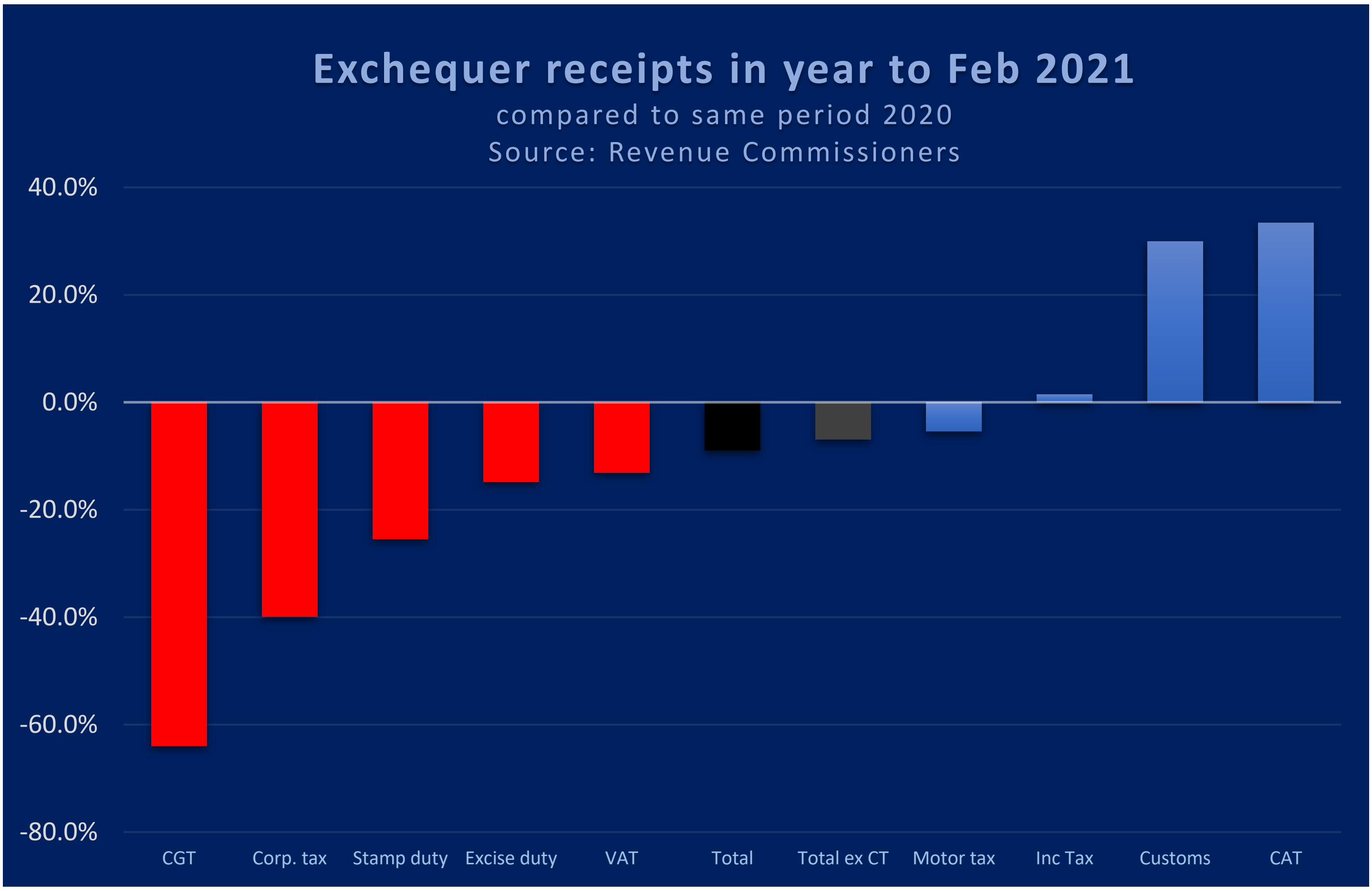
Capital Acquisitions Tax – a tax affected by the real estate and professional services side of our economy – showed even stronger growth at 33.4 per cent. But for indicators of the domestic economy – which drives over two thirds of tax receipts – the position is dramatic and negative: Corporation taxes fell in the period by 39.9 per cent, Stamp Duty by 25.4 per cent, Excise Duties fell by 14.8 per cent and VAT by 13.1 per cent. Falls in retail sales (see below) are further proof of divergence between our domestic and export economies.

Income taxes held up, even rising by 1.4 per cent in the year. But – mainly by the indirect effect of averting permanent lay-offs - this is being sustained by a level of borrowing that cannot continue much longer. With tax revenues down by €14 billion in the twelve months to February compared to a 2019 revenue tax of €59 billion the implied structural fall of almost one quarter in the revenue base cannot be sustained at a time when Total Gross Voted Spending is rising by 20 per cent without bond market implications ensuing.

At €225.8 billion as of end February 2021 (National Treasury Management Agency data), Ireland's Gross National Debt is heading to exceed a dangerous 120 per cent threshold of modified Gross National Income (GNI*) in 2021 (it had been already forecast in the Budget 2021 Economic and Fiscal Outlook to reach 114.7 per cent of GNI*). That threshold is one where debt dynamics and the state's repayment capacity becomes increasingly exposed to the rate of economic growth and also to political stability concerns.

But when could bond market tremors kick in? There are no signs of them thus far. But retail sales figures (see below) suggest these fiscal trends will be with us for at least a few more months. And if the roll out of vaccine is significantly delayed in to the summer and confidence in the capacity of the economy to re-open fully by autumn is undermined then neither the downward tax nor upward spending trajectories will be capable of correction without severe political implications. And falls in business confidence, investment and jobs.

It is hard to end on a positive note, but there is one worth emphasising: As a share of Gross Domestic Product (GDP) Ireland's Gross National Debt remains significantly lower than as a share of GNI*. The issue for Ireland is the relatively low tax yield from much multinational activity that makes up the difference between GDP and GNI*. As we called for in *"An Economic Response to Covid-19"* last April, a well organised and implemented strategy of multinational – SME collaboration can raise the employment and tax richness of this activity and make the lower GDP measure of our debt more appreciated by ratings agencies as a sign of our ability to come out of this crisis with a debt burden that is manageable. As a rake of electoral cycles approach from 2023 onwards, the ability of increasingly fragmented governments to service their debts could bring a lot of chicken's home to roost. Ireland's fiscal policy will need to start adjusting for that risk this year. The sooner, the better.



RETAIL SALES SHOW DIVIDED ECONOMY

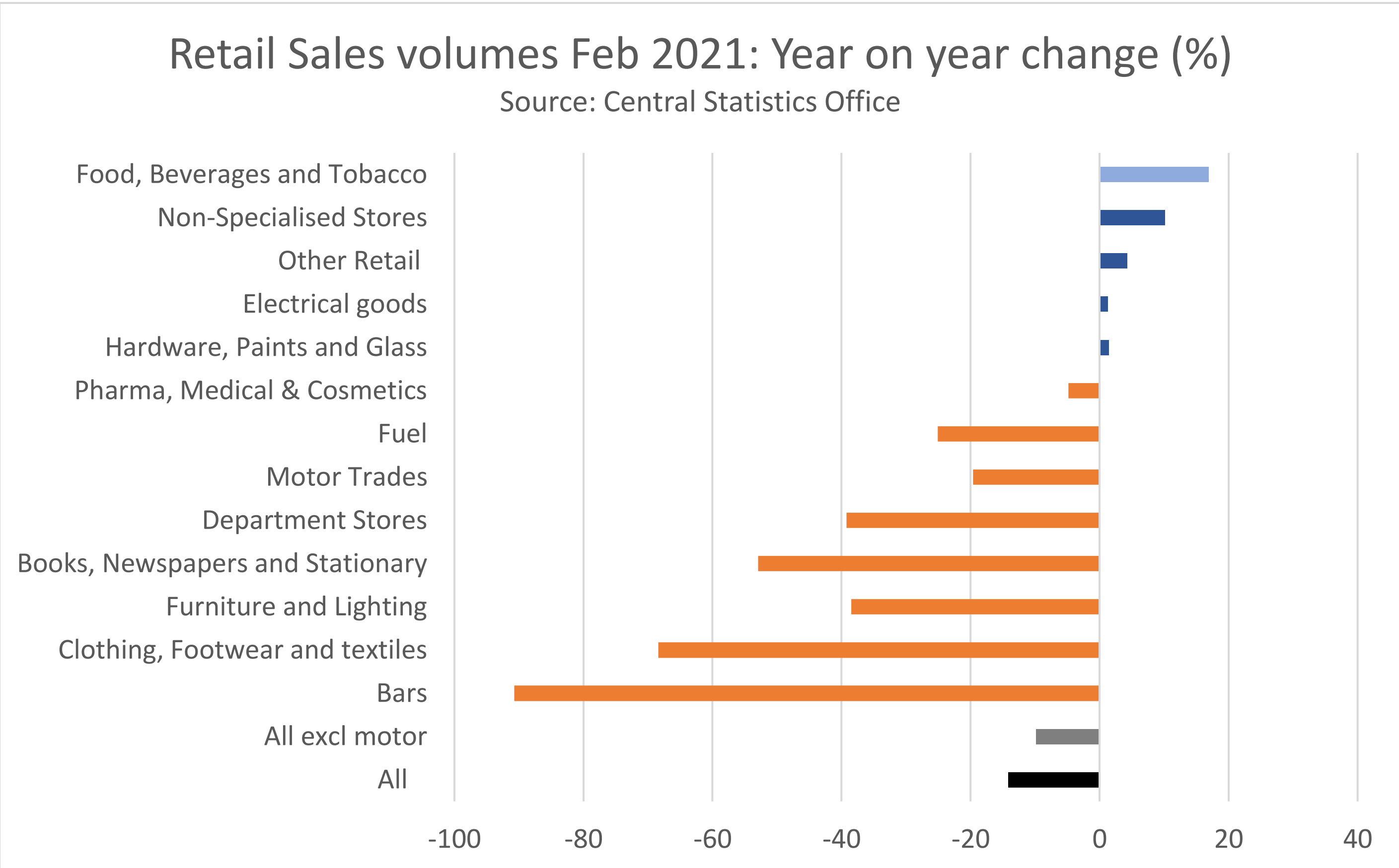
Overall, in February there was a 14.1 per cent decline in the volume (that is adjusting for price changes) of retail sales last month compared with a year earlier. Excluding more volatile motor sales, the figure was 9.8 per cent.

But in an echo of the analysis of tax receipts (see above) for the month, the stark contrast between growth in some sectors (16.9 per cent and 10.1 per cent growth in food related categories of Food, Beverages & Tobacco and Non-Specialised Stores, respectively) and, in other sectors, dramatic falls reflecting the impact of lockdown.

Firstly, and obviously the fall in the Bars sector where volumes were 90.7 per cent down, reflecting one of the most exposed sectors of the economy. Clothing Footwear and Textiles volumes fell by 68.4 per cent while Books, Newspapers and Stationery fell by 52.9 per cent.

The latter category is particularly interesting in that, like food retail outlets, newsagents are open. But unlike food – which is a necessity – more discretionary items of spending are collapsing. This tallies with the high savings rate we reported in last week's briefing. The 38.5 per cent fall in Furniture and Lighting is also noteworthy in that it reflects more long-term spending related to family formation and house purchase.

Overall, the retail sales performance re-enforces the analysis of our last weekly briefing and the foregoing analysis of tax returns: The longer these trends continue, the more likely they are to become embedded in our economy and harder to reverse.



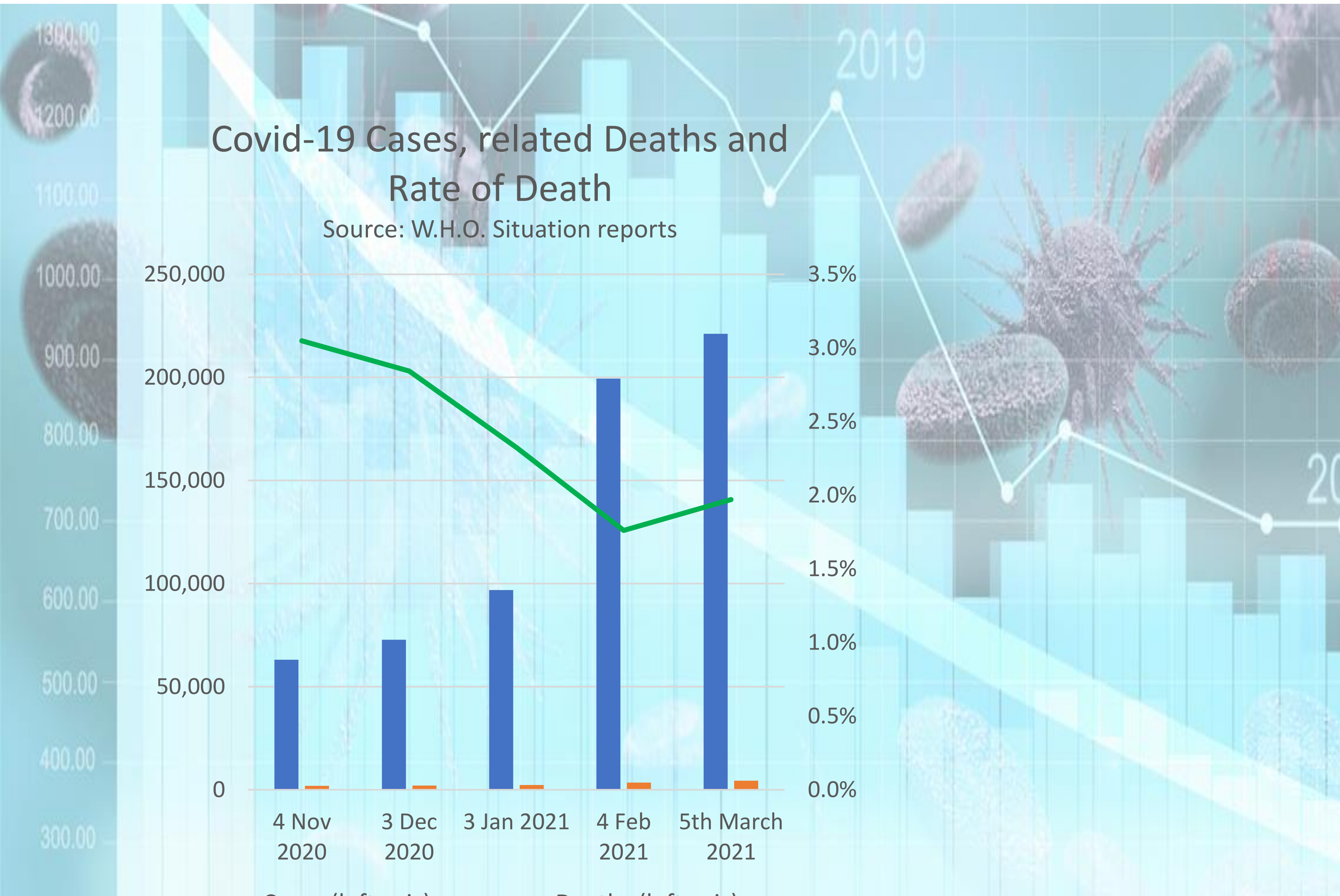
Covid-19 Update: Case growth slows dramatically but death rate edges up.

There was a cumulative total of 221,189 cases of Covid-19 recorded as of March 5th, according to the World Health Organisations latest "dashboard". Some 4,357 cumulative related deaths were recorded.

The rise in cases compared to 4 weeks previously – some 21,759 – was, while very significant, much lower than the rise of over 100,000 recorded in the prior 4 week period: In February it can be truly said that the pace of the virus growth was substantially slowed down.

Compared with a dramatic rise of over 1,200 in the preceding 4 week period, the rise of some 835 in related deaths the four to the 5th of March constituted some slowdown in the rate of increase.

However, compared to 1.8 per cent on 4th February, the rate of cases resulting in a Covid-19 related death rose by early March to 2.0 per cent. That rate remains significantly lower, however, than rates of 7 per cent or higher recorded in the early months of the virus during the March-May period last year.



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