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QB4 – October 2020

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Notes

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2. Unless otherwise stated, statistics refer to the State, i.e., Ireland exclusive of Northern Ireland.
3. In some cases, owing to the rounding of figures, components do not add to the totals shown.
4. The method of seasonal adjustment used in the Bank is that of the US Bureau of the Census X-12 variant.
5. Annual rates of change are annual extrapolations of specific period-to-period percentage changes.
6. The following symbols are used:

e	estimated
n.a.	not available
p	provisional
..	no figure to be expected
r	revised
-	nil or negligible
q	quarter
f	forecast
7. Data on euro exchange rates are available on our website at www.centralbank.ie.

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Comment

The COVID-19 pandemic and the necessary measures to contain the spread of the virus caused a sudden and unprecedented contraction in economic activity, both domestically and globally, during the second quarter of 2020. Similar to the pattern seen elsewhere, since the trough reached in the April-May period, Irish economic activity has rebounded somewhat with the re-opening of economy. However, the recovery has been partial and uneven and, in many cases, levels of domestic-focused economic activity remain well below pre-pandemic levels.

In overall terms, the evolution of domestic economic activity in recent months has been broadly consistent with the baseline scenario outlined in the previous Bulletin, with labour market developments marginally weaker than envisaged, while consumption and underlying domestic demand have performed slightly better.

Since the publication of the last Quarterly Bulletin, evidence from real-time data, and indicators such as retail sales, suggest that there has been a strong rebound in some elements of spending, but with continuing weakness still evident in other areas. In particular, consumer-facing services sectors, such as tourism, hospitality and retail services sectors, which are also more labour-intensive, have been slower to recover. Reflecting this, the pace of decline in the COVID-adjusted unemployment rate has become more gradual and there continues to be differences in labour market impact across sectors and regions, and also by age and gender. While the damage to household incomes has been mitigated by the provision of large-scale income supports, precautionary behaviour has intensified, evidenced most clearly by the sharp rise in household savings. How these savings are used will be important in shaping the recovery from the current downturn.

There has also been evidence of a strong divergence in performance between the resilience of exports and the weakness of domestic demand. In the case of exports, strong growth in pharmaceuticals and computer services exports (see Box C, page 31) masked the fact that most other exporting sectors saw sharp declines in the second quarter. The overall resilience of export growth has significantly mitigated the fall in GDP, which only fell by 3 per cent in the year to the second quarter, in contrast to underlying domestic demand, which fell by 16 per cent over the same period.

The outlook remains highly uncertain and will depend not only on the economic consequences of the COVID-19 pandemic and its containment, but also on the nature and impact of the future trading arrangements

between the EU and the UK, around which there still remains considerable uncertainty.

In relation to the impact of the pandemic, as has been noted in previous Bulletins, the path ahead for the economy will depend on the future path of the virus, the immediate and longer-lasting effects on behaviour and economic activity and the extent to which there is lasting damage to the productive capacity of the economy. In the latest forecasts, the baseline assumption with regard to COVID-19 is that there is only partial success in containing the virus over coming quarters, with, from time to time, some resurgence in infections necessitating some corresponding targeted stepping up of containment measures, though less so than in the initial wave. The type of additional restrictions imposed in a number of counties during August and September broadly fit with this assumption.

On the assumption that containment measures remain targeted and less severe than in the Spring, and that consumers and businesses continue to gradually adapt, the baseline forecast in response to the COVID-19 shock is for activity to continue to slowly recover from its earlier lows, though not necessarily without setbacks. A supportive policy environment and some improvement in prospects for the broader international economy also underpins this outlook. However, a slow unwinding of precautionary behaviour and the maintenance of some containment measures are expected to continue to constrain activity in some sectors. Contact-intensive sectors, which also tend to be labour-intensive sectors, are likely to be slowest to recover.

For 2020, on the basis of the National Accounts data for the first-half of this year and available higher frequency data for more recent months, the contraction in activity this year is now likely to be less than previously projected. The strong performance of exports, and a collapse in imports, is driving a significant upward revision to the baseline projection for GDP growth, which is now forecast to decline by only 0.4 per cent in 2020, an upward revision of 8.6 percentage points compared to the previous Bulletin. Revisions to the projections for 2020 on the domestic side of the economy have also been upward, but much smaller. Although consumer spending declined by 22 per cent in the second quarter, the combination of a somewhat smaller fall in consumption and a slightly stronger subsequent rebound than expected, is driving an upward revision of just over 2 per cent to the projection for underlying domestic demand for 2020, which is now forecast to fall by just over 7 per cent this year.

Looking beyond this year, the outlook for the economy also depends on the nature of the trading relationship between the EU and the UK after the Brexit transition period ends on 31 December 2020. The projections set

out in the previous Bulletin assumed that a Free Trade Agreement (FTA) between the EU and the UK, with no tariffs and quotas on goods, would take effect in January 2021. However, the situation in relation to future trading arrangements remains very uncertain. Therefore, in preparing these forecasts, it was considered prudent to make a change and assume that the EU and the UK move to trading on WTO terms from 1 January 2021 (see Box A, page 17). This would see the introduction of tariffs and non-tariff barriers with respect to goods trade with the UK. Such a development would have the effect of increasing costs, raising uncertainty and disrupting trade flows.

It is likely that the interaction of Brexit and COVID-19 will be different across sectors. With some vulnerable sectors (for example, tourism and accommodation and food services) already experiencing large demand shortfalls, it is possible that losses that would have been triggered by Brexit effects have been brought forward due to the impact of COVID-19. This may not be the case in other areas, with sectors, such as agri-food, more exposed to the larger negative shocks from Brexit.

In aggregate, a sudden and disruptive transition to a WTO trading relationship between the EU and the UK is projected to result in the front-loading of associated output and employment losses, subtracting around 2 percentage points from GDP growth in 2021 and a further 0.3 percentage points in 2022 relative to a scenario where trade takes place on an FTA basis. Under the above assumptions with respect to Brexit and COVID-19, GDP is projected to grow by 3.4 per cent in 2021, rising to 4.7 per cent in 2022. In contrast, more modest growth of 1.6 per cent in underlying domestic demand is projected for next year, rising to 4.8 per cent in 2022. On a COVID-adjusted basis, which includes those in receipt of the Pandemic Unemployment Payment, the unemployment rate is projected to average 15.1 per cent this year. With the planned ending of the income support schemes in 2021, the COVID-adjusted measure of unemployment and the traditional ILO measure will converge, with the unemployment rate projected to average 8 per cent next year and 7.5 per cent in 2022.

A more severe COVID-19 scenario, assuming a stronger resurgence of the virus and stronger containment measures than assumed in the baseline is examined in Box E, page 39. In this scenario, the downturn is more severe and the recovery delayed, with GDP declining both this year and next, before growth resumes in 2022.

Turning to the policy response, the unprecedented challenges posed by COVID-19 have been met by exceptional policy support aimed at safeguarding economic activity. The impact of the pandemic has been mitigated by a range of fiscal, monetary, macro-prudential and micro-

prudential policy actions to support vulnerable households and businesses and to minimise the potential that regulatory capital requirements act as a constraint on the provision of lending.

In terms of fiscal policy, the upcoming Budget provides a further opportunity to respond to the pandemic and chart the way ahead. There are three areas that deserve careful consideration.

First, policy should focus on supporting the productive capacity of the economy, mitigating scarring effects such as long term unemployment and reducing the risk that otherwise viable firms become insolvent. Given the sharp increase in the numbers out of work, labour market activation and training programmes can have a positive impact, as can bringing forward planned investment programmes where possible. It is also important to retain a long-term perspective when it comes to investment. The social return from high-quality public investment accrues over many decades and the improvements it brings are more likely to be felt gradually rather than instantaneously. This means maintaining a steady pace of public investment over time, in both good times and bad.

Second, the rise in the deficit and debt ratios has been both warranted and necessary but a path to lower and more sustainable levels will eventually have to be taken. Assuming that the supports introduced are temporary in nature, favourable growth dynamics in the coming years should support a decline in the public debt ratio. But the current high levels of public debt mean the economy is more vulnerable to future shocks with less room for manoeuvre if circumstances change. Once the outlook is clearer, the Government will need to provide a clear, credible and time-bound return to lower and more sustainable deficit and debt positions.

Third, there needs to be a continued focus on addressing longer-term challenges – such as the ageing of the population and its implications for the growth of the economy and the cost of pensions and healthcare – as well as building resilience to future shocks, including the need to make the transition to a low carbon economy. Policy should be framed to meet such challenges, as failing to address them would, ultimately, be more costly. Effective medium-term expenditure ceilings should be a key part of the fiscal architecture. This would allow for flexibility within a clear budgetary constraint and help to ensure that spending remains consistent with overall budgetary policy. This will become increasingly important as pressures from longer-term challenges intensify in the years ahead.

Ireland's ability to manage the immediate impact of the COVID-19 shock is partly a result of the policy actions taken over the last decade and there needs to be a continued focus on the longer term structural changes that would help to manage future challenges, both known and unknown. Given

the tremendous uncertainty ahead, policy will need to be flexible and ready to adapt as necessary.

The Domestic Economy

Overview

The outturn for the Irish economy in the first half of this year reflects a striking divergence between domestic demand and export performance.

While the COVID-19 pandemic and the measures to contain the spread of coronavirus has caused an unprecedented contraction in domestic demand, exports have proved remarkably resilient. The strong performance of exports, which are expected to decline by just 0.3 percent in 2020, is the main factor driving a significant upward revision in the baseline projection for GDP. GDP is now forecast to decline by 0.4 per cent this year, an upward revision of 8.6 percentage points compared to the last Bulletin.

The outlook for domestic demand has also been revised upwards for this year reflecting a more positive outlook for consumption and an enhanced level of fiscal support arising from the July stimulus package. Although consumer spending declined by 22.8 per cent year-on-year in the second quarter, this was somewhat less than expected. Evidence from high frequency indicators such as retail sales and car sales point to stronger recovery in activity as containment measures were relaxed in recent months. Underlying domestic demand is expected to decline by 7.1 per cent this year.

While prospects for growth in 2020 under the baseline scenario have improved, the outlook for growth next year and in 2022 has been revised downwards to account for the implications of a WTO Brexit. Baseline assumptions regarding the COVID-19 pandemic assume that there is moderate success in containing the virus, but that localised and sporadic restrictions are required into mid-2021. The additional restrictions imposed in certain counties during August and September are an example of this. On Brexit, the scenario now assumes that following the transition phase at the end of this year, the UK will exit the EU without a trade deal and will move to a trading relationship with the EU on WTO terms which, given the short time frame, could lead to severe short-term disruption to trade. As outlined in Box A in this Bulletin, a disruptive transition to a WTO trading relationship would frontload associated output and employment losses, subtracting about 2 percentage points from GDP growth in 2021 and a further 0.3 percentage points in 2022.

Accordingly, GDP growth, under the baseline scenario would recover to 3.4 per cent in 2021, increasing further to 4.7 per cent in 2022. Underlying domestic demand is projected to increase by 1.6 per cent next year and by 4.8 per cent in 2022. A lagged labour market response to the output

recovery would see unemployment increase initially from 5.3 per cent this year to 8 per cent in 2021 before declining to 7.5 per cent in 2022, a rate well above the pre-crisis level of about 5 per cent. On a COVID-adjusted basis, which includes all recipients of the Pandemic unemployment payment, unemployment is projected to average 15.1 per cent this year (see Box D).

While the baseline scenario represents our view of the most likely outlook for the economy, it is contingent on key assumptions on Brexit and COVID-19, which are subject to exceptional levels of uncertainty.

The possibility of a more severe COVID-19 scenario is considered in Box E below. This alternative scenario assumes only limited success in containing the virus, with a further wave or waves of the virus requiring more widespread and stricter lockdowns than assumed in the baseline. In this scenario, the recovery is curtailed with GDP declining both this year and next before a muted recovery in 2022. Regarding Brexit, the disruptive WTO assumption may prove to be too pessimistic and there remains the possibility of a limited Free Trade Agreement which would improve prospects for next year accordingly.

Figure 1: GDP and Underlying Demand Projections (Baseline and Severe)



Source: CBI Calculations

Table 1: Forecast Summary Table

	2019 ^e	2020 ^f	2021 ^f	2022 ^f
Underlying Domestic Demand	4.1	-7.1	1.6	4.8
Private Consumption	3.2	-7.6	1.9	5.3
Government Consumption	6.3	13.5	-3.5	1.8
Investment	74.8	-35.3	2.9	7.7
Exports	10.5	-0.3	0.5	3.1
Imports	32.4	-15.1	-1.7	3.5
GDP	5.6	-0.4	3.4	4.7
Employment	2.9	-4.1	-4.2	4.7
Unemployment Rate (% of Labour Force)	4.9	5.3	8.0	7.5
HICP Inflation	0.9	-0.6	0.2	1.4

Source: CBI Calculations.

Note: All Figures are percentage changes year-on-year unless otherwise specified

Recent developments

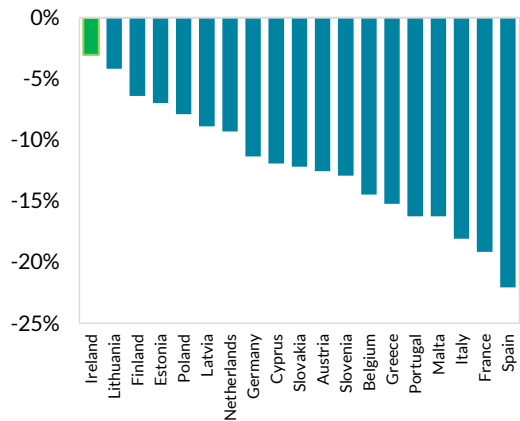
Since the publication of the last Quarterly Bulletin, data have shown the extent of the decline in economic activity during the second quarter.

Consumption fell sharply, as did underlying investment. Consumer-facing services sectors, in particular the hospitality and retail sectors have been worst affected. These sectors are labour-intensive, and job losses have been unprecedented. Exports held up in the second quarter, but strong growth in pharmaceuticals exports disguised the fact that most exporting sectors saw sharp declines between March and June. In recent weeks, some new localised restrictions have been introduced, again affecting the hospitality sector the most.

In the second quarter, GDP declined by 6.1 per cent quarter-on-quarter and 3 per cent year-on-year, with domestic demand falling sharply while international trade mostly held steady. As a result of the latter, Ireland experienced one of the smallest declines in GDP while, reflecting the former, saw one of the largest falls in consumption expenditure across Europe. Modified Final Domestic Demand fell by 16 per cent, driven by a 22.8 per cent decline in consumption and a 23.2 per cent contraction in modified investment. At the same time, government consumption rose by 7.5 per cent.

Figure 2: Ireland had the smallest GDP decline, but one of the largest consumption declines in the Eurozone

Real GDP (2019Q2 Annual Growth) – Eurozone Members



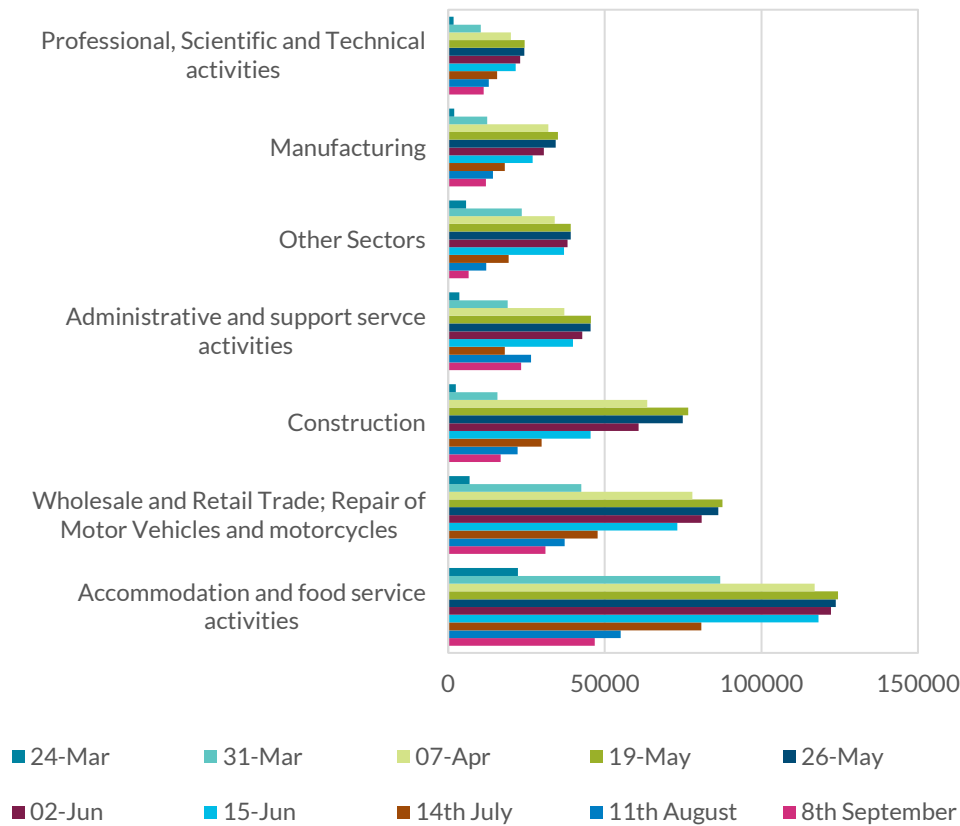
Final Consumption Expenditure (2019Q2 Annual Growth) – Eurozone Members



The impact of the downturn on the labour market has been unprecedented. In April, over 1.2 million people were receiving support via either the Pandemic Unemployment Payment, the Temporary Wage Subsidy Scheme, or the Live Register. The monthly COVID-19 adjusted unemployment rate, which includes all persons claiming benefits under these schemes, reached 29.1 per cent in April. The rate has fallen significantly since then, and stood at 15.4 per cent in August. The youth unemployment rate (15-24) increased to just under 20 per cent on a standard ILO basis in August, compared with 12.4 per cent in August 2019. On a COVID-adjusted basis (including all recipients of the PUP), youth unemployment has increased to 37.8 per cent.

Job losses have been slow to recover in some sectors (Figure 3). The construction and manufacturing sectors have seen a combined 80 per cent decline in the number of PUP claims compared with mid-May. Accommodation and food services has declined more slowly, with 63 per cent now having closed their claim. The rate of decline in this sector has also slowed in recent weeks, and 46,750 people, approximately a quarter of those who worked in the sector prior to the pandemic, remain in receipt of the payment. The retail sector has also been badly affected, 31,000 people who previously worked in that sector are still in receipt of the PUP, approximately a tenth of that sector's total employment in the fourth quarter of 2019.

Figure 3: Job losses in the accommodation, food services and retail sectors have been slower to recover

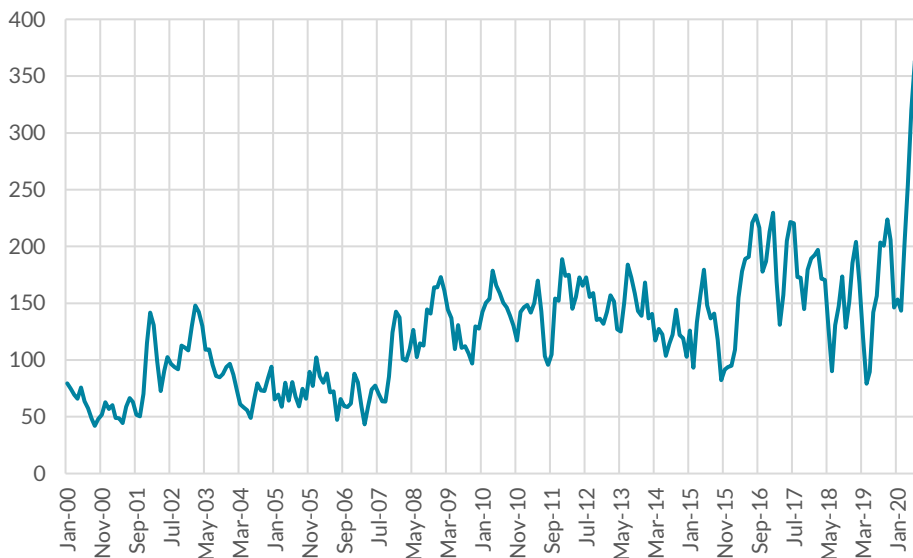


Source: Department of Employment Affairs and Social Protection and CBI calculations.

Note: Each bar represents the number of PUP recipients (by sector) at the end of the relevant week.

Consumption in some sectors has recovered strongly, but for many sectors it remains substantially lower than a year ago. Retail sales data show that consumption has recovered in the third quarter. Card payments data from July suggests that spending on groceries and electrical goods has increased year-on-year, whereas spending on transport, accommodation and entertainment remain well below 2019 levels. Two factors are driving these developments, firstly, a reallocation of spending by consumers as a result of public health restrictions - for example, consumers switching away from restaurant spending and towards groceries. Secondly, uncertainty shocks tend to dampen household spending, particularly consumer durables. By several measures, economic uncertainty has been at its highest level ever recorded during this pandemic (Figure 4).

Figure 4: Economic Policy Uncertainty has reached historically high levels

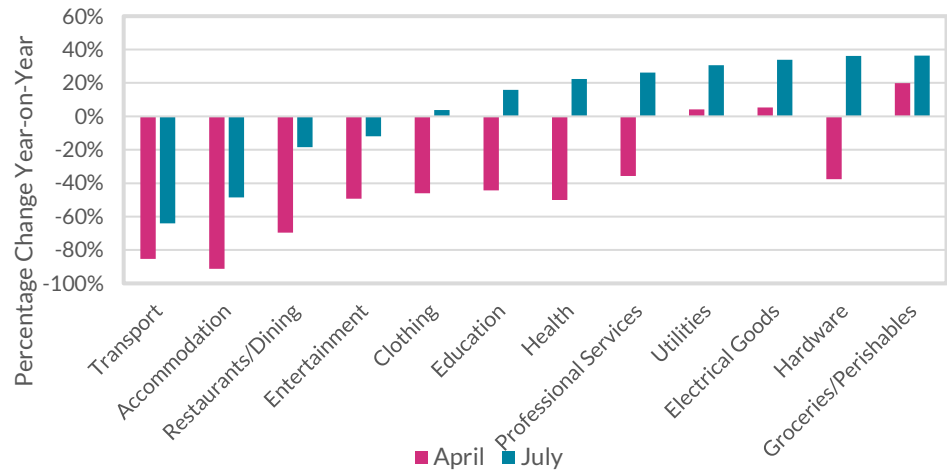


Source: www.policyuncertainty.com

Note: Index by Zalla. Details published in Zalla, R. (2017). Economic policy uncertainty in Ireland. *Atlantic Economic Journal*, 45(2), 269-271.

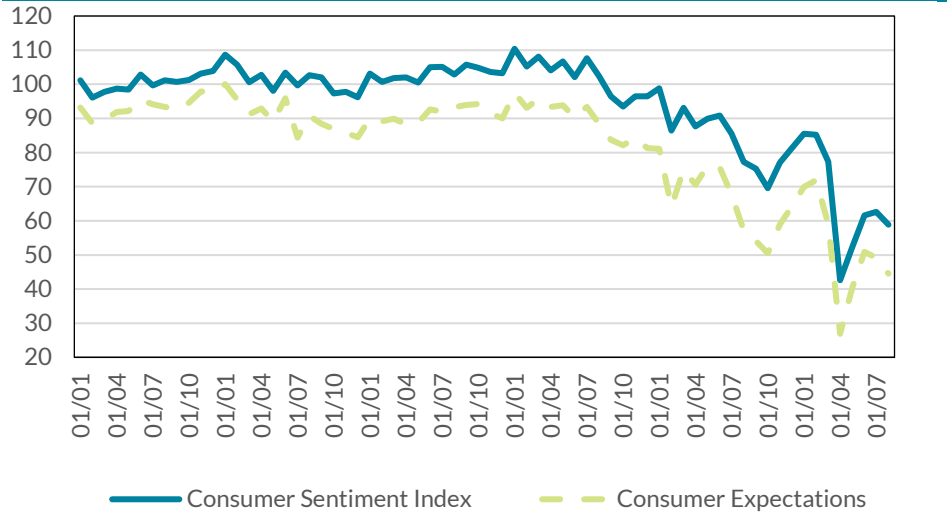
A continuing increase in household savings points towards subdued spending in aggregate terms (see Box G). Household deposits increased by €7.3 billion in the period from April to July, compared with approximately €2bn during the same period in 2019 and €1.2 billion during that period in 2018. A cautious view among households about the state of the economy is reflected in the consumer sentiment index, which remains significantly lower than at the start of the year despite a modest recovery (Figure 3).

Figure 5: Spending in some sectors has recovered, but in face-to-face sectors it remains sharply down



Source: Central Bank of Ireland Credit and Debit Card Statistics
 Note: Values are the sum of credit and debit card payments

Figure 6: Consumer sentiment remains subdued

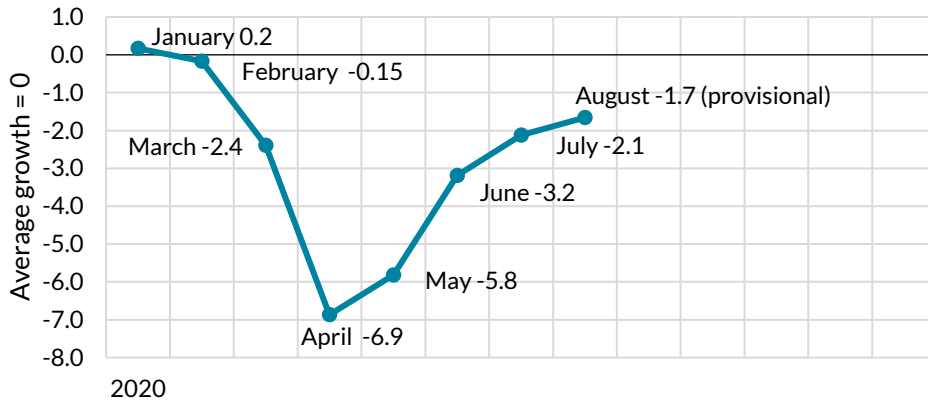


Source: KBC Bank Ireland

The Central Bank’s Business Cycle Indicator (BCI) provides a timely picture of overall domestic economic activity. In response to the outbreak of COVID-19 in Ireland, and the subsequent public health restrictions, the BCI fell sharply during the months of March and April reaching a historical low. This large decline in the BCI (see Figure 7) shows that there was a sharp and deep contraction in domestic activity during these two months. In May and June, the BCI began to recover and this reflects the pickup in domestic activity that occurred as the economy gradually re-opened following a period of lockdown. The latest estimates of the BCI shows that economic conditions continued to improve into July and August, but the rate of recovery has slowed down. Despite the improvement over the four

months to August, the overall level of the BCI remains substantially below that observed prior to the emergence of the COVID-19 crisis.

Figure 7: Business Cycle Indicator (BCI) for Ireland's Economy



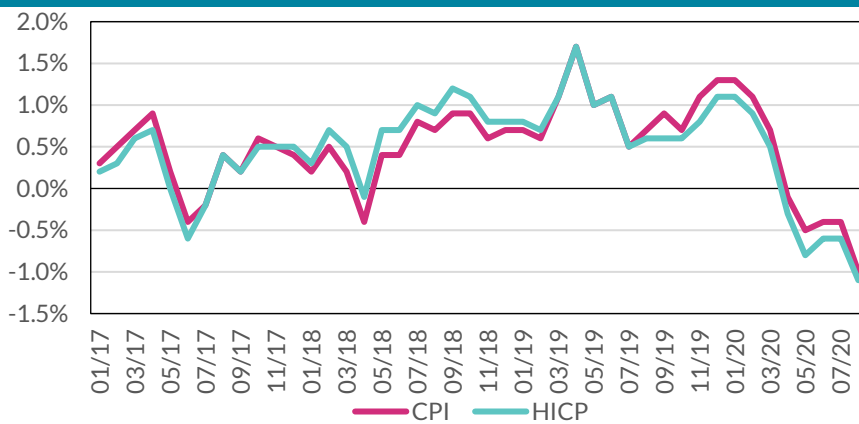
Source: Conefrey and Walsh (2020).

Notes: The BCI is based on data available up to 29 September. The August estimate is provisional as industrial production data is not yet available.

Inflation turned negative in April and fell to -1.1 per cent in August.

Energy prices fell sharply following worldwide lockdowns, and weaknesses in consumer demand caused price declines in several other sectors of the economy. The annual rate of change in the Harmonised Index of Consumer Prices (HICP) was 1.1 per cent as recently as January, but fell to -1.1 per cent in August. On a year-on-year basis, prices in August as measured by the HICP had fallen the most for *Communications* (-8.3 per cent), *Transport* (-4.8 per cent), and *Clothing and Footwear* (-3.1 per cent), with *Education* (+4.0 per cent) and *Health* (+4.2 per cent) registering the steepest increases.

Figure 8: Consumer prices (year-on-year changes)



Source: CSO

Box A: Risks Facing the Irish Economy at the End of the Brexit Transition Period

By Stephen Byrne, Thomas Conefrey, Niall McInerney, and Graeme Walsh¹

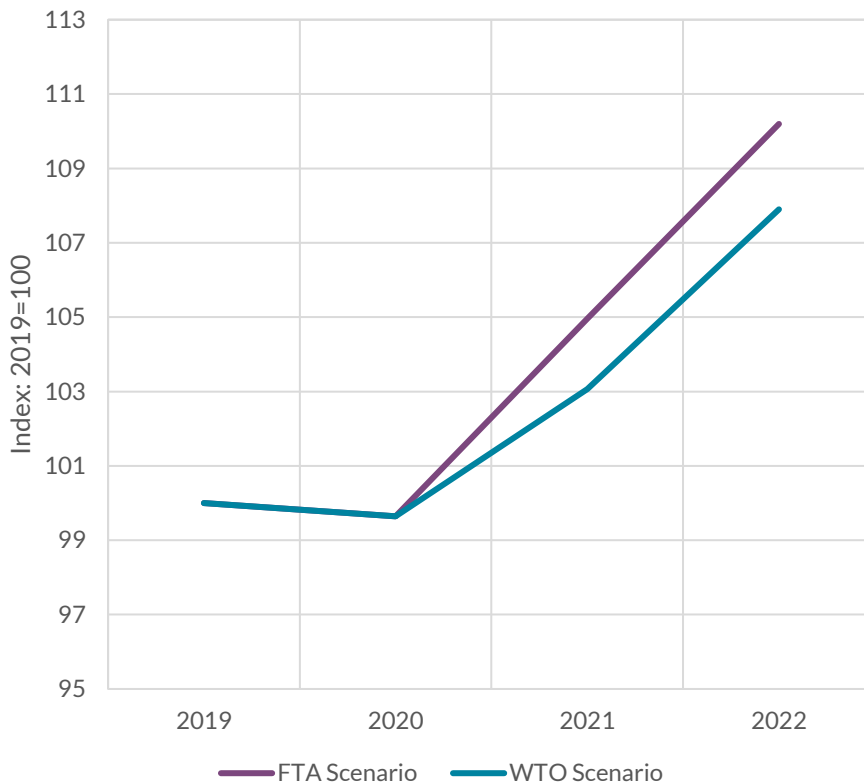
When the transition period ends on 31 December 2020, EU-UK trade will face new frictions, irrespective of whether a trade deal is reached. This Box outlines some of the risks to the Irish economy from the change in EU-UK trading arrangements that will occur on 1 January. Aside from the imposition of tariffs which would occur in a WTO outcome, other non-tariff restrictions will make trading with the UK more difficult for Irish businesses and these frictions will arise even if a free trade deal is agreed.

The projections in this *Quarterly Bulletin* are based on the assumption that the EU and UK move to trading on WTO terms from 1 January 2021. In overall terms, our model-based estimates – embedded in our projections – suggest that moving to WTO terms could reduce the growth rate of the Irish economy by around 2 percentage points in 2021, relative to a scenario where a Free Trade Agreement was concluded (Figure 1).² It is important to note that there is considerable uncertainty around aggregate estimates of the impact on the economy of a WTO or FTA outcome given the unprecedented change in trading arrangements that will take place from January 2021. Regardless of whether a FTA is reached before December, from January the UK will no longer apply the rules of the European Union, the Single Market or the Customs Union which will unavoidably lead to new trade frictions. In this Box we provide a brief outline of some of the particular challenges that will arise for importers and exporters under a WTO or FTA arrangement.

¹ The authors would like to thank Gina Fitzgerald and Cian Murphy (Central Bank) for helpful comments on this box.

² See Conefrey, T. and G. Walsh. 2020. "Implications of Potential EU-UK Trade Arrangements at the End of the Brexit Transition Period." Quarterly Bulletin 3 Box D. Available at: <https://www.centralbank.ie/docs/default-source/publications/quarterly-bulletins/boxes/qb3-2020/box-d-implications-of-potential-eu-uk-trade-arrangements-at-the-end-of-brexit-transition-period.pdf>

Figure 1: GDP in a disruptive WTO scenario and Free Trade Agreement scenario (2019=100)



Source: CBI Calculations.

Trading on WTO Terms

If the UK and EU do not agree a new trade deal, then trade would revert to rules governed by WTO terms. A free trade agreement represents one of the only exemptions to the WTO's "Most Favoured Nation" (MFN) clause.³ MFN means that every time a country lowers a trade barrier or opens up a market, it must do so for the same goods or services from all its trading partners. Accordingly, imported British goods would be charged tariffs according to the EU's Most Favoured Nation (MFN) terms and vice versa. In the case of cars, for example, there would be a 10 per cent tariff on imports into the EU. The UK set out its proposed tariff schedule to the WTO in 2018. In May 2020, it announced a new "UK global tariff" that eliminates a number of low tariffs, but leaves others in place on goods such as cars and ceramics and on many agricultural goods.⁴ These tariffs would apply to UK imports from the EU on 1 January 2021 in the event of no trade deal. Higher tariffs typically apply to agri-food products with lower tariffs on manufactured goods. The aim

³ The description of the MFN principle is the first article of the 1947 General Agreement on Tariffs and Trade (GATT).

⁴ See <https://www.gov.uk/check-tariffs-1-january-2021>

of the tariffs is to protect the UK industry in these goods from cheaper imports.

Although the share of Irish goods exports to the UK has declined over time and currently stands at around 10 per cent, the agri-food sector is still heavily reliant on the UK market. In 2019, around 38 per cent of agri-food exports went to the UK. Sectors such as beef depend even more on the UK market. Estimates suggest that applying the UK's global tariff schedule to Irish exports to Great Britain would result in a tariff cost of between €1.35 to €1.5 billion.⁵ The imposition of tariffs of this magnitude would substantially reduce, or possibly eliminate, Ireland-UK trade in some products. Lawless and Daly (2020) estimate that Irish exports to the UK of food products, beverages and tobacco could be reduced by 75 per cent, assuming tariffs were fully passed through to the price of products.⁶ The imposition of the full range of UK tariffs across all product categories could lower overall Irish exports by around 4 per cent.

Free Trade Agreement

If a FTA is successfully concluded before the end of 2020, it should allow for tariff- and quota-free trade in goods. In this regard a FTA is an improvement relative to trading under WTO terms. While an FTA would eliminate tariffs, firms engaged in EU-UK trade would still face an extensive range of other new frictions – known as non-tariff barriers (NTBs) – than under current arrangements. These NTBs would apply in addition to tariffs in a WTO outcome and would affect both importing and exporting. Non-tariff barriers can increase the cost of doing business. NTBs may be quite specific – such as adherence to individual product standards – or more general, such as more stringent customs and documentary related procedures.

Because the UK would no longer be part of the EU customs union, exporters would need to provide proof that their products meet the “rules of origin” criteria of the EU-UK FTA. Compliance with such rules comes with complications, paperwork and cost.⁷ Businesses trading between the EU and UK will be required to manage new import and export formalities, including customs and security declarations, risk-based inspections and the payment of tariffs (for any goods not covered

⁵ See <https://www.gov.ie/en/publication/849b3-the-brexite-readiness-action-plan/>

⁶ See Daly, L. and M. Lawless. 2020. “Examination of the sectoral overlap of COVID-19 and Brexit shocks.” ESRI Working Paper no. 677. Available at: https://www.esri.ie/system/files/publications/WP677_0.pdf

⁷ See Lowe, S. 2019. “What a Boris Johnson EU-UK Free Trade Agreement means for Business.” Centre for European Reform Insight. Available at: https://www.cer.eu/sites/default/files/insight_SL_5.11.19_2.pdf

by the FTA) and other taxes payable on import such as VAT and excise duty. Unless the UK agrees to adhere fully to the EU's sanitary and phytosanitary regime (for food and plant hygiene), trade in agri-food products will require export health certificates and there will be a need for veterinary border inspections.

Outside of the customs union, British importers will be exempt from adherence to EU regulatory standards on goods imports from non-EU countries. This could harm the competitiveness of exporters selling EU-compliant goods into the UK market. Second, delays associated with increased customs handling times and documentary compliance requirements will increase costs for Irish exporters. While the extent of checks at the UK border is not yet clear, the EU Union Customs Code sets out procedures required for EU exporters when exporting to a third country.⁸ These procedures include declarations at point of export, outward customs arrival, outward clearance, import, inward customs arrival, and where goods consignments must be held in temporary storage. In addition, goods are required to pass UK customs inspection procedures and are likely to be subject to longer handling delays due to the increase in the volume of imports subject to such procedures.

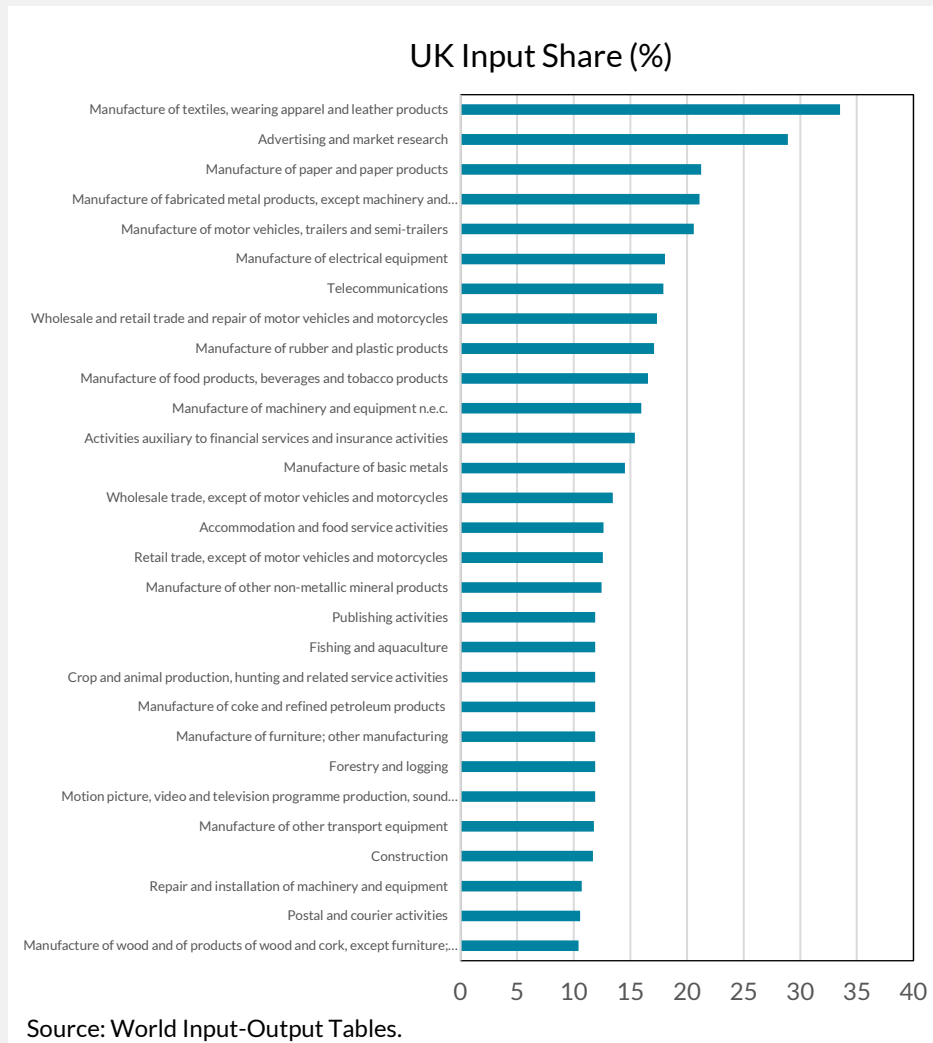
The new non-tariff restrictions will also affect imports. In 2019, Ireland imported over €20 billion of goods from the UK, accounting for 22 per cent of the value of all goods imports. New customs procedures and delays could prove disruptive for Irish firms with supply chain linkages with the UK. Figure 2 shows the share of Irish firms' imported intermediate inputs by sector which originate in the UK as a proportion of overall imported intermediates. It shows the top 30 sectors with a UK input share of over 10 per cent. Intermediate inputs are goods or services used by a firm to produce their final output. The sector *manufacture of textiles* and *advertising and market research* sectors have the highest reliance on the UK for imported intermediates. Other sectors with a high share of imported intermediate inputs from the UK include the wholesale and retail sector and some traditional manufacturing sectors. These sectors are likely to face additional costs and delays associated with sourcing imported intermediate inputs from the UK. For firms in these sectors who use UK imports to produce other goods and services for export, higher costs could affect their international competitiveness. There could also be implications for Irish consumers if higher import costs increase the price of certain consumer goods.⁹ The availability of

⁸ Regulation (EU) No 952/2013 of the European Parliament.

⁹ See Horan, D., McQuade, P. and J. Scally. 2019. "Grocery Prices in Ireland after Brexit." Central Bank Quarterly Bulletin No. 4 2019. Available at:

some goods and services could also be impacted if non-tariff barriers were to severely disrupt supply chains.

Figure 2: Proportion of overall imported intermediate inputs from the UK by sector, top 30 sectors



In relation to services trade, in 2018 Ireland’s services exports to the UK amounted to €28.3 billion or 15.7 per cent of overall services exports, with varying degrees of exposure by sector. 37 per cent of financial services exports went to the UK, with 26 per cent of insurance services and 20 per cent of tourism and travel exports. 9.6 per cent (€17.8 billion) of Ireland’s services imports came from the UK in 2018. Financial services, business services and insurance accounted for the majority of

imports. The UK currently benefits from the ability to passport into the EU single market but will lose this access from 1 January 2021.¹⁰

Although the UK has established a temporary permissions regime enabling certain EEA firms and funds operating in the UK via a passport to continue their activities in the UK for a limited period after the end of the transition period, and the EU has announced a time-limited equivalence decision¹¹ for UK-based central counterparties (CCPs) to continue to operate in the EU until the middle of 2022, in the longer term the loss of passporting rights is likely to have negative implications for Ireland-UK trade in financial services.

The future trading relationship between the UK and the EU in relation to financial services will depend, in part, on the approach taken to granting UK-based firms access to the EU Single Market via equivalence decisions; but also on various EU initiatives to enhance the capacity and functioning of the EU financial sector, for instance the recently-published Capital Markets Union Action Plan from the EU Commission.¹² The level of disruption to cross-border financial services will also depend on the future level of regulatory alignment between the EU and UK frameworks.

More broadly, the EU's regime for the free movement of services is much more comprehensive than would exist under a FTA or WTO regime. In the EU, there is an extensive programme of mutual recognition of qualifications making it much easier to provide different types of services across borders. If EU and UK regulations diverge over time, this could create new regulatory barriers to services trade. In addition, recent research has demonstrated important interlinkages between goods and services trade whereby large amounts of services trade is generated by the activities of firms in the manufacturing sector who export goods.¹³ This bundling of goods and services trade in Global Value Chains (GVCs) could amplify the overall economic impact of any new disruption to goods trade after the end of the transition period.

The negative effects on Ireland-UK trade through the channels discussed above could be mitigated if Brexit results in an increase in FDI inflows into Ireland. This could materialise either from the diversion of some existing UK FDI to Ireland or by attracting new FDI to Ireland that would otherwise have been destined for the UK. Since 2016, there has been

¹⁰ Passporting allows financial services firms, authorised to undertake activity by the regulatory body of one EU member state, to conduct the same business throughout the European Economic Area (EEA) without requiring further authorisation.

¹¹ See: https://ec.europa.eu/commission/presscorner/detail/en/ip_20_1713

¹² See: https://ec.europa.eu/commission/presscorner/detail/en/IP_20_1677

¹³ See <https://blogs.sussex.ac.uk/uktpo/2020/06/11/foreign-investment-as-a-stepping-stone-for-services-trade/>

some relocation of activities from London to Dublin in the financial services sector.

Landbridge

The UK landbridge describes the route that connects Irish importers and exporters to the EU single market and wider international markets using the UK's road and port networks. According to the Irish Marine Development Office (IMDO, 2018), around 38 per cent of unitised Irish exports to EU continental ports transit via the UK landbridge. It is particularly important for importing and exporting bulkier goods, as well as perishable agri-food products. The landbridge provides a significantly faster route for transporting these goods to the continent compared to alternative options. The IMDO estimate that the landbridge route through Dublin and Calais takes approximately 20 hours, when time in port is included. Comparable direct Roll-on Roll-off services can take up to 40 hours.

The UK's decision to remain in the Common Transit Convention (CTC) at the end of the transition period means that it will still be possible to import and export goods via the landbridge; however, such movements will be subject to new checks and potential delays. The CTC allows EU goods to move under transit through the UK without undergoing full customs import and export formalities on entry and exit. To avail of the CTC, hauliers will be required to provide a financial guarantee to cover any potential VAT and customs duties and new paperwork will have to be completed.

A further concern relates to the risk of delays for Irish hauliers transporting goods through UK ports. From January 2021, British freight will be third country freight – subject to customs and regulatory controls at European ports. Unless the infrastructure at EU and British ports (for example, Dover) is capable of differentiating British and Irish freight, then Irish goods transiting through the UK en route to other EU countries could be affected by bottlenecks at UK ports as new customs and border controls are carried out on UK goods. UK customs and logistics associations have recently stated that the IT and other infrastructure that will be required to process new customs and border checks from 1 January 2021 is not yet fully operational.¹⁴

Conclusion

The projections in this *Bulletin* assume that the UK moves to trading on WTO terms from 1 January. Model-based estimates of the potential impact of a *disruptive WTO* scenario contained in the Bank's July Quarterly

¹⁴ See: <https://www.ft.com/content/49af99f3-4669-4654-a444-4e5e9635791c>

Bulletin are used to inform these projections. If a FTA deal can be reached, growth in 2021 and 2022 would be higher than in the baseline forecasts.

The *disruptive* WTO scenario underpinning the *baseline* projections assumes that the move to WTO terms in January 2021 leads to an increase in uncertainty and additional up-front disruption to trade flows. This Box has described some of the channels through which these effects could occur. Since the UK is the first country to leave the EU, there is a large degree of uncertainty as to the likely impact on the economy and the model estimates used in the projections capture only some of the effects. What is evident from the analysis in this Box is that – regardless of whether the outcome in January 2021 involves moving to a basic FTA or WTO terms – there is a risk of significant disruption to economic activity from 1 January 2021, particularly for firms and sectors with high exposure to the UK. To help minimise the short-term economic losses, it is important for firms (importers and exporters) and public authorities to use the time remaining to prepare for the changes in the EU-UK economic relationship that will apply from the end of the year. In the long run, it is possible that the economy will adjust to the new economic relationship between the EU and the UK but the short-run difficulties are likely to be immense.

Macroeconomic Projections

Box B: The International Outlook

By *Monetary Policy Division*

Global economic activity has shown signs of recovery following the easing of measures to contain the COVID-19 pandemic, after collapsing in the first half of the year. However, the pace of recovery has lost momentum over the summer, and the risk that a second wave of infections will force governments to re-impose containment measures is on the rise, negatively affecting confidence. In June, the IMF projected that the global economy will contract by 4.9 percent in 2020, 1.9 percent below April's projection, before expanding by 5.4 percent in 2021. At the same time, the IMF remarked that the degree of uncertainty surrounding baseline projections is much higher than usual.

During the second quarter of 2020, marked by COVID-19 containment measures in most member states, euro area GDP decreased by 11.8 percent on a quarterly basis (down from a 3.7 percent contraction in the previous quarter) and decreased by 14.7 percent on an annual basis. The

number of employed persons in the euro area decreased by 2.9 percent compared with the previous quarter (following a 0.3 percent decrease in the previous quarter). Both GDP and employment registered the sharpest declines observed since the time series started in 1995. In September, the ECB revised upward its projections for the euro area GDP growth in 2020, now expected to decrease by 8.0 percent, up from an 8.7 percent contraction projected in June. GDP is then expected to increase by 5.0 percent in 2021 and 3.2 percent in 2022. However, if a more adverse scenario of the pandemic materialises,¹⁵ the ECB estimates that GDP could decrease by 10.0 percent in 2020, before increasing by only 0.5 percent in 2021 and 3.5 percent in 2022.

Sentiment indicators signal that the recovery of the euro area economic activity has lost momentum in September. After rebounding sharply in July and, to a lesser extent, in August, the Markit Eurozone Composite PMI fell to 50.1 in September (flash estimate, down from 51.9 in August). The reading indicated a near stalling of the economy at the end of the third quarter as rising infection rates and ongoing social distancing measures curbed demand, notably for consumer-facing services. A renewed downturn in the service sector offset faster growth in manufacturing.

Euro area annual HICP was -0.2 percent in August, down from 0.4 percent in July. While negative headline inflation was mainly due to decreasing energy prices (-7.8 percent on annual basis), underlying inflation was subdued, with HICP inflation excluding energy and unprocessed food increasing by only 0.6 percent (down from 1.3 percent in July). August figures, however, were affected by negative base effects due to sales periods falling in August instead of July in a number of member countries. ECB projections for the euro area inflation remained broadly unchanged in September. The ECB foresees annual HICP inflation of 0.3 percent in 2020, 1.0 percent in 2021 (up from a 0.8 percent forecast in June) and 1.3 percent in 2022. However, if a more adverse scenario of the COVID-19 pandemic materialises, the ECB estimates that HICP inflation could be lower – namely, 0.3 percent in 2020, and 0.7 percent in 2021 and in 2022.

At its September meeting, the Governing Council (GC) of the ECB confirmed its forward guidance on the key ECB interest rates, as well as its commitments in terms of net purchases and reinvestment under the

¹⁵ The severe scenario is based on the assumption that a strong resurgence of the pandemic leads governments to restore stringent containment measures, which would significantly dampen activity across sectors of the economy until a medical solution becomes available.

APP and the PEPP programmes. With respect to the latter, the GC confirmed that the PEPP will have a total envelope of €1,350 billion by end of June 2021, and maturing principal payments will be reinvested until at least the end of 2022. Purchases will continue to be conducted in a flexible manner over time, across asset classes and among jurisdictions, so as to stave off risks to the smooth transmission of monetary policy throughout the euro area.

Turning to the United States, GDP decreased by 9.1 on a quarterly basis during the second quarter of 2020 (after decreasing by 1.3 percent in the first quarter). In August, the unemployment rate declined by 1.8 percentage points to 8.4 percent. Unemployment has declined for four consecutive months, reflecting the continued resumption of economic activity that had been curtailed due to the pandemic and efforts to contain it, but is still 4.9 percentage points higher than in February.

On 27 August, the FOMC announced the completion of its strategy review, with the adoption of a strategy that seeks to achieve inflation that averages 2 percent over time. At its September meeting, the Federal Open Market Committee (FOMC) of the US Federal Reserve maintained the target range for the federal funds rate at 0 to 0.25%. As inflation is running persistently below the FOMC's longer-run goal, rates will remain unchanged until inflation will be moderately above 2 percent for some time so that inflation averages 2 percent over time, and longer-term inflation expectations remain well anchored at 2 percent.

In the United Kingdom, the impact on economic activity of the COVID-19 pandemic and related containment measures has been particularly severe in the second quarter of 2020, with GDP decreasing by 20.4 percent on a quarterly basis and by 21.7 percent on an annual basis. At its August meeting, the Bank of England maintained the Bank Rate at 0.1 percent and confirmed the continuation of its quantitative easing programme, with the target for the total stock of asset purchases unchanged at £745 billion. Looking forward, the path of economic activity will depend not only on the evolution of the pandemic and related containment measures, but also on the nature of, and transition to, the new trading arrangements between the European Union and the United Kingdom.

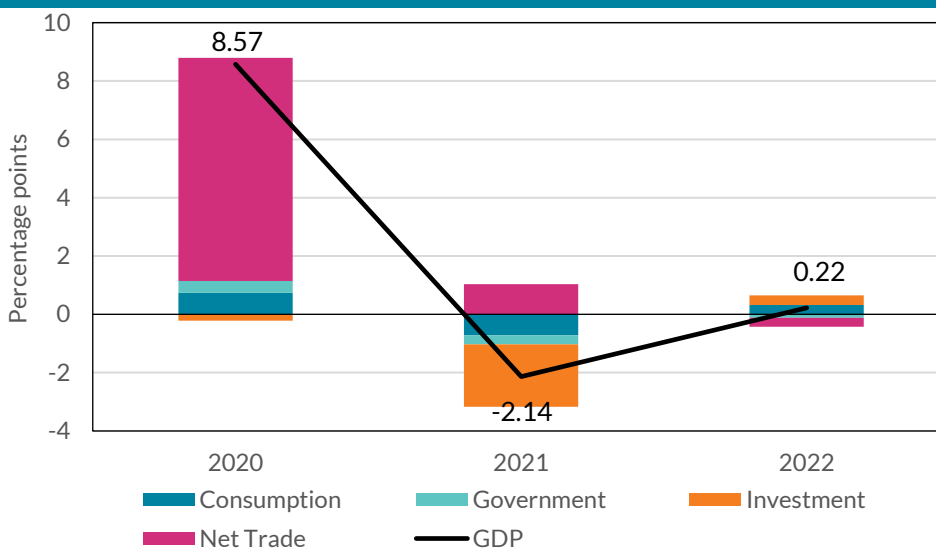
Demand and Output

After a large decline in economic activity during the second quarter, the baseline projection is for a recovery in the second half of this year. The partial reopening of the economy, as well strongly expansionary fiscal and

monetary policy should stimulate the economy in the second half of the year. High frequency indicators suggest that the reopening of the economy is supporting some rebound in activity in the third quarter, albeit to differing degrees across sectors. Overall, the outlook for underlying domestic demand has been revised moderately upwards to -7.1 per cent for 2020.

Unexpectedly robust growth in exports of pharmaceuticals and business services in the second quarter are driving a substantial upward revision in the GDP projection for 2020 (Figure 9). In the previous Bulletin published in July, it was expected that these sectors would be somewhat affected by the pandemic, albeit to much lesser extent than the rest of the economy. In contrast, the output of these sectors continued to grow strongly during the second quarter. This exporting strength, combined with a projected 15.1 per cent decline in imports, will result in a much stronger net trade contribution to GDP growth this year than had been expected at the time of the last Bulletin. As a result, the projection for GDP growth in 2020 has been revised up 8.5 percentage points to -0.4 per cent.

Figure 9: Contributions to GDP forecast revision compared with Quarterly Bulletin 3



Source: CBI Calculations

Looking ahead, the assumption that trade between the EU and the UK will take place on WTO terms from January 2021 will suppress the recovery in the economy in 2021 significantly (see Box A). The direct impact is likely to affect the agriculture and food sectors hardest, with high tariffs and a significant increase in non-tariff barriers in prospect under WTO arrangements for trade in food and agricultural goods. However, the introduction of non-tariff barriers, particularly during the disruptive

transition to the new regime, could affect many other sectors. The introduction of customs procedures, regulatory divergence, the increased potential for border delays and additional bureaucracy will increase costs for exporters using the UK as a land bridge to export to continental Europe.¹⁶ Responding to this significant shock to logistics and supply chains requires substantial investment on the part of firms. This is more difficult than usual, with the coronavirus pandemic keeping levels of uncertainty about the global economic outlook at elevated levels. Accordingly, GDP is forecast to grow by 3.5 per cent in 2021, 2 percentage points lower than would have been the case had there been a Free Trade Agreement. Underlying domestic demand is projected to grow by 1.6 per cent.

In 2022, GDP is projected to grow by 4.7 per cent and underlying domestic demand by 4.8 per cent. The unwinding of pent up savings, accumulated during the pandemic, will support a recovery in consumption while the reduction in economic uncertainty is likely to boost business investment. Nevertheless, some effects will remain in the labour market and in the lagged impact of investment not undertaken during 2020 and 2021.

Turning in more detail to the components of GDP, consumption is expected to decline by 7.6 per cent this year. This upward revision of 2.5 percentage points compared with the last Bulletin, is driven by two factors. First, the consumption decline in Q2 (-22.8 per cent) was slightly smaller than assumed. Secondly, since the publication of the previous Bulletin, the income support schemes have been extended. The likelihood that some containment measures will continue to be required and may, periodically, have to be intensified, along with the continued requirement for physical distancing, will continue to reduce services consumption. Ongoing precautionary behaviour with regard to contact-intensive activities will amplify this effect. While consumption will grow in 2021 compared with 2020, employment losses, as well as the drag on the economy from a WTO Brexit, means growth of only 1.9 per cent is projected. Consumption growth is expected to improve substantially to 5.3 per cent in 2022 as the impact of the pandemic wanes, and savings built up during 2020 and 2021 begin to be unwound.

The components of underlying investment are expected to fall more sharply than GDP in 2020, and are forecast to remain well below pre-crisis levels over the projection horizon. Faced with unprecedented uncertainty, firms are likely to postpone investment decisions. The shape of the downturn in investment is projected to be more severe than other

¹⁶ [Byrne, S., & Rice, J. \(2018\). *Non-tariff barriers and goods trade: a Brexit impact analysis* \(No. 6/RT/18\). Central Bank of Ireland.](#)

components of demand with a slower recovery expected as uncertainty around COVID-19 persists.

Construction sector activity is expected to decline by approximately 30 per cent in 2020. The sector bounced back well from the closures in April and May, with most sites re-opening in mid-June. Indications are that the sector is running at approximately 85 per cent capacity. However, the latest construction PMI reported that the recovery faltered somewhat in August, with the overall index falling from 53.2 (expansion) in July to 44 (contraction) in August. All three housing, commercial and civil engineering sectors recorded a contraction in activity in the month of August.

House completions are expected to decline to approximately 17,500 units in 2020, down from 21,000 units in 2019. More recent data indicate that housing commencements and registrations have held up better than expected during Q2 2020, with over 3,000 new housing units commenced, although considerable uncertainty around demand, prices and financing remains. Current expectations are for approximately 22,000 and 27,400 units in 2021 and 2022, respectively.

Non-residential investment is projected to fall sharply in 2020 and recovery only gradually thereafter. The most recent CSO Business Impact of COVID Survey indicated that 57.7 per cent of office-based staff were still working remotely as of August 2020. Moreover, a recent survey by Moody's Analytics reported that the number of international businesses indicating that they would be adding to office space declined from 50 per cent in 2019 to zero per cent in 2020, while those pointing to a decline in office space requirements increased to 35 per cent in 2020.

Machinery and equipment expenditure, already displaying weakness in 2019, is forecast to decline by approximately 35 per cent in 2020 as uncertainty surrounding COVID continues. Imports of machinery and equipment declined by 26 per cent in the first half of 2020 compared to 2019. Imports of other transport equipment (mainly planes) fell by 46 per cent in the same period. The number of new goods vehicles registered in January to August 2020 declined by 29 per cent compared to the previous year.

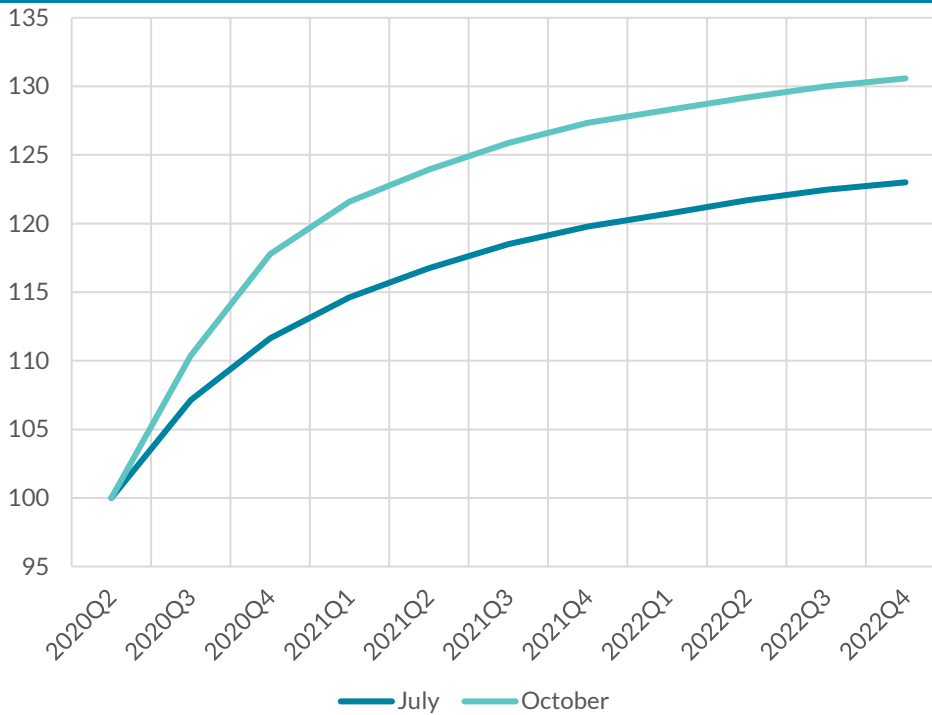
Overall, headline investment is forecast to fall by 36 per cent in 2020 while underlying investment is forecast to fall by 30 per cent.

Net Trade

Despite the downturn in global trade, aggregate exports are projected to fall by only 0.3 per cent in 2020. The resilience of exports reflects strong growth in high-value exports of pharmaceuticals, computer processors and business services (see Box C). While revised up from the previous Bulletin,

the remaining exporting sectors are projected to see significant year-on-year declines in line with developments in the global economy. World demand for Irish exports in the third and fourth quarters, is forecast to be 12.3 per cent lower than during 2019.

Figure 10: The outlook for trade-weighted demand for Irish exports has been revised up



In 2021, a move to a WTO arrangement between the EU and the UK has the potential to cause significant disruption to trade (see Box A).

Substantial adjustment costs will arise for firms and administrative bodies as they implement the entire infrastructure required to trade with a third country in a very short time frame. There is no historical precedent for this type of scenario and there is considerable uncertainty about the trade projections for 2021.¹⁷

The agri-food sector is likely to be worst affected by an increase in tariffs and non-tariff barriers – including phyto-sanitary checks on imports and exports of certain products. However, trade delays for firms using the UK as a land bridge in exporting to the European continents will increase exporting costs for all firms. This occurs at a time when compliance with public health restrictions has already increased costs for firms in the economy more generally. With already weak world demand combined with an appreciating euro, exporting may become prohibitive for some firms.

¹⁷ See [Byrnes, S. Box C: Short-term disruption to trade infrastructure in a no-deal Brexit. Quarterly Bulletin 2019.4](#)

Combined, exports are forecast to grow by 0.5 per cent in 2021, around 4 percentage points less than would be expected under a free trade agreement. In 2022, exports are forecast to grow by 3.1 per cent, as exporters find new markets.

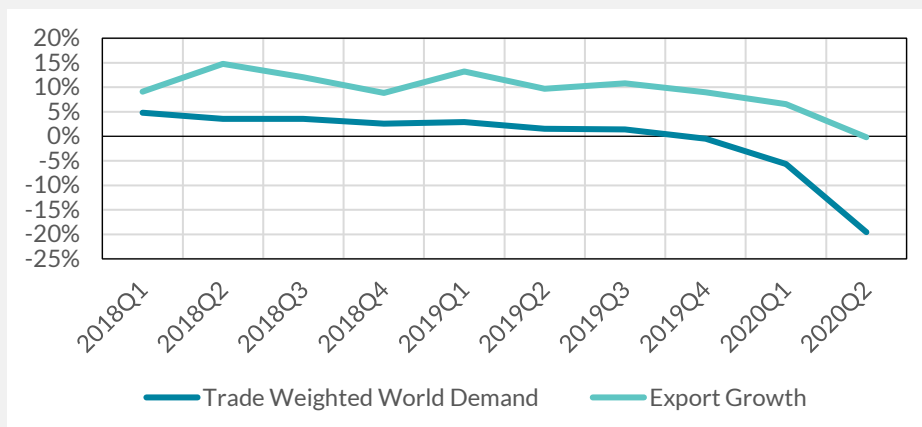
Box C: Exports continue to grow strongly despite downturn in global demand

By Stephen Byrne¹⁸

Irish export growth has remained remarkably resilient throughout the second quarter, and the peak of the pandemic. Despite an expected 19 per cent fall in trade-weighted world demand, exports fell by only 0.2 per cent in the second quarter.

This aggregate figure masks significant divergent trends. Exports of goods increased by 7.6 per cent, while exports of services fell by 8.1 per cent. This box outlines the three primary developments driving the resilience of exports.

Figure 1: Exports growth has outstripped World Demand



1) The continued concentration of merchandise exports in pharmaceutical products

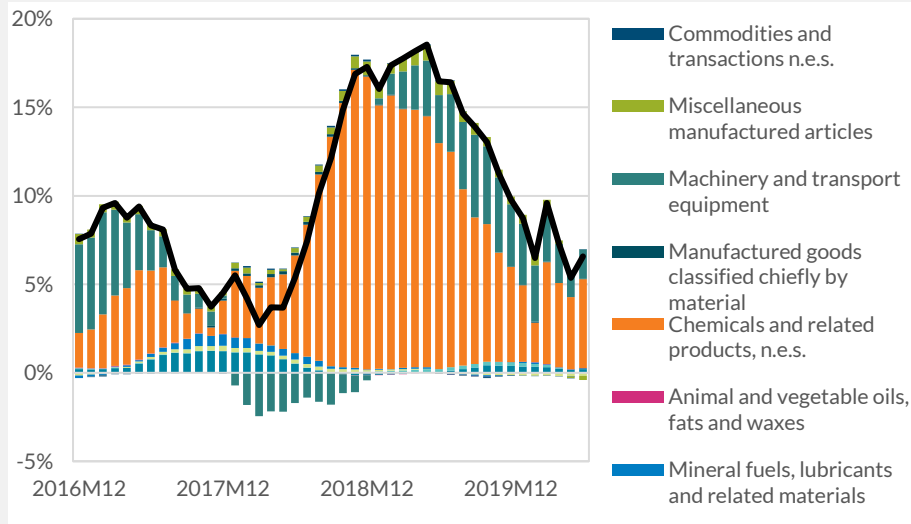
The first Bulletin of 2020 examined the concentration of merchandise exports, with a small number of very high value pharmaceutical products accounting for an increasing share of total exports. This trend has continued. Pharmaceutical products alone accounted for 38 per cent of total merchandise exports in the second quarter of 2020. One product type “Immunological products, put up in measured doses or in forms or packings for retail sale” accounted for approximately 12 per cent of total

¹⁸ Irish Economic Analysis Division

merchandise exports. Exports of this product grew by 41 per cent in value terms in the second quarter compared with a year ago.

Broadly, chemicals and related products accounted for most of the growth in merchandise exports throughout the second quarter. A further substantial contribution came from exports of machinery and transport equipment, specifically exports of computer processors.

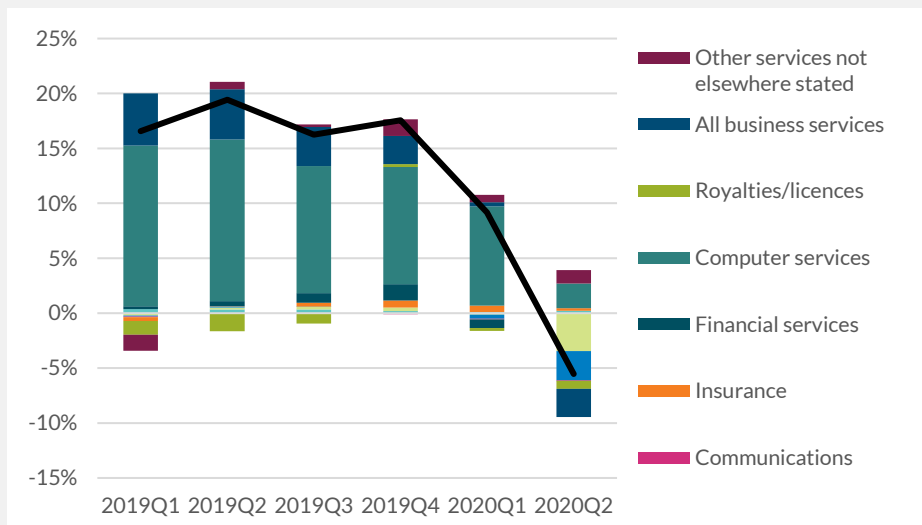
Figure 2: Contributions to Merchandise Export Growth



2) The fall in services exports would have been much larger if not for continued growth in computer services exports

Services fell by 8.1 per cent, but would have fallen by more than 10 per cent if it were not for the strong growth in exports of computer services, which accounted for 58 per cent of total services exports in value terms in the second quarter. Other services also mitigated the decline in services trade by a further one percentage point.

Figure 3: Services trade fall cushioned by strength of Computer Services exports



3) Contract Manufacturing exports increased sharply during the second quarter

Contract manufacturing occurs where a company in Ireland engages a company abroad to manufacture products on its behalf. The product is then sold to a customer in a third country. While the products never cross the Irish border – the entity involved in the sale to the third country is Irish, and an export transaction is recorded in the Irish national accounts. Contract manufacturing exports increased by 14 per cent in year-on-year terms in the second quarter, and by 9 per cent compared with the first quarter.

It is likely that the strong increase in the second quarter was related to manufacturing which had been delayed during the first quarter. A significant proportion of contract manufacturing takes place in China – where large scale closures affected production during January and February, in particular.

The Labour Market

Employment is forecast to decline by 4.1 per cent on average for the year, before decreasing further by 4.2 per cent in 2021. Job losses due to the onset of the pandemic have been mitigated to a significant degree by the PUP and wage subsidy schemes. However, the phasing out of these schemes in 2021 will result in a significant increase in unemployment, owing, in part, to increased redundancies (see Box D). In effect, however, many workers have become unemployed, but while in receipt of the PUP are not counted in official measures of unemployment. The latest CSO

Labour Force Survey (LFS) for Q2 2020 showed a 3.4 per cent annual decline in employment to 2.22 million persons, bringing figures closer to 2017 levels. The LFS results show that the employment losses have been disproportionately greater amongst part-time, female and younger workers and those with secondary level or lower education attainment levels. Part-time employment in particular decreased by 16.1 per cent compared to 2.9 in full-time positions. On a sectoral basis, seven of the fourteen sectors experienced employment declines with the most prominent being accommodation and food services (-29.6 per cent). Employment levels increased in the finance (17.1 per cent) and ICT (14.7 per cent) sectors. Regionally, employment declines were larger in areas that rely to a greater extent on tourism-related activities.

The labour force experienced its largest annual decline during the second quarter, contracting by 3.7 per cent (89,600 persons). This reduction was primarily due to the flow of those ‘away from work’ out of the labour force rather than into unemployment, bringing the labour force participation rate to 58.9 per cent, compared with 62.3 per cent in the first quarter.¹⁹ The decline in the participation rate is more pronounced for younger age cohorts. The female participation rate fell to 52.9 per cent, lower than during the financial crisis in 2008-10.

Looking ahead, the reduction in airline travel and strict international containment measures is likely to result in lower levels of future net inward migration. CSO migration estimates up to April 2020 show a moderation in net figures from 33,700 in 2019 to 28,900 in 2020. On balance, net migration is forecast to make a neutral contribution to changes in the labour force during 2020 and 2021. The labour force is expected to decrease by 3.7 per cent and 1.3 per cent in 2020 and 2021, respectively, before increasing by 4.1 per cent in 2022.

The extension of the income support schemes to end-March 2021 has acted to limit increases in the unemployment rate (see Box D). The COVID-adjusted monthly unemployment rate for August measured 15.4 per cent, while the seasonally-adjusted ILO rate has increased relatively marginally to 5.2 per cent in August. As a result, the unemployment rate is projected to average 5.3 per cent for 2020 before rising further to 8.0 per cent in 2021.

Reflecting the changing composition of the workforce, average hourly earnings levels have increased since the start of the pandemic, with a proportionately sharper reduction in lower-earning and part-time

¹⁹ In the case of persons availing of the emergency income supports such as the PUP, those who considered themselves to be ‘away from work’ but expect to within a period of three months were deemed to still be in employment. The number of persons in this cohort increased from 146,600 in Q2 2019 to 552,300.

employment. EHECS data for Q2 2020 show that aggregate hourly earnings increased by 7.9 per cent on an annual basis with the largest rises observed in the typically lowest earnings sectors of arts and entertainment (15.9 per cent) and the accommodation and food (15.4 per cent). Some moderation in average earnings growth in the coming quarters is likely to reflect some reversal of the underlying composition as more part-time workers return to employment.

The impact of the pandemic on incomes has been cushioned to a large degree by income-support schemes, although the tempering of payment levels in the coming months means firms will bear more of the labour cost.²⁰ CSO Insight Bulletins stated that TWSS payments accounted for 8.5 per cent of total earnings across all non-agricultural sectors in Q2 2020 and 51.8 per cent of total earnings in the accommodation and food sector.²¹

While the aggregate job vacancy rate is lower compared to previous years, rates are highest in sectors with greater working from home potential. Data from Indeed show that despite the current level of job postings being down 33 per cent compared to September 2019 there has been a gradual improvement since June.²² While extensive training and education initiatives were announced in the July stimulus package, a greater level of vacancies will be required in order to reduce the risk of long-term unemployment.

Table 1: Labour Market Developments

	2019	2020f	2021f	2022f
Employment	2322	2228	2134	2233
% change	2.9	-4.1	-4.2	4.7
Labour Force	2443	2352	2321	2415
% change	2.0	-3.7	-1.3	4.1
Unemployment	121	124	187	182
Unemployment Rate	5.0%	5.3%	8.0%	7.5%

²⁰ Keenan, E, and Lydon, R. (2020 – forthcoming) “Wage Subsidy and Job Retention” Central Bank of Ireland Economic Letter Series.

²¹ See [Labour Market Insight Bulletin, Series 2](#)

²² Indeed (2020) “[Coronavirus and Irish Job Postings Through August 21](#)” Indeed (2020) “[Coronavirus and Irish Job Postings Through September 18](#)”

Box D: Measuring and Forecasting the Unemployment Rate during COVID-19

By Stephen Byrne & Enda Keenan²³

The “**unemployment rate**” is calculated as the number of **unemployed** persons as a percentage of the total number of persons in the **labour force**. Because of the unprecedented nature of COVID-related job losses, there are measurement difficulties with respect to both of these definitions.

These difficulties can be illustrated by considering the definition of both taken from ILO (2020):

- **Unemployed:** To be considered as unemployed, all persons must satisfy each of the following criteria: a) without work during the reference period, i.e. were not in paid employment or self-employment; b) currently available for work, i.e. were available for paid employment or self-employment during the reference period; and c) seeking work, i.e. had taken specific steps in a specified recent period to seek paid employment or self-employment.
- The **Labour Force** is the sum of the number of persons employed and the number of persons unemployed. Thus, the measurement of the unemployment rate requires the measurement of both employment and unemployment.

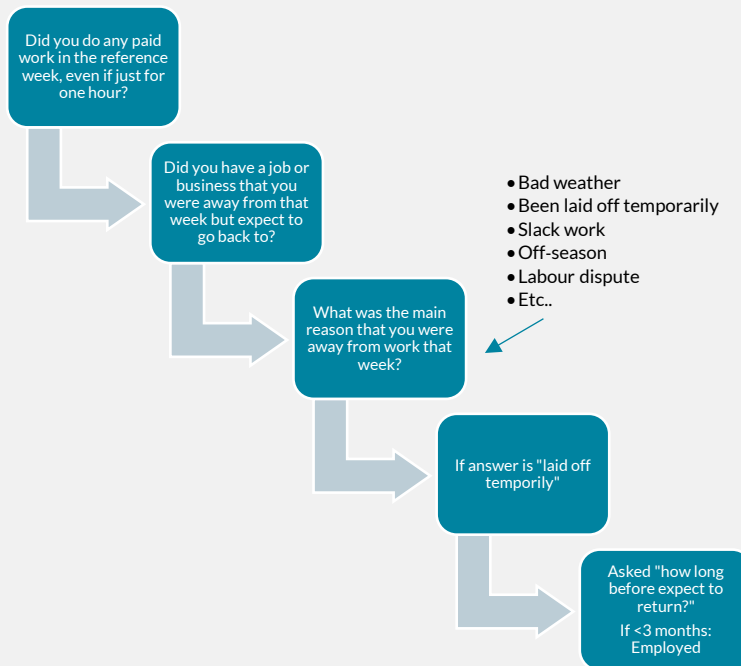
The nature of COVID-19 related unemployment presents particular challenges for statisticians in attempting to measure who is employed and who is unemployed.

For example, Labour Force Survey respondents in receipt of the Pandemic Unemployment Payment (PUP) would have answered a series of questions along the lines outlined in the diagram in Figure 1 to determine their ILO status.²⁴ PUP recipients, by definition, have a reasonable expectation of returning to work within a three month period. As a result, they are classified as “employed”.

²³ Irish Economic Analysis Division

²⁴ Note that the Labour Force Survey does not ask any questions about whether an individual is in receipt of the PUP.

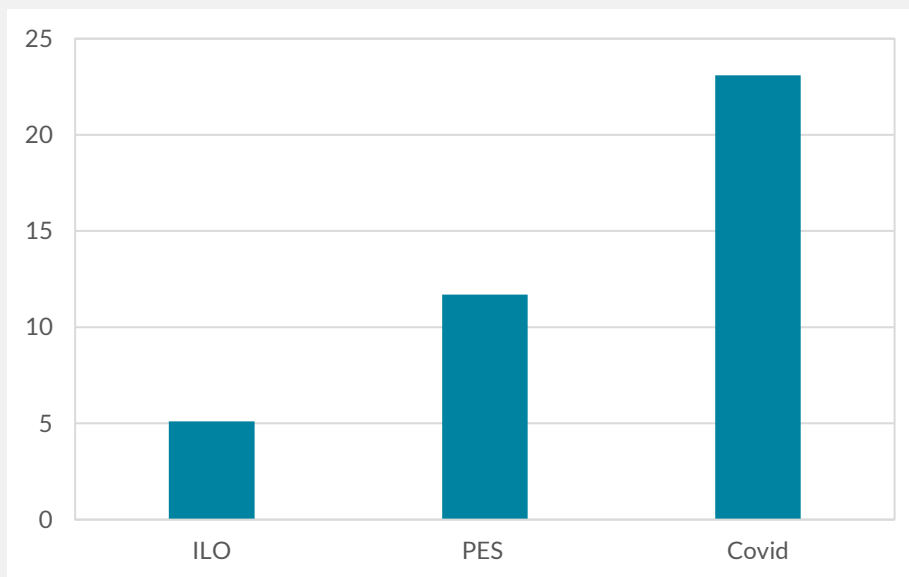
Figure 1: Labour Force Survey Questions



Source: CSO

Because of this classification, the standard unemployment rate for the second quarter only increased to 5.1 per cent compared with 4.7 per cent in the first quarter (Table 1). This is despite the fact that the monthly COVID-adjusted unemployment rate averaged 27.3 per cent during the same period. Unfortunately, the COVID-adjusted rate is not a perfect measure either. It is calculated by adding all of those in receipt of the PUP to the number who are unemployed, less any overlap with other income support schemes.²⁵ Some of these workers would not ordinarily be classified as “unemployed” in the official definition, as they may be casual employees, certain types of part-time workers and students, who would not be measured in the official definition. In light of this, perhaps a more appropriate measure of the true unemployment rate comes from survey respondents’ own description of themselves, the “principal economic status measure”. By this count, approximately 11.7 per cent of the working age population are unemployed (Figure 2).

²⁵ The monthly COVID-adjusted unemployment rate excludes any overlap between PUP and Live Register recipients. See [Technical Note for Monthly Unemployment and COVID-19 Adjusted Estimates – August 2020](#) for details

Figure 2 – Unemployment by measurement type (Q2 2020)

Source: CSO and Authors' calculations

Note: PES is the Principal Economic Status.

Key Results from Q2 2020 Labour Force Survey:

	Q2 2020	Pre-COVID (Q4 2019)
Unemployment Rate	5.1	4.7
Unemployed Persons	118,700	110,600
Employment Rate	65.7	70.2
Employed Persons	2,222,500	2,361,200

Source: CSO

As the income support schemes are phased out in 2021, the standard measure and the COVID-adjusted measures of unemployment will converge. As part of the July Stimulus Package, the PUP scheme has been extended to end-March 2021. There is a restriction on new entrants from end-December 2020 and a staggered decrease in the payment towards the standard jobseeker payment of €203 from 17 September to end-March 2021. The TWSS has also been replaced by the Employment Wage Subsidy Scheme (EWSS), a dual flat-rate subsidy scheme. The eligibility criteria for this scheme are more restrictive, including monthly compliance checks to ensure a turnover loss of 30 per cent or more relative a year ago. If a firm's turnover increases above the threshold, they may no longer be eligible for the EWSS.

At the end of the scheme in March 2021, workers currently in receipt of the PUP will be dispersed across different classifications:

- Many will return to employment, as the firm they worked for reopens and they are rehired (potentially using the EWSS)
- Some will become unemployed in the strict definition, as their firm has gone out of business or lays them off permanently.
- Importantly, many will transition into the “outside the labour force” category.

Our unemployment rate forecast has thus been revised compared with the previous Bulletin to reflect the standard ILO unemployment rate. This results in a substantial increase in the ILO unemployment rate in 2021 to 8 per cent. On a COVID-adjusted basis, the unemployment rate would be 15.1 per cent on average in 2020, falling to 11.1 per cent in the first quarter of next year.

Box E: Short-Term Economic Outlook in a Severe COVID-19 Scenario

By Stephen Byrne, Thomas Conefrey, Niall McInerney, Gerard O'Reilly and Graeme Walsh

The uncertainty surrounding the future path of COVID-19 means that it is important to consider alternative scenarios for the economy. This Box considers the implications of a *severe* COVID-19 scenario as an alternative to the *baseline* forecasts in this *Bulletin*. While the *baseline* forecasts assume that the virus is broadly successfully contained, the *severe* scenario envisages a strong resurgence of the pandemic, leading to the restoration of widespread and stringent containment measures for a more prolonged period. The sustained efforts to prevent the spread of the virus in the *severe* scenario would continue to significantly dampen activity across sectors of the economy until a medical solution becomes available.

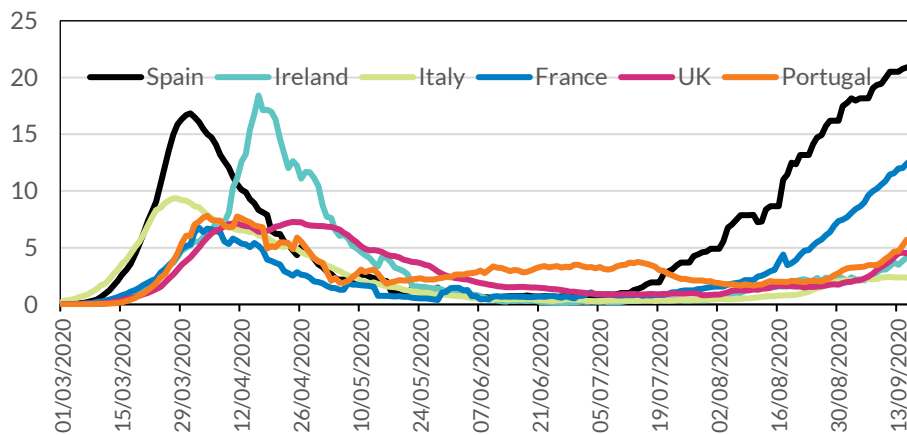
The elevated uncertainty surrounding the impact of the COVID-19 pandemic on the future path of the Irish economy warrants the consideration of alternative scenarios. In the Bank's July 2020 *Quarterly Bulletin* and in Conefrey *et al.*, (2020), two scenarios were presented – *baseline* and *severe*.²⁶ The updated *baseline* projections are presented in

²⁶ Conefrey, T. McInerney, N., O'Reilly, G. and Walsh, G. (2020), “Recovery paths from COVID-19 and the impact of policy interventions”, Central Bank of Ireland Quarterly Bulletin, Vol. 2020, No. 3, Signed Article. The scenario analysis published in the July 2020 *Bulletin* built on earlier similar work published in April. See *Quarterly Bulletin 2 2020*, Box C, “Assessing the Macroeconomic Implications of COVID-19 using Scenario

the main chapter of this *Bulletin*. This Box provides an update of the *severe* scenario as described in the July *Quarterly Bulletin* given the new *baseline* projections.

As illustrated in Figure 1, the containment measures introduced in March and April were effective in suppressing the virus which facilitated a subsequent easing of the measures during the summer. Recently, however, case numbers have started to increase, prompting concerns about a potential resurgence of the virus and the possible re-imposition of restrictions. The latest *baseline* projections in the *Quarterly Bulletin* allow for sporadic flare-ups of the virus leading to localised lockdowns but where the economy broadly remains open.

This Box outlines a *severe* scenario in which the virus is more difficult to contain than assumed in the *baseline* forecast, which leads to a deeper and more persistent impact on the Irish economy. This adverse scenario is consistent with a second wave of the virus requiring more widespread and stricter lockdowns than assumed in the *baseline*. The *severe* scenario would see more prolonged restrictions related to social distancing and foreign travel. Due to the high level of uncertainty about the future path of the virus, it is not possible to precisely specify when a large-scale second wave may occur or additional waves. However, our calibration of the scenario assumes that it occurs within the next three quarters.

Figure 1: Number of confirmed cases per 100,000 population

Note: daily data, 7-day moving average.

Source: European Centre for Disease and Control.

Assumptions

To generate the *severe* scenario, we implement a series of shocks in our macroeconomic models and then use the results from this simulation exercise to inform the preparation of the *severe* scenario projections.²⁷ The final projections incorporate the model results and some judgement-based assessment. The shocks we model encompass the real, financial, domestic and international dimensions of the economy and affect both the supply and demand for Irish goods and services. Importantly, as mentioned above, they capture the potential impact of a continuation of containment measures and a large-scale resurgence of the virus in the short term.

The inability to contain the virus and the absence of an imminent vaccine dampens growth prospects in Ireland's trading partners. Our *severe* scenario assumes the international economy continues to experience a protracted period of weak growth, which lowers demand for Irish exports. The decline in activity internationally is modelled by reducing spending by households and firms across countries. The *severe* scenario assumes a large decline in external demand that persists over the following two years. This is primarily due to the necessity to maintain or re-impose widespread containment measures, which curtails recovery in Ireland's trading partners. Our assumptions are consistent with the *severe* scenario outlined in ECB (2020) in which euro area foreign demand falls by approximately 15.5 percent in 2020. In that scenario, euro area GDP remains approximately 6 percent lower than the *baseline*

²⁷ We estimate the impact of our assumptions about the international economic and financial environment using the National Institute for Economic and Social Research's (NIESR) global model, NiGEM. In the second step, we incorporate these international shocks in to the Central Bank's model of the Irish economy, COSMO.

forecast by the end of 2022.²⁸ Furthermore, trade in intermediate goods is assumed to fall substantially due to the disruption to supply chains. The lack of availability of close substitutes for these inputs in the short term reduces output in sectors that use these inputs intensively.

The uncertainty surrounding the epidemiological evolution of the virus itself affects conditional expectations of the potential future path of the economy. In particular, financial markets reacted strongly to the initial outbreak of the virus, with significant increases in risk premia and credit spreads. While the policy actions of central banks have largely succeeded in reversing these increases (Igan et al, 2020), a scenario in which the virus leads to a prolonged continuation of containment measures is assumed to lead to a further repricing of risks.²⁹ The rise in risk premia and concerns about the strength of private sector balance sheets also affects the real economy by raising the user cost of capital for firms and the cost of credit for households.

In terms of the domestic economy, the *severe* scenario assumes a larger fall in the output of the non-traded sector. This arises from the maintenance of more widespread restrictions that reduce the productivity of the sector. These restrictions further weaken consumption and fixed investment, as limits on gatherings and inward travel and social distancing requirements increase the costs of production, for example on construction sites, and severely constrain levels of economic activity. We assume that the large fall in production and demand in some parts of the non-traded sector of the economy is only gradually recovered over the next two years. The subdued nature of the recovery in the non-traded sector means that the recovery in the labour market is also significantly weaker than in the *baseline*. Moreover, the deeper and more sustained contraction in the economy reduces household income and corporate profitability, which feeds back into lower consumption and investment.

While not directly modelled in this scenario, our assumptions about the persistence of these shocks implicitly capture potential hysteresis effects that could affect the trajectory of output over the medium to long term. Hysteresis mechanisms can lead to structural changes in the economy so

²⁸ ECB (2020). "Alternative scenarios for the euro area economic outlook". Box 3, ECB Staff Macroeconomic Projections, September. Available at: https://www.ecb.europa.eu/pub/projections/html/ecb.projections202009_ecbstaff~0940bca288.en.html#toc6

²⁹ Igan, Deniz, Divya Kirti, and Soledad Martinez Peria (2020). "The Disconnect between Financial Markets and the Real Economy". IMF *Special Notes Series on COVID-19*, August.

that temporary adverse shocks can have a persistent or scarring impact on subsequent growth (Cerra et al, 2020).³⁰

Scenario Results

Table 1: Macroeconomic Projections under the *Baseline* and *Severe* Scenarios

	Baseline			Severe		
	2020	2021	2022	2020	2021	2022
GDP ($\Delta\%$)	-0.4	3.4	4.7	-1.1	-0.3	3.4
Underlying Domestic Demand ($\Delta\%$)	-7.1	1.6	4.8	-8.5	-1.3	3.7
Unemployment rate (%)	5.3	8.0	7.5	6.4	12.5	10.1

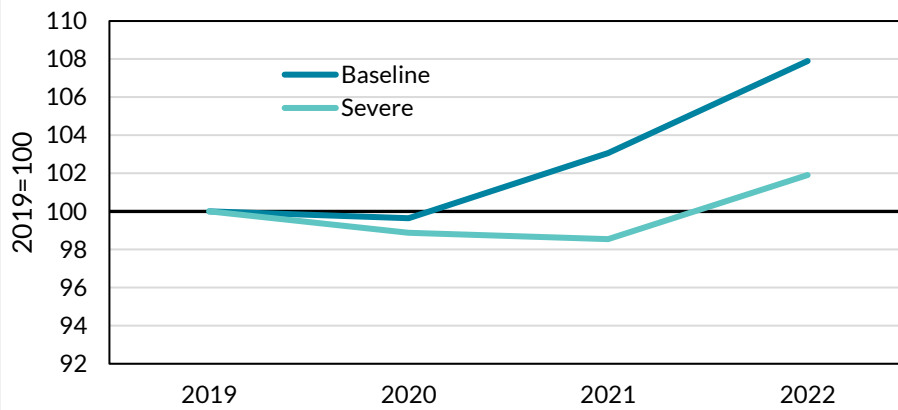
Source: Own calculations.

Table 1 presents the projections for key macroeconomic variables under the *severe* scenario over the period 2020 to 2022. The *baseline* projections are also shown for reference. The difference between the scenarios captures the impact of the additional shocks we impose on the *baseline*, as outlined in the previous section.

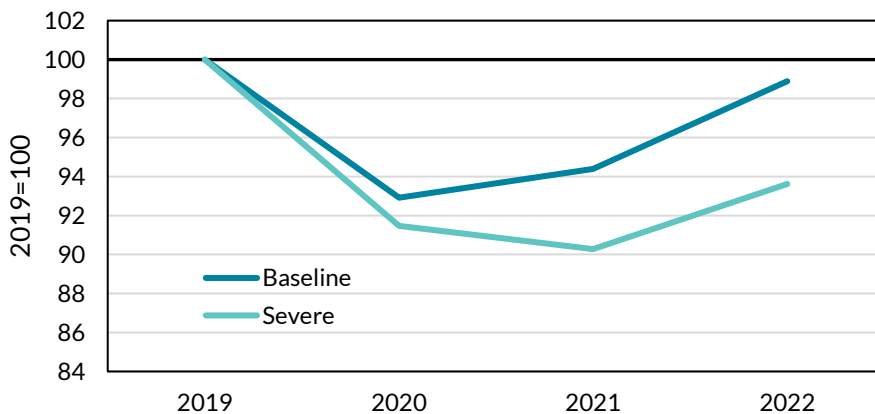
The economic recovery from the pandemic is projected to be much stronger in the *baseline* than in the *severe* scenario. Output begins to recover next year in the *baseline* as economic activity starts to normalise. The economy experiences relatively strong growth towards the end of the projection horizon due to the improved external environment and pent-up demand in the domestic economy. In the *severe* scenario, however, the economy continues to contract next year.

Figure 2 shows the growth path of GDP in each scenario. While the economy does begin to recover in 2022 in the *severe* scenario, growth is from a lower level than in the *baseline* and thus much stronger subsequent growth would be needed if GDP were to return to its pre-COVID trend path.

³⁰ In the case of the labour market, this can be due to the loss of firm-specific human capital, to the increase in hiring and search costs stemming from the severing of worker-firm matches, and to the erosion of skills from long-term unemployment. Hysteresis can also arise through the corporate investment channel, as a prolonged contraction reduces profitability, weakens firms' balance sheets, and raises the real option of postponing investment due to the pro-cyclical increase in economic uncertainty. The rise in public debt as a result of the automatic and discretionary fiscal responses to the pandemic could have a persistent dampening effect on demand by constraining future government expenditure and by raising saving among non-liquidity constrained households, which may expect higher future tax rates (see Conefrey *et al.*, (2020) for a discussion of these effects).

Figure 2: GDP under the *Baseline* and *Severe* Scenarios (2019=100)

Source: Own calculations.

Figure 3: Underlying Domestic Demand under the *Baseline* and *Severe* Scenarios (2019=100)

Source: Own calculations.

Both scenarios show how the domestically-oriented sectors of the economy are more severely affected by the pandemic than the aggregate economy. This reflects the impact of the containment measures that limit the output of sectors associated with social consumption, sectors dependent on foreign travel and sectors in which social distancing restrictions reduce productivity. While underlying domestic demand contracts strongly in 2020 in both scenarios, the recovery is earlier and much more pronounced in the *baseline*. The delayed recovery in the *severe* scenario reflects the assumptions about the severity and persistence of containment measures which reduce consumption and investment. Although household savings have risen sharply during the pandemic, these savings buffers are not sufficient to prevent the continued decline in consumption next year in the *severe* scenario.

Figure 3 presents the level of underlying domestic demand in the *baseline* and *severe* scenarios relative to its level in 2019. In particular, it shows

how the differences in growth rates in each scenario compound to generate a significant divergence in levels over the projection period. By the end of 2021, domestic demand is six per cent below its 2019 level in the *baseline* scenario, but almost ten per cent lower in the *severe* scenario. Consumption and investment growth does return in 2022 in the latter but from a much lower level and at a rate that is slower than in the *baseline*. At the end of 2022, domestic demand has almost reached its 2019 level in the *baseline scenario*, but is still six per cent below the 2019 level in the *severe* scenario. This is consistent with the presence of structural factors that continue to constrain demand.

Finally, Table 1 illustrates the severe and protracted impact that the restrictions associated with the COVID-19 virus could have on the labour market. The unemployment rate is four percentage points higher in 2021 in the *severe* scenario than in the *baseline*. While unemployment starts to fall in both scenarios in 2022, the unemployment rate remains above ten percent in the *severe* scenario. Even in the *baseline*, the fall in unemployment is relatively small and is therefore still elevated when compared to its pre-COVID level. As discussed, labour markets are particularly vulnerable to hysteresis mechanisms taking hold when the economy is hit by a persistent shock. Moreover, these mechanisms often dominate so that the recovery in employment tends to lag behind the recovery in output (Cerra et al, 2020).³¹

Caveats

An important caveat to our analysis concerns the inherent difficulty of mapping epidemiological phenomena to economic outcomes. Prior to the onset of the COVID-19 virus, structural macroeconomic models typically did not incorporate the impact of public health shocks on the aggregate economy. The pandemic has generated a burgeoning literature on modelling the economic impact of the virus, including the development of models that integrate SIR models from epidemiology into a macroeconomic modelling framework.³² However, given the novelty of the virus, it is too soon to ascertain whether these models accurately capture the interaction between the public health and economic dimensions of the pandemic.

It should also be noted that the *severe* scenario only includes policy measures that have been announced by government and central banks. If

³¹ See Cerra, Valerie, Antonio Fatas and Sweta Saxena (2020). "Hysteresis and the Business Cycle." Mimeo.

³² See, for example, Acemoglu, Chernozhukov, Werning & Whinston (2020) "A Multi-Risk SIR Model with Optimally Targeted Lockdown"
<https://www.nber.org/papers/w27102>

fiscal and monetary authorities responded to the *severe* scenario with new additional policy supports then the impact on the economy would be less than shown here.

Conclusion

The COVID-19 virus initiated a public health shock that has already generated substantial economic and financial disruption. In this Box, we have outlined a *severe* scenario in which a resurgence of the virus, along with a protracted continuation of the associated containment measures, causes material and persistent damage to the Irish economy.

The impact of the virus on the economy is determined by the transmission of shocks through a number of channels. First, the scenario assumes that the failure to suppress the virus leads to prolonged weakness in the global economy which reduces external demand for Irish exports. Second, trade in intermediate goods falls substantially due to the disturbance to supply chains, thereby reducing the productive capacity of the economy. Third, the rise in uncertainty about the distribution of future paths for the economy, as well as concerns about weakening private sector balance sheets, leads to a rise in risk premiums and a tightening of credit conditions. Finally, the domestic non-traded sector of the economy suffers a further contraction due to extension of containment measures which severely constrain activity in that sector.

A particularly pernicious aspect of the *severe* scenario is the potential for hysteresis effects to become embedded in certain sectors. Hysteresis mechanisms can have a scarring impact on the economy so that its productive capacity is permanently lowered. It is important to note that many of the fiscal measures that have been introduced by fiscal and monetary authorities across countries in response to the pandemic have been specifically designed to mitigate the risk of this occurring. In particular, furlough and job retention schemes, credit guarantees and direct financial supports preserve job matches and enhance firms' access to liquidity.

However, while the scale and breadth of these policy interventions have been largely unprecedented, a central implication of the *severe* scenario outlined in this Box is that further measures would likely be needed if the economy were to eventually return to its pre-COVID output path.

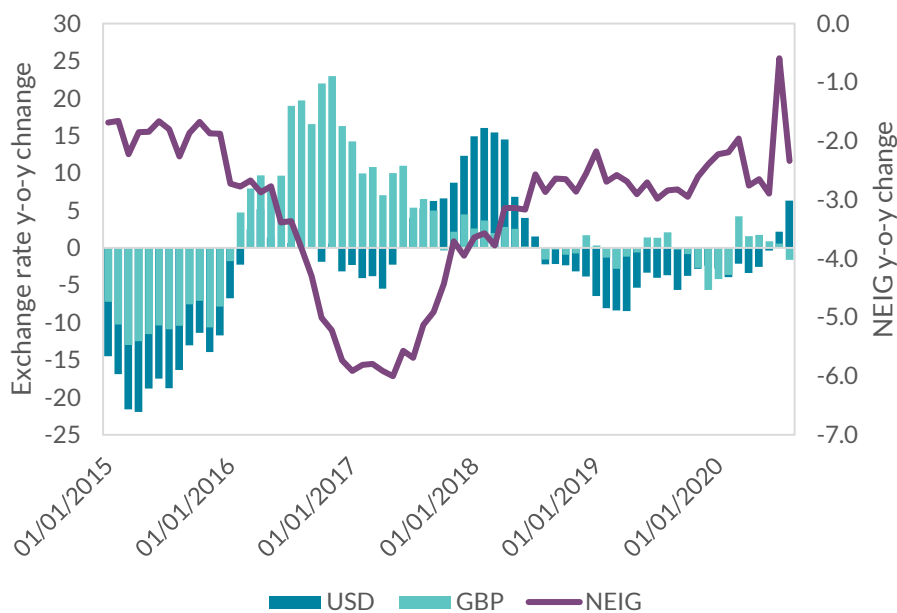
Prices

COVID-19 has had, thus far, a deflationary impact on Irish consumer prices. The HICP fell by 1.1 per cent in August year-on-year. Layering the already complicated forces of the COVID-19 shock on to a WTO Brexit

scenario means the forecasts are subject to more than the usual degree of uncertainty.

There has been a notable change in seasonal factors in the latest inflation data for some products. Traditional seasonal sales patterns failed to emerge for many goods, particularly clothing and footwear. This could be due to a number of issues. Firstly, a change in retailer behaviour - some retailers may simply not have offered the usual discounts on these products. There may also be a measurement issue. Due to COVID restrictions, the CSO collected more prices from websites rather than in-store price checks. When a product is not available on a website, a full-price replacement is chosen. Products may have been available on-site at a discount that was not reflected on the website. These factors may lead to an upward bias in the recorded rate of inflation.

Figure 11: Exchange rate developments and Non-Energy Goods Price Inflation (NEIG)



Source: ECB and CSO

The impact of COVID-19 is expected, on balance, to reduce inflation.

Downward pressures from weak demand are estimated to outweigh cost pressures from supply-side disruptions. At the same time, the effect of a WTO Brexit will have an upward impact on prices. Of all of these forces acting on prices (Table 2), the overall hit to aggregate demand is expected to dominate aggregate price developments. Disinflationary effects are expected to be broad based across the goods and service sectors, as demand remains weak. Price effects may lag the improvement in economic activity in 2021.

Energy prices are expected to decline following oil price declines in 2020.

A base effect in energy prices will see them rebound and bring headline above core inflation in 2021. The market-implied path of oil prices are slightly higher than those of the previous *Bulletin*.

With regard to other factors, a reduction in VAT in September 2020 should also contribute to downward price pressure. Exchange rate changes will also affect consumer prices (Figure 11). A depreciation in sterling associated with a disruptive Brexit would likely result in lower import prices. Given the strains on retailer's margins due to COVID, changes in exchange rates are more likely to be passed through to consumer prices.

Opposing forces could limit the fall in prices and are upward risks to our forecasts. Supply chain disruptions, social distancing measures, reduced slack and reduced competition as some firms exit may exert upward pressure on prices in some sectors. As domestic demand recovers, these factors may play more of a role in price developments.

The extent of the downward effect on aggregate inflation could also be counteracted by the imposition of tariff and non-tariff barriers associated with a WTO Brexit scenario.³³ Tariffs would be imposed on goods imports from the UK in line with the EU's common external tariff. These tariff rates vary considerably but are highest for meat, dairy and confectionery products. The extent to which cost increases for retailers and producers will be absorbed into profit margins is uncertain and sector dependent but given significant COVID-related pressures, the pass through to consumer prices could be relatively high.

The inflationary effect of non-tariff barriers could also be substantial and might even outweigh the effect of tariffs. Non-tariff barriers include higher transport costs, administrative costs, quantity limits, barriers from licencing, labelling, standards, sanitary and phyto-sanitary rules. Moreover, since a significant proportion of Irish imports use the UK as a land bridge, a greater amount of consumer products could be affected by higher non-tariff barrier effects like higher administrative and transport costs.

Headline inflation is expected to average -0.5 per cent in 2020. For 2021 and 2022, the balance between demand and supply forces and a WTO scenario is forecast to result in inflation of 0.2 per cent and 1.4, respectively.

³³ For a more detailed analysis of the impact of tariff and non-tariff barriers on grocery prices, see Box D, Grocery Prices in Ireland after Brexit, QB4 2019.

Table 2: The effects of COVID-19 on consumer price inflation

Transmission Mechanism	Impact on prices
Lower aggregate demand	↓
Exchange rates	↓
Supply chain disruptions	↑
Social distancing costs	↑
Tariffs and Non-Tariff Barriers	↑

Fiscal Outlook³⁴

Overview

The impact of the public health crisis on Ireland's fiscal position will be substantial over the medium term. We expect to see a large deterioration in the budget balance this year, reflecting both the negative effect of the economic downturn on the public finances, and the cost of the necessary support measures introduced by Government. The adverse impact of these channels is evident from Exchequer returns data for the year to August, which showed sharply declining indirect tax receipts and a rapid acceleration in social transfers in the first two-thirds of the year. On a more positive note, the data also showed that direct taxes are proving more resilient than expected. Incorporating the macroeconomic scenario outlined earlier in the Chapter, the general government balance is projected to decline from a surplus of €1.4bn or 0.7 per cent of GNI* in 2019 (0.4 per cent of GDP) to a deficit of €25.5bn or 12.3 per cent of GNI* this year (7.5 per cent of GDP). In nominal terms this represents a downward revision from Quarterly Bulletin 3; the July Stimulus and additional health spending have increased the total cost of support measures, but this is partly offset by the aforementioned resilience of direct taxes. Under the assumption that the fiscal measures introduced in response to the crisis are broadly temporary in nature, and supported by a recovery in economic activity, the budget balance should improve in the coming years. The deficit is expected to remain considerable, however, at 6 per cent of GNI* (3.7 per cent of GDP) at the end of the projection horizon.

In terms of financing this year's projected large deficit, the Government has significant resources to hand, most notably large cash balances held by the National Treasury Management Agency (NTMA). As a result, the deterioration in the budget balance is not expected to be fully reflected in the gross government debt ratio, although the latter is still projected to increase to an elevated 105.6 per cent of GNI* (64 per cent of GDP). While

³⁴ It is important to note that no assumptions are made regarding any additional expenditure or tax measures in Budget 2021.

this represents a downward revision to the ratio from Quarterly Bulletin 3 reflecting a more positive outlook for GNI*, in nominal terms gross debt is higher. Despite the sharp economic downturn, Irish sovereign borrowing rates remain at very low levels - supported by the ECB's pandemic emergency purchase programme - while the medium term maturity profile is relatively favourable, with no bonds maturing in 2021.

As noted in Quarterly Bulletin 3, there is a much higher level of uncertainty surrounding the fiscal outlook than would normally be the case. This not only reflects broader uncertainty about the impact of the pandemic on the macro economy, but also over the final cost and duration of the support measures introduced by Government. Brexit and potential changes to international tax systems could also impact the public finances over the medium term. Accordingly, the risks to the projections presented here are high.

Exchequer Returns

The Exchequer ran a deficit of €9.5bn in the period January to August, a very substantial deterioration when compared to the same period in 2019. The position would have been worse but for factors that have no impact on the general government balance - most notably surplus income payments by NAMA and the Central bank - excluding which the Exchequer deficit was just over €13.4 billion (see Table 3)³⁵.

Table 3: Analytical Exchequer Statement, 2019 (€ millions)

	2020	2019	Annual Change (%)
	Jan to August	Jan to August	
	€m	€m	
Revenue	44389	44572	-0.4
Tax Revenue	34248	35050	-2.3
Appropriations-in-Aid	8876	8275	7.3
Other Revenue	1266	1247	1.5
Expenditure	57829	48096	20.2
Current Primary Expenditure	49946	40782	22.5
Capital Expenditure	4129	3362	22.8
Interest on National Debt	3754	3952	-5
Balance	-13440	-3524	-281.4

Source: Department of Finance

Note: The Figures in the Table exclude transactions with no general government impact, to try and give a closer approximation to the General Government Balance.

³⁵ It is more appropriate to focus on the Exchequer balance excluding transactions with no general government impact. This provides a better proxy for the main international budgetary measure and the one that is relevant for both domestic and European fiscal rules.

Cumulative revenue in August was only marginally lower than a year earlier (-0.4 per cent), with developments in the four major tax heads diverging significantly. Indirect taxes have been severely affected by the pandemic, with VAT and excise receipts declining by 21.3 and 14.8 per cent respectively from a year earlier, reflecting a fall in consumption and a deferment of some payments. Direct taxes, on the other hand, have proven to be quite resilient. Income tax receipts were only 1.4 per cent lower on an annual basis in the first eight months of the year, despite the deterioration in labour market conditions. While this partly reflects strong developments prior the pandemic, declines in subsequent months have not been as strong as had been expected. The factors behind this are discussed in more detail in Box F. Corporation tax receipts, meanwhile, continued their trend of recent years by surprising strongly on the upside, increasing by 31.4 year-on-year following a very strong May. It is important to note that a large proportion of tax revenue in Ireland is paid in the final two months of the year – one quarter of all tax revenue was cumulatively paid in November and December in each of the past three years – so there is still a high level of uncertainty around the final outcome. Nevertheless, the resilience of direct taxes is a positive development.

Table 4: Developments in tax heads, End August 2020

	Year on Year - Cumulative		
	End August 2020	End August 2019	% Change
	€m	€m	
Income Tax	13886	14080	-1.4
VAT	7794	9901	-21.3
Excise	3337	3916	-14.8
Corporation Tax	6478	4928	31.4
Other	2753	2225	23.7
Total	34248	35050	-2.3

Source: Department of Finance

Total gross expenditure, by comparison, was significantly higher than a year earlier (+20.2 per cent or just under €10bn extra), reflecting increased Departmental drawdown in response to the pandemic. The Department of Employment and Social Protection saw spending increase by 48 per cent or €6.6bn compared to the first eight months of 2019 on the back of a very sharp increase in transfer payments. Between jobless payments and the Pandemic Unemployment Payment, 450,000 people were receiving unemployment assistance at the end of August, compared to around 175,000 in February. Expenditure in the Department of Health, meanwhile, increased by 15.2 per cent, almost double the pace of a year earlier. Gross

capital expenditure has remained strong, while the cost of financing interest on the public debt continues to decline.

Fiscal Outlook, 2020 to 2022

The Exchequer data highlight the trends that are expected to lead to a sharp deterioration in the general government balance this year; falling revenue, led by strong declines in indirect taxes, and significantly higher expenditure.

Under the macroeconomic scenario presented earlier in the Chapter, total revenue is projected to decline by 10.8 per cent this year, compared to average growth of 6 per cent in the last three years. The better than expected performance of direct taxes in the first eight months is a positive, but a small contraction for the year as whole is still expected reflecting declines in employment and the fiscal measures introduced in July. Much, however, will depend on developments in November, a key month for both income and corporation tax returns. Indirect taxes are likely to record a much stronger decline, with the effect of lower private consumption weighing on receipts. Non tax revenues are also expected to contract; PRSI receipts have been harder hit than income tax – reflecting their broader base and treatment under income supports – and are set to drive a decline in social contributions, while the weaker economic outlook will affect other revenues (primarily sales and investment income). Supported by the recovering economy, revenue growth is expected to record modest positive growth next year before returning close to its medium term average growth rate in 2022.

Spending is projected to increase by 20.3 per cent this year, compared to average growth of 4.5 per cent in the last three years. This sharp increase primarily reflects the necessary fiscal support measures that have been introduced in response to the Crisis. The Government estimate that expenditure measures up to and including the announcement of the July Stimulus amounted to €21.6bn³⁶ (10.4 per cent of 2020 GNI*), with €17.6bn directly impacting the budget balance³⁷. Around two-thirds of this total is due to the various income support schemes, with increased business supports and health spending also prominent. In the case of the latter, significant additional resources will be made available in the final months of the year to manage service pressures in the Winter months, procure

³⁶ See 'July Stimulus Policy Initiative: Overview of Economic Support Measures', July 2020. Total measures introduced were estimated at €24.5bn (11.8 per cent of 2020 GNI*).

³⁷ The remaining €4bn are indirect expenditure measures. These are measures that do not currently impact the fiscal balance but could do so if, for example, guarantees were called or loans were not repaid.

Personal Protective Equipment and finance the Test and Trace service³⁸. Under the assumption that fiscal support measures are broadly temporary in nature, with most of the support falling out of the base next year, expenditure is expected to contract by 5.7 per cent in 2021 before broadly stabilising in 2022.

As Table 5 outlines, these revenue and expenditure developments result in a deficit of €25.5bn or 12.3 per cent of GNI* (7.5 per cent of GDP) this year. In nominal terms, this represents a downward revision from Quarterly Bulletin 3, with the increased cost of support measures partly offset by a better revenue outlook. The deficit ratio, by comparison, has improved slightly reflecting an upward revision to GNI*. The deficit position is expected to improve over the remainder of the projection horizon, falling to 8.3 and 6 per cent of GNI* in 2021 and 2022 respectively (5.1 and 3.7 per cent of GDP). It will remain at a very elevated position, however, particularly relative to the pre-pandemic outlook where a strengthening budgetary surplus was anticipated.

Table 5: Fiscal outlook under a baseline scenario (per cent of GNI* unless otherwise stated)

	2019	2020	2021	2022
GG Balance (€bn)	1.4	-25.5	-18.2	-13.8
GG Balance (% GNI*)	0.7	-12.3	-8.3	-6
GG Balance (% GDP)	0.4	-7.5	-5.1	-3.7
GG Debt (€bn)	204.1	219.3	235.8	248.4
GG Debt (% GNI*)	95.5	105.6	107.7	107.3
GG Debt (% GDP)	57.3	64	66	66

Source: CSO and Central Bank of Ireland Projections

In terms of general government debt, the scenario would see an increase from 95.5 per cent to 105.6 per cent of GNI* this year (or from 57.3 to 64 per cent of GDP). As in the case of the general government balance, while the nominal debt position has worsened from QB3 the ratio has improved somewhat reflecting a more positive outlook for GNI*. Relative to 2019 the nominal increase in debt - €15.2bn - is not as significant as the €27bn deterioration expected in the budget balance as the Government plans to use sizeable existing resources to fund a large part of the deficit. This includes cash reserves held by the NTMA³⁹, National Asset Management Agency surplus payments and resources in the Rainy Day Fund. While the

³⁸ See Health Service Executive: 'Winter Planning within the COVID-19 Pandemic, October 2020 to April 2021', September 2020.

³⁹ We assume a €9bn rundown in cash balances this year, consistent with the amount outlined in the NTMA's September 2020 Institutional Investor Presentation.

debt ratio is projected to record another increase in 2021, debt dynamics should be more favourable in subsequent years. Strong economic growth and low interest rates are expected to offset the negative impact of primary deficits resulting in a gradual decline in the ratio over the medium term.

Funding and Other Developments

The NTMA entered September with significant cash balances of just under €30bn. Total bond issuance of €21.25bn had taken place by mid-September, with funding activity for 2020 as a whole now expected to be at the upper end of the target range of €20bn to €24bn. The cost of Irish sovereign borrowing remains very low, supported by the ECB's pandemic emergency purchase program. The NTMA have also taken advantage of favourable market conditions in recent years to improve Ireland's maturity profile by extending out borrowing and replacing expensive loans with cheaper ones. While maturing bonds were relatively elevated this year at around €17bn, redemptions are much lower in the coming years. In fact, total bond redemptions for the period 2021 to 2023 as a whole - €19bn - are only marginally higher than those that occurred this year, with none set to mature in 2021⁴⁰. This should further increase flexibility in the coming years.

Box F: The resilience of income tax in 2020

By Rónán Hickey, David Horan and Enda Keenan⁴¹

Developments in Irish corporation tax have rightly received significant attention in recent years. This is reflective of their rapid growth, the disproportionate role they have played in driving total tax growth and the narrow nature of the tax base. In nominal terms, however, income tax remains Ireland's largest tax head, and its importance has grown following the introduction of the Universal Social Charge (USC) – and its predecessor the income levy – in 2009. As Chart A shows, income tax represented an average of 30 per cent of total tax revenue throughout the 2000s. Following the financial crisis, however, this figure has grown to around 40 per cent, with the USC responsible for much of the increase.

⁴⁰ Around €500m of UK bilateral loans are due to be repaid in 2021 following a payment of €2bn this year.

⁴¹ Irish Economic Analysis

Chart A: Tax Heads as Proportion of total tax

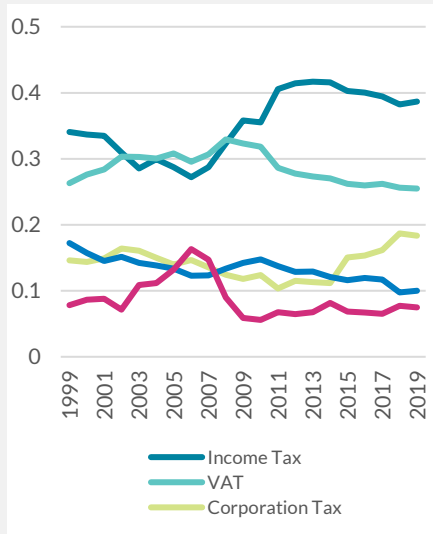
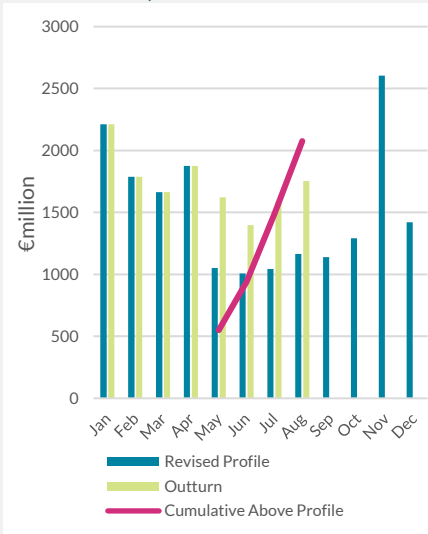


Chart B: Income Tax Profile and Outturn, 2020



Turning to developments this year, income tax receipts have proven to be extremely resilient despite the strong adverse impact of the pandemic on the labour market. In April, the Department of Finance revised down its Budget 2020 projection for income tax receipts by almost one-quarter (or by €5.6bn) against the backdrop of a severely weaker outlook for the labour market. Similarly, the fiscal deterioration outlined in Quarterly Bulletin volumes 2 and 3 for 2020 partly reflected an expectation of a sharp decline in direct tax revenue. Following a very strong start to the year, which saw year-on-year growth of 13.5 per cent in the first quarter, income tax receipts have recorded annual declines in each month since the health crisis began. These declines, however, have not been of the magnitude expected; in August, for example, monthly receipts were €589m higher than anticipated. As Chart B shows this has resulted in cumulative income tax receipts of €2.1bn (17.6 per cent) higher than the revised profile for the first eight months of the year.

The better than expected performance appears to reflect the progressive Irish income tax system, coupled with the nature of the shock to the Irish labour market. The former is clearly illustrated in Chart C, which shows the percentage of income tax paid by income range for 2018 (the latest data available). This highlights the small proportion of the tax paid by lower income workers. Employment disruptions or job losses during the pandemic, meanwhile, have been disproportionately focused among these very workers at the lower-end of the income distribution. Research by Byrne et al (2020) on Pandemic Unemployment Payment claimants showed that affected workers are on average younger, employed on a part-time basis, more likely to be a citizen of another country, and more likely to be in their role for less than 12 months than the population

average.⁴² The latest Q2 2020 Labour Force Survey show employment decreases across all of these categories and most notably for part-time employment, down 12.5 per cent on annual basis compared to a fall of 1.1 per cent in full-time employment.

Chart C: Income Earners by Gross Income Range



Source: Central Statistics Office

Analysis of Temporary Wage Subsidy Scheme (TWSS) data shows that, at peak levels, take-up was proportionately greater among employees in higher-wage sectors than compared to the PUP, suggesting employment disruption or job loss was more prevalent amongst workers in lower earning sectors. TWSS data releases from the Revenue Commissioners highlighted that employees in receipt of higher weekly earnings were also more likely to be in receipt of additional wage top-ups by their employer. While the government income-support subsidy is not subject to taxation at source, additional top-ups provided by the employer are subject to income tax and USC charges as they are recorded under gross pay. Analysis by Keenan and Lydon (2020) estimates that the average subsidy amounts in the TWSS decreased continually on a weekly basis due to composition effects of higher earning sectors flowing off of the scheme and lower wage sectors flowing on.⁴³

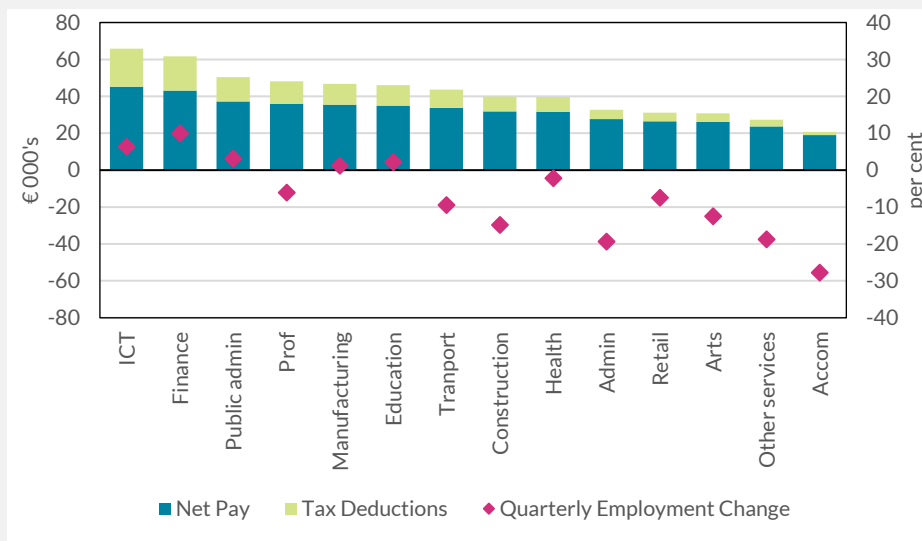
Finally, CSO Earnings and Labour Costs (EHECS) data for Q2 2020 show that average weekly seasonally-adjusted earnings are highest for workers in the ICT sector (€1,258), which has a far greater working home applicability, compared to the lower earnings sectors such as accommodation and food services (€380) in which there is a higher

⁴² Byrne et al (2020) "[The Initial Labour Market Impact of COVID-19](#)" Central Bank of Ireland Economic Letter Series. Vol 2020, No. 4

⁴³ Keenan and Lydon (2020) "Wage Subsidies and Job Retention" Central Bank of Ireland Economic Letter Series. Vol 2020, Forthcoming.

proximity risk.⁴⁴ The tax liabilities of the workers in these sectors vary substantially from 31.3 per cent of gross earnings in ICT and 7.3 per cent in accommodation.⁴⁵ EHECS data also show that despite containment measures negatively influencing aggregate employment activities, a higher-wage sector such as ICT increased employment figures by 6.3 per cent quarter-on-quarter, while accommodation and food services decline by 27.8 per cent as firms closed premises in light of public health advice (Chart D). The increasing level of higher-income workers appears to have offset a proportion of the reduction in tax take from the much larger level of employment loss in severely affected consumer-facing sectors.

Chart D: Tax contributions and employment change



Source: CSO EHECS

While developments in the labour market and the progressive nature of the Irish income tax system explain the resilience of income tax in recent months, it should be noted that the outlook remains clouded by significant uncertainty. A further caveat is the high proportion of tax that is paid in the final two months of the year of the Irish tax system. Nevertheless, the strength of income tax – and direct taxes more broadly – provide a clear positive in an otherwise challenging fiscal environment.

⁴⁴ See Lydon, R. (2020) "[CSO assessment of Occupations with Potential Exposure to COVID-19](#)" The Irish Economy

⁴⁵ Calculations for income tax deductions are based on seasonally-adjusted weekly earnings scaled to annual levels for a single person with no dependents or pension contributions.

Box G: Household and Business Financing Developments in the Irish Economy

By: Statistics Division

Introduction

The COVID-19 pandemic caused a sudden decline in economic conditions in Ireland. To help assess the unprecedented nature of the pandemic, the Central Bank has developed new high frequency indicators such as daily payments data. As more of the traditional measures of economic activity become available for the pandemic period, they will complement the new high frequency indicators in understanding the impact of the initial lockdown.

This box aims to describe the key trends observed in households, firms and banks across both high frequency and traditional data. Recent months have seen firms' and households' deposits continue to rise, while household card spending, which has recovered strongly, remains vulnerable to the evolving nature of the pandemic. Government support and payment breaks have helped limit the vulnerability of households facing temporary reductions in earnings and eased pressure on firms during the pandemic. It remains unclear if the initial signs of a recovery will persist, with overall economic conditions tied to the spread of the virus.

Households

Household spending was severely impacted by the COVID-19 pandemic and its associated restrictions. The decline in spending was particularly stark prior to the initial easing of restrictions. It has recovered significantly since, with the most recent trends indicating that total spending is close to the daily average level for the equivalent month last year (Figure 1).

Figure 1: Daily Payments Data

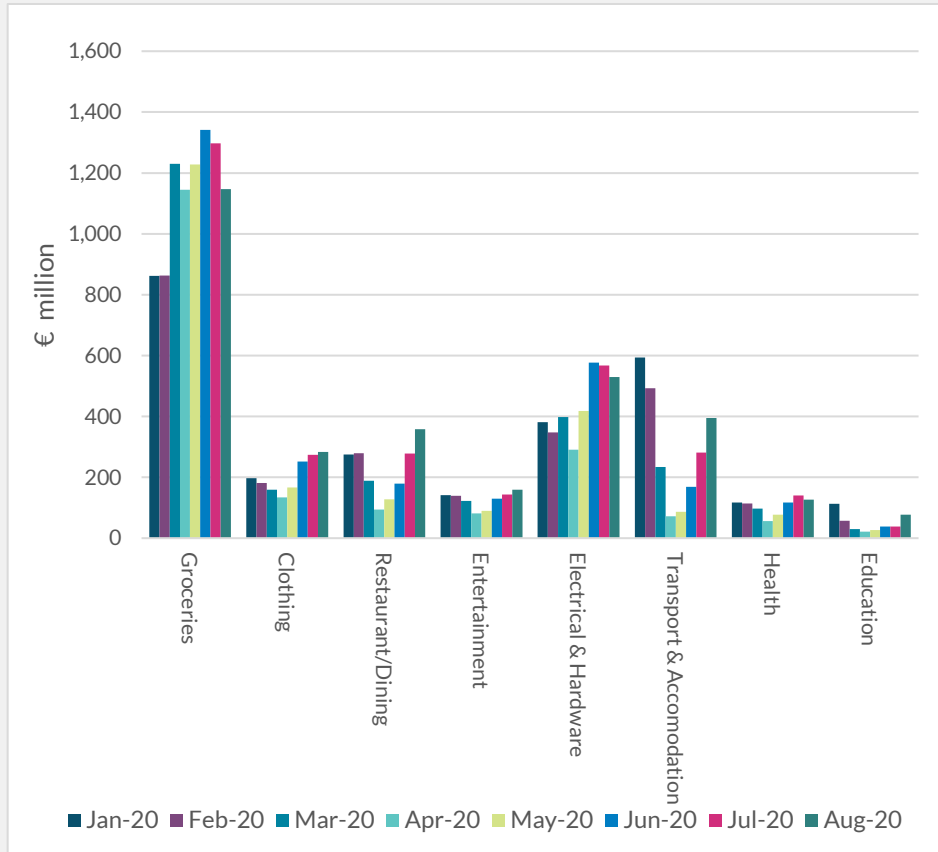


Source: Central Bank of Ireland

Notes: Card data are calculated as 7-day moving average

Looking back over the summer months, July saw daily total spending, which includes ATM withdrawals, fall below the July 2019 daily average. However, this reflects an increase in spending between June and July last year rather than a sizable decrease in spending between months this year. Daily total spending in August was quite stable relative to the equivalent average in 2019, albeit with a pickup in spending over the final weekend of the month. More recently, in September, total card spending has declined relative to the September 2019 daily average, perhaps reflecting the increasing COVID-19 case numbers in September, which could weigh on consumer confidence. Throughout this period, ATM withdrawals remained well below the daily average for the equivalent period last year, perhaps reflecting public perceptions around the risk of using physical cash during the pandemic. The data suggests that card spending has remained relatively stable since Dublin and Donegal moved to Level 3 of the living with COVID-19 plan. However, these additional restrictions, as well as the potential for other localised restrictions related to the virus, could affect consumer confidence even outside the area subject to restrictions and highlight that controlling the spread of the virus is likely to be more relevant for the path of spending than traditional seasonal patterns.

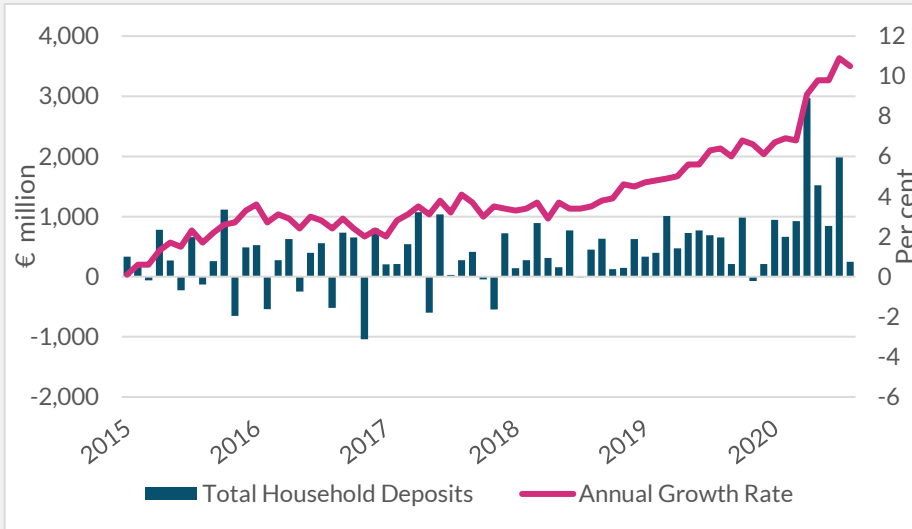
Figure 2: PoS Card Expenditure by Sector



Source: Central Bank of Ireland

In order to examine sectoral effects, we focus on the card component of spending and see that the impact of the pandemic on spending patterns varied widely, with sectors where the containment measures limited the opportunity for spending having experienced substantial declines during the initial lockdown. For instance, there was a drop off on spending in areas such as restaurants and transport & accommodation while spending on groceries saw a notable spike during the initial pandemic period. As restrictions eased, spending on restaurants and transport & accommodation has picked up, with strong monthly growth. Meanwhile, grocery spending has remained at an elevated level, despite falling on a monthly basis in both July and August. This pattern is reflected in CSO retail sales data, where spending in areas subject to restrictions such as bars or department stores remains low on a year-on-year basis, but has started to pick up as restrictions lifted. This ongoing change in spending patterns relative to pre-pandemic norms is unsurprising given the degree to which the virus continues to affect day-to-day life.

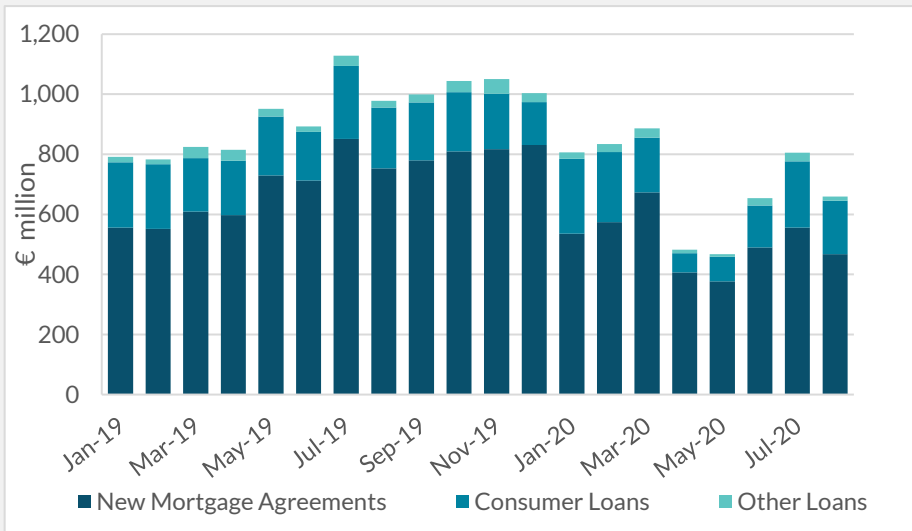
Figure 3: Household Deposits Net flows and Annual Rate of Change



Source: Central Bank of Ireland

Household deposits have seen a notable increase since the start of the pandemic, with net inflows of over €7.5 billion since April (Figure 3). This increase in deposits reflects restrictions on household spending over the last number of months, which resulted in reduced consumption choices for households, even where there was not a loss of income. The lower net inflows of deposits in August, when restrictions were reduced at the national level, supports this. There may also have been an increase in precautionary saving since the onset of the pandemic, as households looked to mitigate potential income shocks, increased job insecurity or health concerns.

Figure 4: Volume of Loans to Irish Households by Purpose of Loan



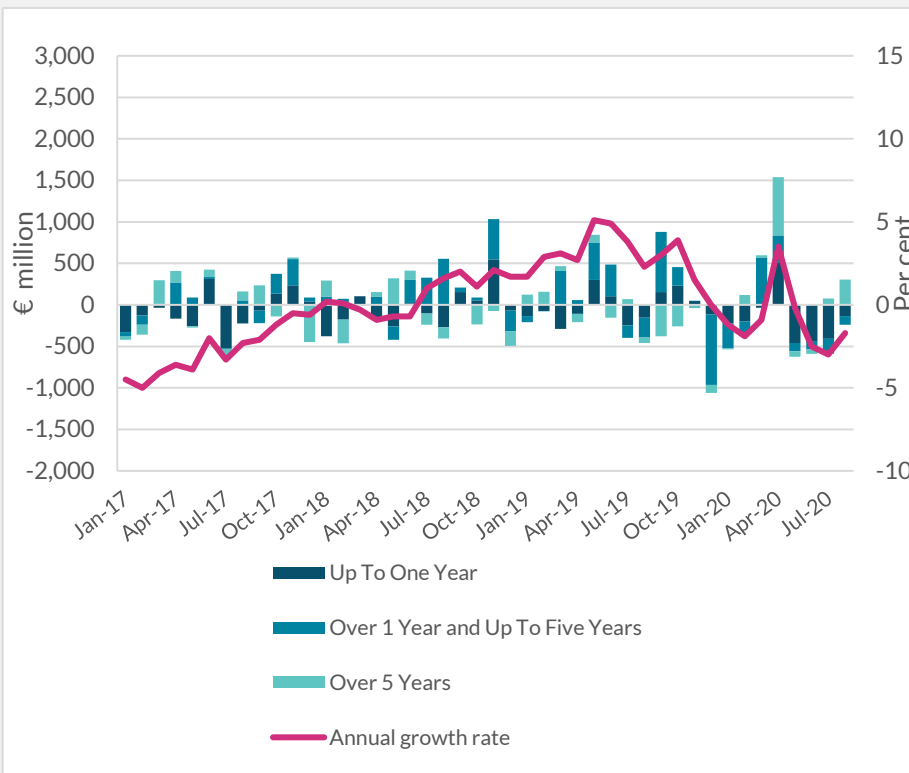
Source: Central Bank of Ireland

Loans to households remain well below volumes seen in the equivalent period last year, with declines across each loan category. The Bank Lending Survey suggests there was also an increase in rejected loan applications in 2020 Q2, with credit standards and term conditions tightening at the fastest rate since 2008 . However, new mortgage agreements had seen two consecutive monthly gains prior to declining in August, albeit with new lending still down by 38 per cent from a year-on-year perspective. New consumer lending agreements also declined in August on a monthly basis and remain circa 12 per cent lower annually.

Payment breaks continue to help relieve pressure on households, with roughly 6 per cent of outstanding loans for Irish households under active payment breaks as of early September. This ratio of loans with active payment breaks has almost halved since the end of June . Payment breaks were initially granted on a three-month basis, with the option to extend for a further three months. Based on the current schemes in place, borrowers will begin to come to the end of the maximum agreed duration of payment breaks, from end-September 2020.

Business

Figure 5: Net flow of Loans to NFCs by Maturity

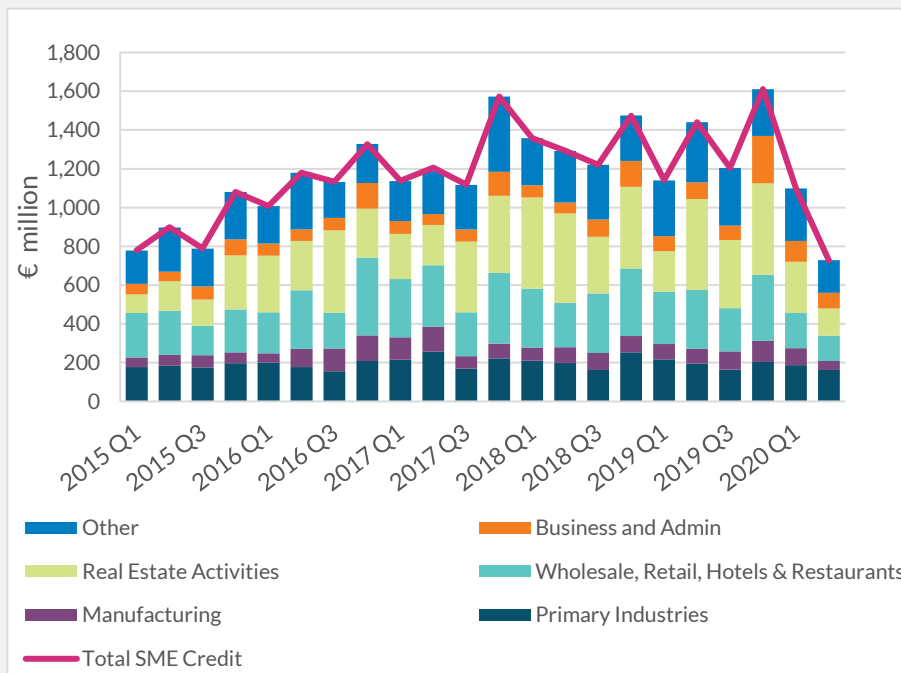


Source: Central Bank of Ireland

Banks reported a modest fall in demand for loans from enterprises in the July Bank Lending Survey, driven mainly by large enterprises, as firms attempted to deal with the fallout from the pandemic. Figure 5 above shows an initial spike in lending to NFCs at the onset of the pandemic, followed by three months of repayments exceeding gross new lending, and a modest increase in net lending in August, despite the prevalence of NFC loans being subject to payment breaks over this time. Payment breaks for NFCs stood at 14.5 per cent of total NFC loans in early September, down from 17.2 per cent at the end of June. Overall, the annual growth rate of NFC lending has turned negative, with annual declines recorded in each of the last four months.

The volume of new loans to NFCs stabilised in July, after two preceding months of sharp annual declines but was down 21.5 per cent annually in August, driven by the decline in loans over €1 million. Small loans (up to €250k), which typically include SMEs, were down 26 per cent in August on a year-on-year basis, while new NFC loans over €250k and up to €1 million were 26 per cent higher annually. This breakdown by loan size highlights a potential divergence based on firm size.

Figure 6: Gross New Lending to SMEs



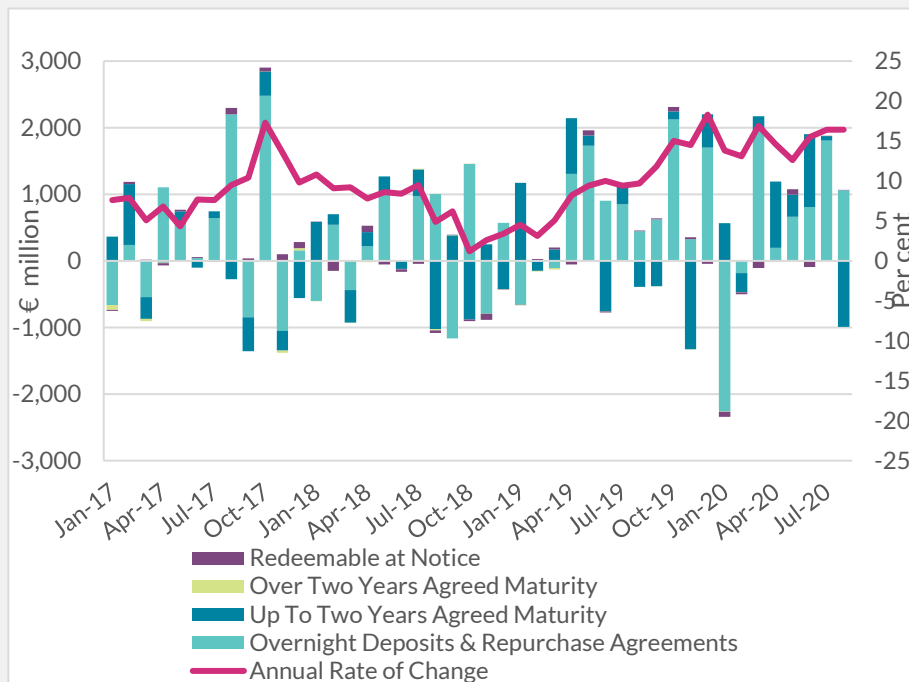
Source: Central Bank of Ireland

Gross new lending to SMEs continued to decline in the second quarter (Figure 6), falling 50 per cent relative to the same period in 2019, reaching its lowest level since 2014. At the sector level, lending to real

estate activities, manufacturing and wholesale, retail, hotels & restaurants was particularly impacted.

SME borrowers were significantly more likely than larger firms to utilise payment breaks available since the onset of the pandemic. This will suppress SME loan repayments over the period of the payment breaks. As of early September, the payment break ratio on SME loans was around 18 per cent, down from 23 per cent at the end of June, equivalent to a fall of around €1.9 billion in value.

Figure 7: NFC Deposits Net Flows by Category



Source: Central Bank of Ireland

The general trend of growth in NFC deposits since 2019 has continued into the pandemic period, with a net inflow of around €6 billion since April, mainly from overnight deposits (Figure 7). Payment breaks may have partially facilitated this increase in deposits at an aggregate level by reducing the debt burden faced by firms. However, this does not appear to be the main driver of participation in the payment break scheme, as the highest rate of payment breaks are amongst borrowers in sectors most impacted by the pandemic and thus in need of liquidity relief.

Summary

The economic shock from the initial restrictions related to the COVID-19 pandemic led to a notable change in behaviour from households and firms. Household spending fell sharply and then gradually increased as restrictions were lifted, although the pattern of spending continues to diverge from pre-pandemic norms. The potential for further (localised)

restrictions and ongoing economic uncertainty could affect the path of spending going forward. This curtailment in household spending has coincided with increasing household deposits, which have grown substantially since the start of the pandemic. There has also been a decline in new lending to households, which remains well below the equivalent period in 2019 despite more recent monthly gains.

As with households, there has been a pattern of increasing deposits and declining loan demand amongst firms. The volume of new loans to NFCs has started to stabilise, but applications remain low. SME data shows that gross new lending fell to its lowest level since 2014, with the impact of the pandemic varying across sectors. This pattern was unsurprising given the nature of restrictions following the onset of the pandemic. Importantly, both households and firms, particularly SMEs, have benefited from payment breaks on loans, limiting their vulnerabilities to reductions in earnings and consumer spending respectively.

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