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Comments and enquiries should be addressed to:

European Commission
Directorate-General for Economic and Financial Affairs
Unit Communication
B-1049 Brussels
Belgium
E-mail: ecfin-info@ec.europa.eu

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Directorate-General for Economic and Financial Affairs

Post-Programme Surveillance for Ireland

Spring 2014 Report

EUROPEAN ECONOMY Occasional Papers 195

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The main contributors were Stephanie Medina Cas, Quentin Dupriez, Jānis Malzubris, Irena Peresa, and Graham Stull. Statistical assistance was provided by Jacek Szelożyński. Comments gratefully received from Rada Tomova (DG ECFIN) and Miguel Kruse Trigo (DG COMP).

The report was prepared in liaison with the European Central Bank.

Comments on the report would be gratefully received and should be sent, by mail or e-mail to:

Martin Larch

European Commission

Head of Unit responsible for Ireland, Lithuania and Poland

CHAR 14/174

B-1049 Brussels

E-mail martin.larch@ec.europa.eu

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ABBREVIATIONS

AIB	Allied Irish Bank
AQR	asset quality review
BOI	Bank of Ireland
BSA	Balance Sheet Assessment
BTL	buy-to-let
CA	comprehensive assessment
CBI	Central Bank of Ireland
CER	Commission for Energy Regulation
CET1	common equity tier 1
CRE	commercial real estate
CRO	Credit Review Office
CSO	Central Statistics Office of Ireland
CT1	core tier 1
DSA	debt sustainability analysis
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
EDP	Excessive Deficit Procedure
EFSF	the European Financial Stability Fund
EFSM	European Financial Stabilisation Mechanism
EIB	European Investment Bank
EPC	Economic Policy Committee
ESB	Electricity Supply Board
ESM	European Stability Mechanism
ESRB	European Systemic Risk Board
ETBs	Education and Training Boards
FET	further education and training
GDP	gross domestic product
GP	general practitioner
HICP	harmonised indices of consumer prices
HSE	Health Services Executive
IBF	Irish Banking Federation
IBRC	Irish Bank Resolution Corporation
ICT	information and communication technology
IDR	in-depth review
INN	International Non-proprietary Name
ISI	Insolvency Service of Ireland
ISIF	Irish Strategic Investment Fund
MART	mortgage arrears restructuring targets
MIP	Macroeconomic Imbalance Procedure
MNCs	multi-national companies
MTO	Medium-Term Budgetary Objective
NAMA	National Asset Management Agency
NFCs	non-financial corporations
NIM	net interest margin

NPL	non-performing loan
NPRF	National Pension Reserve Fund
NTMA	National Treasury Management Agency
PDH	principal dwelling home
PIPs	Personal Insolvency Practitioners
PMIs	Purchasing managers indices
PPM	post-programme monitoring
PPS	post-programme surveillance
PTSB	Permanent TSB
qoq	quarter-on-quarter
RWA	risk weighted assets
sa	seasonally adjusted
SBCI	Strategic Banking Corporation of Ireland
SCP	Stability and Convergence Programme
SMEs	small and medium-sized enterprises
SSM	Single Supervisory Mechanism
yoy	year-on-year

EXECUTIVE SUMMARY

This first post-programme surveillance (PPS) report provides an assessment of Ireland's economic, fiscal and financial situation following the completion of the EU-IMF financial assistance programme. Overall, the positive trends of economic adjustment observed during the EU-IMF financial assistance programme have continued against the backdrop of an improving external environment and increased risk appetite in international financial markets. Further progress is required in several areas to complete the adjustment process and to achieve balanced and sustainable growth. In particular, in view of still very high government and private indebtedness, coupled with a large stock of impaired assets in the domestically owned banks, Ireland needs to continue with fiscal consolidation, reduce the private sector debt overhang, and further progress financial sector repair to safeguard and strengthen the momentum of the economic recovery. This assessment is consistent with the conclusions of the Commission's 2014 in-depth review (IDR) under the Macroeconomic Imbalances Procedure that vulnerabilities are still present and continue to require specific monitoring and decisive policy action.

While economic growth turned out lower than expected in 2013, the outlook for 2014 and 2015 is improving. At -0.3% real gross domestic product (GDP) growth was below expectations in 2013, and at odds with other economic indicators, especially employment. Nonetheless, high-frequency indicators continue to point to a solid recovery in 2014, with both services and manufacturing purchasing managers indices (PMIs) in solid positive territory in April 2014. In the first few months of the year, unemployment remained on a downward path, reaching 11.8% in April, and the property market prices are picking up, though the highly leveraged private and public sectors inhibit a faster recovery, especially of private consumption. The Commission services' Spring Forecast projects GDP growth to rise to 1.7% in 2014 and 3% in 2015. Inflation is expected to remain muted as the necessary process of relative price adjustments continue.

Fiscal consolidation remains on course though political pressures on the budget are increasing. The general government deficit narrowed by 1 percentage point of GDP in 2013 to 7.2% of GDP, below the Excessive Deficit Procedure (EDP) ceiling of 7.5% of GDP. Overall, expenditure developments were on track, while some overruns in the health sector (0.1% of GDP) were offset by savings in other areas. The 2014 fiscal deficits target under the EDP will likely be met despite some slippages in the health sector, which may be offset from savings in other. The government remains committed to sustainably correct the excessive deficit by 2015 and achieve a balanced budget by 2018. Measures needed to meet the 2015 EDP target of 2.9% of GDP have not been detailed and are expected to be announced in October with the draft budget. In recent months, and against the backdrop of improving economic conditions, there has been growing political debate contemplating the possibility of cutting taxes and/or increasing spending in the 2015 budget. While no concrete measures have been tabled, any plans to cut taxes or increase expenditure would need to be compatible with the agreed fiscal consolidation path.

Though still susceptible, the financial sector continues to recover while non-performing loan (NPL) resolution advances, and the European Central Bank's (ECB) comprehensive assessment (CA) is underway.

- *The three main domestic banks' performance continues to improve.* The banks' capital ratios are above the regulatory minimum and though non-performing loans (NPLs) remain very elevated, provision coverage is relatively high. Two of three banks, Allied Irish Bank (AIB) and Bank of Ireland (BOI, returned to profitability in early 2014, and have now had state aid restructuring plans approved by the European Commission (EC). The outlook remains challenging particularly for the third institution, Permanent TSB (PTSB).

- *Loan restructurings continue to progress but at a slow pace.* In the fourth quarter 2013 mortgage arrears restructuring targets (MART) were met but the banks' returns suggest that a sizeable proportion of solutions continue to rely on legal action using the threat of repossession, while actual repossessions remain low so far. Both mortgage and commercial loan resolutions can take multiple

years, thus it will take some time for NPLs to fall significantly. With many legal cases in the pipeline, the court system could face capacity problems, though evidence of this has not yet materialised, and developments are closely monitored by the authorities. The newly established personal insolvency procedure remains little used and there is criticism that it is expensive among other issues.

- *The Central Bank of Ireland (CBI) is undertaking the relevant work for the ECB's CA.* The CA takes place after the balance sheet assessment carried out under the EU-IMF financial assistance programme in 2013. This balance sheet assessment contributed to some reclassification of assets, increased loan-loss provisions and risk-weighted assets. While capital ratios were adjusted downwards, all three main domestic banks have capital buffers above the core tier 1 regulatory threshold of 10.5% at the time. The authorities do not expect major shocks from the new asset quality review and stress test elements under the ECB's CA, though any additional capital needs should be promptly addressed by banks, in line with the modalities outlined by the ECB. The supervisory risk assessment element of the CA will examine among other things banks' liquidity, governance and profitability, and it may result in follow-up supervisory actions to enhance financial stability.

- *The successful sale of over 90% of Irish Bank Resolution Corporation's (IBRC) assets and the strong demand for Irish commercial real estate may accelerate the wind-down of the National Asset Management Agency (NAMA).* The unsold IBRC assets will no longer be transferred to NAMA and are instead being auctioned to private investors. The speedy wind-down of IBRC reduces the amount of the state's contingent liabilities and some revenues may be available to the government from the operation. NAMA also plans to accelerate the redemption of its bonds, although the original target date of 2020 for the repayment of all senior bonds remains in place.

Financing initiatives to boost growth and small and medium-sized enterprises (SMEs) are welcome but careful planning is required to make them sustainable. Plans have recently been outlined for the establishment of the Strategic Banking Corporation of Ireland (SBCI) to boost SME lending. The institution would be funded by the European Investment Bank (EIB), the German development bank KfW, the National Pension Reserve Fund (NPRF) and other potential funders. Plans to review or streamline the numerous public schemes already available to raise SME credit are not available yet. The establishment of the Irish Strategic Investment Fund (ISIF), due to replace the NPRF, will need cautious oversight. The new fund will amount to 4% of GDP and involve private co-funding of Irish firms. ISIF will have a double objective: raising jobs and growth, while also generating a commercial return. It will also focus on SMEs and infrastructure investment. To boost investment in new housing, the government is studying the introduction of a mortgage insurance scheme for first-time buyers of new homes. While details are still lacking, it will be crucial to prevent potential effects on house prices and possible contingent liabilities for the state.

Structural reforms continue to progress and aim to support fiscal consolidation, improvements in the labour market and competition in sheltered sectors. Water charges will be introduced in the final quarter of 2014 with a positive impact on public finances, and the water sector reform process is proceeding. The implementation of the Legal Services Regulation Bill has slipped again and renewed momentum is needed to enable enactment during the third quarter and the establishment of the regulatory authority by the end of 2014. Active labour market policy reforms continue while further education and training measures are at a much earlier stage. These need to be geared to satisfying jobseekers' and employers' needs, while helping get the long-term unemployed back to work. The key health sector reforms are proceeding, but important steps are still to be taken. Further pharmaceutical cost savings could to be achieved through negotiations with the industry body representing the manufacturers of patent protected medicines. The sale of state assets has progressed in recent months with the sale of Bord Gáis Energy and two power plants of the Electricity Supply Board. Proceeds from these asset sales could yield up to EUR 500 million (about 0.3% of GDP) in 2014 in government revenue, but the precise deficit-improving effect is not clear yet.

On the basis of the analysis in this report, repayment risks for the EFSM and EFSF loans are very low at present. This assumes that the authorities continue to implement agreed policy plans and access to credit markets is maintained. Market access conditions of the Irish sovereign have considerably improved due to policy actions at national and European level along with recovering confidence in the Irish economy and public finances. In addition, cash buffers remain at comfortable levels. The first principal repayment on the EFSF loan is due only in 2029 and on the EFSM loan, it is due in 2027 at the earliest.

1. INTRODUCTION

Ireland successfully completed the EU-IMF financial assistance programme in December 2013. The three-year programme had been approved by the ECOFIN Council and the IMF Board in December 2010. The economic adjustment programme provided financing by the European Financial Stabilisation Mechanism (EFSM), the European Financial Stability Fund (EFSF), the IMF, and bilateral partners (UK, Denmark and Sweden) of EUR 67.5 billion. The objective of the arrangement was to address Ireland's financial sector weaknesses, put its public finances on a sustainable path, implement structural reforms aimed at lowering unemployment and, to fully regain international capital market access at sustainable rates. Implementation of the programme conditionality was strong ([1]).

Staff from the European Commission (EC), in liaison with the ECB, undertook the first post-programme surveillance (PPS) review mission for Ireland from 29 April to 2 May 2014. The mission was coordinated with the IMF's post-programme monitoring (PPM) mission. The European Stability Mechanism (ESM) participated in the meetings on aspects related to its own Early Warning System. PPS aims at a broad monitoring of the repayment capacity of a country having received financial assistance ([2]). While there is no policy conditionality under PPS, the Council can issue recommendations for corrective actions if necessary and where appropriate. PPS is biannual in terms of reporting and missions. Following the conclusions of 2014 in-depth review (IDR), in the case of Ireland PPS will also cover the specific monitoring with regards to the adjustment of macroeconomic imbalances in the context of macroeconomic imbalances procedure (MIP)([3]).

([1]) For more details see the final programme review report: http://ec.europa.eu/economy_finance/publications/occasional_paper/2013/op167_en.htm

([2]) PPS is foreseen by Article 14 of the two-pack Regulation (EU) N°472/2013. It starts automatically after the expiry of the programme and lasts at least until 75% of the financial assistance has been repaid.

([3]) See communication from the Commission to the European Parliament, the Council and the Eurogroup: "Results of in-depth reviews under Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances" http://ec.europa.eu/economy_finance/economic_governance/documents/2014-03-05_in-depth_reviews_communication_en.pdf

2. RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

GDP growth in 2013 disappointed on the downside yet there are positive indications from high-frequency indicators. Real GDP shrank by 0.3% year-on-year (yoy) in 2013, with a disappointing contribution to growth from the final quarter related to a surge in imports and sluggish private consumption. While this may in part reflect ongoing deleveraging and weak earnings, statistical anomalies in the construction of the private consumption price deflator also had an impact ([4]). Investment grew at 3.6% in real terms in 2013, albeit from very low levels. The more robust performance of GNP in 2013, at 3.4% yoy, better reflects the relative health of the domestic economy as it strips out the impact of income repatriated to non-residents from the large foreign-owned multi-national companies (MNCs)([5]). This is also supported by high frequency indicators, with both services and manufacturers PMIs showing strongly positive results, and retail sales in April 2014 growing at 8.9% yoy. Confidence in the economic recovery was evidenced by a surge in machinery investment at the end of 2013, and a steady increase in construction, though from very low levels. Inflation has remained muted, with the harmonised indices of consumer prices (HICP) inflation at 0.5% yoy in 2013, well below the euro-area average of 1.3%. This was due to lower energy prices, low imported inflation and the lack of wage pressures in the domestic economy.

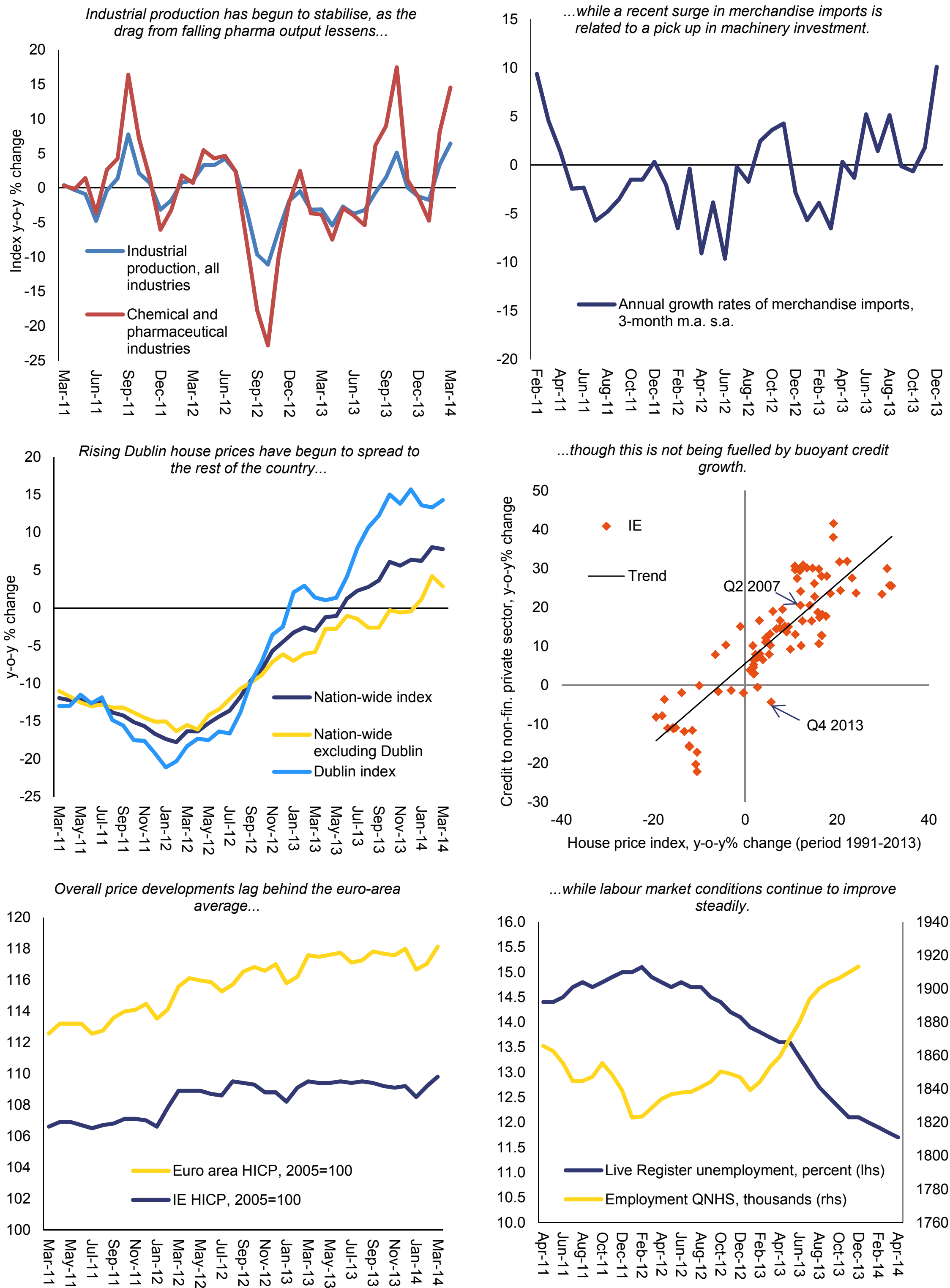
The drag on goods exports from the 'patent cliff' remains, while services exports and the current account balance strengthened. The dampening effect of patent expirations for some pharmaceutical products is showing early signs of abating. Nonetheless, recent drops in the value of pharma output have disguised steady improvements in other categories of goods exports, for which the three-month annual moving average increased by 1.6% in March 2014. Real services exports grew by 3.9% yoy in 2013, bolstered by competitiveness gains and a favourable business climate for the mostly foreign-owned companies operating in the information and communication technology (ICT) and financial services sectors. Overall the current account surplus further improved in 2013 to 6.6% of GDP, aided by a large drop in factor income outflows, which fell by 9.2% yoy. Ireland maintained a large positive trade balance in 2013 of 23.3% of GDP.

Improvements in the labour market continue to outpace GDP growth. In 2013, employment rose by 2.4% yoy. The standardised unemployment rate has dropped steadily since February 2012 to 11.8% seasonally adjusted (sa) in April 2014. Though long-term unemployment remains high at 60.5% of the total unemployed in the first quarter of 2014, since early 2012, long-term unemployment has declined from 9.5% of the total labour force to 7.3% in the first quarter of 2014. Similarly, youth unemployment was at 25.3% in the first quarter of 2014, down from its high of 29.7% in the first quarter of 2012. Wage growth has been contained by slack in the labour market, leading to some further improvements in competitiveness.

([4]) In addition to HICP consumption items, the Central Statistics Office of Ireland (CSO) includes imputed rents in the basket used to calculate the private consumption deflator. Thus, an increase in actual rents paid by tenants (which rose 8.5% yoy in December 2013) impacts the private consumption price deflator more than five times as much as it affects HICP inflation, given roughly 70% of homes are owner-occupied. The deflator may also differ due to the different characteristics of the private rented stock to the owner-occupied stock.

([5]) The quarterly national accounts series is highly volatile in Ireland and subject to frequent, large revisions, in part due to the open nature of the economy and large share of output accounted for MNCs. For instance, the first two quarters of 2013 came out fairly negative in the first national accounts estimates and were revised upward significantly later on, closing the gap with high-frequency indicators.

Graph 2.1: **Recent economic developments**



Source: BIS, Eurostat and CSO.

The housing market has stabilised, with price recovery driven by a shortage of new supply, especially in Dublin. Property prices began to rise in 2013 and were up 7.8% yoy in March 2014. The national figure disguises divergent regional trends, as a supply shortage in Dublin continues to drive price increases higher, at 14.3% yoy in March, whereas price growth in Cork and Galway has turned positive but remains flat elsewhere in the country. However, the level of sales transactions underpinning these data was low, at only 3 500 in March. A 16.5% yoy increase in new home starts in January 2014, with a strong focus on Dublin activity, reveals the market is responding to rising prices. Still, the lag to completion implies continued low levels of supply for much of this year, and the projected number of new home completions for 2014, at 12 000 units, is insufficient to meet current levels of housing demand. Last but not least, experience shows a strong positive relationship between accelerated house price growth and a rise in credit (Graph 2.1). Thus the weak mortgage lending observed supports the view that current house price rises are related to fundamentals, and do not as yet pose tangible risks of a credit-driven property price bubble.

Table 2.1: **Main features of macro forecast**

		2012			Annual percentage change					
bn EUR		Curr. prices	% GDP	94-09	2010	2011	2012	2013	2014	2015
GDP		163.9	100.0	5.7	-1.1	2.2	0.2	**-0.3**	**1.7**	**3.0**
Private consumption		78.3	47.8	4.9	0.4	-1.4	-0.3	**-1.1**	**0.4**	**0.8**
Public consumption		29.4	18.0	4.6	-4.9	-2.9	-3.2	**-0.6**	**-0.7**	**-0.1**
Gross fixed capital formation		17.5	10.7	5.4	-22.7	-9.1	-0.8	**3.6**	**12.0**	**6.5**
of which: equipment		6.8	4.2	6.6	-11.2	-1.6	2.3	**-9.3**	**12.0**	**5.1**
Exports (goods and services)		176.7	107.8	9.7	6.4	5.3	1.6	**0.1**	**2.8**	**3.7**
Imports (goods and services)		137.0	83.6	9.0	3.8	-0.4	0.0	**1.0**	**3.1**	**2.6**
GNI (GDP deflator)		133.9	81.7	5.1	-0.2	-1.4	0.8	**3.4**	**1.5**	**3.5**
Contribution to GDP growth:	Domestic demand			4.3	-4.4	-2.4	-0.8	**-0.3**	**1.4**	**1.2**
	Inventories			0.1	0.6	0.9	-0.4	**0.2**	**-0.1**	**0.0**
	Net exports			1.7	3.0	5.6	1.6	**-0.7**	**0.4**	**1.8**
Employment				3.1	-4.1	-1.8	-0.6	**2.4**	**2.4**	**2.3**
Unemployment rate (a)				7.2	13.9	14.7	14.7	**13.1**	**11.4**	**10.2**
Compensation of employees / head				4.7	-3.8	-0.1	0.8	**-1.7**	**0.4**	**0.5**
Unit labour costs whole economy				2.1	-6.7	-4.0	0.0	**1.0**	**1.1**	**-0.2**
Real unit labour cost				-0.4	-5.3	-4.6	-0.6	**0.6**	**-0.1**	**-1.1**
Saving rate of households (b)				-	13.2	11.2	10.2	**11.8**	**10.2**	**9.8**
GDP deflator				2.6	-1.5	0.7	0.7	**0.4**	**1.1**	**0.9**
Harmonised index of consumer prices				-	-1.6	1.2	1.9	**0.5**	**0.6**	**1.1**
Terms of trade goods				0.1	-3.6	-6.2	-0.7	**-0.2**	**0.2**	**0.3**
Trade balance (c)				19.9	22.6	22.6	22.2	**19.6**	**18.1**	**17.9**
Current-account balance (c)				-0.5	1.1	1.2	4.4	**6.6**	**7.4**	**8.9**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-0.1	0.7	1.1	3.2	**6.6**	**6.8**	**7.4**
General government balance (c)				-0.5	-30.6	-13.1	-8.2	**-7.2**	**-4.8**	**-4.2**
Cyclically-adjusted budget balance (c)				-0.8	-28.5	-12.5	-8.0	**-6.6**	**-4.4**	**-4.3**
Structural budget balance (c)				-	-9.2	-8.4	-8.0	**-6.4**	**-4.6**	**-4.2**
General government gross debt (c)				47.0	91.2	104.1	117.4	**123.7**	**120.9**	**120.1**

(a) Eurostat definition. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.

Source: Commission services

The general government deficit narrowed by 1 percentage point of GDP in 2013 to 7.2% of GDP, below the EDP ceiling of 7.5% of GDP. Public finances in 2013 were broadly in line with expectations. The improvement mostly stems from higher tax revenues (in the order of 1.5% of GDP) as weaker VAT revenue was offset by somewhat stronger corporation and labour tax revenue. Expenditure developments were on track, while some overruns in the health sector (0.1% of GDP) were offset by savings in other areas. A reduction in primary expenditure (of around 0.4% of GDP) more than offset an increase in debt servicing costs (of 0.9% of GDP). In structural terms, the 2013 general government deficit is estimated to

have improved by 1.6 % of GDP ([6]).General government debt peaked at 123.7% of GDP at the end of 2013.

In cash terms, public finances were on track through end-April 2014. Tax returns were somewhat better than expected by the authorities (almost 0.2% of GDP), in particular taxes on labour were above expectations in line with strong employment growth, and excise revenue was boosted by a pick-up in car sales. Overall spending was lower than planned (less than 0.1 % of GDP). Most government departments showed small savings, except for health. Annualised overruns in the health sector would amount to some 0.1% of GDP. The main overruns are in the hospital sector, including agency costs, which are increasing despite the intended savings under the Haddington Road Agreement.

Table 2.2: **Financial sector indicators**

	2008	2009	2010	2011	2012	2013
(All year-end data, unless otherwise specified.)						
Total assets (in % of GDP)	960.6	1006.9	965.9	807.8	713.7	613.9
Share of assets of five largest banks (in % of total assets)	55.3	58.8	56.8	53.2	56.9	n.a.
Non-performing loans ratio (in % of total loans)*	1.9	9.8	12.5	16.1	24.6	24.6
Regulatory capital to risk-weighted assets (in %)	12.1	12.8	14.5	18.9	19.2	21.1
Return on equity ratio (in %)*	1.3	-35.8	-41.0	-10.8	-7.8	-3.1
Credit growth (% yoy change)	1.4	-5.6	-12.3	-4.7	-2.6	-6.8
Lending for house purchase (% yoy change)**	-6.9	-4.1	-2.5	-0.9	6.6	-1.7
Loan to deposit ratio (in %)	179.0	162.0	141.7	133.4	128.7	113.3
Central bank liquidity (in % of total liab.)	5.6	6.0	8.7	9.1	10.9	4.5

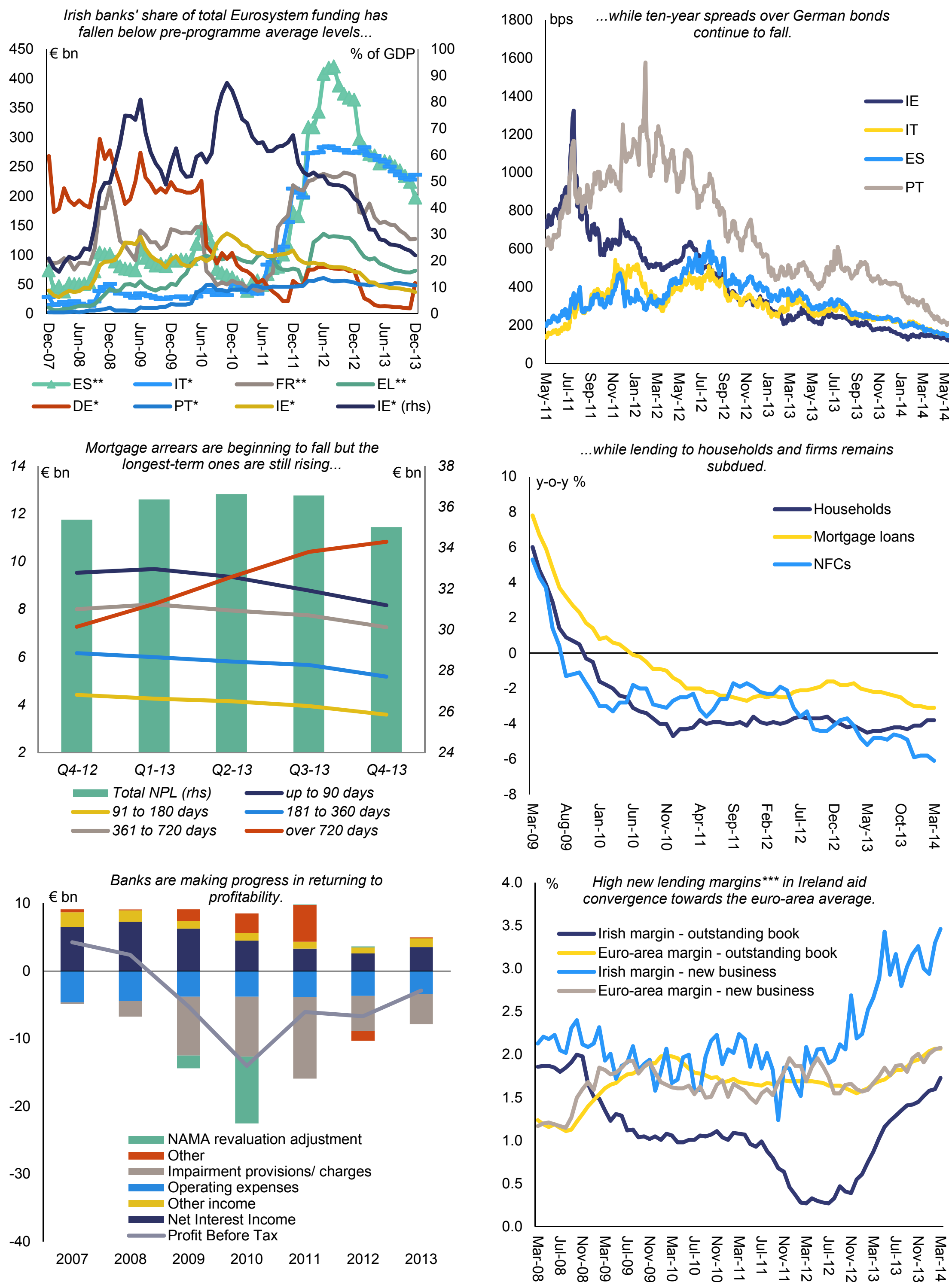
* For 2013, latest data available is for Q3.

**Data for end-2012 reflects the expiration of a mortgage interest relief for first time buyers.

(1) Indicators cover monetary and financial institutions (MFIs) in Ireland.
Source: ECB and IMF.

([6]) In 2013, one-off guarantee payments related to the liquidation of IBRC increased expenditure by 0.7% of GDP, but one-off revenue from the sale of mobile telephone licenses (classified as negative expenditure) improved the fiscal deficit by 0.4% of GDP.

Graph 2.2: **Recent financial developments**



(1)*Related to monetary policy operations. **Total domestic MFIs, not further specified. ***Margin is the difference between interest on loan and interest on deposits.
Source: CBI, ECB, iBoxx, annual financial reports of BOI, AIB and PTSB.

The Irish sovereign and banks continue to benefit from regained market confidence and a more general increase in demand for bonds of euro-area sovereigns. After a heavily subscribed issuance of EUR 3.75 billion at a yield of 3.54% in January, the National Treasury Management Agency (NTMA) sold EUR 2.75 billion worth of ten-year sovereign bonds in the period from March to May, with the last one at a record low yield of 2.73% in May. The favourable outcome was in the context of a general drop of sovereign bond yields in the euro area. Moreover, in the past six months Moody's upgraded Ireland's sovereign rating twice: in January the long-term credit rating of the Irish government was raised by one notch to investment grade (Baa3), and in mid-May it was further raised by two notches (to Baa1) with a "stable outlook". The ten-year bond spread over German Bunds hit a record low at 120 basis points in mid-May. Domestic banks have also benefitted through low-yield issuances: since September 2013, the three main domestic banks have issued a total of EUR 6.75 billion of new securities. This has contributed to a significant decrease in the reliance of the three PCAR banks on ECB funding, which has dropped from approximately 17.4% of their total liabilities in December 2012 to approximately 11% in December 2013. However, despite a better operating environment and gradual improvements in profitability, asset quality remains a persisting concern. NPLs as a share of total loans for the three covered Irish banks remain very high at 27% in December 2013, while the large amount of loss-generating tracker mortgages on banks' balance sheets also limits profitability.

Mortgage arrears remain very high but have begun to decline. Loans past-due by over three months (which corresponds to the EBA definition of a NPL) were 19.6% of all mortgages in the final quarter of 2013 and fell by 1141 cases from the previous quarter, or by 1.1% quarter-on-quarter (qoq). This was the first decline in the over 90-days-past due mortgage arrears since September 2009 when the data series was created. The only category of arrears that continued to increase, by 4.5% qoq in the fourth quarter of 2013, was the longest-term category (over 720 days-past-due), in line with prevailing trends in previous quarters.

Under MART([7]), banks have increasingly been deploying sustainable solution products though a substantial amount of resolution relies on legal action. In addition to offering split mortgages([8]), banks are involving mediators, cutting interest rates and even proposing substantial debt write-offs in a few cases ([9]). There was a notable increase of 3.4% qoq in the number of restructured mortgage accounts in the fourth quarter of 2013, driven mostly by principal dwelling home (PDH)-mortgage restructuring arrangements. However, increasing longest-term arrears signal that banks are still struggling with finding loan restructuring solutions for the toughest arrears cases. There has been a significant increase in the number of letters sent by banks to customers in arrears, introducing the possibility of legal action (and thereafter civil bills which could lead to repossessions). They have reportedly led to a notable increase in the level of re-engagement of debtors. Although still viewed as a last-resort option, the banks have announced an increase in the estimated number of repossessions procedures over the next few years.

Net lending to the private sector has continued to fall though there are some recent signs mortgage lending may be beginning to pick up from low levels. Lending to Irish resident non-financial corporations (NFCs) declined by 6.1% yoy in March 2014. The outstanding amount of credit advanced to Irish SMEs was EUR 67.6 billion at the end of the fourth quarter of 2013, which represented a decrease of 5.5% yoy. Despite improving macro-economic conditions, demand for credit remains subdued as the private sector is highly leveraged. Though gradually declining until recently, private sector debt stood at 319% of GDP in the fourth quarter of 2013 and rose by 3% qoq, the first increase since the second quarter

(7) See CBI's Mortgage Arrears Resolution Targets (MART): https://www.mortgageholders.ie/media/130313-approach-to-mortgage-arrears-resolution.pdf

(8) Split mortgages involve the set-up of two accounts: one which is serviced and the other portion is placed in a "warehouse account" with little or no repayments. In this way, the amount of total monthly repayments is reduced.

(9) Media reported a EUR 195 000 write-off made by AIB, for a family owing EUR 478 000 in total. A previous case that had attracted attention was a EUR 150 000 write-off (out of approx. EUR 400 000 of debt). http://www.independent.ie/business/personal-finance/family-gets-to-keep-home-after-150k-debt-is-written-off-by-aib-30084311.html, http://www.independent.ie/business/personal-finance/family-receive-200000-writeoff-and-allowed-to-stay-in-home-30109376.html

of 2012. This increase was driven by a higher non-financial corporate (NFC) debt, while household debt still declined. According to the Irish Banking Federation (IBF), there are also indications of pick-up in new mortgage lending: in the first quarter of 2014, 3 425 mortgage loans were issued, representing a 66% yoy increase (though the first quarter is historically the weakest each year). Over a half were first-time buyers ([10]). Nonetheless, mortgage lending data from the CBI continues to show annual declines (Graph 2.2). In order to stimulate mortgage lending, a stamp duty refund, amounting to 1% of the mortgage value, is being proposed to first-time buyers by one of the large domestic banks until end-September.

Economic growth in 2014 and 2015 is projected to be driven by a pick-up in domestic demand and net exports. In the Commission services' 2014 Spring Forecast, GDP is projected to grow by 1.7% in 2014 and accelerating to 3.0% in 2015, although under the usual no-policy change assumption this does not account for the effects of further fiscal consolidation required to meet EDP targets in 2015. Investment growth is expected to be strong, albeit coming from low levels; the gradual recovery in private consumption will result in a positive contribution to growth for the first time since 2009. The firming recovery in key trading partners, in particular the United Kingdom, together with a gradual tapering of the drag from the patent cliff will combine to further boost net exports in 2014, a trend set to continue into 2015. Improvements in the labour market are expected to continue, with unemployment forecast at 11.4% for 2014, and falling to 10.2% in 2015. Robust employment growth is set to continue and broaden into more sectors, while still considerable slack in the labour force is expected to contain emerging wage pressures for most sectors. Inflation is expected to remain below the euro-area average over the forecast horizon. The Commission services' Spring Forecast numbers remain broadly in line with forecasts by the Irish authorities underpinning the April stability programme update. However, there are differences in the composition of growth, with the Commission services forecasting a smaller contribution from domestic demand and a larger contribution from net exports.

The implementation of the 2014 budget is broadly on track, with balanced risks around the central deficit forecast. Both Commission services and the Irish authorities expect the general government deficit to narrow to 4.8% of GDP, down from 7.2% in 2013, and well within the nominal deficit ceiling of 5.1% of GDP recommended by the Council (see Table A2.6). The forecast includes discretionary measures of 1.5% of GDP, and other deficit-improving elements, some of which are temporary. Discretionary measures include tax increases on alcohol and tobacco, on bank deposits, on pension fund assets and on financial institutions. Expenditure measures include further public sector wage savings, and tighter eligibility for social benefits and medical services. The main downside risks concern the implementation of the health budget, while expenditure control is strong in other areas. The improved employment outlook is an upside risk as it benefits the fiscal balance through lower unemployment benefits and higher income and consumption tax receipts. There are also upside risks from higher than budgeted one-off revenue from the sale of state assets. Asset-sale revenue transferred to the government in 2014 may amount to around EUR 0.5 billion compared to the budgeted EUR 0.1 billion, but part of the revenue is earmarked for spending on public-private partnerships. General government debt is projected to decline by almost three percentage points of GDP to 121% of GDP due to a reduction in precautionary cash balances and an improvement in the primary balance position.

([10]) See IBF/PWC Mortgage Market Profile; Quarterly Report – New Lending: http://www.ibf.ie/gns/media-centre/news/14-05-13/New_Mortgage_Lending_Shows_Welcome_Year-on-Year_Growth.aspx

Box 2.1: **A growth accounting approach to medium-term growth prospects in Ireland**

What will be Ireland's average output growth in the next five to ten years? While this question is crucial for any forward-looking economic policy assessment, especially for countries with large public and private debt, it is difficult to provide a conclusive answer. Forecasts are surrounded by a considerable degree of uncertainty and this uncertainty increases with the forecast horizon. One commonly accepted way to nevertheless explore the medium to long-term growth prospects of a country are simply simulations, which, based on specific assumptions narrow down the range of possible growth paths.

This box discusses the results of a simple growth accounting exercise for the Irish economy. Aggregate economic growth is broken down into contributions from labour, capital and total factor productivity, and labour and capital are further decomposed in hours worked and labour force composition effects (as a proxy for the quality of labour); and ICT and non-ICT capital, respectively. Historical data for Ireland and the 15 EU countries from the EU KLEMS database is used.

Table 1:
Real Gross Value Added: growth rates and contributions (percentage points)

	Ireland			EU-15 *		
	1990-1995	**1996-2001**	**2002-2007**	**1990-1995**	**1996-2001**	**2002-2007**
	Phase 1	Phase 2	Phase 3	Phase 1	Phase 2	Phase 3
	Total Industries			**Total Industries**		
Labour	1.76	2.88	2.06	0.02	0.88	0.59
Hours	1.79	2.41	1.46	-0.24	0.69	0.46
Composition	-0.03	0.48	0.60	0.26	0.19	0.13
Capital	1.41	4.21	3.53	1.08	1.34	0.90
ICT	0.27	0.75	0.08	0.28	0.58	0.29
Non-ICT	1.14	3.47	3.45	0.81	0.76	0.61
TFP	1.54	1.77	-0.51	0.72	0.30	0.43
TOTAL	4.71	8.87	5.07	1.83	2.51	1.92

*EU-15 are BE, DK, DE, IE, FR, GR, ES, IT, LU, NL, PT, AU, SE, FI, UK

Table 1 compares average annual contributions of labour, capital and total factor productivity (TFP) to gross value added (GVA) growth for Ireland and 15 EU countries, in three phases spanning the period 1990 to 2007. In phase 1 (1990 – 1995), which precedes the boom, Irish labour contribution to growth was substantially higher than for the EU-15, while capital's contribution was more in line with the EU average. TFP growth was twice as high, perhaps reflecting the high quality of education, and a young, flexible labour force. In phase 2 (1996-2001), strong growth in the contribution from non-ICT capital, driven by inward FDI, and in the contribution from labour, by demographic fundamentals, combined to yield very high average annual GVA growth (8.87%) ([1]). In phase 3, although GVA growth remains high, TFP represents a drag on Irish growth while the contribution of capital, particular ICT capital, declines.

Real GVA growth for Ireland has been simulated under different hypothetical scenarios where contributions to GVA growth and sector shares are varied (Graph 1a). **Simulation 1** assumes the supply-side sector shares (such as construction) of GVA for Ireland remain at the average for the period 2008–2012, but that the contributions of the growth accounting components converge to the EU-15 (phase 3) average. Under this simulation, Ireland's average annual GVA growth rate would fall to 1.91%.

([1]) Strong TFP growth in phases 1 and 2 was to a certain extent possible as distance to the technology frontier was quite large.

(Continued on the next page)

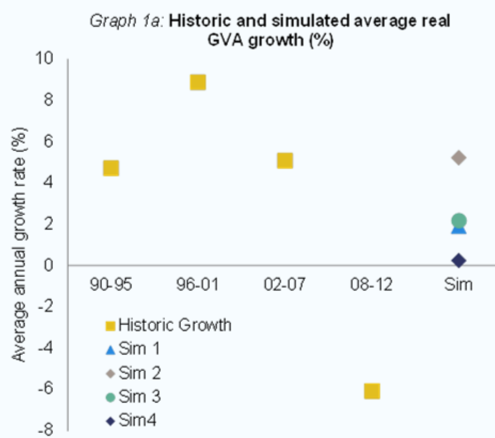
Box (continued)

By contrast, in **simulation 2,** it is assumed the sector shares of Irelands GVA return to the long run 1990-2012 average and the contributions of growth accounting components remain at phase 3 levels observed in Ireland. Under this scenario, average annual GVA growth is substantially higher (5.23%), driven mainly by the historically significant contributions of (non-ICT) capital and labour (hours worked) to growth.

In simulation 3, it is assumed that Ireland's capital contribution to GVA growth falls to the long-term average for the EU-15 (1990-2007), all other contributions of growth accounting have remained at phase-3 levels, and Ireland's sector shares of GVA return to a long-term trend (1990-2012). This is consistent with a scenario in which Ireland's dependence on, in particular foreign direct investment, converges to the EU average, but in which demographics remain relatively favourable. In this case, average annual GVA growth is estimated to be lower (2.17%) This is below many estimates for medium term potential growth.

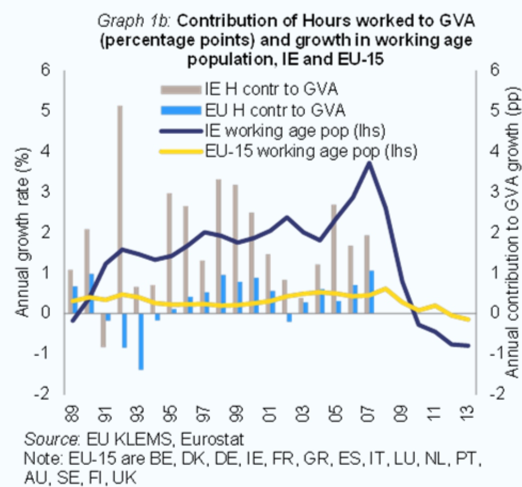
Finally, in **simulation 4,** both capital and labour contributions are assumed to converge to the long run average for the EU-15. This is consistent with a scenario in which net outward migration persists and offsets positive demographic trends, and Ireland's dependence on foreign direct investment converges to the EU average. Under this scenario, average annual GVA growth is estimated at just 0.24%.

Graph 1a: **Historic and simulated average real GVA growth (%)**



Source: EU KLEMS

Graph 1b: **Contribution of Hours worked to GVA (percentage points) and growth in working age population, IE and EU-15**



Source: EU KLEMS, Eurostat
Note: EU-15 are BE, DK, DE, IE, FR, GR, ES, IT, LU, NL, PT, AU, SE, FI, UK

Thus, for Ireland to achieve sustained high output growth it must maintain labour and (non-ICT) capital contributions at levels consistent with historical trends. As shown in graph 1b, both the rate of growth in working age population and the contribution of hours worked (labour) to GVA growth have been historically much higher for Ireland than for the EU-15 as a whole. If contributions of either capital or labour were to converge to EU averages, then growth would be lower. Indeed, the historic importance of these factors in the Irish context outweighs the relatively low contributions of ICT capital and TFP, compared to the EU average. Estimates of a rate of growth of 3% or more are therefore clearly predicated on sustaining the Irish growth model of attracting foreign direct investment and expanding the labour force.

3. POLICY ISSUES

3.1. PUBLIC FINANCES

Slippages in the health sector constitute a risk to the achievement of the 2014 fiscal targets and deserve close monitoring and action. Around half of the planned adjustment of current expenditure in 2014 - EUR 660 million - announced in the original budget for 2014 was expected in the health sector. Since then, some of these savings have been deemed unachievable by the authorities. The planned savings from increased control of medical cards were lowered from originally EUR 113 million to EUR 23 million in the revised estimates in December 2013. In May 2014, the health authorities signalled their inability to deliver part of the savings under the Haddington Road Agreement, as efficiency savings from longer and more flexible working hours fall short of plans in terms of expected agency and overtime costs reductions. Achieving these savings presupposes an effective management and agreement by staff, which is difficult to predict. An additional slippage relates to the planned replacement of medical cards by general practitioner (GP) visit cards for those returning to work, with estimated savings of EUR 10 million for 2014. The authorities have now indicated that this measure, which would have required new legislation, will no longer be pursued. Given the steady decline in the live register of unemployed people, the potential savings from such a measure would have been significantly higher for 2015. The government is considering options to address emerging overruns in health care spending by following the procedural steps of the new expenditure framework ([11]).

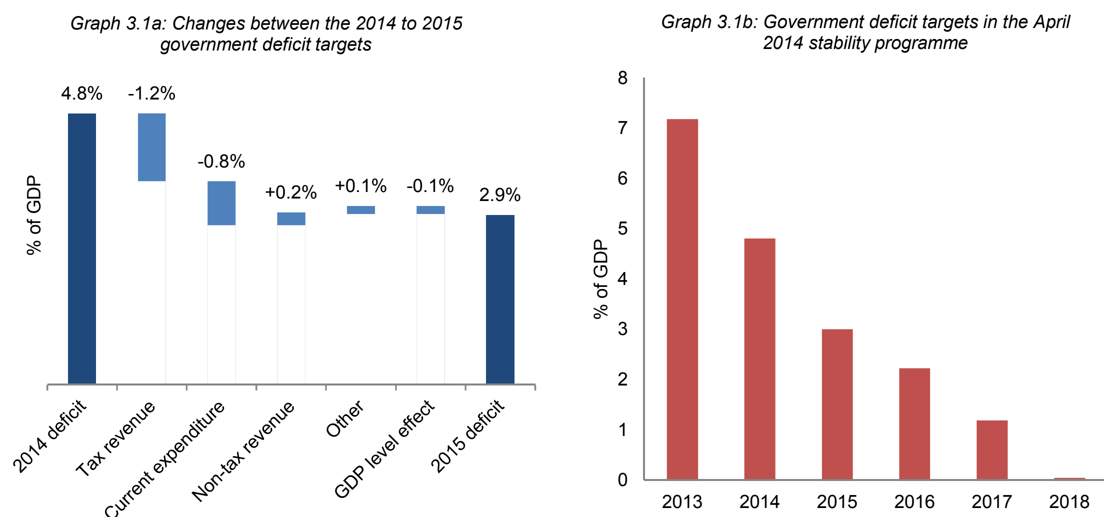
While the authorities remain committed to reducing the fiscal deficit below 3% of GDP in 2015, specific adjustment measures are still to be announced. The fiscal target for 2015 presented in the 2014 stability programme assumes EUR 2 billion (1.1% of GDP) in new consolidation measures, bringing the underlying government deficit to 2.9% of GDP ([12]). Detailed measures needed to meet the 2015 EDP target are expected to be announced, at the latest, in October 2014 when the Irish authorities are scheduled to release the draft 2015 budget. Currently available information from the 2014 stability programme indicates that one-third of the adjustment is expected on the revenue side and two-thirds on expenditure. Government debt is projected to decline further to just under 120% of GDP in 2015. Based on the usual no-policy change assumption, the Commission services' 2014 spring forecast projects a deficit of 4.2 % of GDP. This forecast implies a fiscal effort of some 1.5% of GDP in 2015 in order to reduce the deficit below 3 % of GDP.

The expected budgetary improvement in 2015 is likely to results from a combination of higher tax revenues and lower current expenditure. While, as indicated above, details about the fiscal adjustment in 2015 are not available, official budgetary targets and budgetary trends provide useful first indications about the likely drivers of the projected decline of the headline deficit (see Graph 3.1). An increase of tax revenues of EUR 2.1 billion (1.2% of GDP) is largely driven by the projected growth of relevant tax bases in line with the economic growth projections, as presented in the stability programme (Table 3.1). New discretionary revenue measures of overall EUR 0.7 billion are expected to offset the impact of the expiration of previously implemented measures (EUR 0.5 billion). Current expenditure is planned to fall by EUR 1.4 billion (0.8% of GDP) in 2015, as per the government expenditure ceiling for 2015 (Table 3.2). Announced ministerial expenditure ceilings that need to add up to the government expenditure ceiling are not yet adjusted for unallocated savings of EUR 0.75 billion (0.4% of GDP). Ministerial expenditure ceilings for 2015 include the planned pay savings under the Haddington Road Agreement (EUR 0.2 billion), but the amount of other non-pay savings is not clear. These unspecified savings are estimated at EUR 0.7 billion (0.4% of GDP) by the Commission services, assuming that demographic cost pressures, amount to EUR 0.5 billion (0.3% of GDP).

([11]) The Circular 15/13 on the medium-term expenditure framework sets out steps that need to be followed to ensure compliance with the expenditure ceilings.

([12]) The underlying fiscal deficit excludes one-off deficit-increasing financial sector measures. The authorities assume one-off deficit increasing transfers to credit unions of EUR 50 million in 2014 and EUR 100 million in both 2015 and 2016 (less than 0.1% of GDP).

Graph 3.1: **General government deficit projections**



Source: April 2014 stability programme update for Ireland

Rising political pressure could increase uncertainties around budgetary plans for 2015. In the very recent past, statements and discussions have appeared in the political debate assessing the possibility of cutting taxes and/or increasing spending in light of improving economic conditions. These statements can create expectations that may be difficult to manage, especially in view of the general elections due at the beginning of 2016 or earlier. At the same time, the budgetary projections of the 2014 stability programme and the latest Commission services' forecast reveal no room for manoeuvre, also taking into account that growth projections underpinning budgetary plans are still subject to downside risks. While Irish authorities have so far consistently (over)delivered the recommended fiscal adjustment under the EU-IMF-supported adjustment programme, there is a recent tendency to increasingly rely on (i) efficiency measures from better work organisation, eligibility controls of social and health care payments, which outturn is difficult to predict , and (ii) non-discretionary deficit-improving factors, including temporary windfall revenue. Also, the projected improvement in economic growth is expected to relieve the need for difficult discretionary measures. In that respect, the assumed fairly tax-rich composition of economic

Table 3.1: **Breakdown of tax revenue developments**

EUR billion	2013	2014	2015	2016	2017	2018
Tax revenue	37.8	40.0	42.1	43.9	45.9	48.1
change		2.2	2.1	1.7	2.0	2.3
			contribution to change			
New measures		0.4	0.7			
Existing measures (1)		0.5	-0.5	0.0	-0.2	
Tax base increase (2)		1.1	1.2	1.4	1.5	1.5
Other (3)		0.3	0.7	0.4	0.7	0.7

(1) Item "Existing measures" includes full-year effect of already implemented measures and expected revenue losses due to discontinuation of previously implemented measures, in particular part of the pension levy in 2015 (EUR 540 million) and levy on financial institutions in 2017 (EUR 150 million).
(2) Item "Tax base increase" represents nominal tax revenue increase in line with increase in tax base. The tax forecasting methodology presented in the Medium-Term Budgetary Framework is limited to the macroeconomic indicators available in the stability programme and tax elasticities to their bases are assumed to be 1.
(3) Item "Other" is calculated as a residual and represents additional tax revenue forecast that is not captured in the limited tax base increase estimates in the line above, e.g. elasticity higher than 1 for some tax revenue and specific sectoral developments that may have stronger impact on tax dynamics than macroeconomic indicators suggest.
Tax revenue definition is in line with the Exchequer reports.
Source: Commission services' estimates based on the 2014 budget and the April 2014 stability programme update for Ireland.

growth underpinning budgetary plans appears somewhat optimistic, in particular private consumption and wage growth assumptions. Moreover, implementation risks remain high in the health care sector. Positive risks to government finances in 2015 relate to the establishment of waters services outside the general government sector and the introduction of water user charges. While the government will continue to partly finance water services, some savings are expected with the move to a commercial model of service delivery (some EUR 240 million from 2015), which are not yet included in the government's budgetary estimates.

The government plans to continue the path of fiscal adjustment until 2018 when, according to the 2014 stability programme, the Medium-Term Budgetary Objective (MTO) is expected to be reached. Based on current government projections, the achievement of the MTO of a balanced budget in structural terms in 2018 implies a reduction of the headline deficit by around 1 percentage point of GDP annually in 2016–18. Such an adjustment is necessary in view of the high level of public debt and the projected expenditure increases linked to an ageing population. The debt sustainability analysis (Appendix I) highlights the need for continued fiscal adjustment, otherwise public debt may remain at elevated levels. The reduction of the fiscal deficit is planned mostly by limiting expenditure growth in nominal terms to 0.1% annually and allowing tax revenue to grow in line with economic growth. Since 2009, significant cuts in investment spending have been a very important factor driving overall fiscal adjustment while the contribution from other larger budgetary items, such as transfer payments, has been comparatively small. An assessment of the expenditure adjustment implemented under the programme suggests that there is room to reduce current expenditure, especially transfers, thus allowing more resources to be spent on capital (Box 3.1). A review of the budgetary adjustment strategy with a view to reducing its growth impact could be useful.

Concrete policy actions underpinning the medium-term fiscal adjustment strategy are to be released in successive budgets. Planned expenditure restraint until 2018 is higher than the combined effect of underlying demographic cost pressures on the budget and budgetary savings from the decline in unemployment (see Table 3.2). The estimated gap in current expenditure plans until 2018 is around EUR 0.2 billion (0.1% of GDP) annually. While this could be covered by savings from the ongoing public service reform initiatives, a reduction in the level of public services may be required. The largest efficiency savings from the reforms are expected in the area of public procurement (some 0.3% of GDP in total). Further risks to the expenditure adjustment are related to uncertainty around announced reforms in the health sector, in particular the fiscal impact of the move towards the universal health insurance model. Moreover, tax revenue projections appear to be based on the optimistic growth assumptions, in particular, direct tax revenue projections that rely on strong wage growth.

Table 3.2: **Breakdown of change in the current expenditure ceilings**

EUR billion	2013	2014	2015	2016	2017	2018
Current expenditure ceiling	51.1	49.6	48.3	48.3	48.4	48.4
change		-1.5	-1.4	0.1	0.1	0.1
				contribution to change		
Unemployment expenditure (1)		-0.4	-0.2	-0.2	-0.2	-0.2
Pay savings		-0.6	-0.2			
Non-pay savings		-1.0	-0.7			
Demographic cost pressures (2)		0.5	0.5	0.5	0.5	0.5
Unallocated savings / residual (3)			-0.8	-0.3	-0.2	-0.2

(1) Change in unemployment expenditure is calculated based on unemployment rate projections of the stability programme.
(2) Demographic cost pressures are based on discussions with the authorities and Commission services calculations. Estimates represent cost pressures arising from ageing and increasing population in Ireland.
(3) Unallocated savings in 2015 are in line with those presented in the 2014 Expenditure report. From 2016, numbers represent a residual savings that seem to be necessary to achieve the planned expenditure ceilings in view of unemployment expenditure trend and demographic cost pressures.
Source: Commission services' estimates based on the 2014 budget and the 2014 stability programme of Ireland.

The Irish fiscal framework and transparency continue to improve. New fiscal reports are coming on stream that cover the general government sector and complement the existing fragmented reports by individual government entities. A report on contingent liabilities of the general government is planned from October 2014. However, medium-term budgetary plans are not supported by well specified adjustment measures and are subject to notable revisions at the time of annual budget decisions. The 2014 stability programme presents fiscal deficit targets and underlying estimates until 2018, but no further details on budgetary measures are provided. Departmental expenditure plans are to some extent anchored by the ministerial expenditure ceilings until 2016, but unspecified expenditure savings are allocated across government departments and revenue measures are announced only at budget time. The authorities are undertaking a comprehensive expenditure review ahead of the October 2014 budget, which will identify a range of measures and expenditure priorities out to 2017. The credibility of the medium-term expenditure plans could be also strengthened by limiting changes to the expenditure ceilings to the pre-defined adjustments specified in Circular 15/13 on the medium-term expenditure framework, both in substance and in presentation.

3.2. FINANCIAL SECTOR

3.2.1. Enhancing financial stability

The Balance Sheet Assessment (BSA) completed at the end of 2013 focused on underpinning the financial soundness of banks. The banks' end-2013 financial accounts were released in March 2014 (Box 3.2). The BSA assessed the adequacy of provisions on an incurred loss basis and reviewed the appropriateness of risk weighted assets (RWA). The BSA results did not call for an increase in capital, as all banks were estimated to have a buffer over the central bank's 10.5% core tier 1 (CT1) threshold on a point-in-time basis as at June 2013. However, partly in response to the BSA findings, all the banks' 2013 financial statements reflected revised impairment charges and increases in both loan-loss provisions and RWAs, which reduced their capital ratios. The banks end-2013 financial accounts incorporated an updated expected loss treatment, RWA adjustments and revised impairment charges. The main drivers behind this were adjustments in collateral valuations and the re-classification of some restructured loans as impaired, in line with the CBI's revised impairment provisioning guidelines published in May 2013.

The ECB's Comprehensive Assessment (CA) is well underway. It aims to enhance the transparency of the balance sheets of significant banks in Ireland as well as the whole euro area, and, in so doing, to trigger balance sheet repair where necessary, with the ultimate objective to increase confidence in the banks. The CA results will be published in October 2014 before the Single Supervisory Mechanism (SSM) assumes its full responsibilities in November. The exercise includes an asset quality review (AQR) assessing banks' asset classifications and collateral valuations, as well as the adequacy of their loan-loss provisions, capital and leverage. The reference date for the AQR will be 31 December 2013 and the AQR will be complete by early July. The CA also comprises a stress test, in coordination with the European Banking Authority (EBA) assessing the resilience of banks' balance sheets under forward-looking (three-year) baseline and adverse scenarios. In parallel, the CBI on behalf of the ECB is carrying out an assessment of the risk profile of the banks under review (including governance, leverage, market and operational risks), based on both quantitative and qualitative indicators. In addition to the three domestic banks, the CA will also cover Ulster (part of the Royal Bank of Scotland Group) and Merrill Lynch. The capital threshold under the CA is 8% common equity tier 1 (CET1), in line with the Capital Requirements Directive IV/Capital Requirements Regulation. The ECB published the methodology of the AQR in March and details of the stress testing methodology with its macroeconomic scenarios were released by the EBA in late April. Banks' capital positions would be assessed to identify potential shortfalls versus the 8% and 5.5% CET1 minimum thresholds under the baseline and adverse scenarios respectively. Capital shortfalls will be expected to be covered within six months for those found in the AQR or the baseline stress test scenario, and within nine months for those identified in the adverse stress test scenario.

Table 3.3: **Domestic banks' capital positions**

Capital Ratios post BSA/AQR at end-2013			
	BOI	AIB	PTSB
Core Tier 1 (CT1) Ratio	12.3%	14.3%	13.1%
Fully loaded Basel III Common Equity Tier 1 (CET1) Ratio	9.0%	10.5%	10.9%

The difference between the two ratios reflects mostly, in the case of Ireland, the gradual phasing out of preference shares and deferred tax assets (DTAs) - except as tax credits - from CET1.
Source: Banks' annual reports for 2013

The drag from low-yielding assets and low levels of new lending continue to weigh on the profitability outlook. The net interest margin (NIM) is being rebuilt in the three main Irish banks due to eased funding costs as access to capital markets has improved at relatively low rates. Weaker domestic deposit competition has also resulted in deposit rate reductions and boosted NIM. Cost-to-income ratios have also improved significantly. However, the modest volume of new lending remains an obstacle to raising profitability which is critical to internal capital generation. Though bank prospects have improved somewhat, low-yielding tracker mortgages remain a drag on banks' profitability, especially for PTSB.

Bank restructuring has advanced as two of three main domestic banks, BOI ([13]) and AIB, have had restructuring plans approved, while PTSB's plan requires further examination.

- *The EC approved AIB's restructuring plan in May 2014 as its outlook improves.* This followed the initial submission of the plan in September 2012. AIB has already undertaken major restructuring and downsizing of its balance sheet. Over the period of the plan from 2014 to 2017, AIB is expected to increase profitability by enhancing its NIM and limiting operating expenses. The bank is also expected to maintain a strong capital buffer, and the government-owned EUR 1.6 billion in convertible bonds (cocos) can be converted to equity if necessary. Thus, these measures should allow AIB to return to viability without further state support.

- *The outlook for PTSB remains more trying than the other two domestic banks.* PTSB's 2013 operating loss ([14]) was largely unchanged from the previous period and as a single legal entity it is not expected to return to profitability until 2017 on a full financial year basis. The restructuring plan for PTSB has not yet been approved by the EC. The last restructuring plan was submitted to the EC in August 2013. PTSB continues to consider restructuring options, while focusing on arrears management, cost reduction and enhancing operational efficiencies within the group structure. PTSB now manages a core and non-core bank structure. PTSB announced its plans to sell its loss-making non-core EUR 2.1 billion Irish commercial real estate (CRE) book and its EUR 0.4 billion Springboard Mortgage business, which is no longer writing loans and is being wound down. While a significant amount of the CRE portfolio is impaired, it has been well provisioned. This should help limit the capital impact of the market-based disposal.

The effective sale of over 90% of IBRC's assets and the current strong demand for Irish commercial real estate may accelerate the wind-down of NAMA. The sale and valuation of EUR 21.7 billion of assets by the liquidators of IBRC was completed in the first quarter of 2014. The EUR 1.9 billion of unsold IBRC assets will no longer be transferred to NAMA, but will instead be auctioned to private investors in the second quarter of this year. The speedy wind-down of IBRC reduces the amount of the state's contingent liabilities and some return may be available to the government in early 2015. NAMA achieved its 2013 target of redeeming EUR 7.5 billion of senior bonds issued to buy bank loans in

([13]) BOI's restructuring plan was approved in December 2011 and updated in July 2013. See http://www.bankofireland.com/about-bank-of-ireland/press-room/press-releases/item/373/eu-restructuring-plan-update/
([14]) The number refers to loss before exceptional items, including a write-back of pension liabilities (EUR 329 million). In addition, there was a EUR 407 million credit from deferred tax assets.

2010 and 2011. This leaves EUR 22.7 billion of the original senior bonds outstanding for NAMA. NAMA plans to accelerate the redemption of EUR 7.5 billion of its bonds by the end of this year, instead of by the end of 2016, bringing its outstanding senior debt down by half since inception. NAMA's balance sheet may be reduced to zero before its original target of 2020, although this target currently remains in place..

The establishment of a central credit registry continues but it will take time for it to become fully operational. The Credit Reporting Act 2013 was enacted in December 2013. A procurement process to select a partner to assist in establishing and operating the registry is in progress. It is estimated that a contract should be approved and signed by the third quarter of this year. The "go-live" phase is expected in mid-2016, likely with a phased-in approach (consumer credit data to be followed by corporate, new credit to be supplemented by existing credit data). Lenders and other stakeholders are being consulted on the relevant procedures and issues such as technical requirements and data protection.

The CBI is developing its macro-prudential framework to enhance the stability of the financial system. In conjunction with the ECB, the CBI is working on the implementation of the European Systemic Risk Board's (ESRB) recommendation on intermediate objectives and instruments of macro-prudential policy. The choice of objectives and instruments will be reported by end-year while the policy strategy will be developed by the end of 2015. Related activities have already been announced in the area of mortgage lending by the CBI and Department of Finance in May 2014. The focus will be on ensuring transparent and efficient mortgage lending by defining application and approval processes, loan-to-value ratios and loan-to-disposable income ratios.

3.2.2. Reducing NPLs

Banks have progressed in finding sustainable solutions for mortgage arrears though this remains a challenging and lengthy process. While the pace of formation of new mortgage arrears continues to fall, the long-term nature of arrears remains a key concern. In December 2013, the banks met their mortgage arrears restructuring targets for proposed and concluded solutions of 50% and 15% respectively. According to the banks' own figures, just over half of the concluded solutions stem from restructures and the rest continue to rely on legal action using the threat of repossession, while actual repossessions remain low so far. There are some issues relating to the durability of the proposed solutions and excessive forbearance. There are also some concerns with the banks' affordability assessments of customers not being sufficiently conservative. Mortgage loan resolution can take several months to allow time for trial periods before restructures conclude. There is also an on-going need for borrowers to re-engage and for banks to work with them more effectively to find solutions. With many legal cases in the pipeline, the court system could face capacity problems, though evidence of this has not yet materialised and developments are closely monitored by the authorities. There are also concerns that banks are taking very different approaches when it comes to offering restructuring proposals which range from partial principal debt write offs to solutions that offer little debt relief.

A multi-debt pilot scheme was tested with limited results. The CBI designed and tested a framework for a pilot approach to the co-ordinated resolution of multiple debts owed by a distressed borrower, a pilot scheme for the resolution of multiple debts, and published a report in May 2013. The aim was to encourage cooperation between lenders of secured and unsecured debt, in order to equitably resolve distressed debt. However, an agreement proved elusive and the project has been dropped. It is hoped that the new personal insolvency framework will take over this area.

Looking ahead, the CBI remains committed to the MART framework. At end 2013, the CBI announced targets for proposed and concluded restructuring solutions for end-June 2014. These entail banks to have proposed sustainable solutions to 75% of customers in arrears of over 90 days by the end of June, and to have concluded sustainable restructuring agreements in 35% of these cases. Quarterly targets for the rest of 2014 should be announced soon. There are also plans to focus on large buy-to-let (BTL)

exposures. The goal still remains to largely complete the restructuring framework for mortgages in arrears greater than 90 days by end-2014.

The two main banks, AIB and BOI continue to make progress with their commercial/SME arrears restructuring targets yet this will take time. Bank specific non-public targets for these two banks have been set. The recent focus has been on transitioning borrowers into longer-term solutions from short-term forbearance. Banks have developed restructure products in 2013 and are implementing them. The CBI is undertaking loan file reviews to audit the durability of the solutions and is assessing the strategies and operational effectiveness in loan resolution. There are concerns that the large stock of commercial NPLs reflects in many cases property-related exposures in the loan book of SMEs with limited resolution. The restructuring or disposal of these loans should be prioritized. Loan restructures usually involve three to five-year plans and can be quite complex, consisting of a range of potential solutions including amongst other things, improvements in trading performance, agreed asset disposals, term extensions, interest-only payments and interest and part-capital repayments. Thus, it will take some time for NPLs to fall significantly. Issues remain with customer resistance, legal formalities and multi-banked debt. The authorities adopted legislation to facilitate SME examinership by the Circuit Court in late 2013. The court rules are being finalised and the new procedure is expected to be operational by July 2014.

There has been limited use of the new personal insolvency regime so far. The Insolvency Service of Ireland (ISI) began accepting cases in September 2013. The first quarterly report of the ISI revealed a modest take-up of the personal insolvency procedures: at end-March 2014, 55 debt solution arrangements have been approved (and 66 bankruptcies). The report also revealed that since September 2013, over 500 applications for new cases have been created. Thus a significant increase in numbers is likely for the rest of 2014. There has been some criticism of the costs and complexity of the insolvency procedure, its business model, and the quality of education programmes for Personal Insolvency Practitioners (PIPs). In order to address some of these challenges, the ISI is working on additional protocols that would streamline and simplify the procedure. Reportedly, the mere existence of the new insolvency framework has led to an increase in the number of informal agreements between lenders and distressed borrowers.

The report of the Expert Group on repossessions has made recommendations aiming to increase the capacity of lenders to deal with large numbers of repossessions and to improve data. The report was published in January 2014. It examined the possibility of introducing expedited proceedings, for repossession cases relating to BTL mortgages, as such a fast-track scheme would reduce the costs of BTL repossessions and allow the banks to focus more on working with co-operating home owners to find sustainable solutions. However, the report found that this was not necessary for now. The capacities of the system were assessed as adequate and ready for a possible higher influx of new cases. The existing system will remain under monitoring. The report found that there were capacity constraints of lenders in dealing with the large amount of repossessions, as a very high proportion of adjournments in repossession proceedings are granted at the request of lenders and that may result in longer waiting times for cases to proceed. It recommended harmonised documentation standards, more effective case management by lenders (e.g. banks seeking a repossession order should make better efforts to locate defaulting borrowers) and pointed to the need for better and timelier data on repossessions ([15]). Banks have informally given positive feedback on the recommendations, signalling that they saw no significant problem in complying.

3.2.3. Financing for growth

Given its importance to growth, enhancing SME financing is critical. Despite improved trading conditions, SME's demand for credit is low as they remain highly leveraged, and there are also some

([15]) An interesting feature of repossession statistics is that a majority of repossessed properties are PDH, rather than, as may have been expected, BTLs. This is largely due to the fact that in most BTL cases, banks opt to appoint receivers rather than initiate court repossession proceedings (the bank receives the rent until the lease expires and thereafter has the right to either sell or re-let the property).

supply constraints to credit. The SME credit market is becoming increasingly concentrated with the withdrawal of many foreign banks. With less competition, the remaining banks have more opportunity to be more selective when extending credit and this endangers meeting the needs of the real economy. The Credit Review Office (CRO) recently reported that 55% of appeals it reviewed were found in favour of the borrowers, resulting in an additional EUR 21.6 million in credit extended to SMEs helping to protect/create 1 725 jobs. There are a number of dedicated SME state supports in place but the use so far has been less than anticipated. Thus, the government launched a campaign in May to enhance SMEs' awareness of the range of SME state support, including an online guide. There is also a need to boost the financial planning capacity of SMEs. In this regard, the government has introduced a pilot programme to build financial capabilities in SMEs.

Financing initiatives to boost growth and SMEs are laudable but will need careful evaluation.

- *The government intends to create a state development bank, SBCI, to boost SME lending.* The institution would be funded by the EIB, the German development bank KfW, the NPRF/ISIF, and other European state development banks yet to be determined. It would not have a banking license. The SBCI aims to provide loans of longer duration, potentially lower cost of funding, and to promote competition. At the beginning, it will source funds externally and lend them to SMEs via other institutions or on-lenders, including retail banks. It will have an initial credit of about EUR 500 million (0.3% of GDP) available to lend to SMEs. Projects would be assessed on commercial merits. As this may involve public money or guarantees, it will be necessary to comply with state-aid rules. It would also be important to continue to review more and possibly streamline the numerous public schemes already available to raise SME credit.

- *The ISIF will invest in commercial Irish investments.* The ISIF replaces the NPRF, which is currently invested internationally in relatively liquid assets. It will be managed by the NTMA. The ISIF will manage assets worth EUR 6.8 billion (4% of GDP) and will redeploy NPRF assets towards productive commercial investments in the Irish economy. The ISIF will have a double objective: raising jobs and growth, while also generating a commercial return. It will also focus on SMEs and infrastructure investment. The implementation of ISIF will require a change in the skill set needed by NTMA staff for this type of private equity investments. The establishment of this type of fund is a unique case and has few international precedents. The performance of the ISIF should be closely monitored, especially as regards the objective of ensuring commercial returns on investments.

- *To boost investment in new housing, the government is among other things studying the introduction of a mortgage insurance scheme for first-time buyers of new homes.* This was part of the authorities' construction strategy released in May that aims also to tackle construction bottle necks and property issues ([16]). The decision regarding this mortgage insurance scheme is pending the results of an economic impact analysis that is to be completed in July. While details are still lacking, it will be crucial to prevent potential unintended effects on house prices and avoid additional contingent liabilities for the government. A careful evaluation of its impact on public finances and of state aid considerations is warranted. In parallel, efforts to ensure sustainable mortgage lending, including the development of certain macro-prudential measures, are welcome.

3.3. STRUCTURAL REFORMS

3.3.1. Improving the labour market

Labour market reforms continue, with increasing emphasis on skills-related issues. Ireland's activation policy and its institutions delivering support to the unemployed in their efforts to regain

([16]) http://taoiseach.gov.ie/eng/Publications/Publications_2014/Construction_Strategy_-_14_May_2014.pdf

employment have been fundamentally re-shaped over the past few years. Although additional work needs to be carried out in order to finalise the new activation landscape, the set-up is likely to be completed by end-2014. In contrast, reforms to further education and training (FET) institutions and programmes are at a much earlier stage, in spite of being equally critical for a sustained reduction in unemployment, particularly that of a long-term nature.

New activation mechanisms are soon to be fully operational. Forty-four *Intreo* offices providing one-stop shop employment services are up and running, with the remaining 16 to be opened by end-2014. The new activation and welfare payment decision processes have already been phased in and all jobseekers on the Live Register have now been profiled. *Intreo*'s capacity to deliver front-line support services through one-to-one engagement has been increased with the doubling of the number of case workers to 600 through redeployments. However, the casework to client ratio remains high at about 1:400.

The timely and efficient implementation of the JobPath programme is critical. Under JobPath, private providers will be contracted out to provide support services to around 120 000 jobseekers, all of them long-term unemployed or with a high probability of becoming unemployed. The request for tender was issued in December 2013, and the authorities expect to finalise their assessment of the bids by late May. The opening of private offices to support Intreo's work is therefore scheduled for the latter part of 2014. JobPath contracts have been designed building on experiences elsewhere and so as to ensure a high level of service for jobseekers through performance-based payments and to enable the authorities to benchmark outcomes. JobPath should at last provide a significant boost to the level of support given to the long-term unemployed, while enabling Intreo to increase its own services to those remaining under its remit. It will be critical, however, to ensure that jobseekers referred to private providers receive the same access to training opportunities or employment support schemes.

The monitoring of activation reforms has been strengthened. Reforms to active labour market policies under the Pathways to Work strategy have been subject to regular monitoring since the first iteration of the strategy in 2012. In addition, the Labour Market Council ([17]) was established in late 2013 to provide an independent monitoring of Pathways to Work and provide advice on future reforms and labour market and employment policy. The council issued its first interim report in April 2014, which provided a number of important recommendations that should be acted upon. The 2014 iteration of Pathways to Work will be released in the summer and will rightfully focus on measures to address long-term unemployment.

FET reforms lag behind new activation mechanisms. SOLAS, the new institution in charge of piloting the FET sector, submitted its proposal for the FET strategy 2014–2019 to the minister at end-March. The proposal, which is yet to be endorsed by the minister, defines broad principles and strategic goals ([18]). It is to be backed up by an implementation plan, a detailed operational plan, and by a services plans with Education and Training Boards (ETBs). The 16 ETBs have been established and the consolidation process of former vocational education centres and FÁS training centres is well under way. In spite of this progress, it will take time until SOLAS is in a position to make its strategy operational, ensure that training programmes are relevant to employers and jobseekers, and allocate funding across ETBs on the basis of measured performance. It also appears that it will have relatively little leeway in reallocating funds across ETBs, which complicates its task and make careful impact assessment of programmes all the more essential. Although equally critical to returning long-term jobseekers to employment, reforms to FET are around two years behind those related to activation policy. In spite of this, it will be important to put in place seamless links between *Intreo* offices and private providers under JobPath on one side, and SOLAS and ETBs on the other.

([17]) The Council has been established as an independent group of industry leaders and labour market experts.
([18]) The five strategic goals are: (1) providing skills for the economy; (2) supporting the active inclusion of people of all abilities in society; (3) providing high quality training programmes; (4) ensuring integrated planning and funding for FET; and (5) providing a path to employment.

Job creation efforts are paying off. In terms of job creation, the authorities continue the forceful implementation of the Action Plan for Jobs, whose third annual iteration was published in February2014. The action plan has generated good momentum for reforms and stakeholders' involvement in its design and the monitoring of its implementation has increased. Although the impact of specific measures and the overall effect of the Action Plan for Jobs are difficult to measure, job creation has gained significant momentum in Ireland in recent quarters. The authorities' intention to carry out more systematic impact assessments is also welcome ([19]).

3.3.2. Raising value-for-money in healthcare

Progress is uneven on structural healthcare reforms begun under the programme. The establishment of the office of the chief financial officer within the Health Services Executive (HSE) is an important vehicle for driving financial management reform. However, key milestones remain to be addressed, including the finalisation of the business case for the development of a new integrated financial model. Likewise, while the roll-out of a common chart of accounts across HSE budget holders is expected to be complete by end-2014, the roll-out among hospitals and voluntary healthcare providers will take more time. Following the eHealth Strategy published in December 2013, governance arrangements for the new eHealth Ireland body within the HSE have been concluded, and the legislation required to roll out individual health identifiers for patients and professionals is expected to be passed by the end of June 2014. However, a chief information officer has not yet been appointed ([20]). The finalisation of a new ICT strategy for the HSE awaits input from this key role. This strategy is necessary for the practical implementation of the eHealth Strategy, including in order to estimate costs for ICT projects for the next budget cycle.

Measures to achieve further savings in the state pharmaceutical budget are proceeding, though key challenges remain. A new round of negotiations with the industry body representing manufacturers of patent-protected medicines is scheduled to take place this summer. Given these medicines represent over 70% of overall public spending on pharmaceuticals, the outcome of these negotiations will be critical to the achievement of further cost savings and could potentially substantially reduce budgetary pressures. For off-patent drugs, the authorities are finalising the establishment of the 20 groups of interchangeable medicines under the new system of internal reference pricing, expected to deliver annual cost savings of EUR 50 million (0.03% of GDP). A new ministerial order making the inclusion of the International Non-proprietary Name (INN) mandatory for all prescriptions is expected to be published before the end of June 2014. However, the order will allow for the inclusion of brand names on prescriptions, thus potentially weakening its effectiveness in encouraging generic use.

3.3.3. Reforming the water sector

Water sector reforms are reaching the final stages. Irish Water is established as a commercial semi-state body under full public ownership, and the authorities are committed to ensure that it is classified outside of the general government sector by Eurostat ([21]). The transfer of functions from local authorities to Irish Water has been effective since 1 January 2014, though water services will continue to be operated by local authorities under service level agreements for 12 years. The transfer of assets and liabilities should be completed by end-2014. This transfer will not have any measurable impact on general government debt, regardless of Eurostat's decision on the classification of Irish Water, as the local authorities have little water sector-related debt. On the operational side, 200 000 water meters have been installed, and the full roll-out initially planned for end-2016 could be achieved six months ahead of

([19]) Upon request from the authorities, the OECD prepared a preliminary review of the Action Plan for Jobs, published in April 2014.
([20]) The post of chief information officer was advertised on 30 May 2014.
([21]) Eurostat will issue a decision on Irish Water's classification later once further details on the funding model are determined.

schedule. Irish Water is also evaluating its assets, determining investment needs and setting up the various systems needed to operate.

The authorities recently announced key funding decisions. While final details are pending approval, the funding model for Irish Water will follow the proposal made by the Commission for Energy Regulation (CER) in the October 2013 consultation paper ([22]). In April 2014 the CER, which has assumed regulatory oversight of the water sector, published six consultation papers on tariff design and customer protection. The government has determined that: (1) households would be entitled to a free water allowance of 30 000 litres per year, plus 38 000 litres per child below 18 years of age; (2) no standing charges would apply; (3) assessed charges would be determined mainly on the basis of occupancy; (4) average household charge would not exceed EUR 240 per year; and (5) domestic charges would remain fixed at least until end-2016.

Although government support for the water sector will remain significant, the estimated net fiscal impact of the reforms is positive. Although the exact details of water charges will be set by the CER after more consultations in August 2014, enough is known to approximate the fiscal impact in the near term. Based on about 1.25 million households, the introduction of charges for domestic users in the fourth quarter of 2014 should generate revenue of about EUR 75 million for Irish Water in 2014 and EUR 300 million (0.18% of GDP) in 2015. It is also expected that Irish Water will gradually start financing its operations by borrowing on the market. Charges from non-domestic users will remain unchanged for the next two years. There are two main fiscal impacts:

- *Since the capital expenditure programme is operated by Irish Water from 2014, capital expenditure of EUR 240 million (about 0.14% of GDP) in 2014 is reclassified as an equity injection in Irish Water.* This equity injection (and future ones) no longer impacts the general government balance resulting in a lower deficit, as long as Irish Water is classified outside of general government. It is planned that further equity injections of EUR 400 million per year will be made in 2015 and 2016.

- *As Irish Water will be generating revenues, the level of government subsidies for operating expenditure is set to decline by around EUR 300 million from 2015 (about 0.18% of GDP),* thus reducing the deficit by this amount. Over time, the subsidy should fall gradually as Irish Water becomes increasingly self-funded through rising water charges and expected efficiency gains. Nonetheless, obtaining efficiency gains while upgrading the infrastructure in need of repair will be a challenge.

3.3.4. Continuing with privatisation

The sale of state assets is generating significant revenue for the government. The Electricity Supply Board (ESB) recently completed the sale of its ownership in two overseas power plants. The sale has enabled ESB to transfer around EUR 200 million (0.12% of GDP) to the Exchequer in 2014 through special dividend payments. The ESB is expected to transfer another EUR 200 million through the sale of its stake in two domestic peat-fired power plants. These transactions are expected to be completed by end-2014. After a cancellation in November 2013, a second round of bidding has enabled Bord Gáis Éireann to sell Bord Gáis Energy. Bord Gáis Energy has been valued at EUR 1.1 billion (0.7% of GDP), and the deal is expected to close by June. The government intends to repatriate proceeds from the sale of Bord Gáis Energy in instalments over time (possibly over a number of years), due to a number of factors including the consideration that the amount of proceeds payable by dividend in any one year that can be counted as improving the general government balance is limited by the company's annual entrepreneurial income. Total one-off government revenue from the ESB and Bord Gáis Energy sales in 2014 could amount up to EUR 500 million (0.3% of GDP), but the precise deficit-improving effect is not clear yet.

([22]) The funding model will be similar to that applied to other regulated monopolistic utilities in Ireland, i.e. the revenue cap (RPI-x) model. See ECFIN Occasional Papers 167, December 2013 for details.

The budget assumed only proceeds of EUR 110 million (0.06% of GDP), which have been earmarked to foster public-private partnerships in infrastructure, with a number of projects well under way. There has been no indication what proceeds from the sale of state assets would be used for debt reduction, a commitment under the former EU-IMF programme.

3.3.5. Improving legal services

There has been another delay to the important legal services reforms. The Legal Services Regulation Bill aims to increase competition in legal services and reduce high legal services costs, which have impeded Ireland's competitiveness and negatively affected the SME sector. Although progress has been achieved with the completion of the committee stage in February 2014, expectations that the bill would be enacted before the summer recess have evaporated. Additional amendments regarding limited liability practices and the balance between lay-persons and representatives from the legal profession on the board of the future Legal Services Regulatory Authority are under preparation by the government. No date has been set so far for Report and Final Stages (the last steps of adoption by the lower house). However, renewed momentum and forceful actions are necessary as ever, particularly if the authorities aim to stick to their commitments in the Action Plan for Jobs 2014 and the National Reform Programme to have the bill enacted and the authority established by end-2014.

Box 3.1: The quality of government expenditure adjustment

In 2000-2007, primary government spending increased by 5.7 percentage points of GDP. According to the functional classification of expenditure ([1]), the largest increase was recorded in social protection, followed by health, housing and community, and education (Graphs 1a and 1b). The expansion of social expenditure was led by a more generous welfare system (Graph 1f).

Primary expenditure, led by social transfers, continued to increase by 8.0 percentage points of GDP between 2007 and 2009 on the back of the sharp economic downturn. The contraction in GDP accounted for 6.5 percentage points of this increase. The general government balance moved from a small surplus of 0.2% of GDP in 2007 to an underlying deficit of 11.2% of GDP in 2009([2]). The increase in nominal primary expenditure during this period was mostly due to a rise in social protection due to an increase in the number of unemployed and in social benefit rates (Graph 1e and 1f). Nonetheless, expenditure decreased in housing and community services, transport and environmental protection, as capital spending cuts were the first response to the acute fiscal crisis.

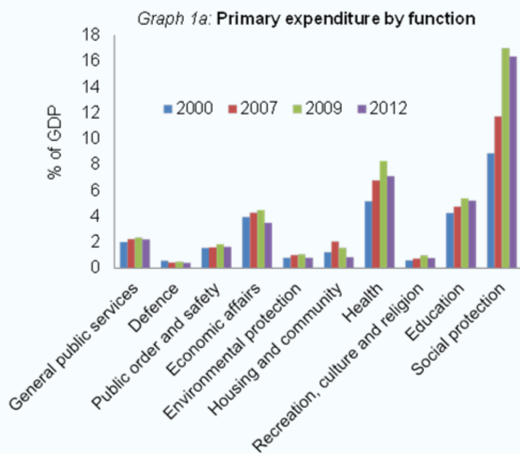
The large adjustment to primary expenditure started in 2010 with reductions across virtually all functional categories and in capital spending. In 2009-2012, primary expenditure declined by 4.7 percentage points of GDP with the main reductions in health, economic affairs (including transport), housing and community, education, and social protection (Graph 1d). The decline in health spending mostly reflected lower purchases of goods and services and lower wages. The reduction of social protection expenditure reflected reduced family, children, and sickness and disability benefit rates, partly offset by an increase in pension expenditure owing to a rising number of pensioners (Graph 1e and 1f). Education spending cuts were limited as reductions for primary and secondary education were partly offset by increased benefits for tertiary education incentivizing further education of the unemployed. A breakdown by economic category reveals that almost half of the adjustment in 2009-2012 was in capital expenditure with the rest coming from wages and purchases of goods and services (Graph 1c).

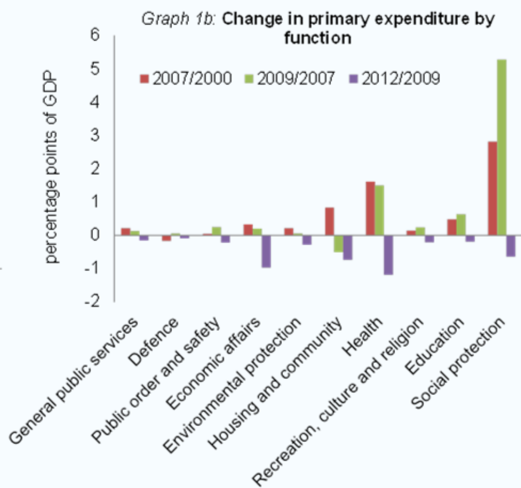
There is room for the expenditure adjustment to become more growth friendly. A reduction of government current transfers is generally considered to be less damaging to economic growth than a decrease in capital spending ([4]). Looking at Ireland's experience, the sizable reduction in capital expenditure could have a negative effect on the economy's growth potential, although some cut backs to boost efficiency of spending can be justified after a prolonged period of significant investment. There is also evidence that curtailing current spending, particularly in transfers, subsidies and wages, supports more sustainable adjustments ([5]). In Ireland, government current transfers, which rose significantly before the crisis, have seen limited adjustment though wages have decreased. This suggests there is room to reduce transfers. Conversely, the protection of education spending is positive as it plays a role in the reskilling of the unemployed and in building human capital which is key to boosting economic growth.

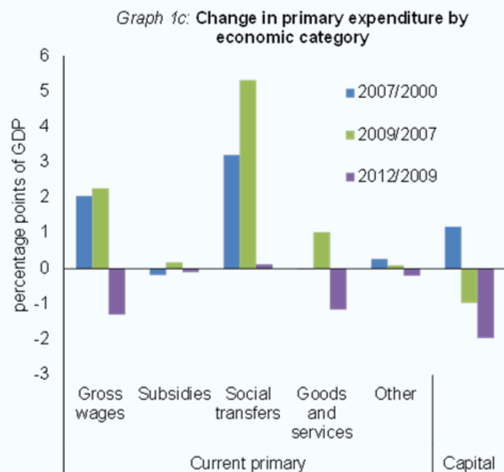
([1]) COFOG (classification of the functions of government) data is available until 2012 only.
([2]) The underlying deficit excludes one-off expenditure-increasing financial sector measures.
([4]) For analysis of the impact of different revenue and expenditure items on economic activity, see chapter I.2 "The impact of fiscal consolidation on Europe's economic outlook" in European Commission, European Economic Forecast - Autumn 2010, European Economy 7/2010.
([5]) See *Fiscal Adjustment for Stability and Growth*, Pamphlet Series No. 55, by Daniel, Davis, Fouad, and Van Rijckeghem, IMF 2006.

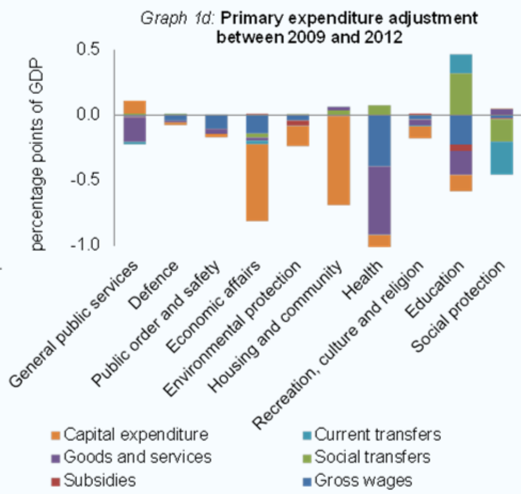
(Continued on the next page)

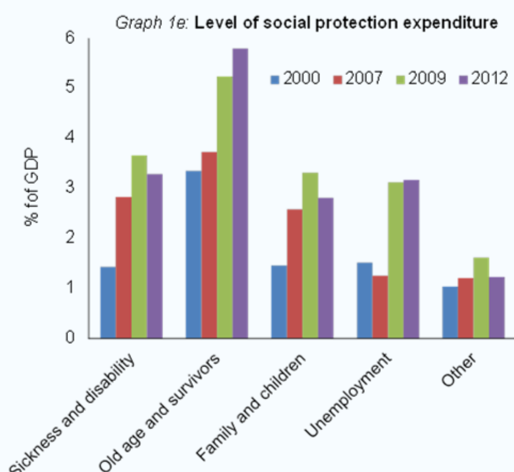
Box (continued)

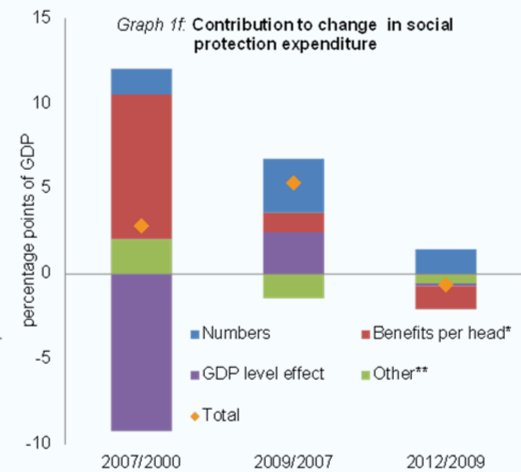












Source: Eurostat, Commission services' estimates
Note: One-off deficit-increasing financial sector measures are excluded.
* Estimated effect of changes in social protection personal rates.
** Other effect including changes in elegibility for social benefits and composition of benefit recepients.

Box 3.2: Domestic banks' financial results for 2013

Bank of Ireland (BOI) is historically the most resilient of the three main domestic banks, and showed a core tier 1 capital ratio (CT1) of 12.3% in 2013. The bank was also the first of the three domestic ones to announce its return to profitability in early 2014, after a loss before taxes of EUR 525 million in 2013 (down 76% from 2012). In the second half of 2013 net interest income increased by 27%, compared to the same period of 2012, driven by the substantial improvement in the net interest margin (NIM), which rose from 1.34% to 2.03%. Between January 2013 and May 2014, bond issuances amounting to EUR 5.25 billion in total have attracted investors at increasingly favourable terms. The bank also had the lowest level of reliance on ECB funding of all three domestic banks, at about 8% of total funding in 2013. Loan arrears formation stabilised and from June to December 2013, the value of defaulted loans (in arrears and/or impaired) decreased by EUR 1.2 billion or by 6%. The bank's provisioning of NPLs (or coverage ratio) increased to 48% in 2013 from 43% in 2012, partly in response to the findings of the BSA and reflecting the revised provisioning guidelines published in May. With regards to mortgage loans in arrears specifically, they increased to 14.2% of total loans in 2013 from 13.1% in the previous year. BOI also announced new lending plans for 2013-2017 of EUR 33 billion in total. However, as its balance sheet continues to shrink (down by EUR 36 billion since December 2010), BOI's loan-to-deposit (LTD) ratio fell to 114% at end-2013 from 123% the previous year.

Allied Irish Bank's (AIB) financial position continued to improve. The bank's plans to return to profitability in 2014 were realized during the first quarter of the year. Its annual report revealed that the bank had a CT1 ratio of 14.3% in 2013. It also has a satisfactory liquidity position with its liquidity coverage ratio (LCR) ([1]) at 95% and the net stable funding requirement (NSFR) ([2]) at 105%. Its revenue rose by 34% in 2013 from the previous year, due to a recovery in NIM, a 25% decrease in provisions and a reduction in operating expenses. AIB's balance sheet contracted further as a result of deleveraging, NAMA bond redemptions and weak credit demand. Loan reductions resulted in a decrease in risk weighted assets. An annual increase in deposits of 3% in 2013, led to a significantly more stable and lower LTD ratio of 100% in 2013. However, NPLs increased by 2% yoy in 2013, to 35% of total loans. AIB had total provisions of EUR 17.1 billion in 2013, implying a coverage ratio of 59% of impaired loans.

Permanent TSB (PTSB) remains the least profitable of the three banks, due to the large proportion of tracker mortgages on its balance sheet. It reported a NIM of 0.82% in 2013 which is modest in comparison to the two peer banks. Nonetheless, its capital position remains relatively comfortable given its CT1 ratio of 13.1% in 2013. PTSB closed 2013 with approximately the same losses as in 2012. Including a one-off accounting adjustment for pension schemes and for deferred tax assets, it recorded an after-tax loss of EUR 261 million. Its funding profile improved with a decline in net loans and an increase in deposits. The LTD ratio fell significantly in 2013 but it is still high at 150%. PTSB sold a EUR 0.5 billion residential mortgage backed securities (RMBS) issuance in late 2013 which was three times over-subscribed, due to the high quality of the portfolio selected. PTSB also decreased its reliance on ECB funding. Still, NPLs continued to increase to 26% of total gross loans in 2013, from 20% the previous year. PTSB's total coverage ratio increased to 47% in 2013 from 45% in 2012. As of May 2014, on a stand-alone basis PTSB business unit (the core bank) has been profitable after impairments for the year-to-date.

([1]) The LCR demands that the amount of highly liquid assets (such as cash or Treasury bonds) held by financial institutions in order to meet short-term obligations is equal to or greater than their net cash over a 30 day period (having at least 100% coverage).

([2]) The NSFR requires a minimum amount of funding that is expected to be stable over one year based on liquidity risk factors assigned to assets and off-balance sheet liquidity exposures. It is defined as the ratio of the available amount of stable funding to the required amount of stable funding. This ratio must be greater than 100%.

4. FINANCING ISSUES AND CAPACITY TO REPAY

The financing outlook for 2014 and 2015 remains relatively comfortable. The final IMF disbursement under the programme of EUR 0.6 billion was in December 2013; while the final EFSM disbursement of EUR 0.8 billion was drawn down in March 2014. Following its syndication of a EUR 3.75 billion new ten-year benchmark bond in January, the NTMA announced plans in February to hold a series of bond auctions over the remainder of 2014. It is also issuing treasury bills. As of mid-May 2014, the NTMA had raised a total of EUR 6.5 billion, out of an annual target of EUR 8.0 billion. Significant debt redemptions reduced the size of the cash buffer at the end of the first quarter of 2014 to EUR 21.1 billion, covering about 14 months of financing needs. At the end of 2014, cash balances including contingency buffers are projected to decline to about EUR 11 billion. Given the expected pace of reduction in the borrowing requirement this should be sufficient to cover financing needs into the early part of 2016. Moreover, historically low market borrowing interest rates and recent sovereign credit rating upgrades further alleviate any financing pressures.

Table 4.1: **Financing plan**

EUR bn	2013	2014 est.
Funding requirement		
Exchequer borrowing requirement (EBR) 1/	11.5	8.7
Medium to long-term debt redemption 2/	10.0	4.7
Net short-term debt redemption 3/	0.0	2.0
Other 4/	0.8	1.1
Total requirement	*22.3*	*16.5*
Funding sources		
Government bonds 5/	8.4	8.0
EU-IMF loan disbursement 6/	11.0	0.8
Other including state savings	2.1	0.6
Use of cash and other short-term investments	0.8	7.1
Total sources	*22.3*	*16.5*
Financial buffer	18.5	11.4

1/ For 2014, this is the department of finance 2014 SPU estimate.
2/ Medium/long-term debt maturities include government bond maturities and bond buy-backs.
3/ Reflects net short-term debt funding; includes treasury bills.
4/ Includes contingencies.
5/ 2014 bond funding target of EUR 8bn, as per NTMA funding statement (February 2014); 2013 figure excludes EUR 25bn floating rate bonds issued in February 2013 to replace promissory notes.
6/ 2014 figure reflects final EU/IMF programme disbursement from EFSM in March 2014.

2013 figures are provisional and unaudited; 2014 figures are estimates.
Source: NTMA, Commission services

Overall, repayment risks for the EFSM and EFSF loans are very low. This assumes that the authorities continue to implement agreed policy plans and access to credit markets is maintained. Market access has significantly improved due to policy actions at national and European level along with recovering confidence in the Irish economy and public finances. Following the extensions of maturities, the first principal repayment on the EFSF loan is due only in 2029 and on the EFSM loan, it is due in 2027 at the earliest ([23]).

The CBI has a minimum schedule to divest its government bond holdings. The sale of EUR 25 billion in long-term government bonds held by the CBI, which were issued in exchange for the promissory notes in 2013, is not projected to impact the market at the current minimum pace of disposal, of EUR 0.5 billion

([23]) Based on current maturities. Due to the method of financing EFSM loans, the details of the maturity extension for the EFSM loans agreed in 2013 will only be determined as they approach the original maturity dates.

per year initially([24]). In 2013, the CBI sold EUR 350 million of these bonds. The central bank has also indicated that any acceleration in the pace of divestment would depend on market conditions and is also subject to financial stability concerns. This follows recent ECB statements highlighting some concerns in relation to the promissory note deal.

Debt sustainability hinges critically on continued fiscal adjustment. Annex I presents a new standardised Commission services' debt sustainability analysis (DSA) ([25]). The baseline scenario is based on Commission forecasts and a standard no-policy change assumption, with a constant primary surplus from 2015 of 0.7% of GDP in structural terms. It reveals that public debt is projected to rise modestly over the medium term to 128% of GDP in 2020. However, in the Stability and Convergence Programme (SCP) scenario, public debt is projected to decline as this assumes that the government's budgetary plans are fully met, specifically the primary structural balance improves to about 2.9% of GDP by 2018 and remains at that level. This highlights the importance of a continued improvement of the primary balance over the medium term to reduce the public-debt-to GDP ratio. So far, the Irish authorities have consistently delivered on the agreed targets for the headline deficit under the programme. Of all the macro shocks examined in the standardised DSA, the debt path is most vulnerable to a negative fiscal shock.

([24]) Bonds mature between 2038 to 2053, implying maturities of between 24 and 39 years with a weighted average of about 32 years. A minimum of bonds will be sold in accordance with the following schedule: 2014-2018, EUR 0.5 billion per year; 2019-2023, EUR 1billion per year; and 2024 and after, EUR 2 billion per year.

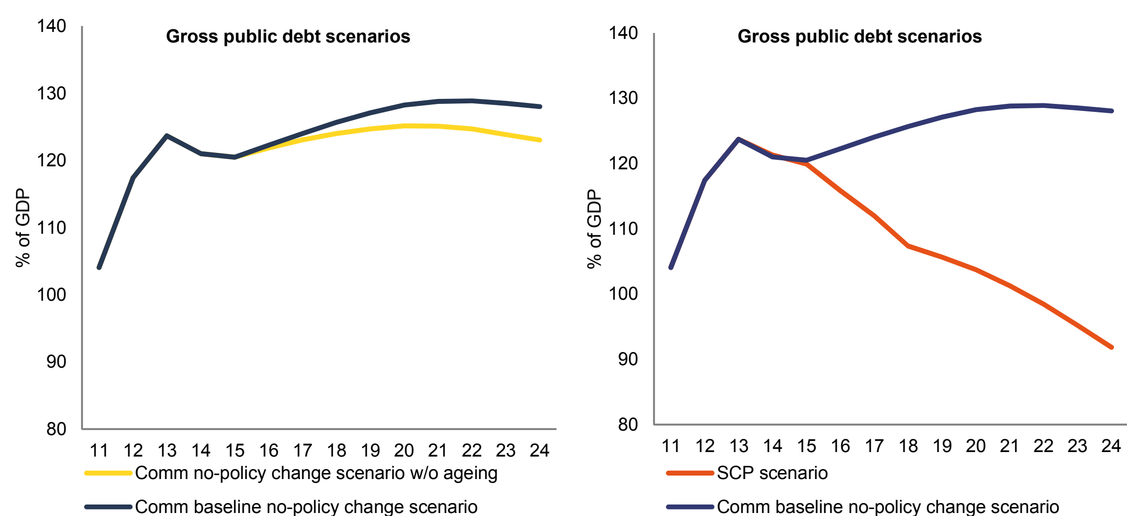
([25]) Please see forthcoming *European Economy Occasional Paper*, "Assessing public debt sustainability in EU Member States: a guide", by K. Berti and G. Carone.

ANNEX 1
Debt sustainability analysis

A1.1. BASELINE SCENARIOS AND SENSITIVITY ANALYSIS

A new standardised debt sustainability analysis (DSA) has been applied to Ireland. Following the completion of the EC/IMF adjustment programme, the baseline scenario and the sensitivity tests are based on a no-policy change scenario, as is done for all non-programme EU countries. The no-policy scenario includes only budgetary measures that have been publically and credibly announced (read adopted by government) with a sufficient degree of detail. Hence, it does not yet include the draft 2015 budget. Rather, from 2015 the budget balance is assumed to remain constant in structural at the level forecast by the Commission in its 2014 Spring forecast (for more details see next section on methodology and Tables A1.1 and A1.2). The economic projections are based on Commission forecasts agreed with the Economic Policy Committee (EPC) of potential growth of about 1.3% in 2016-19, which is then projected to pick up gradually to 3.3% by 2024([26]). The annual increase of the GDP deflator is expected to converge to 2% by 2018. The projected rise in age-related expenditures is based on the 2012 Ageing Report which does not take into consideration pension reforms undertaken from 2012 ([27]). The DSA applied to Ireland is an enhanced DSA methodology developed by the Commission services for countries whose current or forecasted public debt is at or higher than 90% of GDP.

Graph A1.1: **Baseline public debt and SCP scenarios**



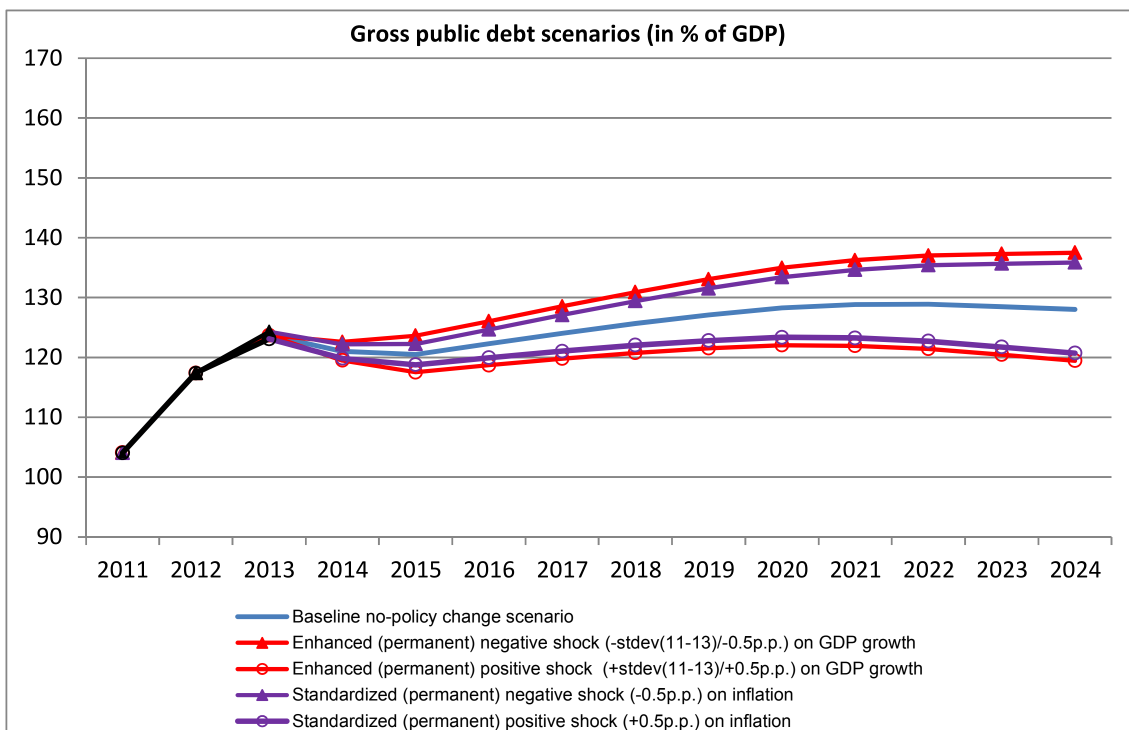
Source: Commission services.

Under the standard no-policy change baseline scenario, there would be a gradual rise of general government debt in percent of GDP in the medium to long term. Government debt is projected to rise to about 128% of GDP in 2020 from about 124% in 2013, and to broadly stabilise at that level as no further fiscal adjustment is assumed. The temporary decline in the debt-to-GDP ratio in 2014-2016 results from linking short-term economic growth projections from the Commission services' 2014 Spring Forecast with medium to long-term projections agreed with the EPC. Without the estimated impact of ageing, the public debt-to-GDP ratio would be somewhat lower but still elevated. Persistently high interest expenditures (at about 5-6% of GDP from 2014) negatively impact the debt dynamics.

([26]) GDP growth projections are sensitive to population growth assumptions. EUROPOP2013 population projections published by Eurostat are used in line with the methodology agreed by the EPC. These projections assume little or no closure in existing outward migration patterns over the next 10 years.
([27]) Pension reforms undertaken in 2012 and 2013 will be taken into consideration in the 2015 Ageing Report.

In contrast, the Stability and Convergence Programme (SCP) scenario implies a gradual decline in general government debt to about 90% of GDP by 2024 with the implementation of the government's budget plans. This is due to the targeted improvement of the government budget balance, with a close to 3% of GDP primary surplus in structural terms from 2018. The relatively large gap between the no-policy change scenarios and the SCP scenario highlights the importance of maintaining continued fiscal discipline for debt sustainability going forward. In addition, real GDP projections under the SCP are higher than the baseline scenario reflecting the assumptions underpinning the government's budgetary plans.

Graph A1.2: **Sensitivity analysis on macro-fiscal assumptions**



Source: Commission services.

Sensitivity analysis around the no-policy-change scenarios confirms that the public debt trajectory is vulnerable to negative shocks, particularly fiscal ones. General government debt is most sensitive to a negative shock on the primary balance, which raises debt to about 140% of GDP by 2024. An upward shock on interest rates and a negative growth shock would also keep the public debt-to-GDP ratio above the baseline scenario. Favourable macro-economic shocks would lower debt over the projection period, but still maintain it above 120% of GDP.

Table A1.1: **Evolution of gross public debt in baseline scenario**

% of GDP	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Gross debt ratio	104.1	117.4	123.7	121.0	120.5	122.3	124.0	125.7	127.1	128.3	128.8	128.9	128.5	128.0
Changes in the ratio	12.9	13.3	6.3	-2.7	-0.5	1.8	1.8	1.6	1.4	1.2	0.5	0.1	-0.4	-0.4
of which														
(1) Primary balance	5.7	4.5	2.3	0.3	-0.7	-0.3	-0.1	0.0	0.1	0.1	-0.1	-0.1	-0.1	-0.2
Primary balance in structural terms	5.1	4.2	1.5	-0.2	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7
Cyclical component	0.6	0.3	0.7	0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Cost of ageing	0.0	0.0	0.0	0.0	0.0	0.4	0.5	0.7	0.7	0.7	0.5	0.5	0.4	0.4
Taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Property incomes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1
(2) Snowball effect	0.8	2.9	4.6	1.2	0.4	2.1	1.9	1.6	1.4	1.1	0.7	0.2	-0.2	-0.2
Interest expenditure	3.3	3.7	4.7	4.7	4.9	5.2	5.4	5.6	5.9	6.1	6.2	6.2	6.3	6.3
Growth effect	-1.9	-0.2	0.4	-2.4	-3.5	-1.6	-1.6	-1.6	-2.1	-2.6	-3.1	-3.6	-4.0	-4.0
Inflation effect	-0.6	-0.7	-0.6	-1.0	-1.1	-1.5	-2.0	-2.4	-2.4	-2.4	-2.5	-2.5	-2.4	-2.4
(3) Stock flow adjustment	6.4	6.0	-0.6	-4.1	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Per memo														
Structural deficit	9.6	8.5	7.7	5.4	4.3	5.0	5.3	5.7	6.0	6.2	6.1	6.2	6.1	6.1

(1) A positive sign for primary and structural primary balance indicates a deficit. Primary and structural primary balance is expressed in percentage of GDP.
Source: Commission services.

Table A1.2: **Underlying macro-fiscal assumptions in scenarios.**

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
1. Comm. baseline no-policy change scenario														
Primary balance	5.7	4.5	2.3	0.3	-0.7	-0.3	-0.1	0.0	0.1	0.1	-0.1	-0.1	-0.1	-0.2
Structural primary balance	5.1	4.2	1.5	-0.2	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7
Real GDP growth	2.2	0.2	-0.3	1.7	3.0	1.4	1.3	1.3	1.7	2.1	2.5	2.9	3.3	3.3
Potential GDP growth	-0.8	-0.5	0.5	1.3	2.0	1.4	1.3	1.3	1.7	2.1	2.5	2.9	3.3	3.3
Inflation rate	0.7	0.7	0.4	1.1	0.9	1.3	1.6	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Implicit interest rate (nominal)	3.7	3.6	4.0	3.8	4.2	4.5	4.5	4.7	4.9	5.0	5.1	5.1	5.1	5.1
	2011	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**
2. Comm. no-policy change scenario w/o ageing costs														
Primary balance	5.7	4.5	2.3	0.3	-0.7	-0.7	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.5
Structural primary balance	5.1	4.2	1.5	-0.2	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7
Real GDP growth	2.2	0.2	-0.3	1.7	3.0	1.4	1.3	1.3	1.7	2.1	2.5	2.9	3.3	3.3
Potential GDP growth	-0.8	-0.5	0.5	1.3	2.0	1.4	1.3	1.3	1.7	2.1	2.5	2.9	3.3	3.3
Inflation rate	0.7	0.7	0.4	1.1	0.9	1.3	1.6	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Implicit interest rate (nominal)	3.7	3.6	4.0	3.8	4.2	4.5	4.5	4.7	4.8	5.0	5.0	5.1	5.1	5.1
	2011	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**
3. SCP scenario														
Primary balance	5.7	4.5	2.5	0.3	-1.9	-2.7	-3.7	-4.8	-2.8	-2.8	-3.0	-3.0	-3.0	-3.1
Structural primary balance	5.1	4.2	1.8	0.0	-2.1	-2.3	-2.5	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9
Real GDP growth	2.2	0.2	-0.3	2.1	2.7	3.0	3.5	3.5	1.7	2.1	2.5	2.9	3.3	3.3
Potential GDP growth	-0.8	-0.5	0.4	1.5	2.2	2.9	3.3	3.5	1.7	2.1	2.5	2.9	3.3	3.3
Inflation rate	0.7	0.7	0.4	0.5	0.9	1.2	1.2	1.2	2.0	2.0	2.0	2.0	2.0	2.0
Implicit interest rate (nominal)	3.7	3.6	4.0	3.8	4.1	4.2	4.4	4.6	4.8	5.0	5.1	5.1	5.1	5.1

(1)A positive sign for primary and structural primary balance indicates a deficit. Primary and structural primary balance is expressed in percentage of GDP.
Source: Commission services.

Table A1.3: **Macro-fiscal assumptions in sensitivity analysis**

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Comm. baseline no-policy change scenario														
Primary balance	5.7	4.5	2.3	0.3	-0.7	-0.3	-0.1	0.0	0.1	0.1	-0.1	-0.1	-0.1	-0.2
Structural primary balance	5.1	4.2	1.5	-0.2	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7
Real GDP growth	2.2	0.2	-0.3	1.7	3.0	1.4	1.3	1.3	1.7	2.1	2.5	2.9	3.3	3.3
Potential GDP growth	-0.8	-0.5	0.5	1.3	2.0	1.4	1.3	1.3	1.7	2.1	2.5	2.9	3.3	3.3
Inflation rate	0.7	0.7	0.4	1.1	0.9	1.3	1.6	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Implicit interest rate (nominal)	3.7	3.6	4.0	3.8	4.2	4.5	4.5	4.7	4.9	5.0	5.1	5.1	5.1	5.1
	2011	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**
Higher IR scenario	3.7	3.6	4.0	3.9	4.4	4.7	4.8	5.1	5.3	5.6	5.6	5.6	5.7	5.7
Implicit interest rate (nominal)	3.7	3.6	4.0	3.9	4.4	4.7	4.8	5.1	5.3	5.6	5.6	5.6	5.7	5.7
	2011	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**
Lower IR scenario														
Implicit interest rate (nominal)	3.7	3.6	4.0	3.7	4.1	4.3	4.3	4.4	4.4	4.5	4.5	4.6	4.6	4.6
	2011	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**
Higher growth scenario														
Real GDP growth	2.2	0.2	-0.3	2.2	3.5	1.9	1.8	1.8	2.2	2.6	3.0	3.4	3.8	3.8
Potential GDP growth	-0.8	-0.5	0.5	1.8	2.5	1.9	1.8	1.8	2.2	2.6	3.0	3.4	3.8	3.8
	2011	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**
Lower growth scenario														
Real GDP growth	2.2	0.2	-0.3	1.2	2.5	0.9	0.8	0.8	1.2	1.6	2.0	2.4	2.8	2.8
Potential GDP growth	-0.8	-0.5	0.5	0.8	1.5	0.9	0.8	0.8	1.2	1.6	2.0	2.4	2.8	2.8

(1) A positive sign for primary and structural primary balance indicates a deficit. Primary and structural primary balance is expressed in percentage of GDP.
Source: Commission services.

A1.2. METHODOLOGY AND ASSUMPTIONS UNDERPINNING DEBT SCENARIOS AND SENSITIVIY TESTS

Deterministic debt projections are run in the debt sustainability analysis (DSA) under the following **scenarios**:

- A **Commission baseline no-policy change scenario**, relying on Commission forecasts, the EPC agreed long-run convergence assumptions of underlying macroeconomic variables (real interest rate, real GDP growth ([28]), inflation rate) and the assumption of constant fiscal policy (i.e. constant structural primary balance, at last forecast value) beyond the forecast horizon. The cyclical component of the balance is calculated using standard country-specific semi-elasticity parameters ([29]) and the stock-flow adjustment is set to zero beyond forecasts. This scenario incorporates implicit liabilities related to ageing.

- A **Commission no-policy change scenario without ageing costs**, which differs from the Commission baseline no-policy change scenario only for the exclusion of age-related implicit liabilities (the comparison between the two scenarios allows assessing the impact of the cost of ageing on projected debt developments).

- A **Stability and Convergence Programme (SCP) scenario**, relying on SCPs' macro-fiscal assumptions over the programme horizon and constant fiscal policy assumption (constant structural primary balance at last programme year value) beyond the programme horizon.

In the enhanced DSA, the sensitivity analysis around the Commission baseline no-policy change scenario would include the following **sensitivity tests**:

- The **sensitivity test on interest rates** would be strengthened in terms of upside risk, by introducing a scenario imposing +2 percentage point /-1 percentage point shocks on short- and long-term interest rates on newly issued and rolled over debt, *for three years* starting from the year following the one of last actual data available. After the first three projection years the usual +1 percentage point /-1 percentage point permanent shocks on interest rates would be applied till the end of the projection horizon.

- The **sensitivity test on GDP growth** would be strengthened by reducing/increasing the real GDP growth rate by one standard deviation, *for two years* from the year following the one of last actual data available, in case the standard deviation for the country under examination is greater than the 0.5 percentage point shock envisaged for the standard DSA (as is the case for Ireland that has a standard deviation of real GDP growth of 0.9 over 2011-13). After the first two projection years, the usual -0.5 percentage point /+0.5 percentage point permanent shocks on the GDP growth rate would be applied till the end of the projection horizon ([30]).

- A **standardized (permanent) negative shock on the primary balance** equal to 50% of the forecasted cumulative change over the two forecast years ([31])(the structural primary balance is then

([28]) The output gap is assumed to close in T+5.

([29]) Estimated semi-elasticity parameters are taken from Mourre G., G.M. Isbasoiu, D. Paternoster and M. Salto (2013) "The cyclically-adjusted budget balance used in the EU fiscal framework: an update" *European Economy Economic Paper* No. 478.

([30]) The permanent 0.5 percentage point shock is applied symmetrically to *actual and potential* GDP growth (implying no change in the output gap). On the contrary, the part of the assumed growth shock in excess of 0.5 percentage point (given by the difference between the standard deviation and the 0.5 percentage point shock, whenever the standard deviation is greater than 0.5) is applied only to *actual* GDP growth over two years as indicated above (thus leading to a change in the output gap, affecting the budget balance cyclical component). This is based on the fact that the temporary nature of this "excess shock" does not justify the assumption of a change in *potential* GDP growth

([31]) The usual feedback effect on growth applies in this case (-1 percentage point fiscal consolidation leading to +0.5 percentage point in GDP growth in the same year).

kept constant for the remaining of the projection horizon at the lower level obtained for the last forecast year after applying the shock of the indicated size).

ANNEX 2

Supplementary tables

Table A2.1: **Use and supply of goods and services (volume)**

Annual % change	2008	2009	2010	2011	2012	2013	2014	2015
1. Private consumption expenditure	-0.2	-5.4	0.4	-1.4	-0.3	-1.1	0.4	0.8
2. Government consumption expenditure	1.2	-2.9	-4.9	-2.9	-3.2	-0.6	-0.7	-0.1
3. Gross fixed capital formation	-9.5	-27.0	-22.7	-9.1	-0.8	3.6	12.0	6.5
4. Final domestic demand	**-2.6**	**-10.1**	**-5.2**	**-2.9**	**-1.1**	**-0.4**	**1.8**	**1.5**
5. Change in inventories								
6. Domestic demand	**-3.3**	**-10.8**	**-4.6**	**-1.8**	**-1.6**	**-0.1**	**1.7**	**1.5**
7. Exports of goods and services	-1.1	-3.9	6.4	5.3	1.6	0.1	2.8	3.7
7a. - of which goods	-0.3	-5.4	5.2	3.8	-3.6	-3.9	0.9	2.0
7b. - of which services	-2.0	-2.1	7.7	7.0	6.9	3.9	4.5	5.2
8. Final demand	**-2.3**	**-7.5**	**1.1**	**2.2**	**0.2**	**0.0**	**2.4**	**2.8**
9. Imports of goods and services	-2.9	-9.8	3.8	-0.4	0.0	1.0	3.1	2.6
9a. - of which goods	-13.0	-17.2	-1.1	-2.4	-2.9	1.0	5.2	2.8
9b. - of which services	6.1	-4.3	6.7	0.8	1.7	0.9	2.0	2.5
10. Gross domestic product at market prices	**-2.2**	**-6.4**	**-1.1**	**2.2**	**0.2**	**-0.3**	**1.7**	**3.0**
Contribution to change in GDP								
11. Final domestic demand	-2.3	-9.2	-4.4	-2.4	-0.8	-0.3	1.4	1.2
12. Change in inventories + net acq. of valuables	-0.7	-0.6	0.6	0.9	-0.4	0.2	-0.1	0.0
13. External balance of goods and services	1.2	4.1	3.1	5.7	1.6	-0.7	0.4	1.8

Source Commission Services

Table A2.2: **Use and supply of goods and services (value)**

Annual % change	2008	2009	2010	2011	2012	2013	2014	2015
1. Private consumption expenditure	1.3	-12.0	-1.7	0.3	0.1	0.7	1.8	1.8
2. Government consumption expenditure	5.8	-3.4	-8.6	-1.7	-1.4	0.4	-2.0	0.4
3. Gross fixed capital formation	-18.3	-34.2	-26.2	-10.1	1.4	4.8	14.0	8.4
4. Final domestic demand	**-3.4**	**-15.5**	**-8.0**	**-1.8**	**-0.1**	**1.2**	**2.7**	**2.5**
5. Change in inventories	-130.7	344.5	-65.1	-289.1	-70.2	74.9	-40.2	0.0
6. Domestic demand	**-4.2**	**-16.2**	**-7.3**	**-0.6**	**-0.6**	**1.4**	**2.5**	**2.5**
7. Exports of goods and services	-1.4	-2.5	7.8	5.8	5.9	0.2	3.5	4.9
8. Final demand	**-2.9**	**-9.7**	**3.4**	**-2.9**	**6.1**	**0.7**	**3.1**	**3.9**
9. Imports of goods and services	-1.1	-10.1	6.6	2.7	3.9	1.3	3.3	3.9
10. Gross national income at market prices	-4.9	-13.4	-1.8	-0.7	1.5	3.7	2.9	4.4
11. Gross value added at basic prices	-4.5	-9.3	-1.0	3.1	-1.0	0.9	2.9	4.1
12. Gross domestic product at market prices	**-5.0**	**-10.0**	**-2.6**	**2.8**	**0.8**	**0.2**	**2.9**	**4.0**

Source Commission Services

Table A2.3: **Implicit price deflators (% change)**

	2008	2009	2010	2011	2012	2013	2014	2015
1. Private consumption expenditure	1.5	-7.0	-2.1	1.7	0.5	1.8	1.4	0.9
2. Government consumption expenditure	4.6	-0.5	-3.9	1.3	1.8	1.0	-1.3	0.5
3. Gross fixed capital formation	-9.7	-9.9	-4.5	-1.1	2.2	1.2	1.8	1.8
4. Domestic demand	**-0.9**	**-6.1**	**-2.9**	**1.2**	**1.0**	**1.5**	**0.8**	**1.0**
5. Exports of goods and services	-0.4	1.4	1.3	0.4	4.2	0.1	0.6	1.2
6. Final demand	**-0.7**	**-2.4**	**-0.6**	**0.8**	**2.9**	**0.7**	**0.7**	**1.1**
7. Imports of goods and services	1.9	-0.4	2.8	3.1	3.9	0.3	0.2	1.2
8. Gross domestic product at market prices	**-2.9**	**-3.8**	**-1.5**	**0.7**	**0.7**	**0.5**	**1.1**	**0.9**
HICP	**3.1**	**-1.7**	**-1.6**	**1.2**	**1.9**	**0.5**	**0.6**	**1.1**

Source Commission Services

Table A2.4: **Labour market and cost**

Annual % change	2008	2009	2010	2011	2012	2013	2014	2015
1. Labour productivity	-1.5	1.6	3.1	4.0	0.8	-2.7	-0.6	0.7
2. Compensation of employees per head	5.2	-1.1	-3.8	-0.1	0.8	-1.7	0.4	0.5
3. Unit labour costs	6.7	-5.1	-7.5	0.2	1.0	0.3	1.1	-0.3
4. Total population	2.1	1.0	-1.4	2.3	0.2	0.2	0.8	1.5
5. Population of working age (15-64 years)	1.7	0.3	-3.1	2.2	-0.8	-0.8	0.2	0.6
6. Total employment	-0.5	-7.6	-3.9	-1.6	-0.6	2.4	2.4	2.3
7. Calculated unemployment rate - Eurostat definition (%)	6.4	12.0	13.9	14.6	14.7	12.9	11.2	10.0

Source Commission Services

Table A2.5: **External balance**

levels	2008	2009	2010	2011	2012	2013	2014	2015
1. Exports of goods (fob)	81.0	77.6	82.6	85.0	85.9	81.9	83.1	85.7
2. Imports of goods (fob)	57.2	45.2	46.9	48.3	49.5	49.7	52.5	54.4
3. Trade balance (goods, fob/fob) (1-2)	**23.8**	**32.5**	**35.8**	**36.7**	**36.4**	**32.2**	**30.6**	**31.3**
3a. p.m. (3) as % of GDP	*13.2*	*20.0*	*22.6*	*22.6*	*22.2*	*19.6*	*18.1*	*17.8*
4. Exports of services	69.1	68.7	75.2	82.0	90.9	95.2	100.2	106.6
5. Imports of services	76.7	75.2	81.5	83.5	87.5	89.0	90.9	94.6
6. Services balance (4-5)	**-7.5**	**-6.4**	**-6.3**	**-1.6**	**3.4**	**6.2**	**9.3**	**12.1**
6a. p.m. 6 as % of GDP	*-4.2*	*-4.0*	*-4.0*	*-1.0*	*2.1*	*3.8*	*5.5*	*6.9*
7. External balance of goods & services (3+6)	**16.3**	**26.0**	**29.5**	**35.1**	**39.7**	**38.4**	**39.9**	**43.4**
7a. p.m. 7 as % of GDP	*9.0*	*16.0*	*18.6*	*21.6*	*24.2*	*23.4*	*23.6*	*24.7*
8. Balance of primary incomes and current	-26.5	-29.8	-27.7	-33.1	-32.5	-27.3	-27.5	-27.9
8a. - of which, balance of primary income	*-24.0*	*-27.0*	*-25.2*	*-30.7*	*-30.1*	*-25.5*	*-26.2*	*-26.6*
8b. - of which, net current Transfers	*-2.5*	*-2.8*	*-2.5*	*-2.5*	*-2.4*	*-1.8*	*-1.3*	*-1.3*
8c. p.m. 8 as % of GDP	*-14.7*	*-18.4*	*-17.5*	*-20.4*	*-19.8*	*-16.6*	*-16.3*	*-15.9*
9. Current external balance (7+8)	**-10.2**	**-3.8**	**1.8**	**2.0**	**7.2**	**11.1**	**12.4**	**15.5**
9a. p.m. 9 as % of GDP	-5.6	-2.3	1.1	1.2	4.4	6.8	7.4	8.8
10. Net capital transactions	0.0	-1.3	-0.7	-0.3	-2.1	-2.0	-1.0	-2.5
11. Net lending (+)/ net borrowing (-) (9+10)	**-10.1**	**-5.0**	**1.1**	**1.7**	**5.2**	**9.1**	**11.4**	**13.0**
11a. p.m. 11 as % of GDP	*-5.6*	*-3.1*	*0.7*	*1.1*	*3.2*	*5.5*	*6.7*	*7.4*

Source Commission Services

Table A2.6: **Fiscal accounts**

	2008	2009	2010	2011	2012	2013	2014	2015
				% of GDP				
Indirect taxes	12.3	11.2	11.4	10.8	11.0	11.6	11.6	11.4
Direct taxes	11.5	10.7	10.5	11.9	12.6	13.1	13.3	13.4
Social contributions	6.8	7.4	7.3	6.2	5.9	6.2	6.2	6.1
Sales	2.3	2.8	3.3	3.1	3.0	2.5	2.4	2.3
Other current revenue	1.3	1.3	1.4	1.3	1.4	1.7	1.4	1.4
Total current revenue	**34.2**	**33.4**	**33.9**	**33.4**	**33.9**	**35.2**	**34.8**	**34.7**
Capital transfers received	1.2	1.0	1.0	0.7	0.7	0.7	0.9	0.5
Total revenue	**35.4**	**34.5**	**34.9**	**34.0**	**34.5**	**35.8**	**35.7**	**35.2**
Compensation of employees	11.8	12.8	12.2	11.8	11.5	11.2	10.4	10.0
Intermediate consumption	5.7	6.3	5.9	5.4	5.2	5.1	4.9	4.6
Social transfers in kind via market producers	2.3	2.4	2.7	2.6	2.6	2.7	2.7	2.6
Social transfers other than in kind	12.3	15.1	15.3	15.2	15.0	14.6	13.9	13.4
Interest paid	1.3	2.0	3.1	3.3	3.7	4.7	4.7	4.9
Subsidies	1.0	1.0	1.0	0.8	0.9	0.9	0.9	0.9
Other current expenditure	1.3	1.3	1.2	1.1	1.1	1.3	1.1	1.0
Total current expenditure	**35.7**	**41.0**	**41.3**	**40.2**	**40.1**	**40.5**	**38.6**	**37.4**
Gross fixed capital formation	5.3	3.7	3.4	2.4	1.9	1.7	1.6	1.5
Other capital expenditure	1.8	3.5	20.7	4.6	0.8	0.8	0.3	0.5
Total expenditure	**42.8**	**48.2**	**65.5**	**47.2**	**42.7**	**43.0**	**40.5**	**39.5**
General government balance	**-7.4**	**-13.7**	**-30.6**	**-13.1**	**-8.2**	**-7.2**	**-4.8**	**-4.2**
Underlying government balance (EDP)	**-7.4**	**-11.2**	**-10.6**	**-8.9**	**-8.2**	**-7.2**	**-4.8**	**-4.2**
				EUR billion				
Indirect taxes	22.1	18.2	18.0	17.6	18.0	19.0	19.6	20.1
Direct taxes	20.7	17.4	16.6	19.3	20.7	21.6	22.4	23.6
Social contributions	12.3	12.0	11.5	10.1	9.7	10.2	10.5	10.8
Sales	4.2	4.5	5.2	5.1	4.9	4.1	4.0	4.0
Other current revenue	2.3	2.1	2.3	2.1	2.3	2.8	2.4	2.5
Total current revenue	**61.6**	**54.3**	**53.6**	**54.2**	**55.6**	**57.8**	**58.9**	**61.0**
Capital transfers received	2.2	1.7	1.6	1.1	1.1	1.1	1.5	0.9
Total revenue	**63.8**	**56.0**	**55.1**	**55.3**	**56.6**	**58.9**	**60.4**	**61.9**
Compensation of employees	21.2	20.7	19.3	19.1	18.8	18.4	17.6	17.6
Intermediate consumption	10.3	10.2	9.3	8.8	8.5	8.3	8.2	8.2
Social transfers in kind via market producers	4.1	4.0	4.2	4.2	4.3	4.5	4.5	4.5
Social transfers other than in kind	22.2	24.5	24.2	24.8	24.6	24.0	23.6	23.5
Interest paid	2.4	3.3	5.0	5.3	6.1	7.7	8.0	8.6
Subsidies	1.8	1.7	1.6	1.3	1.5	1.5	1.5	1.5
Other current expenditure	2.3	2.1	1.9	1.8	1.8	2.2	1.8	1.8
Total current expenditure	**64.3**	**66.5**	**65.4**	**65.3**	**65.7**	**66.6**	**65.2**	**65.7**
Gross fixed capital formation	9.5	6.1	5.4	3.9	3.1	2.7	2.7	2.7
Other capital expenditure	3.3	5.6	32.8	7.5	1.3	1.3	0.6	0.9
Total expenditure	**77.1**	**78.2**	**103.5**	**76.7**	**70.1**	**70.6**	**68.5**	**69.3**
General government balance	**-13.3**	**-22.2**	**-48.4**	**-21.4**	**-13.4**	**-11.8**	**-8.1**	**-7.5**
Deficit-increasing financial sector measures		4.0	31.6	6.8	0.0	0.0	0.1	0.1
Underlying government balance (EDP)	**-13.3**	**-18.2**	**-16.8**	**-14.5**	**-13.4**	**-11.8**	**-8.0**	**-7.4**

Source Commission Services

Table A2.7: **Government debt developments**

	2007	2008	2009	2010	2011	2012	2013	2014	2015
Government deficit (% of GDP)		**-7.4**	**-13.7**	**-30.6**	**-13.1**	**-8.2**	**-7.2**	**-4.8**	**-4.2**
Government gross debt (% of GDP)	25.0	44.2	64.4	91.2	104.1	117.4	123.5	121.0	120.4
					levels, EUR billion				
Government deficit		**-13.3**	**-22.2**	**-48.4**	**-21.4**	**-13.4**	**-11.8**	**-8.1**	**-7.5**
Gross debt	47.3	79.6	104.5	144.2	169.2	192.5	202.9	204.5	211.5
Change in gross debt		32.3	24.9	39.6	25.1	23.2	10.5	1.5	7.1
Nominal GDP	189.7	180.2	162.3	158.1	162.6	163.9	164.3	169.0	175.7
Real GDP	175.6	171.8	160.9	159.1	162.6	162.9	162.3	165.1	170.1
Real GDP growth (% change)	**2.2**	**-2.2**	**-6.4**	**-1.1**	**2.2**	**0.2**	**-0.3**	**1.7**	**3.0**
Change in gross debt (% of GDP)	0.00	17.9	15.4	25.1	15.4	14.2	6.4	0.9	4.0
Stock-flow adjustments (% of GDP)		10.5	1.7	-5.5	2.3	6.0	-0.8	-3.9	-0.2
					% of GDP				
Gross debt ratio	**25.0**	**44.2**	**64.4**	**91.2**	**104.1**	**117.4**	**123.5**	**121.0**	**120.4**
Change in gross debt ratio		19.2	20.3	26.8	12.9	13.3	6.1	-2.5	-0.6
					Contribution to change in gross debt				
Primary balance		6.1	11.6	27.5	9.9	4.5	2.5	0.1	-0.6
"Snow-ball" effect		2.7	7.0	4.9	0.8	2.9	4.4	1.3	0.3
of which									
Interest expenditure		*1.3*	*2.0*	*3.1*	*3.3*	*3.7*	*4.7*	*4.7*	*4.9*
Real growth effect		*0.6*	*3.1*	*0.7*	*-1.9*	*-0.2*	*0.4*	*-2.1*	*-3.5*
Inflation effect		*0.8*	*1.9*	*1.0*	*-0.6*	*-0.7*	*-0.6*	*-1.3*	*-1.1*
Stock-flow adjustments		**10.5**	**1.7**	**-5.5**	**2.3**	**6.0**	**-0.8**	**-3.9**	**-0.2**
Implicit interest rate		*5.1*	*4.1*	*4.8*	*3.7*	*3.6*	*4.0*	*3.9*	*4.2*

Source Commission Services

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