© 2003 International Monetary Fund

August 2003
IMF Country Report No. 03/242

Ireland: 2003 Article IV Consultation—Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion for Ireland

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2003 Article IV consultation with Ireland, the following documents have been released and are included in this package:

- the staff report for the 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **May 15, 2003,** with the officials of Ireland on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on July 9, 2003.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff supplement of **July 25, 2003** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its July 30, 2003 discussion** of the staff report that concluded the Article IV consultation.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org • Internet: http://www.imf.org

Price: $15.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

IRELAND

Staff Report for the 2003 Article IV Consultation

Prepared by the Staff Representatives for the 2003 Consultation with Ireland

Approved by Ajai Chopra and Martin Fetherston

July 9, 2003

- The Article IV consultation discussions were held in Dublin during May 6–15, 2003. The mission comprised Ms. Coorey (head), Mr. Soikkeli (both EU1), and Mr. Morales (MFD). Ms. Koeva (EU1) contributed at headquarters. The mission met with the Minister for Finance, the Governor of the Central Bank, other senior officials, the employers' federation, trade unions, and members of the financial and academic communities. Mr. Bennett (Executive Director) attended the concluding meeting.

- Ireland has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system free of restrictions, other than those in accordance with U.N. Security Council resolutions and EU regulations (Appendix I).

- Ireland has subscribed to the Special Data Dissemination Standard (SDDS).

- The authorities intend to publish the staff report.

- A coalition government headed by Prime Minister Ahern, which has been in power since June 1997, was re-elected in May 2002.

- At the conclusion of the last consultation in August 2002, Directors commended the authorities for Ireland's outstanding economic performance. They noted the downside risks to the global recovery and cautioned that euro appreciation and high wage inflation could adversely affect Ireland's competitiveness. Directors expressed concern about the sharp deterioration of the public finances and cautioned against continued rapid increases in public spending.

Contents Page

I. Background and Key Issues 4

II. Report on the Discussions 14
A. Short-Term Economic Outlook and Risks 14
B. Ensuring Financial Sector Stability 15
C. Maintaining Strong Macroeconomic Performance Following the 1990s' Boom ...17
D. Sustaining Growth Over the Medium Term 21
E. Other Issues 24

III. Staff Appraisal 25

Tables
1. Selected Economic Indicators 38
2. Summary of Balance of Payments 39
3. Contribution to GDP Growth 40
4. General Government Finances 41
5. Medium-Term General Government Finances 42

Figures
1. Output Growth and Labor Market Trends 5
2. Fiscal Trends 6
3. Output Growth 7
4. Comparisons of Key Indicators with Other Euro Area Countries in 2002 8
5. Nominal and Real Exchange Rates 10
6. Money, Credit, and Interest Rates 11
7. High Frequency Indicators 12
8. Asset and Consumer Prices 13

Annexes
I. Can Fundamentals Explain the Growth of House Prices in Ireland? 28
II. Financial Sector Risks in Ireland 31
III. What Explains Ireland's Inflation Differential Over the Euro Area? 35

Annex Tables
2.1 Indicators of External and Financial Vulnerability 34
3.1 Contributing Factors to the Overall Inflation Differential 36

Annex Figures

1.1 Ratios of House Prices to Disposable Income (P/DI) and Private Rents (P/E) 29
1.2 Actual, Fitted, and Equilibrium Real House Prices 29
3.1 HICP Inflation Differential Over the Euro Area Average 35
3.2 Goods and Services Inflation Differentials Over Euro Area Averages 35

Appendices

I. Fund Relations 43
II. Sustainability Exercise 44
III. Statistical Issues 47
Core Statistical Indicators 48

Apendix Tables

A.1 Public Sector Debt Sustainability Framework, 2000–08 45
A.2 Net Investment Position 46

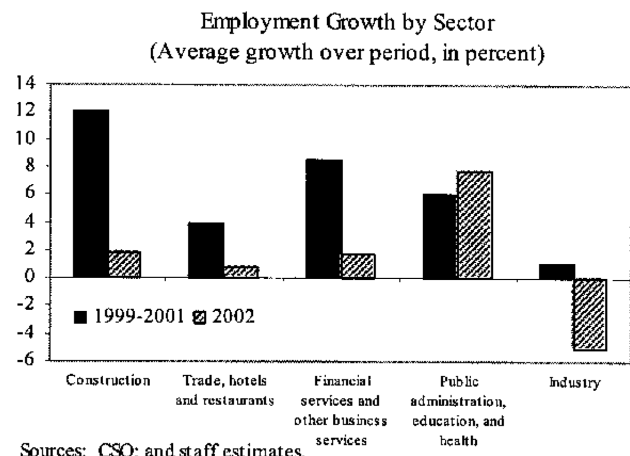
I. BACKGROUND AND KEY ISSUES

1. **Ireland's economy has performed impressively over the past decade.** Income growth, measured by real GNP, averaged 6½ percent in 1991–2001, bringing per capita income above the euro area average (Table 1 and Figure 1). The unemployment rate plummeted from almost 16 percent to less than 4 percent and the employment ratio rose well above the euro area average. Substantial gains in competitiveness, particularly in the multinational-dominated manufacturing sector, kept the current account in surplus or close to balance. The fiscal position strengthened with the public debt ratio falling from almost 100 percent of GDP in the early 1990s to well below 40 percent in 2001 (Figure 2 and Appendix II).

2. **These enviable achievements have been due in significant measure to sound policies.** A high degree of openness to trade and foreign investment as well as EU and EMU membership, the latter of which caused a sharp decline in real interest rates, were significant factors. National wage agreements quelled industrial unrest and, in the initial stages, delivered wage moderation, allowing the burgeoning labor force to be absorbed into employment. Sensible public policies in the form of investment in education and skills, tax reforms that increased incentives to work and invest, and fiscal restraint were also important. A virtuous circle was created that took advantage of favorable circumstances—in particular, the global high-tech and financial services boom of the late 1990s.

3. **While openness has brought clear benefits to Ireland, it also exposes the economy to shifting global currents, as slowing activity since mid-2001 demonstrates.** GDP growth remained strong reaching almost 6½ percent in 2002 (outpacing that of other EU countries), but GNP growth—which normally better reflects domestic economic conditions[1]—decelerated sharply, from over 10½ percent in 2000 to just ½ percent in 2002 (Figures 3 and 4).

Employment Growth by Sector
(Average growth over period, in percent)

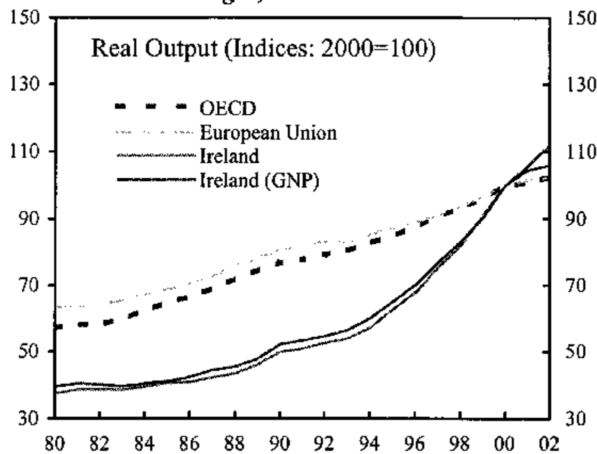


Sources: CSO; and staff estimates.

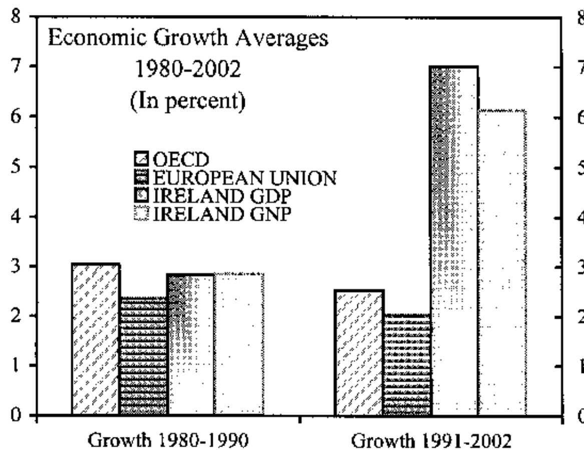
[1] The substantial contribution of multinationals to Irish output, and associated profits (possibly reflecting transfer pricing), create significant differences between measures of output and income. In 2002, GDP was boosted by unusually strong multinational profits—particularly in pharmaceuticals—which had limited implications for the rest of the economy (Table 2). On the other hand, GNP may exaggerate the slowdown in activity because the unusually sharp drop in profits of Irish firms abroad was partly driven by some firm-specific one-time factors. Officials noted that the growth in domestic demand—at about 2¾ percent—perhaps provided a better indication of the underlying pace of economic activity in 2002.

Figure 1. Ireland: Output Growth and Labor Market Trends

Output significantly outpaced EU and OECD averages,...



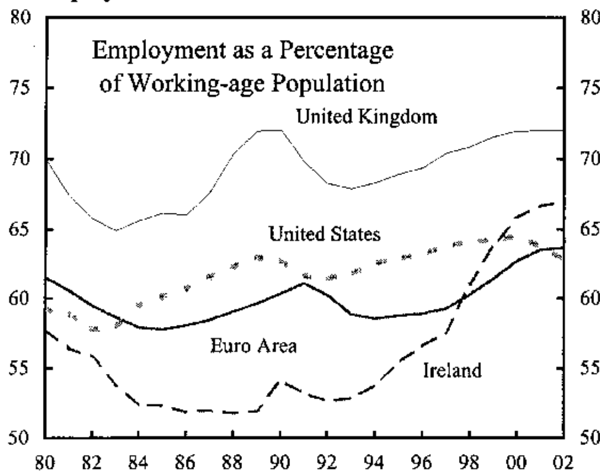
...particularly in the 1990s,...



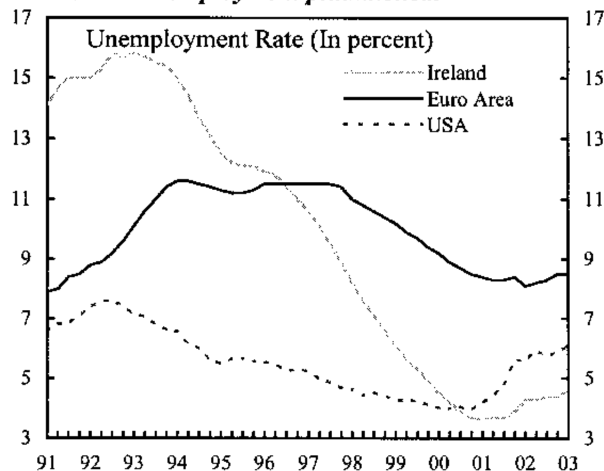
...absorbing a rapidly growing labor force...

...and reversing net immigration flows.

Employment rose above euro area and US levels...



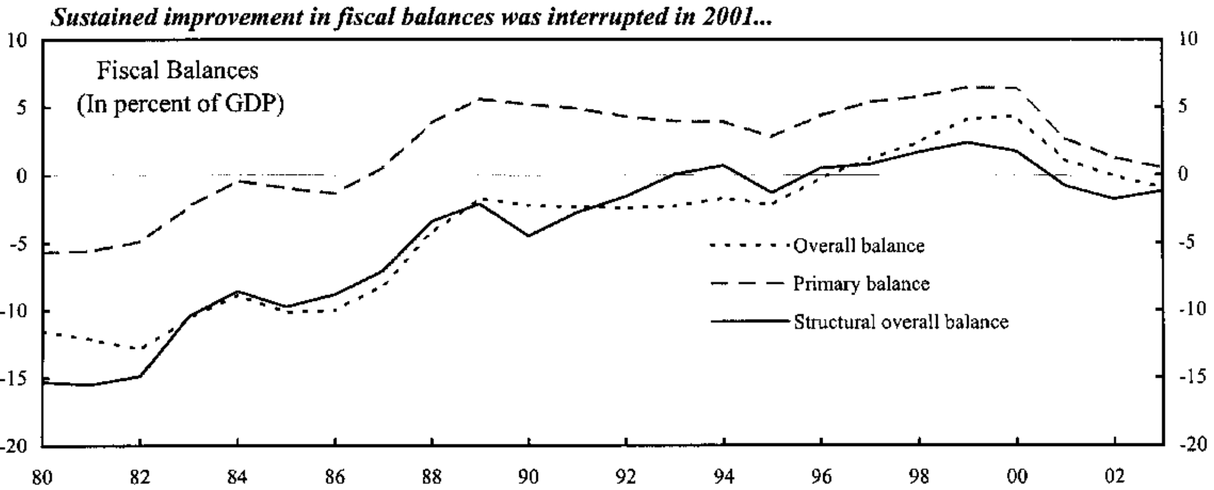
...and unemployment plummetted.



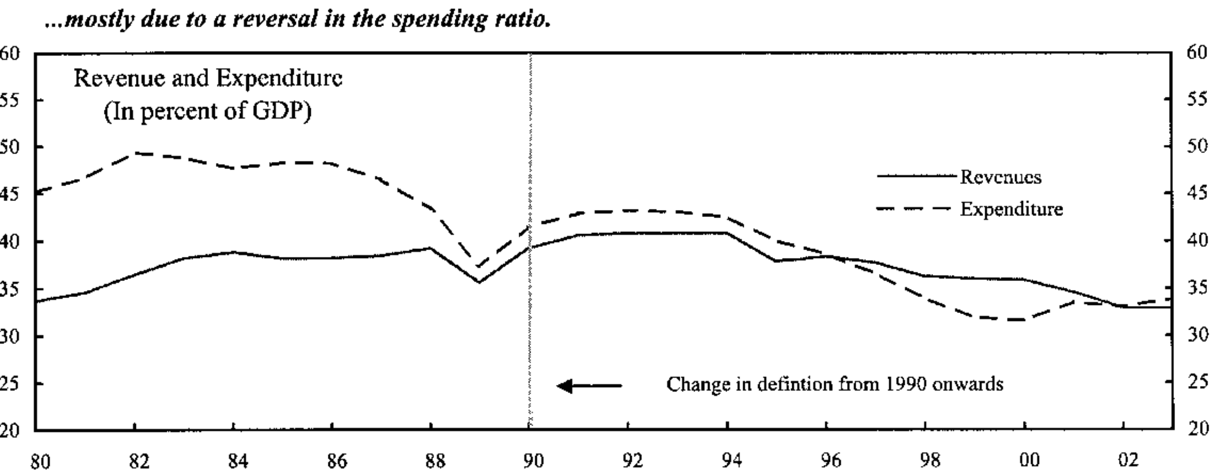
Sources: Central Statistics Office; OECD Main Economic Indicators; WEO; and IMF staff estimates.

Figure 2. Ireland: Fiscal Trends

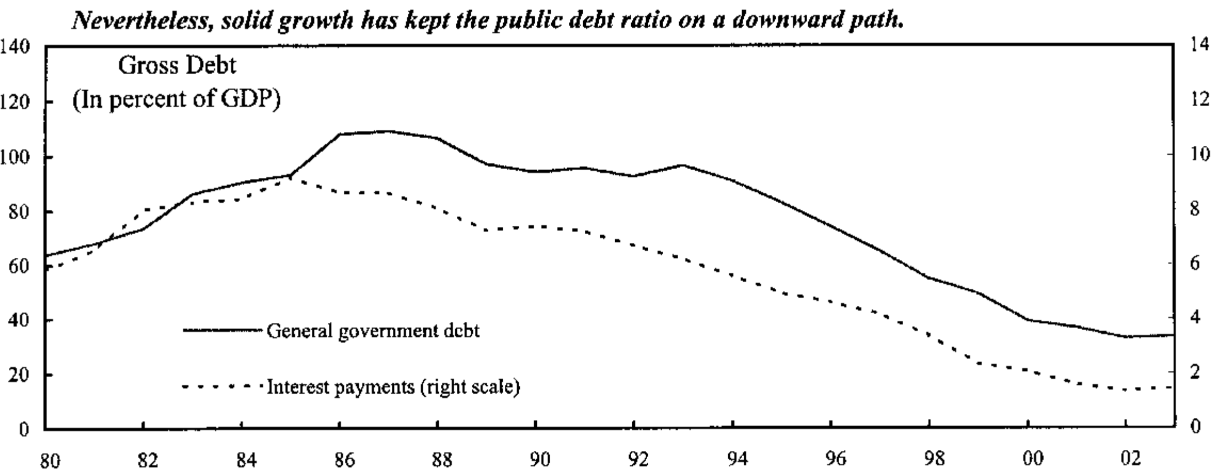
Sustained improvement in fiscal balances was interrupted in 2001...



...mostly due to a reversal in the spending ratio.



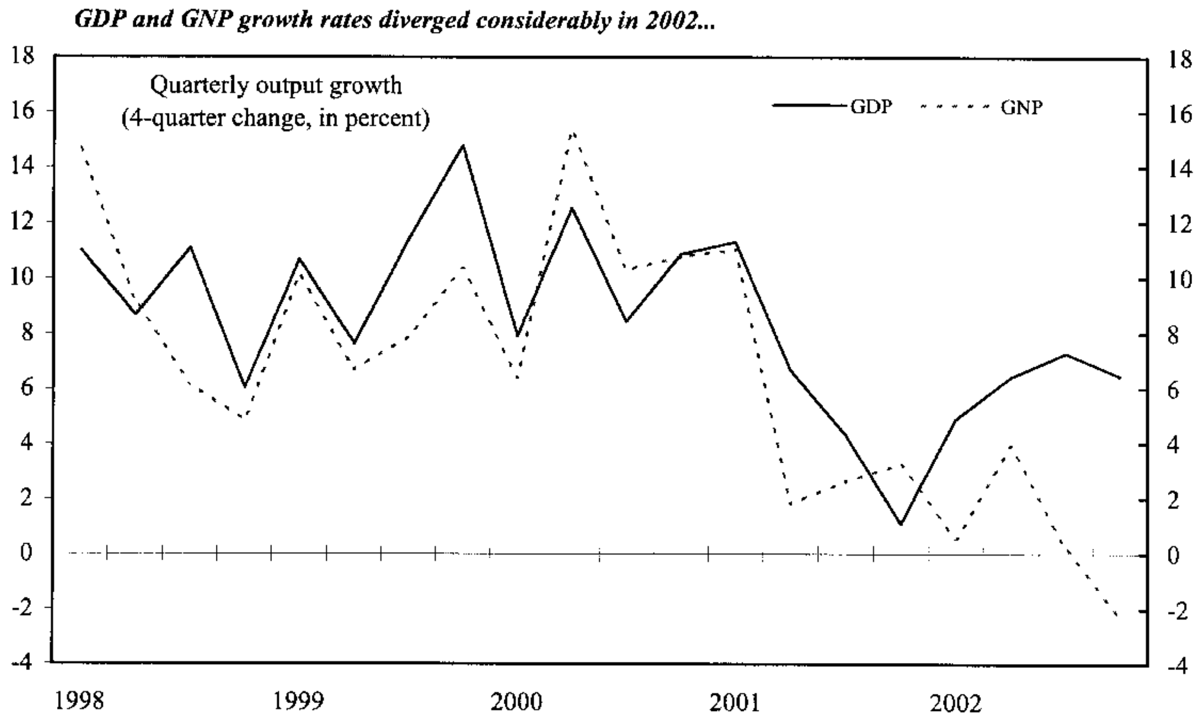
Nevertheless, solid growth has kept the public debt ratio on a downward path.



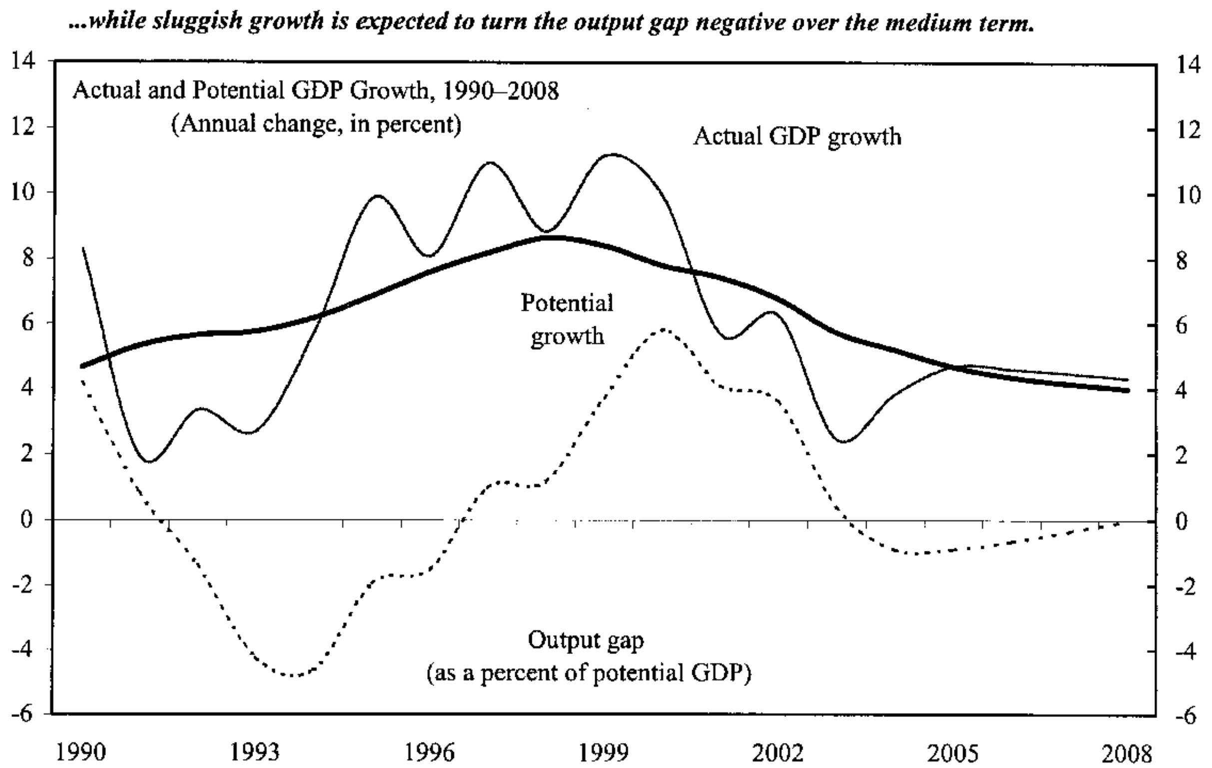
Sources: Central Statistics Office; Department of Finance; and staff estimates.

Figure 3. Ireland: Output Growth

GDP and GNP growth rates diverged considerably in 2002...

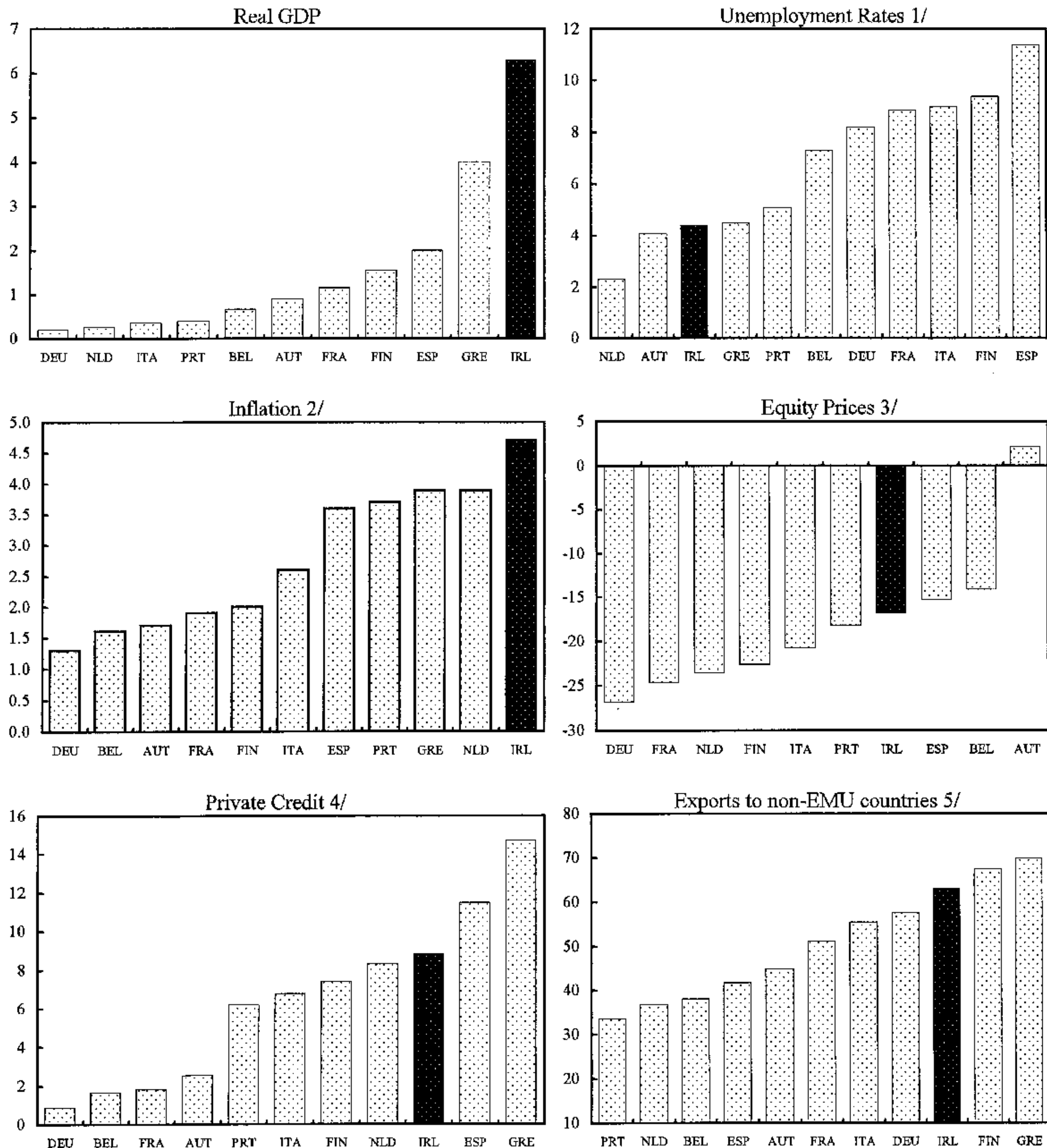


...while sluggish growth is expected to turn the output gap negative over the medium term.



Sources: Central Statistics Office; Economic and Social Research Institute; and staff estimates.

Figure 4. Ireland: Comparisons of Key Indicators with Other Euro Area Countries in 2002
(Annual growth rates, in percent, unless otherwise indicated)



Sources: WEO; IFS; Bloomberg; and staff estimates.

1/ ILO basis; levels, in percent.
2/ The EU Harmonized Index of Consumer Prices (HICP).
3/ Change from December 2001 to December 2002 (first working day of month).
4/ Bank lending to residents other than monetary authorities and banking institutions, year-on-year percent change, December 2002.
5/ As a share of total exports.

Personal consumption and export growth weakened from their previous rapid pace, while investment increased marginally, with strong residential investment offsetting a fall in business investment (Tables 1 and 3). However, unemployment increased only modestly as the rapid pace of public sector recruitment largely offset layoffs in manufacturing and business services, and wage growth moderated somewhat from the high rates seen in 2001 (Figure 5). Macroeconomic policies facilitated the soft landing: the ECB's monetary easing has kept short-term real interest rates negative since late 2001 (Figure 6), while fiscal policy was expansionary.

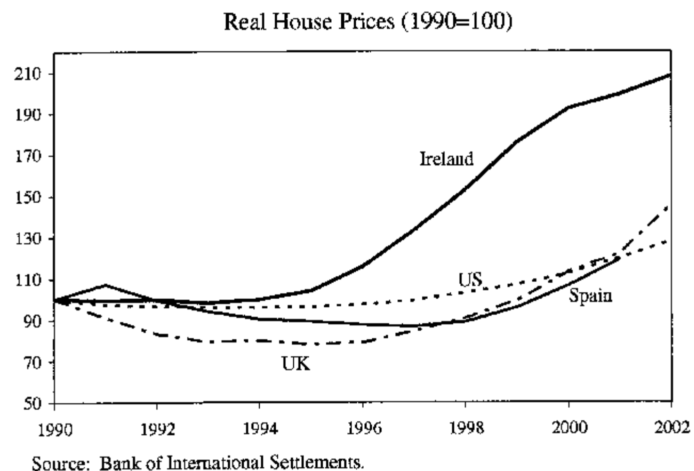
4. **Recent indicators suggest that activity has remained subdued so far in 2003.** The trend in manufacturing growth has been weak while both industrial confidence and orders have fallen back to, or below, the low levels of late 2001, after a modest improvement during 2002 (Figure 7). Moreover, consumer and service sector confidence deteriorated further and retail sales remained sluggish. However, unemployment remained stable at 4.6 percent (claimant count basis) in May 2003. Inflation eased to 3.9 percent in May, still well above the euro area average of 1.9 percent (Figure 8).

5. **Ireland has generally responded appropriately to policy challenges identified in previous Article IV consultations.** Fiscal policies were expansionary in 2000–02, contrary to Fund advice. However, starting in 2002, the authorities have reined in spending growth in order to stem the deterioration in the budget balance. In contrast to its predecessor, the national wage agreement signed in spring 2003 offered no fiscal concessions and provided a degree of wage moderation. Financial supervision is being strengthened along the lines recommended in the 2000 FSAP. Progress in improving public expenditure efficiency, controlling public sector wages, and increasing domestic competition has been more limited.

6. **Against this background, discussions focused on near-term vulnerabilities and challenges in sustaining strong medium-term economic performance.** The following questions were key:

- With external demand slowing, strong credit growth and a prolonged house price boom have, to some extent, sustained domestic demand. **Can financial stability and strong macroeconomic performance be maintained if the global economy remains weak, the euro appreciates further, or house prices unwind—perhaps abruptly?**

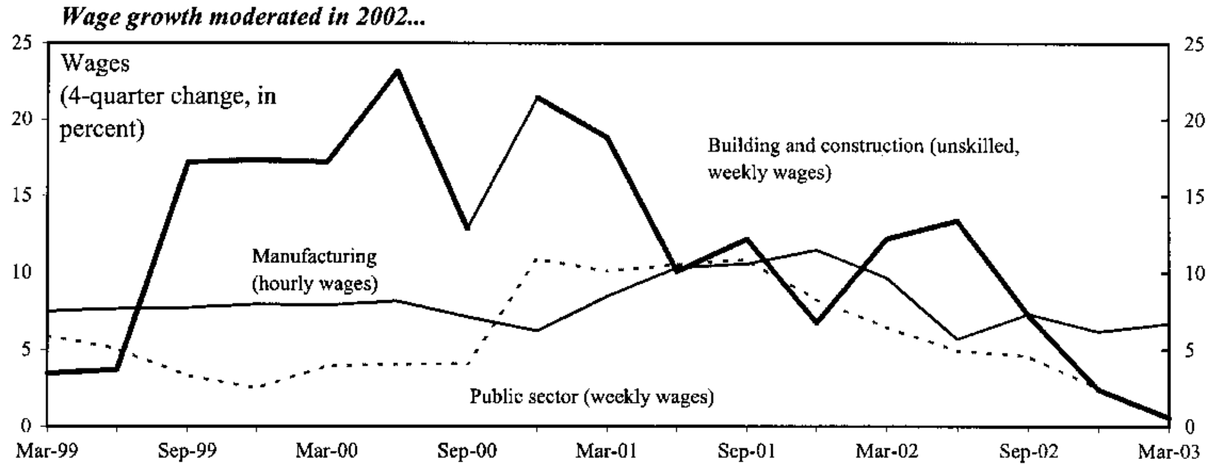
Real House Prices (1990=100)



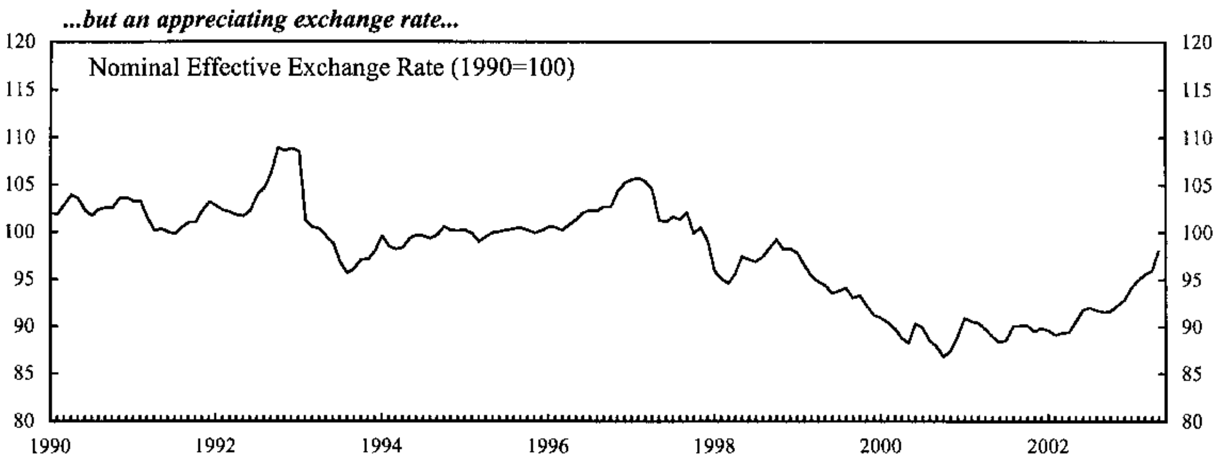
Source: Bank of International Settlements.

Figure 5. Nominal and Real Exchange Rates

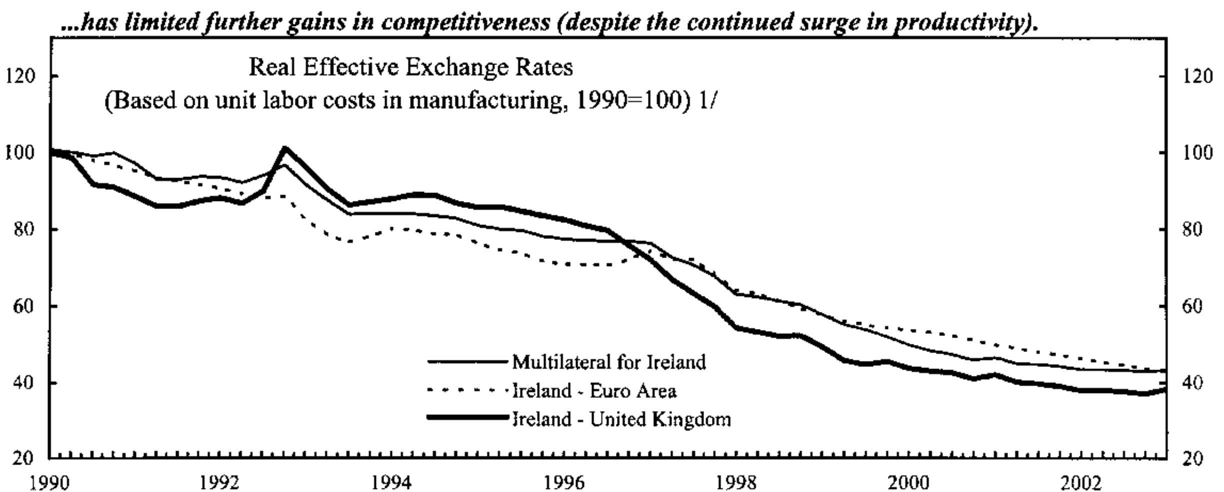
Wage growth moderated in 2002...



...but an appreciating exchange rate...



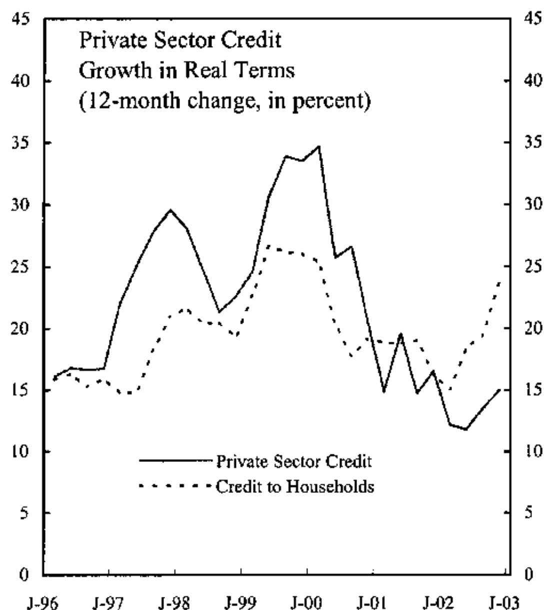
...has limited further gains in competitiveness (despite the continued surge in productivity).



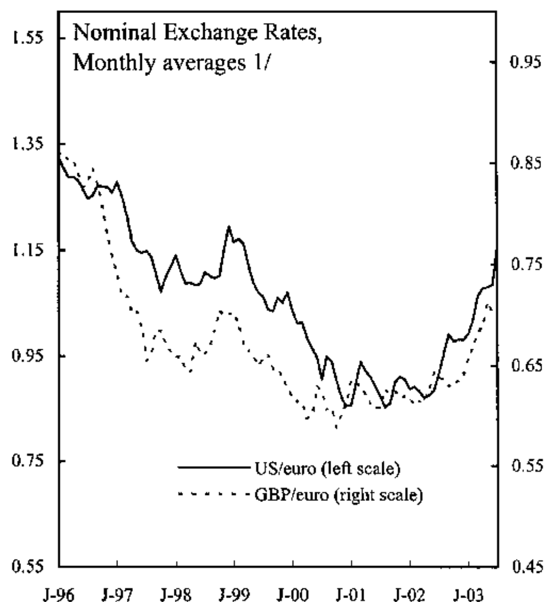
Sources: Central Statistics Office; IFS; and OECD.
1/ With normalized productivity growth.

Figure 6. Ireland: Money, Credit, and Interest Rates

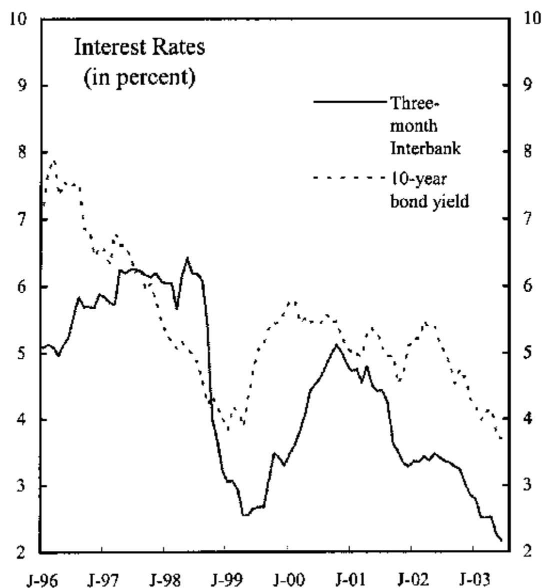
A boom in household lending underpinned credit growth.



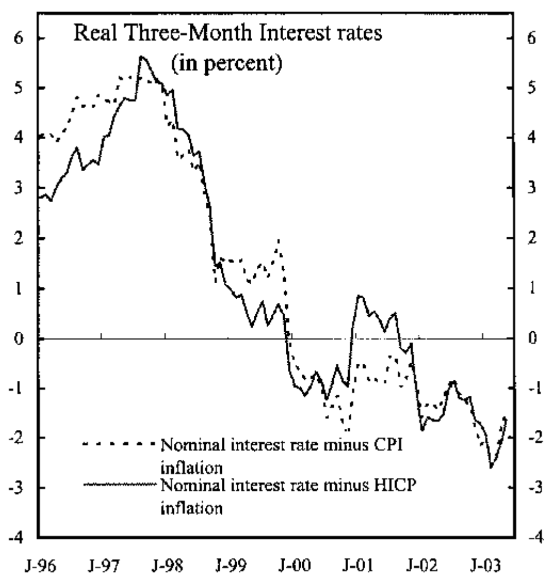
The impact on monetary conditions from an appreciating euro...



...was offset by falling euro-area interest rates...



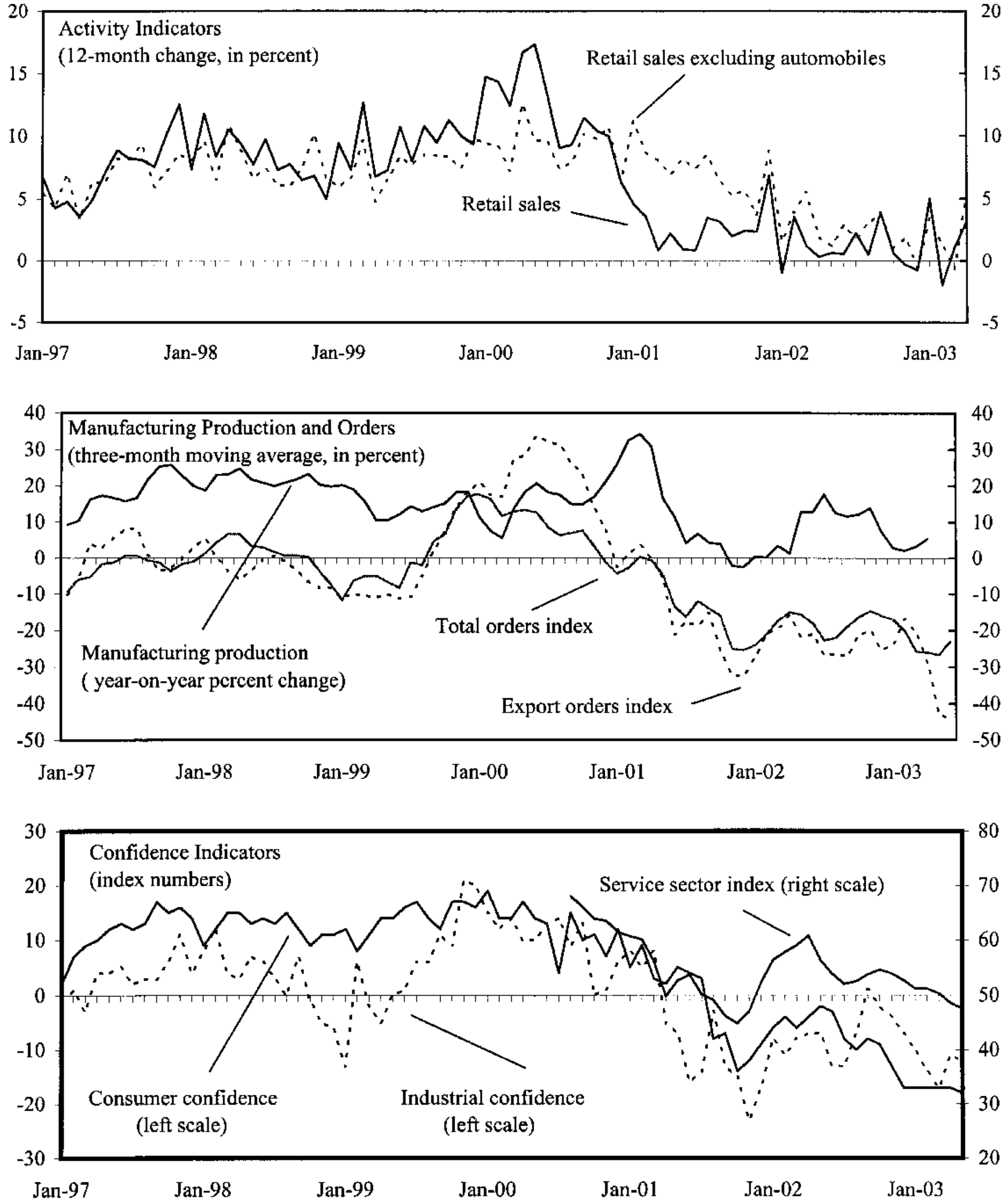
...that kept real interest rates negative.



Sources: IMF; Central Bank of Ireland; Central Statistics Office; and staff calculations.
1/ Prior to 1999, synthetic euros used.

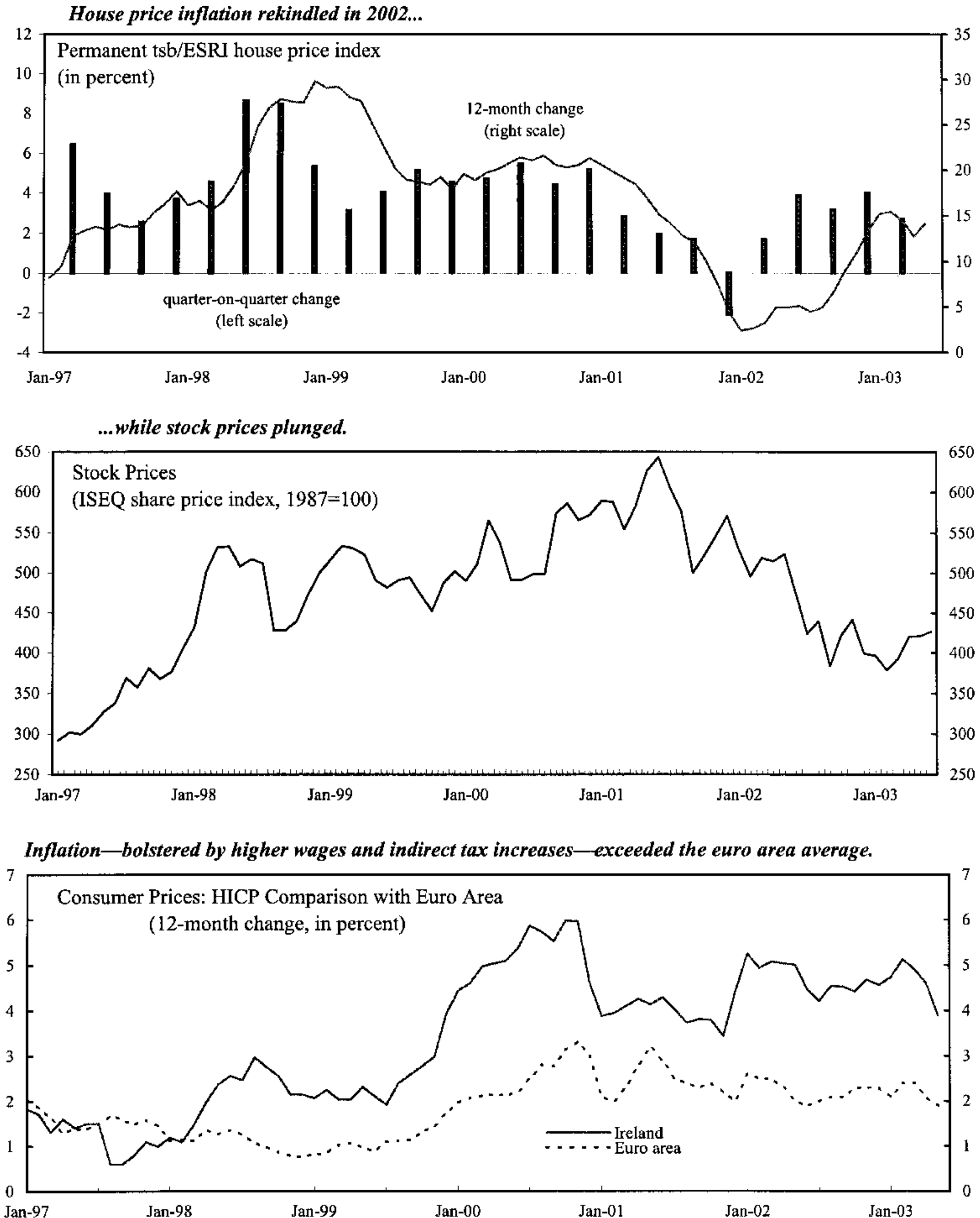
Figure 7. Ireland: High Frequency Indicators

Retail sales, manufacturing production and orders, and confidence indices all suggest weak activity in early 2003.



Sources: Central Statistical Office; NCB Stockbrokers; WEFA; and IMF staff estimates.

Figure 8. Asset and Consumer Prices



Sources: Central Statistics Office; IFS; and permanent tsb.

- Inflation has been persistently higher than the euro area average and, if wage bargaining focuses on maintaining real wages, this could lead to higher wage inflation than justified by productivity growth and recent euro appreciation. **Can competitiveness be maintained and wage pressures—particularly in the public sector—be contained?**

- A decade of rapid, export-led, income growth has led to high expectations about the future. **How can strong growth be sustained over the medium term, particularly, how can productivity growth in services (including the public sector), which now accounts for over half of value added, be improved?**

II. Report on the Discussions

A. Short-Term Economic Outlook and Risks

7. **There was general agreement that the expected economic recovery would be gradual given the weakness in the global economy.** Staff projects real GDP growth of 2½ percent in 2003—with GNP growing by 1¼ percent—both about a percentage point below the authorities' latest projections released in December 2002 (Table 3). This difference stems mainly from the authorities' expectations of a sharper rebound in global demand that they acknowledged would now need to be revised. Staff projects growth to pick up in 2004, with GNP picking up to about 3 percent (and GDP to 3¾ percent). Following a slowdown in 2003, private consumption growth would recover in 2004 as the external outlook improves. Exports would gather steam in late 2003, but given the ICT overhang, investment would decline before reviving next year as growth prospects improve. Monetary conditions would still remain supportive, as the effects of euro appreciation would be largely offset by the ECB's June rate cut (Figure 6).

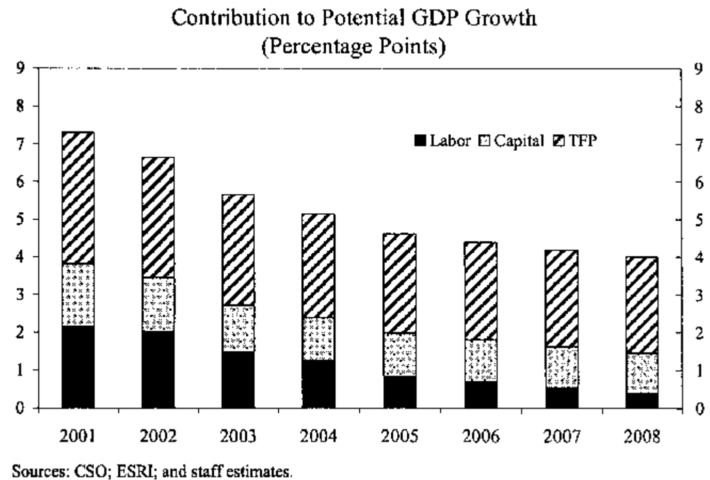
8. **The authorities and staff agreed there were significant downside risks to this outlook.** In particular:

- Global economic weakness may be prolonged further, thus delaying the expected rebound in Irish activity. Moreover, the euro could continue to strengthen, squeezing export margins, particularly in the employment-intensive indigenous sector, where productivity gains have been less pronounced.

- Unemployment may rise considerably if external demand does not recover and competitiveness deteriorates further, especially since employers may still be hoarding labor, given the previously very tight labor market. Furthermore, with the planned freeze in public employment, public sector hiring would not offset private sector layoffs.

- The spectacular increase in house prices and credit to households over the past several years inevitably raises the risk that prices may unwind, possibly abruptly, especially if unemployment were to rise further.

9. **The consensus was that, over the medium term, output would grow at a pace of about 4–5 percent per annum** (Figure 3). Given rapid structural changes, elastic labor supply, and very high rates of past TFP growth, potential output estimates for Ireland are subject to an unusually large degree of uncertainty. Staff—like many private forecasters—expect potential growth to slow to about rates of 4–5 percent due to lower growth of the labor force (reflecting the sharp decline in the birth rate in the early 1980s) and productivity (reflecting income convergence and lower FDI flows).[2] The authorities agreed with this view, but had higher potential growth projections (applying the EC's methodology) that gave rise to a sizeable negative output gap by 2005.

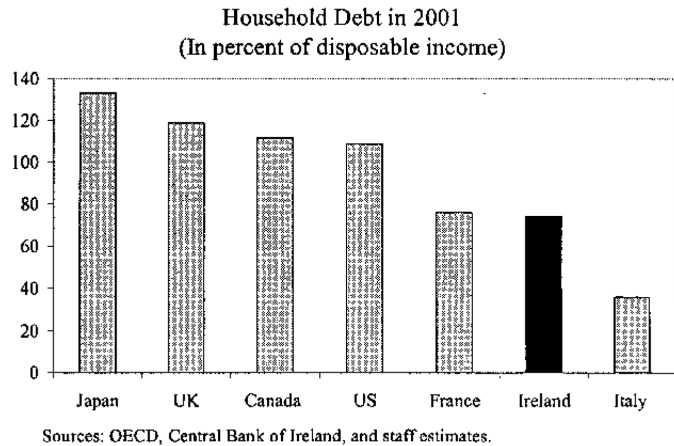


Sources: CSO; ESRI; and staff estimates.

B. Ensuring Financial Sector Stability

Risks from the housing market

10. **Ireland's house price and credit boom has been spectacular, but views differed on the possibility of a bubble.** Real house prices have increased by over 130 percent since 1993, while credit to households has grown in real terms at rates of 15–30 percent each year since 1996 (Figures 6 and 8). Many officials and analysts felt that house prices were not out of line with fundamentals. Moreover, the average household debt to income ratio, while rising rapidly, was still not high by international comparison, especially considering Ireland's relatively young population. With income growth and rents slowing and supply increasing, they expected house price inflation to moderate considerably, without a significant risk of a crash. But others



Sources: OECD, Central Bank of Ireland, and staff estimates.

[2] The general view was that FDI would slow from levels during the late-1990s' ICT boom, but would not be significantly affected by competition from EU accession countries given the shift to higher value-added activities.

cautioned that a bubble was likely since house prices had been outstripping rents and were inflated by speculative activity as investors had been shifting out of the stock market. Staff's analysis of the empirical evidence indicates that the possible existence of a house price bubble depends on whether the change in demand behavior observed in the late 1990s represents a permanent structural adjustment (e.g., to a different economic environment from joining EMU) or a temporary deviation. In the former case, fundamentals such as real income and real interest rates could largely explain house price growth. However, if behavior itself has been temporarily affected by boom conditions, there is a substantial risk that house prices may be significantly overvalued.[3]

11. **Discussions touched on whether the authorities' attempts to control house price developments might have contributed to price instability.** Various tax changes in recent years have sought to achieve a better balance between housing supply and demand, improve the position of first-time buyers, and facilitate the rental market. The stamp duty regime has been changed frequently. After measures to cool the housing market contributed to an unexpectedly sharp deceleration in house prices in 2001, the 2002 budget reintroduced measures that many analysts felt were fuelling the resurgence in house prices. Staff noted that frequent policy reversals could distort intertemporal decisions and induce market volatility. Moreover, care would need to be taken that measures do not postpone the adjustment of house prices, given the risk of an even sharper unwinding later on.

Financial system risks and reform

12. **The authorities were concerned about risks to banks from rapid house price and credit growth, but noted that high levels of capitalization and profits provided an adequate cushion to absorb the effects of potential shocks without systemic distress.** The Governor of the CBI had recently issued a warning letter to mortgage lenders on the need to maintain rigorous lending criteria despite intensifying competition. Supervisors were carrying out themed inspections on property loan portfolios of more exposed banks and planned to coordinate a stress testing exercise better tailored to pick up risks in loan portfolios and requiring disclosure of lenders' methodologies. Discussions also covered the health of the insurance sector, which officials noted remained well capitalized and less exposed to equities than U.K. and European counterparts. Staff agreed with the authorities' concerns about risks in mortgage lending, particularly from a possible rise in unemployment and from differential credit risks within mortgage loan portfolios.[4] Staff also noted that the concentration of large exposures to commercial property loans as well as insurance industry risks merited close attention.

---

[3] See Annex I at the end of this report, "Can Fundamentals Explain the Growth of House Prices in Ireland?"

[4] See Annex II, "Financial Sector Risks in Ireland."

13. **Financial sector supervision has been unified under the Irish Financial Services Regulatory Authority (IFSRA) within the central bank.** The legislation establishing the new entity, which is also responsible for consumer protection, came into force on May 1, 2003. IFSRA's agenda placed priority on improving consolidated supervision of complex financial groups by implementing the related EU directive by 2004 and strengthening insurance supervision (falling under the central bank's purview for the first time), as recommended by the 2000 FSAP. The authorities intended to base insurance supervision reforms on best practice systems—adapted to local needs—and seek advice from the relevant countries on key issues, such as strengthening reserves and evaluating risks in asset/liability portfolios. They would also be recruiting the necessary expertise, strengthening reporting and disclosure requirements, and improving the on-site inspection program. The authorities observed that the new organizational structure allowed better information flow between supervisors and those monitoring systemic risks, as well as appropriate coordination among supervisory, monetary, and fiscal authorities, should a problem arise. Staff noted that these links should continue to be enhanced and encouraged further strengthening the analysis of forward-looking systemic risks, as recommended by the FSAP.

C. Maintaining Strong Macroeconomic Performance Following the 1990s' Boom

Inflation and competitiveness

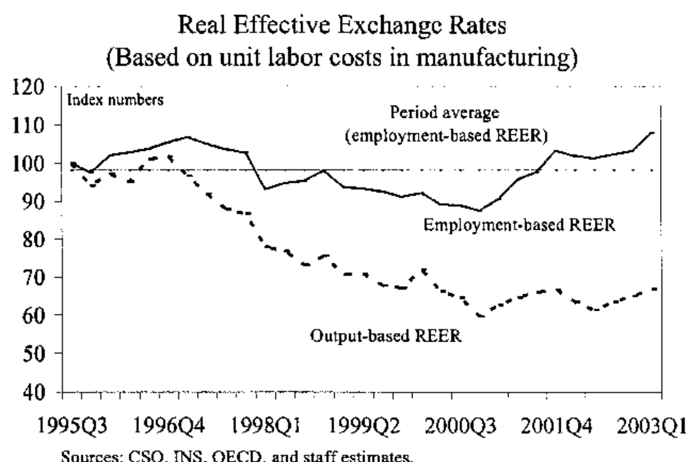
14. **Inflation has continued to exceed the euro area average by a significant margin, with the differential averaging 2½ percent since the beginning of 2002** (Figure 8). Previous staff work has suggested that Balassa-Samuelson effects could account for an inflation differential above the euro area of about 1–1¼ percentage points over the medium term.[5] Further staff analysis suggests that specific, mostly temporary factors—particularly indirect taxes in 2002—could explain most of the remaining differential.[6] In the authorities' view, higher wage growth and anti-competitive practices led to the tax and administrative price increases underlying the higher inflation. Staff agreed on the need to control public sector wage increases, including in highly-unionized public enterprises. While anti-competitive practices could account for price level differences, continued service price inflation in the private sector most likely reflected strong productivity growth in the tradable sector and, in the short-run, possibly some excess demand pressures, with the resulting real appreciation and relative price adjustment being a largely equilibrating phenomenon. Staff felt that excess demand pressures were not large since the current account was close to balance, the deterioration of the real effective exchange rate (REER) was limited until end-2002 (see paragraph 15), and the output gap was shrinking rapidly. Indeed, there was broad consensus that inflation pressures would subside in 2003–04, reflecting slackening demand, euro appreciation, and slowing wage growth.

---

[5] See IMF Staff Country Report No. 99/108.

[6] See Annex III, "What Explains Ireland's Inflation Differential over the Euro Area?"

15. **The authorities were concerned that persistently higher wage and price inflation would worsen competitiveness as the euro strengthened and external demand weakened.**[7] Staff noted that the sharp deterioration in competitiveness in 2001 appeared to reflect mainly a catch-up in wages, since the unit-labor cost based REER—measured on an employment-weighted basis to remove output distortions due to multinational activity—had stabilized in 2002 at a level only somewhat above the average of the past several years.[8] Staff agreed that, from such a starting point, the rapid strengthening of the euro in 2003 was a risk—indeed, in the first quarter, the employment-weighted REER had already appreciated to a level some 10 percent above the period average. Wage growth would thus need to slow sharply to arrest a further deterioration in competitiveness, particularly in indigenous export sectors.



Sources: CSO, INS, OECD, and staff estimates.

16. **The latest national wage agreement has provided for some degree of wage moderation, without significant fiscal concessions as in the past.** Staff noted, nevertheless, that the negotiated wage increases (some 7 percent over 18 months) might still prove a burden for some producers, given the less favorable external environment. The wage norm for the second phase of the agreement (to be negotiated in spring 2004) would need to reflect the deterioration in competitiveness and anticipate changing cyclical conditions. There should be sufficient de facto flexibility at the firm level to ensure that wages adjusted rapidly to minimize risks to employment and output. Most importantly, public sector wages, which were sheltered from market pressures, would need to be kept under firm control. The mission was assured that the agreement permitted flexibility if economic conditions hampered firms' ability to pay. Given the focus on real wages, social partners stressed that inflation would need to decelerate if wage demands were to moderate by next spring's negotiations.

17. **Many in the private sector regarded last July's pay recommendations of the Public Sector Benchmarking Body as overly generous, given sizeable public wage increases in recent years and because the exercise was carried out at the peak of a cycle.** Concerns were also raised about transparency since the report did not supply evidence of pay gaps vis-à-vis the private sector. (In fact, *all* groups were judged to qualify for a pay raise).

---

[7] They noted, for instance, the European Commission's estimate that the Irish price level—measured by the GDP deflator in common currency terms—had increased from under 85 percent of the euro area average in 1995 to over 112 percent in 2002.

[8] The construction of this series is discussed in IMF Staff Country Report No. 02/171.

The pay increases—averaging 9 percent—will be phased in over three years at a cost of about 0.8 percent of 2002 GDP.[9] There could also be potential knock-on effects on inflation—to the extent that user fees and indirect taxes are raised to cover higher expenditure. However, 75 percent of the benchmarking awards and pay increases under the wage agreement are conditional on modernization and productivity improvements. Staff urged the authorities to strictly enforce this conditionality, including by insisting that improvements be substantive and publicly verifiable (see paragraph 26). In addition, the exercise should be a first step in developing a market-linked compensation system for public pay, with merit- and skill-based elements. The authorities noted that the recommendations were based on substantive evidence, the details of which could not be published due to their sensitivity. They stressed their intention to obtain demonstrable improvements in efficiency and acknowledged the need to reform public sector pay.

Short-term fiscal policy

18. **Following several years of procyclical, expansionary policy, the major challenge for fiscal policy is to adjust to the new economic reality in the aftermath of the late-1990s' boom.** Ireland's prolonged economic expansion had bolstered fiscal revenue in the late 1990s, allowing the government to maintain sizeable budget surpluses, while simultaneously cutting taxes and increasing expenditure rapidly. As growth slowed in 2001, revenue fell short of expectations but spending overshot (increasing by 12½ percent in real terms), shifting the fiscal balance to a structural deficit for the first time in many years. With prospects for regaining very high output growth rates looking increasingly unlikely, the efficiency and control of public expenditure have become pressing concerns. From a short-term perspective, given the difficulties in precisely estimating Ireland's cyclical position and the well-known lags in adjusting fiscal policy, staff has advised aiming for a broadly neutral fiscal stance (that is, no change in the structural balance and allowing full operation of the automatic stabilizers)—other than to address serious overheating or recession, neither of which has been a significant threat recently.

19. **In 2002, fiscal policy turned out more expansionary than the broadly neutral stance that had been budgeted, mainly because of the overestimation of structural revenue**. The authorities explained that revenue—in particular personal and corporate taxes—underperformed mainly because of: (i) higher-than-expected take up of Special Savings Investment Accounts introduced last year; and (ii) weaker-than-expected corporate profits in 2001 that had a negative impact on 2002 corporate taxes, given collection lags. In contrast to 2001 and despite widespread expectations to the contrary, spending was held below budget due to a mid-year decision to claw back expenditure overruns and fortuitously low interest payments.

[9] The phasing would be: (i) 25 percent from June 2003 (backdated to December 2001); (ii) 50 percent from January 2004; and (iii) 25 percent from June 2005.

General Government Budget and Outturn for 2002; Selected Components 1/
(Percent of budgeted GNP)

	Budget	Outturn	Cyclical error 2/	Non-cyclical deviation 3/
Total revenues	42.2	41.3	0.1	-0.9
o/w total taxes	29.7	29.1	0.0	-0.7
o/w income tax	9.1	8.8	0.0	-0.4
o/w corporate tax	5.2	4.6	0.0	-0.6
o/w indirect taxes	12.8	12.9	0.0	0.1
Total expenditures	41.8	41.4	-0.2	-0.1
o/w total current expenditures	35.2	34.8	-0.2	-0.1
o/w compensation of employees	10.0	10.3	0.0	0.3
o/w goods and services	7.8	7.2	0.0	-0.7
o/w interest rates	1.9	1.7	-0.2	0.0
o/w government investment	5.2	5.4	0.0	0.3
General government balance	0.4	-0.1	0.3	-0.8

Sources: Ministry of Finance and staff estimates.
1/ Based on OECD (GDP-based) tax elasticities applied on nominal GNP growth.
2/ Part of the deviation b/w budget and outturn that can be attributed to errors in forecasting nominal GNP growth, and interest payments.
3/ The remaining deviation between budget and outturn after adjusting for forecasting errors.

While supporting expenditure control, staff noted that such stop-and-go measures were unlikely to result in sustainable spending restraint.

20. **The authorities were aiming for a somewhat contractionary fiscal stance this year, reversing the expansionary trend of recent years and marking progress towards their objective of structural balance over the medium term.** The 2003 budget implies a fiscal tightening of about ½ percent of GDP (Table 4).[10] The structural revenue-GDP ratio would be sustained by various measures, including increases in VAT and excise duties, while expenditure growth is projected to slow—although to a still-rapid pace—helped by a sharp cutback in public investment. Output was still estimated to be somewhat above potential, so that a mild contraction would not be procyclical. The authorities felt that revenue would perform close to budget and noted that spending would be held to budgeted levels.[11] Staff welcomed the emphasis on expenditure control, particularly since outturns so far

Fiscal Stance (General Government): 2001–03 1/
(In percent of potential GDP, unless otherwise noted)

	2001 Act.	2002 Budg.	2002 Act.	2003 Budg.
Structural Balances:				
Revenue	34.5	34.9	32.7	32.7
Expenditure	35.3	35.7	34.5	34.0
Overall balance	-0.8	-0.8	-1.8	-1.4
Fiscal impulse 2/ ("-" indicates expansion)	-2.5	0.0	-1.0	0.4
Memorandum item:				
Nominal overall balance	1.1	0.4	-0.1	-0.8

Sources: Ministry of Finance, and staff estimates.
1/ Based on Staff's methodology and estimates of potential output (see Table 4).
2/ Change in the structural balance over the actual outcome of the previous year.

[10] The fiscal stance is similar when measured on the basis of GNP, rather than GDP, growth.

[11] In early-July, however, the Minister of Finance announced that revenue was expected to fall short of budget by up to €500 million (0.4 percent of GDP), while expenditure was on track.

this year suggested that revenue could continue to underperform.[12] However, restraint on current spending—especially the wage bill and transfers—would be preferable to curtailing capital spending (and tax increases), given the need to improve Ireland's lagging infrastructure, particularly at a time when construction inflation was moderating. The authorities assured the mission that steps were being taken to protect capital spending. For 2004, staff advised that fiscal policy should, at a minimum, be neutral, barring any major unanticipated shocks to the economy.

Central Government Revenue and Expenditure Growth in 2003
(Annual changes in percent)

	First half of 2003		2003
	Outturn	Projected	Budgeted
Tax Receipts	9.2	12.8	8.6
Of which:			
Income	-7.1	-1.8	2.7
Corporate	47.5	55.0	5.5
VAT	10.6	11.1	10.6
Excise	0.9	12.8	12.1
Discretionary Spending	6.1	14.8	6.8

Source: Department of Finance

D. Sustaining Growth Over the Medium Term

Improving the medium-term public finances

21. **The authorities emphasized their commitment to the SGP, including achieving a zero structural balance over the medium term.** The projected structural balances in the 2003 Stability Programme were in line with commitments under the SGP and would maintain sufficient margin against the risk of breaching the 3 percent of GDP deficit limit. Given this year's structural deficit of 1¼–1½ percent of GDP, staff estimated that a modest adjustment would be required over the next few years to reach this target.

22. **Would current policies be sufficient for balancing the structural budget?** The authorities noted that the projected sharp slowdown in spending, as well as several revenue-enhancing measures introduced in the 2003 budget would halt the deterioration in the nominal government finances over the next few years. At the same time, the Stability

Contribution to Real General Government Expenditure Growth 1/
(Annual change in percent)

	2001	2002	2003	2004	2005
Total expenditure	12.6	6.7	4.6	2.8	3.6
Current transfers	5.4	2.9	2.8	2.1	1.6
Compensation of employees	3.0	2.4	1.4	1.0	0.8
Spending on goods, services, and depreciation	3.5	1.9	1.0	0.6	0.4
Interest payments	-1.3	-0.3	0.3	-0.7	0.7
Capital spending 2/	2.0	-0.1	-0.9	-0.2	0.2

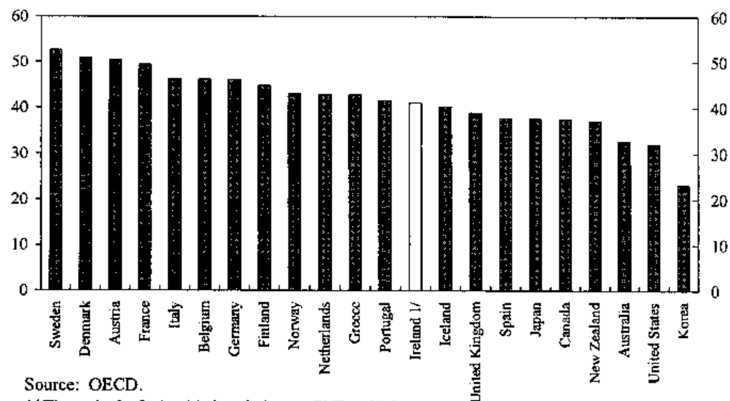
Sources: Department of Finance and staff estimates.
1/ Current expenditures deflated by HICP and capital expenditures by capital-goods deflator.
2/ Includes fixed investment and capital transfers.

[12] ESRI, a well-known think tank, argued that shortfalls in income taxes reflected the fact that the revenue impact of past tax cuts and changing demographics was not well understood. The shortfall in excise taxes could reflect substitution effects following recent increases in duty rates.

Programme envisaged that strong potential growth (projected at about 6 percent in 2004–05) would eliminate the structural deficit by 2005. However, staff projected that without further measures, the structural deficit would remain close to its 2003 level over the medium term (Table 5). Therefore, additional—albeit moderate—tightening efforts would be needed as soon as the economic recovery was firmly established. Staff cautioned against relying entirely on favorable economic conditions to eliminate the structural deficit: (i) potential output growth might well be weaker than estimated; (ii) the structural revenue ratio could decline further,[13] while the cost of spending commitments might turn out higher than anticipated; and (iii) repeated upward revisions to the deficit outlook might eventually weaken fiscal credibility. The authorities did not take issue with staff's analysis, but indicated that medium-term revenue projections had been made on a cautious basis, minimizing the potential need for downward revisions.

23. **Staff argued that further tax increases should be avoided as a means to improve the fiscal balances.** There did not appear to be a *prima facie* case for increasing the overall tax burden, given that the size of government was not small in comparison with other OECD countries. Moreover, the significant improvements to the tax structure over the past several years, which had enhanced incentives to work and invest, should be preserved. However, if revenue had to be raised, limiting tax expenditures and broadening the scope of user fees (with targeted transfers to the poor) would be more efficient than increasing tax rates. Officials were open to these suggestions, noting that all options would be kept under consideration in future budgets.

Total Expenditure in 2002 (In percent of GDP)



Source: OECD.
1/ The ratio for Ireland is in relation to GNP, which better reflects the size of the domestic economy given large multinational profits.

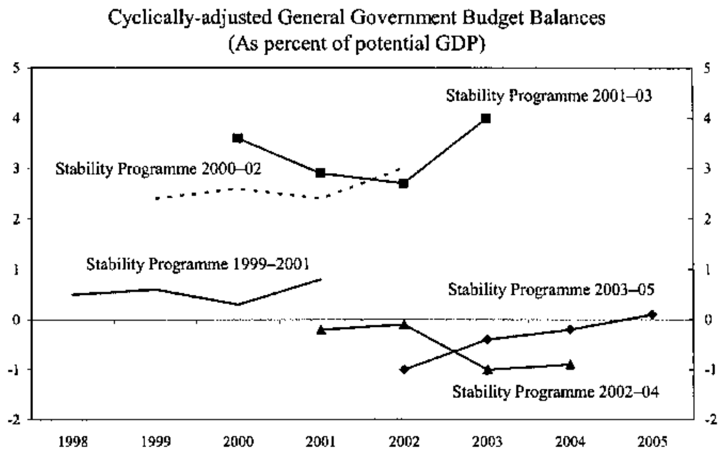
24. **The authorities agreed that the most obvious alternative would be to restrain public spending, especially current expenditure, by increasing its efficiency.** In staff's view, popular dissatisfaction with the quality of public services in health, education, and infrastructure, despite double-digit spending growth rates in recent years, indicated significant expenditure inefficiencies. Staff suggested that both current and capital budgets be comprehensively reviewed on a zero base to assess the most efficient means of delivering services and that all projects be rigorously screened for value for money. Moreover, administrative structures in certain sectors—most notably healthcare—needed to be

[13] For instance a deceleration in housing turnover would adversely affect indirect taxes and stamp duties. More generally, tax revenue could decline if the house price boom unwound quickly.

fundamentally reformed to foster accountability and rationalize service provision, and public expenditure management strengthened across all levels of general government. Increased competition and greater private sector involvement in public service provision could also improve efficiency. The authorities noted ongoing efforts to improve expenditure management, including expenditure reviews to assess spending efficiency and a framework to strengthen management information systems. They indicated their intention to reform healthcare, but cautioned that such reform was extremely complex and likely to be gradual. Subsequent to the discussions, on June 18, the authorities announced a significant healthcare reform program that would consolidate the administrative structure, devolve the budgetary process, and reform the hospital sector.

25. **The authorities were also improving budget planning through a greater medium-term orientation.** They indicated that steps were being taken to introduce multi-year departmental spending envelopes for capital expenditure and measures to improve flexibility and incentives, such as allowing departments to use savings—achieved through efficiency gains or spending cuts—to finance other high priority programs. Staff noted that a formal medium-term fiscal framework—at the general government level—would place these improvements in a broader context and usefully supplement the Stability Programme, which did not provide sufficient policy predictability in its current form (e.g., as demonstrated by the large swings in projected Programme fiscal balances). Such a framework could include: (i) an overall fiscal constraint—consistent with the SGP—requiring structural balance over the medium-term; (ii) transparent rolling five-year budget projections that set out revenue and expenditure plans demonstrating how this overall constraint would be met; and (iii) a medium-term expenditure framework, for instance, extending the capital spending envelopes to cover all non-cyclical primary departmental spending, in a binding manner, with safeguards to protect capital expenditure from overall budget squeezes. As experience from other countries suggested, it would be critical to foster ownership of such a framework by committing both the parliament and the government to the agreed ceilings and to facilitate public scrutiny through clear communication and a high degree of transparency. The authorities did not dispute the usefulness of a formal framework, but progress towards establishing such a framework has so far been slow.

Cyclically-adjusted General Government Budget Balances
(As percent of potential GDP)



Source: Department of Finance.

26. **Staff encouraged greater fiscal transparency both as a part of a medium-term framework and as a means of fostering public sector efficiency.** Advance publication and regular ex-post valuation of each department's service delivery commitments would enhance accountability and incentives. It would also permit public scrutiny of modernization and

productivity improvements actually delivered under the benchmarking exercise. The authorities noted that they published departmental expenditure reviews and had begun to publish monthly departmental spending profiles to facilitate monitoring. Staff welcomed these practices and encouraged the authorities to undertake a fiscal ROSC to identify areas where transparency could be further enhanced.

Strengthening productivity through increased competition

27. **Enhancing competition and reducing regulatory restrictions are key for sustaining strong productivity and income growth over the medium term, as well as for lowering the cost of living.** The Competition Authority and the legal framework governing competition have been strengthened, particularly with respect to investigative powers and the approval of mergers. The Authority noted that regulatory reform should be oriented to fostering competition in order to break Ireland's traditional focus on producer interests. With regard to specific sectors, competition within network utilities needed to be increased, for example, by separating electricity generation from its transmission. The Authority was shifting its focus to scrutinizing restrictive practices in services—particularly transport, pubs, pharmacies, legal, medical and other services—and an ongoing assessment of anti-competitive practices in various professions had already identified issues to be addressed. Staff encouraged these efforts, as well as overcoming union resistance and exposing public enterprises and public services—including transport and health—to private competition. In addition, scope remained for further enhancing competition law to provide for civil sanctions.

E. Other Issues

28. **Ireland's statistics are being improved to meet international requirements** (Appendix III). Staff welcomed the newly-introduced data on the International Investment Position and stressed the need to improve fiscal reporting at the general government level and to publish a national earnings index as well as sectoral balance sheets. The authorities noted difficulties in obtaining timely data from local governments. They were compiling an earnings index and complete balance sheet data, but this would take 2–3 years to complete.

29. Ireland has signed the OECD **anti-bribery** convention, and the Parliament approved the motion to ratify the convention—along with relevant EU and Council of Europe Conventions on corruption—in December 2002. The authorities expect to complete ratification this year. Ireland is also a member of the FATF and party to the principal international treaties and conventions on **money laundering**. It has signed the International Convention for the Suppression of **Terrorist Financing** and the relevant legislation has been prepared for the Parliament, although no date for its consideration has been set yet.

30. **The authorities indicated strong opposition to proposals to reform CAP**—put forward in the Commission's Medium Term Review—maintaining that these changes were not in accordance with EU policy objectives and strategically not well-timed given that the

likely shape of the WTO round was not yet known.[14] Nevertheless, Ireland subsequently supported the proposals for CAP reform agreed in Luxembourg on June 26. Ireland is also centrally involved in the EU's "Everything but Arms" initiative that provides least developed countries duty- and quota-free access for most goods.

31. **The authorities remain committed to reaching the U.N. target of 0.7 percent of GNP for official development assistance (ODA) by 2007**. Accordingly, ODA is budgeted at 0.4 percent of GNP in 2003.

III. Staff Appraisal

32. **After a decade of spectacular growth, the Irish economy has achieved a soft landing, thanks to a long record of sound policies that have left the economy comparatively robust and flexible**. Openness, years of wage moderation, investment in human capital, as well as the considerable fillip from the decline in interest rates from EMU membership, have sustained growth, allowing Ireland to "catch up" with the rest of the euro area. At the same time, a strong fiscal position and flexible private labor market have enhanced the economy's capacity to weather external shocks. Supportive fiscal and monetary policies have also softened the impact of the ongoing global slowdown.

33. **There are, nonetheless, appreciable risks to the outlook.** Activity is expected to pick up with the recovery in world demand towards the end of this year and thereafter to accelerate towards its potential growth rate. But the global recovery could be more anemic than expected and the euro may continue to appreciate rapidly, adversely affecting competitiveness. Unemployment, no longer held down by public sector recruitment, could rise, posing risks to the housing market and—most likely to a manageable extent—to the financial sector.

34. **After a long credit boom, there is a substantial risk that house prices could be overvalued**. Equilibrium asset price levels cannot be reliably estimated and the prolonged nature of the house price boom itself may have temporarily affected investors' behavior, driving house prices well above equilibrium values consistent with disposable income growth, real interest rates, and demographics. Frequent policy reversals, as seen in the past, should be avoided as they could induce market volatility. Care should also be taken that measures do not postpone the adjustment of house prices, lest this lead to a sharper unwinding further down the road.

35. **Continued supervisory vigilance will be needed to ensure the stability of the financial system, given risks from slower growth, higher unemployment, and a potentially abrupt unwinding of house prices**. While high levels of capitalization and profitability have fortified banks' capacity to absorb the effects of potential macroeconomic

[14] In 2002, Ireland received €1.9 billion in transfers to agriculture from the EU budget.

shocks without systemic distress, some issues merit close attention. These include differential credit risk within mortgage loan portfolios; the vulnerability of debt service payments to sharp increases in unemployment; the concentration of large exposure to commercial property loans among a few institutions; and the health of the insurance industry. The unification of supervision under IFSRA within the central bank has strengthened the supervisory regime. Plans to improve insurance supervision are welcome and priorities should include obtaining an accurate picture of risks in insurance portfolios and monitoring potential vulnerabilities from links between bank and insurance activities, especially through consolidated supervision of complex financial groups. The central bank's analysis of forward-looking systemic risks should continue to be strengthened as should the information flow between supervisors and those charged with monitoring and responding to systemic risks.

36. **With the late 1990s' boom past and risks to competitiveness intensifying, particularly from rapid euro appreciation, wage growth must continue to moderate**. The persistent inflation differential above the euro area average is largely explainable, and likely to narrow during this year and next as one-time factors wear off, domestic demand and wage pressures slacken, and the effects of euro appreciation pass through. Nevertheless, with weak external demand and sharp appreciation of the euro in 2003, wage growth will have to slow significantly to stem the deterioration in competitiveness and consequent risks to employment and output. While the new national wage agreement is commendable for its wage moderation and avoidance of fiscal concessions, the wage norm for the second phase will need to reflect these changing cyclical conditions. In particular, wage earners may need to accept declines in real wages (i.e., wages deflated by HICP), especially in the public sector and publicly-owned enterprises, which are less exposed to immediate market pressures. In addition, public sector productivity improvements delivered under the very generous benchmarking recommendations must be substantive and publicly verifiable. The exercise should be a first step in developing a market-linked compensation system for public pay, with merit- and skill-based elements.

37. **The somewhat contractionary fiscal stance envisaged for 2003 is appropriate and makes adequate progress towards the medium-term fiscal target**. Spending should be held to budgeted levels since cyclically-adjusted revenue might continue to underperform. Spending restraint should be focused on the wage bill and transfers, with capital spending protected given pressing infrastructure needs. For 2004, fiscal policy should, at a minimum, be neutral, barring any major economic shocks.

38. **A medium-term fiscal target of overall structural balance is appropriate.** To ensure this target is met, further moderate contractionary measures will be needed as soon as the economy recovers and the downside risks to the short-term outlook recede. The assumption that potential growth will continue to be strong should not be relied on to eliminate the structural deficit, given uncertain fiscal prospects and the need to maintain policy credibility.

39. **There is not a strong case for further tax increases.** Most importantly, the considerable improvements to the tax structure in recent years should be preserved. Moreover, increases in indirect taxes would raise inflation, adding upward pressure to private sector wages. If a compelling need arose, limiting tax expenditures and broadening the scope of user fees (with targeted transfers to the poor) would be less distorting than increasing tax rates.

40. **Restraining public spending, especially current expenditure, by increasing efficiency would be a better way to reach the medium-term fiscal target**. Public expenditure management should be strengthened across all levels of general government and fundamental reforms made in key areas. The recently-announced healthcare reforms are welcome in this context. Increased competition and greater private sector involvement in public service provision should also be considered.

41. **A formal medium-term fiscal framework—at the level of general government—and greater fiscal transparency would foster efficiency in public spending and improve policy predictability**. Such a framework could include an overall fiscal constraint consistent with the SGP and five-year budget projections based on a medium-term expenditure framework. The planned multi-year departmental capital spending envelopes is a welcome first step and should be extended to cover, in a binding manner, all non-cyclical primary expenditure, with adequate protection of capital expenditure. Public scrutiny of spending would be facilitated through more extensive publication of service commitments and ex-post evaluations. A fiscal ROSC would be a useful means to identify ways to further improve fiscal transparency.

42. **Enhancing competition is key for sustaining medium-term productivity and income growth**. Strengthening the Competition Authority's powers and the legal framework governing competition is welcome and further efforts could be made to provide for civil sanctions. Regulatory reform should be reoriented from protecting producer interests to serving consumer interests. Greater political commitment is needed to improve competition within network utilities and transport. The Authority's scrutiny of restrictive practices in services is timely and issues that are identified should be addressed without delay.

43. **Scope remains for improving the provision of statistics**. Ensuring the timeliness of general government accounts and developing a national earnings index and sectoral balance sheets should be priorities.

44. **The authorities should adopt a more supportive stance within the EU in favor of trade liberalization,** particularly on CAP, which has a particularly adverse impact on developing countries. This would complement the welcome progress and commitment towards achieving the U.N.'s ODA target by 2007.

45. It is proposed that the next Article IV consultation be held on the standard 12-month cycle.

Can Fundamentals Explain the Growth of House Prices in Ireland?[1]

What do we learn from the empirical analysis?

1. The potential for fundamentals—strong demand and insufficient supply—to justify the sustained rise in house prices in Ireland is easy to recognize *qualitatively*. On the supply side, Ireland's housing stock remains low compared with other countries, despite its comparatively high growth rate in recent years. In 2002, dwellings per thousand persons was 340 in Ireland, well below continental European levels of 400–450. On the demand side, real disposable income has risen by over 70 percent since 1993, real mortgage rates have fallen from over 7 percent in the early 1990s to below zero in 2002, while growth in the number of households has picked up in the 1990s—reflecting a surge in net migration and a rise in the proportion of the population in household-forming age groups.

2. However, it is difficult to assess *quantitatively* the degree to which these strong fundamentals explain Ireland's housing boom.

- First, two standard measures of asset price valuation, the price-to-rent ratio (P/E)—equivalent to a price earnings ratio—and the price-to-income ratio (P/I), do not provide a clear answer (Figure 1.1). In recent years, while the P/E ratio has reached a record-high level, the P/I ratio has exceeded its long-run average only by about 15 percent.

- Second, staff analysis—based on a simple error-correction model of house prices, incorporating the impact of real disposable income, real mortgage rates, and household formation during 1976–2002 (see below)—suggests that the actual house price in 2002 was 16½ percent higher than its long-run equilibrium,[2] but only 3 percent higher than the fitted value that allows for short-run dynamics (Figure 1.2).

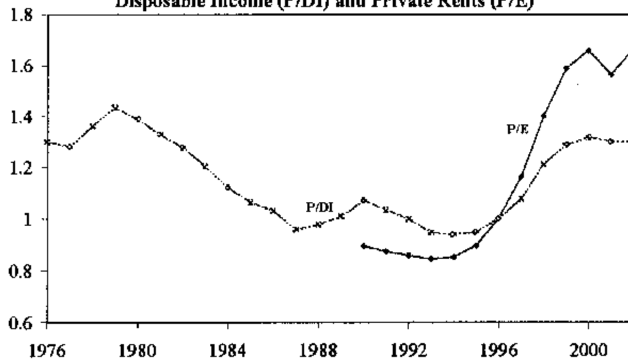
- However, the estimated responsiveness of house prices to fundamentals could be biased, given that many observations could be coming from a bubble period. For example, if the model is estimated for 1976–97 and the derived coefficient estimates used to forecast prices in 2002, the implied deviation of the actual house price from its long-run equilibrium is over 50 percent!

---

[1] Prepared by Petya Koeva.

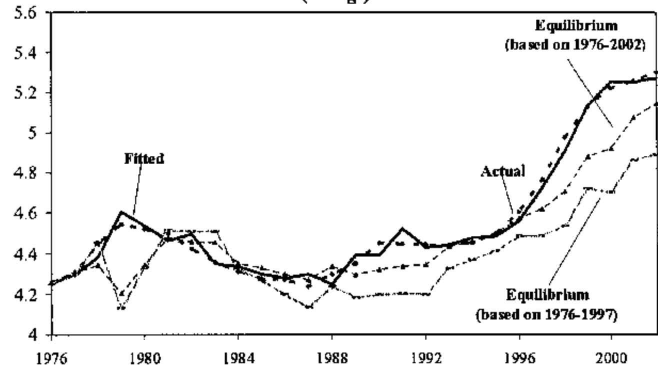
[2] This deviation of actual prices from their long-run equilibrium may be underestimated if one assumes that some of the rise in fundamentals in the late 1990s is temporary and should not be taken into account in the computation of long-run equilibrium house prices.

Figure 1.1 Ratios of House Prices to Disposable Income (P/DI) and Private Rents (P/E)



Sources: ESRI, CSO, and staff estimates.

Figure 1.2 Actual, Fitted, and Equilibrium Real House Prices (In logs)



Source: Staff estimates.

3. In conclusion, no one can know the equilibrium price of an asset with any degree of certainty. In the case of Irish house prices, the empirical evidence suggests, that as long as the change in demand behavior that seemed to have occurred in the late 1990s is permanent, the sustained rise is quite consistent with the strong fundamentals. (Some of these fundamentals, particularly real interest rates could reverse, but not necessarily abruptly). For instance, it is possible that as it became clear in the mid-1990s that Ireland would join EMU and real interest rates would decline permanently, there was a structural shift in the demand for housing. Similar arguments could be made with regard to the extensive structural changes that have taken place in the economy, including increased financial sector competition and the reduced future tax burden associated with the strengthening of the fiscal position. On the other hand, it is possible that the housing boom itself spurred changes in market psychology and led to a temporary change in demand behavior. If so, the underlying behavioral relationships would be better represented by the coefficients of the regression covering the pre-boom period. In this case, house prices would be considerably above their long-run equilibrium values, indicating a bubble.

Empirical methodology[3]

4. House prices can be estimated from a system of two structural (supply and demand) equations. However, these equations are difficult to estimate consistently given simultaneity problems. Hence, the empirical approach used in the analysis focused on estimating a reduced-form equation of log real house prices (*p)* as a function of log disposable income (*di)*, real mortgage rates (*mr*), and the share of households aged 25–35 (*dem*). After testing that all variables were nonstationarity (that is I(1)), an error-correction VAR model produced the following house-price equation:

[3] The estimation was conducted using data on house prices, disposable income, and mortgage interest rates from the Economic and Social Research Institute (ESRI). Household formation and construction cost data were available from the Central Statistics Office (CSO).

$$\Delta p_t = 0.76\Delta p_{t-1} - 0.001\Delta mr_{t-1} + 0.83\Delta di_{t-1} + 0.14\Delta dem_{t-1} - 0.31\left(p_{t-1} + 0.02mr_{t-1} - 0.92di_{t-1} - 5.40\Delta dem_{t-1} + 0.76\right)$$

(3.43) (-0.30) (2.30) (0.03) (-2.75) (6.76) (-17.77) (-2.12) (1.12)

5. An alternative specification that included real construction costs in addition to the above explanatory variables showed a smaller deviation of real house prices from their long-run equilibrium. In other words, when the upward shift in the supply curve reflecting increases in construction costs were taken into account, the degree of house price overvaluation appeared smaller than under the preferred specification, reported above. However, these estimates were somewhat unstable partly reflecting the loss in degrees of freedom in this relatively small sample. This specification had the added disadvantage that the house price equation could not be estimated for the restricted sample, excluding the late 1990s, because of problems with the degrees of freedom.

Financial Sector Risks in Ireland[1]

The financial sector faces numerous risks related to loan quality, competition pressures, the macroeconomic environment, and the insurance industry.

A. Banks' Risks

Credit risks

- Credit growth has remained very high for some years, with heavy exposure to the mortgage and real estate markets. While growth in non-mortgage credit to the private sector slowed to 10 percent in 2002, mortgage loans rose by 23 percent and other real estate lending by 28 percent. At end-2002, mortgage loans accounted for over 42½ percent, and commercial real estate for an additional 22 percent, of total loans (excluding financial intermediation). (See Table 2.1).

- Credit risks within the mortgage portfolio have also risen. The boom in house prices has led to an increase in borrowers' leverage, resulting in rising mortgage equity withdrawal and loans to small investors to acquire rental properties. (The latter was boosted by measures introduced in the 2002 budget as well). A recent survey indicated that about 60 percent of landlords in Ireland have entered the property market in the last 3 years.

- In commercial real estate, borrowers' cash flow likely declined in 2002 as office rents fell by 6 percent and office values declined by 8 percent, while vacancy rates rose to 14 percent. No defaults have occurred so far and market participants were of the view that profitability, while lower than anticipated, was sufficient to service debt at current interest rates. Nonetheless, the largest banks appear to have become more cautious in lending to this sector and exposures appear to be concentrated around a few institutions.

Risk management and competition issues

- Banks have shifted their loan policy from loan-to-value (LTV) criteria to capacity-to-repay considerations based on the borrowers' disposable income, resulting in a non-negligible share of loans showing LTV ratios above 90 percent. Most banks, however, insure the segment of mortgage loans exceeding LTV ratios above 70-80 percent at origination through indemnity guarantees.[2]

[1] Prepared by Armando Morales.

[2] Some banks indicated that the social welfare system also provides for mortgage repayment protection to lower-income borrowers. In fact, mortgage borrowers eligible for social welfare assistance (i.e., those who satisfy means test criteria) can also apply for assistance towards the interest portion of their mortgage repayments.

- The increase in competition has eroded margins. The spread between clearing banks' prime rate and demand deposit rates fell to 340 basis points in 2002 from 470 in 2000. As returns from non-interest earning activities slipped, the contribution of non-interest income to total income declined to 35 percent in 2001 from 42 percent in 2000. Banks appear to have shifted toward mortgage lending partly because this market—despite rising competition—still allowed for larger margins than other activities. However, competition is intensifying in the mortgage market as well.

B. Insurance Industry Risks

- Links between banking and insurance could pose a risk as some banks contract indemnity guarantees and provide mortgage and home insurance to borrowers with insurance companies belonging to the same group. Market participants noted that this risk was usually reinsured abroad. However, for indemnity guarantees as for most credit derivatives, the legal vulnerability of such reinsurance is difficult to ascertain in the absence of a trigger event.

- Market risk exposure of the insurance sector has been mitigated by the use of unit-linked schemes (estimated at 90 percent of policies), which entail adjustable premia and/or coverage. Nonetheless, the operating profit of the main life insurance companies fell by 4–29 percent in 2002, reflecting low yields and declining equity prices. Also, problems in the international market for parent companies may have consequences domestically.

- Until insurance supervision reforms have been implemented and the risks in insurance companies' asset/liability portfolios better understood, there are potential, as yet unidentified, risks in this sector.

C. Macroeconomic Vulnerabilities and Risk Mitigators

Financial institutions are vulnerable to sharp increases in unemployment and/or interest rates and to decreases in house prices.

- An increase in unemployment is a key macroeconomic vulnerability to banks. It would initially lower the demand for mortgage loans, requiring banks to shift to other, less profitable, activities. Market participants felt, however, that an increase in unemployment severe enough to affect default rates significantly was unlikely.

- A sharp increase in interest rates—beyond two percentage points—is another vulnerability, given the widespread preference for floating rates among borrowers (93 percent of new mortgage loans in 2002). Again, market participants viewed such a rise as unlikely, given economic conditions in the euro area. Moreover, mortgage debt service remains low, on average, at 25.4 percent of disposable income in 2002.

- A fall in house prices was perceived as less of a vulnerability in and of itself. The general view was that, given the strong preference for home ownership, borrowers were unlikely to renege on debt obligations in the face of negative equity. However, risks remain, since about one-third of mortgage loans were approved in the last two years (at higher loan-to-value ratios) and exposures to small investors in the rental property market—who may behave differently from owner-occupiers—have increased (see above). Moreover, even if only a small portion of borrowers renege on obligations, execution of the corresponding collateral could create a dangerous dynamic if Ireland's small housing market were not able to absorb the additional supply without a further sharp reduction in house prices (particularly in a deepening downturn).

These risks and vulnerabilities are mitigated by several factors:

- Domestic banks have comfortable levels of capitalization and profitability. In 2002, the average risk-weighted capital-asset ratios increased to 12.5 percent (Table 2.1), while the two main banks showed rates of return on equity of 25–29 percent. The average rates of return on assets were 0.9 percent in 2001, above that of comparable financial systems, except those in the United Kingdom and the United States.

- Asset quality remains high, with non-performing loans at 1.7 percent of total loans; and loan-loss provisions accounted for more than 100 percent of nonperforming loans (Table 2.1).

- Small mortgage-lending institutions—identified in the 2000 FSAP as being more vulnerable to adverse macroeconomic shocks—have, for the most part, been absorbed by better-capitalized domestic and foreign commercial banks.

- Supervision is being strengthened under the newly formed IFSRA, particularly with regard to the insurance/reinsurance industry and the consolidated supervision of complex financial groups. The central bank's monitoring and analysis of systemic risks is also being continually enhanced, as recommended by the 2000 FSAP.

Table 2.1. Ireland: Indicators of External and Financial Vulnerability
(In percent of GDP, unless otherwise indicated)

	1999	2000	2001	2002	2003 Latest estimate	Date
External Indicators						
Exports (annual percent change, value in U.S. dollars)	12.4	10.6	8.0	11.8	22.7	
Imports (annual percent change, value in U.S. dollars)	9.2	12.8	6.6	5.2	21.0	
Terms of trade (goods, annual percent change)	-2.5	-3.1	0.7	4.1	0.8	
Current account balance 1/	0.4	0.1	-0.3	-0.1	-0.7	
Capital and financial account balance, 1/	-1.5	10.0	1.6	1.8	...	
Of which:						
Inward portfolio investment	70.9	81.5	91.0	56.2	...	
Inward foreign direct investment	19.3	27.9	15.3	15.6	...	
Other investment liabilities (net)	-1.1	-8.8	9.2	15.5	...	
Total external debt 2/	2.8	2.0	1.8	0.6	...	
Of which:						
External debt to exports ratio	3.2	2.1	1.8	0.6	...	
External interest payments to exports (in percent)	0.2	0.2	0.1	0.1	...	
US dollar per euro (period average)	1.07	0.92	0.90	0.95	1.15	July 3
UK £ per euro (period average)	0.66	0.61	0.62	0.63	0.69	July 3
Financial Markets Indicators						
General government debt	49.3	39.3	36.8	33.0	33.6	
Government bond yield (10-year, end-period)	5.6	5.1	5.1	4.3	3.7	June
Real government bond yield (10-year, period average, based on national CPI)	3.2	-0.2	0.1	0.4	...	
Annual change in stock market index (in percent, end of period)	3.0	6.9	8.2	-19.4	-9.8	June
Spread of government bond yield with Germany (end of period)	0.6	0.2	0.6	0.2	0.1	June
Interest rate spread (basis points)	375.0	472.0	380.0	340.0		
Personal lending interest rate	10.5	11.8	10.6	10.4		
Variable Mortgage interest rate	4.2	6.0	4.6	4.2		
Financial Sector Risk Indicators						
Annual credit growth rates (to private sector)	33.5	21.3	15.1	15.0		
Annual deposit growth rates	8.1	16.6	13.9	9.0		
Personal lending as a share of total loans	53.7	52.1	52.2	55.3	...	
(excluding financial intermediation and government)						
Of which:						
House mortgage finance	39.7	39.0	38.8	42.4	...	
Other housing finance	0.9	1.0	0.9	0.8	...	
Other personal lending	13.0	12.2	12.5	10.3	...	
Annual Mortgage Credit Growth Rates	24.0	24.3	17.8	23.1		
Commercial property lending as a percent of total loans						
(excluding financial intermediation)	18.2	20.5	21.6	22.1	...	
Foreign-currency denominated assets (in percent of total assets)	36.5	37.4	36.3	31.2	...	
Foreign-currency denominated liabilities (in percent of total liabilities)	32.9	34.1	33.1	29.4	...	
Contingent and off-balance sheet accounts (in percent of total assets) 3/	400.5	465.1	591.8	505.2	...	
Non-performing loans (in percent of total loans) 4/	1.8	1.9	1.9	1.7	...	
Total provisions for loan losses (in percent of total loans)	2.0	2.0	2.3	1.9		
Risk-weighted capital/asset ratios of domestic banks (in percent)	10.4	9.7	11.2	12.5	...	
Banks return on assets 5/	1.3	1.2	0.9	1.5		
Banks return on equity 5/	23.0	22.0	16.0	27.0		
Liquid assets of all banks to total assets (liquid asset ratio)	32	32	30	30	...	
Liquid assets of all banks to short-term liabilities (in percent)	39	44	62	58	...	
Deposits to M3 ratio 6/	1.03	1.03	1.02	1.02	...	
Loan-to-deposit ratiovis-à-vis Irish residents 7/	1.29	1.36	1.44	1.49	...	
vis-à-vis total 7/	1.48	1.55	1.61	1.53	...	
Concentration ratios in the banking sector						
No. of banks accounting for 25% of total assets	3	3	3	3	...	
No. of banks accounting for 75% of total assets	23	23	21	19	...	
Share of state-owned banks in total assets	3	2	1	0		
Share of foreign-owned banks in total assets	37	39	42	51		

Sources: Data provided by the authorities; Central Bank of Ireland; International Financial Statistics; Bloomberg; and staff estimates.

1/ Owing to methodological changes, a break in the series occurred between 1997 and 1998.

2/ Represents a non-Irish pound debt in 1995-98, and a non-euro debt of the government sector in 1999.

3/ Credit equivalent values.

4/ Owing to differences in classification, international comparisons of non-performing loans are indicative only.

5/ For 2002, data corresponds to Allied Irish Bank and Bank of Ireland only.

6/ Non-government deposits vis-à-vis Irish and non-residents to M3 ratio.

7/ Non-government loans/non-government deposits ratio.

What Explains Ireland's Inflation Differential Over the Euro Area?[1]

1. **Since the late 1990s, Ireland's consumer price inflation—measured by the Harmonized Consumer Price Index (HIPC)—has been among the highest in the euro area** (Figure 3.1). The inflation differential between Ireland and the euro area turned positive starting in mid-1998 (just before EMU membership in 1999) and fluctuated between 1.3–3.1 percentage points from January 1999 to May 2003, with a peak in late 2000. This note takes a closer look at some of the factors that could account for this differential.

Figure 3.1 Ireland: HICP Inflation Differential over the Euro Area Average

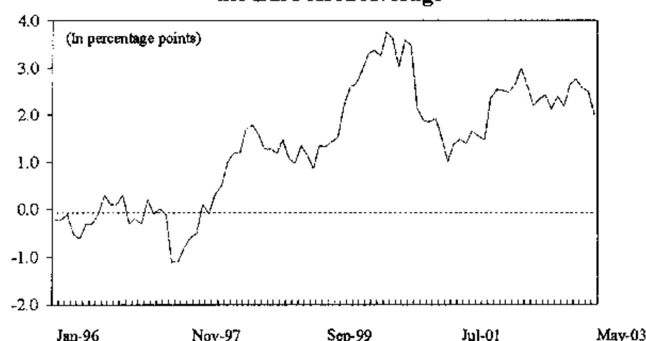
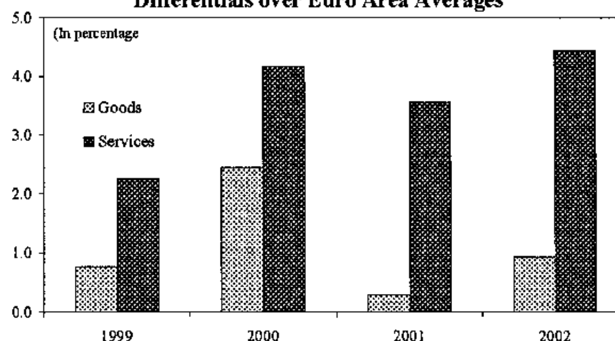


Figure 3.2. Ireland: Goods and Services Inflation Differentials over Euro Area Averages



2. **Ireland's stronger service price inflation has been a key driver of its higher inflation rate** (Figure 3.2). Given the robust productivity growth in the tradable sector, Balassa-Samuelson effects could be responsible for part of the higher wage inflation in nontradable (mainly service) sectors in Ireland compared with the euro area average (see below). However, these effects prevail over long periods of time and, in the short-run, other factors could also be important in boosting wage growth. In practice, it is difficult to disentangle Balassa-Samuelson effects from the impact on wages of disparate macroeconomic shocks that have boosted domestic demand at a time of tight labor market conditions. Such shocks could include: (i) the initial boost to demand from the sharp fall in real interest rates as a result of joining EMU; (ii) the impact on consumption from the wealth effects of the house price boom (itself partly driven by the fall in interest rates); (iii) an FDI-led surge in investment as a response to EMU membership and the ICT boom of the late 1990s; and (iv) expansionary fiscal policy in 2000–02.

3. Some factors can be identified as having contributed to Ireland's inflation differential over the euro area average during 1999–2002 (Table 3.1):

---

[1] Prepared by Petya Koeva.

- **Depreciation of the nominal effective exchange rate (NEER).** Owing to a large share of trade with the United States and the United Kingdom, Ireland's NEER reflects closely movements of the euro against sterling and the U.S. dollar. Since Ireland's NEER weakened by more 8 percent in the period 1998–2000, exceeding the NEER depreciations in all other EMU members, Ireland's high inflation could have reflected—via a pass-through to domestic prices—a larger exchange rate shock. Staff calculations, based on work by Honohan and Lane (2003), suggest that this more pronounced depreciation can account for a significant part of Ireland's inflation differential in 1999–2001.

Table 3.1 Contributing Factors to the Overall Inflation Differential

	1999	2000	2001	2002
Contributing factors				
NEER	1.3	0.6	0.7	-0.2
Housing market	0.0	0.2	0.2	0.0
Indirect taxes 1/	0.3	1.1	-0.3	1.2
Administrative and government-affected prices, of which:	0.0	0.1	0.1	0.3
Education	0.0	0.1	0.1	0.2
Health	0.0	0.0	0.1	0.1
Productivity	1- 1¼	1- 1¼	1- 1¼	1- 1¼
Effect of contributing factors 2/	2.6	3.0	1.7	2.3
Overall inflation differential	1.3	3.1	1.6	2.5

Sources: Eurostat, CSO, INS, and staff estimates.

1/ Assuming a neglibible effect of indirect taxes on inflation in the eurozone.

2/ Assuming a productivity effect of 1 percentage point.

- **Housing market boom.** The boom in the housing market—partly due to a decline in real interest rates after joining the EMU in 1999—could have also contributed to the inflation differential. While the overall effect of the surge in house prices on consumer inflation is difficult to estimate (due to potentially important wealth effects), the HICP component *Actual rents* can capture the direct impact of the housing boom on consumer inflation to the extent that house prices move together with rents. Staff estimates indicate that cross-country variation in rents explains some of Ireland's inflation differential in 2000 and 2001.

- **Indirect taxes.** Using the CSO constant tax price index, indirect tax measures—mainly changes in VAT rates and excise duties—appear to have pushed up inflation in 2000 and 2002. Estimates of the impact of indirect taxes on inflation for the euro area as a whole are not readily available, but staff work suggests these effects were relatively small in 1999–2002. Therefore, assuming a negligible role for indirect taxes in euro area inflation, the hikes in indirect taxes in Ireland in 2000 and 2002 can be seen to contribute significantly to the inflation differential in these years. By the same token, indirect taxes contributed to narrowing the inflation differential in 2001.

- **Administered and government-influenced prices**. The inflation differential can also be attributed to different price movements between Ireland and the euro area in sectors dominated by government—such as health, education, and transport—to the extent that these prices are influenced by non-market factors, including public sector wage and price policies. Using detailed HICP data, staff estimates the magnitude of this effect to be about ¼ percentage point in 2002.

- **Productivity differential**. Ireland has had notably higher productivity growth in tradables than most countries in the euro area. Previous staff analysis (IMF Staff Country Report No. 99/108)—which adjusts for the distorting effects of multinational activity on measured productivity in tradable goods—indicates that Balassa-Samuelson effects could account for an inflation differential of 1–1¼ percentage points over the rest of the euro area. As discussed above, in the short run, it is difficult to disentangle these effects from demand-led factors, but over this period Balassa-Samuelson effects are likely to have been an underlying factor.

4. **In conclusion, Ireland's inflation differential over euro area can be largely explained.** When one accounts for specific factors, such as nominal effective depreciation and indirect tax changes, the remaining differential is of a magnitude consistent with a conservative estimate of a Balassa-Samuelson effect—even if, in the short-run, this cannot be distinguished precisely from the impact of demand-led factors.

Table 1. Ireland: Selected Economic Indicators

(Annual change unless otherwise stated)

	1999	2000	2001	2002	2003 Proj./Latest		2004 Proj.
National accounts (constant prices) 1/							
GNP	8.8	10.7	4.6	0.6	1.3		3.1
GDP	11.1	10.0	5.7	6.3	2.5		3.8
Domestic demand	8.3	8.5	4.1	2.7	1.1		2.3
Private consumption	9.3	9.0	5.1	2.6	2.2		3.1
Public consumption	6.6	7.5	10.8	8.3	1.5		1.7
Gross fixed investment	14.4	6.7	-0.5	0.4	-1.5		0.5
Net exports (contribution to GDP growth)	4.3	2.4	1.6	5.0	1.0		2.0
Exports of goods and services	15.2	20.6	6.7	3.8	2.5		4.4
Imports of goods and services	12.0	21.2	6.1	-1.0	2.0		3.1
Prices, wages and employment							
Harmonized Index of Consumer Prices (annual average)	2.5	5.3	4.0	4.7	4.1		2.6
Average hourly earnings , manufacturing	5.6	6.2	10.3	7.2	...		...
Output, manufacturing 2/	15.0	15.7	10.2	8.4	...		...
Unit wage costs (manufacturing) 2/	-9.0	-4.7	-2.6	-8.9	...		...
GNP/Employment	2.4	5.7	1.6	-0.8	0.5		2.0
Employment	6.3	4.7	2.9	1.4	0.8		1.1
Unemployment rate (in percent)	5.6	4.3	3.9	4.4	5.3		5.6
Money and credit (end-period)							
M3E 3/	...	14.7	17.2	9.3	8.8	6/	...
Private sector credit 4/	21.3	21.3	15.9	15.0	16.0	6/	...
Financial and asset markets (end of period)							
Three-month treasury bill	3.3	4.8	3.3	2.9	2.2	7/	...
10-year government bond	5.6	5.1	5.1	4.3	3.7	7/	...
ISEQ share prices	3.0	6.9	8.2	-19.4	-9.8	7/	...
House prices (permanent tsb index/ESRI)	17.9	21.3	4.4	13.3	14.2	6/	...
Public finance (In percent of GDP)							
General Government Balance 5/	4.1	4.3	1.1	-0.1	-0.9		-1.4
Primary balance 5/	6.5	6.4	2.7	1.3	0.5		-0.2
General government debt	49.3	39.3	36.8	33.0	33.6		34.5
External trade and balance of payments							
Balance of goods and services (Percent of GDP)	13.8	13.6	14.7	18.4	18.9		19.7
Current account (Percent of GDP)	0.4	0.1	-0.3	-0.1	-0.7		-0.4
Official reserves(In billions of SDRs, end of period.)	3.9	4.2	4.5	4.0	2.8	6/	...
Effective exchange rates (1995=100, annual average)							
Nominal	94.0	88.3	89.2	90.7	95.9	8/	...
Real (CPI based)	93.9	90.9	94.3	98.7	106.6	8/	...
Memorandum items for 2002							
Area		70.3 thousand square kilometers					
Population (in million)		3.9					
Natural rate of increase (percent change)		1.5					
GDP per capita (in SDRs)		24,189					

Sources: Department of Finance; Central Bank of Ireland; IMF, International Financial Statistics; and staff calculations.

1/ Based on National Income and Expenditure, compiled in accordance with the new European System of National Accounts (ESA 95).

2/ Underlying productivity growth data may be overstated because of problems related to the measurement of output produced by multinational companies operating in Ireland.

3/ M3E was discontinued in December 1998. The methodology for calculation of Ireland's contribution to the Euro area money supply was amended in January 2000.

4/ Adjusted change, which includes the effects of transactions between credit institutions and non-bank international financial companies and valuation effects arising from exchange rate movements.

5/ Estimated prior to allocations for financing of future pensions liabilities and one-off expenditures, but including contingency provision for 2004.

6/ As of May 2003.

7/ As of June 2003.

8/ As of April 2003.

Table 2. Ireland: Summary of Balance of Payments

	1999	2000	2001	2002	2003	2004	2005	2006
				(In millions of euro)				
Current account balance	333	53	-345	-184	-1,013	-595	-267	122
Trade balance	22,802	28,133	34,258	38,279	39,393	42,478	46,212	50,383
Exports of goods	64,406	80,922	88,551	90,397	92,027	97,234	105,017	113,962
Imports of goods	-41,604	-52,789	-54,294	-52,118	-52,634	-54,756	-58,805	-63,579
Services	-10,428	-14,098	-17,380	-14,387	-13,520	-13,572	-14,286	-15,305
Credit	14,608	19,967	23,817	28,731	30,501	32,475	35,378	38,392
Debit	-25,037	-34,065	-41,197	-43,119	-44,021	-46,047	-49,664	-53,697
of which Royalties								
Credit	392	492	241	284	...	...	...	...
Debit	-6,902	-9,051	-9,989	-10,841	...	...	...	...
Balance on goods and services	12,373	14,035	16,877	23,891	25,873	28,906	31,926	35,078
Net factor incomes	-13,218	-14,976	-17,677	-24,957	-27,176	-29,732	-32,378	-35,105
Credit	23,002	30,089	29,956	27,899	...	...	...	...
Debit	-36,220	-45,065	-47,633	-52,855	...	...	...	...
Balance on goods, services and income	-844	-941	-800	-1063	-1303	-826	-452	-26
Current transfers (net)	1,177	994	455	879	290	232	185	148
Capital and financial account	-1,379	10,327	1,871	2,274	...	...	...	...
Capital account balance	560	1182	654	564	...	...	...	...
Financial account	-1,939	9,145	1,217	1,710	...	...	...	...
Direct investment	11,631	23,682	10,972	17,348	...	...	...	...
Portfolio investment	-14,342	-5,358	-19,893	-36,135	...	...	...	...
Other investment	-974	-9,037	10,579	20,153	...	...	...	...
Reserve assets	1,746	-142	-441	343	...	...	...	...
Net errors and omissions	1,046	-10,380	-1,526	-2,089	...	...	...	...
				(In percent of GDP)				
Memorandum itmes								
Current account balance	0.4	0.1	-0.3	-0.1	-0.7	-0.4	-0.2	0.1
Trade balance	25.4	27.3	29.9	29.5	28.7	28.9	29.2	29.8
Services	-11.6	-13.7	-15.2	-11.1	-9.9	-9.2	-9.0	-9.0
Net factor incomes	-14.7	-14.6	-15.4	-19.2	-19.8	-20.2	-20.5	-20.7
Balance on goods, services and income	-0.9	-0.9	-0.7	-0.8	-0.9	-0.6	-0.3	0.0
Transfers	1.3	1.0	0.4	0.7	0.2	0.2	0.1	0.1

Sources: The Central Statistics Office; and staff estimates.

Table 3. Contribution to GDP Growth
(In percent) 1/

	1999	2000	2001	2002	2003 Proj.	2004 Proj.
Domestic demand	7.3	7.4	3.5	2.3	0.9	1.8
Private consumption	4.8	4.6	2.6	1.3	1.1	1.5
Public consumption	0.9	0.9	1.3	1.1	0.2	0.2
Fixed investment	3.1	1.5	-0.1	0.1	-0.3	0.1
Business	1.8	0.2	-1.1	-0.3	0.1	0.0
Residential investment	0.6	0.5	0.3	0.4	0.0	0.0
Public	0.7	0.8	0.7	0.0	-0.4	0.1
Change in stocks	-1.5	0.3	-0.4	-0.2	-0.1	0.0
Net exports	4.3	2.4	1.6	5.0	1.0	2.0
Exports	14.2	20.0	7.1	4.0	2.7	4.6
Imports	-9.9	-17.6	-5.6	0.9	-1.7	-2.6
Statistical discrepancy	-0.5	0.2	0.6	-1.0	0.6	0.0
GDP (annual percent change)	11.1	10.0	5.7	6.3	2.5	3.8
GNP (annual percent change)	8.8	10.7	4.6	0.6	1.3	3.1
Memorandum:						
Current account (as a percent of GDP)	0.4	0.1	-0.3	-0.1	-0.7	-0.4

Source: Staff estimates.

1/ Rounding may affect totals.

Table 4. Ireland: General Government Finances
(In percent of GDP)

	1999	2000	2001	2002	Proj. 2003	Official 2003 1/
Current surplus:	6.2	7.3	4.6	3.3	2.1	2.2
Current revenue, of which	33.8	33.8	32.5	31.1	31.1	31.3
Tax revenue (excluding taxes on capital)	26.2	26.0	24.4	23.2	23.2	23.5
Social security receipts	4.1	4.3	4.4	4.2	4.2	4.2
Miscellaneous	3.5	3.5	3.7	3.7	3.7	3.7
Current expenditure, of which	27.6	26.5	27.8	27.8	29.0	29.1
Interest payments	2.4	2.1	1.6	1.4	1.4	1.5
Goods and services	5.1	5.1	5.7	5.7	5.8	5.8
Compensation of employees	8.1	7.8	8.1	8.2	8.5	8.5
Transfers	11.4	10.8	11.6	11.6	12.3	12.3
Depreciation	0.7	0.7	0.8	0.8	1.0	1.0
Current expenditure, excluding interest and transfers	13.9	13.6	14.6	14.8	15.3	15.3
Capital deficit 2/	2.1	3.0	3.5	3.4	3.0	3.0
Capital receipts (including taxes on capital)	2.2	2.1	2.1	1.9	1.9	1.9
Gross capital formation	3.2	3.9	4.6	4.3	3.8	3.8
Capital transfers 2/	1.1	1.2	1.1	1.0	1.0	1.0
General government balance 2/	4.1	4.3	1.1	-0.1	-0.9	-0.8
Primary balance	6.5	6.4	2.7	1.3	0.5	0.8
Memorandum items:						
Structural (as a percent of potential GDP):						
Revenue 3/	35.9	35.7	34.5	32.7	32.8	32.7
Expenditure, of which	33.6	34.0	35.3	34.5	34.0	34.0
unemployment benefits	1.6	1.4	1.1	1.0	0.8	...
Government balance	2.4	1.7	-0.8	-1.8	-1.2	-1.4
Primary balance	4.7	3.8	0.8	-0.4	0.3	0.1
General government gross debt (as percent of GDP)	49.3	39.3	36.8	33.0	33.6	33.3
Growth in nominal GDP	15.7	14.6	11.2	13.3	5.8	7.2

Sources: Department of Finance and staff estimates.

1/ The official projections are based on Budget 2003 and revised estimates from March 2003 but are presented as a percent of staff's estimate of GDP. Structural numbers are based on the staff's methodology and estimates of structural unemployment, unemployment benefits and potential output, but on the authorities' estimates of revenues, expenditures and actual GDP growth.

2/ Excluding a capital transfer related to the repayment of the government's pension liabilities with respect to An Post and Telecom Eireann of 1.8 percent of GDP in 1999 to maintain comparability. If the transfer were included, capital transfers and the overall balance would have been 3.0 and 2.3 percent of GDP in 1999, respectively.

3/ Revenues in 2002 exclude UMTS receipts of 0.2 percent of GDP.

Table 5. Ireland: Medium-Term General Government Finances 1/
(As a percent of GDP)

	2001	2002	2003	2004	2005	2006	2007	2008
Total revenue	34.6	33.0	32.9	32.1	31.5	31.6	31.4	31.4
of which:								
Taxes and social security contributions	29.7	28.2	28.3	28.0	27.6	27.7	27.6	27.7
Other	4.9	4.8	4.6	4.1	3.9	3.9	3.8	3.8
Total expenditure	33.5	33.0	33.9	33.4	33.0	32.8	32.6	32.3
of which:								
Primary expenditure	31.9	31.7	32.4	32.3	31.7	31.3	31.0	30.7
of which:								
Gross fixed investment	4.6	4.3	3.8	3.9	3.8	3.7	3.7	3.7
Interest payments	1.6	1.4	1.4	1.2	1.3	1.5	1.6	1.7
Budget balance	1.1	-0.1	-0.9	-1.4	-1.5	-1.2	-1.1	-0.9
Memorandum:								
Nominal GDP growth in percent	11.2	13.3	5.8	7.0	7.6	7.2	6.9	6.6
Gross debt	36.8	33.0	33.6	34.5	35.3	36.0	36.6	37.0
Structural budget balance 2/	-0.8	-1.8	-1.2	-1.0	-1.2	-0.9	-1.0	-0.9
Output gap	4.1	3.6	0.4	-0.9	-0.9	-0.6	-0.3	0.0
	Stability Programme December 2002 Update							
Total revenue	35.8	35.0	34.4	33.5	32.9	...	...	...
Total expenditure	34.2	35.3	35.1	34.7	34.1	...	...	...
of which:								
Collective consumption	5.5	5.8	6.0	5.9	5.7	...	...	...
Individual consumption	9.2	9.6	9.8	9.7	9.5			
Social transfers in kind	1.3	1.4	1.4	1.4	1.3	...	...	...
Social transfers other than in kind	8.6	9.1	9.1	9.2	9.3			
Gross fixed investment	4.3	4.4	4.1	4.1	4.0	...	...	...
Interest payments	1.6	1.5	1.6	1.5	1.5	...	...	...
Subsidies	1.1	0.9	0.8	0.8	0.7	...	...	...
Other	2.6	2.5	2.3	2.1	2.0	...	...	...
General government balance	1.6	-0.3	-0.7	-1.2	-1.2	...	...	...
of which due to contingency	...	...	...	-0.4	-0.8	...	...	...
Memorandum:								
Nominal GDP growth in percent	11.2	9.7	7.2	7.4	7.7	...	...	...
Gross debt	36.7	34.1	34.0	34.5	34.9	...	...	...
Structural budget balance 2/	0.1	-1.0	-0.4	-0.2	0.1	...	...	...
Output gap	4.4	2.0	-0.9	-2.9	-3.7	...	...	...

Sources: Staff estimates and Department of Finance

1/ Based on current policies. The staff estimates assume that tax revenues will perform according to the latest SP projections in 2004–05, but are adjusted for the difference between the government's and staff's growth assumptions. From 2006 onwards, tax revenues (excluding indirect taxes) are projected using the OECD's estimates of tax elasticities. Expenditure estimates for 2003 are based on the latest available official information, whereas projections for 2004–05 assume expenditure to increase at the pace envisaged in the SP (except for interest rate expenditure). Due to different accounting conventions, the staff's estimates of total revenue and expenditure ratios differ from the Stability Programme.

2/ As a percent of potential GDP. The balance for 2002 excludes UMTS receipts of 0.2 percent of GDP.

Ireland: Fund Relations
(As of April 30, 2003)

I. **Membership Status**: Joined 8/08/57; Article VIII

II. **General Resources Account:**	**SDR Million**	**% Quota**
Quota	838.40	100.00
Fund holdings of currency	492.53	58.75
Reserve position in Fund	345.87	41.25
Financial Transaction Plan transfers (net)	20.00	

III. **SDR Department:**	**SDR Million**	**% Allocation**
Net cumulative allocation	87.26	100.00
Holdings	49.87	57.14

IV. **Outstanding Purchases and Loans:** None

V. **Financial Arrangements:** None

VI. **Projected Payments to the Fund**

(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2003	2004	2005	2006	2007
Principal					
Charges/Interest	0.49	0.66	0.66	0.66	0.66
Total	0.49	0.66	0.66	0.66	0.66

VII. **Exchange Arrangement**

As of January 1, 1999, the euro became the currency of Ireland and the irrevocably fixed conversion rate between the euro and the Irish pound is 0.787564.

VIII. **Article IV Consultations**

The discussions for the last Article IV consultation were conducted in Dublin during May 7–16, 2002. The staff report (SM/02/209) was considered by the Executive Board on July 31, 2002 (SUR/02/89). Article IV consultations with Ireland are currently on the standard 12-month cycle.

IX. **Technical Assistance:** None

X. **Resident Representative:** None

Ireland: Sustainability Exercise

Fiscal Sustainability

The sustainability of Ireland's fiscal position was assessed, analyzing the evolution of gross public sector debt under several alternative scenarios that deviate from staff's baseline projections (Table A1). In the baseline, gross public sector debt would increase somewhat from 33 percent of GDP in 2002 to 37 percent of GDP in 2008. However, this corresponds mainly to increases in assets, such as those accumulated in government pension and social security funds.[1] In fact, if these assets were excluded (on a net basis), public debt-to-GDP ratio would decline further to about 30.5 percent of GDP in 2008.[2] The primary balance remains close to balance throughout, while GDP growth exceeds the average real interest rate, leading to a favorable medium-term fiscal outlook.

The alternative scenarios all show a sustainable fiscal position.

- Given the low initial debt, real interest rate and growth shocks would not have severe effects on the public debt ratio (scenarios 2 and 3).
- A real deprecation scenario has no appreciable effect given the very low level of non-euro denominated public debt.
- A lower primary balance has no appreciable impact given the very large primary surpluses in past years.
- The only scenario that has an appreciable impact on debt levels is a 10 percent of GDP increase in the debt stock in 2003, which raises the 2008 debt-ratio by some 13 percentage points to just under 46 percent of GDP, still well below the prevailing EU average.

External Sustainability

With a net external position (excluding direct investment) showing substantial claims on the rest of the world (around 100 percent of GDP), external debt sustainability does not seem to be an issue (Table A2). The net external position, including direct investment, is in broad balance given the very strong continued FDI inflows into Ireland. The fact that Ireland is a net creditor with regard to portfolio and other investment suggests little vulnerability to interest rate shocks or to a sudden reversal in short-term capital flows. The large gross assets and liabilities in portfolio and other investments reflects the activities of the International Financial Service Center, which the 2000 FSAP noted does not appear to pose a systemic risk to the domestic financial system.

---

[1] These items are included in the category "other identified debt-creating flows."

[2] This would correspond to including contribution from categories "primary deficit" and "automatic debt dynamics" to debt dynamics, while excluding the impact of "other identified debt-creating flows."

Table A1. Ireland: Public Sector Debt Sustainability Framework, 2000–08
(In percent of GDP, unless otherwise indicated)

	Actual		Projections						
	2000	2001	2002	2003	2004	2005	2006	2007	2008
			I. Baseline Medium-Term Projections						
Public sector debt 1/	39.3	36.8	**33.0**	**33.6**	**34.5**	**35.3**	**36.0**	**36.6**	**37.0**
Change in public sector debt	-9.9	-2.6	-3.8	0.6	0.9	0.9	0.6	0.6	0.4
Identified debt-creating flows (4+7+12)	-7.9	-2.1	-4.2	0.6	0.9	0.9	0.6	0.6	0.4
Primary deficit	-6.4	-2.7	-1.3	-0.5	0.2	0.2	-0.3	-0.4	-0.8
Revenue and grants	35.9	34.6	33.0	32.9	32.1	31.5	31.6	31.4	31.4
Primary (noninterest) expenditure	29.5	31.9	31.7	32.4	32.3	31.7	31.3	31.0	30.7
Automatic debt dynamics 2/	-4.0	-2.3	-3.2	-0.4	-1.0	-1.1	-0.9	-0.8	-0.7
Contribution from interest rate/growth differential 3/	-4.2	-2.4	-2.9	-0.4	-1.0	-1.1	-0.9	-0.8	-0.7
Of which contribution from real interest rate	0.1	-0.4	-0.9	0.4	0.2	0.4	0.6	0.7	0.8
Of which contribution from real GDP growth	-4.3	-2.0	-2.0	-0.8	-1.2	-1.5	-1.5	-1.5	-1.5
Contribution from exchange rate depreciation 4/	0.2	0.1	-0.3	0.0	0.0	0.0	0.0	0.0	0.0
Denominator = $1+g+\pi+g\pi$	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1
Other identified debt-creating flows 5/	2.5	2.9	0.3	1.5	1.7	1.8	1.8	1.8	1.8
Residual, including asset changes (2-3)	-2.1	-0.5	0.4	0.0	0.0	0.0	0.0	0.0	0.0
Public sector debt-to-revenue ratio 1/	109.6	106.3	100.0	102.0	107.5	112.0	113.8	116.3	117.7
Key Macroeconomic and Fiscal Assumptions									
Real GDP growth (in percent)	10.0	5.7	6.3	2.5	3.8	4.7	4.6	4.5	4.3
Average nominal interest rate on public debt (in percent) 6/	4.8	4.5	4.2	4.7	3.7	4.1	4.4	4.6	4.7
Average nominal interest rate on forex debt (in percent) 6/	7.0	6.1	4.2	5.2	4.7	5.1	5.4	5.6	5.8
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	0.6	-0.8	0.0	1.4	0.6	1.3	1.9	2.3	2.5
Exchange rate (LC per US dollar)	1.07	1.13	0.95	0.88	0.88	0.89	0.90	0.91	0.91
Nominal depreciation of local currency (LC per dollar)	8.0	5.6	-16.0	-7.4	-0.1	1.0	0.9	0.9	0.5
Exchange rate (US dollar per LC)	0.93	0.88	1.05	1.13	1.13	1.12	1.11	1.10	1.10
Nominal appreciation (increase in US dollar value of local currency, in percent)	-7.4	-5.3	19.0	8.0	0.1	-1.0	-0.9	-0.9	-0.5
Inflation rate (GDP deflator, in percent)	4.3	5.3	6.6	3.3	3.0	2.8	2.4	2.3	2.2
Growth of real primary spending (deflated by GDP deflator, in percent)	9.8	14.2	5.5	4.9	3.3	2.9	3.3	3.3	3.2
			II. Stress Tests for Public Debt Ratio						
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-2007			**33.0**	**28.0**	**23.4**	**19.2**	**15.1**	**11.2**	**7.5**
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004			**33.0**	**35.0**	**37.5**	**38.2**	**38.8**	**39.4**	**39.7**
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004			**33.0**	**33.9**	**35.6**	**36.5**	**37.1**	**37.8**	**38.2**
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004			**33.0**	**32.2**	**31.0**	**32.0**	**32.7**	**33.4**	**33.8**
5. Combination of 2-4 using one standard deviation shocks			**33.0**	**30.9**	**29.1**	**30.9**	**32.4**	**33.9**	**35.2**
6. One time 30 percent real depreciation in 2003 7/			**33.0**	**33.6**	**34.5**	**35.3**	**36.0**	**36.6**	**37.0**
7. 10 percent of GDP increase in other debt-creating flows in 2003			**33.0**	**43.6**	**44.2**	**44.7**	**45.1**	**45.5**	**45.8**

Historical Statistics for Key Variables (past 10 years)	Historical Average	Standard Deviation	Average 2002-07
Primary deficit	-4.6	1.3	-0.3
Real GDP growth (in percent)	7.6	3.1	4.4
Nominal interest rate (in percent) 6/	6.0	1.0	4.3
Real interest rate (in percent)	1.8	2.0	1.3
Inflation rate (GDP deflator, in percent)	3.9	1.5	3.4
Revenue to GDP ratio	37.9	2.3	32.1

Sources: CSO, Central Bank of Ireland, Department of Finance, and staff estimates.

1/ General government gross debt. Although no official figures for the net debt position of general government are available, its level is considerably lower given the accumulated assets, such as capital in the National Pension Reserve Fund (estimated at 5.7 percent of GDP at end-2002).

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ These factors include net receipts of the government pension and social security funds, privatization receipts, and changes in local government debt.

6/ Derived as nominal interest expenditure divided by previous period debt stock.

7/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table A2. Ireland: Net Investment Position
(In percent of GDP)

	1998	1999	2000	2001
Assets	469	609	659	725
Direct investment abroad	22	28	29	33
Portfolio investment abroad	211	314	355	433
Other investment abroad	227	261	270	253
Reserve assets	8	6	6	6
Liabilities	430	546	652	735
Direct investment to Ireland	69	81	124	137
Portfolio investment to Ireland	169	239	292	362
Other Investment to Ireland	192	226	237	236
Net investment position	39	63	7	-11
Direct investment abroad	-46	-53	-95	-104
Portfolio investment abroad	43	75	63	71
Other investment abroad	34	35	33	16
Reserve assets	8	6	6	6
Net investment position, excluding direct investment	85	116	101	93

Source: CSO.

Ireland: Statistical Issues

Ireland is subject to the statistical requirements and timeliness and reporting standards of the Eurostat and the European Central Bank (ECB). Ireland has cooperated fully with the Fund in providing monetary, international reserves, and selected other financial statistics related to its membership in the European Economic and Monetary Union (EMU). These data are considered comprehensive, reliable, timely, and well documented. Ireland has subscribed to the Fund's Special Data Dissemination Standard (SDDS).

1. Quarterly national accounts on an ESA 1995 basis have been introduced and are currently published within 4 months of its reference period. Real sector data are sometimes published with a lag of 3–6 months, but some non-SDDS series even one and a half years later (e.g., household disposable income). Lags are particularly long for employment, earnings, unit wage costs, and national income and expenditure data. These data are available with a 3–7 month lag. However, Ireland does not have an overall earnings index or comprehensive sectoral balance sheet data.

2. While the authorities publish Exchequer returns on a monthly and quarterly basis, only annual data on the general government balance are currently available. Furthermore, some discrepancies remain between the general government data reported by the Department of Finance and the Central Statistics Office.

3. The Irish authorities began publication of the current account of the balance of payments within three months of the reference quarter, although recent reports have been published with slightly longer lags. The balance of payments data are in line with the *Balance of Payments Manual*, 5th edition (BPM5), although the historical data covers only years starting from 1998. The Irish authorities have also started to publish on the country's International Investment Position (IIP).

Ireland: Core Statistical Indicators
(As of July 3, 2003)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Govern-ment Balance	External (Non-euro denominated) Debt	GDP/ GNP
Date of Latest Observation	7/3/2003	May 2003	May 2003	May 2003	May 2003	7/3/2003	May 2003	Apr 2003	4th Quarter 2002	2002	2002	4th Quarter 2002
Date Received	7/3/2003	6/30/2003	6/30/2003	6/30/2003	6/30/2003	7/3/2003	6/12/2003	6/26/2003	4/9/2003	3/21/2003	Apr. 2003	5/1/2003
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Annual	Quarterly	Quarterly
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Annual	Quarterly	Quarterly
Source of Update	Commercial	Central Bank	Central Bank	Central Bank	Central Bank	Commercial	CSO	CSO	CSO	Dept. of Finance	Central Bank	CSO
Monthly Reporting	Internet	Internet	Internet	Internet	Internet	Internet	Internet / Publication	Internet / Publication	Internet / Publication	Internet	Internet/ Publication	Internet/ Publication
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Biannual	Quarterly	Quarterly

INTERNATIONAL MONETARY FUND

IRELAND

Staff Report for the 2003 Article IV Consultation

Supplementary Information

Prepared by the European I Department

Approved by Ajai Chopra and Leslie Lipschitz

July 25, 2003

1. This supplement reports on information that has become available since the issuance of the staff report (SM/03/243). This information does not change the thrust of the staff appraisal.

2. Revised national income accounts data indicate that real GNP grew by 0.1 percent in 2002, somewhat lower than the preliminary 0.6 percent estimate shown in the staff report (see Table 1 below). Given revisions to the previous year's GNP, the deceleration in growth in 2002 was less sharp than previously suggested. GDP growth in 2002 was revised upwards to 6.9 percent, compared with 6.3 percent in the staff report. The revised data thus widen the difference between the growth rates of GDP and GNP in 2002, owing to larger net factor income outflows than previously reported (consistent with revised balance of payments data; see below). Growth in domestic demand was raised somewhat, while the contribution from net exports was lowered, reflecting a proportionally larger upward revision to imports compared with exports.

3. Balance of payments data for 1998–2002 have also been revised, with the path of current account balances lowered for the whole period, reflecting updated merchandise trade data. The current account deficit in 2002 was revised to 0.7 percent of GDP from the previous estimate of 0.1 percent of GDP (the largest revision), in part due to larger debits on net factor income. New data for the first quarter of 2003 indicate a widening of the current account deficit compared with the same quarter a year ago, due to a sizeable decline in net exports, which was partly offset by a reduction in net factor outflows.

4. Due to the revision of the National Accounts and consequent adjustments to staff's potential output estimates, the general government structural budget balances are estimated to have improved somewhat in 1999–2001. The fiscal stance in 2002 is thus estimated to be slightly more expansionary, with the fiscal impulse (i.e., change in the structural balance) revised to 1.2 percent of GDP from 1 percent of GDP (see Table 1).

5. Harmonized consumer price inflation decelerated further to 3.8 percent (year-on-year) in June, narrowing the differential over the euro area average to 1.8 percentage points.

6. The unemployment rate (claimant count basis) edged up to 4.7 percent in June.

7. The volume of retail sales fell by 2.2 percent (year-on-year) in May, following an increase of 3.4 percent in April. Excluding motor trades, volume of sales declined by 0.1 percent in May.

Table 1. Ireland: Revised Indicators
(Annual change unless otherwise stated)

	1999	2000	2001	2002	2003 Proj.
National accounts (constant prices) 1/					
GNP	8.9	10.2	3.8	0.1	1.5
GDP	11.3	10.1	6.2	6.9	2.5
Domestic demand	8.7	8.6	4.4	2.9	1.2
Private consumption	9.6	8.5	5.5	2.7	2.2
Public consumption	7.7	7.4	11.1	9.4	1.5
Gross fixed investment	14.5	6.8	0.1	1.7	-1.5
Net exports (contribution to GDP growth)	4.3	2.3	2.9	4.6	0.7
Exports of goods and services	15.2	20.6	8.3	6.2	1.5
Imports of goods and services	12.1	21.3	6.5	2.3	1.0
Prices, wages and employment					
Harmonized Index of Consumer Prices (annual average)	2.5	5.3	4.0	4.7	4.0
Unemployment rate (in percent)	5.6	4.3	3.9	4.4	5.1
Public finance (In percent of GDP)					
General Government Balance 2/	4.1	4.3	1.1	-0.1	-0.9
Structural budget balance 2/	2.6	2.0	-0.6	-1.8	-1.2
Balance of payments					
Balance of goods and services (Percent of GDP)	13.4	13.0	15.0	18.7	18.7
Current account (Percent of GDP)	0.3	-0.4	-0.7	-0.7	-1.3

Sources: Department of Finance; Central Bank of Ireland; IMF, International Financial Statistics; and staff calculations.
1/ Based on National Income and Expenditure, compiled in accordance with the new European System of National Accounts (ESA 95).
2/ Estimated prior to allocations for financing of future pensions liabilities and one-off expenditures. Structural balance is presented in percent of potential GDP and it excludes UMTS receipts of 0.2 percent of GDP in 2002.

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 03/93
FOR IMMEDIATE RELEASE
August 6, 2003

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2003 Article IV Consultation with Ireland

On July 30, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Ireland.[1]

Background

Over the past decade, Ireland has experienced a sustained expansion in output and employment that has raised its per capita income above the EU average. During 1991-2001, income growth, measured by real GNP, averaged 6.5 percent, while the unemployment rate plummeted from almost 16 percent to below 4 percent. The fiscal position strengthened, with the public debt ratio falling from close to 100 percent of GDP in the early 1990s to well below 40 percent of GDP in 2001. Substantial gains in competitiveness, particularly in the multinational dominated manufacturing sector, kept the current account in surplus or close to balance.

Growth began to slacken in mid-2001 as the global economy started to slow. While GDP growth remained robust at 6.9 percent in 2002, GNP growth slowed sharply from 10.2 percent in 2000 to just 0.1 percent in 2002. Private consumption and export growth weakened from their previous rapid pace while investment increased marginally mainly because strong residential investment offset a fall in business investment. Yet the unemployment rate rose only slightly to 4.4 percent, while the current account remained in a small deficit. Recent indicators suggest that economic activity remains sluggish in 2003—industrial confidence and

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

orders have fallen, retail sales remain weak, and consumer and service sector confidence have deteriorated further. Inflation eased to 3.8 percent in June, still well above the euro area average of 2 percent, while wage growth moderated somewhat.

Monetary conditions have remained easy for several years. Interest rates fell markedly in the run up to joining European Monetary Union in 1999 and credit to the private sector rose sharply. With inflation persistently above the euro area average, short- term interest rates have been negative since late 2001. Credit to households has grown in real terms at rates of 15–30 percent each year since 1996, but the average household debt to income ratio is still not high by international comparison. The decline in interest rates and increasing financial sector competition as well as rapidly rising disposable income and high rates of household formation have fuelled a spectacular increase in house prices, with real house prices rising by over 130 percent since 1993.

The prolonged economic expansion bolstered fiscal revenue in the late 1990s, allowing the government to maintain sizeable budget surpluses, while simultaneously cutting taxes and increasing expenditure rapidly. As growth slowed in 2001, revenue fell short of expectations, but spending rose sharply (by 12.6 percent in real terms), shifting the fiscal balance to a structural deficit for the first time in many years. In 2002, when adjusted for the effects of the economic cycle, the general government balance turned out somewhat weaker than budgeted mainly due to the underperformance of structural revenues—particularly in personal and corporate taxes. After an initial rapid increase, expenditure was brought under control and ended the year below budget. The cyclically-adjusted general government deficit increased to 1.8 percent of GDP, resulting in a fiscal expansion in excess of 1 percent of GDP.

Staff projects a gradual recovery in line with the expected pick up in global growth. Real GNP is projected to grow by 1.5 percent in 2003 and to rebound to about 3 percent in 2004 as private consumption and exports recover in late 2003, with the improvement in external demand. Given the information and communication technology overhang, investment would continue to decline in 2003 before reviving in 2004 as growth prospects improve. Monetary conditions would remain supportive, as the effects of euro appreciation so far would be largely offset by the European Central Bank's recent rate cuts. Over the medium-term, output is projected to grow at a trend rate of about 4-5 percent a year reflecting slower labor force and productivity growth compared with the late-1990s due to income convergence and lower foreign direct investment flows following the bursting of the global ICT bubble.

Executive Board Assessment

Directors commended the Irish authorities for their exemplary track record of sound economic policies, which have resulted in a dynamic, open, and robust economy—with growth notably above the EU average over the past decade—and resilience to external shocks. Directors saw signs, however, that trend growth was beginning to moderate toward euro-area levels, with implications for macroeconomic policy implementation and the expectations of economic agents. The likelihood of sustained slower growth in the period ahead calls for a sharper policy focus on reducing inflation further toward the euro-area average, improving competitiveness,

safeguarding financial sector soundness and flexibility, and securing the medium-term fiscal position, in line with the Stability and Growth Pact (SGP) objective.

Directors expected activity to pick up with the recovery in world demand towards the end of this year and to accelerate thereafter to a sustainable rate. Nevertheless, they saw some risks to the outlook. The global recovery could be more anemic than expected and the euro may continue to appreciate, adversely affecting competitiveness and employment, particularly in indigenous, employment-intensive industries. A sharp rise in unemployment could, moreover, pose risks to the housing market and to the financial sector. Given Ireland's prolonged credit boom, Directors noted that there is a significant risk that house prices could be overvalued, although financial sector risks appear to be manageable.

Directors observed that high levels of capitalization and profitability have strengthened banks' capacity to absorb the effects of potential macroeconomic shocks without systemic distress. However, credit risks related to investor-owned housing properties, the concentration of exposures in the commercial property market among a few institutions, and the health of the insurance industry merit close attention. Directors stressed the need for continued supervisory vigilance to ensure the stability of the financial system, and they welcomed the unification of supervision under the Irish Financial Services Regulatory Authority (IFSRA) within the central bank, which has enhanced the supervisory regime. They also welcomed the authorities' plans to improve insurance supervision and the consolidated supervision of complex financial groups. Directors encouraged the authorities to continue strengthening the monitoring of forward-looking systemic risks.

Directors emphasized that wage growth must moderate in order to preserve external competitiveness and avoid risks to output and employment. They welcomed the new national wage agreement in this regard, but emphasized that the wage norm for the agreement's second phase would need to reflect closely changes in productivity and economic conditions. With temporary factors adding to inflation this year, Directors felt that real wage declines may need to be accepted in that phase, especially in the public sector and publicly-owned enterprises. Directors noted the importance of having substantive and publicly verifiable evidence of productivity improvements in order to support benchmarking pay increase recommendations. They suggested that the compensation system for public pay be based on private sector comparators, and that merit and skill differences be taken into account.

Following several years of procyclical fiscal expansion, Directors welcomed the somewhat contractionary fiscal stance envisaged for 2003. Since structural revenue could continue to underperform, they stressed that spending should be held to budgeted levels, and that any revenue shortfalls be offset by restraint with respect to the wage bill and transfers; given the pressing need to invest in infrastructure, capital spending should be protected. Barring major adverse shocks to output and employment, the fiscal stance should—at a minimum—be neutral in 2004, with no increase in the cyclically-adjusted deficit, and with the automatic stabilizers allowed to operate freely.

Directors agreed that the authorities' medium-term fiscal target of overall structural balance is appropriate. However, the authorities should not rely on continued strong output growth to eliminate the deficit. In the view of most Directors, implementation of moderate contractionary

measures once the economic recovery is established, would protect policy credibility and secure the path toward achieving the medium-term objective. However, a few Directors noted the urgency of targeting the medium-term balance decisively and early, and recommended that adjustment measures be taken soon.

Directors observed that restraining current expenditure was preferable to increasing taxes as a means to improve the fiscal balances. In that vein, they urged limiting public sector wage increases, raising productivity, and continuing to strengthen public expenditure management across all levels of general government. They noted that greater competition and private provision of public services could also foster efficiency and reduce costs. They welcomed the recently announced plans to reform healthcare. If a compelling need to address taxation arose, broadening the tax base and the scope of user fees, with targeted transfers to the poor when appropriate, would be less distorting than increasing tax rates. Directors drew attention to the considerable improvements to the tax system made in recent years, which should be preserved.

Directors considered that the adoption of a formal medium-term fiscal framework at the general government level would improve transparency and policy predictability. Such a framework could include an overall fiscal constraint consistent with the SGP, and budget projections based on a medium-term expenditure framework. Directors welcomed the planned multi-year departmental capital spending envelopes, and recommended extending them to cover all non-cyclical primary expenditure, with safeguards to protect capital spending from budget pressures. They urged more extensive publication of public service commitments and ex-post evaluations of the effectiveness of public services. A few Directors suggested that the authorities undertake a fiscal Reports on Observance of Standards and Codes to identify ways to further improve fiscal transparency.

Directors agreed that enhancing competition and lowering regulatory obstacles will be important for sustaining medium-term productivity and income growth. Regulatory reform should be oriented firmly toward serving consumer welfare. Directors welcomed the strengthening of the Competition Authority's powers and the legal framework governing competition. They also welcomed the Competition Authority's scrutiny of restrictive practices in services, and encouraged the government to address the issues identified.

Directors noted the progress made in the provision of statistics, and encouraged the authorities to make further improvements, especially regarding the timeliness of general government accounts, and development of a national earnings index and sectoral balance sheets.

Directors encouraged the authorities to adopt a more supportive stance within the EU in favor of trade liberalization, in particular on the Common Agricultural Policy. They commended the authorities for their progress toward achieving the U.N.'s target for official development assistance by 2007.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2003 Article IV Consultation with Ireland is also available.

Ireland: Selected Economic Indicators

	1999	2000	2001	2002	2003 1/
Real Economy (change in percent)					
Real GDP	11.3	10.1	6.2	6.9	2.5
Real GNP	8.9	10.2	3.8	0.1	1.5
Domestic demand	8.7	8.6	4.4	2.9	1.2
Exports of goods and services	15.2	20.6	8.3	6.2	1.5
Imports of goods and services	12.1	21.3	6.5	2.3	1.0
HICP	2.5	5.3	4.0	4.7	4.0
Unemployment rate (in percent)	5.6	4.3	3.9	4.4	5.1
Public Finances (percent of GDP) 2/					
General government balance	4.1	4.3	1.1	-0.1	-0.9
Structural balance 3/	2.6	2.0	-0.6	-1.8	-1.2
General government debt	49.3	39.3	36.7	33.0	33.6
Money and Credit (end-year, percent change)					
M3E 4/	...	14.7	17.2	9.3	8.8 5/
Private sector credit	21.3	21.3	15.9	15.0	16.0 5/
Interest rates (end of period)					
Three-month	3.3	4.8	3.3	2.9	2.1 6/
10-year government bond yield	5.6	5.1	5.1	4.3	3.8 6/
Balance of Payments (percent of GDP)					
Trade balance (goods and services)	13.4	13.0	15.0	18.7	18.7
Current account	0.3	-0.4	-0.7	-0.7	-1.3
Reserves (gold valued at SDR 35 per ounce end of period, in billions of SDRs)	3.9	4.2	4.5	4.0	2.8 5/
Exchange Rate					
Exchange rate regime		Member of euro area			
Present rate (July 30, 2003)		US$ per euro 1.1346			
Nominal effective rate (1995=100)	94.0	88.3	89.2	90.7	95.9 7/
Real effective rate (1996=100, CPI based)	93.9	90.9	94.3	98.7	106.6 7/

Sources: Central Statistics Office; Department of Finance, Datastream and IMF International Financial Statistics

1/ Staff projections, except where noted.

2/ In percent of GDP. In 1999 the overall balance of 4.1 percent does not take account of discharging future pensions liabilities at a cost of 1.8 percent of GDP.

3/ The balance for 2002 excludes UMTS receipts of 0.2 percent of GDP.

4/ ME3 was discontinued in December 1998 and the methodology for calculation of Ireland's contribution to the Euro area money supply was amended in January 1999.

5/ End-May 2003.

6/ End-June 2003.

7/ End-April 2003.