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Ireland: Staff Report for the 1999 Article IV Consultation

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IRELAND

Staff Report for the 1999 Article IV Consultation

Prepared by the Staff Representatives for
the 1999 Consultation with Ireland

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July 14, 1999

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Executive Summary

Background: Ireland's remarkable economic performance continues into its sixth consecutive year. Output and employment growth in 1998 were by far the highest in the euro area. Demand growth was led by private consumption, with the external current account surplus narrowing sharply for the first time in recent years. Consumer price inflation rose to levels above the euro area average while asset prices, particularly of houses, surged. Monetary conditions have eased significantly amid intensifying wage and demand pressures with short-term rates converging to euro area levels and the euro depreciating. Private sector credit growth, which has been rapid since early 1997, has picked up sharply in recent months.

Policy Issues: Although the fiscal position continued to improve in 1998 and the first half of 1999 mainly reflecting cyclical factors and lower interest payments, discretionary fiscal policy measures have tended to provide stimulus to economic activity. Incomes policy, under which tax cuts are traded off for wage restraint, has imparted a procyclical bias to fiscal policy in that tax concessions are likely to be largest when wage pressures are strongest. A minimum wage, with a proposed rate that is high by international comparison, is expected to be introduced early next year. The main policy challenge is to ensure that timely action is taken to forestall risks that threaten Ireland's impressive record. Fiscal policy is the principal tool for macroeconomic stabilization, given monetary union, cyclical asynchronization with the rest of the euro area, and the limited effectiveness of incomes policy under tight labor market conditions. It would also be important to further strengthen financial sector supervision, especially by building on recent initiatives to assess vulnerability to macroeconomic shocks.

Report on the discussions: Given possible initial undervaluation in converting to the euro and strong productivity growth in traded goods, wage and price inflation may, to some extent, be higher in Ireland than elsewhere in the euro area without giving rise to competitiveness problems or overheating. Nevertheless the authorities, like staff, were concerned about a prospective overshooting of sustainable wage levels. While appreciating the risks posed by the sharp decline in interest rates, the authorities were on the whole more sanguine about the prospects for a smooth transition to a lower growth path. Buoyant economic conditions and falling interest payments are expected to raise the fiscal surplus in 1999 well beyond initial budget projections, although the cyclically-adjusted primary surplus is projected to remain largely unchanged from last year. In view of the relatively high rates of personal income taxation and the tax-based incomes policy, the authorities are committed to reducing taxes further both in the 2000 budget and over the medium term. Staff noted the need for a more strongly countercyclical fiscal policy, particularly in view of the substantial increase in the public sector wage bill in recent years. Staff also cautioned against tax reduction in view of cyclical considerations and medium-term budget pressures: the need to increase public infrastructure investment; substantial unfunded pension liabilities; and declining corporate tax rates and EU transfers. The authorities support a lower minimum wage rate for youth and trainees. The banking system is well-capitalized, but vulnerability to an adverse shock remains difficult to gauge. The authorities have taken steps to strengthen supervision.

Issues for discussion:

- Given significant monetary easing, to what extent are wage and demand pressures a concern, notwithstanding strong productivity growth and the apparent flexibility of the output response in Ireland?
- If the risks of overheating and a subsequent hard landing to a more sustainable rate of growth is a concern, what policy actions can be taken in the context of monetary union? In this regard, should fiscal policy be more strongly countercyclical?
- What areas offer the greatest scope for action with regard to fiscal policy? Should the growth of wage expenditures be reined in and further tax reductions avoided, particularly in the context of a new wage agreement? Are tax reductions advisable over the medium-term in view of the declining structural revenue ratio and budget pressures?
- Given the rapid increase in private sector credit growth and surging asset prices, can a further strengthening of supervision reduce the vulnerability of the financial system to an adverse shock? In what ways can regulation and supervision be further strengthened?

I. INTRODUCTION

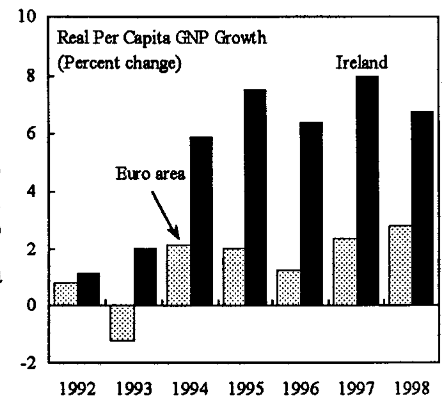
1. The 1999 Article IV consultation discussions with Ireland were held in Dublin from May 7 to 17, 1999.[1] The team met with the Minister of Finance, Governor of the Central Bank, other senior government officials, bank supervisors, and representatives of employers and labor unions as well as members of the financial and academic communities. Ireland has accepted the obligations of Article VIII, Sections 2, 3, and 4.

2. At the conclusion of the last Article IV consultation on October 14, 1998 (SUR/98/120), Executive Directors commended Ireland's impressive economic performance and noted the important role played by sound economic management. Directors underscored the importance of adequate and timely responses to challenges posed by the advanced stage of the business cycle, the prospective downward convergence of short-term interest rates, and Ireland's apparently competitive exchange rate at the onset of EMU. They recommended a tightening of fiscal policy to offset the stimulus from the easing of monetary conditions, and continued emphasis on structural reforms to alleviate labor and other supply constraints.

3. In reading this report, Directors may wish to reflect on two broad issues. First the extent to which wage and demand pressures are a concern, notwithstanding the apparent flexibility of Ireland's output response in recent years and against the background of broadly sound medium-term prospects. And second, if the risks of overheating and a subsequent hard landing are a concern, what near-term policy actions, if any, would be needed in the context of EMU membership.

II. BACKGROUND TO THE DISCUSSIONS

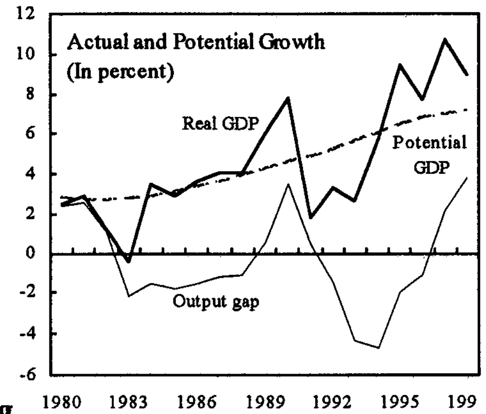
A. Recent Economic Developments



4. **Ireland's remarkable economic performance continues into its sixth consecutive year.** For most of the 1990s, strong growth had been underpinned by sound macroeconomic policies, social consensus, and rapid changes in economic structure (Table 1 and Figure 1). In 1998, real GDP is estimated to have grown by 9 percent and real GNP by some 8 percent, far in excess of growth in the rest of the euro area (Figure 2).[2] Staff estimates suggest output was well above potential, although as discussed below (see paragraph 22), such estimates are

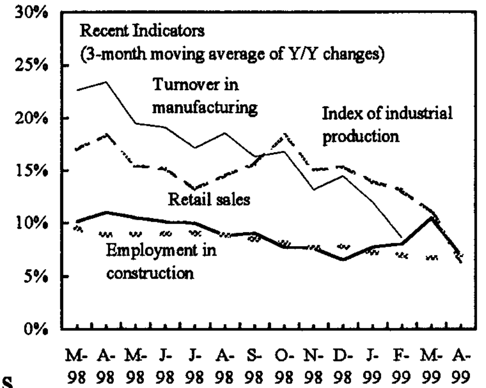
[1] The staff team comprised of Ms. Coorey (head), Mr. Aitken, Ms. Koliadina, and Mr. Kontolemis (all EU1). Messrs. Bernes and Charleton, Executive and Alternate Executive Director for Ireland, respectively, also participated in the meetings.

[2] According to the European Commission, Ireland's per capita GDP reached 105 percent of the EU average in 1998, while the corresponding GNP-based measure reached 87 percent.



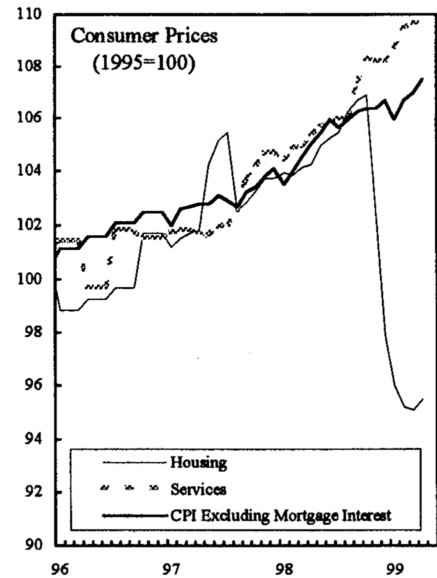
subject to a high degree of uncertainty. Domestic demand was driven mainly by private consumption (Figure 3). The current account surplus narrowed sharply (by 1½ percentage points of GDP) reflecting a widening of the deficit on the balance of goods, services and income for the first time in recent years (Table 2 and Figures 4 and 5).

5. **Indicators suggest growth may have slowed somewhat during 1998, but recent data point to a strong economy**. Consumer confidence remains high, tax receipts grew strongly in the first half of 1999, and the unemployment rate declined further to a low of 6.7 percent in May.



6. **Buoyed by the strength of economic activity, employment is estimated to have increased by a remarkable 6.2 percent in 1998 with major gains in the private sector, particularly banking and construction.** Employment gains were met by an increase in the labor force of 3.8 percent, bolstered in part by returning emigrants and rising female participation (Figure 6).

7. **Consumer price inflation increased to 2.4 percent in 1998, significantly outpacing inflation in the rest of the EMU area** (see Figures 1 and 7). The pick up in inflation was driven by housing costs and service price increases reflecting an upward trend in wage growth across a broad cross-section of sectors. Although annual inflation slowed to 1.5 percent in May (2.3 percent on an HICP basis), this was mainly due to a sharp fall in mortgage interest rates which lowered housing costs, rather than to an easing of underlying pressures.[3] Service price inflation continued unabated in the first five months of 1999.



8. **Asset prices have surged suggesting excess demand pressures and mounting infrastructure**

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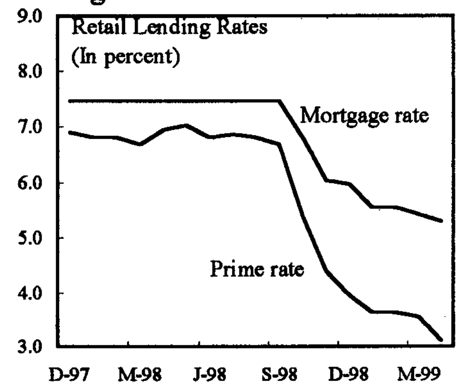
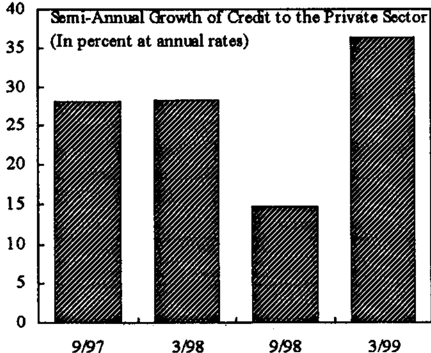
[3] The CPI includes the cost of housing services which is influenced by changes in mortgage costs. It does not reflect house price increases—which are asset price changes—except insofar as rents are affected. The HICP excludes housing servicing and hence has shown a higher rate of inflation than the CPI in recent months. Two-thirds of the consumption basket in Ireland comprises tradable goods.

constraints. House prices, which increased by 30 percent during 1998, rose by a further 15 percent (at an annual rate) during the first four months of this year (Figure 8). The slower rate of house price inflation may partly reflect government measures to lower tax incentives on residential investment and to increase the supply of land available for residential construction. Equity prices, which increased by 21 percent during 1998, rose by another 37 percent (at an annual rate) during the first five months of this year reflecting both buoyancy of the domestic economy and a surge in the share prices of Irish banks. Rapid increases in housing and equity market wealth are likely to have contributed to strong private spending.

9. **Monetary conditions have eased significantly, with the ECB's April interest rate cut exacerbating the sharp stimulus received in 1998 from the convergence of short-term interest rates to EMU levels in anticipation of the launching of the euro.** The base rate declined by some 3½ percentage points during 1998 and the first four months of 1999 (Figure 9). With the Irish pound widely regarded as having locked into the euro at a somewhat undervalued exchange rate, the depreciation of the euro has also contributed to a further easing of monetary conditions (Figure 10).



10. **Private sector credit growth picked up sharply during the six months ending March 1999 following a slowdown in the middle of 1998.** The increase coincided with the reduction in short-term interest rates starting in October, suggesting that borrowing may have been postponed given widespread expectations that interest rates would decline with Ireland's membership in EMU. Credit has been expanding rapidly (at year-on-year rates in excess of 20 percent in real terms) since 1997 (Figure 11).



B. Policy Developments

11. **The fiscal surplus rose in 1998 and the first half of 1999 mainly reflecting the cyclical strength of the economy and lower interest payments** (Table 3 and Figure 12). The cyclically-adjusted primary surplus remained broadly unchanged in 1998, indicating that the increase in the overall balance is likely to have had little, if any, contractionary impact on demand since almost all of the adjustment came from a reduction in interest payments (see Supplementary Note).[4] Noninterest expenditures increased markedly by 9½ percent in 1998 mainly due to spending on goods and services and wages (the public sector wage bill rose by 11½ percent).

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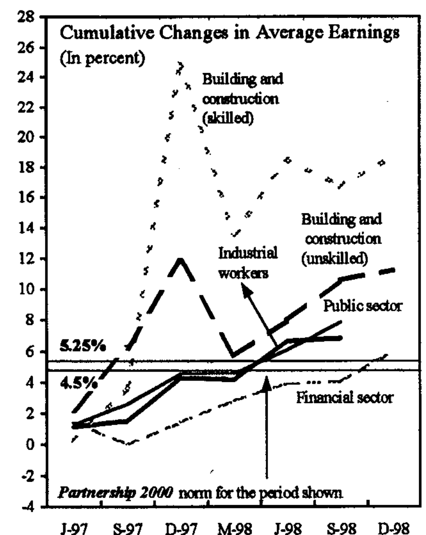
[4] Estimates of the cyclically-adjusted fiscal position are subject to a significant margin of error mainly because of uncertainties regarding the output gap.

12. **In 1999, the general government surplus is projected to reach 2.7 percent of GDP (1 percent of GDP in cyclically-adjusted terms), about the same as the 1998 outcome.** Key elements of the 1999 budget were continued reform of the tax system and greater infrastructure spending. Substantial net tax reductions were aimed primarily at improving work incentives by reducing tax distortions and lowering the tax burden of low income earners. Corporate income taxes were reduced as part of a move to unify corporate tax rates.[5] The decline in revenues is projected to be more than offset by a reduction in current spending—stemming mainly from lower interest and transfer payments—allowing a substantial increase in capital spending.

13. **Ireland's Stability Program envisages a broadly stable overall fiscal balance and a 1 percent of GDP fall in the primary balance in 2000-2001** (Table 4). The government announced its intention to continue reducing corporate and personal taxes, with the impact on the overall balance being offset by further contraction in current spending, mainly transfers and debt service payments (Table 4).[6] ECOFIN concluded that the program complies with the Stability and Growth Pact (SGP), but cautioned that the economic situation contained risks, particularly of an overheating economy with rising wages and prices. The Council noted that while there had been some tightening of policy, a greater tightening would be more prudent and a budget surplus should be maintained throughout the program. It supported increasing public investment to meet infrastructural needs.



14. **Incomes policy came under increasing strain as wage growth in a broad cross section of sectors exceeded the norms stipulated in**

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[5] The standard (non-manufacturing) corporate tax rate was reduced from 32 to 28 percent. Under the July 1998 agreement with the European Commission, the current 10 percent tax rate applying to manufacturing and certain internationally traded services will be unified at a standard rate of 12.5 percent by 2003.

[6] The program is based on unchanged policies—for instance, it includes only a modest allowance for public capital expenditure. Staff estimates, based on various output gap estimates, suggest that the structural balance required to comply with the provisions of the SGP is in the range of -1½ to ¼ percent of GDP (SM/98/238). The recently-announced EU budget envisages a sharp cut in overall EU transfers to Ireland from IR£6.5 billion (1.8 percent of GDP) in the current six-year program ending in 1999 to less than IR£3 billion over the next program.

the multiyear centralized wage agreement *(Partnership 2000)*.[7] Driven by sectoral labor shortages, wage growth in services exceeded that in the tradable sectors, with the largest increases recorded in the public sector and in construction.

15. **Notwithstanding the impressive decline in the overall unemployment rate, the government has been taking active measures to reduce the incidence of long-term unemployment which has remained relatively high.** Following the introduction of interviews for benefit claimants late last year, the number of claimants has dropped sharply.[8] The government has also sponsored job creation schemes and enhanced training opportunities.

16. **A minimum wage is expected to be introduced early next year.** In 1997, the Minimum Wage Commission had recommended that the rate be set at two-thirds of median earnings (IR£4.40 at the time) with a lower wage (70-90 percent of the full rate, applicable for a maximum of 3 years) for job entrants, trainees, and workers under 18 years of age.

17. **A number of steps have been taken in the area of deregulation and privatization.** The telecommunication market has been opened up to private companies and the government's majority share of Telecom Éireann was put up as a public share offering in July, with proceeds expected to reach at least IR£3 billion. The government has approved the sale and merger of the two state-owned banks, and the sale of the state-owned fertilizer company is under way.

18. **Given the increasing complexity of financial transactions, the government has decided, in principle, to establish a Single Regulatory Authority (SRA) for banks and financial institutions.** The recommendations made by an Advisory Group on the issue included the following: (i) all financial services should be supervised by the SRA which should also be given statutory responsibility for consumer issues related to these entities; (ii) the SRA should be an entirely new, independent organization, funded by industry, although a minority opinion preferred to locate it within a restructured central bank; (iii) in order to ensure cooperation and information disclosure, a statutory high-level Standing Committee should be established composed of representatives from the Department of Finance, central bank and the SRA. The proposals are being discussed by the government, but no final decisions on the specific recommendations have been made as yet.

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[7] *Partnership 2000 for Inclusion, Employment and Competitiveness* covers a three- year period through March 2000 and specifies a cumulative pre-tax wage increase of 9¼ percent in exchange for personal tax reductions worth of IR£900 over the three years.

[8] The incidence of long-term unemployment was about 45 percent in 1998. In the first 6 months of interviews, 61 percent of those contacted left the benefit roll ("Live Register"), with a substantial portion of the leavers never turning up for the interview.

C. Economic Outlook

19. **The outlook is for output growth to slow in 1999 and over the medium term, albeit to rates significantly above growth rates elsewhere in the euro area.** The staff's 1999 growth projection, in line with private forecasts, is somewhat higher than that of the authorities mainly reflecting different judgements on the contribution from net exports as a result of the slowdown in Europe and increased global competition (see Table 1). Private consumption growth is also somewhat stronger reflecting continued increases in asset prices, lower interest rates, and falling unemployment. Over the medium term, output growth is expected to slow further as capacity constraints become increasingly binding and labor force expansion tapers off. Consumer price inflation would remain above the euro area average due to stronger wage growth reflecting higher productivity growth in Ireland.

20. **There are risks in both directions to the near-term forecast.** The response of domestic demand to monetary easing may turn out to be stronger than anticipated. A stronger recovery in Europe, particularly the U.K., may also boost exports and output further. On the downside, the global slowdown may exert a greater-than-expected drag on exports, particularly if Ireland is unable to sustain the increases in market share it has experienced in the past. Also, a weakening of sterling from its present high level may dampen Irish export growth further. At the same time, a decline in U.S. stock prices and slower U.S. growth could have negative spillovers on local asset prices and spending as well as on foreign direct investment.

III. POLICY DISCUSSIONS

21. Discussions focused on the risks of a hard landing from the present high rates of growth and appropriate policy actions, particularly given the asynchronized cycles of the Irish and other EMU economies. Policy recommendations were based on an assessment of potential output growth in Ireland; excess demand pressures and sustainable inflation rates; and short-term monetary conditions. There are three main sources of risk of a hard landing: (i) an overshooting of sustainable wage levels due to excess demand pressures and realization of long-suppressed wage demands reflecting the expectations of an increasingly prosperous population; (ii) monetary conditions that are not fully consistent with Ireland's business cycle; and (iii) increased vulnerability of the financial system and indebted households to an increase in interest rates or an economic downturn due to inflated real estate prices and high credit growth. Although the authorities were mindful of these risks, they were, on the whole, more sanguine than the staff about the prospects of a smooth transition to a lower growth path.

A. Current Policy Setting

Potential output growth

22. **The authorities and the staff agreed that the extent to which wage and demand pressures are excessive needs to be established since rapid output growth *per se* need not**

signal a concern given Ireland's low inflation rate and a current account surplus. Although assessments of overheating are usually based on a view that the economy is operating above potential, the particular structural features of the Irish economy render the usual estimates of potential output highly unreliable and difficult to interpret. Not only has Ireland undergone rapid growth and far-reaching structural change, but it also has a highly flexible labor supply due to migration and rising female participation. Standard techniques for estimating potential output based on extrapolating past experience may be unreliable because the factors which have driven past growth are unlikely to continue long into the future.

23. **The authorities agreed that it would be more useful to formulate a view of potential growth from a forward-looking perspective.** The Irish economy is growing temporarily at an unusually rapid pace as it catches up with income levels in the rest of Europe. However, as the demographic effects taper off and income levels converge, growth would be expected to slow to a more sustainable rate based on more normal rates of productivity growth, although the timing of the transition would be difficult to predict. The authorities estimated this potential growth rate at 4-5 percent per annum, still significantly above potential growth in the rest of Europe. Staff studies, based partly on a sectoral analysis of total factor productivity growth, suggest a somewhat higher range of 6-6½ percent.[9] The implication is that demand and wage growth consistent with these ranges would help lower the risk of a hard landing as growth eventually slows.

Excess demand and sustainable inflation

24. **The staff noted that demand pressures were intensifying as indicated by surging house prices, the upward trend in wages, and pressures on public infrastructure.** Although some indicators appear to contradict this view, a closer look suggests otherwise.

- While price inflation appears subdued, the CPI does not in an economy as open as Ireland's accurately reflect domestic demand pressures given the high weight of imports in the consumption basket. Inflation of nontradables (both wage and asset prices) which provides a better gauge of risks, has been picking up strongly. The GDP deflator, for instance, rose by 5.6 percent in 1998.

- Although the external current account is in surplus, there was a marked narrowing of the balance in 1998 mainly due to a weakening of the goods and services balance and a further decline in net EU transfers.

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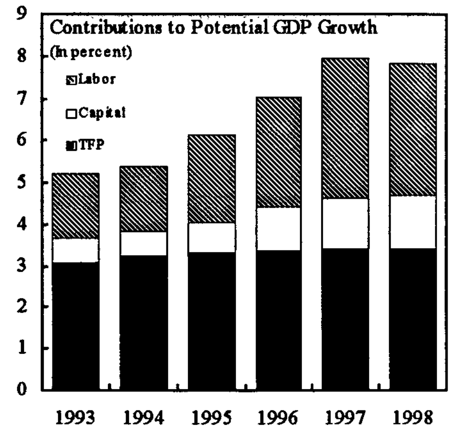
[9] These issues are discussed in greater depth in the *Selected Issues* paper "Potential Output Growth in Ireland."

- While the rapid output growth in recent years would appear to support a pick up in wage growth, in fact, most of the rise in trend growth since 1993 is accounted for by an expansion in labor supply rather than rising productivity. Total factor productivity growth has been high, but stable suggesting that wage growth should be strong, but stable as well.



25. **Authorities and staff agreed that it would be useful to quantify, as a rough benchmark, sustainable wage and price inflation in light of productivity growth in Ireland in relation to that of its trading partners.** Rapid growth in Ireland relative to the rest of the euro area suggests the need for real appreciation which, in a currency union, implies higher real wage growth and price inflation than elsewhere (the Balassa-Samuelson effect). Given possible initial undervaluation in converting to the euro and strong productivity growth in traded goods, wage growth and price inflation may well continue to be higher than elsewhere in the union without any loss of competitiveness or overheating. Rough estimates by staff based on examination of sectoral data suggest sustainable average wage increases in the order of about 5 percent in nominal terms corresponding to a price inflation differential over the euro area of about 1 percentage point (Box 1).[10] Average earnings growth in 1998 (before much of the recent short-term interest rate decline took place) was within this range, but officials noted it was on an upward trend and likely to pick up further given current wage demands (see Table 1 and see Figure 7).

Monetary conditions

26. **Staff noted that while Ireland's participation in EMU is likely to yield substantial long-term benefits, the sharp decline in interest rates at a time of intensifying demand and wage pressures, poses considerable short-run risks.** Given the asynchronized cyclical conditions with the rest of the euro area, there is a further risk that the ECB would eventually raise interest rates at a time when growth in Ireland was slowing down. Staff argued that the full effects of the rate reduction are not yet likely to have been felt, particularly since short-term interest rates did not decline until October last year and credit growth has been especially rapid since then. Moreover, the existence of fixed rate contracts and the time it takes for consumers

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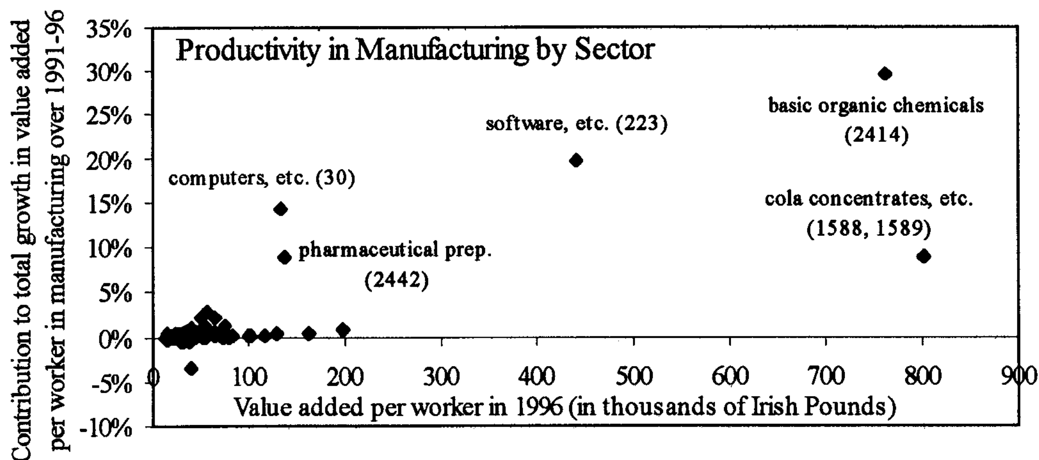
[10] These estimations are discussed in greater detail in the *Selected Issues* paper on "Ireland and the Euro: Productivity Growth, Inflation and the Real Exchange Rate."

Box 1: Inflation, Wages, and Productivity Growth in Ireland

1. Ireland's manufacturing sector has experienced growth well above euro area rates through much of the 1990's. This growth, were it to continue, could be expected to lead to a real appreciation of the exchange rate which, in a currency union, would imply wage and price inflation differentials over the rest of the union (the Balassa-Samuelson effect). However, for reasons outlined below, **the measured productivity growth of Irish manufacturing is likely to overstate the actual productivity gains embodied in Irish factors of production, and therefore, the apparent scope for higher wage and price inflation over the rest of the euro area.**

2. Ireland's recent manufacturing growth has been highly concentrated in a few sectors characterized by large foreign (typically U.S.)-owned export-oriented firms. For example, over 80 percent of the measured real growth in value added per worker in manufacturing during 1991-96 is accounted for by five sectors which together employ less than 10 percent of manufacturing workers. The chart below illustrates the extent to which a few sectors dominate aggregate productivity growth in manufacturing. In these sectors, unusually high earnings are attributed not to Irish labor or capital, but to other factors such as activities carried out in the home country (R&D, advertising), returns to patents and licenses etc. which arise from the integrated production relationships between multinationals and their Irish subsidiaries. These earnings are reflected as outflows in the form of repatriated profits and royalties in Ireland's balance of payments, thus creating the significant difference between GDP and GNP. **Measured productivity growth arising from multinational activity need not place direct pressure on Irish wages and, indeed, have greatly exceeded real wage growth.** For instance, in 1991-96 measured value added per worker grew by an average of over 8 percent in these industries (compared with 4 percent in other industries) although average real wages grew by less than the 3½ percent in other industries.



3. A staff background paper attempts to broadly quantify the range of wage and price inflation that could be sustainable in Ireland by isolating that portion of productivity growth attributable to Irish factors of production from productivity attributable to intangible assets of multinationals.[1/] On this basis, annual total factor productivity growth for the tradables sector between 1991-96 is estimated at about 3½ percent, compared with 1½-2 percent for euro area countries. Using the Balassa-Samuelson framework, such differentials in total factor productivity growth, if sustained, are estimated to be consistent with Irish inflation exceeding euro area inflation by about 1 percent. **Assuming an euro area inflation rate of about 1 percent, this suggests that Ireland could sustain price inflation rates of about 2 percent and wage growth rates in the order of about 5 percent over the long run.**

1/ See *Selected Issues* paper on "Ireland and the Euro: Productivity Growth, Inflation, and the Real Exchange Rate."

to adjust spending patterns to a new lower level of interest rates would suggest some lags in the monetary policy transmission mechanism.[11]

27. **Views were divided among the authorities regarding the economic impact of the decline in interest rates.** Some were very concerned that it would exacerbate demand pressures, stimulate the housing market, and encourage credit expansion with potential ramifications for the vulnerability of the financial system down the road. Others argued that since Ireland's participation in the final stages of EMU had been widely anticipated, most of the convergence in interest rates during 1998 was already incorporated into private sector decisions. They noted that long-term rates had already converged early last year and thus expected the remaining effect on domestic spending to be minimal, although they acknowledged that some effects still remain, as evidenced by the high rates of growth of car and retail sales.

B. Fiscal Policy

Short-term issues

28. **Given monetary union, fiscal policy must become the principal tool of macroeconomic stabilization.** Staff and the authorities agreed that fiscal policy in 1998 may not have been as contractionary as the cyclically-adjusted overall balance suggests (see Supplementary Note), and that tax cuts this year may be having an expansionary impact on private consumption. Staff advised that in view of the recent sharp decline in interest rates on the back of rising demand and wage pressures, fiscal policy needed to be more unambiguously countercyclical with a tightening of the stance—in terms of an increase in the cyclically-adjusted primary surplus—this year and, most likely, next year as well. Officials noted that fiscal tightening may not have a significant domestic demand impact in a small open economy such as Ireland and also that private savings could offset increases in public savings as in past years (see Figure 5).[12] While acknowledging these factors, staff suggested that the effectiveness of

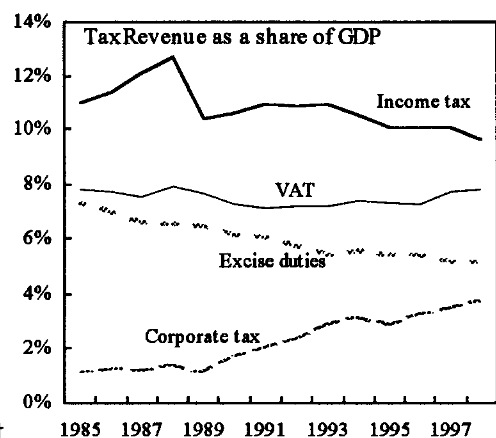
[11] Preliminary estimates suggest a two-year lag, albeit with about half of the full effect felt in the first two quarters. In the United Kingdom, which has a similar interest rate structure, monetary policy shocks are also estimated to take two years to show full effect. About 60 percent of mortgages in Ireland are at rates that are fixed for one-year.

[12] No reliable estimates of the fiscal multiplier are available for Ireland in part because of estimation difficulties associated with controlling for offsetting interest rate and exchange rate effects as well as for the level of the public debt. Tentative estimates (based on pre-EMU relationships) suggest a multiplier of about 1 (i.e., a one to one impact) in the first five years, but this appears to be on the high side.

fiscal policy is likely to be greater in a monetary union than in the past when offsetting movements in the interest rate and exchange rate were possible.

29. **The authorities noted the political difficulties in justifying fiscal restraint given the sizeable surpluses generated by the strong economy and indicated that political realities would not permit a tightening this year.** They recognized nonetheless that Ireland's fiscal strength may be somewhat overstated. Pension liabilities, which are substantial, are not adequately reflected in the budget numbers and funding them would essentially wipe out the reported surplus (see paragraph 34 below). In addition, the methodology used to calculate the cyclical adjustment is likely, for technical reasons, to overstate potential output growth in recent years, and hence, the cyclically-adjusted fiscal surplus as well.[13]

30. **The falling public interest burden, strong fiscal surplus, and the tax-based incomes policy provide a strong political impetus to reduce taxes.** In view of the relatively high rates of marginal taxation of personal income, the authorities reiterated their commitment to further tax reduction, especially the objective of lowering the standard and maximum personal income tax rates to 20 and 40 percent, respectively (from 24 percent and 46 percent currently). In addition, the process of replacing personal tax allowances with tax credits (introduced in the 1999 budget) needed to be completed in the next budget. They noted that personal income tax reductions so far had mainly offset the upward drift in the revenue ratio due to bracket creep and that the sharp reduction in the standard corporate tax rate by 2003 would not have an overly negative revenue impact in view of the rising corporate tax ratio. Given the need for demand restraint in the present macroeconomic environment, staff cautioned against tax reductions in next year's budget.



31. **The clear need to increase investment in public infrastructure in order to ease supply constraints poses a dilemma for budget policy**. Reflecting past budget cuts and notwithstanding prudent investment of EU funds, public infrastructure in Ireland has failed to keep up with rapid income growth. Hence, on the one hand, greater capital spending is urgently needed to upgrade public infrastructure, particularly roads and transportation. On the other hand, higher public expenditures add to wage and demand pressures in the short-run, particularly given labor shortages in construction. The authorities are developing a new National Development Plan to set public investment priorities over the medium-term.

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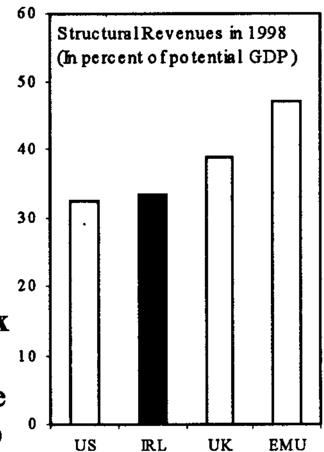
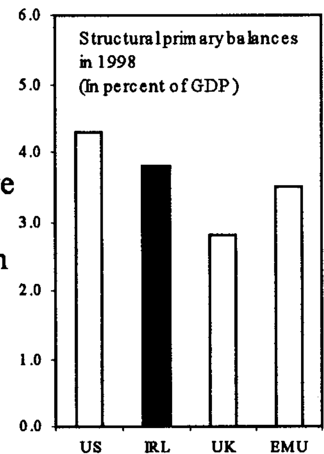
[13] See *Selected Issues* paper "Potential Output Growth in Ireland." Staff estimates suggest, for instance, that if the potential growth rate were lowered by 1 percentage point in 1998, the cyclically-adjusted fiscal balance would decline by 0.4 percent of GDP.

32. **Staff expressed concern regarding the sharp increase in the public wage bill in 1997-98 and the emergence of a potentially problematic dynamic in public sector wage settlements.** Excessive wage increases granted to certain public sector employees through a reopening of past wage agreements were creating risks of further wage pressures as other groups attempted to restore wage relativities. A wide range of private sector representatives echoed these views, pointing to the influence of public sector settlements on private sector wage outcomes. The authorities shared concerns on wage pressures, but felt that while public sector wage increases were more visible, the real impetus was coming from the private sector, with public sector wages attempting mainly to catch up. Public wage growth in the year ending September 1998 (the data latest available) was 5 percent, similar to industrial sector wage growth, although this excludes the very large increases granted to nurses and police late last year.



Medium-term issues

33. **Staff supported the need for tax reform over the medium term, but stressed that this should focus mostly on changes to the tax structure rather than overall tax reduction.** The government has made substantial improvements to the tax structure, but further efforts are warranted particularly in personal income taxes where, for instance, the top tax rate applies at a relatively low level of income (about 87 percent of average industrial earnings). It is worth noting that the structural revenue ratio has declined sharply by some 2½ percentage points of GDP since 1996 (see Supplementary Note) and may decline further when corporate tax rates are reduced over the next few years. Moreover, the public debt ratio at end-1998 was still high (53 percent of GDP), net EU transfers are projected to decline sharply, and there are substantial future expenditure needs related to public infrastructure investment and unfunded pension liabilities. Ireland's structural revenue ratio is lower, and its structural primary balance not particularly high, relative to other European countries. These considerations suggest that further reductions in the structural revenue ratio need to be considered in a medium-term context that factors in competing demands on public resources.



34. **Pension liabilities are substantial, and the government is working on pension reform to begin at least partially funding public service and social welfare pensions.** It is considering recognizing pension liabilities in the budget and is exploring various funding options including making payments into a notional fund within the budget or creating an

independently managed fund outside the treasury.[14] Staff estimates based on current contribution and replacement rates suggest that the net present value of existing and future pension liabilities is substantial. (Estimates of the addition to the public debt ratio range upward from 130 percent of GDP, depending on assumptions).[15] Moreover, fully funding these pension liabilities is estimated to lower the general government balance by around 2½-3½ percent of GDP, essentially wiping out the present surplus.

35. **The authorities are taking steps to place budget policy on a medium-term footing.** A comprehensive spending review is envisaged to assess departmental spending practices. They acknowledged that the nominal current spending limit of 4 percent per annum was not binding as currently specified because it included interest payments and was defined net of social security contributions, but said there was limited scope to change this definition since it was an election commitment. Staff suggested that medium-term budgeting be further strengthened by an articulation of the government's intentions on tax policy in the form of a multi-year tax reform package with implications for the structural revenue ratio clearly laid out; multi-year departmental spending limits—consistent with a medium-term public investment program—under which expenditure overruns would be offset by cuts elsewhere; and a transparent accounting of accrued pension liabilities. The authorities noted that the government's intentions with regard to tax reform had already been laid out clearly in the election manifesto. Staff also encouraged the authorities to undertake a self-assessment with respect to the Fund's *Code of Good Practices on Fiscal Transparency.*

C. Incomes Policy

36. **Staff agreed that centralized agreements have been useful in moderating wage pressures, but pointed out that the practice of trading off tax cuts for wage concessions imparts a procyclical bias to fiscal policy in that tax concessions are likely to be largest when wage pressures are strongest.**[16] Hence, revenue-neutral changes to the tax structure

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[14] Under ESA 95, notional funds within the control of the government do not affect the fiscal balance. However, payments made to an independently-managed pension fund outside government could be considered current expenditures, thereby reducing the fiscal balance.

[15] For a more detailed discussion see the *Selected Issues* paper on "The Impact of Future Pension Liabilities on the Fiscal Position." Estimates are based on the pension projections and economic assumptions in two government-sponsored reports: *The Actuarial Review of Social Welfare Pensions* (1997) and *The Interim Report of the Commission on Public Service Pensions to the Minister for Finance* (1997). Results are highly sensitive to the assumed real discount rate and to the estimated initial (1999) pension balance.

[16] There is, for instance, an understanding among social partners that if growth turned out less than expected, tax cuts would be lower than agreed. With growth higher than expected, tax cuts

(continued...)

rather than net tax reductions should be considered in future wage agreements. Authorities acknowledged that the wage agreement in its current form imposed a constraint on fiscal policy, but noted that since tax reductions were essential for restraining wage demands and maintaining social consensus, the benefit in terms of wage moderation was worthwhile.

37. **The authorities thought it likely that another centralized wage agreement would be reached when *Partnership 2000* expired next March, but negotiations were not scheduled to start until later this year.** They stressed the need for a coherent strategy with regard to the next such agreement. In particular, greater flexibility would be required in determining acceptable wage increases given tight labor market conditions and the need to minimize the tendency for such agreements to thwart relative wage changes. More extensive use of performance-related wage increases, including profit-sharing options, is thus likely.

D. Labor Market and Other Structural Policies

38. **Unions are pressing for a realignment of the proposed minimum wage rate of IR£4.40 per hour to two-thirds of current median earnings (approximately IR£5 per hour as of December 1998.).** Authorities were concerned that the proposed rate is high compared with minimum wages in other industrialized countries. They support a youth rate in order to limit the negative impact on youth employment. Private sector views were mixed regarding the impact of the minimum wage on employment. A government-sponsored study suggests that the effects on employment would be relatively minor (the impact effect would raise the unemployment rate by 0.5 percentage points) in part because wage increases would vitiate the employment impact by the time the wage is introduced (assuming the minimum wage is, in fact, set at IR£4.40 an hour and that it is not indexed).[17]

Minimum Wages in 1998

	US$/hour	As ratio of average earnings
Ireland (proposed)	6.0	0.58
France	7.2	0.55
United Kingdom	5.4	0.38
United States	5.2	0.39

Sources: Authorities and Fund staff estimates.

39. **The authorities expect active labor market policies to have a significant impact on long-term unemployment, particularly among younger workers.** The focus of recent budget policies has been to reduce poverty traps and encourage work incentives by attempting to alleviate the tax burden on lower paid workers, rather than by lowering benefits. However, staff estimates suggest that replacement ratios may not have changed significantly when the

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have gone beyond *Partnership 2000*. During 1997-99, personal tax reductions amounted to some 2.5 percent of GDP compared with tax cuts of 1 percent of GDP in the original agreement.

[17] *The Impact of the Minimum Wage in Ireland*, Report for the Inter-Departmental Group on the Implementation of a National Minimum Wage, March 1999.

total impact of all measures in the 1999 budget are considered, suggesting scope for more efforts to lower replacement ratios. (Box 2).[18]

40. **On trade policy, the authorities felt that the draft copyright bill adequately addresses concerns relating to the U.S. complaint to the WTO on Ireland's intellectual property laws.** They acknowledged that the existing copyright law was out of date and said that the new bill, published in April, brought Irish legislation in line with that in other OECD countries. The bill is currently before Parliament and is expected to be passed by end- year.

E. Financial Sector Issues

41. **Staff expressed concern about the effects of rapid credit growth and sharp increases in asset prices on the health of the financial system and the quality of banks' portfolios, particularly those exposed to the housing and property markets.** Currently, the banking system is well-capitalized and highly profitable reflecting the strong economy, but vulnerability to an adverse shock such as an economic downturn, an increase in interest rates, or a decline in real estate prices remains difficult to gauge.[19] Supervision would need to consider the risks to the financial system from a generalized macroeconomic shock, particularly since many standard indicators of financial health are not sufficiently anticipatory in this regard. The authorities shared these concerns and noted their recent request for credit institutions to carry out sensitivity analyses of portfolios to a specified deterioration in macroeconomic conditions. In addition, banks were being monitored carefully, particularly with respect to lending standards. Following a series of inspections, the Governor of the central bank wrote a letter to mortgage lending institutions in April expressing concerns about cases where lending standards had been relaxed. The authorities were of the view that while there have been specific instances of questionable standards, there were no generalized problems with regard to deteriorating credit approval criteria or asset quality. They welcomed the staff's suggestion to undertake a peer review as a means of further strengthening supervision.

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[18] For a more detailed discussion of recent labor market policies, see *Selected Issues* paper on "Work Incentives and Recent Labor Market Policies "

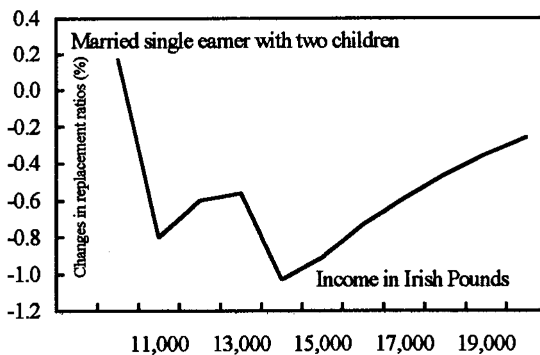
[19] See *Selected Issues* paper on "Structure and Performance of the Financial System" which provides a description of supervisory arrangements and discusses indicators of financial system vulnerability based on the *Guidance Note for Monitoring Financial Systems under Article IV Surveillance* (SM/98/151).

Box 2. Recent Changes in Incentives to Work

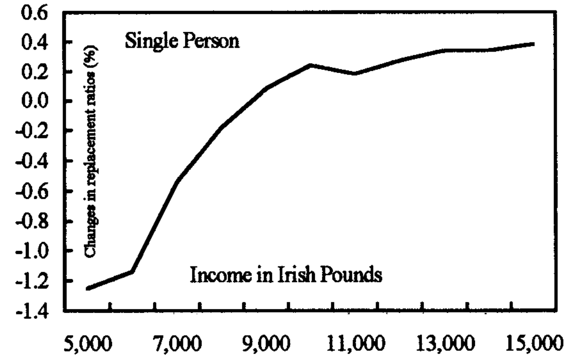
1. **In the budgets for 1998 and 1999, the government made significant efforts to improve incentives to work for low wage earners and the unemployed.** Measures included (i) reducing income tax rates; (ii) extending eligibility for certain social welfare benefits to former unemployed for the first 3 years of their employment; and (iii) raising the level of personal tax allowances above the tax exemption limit, thus significantly reducing poverty traps created by high marginal tax rates (reaching as much as 40 percent).

2. Notwithstanding these efforts, **replacement ratios have remained quite high,** particularly for workers with families, implying low incentives to work. [1/] In 1999, for instance, replacement ratios for a single person ranged between 34-56 percent, depending on the income level, while for a married earner with 2 children, they ranged about 64 -78 percent. Although tax measures in the 1999 budget were aimed at improving incentives to work, **the combined effect of all 1999 budget measures on replacement ratios appears to have been rather modest.** This is in part because, as in past years, social welfare benefits were increased in line with average earnings. As shown in the charts below, for most income ranges and for different types of workers, the net reduction in replacement ratios due to 1999 budget measures ranged between 0 and 1 percent.

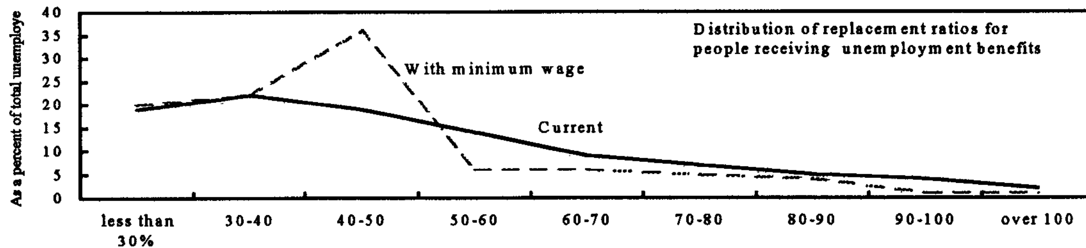
Changes in 1999 budget over 1998[2/]



Changes in 1999 budget over 1998[2/]



3. **The introduction of the national minimum wage (NMW) is expected to result in a significant reduction in replacement ratios because of the increase in starting pay** (about 30 percent of unemployed are estimated to benefit from the NMW if they start work).[3/] The chart below shows how the distribution of replacement ratios shifts when the NMW is introduced. In particular, those currently experiencing a replacement ratio above 50-60 percent (i.e., most unemployed, low-wage earners) would find their ratio pushed down below 50 percent (peaking at 40-50 percent). While work incentives are, not surprisingly, improved by the NMW, the important question is whether the demand for these workers will be correspondingly improved.[4/]



1./ The replacement ratio is defined as the benefit level when unemployed over the after-tax income when employed. A fall in the replacement ratio signifies an increase in the incentives to work.
2/ A negative number denotes a decline in the replacement ratio (for a specific type of worker at given income level) due to measures in the 1999 budget. Median annual earnings in 1999 are estimated at IR£15,000.
3/ T. Callan and J. Walsh, *Microsimulation Analysis of the Impact of the Minimum Wage on Work Incentives.*
4/ See *Selected Issues* paper on "Work Incentives and Recent Labor Market Policies."

42. **Staff inquired into the adequacy of the institutional setup in Ireland for handling a possible financial crisis and the changes necessitated by EMU, in particular with regard to the functioning of the lender of last resort (LOLR) role.** The authorities assured the staff that they were well-prepared to deal with a crisis should one emerge and that current understandings between the ECB and national central banks were clear with regard to the modalities for emergency LOLR actions, including the sharing of necessary supervisory information. The issue of LOLR had been actively discussed at the EU Council level and the ECB had set up a system of communication for crisis situations, with every national central bank aware of its responsibilities. The authorities expected that, following EMU, competition in the financial services sector would increase over time with possible banking system consolidation. Such pressures, however, were not evident as yet.

IV. Other Issues

43. **In 1998, Ireland's spending on official development assistance was broadly unchanged at 0.2 percent of GDP.** This falls short of U.N. target of 0.7 percent of GDP.

44. **The government has made good progress in Y2K compliance and Ireland has been rated at level 1 – the best state of readiness—by an independent industry study** (the Gartner Group). The government is confident of meeting its deadline of July 31, 1999 to achieve compliance. According to the Central Bank, most credit institutions are now in the testing and contingency planning stages. The Bank requires all institutions to have adequate business continuity and disaster recovery plans in place.

45. **Ireland has subscribed to the Fund's Special Data Dissemination Standards and is also subject to the statistical requirements and timeliness and reporting standards of the Eurostat and the ECB.** The authorities have made significant progress in improving data reporting, but scope for improvement remains in some areas (Appendix II).

V. Staff Appraisal

46. **The performance of the Irish economy remains impressive.** Over the past few years, sound macroeconomic policies backed by social consensus, a strategic approach to foreign direct investment, and an unusual confluence of favorable supply factors have left Ireland well placed to take advantage of integration into the euro area as well as global markets. The external current account appears to have weathered the turbulence in world markets relatively well and the outlook for growth remains favorable in the near term. Prudent management has substantially strengthened the fundamental fiscal position while structural policies have enhanced incentives toward gainful employment and further deregulated markets.

47. **Excess demand pressures, however, are mounting.** Clearly, some degree of wage and price inflation higher than in the rest of the euro area is justified by the possible initial undervaluation in converting to the euro and stronger productivity growth in traded goods in

Ireland. Nonetheless, surging house prices, sectoral labor shortages, and pressures on public infrastructure are raising the risk that wages may overreach rates of growth justified by productivity gains. Staff estimates, admittedly rough, suggest that wage growth in 1998 was at the upper end of a range consistent with underlying productivity growth differentials between Ireland and the rest of the euro area. A sustained pick up in wage growth beyond this range would be a cause for concern. Notwithstanding the clear long-term benefits of joining EMU, the associated sharp fall in interest rates has taken place at a time when wage pressures are intensifying and demand pressures are straining capacity. With domestic credit growth picking up from already high rates, the vulnerability of bank portfolios to an adverse shock is naturally a concern.

48. **While it is possible, indeed likely, that the Irish economy will continue to rack up very high growth rates in the near-term, the risks of a hard landing also rise as the expansion continues and demand pressures mount.** If wages overshoot sustainable levels, output and employment growth may have to decline unnecessarily sharply to restrain real wages. If a shock, such as an increase in euro interest rates, exposes weaknesses in asset portfolios, banks may be forced to contract credit, thus exacerbating a downturn. Similarly, overextended households may be forced to cutback spending more sharply than otherwise. Membership of the larger euro area will not necessarily shield Ireland from a localized downturn, particularly given limited factor mobility.

49. **While the Irish economy's strong performance and sound fundamentals hold much promise, the challenge is to ensure that timely action is taken to forestall the risks that threaten its impressive record.** Given monetary union and cyclical asynchronization with rest of the euro area, fiscal policy must take on a greater role as a stabilizing force. A tightening of the fiscal stance in 1999, and probably next year as well, would reduce the risk of a hard landing as Ireland transitions to its medium-term growth path. Given that wage and price inflation in 1998 were already around benchmark levels suggested by productivity differentials, the tightening should at least offset the expansionary effect of the 3½ percentage point fall in base rates since late last year. Even in a small open economy such as Ireland, the short-term demand effects of a fiscal tightening can be sizeable, particularly since monetary union rules out offsetting movements in interest rates and exchange rates.

50. **It is important, in this context, to restrain public sector wage increases which have picked up significantly in the last two years.** The increase in public sector wages in excess of norms agreed under *Partnership 2000* is a cause for concern, even if the adverse impact on the fiscal balance has been offset so far by the cyclical strength of tax revenues and the decline in interest payments. Further wage pressures—particularly from attempts to restore wage relativities—should be firmly resisted. It is essential that the public sector play its part in delivering wage moderation, particularly in the run up to negotiations on the next centralized wage agreement. Moreover, given the political constraints to raising taxes and the clear need to expand public infrastructure spending, the wage bill offers the greatest scope for action in tightening fiscal policy.

51. **In view of current cyclical pressures, further net tax reductions should be avoided in the 2000 budget, all the more so since this would go beyond the commitment in *Partnership 2000*.** The government's efforts at tax reform are commendable, particularly the measures in the 1999 budget to reduce poverty traps and disincentives to work. Further efforts are needed to change the tax structure, but these changes should not lead to unsustainable structural revenue losses over the medium-term, nor be vulnerable to reversal during an economic downturn.

52. **Given monetary union, it is critical that future wage agreements not constrain the use of fiscal policy, or worse, force it to act procyclically.** While these agreements have been effective in moderating wage demands in the past, their reduced effectiveness in tight labor market conditions changes the strategic calculus in trading tax reductions for wage moderation. The next wage agreement, if one emerges, should focus on changing the tax structure rather than reducing net taxes at a time of intensifying demand pressures and a declining structural revenue ratio. More extensive use of performance-related pay provisions would be welcome to foster greater relative wage flexibility and to reduce the risk of excessively high across-the-board wage increases.

53. **The government should seize the opportunity created by the present fiscal surpluses to begin funding public service and social welfare pensions.** Pension liabilities are large, notwithstanding Ireland's relatively young population, and substantive moves must be made without delay to address the problem. In order to protect pension resources from future budget pressures, independently managed pension funds could be created with appropriate safeguards in terms of public accountability. Annual charges based on a preset formula should be made to the budget to properly reflect the true level of expenditure commitments. Proceeds from the privatization of public enterprises could be used to strengthen the pension funds and help move towards full funding over the medium-term.

54. **The recent moves towards a multi-year budgeting framework are commendable; this approach needs to be further strengthened, particularly through a tightening of expenditure control mechanisms.** The staff supports the development and implementation of a sustainable medium-term investment plan with a view to upgrading public infrastructure over time. A clearer articulation of the government's intentions on tax policy and associated structural revenue implications as well as a transparent accounting of all pension liabilities would also be important for clarifying the true underlying fiscal situation. A self assessment with reference to the Fund's *Code of Good Practices on Fiscal Transparency* may be useful in this regard.

55. **The government's active labor market policies are highly commendable.** The economy's strong demand for labor has been met in part by an impressive shift of workers from unemployment into employment. The recent tax changes and efforts to intervene actively through interviews and training of benefit claimants promises further progress in this direction. Challenges remain, however, in tackling the incidence of core, long-term unemployment.

56. **Given its high level, the introduction of a minimum wage at IR£ 4.40 per hour could jeopardize efforts to reduce unemployment, particularly among youth and the long-term unemployed.** A realignment of the rate to two-thirds of current median earnings or indexation to earnings should be avoided in order to limit potential adverse effects both on the unemployment rate and—in current tight labor market conditions—on overall wage levels. The proposed lower rate for youth, job entrants and trainees is welcome, but the age limit for the youth rate should be set at 21 years so as to limit the negative impact on youth unemployment.

57. **Although the banking system appears well-capitalized, rapid credit growth and strong house price increases raise the vulnerability to an economic downturn or an increase in interest rates from their current low levels.** With competitive pressures driving financial institutions to deviate from traditional lending norms, there is increasing risk of an asset price bubble, particularly if easy credit availability allows house prices to be bid up on the expectation of further price increases. The supervisory authorities have a solid professional reputation and their efforts to strengthen prudential supervision are welcome. In order to enhance the forward-looking aspects of regulatory policy, it would be useful to build on the recent initiative to assess financial system vulnerability to macroeconomic shocks. The authorities may also find a peer review helpful, especially by supervisors in a country that has undergone a real estate expansion. Whatever decisions are finally made with regard to the location and functions of the SRA, it would be important to ensure that the process is not disruptive to the maintenance of supervisory vigilance and that the arrangements function effectively within the context of the ESCB in both anticipating potential problems and facilitating a rapid response should problems emerge.

58. **Ireland's macroeconomic data permit effective surveillance on the whole, although there is scope for improvement in some areas.** While the authorities have made significant efforts to improve data reporting, further progress in shortening lags in publishing key economic indicators would enhance the monitoring of short-term economic developments.

59. **The staff encourages the government to make further progress towards achieving the U.N. target of 0.7 percent of GDP for official development assistance,** particularly in view of Ireland's relatively strong fiscal position.

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

SUPPLEMENTARY NOTE

Composition of Fiscal Adjustment

1. **Ireland's fiscal position has strengthened significantly in recent years** with the general government balance shifting from a deficit of 2.1 percent in 1995 to a surplus of 2.4 percent in 1998. As indicated by the table below, this improvement reflected strong GDP growth, a decline in debt service payments, and some fiscal adjustment.

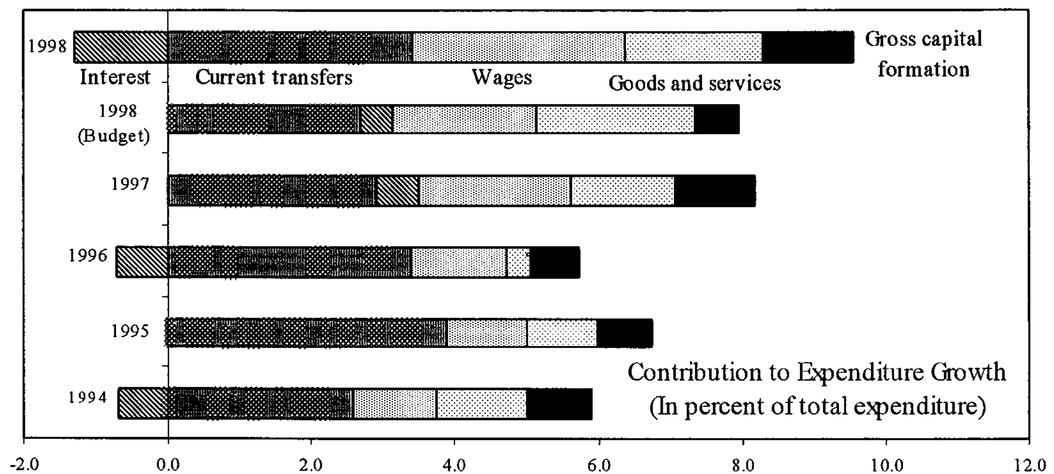
2. **In 1998, the cyclically-adjusted primary balance remained almost unchanged with most of the increase in the (cyclically-adjusted) overall balance coming from a substantial decline in interest payments.** In addition, the cyclically-adjusted overall balance did not strengthen by as much as the actual overall balance due to the importance of cyclical factors in the fiscal performance. The structural revenue ratio fell by almost 2 percentage points of GDP compared with 1995.

Composition of Fiscal Adjustment 1/

	1995	1996	1997	1998 (bud.)	1998	1999 (proj.) 2/
	(As a percent of potential GDP)					
Revenue	35.1	35.0	34.2	31.7	33.3	32.6
Non-interest expenditure	32.1	31.1	30.5	30.2	29.9	29.1
Primary balance	3.0	3.8	3.6	1.5	3.4	3.5
Net interest expenditure	4.2	3.6	3.4	2.6	2.6	2.4
Overall balance	-1.2	0.3	0.2	-1.1	0.8	1.1
Actual balance	*-2.1*	*-0.3*	*1.1*	*0.3*	*2.4*	*2.7*
	Fiscal Impulse 3/ (In percent)					
Revenue	-2.8	-0.1	-0.8	-2.5	-0.8	-0.7
Non-interest expenditure	-0.6	-1.0	-0.6	-0.3	-0.6	-0.8
Primary Balance	-2.2	0.9	-0.2	-2.1	-0.2	0.1
Net interest expenditure	-0.4	-0.6	-0.2	-0.8	-0.8	-0.2
Overall balance	-1.8	1.5	-0.1	-1.3	0.6	0.3
Actual Balance	*-0.4*	*1.8*	*1.4*	*-0.8*	*1.3*	*0.3*

Sources: Department of Finance, and staff estimates.
1/ Cyclically adjusted, unless otherwise indicated, based on revised National Income and Expenditure data compiled in accordance with ESA95. Cyclical adjustments are sensitive to the revisions to GDP.
2/ 1999 budget adjusted for revised revenue projections based on Exchequer outturn for the first half of the year.
3/ First difference of the corresponding levels.

3. **Nominal expenditure increased sharply in 1997-98,** although it fell as a ratio to potential GDP because of the strong growth of the denominator (see chart below). **Wages, expenditure on goods and services, and public investment contributed most to this increase** with the impact on total expenditure in 1998 being mitigated by the decline in interest payments. In 1998, spending on wages, transfers and public investment exceeded the budget limits, but these overruns were partly offset, at the level of the primary balance, by lower expenditures on goods and services. Noninterest expenditures grew more strongly than anticipated in the budget.



4. **This decomposition of fiscal adjustment suggests a shift in the sources of adjustment in 1998. Although the overall balance increased in cyclically-adjusted terms, the impact of fiscal measures on domestic demand may not have been contractionary.** Most of the apparent contraction arose from reductions in interest payments which are likely to have weak multiplier effects, particularly since about a third of the public debt is held abroad. The cyclically-adjusted primary balance in fact deteriorated slightly. The substantial decline in the structural revenue ratio—mainly reflecting reductions in personal income taxation—and increases in the public wage bill, direct government spending on current goods and services as well as capital investment are likely to have had stronger multiplier effects by comparison.

5. **The cyclically-adjusted primary balance is projected to remain unchanged in 1999, notwithstanding the increase in the actual overall balance due to cyclical factors.** Despite a substantial upward revision to revenues to reflect strong Exchequer returns in the first half of the year (with the overall balance correspondingly increasing from 1.7 percent of GDP in the original budget to 2.7 percent of GDP), the cyclically-adjusted (structural) revenue ratio is projected to decline sharply again. Although the cyclically-adjusted overall balance is projected to increase slightly (0.3 percent of GDP), this mostly arises from lower projected interest payments. Hence, as in 1998, the (projected) strong fiscal outturn is likely to reflect mainly cyclical factors and reductions in interest payments.

Table 1. Ireland: Selected Economic Indicators

	1994	1995	1996	1997	1998 Prel.	1999 Proj.	2000 Proj.
	(Percent change from preceding year, unless otherwise noted)						
National accounts (constant prices) 1/							
GNP	6.3	8.0	7.2	9.0	8.1	6.9	6.5
Net foreign balance 2/	0.9	1.6	-0.3	-0.2	-1.4	-0.8	-0.7
GDP	5.8	9.5	7.7	10.7	8.9	7.5	7.0
Domestic demand	5.6	7.0	7.8	9.5	9.4	6.7	7.0
Private consumption	4.3	3.7	6.5	7.3	7.4	7.5	6.8
Public consumption	4.1	2.9	2.8	4.8	5.9	4.0	3.5
Gross fixed investment	12.0	13.5	16.2	17.4	16.8	14.0	9.5
Exports of goods and services	14.7	19.6	11.8	17.0	20.5	11.4	8.0
Imports of goods and services	15.1	16.1	12.0	16.1	23.2	12.0	8.1
Prices, wages and employment							
Consumer prices (annual average)	2.4	2.5	1.6	1.5	2.4	2.0	2.0
Consumer prices (end of period)	...	...	...	...	1.7	1.5 3/	...
Average hourly earnings	1.8	2.2	2.8	2.9	5.6 4/	...	...
Output, manufacturing	12.8	20.1	8.2	16.6	16.9	...	...
GNP/Employment	3.0	2.8	3.4	5.0	1.7	3.5	4.2
Unit wage costs	-7.2	-9.9	-1.4	-6.4	-6.9 5/	...	...
Employment	3.2	5.0	3.7	3.8	6.2	3.3	2.2
Unemployment rate (in percent)	14.1	12.1	11.5	9.8	7.7	6.5	6.2
Money and credit (end-period)							
M3E 6/	10.3	11.6	15.7	19.1	18.1	...	...
Private sector credit 6/	11.8	11.2	15.4	23.6	23.6	...	...
Public finance (In percent of GDP)							
General Governement Balance	-1.7	-2.1	-0.3	1.1	2.4	2.7	2.6
Primary balance	3.1	2.1	3.4	4.5	4.9	5.0	4.7
General government debt	88.1	80.8	71.1	62.3	52.6	46.0	40.1
External trade and balance of payments							
Merchandise export volume	15.4	21.4	11.5	17.6	22.0	11.0	8.0
Merchandise import volume	14.0	15.0	11.0	15.0	23.0	12.0	8.1
Terms of trade	-2.6	-2.4	0.6	0.6	0.3	...	...
Balance on goods and services (In percent of GDP)	9.4	10.9	11.0	12.2	11.7	11.8	11.9
Current account (In percent of GDP)	2.7	2.6	2.8	2.5	0.9	0.6	0.4
Official reserves (In billions of SDRs, end of period)	4.2	5.8	5.7	4.8	6.7	...	...
Effective exchange rates (1995=100, end of period)							
Nominal	99.5	100.0	102.1	102.4	97.1	91.8 7/	...
Real (CPI based)	99.4	100.0	101.9	101.6	97.0	...	...

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/ Contribution of net exports and net factor incomes to GNP growth.

3/ Year-on year in May 1999.

4/ Estimates based on available data—first nine months of 1998.

5/ Estimates based on available data—first six months of the 1998.

6/ Adjusted for the effects of transactions between credit institutions and non-bank international financial companies and valuation effects arising from exchange rate movement.

7/ End-May 1999.

Table 2. Ireland: Summary of Balance of Payments
(In percent of GDP)

	1992	1993	1994	1995	1996	1997	1998
Current account balance	1.0	3.7	2.7	2.6	2.8	2.5	0.9
Trade balance	11.1	14.2	14.8	18.2	19.4	21.4	24.9
Exports of goods	52.6	57.4	61.5	67.5	68.0	70.5	76.4
Imports of goods	-41.4	-43.2	-46.7	-49.3	-48.6	-49.1	-51.5
Services	-3.9	-4.0	-5.4	-7.3	-8.4	-9.2	-13.2
Credit	7.6	7.6	7.9	7.7	8.0	8.0	8.0
Debit	-11.4	-11.6	-13.3	-14.9	-16.4	-17.1	-21.2
of which Royalties	-2.1	-2.6	-3.3	-3.9	-4.6	-5.1	-7.1
Credit	0.1	0.1	0.2	0.2	0.1	0.2	0.2
Debit	-2.2	-2.8	-3.5	-4.1	-4.7	-5.2	-7.3
Balance on goods and services	7.3	10.2	9.4	10.9	11.0	12.2	11.7
Factor incomes	-10.2	-10.4	-9.8	-11.0	-11.2	-12.2	-12.5
Credit	6.3	5.7	6.6	7.9	7.8	9.5	11.8
Debit	-16.5	-16.1	-16.4	-18.9	-19.1	-21.7	-24.3
Balance on goods, services and income	-2.9	-0.2	-0.4	-0.1	-0.2	0.0	-0.8
Current transfers (net)	4.0	3.9	3.2	2.7	3.0	2.5	1.7
Capital and financial account	-1.9	-5.9	-6.1	-2.3	-2.6	-7.3	-2.1
Capital transfers	1.5	1.5	0.7	1.2	1.1	1.1	1.1
Private capital	-2.4	-1.4	-3.8	-4.4	-1.2	-5.0	-5.6
Official capital	-0.5	1.6	-3.7	0.1	0.1	-4.2	-2.1
Credit institutions	-4.3	-2.5	0.4	4.4	-2.7	-0.6	7.3
Official external reserves	3.8	-5.2	0.3	-3.5	0.1	1.5	-2.8
Net residual	0.9	2.3	3.3	-0.3	0.0	4.8	1.1

Sources: The Central Statistics Office and staff estimates.

Table 3. Ireland: Government Finances
(In percent of GDP)

	1993	1994	1995	1996	1997	1998	1999 (proj.) 1/
Current surplus:	-1.1	0.7	-0.1	1.6	3.1	4.5	5.0
Current revenue, of which	37.1	37.8	35.0	34.9	34.2	33.4	33.0
Tax revenue	29.3	30.6	28.4	28.7	28.4	27.9	27.5
Social security receipts	5.3	5.2	4.8	4.4	4.2	4.1	4.1
Miscellaneous	2.4	2.1	1.9	1.9	1.6	1.5	1.4
Current Expenditure, of which	38.1	37.1	35.1	33.4	31.4	29.3	28.3
Interest payments	6.2	5.6	5.0	4.4	4.0	3.1	2.9
Goods and services	4.0	4.2	4.0	3.8	3.7	3.8	4.1
Compensation of employees	10.8	10.5	9.7	9.3	8.8	8.5	8.0
Transfers	16.4	16.3	15.8	15.5	14.4	13.5	12.9
Other	0.6	0.6	0.5	0.5	0.5	0.4	0.4
Capital expenditure	1.2	2.4	2.0	1.8	1.7	1.8	2.1
Gross capital formation	2.2	2.3	2.3	2.3	2.4	2.5	2.7
Net capital transfers	-0.9	0.0	-0.3	-0.5	-0.7	-0.7	-0.6
General government balance	-2.3	-1.7	-2.1	-0.3	1.1	2.4	2.7
Net interest	-5.5	-4.8	-4.3	-3.6	-3.4	-2.5	-2.3
Primary balance	3.2	3.1	2.1	3.4	4.5	4.9	5.0
Memorandum items:							
Cyclically adjusted:							
Government balance	-0.2	0.6	-1.2	0.3	0.2	0.8	1.0
Primary balance	5.1	5.2	3.0	3.8	3.6	3.4	3.5

Source: Department of Finance and staff estimates.

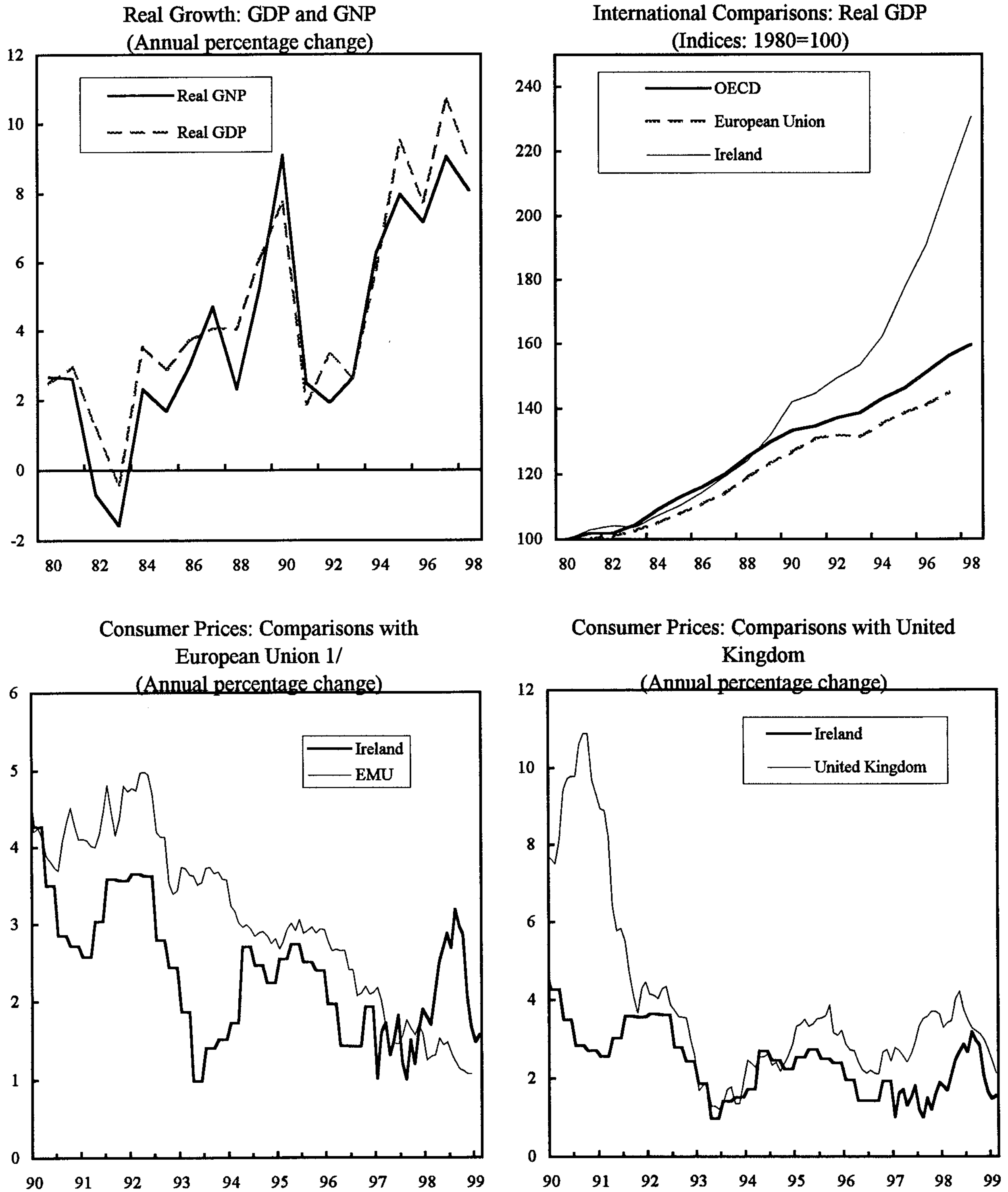
1/ Revised staff projections based on End-June 1999 Exchequer Returns. The original 1999 budget target for the general governmenbt surplus was 1.7 percent of GDP (see Table 4). The authorities raised the projected general government surplus to 2.3 percent of GDP in February 1999, which corresponded to the primary balance of 4.9 percent of GDP.

Table 4. Ireland: Stability Program (1999-2001)
(As a percent of GDP)

	1998	1999	2000	2001
	Fiscal Projections 1/			
Current surplus:	3.7	4.0	4.6	5.1
Current revenue	35.1	34.5	33.8	33.3
of which:				
Tax revenue	29.3	28.7	28.2	27.9
Social Security Receipts	4.2	4.3	4.1	4.0
Miscellaneous	1.6	1.5	1.5	1.4
Current expenditure	31.4	30.5	29.2	28.1
of which:				
Interest payments	3.7	3.4	2.8	2.5
Goods and services	13.3	13.3	13.0	12.6
Other transfers	14.4	13.8	13.4	13.0
Capital deficit	2.0	2.3	2.8	2.7
Government investment	3.5	3.8	3.8	3.7
Capital resources	1.5	1.5	1.0	1.0
General government surplus before contingency	1.7	1.7	1.8	2.4
Contingency	...	...	0.4	0.8
General government surplus after contingency	1.7	1.7	1.4	1.6
of which primary surplus	5.4	5.1	4.2	4.1
General government debt	59	52	47	43
	Cyclically Adjusted Budget (In percent of potential GDP)			
Potential GDP 2/	7.1	6.9	6.7	6.5
Actual growth in excess of potential	3.8	3.7	3.4	2.7
Cyclically adjusted fiscal balance				
excluding contingency	0.5	0.6	0.8	1.6
including contingency	0.5	0.6	0.3	0.8
	(Percent change from preceeding year)			
Memorandum items:				
GDP	9.5	6.7	6.4	5.8
GNP	8.5	6.0	5.7	5.2
Current account 3/	3.2	1.7	0.1	-0.6
Consumer prices	2.5	2.0	2.0	2.0
Employment	4.6	3.1	2.3	1.7
Unemployment rate	7.8	6.8	6.2	5.9

Source: Department of Finance.
1/ Fiscal projections are based on ESA95 basis.
2/ Annual change in percent.
3/ As a percent of GNP.

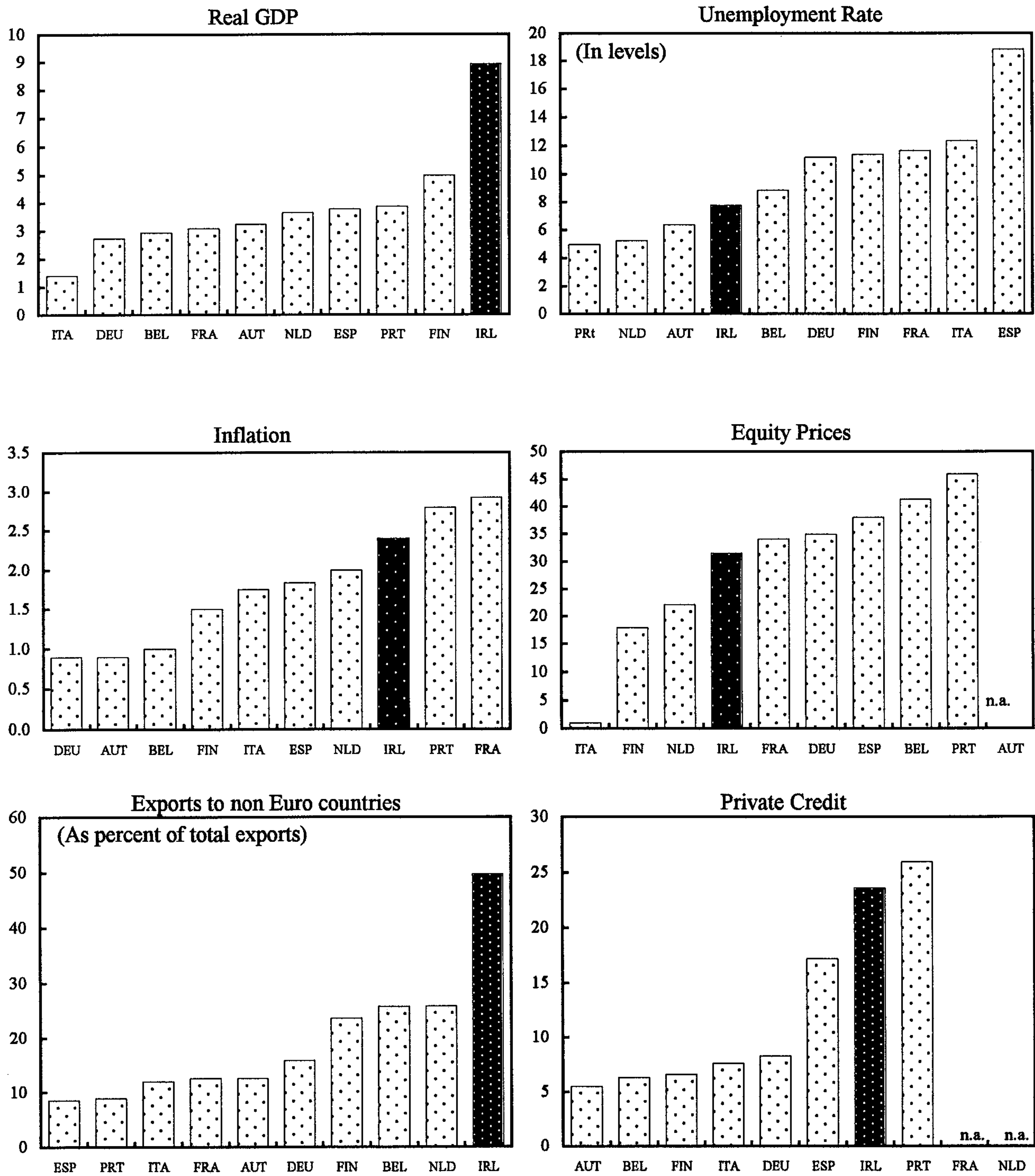
Figure 1. Ireland: Growth and Inflation



Sources: IMF, International Financial Statistics; Department of Finance; Central Bank of Ireland, Quarterly Bulletin; and OECD, Main Economic Indicators.

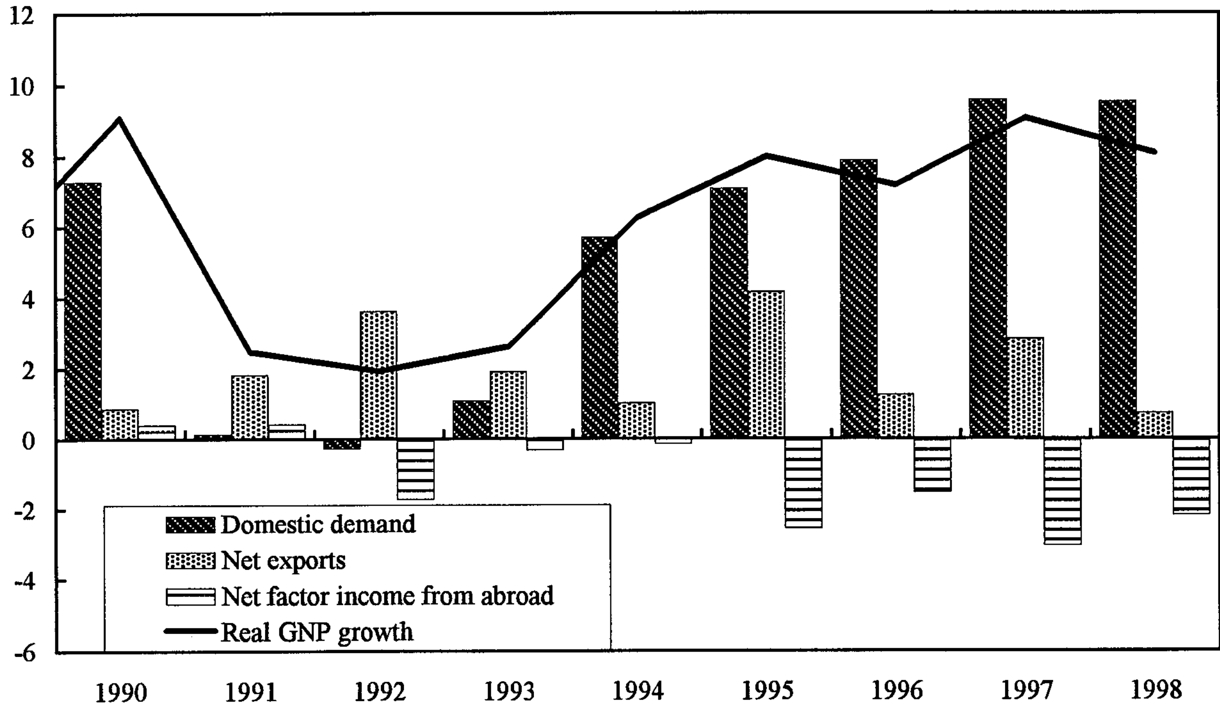
1/ Consumer price index.

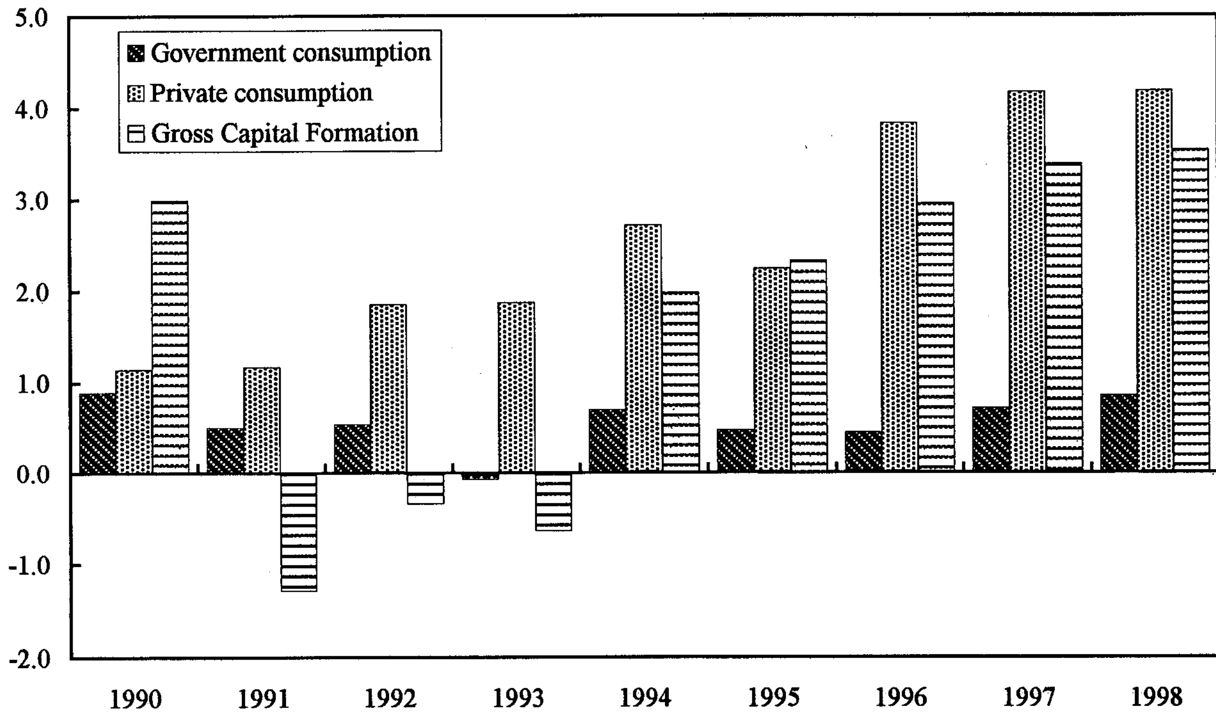
Figure 2. Ireland: Comparisons of Key Indicators with Other Euro Area Countries, 1998
(Growth rates, in percent, unless otherwise indicated)



Source: WEO and staff estimates.

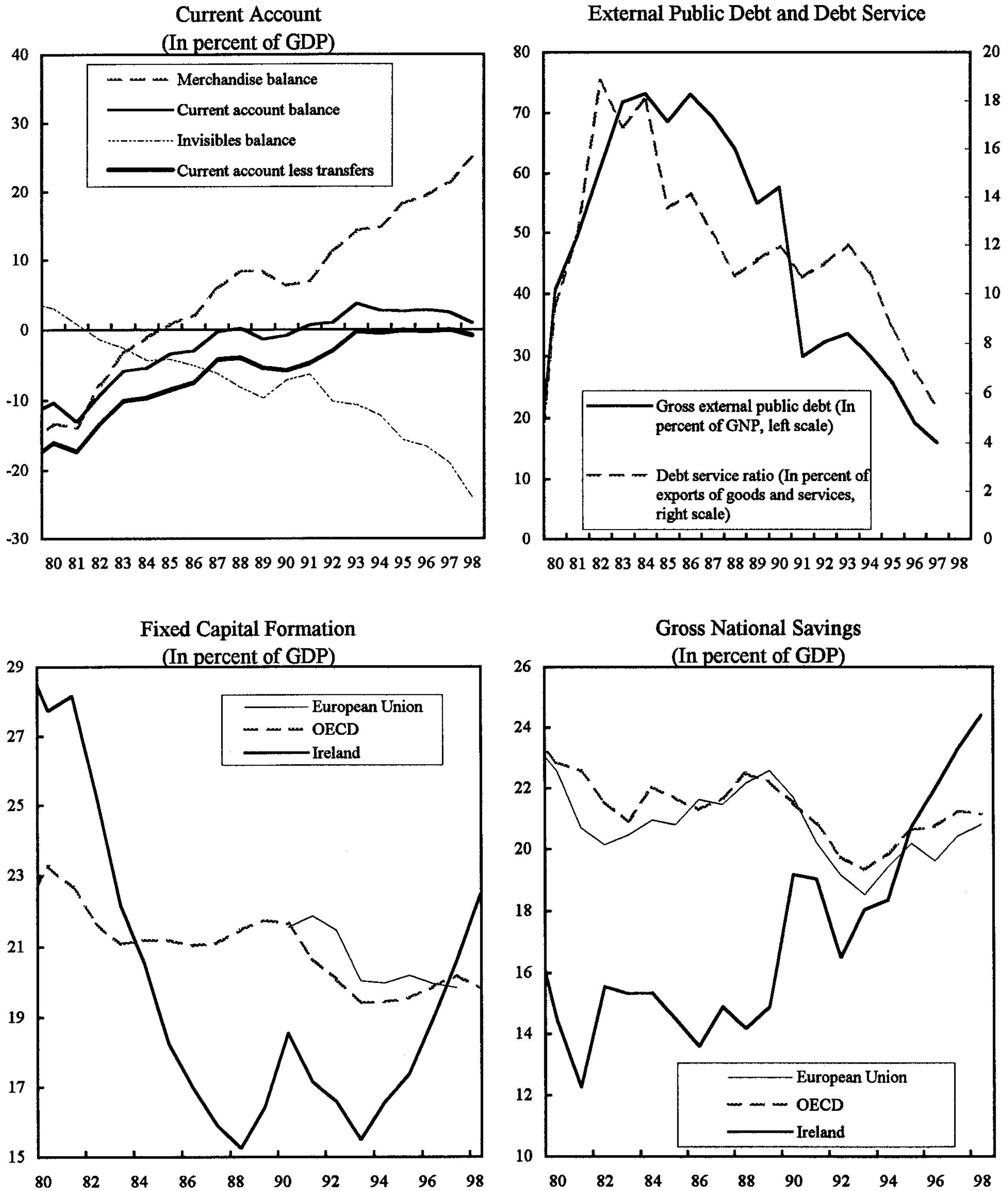
Figure 3. Ireland: Contribution to GNP Growth, 1990-98





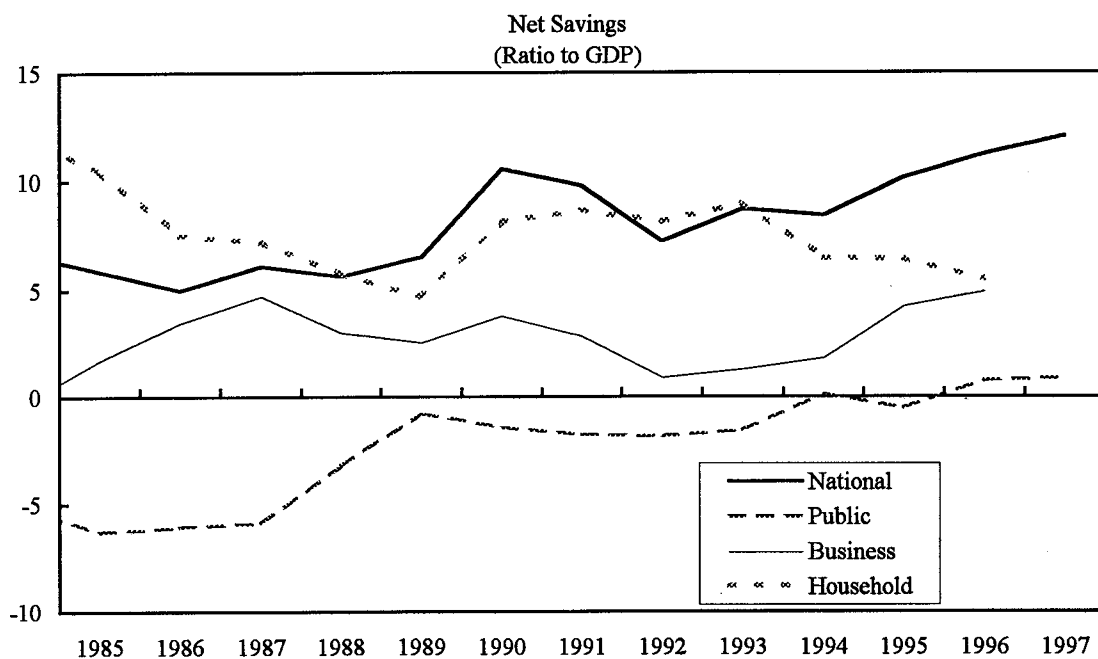
Sources: Central Statistics Office and staff calculations.

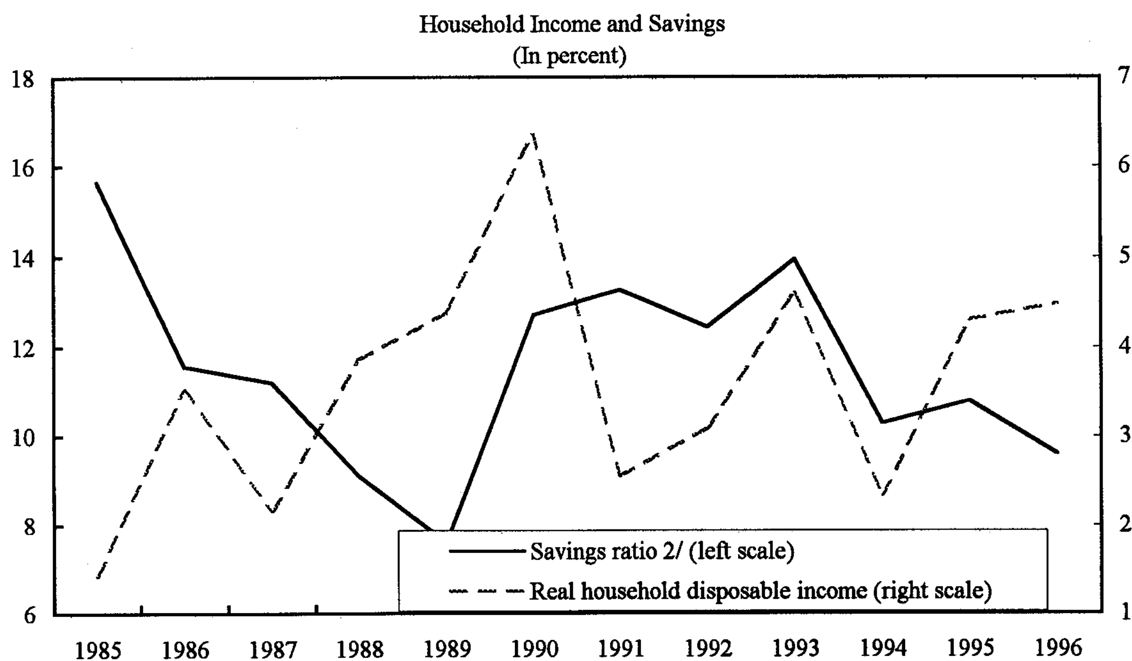
Figure 4. Ireland: Balance of Payments, Saving, and Investment



Sources: IMF, World Economic Outlook; Department of Finance; Central Bank of Ireland, Quarterly Bulletin; and OECD, Quarterly National Accounts.

Figure 5. Ireland: Development in Net Savings, 1985-97 1/



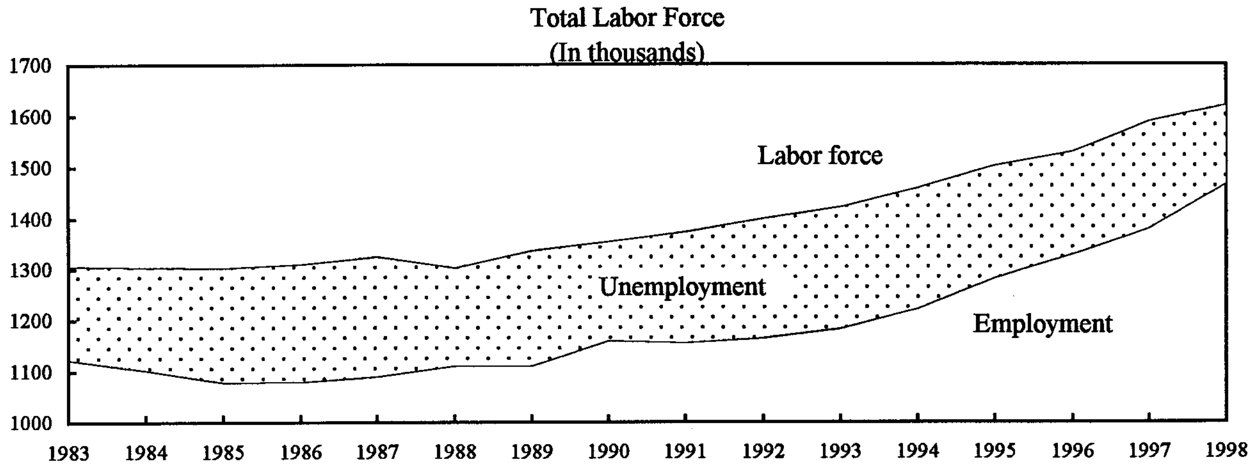


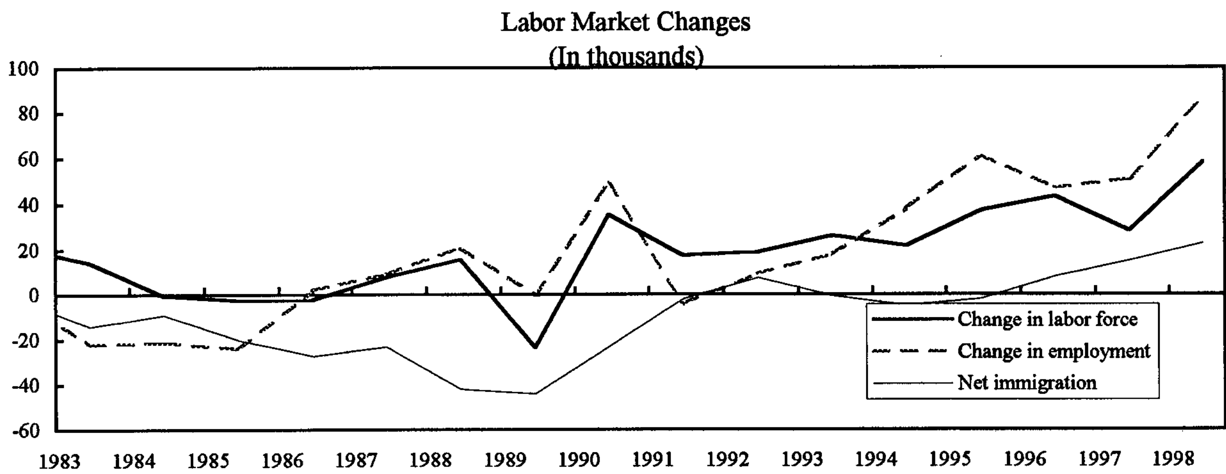
Sources: Central Statistics Office, staff estimates and projections.

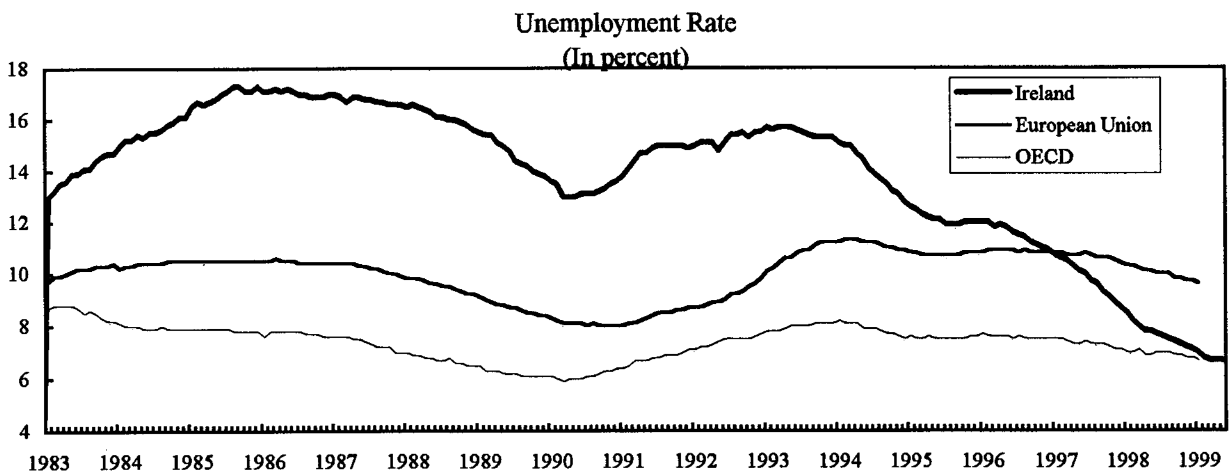
1/ Based on National Income and Expenditure compiled in accordance with ESA79.

2/ The ratio of net household saving as a ratio of disposable income.

Figure 6. Ireland: Employment and Unemployment

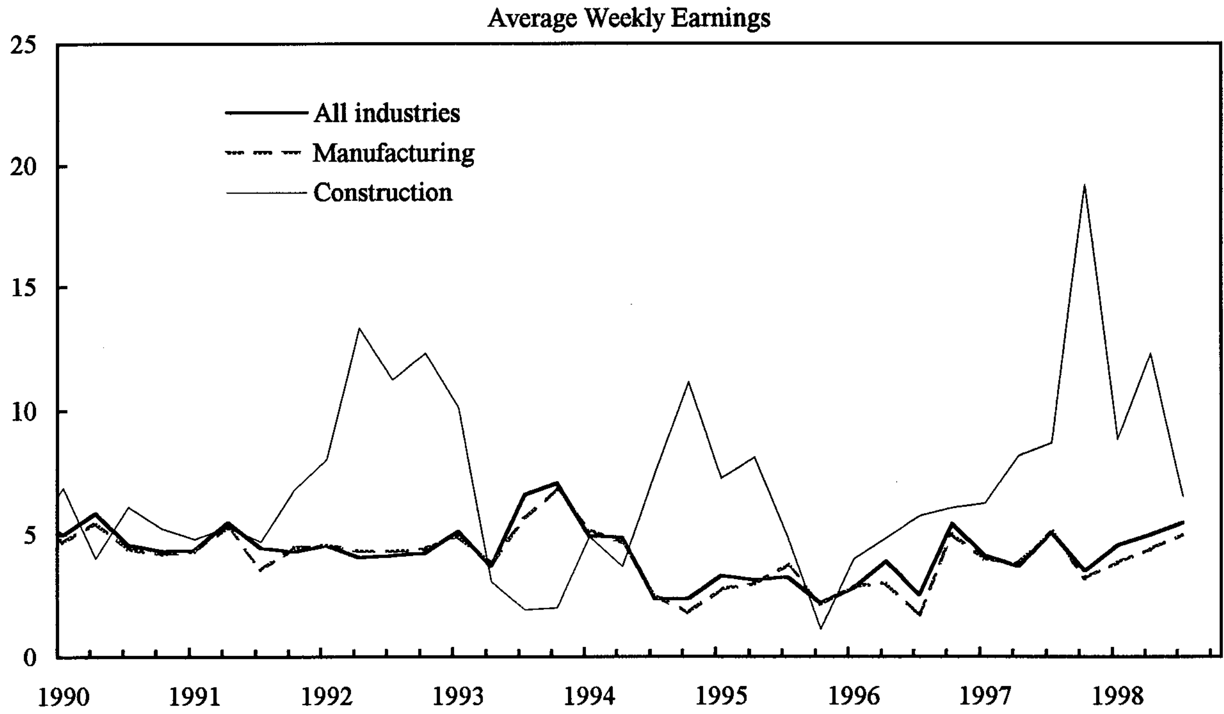


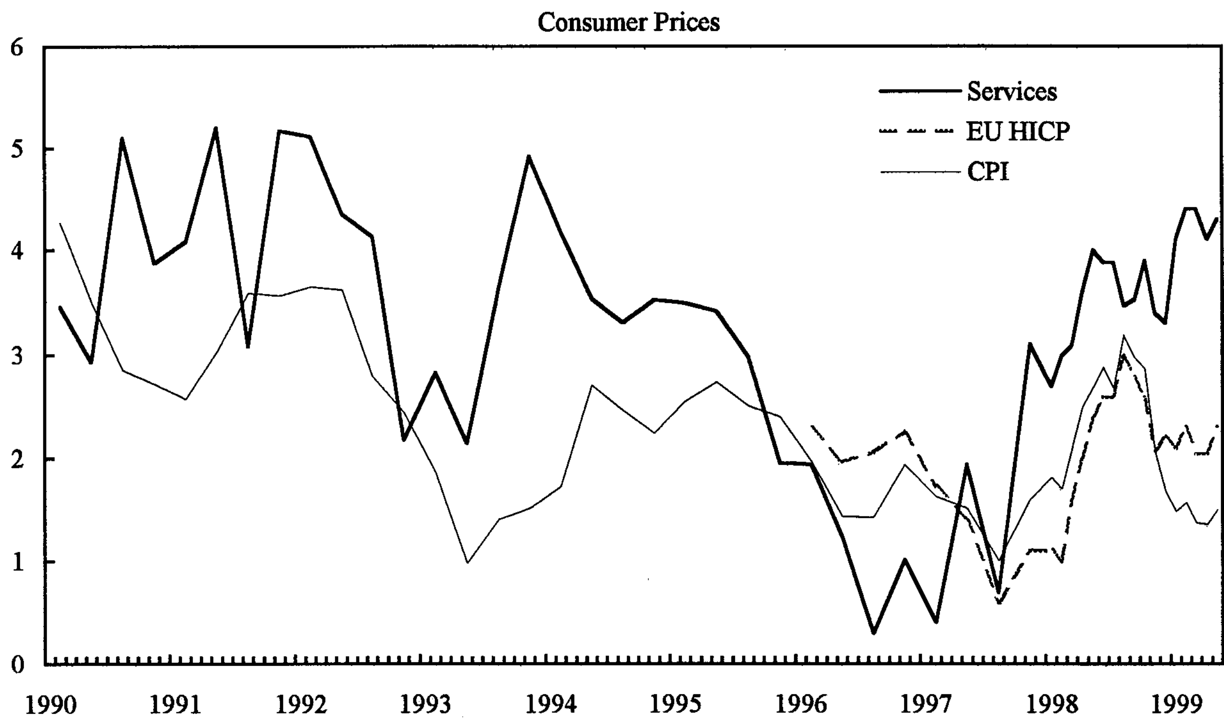




Sources: Central Statistics Office, Census of Population, Labor Force Surveys, and Live Register Statements; and Department of Finance.

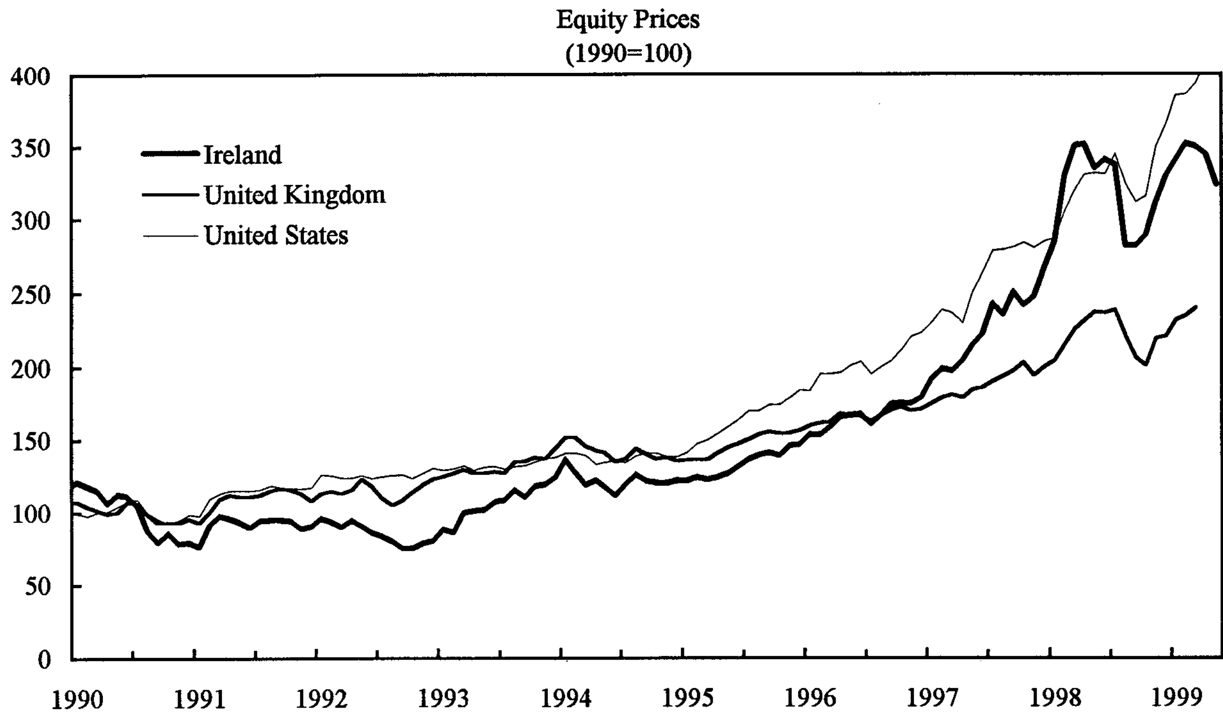
Figure 7. Ireland: Wage and Price Indicators
(Percent change from a year ago)

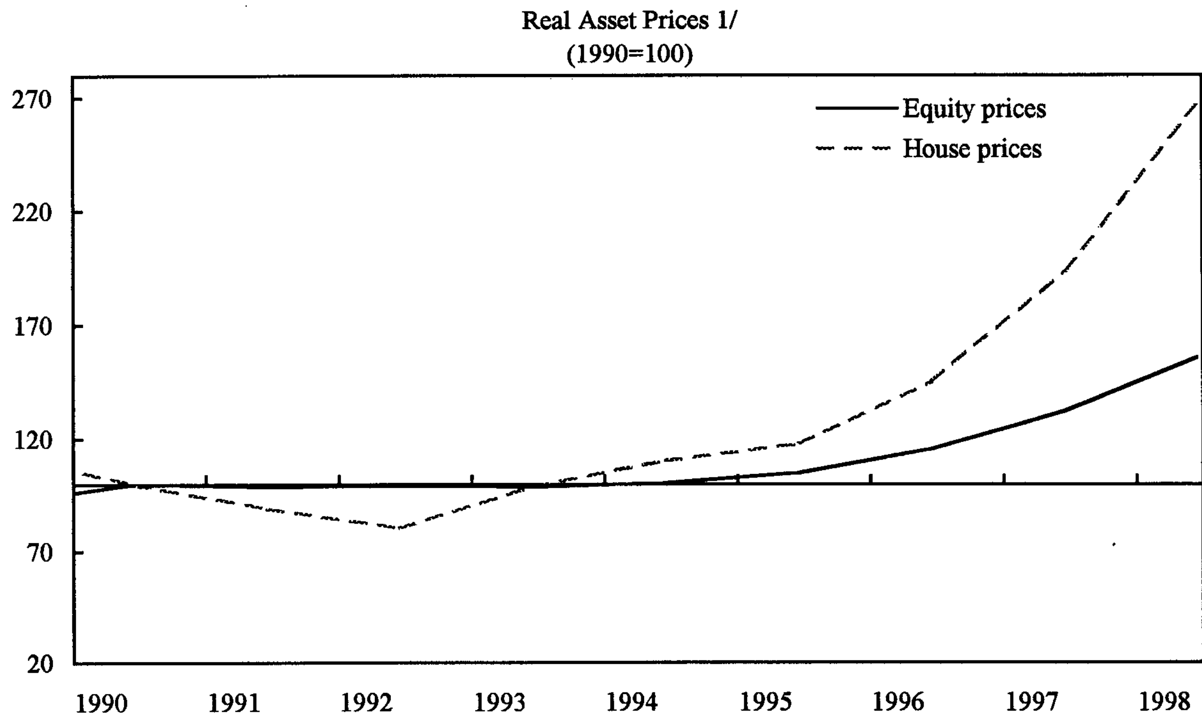




Sources: CSO, Statistical Bulletin; and staff estimates.

Figure 8. Ireland: Asset Prices

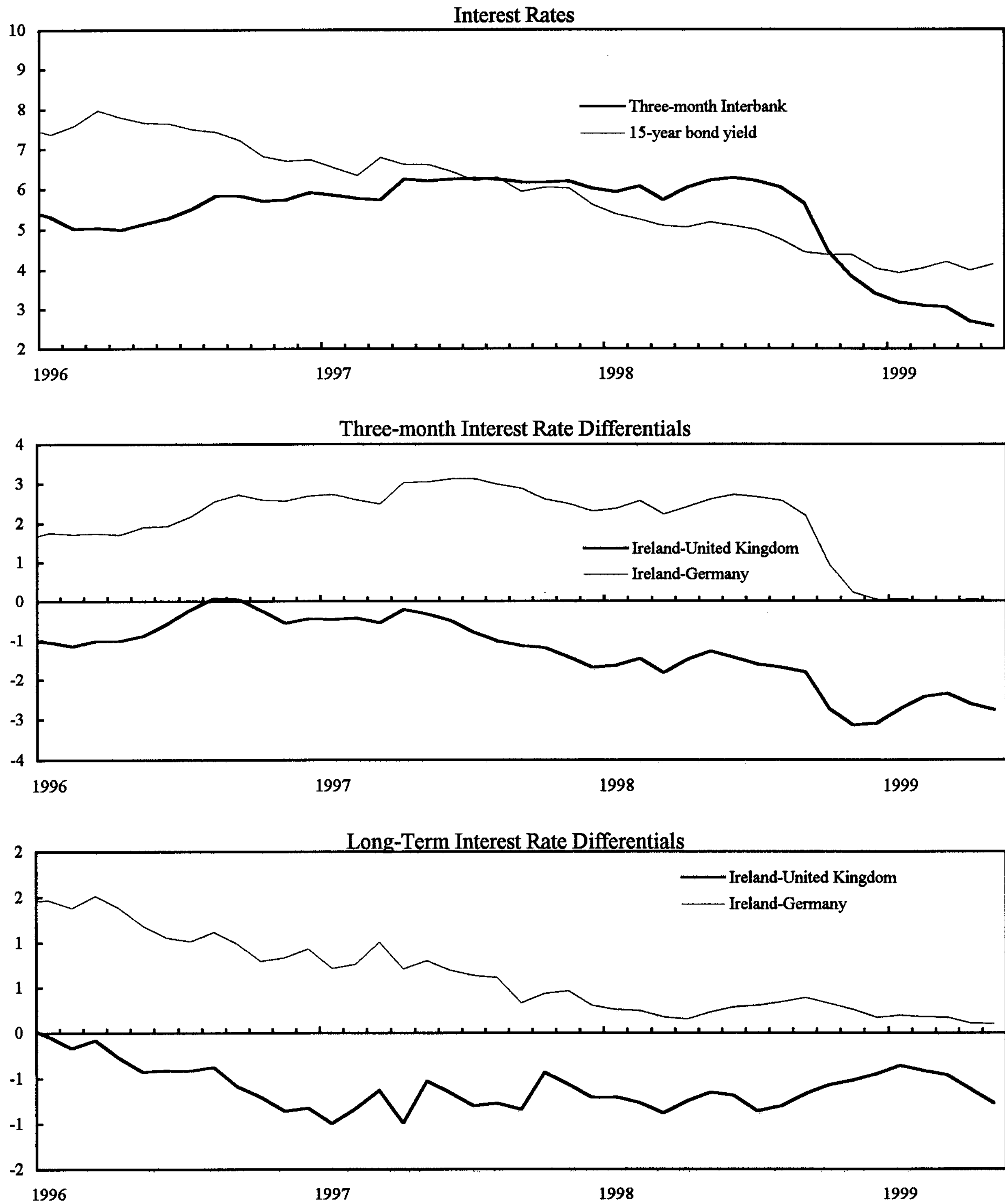




Sources: IMF, International Finance Statistics; and Central Statistics Office.

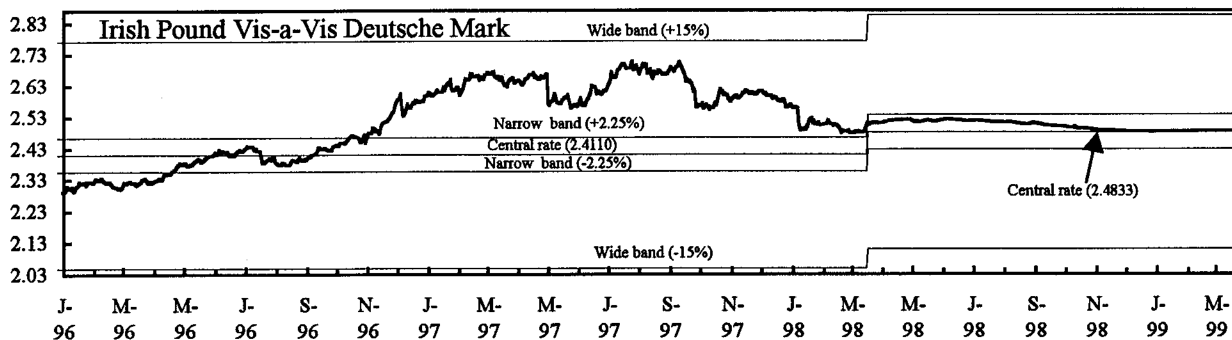
1/ House prices for Ireland refer to new house prices.

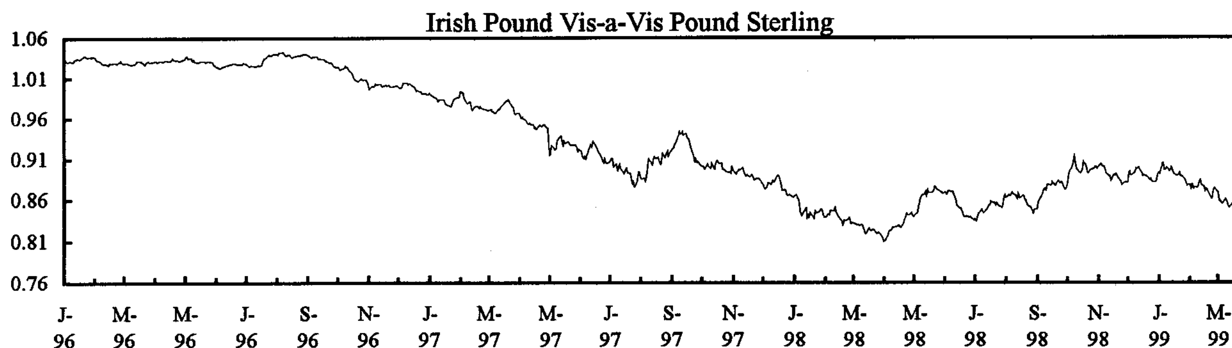
Figure 9. Ireland: Interest Rate Developments, 1990-99

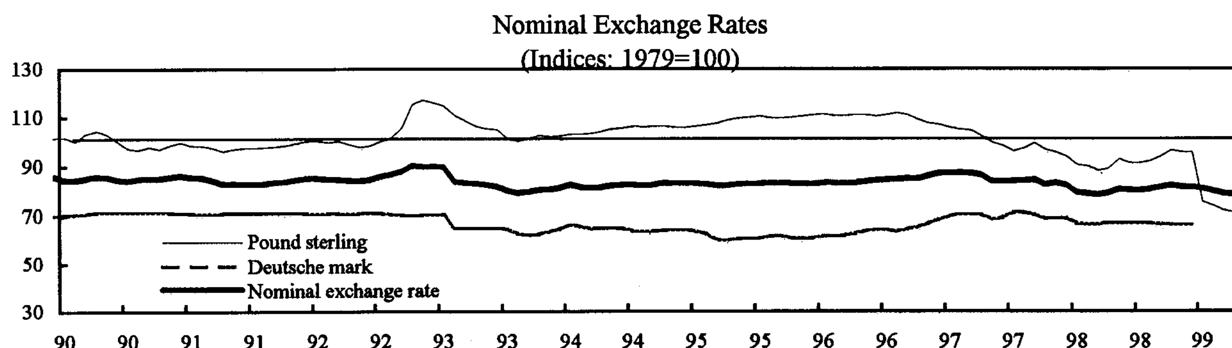


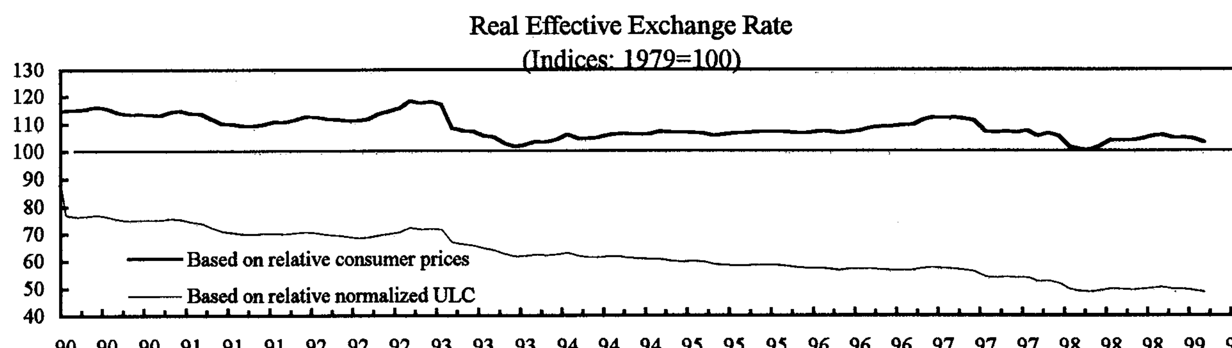
Sources: Central Bank of Ireland, Quarterly Bulletin; and IMF, Surveillance Database.

Figure 10. Ireland: Exchange Rate Developments 1/





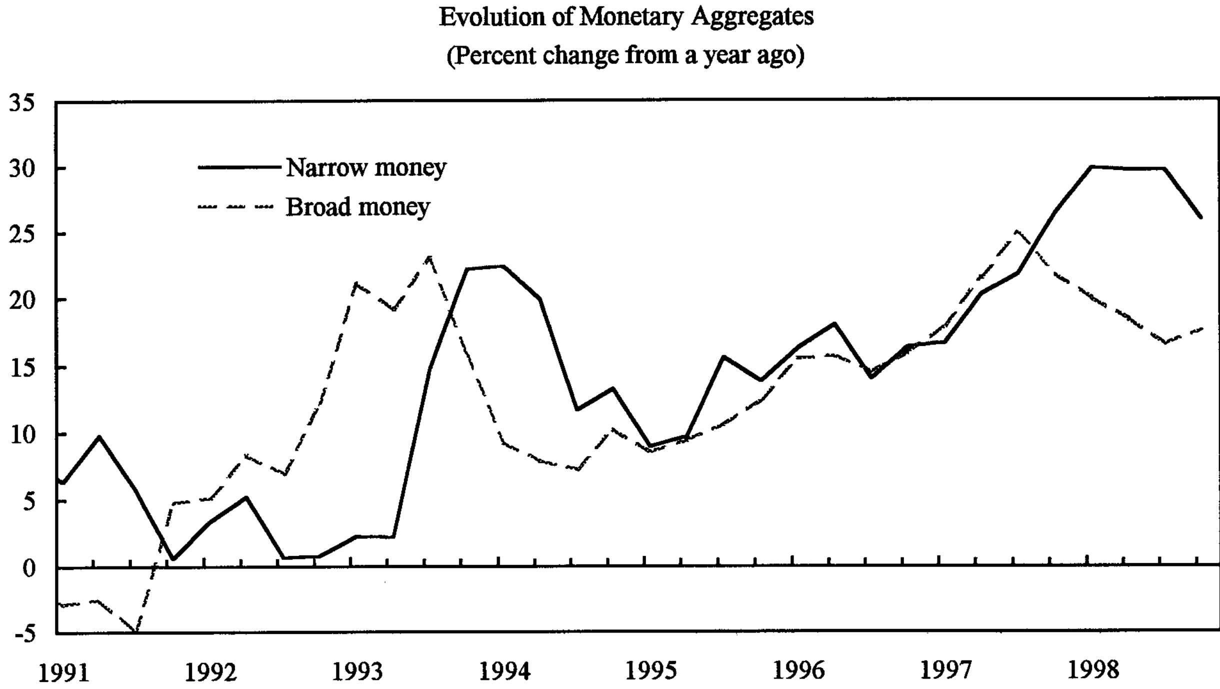


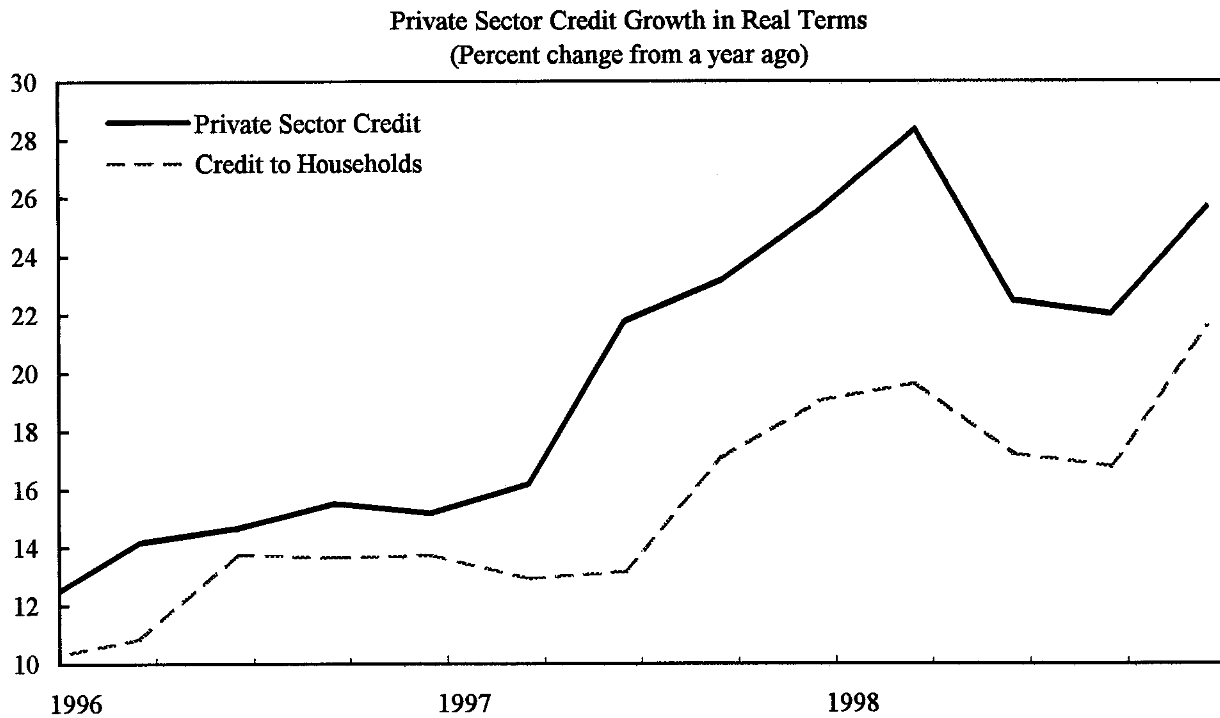


Source: IMF, International Financial Statistics.

1/ Data are expressed in foreign currency units per Irish pound. As of January 1, 1999 the euro is the currency of Ireland, the irrevocably fixed conversion rate between the euro and the Irish pound is 0.787564.

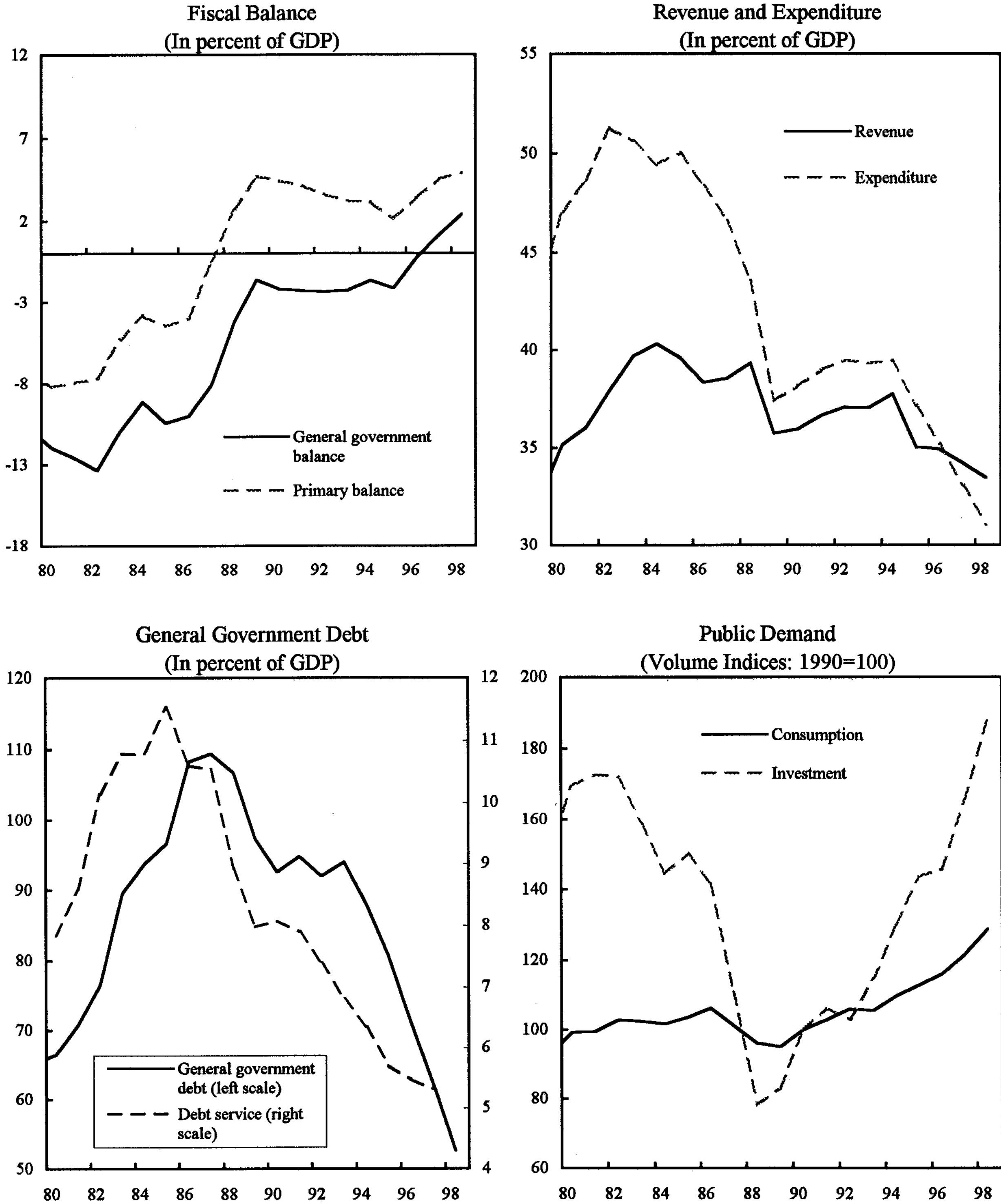
Figure 11. Ireland: Money and Credit Indicators





Sources: IMF, International Finance Statistics; Central Bank, Quarterly Bulletin; and staff calculations.

Figure 12. Ireland: General Government Finances, 1980-98



Sources: Department of Finance, Economic Statistics.

Ireland: Basic Data

Demographic and other data:			
Area:	70.3 thousand square kilometers		
Population (in million)	3.7		
Natural rate of increase (percent change)	0.6 percent		
Infant mortality	0.62 percent		
Population per physician	633		
GDP per capita (SDR)	17,003		
Composition of GDP in 1998 at current prices	In millions of Irish pounds		Distribution in percent
Private consumption	30,689		51.5
Public consumption	7,983		13.4
Total investment (including stockbuilding)	14,186		23.8
Total domestic demand	52,858		88.6
Exports of goods and services	50,305		84.4
Imports of goods and services	43,326		72.6
GDP at market prices (expenditure estimate)	59,637		100.0
Selected economic data	1996	1997	1998
	(Annual percentage change)		
Output and unemployment:			
Real GDP (expenditure estimate)	7.7	10.7	8.9
Manuafacturing production	8.2	16.6	16.9
Average unemployment (in percent)	11.5	9.8	7.7
Earnings and prices:			
Average earnings in manufacturing	2.8	2.9	5.6
Consumer price index	1.6	1.5	2.4
Money and interest rates (end period)			
M3E	15.7	19.1	18.1
3-month Interbank rate	5.9	6.1	3.2
10-year government bond yield	6.6	5.5	4.0
Fiscal accounts:	(In million of Irish pounds)		
General government receipts	15,800	17,734	19,946
General government expenditure	15,920	17,150	18,536
Balance of payments			
Current account balance	1,264	1,283	563
in percent of GDP	2.8	2.5	0.9
Trade balance	8,755	11,071	14,869
Exports	30,723	36,515	45,562
Imports	-21,968	-25,444	-30,693
Services, incomes and transfers (net)	-7,491	-9,789	-14,306
Capital and financial account	-1,182	-3,767	-1,233
Gross reserves			
(billion of SDR, end of period)	5.7	4.8	6.7

Sources: Narional Income and Expenditure; Balance of International Payments; and staff estimates.

Ireland: Fund Relations
As of May 31, 1999

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

II	**General Resources Account:**	**SDR Million**	**% Quota**
	Quota	838.40	100.0
	Fund Holdings of Currency	480.32	57.3
	Reserve position in Fund	358.09	42.7
	Operational budget transfers (net)	3.00	

III	**SDR Department:**	**SDR Million**	**% Allocation**
	Net cumulative allocation	87.26	100.0
	Holdings	24.95	28.6

IV **Outstanding Purchases and Loans:** None

V **Financial Arrangements:** None

VI **Projected Obligations to Fund:** None

VII **Exchange Arrangement**

As of January 1, 1999, the euro became the currency of Ireland; the irrevocably fixed conversion rate between the euro and the Irish pound is 0.787564. Previously, the Irish authorities had maintained a maximum margin of ±15 percent between the Irish pound and the currencies of other countries participating in the exchange rate mechanism of the European Monetary System. Prior to August 2, 1993, this maximum margin had been ±2.25 percent. The Irish pound's central parity was revalued by 3 percent in March 1998.

VIII **Article IV consultations:**
The discussions for the most recent Article IV consultation were conducted in Dublin during June 12-22, 1998. The staff report (SM/98/234) for that consultation was considered by the Executive Board on October 14, 1998 (SUR/98/120). Article IV consultations with Ireland are currently on the standard 12–month cycle.

IX **Technical Assistance:** None

X. **Resident Representative:** None

Ireland: Statistical Annex

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.

1. Ireland has subscribed to the Fund's Special Data Dissemination Standards (SDDS). The Irish authorities began publication of the current account of the balance of payments within three months of the reference quarter. However, the authorities are lagging behind on the adoption of the 1993 System of National Accounts (SNA), and the introduction of quarterly national accounts, both of which had been originally scheduled for early 1999.

2. Information on flows of direct investment, equity, and other capital is provided on a net basis and does not permit monitoring of gross capital inflows and outflows. Moreover, capital and financial account data prior to 1990 were not revised in line with the 1995 Balance of Payments Compilation Guide.

3. While the authorities publish Exchequer returns on a quarterly basis, information on the general government balance is available only annually.

4. Real sector data are sometimes published with a lag of 3-6 months, and in some cases even a year later. Lags are particularly long for unemployment benefits and assistance, employment, earnings, and productivity indicators. Information on unemployment benefits and assistance becomes available 12 months after the reference month, while earnings (including public sector earnings), employment, and the index of unit wage costs, are available with a six-month lag.

Ireland: Core Statistical Indicators
(As of June 1999)

	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 Debt/ Debt Service	GDP/GNP
Date of Latest Observation	June 28, 1999	May 1999	February 1999	April 1999	April 1999	June 28, 1999	April 1999	February 1999	4th quarter 1998	4th quarter 1998	1997	1997
Date Receive	June 28, 1999	mid-June 1999	mid-June 1999	mid-June 1999	mid-June 1999	June 28, 1999	June 17, 1999	June 1, 1999	April 1, 1999	March 1, 1999	March 1999	June 1998
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Quarterly	Annual	Annual
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Quarterly	Annual	Annual
Source of Update	Commercial	Central Bank	Central Bank	Central Bank	Central Bank	Commercial	CSO	CSO	CSO	Dept. of Finance	Central Bank	CSO
Monthly Reporting	On Line	Internet	Internet	Internet	Internet	On Line	On Line/ Diskette/ Publication	On Line/ Diskette/ Publication	On Line/ Diskette/ Publication	On Line	Publication	Diskette 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	Quarterly	Quarterly	Quarterly

Statement by the IMF Staff Representative
August 4, 1999

The following information has become available since the staff report (SM/99/176) was issued on July 14, 1999. This information does not change the thrust of the staff appraisal.

1. The government announced its decision to begin partially funding its future public service and social welfare pension liabilities by making an annual set aside equivalent to 1 percent of GNP, starting in 1999. Details of the proposal (e.g., the management of the funds) have not yet been decided, but the authorities expect the necessary legislation to be in place by the middle of next year. The government has also decided to use a part of the proceeds from the privatization of Telecom Èireann to supplement the 1999 set aside and to fund the Exchequer's pension liabilities with respect to Telecom Èireann and An Post employees, accrued prior to 1984.

2. The government has approved the policy priorities and the general financial framework for the National Development Plan (2000–06). The plan is expected to address national and regional investment needs through a seven-year investment program at an estimated total cost of IR£ 38 billion in 1999 prices. The annual average provision is equivalent to about 8 percent of 1999 GDP, and represents an amount some 25 percent higher than the 1999 level of capital spending. The contribution of EU structural funds is projected to be less than 8 percent of the total cost of the Plan.

3. Consumer price inflation slowed marginally in June. The 12-month increase in the CPI slowed to 1.3 percent in June from 1.5 percent in May, while the EU-harmonized index (HICP) declined to 2.1 percent from 2.3 percent. Service price inflation, however, remained broadly unchanged at around 4.2 percent.

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IMF Concludes Article IV Consultation with Ireland

On August 4, 1999, the Executive Board concluded the Article IV consultation with Ireland.[1]

Background

Ireland's economic performance in recent years has been exceptionally strong. Output and employment have been growing much faster than in the rest of Europe. Real GDP growth averaged 7.5 percent per annum in 1993-98 reflecting a sharp increase in capital accumulation—fueled in part by foreign direct investment—and an expansion of the skilled labor force due to young entrants, increasing female participation, and a reversal of net emigration. Inflation has remained subdued. Public finances have improved significantly and the external current account has remained in surplus.

Economic activity continued to expand robustly in 1998. Business and consumer confidence was boosted by the final advance to EMU. Real GDP is estimated to have grown by almost 9 percent and real GNP by more than 8 percent. Demand has been driven mainly by private consumption, although investment also grew rapidly. The sharp increase in employment was met both by a substantial increase in the labor force and further declines in unemployment. The external current account appears to have weathered the turbulence in world markets relatively well. Although exports continued to grow robustly, strong import growth and a decline in net EU transfers caused the external current account surplus to narrow significantly to 0.9 percent of GDP from 2.5 percent of GDP the previous year.

With the economy expanding above trend for a sixth year in a row, wage and price pressures have begun to mount. Consumer price inflation picked up to 2.4 percent in 1998 (2.2 percent on

[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. In this PIN, the main features of the Board's discussion are described.

an HICP basis), well above the average in the EMU area. The pickup was driven by exchange rate factors and by service price increases reflecting strong wage growth across a broad cross-section of sectors. Although 12-month inflation slowed to 1.3 percent in June 1999, this was mainly due to a sharp fall in mortgage interest rates, rather than to an easing of underlying pressures. Service price inflation continued unabated during the first half of 1999. Asset prices, particularly of houses, have also increased sharply. Rapid increases in housing and equity market wealth are likely to have contributed to strong private spending.

During 1998 and the first half of 1999 monetary conditions eased significantly—initially on the heels of the short-term interest rate convergence to EMU levels and, subsequently, as a result of the interest rate reduction by the European Central Bank (ECB) and the euro's nominal effective depreciation. Private sector credit growth, which has been strong since early 1997, picked up markedly starting in October 1998, coinciding with the decline in short-term interest rates.

Although discretionary fiscal policy measures have tended to impart stimulus to economic activity, the fiscal position continued to improve. The sizeable general government surplus last year reflected mainly the cyclical strength of the economy and lower interest payments. Buoyant tax receipts of the first half of 1999 underpinned by vigorous economic activity are likely to raise the fiscal surplus in 1999 to about 2.7 percent of GDP, notwithstanding reductions in personal and corporate tax rates.

The government's active labor market policies have contributed to lowering the long-term unemployment. A minimum wage is expected to be introduced early next year. The proposed hourly rate of IR£ 4.40 appears high in relation to minimum wage rates in other industrialized countries.

The outlook for 1999 and over the medium term is for output to gradually slow down, as capacity constraints become increasingly binding and labor force expansion tapers off. Rates of economic growth and consumer price inflation, however, would remain higher than elsewhere in the euro area reflecting stronger productivity growth in Ireland.

Executive Board Assessment

Executive Directors commended the authorities for Ireland's impressive and sustained economic performance, which has been marked by vigorous growth and rapidly declining unemployment. The fiscal position has strengthened substantially and the external current account is in surplus. Ireland is well placed to continue its ongoing integration with the economies of the euro area and with global markets.

Directors agreed that the Irish economy was likely to continue to grow rapidly in the short term. They noted that the extent of structural changes added particular uncertainty to estimates of the rate of growth that was sustainable in the long run. Some Directors also noted that some degree of wage and price inflation higher than in the rest of the euro area was acceptable, given a possible initial undervaluation of the Irish pound and faster productivity growth in Ireland.

However, Directors generally agreed that capacity constraints were likely to become more binding than they had been, and that indications of inflationary pressures—in goods, labor, and asset markets—had grown. Against this background, they broadly agreed that a shift of policy emphasis toward containing inflationary pressures was appropriate so as to ensure a basis for the continuation of Ireland's remarkable record of noninflationary growth.

Directors considered that, notwithstanding its long-term benefits, Ireland's membership in the euro area created additional difficulties regarding demand management in the short run. The sharp fall in interest rates associated with joining the euro area had come at a time when demand and wage pressures were already intensifying. Ireland's business cycle was not synchronized with that of the rest of the euro area, resulting in monetary conditions that were not contributing to the containment of inflationary pressures. In these circumstances, most Directors considered that fiscal policy would take on a greater role in stabilizing aggregate demand. Directors agreed that any relaxation of fiscal policy would be inappropriate. A number of Directors went further, and considered that some tightening of fiscal policies would be appropriate in the near term, if inflationary pressures continued unabated. Some other Directors, however, believed that policy adjustments to lower the level of aggregate demand were not called for at the moment. They saw the need, rather, for any measures to be addressed to reducing overheating in particular markets, notably with regard to credit expansion and the real estate market.

Directors generally agreed on the importance of wage restraint in controlling demand pressures. In this connection, most Directors emphasized the importance of restraining public sector wage increases, given the signaling effect on the private sector. Directors noted the contributions which agreements among social partners had made to wage moderation in the past. However, a number of Directors considered that changes in the provisions of national pay agreements may be appropriate given the tightening of the labor market, and specifically that the authorities should be careful not to secure agreements at the price of procyclical tax reductions. Directors encouraged more extensive use of performance-related pay provisions to foster greater relative wage flexibility and to reduce the risk of excessively high across-the-board wage increases.

Directors agreed that a number of issues for fiscal policy need to be considered in the immediate and medium term. In light of current demand pressures, Directors were of the view that further net tax reductions should not be included in the 2000 budget. They also saw a need to place tax reform in a medium-term context and, in this regard, noted that tax rates could be reduced in a revenue-neutral manner if tax bases were increased. Directors also emphasized the need for a fiscal plan to take realistic account of the need for infrastructure spending and its alternative sources of financing; of the declining level of net transfers from the EU; and of future pension commitments. Regarding the latter, Directors encouraged the authorities to seize the opportunity created by the present fiscal surpluses to fund public service and social welfare pensions. They welcomed, in this regard, the authorities' recent decision to make a sizeable annual set aside to partially fund the government's future pension liabilities. Directors also welcomed progress in developing a multiyear budgetary framework, and encouraged the authorities to strengthen this framework further, particularly through the tightening of

expenditure control mechanisms and the incorporation of the recently announced multiannual investment program.

Directors commended the authorities for their active labor market policies, which have contributed to the significant reduction in the unemployment rate. They noted, nonetheless, that challenges remained in tackling the high rate of long-term unemployment. Directors cautioned against setting the proposed minimum wage too high or indexing the minimum wage to earnings in order not to jeopardize efforts to reduce unemployment, particularly among the young and the long-term unemployed.

In light of the rapid growth in credit and strong housing price increases, a number of Directors expressed concern about the risks of an asset price bubble and the potential vulnerability of the banking system. Directors stressed the need to enhance the forward-looking aspects of regulatory policy and, in this regard, welcomed the supervisory authorities' recent initiative to assess the financial system's vulnerability to specified macroeconomic shocks. They felt that a peer review, particularly by supervisors from a country that had undergone a real estate boom, might be helpful.

Directors praised Ireland's continued commitment to raise official development assistance spending, and encouraged the authorities to accelerate progress toward achieving the U.N. target of 0.7 percent of GDP, particularly in view of Ireland's strong fiscal position. Directors welcomed Ireland's support for the HIPC Initiative.

Directors welcomed the authorities' continued efforts to improve the comprehensiveness and timeless of Ireland's statistics, which were broadly adequate in the context of the Article IV consultation and for the purposes of ongoing surveillance.

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. As part of a pilot project, the staff report for the 1999 Article IV consultation with Ireland is also available on the IMF's website (http://www.imf.org).

Ireland: Selected Economic Indicators

	1994	1995	1996	1997	1998	1999 1/
Real Economy (change in percent)						
Real GDP	5.8	9.5	7.7	10.7	8.9	7.5
Real GNP	6.3	8.0	7.2	9.0	8.1	6.9
Domestic demand	5.6	7.0	7.8	9.5	9.4	6.7
CPI	2.4	2.5	1.6	1.5	2.4	2.0
Unemployment rate (in percent)	14.1	12.1	11.5	9.8	7.7	6.5
Gross national saving 2/ 3/	18.9	21.0	22.7	24.3	24.7	25.1
Gross national investment 3/	16.2	18.4	19.9	21.9	23.8	24.5
Public Finance (percent of GDP)						
Exchequer borrowing requirement	-1.8	-1.5	-1.0	-0.5	1.3	1.5
General government balance	-1.7	-2.1	-0.3	1.1	2.4	2.7
General government debt	88	81	71	62	53	46
Money and Credit (end-year, percent change)						
M1	13.2	13.8	16.4	23.6	26.0	...
M3E	10.3	11.6	15.7	19.1	18.1	...
Private sector credit	11.8	11.2	15.4	23.6	23.6	...
Interest rates (year average)						
Three-month balance	6.4	5.5	5.9	6.1	3.2	...
10-year government bond yield	8.8	7.3	6.6	5.5	4.0	...
Balance of Payments (in percent of GDP)						
Trade balance	14.8	18.2	19.4	21.4	24.9	25.5
Current account	2.7	2.6	2.8	2.5	0.9	0.6
Reserves (gold valued at SDR 35 per ounce end of period, in billions of SDRs)	4.2	5.8	5.7	4.8	6.7	...
Exchange Rate						
Exchange rate regime				EMU		
Present rate (July 8,1999)				US$1 = euro 1.015		
Nominal effective rate (1995=100)	99.5	100.0	102.1	102.4	97.1	...
Real effective rate (1995=100, CPI based)	99.4	100.0	101.9	101.6	97.0	...

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

1/ IMF staff projections, except where noted.
2/ IMF staff extimates.
3/ In percent of GDP.