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Ireland, Spring 2015

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Directorate-General for Economic and Financial Affairs

Post-Programme Surveillance Report

Ireland, Spring 2015

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ABBREVIATIONS

AIB: Allied Irish Banks
AT1: additional tier one
BOI: Bank of Ireland
BTL: buy-to-let
CBI: Central Bank of Ireland
CCMA: Code of Conduct on Mortgage Arrears
CET1: common equity tier 1
CGS: Credit Guarantee Scheme
CRD IV: Capital Requirements Directive IV
CRE: commercial real estate
CRR: Capital Requirements Regulation
CSRs: country specific recommendations
DSA: debt sustainability analysis
DTAs: deferred tax assets
EC: European Commission
ECB European Central Bank
EDP: Excessive Deficit Procedure
EFSF: European Financial Stability Facility
EFSM: European Financial Stabilisation Mechanism
ESM: European Stability Mechanism
ESRI: Economic and Social Research Institute
ETBs: Education and Training Boards
EU: European Union
FDI: foreign direct investment
FET: further education and training
GDP: gross domestic product
GP: general practitioner
IBRC: Irish Banking Resolution Corporation
IDR: in-depth review
IMF: International Monetary Fund
INN: international non-proprietary name
IPHA: Irish Pharmaceutical Healthcare Association
ISI: Insolvency Service of Ireland
ISIF: Ireland Strategic Investment Fund
LTI: loan-to-income
LTV: loan-to-value
MART: Mortgage Arrears Resolution Targets
MDPs: multidisciplinary practices
MIP: Macroeconomic Imbalances Procedure
MNE: multinational enterprises
MTO: medium-term objective
NAMA: National Asset Management Agency
NESC: National Economic and Social Council
NFCs: non-financial corporations
NPLs: non-performing loans

NPRF: National Pensions Reserve Fund
NTMA: National Treasury Management Agency
PDH: primary dwelling homes
PIAs: personal insolvency arrangements
PPM: post-programme monitoring
PPS: post-programme surveillance
PTSB: Permanent TSB
QNA: quarterly national accounts
REITs: Real Estate Investment Trusts
RWAs: risk-weighted assets
SBCI: The Strategic Banking Corporation of Ireland
SCP: Stability and Convergence Programme
SGP: Stability and Growth Pact
SME: small and medium-sized enterprise
SP: Stability Programme
SSM: Single Supervisory Mechanism
TFP: total factor productivity
UHI: universal health insurance
UK: United Kingdom
US: United States
VAT: value-added tax
yoy: year-on-year

EXECUTIVE SUMMARY

The Irish economy is rebounding strongly yet the legacies of the crisis still call for determined policy efforts in public finances and financial sector repair. Ireland is among the fastest growing economies in the euro area due to the improved economic environment and a successful domestic rebalancing with policies to strengthen public finances and repair the banks. Ahead of the next parliamentary elections, the challenge is to enhance the public debate on prudent fiscal policies and structural reforms to further reduce high levels of public and private debt and to set the course for balanced and sustainable economic growth. Despite a recent correction in the European bond markets, yields on Irish government bonds remain historically low. Ireland's financing conditions remain comfortable, also benefitting from the European Central Bank's (ECB) asset purchase programme.

While displaying volatility within the year, economic growth was very strong in 2014. Real gross domestic product (GDP) is currently estimated to have grown by 4.8% in 2014 due mostly to net exports, which have benefited from improved competitiveness and strong trade links with the UK and US economies. Growth was uneven throughout 2014, highlighting the persistent volatility of Irish quarterly GDP growth rates. This complicates economic monitoring and policy making. While growth in small open economies tends to be more volatile, recent studies emphasise that the degree of volatility and frequency of revisions to Irish national accounts are high, in spite of longer processing times. More efforts could be made to explore how to better explain volatility and revisions.

The economic recovery is expected to be increasingly driven by domestic demand. From low levels, investment and construction accelerated in 2014, while consumption only picked up towards the end of the year. From 12.2% at end-2013, unemployment has continued to decline to 9.8% in May 2015 and is now well below the euro-area average of 11.1%. Job creation has been across sectors and mostly in full-time jobs. Real GDP is projected to grow at about 3.5% in 2015 and 2016 with a stronger contribution from domestic demand than in previous years. Households should benefit from the growth in employment and wages, subdued inflation, and improving confidence. Upside economic risks stem from the weak euro and strong activity of multinational companies. Downside risks still emanate from continued debt deleveraging, which may dampen the recovery in private consumption, a rebound of energy prices and increased volatility in financial markets.

While public finances continue to improve, the 2016 budget deficit target does not fully take advantage of strong economic growth. Ireland is on track to correct the excessive deficit in 2015, and the gross government debt ratio is also expected to decline after having peaked in 2013. Government contingent liabilities related to the National Asset Management Agency (NAMA) have also declined to 5.5% of GDP in mid-2015, from 18% of GDP in 2009. For 2016, the Stability Programme (SP) targets a deficit of 1.7% of GDP. Compared to previous government plans, and against the backdrop of a very robust growth outlook, the target includes a yet unspecified package of expansionary measures of around EUR 1.2 billion or 0.6% of GDP. Reaping the full benefits of the strong growth momentum would avert the risk of pro-cyclical fiscal policy and create the necessary buffers to address future challenges.

The government's medium-term fiscal strategy still needs to be fully developed. Budgetary plans for 2017 onwards in the 2015 Stability Programme are predicated on current policies, while the Stability and Growth Pact (SGP) requires Member States to present budgetary objectives including a description and quantification of the related measures. Total expenditure is assumed to increase only moderately in absolute terms, against the backdrop of persisting demographic and wage spending pressures. According to the government's projections, debt would decline markedly to well below 90% of GDP in the medium term. The disposal of the government's equity stakes in the domestic banks, valued at 9% of GDP, would further contribute to debt reduction. Until then, and with general government gross debt still well above GDP, debt dynamics remain sensitive to growth and interest rate shocks.

Financial sector reforms continue to advance well, though the durable resolution of non-performing loans (NPLs) requires sustained efforts. As expected, Permanent TSB (PTSB) raised EUR 525 million in capital from the market at the end of April 2015. This was used to cover the capital shortfall identified

in the adverse scenario of the stress test under the ECB's comprehensive assessment. The Irish government also sold PTSB shares to lower its stake from 99.2% to 75%. The capital raise generated strong international investor appetite and bodes well for the ability of the banks to raise capital and a potential state divestment in Allied Irish Banks (AIB). Though declining gradually, NPLs remain high at 23.2% of total loans at end-2014 in the three main domestic banks. Loan restructurings need to accelerate and their sustainability should be continuously monitored. Voluntary engagement between lenders and debtors in addressing primary-dwelling mortgage arrears has improved, but the legal system slows the resolution process of debts. The use of the new insolvency and bankruptcy framework also remains low, though recent government measures aim to address this problem.

Recent mortgage regulations aim to enhance macro-financial resilience, while more needs to be done to improve bank performance and address supply shortages in the property market. Domestic banks' profitability has improved but remains challenged. Given the drag of legacy assets and substantial loan arrears, it is important to allow banks sufficient leeway in setting mortgage interest rates. Still, efforts to promote bank transparency in this area are welcome. It is also important to encourage further competition in the banking sector, especially with upcoming bank privatisations. Mortgage regulation rules are intended to enhance the resilience of households and banks to financial shocks. Though domestic banks are largely not financing the soaring commercial real estate market, additional regulations should be considered here before they do. With supply shortages in Dublin, residential property prices and rents continue to surge. The authorities are undertaking numerous measures to boost housing supply and the construction sector. Policies should aim to increase supply more effectively through raising low private-sector financing to developers and revising planning and development regulations.

Structural reforms continue to advance, though not all at the same pace. Labour activation reforms are almost finalised as contracts for the provision of support services for long-term job seekers will begin soon. The authorities plan to launch reviews of several employment support schemes and of *Intreo* offices to help monitor policy effectiveness. The modernisation of further education and training programmes is progressing. Further efforts are needed to reduce public expenditure on pharmaceuticals and to improve cost effectiveness in healthcare. The prospects for the enactment of the Legal Services Regulation Bill in the near term have improved, though a final push will be needed to get it passed without further delays. This would be an important first step towards the reduction of legal services costs. Irish Water has started sending bills to users, but it is unclear what the level of payment compliance will be. Irish Water is provisionally classified within general government accounts. The situation regarding the company's classification will be clarified at the latest with the publication of Eurostat's *Reporting of Government Deficits and Debt Levels* in October. It will be important to ensure the company has sufficient funding for much-needed infrastructure investment.

Repayment risks for European Financial Stability Mechanism (EFSM) and European Financial Stability Facility (EFSF) loans remain low. Market access conditions for the Irish sovereign remain favourable, following policy actions at national and European levels and due to the strong Irish economy. Moreover, cash buffers of the sovereign remain at comfortable levels. In June 2013, the average maturity of EFSM and EFSF loans to Ireland was extended by seven years. The first principal repayments of the EFSF loans are due in 2029, and the EFSM loans principal repayments are not expected before 2027. Annual interest payments on EFSM and EFSF loans both amount to about 0.6% of GDP. Finally, most outstanding credits to the International Monetary Fund (IMF) have been repaid.

Ireland has made good progress with the 2014 Council recommendations. The specific monitoring of the implementation of the Council recommendations under the Macroeconomic Imbalances Procedure (MIP) relies on post-programme surveillance (PPS). Overall, there has been good progress with the relevant country specific recommendations (CSRs): some progress with addressing the fiscal CSR, substantial progress with the CSR on implementation of training and activation programmes, substantial progress with the CSR regarding measures to boost financing to small and medium-sized enterprises (SMEs) and some progress with the CSR on the restructuring of loans in arrears.

1. INTRODUCTION

Staff from the European Commission (EC), in liaison with the ECB undertook the third PPS review mission for Ireland from 27 April to 1 May 2015. The mission was coordinated with the IMF's post-programme monitoring (PPM) mission. The European Stability Mechanism (ESM) participated in the meetings on aspects related to its own Early Warning System. As the previous time, the Single Supervisory Mechanism (SSM) was also represented in the relevant meetings on Irish banks, with staff from both the ECB and the national competent authority, the Central Bank of Ireland (CBI). PPS aims at a broad monitoring of economic, fiscal and financial conditions with a view to monitoring the repayment capacity of a country having received financial assistance ⁽¹⁾. While there is no policy conditionality under PPS, the Council can issue recommendations for corrective actions if necessary.

In line with the Council conclusions of 2014, the PPS mission encompasses specific monitoring of the adjustment of Macroeconomic Imbalances. Under the 2015 European Semester, the results of the in-depth review (IDR) under the MIP for Ireland confirmed that remaining macroeconomic imbalances require decisive policy action and the specific monitoring of the implementation of MIP-tagged CSRs ⁽²⁾. In general, there has been good progress with the relevant CSRs: there has been some progress with addressing fiscal CSR 1, there has been substantial progress with the CSR 3 on active labour market policies, there have been substantial progress with the CSR 5 regarding improving access to finance to SMEs and there has been some progress with the CSR 6 concerning the restructuring of mortgage loans in arrears. A detailed overview of the progress made with 2014 MIP-tagged CSRs is provided in Annex 1.

⁽¹⁾ PPS is foreseen by Article 14 of the two-pack Regulation (EU) N°472/2013. It started after the expiry of the EU/IMF financial assistance programme and lasts until a minimum 75% of the financial assistance has been repaid. (This may be extended where there are perceived to be financial difficulties or fiscal instability issues.)

⁽²⁾ See Communication from the Commission to the European Parliament, the Council and the Eurogroup: "2015 European Semester: Assessment of growth challenges, prevention and correction of macroeconomic imbalances, and results of in-depth reviews under Regulation (EU) No 1176/2011: http://ec.europa.eu/europe2020/pdf/csr2015/cr2015_comm_en.pdf

2. RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

2.1. RECENT DEVELOPMENTS

Real GDP grew by 4.8% in 2014 in Ireland. Growth was primarily driven by net exports in the first half of the year. Quarterly national accounts suggest that economic growth was exceptionally strong in the first half of the year and decelerated markedly in the second half, underscoring once again the volatility of Irish GDP data (Box 2.1 discusses the volatility and revisions of quarterly national accounts). Ireland benefitted from its improved competitiveness — with a weaker euro, the real effective exchange rate depreciated by 5% in 2014 and by 21% since 2008 ⁽³⁾ — and strong trade links with the more dynamic United Kingdom (UK) and United States' (US) markets. Economic growth was also supported by a sizeable contribution from multinational enterprises (MNE), most notably by pharmaceutical companies whose exports recovered after the expiration of patents in 2013. As a result, total exports grew by 12.6% in 2014 in real terms. However, a substantial proportion of this increase in exports was due to contract manufacturing which has less impact on tax revenues and jobs in Ireland than indigenous production ⁽⁴⁾. Imports, which include the inputs used in contracted production, accelerated with a lag towards the end of the year ⁽⁵⁾ with the net effect of contract manufacturing ultimately washing out in yoy terms. The annual national accounts for 2014 and quarterly figures for the first quarter of 2015 were not available at the cut-off date for this report.

Investment and construction accelerated strongly and consumption picked up towards the end of 2014. Gross fixed capital formation grew by 11.3% in 2014, as Ireland continued to attract foreign direct investment (FDI) flows from multinationals. Construction investment started to pick up from low levels, posting an increase of 11.2% year-on-year (yoy) in the final quarter of 2014.. Despite positive high-frequency indicators, household consumption remained flat in the first three quarters of 2014 and only started to grow at the end of the year. This was partly the result of high consumption deflators on the back of increasing imputed rents for owner-occupied dwellings. Yet, it may also be indicative of the difficulties faced by highly-indebted households. While net exports had driven GDP growth in the first half of 2014, by year-end, the contributions of domestic demand and the external sector were balanced.

The property markets, both residential and commercial, have continued to recover with some regional variation. Residential prices rose by 15.8% yoy in April 2015 but were still 38% below their 2007 peak (Graph 2.1). While price increases are significant, there is no strong evidence of overvaluation when compared with standard indicators (price-to-income and price-to-rent ratios) or regression-based equilibrium property price estimates ⁽⁶⁾. The number of transactions is still low and about half of all transactions are in cash as mortgage lending remains weak. The lack of housing supply in Dublin has supported rapid price increases but the recovery in prices has spread to other areas of the country, most notably the other urban centres and commuter counties ⁽⁷⁾. Although residential construction output increased 35.8% yoy in the final quarter of 2014, new residential construction in 2014 stood at just 12% of its pre-crisis peak. Supply constraints are also evident in the residential rental market where the annual increase in rents was 9.6% in Dublin and 5.8% nationally in 2014 ⁽⁸⁾. Commercial capital values

⁽³⁾ This is defined at the real effective exchange rate using a deflator based on unit labour costs in the total economy, and 37 trading partners. Source: Eurostat.

⁽⁴⁾ Contract manufacturing refers to the situation where a firm operating in Ireland outsources manufacturing to an offshore firm operating under contract. This strategy has become increasingly popular with MNEs operating in Ireland.

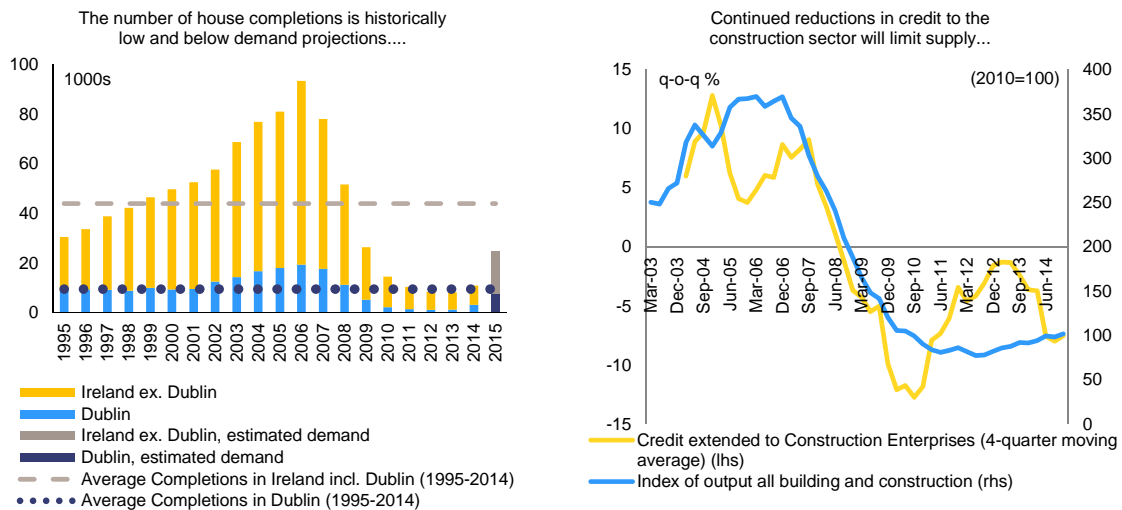
⁽⁵⁾ Inputs to contract manufacturing are booked as Irish imports even if they never enter Ireland. In 2014, it is understood that MNEs booked most imports in relation to contract manufacturing in the second half of the year while exports linked to contract manufacturing soared mostly on the first half.

⁽⁶⁾ The equilibrium house price estimates, based on Langedijk and Tatar (2014), indicate substantial variability in the estimated level of over- or under-valuation depending on the specification employed. Indeed, the credit imbalance adjusted estimate still suggests some undervaluation, in contrast to the majority of specifications.

⁽⁷⁾ However, data from Daft.ie indicate that, contrary to the pattern observed in recent years, the annual increase in asking prices observed in Dublin (+3%) was lower than in the rest of Ireland (+6%) in the first quarter of 2015.

⁽⁸⁾ This compares to annual increases of 7.0% in Dublin and 2.9% nationally in 2013, according to the Private Rented Tenancies Board [Rent Index](#).

Graph 2.1: Developments in the construction sector



Source: Department of Environment, Community and Local Government. Estimated demand based on Morgenroth (2014) and Duffy et al. (2014). CSO and Central Bank of Ireland.

increased by 30% and commercial rents by almost 20% in 2014⁽⁹⁾. International investors have contributed to the rapid rise in the volume of commercial property transactions while multinational technology firms were a notable source of demand for additional office space in Dublin.

Real Estate Investment Trusts (REITs) have become important financing vehicles for commercial property and less so for housing. There are three REITs currently operating in Ireland, holding property assets of a combined value of approximately EUR 1.8 billion or around 1% of GDP⁽¹⁰⁾. A large portion of investment in Irish REITs has come from overseas, primarily from US mutual funds and the UK, seeking exposure to the Irish economic recovery. REITs have become an important channel through which foreign capital can enter the Irish property market. So far REITs have primarily focused on purchasing or refurbishing existing properties.

Despite falling unemployment, inflation remains low. Job creation continues across most sectors with the largest increases in construction and real estate services. Construction employment stood at 122,000 in the first quarter of 2015, a rise of 19.1% yoy, but still well below the peak of 276,000 in 2007. Most new jobs are full-time positions while part-time employment continued to decline. Total employment grew by 2.2% yoy in the first quarter of 2015. The unemployment rate fell to 9.9% in the same period, down from 12.0% a year earlier. The number of long-term unemployed increased slightly in the first quarter of 2015 and remained high at 59.8% of total unemployment. At the same time, the number of young people unemployed fell by 22% yoy. Labour force participation remains fairly stable despite the economic recovery. Average weekly earnings decreased by 0.9% in the first quarter of 2015 following moderate salary increases in the last quarter of 2014. Inflation remains mild, following the large falls in oil prices, and was below the euro-area average. In May 2015, the HICP increased by 0.5% mom and by 0.2% yoy, though core inflation was up by 1.1% yoy, led by sustained increases in services prices.

Public finances improved in 2014 as a result of consolidation efforts and a stronger-than-expected economic recovery. The general government deficit narrowed to 4.1% of GDP, well within the EDP ceiling of 5.1% of GDP. As total revenue grew broadly in line with GDP, the improvement of the deficit

⁽⁹⁾ The capital values refer to those provided by the Society of Chartered Surveyors/Investment Property Databank Irish Commercial Property Index and are based on a portfolio of retail, office and industrial properties located primarily in Dublin.

⁽¹⁰⁾ According to financial statements from the Green, Hibernia and IRES REITs currently operating in Ireland.

ratio mostly originates from the expenditure side of the budget. Compared to the previous year, current expenditure remained flat in absolute terms while capital expenditure increased. The transition to the new ESA 2010 methodology improved the deficit ratio by around 0.4% of GDP. Nonetheless, the 2014 deficit outturn is higher than the 3.7% of GDP projected in the 2015 Draft Budgetary Plan. This is mainly due to higher spending on health compared to plans ⁽¹¹⁾, and statistical reclassifications such as the provisional inclusion of Irish Water into the general government sector (0.2% of GDP) and the spreading of revenues from the sale of the National Lottery licenses over two decades ⁽¹²⁾. Consequently, total expenditure increased by 0.4% of GDP compared to the Draft Budgetary Plan, split between statistical reclassifications and additional spending. In 2014, the general government debt-to-GDP ratio declined for the first time since 2006 to 109.7% from the peak of 123.2% of GDP in 2013. Almost half of this reduction reflects the liquidation of the Irish Banking Resolution Corporation (IBRC) ⁽¹³⁾.

In cash terms, public finances continued to record better-than-anticipated results through end-May 2015. In the first five months of 2015, the cumulative exchequer cash deficit (excluding transactions not impacting the general government balance) was EUR 2 billion (1.0% of GDP), 45% lower than planned in the budget. The improvement was mainly driven by higher-than-planned increased tax and non-tax receipts. On the back of robust economic growth and tax cuts included in the 2015 budget, tax revenues amounted to EUR 17.3 billion, 4.4% above budget plans. However, two thirds of this over-performance is due to strong corporation tax receipts (at 46.5% above budget plans) which tend to be volatile. VAT receipts were around 1.6% above plans. Surpluses from the central bank, which are normally remitted to the central government once a year in May, amounted to EUR 1.7 billion, or 22% above budget plans ⁽¹⁴⁾. May data also indicate that total spending was 0.5% below plans, mainly on account of capital expenditure. Due to lower-than-expected market interest rates, interest expenditure was 6.1% below budget plans by end-May.

Market conditions have remained largely favourable for the sovereign, in part supported by the ECB's asset purchase programme. In March 2015, the National Treasury Management Agency (NTMA) issued EUR 1 billion of 30-year bonds at a record-low yield of 1.31%. Further auctions were completed in May and June respectively: EUR 750 million of seven-year bonds were issued at a yield of 0.81% and EUR 750 million of 15-year bonds at a yield of 2.22%. Treasury-bill yields turned negative in March 2015 when Ireland issued EUR 500 million at a yield of -0.01%. The prolonged decrease in the ten-year Irish government bond yields underwent an upwards correction in the spring, in line with the euro-area bond market. In early June, the yield on ten-year bonds was 1.65%, 100 basis points higher than the low reached in April 2015. After hitting a low of around 50 basis points in mid-March, the Irish ten-year spread over German bonds has widened to about 85 basis points. In June, Standard & Poor's raised Ireland's long-term sovereign credit ratings to A+ from A.

The domestic banks have had successful market issuances in 2015 and their credit ratings were upgraded. AIB and Bank of Ireland (BOI) issued covered bonds at yields of 0.75% and 0.53%

⁽¹¹⁾ Overall, ministerial spending was EUR 1.0 billion (around 0.6% of GDP) above target in 2014. Part of this additional expenditure - around 0.2% of GDP - was not known at the time of the Draft Budgetary Plan. Unlike previous years, the overspending has not been offset by savings in other departments. To fund the overspending the government submitted to parliament a supplementary budget in early December 2014. Apart from additional resources for health care, other extra spending was allocated to transport (EUR 162 million), education (EUR 103 million), justice (EUR 85 million) and environment (EUR 34.7 million).

⁽¹²⁾ The sale of the National Lottery Licences took place on 30th November 2014 and revenues were originally included in the 2015 Draft Budgetary Plan as deficit-reducing capital transaction. As the licence holder was unable to sell the permit to a third party, receipts were reclassified as "other taxes" and spread over the 20-year life of the licence (about EUR 20 million per year).

⁽¹³⁾ With the transition from ESA 95 to ESA 2010, IBRC (which was created to effectively wind down the former Anglo Irish Bank and the Irish Nationwide Building Society) became part of general government and retroactively raised the level of general government debt in percent of GDP. However, the liquidation of IBRC initiated in early 2013 reverses this effect.

⁽¹⁴⁾ Such unexpected profit primarily reflects the realised capital gains (around EUR 720 million) on the partial sales of the 5.4% Irish Government Bond 2025 and the 2038 Floating Rate Notes (FRN), bonds which were used to replace the Promissory Notes as part of the liquidation of the Irish Bank Resolution Corporation (IBRC). Surpluses from these realised capital gains should not impact the General Government balance.

respectively, and AIB issued a five-year senior unsecured bond at a yield of 1.38%. In December 2014, Standard & Poor's upgraded BOI's outlook while Moody's upgraded AIB's debt and deposit ratings. Moody's also upgraded both AIB's and BOI's credit ratings as well as PTSB's deposit and senior unsecured ratings in May 2015. Following this, PTSB raised EUR 300 million in three-year unsecured debt for the first time in eight years. Moody's also upgraded the outlook for Ireland's banking system from negative to stable in March 2015. However, in May 2015 Fitch downgraded AIB, BOI and Ulster Bank's issuer default ratings as it believes that regulatory and policy changes (in particular, on account of the implementation of the European Union's (EU) bank resolution legislation) over the last year have reduced the probability of sovereign support for the banks.

In 2014, BOI and AIB recorded their first full-year return to profitability since the crisis, while losses at PTSB decreased. The 2014 results for the three domestic banks have shown the continuation of favourable trends in profitability, though it remains fragile and was partly due to one-off effects such as provision write-backs and revaluation of NAMA bonds (Graph 2.3). Lower funding costs and improvements in asset quality due to a rise in the value of collateral ⁽¹⁵⁾ also helped improve the banks' performance (Table 2.1). Some banks reported a smaller tracker mortgages' drag on their profits due to loan expiration, borrowers moving houses and switching loan products to fixed or variable-rate. The capital positions strengthened further supported by the improved profitability and due to the decline in risk-weighted assets (RWAs) stemming from continued balance sheet contraction. On the funding side, the loan-to-deposit ratios have continued to fall. The domestic banks have also further reduced their reliance on central bank liquidity, to about 4.9% of total assets at end-2014, from a peak of 21.4% in March 2011. Liquidity indicators are improving, albeit with differences among banks ⁽¹⁶⁾.

Table 2.1: Domestic banks' end-2014 performance

	AIB		BOI		PTSB	
	2013	2014	2013	2014	2013	2014
Profit / loss for the year (in EUR million)	-1597	915	-486	786	-261	-102
Return on assets (RoA)	-1.4%	0.9%	-0.4%	0.6%	-0.7%	-0.3%
Return on equity (RoE)	-15.2%	7.9%	-6.2%	8.9%	-10.9%	-4.6%
NIM (1)	1.4%	1.7%	1.8%	2.1%	0.8%	0.9%
Non-performing loans (NPL) ratio	34.9%	29%	18.5%	16.0%	27%	26%
Coverage Ratio	55%	51%	48%	52%	47%	48%
Common equity tier 1 (CET1) ratio, transitional	15.0%	16.4%	12.3%	14.8%	13.4%	14.2%
Common equity tier 1 (CET1) ratio, fully loaded	10.5%	11.8%	9.0%	11.9%	10.9%	12.4%
Common equity tier 1 (CET1) ratio, fully loaded (2)	n/a	5.9%	6.3%	9.3%	n/a	n/a
Liquidity Coverage ratio (LCR)	105%	116%	n/a	98%	n/d	n/a
Net Stable Funding ratio (NSFR)	95%	112%	n/a	114%	n/d	n/a
Loan to deposit ratio (LDR)	100%	99%	114%	110%	151%	138%

(1) before Eligible Liability Guarantee fees

(2) excluding preference shares

Source: banks' end-year reports

There has been progress in the reduction of NPLs but their level remains among the highest in the euro area. Total NPLs accounted for 23.2% of total loans in the three main domestic banks at the end of 2014, down from 25% in the previous three months and from a high of 27.1% at the end of 2013, resulting from a combination of restructuring and asset disposals. Commercial portfolios remain heavily impaired. Domestic banks' commercial real estate impaired loans have declined to about 50% of total loans and SME/corporate impaired loans to about 20% of all loans. The average provisioning coverage ratio on total NPLs for the three main domestic banks was a solid 51.7% at end-December 2014. The CBI reported that the outstanding balance of all mortgages in arrears of over 90 days continued decreasing to

⁽¹⁵⁾ The "peak-to-trough" property price assumptions in banks' provisioning models have resulted in increases in collateral values, allowing the banks to reduce their impairment provisions.

⁽¹⁶⁾ The average liquidity coverage ratio (LCR) for domestic banks was 110% at end-2014, compared to 92% at end-2013. The net stable funding ratio (NSFR) increased from 96% to 110% over the same period.

17.1% of total mortgages in the first quarter of 2015, from a high of 19.9% in the third quarter of 2013 (Box 2.2). By contrast, the share of long-term mortgage arrears (over two years) continued to increase to 58.3% of the total arrears balance in the first quarter of 2015 and was particularly high for buy-to-let (BTL) mortgages (Figure 3). The use of rent receivership (as an alternative to repossession) means that the decline in the stock of BTL arrears will be slow (Section 3.2.1). The high level of long-term arrears signals that banks are still having difficulty solving the toughest arrears cases, though the rate of increase of long-term arrears has slowed.

Mortgage Arrears Resolution Targets (MART) were met at the end of 2014. Starting in 2013, the main six banks had been required to meet quarterly targets on offered and concluded restructuring solutions for customers in mortgage arrears (Table 2.2). At end-December 2014, 52% of the solutions proposed by the banks involved restructuring and 47% loss of ownership, while amongst the concluded solutions, 60% involved restructures. The vast majority of the concluded solutions (91%) were meeting their restructuring terms in the final quarter of 2014. Personal insolvency cases are still rare, at about 1% of the solutions proposed and concluded. Although banks have stepped up their repossession efforts over the past year for cases where no durable restructuring solution could be concluded, the overall number of properties repossessed is still low: at the end of March 2015, the lenders had 2349 properties in possession, with the majority being voluntarily surrendered. Legal proceedings remain characterised by numerous adjournments and a large number of pending cases. This results in an average of 50 weeks (70 weeks in Dublin) for procedure completion and a further 12-18 weeks for the property to be vacated following the granting of the order for possession. As banks also initiate court proceedings in order to comply with the MART targets and as a tool to re-engage with the debtors, negotiations on mortgage restructuring often continue while the cases still appear as pending in courts.

Table 2.2: Mortgage arrears restructuring targets

	Status	Total	Target
Q1 2014	proposed	77%	70%
	concluded	34%	25%
	meeting terms	91%	75%
Q2 2014	proposed	87%	75%
	concluded	45%	35%
	meeting terms	91%	75%
Q3 2014	proposed	94%	80%
	concluded	55%	40%
	meeting terms	91%	75%
Q4 2014	proposed	98%	85%
	concluded	62%	45%
	meeting terms	92%	75%

Source: Central Bank of Ireland

Net bank lending to the private sector continued to decrease as credit demand remained subdued.

Net lending by banks to Irish resident non-financial corporations (NFCs), in decline since late 2009, decreased by 8.7% yoy in April 2015, as repayments continue to outpace new lending. Similarly, outstanding bank credit to SMEs declined by 12.7% yoy in December 2014. However, gross new lending to SMEs picked-up by almost 30% yoy to end-March 2015. Rising levels of investment observed in 2014 confirm that the recovery in Ireland is mostly financed by NFCs' retained earnings and by multinationals financed from abroad, rather than by credit from domestic banks. Bank lending to households also declined further, by 3% yoy in April as households continue to reduce their debt. However, in spite of the continued deleveraging trend across the private sector, overall household and NFC debt levels remain

very elevated at about 279.5% of GDP ⁽¹⁷⁾ in the fourth quarter of 2014. For households with a mortgage on the main residence, the median loan-to-value ratio on this property is 72.7%, double that of the euro area of 37.3%. Household net worth has recovered with the increase in residential property prices and it rose by 19% yoy in the fourth quarter of 2014.

Table 2.3: Financial sector indicators

	2008	2009	2010	2011	2012	2013	2014
(All year-end data, unless otherwise specified.)							
Total assets (in % of GDP)	960.6	1006.9	965.9	807.8	713.7	619.9	582
Share of assets of five largest banks (in % of total assets)	55.3	58.8	56.8	53.2	56.9	47.8	n/a
Non-performing loans ratio (in % of total loans) (1)	1.9	9.8	12.5	16.1	24.6	25.3	23.1
Regulatory capital to risk-weighted assets (in %) (1)	12.1	12.8	14.5	18.9	19.2	20.4	22.9
Return on equity ratio (in %) (1)	1.3	-35.8	-41.0	-10.8	-7.8	-6.8	1.4
Private credit growth (% yoy change)	1.4	-5.6	-12.3	-4.7	-2.6	-6.8	-11.5
Lending for house purchase (% yoy change) (2)	-6.9	-4.1	-2.5	-0.9	6.6	-1.7	-3.9
Loan to deposit ratio (in %)	179.0	162.0	141.7	133.4	128.7	113.3	100
Central bank liquidity (in % of total liab.) (3)	7.9	9.0	18.3	18.4	16.6	6.9	4.1

(1) In 2014 the non-performing loans ratio and the return on equity ratio refer to Q2 2014 data; the capital adequacy ratio refers to Q3 2014 data.

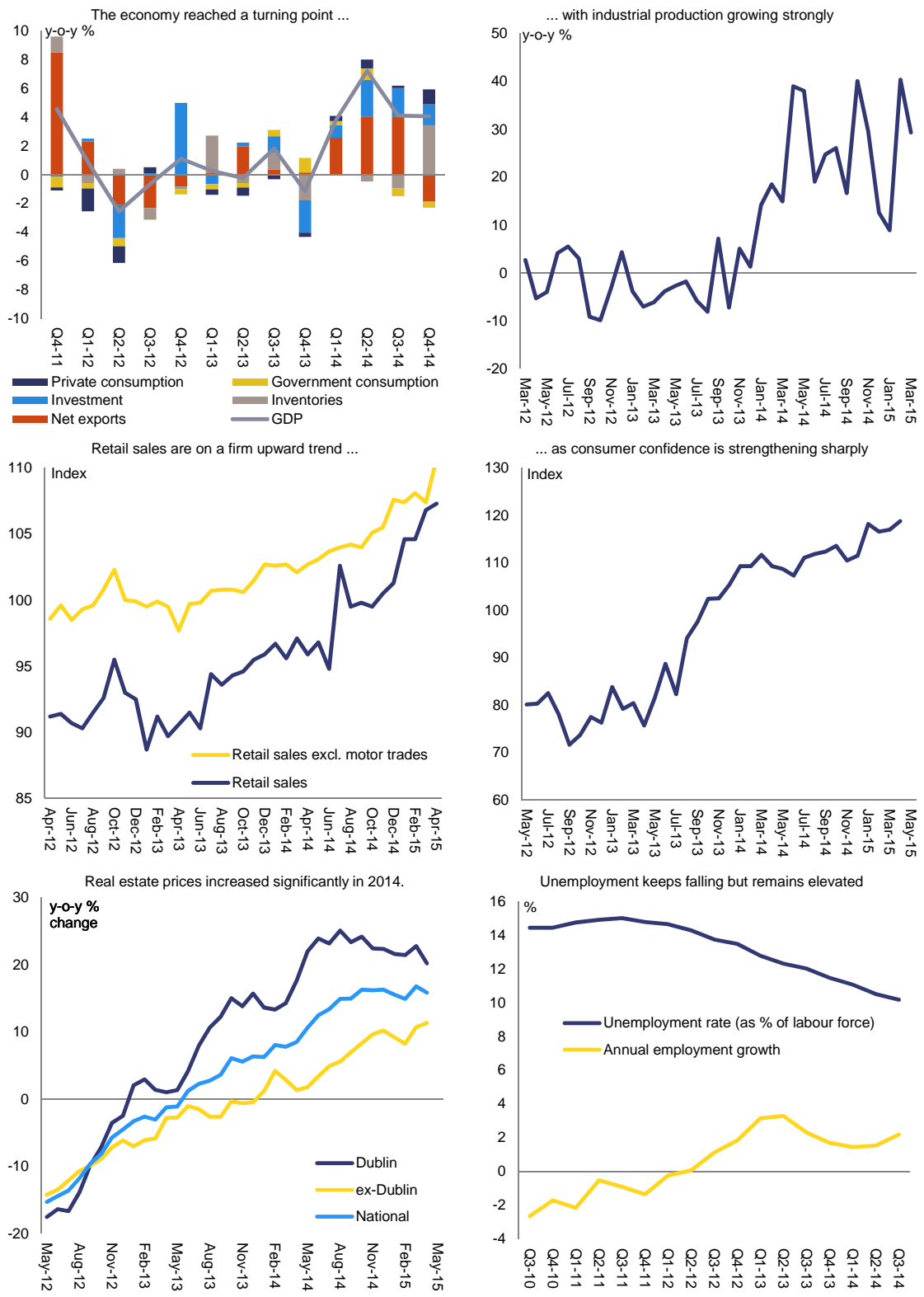
(2) Data for end-2012 reflects the expiration of a mortgage interest relief for first time buyers.

(3) ECB derived data, and refers to the share of central bank funding in credit institutions liabilities (total liabilities exclude capital and reserves as well as remaining liabilities).

Source: ECB, IMF, European Commission

⁽¹⁷⁾ The ratio of NFC debt to GDP includes multinational corporations (MNCs). Ireland's economy has a large MNC sector and its intra-group cross-border lending inflates corporate debt-to-GDP levels.

Graph 2.2: Recent economic developments



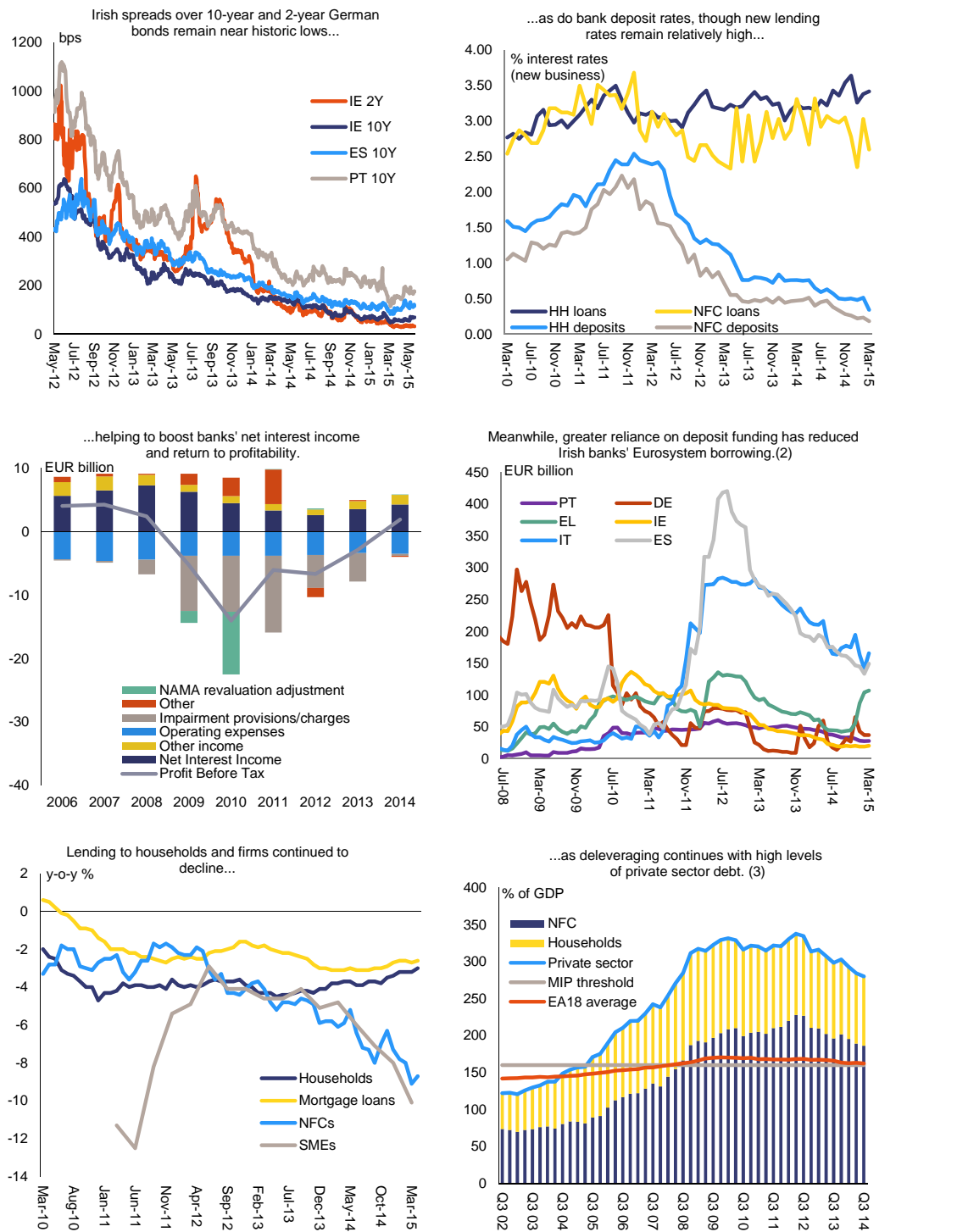
Source: European Commission, CSO

2.2. OUTLOOK

Real GDP is projected to grow by around 3 ½ % in 2015 and 2016. These are robust growth rates, yet more moderate than in 2014. The Commission released its spring forecast in May (Table 2.4). Domestic demand is expected to play a bigger role in driving GDP growth. Households are set to benefit from the ongoing recovery in employment and salaries, the mild outlook for inflation, announced tax cuts and strengthening confidence. However, the recovery of private consumption is expected to be partially held back by further deleveraging of still highly indebted households. The growth in imports is expected to outpace that of exports, although net trade continues to contribute positively to growth, as domestic demand recovers and aircraft leasing is reclassified in the national accounts, even though the evolution of contract manufacturing is uncertain. Irish exporters are likely to benefit from the weak euro.

The share of investment is expected to rise to its long-run average and continue to support growth. Investment expenditure is expected to rise to 17.1% of GDP in 2015 and 18.2% of GDP in 2016, with upside risks, as the external environment remains favourable (Graph 2.4). Firms are expected to continue replenishing their capital stock after years of under investment, and significant excess demand for housing will drive the recovery in construction. Overall, Ireland is set to continue attracting FDI, driven by the country's favourable business environment and improved external competitiveness since the crisis. Investment will remain supported by expected large purchases of aircraft. The government's capital expenditure plan is also expected to increase the GDP-share of public investment in Ireland, which was 35% below the EU average in 2014. In addition, the Investment Plan for Europe has the potential to mobilise both public and private funding for additional investment.

Graph 2.3: Recent financial developments



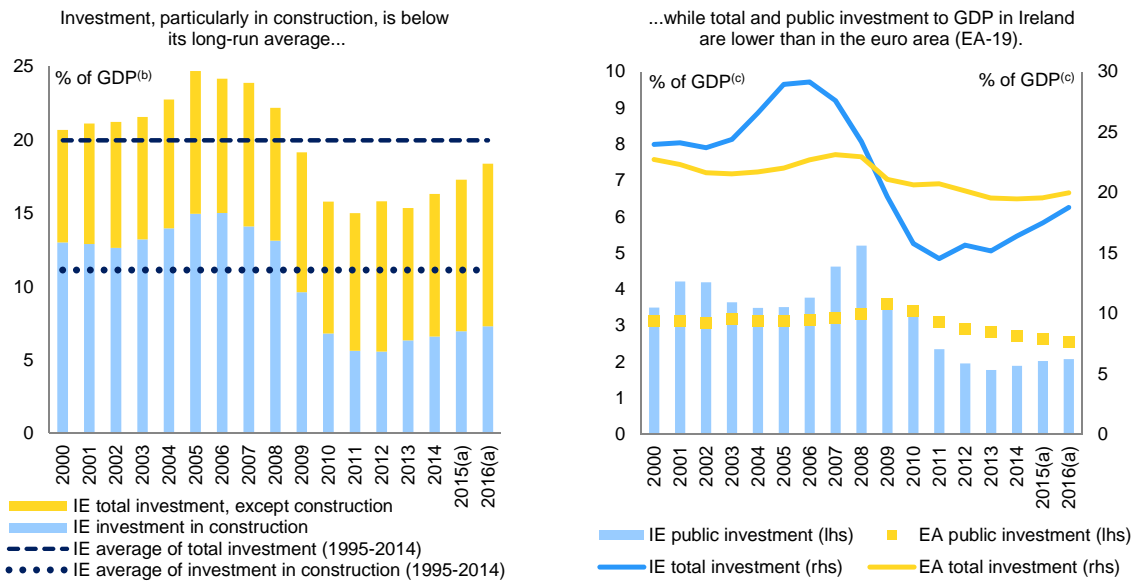
(1) HH: household, NFC: non-financial corporation, NAMA: National Asset Management Agency, MIP: Macroeconomic Imbalance Procedure

(2) The DE, IE, IT and PT data refer to monetary policy operations while for EL and ES the data are expressed as total to domestic monetary financial institutions.

(3) The NFC debt levels include multinational corporations.

Source: CSO, European Commission, national central banks, Banks' end year reports

Graph 2.4: Investment in Ireland, recent evolution and forecast



Inflation is forecast to rise gradually and unemployment to continue falling. Driven by the asset purchase programme of the ECB and the expected recovery of oil prices, inflation is forecasted to rise gradually in Ireland, in line with re-anchored inflation expectations for the euro area. The weak euro is expected to contribute to rising prices, given in particular the weight of Irish imports from the UK. Ireland's unemployment rate is forecast to fall to 9.2% in 2016, down from 11.3% in 2014, while employment continues to grow, albeit at a slower pace than last year. The weak euro should contribute to job creation, as it favours exports, in particular from relatively labour-intensive industries in the indigenous sector, notably food exports to the UK⁽¹⁸⁾. Potential increases in labour force participation could dampen the pace of reduction of the unemployment rate.

The growth outlook underpinning the budgetary targets in the 2015 SP is more favourable than the Commission 2015 spring forecast. The SP projects growth of 4.0% in 2015, 3.8% in 2016 and close to 3.0% thereafter. For 2015, the difference stems chiefly from the Commission's more cautious outlook on private consumption, given the on-going deleveraging by private households. Unlike the Commission forecast, for 2016, the SP assumptions incorporate a 0.2 percentage point increase in real GDP due to EUR 1.2 billion in expansionary fiscal measures⁽¹⁹⁾ announced for the 2016 budget. Upside risks for the Irish economy arise from the weak euro and the strong activity and investment by multinationals. Conversely, the burden of household debt could weigh more than expected on the recovery of private consumption.

Over the longer term, strong productivity gains and a strong expansion in the labour force are required to sustain annual growth rates in excess of 3%. In the SP, the government expects potential GDP growth to remain in the region of 3½% per year from 2017 to until 2020. To achieve such rates over the long run, labour participation, investment and total factor productivity (TFP) would need to grow at higher rates than the historical averages in Ireland. For instance, TFP would need to grow close to 2% per

⁽¹⁸⁾ By way of contrast, the weak euro is not expected to have a large impact on exports by foreign multinationals established in Ireland, as these exports are rich in inputs priced in US dollars.

⁽¹⁹⁾ The Commission forecast does not take into account these measures, given the no-policy-change assumption in the forecast and as they were announced after the forecast had been finalised.

year until 2020, compared to an average growth of less than 1% in the past decade. Strong inward migration flows would also be required to sustain the rates of growth in the labour force that underpin these estimates ⁽²⁰⁾.

Table 2.4: Main features of the Commission 2015 spring forecast for Ireland

	2013			95-10	Annual percentage change					
	bn EUR	Curr. prices	% GDP		2011	2012	2013	2014	2015	2016
GDP	174.8	100.0	5.1	5.1	2.8	-0.3	0.2	4.8	3.6	3.5
Private Consumption	78.9	45.2	4.6	4.6	-1.1	-1.4	-0.4	1.1	2.1	1.9
Public Consumption	30.4	17.4	4.0	4.0	-2.2	-1.3	0.0	0.3	1.7	2.9
Gross fixed capital formation	26.5	15.2	4.7	4.7	-2.2	5.2	-2.8	11.3	9.8	9.9
of which: equipment	6.8	3.9	4.8	4.8	2.1	-2.5	1.8	31.0	10.0	11.0
Exports (goods and services)	184.1	105.3	9.2	9.2	5.5	4.7	1.1	12.6	5.6	5.4
Imports (goods and services)	147.7	84.5	8.3	8.3	-0.6	6.9	0.6	13.2	6.0	6.1
GNI (GDP deflator)	148.7	85.1	4.5	4.5	-0.5	0.3	3.2	5.9	2.2	3.3
Contribution to GDP growth:	Domestic demand			4.0	-1.3	-0.1	-0.6	2.3	2.8	3.0
	Inventories			0.0	0.7	-0.3	0.4	0.5	0.0	0.0
	Net exports			1.7	5.7	-0.8	0.6	2.2	0.8	0.5
Employment				2.7	-1.8	-0.6	2.4	1.7	1.6	1.5
Unemployment rate (a)				7.2	14.7	14.7	13.1	11.3	9.6	9.2
Compensation of employees / head				4.4	1.2	0.8	2.0	3.8	3.2	2.8
Unit labour costs whole economy				1.9	-3.2	0.5	4.2	0.8	1.2	0.9
Real unit labour cost				-0.7	-4.1	-0.8	3.2	-0.4	-0.9	-0.7
Saving rate of households (b)				-	11.8	12.9	12.7	13.8	13.0	12.4
GDP deflator				2.7	0.9	1.3	1.0	1.2	2.2	1.5
Harmonised index of consumer prices				2.4	1.2	1.9	0.5	0.3	0.4	1.5
Terms of trade goods				0.0	-6.2	-0.7	0.5	-1.4	0.2	0.1
Trade balance (goods) (c)				21.2	25.3	24.5	20.7	24.8	25.5	24.8
Current-account balance (c)				-0.8	0.8	1.6	4.4	6.2	5.7	5.3
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-0.3	1.0	1.6	4.4	6.3	5.3	4.9
General government balance (c)				-2.4	-12.7	-8.1	-5.8	-4.1	-2.8	-2.9
Cyclically-adjusted budget balance (d)				-2.7	-12.1	-7.2	-4.5	-4.2	-3.3	-3.3
Structural budget balance (d)				-	-8.1	-7.2	-4.9	-4.1	-3.6	-3.3
General government gross debt (c)				45.9	111.2	121.7	123.2	109.7	107.1	103.8

(a) As % of total labour force; (b) Gross saving divided by gross disposable income; (c) As a % of GDP; (d) As a % of potential GDP

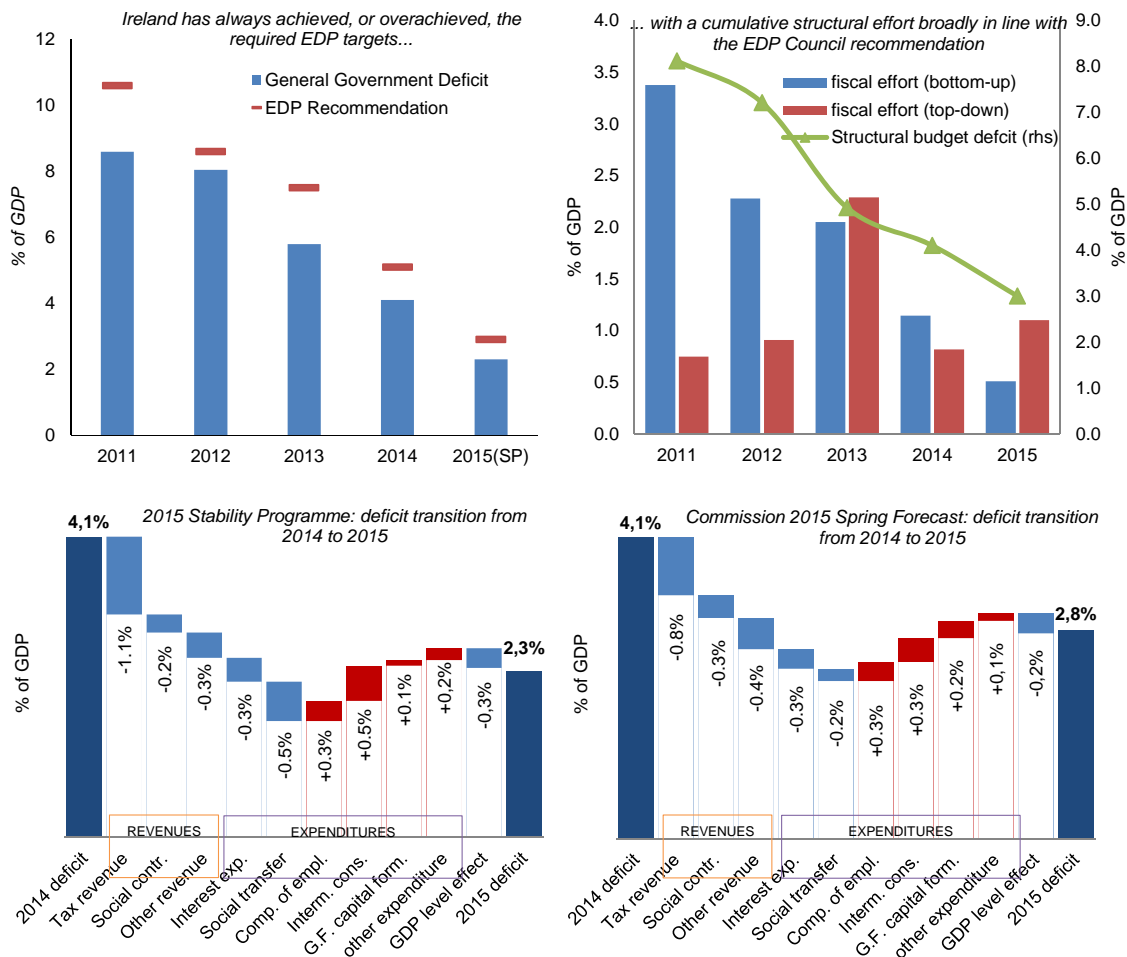
Source: European Commission

The general government deficit is expected to narrow further in 2015. In the 2015 SP, the authorities project the general government deficit to improve to 2.3% of GDP in 2015 ⁽²¹⁾ compared to 4.1% of GDP in 2014. Despite the income tax cuts adopted with the 2015 budget, tax revenues are expected to increase steadily (by almost 4.9%) as domestic demand is assumed to recover more strongly than previously expected. Important contributions are also expected from the continued reduction of social transfers to jobseekers (-3.7%) due to the improved labour market conditions and from declining interest expenditures (-8.5%) with the low-interest rate environment and early repayments of the IMF loans. The net deficit-increasing impact of Irish Water provisionally being classified as part of the general government is estimated at around 0.3% of GDP. The mechanical effect of GDP growth on the deficit-to-GDP ratio amounts to about 0.3% of GDP (Graph 2.5). The Commission 2015 spring forecast sees the 2015 budget deficit at 2.8% of GDP, 0.5 percentage points of GDP higher than government's estimate. The difference is largely explained by two factors: (i) a lower increase of tax revenues (by 3.3%), in line with the Commission's more conservative growth assumption and (ii) higher primary expenditure reflecting possible expenditure overruns evident in recent years, including in the health sector.

⁽²⁰⁾ See "Ireland's Medium Term-Growth Prospects: a Phoenix Rising?" by Nicholas Crafts, CAGE University of Warwick, January 2014.

⁽²¹⁾ The improvement compared to the 2015 Draft Budgetary Plan (0.4% of GDP) reflects better-than-expected cash returns in the first quarter of 2015, higher non-tax revenues and lower interest expenditure.

Graph 2.5: General government deficit: targets and transition from 2014 to 2015



(1) The "top-down" and the "bottom-up" metrics refer to two complementary methods for the assessment of effective fiscal consolidation/action. The "top down" approach looks at the estimated change in the structural budget balance. The "bottom-up" approach consists in estimating, measure-by-measure, the budgetary impact of discretionary interventions on the revenue side and the expenditure side of the budget. The application of the two methods under the Stability and Growth Pact are detailed in the Code of Conduct on the "Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence Programmes" (http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/code_of_conduct_en.pdf) The structural balance is based on the information included in the 2015 stability programme recalculated by the Commission according to the commonly agreed methodology.

Source: 2015 Stability Programme (SP) and Commission 2015 Spring Forecast

Government gross debt is projected to decrease further to 103.8 % of GDP in 2016. This advance largely reflects improved economic growth prospects and deficit targets. The announced but still to be confirmed disposal of stakes in government-owned banks would further reduce high public debt by a significant amount. Government equity stakes in the three domestic banks are currently estimated at around 9% of GDP.

Box 2.1: Quarterly National Accounts (QNA) in Ireland

The timeliness and accuracy of QNA data are important to fiscal policy-making and surveillance. QNA data are used by public and private entities to inform many business and policy decisions. This is also the case for fiscal policy-making in Member States and EU surveillance. The annual budget is produced every autumn and based in part on QNA data for the first two quarters of the year. Similarly, fiscal goals and compliance assessments under the Stability and Growth Pact also rely on annual or otherwise quarterly, national accounts. QNA statistics are preliminary estimates of economic activity in each quarter. Their main role is to capture growth rates, rather than levels, and they are revised in subsequent quarters as more information becomes available, and when annual accounts are released the following years.

Irish QNA data are very volatile, have long processing times and are subject to large revisions. Irish QNA data are very volatile as measured by the standard deviation of quarterly growth rates. A study by the Irish Fiscal Advisory Council (IFAC) ⁽¹⁾ finds that revisions to Irish GDP data are unbiased, even though large by international standards. While revisions to QNA statistics are a common feature across countries, the study finds that the degree of observed revisions in Ireland cannot be fully explained by the small size and open nature of the Irish economy. As for processing times, Ireland releases QNA data later than most other Member States. Ireland has requested derogation to still transmit data to Eurostat after 70 days until 2020 and these transmissions are often flagged as confidential until the national release date. Balance of payments data, which are a key input to QNA statistics, particularly in Ireland, are published 85 to 90 days after the end of each quarter.

Part of the data's volatility is explained by the weight and operations of multinationals. QNA statistics are usually less stable in small open economies such as Ireland, where exports account for over 100% of GDP driven by a small set of multinationals. A minor change to any of their businesses can therefore have a significant impact on GDP aggregates. Such changes might spring from market forces or company decisions to restructure operations, for instance, for reasons of tax efficiency. Complex trading arrangements, pricing policies and inter-affiliate activities mean that these companies sometimes only settle or report the precise accounting of significant operations towards the end of the year. For instance, in 2014, following an increase in the level of contract manufacturing by some multinationals, exports surged in the first half of the year but were offset by royalty payments mostly during the second half, washing out the net impact on GDP growth in annual terms. However, volatility is not only linked to multinationals. For instance, public consumption is often revised significantly between quarters too.

Extreme estimates and other factors can cloud the budgetary process. The recent study by IFAC finds that extreme data estimates tend to mean revert to varying extents within four years. Mean reversion can cloud the budgetary process if the government prepares a budget based on high quarterly GDP growth rates that are revised down after budget approval. The challenges posed by globalisation to the compilation of macro-economic statistics require continuous innovation and investment by statistical offices. A dedicated unit within the Irish Central Statistics Office (CSO) checks the data provided by multinationals, including through on-site visits and interviews with staff. In this respect, the CSO is recognised as leading in terms of best practice at the international level.

Further improving the communication of QNA revisions and specific factors would be helpful to users of QNA data. In line with the European Statistics Code of Practice, the explanations that accompany statistical releases and revisions (also called metadata) are of great importance. Contacts with users of Irish national accounts indicate that there might be scope for further enhancing these accompanying explanations. More detailed and timely information on the reasons that underlie data revisions or the nature and impact of Ireland-specific factors, such as contract manufacturing in 2014, would be helpful to users, including national and international observers. Enhanced metadata would also help data validation carried out by Eurostat, when the economic rationales for revisions are checked.

⁽¹⁾ Uncertainty in Macroeconomic Data: The Case of Ireland (IFAC Working Paper, by Eddie Casey and Diarmaid Smyth, March 2015): <http://www.fiscalcouncil.ie/wp-content/uploads/2015/03/Uncertainty-in-Macroeconomic-Data.pdf>

See also: An analysis of Revisions to Growth Rates in Quarterly National Accounts (ESRI Special Article, by Patrick Quill, Quarterly Economic Commentary, Autumn 2008): http://www.esri.ie/UserFiles/publications/20081013171426/QEC2008Aut_SA_Quill.pdf

Box 2.2: Developments with mortgage arrears in Ireland

Mortgage arrears have begun to decline but long-term arrears have grown, while non-banks' mortgage holdings have increased. At end-March 2015, 17.1% of total mortgage balances were non-performing. The CBI's data on mortgage arrears started in mid-2009, when 4.1% of primary dwelling housing (PDH) mortgage balances were in arrears, or over 90 days past due. The balance (or value) of PDH arrears more than quadrupled to peak in late 2013 at 17.4% of the total balance of PDH mortgages. It has since then been decreasing slowly (Graph 1). Buy-to-let (BTL) mortgage arrears, on the other hand, continued to rise and the ratio to total BTL mortgage balances peaked more recently in the third quarter of 2014 at 30.8%. The balance in arrears for over two years (long-term arrears) has continued to rise for PDH to 8% of PDH mortgage balances while BTL long-term arrears were at 17.5% of total BTL mortgage balances at end-March 2015. There are new CBI data on residential mortgages held by non-banks that are either former banks with residual loan portfolios or non-bank buyers of such portfolios from banks. Non-bank loan holdings grew in 2014. Although they accounted for only 6.2% of total mortgage balances, they represented a significant 24% of total long-term arrears balances at end-March 2015. They also have a higher share of restructured mortgage accounts still in arrears than banks at about 35%, compared to 15% for banks.

The decline in arrears has followed the improvement in macroeconomic fundamentals with a lag. The pace of arrears formation has responded to rises in house prices and the unemployment rate but with a delay ⁽¹⁾. PDH arrears began to fall in late 2013, after the unemployment rate had begun declining in 2012 and following the residential price index trough in 2012-13. The pace of BTL arrears formation has shown a longer response time to improved fundamentals with only a recent fall in arrears in late 2014, well after the economic recovery started, due to riskier borrower profiles and originating conditions (interest-rate type, time-of origination, and high loan-to-value ratios). In addition, the longer lag for BTL arrears could also be due to the banks use of rent receivership schemes that ensure cash flows for lenders while the account remains in arrears. [Lydon and McCarthy \(2014\)](#) find that the significant income shocks borrowers have faced are a factor that has driven the rise in mortgage arrears despite falling unemployment. This is also likely to explain why there is a large group of borrowers in long-term arrears. Moreover, [McCarthy \(2014\)](#) finds that many borrowers in arrears are currently employed but experienced a large drop in income or a change in employment terms, and some are in fragile employment (i.e. temporary contracts).

The significant and sustained build-up in arrears was likely also due to the underdeveloped regulatory environment for arrears resolution and relatively late policy actions to decrease arrears. Initially when arrears rose, the bankruptcy regime was hardly used, partly due to the lengthy discharge period, while out-of-court debt resolution procedures were unavailable. Thus in 2010, work began on its reform and the expansion of the debt resolution framework to include personal insolvency ⁽²⁾. However, the reform process was slow and [Andritzky \(2014\)](#) finds that this, along with barriers to repossessions and loan collection, delayed mortgage restructurings. Finally in July 2013, the legal barrier to repossession was removed and in September 2013, the Insolvency Service of Ireland became operational. The Mortgage Arrears Resolution Targets (MART) framework was introduced for the principal mortgage banks in March 2013. It saw the strong involvement of the supervisor by setting quarterly targets for mortgage arrears resolution, with an emphasis on long-term solutions. It has fostered an increased engagement of borrowers and lenders to restructure loans. Together these reforms helped support the reversal of arrears creation since late 2013.

Mortgage arrears should continue to decline with the improved economy though continued policy actions are also critical. In line with total NPLs, mortgage arrears are expected to decline gradually with the economic recovery (see Box 3.1 on NPLs in the [Autumn 2014 PPS report](#)). The revised bankruptcy and insolvency frameworks have provided new solutions for distressed borrowers, but their use has been limited and is being encouraged for cases that cannot be resolved otherwise. Lenders have not resorted to repossession on a large scale but they have used its threat to engage non-responsive debtors. In addition, banks may sell parts of their non-performing mortgage loan portfolios to the largely unregulated non-bank entities. Thus, careful monitoring of arrears resolution should continue and include these non-bank entities. This will be essential to ensure durable restructuring solutions are concluded and borrowers adhere to renegotiated terms.

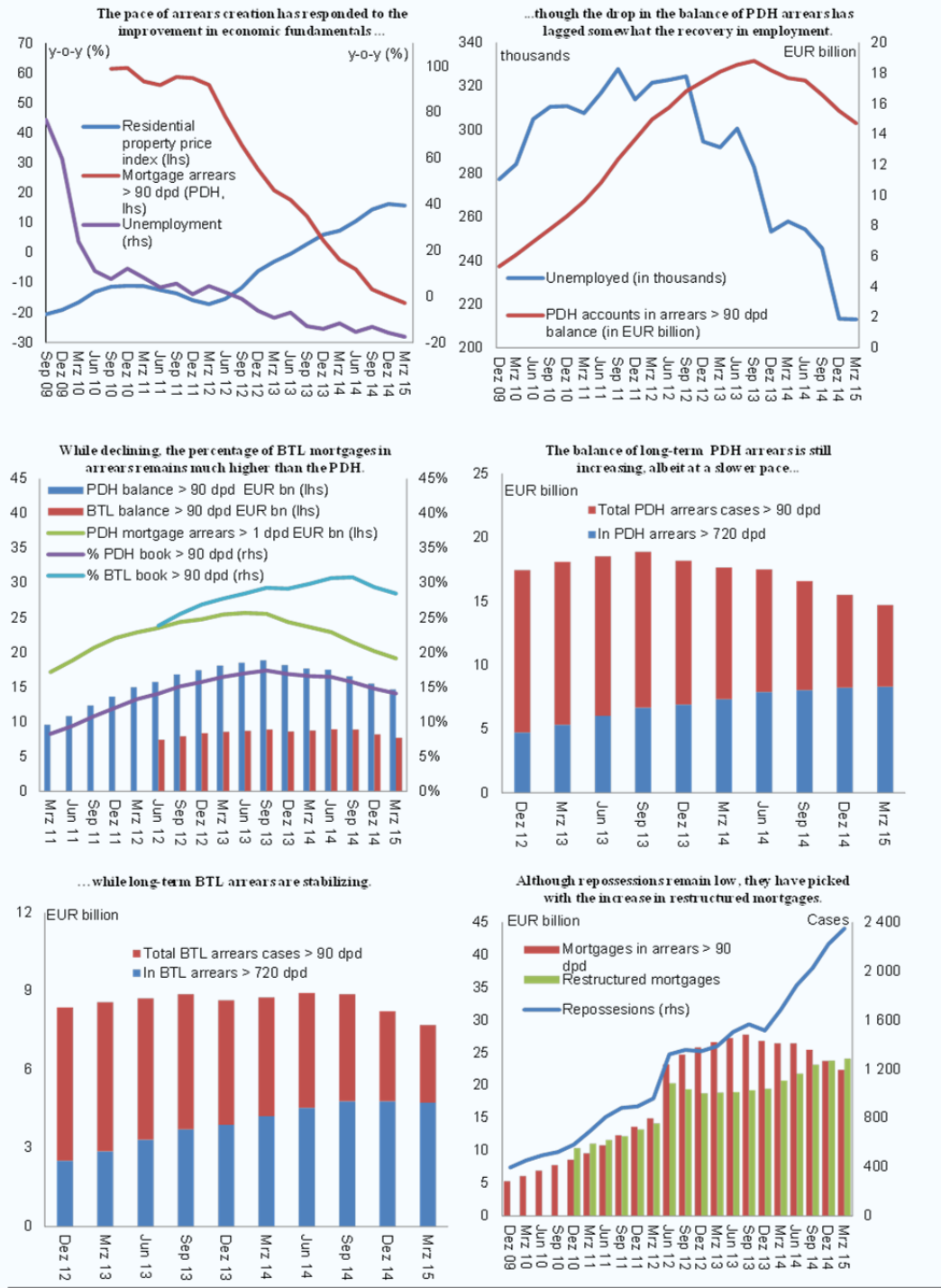
⁽¹⁾ According to the CBI mortgage arrears statistics, an account is no longer in arrears when the arrears on a mortgage account have been cleared in full and reported to the CBI. This implies a certain time-lag that could also contribute to the delayed response to the improvement in fundamentals.

⁽²⁾ For more details on the new personal insolvency framework see previous PPS reports.

(Continued on the next page)

Box (continued)

Graph 1: Mortgage arrears developments



(1) PDH - primary dwelling housing; BTL - buy-to-let; dpd - days past due.
(2) The data for BTL arrears was first published in Q2 2012.

Source: CBI and CSO

3. POLICY ISSUES

3.1. PUBLIC FINANCES

3.1.1. Buoyant economic growth: opportunity or temptations for fiscal policy?

The 2015 general government deficit is expected to be below the 3% of GDP reference value of the Treaty. The Commission expects Ireland to correct the excessive deficit by the recommended deadline of 2015. Based on an assessment of the discretionary measures taken during 2011 and 2015 (bottom-up approach), the cumulative structural effort is estimated to be in line with the Council recommendation of December 2010. The main downside risks to the fiscal projections for 2015 are persistent spending pressures to maintain current services and meeting demands for increases in public services, including wage increases. On the upside, if monthly cash returns continue to be as strong as in the first five months of 2015, tax revenues could end up exceeding estimates for 2015 as a whole by a considerable margin.

The authorities' deficit target for 2016 does not fully reap the benefits of strong economic growth. The 2015 Stability Programme (SP) released in April targets a general government deficit of 1.7% of GDP (Graph 3.1). The programme does not include any details about the measures underpinning the deficit target. It merely highlights a broad package of new expansionary measures compared to the 2015 budget worth EUR 1.2 billion (0.6% of GDP) evenly split between tax cuts and expenditure increases⁽²²⁾. With reference to the yet unspecified tax cuts and expenditure increases, the authorities' 2016 deficit forecast also discounts a positive second-round effect on the budget estimated at around 0.15% of GDP. As in the previous year, the budgetary improvement of the deficit-to-GDP ratio targeted in 2016 mainly results from an essentially flat expenditure path in absolute terms (including a close to 2% increase in the government wage bill), while revenues are set to increase by somewhat less than nominal GDP (Table 3.1).

⁽²²⁾ Both the 2015 SP and the Spring Economic Statement refer to a National Economic Dialogue with stakeholders to be held over the summer with a view to establishing, how the EUR 1.2 billion are to be allocated.

Graph 3.1: 2015 Stability Programme fiscal projections (nominal and structural adjustment)



(1) COM = recalculated by the Commission from the information provided in the SP using the EU commonly agreed methodology.

Source: 2015 Stability Programme (SP) and Commission recalculated estimates (COM)

Recent wage negotiations entail public sector pay rises over the next three years. In May, the government reached an agreement with the unions. This *Lansdowne Road Agreement* safeguards a gradual wage bill rise over the next three years⁽²³⁾. It meets the existing commitments for pay restoration under the *Haddington Road Agreement* (roughly EUR 280 million of wage increases over the same period) and provides for extra cumulative resources of EUR 566 million (0.3% of GDP) in 2016-2018⁽²⁴⁾. The pay increases will be achieved through changes to the public service pension related deduction (the pension levy) and a partial reversal of the 2010 pay cuts. The resources foreseen for 2016 (about EUR 250 million) are within the allocations in the 2015 SP⁽²⁵⁾. However, additional pressure on public pay could arise. Whereas some sector-specific union organisations have expressed concerns over certain aspects of the agreement, it is now a matter for union and association members representing the public service workforce to consider and ballot on the proposals. Subject to agreement by the Public Services Committee and associations, the minister has indicated the necessary legislative amendments will be brought forward to enable the terms of the agreement to be implemented from 1 January 2016.

⁽²³⁾ <http://per.gov.ie/wp-content/uploads/Public-Service-Stability-Agreement-2013-2018.pdf>

⁽²⁴⁾ Whereas the reduction in pay and any deferral of increment progression provided for under the Financial Emergency Measures in the Public Interest Act, 2013 will be *de facto* inhibited from the 1 January 2016, the legislative constraints imposed on public service employers under the financial emergency legislation will continue during the lifetime of this agreement. This will be crucial for achieving a sustainable public pay policy that will continue to support the ongoing economic recovery.

⁽²⁵⁾ The 2015 SP provides for an increase of the total pay and pensions bill of about EUR 350 million in 2016 compared to the previous year.

Table 3.1: Breakdown of change in the primary expenditure

EUR Billion	2014	2015	2016	2017	2018	2019	2020
Total primary expenditure	64.83	65.74	66.13	66.23	66.55	66.99	67.15
<i>change</i>		0.91	0.39	0.11	0.32	0.44	0.16
<i>contribution to change</i>							
intermediate consumption		0.95	-0.11	0.09	0.12	-0.05	0.01
compensation of employees		0.55	0.34	0.11	0.11	0.11	0.08
social transfers		-1.07	0.08	0.08	0.07	0.14	0.09
subsidies		0.32	0.01	0.02	0.01	0.01	0.00
gross fixed capital formation		0.15	0.01	-0.11	0.03	0.19	-0.07
% of GDP							
Total primary expenditure	35.0%	33.2%	31.7%	30.4%	29.3%	28.3%	27.2%
<i>percentage point changes</i>		-1.81	-1.50	-1.24	-1.14	-1.00	-1.07
<i>contribution to change</i>							
intermediate consumption		0.2	-0.3	-0.1	-0.1	-0.2	-0.2
compensation of employees		-0.4	-0.3	-0.3	-0.3	-0.3	-0.3
social transfers		-1.5	-0.7	-0.5	-0.5	-0.4	-0.4
subsidies		0.1	0.0	0.0	0.0	0.0	0.0
gross fixed capital formation		0.0	-0.1	-0.1	-0.1	0.0	-0.1

Source: 2015 Stability Programme

Fiscal plans for 2017 and beyond do not include specific policy measures. Rather than representing policy objectives, the fiscal targets from 2017 onwards laid down in the 2015 SP are based on a no-policy-change-assumption. Tax revenues are set to increase in line with nominal GDP (net of the indexation of income tax bands), while government primary expenditures are kept broadly constant in level terms until 2020, with the exception of a 0.15% of GDP increase in current spending each year to accommodate demographic pressures, mainly in social protection, health and education. The decision to present no-policy-change projections clashes with the provisions of the Stability and Growth Pact (SGP), according to which stability programmes are expected to set out the budgetary objective for the medium term together with information about the budgetary measures to achieve these objectives⁽²⁶⁾. Furthermore, the assumption of broadly stable expenditure in level terms contrasts with the government's own spending estimates presented in the last expenditure review⁽²⁷⁾, which project current and capital departmental expenditures to increase by 1.6% and 5.6% respectively between 2015 and 2017. Overall, the targeted improvement of the general government budget balance in the medium-term largely results from an essentially flat profile of government expenditure in absolute terms and tax revenues evolving broadly in line with the robust growth outlook.

⁽²⁶⁾ In particular, article 3 of the Council Regulation (EC) N. 1466/97 on the strengthening of the surveillance of budgetary position and the surveillance and coordination of economic policies, indicates that the Stability Programmes shall present "...the medium-term budgetary objective and the adjustment path towards that objective" and "... a quantitative assessment of the budgetary and other policy measures being taken or proposed to achieve the objectives of the programme".

⁽²⁷⁾ <http://per.gov.ie/wp-content/uploads/Comprehensive-Expenditure-Report-2015-2017.pdf>

Table 3.2: Average yearly growth of main expenditure items

	1995-2000	2001-2005	2006-2010	2011-2015 ^{SP}	2016 ^{SP} -2020 ^{SP}
Total Expenditure (net of financial crisis costs)	8.4%	11.2%	5.1%	0.2%	0.3%
intermediate consumption	12.0%	7.7%	2.9%	1.6%	0.1%
compensation of employees	8.9%	13.2%	3.3%	-0.1%	0.8%
social transfers	7.8%	14.1%	9.5%	-0.9%	0.3%
gross fix capital formation	24.2%	10.4%	1.6%	-6.9%	0.3%
nominal GDP	14.6%	9.5%	-0.2%	3.8%	4.5%

Source: European Commission, 2015 Stability Programme (SP)

While the deficit targets in the 2015 SP are in line with the EU fiscal rules, the Commission's assessment points to risks and issues in 2016. The planned growth rate of government expenditure, net of discretionary revenue measures, stays within the expenditure benchmark of the preventive arm of the SGP. However, the 2015 SP assumes positive second-round effects in 2016 of around 0.2% of GDP of the tax cuts and expenditure increases envisaged in the 2016 budget. If eventually included in the budget, such effects would generally not represent discretionary revenue measures under EU fiscal rules. The annual average improvement of the structural budget balance as recalculated by the Commission with the commonly agreed method based on the figures provided in the SP exceeds 0.6% per year⁽²⁸⁾ and, hence, is also in line with the provisions of the SGP (Graph 3.1). However, according to the Commission 2015 spring forecast, under the usual no-policy-change assumption, the structural balance would improve by only 0.3% of GDP falling short of the required 0.6% of GDP. Similarly, the growth rate of government expenditure, net of discretionary revenue measures, is expected to deviate by 0.9% of GDP from the expenditure benchmark, again under the usual no-policy-change assumption although the spending profiles presented in the 2015 SP are expected to be in line with the requirements of the expenditure benchmark pillar⁽²⁹⁾. Therefore, the Commission's forecast points to the risk of a significant deviation from the required adjustment path towards the medium-term objective (MTO). In sum, compliance with the rules hinges on the government specifying and implementing the measures necessary to achieve the budgetary target of 2016.

Budgetary windfalls in 2016 and beyond should be used to accelerate debt reduction and prepare for future challenges. The stronger than expected economic momentum offers a unique opportunity to make progress with fiscal consolidation and debt reduction and averts the need to support aggregate economic activity. While estimates of the output gap are uncertain, especially for small open economies like Ireland, international institutions agree that the economy is fast reaching its potential. In addition, past experience in Ireland and other countries shows that there has been a tendency to overestimate the slack and underestimate the overheating of the economy in real time. Moreover, Ireland is also facing considerable expenditure pressures linked to demographics in the medium term and remains vulnerable to economic and interest-rate shocks, given the still very high level of public debt (Annex 2). All these elements stress the importance of building fiscal buffers.

3.1.2. Reinforcing expenditure policies

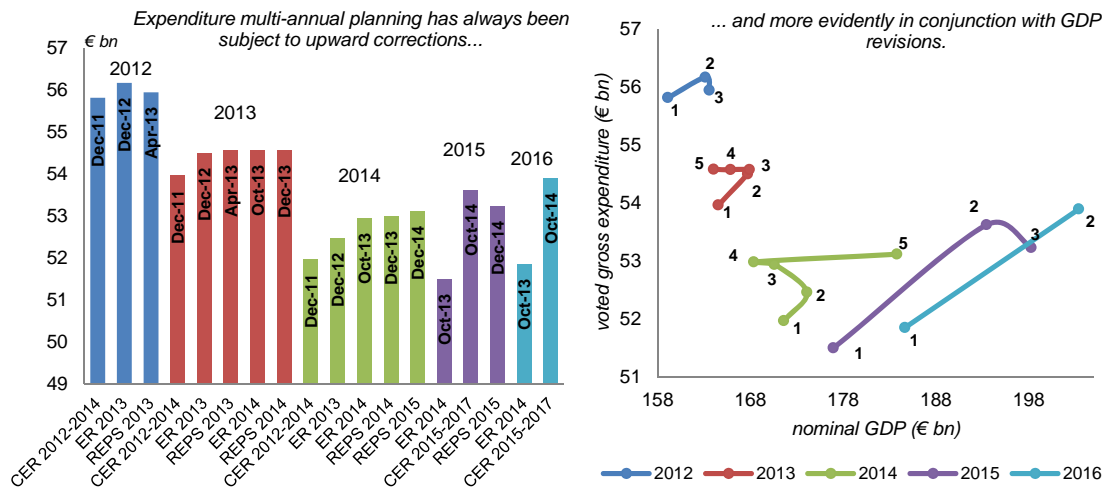
Although the domestic fiscal framework has improved considerably, weaknesses remain. Upward revisions of planned expenditure ceilings have been a recurring feature of multi-annual fiscal planning in

⁽²⁸⁾ The 2015 SP reports an estimated improvement in structural budget balance of 0.3% of GDP in 2016. This contrasts with an estimate of 0.8% of GDP in the same year when recalculating the estimated improvement with data provided in the SP and using the commonly agreed methodology. As indicated in the Commission's Assessment of the 2015 SP, the difference seems to originate from specific assumptions used by the Irish authorities. In particular, the output gap estimates reported in the programme turn significantly negative in 2020. This assumption also affects the profile of the estimated improvement of the structural balance in 2016 (Graph 3.1).

(http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/20_scps/2015/07_ie_scp_en.pdf).

⁽²⁹⁾ A full assessment of compliance from ex-ante perspective will be made on the basis of the 2016 Draft Budgetary Plan.

Graph 3.2: Expenditure targets (plans, revisions and outturns)



(1) Numbers on the right-hand chart represent the sequence of vintage expenditure plans indicated in the left-hand chart.

Source: Comprehensive Expenditure Report (CER) 2012-2014, 2015-2017; Expenditure Report (ER) 2013, 2014; Revised Estimates for Public Services (REPS) 2013, 2014, 2015; Draft Budgetary Plans and Stability Programme (SP), 2012, 2013, 2014, 2015.

Ireland. This has become more evident recently, with the end of the EU-IMF financial assistance programme and the general improvement of the economic outlook⁽³⁰⁾. While expenditure ceilings are meant to serve as an anchor, expenditure targets for 2014 and 2015 have been repeatedly revised in response to increasing spending pressures (Graph 3.2). Upward revisions mainly reflect the expenditure dynamic in health, education and the transport sector. Since 2012 overall ministerial expenditures ceilings have always turned out above initial targets. Moreover, the positive correlation between the upward revision of expenditure ceilings and nominal GDP underpinning the budget is an indication of procyclicality.

3.1.3. Policies to broaden the tax base

The substantial activities of multinational enterprises expose Ireland to potential adverse revenue shocks that could arise from changes to international tax standards and practices⁽³¹⁾. At the same time, the government recently proposed new corporation tax initiatives in order to attract further FDI inflows. Most notably, budget 2015 included a proposal to introduce a *knowledge development box* with the conclusions of a public consultation on the initiative due in the coming months. Although Member States have agreed on how similar *patent boxes* should be implemented in future⁽³²⁾, a recent European

⁽³⁰⁾ For the coming years, the specific expenditure allocations to government departments are set out in the "2015-2017 Comprehensive Expenditure Report" (<http://per.gov.ie/wp-content/uploads/Comprehensive-Expenditure-Report-2015-2017.pdf>). The specific ceilings have been subsequently revised ("2015 Revised Estimates for Public Services") and adopted by the parliament at the end of December 2014 (<http://per.gov.ie/wp-content/uploads/Master-Copyv1.pdf>).

⁽³¹⁾ The OECD *Base Erosion and Profit Shifting* (BEPS) initiative has recommendations regarding harmful tax practices. In March 2015, the European Commission presented its *Tax Transparency Package* which aims to introduce the automatic exchange of information between Member States on tax rulings. Furthermore, the Commission is now re-launching the *Common Consolidated Corporation Tax Base* (CCCTB).

⁽³²⁾ The EU Council's Code of Conduct Group (on Business Taxation) met three times during the second half of 2014 and continued work on standstill and rollback of harmful tax regimes. With respect to patent boxes, the Group discussed the features of the "modified nexus approach" and its compatibility with EU law. Notably, the Commission prepared an evaluation of the patent box regimes, but without any assessment under the requirement for substantial economic activity to be based in the Member

Commission study of research and development tax incentives was critical of existing patent box schemes employed by other countries arguing that the rationale for patent boxes to stimulate innovation is not evident because it is not clear which market failures patent boxes address⁽³³⁾. The report concludes that existing patent boxes are more likely to relocate corporate income than to stimulate innovation.

There is potential to further raise property tax revenues. Revenues from immovable properties stood at 1.1% of GDP in 2013 and remain below the EU average of about 1.5% of GDP in 2012. The recent change in residential property taxation from a transaction tax to a recurrent tax based on residential property values is commendable because, apart from reducing the cyclical sensitivity of government revenues, recurrent taxes on immovable property are considered to be among the least harmful to growth⁽³⁴⁾. Nevertheless there are some areas of concern. The recurrent property tax is based on self-assessed property prices at historic values. As there is still no property register with cadastral values, the re-evaluated values used from 2016 will continue to be based on self-assessment. In theory, recent increases in residential property prices mean that the yield from the property tax should increase. However, the authorities aim to maintain the current revenue and high rate of compliance (approximately 95%), emphasising the need to maintain "taxpayer acceptance" over potential extra revenue generation or pro-cyclicality concerns. Moreover, the base is reduced by the exclusion of some non-residential properties, in particular development land and derelict sites (Box 3.1). The potential for local authorities to vary the basic local property tax rate could further limit tax revenues⁽³⁵⁾.

The value-added tax (VAT) policy gap⁽³⁶⁾ remains comparatively high and the current system of indirect tax expenditures is quite extensive and complex. The yield on VAT is low in comparison with other Member States because of the extensive use of reduced rates and exemptions in Ireland. As a result, Ireland has a large VAT policy gap. According to the latest available data⁽³⁷⁾, Ireland's VAT policy gap is estimated at 48% against a EU-27 median of about 43% with only four EU Member States scoring higher. For a given tax burden, it is more growth-friendly to have indirect taxes accounting for a large share of total revenue than a system with a large share of direct taxes⁽³⁸⁾. Thus, Ireland could move towards more limited use of reduced rates, exceptions and exemptions on VAT. Moreover, there is no process for evaluating the costs and benefits of reduced rates and exemptions on VAT even though reduced rates are not generally considered to be ideal for redistribution because they do not target specific recipients. Ex-post evaluations of VAT measures should be introduced along the lines described for direct taxation in the department of finance's report on tax expenditures⁽³⁹⁾.

State granting the tax benefit. After the publication of the evaluation, an agreement was reached on the interpretation of substantial economic activity criteria of the code of conduct with regard to patent boxes as contained in the existing mandate as set out in the report to ECOFIN. On 9 December 2014 the Council (ECOFIN) endorsed the report.

⁽³³⁾ Specifically, it is not obvious why innovations for which clear property rights are already defined should receive special tax incentives. Patent boxes are generally a relatively recent initiative and are being introduced in a number of other countries such as the United States, the United Kingdom, Belgium, Spain, Portugal, France, the Netherlands, Luxembourg, Malta and Hungary. TAXUD (2013) [A Study on R&D Tax Incentives: Final Report](#), TAXUD 2013/DE/315.

⁽³⁴⁾ See, for example, Arnold, J.M., B. Brys, C. Heady, A. Johansson, C. Schweltnus and L. Vartia (2011), 'Tax Policy for Economic Recovery and Growth', *Economic Journal*, 121 (550), F59-F80.

⁽³⁵⁾ A review of local property tax is due to be completed in the summer of 2015.

⁽³⁶⁾ The VAT policy gap is additional revenue that could be collected if a uniform rate was applied to all consumption.

⁽³⁷⁾ CPB/CASE (2014), 2012 Update Report to the Study to quantify and analyse the VAT Gap in the EU-27 Member States (No TAXUD/2013/DE/321).

⁽³⁸⁾ See for example: OECD (2010), *Tax policy reform and economic growth* (No. 20), OECD Tax Policy Studies, OECD Publishing; or OECD (2013), *Tax Administration 2013, Comparative information on OECD and other advanced and emerging economies*, OECD Publishing.

⁽³⁹⁾ Department of finance (2014) [report on tax expenditures](#).

3.2. MACRO FINANCIAL

3.2.1. Returning the domestic banks to the private sector

PTSB's recent successful capital raise and the approval of its restructuring plan bode well for divestment of state holdings in the domestic banks. At end-April, the bank issued EUR 400 million in common shares and EUR 125 million in additional tier one (AT1) capital at a coupon of 8.63%. The proceeds are being used to cover the remainder of the EUR 855 million capital shortfall identified in the adverse scenario of the stress test under the ECB comprehensive assessment⁽⁴⁰⁾ and to repurchase the EUR 400 million (0.2% of GDP) of the state's contingent capital notes (cocos)⁽⁴¹⁾. The Irish government also sold shares to lower its stake in PTSB from 99.2% to 75% to meet exchange listing requirements⁽⁴²⁾. In April, the European Commission agreed to PTSB's restructuring plan. It envisages PTSB returning to profitability in 2017. Overall, the state has invested about EUR 4 billion during 2011-12 in Irish Life and Permanent (now PTSB). So far the state has received EUR 1.8 billion (0.9% of GDP) in capital receipts comprising EUR 1.3 billion from the sale of Irish Life, EUR 0.4 billion from the coco repurchase and EUR 0.1 billion from the sale of equity. The remaining 75% equity stake in PTSB is valued at about EUR 1.45 billion (0.7% of GDP).

AIB's privatisation remains the largest potential domestic bank sale. The bank is 99.8% government-owned and the state's holdings were valued at EUR 13.3 billion (7.1% of GDP) as of December 2014. The minister for finance has stated the government may sell up to 25% of its shares toward the end of 2015 or early 2016. For now, the focus is on restructuring the bank's capital base with a partial repayment and conversion of all or part of the EUR 3.5 billion government preference shares into common stock expected at some point. The approval of the SSM will be needed for the capital restructuring. Overall, the government has invested EUR 20.8 billion in AIB and aims to recover this amount in full through a managed disposal strategy.

The government's holds a 14% stake in BOI with no imminent plans to sell yet. The equity stake is valued at EUR 1.5 billion (0.8% of GDP) as of March 2015. In June, the bank raised EUR 750 million of AT1 capital from the market at a coupon of 7.38%. The authorities have suggested they are in no rush to exit their position. However, with bank market valuations currently favourable, the authorities should carefully weigh this against the risk of any future market shift. BOI's improving profitability facilitates a possible redemption of the remaining EUR 1.3 billion preference shares by July 2016, before the expected resumption of dividend payments to shareholders. These are preference shares which were originally held by the government and which have been in private ownership since December 2013. In total, the government had invested EUR 4.8 billion in BOI and has received proceeds of about EUR 6 billion from the bank⁽⁴³⁾.

3.2.2. Enhancing financial resilience to shocks

Under the new supervisory framework, improving the banks' profitability outlook is key to tackling capital challenges. The capital positions of the domestic banks face hurdles as transitional elements of the Capital Requirements Directive IV (CRD IV) and Capital Requirements Regulation (CRR) are implemented and as the market and supervisors increasingly focus on fully-loaded capital ratios. These are well below transitional ratios due to the fact that BOI and particularly AIB have large holdings of deferred tax assets (DTAs) and government preference shares which will no longer count as common

⁽⁴⁰⁾ PTSB was able to cover part of the shortfall with risk-weighted asset reducing measures (i.e. asset disposals).

⁽⁴¹⁾ The cocos carry an annual coupon of 10% and can be converted into ordinary shares on their maturity in July 2016.

⁽⁴²⁾ The "free-float" requirement refers to the minimum portion of a company's shares that can be publicly traded. The Irish stock exchange and the UK listing authority require companies to have a free float of at least 25%.

⁽⁴³⁾ This has been through the sale of its equity in the bank in July 2011, the sale of its cocos in January 2013, the sale of its preference shares at the end of 2013 and fees and investment income.

equity tier 1 (CET1) capital under the CRR⁽⁴⁴⁾. Thus, it will be important for the supervisory authorities to encourage further capital raising from the market and capital restructuring via the conversion of preference shares into high-quality CET 1 capital instruments. A further challenge for AIB and BOI are their pension deficits and the ensuing increase in their contributions to employees' defined benefit pension funds as these contributions are directly deducted from fully-loaded capital ratios. Improvements in profitability will be key to allow banks to use their DTAs and preserve profits to rebuild their capital ratios. However, profitability growth is limited by low levels of new lending, the prevailing low-yield environment and net balance sheet contraction. It is further constrained as room to expand net interest income is limited by policy rates close to zero.

Allowing banks to obtain sufficient interest rate margins is also important to sustaining the return to profitability. The standard variable mortgage rate in Ireland is relatively high compared to other euro-area countries. This is mainly due to credit risks with high NPLs and legacy assets⁽⁴⁵⁾. The minister of finance has recently pressured the banks to reduce the interest rates on mortgage loans⁽⁴⁶⁾. Subsequently, the banks agreed to review their rates, and by early July, to have simple options to reduce mortgage payments for standard variable rate customers. This is in addition to offering more alternative products such as fixed-rate mortgages. This also followed the government's consideration of a bank levy and legislation aiming at empowering the CBI to cap mortgage rates. The central bank has stated that it would be reluctant to pursue this type of market intervention, given the possible implications for market competition, bank profitability and the future privatisation of the banks. However, it has requested that banks provide a clear and quantified statement on how they set their standard variable rates, as this is lacking⁽⁴⁷⁾. Continued pressure on the banks to cut rates may undermine financial sector stability by reducing bank profitability and impact future privatisation prospects. It could also have negative implications for market competition by discouraging potential new entrants to the market.

The CBI's recent residential mortgage lending rules aim at boosting financial stability and similar measures could be considered for commercial property. The objectives of the measures are to underpin the resilience of households and the banks to financial shocks by lowering the risk of a new credit-fuelled housing price boom from developing. The new regulations came into force in February with the implementation of limits on loan-to-value (LTV) and loan-to-income (LTI) ratios for new mortgages (Table 3.3)⁽⁴⁸⁾. Following the CBI consultation process, it was decided to increase the limit for first-time buyers of lower-cost houses, so that they are subject to an LTV of 90% on the value of homes up to EUR 220,000. This gives more flexibility to first-time buyers with CBI research showing that this group tends to have lower default rates even for LTVs above 80%⁽⁴⁹⁾. It will be important to continue to monitor the compliance with the regulations, especially the more favourable treatment given to first-time buyers and their default rate⁽⁵⁰⁾. The authorities do not currently view the rapid increase in commercial property prices in Dublin as a serious concern for financial stability partially because much of the investment is in the form of foreign equity. Nevertheless, continued supervision of developments in the commercial

⁽⁴⁴⁾ In Ireland, this involves a phasing out of the counting of DTAs towards CET1 capital by 10% annually from 2015 until end 2023 for AIB and BOI. According to the CRR, preference shares subscribed by the government will no longer count as regulatory capital own funds, after 1 January 2018.

⁽⁴⁵⁾ For more details on these issues, see CBI report at [http://www.centralbank.ie/press-area/press-releases/Documents/Influences%20on%20SVR%20Pricing%20in%20Ireland%20\(5\).pdf](http://www.centralbank.ie/press-area/press-releases/Documents/Influences%20on%20SVR%20Pricing%20in%20Ireland%20(5).pdf)

⁽⁴⁶⁾ Rates in some banks have already been reduced for new customers. See press release at <http://www.finance.gov.ie/news-centre/press-releases/minister-noonan-concludes-positive-series-meetings-main-mortgage-lenders>.

⁽⁴⁷⁾ <http://www.centralbank.ie/press-area/speeches/Pages/IntroductorystatementbyGovernorPatrickHonohanatOireachtasCommitteeonFinancePublicExpenditureandReform.aspx>

⁽⁴⁸⁾ See more details at <http://www.centralbank.ie/press-area/press-releases/Pages/CentralBankannouncesnewregulationsonresidentialmortgagelending.aspx>

⁽⁴⁹⁾ See <http://www.centralbank.ie/publications/Documents/Economic%20Letter%20-%20Vol%202014.%20No.%2014.pdf>

⁽⁵⁰⁾ The rules do give lenders some flexibility as the limits are not absolute but proportionate, i.e. banks can issue loans in excess of the limits. For example, for PDH mortgages, 15% of the euro value of the loans for one year may be in excess of the LTV limit (90% for first-time buyers and 80% for other buyers).

Table 3.3: CBI mortgage regulation rules

	Primary dwelling		Buy-to-let
	LTV (1)	LTI (2)	LTV
Normal buyer	80%	3.5 times	70%
First-time buyer	90%	80%	
Property value	<€220,000	>€220,000	
Max allowed over limit	15% of loans	20% of loans	10% of loans

(1) Does not apply to borrowers in negative equity who obtain a mortgage for a new property.

(2) Does not apply to switcher mortgages and housing loans for the restructuring of mortgages in arrears or pre-arrears.

Source: CBI

[Explain LTV and LTI in notes]

property market is warranted. Macroprudential rules along the lines of those introduced for residential property could help alleviate the risk of a return to unsustainable commercial property lending.

Increasing the supply of social housing would help to ease price pressures. Housing supply shortages have been a key factor in driving up housing prices, notably in Dublin (Box 3.1). After the burst of the pre-2007 housing bubble, there has been a precipitous decline in housing completions and acquisitions by local authorities from almost 7000 per year in 2007 to just 285 in 2014 ⁽⁵¹⁾. Planning legislation included a provision that allowed local authorities to purchase up to 20% of properties on larger sites zoned for social and affordable housing development at below market prices. A new bill envisages that this requirement should be halved to 10%. The authorities anticipate that this will reduce the burden on developers, while still providing a potentially important channel for the acquisition of social housing units. Nevertheless, further instruments may need to be used to ensure that an adequate supply of local authority housing is restored. The Social Housing Strategy 2020 envisages a marked increase in social housing provision in the coming years, not only through local authority construction and approved housing bodies but also via off-balance sheet funding using the NAMA special purpose vehicle ⁽⁵²⁾.

Actions to address sharp increases in rents should be aimed to boost rental supply to help moderate property cycles. In the context of rising rents, the National Economic and Social Council (NESCC) has recently suggested measures aimed at ensuring secure occupancy for tenants by (i) introducing a regulated rent setting mechanism, (ii) changing from four-year to indefinite leases and (iii) removing the sale of property as a reason for ending a lease agreement. Introducing these measures may not be appropriate particularly in the short-term, as there is evidence of supply shortages. In the medium term, however, well-balanced efforts to improve security of tenure could help improve the functioning of the rental market and increase the share of rented housing.

3.2.3. Reducing the high share of non-performing loans

Resolution of the high mortgage NPLs has continued, but sustained efforts are needed, especially to tackle long-term ones. Banks are making progress in concluding sustainable solutions for non-performing mortgage accounts. However, long-term arrears (over 720 days past due) remain a challenge as they have continued to rise while non-bank entities increasingly hold more mortgages in arrears (Box 2.2). The CBI recently decided that quarterly MART targets for the banks will not be extended beyond the initial plan. Instead, it is requiring that banks conclude sustainable solutions for most distressed

⁽⁵¹⁾ It should be acknowledged that Local Authority Housing is not the only element in the Social Housing Strategy and other important measures include the Rental Accommodation Scheme (RAS) and the Housing Assistance Payment (HAP).

⁽⁵²⁾ Department of Environment, Community and Local Government (2014) [Social Housing Strategy 2020](#). The *National Asset Residential Property Services* is a NAMA SPV established in April 2013 to facilitate the sale or lease of NAMA debtor or receiver residential properties for the purpose of social housing.

borrowers by end-2015 and that 75% of concluded solutions achieve the 'terms being met' target at end-2015 and beyond⁽⁵³⁾. The new framework endorses a more bank-specific approach with more granular monitoring of problematic loans. The use of debt write-offs in mortgage arrears restructurings has so far been limited by the domestic banks, but it is increasing. Given the pick-up in legal action by the banks to secure possession of underlying properties, the CBI has reminded them to comply with the Code of Conduct on Mortgage Arrears (CCMA) ensuring that they make every effort to engage with customers to reach an alternative arrangement before resorting to the legal route. Recent Supreme Court decisions have clarified that only a failure by a lender to abide by the moratorium in the CCMA affects the lender's entitlement to obtain an order for possession while() other cases of non-compliance with the CCMA do not affect this⁽⁵⁴⁾.

Issues and solutions with long-term mortgage arrears differ by their type. For *primary dwelling homes (PDH)*, many long-term arrears involve a potential loss of ownership (including voluntary sales/surrender agreements) and legal proceedings. Thus re-engagement between the borrowers and the banks will be necessary to arrive at sustainable restructuring solutions. While a surge in repossessions is not expected, a steady rise may continue due to the amount of protracted arrears cases. Repossession procedures usually take a long time until executed due to numerous adjournments during the legal proceedings. Careful supervision of banks resolution efforts along with efforts to make legal proceedings more efficient is thus needed. *Buy-to-let (BTL)*, long-term arrears are often characterised by the use of rent receivership, whereby the bank receives rental income from the property. This in part could reduce the incentive for the banks to resolve these exposures. Proposed restructuring solutions for BTL involve higher loss of ownership compared to PDH, in part as some BTL contracts allow the bank to obtain a title to the property under receivership. In these cases, the loan remains classified as distressed until the property is sold and the whole process can be lengthy. Speedier resolutions here should be encouraged.

Recent mortgage arrears measures package aims to improve existing schemes, support those in arrears and boost the low usage of personal insolvency. The government has decided to give courts the power to review banks' vetoes on personal insolvency arrangements (PIAs)⁽⁵⁵⁾. The mortgage-to-rent scheme will also be expanded by increasing the maximum property value thresholds⁽⁵⁶⁾ and a more active role would be given to the Money Advice and Budgeting Service in assisting and advising distressed borrowers. To boost usage of personal insolvency procedures, the Insolvency Service of Ireland (ISI) has reduced the average application costs by about 80%, suspended all application fees for debt solutions until the end of 2015 (which is likely to be extended), launched a comprehensive information campaign and published a common personal insolvency protocol in order to simplify the procedure. As a result, the report for the fourth quarter of 2014 pointed to an increase in the number of debt solution arrangements albeit from a very low base.

The need for a decrease of the high levels of commercial NPLs persists, especially since they account for about two-thirds of the domestic banks' total distressed loan value. Commercial real estate (CRE) NPLs, though declining substantially in 2014 thanks to amortisations, asset sales, and restructuring including write offs, were still 53% of total domestic lenders' CRE loans at end-December 2014. Progress was also made in the SME/corporate distressed portfolio which fell by one fifth in 2014. The supervisors will continue to monitor banks' individual strategies and results for achieving their non-

⁽⁵³⁾ See April 2015 update on central bank's supervisory engagement on mortgage arrears <http://www.centralbank.ie/press-area/press-releases/Pages/UpdateonCentralBankssupervisoryengagementonmortgagearrears.aspx>

⁽⁵⁴⁾ <http://www.courts.ie/Judgments.nsf/bce24a8184816f1580256ef30048ca50/f208c356b1843cd280257e460057e798?OpenDocument>

⁽⁵⁵⁾ http://www.merriionstreet.ie/MerriionStreet/en/News-Room/Releases/Government_Strengthens_Framework_to_Support_Mortgage_Holders_in_Arrears.html

⁽⁵⁶⁾ The scheme allows mortgage holders to surrender their homes to a housing association, which then rents it back to the original owners. Currently, the property must have a market value of less than EUR 220,000 in the greater Dublin area and EUR 180,000 in the rest of the country. Concerns have been voiced on the value thresholds being too restrictive. To date, there have been less than 100 beneficiaries of the scheme.

public commercial NPL restructuring targets. BOI and AIB have moved the majority of the challenged commercial portfolio to "end state" (i.e. entering a restructuring arrangement) but further migration from "end state" to performing is expected to take several years. As the property market recovers, it is important that banks encourage the implementation of workout plans with their debtors or undertake asset disposals. Attention should be paid to SME accounts with CRE connections, given their higher probability of default. The SME examinership scheme was made more affordable to firms in July 2014 but its use is still limited⁽⁵⁷⁾. Relatedly, NAMA has made advances in selling off its portfolios of large distressed CRE loans (Box 3.2).

Once in place, the creation of a central credit register will support prudent lending by improving the assessment of the borrowers' creditworthiness. The Credit Reporting Act 2013 was enacted in December 2013, followed by the development of the register's design and supporting regulation. A data questionnaire was sent to the main lenders in March and a public consultation was launched by the CBI in April. Both should inform the data collection process, leading to the finalisation of the regulations in the autumn of 2015. The credit register is set to become operational in late 2016 for consumer credit and in 2017 for corporate credit. The absence of a credit register makes supervision, credit underwriting and internal risk management more difficult. The register will also be an important component of calibrating some macro-prudential measures (e.g. total debt-to-income and debt-service-to-income ratios).

3.2.4. Boosting credit for economic growth

SME financing remains low for various reasons. In addition to low demand for funds, SME financing constraints stem in part from the banks' more cautious approach to new lending (rather than a lack of liquidity) and the concentrated system of lenders. SMEs are still reluctant to access equity financing because of a potential loss of upside to future profits and a general lack of non-bank financing knowledge. Although firms believe that banks are now more willing to lend, interest rates remain higher than the euro-area average, due to risk-pricing that reflects the still numerous distressed SME loans of the banks. The insistence on personal guarantees and certain types of asset collateral, costly external parties' credit worthiness reports for credit applications, and the time needed for refinancing loan decisions, are amongst SME concerns.

The Ireland Strategic Investment Fund (ISIF) aims at supporting economic activity and job creation through commercial investments. With an active pipeline of almost 60 projects, it has executed one investment deal and approved a number of further transactions since it was established in December 2014. The ISIF is managed by the NTMA. Its discretionary portfolio is valued at EUR 7.2 billion or 3.7% of GDP as of end-2014⁽⁵⁸⁾, and its investment strategy will focus mostly on activities with a high impact on GDP growth, such as infrastructure, exports and manufacturing. About 20% of the funds will be marked for lower economic impact activities including SME equity funding. The ISIF hopes for its investments to have a signalling effect and attract further private investors. Given its new role in venture capital, the fund should be monitored and the take-up of such funding by firms assessed also in the context of the Investment plan for Europe⁽⁵⁹⁾, as the ISIF anticipates partnership with the European Fund for Strategic Investments.

The Strategic Banking Corporation of Ireland (SBCI) intends to diversify funding for Irish SMEs. It will do this by channelling its lower cost of funding to firms through on-lenders, including retail banks. Its initial products include longer-term loans, working capital facilities with durations of two years and loans for the refinancing of credit extended by banks who are exiting the domestic market. The lenders

⁽⁵⁷⁾ Examinership allows a company that is experiencing financial difficulties a period of protection from creditor action during which a third party (the examiner) has an opportunity to study the affairs of the company and, if there is a prospect for the continuation of the company, to draw up a plan for its continuation. Only about 30 SMEs had sought the appointment of an examiner through the Circuit Court in 2014.

⁽⁵⁸⁾ Quarterly Portfolio and Performance Update for Q4 2014, <http://www.ntma.ie/business-areas/ireland-strategic-investment-fund/>

⁽⁵⁹⁾ <http://www.eib.org/about/invest-eu/index.htm>.

need to diversify among sectors while the SBCI has allocated 50% of its funds to the two main lenders, AIB and BOI. So far these two banks are the only lenders participating in the scheme though there are more prospective on-lenders at various stages of discussion with the SBCI. The SBCI funds are partly guaranteed by the government. It launched its loan products in March 2015 and since then AIB and BOI have together approved EUR 60 million in SME credit under the scheme.

3.3. STRUCTURAL REFORMS

3.3.1. Improving the labour market and addressing skills mismatches

Contracted employment services are about to start. The delivery of support services to the long-term unemployed under *JobPath* is to start in the second half of 2015. It is expected that around five months will be necessary for the programme to reach full capacity and for all offices to be opened nationwide. As of 2016, around 100 000 long-term unemployed are targeted to be referred to *JobPath* services providers, for a total of 440 000 referrals for the limited duration of the contracts. This should significantly improve the intensity of service provided to long-term jobseekers and further contribute to the reduction in unemployment, which has steadily progressed since late 2012. In turn, the vast majority of *Intreo* offices are fully operational, with a limited number of offices yet to open. The *Intreo* system has been the central element in the reform of activation policies over the past few years. It is therefore positive that the authorities will review the programme later this year, focusing on the new processes, "client" satisfaction and effectiveness. Performance indicators will also then be published and *Intreo* offices will be benchmarked against each other.

Reforms to further education and training (FET) continue. The integration of training centres into the wider setting of Education and Training Boards (ETBs) is deepening, and changes in course provision are taking place gradually. Efforts are also made to promote a systematic engagement with employers at the local level with ETBs so as to ensure a closer connect between course provision and business needs. The Apprenticeship Council launched a call for proposals for new apprenticeship schemes in early 2015. A significant number of proposals were received, including from education and training providers and from employers. Areas not previously covered by apprenticeships such as manufacturing, tourism and other services sectors represented an important share of the submissions. These will be assessed by the Council before it makes recommendations to the minister for funding allocations.

The minimum wage setting mechanism is under review. The government established the Low Pay Commission in January 2015 and published the general scheme of a National Minimum Wage (Low Pay Commission) Bill. The bill seeks to establish the Commission on a statutory basis, with the mandate to examine the national minimum wage and make an annual recommendation to the minister. The intent is to generate a non-political recommendation on appropriate changes to the minimum wage and reduce large step-wise increases in the level of minimum wage by putting in place incremental changes on an annual basis. The Commission would be mandated to consider a number of factors in its recommendations, including international comparisons, the need for job creation, changes in income distribution, labour market conditions and competitiveness issues. Employers have indicated that they are concerned that there is a presumption in the general scheme that the minimum wage will be increased every year, and that knock-on effects to minimum wages set under collective agreements could be significant.

3.3.2. Increasing efficiency in the delivery of healthcare

Spending in the health sector is only marginally above profile so far, but pressure points persist. The health budget was increased in 2015 for the first time in seven years. The department of health indicated that it was therefore confident that it had enough resources. However, expenditure was 0.4% above budget plans through end-May and spending pressures remain, including in the hospital sector and

in pharmaceuticals. In the past four years, spending deviations from budget plans by mid-year have not been corrected during the second half and have on two occasions further increased significantly.

Budgeted savings on patented medicines will not materialise in 2015. The planned mid-term review of the agreement with the Irish Pharmaceutical Healthcare Association (IPHA) – which set the supply terms conditions and prices for on-patent medicines for the period of November 2012 to October 2015 – ended in a deadlock. Budgeted savings of around EUR 40 million in 2015 from the mid-term review will therefore not materialise. The agreement expires in October 2015, and the failure of the mid-term review places additional uncertainty about Ireland's ability to generate savings on pharmaceuticals spending, in particular for on-patent medicines. Regarding a new agreement, discussions with IPHA have not yet started. Achieving price reductions in the on-patent group is key to generate overall savings, as on-patent medicines represent around 76% of the total in price terms, though only 46% in volume terms. The government is seeking to review the basket of countries used for reference prices, use minimum prices instead of average prices, have more frequent price realignments, gain additional rebates and review the quality of life ratios. Concerning off-patent medicines, good progress has been made to improve the uptake of generics and reduce prices through the system of internal reference pricing and the list of interchangeable medicines. To boost off-patent use, the authorities intend to mandate prescription by international non-proprietary name (INN) for dispensing within Ireland by the end of 2015.

Other health reforms progress at varying paces. Activity-based funding is still only operating on a shadow basis in the 38 largest hospitals, and the authorities have indicated that switching away from block-funding will be a multi-year project. The roll-out of individual health identifiers is advancing gradually. They will be used in the provision of free general practitioner (GP) care for the under six before being phased in slowly for other areas, mainly in primary care at first. Free GP care for the over 70 has also been approved recently and will be phased in during the second half of 2015. These are both viewed as intermediate steps towards the eventual introduction of universal health insurance (UHI). The government commissioned the Economic and Social Research Institute (ESRI) to conduct a preliminary costing analysis of introducing UHI. It is unclear whether the results will be made public. Overall, uncertainty continues to surround the introduction of UHI and its practical modalities. In addition, the interaction between the planned phasing of UHI and efforts to encourage the use of private health insurance through the introduction of lifetime community rating⁽⁶⁰⁾ is unclear, as UHI would not rely on such rating. Lifetime community rating has become effective as of 1 May. Anecdotal evidence suggests that interest in private health insurance picked up in the run-up to the deadline, but no official figures have been published.

3.3.3. Reforming the water sector

Compliance with payment of water bills will be a critical test of the reform. Irish Water has indicated that about two-thirds of households had registered as customers as of late April. Given that the EUR 100 water conservation grant is conditional upon registration, this rate is an indication that resistance against paying for water services remains high, with some social groups actively calling for boycotting the charges. Irish Water also started sending the first quarterly bills to domestic users in early April, with around 1.7 million bills to be issued by June. It has so far refused to publish data on payment compliance or delays, including under a request under the Freedom of Information Act 2014. The ability of the government and Irish Water to explain further the rationale for the reform and demonstrate that the public utility model is best to deliver needed high-quality infrastructure in the most cost-effective manner will therefore be critical. In turn, payment compliance will be key for Irish Water's ability to raise revenue and

⁽⁶⁰⁾ Community rating refers to people taking private health insurance and they all pay the same premium for a given insurance plan, irrespective of age, gender or health status. Under lifetime community rating, a penalty (for late entry) is applied to people contracting private insurance after the age of 35. Those who contract private health insurance before the age of 35 will not be subject to the penalty for as long as they maintain their insurance. This system aims to encourage the take-up of private health insurance by the younger population with lower healthcare needs and thus reduces premiums in the insurance system.

deliver upon its investment programme. Late payment penalties will be put in place, but only in cases where households are in arrears for a full annual billing period. The government has approved the drafting of a Civil Debt (Procedures) Bill, which will modify the legal framework for the recovery of debts. The bill will introduce a distinction between "can't pay" and "won't pay" and will abolish imprisonment for non-payment of debt in most cases. It will also make provisions for the attachment of earnings or deductions from welfare payments.

Funding for Irish Water continues to rely heavily on government support. Revenue from water charges are expected at EUR 500 million (0.25% of GDP) in 2015, of which EUR 271 are from domestic household users. Operational expenditure is projected at EUR 799 million (0.4% of GDP), with planned capital expenditure of EUR 681 million (0.3% of GDP). This generates a revenue-to-expenditure ratio of 33.8%, which is expected to increase to 37.1% in 2016. The shortfall is to be covered by transfers from the government of EUR 399 million and EUR 479 million in 2015 and 2016 respectively (about 0.2% of GDP each year) and by borrowing to fund the investment programme. Irish Water's investment programme from the fourth quarter of 2015 to end-2016 was approved by the Commission for Energy Regulation, for EUR 1.4 billion (about 0.7% of GDP). Regulatory approval for capital projects could increase to EUR 1.8 billion subject to availability of funds, which reflects the urgent need of investment in the sector for supply and treatment facilities ⁽⁶¹⁾.

Irish Water is presently classified within general government accounts. The Central Statistics Office indicated in April that Irish Water had been provisionally classified as part of the general government sector and Eurostat included Irish Water in the general government accounts in its April *Reporting of Government Deficits and Debt Levels* ⁽⁶²⁾. The inclusion of Irish Water increased the deficit by EUR 338 million (0.3% of GDP) in 2014 and likely by EUR 581 million (0.2% of GDP) in 2015. At the latest, the publication of Eurostat's *Reporting of Government Deficits and Debt Levels* in October will clarify Irish Water's classification based on the current level and structure of charges and regulatory regime. A classification within general government has not compromised compliance with fiscal rules. However, preserving Irish Water's ability to deliver on its capital investment programme is key given the economic importance of this infrastructure sector.

3.3.4. Reducing legal services costs

Enactment of the Legal Services Regulation Bill has become a genuine near-term possibility at last. The bill was passed by the Dáil and sent to the Seanad at the end of April. However, the establishment of legal partnerships and multidisciplinary practices (MDPs) will be subject to specific commencement of the relevant sections of the bill after its enactment. The Legal Services Regulatory Authority will have six months upon its establishment to conduct consultations on the regulation, monitoring and operation of legal partnerships and report to the minister, who should then commence the relevant section of the act.

The establishment of MDPs faces continued uncertainties. The authority will have six months to conduct research on MDP establishment. This will be followed by six months of consultation with stakeholders leading to a recommendation to the minister. Thus, there is no certainty that the relevant section of the act will be commenced and that MDPs will be allowed. A number of substantive amendments will also still be tabled. These concern mainly advertising, limited liability partnerships and the staffing of the authority. Determination is therefore still needed to achieve enactment of the bill without further delays.

Passage of the bill would only be a first, albeit important, step to reduce the high cost of legal services. It will be key to ensure that the authority becomes operational as quickly as possible. It will also be critical to ensure that the reformed regulatory framework does generate increased competition and

⁽⁶¹⁾ See European Commission's [Country Report Ireland 2015](#).

⁽⁶²⁾ Eurostat, [Reporting of Government Deficits and Debt Levels](#).

reduces legal services costs as intended, as high costs not only make it more expensive to do business in Ireland, but are also a burden on its citizens.

3.3.5. Privatising non-financial state assets

The sale of non-bank state assets is being finalised. The authorities undertook to sell a number of state assets under the EU/IMF financial assistance programme. The sale of assets by the Electricity Supply Board (ESB) enabled the payment of EUR 400 million (about 0.2% of GDP) in special dividends to the government in 2014-2015. State-owned Ervia sold its subsidiary Bord Gáis Energy for EUR 1.1 billion (0.6% of GDP) in 2014. Parts of the proceeds were transferred to the government in 2014 as special dividends, with some additional special dividends to be paid in mid-2015. The balance will be paid as super dividends in tranches extending perhaps to 2017, but will have no effect on the general government balance as they will be treated as financial transactions. At the end of May, the Dáil approved the general principles for the sale of the state's remaining 25.1% stake in Aer Lingus to the International Airlines Group (IAG). The sale's completion is contingent on the European Commission's approval under its merger rules and on Ryanair agreeing to sell its equity participation. The proceeds of EUR 335 million (0.2% of GDP) would be used by ISIF to establish a connectivity fund. Although privatisation proceeds have been modest, they have enabled the early repayment of debt as required under the former EU/IMF financial assistance programme, and supported public-private partnership projects, mainly in infrastructure.

Box 3.1: Supply-side shortages in the property market

Signs of supply shortage have emerged in the Dublin property market. Developments in the property market have triggered a debate on how to address supply constraints in the national capital. To this end, it is useful to examine both the intended and unintended effects of various recent policies.

New mortgage lending regulations announced by the CBI could have an indirect effect on the supply of residential property. The loan-to-value (LTV) and loan-to-income (LTI) limits aim to strengthen financial stability by mitigating the exposure of both banks and borrowers to large losses in the event of a negative shock to the housing market. [Cussen et al. \(2015\)](#) estimate that the introduction of the LTV measure may lead to a small decline in new house completions in Ireland. Although these macroprudential measures have attracted some criticism, it is likely that other factors play a more significant role in constraining supply.

Strict planning and development regulations represent a supply constraint in the property market. For instance, General Site Development Standards are published in the Dublin City Council [City Development Plan](#) and a new edition is due to be published at the end of 2015, covering the period 2016-2022. The current plan specifies minimum requirements on a number of criteria such as size, aspect, and ceiling heights. The revised regulations will aim to improve the quality of future residential property developments. However, some argue that the current guidelines are excessively severe and could be constraining housing supply as they increase the cost of construction.

Funding constraints are weighing on the supply of property as banks are no longer willing to provide 100% debt finance to developers, though REITs could potentially become a new source of finance for some properties. In contrast to the pre-crisis period, banks are now willing to provide debt funding of no more than 70% of the total funding required by property developers ⁽¹⁾. To bridge the remaining 30% funding gap, developers must either invest their own equity or source it from a third party. This policy has desirable consequences for financial stability in so far as it reduces the exposure of banks to property development risks. However, many construction firms are reluctant to use external equity because it is perceived to be more costly as it requires developers to share their profits as well as transferring some ownership of the firm. As a result, the transition to the new funding model has been gradual and the consequent funding constraints have contributed to the depressed level of construction and development activity. However, it is likely that some REITs will switch toward funding new property development as the supply of existing properties is limited. REITs may develop properties to hold in their rental investment property portfolios, and have a time-limited ability to invest cash reserves pending the acquisition of property assets. As they have been successful in bringing in foreign capital, REITs have some potential to become a source of equity funding for property developers, in the absence of debt funding from the banks.

To support housing supply and the construction sector, the government is in the process of introducing an array of policies. The Department of Environment, Community and Local Government (DECLG) intends to pass a bill soon that includes measures designed to support supply such as a vacant site levy and 'use it or lose it' planning permissions. In addition, the DECLG also plans to substantially increase the provision of social housing having set a target of 35,000 new social housing units by 2020. The government's *Construction 2020* initiative contains a broad range of measures designed to support the recovery of the sector, including the publication of reports investigating access to equity and debt finance for development. The authorities also hosted an event to inform developers and potential funding providers of the potential for equity funding. Moreover, they have encouraged NAMA to become proactive in supporting the recovery of the property market. Since its inception in 2009, NAMA has delivered 1,198 social housing units nationally, provided over EUR 1 billion in development funding and completed 1,600 new houses and apartments in Dublin from a target of 4,500 residential units by 2016.

Given supply constraints, targeted but prudent measures are warranted. These measures should focus on increasing the availability of property in areas where supply is most limited, most notably Dublin and the commuter area. Furthermore, it is important that mistakes of the past be avoided. Amongst other factors, inappropriate pro-cyclical fiscal policy implemented in Ireland in the pre-crisis period included specific subsidies and tax expenditures for the construction sector which contributed to the inflation of an unsustainable construction and housing boom. In this regard, it is positive the government ended the capital gains tax exemption on property last year.

1) This is according to the Department of Finance Report on [Access to Finance for Construction and Development](#). See also [4 March 15 Speech](#) by Michael Noonan.

Box 3.2: NAMA, the good 'bad bank'

The National Asset Management Agency (NAMA) was set up in 2009 to remove non-performing land, development property, and associated commercial loan portfolios from the banks. NAMA paid EUR 31.8 billion for bank loans with a face value of EUR 74 billion, representing a 57% discount based on the valuation made on 30 November, 2009. The purchase was financed by issuing to the banks EUR 1.6 billion in subordinated debt and EUR 30.2 billion government-guaranteed senior debt (18% of GDP). NAMA is not part of the general government sector as it is 51% privately owned.

NAMA has been successful at disposing of assets while aiming to ensure the best achievable return for the state. It has taken advantage of the geographical composition of its portfolio, selling mostly UK assets earlier on, when the Irish market was hitting bottom, and gradually increasing its Irish disposals as prices began to recover in 2014 (Graph 1a). As the largest supplier of commercial property in Ireland⁽¹⁾, it can influence the market by planned, gradual property releases that can satisfy rising investor appetite. In addition to recent strong investor demand, the homogeneity and the type of NAMA's assets (land and development loans secured by property collateral) also facilitate work-out and disposals, compared to other similar institutions (Graph 1b).

Institutional and management factors have underpinned NAMA's positive performance. NAMA has positioned itself as a centralised entity able to break the past speculative close link between developers and lenders, and was thus likely better able to collect on loans. In fact, NAMA benefits from several features that support a centralised approach to asset recovery. According to [Klingebiel \(2000\)](#), these include a consolidation of scarce work out skills and resources in one entity, a centralised control over collateral which thus possibly provides more leverage over debtors and better management, an application of homogeneous workout practices and a facilitation of government monitoring of workout practices. Moreover, upon the loan transfers, NAMA with the help of other firms and auditors thoroughly reviewed the valuation of assets, including legal titles, related to collateral. NAMA also chose to actively manage its portfolio and enhance its value, including through debtor and vendor financing, and boosting its rental (non-disposal) income. Regarding enforcement over debtors, NAMA has benefitted from a sound legal and judicial framework.

NAMA's performance as a "bad bank" has been positive since it has contributed to the stabilisation of the financial system. The establishment of NAMA allowed banks to take problem assets off their books, allowing them to focus on their core business and to gradually improve their solvency levels with the goal of restoring their capacity to intermediate. [Schoenmaker \(2015\)](#) finds its creation reduced the uncertainty over the scale of banks' losses and their recognition, which otherwise could have taken much longer. In addition NAMA helped bank liquidity as it allowed banks to access eurosystem funding using the government-guaranteed NAMA bonds as collateral, which was not possible against the loan portfolios prior to the transfer of assets. The sale of loans to NAMA at 2009 values also insulated the banks from the further decline in the property market. Some, such as Schoenmaker, suggest that an asset management agency such as NAMA should have been utilized for distressed mortgages also, as it may have sped up their resolution.

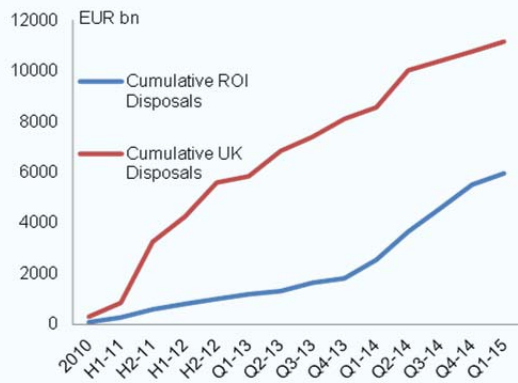
The fiscal costs created by NAMA have diminished. Issuing government guaranteed senior bonds to the banks came at the expense of increasing sovereign contingent liabilities when financing costs were soaring. Achieving the first senior debt redemption target (25% by end-2013) signalled that NAMA was working. NAMA has redeemed 64% of its senior debt as of end-May and intends to redeem it fully by end-2018, two years ahead of schedule, and pay off all subordinated debt by 2020. The accelerated redemption has sped up the reduction of the government's contingent liabilities, which were EUR 10.8 billion, or 5.5% of GDP as of end-May 2015. Moreover, NAMA predicts it could generate EUR 1 billion (0.5% of GDP) in surplus for the government when it winds down in 2020 if favourable market conditions persist. This may be surpassed as it ended 2014 with EUR 1.8 billion in cash balances and liquid assets.

⁽¹⁾ Properties securing NAMA's loans are managed and sold by their owners or, in the case of enforcement, by appointed receivers.

(Continued on the next page)

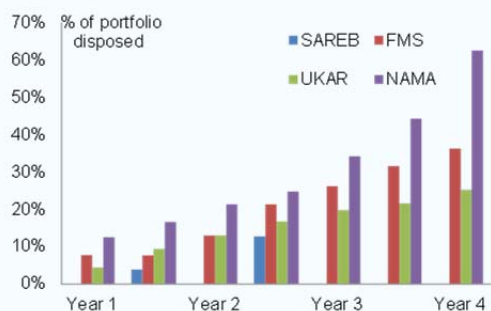
Box (continued)

Graph 1a: The disposal of Irish assets has intensified with the recovery of the property market.



Source: NAMA

Graph 1b: NAMA's asset disposal pace compares well to similar asset management companies.



SAREB: Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria (Spain),
 FMS: FMS Wertmanagement (Germany),
 UKAR: UK Asset Resolution Limited (United Kingdom)
 Source: NAMA, SAREB, FMS and UKAR

4. FINANCING ISSUES AND CAPACITY TO REPAY

The sovereign's financing position and outlook remains comfortable supported by the monetary easing of the ECB. Ireland had a cash buffer of EUR 11.1 billion at the end of 2014. The NTMA is pre-funded for the whole of 2015. This year it plans to hold nominal cash balances close to 2014 levels (Table 4.1). A EUR 5 billion EFSM loan originally due in 2015 is expected to be extended by seven years⁽⁶³⁾. The NTMA expects to issue EUR 12-15 billion of long-term bonds in 2015 and EUR 11 billion had been issued by June 2015. Under the ECB's asset purchase programme, the CBI is expected to purchase EUR 700 million of Irish government bonds a month from March 2015. According to the NTMA, this will total about EUR 7.1 billion in 2015 and EUR 6.4 billion in 2016⁽⁶⁴⁾.

Ireland has replaced most of its IMF loans with bonds at longer maturities and lower interest rates. In 2014, the Irish government announced that it planned the early repayment of 81% (or SDR 15.7 billion) of the IMF loans linked to the financial assistance programme⁽⁶⁵⁾. Ireland reimbursed SDR 7.65 billion (EUR 9 billion) in December 2014 and a further SDR 2.83 billion (EUR 3.5 billion) in February 2015. These payments discharged all loans due between July 2015 and June 2019. The remaining SDR 5.2 billion was repaid in March 2015 which redeemed loans due up to January 2021. The Irish authorities expect the interest and hedging savings from these early repayments to exceed EUR 1.5 billion (0.8% of GDP) over the original lifetime of the loans. The Eurogroup agreement of 12 September 2014 to waive the proportional early repayment clause on EFSF loans was based on the understanding that the savings from the early repayment of IMF credits would be earmarked for budget deficit and public debt reduction.

Debt sustainability has improved somewhat since the second PPS review but the debt path remains sensitive to growth and interest rate shocks. The Commission's latest debt sustainability analysis (DSA, Annex 2) shows that, in the absence of further consolidation measures, public debt-to-GDP would bottom out at around 100% in 2020 and then rise to 106% in 2025. The trough is 4 percentage points of GDP lower in 2020 than in the previous PPS report published in January 2015. The full implementation of the 2015 Stability Programme could bring the debt-to-GDP ratio close to 60% in 2025, and this would require sustaining primary surpluses of 3.6% of GDP. Across all scenarios of the DSA the debt profile remains sensitive to negative economic growth shocks and to increases in the interest rate. The sensitivity largely results from the high initial debt level which amplifies the effect of growth and interest rates on debt dynamics. Debt sustainability has also improved as contingent liabilities related to NAMA have declined from a high of 18% of GDP in 2009 to 5.5% of GDP as of end-May (Box 3.2).

⁽⁶³⁾ The agreed maturity extension is already effective for EFSF loans whereas, for EFSM loans, the potential maturity extension will be determined at a later stage as the loans approach their original maturity dates.

⁽⁶⁴⁾ As of March 2015, the central bank is estimated to hold EUR 15.5 billion in government bonds. See NTMA Institutional Investor Presentation, June 2015: <http://www.ntma.ie/news/ntma-institutional-investor-presentation-june-2015/>

⁽⁶⁵⁾ In 2014, Ireland obtained a waiver for the mandatory proportional early repayment clause in their loan agreements from its bilateral creditor countries, the EFSF and the ESM.

Table 4.1: Government financing plans

EUR billion	2014 prov.	2015 est.
Funding requirement		
Exchequer borrowing requirement (EBR) 1/	8.2	3.5
Medium/long-term debt redemption 2/	15.9	12.1
Other 3/	0.0	1.0
Total requirement	24.1	16.6
Funding sources		
Government bonds 4/	12.1	13.5
EU-IMF loan disbursement 5/	0.8	0.0
Net short-term paper funding 6/	1.5	3.0
Other including net State Savings (Retail)	2.3	0.9
Use of cash and other short-term investment balances (- represents an increase)	7.4	-0.8
Total sources	24.1	16.6
Financial buffer 7/	11.1	11.9

Rounding may affect totals. 2014 figures are provisional and subject to revision; 2015 figures are estimates.

(1) 2015 EBR estimate as per Department of Finance, Stability Programme Update (April 2015).

(2) Includes Government bond maturities, bond buy-backs/cancellations/switches and early IMF loan repayments.

(3) Includes contingencies.

(4) The NTMA announced in December 2014 that it plans to issue EUR 12 - EUR 15 billion of long-term Government bonds in 2015. EUR 13.5 billion, the mid-point of the range, is reflected in the table as an indicative amount for 2015.

(5) 2014 figure reflects final EU/IMF programme disbursement from EFSM in March 2014.

(6) Net short-term paper funding: includes Treasury Bills.

(7) End-year cash and other short-term investment balances.

Source: National Treasury Management Agency (NTMA)

ANNEX 1

State of play with Macroeconomic Imbalance Procedure (MIP) relevant recommendations

2014 Country-specific recommendations (CSRs)	
Commitments	Summary assessment
<p>CSR 1: Fully implement the 2014 budget and ensure the correction of the excessive deficit in a sustainable manner by 2015 through underpinning the budgetary strategy with additional structural measures while achieving the structural adjustment effort specified in the Council Recommendation under the Excessive Deficit Procedure (EDP).</p> <p>After the correction of the excessive deficit, pursue a structural adjustment towards the medium-term objective (MTO) of at least 0.5% of GDP each year, and more in good economic conditions or if needed to ensure that the debt rule is met in order to put the high general government debt ratio on a sustained downward path.</p>	<p>Ireland has made some progress in addressing CSR 1:</p> <ul style="list-style-type: none"> • Substantial progress: in 2014, Ireland achieved a headline deficit of 4.1% of GDP, well below the target under the EDP of 5.1% of GDP. Commission 2015 spring forecast projects the headline deficit to 2.8% of GDP in 2015, the deadline for correction. The year after, the deficit, at 2.9% of GDP, is forecast to stay below the 3% of GDP Treaty reference value on a no-policy-change basis. Whereas the fiscal effort in 2011-2015 is estimated to be below what is recommended based on the estimated unadjusted and adjusted change in the structural balance, the cumulated yield of the individual permanent consolidation measures taken over 2011-2015 amounts to around 9½% of GDP, in line with the cumulative fiscal effort recommended by the Council. Therefore, the Commission expects a timely correction of the excessive deficit. Notwithstanding, Ireland should still use windfall gains from better-than-expected economic and financial conditions to accelerate the deficit and debt reduction. • Limited progress: assuming a timely correction of the excessive deficit by 2015, Ireland would be subject to the preventive arm of the Stability and Growth Pact from 2016 onwards. Based on data presented in the programme, recalculated according to the commonly agreed methodology, progress towards the MTO is in line with the requirements of the preventive arm of the Pact. However, under the usual no-policy-change assumption, the Commission 2015 spring forecast, points to a risk of a significant deviation from the required adjustment path. Hence, achieving the required structural targets hinges on the Irish government specifying and implementing the measures necessary to achieve the budgetary target. Concerning the transitional debt rule,

<p>Enhance the credibility of the fiscal adjustment strategy, effectively implement multi-annual budgetary planning and define broad budgetary measures underlying the medium-term fiscal targets. Ensure the binding nature of the government expenditure ceiling including by limiting the statutory scope for discretionary changes.</p> <p>To support fiscal consolidation, consideration should be given to raising revenues through broadening the tax base. Enhance the growth and environmental friendliness of the tax system.</p>	<p>Ireland is forecast to deliver the required minimum linear structural adjustment (MLSA) in 2016 (0.3% of GDP vs. required 0.1% of GDP).</p> <ul style="list-style-type: none"> • No progress: no changes have been made to the legal framework for expenditure ceilings introduced in 2013 in the Ministers and Secretaries (Amendment) Act 2013. • Some progress: starting in 2015 for new companies, and following a transition period until the end of 2020 for established ones, companies registered in Ireland will be treated as resident for tax purposes regardless of ownership structure, thereby scheduling an end to the <i>double Irish</i> scheme and potentially broadening the tax base. No other measures have been taken to broaden the tax base, and little has been done to enhance the growth and environmental friendliness of the tax system.
<p>CSR 3: Pursue further improvements in active labour market policies, with a particular focus on the long-term unemployed, the low-skilled and, in line with the objectives of a youth guarantee, young people.</p>	<p>Ireland has made substantial progress in addressing CSR 3:</p> <ul style="list-style-type: none"> • Substantial progress: a new version of <i>Pathways to Work</i>, the strategy setting out Ireland's reform of activation and training services, was published in October 2014. It sets out new actions to be implemented in the coming year as well as quantitative targets, with a greater emphasis on long-term and youth unemployment. A <i>Youth Guarantee Implementation Plan</i> has been prepared that sets out measures tailoring existing services and initiatives to young jobseekers, including under the <i>Intreo</i> setting. The provision of support services to the long-term unemployed under the <i>JobPath</i> initiative will start in the second half of 2015 as contracts with providers have been signed and as they have started establishing their offices. When fully implemented, it will enable a large number of long-term unemployed to benefit from activation services provided by private contractors. • Substantial progress: all training centres

<p>Advance the ongoing reform of the further education and training (FET) system, employment support schemes and apprenticeship programmes. Offer more workplace training; improve and ensure the relevance of FET courses and apprenticeships with respect to labour market needs.</p> <p>Increase the level and quality of support services provided by the Intreo labour offices.</p> <p>Put in place a seamless FET referrals system between Intreo offices and Education and Training Boards.</p>	<p>under the management of SOLAS have been consolidated under their respective Education and Training Boards, and SOLAS published its three-year corporate strategy and a five-year strategy for developing and delivering an integrated further education and training sector. In line with Annual Service Plan targets between SOLAS and the ETBs, adaptations in course provision are taking place gradually and efforts are made to promote systematic engagement with employers at the local level with ETBs so as to ensure a closer connect between course provision and business needs.</p> <ul style="list-style-type: none"> • Substantial progress: there are about 550 case officers dealing with jobseekers in <i>Intreo</i> offices. The vast majority of <i>Intreo</i> offices are fully operational, with a small number of offices yet to open. The authorities will review the <i>Intreo</i> structures later this year, focusing on "client" satisfaction and effectiveness. Performance indicators will be published and <i>Intreo</i> offices will be benchmarked against each other. • Some progress: protocols have been put in place between Education and Training Boards and <i>Intreo</i> offices.
<p>CSR 5: Advance policies for the SME sector including initiatives to address the availability of bank and non-bank financing and debt restructuring issues, while avoiding risks to public finances and financial stability. Advance initiatives to improve SME's access to bank credit and non-bank finance.</p>	<p>Ireland has made substantial progress in addressing CSR 5:</p> <ul style="list-style-type: none"> • Substantial progress: the National Pensions Reserve Fund (NPRF) was replaced with the Ireland Strategic Investment Fund in December 2014. The mandate of the Ireland Strategic Investment Fund is to invest on a commercial basis to support economic activity in Ireland. It focuses in part on SMEs and manages assets worth EUR 7.2 billion (3.7% of GDP). The state development corporation for SMEs, the Strategic Banking Corporation of Ireland was launched in 2014 to provide discounted lending products, which become available in March 2015 The SBCI can allocate a maximum of 50% of its funds to the two main lenders, AIB and BOI. So far these two banks are the only

<p>Introduce a monitoring system for SME lending in the banking sector.</p> <p>In parallel, work to ensure that available non-bank credit facilities, including the three SME funds co-funded by the National Pensions Reserve Fund, Microfinance Ireland and the temporary loan guarantee scheme, are better utilised. Promote the use of these and other non-bank schemes by SMEs.</p> <p>Enhance the Credit Review Office’s visibility and capabilities in mediating disputes between banks and prospective SME borrowers who have been refused credit.</p>	<p>lenders participating in the scheme and there are about 10 prospective on-lenders. The SBCI secured an initial amount of EUR 800 million in funds, of which EUR 550 million are guaranteed by the government. Since March, AIB and BOI have approved EUR 60 million under the scheme.</p> <ul style="list-style-type: none"> • Substantial progress: The authorities publish quarterly data on bank lending to SMEs, but no longer have a formal target-based system to monitor lending to SMEs though it is closely watched. • Some progress: Two SME funds, co-financed by the NPRF, are lending with a growing number of projects in the pipeline. The mandate of a third NPRF fund, the Turnaround Fund, was not renewed at the end of 2014 due to the limited pool of underperforming/distressed businesses eligible as turnaround investment cases amid a continued economic recovery. The Action for Jobs 2015 announced a reconfigured Credit Guarantee Scheme (CGS) and a simplified operation of the Microenterprise Loan Fund. A rule that restricted loan access to businesses that were previously refused credit by a commercial bank was removed and the maximum length of the CGS was extended from 3 to 7 years. A supporting SMEs Online Tool was launched to increase awareness among SMEs of available business supports. A communications campaign is being run to showcase the website. • Some progress: PTSB has agreed to participate in the Credit Review Office process since it will begin lending to SMEs. The upper limit for referring refusals to the Credit Review Office has been increased to EUR 3 million. As the latest RedC SME Credit Demand Survey (September 2014) shows, there are still issues with the visibility and usage of non-bank schemes and of the Credit Review Office for appeals against credit refusals. Awareness and knowledge of SME
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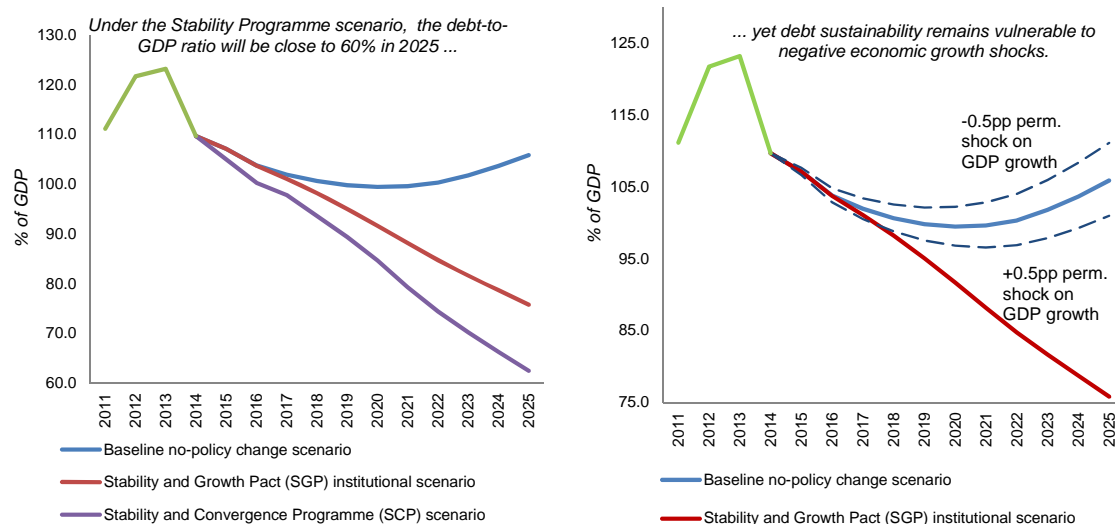
<p>CSR 6: Monitor banks' performance against the mortgage arrears restructuring targets.</p> <p>Announce ambitious targets for the third and fourth quarters of 2014 for the principal mortgage banks to propose and conclude restructuring solutions for mortgage loans in arrears of more than 90 days, with a view to substantially resolving mortgage arrears by the end of 2014.</p> <p>Continue to assess the sustainability of the concluded restructuring arrangements through audits and targeted on-site reviews.</p> <p>Develop guidelines for the durability of solutions.</p> <p>Publish regular data on banks' SME loan portfolios in arrears to enhance transparency.</p> <p>Develop a strategy to address distressed commercial real-estate exposures.</p>	<p>funding options remains low.</p> <p>Ireland has made some progress in addressing CSR 6:</p> <ul style="list-style-type: none"> • Full implementation: Mortgage Arrears Resolution Targets (MART) were met at the end of 2014 and quarterly targets have been phased out for 2015. • Full implementation: In April 2015, the central bank announced the new post-MART framework that will endorse a more granular, bank-specific approach. It requires that banks have concluded sustainable solutions for most distressed borrowers by end-2015 and that 75% of concluded solutions are achieving the 'terms being met' target at end-2015 and beyond. • Substantial progress: the Central Bank of Ireland (CBI) is committed to continuously assessing the sustainability of the concluded restructuring arrangements through on-site supervision, targeted inspections and audits. The CBI has requested banks for information on their strategies, data and internal targets to reduce non-performing loans. • Some progress: Although guidelines for the durability of solutions proposed for mortgages are in place, there is no equivalent for SME or commercial loan restructurings. • No progress was made in publishing regular data on the banks' SME loan portfolios in arrears. • Limited progress: the National Asset Management Agency (NAMA) is ahead of schedule with EUR 21 billion of asset disposals at end-May 2015 (about 30% of which are disposals of Irish assets), taking advantage of strong market demand. Although NAMA is addressing the large commercial real estate (CRE) exposures, no new strategy has been devised to deal with the smaller exposures that often also
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<p>Establish a central credit registry.</p>	<p>have SME connections.</p> <ul style="list-style-type: none">• Limited progress: the Credit Reporting Act, 2013 came into force in January 2014. Work on the central credit register has been well underway since January 2014, but the current timeline envisages some delay with the register being operational in late 2016 for consumer credit, and in 2017 for corporate credit.
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ANNEX 2

Debt sustainability analysis

Graph A2.1: Gross government debt projections



(1) *The SGP scenario assumes a structural adjustment path in compliance with the fiscal effort recommended by the Council until the excessive deficit is corrected, and thereafter an annual structural consolidation effort of 0.6 percentage point until the medium-term objective (MTO) is reached.

**The Stability and Convergence Programme (SCP) scenario, relying on SCP's macro-fiscal assumptions over the programme horizon and constant fiscal policy assumption (constant SPB at last programme year) beyond the programme horizon.

***The sensitivity tests on real GDP growth consists of standard (permanent) negative and positive shocks (-0.5 p.p./ +0.5 p.p.) on real GDP growth applied from the year following the one of last actual data available (2014) until the end of the projection horizon (2025). The shock is symmetrically applied to actual and potential GDP growth, so that the output gap remains unchanged. The cyclical component of the balance is therefore not affected by these shocks to growth. Shocks to real economic growth and inflation have the same impact on public debt.

Source: European Commission

On the whole, debt sustainability has improved since the last PPS review. According to the Commission 2015 spring forecast, in the baseline no policy change scenario the general government debt-to-GDP ratio would bottom out at around 100% in 2020 and then rise to reach 106% in 2025 (Graph A2.1). These projections assume that no additional consolidation measures take place from 2016 onwards. The minimum for debt in 2020 is 4 percentage points of GDP lower in 2020 than in the previous DSA carried out for the second PPS review, though by 2025 debt is now somewhat higher. Under the Stability and Growth Pact (SGP) scenario⁽⁶⁶⁾, gross government debt is projected to decline to around 75.8% of GDP by 2025. Similarly, this number is about 4 percentage points of GDP lower in 2025 than in the previous DSA.

Under the Stability and Convergence Programme scenario (SCP), debt would decline to near the Treaty value, but debt remains vulnerable to growth shocks. In this scenario, the full implementation of the 2015 Stability Programme (SP) would bring general government debt down to 62.5% of GDP in 2025. Though still high, this is an improvement on earlier forecasts, mainly as a result of a stronger growth outlook and higher primary budget balances projections. However, the SCP scenario is contingent upon Ireland sustaining primary surpluses close to 3.6% of GDP. The debt profile remains vulnerable to negative economic growth shocks. In the no-policy-change scenario, a negative permanent shock to nominal GDP growth of 0.5 percentage points would increase the public debt-to-GDP ratio by 6.2

⁽⁶⁶⁾ The SGP scenario assumes that, for countries under the EDP the structural adjustment is in line with effort recommended by the Council, and thereafter, an annual structural consolidation effort of 0.5 percentage point of GDP, or 0.6 percentage point, if public debt exceeds 60% of GDP, is maintained until the medium-term objective is reached.

percentage points to about 111.1% by 2025 (Graph A2.1). In addition, a permanent positive shock of 1 percentage point to the short- and long-term interest rates on newly issued and rolled over debt would increase the public debt-to-GDP ratio by 5.2 percentage points to about 110.1% by 2025.

Age-related expenditure pressures and the high stock of public debt pose important risks to medium and long-term debt sustainability. The 2015 Ageing Report, published in early May, indicates that Ireland faces high debt-sustainability risks in the medium term due to projections of age-related expenditure⁽⁶⁷⁾. The S1 medium-term sustainability indicator⁽⁶⁸⁾ is positioned at 5.1 % of GDP, compared to an EU average of 1.8% of GDP (Table A2.1). The large difference with the EU average is explained by the high initial level of government debt in Ireland. In the longer term, risks become less pronounced, with the S2 indicator⁽⁶⁹⁾ at 2.5% of GDP. This means that, over the very long run, Ireland faces medium fiscal sustainability risks, primarily related to the projected costs of ageing, in particular pensions and healthcare. Both sustainability indicators have improved compared to previous projections⁽⁷⁰⁾ but remain very significant, although they incorporate revised and improved population projections⁽⁷¹⁾.

⁽⁶⁷⁾ These include expenditure linked to pensions, healthcare, long-term care, education and unemployment benefits.

⁽⁶⁸⁾ See Table A2.1 for definition.

⁽⁶⁹⁾ See Table A2.1 for definition.

⁽⁷⁰⁾ This reflects not only the impact of pension reforms (particularly evident in relation to pension expenditure projections), but also the improvement of the economic and fiscal outlook and more favourable demographic long-term projections.

⁽⁷¹⁾ Population projections were revised for a number of countries in February 2015. Following a request by the Irish authorities, that was discussed with and subsequently agreed with all Member States in the competent Council committee, the new population projections aim at aligning better population dynamics in Ireland from 2017 to 2019 with the past.

Table A2.1: Sustainability indicators

	Ireland			European Union		
	2014 scenario	No-policy-change scenario	SP scenario	2014 scenario	No-policy-change scenario	SCP scenario
S2*	2.8	2.5	-2.9	1.4	1.7	0.4
<i>of which:</i>						
Initial budgetary position (IBP)	0.5	0.3	-3.8	0.4	0.5	-0.7
Long-term cost of ageing (CoA)	2.3	2.2	0.9	1.0	1.1	1.1
<i>of which:</i>						
pensions	1.2	1.1	0.2	0.0	0.1	0.1
healthcare	1.1	1.0	0.9	0.8	0.7	0.6
long-term care	0.7	0.7	0.8	0.7	0.7	0.6
others	-0.7	-0.7	-0.9	-0.4	-0.3	-0.2
S1**	5.2	5.1	-2.0	1.4	1.8	0.5
<i>of which:</i>						
Initial budgetary position (IBP)	0.5	0.4	-5.2	-0.4	-0.3	-1.6
Debt requirement (DR)	3.1	3.1	2.5	1.7	1.9	1.8
Long-term cost of ageing (CoA)	1.5	1.6	0.7	0.1	0.3	0.4
S0 (risk for fiscal stress)***	0.30	:	:	:	:	:
<i>Fiscal subindex</i>	0.36	:	:	:	:	:
<i>Financial-competitiveness subindex</i>	0.28	:	:	:	:	:
Debt as % of GDP (2014)		109.7			88.6	
Age-related expenditure as % of GDP (2014)		21.6			25.6	

(1) the '2014' scenario depicts the sustainability gap under the assumption that the structural primary balance position remains at the 2014 position according to the Commission 2015 spring forecast; the 'no-policy-change' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commission 2015 spring forecast until 2016. The 'stability programme' scenario depicts the sustainability gap under the assumption that the budgetary plans in the programme are fully implemented over the period covered by the programme. Age-related expenditure as given in the 2015 Ageing Report.

* The long-term sustainability gap (S2) indicator shows the immediate and permanent adjustment required to satisfy an inter-temporal budgetary constraint, including the costs of ageing. The S2 indicator has two components: i) the initial budgetary position (IBP) which gives the gap to the debt stabilising primary balance; and ii) the additional adjustment required due to the costs of ageing. The main assumption used in the derivation of S2 is that in an infinite horizon, the growth in the debt ratio is bounded by the interest rate differential (i.e. the difference between the nominal interest and the real growth rates); thereby not necessarily implying that the debt ratio will fall below the EU Treaty 60% debt threshold. The following thresholds for the S2 indicator were used: (i) if the value of S2 is lower than 2, the country is assigned low risk; (ii) if it is between 2 and 6, it is assigned medium risk; and, (iii) if it is greater than 6, it is assigned high risk.

** The medium-term sustainability gap (S1) indicator shows the upfront adjustment effort required, in terms of a steady adjustment in the structural primary balance to be introduced over the five years after the forecast horizon, and then sustained, to bring debt ratios to 60% of GDP in 2030, including financing for any additional expenditure until the target date, arising from an ageing population. The following thresholds were used to assess the scale of the sustainability challenge: (i) if the S1 value is less than zero, the country is assigned low risk; (ii) if a structural adjustment in the primary balance of up to 0.5 p.p. of GDP per year for five years after the last year covered by the spring 2015 forecast (year 2016) is required (indicating an cumulated adjustment of 2.5 pp.), it is assigned medium risk; and, (iii) if it is greater than 2.5 (meaning a structural adjustment of more than 0.5 p.p. of GDP per year is necessary), it is assigned high risk.

*** The S0 indicator reflects up to date evidence on the role played by fiscal and financial-competitiveness variables in creating potential fiscal risks. It should be stressed that the methodology for the S0 indicator is fundamentally different from the S1 and S2 indicators. S0 is not a quantification of the required fiscal adjustment effort like the S1 and S2 indicators, but a composite indicator which estimates the extent to which there might be a risk for fiscal stress in the short-term. The critical threshold for the overall S0 indicator is 0.43. For the fiscal and the financial-competitiveness sub-indexes, thresholds are respectively at 0.35 and 0.45.

Source: European Commission

ANNEX 3

Supplementary tables

Table A3.1: Fiscal accounts

	2009	2010	2011	2012	2013	2014	2015	2016
<i>% of GDP</i>								
Indirect taxes	10.7	10.8	10.2	10.4	10.9	11.2	11.3	11.2
Direct taxes	12.2	12.1	12.4	13.1	13.3	13.6	12.9	12.8
Social contributions	6.1	5.8	5.8	5.6	5.9	5.9	5.8	5.7
Sales	2.7	3.2	3.0	2.9	2.6	2.2	2.4	2.4
Other current revenue	1.3	1.5	1.6	1.9	1.9	1.7	1.7	1.5
Total current revenue	33.0	33.3	33.0	33.9	34.5	34.6	34.1	33.6
Capital transfers received	0.6	0.3	0.5	0.3	0.3	0.3	0.3	0.3
Total revenue	33.6	33.6	33.5	34.2	34.9	34.9	34.4	33.9
Compensation of employees	12.3	11.7	11.2	10.9	10.7	10.0	9.7	9.6
Intermediate consumption	5.9	5.5	5.0	4.8	4.7	4.7	4.7	4.6
Social transfers in kind via market producers	2.5	2.7	2.6	2.7	2.6	2.7	2.6	2.6
Social transfers other than in kind	14.7	14.7	14.2	14.3	13.7	12.7	11.8	11.5
Interest paid	2.0	3.0	3.4	4.1	4.4	4.0	3.6	3.5
Subsidies	1.1	1.1	1.0	1.0	0.9	0.9	1.0	1.1
Other current expenditure	1.6	1.6	1.5	1.5	1.6	1.4	1.2	1.2
Total current expenditure	40.2	40.3	39.0	39.4	38.7	36.5	34.6	34.1
Gross fixed capital formation	3.7	3.4	2.4	2.0	1.8	1.9	2.0	2.1
Other capital expenditure	3.7	22.5	4.9	1.0	0.2	0.7	0.6	0.6
Total expenditure	47.6	66.1	46.3	42.3	40.7	39.0	37.2	36.8
General government balance	-13.9	-32.5	-12.7	-8.1	-5.8	-4.1	-2.8	-2.9
Underlying government balance (EDP)	-11.6	-13.4	-8.8	-8.1	-5.8	-4.1	-2.8	-2.9
<i>EUR billion</i>								
Indirect taxes	18.0	17.8	17.5	18.0	19.0	20.8	22.2	23.1
Direct taxes	20.5	19.9	21.2	22.6	23.2	25.2	25.3	26.5
Social contributions	10.2	9.5	10.0	9.7	10.3	10.9	11.3	11.8
Sales	4.6	5.3	5.2	4.9	4.5	4.2	4.7	4.9
Other current revenue	2.2	2.4	2.7	3.3	3.4	3.1	3.4	3.1
Total current revenue	55.4	54.8	56.5	58.5	60.4	64.1	66.9	69.3
Capital transfers received	1.1	0.6	0.9	0.6	0.6	0.6	0.7	0.6
Total revenue	56.5	55.4	57.3	59.1	60.9	64.7	67.6	69.9
Compensation of employees	20.7	19.3	19.2	18.9	18.7	18.6	19.1	19.8
Intermediate consumption	10.0	9.0	8.6	8.2	8.2	8.7	9.1	9.5
Social transfers in kind via market producers	4.1	4.5	4.5	4.7	4.6	5.0	5.0	5.3
Social transfers other than in kind	24.7	24.3	24.3	24.7	24.0	23.5	23.2	23.8
Interest paid	3.4	4.9	5.9	7.2	7.7	7.5	7.0	7.2
Subsidies	1.9	1.8	1.7	1.7	1.7	1.7	2.0	2.2
Other current expenditure	2.7	2.7	2.5	2.6	2.9	2.6	2.4	2.5
Total current expenditure	67.6	66.5	66.7	68.0	67.6	67.6	67.9	70.2
Gross fixed capital formation	6.2	5.6	4.1	3.4	3.1	3.5	4.0	4.3
Other capital expenditure	6.1	37.0	8.3	1.7	0.4	1.2	1.2	1.3
Total expenditure	80.0	109.1	79.1	73.1	71.1	72.3	73.1	75.8
General government balance	-23.4	-53.7	-21.8	-14.1	-10.2	-7.6	-5.5	-5.9
Deficit-increasing financial sector measures	4	31.6	6.8	0.0	0.0	0.1	0.1	0.0
Underlying government balance (EDP)	-19.4	-21.9	-14.8	-13.9	-10.1	-7.5	-5.3	-6.1

Source: European Commission

Table A3.2: General government debt projections (based on 2015 Spring forecast)

	2008	2009	2010	2011	2012	2013	2014	2015	2016
Government deficit (% of GDP)	-7.0	-13.9	-32.5	-12.7	-8.1	-5.8	-4.1	-2.8	-2.9
Government gross debt (% of GDP)	42.6	62.2	87.4	111.2	121.7	123.2	109.7	107.1	103.8
levels, EUR billion									
Government deficit	-13.1	-23.4	-53.7	-21.8	-14.1	-10.2	-7.6	-5.5	-5.9
Gross debt	79.6	104.5	144.2	190.1	210.2	215.3	203.3	210.3	214.1
Change in gross debt	32.3	24.9	39.6	46.0	20.1	5.1	-12.0	7.0	3.8
Nominal GDP	186.9	168.1	164.9	171.0	172.8	174.8	185.4	196.3	206.3
Real GDP	176.6	165.4	164.9	169.5	169.0	169.3	177.4	183.8	190.1
Real GDP growth (% change)	-2.6	-6.4	-0.3	2.8	-0.3	0.2	4.8	3.6	3.5
Change in gross debt (% of GDP)	17.3	14.8	24.0	26.9	11.6	2.9	-6.5	3.6	1.8
Stock-flow adjustments (% of GDP)	10.3	0.9	-8.5	14.1	3.5	-2.9	-10.6	0.7	-1.0
% of GDP									
Gross debt ratio	42.6	62.2	87.4	111.2	121.7	123.2	109.7	107.1	103.8
Change in gross debt ratio	18.5	19.6	25.2	23.7	10.5	1.5	-13.5	-2.5	-3.3
Contribution to change in gross debt									
Primary balance	-5.7	-11.9	-29.6	-9.3	-4.0	-1.4	-0.1	0.7	0.6
"Snow-ball" effect	2.6	6.9	4.2	0.3	3.0	3.0	-2.9	-2.5	-1.7
of which									
Interest expenditure	1.3	2.0	3.0	3.4	4.1	4.4	4.0	3.6	3.5
Real growth effect	0.7	3.0	0.2	-2.3	0.3	-0.2	-5.6	-3.7	-3.5
Inflation effect	0.6	1.9	1.0	-0.8	-1.5	-1.2	-1.4	-2.3	-1.6
Stock-flow adjustments	10.3	0.9	-8.5	14.1	3.5	-2.9	-10.6	0.7	-1.0
<i>Implicit interest rate</i>	5.1	4.3	4.7	4.1	3.8	3.6	3.5	3.4	3.4

Source: European Commission

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